KOREA'S ROLE IN ASIAN INTEGRATION

FINANCIAL INTEGRATION IN ASIA: DEVELOPMENT AND KOREA'S ROLE

By Park Young-Joon

Abstract

Since the Asian financial crisis in 1997-98, financial integration in Asia has been induced by collective intra-regional initiatives. It has manifested in various aspects, including gradual financial liberalization, increasing cross-border capital flows, establishing regional financial safety nets, and developing local currency bond markets. While financial deregulation and capital account liberalization has made progress, Asian countries have experienced sudden stops or sharp capital reversals due to external shocks and currency instability. The CMIM, a regional financial safety net, plays its role as a central platform for managing regional financial arrangements. In addition to its crisis resolution function, the CMIM can also be expanded by augmenting a crisis prevention function. Moreover, the ABMI and the ABFs were intended to achieve a more efficient recycling of Asian savings into investment in the region by developing regional bond markets. Gathering regional momentum, Korea's role as an honest broker for further financial institutional integration is important especially in 2012 as a co-chair country of ASEAN+3.

The process of Asian financial integration has been induced by the coordinated regional initiatives of financial cooperation along with real economic integration through the intra-regional free trade agreements. Unlike in Europe, economic integration in Asia emerged with the need for creating regional financial self-help measures after the Asian financial crisis in 1997-98. Since then, financial integration has manifested in various aspects: gradual financial liberalization, increasing cross-border capital flows, establishing regional financial safety nets, and developing local currency bond markets.

Asian economic regionalism has been driven by market-based forces, rather than by a grand blueprint of economic integration. In fact the Asian crisis triggered regional collective initiatives to promote financial integration in East Asia. The crisis revealed what Asia has been lagging behind in terms of its financial system and development compared with real sector integration. Poor performance in the financial sector was caused by several factors, such as: high risk vulnerability to external shocks, heavy dependence on bank financing, insufficient long-term credits and underdevelopment of regional bond markets, weakness of a financial surveillance mechanism, and the lack of competition in financial sectors and premature capital markets. This process of regional financial integration has been supported by the rationale that it achieves better allocation of financial resources and better risk sharing, as well as ultimately promoting regional economic growth.

Intra-regional initiatives have started playing a significant role in fostering financial integration. Asian policymakers realized the absence of regional mechanisms which could have helped avoid the crisis and be used to prevent future crises. They also understood the intrinsic weakness of Asian financial systems and their poor development of both regional and domestic financial markets. As a result of extensive dialogue among ASEAN+3[1] countries, they were able to push forward several initiatives for regional cooperation as part of financial integration.

The subsequent sections focus on financial institutional integration in the region. East Asia's initiatives in support of regional financial integration can be classified into four pillars: (1) the Chiang Mai Initiative (CMI) and its multilateralization (CMIM) as a commitment to provide U.S. dollar liquidity support to member countries through currency swaps in response to urgent short-term liquidity shortages and balance of payment difficulties in crisis; (2) the establishment of the ASEAN+3 Macroeconomic Research Office (AMRO) as an independent regional economic surveillance mechanism; (3) new introduction of regional crisis prevention scheme; and (4) the Asian Bond Market Initiative (ABMI) and the Asian Bond Funds (ABFs) to develop local bond markets for recycling regional capital and to mitigate the double mismatch problem.

Extent of Financial Integration in East Asia

Existing literature points out Asian financial integration lags behind its trade and real-side economic integration. Asia's intra-regional financial linkage is also weaker than the global link. This might be attributed to the lack of well-functioning regional financial institutions and underdevelopment of regional and domestic financial markets. Since the Asian currency crisis, financial market integration and cross-border financial transactions have begun to increase but do not yet reflect convergence for regional integration.

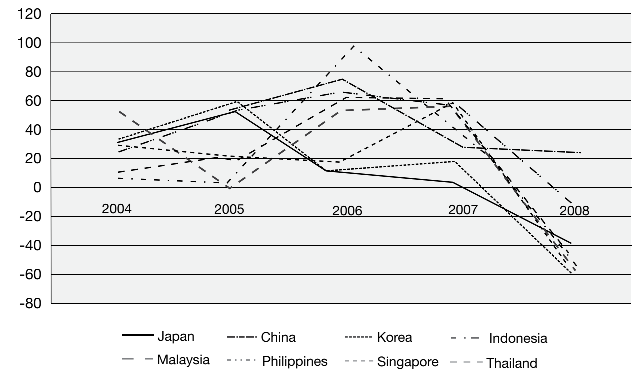
While East Asia has focused on real economic integration through regional trade agreements, the region has also begun working towards financial integration. The 1997-98 Asian crisis raised awareness on two points: (1) Asian countries need to strengthen their domestic financial sectors for managing the efficient absorption of capital inflows and the financial intermediation needs, and (2) the region needs to develop the institutional capacity to resolve cross-country contagion of common financial problems.

Increasing the degree of financial deregulation and capital account liberalization since the 1990s has led to a significant rise in capital inflows towards emerging Asian economies. This surge in capital flows consists mainly of foreign direct investment (FDI) flows, portfolio investments, and short-term banking flows. Even though China is a dominant recipient of FDI inflow in Asia, the general pattern of FDI flows is relatively stable. However, portfolio investment flows and short-term banking flows are regarded as potential sources of systematic risk to Asian economies. In fact, Asian countries experienced the risk of sudden stops or sharp capital reversals due to external economic shocks, currency instability and the double mismatch problem.

Recently the ADB warned that government authorities of emerging Asian economies should be ready to respond when volatile capital flows threaten to destabilize their financial markets. Surges in short-term capital inflows could potentially leave countries vulnerable to sudden reversals in portfolio investment and to currency instability. The huge investment from overseas has put significant pressure on the currencies of emerging economies. Recent surges in capital flows during a global financial crisis have been driven by portfolio equity flows, shown in Figure 1, as investors take advantage of earnings differential between emerging Asian markets and mature markets.

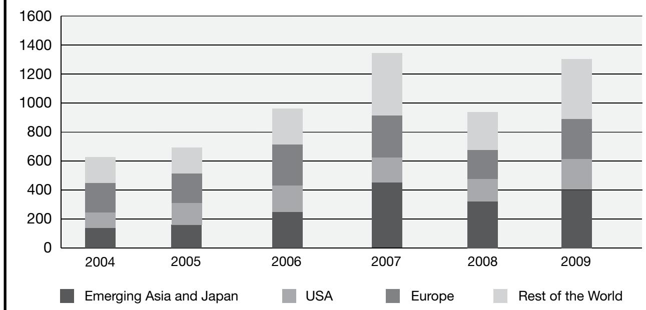
Financial integration implies an increase in capital flows and a convergence tendency for prices and returns on traded financial assets across countries. Since the 1980s, many East Asian countries have been gradually deregulating their financial markets, opening financial services to foreign investors, and

Figure 1 Portfolio Investment Flows in Equity (in U.S. billions)



Source: International Financial Statistics, IMF

Figure 2 Cross-Border Portfolio Investment (in U.S.)



Source: Coordinated Portfolio Investment Survey, IMF

liberalizing capital accounts to improve the efficiency of their financial markets and attract foreign capital. Figure 2 depicts the recent trend of the cross-border portfolio investments of eight emerging Asian countries.[2] Emerging Asia's foreign portfolio investments are increasingly being invested in the region, with intra-regional portfolio holdings rising from 17.8 percent of the region's total foreign asset holdings in 2004 to 27.6 percent in 2009. This implies a higher share of financial assets has been traded within the region and held by regional investors, which is evidence of ongoing financial integration in the regional financial market. In addition, the combined share of the United States and Europe in Asian emerging economies' total foreign portfolio has declined from 47.3 percent in 2004 to 36.9 percent in 2009. These patterns in emerging Asia's portfolio investments imply a higher degree of regional financial integration and cross-border openness.

Regional Financial Safety Nets

Overview of CMI and CMIM

After experiencing the severe contagion of the financial crisis in the region, ASEAN+3 realized the need for a regional self-help measure against the recurrence of a similar crisis in the future. The CMI was designed to address short-term liquidity difficulties as a network of bilateral swap arrangements and to supplement existing international financial arrangements. The CMI expanded the existing ASEAN Swap Arrangement (ASA), which was initially established by the five ASEAN countries (Indonesia, Malaysia, the Philippines, Singapore, and Thailand) in 1977. However, its size of $0.2 billion was insufficient to provide emergency liquidity in crisis.

ASEAN+3 has extended ASA to the other five ASEAN members and the Plus Three countries by increasing its size to $1 billion. CMI was agreed to in May 2000 in Chiang Mai, Thailand, with the objective of establishing a network of bilateral swap arrangements to address short-term liquidity difficulties in the region and to supplement existing international financial arrangements. The ASEAN+3 finance ministers took the framework of the existing CMI and moved toward its multilateralization in May 2009, and the CMIM was finally made effective on March 24, 2010. The multilateralized CMI provides emergency liquidity support from the total fund of $120 billion under a single agreement.[3] Since the CMIM is financed in the form of promissory notes, there is no direct and immediate impact on the member country's international reserves.

The CMIM represents a highly significant institutional development for regional financial integration as it not only plays the role of financial safety nets in times of crisis, but also provides a central platform for managing regional financial arrangements. In particular, it enhances ASEAN+3 inter-governmental dialogue for further financial cooperation in related areas by using CMIM governance, including financial surveillance and the development of local bond markets. Future progress on its institutional setup will also serve to facilitate financial integration in the region and contribute to the development of both regional and domestic financial markets.

CMIM and ESM

In early May 2010, the European sovereign debt crisis and its contagion in the region led European Union policymakers to approve three lending facilities for euro area member states in serious financial distress. The first facility is a 110 billion euro support package for Greece, approved on May 3rd and provided jointly with the IMF. The second facility is the European Financial Stabilization Mechanism (EFSM)[4] with 60 billion euros. The third facility is the European Financial Stability Facility (EFSF)[5] with an amount of 440 billion euros, supplemented with a 250 billion euro IMF commitment.

Comparing the CMIM with the European Stabilization Mechanism (ESM), which consists of the EFSM and EFSF,

Table 1 CMIM Contributions and Purchasing Multiple

	Contributions				Purchasing Multiple	Voting Power (%)
	USD (Bil.)		Share (%)			
China	38.4	Exc. HK 34.2	32.0	28.5	0.5	25.43
		HK 4.2		3.5	2.5	2.98
Japan	38.4		32.0		0.5	28.41
Korea	19.2		16.0		1.0	14.77
Plus Three	**96.0**		**80.0**		**-**	**71.59**
Indonesia	4.552		3.793		2.5	4.369
Thailand	4.552		3.793		2.5	4.369
Malaysia	4.552		3.793		2.5	4.369
Singapore	4.552		3.793		2.5	4.369
Philippines	4.552		3.793		2.5	4.369
Vietnam	1.00		0.833		5.0	1.847
Cambodia	0.12		0.100		5.0	1.222
Myanmar	0.06		0.050		5.0	1.179
Brunei	0.03		0.025		5.0	1.158
Lao PDR	0.03		0.025		5.0	1.158
ASEAN	**24.0**		**20.00**		**-**	**28.41**
Total	120.0		100.0		-	100.0

Source: The Joint Ministerial Statement of the 13th ASEAN+3 Finance Ministers' Meeting

the ESM is the facility to cope with difficulties caused by exceptional circumstances beyond the member state's control such as its fiscal crisis. The ESM plays its role as a crisis resolution mechanism, much like the CMIM. However, while the purpose of the CMIM is to resolve short-term foreign exchange liquidity crisis by providing US dollars, the ESM aims to overcome a solvency crisis by providing euros. Accordingly, the CMIM conditionality requires no capital control, participation in the Economic Review and Policy Dialogue (ERPD), and maintenance of an appropriate level of international reserve, while the ESM conditionality focuses on fiscal and economic policies. In addition, CMIM supports short-term liquidity via currency swap arrangements, while EFSF is a special purpose vehicle (SPV) setup to make loans to euro area countries.

New ASEAN+3 Economic Surveillance Mechanism

In terms of regional macroeconomic and financial surveillance, innovation was introduced within the CMIM framework by establishing the new surveillance unit AMRO. Its mandate includes monitoring potential risk vulnerabilities and keeping track of key macroeconomic and financial condition trends, as well as minimizing the moral hazard problem arising from the crisis resolution function of the CMIM through short-term liquidity support. It is also important to ensure that potential recipient members of ASEAN+3 maintain proper conditions to repay loans from the CMIM. Established in Singapore in April 2011 by ASEAN+3 countries, AMRO is expected to perform regional macroeconomic surveillance activities, supplementing the global surveillance activities through the IMF mission of Article IV consultations.

AMRO's first director, a Chinese national, was appointed in May 2011 and leads the organization for one year of a three-year term. After his tenure, a second director, a Japanese national, will serve the remaining two years. The first director was expected to represent China's position and to focus on the IMF link. For example, China proposed that the CMIM's IMF-delink portion increase to 30-40 percent of its funds from the current 20 percent.[6] As AMRO becomes effectively operational, the level of the IMF-linked portion will be reduced.

AMRO may not be a perfect substitute for the IMF, but its role in regional surveillance will complement the work being done by the IMF. As part of becoming a solid and well-functioning institution, AMRO is expected to introduce regional policy conditionality in support of the CMIM, contribute to a membership enlargement, and introduce crisis a prevention function in the region.

Introducing Regional Crisis Prevention Function

During the global financial crisis, capital flows have shown volatile behavior especially in emerging markets. However, despite their relatively sound economic fundamentals, Asian financial markets are vulnerable to external shocks due to increasing capital flows from and to the region. Therefore, it is natural to consider a regional crisis prevention function to serve as the first firewall against financial risks.[7]

In order to design an effective crisis prevention program, the following key elements should be considered. First, a crisis prevention function needs to be equipped with ex-ante qualifications. In making the decision to provide liquidity, we need to evaluate a country's economic status and the symptoms of the financial crisis, and to minimize potential moral hazard. However, if the ex-ante qualifications were excessively strict, it would lower the chances of using the crisis prevention facility (CPF), therefore making its effectiveness uncertain and eventually eliminating the demand. Considering the trade-off between reducing moral hazard and creating potential demand for the CPF, the regional CPF should strike a balance between ex-ante qualifications and ex-post conditionality. Second, once a swap-requesting country qualifies for the ex-ante conditions, its drawing rights should be guaranteed by an agreement. This automaticity of drawing is critical for the CPF to ensure its credible activation. Third, a regional surveillance unit should properly function to support the two elements mentioned above. To screen ex-ante qualifications and guarantee automaticity of drawing, a surveillance unit should provide appropriate analyses on regional economic conditions.

ASEAN+3 can consider a two-track operation of the current CMIM as a basic framework for the CPF. Its two-track mechanism can be operated as the crisis resolution and crisis prevention functions.[8] That is, the crisis prevention function can be augmented to the current crisis resolution function of the CMIM. If this is the case, a country, showing symptoms of a financial crisis but qualifying ex-ante conditions, may request liquidity support and its drawing rights are granted for a designated period of time. According to de las Casas and Serra (2008), the use of IMF lending with the actual duration of six months or less was only for three cases out of 290 programs between 1990 and 2006.[9] In this regard, the six-month arrangement period of the regional CPF would be reasonable because the ASEAN+3 CPF is able to meet the corresponding demand for short-term precautionary lending. In designing the details of the ASEAN+3 CPF, members can refer to the IMF lending facilities for crisis prevention, such as flexible Credit Line, Precautionary and Liquidity Line, and the High-Access Precautionary Arrangements program under the Stand-By Arrangement.

In addition, regional policy conditionality by the CMIM framework can be imposed with the aid of AMRO or ASEAN+3 ERPD. In order for this scheme to be effective some prerequisites should be satisfied. For example, the surveillance function will have to be enhanced first before reducing the IMF linked portion, and it might be difficult to ensure market credibility with a limited amount of resources and a lack of reserve pooling.

Another important thing that ASEAN+3 CPF should consider is to characterize exit strategies from the crisis prevention function. If a country still requires additional liquidity support after exhausting the CPF's arrangement period, the CPF-requesting country could be deemed to have structural economic problems, rather than showing crisis symptoms. If this is the case, the crisis prevention function can be switched to the CMIM's crisis resolution track or be linked with the IMF lending facility.

Institutional Integration in Asian Bond Markets

Overview of ABMI and ABFs

After the Asian financial crisis, East Asian countries paid attention to reforming domestic financial markets and developing regional bond markets. It was widely acknowledged that excessive financial dependence on the bank-based system in the region was a cause of the crisis in 1997. The ABMI was established in 2003 to develop the Asian bond markets under the ASEAN+3 framework, and became fully operational that same year. The ABMI aims to develop efficient and liquid local currency bond markets in Asia through recycling savings and international reserves of East Asian countries. It emphasizes the creation of regional bond markets where bonds are denominated in regional currencies. It was also expected to mitigate the chronic double-mismatch problem in East Asia: currency and maturity mismatch. In this regard, developing local currency bond markets constitutes another aspect of ASEAN+3 financial integration.

The main reason behind the establishment of the ABMI and ABFs was the intention to achieve a more efficient recycling of Asian savings into investment in the region by developing local currency bond markets. The 1997-98 crisis was indeed made more severe by the absence of well-developed bond markets, which made Asian companies rely on bank loans and borrow foreign ones. International reserves and savings in Asia have been largely invested in the U.S. and Europe, and they are then re-invested in Asia. It is known that about 80 percent of Asia's portfolio investment tilts toward assets in the U.S. and Europe. As of March 2009, ASEAN+3 foreign reserves amount to 52 percent of the total reserve in the world, but most of them are still invested in assets outside of East Asia.

As regional financial authorities realized such weakness in their domestic systems, they promoted regional initiatives of the ABMI and ABFs to develop local bond markets. In fact, the size of bond markets increased from about one-fifth of total financial intermediation in East Asian countries in 1995 to approximately one-third in 2010. During the same period, the share of total outstanding local currency bonds issued in East Asia in relation to the world's total increased from about 2.5% to more than 8%.[10]

After the ASEAN+3 endorsement of the ABMI, specific actions have been taken on particular issues of the initiative. In particular, bonds were issued in local currencies by multilateral development banks. For example, the ADB issued several local currency bonds; in 2004 the ADB undertook five market-opening transactions in the region's local currency bonds in Malaysia, China, the Philippines, Thailand, and India. As well as issuing bonds, the ADB has launched a new and publicly accessible website, Asian Bonds Online, in 2004 to share information on regional markets, economies, and companies. It provides a wide range of information such as taxation, regulations, bond indices, credit ratings, settlement systems and secondary market trading.

While ASEAN+3 has been involved in developing local currency bond markets along with the ABMI, the Executive Meetings of East Asia and Pacific Central Banks (EMEAP) launched the first Asian Bond Fund (ABF 1) with a capitalization of $1 billion in 2003. ABF 1 was mandated to invest in dollar-denominated sovereign bonds issued by eight EMEAP countries.[11] However, due to its small size, ABF 1 was expected to have little effect on the market for dollar-denominated sovereign bonds in East Asia.

ABF 2, introduced in 2004 with a capital of $2 billion, was implemented to purchase local currency bonds from Asian countries. It consists of both a Pan-Asian Bond Index Fund (PAIF) and a Fund of Bond Funds (FoBF). PAIF is a single bond fund index investing in local currency sovereign bonds issued in eight EMEAP countries. FoBF has a two-layered investment structure in eight single-market funds, each of which invests in local currency bonds issued in their own markets.

The ABMI and ABFs have helped the development of bond markets in East Asia and have reduced the currency and maturity mismatch problem. Accordingly, East Asian economies were able to withstand the global financial crisis showing relatively stronger resilience than the U.S. and Europe. A lot still remains to be done, however, to harmonize rules across the region, strengthen market infrastructure, overcome remaining market impediments, and tighten legal and regulatory frameworks. While Asian authorities need to promote their growth to attract more investment in the region, domestic reforms and regional cooperation initiatives are especially needed to improve accounting standards, market infrastructure, and legal systems.

Credit Guarantee Investment Facility

To develop local currency bond markets in Asia, it is essential to facilitate issuers' access to Asian bond markets. This might require guaranteed credit ratings for local currency bond investments. Moreover, local capital in Asia is required to be invested in medium- and long-term infrastructure projects that lead to Asian economic growth.[12] Therefore, Asia needs to use a large amount of savings and international reserves to fill the financial gaps and to overcome constraints in local currency financing due to the lack of investor's confidence in Asian bond markets.

Strengthening and deepening local currency bond markets can develop domestic financial markets and ultimately enhance regional financial integration and economic growth. Based upon this rationale, in 2008 ASEAN+3 agreed to establish a Credit Guarantee and Investment Mechanism (CGIM), renamed as Credit Guarantee Investment Facility (CGIF) in 2009, to provide credit guarantees to local currency bonds issued in the region and to enable them to raise medium-and long-term financing instruments by improving the conditions for issuing bonds. It is expected to facilitate capital market development and to make the regional financial system less vulnerable to external shocks. The objective of CGIF is to support the issuance of local currency denominated bonds in Asia, so as to contribute to Asian economic development and prosperity through credit guarantee schemes. It is currently in the process of finalizing its operational policies and business plan, and is expected to start its operations before the end of 2012. The CGIF will be established as an ADB trust fund with an initial capital of $700 million.[13] Major issues regarding the establishment of CGIF, such as business scope, leverage ratio and country limit, were discussed at the ASEAN+3 Finance and Central Bank Deputies Meeting in May 2011.

The CGIF is expected to have the following effects. First, high-rated issuers can seek to lengthen the maturity of their debt issuance and lower-rated issuers can also issue bonds with the aid of the credit guarantee scheme. Second, member countries' external borrowing costs can be reduced. Third, credit guarantees for local currency bonds would help reverse capital outflows and make the regional financial system sound and resilient. Fourth, supports for infrastructure bonds can serve to provide regional public goods and ultimately lead to regional economic growth.[14] In addition to credit guarantees via the CGIF, some issues are currently part of ASEAN+3 dialogue, including establishing a Regional Settlement Intermediary and Asian Bond Standards among others.

Asian Bond Markets Forum

At the fourteenth ASEAN+3 Finance Ministers meeting in Hanoi in May 2011, ASEAN+3 welcomed the progress of the Asian Bond Markets Forum with the aim of standardizing market practices and harmonizing cross-border regulations of financial transactions. It is a common platform to foster standardization of market practices and harmonization of regulations relating to cross-border bond transactions in the region.

Since its onset, it has become an important forum for bond market experts from both public and private sectors in the region. There also has been progress in the technical working group on legal and regulatory feasibility assessment of the Regional Settlement Intermediary (RSI). Another possible development relates to the enhancement of domestic rating agencies through capacity building programs, as credit rating agencies of East Asian countries are often relatively small and tend to use non-comparable methodologies and benchmarks in their rating process, needing therefore some form of standardization and harmonization across the region.[15]

Challenges of Financial Integration and Korea's Role

To promote Asian financial integration, a key priority would be laid on regional financial cooperation. Earlier discussion on progress toward financial integration was assessed in terms of regional institutional measures. An even stronger degree of financial market integration is possible if significant efforts are made toward regional institutional integration. Since it is not easy to integrate cross-border markets and harmonize regulations in the region, regional institutional development is necessary to generate benefits from economic integration.

The recent global financial crisis accelerated ASEAN+3 financial cooperation. With this momentum, Korea's role for further regional institutional integration is important, especially in 2012 as a co-chair country of the ASEAN+3 framework. In fact, Korea has been deeply involved in regional financial cooperation and also shown strong leadership in initiating detailed proposals and cooperative actions. Many important issues are currently being discussed among ASEAN+3 members, including increasing the size of CMIM, increasing the IMF-delinked portion of CMIM, operational issues of AMRO and surveillance activities, members opening bank accounts of CMIM in the central bank, introducing new regional crisis prevention facility, various issues of Asian bond markets, and regional-global cooperation with the IMF among others.

The ASEAN+3 ERPD aims to identify potential macroeconomic and financial risks, prevent crises, monitor regional capital flows and currency markets, and enhance self-help support mechanisms in the region. While the ERPD was not sufficient for regional surveillance, a new surveillance unit, AMRO, is expected to play an important role towards regional financial integration. Even though the ERPD became an information exchange mechanism on economic conditions and policies, its non-interference principle was an impediment to make effective surveillance activities. In general, three components of economic surveillance are suggested: information sharing, peer review/peer pressure, and due diligence. Currently ASEAN+3 surveillance is in transition from the information sharing stage to the next stage of a more rigorous scrutiny stage, which must involve due diligence in the future. The EU's reform of financial supervisory institutions includes the Comply-or-Explain principle for policy recommendations which makes it a more binding peer review/peer pressure. In the long-run AMRO should focus on providing the regional equivalent of IMF multilateral surveillance by moving forward to the effective peer review and pressure stage and due diligence. This would make AMRO a well-resourced professional surveillance unit, and introduce a more effective macroprudential supervisory framework for financial supervision and integration.

Korea has taken the lead in dialogue within the ASEAN+3 framework: for example, it proposed the ABMI in 2002. Korea is also expected to exhibit its intellectual leadership in the process of establishing a regional crisis prevention mechanism. It is particularly important to introduce the regional CPF because, given the stigma from the IMF lending facilities, it would be politically difficult for any government in the region to seek an IMF program. Moreover, Korea's efforts to coordinate member opinion on the current issues mentioned earlier will significantly contribute to the outcome of regional financial integration and to continuing its momentum in the future. In doing so, Korea's role as the honest broker in the ASEAN+3 framework is emphasized. For example, the ASEAN+3 negotiation on CMIM contribution shares was a fierce diplomatic battle among member countries. In the process, Korea proposed the mediated settlement on the member's CMIM contribution shares that became the agreement's final outcome. It also has an important role with regional decision-making between China and Japan. For instance, the selection process of the first director of AMRO was indeed a fierce diplomatic battle, especially between China and Japan. While Japan pioneered the institution's development, selecting a Chinese national as the first director may imply that China takes the initiative in both establishing AMRO as an international institution and setting up its tone and mandate for future institutional developments. In this regard, Korea's role in regional cooperation is important for the development of financial integration.

An important factor with Asian financial integration is the fact that Asian emerging economies have experienced financial instability when domestic markets were opened to foreign participation. The global financial crisis affected Asian financial systems in various ways, including a massive decline in capital inflows, currency values and asset prices. Deepening regional financial integration will provide more benefits to the Asian economy through efficient allocation of financial resources and risk diversification. Therefore, ASEAN+3 member countries have to keep their balance between the net benefits derived from financial integration, and the potential cost of risk vulnerability and crisis contagion in designing a regional financial institutional mechanism.

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[1] The ten ASEAN (Association of South East Asian Nations) member countries are Thailand, Malaysia, Singapore, Indonesia, the Philippines, Brunei Darussalam, Burma, Laos, Vietnam, and Cambodia. The Plus Three countries are the Republic of Korea, Japan, and the People's Republic of China.

[2] Singapore, the Philippines, Malaysia, Korea, Indonesia, India, Hong Kong, and Thailand.

[3] ASEAN+3 has agreed to double the CMIM reserve pool from $120 billion to $240 billion in May 2012. (Source: The Joint Statement of the 15th ASEAN+3 Finance Ministers and Central Bank Governors' Meeting).

[4] The European Commission is empowered to contract borrowings on behalf of the EU for the purpose of funding loans made under EFSM. EFSM is a treaty-based mechanism, covering all EU Member States. Under the EFSM, the EU can borrow up to 60 billion euros to lend to any EU Member State. Under the Balance of Payments facility, support is available only to Member States which have not yet adopted the euro. (http://www.efsf.europa.eu).

[5] In order to reach its objective, EFSF can issue bonds or other debt instruments on the market to raise the funds needed to provide loans to countries which submit a request. Issues are backed by guarantees given by euro area Member States of up to 440 billion euros. EFSF is part of a wider safety net. Its funds are combined with loans of up to 60 billion euros coming from the EFSM, and up to 250 billion euros from the IMF for an overall rescue package worth up to 750 billion euros. (http://www.efsf.europa.eu).

[6] ASEAN+3 has agreed to increase the IMF-delink portion to 30% in May 2012. (Source: The Joint Statement of the 15th ASEAN+3 Finance Ministers and Central Bank Governors' Meeting).

[7] The current CMIM is an arrangement of the regional crisis resolution facility in the sense that it is associated with ex-post treatment after the trigger event of a crisis that macroeconomic fundamentals have already been deteriorated.

[8] ASEAN+3 adopted "CMIM Stability Facility (CMIM-SF)" as the name for crisis resolution mechanism and "CMIM Precautionary Line (CMIM-PL)" for crisis prevention function. (Source: The Joint Statement of the 15th ASEAN+3 Finance Ministers and Central Bank Governors' Meeting)

[9] de las Casas M. and X. Serra, 2008, "Simplification of IMF lending – Why not just one flexible credit facility," Banco de Espana.

[10] Capannelli G., 2011, "Institutions for economic and financial integration in Asia: Trends and prospects," ADBI Working Paper No. 308, Asian Development Bank Institute.

[11] China, Hong Kong, Korea, Singapore, Indonesia, the Philippines, Malaysia, and Thailand.

[12] Bhattacharyay (2010) estimates the financing needs for Asia's infrastructure at around $750 billion per year in energy, water, transport, telecommunications, and sanitation between 2010 and 2020. (Source: Bhattacharyay B., 2010, "Financing Asia's infrastructure: Modes of development and integration of Asian financial markets," ADBI Working Paper No. 229, Asian Development Bank Institute).

[13] Japan and China are to contribute $200 million, Korea $100 million, and the ADB $130 million. Five members of ASEAN including Malaysia, Thailand, Indonesia, the Philippines and Singapore, are to contribute US$12.6 million each; Brunei pledged to contribute $5.6 million, Vietnam $1.1 million, and three remaining countries of Laos, Cambodia and Myanmar each contributing $100,000.

[14] Park and Rhee (2011) conduct a quantitative analysis on the macroeconomic effects of credit guarantees in Asian bond markets by simulating a five-block version of the IMF Global Integrated Monetary and Fiscal model. The simulation scenarios reveal that (1) even though East Asian financial cooperation upgrades some of ASEAN+3 member countries' credit fundamentals, it helps increase both the corresponding countries' real GDP and regional real GDP, and (2) this effect is amplified as more member countries' credit ratings are upgraded. (Source: Park Y.-J. and D.-E, Rhee, 2011, "A quantitative assessment of regional credit guarantee scheme in Asian bond markets," KIEP Working Paper 11-07, Korea Institute for International Economic Policy).

[15] ADB (2010) Institutions for Regional Integration: Toward an Asian Economic Community. Manila: Asian Development Bank.

KOREA AND ECONOMIC INTEGRATION IN EAST ASIA: THE WAY FORWARD

By Françoise Nicolas

Abstract

It is now a well-established fact that intraregional trade has been expanding quite fast in East Asia in the absence of any institutional arrangements to that end. Korea has been a major beneficiary of this organization of the East Asian region. In the wake of the recent global financial crisis, however, a number of developments suggest that the region may be at a cross-road, and that substantial changes may be expected in the way the region is organized. As a traditional promoter of East Asian regionalism and as one of the best-integrated economies in the region, Korea provides an interesting case study. An analysis of Korea's reactions to the recent changes suggests that the importance of vertically-integrated production networks is likely to be shrinking in parallel with a rising role of institutional arrangements. Although East Asian economic integration will keep its specificity, the de facto and de jure dimensions are likely to be increasingly mutually reinforcing, with Korea as a key player in both areas.

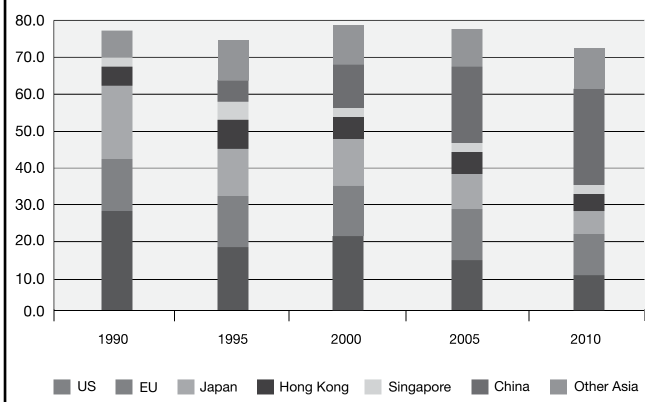
Introduction

It is now a well-established fact that intraregional trade has been expanding quite fast in East Asia (although this does not necessarily mean that the region is getting increasingly inward-oriented[1]) in the absence of any institutional arrangements to that end. Dynamic intraregional trade accounts for the strong rate of economic growth in a number of countries in the region, with Korea as a case in point. In the wake of the 1997-98 Asian financial crisis in particular, the Korean economy managed to recover swiftly thanks to its exports to rapidly growing China.

However, a widely-held consensus view claims that East Asia has been gradually shifting from a market-led (*de facto*) to an institution-based (*de jure*) form of regional economic integration. Since Korea was among the first economies to promote East Asian regional *de jure* integration through its active role in the East Asia Vision Group in particular, and since it is one of the best-integrated economies in the region, it provides an interesting case study.

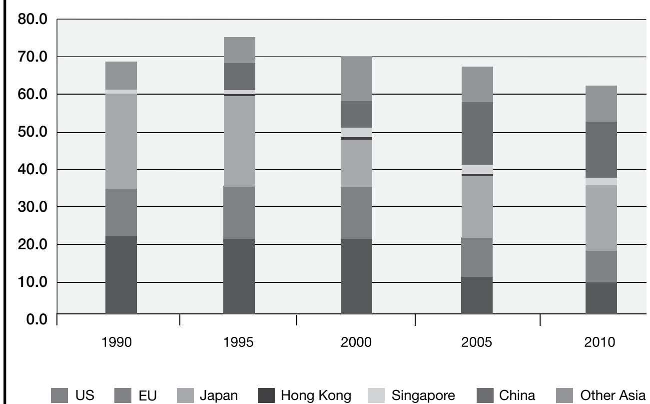
The objective of the paper is to examine the current state of play and the future prospects of regional economic integration in East Asia from a *de facto* as well as from a *de jure* perspective, focusing on the Korean case. The first section assesses Korea's participation in the regional production networks as well as its contribution to the institution-based regional cooperative efforts. The second section starts by highlighting several developments which are likely to deeply modify the economic environment in East Asia before analyzing their impacts on Korea's regional strategy and on the future organization of the region as a whole.

Figure 1 Korea's Exports by Destination, 1990-2010



Source: Author's calculation based on IMF Direction of Trade Statistics

Figure 2 Korea's Imports by Country of Origin, 1990-2010



Source: Author's calculation based on IMF Direction of Trade Statistics

Korea's Economic Integration in East Asia

Korea is Increasingly Integrated with East Asia …

As is the case with all other East Asian economies (with the notable exception of China), Korea has been trading more and more intensively with the rest of East Asia since the mid-1990s, leading to a sharp decline in the relative importance of its other traditional trading partners such as the U.S. and the EU. The combined shares of these two partners dropped from close to 40 percent in 1990 to about 20 percent in 2010. In contrast, the share of Korea's trade with East Asia rose from 33.5 percent to 48.2 percent over the same period of time. Its exports to the rest of the region rose from 33.6 percent to 52 percent, while the share of its imports coming from the same partners rose from 33.5 percent to 44.4 percent over the past twenty years.

Within the East Asian region, the most dramatic changes are the increase in China's share as an export destination as well as a source of imports, and the parallel drop in Japan's share as an export market (but, interestingly, not as an import supplier). China is now well ahead of the U.S., Japan and the EU among Korea's top trading partners (Figures 1 and 2).

Trade between China and Korea has been growing at an astoundingly average annual rate of close to 19 percent over the period 1993-2010, leading to deepening economic interdependence and the trend is still ongoing, with two-way trade between China and Korea crossing the $200 billion line in 2011. As a result the share of Korea's exports going to China more than doubled, rising from about 10 percent in 2000 to close to 25 percent in 2010, while the share of its imports from China doubled from 8 to 16.8 percent. Today China is Korea's largest export destination (it has been the case since 2003, when China overtook the U.S.) and also its largest import supplier (ahead of Japan, since 2007).

The dynamism in Sino-Korean trade has obviously to do with China's stellar economic growth and hence with its rising importance as a trade powerhouse and as an expanding market.

However, the calculation of Korea's export bias with respect to China[2] suggests that exports to this country were exceptionally dynamic, at least until recently. Although still high, the indicator has been dropping lately after reaching a peak in 2005. This suggests that Korea's exports to China are greater than expected but decreasingly so (Figure 3). On the import side, the bias indicator is much lower (although slightly rising) at about 1.40. These results reflect an asymmetry in Sino-Koran trade, with greater than expected Korean exports to China, while its imports are more or less in line with expectations.

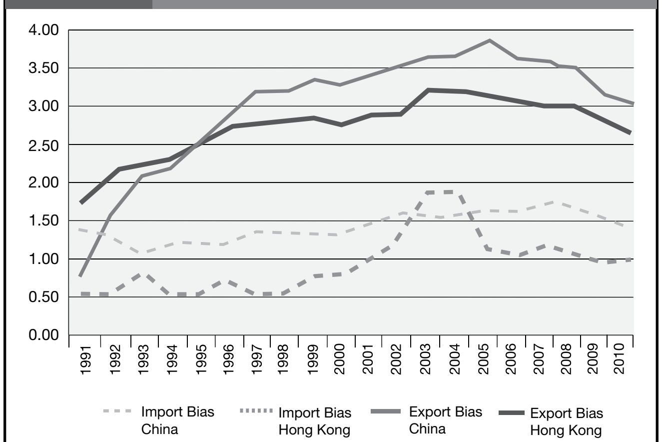
Another way of gauging whether a trade relationship is greater than expected is to resort to a gravity equation. The estimation helps determine what can be seen as the "potential" trade between a given pair of countries. As a next step, comparing the fitted values with the actual values indicates whether there is still an untapped potential or not. The evolution highlighted earlier is confirmed by the results of a gravity equation estimated for Korea's exports over the period extending until 2007.[3] The estimation suggests that Korea tends to over-export to China, while the reverse is not true. These various elements suggest that the China-Korea trade relation is a major building block of intra-East Asian integration.

Next to the two Northeast Asian partners, ASEAN countries (in particular Indonesia, Singapore and Vietnam) have emerged as important trading partners. Today ASEAN is Korea's second largest trading partner after China and ahead of Japan and the European Union. As in the case of China, the estimation of a gravity equation suggests that Korea's exports to ASEAN are greater than expected with very little untapped potential.

… Through Regional Production Networks …

A detailed analysis of the structure of Korean exports to, and imports from, East Asia (in particular China) provides a clearer picture of the way the various economies are interlinked.

Figure 3 Korea's Trade Bias



Source: Author's calculation based on IMF Direction of Trade Statistics

Using the Broad Economic Categories (BEC) classification and following Gaulier et al. (2005)[4] commodities are aggregated by stages of production and a distinction is made between i) primary goods [food and beverages, primary mainly for industry (111), primary industrial supplies (21), primary fuels and lubricants (31)], ii) intermediate goods [processed industrial supplies (22), processed fuels and lubricants (32), parts and components of capital goods excl. transport equipment (42) and of transport equipment (53)] and iii) final goods [capital goods (41), and consumption goods: food and beverages (112 and 122), passenger motor cars (51), consumer goods (61, 62, 63)].

The bulk of Korea's exports to China are intermediate goods (75 percent in 2010) and primarily for processing. Part of these intermediate products may be used to produce goods to be sold on the Chinese market, but this share is small. Most intermediate products are processed in China and exported to other countries as final products. While these intermediate goods were initially industrial supplies (22), overtime the share of parts and components (categories 42 and 53) has risen substantially to account for about 35 percent. At the same time, the share of capital goods (41) has also tended to rise (to account for 25 percent of total Korean exports to China). In contrast, consumer goods only account for less than 3 percent of Korea's exports to China.

Korea's imports from China also had a large portion of intermediate goods, but the share of final goods (and in particular consumption goods with 12.1 percent) was larger than what is observed for Korea's exports to China. As a result, Korea has a deficit in final goods trade with China and a surplus in intermediate goods.

Korea's exports to ASEAN countries such as Malaysia or Vietnam in particular are also dominated by intermediate products—parts and components of capital goods (42), as well as processed industrial supplies (22).[5] These exports are mainly semiconductors, TV screens, electronic goods, vehicles, steel, chemicals, refined petroleum products, ships and machinery, while its imports from Southeast Asia are mainly oil and gas, coal, paper, rubber, wood products and garments.

All these observations suggest that Korea, China and a number of ASEAN countries belong to regional production networks. The existence of a strong correlation between Korea's exports to China and China's exports to the U.S. provides further evidence that Korea and China are parts of the same production chain.

The tight interconnections between Korea and the rest of East Asia are also reflected in the active involvement of Korean firms in the region. Since the establishment of diplomatic relations in 1992, Korea's FDI to China has grown dramatically. Korea invested massively in China in the early-2000s, making it one of the most important sources of FDI in China. However, according to the latest Mofcom statistics, Korea's FDI in China peaked in 2005 (when it reached $5.17 billion, accounting for over 10 percent of total foreign inflows) and has been shrinking ever since to drop below 3 percent of total foreign inflows. Similarly, from Korea's perspective, while China accounted for close to 40 percent of Korea's total ODI outflows in 2003-2004, it started declining in the following years and accounted for merely 14 percent in 2011. In terms of stock, Korea lags behind Hong Kong, Taiwan, Japan, Singapore and the United States. These various observations suggest that Korea may be losing ground in the competition with other economies in the region which are closely connected to China, namely Hong Kong and Taiwan.

Next to China, Southeast Asia accounts for a non-negligible destination of Korean outward direct investment and ASEAN as a whole ranks as the second largest investment destination (after the U.S.). Korean ODI flows to the region have been particularly dynamic over the past few years, making Korea ASEAN's fourth largest investor. Most of Korea's investments are in labor intensive and export-oriented industries like footwear, garments, electronic and electrical goods and chemicals.

… With Institutional Arrangements Playing a Marginal Role

Interestingly Korea's dynamic trade with a number of its neighbors cannot be accounted for by the existence of preferential arrangements. As explained, Korea's trade is particularly dynamic with China but the two partners have not engaged in any preferential arrangement.

In contrast, Korea has an FTA with its second largest trading partner, namely ASEAN. However, the Korea-ASEAN FTA has only been in effect since 2007 for goods and 2009 for services and the sharp rise in bilateral trade predates the signing of the agreement and cannot thus be accounted for by the FTA.

The logic underlying Korea's FTA strategy is pragmatic. The country has chosen to negotiate FTAs with its major trading partners, be they neighbors or not. Today, Korea has FTAs in force with the EU, the U.S., Chile, the European Free Trade Association (EFTA), Peru, Singapore, ASEAN, and India. It has also been trying to reach an agreement with Japan for a number of years. Korea may thus be seen as a champion of bilateral agreements rather than a champion of regional trade agreements.

So far, there has been a proliferation of FTAs in the region but no major attempt at creating a formal trade block. More progress may be observed in the financial area (with the establishment of the Chiang Mai Initiative in 2000 followed by the multilateralization of the mechanism in 2011) while the opening of negotiations for the establishment of an East Asian Free Trade Area for instance is still to take place.

Looking Ahead: Changing Conditions and Their Implications for Korea

In the wake of the global financial crisis (GFC) a number of developments are likely to impact the economic environment in East Asia and change the conditions for regional economic integration and the way Korea interacts with its regional partners, in particular China. The following section examines three such developments in turn: China's shift in economic strategy, the full implementation of the economic partnership agreement between China and Taiwan, and the new project of a Trans-Pacific Partnership (TPP).

Major Factors of Change

China's Economic Strategy Shift

In China, the GFC has led to the conclusion that the development strategy followed so far was deeply flawed and that it was as a result necessary to reduce the economy's vulnerability to external demand shocks and to move away from too exclusive a strategy of export-orientation by rebalancing growth, especially through the promotion of domestic consumption. Although the awareness of the need to enhance the expansion of domestic consumption is nothing new in China and although it had already inspired the eleventh Five-Year Plan (2006-2010), the much needed structural reform has become a more explicit objective of the recently issued twelfth Five-Year Plan (2011-2015). As a result, the Chinese Government now seeks to deeply reform its economic strategy beyond the mere promotion of domestic consumption. The major objectives of the twelfth Five-Year Plan are first to rebalance the country's growth strategy by moving away from exclusive export-orientation towards developing the domestic market, and secondly to move the economy up the value chain in the coming years so as to enhance its technological independence.[6]

As a result of these strategy shifts in China, the existing form of cooperation and interconnections between China and the rest of East Asia is likely to be deeply modified. As explained by Shim (2011), East Asia's division of labor in manufacturing is based on differences in technologies and the labor productivity of the various countries. This division of labor will change as China continues to develop technologies and improve productivity, and Korea and Japan try to gain a comparative advantage by developing new technologies and new products.

Full Implementation of the ECFA between Taiwan and China

From Korea's perspective, another major recent development with potentially important implications pertains to the coming into force of the Economic Cooperation Framework Agreement (ECFA) signed between mainland China and Taiwan in June 2010. The objective of the ECFA is to "normalize" trade across the straits, in particular by putting an end to the numerous restrictions imposed by Taiwan so far on imports from the mainland. As the name indicates the agreement merely provides a framework that outlines the main content of the future FTA, before individual agreements are signed on specific issues. So far, tariffs were lowered for products covered in the Early Harvest Product list (EHP) with effect from January 1, 2011 and they are scheduled to be fully eliminated on January 1, 2013. Further follow-up talks are expected in the coming years. For the time being, the liberalization has been rather asymmetrical with higher commitment level on the part of mainland China. This agreement is no doubt of importance to Korea since Taiwan and Korea share a number of similarities in their specialization patterns and in particular in their export structures to China. The two countries are export competitors in China which is their largest export market. Although the agreement is far from being complete, rising competition may be expected from Taiwan, with Taiwanese firms able to export on more favorable terms.

TPP Project

Lastly, a recent initiative, the Trans-Pacific Partnership (TPP), is likely to bring about further changes in the way the region is economically organized. The TPP is a trade agreement currently under negotiation between nine countries in three continents, including Australia, Brunei, Chile, Malaysia, New Zealand, Peru, Singapore, the United States and Vietnam.[8] In late 2011 three additional countries—Japan, Canada and Mexico—announced their intention to join as well. The TPP aims to establish an ambitious high-quality trade agreement encompassing issues which are not often part of a FTA, such as intellectual property rights, government procurement, environmental protection regulations, labor issues as well as small and medium enterprises.[9]

At this stage it remains to be seen whether this project will go ahead and whether it may sideline other competing schemes. From Korea's perspective the importance of the TPP lies in its being designed to allow further members to join. As a result the TPP could very well become the core of a future grand Asia Pacific trade agreement. It may thus be perceived as a competitor to the Comprehensive Economic Partnership in East Asia (CEPEA) or the East Asian Free Trade Agreement (EAFTA).

Korea's Renewed Contribution to East Asian Integration

So far regional integration in East Asia has been primarily of the *de facto* kind rather than *de jure* because the need for trade liberalization was not perceived as very high (given the type of intraregional trade), but this form of integration seems to have reached its limits. China is seeking to develop its own market rather than being exclusively a production base. This poses a challenge for its trading partners which need to adjust their economic strategies accordingly but this may also require a change in the institutional setting with better structured regional trade liberalization. Korea has to face these two challenges.

Korea's Approach to China Revisited

If China manages to reduce its dependence on the export manufacturing sector and increase its domestic consumption in line with the objectives of the twelfth Five-Year Plan, it will provide Korea with an opportunity for more stable growth based on China's final demand. But this is only possible if Korea proves able to seize this opportunity. In the wake of the GFC, the share of intermediate goods in Korea's exports has tended to decline slightly, while the share of capital goods (41) has increased. This may be indicative of Korea's ability to also cater to Chinese needs as a market rather than exclusively as an exporting engine but it may alternatively merely reflect that China's major exportable goods have changed from simple and labor-intensive goods to more complicated and capital intensive goods.

For the time being Korea may not be particularly well-positioned to take advantage of the Chinese market, compared to Taiwan. Already Korea's apparent loss of competitiveness vis-à-vis Taiwan suggests that it is time for a rethink of Korea's expansion strategy in China. The challenge for Korea is to find ways of taking advantage of the new conditions prevailing in China. As explained by Chung (2011), "South Korea should focus its investments in China's domestic market and try to shift its processing trade with China to complex (or network) processing trade, which links the markets of South Korea, China, and third countries. It should also move away from simple manufacturing toward complex manufacturing, which offers a combination of manufacturing and services. Moreover, South Korea needs to expand its business areas to include logistics, science and technology, medical science, education, and other services."[10] All this means that substantial domestic reform is needed if Korean firms are to make the best of the Chinese market, with a particularly important role played by tertiary activities.

Korea's Regional FTA Strategy

In order to enhance the expansion of China, and East Asia as a whole, as a market, reducing tariffs on final goods is required. Pushing for an East Asia-wide FTA may thus be an appropriate step forward. The past few years have seen a renewed interest in the establishment of an East Asian FTA, involving ASEAN+3 countries and possibly some other partners. In August 2009, ASEAN and its six major trading partners (China, Japan, South Korea, India, Australia, and New Zealand) reasserted their commitment to establishing an East Asia Free Trade Agreement (EAFTA) and Comprehensive Economic Partnership in East Asia (CEPEA) within the next fifteen years. For the time being, opening such an ambitious negotiation still seems to be out of the question. However, the aforementioned developments may help give new momentum to the project.

The establishment of a trilateral agreement between China, Japan and Korea or at least a bilateral agreement between Korea and China may contribute to pave the way to a broader East Asian FTA but also facilitate Korea's penetration of the expanding Chinese market. Korea may thus emerge as an important contributor if not the major driver of further *de jure* economic integration in East Asia.

In the wake of the GFC, Korea's attitude toward a Korea-China FTA has indeed changed and it is seriously considering pushing for such an FTA[11] in order to move into the Chinese domestic market further, improve the trade structure, and establish a stable framework for economic cooperation. In October 2009, the Ministers of Trade of the two countries signed an agreement to increase bilateral economic cooperation, and Seoul began to consider serious talks with Beijing about negotiating a FTA.[12] A major reason for the change in Seoul's position is the need to respond to China's FTA activism, as exemplified by the full entry into force of the China-ASEAN FTA (as of January 1st, 2010) and of the Economic Cooperation Framework Agreement (ECFA) between China and Taiwan (as of January 1, 2011). As explained earlier, Korea is in direct competition with Taiwan on the Chinese market; with the ECFA likely to improve Taiwan's competitiveness in the China market possibly at Korea's expense, the case for a China-Korea FTA is made more compelling than ever.

It is worth stressing at this stage that an FTA with China was so far not really deemed necessary because the level of tariffs imposed on intermediate goods (the most intensively traded goods) was quite low, at least much lower than on final goods, in particular consumption goods. Going ahead with tariff liberalization will thus facilitate the further expansion of bilateral trade and the diversification of such trade beyond intermediate goods.

Next to this bilateral move, a potential trilateral FTA (involving China, Japan, and South Korea) is also increasingly being envisaged. The three Northeast Asian countries agreed in October 2009 to examine the feasibility of a trilateral FTA, and committed in May 2010 to conduct a joint study on this issue.[13] The feasibility study was completed by the end of 2011. On May 14, 2012, the three parties concluded the Fifth Trilateral Summit meeting in Beijing by signing the Trilateral Agreement for the Promotion, Facilitation and Protection of Investment, and agreed to launch negotiations for a three-way FTA by the end of the year. China's determination to go ahead with this trilateral FTA has no doubt to do with Japan's interest in joining the U.S.-sponsored TPP which involves a number of countries on both sides of the Pacific, with the exception of China.

A trilateral agreement is widely believed to be instrumental in strengthening trilateral relations, hence contributing to the ongoing process of economic integration in East Asia, such as ASEAN+3 or ASEAN+6. A CJK FTA would be regarded as a milestone in regional integration, fostering prosperity not only for the region but for the world as a whole. According to some estimates, a trilateral deal may be the most promising scenario in terms of gains, but as it is certainly not the easiest one to negotiate it is not the most likely.

Whatever the means, Korea can be expected to play a key role and contribute to the deepening of economic integration at the East Asian level.

Concluding Remarks

Until recently, Korea has benefited enormously from China's opening up strategy and this explains to a large extent the deepening of its integration with East Asia. Similarly, Korea has also benefited by moving part of its production capacities to China, also contributing to the tightening of regional production networks. Recent developments call for changes in this so far successful strategy. The challenge for Korea is to adjust its policy.

Korea is probably illustrative of the possible changes in the way the whole of East Asia will be integrating in the coming years, with a shrinking importance of vertically-integrated production networks and a rising role of institutional arrangements. The emergence of East Asia as a market rather than as a production base requires substantial changes in the specialization and trade patterns of the countries in the region but it also requires institutional adjustments, and in particular a broader liberalization move. Although East Asian economic integration will keep its specificity, the *de facto* and *de jure* dimensions are likely to be increasingly mutually reinforcing, with Korea as a key player in both areas.

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1 Hamanaka, Shintaro, "Is Trade in Asia Really Integrating?," ADB working paper series on Regional Economic Integration, No 91 (January 2012).

2 The export bias is calculated as the ratio of the share of country's i exports to country j in country i's total exports to the share of the world's exports to country j in total world exports.

3 The estimated model makes use of the ARTNet gravity modeling analysis tool developed by the UN Economic and Social Commission for Asia and the Pacific. (http://www.unescap.org/tid/artnet/artnet_app).

4 Gaulier, Guillaume et al., "China's Integration in East Asia: Production-sharing, FDI and hi-tech trade," CEPII working papers, No 2005-09, 2005.

[5] Cheong, Jaewon, "Korea's Intermediate Goods Trade with ASEAN," in Kagami, Mitsuhiro (ed.), Intermediate Goods Trade in East Asia: Economic Deepening Through FTAs/EPAs, BRC Research Report No 5, BRC, IDE Jetro, Bangkok (2011).

[6] In order to reach the latter objective, China is targeting seven emerging strategic industries: energy conservation and environmental protection, new information technology, biotechnology, high-level equipment manufacturing, alternative energy, alternative materials, and new energy vehicles.

[7] Shim, Sang-Hyung, "Rapidly Changing Division of Labor in East Asia," POSRI Chindia Quarterly (Autumn 2011): 17-23.

[8] The agreement builds upon another agreement reached by four Asia-Pacific economies (P4: Singapore, Brunei, New Zealand and Chile).

[9] Capling, Ann and John Ravenhill, "Multilateralising Regionalism: What Role for the Trans-Pacific Partnership Agreement?," T*he Pacific Review*, vol. 24, No 5 (2011): 553-575. Elms, Deborah and C. L. Lim, "The TransPacific Partnership Agreement (TPP) Negotiations: Overview and Prospects," RSIS working paper, No 232 (21 February 2012).

[10] Chung, Whan-Woo, "The Decrease in South Korea's Investment in China after the Global Financial Crisis," POSRI Chindia Quarterly (Summer 2011): 63-69.

[11] The two parties launched a joint study on the feasibility of a bilateral FTA in 2004 and eventually upgraded it to government-industry-academia research in 2007, but the decision to go ahead with negotiations did not materialize until 2010.

[12] Zhang, Jian, "Vigorous Waves of East Asia Economic Integration and the Sino-South Korea Trade Relationship," mimeo, Brookings Center for Northeast Asia Policy Studies (January 2010).

[13] A major advantage of such a trilateral scheme is to help defuse bilateral tensions, in particular between Japan and Korea, as well as ease China's suspicions vis-à-vis Japan's and Korea's attempts at containing its rise, as explained in Byun, See-Won, "The China-Japan-South Korea Triangle: The Shape of Things to Come," Asia-Pacific Bulletin, No 115 (June 2011).

REGIONAL INTEGRATION IN EAST ASIA: LESSONS FROM EUROPE

By Kim Heungchong

Abstract

When considering East Asian integration there are valid reasons to examine the history of European integration. First of all, regional integration deserves careful consideration, as it can contribute to extricating economies from worldwide recession, while holding the promise of creating a bigger market and leading an economic recovery. Europe remains a model for regional integration in spite of revealed defects in the monetary integration mechanism. Second, the history of European integration tells us that creating blueprints and taking another step for regional integration even in the worst of situations is very important in making continued progress. Third, the European integration process provides ample examples of the roles players in the negotiation process have played for integration. These can provide good lessons for East Asian countries in a time of growing international tension and conflicts as well as difficulties in the integration process itself. The lessons from the European integration process can be grouped into the following categories: (1) the development of a regional identity; (2) a high degree of economic integration and maturity of consumption within the region; (3) the emergence of avowed Euro-federalists; (4) the intra-regional movement of people; (5) the development of an advanced blueprint or vision for regional integration; (6) the need for exposure to binding negotiation on regional issues; (7) the need to compensate those disadvantaged by integration; and (8) the need for a core group to drive the integration process.

The world economy is still shrouded in a fog of uncertainty, even after governments of the major economies have conducted an unprecedented cooperative financial easing since 2008. The world economy has shown neither a conspicuous rebound, nor cleared out the many chronic problems in banking sectors, government budgets, and household sectors of the respective economies. Furthermore, the 2008 crisis seems to have developed into another recession just as sluggish growth of China, incipient recovery in the U.S., and the catastrophe in Europe plague the world economy.

In hard times, it may be absurd, or at least anachronistic, to argue for regional integration, as economic recession has always gone hand in hand with the emergence of chauvinistic nation-states and protectionism in trade. It would be even more out of point to argue that we need to think about European integration when Asians are earnestly drawing up a map for regional integration. Europe is now the center of the global economic crisis and many of the current difficulties in Europe are believed to be due to the system of European monetary integration, the euro-zone. The European case casts a fundamental doubt on regional integration.

Nevertheless, we have valid reasons to think things over regarding European integration. First of all, regional integration does still deserve careful consideration, as it can contribute to extricating economies from worldwide recession, while holding the promise of creating a bigger market and leading an economic recovery. Europe remains a model for regional integration in spite of revealed defects in the monetary integration mechanism. Second, the history of European integration tells us that creating blueprints and taking another step for regional integration even in the worst of situations is very important in making continued progress. Figuratively speaking, as the night is always darkest just before dawn, we need to prepare ourselves for another heyday instead of bracing for gloom and doom. Third, the European integration process provides ample examples of the roles players in the negotiation process have played for integration. These can provide good lessons for East Asian countries in a time of growing international tension and conflicts as well as difficulties in the integration process itself.

What kind of lessons can East Asia learn from the European integration process? Foremost, there is the intangible, creating a regional identity. East Asia has to continue its institutional efforts to form an East Asian identity. A person’s identity may be composed of different layers. We identify ourselves at the individual level through our families, friends, and the society to which we belong. Cities where we live are another larger category which we use to distinguish ourselves from other city dwellers. Nation-states and perhaps the global village would be the biggest categories with which we identify ourselves. The European integration process shows that the formation of a supranational layer, beyond the national level, is crucial for achieving peace and prosperity in the region.

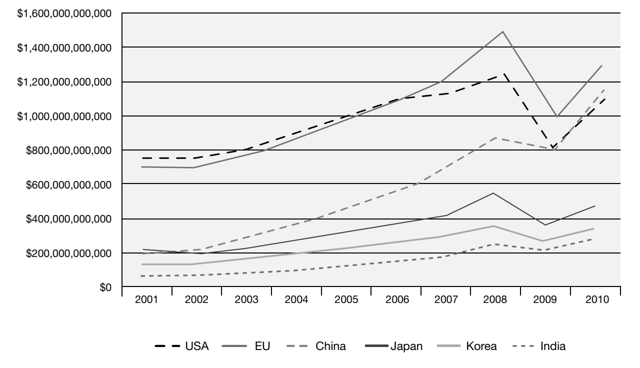
I am not sure whether East Asians think of themselves as East Asian or Asian. Creating regional perception ahead of visible regional integration achievements is the first step towards integration. This can provide a buffer for toning down the exhausting conflicts and disputes in East Asia, and negate chauvinistic behaviour which the political leaders are easily tempted to adopt.

To achieve a formation of a firm East Asian identity, it is very important that East Asian countries carry out various programs and actions under the banner of the East Asian community, rather than that of individual countries. People may perceive East Asia through a ‘regional’ scholarship program from which both the present and future generations may benefit. People may appreciate East Asia for its contribution to building bridges, museums, concert halls, etc., in their hometowns. Disadvantaged people in the region would not be easily tempted to be chauvinistic if they benefit from development aid programs in the name of the East Asian community. Taking the initiative in regional integration would assuage the public’s irrational fear of market opening and globalization, if a regional identity is to form.

Second, East Asia should notice that there was a relatively high degree of economic integration in Europe even at the very first stage of integration in the 1950s. East Asia needs to emulate Europe in terms of trade and economic integration by encouraging intra-industry trade and building an exchange rate mechanism, which seems to be a cliché, as it has been repeated so often. I believe, however, more emphasis has to be given to the fact that Europe was a community in terms of consumption as well as intra-regional production. East Asia should move beyond the FTA and production network formation, and form a consumption network in order to raise its status as a self-sufficient economic entity. It may take time, but East Asian countries should concentrate on boosting their domestic consumption in spite of adversities within the region.

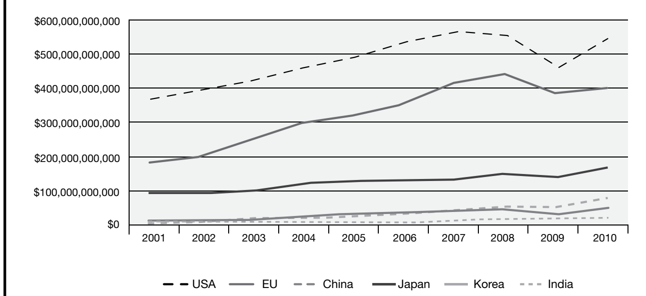
Figure 1 and Figure 2 reveal some striking facts on vulnerability of East Asian economies related to consumption. The first important finding from the figures is that in spite of dizzying economic growth among Asian economies, the U.S. and the EU still dominate other countries as the last destination of final goods. This is notably true if we compare the trends of China manifest in two figures: China has caught up with the U.S. in terms of intermediate goods trade, but never in the final goods market. China stood as the second biggest intermediate goods market, but was fourth as a final goods market. The second finding that we need to pay attention to is that the final goods market is more resilient to the economic shock than the intermediate goods market. Figure 2 shows milder V-shape than Figure 1 in the era of a global economic crisis. What the two findings tell us is, therefore, that

Figure 1 Import of Immediate Goods in Several Economies



Source: Author's calculation from BEC dataset

Figure 2 Import of Final Goods in Several Economies



Source: Author's calculation from BEC dataset

building intra-industry and intra-regional production networks is a major source of Asian countries' economic miracle, and this production network is very vulnerable to external shock. To borrow the words of a certain politician; it's the consumption, stupid, not the production!

To complete a consumption network in the region, a rise in consumption in the region is vital, but there are limitations for developing countries of the region in increasing their spending in the short-term. It could be true that the East Asian governments' export-driven policy may lead to weakening domestic consumption, but it may be the result of widening income disparities in the region. Widening income disparity prevents consumption growth from keeping pace with income growth, and the gap between consumption and income has opened up as the income gap increased. Asia has become increasingly dependent on exports as a source of economic growth in the face of flagging consumption.

Also, different consumption patterns between generations may weaken the region's consumption as a whole, and the underdeveloped financial industry could cause vulnerability among consumers in the region. Due to a very rapid change in the income level, the generational gap in consumption behavior varies much more among Asian countries than in other economies in the world. Let me explain this with an example. Korea reached $20,000 in per capita income in the mid-2000s, twenty years after most western European countries. Despite the similar level of income between contemporary Korea and Europe in the 1980s, older generations in Korea consume much less than their European counterparts in the 1980s, as they were much poorer than the previous European generation when they were young. Therefore, old frugal habits die hard. If rapid economic growth is the reason for weak consumption, then East Asian countries need to develop a policy initiative to strengthen financial intermediation, and secure liquidity backed by assets in bilateral, regional or multilateral arenas.

Moreover, we must remember that corruption in the region has negative impacts on vulnerable segments of the population. While these problems cannot all be resolved in a short period of time, East Asia must begin to strengthen its regional efforts to expand consumption. This is another lesson that East Asia should learn from the European integration process.

Third, we need to pay attention to the emergence of the "Europeans," in the process of European integration. "Europeans," who, more or less, tend to be avowed Euro-federalists, have formed a strong and loyal base of support for the integration process. As is the case for Europe, how can we, then, train or nurture true "East Asians"? Before thinking about nurturing, however, we need to pay attention to the Asian diaspora living in Asia and other parts of the world. Overseas Chinese, minorities in East Asia, Korean-Japanese and etc. may not have properly been provided with supranational playgrounds or institutional set-up where they could contribute to the building of the East Asian community. It may be easier for them to accept the East Asian identity that I have just mentioned. East Asia needs to make efforts to provide a supranational frame to the people of the region for formation of multiple nationalities and identities.

Fourth, after WWII, intra-regional movement of people in Europe substantially increased, and this trend has been strengthened afterwards. In the case of ASEAN+3, the degree of labor mobility in the region is far lower than that of Europe. More importantly, labor mobility, once showing steady increase, has stagnated over fifteen years. It is important to encourage intra-regional labor mobility through employment in foreign countries, but that is not the whole story. Short-term visits, study abroad, tours and other types of intra-regional movement of people can contribute to making a firm base for regional integration.

Fifth, creating an advanced blueprint or vision report for regional integration in East Asia would prove decisive for the entire process. The Werner report has influenced the thinking of a lot people concerning the integration process, and subsequently, the shape of the regional integration in Europe, although it was not immediately implemented. Drawing up a future with a precise plan, communicating the dream to other people, discussing the plan with experts in the field around the world, commemorating the date when the blueprint was published, is all very important for the work towards future integration.

Sixth, East Asian countries need exposure to binding negotiation on regional issues, and accumulate ample experience in solving the issues. It is important to create various forums discussing region-specific, but common issues such as intra-regional trade, intra-regional investment, environmental issues, development, gender issues, human security, etc. within our own capacity. It took many years for the European member states to acquire negotiation skills, and to reach the stage of mutual understanding.

Seventh, a varied policy mix is required for supporting the possible losers of regional integration. It is important to compensate losers during the integration process, as it can encourage them to keep engaged in the process. The Common Agricultural Policy introduced in the early 1960s, and Structural Funds refined in the 1970s played key roles in this regard in Europe, although the programs were not originally created for that purpose. On top of those initiatives, East Asia can initiate other schemes such as funds for green ODA and women's development. In the process, all countries including LDCs in the region should contribute to the creation of such funds, as it leads to enhancement of responsibility and self-motivation.

Eighth, it is recommended that a kind of core group be formed so as not to lose the momentum for integration. Germany and France have maintained a key bilateral relationship during the course of the European integration process. In East Asia, Japan and China are expected to play such a role, but if the case does not hold for the two countries, Korea is advised to initiate a type of trilateral relationship. Korea, unique in being a divided country, also needs to recognize that it should take the moral responsibility to disseminate ideas and action plans for peacekeeping, and to advocate peace and prosperity in the region. It can play an important role in initiating and leading the whole process of peace and prosperity through economic and monetary integration. In this sense, the role of Trilateral Cooperation Secretariat (TCS), based in Korea, is worthy of note.

The regional integration movement in East Asia has taken a long time and faced adversities, but the process is still at a rudimentary stage. We need to recall that the original six countries in the European Economic Community (EEC), which we regard as more or less homogeneous economies, were identified as genuinely heterogeneous when the EEC started some fifty years ago. In those days, they recognized so many differences amongst each other that it would have been difficult for them to think about integration of these heterogeneous economies. Even without focusing on the differences between East Asian countries, it would be important to do something immediately for regional cooperation in order to bring about solid progress in regional integration. An additional implication of the European integration process is to keep the momentum of the process for cooperation by creating teams of enthusiastic policy entrepreneurs who are eager to make efforts to bring about regional integration in Korea and East Asia. This is the last, but not the least point that I would like to raise.

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[1] This paragraph and next one are mainly adapted from Heungchong Kim (2012), p. 59. Kim, Heungchong (2012), "Asia and the EU: Looking for a Way in Creating Shared Value, in The Asian-Europe Agenda, Ideas for Crisis Prevention and Effective Cooperation," Europe in Dialogue 2012|04, Bertelsmann Stiftung, pp. 55-61.

[2] Lessons fifth through eighth are substantially revised and updated from Kim, H. & S. Park (2004), "The Political Economy of the EMU Negotiation and its Implications to East Asian Monetary Integration," Policy Analysis 04-10, Korea Institute for International Economic Policy.