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International Economic Analysis and Prospects

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How International Economic Links Affect East Asia

Vikram Nehru

An anatomy of economic links between East Asia and the global economy — and a description of how those links shape the region's exposure to risks from the global economy.

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This paper — prepared by the Office of the Regional Vice President, East Asia and Pacific Region — was written as a background study for the East Asia and the Pacific Regional Development Review. It reflects the Bank's recent emphasis on analyzing the effect of the external economic environment on developing country prospects and policies. Copies of this paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Moira Coleridge-Taylor, room S8-049, extension 33704 (April 1993, 21 pages).

Nehru applies the theme of the last two papers in the Global Economic Prospects series, written by the International Economics Department, to the case of one developing region: East Asia.

He documents the rapid integration of the East Asian economies into the world economy through trade and foreign direct investment, and suggests that this has helped create a relatively well-diversified structure of production and of external markets. As a result, East Asia was relatively unaffected by the great terms-of-trade shocks experienced by other developing countries in the 1980s. East Asia's creditworthiness in international financial markets meant that (except for the Philippines) it could maintain access to external capital flows during the world years of the debt crisis.

East Asia's close economic links with the rest of the world makes the region particularly vulnerable to shocks originating externally. Simulations suggest that its growth rate is closely related to the growth rate of the OECD economies, even if its export markets are more diversified than those of other developing regions.

Similarly, given the strength of its export drive to the industrial economies in the last two decades, especially in labor-intensive products, East Asia would stand to gain the most from a successful Uruguay Round. By the same token, it would also be hurt the most were the Uruguay Round to fail and were industrial protection to increase as a result.

So, East Asia must closely watch developments involving the North America Free Trade Agreement (NAFTA). Although preliminary analysis suggests that the immediate trade consequences of NAFTA would be negligible for East Asia, the longer-run consequences for foreign direct investment and trade flows are more difficult to predict.

Finally, the region's strong physical and institutional infrastructure, its outwardly oriented trade policies, and its well-developed human resource base, have attracted a large share of incremental private capital flows to developing countries. But such flows are volatile and sensitive to macroeconomic conditions and the regulatory environment in host countries. Were these conditions to change in East Asia and inhibit foreign direct investment and private portfolio flows, the region's rapid transformation into a competitive producer of manufactures would be affected adversely.

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by

Vikram Nehru

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INTERNATIONAL ECONOMIC LINKAGES: The Case of East Asia [1]

1. In the 1980s, per capita incomes in East Asia grew twice as fast as in South Asia and five times as fast as the average for the developing world. East Asia's export volume has grown threefold since 1965 and more than doubled in the last decade alone. Its share of industrial country imports of labor intensive manufactures has grown ninefold in two and a half decades. Over a third of the region's output is saved and invested, far higher than in any other developing region. And its indicators of external indebtedness are, on average, the healthiest in the developing world. Moreover, East Asia's rapid economic development has been matched by equally impressive progress on other development fronts: poverty has been reduced substantially, primary education is almost universal, life expectancy at birth for males and females has improved sharply, the infant mortality rate is a third of what it was in 1965, and its population growth rate is the lowest among developing regions (apart from developing Europe).

2. Of course, economic performance and social progress has not been uniform. Indeed, it would be surprising if it had been. Probably more so than any other developing region, the countries of East Asia present a striking study in contrasts: in terms of economic size, land area, population level, natural resource endowments, and economic and political systems.

3. Nevertheless, by virtually any measure, East Asia's economic performance in the 1980s is impressive, especially when set against the experience of other developing regions. For example, the 1980s has often been called a "lost" decade for Latin America and Sub-Saharan Africa: per capita incomes declined in these regions, several countries defaulted on their large external debt obligations, savings and investment fell as a share of GDP, and social progress slowed.

4. Differences in economic policies explain much of the difference in the economic performance between East Asia and other developing regions during the 1980s. When the debt crisis broke, there were fears that East Asia would go the way of Latin America. But adjustment programs in Indonesia, Korea, Malaysia, and Thailand were timely and successful. The earlier emphasis on macroeconomic stability and prudent external borrowing paid rich dividends: the adjustments required were not as deep or painful as in Latin America and Sub-Saharan Africa; and the relatively well developed physical, social, and institutional infrastructure helped stimulate a quick supply response.

5. The pattern of economic links between East Asia and the global economy has helped as well. While these links have exposed East Asia to risks emanating from the world economy, they have also worked to the region's benefit. This paper studies the anatomy of these links and asks how they have influenced the region's economic performance. It does so for two reasons: to identify the channels through which the economies of East Asia are likely to be influenced by economic trends and events in the rest of the world, and to examine the policy options available to respond to unanticipated developments in the world economy without jeopardizing the objectives of sustainable growth and welfare. The bulk of the evidence now available shows that economies that have nurtured international links through trade and financial flows have improved resource allocation, increased competition and product specialization, and benefitted from technology transfer.[2] Economies that have strong international linkages are naturally more exposed to risks emanating from the world economy. However, the economic structure resulting from these linkages also appears to make these economies more resilient in absorbing these risks and, together with

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1 East Asia in this paper refers to all low and middle income countries in the region. The term, therefore, excludes Japan, Hong Kong, Singapore, and Taiwan, China.

2 See World Bank. 1991b. Chapter 5.

judicious policy, appears to have made them better able to adapt to changes in the external environment and sustain growth momentum.[3]

Integration and Diversification Through Trade

6. Over the last two decades, East Asia's integration with the world economy through trade has progressed more rapidly than for any other developing region. The difference between the rates of growth of trade and output was higher for East Asia than it was for the world economy during the 1970s and 1980s (Table 1), although the pace of integration in the 1980s decelerated for East Asia just as it did in the rest of the world. The decline in the growth rate of trade in the 1960-70 period was due to China's stagnant export performance in that period; trade in the rest of the region outpaced production.

Table 1: *East Asia's integration with the world economy accelerated only after the 1960s*

Growth of exports and GDP: East Asia and the World, 1950-90
(average annual percentage change)

	1950-60	1960-70	1970-80	1980-90
World				
Trade	6.5	8.3	5.7	5.1
GDP	4.2	5.3	3.4	3.2
Difference	2.3	3.0	2.3	1.9
East Asia				
Trade	5.4	3.8	10.0	10.2
GDP	4.8	5.5	6.3	7.9
Difference	0.6	-1.7	3.7	2.3
Latin America				
Trade	3.3	5.1	3.4	5.5
GDP	6.0	5.4	5.6	1.6
Difference	-2.7	-0.3	-2.2	3.9
Sub-Saharan Africa				
Trade	3.7	4.1	3.7	2.0
GDP	5.5	3.2	3.3	2.1
Difference	-1.8	0.9	0.4	-0.1

Source: World Bank's Economic and Social Database.

7. East Asian trade accelerated in the 1980s in the face of protectionist trends in industrial countries which were on the rise. Although trade barriers in industrial country markets remain low (compared with those in

3 Mitra, P. 1986.

developing countries), most OECD economies are, on balance, more protectionist now than they were ten years ago. While tariffs continued to fall steadily in these countries, non-tariff barriers grew in significance. Such barriers include antidumping measures, countervailing duties, voluntary export restraints, and domestic subsidies. Where non-tariff barriers have been lowered, it has usually been in the context of a bilateral or a regional trading arrangement.

8. It is difficult to assess whether trade barriers in industrial country markets affect East Asia more than other developing regions. Some indicators, however, tend to point to this conclusion. One measure of the extent of protection is the trade coverage ratio, that is the share of imports affected by non-tariff barriers. [4] The share of OECD imports from developing countries subject to non-tariff barriers climbed marginally from 20.5 percent in 1981 to 21.8 percent in 1990. In the case of East Asia, the trade coverage ratio is higher, although it declined from 30.2 percent in 1981 to 26.2 percent in 1990.

Table 2: *Trade coverage ratios of industrial country NTBs are generally more extensive for imports from East Asia than for other developing regions*

Trade coverage ratios of industrial country NTBs on imports from developing countries, 1990
(in percent)

	U.S.A			EC			JAPAN		
	Agric.	Manfg	Total	Agric.	Manfg	Total	Agric.	Manfg	Total
East Asia	12.8	36.8	30.2	27.4	40.6	33.8	38.8	13.0	17.0
China	8.5	59.6	47.0	17.3	40.5	29.5	34.1	23.3	22.9
Indonesia	0.1	46.0	9.2	10.8	32.8	16.1	44.3	4.5	8.6
Malaysia	1.0	13.1	10.4	2.1	13.9	6.3	3.6	23.2	3.6
Korea	8.4	34.0	33.2	12.0	40.2	39.1	89.1	7.3	27.3
Philippines	20.2	32.1	28.0	7.6	41.9	20.9	19.5	6.1	12.6
Thailand	32.4	28.5	27.6	79.9	55.2	67.8	42.9	23.2	35.2
Latin America	11.5	17.2	9.9	17.7	26.9	13.5	25.0	9.6	12.3
South Asia	0.2	45.7	33.0	18.5	50.4	36.2	64.1	11.7	25.8
Sub-Saharan Africa	4.4	18.7	3.9	13.0	17.2	5.7	45.6	23.2	31.8
All developing countries	9.7	28.5	15.7	21.5	32.4	13.7	38.5	12.9	15.0

Source: IEC estimates based on: World Bank/UNCTAD SMART database and COMTRADE data.

9. The pattern of protection in individual OECD markets tends to differ (Table 2). In the U.S. and the EC, the manufacturing sector is more highly protected than agriculture; in Japan, the situation appears to be the opposite -- agriculture is more heavily protected than manufacturing. For East Asia, exports of relatively labor intensive manufactures tend to face the stiffest non-tariff barriers. For example, the NTB trade coverage ratio for East Asian exports has grown sharply for exports of iron and steel and has been high and rising for textiles and clothing.

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4 Non-tariff barriers include import prohibitions, quantitative restrictions, voluntary export restraints, variable levies, MFA restrictions, nonautomatic licensing, and countervailing and antidumping measures.

10. The trade coverage ratio, however, is an unreliable guide to the level and pattern of protection. It may systematically underestimate or overestimate the protective effect of non-tariff barriers. Estimates of import penetration (imports as a share of total domestic demand) tell a different story. They indicate that protection in industrial country markets seem not to have deterred East Asian exporters (Table 3). East Asia accounted for all the incremental penetration of the Japanese market for manufactures by developing countries between 1968 and 1988; in the case of the EC market, East Asia accounted for four-fifths, and in the U.S. market, about two-thirds.

Table 3: *East Asia has been more successful than other developing regions in penetrating industrial country markets*

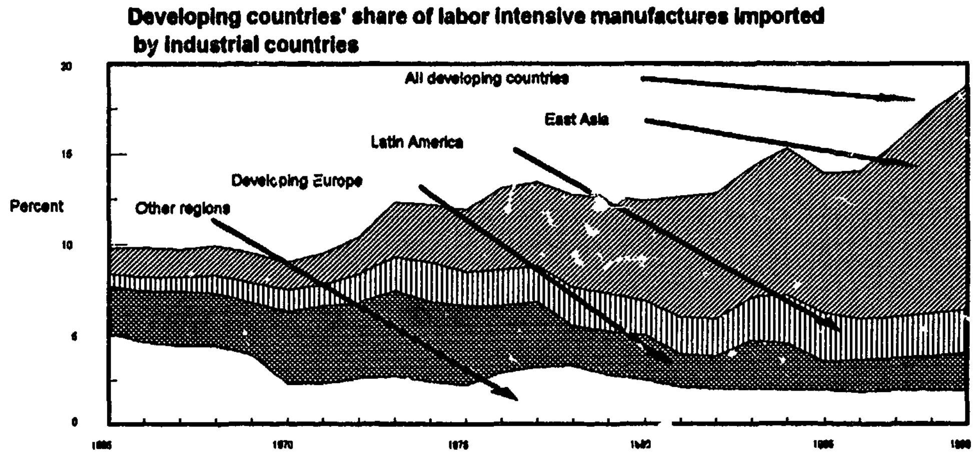
Imports from Developing Regions as a Share of Consumption in Industrial Countries: All Manufactures
(in percent)

	1968	1974	1980	1984	1988
Developing countries					
- EC	1.1	1.7	2.7	2.9	2.9
- North America	0.8	1.8	2.4	3.1	4.1
- Japan	0.9	1.7	1.7	1.7	1.8
East Asia					
- EC	0.2	0.4	0.9	1.6	1.6
- North America	0.3	0.8	1.3	1.7	2.4
- Japan	0.5	1.4	1.4	1.2	1.4
Latin America					
- EC	0.1	0.2	0.4	0.3	0.2
- North America	0.2	0.6	0.7	1.2	1.1
- Japan	0.0	0.2	0.2	0.2	0.1
Sub-Saharan Africa					
- EC	0.2	0.1	0.1	0.4	0.3
- North America	0.0	0.0	0.0	0.1	0.1
- Japan	0.1	0.0	0.0	0.1	0.1

Note: Membership of the EC grew from 6 to 12 during this period.
Source: UNCTAD, 1991

11. East Asia has been particularly successful in penetrating industrial country markets for labor intensive manufactures (garments, textiles, leather goods, furniture, iron and steel products etc.). East Asia's share of industrial country imports of labor intensive manufactures grew ninefold in two and a half decades, rising from 1.4 percent in 1965 to 12.4 percent in 1989 (Figure 1). This spectacular growth occurred despite the fact that the most extensive coverage of non-tariff barriers in industrial countries is of labor intensive manufactures.

Figure 1: East Asia's share of industrial country imports of labor intensive manufactures has grown rapidly since the mid-1960s



12. East Asia's success in exporting manufactures has not just been in labor intensive manufactures. The region has also emerged as an exporter of technology intensive manufactures.[5] Of the five largest developing country exporters of technology intensive manufactures, three (Korea, Malaysia, and China) belong to East Asia.[6] Malaysia, for example, barely exported US$3 million of technology intensive manufactures in 1968, or 0.2 percent of its total exports; by 1988, it exported US$1.4 billion (at 1968 constant prices). This rapid growth was largely because several high technology firms in Japan, pressured by the appreciating yen, relocated their labor intensive stages of production in developing countries, especially East Asia. By 1989, Thailand and Malaysia accounted for almost three-quarters of the Japanese foreign direct investment in Asia (see para. 24).

13. East Asia's impressive success in export markets was accompanied by substantial liberalization of trade policies at home. Korea eliminated its quantitative restrictions on imported manufactures and raw materials by 1991 and introduced a phased reduction of tariffs that will see them averaging 7.9 percent by 1993. Malaysia began replacing its QRs with tariffs in 1986, and reduced its average tariff levels on manufactures and non-agricultural raw materials to 10 percent. In programs beginning in the first half of the 1980s, Indonesia, the Philippines, and Thailand, also reduced the number of non-tariff barriers on imports of manufactures, simplified their tariff structures, and reduced the average tariff level. In China, however, imports continue to be controlled to a significant degree, although some reforms have been implemented in the foreign exchange retention system.

14. Increased openness and integration with the world economy through trade has fostered a more diversified production and export base in East Asia. In this regard, East Asia has moved further ahead than either Latin America or Sub Saharan Africa. East Asia's dependence on primary commodities has diminished steadily, and now roughly 69 percent of the region's exports are manufactures compared to 13 percent in 1965. Manufactures constitute the bulk of Korea's merchandise exports (90 percent) and of China's (70 percent); and comprise an important share of the export earnings of the Philippines (62 percent), Thailand (54 percent), Malaysia (44 percent), and even Indonesia (32 percent). In contrast, primary commodities account for 66 percent of Latin America's merchandise exports and 91 percent of Sub-Saharan Africa's.

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5 The definitions of labor- intensive and technology-intensive manufactures are the same as that used in World Bank, 1992, Global Economic Prospects and the Developing Countries, 1992, Appendix B.

6 The other two are Mexico and Brazil.

15. Reflecting this export diversification, the five most important (5-digit SITC) products in East Asia account for only 14 percent of total exports, compared to 38 percent for Latin America and 61 percent for Sub-Saharan Africa (Table 4). Moreover, only two of the five most important export items are primary commodities (crude oil and natural rubber); in the case of Latin America and Sub Saharan Africa all five are.

Table 4: *East Asian exports are more diversified than other developing regions*

Product Concentration Ratios, 1988
(in percent)

Region	Product Concentration Ratio a/	Product description
East Asia	14.4	Crude oil, electronics, natural rubber, footwear, passenger vehicles
Latin America	38.0	Crude oil, gas oil, coffee, copper, bananas
South Asia	26.5	Cut diamonds, tea, raw cotton, shell fish, milled rice.
Sub-Saharan Africa	60.9	Crude oil, coffee, cocoa, copper, diamonds

a/ Defined as the share of the five most important 5-digit SITC items in total exports.

Source: IECIT

Table 5: *East Asia's exports are relatively well diversified across markets.*

East Asia: Export share and growth rate of all merchandise goods and manufactures by market
(shares in percent; growth in annual average percentage change per year)

	All merchandise goods		Manufactures	
	Share 1990	Growth 1980-90	Share 1990	Growth 1980-90
High income countries	81	10.0	85	13.1
U.S.A.	19	12.1	24	14.6
EC	13	11.1	14	12.8
Japan	21	6.8	13	14.8
Other	29	10.9	34	11.4
Developing countries	18	8.7	15	8.6
East Asia	7	11.7	6	13.6
South Asia	2	1.3	2	8.3
Europe	3	8.1	2	10.0
MENA	2	4.4	1	2.3
Sub-Saharan Africa	2	6.6	2	5.2
Latin America	2	4.3	2	11.3
All developing countries	100	9.8	100	12.4

Source: COMTRADE data.

16. East Asia's import sources and export markets are also relatively well diversified. Japan contributes a quarter of the region's imports and absorbs a fifth of its exports. The U.S. is almost as important a trading partner, supplying 16 percent of the region's imports and buying 19 percent of its exports. The EC is more important as a supplier of goods to East Asia (20 percent of East Asia's imports) than it is as a market for East Asian products (13 percent of exports). Latin America, in contrast, is closely integrated with the U.S. economy, relying on the U.S. for two-fifths of its trade. Sub-Saharan Africa's trade is even more concentrated geographically; the region sources almost half its imports from the EC and sells 42 percent of its exports to the Community.

17. East Asia's export markets for manufactures are even more diversified than for total exports (Table 5). The U.S. emerges as the single largest market for East Asian manufactures, [7] and the importance of Hong Kong, Taiwan (China), and Australia (all included under the rubric of "other high income economies" in Table 5) becomes apparent. Much of this reflects China's use of Hong Kong as a transhipment port for its trade with the rest of the world. In comparison to East Asia, the concentration of Latin America's exports is greater in the case of manufactures, as is the case of Sub-Saharan Africa's exports to the EC.

18. Intra-regional trade within developing East Asia is a small share of total East Asian trade, but is growing rapidly. The rapid growth of manufacturing in the large East Asian economies, together with high levels of foreign direct investment, has spurred the growth of intra-industry trade within the region (Forstner and Ballance, 1989). The most dynamic component of East Asia's total trade, however, is not with Japan but with the U.S. and the EC. This is surprising, given that Japan is geographically proximate to developing East Asia and grew faster than both the EC and the U.S. during the 1980s.

19. The diversification of markets and export products has helped East Asia manage external risks better than other developing regions. In recent years, the asynchronous cyclical pattern of economic activity in the industrial countries has, in aggregate, had little effect on East Asian export performance. Japan's strong growth in 1991 helped alleviate the dampening effects of the U.S. recession; and the U.S. recovery in 1992 has helped counterbalance the slowdown in Japan.

20. The importance of market diversification is highlighted by the recent experience of the socialist economies of Mongolia and, to a lesser extent, Viet Nam and the Lao People's Democratic Republic. The external trade of these economies was oriented toward the former Soviet Union and Eastern Europe (Table 6).[8] They have consequently been affected by the collapse of the CMEA in 1991 and the contraction in output of Eastern Europe and the FSU. Although complete data for 1991 have not been released, the fall in FSU external trade was dramatic; partial estimates suggest that exports declined by between 30 and 40 percent and imports by between 40 and 50 percent. The fall in FSU trade with former CMEA members was exacerbated by an agreement to settle payments in hard currencies and at world prices. Mongolia, almost totally dependent on trade with CMEA members, was hit the hardest. By 1991, the country's exports were almost a half of their 1989 value and their imports almost a third. Production was disrupted because of severe shortages of raw materials, intermediate inputs, and petroleum products. Viet Nam's losses, a combination of lower trade with the FSU and Eastern Europe and lost concessional finance from CMEA members, could reach as high as 7 percent of GDP; actual losses would, of course, be higher given the disruption caused to domestic production.

21. East Asia's diversification of its product base has helped dampen the volatility of the region's external terms of trade (Figure 2). With the sharp downtrend in real commodity prices during the 1980s, Latin America and Sub Saharan Africa faced a relatively large decline in their terms of trade; for East Asia, the decline was moderate, and for countries such as Korea, the external terms of trade actually improved during this period. What

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7 Since Indonesia's crude and LNG exports are excluded.

8 Mongolia and Viet Nam were members of the CMEA.

is more, world trade in manufactures grew faster than for commodities (5 percent a year in the 1980s compared to less than 2 percent a year). The dual advantages of a relatively stable terms of trade and rapidly growing export volumes meant that export earnings remained buoyant throughout the 1980s. Neither Latin America nor Sub Saharan Africa enjoyed either of these benefits and export earnings remained stagnant. Together with sharp increases in external interest payments in the same period (Latin America's interest payments grew by 50 percent in 1980-83), this meant rapid import compression in both regions and, in turn, a sharp downturn in private and public investment.

Table 6: *Some East Asian countries have been affected severely by the economic changes in Eastern Europe and the former Soviet Union*

Trade Between Selected East Asian Countries and Eastern Europe and the FSU, 1987-89

	Average share (% of total)		Average annual growth rate	
	Exports from	Imports from	Exports	Imports
China	6.0	5.9	15.8	12.9
Lao PDR a/	14.9	23.1	-23.9	-23.1 b/
Malaysia	0.9	0.4	28.9	68.1
Mongolia	92.1	94.6	-1.1	-6.6
Myanmar	3.0	1.6	-3.7	-13.8
Thailand	0.9	1.1	93.2	54.9
Viet Nam	30.7	53.0	38.4	-1.4

a/ Refers to trade with the non-convertible currency area using the exchange rate Rubles 2.4=$1.
b/ Annual growth rate for 1989

Source: Asian Development Bank, 1992.

22. East Asia's openness to trade and its reliance on industrial country markets do make it vulnerable to downturns in the world economy or to sharp changes in relative prices in international markets. But the flexibility in its industrial structure has turned this into a strength. Openness in trade has meant that international price signals transmit quickly to the domestic economy and trigger adjustments in input and output mix. Several studies have concluded that during the 1970s and 1980s, economies with relatively open trading systems experienced large terms of trade shocks, but these economies were also the fastest to adjust and resume growth. Korea and Thailand are two such examples in East Asia. Economies with inhibited trading systems, controlled by restrictive trade and pricing policies, encountered substantial budget and balance of payments difficulties that were financed through external borrowing. Those following such a route included Argentina, Mexico, and Venezuela in Latin America, and Nigeria, Cote d'Ivoire and Zaire in Sub-Saharan Africa; the only example of this strategy in East Asia was the Philippines, which also ran into severe external payments difficulties.

Promoting Links Through Foreign Direct Investment

23. East Asia's international economic linkages through trade have been shaped in part by substantial increases in foreign direct investment (FDI) inflows from abroad. In the 1970s, East Asia accounted for about 16 percent of total FDI flows to developing countries. In the 1980s it had more than doubled this share (Figure 3). Part of the reason was China's emergence as an attractive destination for foreign capital, particularly from Hong Kong, which contributes over 60 percent of total FDI to China (Table 7). Attracted by low wages in the coastal economic zones of China where wages are only a fifth of the average wage in Hong Kong and 70 percent of that in Malaysia, most FDI in China is involved in labor-intensive, export-oriented production. In 1990, these enterprises

are estimated to have exported goods worth $6 billion. [9] Recent studies also show that the average cost of standard factory construction in Hong Kong is more than five times the cost in Zhuhai, a special economic zone located in Guangdong, China, and that production costs in Taiwan, China are at least 25 percent higher than in Fujian province.

Figure 2: East Asia's terms of trade have been less volatile than Latin America's or Sub-Saharan Africa's

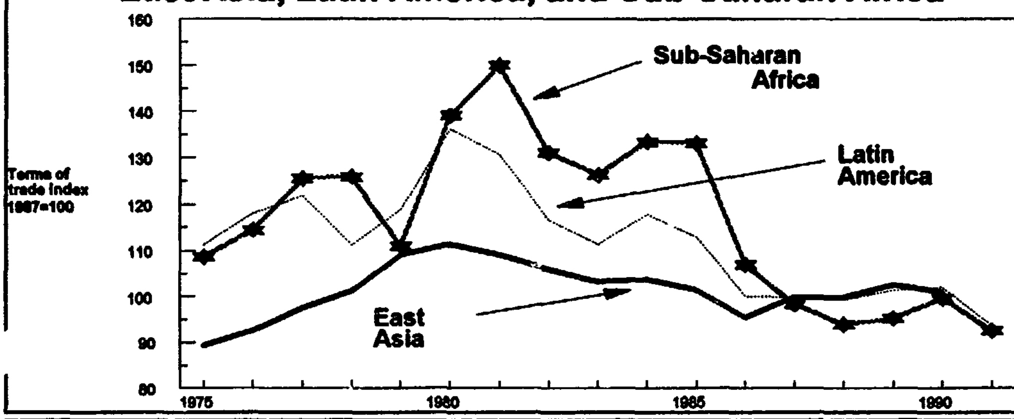
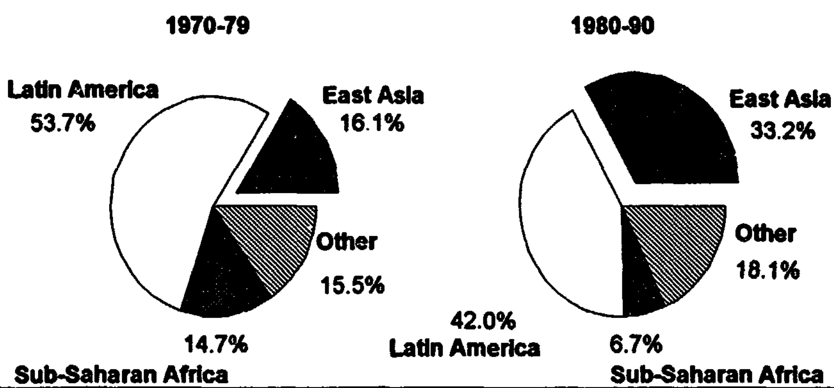


Figure 3: ***East Asia's share of total FDI to developing countries doubled in the 1980s***



24. Korea, Thailand, and the Philippines increased their share of FDI as well. For a country of its relatively small size, Malaysia has maintained a remarkably high share of FDI flows over the two decades 1970-89. FDI in Indonesia, on the other hand, rose in the late 1970s because of high rates of return in the oil sector, only to subside in the first half of the 1980s when oil prices declined. In recent years, however, foreign investors have been taking

[9] Asian Development Bank, 1991.

a renewed interest in Indonesia after trade and regulatory reforms have increased the attractiveness of investments in the non-oil sector.

Table 7: *The newly industrializing economies of East Asia are becoming important foreign investors in developing East Asia*

Share of Inward Net Flows of Foreign Direct Investment: Selected East Asian Countries
(in percent)

	China 1987	Indonesia 1990	Malaysia 1990	Philippines 1989	Korea 1988	Thailand 1988
OECD	29.9	56.7	38.0	79.4	93.7	78.5
EC	4.6	9.1	6.4	10.8	13.6	8.0
North America	7.6	1.9	3.7	34.6	26.7	11.5
Japan	16.1	25.6	23.9	25.5	48.9	51.6
Other	1.6	20.1	4.0	8.5	4.5	2.4
NIEs	66.4	29.8	46.9	17.9	2.7	28.4
Hong Kong	65.5	11.4	2.1	7.7	2.1	10.8
Taiwan, China	-	7.1	36.0	7.2	0.1	11.2
Korea	-	8.3	3.7	0.6	-	1.1
Singapore	0.8	3.0	5.1	2.4	0.5	5.4
LMICs (excl. Korea)	3.7	13.5	15.1	2.7	3.6	-1.9
Total	100.0	100.0	100.0	100.0	100.0	100.0

Source: UNCTC, 1992.

25. Japanese FDI grew sharply in the 1980s (Table 8). So even though a smaller share went to East Asian countries, the absolute amounts increased sharply enough to make Japan one of the most important sources of FDI in East Asia, contributing between a third to a half of all FDI flows to the region. [10] (For Japan, however, the North American continent remains the most important destination for investment capital, followed by Europe and Latin America). But in more recent years, the newly industrializing economies of Hong Kong, Korea, Singapore, and Taiwan (China), have, as a group, become the largest foreign investors in China, Indonesia, and Malaysia. Part of the reason for Japan's lower FDI flows to East Asia lies in its own economic problems and the strains being experienced in its financial sector. In addition, rising real wages in the NIEs is encouraging a structural shift toward more technology intensive industrial production and the relocation of labor intensive activity to China and the ASEAN economies. Reflecting demand pressures on the labor market in these economies, Hong Kong, Taiwan (China), and Singapore have also partly relaxed controls on the use of foreign labor.

26. The proximity of labor-scarce and labor-abundant economies in the East Asia region has given rise to the spontaneous creation of "growth triangles" that exploit the complementarities of adjoining regions. One of these comprises Singapore, the southern section of the Malaysian state of Johore, and the islands of Riau Province of Indonesia. Another includes Hong Kong, southern China, and Taiwan, China. In both, capital, technology, designs, management, and marketing services in the NIE are harnessed to relatively cheap land and labor in the

10 A precise estimate is difficult because a breakdown of FDI by destination is provided by Ministry of Finance statistics which, however, cover only "intentions" to invest abroad. Balance of payments statistics include actual gross FDI flows, but a breakdown by destination is not available.

adjoining region. Such combinations permit the rapid transmission of new technologies and management practices. It has helped make China the largest exporter of shoes in the world in less than a decade. It also now provides Indonesia with potential to become an even more successful exporter of labor intensive manufactures.

Table 8: *The share of Japanese FDI going to developing East Asia has been declining gradually, but the level has been increasing*

Japan's Foreign Direct Investment Abroad
(percentage share)

	1971-75	1976-80	1981-85	1986-89
North America	24	29	36	48
Europe	15	9	14	20
Latin America	19	16	20	13
East Asia				
Developing	22	20	13	6
High income a/	6	7	8	6
Other	14	19	9	7
TOTAL	100	100	100	100
Memo item Total FDI (US$ billion)	12	21	47	170

a/ Hong Kong, Singapore, and Taiwan (China).
Source: Hanazaki, M. 1990; JETRO, 1991.

Maintaining Access to Capital Markets

27. East Asia's access to foreign direct investment bears testimony to the creditworthiness of the region as a result of its stable and prudent macroeconomic management, relatively liberal trade policies, and flexible exchange rate management. External debt grew more rapidly in East Asia than Latin America during the 1970s (Table 9). Yet most East Asian economies escaped the debt crisis that erupted in the early 1980s. The region's creditworthiness meant continued access to the world's capital markets through the troubled '80s, a time when several middle income Latin American economies defaulted on their debt-service payments. Only the Philippines experienced severe difficulties in its external payments position, and eventually negotiated a Brady-type debt reduction agreement with its commercial creditors. By 1990, East Asia's total external debt had grown almost threefold from its level in 1980, far faster than in Latin America and at about the same pace as South Asia. Yet, East Asia's external debt indicators remained largely unchanged, even as those of Latin America and South Asia worsened (Table 10).

29 That East Asia would manage its external debt relatively successfully through the 1980s was not a foregone conclusion at the beginning of the decade. When the debt crisis was reaching its crescendo, it was feared that some countries in East Asia could go the way of Latin America. Korea, for example, faced a serious debt crisis in 1980. Indonesia faced difficult problems when oil prices fell in 1983. Malaysia was confronted with an external current account deficit equivalent to 14 percent of GNP in 1982. Three factors set these countries apart from those in Latin America. First, not only did they enter the 1980s less burdened with external debt, but a relatively small proportion of this was at variable rates (compared to Latin America); this partially protected the

East Asian economies from the sudden rise in real interest rates in the first half of the 1980s. Second, East Asia was less reliant on primary commodity exports (40 percent of total exports in 1980) than the economies of Latin America (83 percent) and Sub-Saharan Africa (98 percent). Thus, the sharp downtrend in commodity prices during the 1980s affected them less than it did the other two regions. And last, and perhaps most importantly, the quality and speed of their policy responses to the sudden deterioration in economic circumstances led to much more rapid adjustment. With a few exceptions, these adjustments included expenditure reduction and switching, expansion of exports through aggressive trade policy reforms, and the encouragment of domestic savings. Prudent and credible macroeconomic management, together with flexible exchange rate management, helped to maintain relative price stability and external competitiveness, strengthen investor confidence, and discourage capital flight.

Table 9: *Long term debt of selected developing regions (US$ billions)*

	1970	1980	1990	Growth rate 1970-80	Growth rate 1980-90
East Asia	7.9	61.9	187.4	22.8	11.7
Latin America	27.7	172.8	345.8	20.1	7.2
South Asia	11.4	35.5	101.9	11.4	11.8

Source: World Debt Tables, 1991-92

30. The Philippines was the only large country in East Asia which failed to adjust adequately and quickly to the shift in the global economic environment in the early 1980s. The economy was already facing large fiscal and external current account deficits in the latter years of the 1970s. In the early 1980s, rather than cut government expenditures and sacrifice some growth in the short term, the government expected that export growth would accelerate. Expansionary fiscal policies were financed by external borrowing. The Philippine peso appreciated in

Table 10: *Selected external debt indicators, 1980 and 1990 (in percent)*

	Indicators	1980	1990
East Asia	EDT/XGS	89.1	91.2
	EDT/GNP	16.8	26.8
	TDS/XGS	13.5	14.6
Latin America	EDT/XGS	197.1	261.4
	EDT/GNP	35.1	40.8
	TDS/XGS	37.4	25.3
South Asia	EDT/XGS	162.9	283.0
	EDT/GNP	17.3	30.8
	TDS/XGS	12.2	25.2

EDT: Total external debt
XGS: Exports of goods and services
PDS: Total debt service

Source: World Debt Tables

real terms, lowering export competitiveness and triggering capital flight. The economy's growth rate declined

Table 11: *Private creditors are retreating; official creditors have increased their exposure*

Composition of External Debt by Source, 1980-90
(in percent)

	1980				1990			
	Official	Private	Other	Total	Official	Private	Other	Total
East Asia	28.3	42.4	29.3	100.0	44.5	37.4	18.2	100.0
Latin America	12.6	58.6	28.6	100.0	27.2	53.0	19.8	100.0
South Asia	78.7	9.0	12.4	100.0	63.6	24.7	11.7	100.0
Sub-Saharan Africa	43.0	34.5	22.5	100.0	60.6	23.6	15.8	100.0

a/ IMF credit and short term financing.
b/ Totals include data for Kampuchea, Mongolia, and Viet Nam.

Source: IECDI and OECD data.

sharply, so much so that per capita income in 1990 was lower than it had been in 1980. The country is now only one of two highly indebted economies to have debt and debt service reduction agreements with its commercial creditors.

31. Three features have marked East Asia's continued integration with global capital markets:continued access to debt finance, increases in non-debt capital inflows, and prudent external debt management.

32. Continued access to debt financing. Total debt stocks of developing countries peaked in 1987; it has declined ever since because of the slow down in commercial bank financing, particularly to severely indebted middle income countries in Latin America. This decline in commercial bank lending was less drastic in East Asia and Sub-Saharan Africa. East Asia's external debt stock reached a plateau after 1987; so too did Sub-Saharan Africa's. Nevertheless, with private creditors pulling out, official creditors increased their exposure in all three regions (Table 11).

33. The average terms of new commitments to East Asia during the 1980s compare favorably with those for Latin America (Table 12). Sub-Saharan Africa, on the other hand, benefitted from a higher proportion of official assistance which was also provided on more concessional terms; consequently, the average maturity and grant element of these new commitments were significantly higher than in the case of East Asia or Latin America. The average interest rate on new commitments to East Asia dipped between 1982 and 1987, but increased in the following years as a result of a world-wide rise in interest rates. However, East Asia has consistently obtained new credit at lower interest rates than Latin America, where the average interest rate has been one to two percentage points higher. The lower interest rate terms for Sub-Saharan Africa reflects a larger element of concessionality on its official debt. The average grant element in new commitments to East Asia was much higher than in Latin America, but not as high as in Sub-Saharan Africa. The region's shrinking grant element after 1987 reflects the steady "graduation" of its more successful economies -- Korea, Malaysia, and Thailand -- from official development assistance.

34. East Asia's mix of creditors has also differed from that of Latin America and Sub-Saharan Africa. But one feature is common to all three regions; the countries belonging to the European Economic Community are the largest source of finance, and their share grew in the second half of the 1980s. Japan, the second largest creditor to East Asia, expanded its lending rapidly to the region and is now challenging the EC countries for first place. From 1985 to 1989, five East Asian countries became more dependent on Japanese credit; the sole exception was China, where the virtual halving of Japan's share was mirrored by a doubling of the EC's. The U.S. share has declined for all regions and for developing countries as a whole.

Table 12: *The average terms of new commitments for East Asia compare favorably with Latin America, but not with South Asia*

Average Terms of New Commitments

	Interest (%)		Grant element (%)		Maturity (yrs)		Grace period (yrs)	
	1980	1990	1980	1990	1980	1990	1980	1990
East Asia	9.4	6.8	8.8	22.1	15.6	17.8	4.7	5.4
Latin America	11.6	8.0	n.a.	12.1	11.1	15.0	4.1	4.6
South Asia	4.5	4.4	49.9	44.7	32.9	25.8	7.4	7.8
Sub-Saharan Africa	7.1	3.9	21.7	46.6	17.4	26.1	5.0	7.0

Source: IECDI

35. **Shift to non-debt financing**. Commercial banks have been hesitant to advance large new loans to developing countries since the 1982 debt crisis, and have forced developing countries to look beyond debt financing. In this regard, East Asia has achieved some success. Foreign direct investment (FDI) inflows reached $11.1 billion in 1990, rising from $1.3 billion in 1980 (Table 13). To a certain degree, Latin America also achieved some success in attracting foreign direct investment via debt-equity swap programs. But it was more successful in attracting portfolio investment, which increased from 6 percent of total capital inflows to Latin America in 1980 to 46 percent in 1989. East Asia has been less successful in attracting large flows of foreign portfolio investment, which accounted for only 9% of the region's capital inflows in 1989.

36. **External debt management**. East Asia managed its external debt relatively well, employing a judicious mix of variable-rate and fixed-rate debts to hedge against international interest rate risk, and ensuring a relatively stable payment currency mix to hedge against exchange rate risk. To assess the effect of international interest rate variability on external payments, the difference between the peak and the trough aaverage interest rate was calculated for the entire decade of the 1980s in each major financial market. The effect on interest payments on the outstanding stock of debt in 1990 was estimated as an increment to the debt service of the order of 1 percent of export earnings for East Asia, 11 percent for Latin America and 4 percent for Sub-Saharan Africa (Table 14). The relatively low variability in interest payments in the case of Sub-Saharan Africa stemmed from its lack of access to international financial markets, which prevented the region from accumulating variable rate debt. In the event of a downturn in international interest rates, as occurred during 1991, countries and regions with the higher stock of variable rate debt (such as Latin America) will benefit more from lower interest payments.

Table 13: *Total resource inflows increased in East Asia during the 1990s, largely due to foreign direct investment*

Breakdown of debt and non-debt financing
(US$ billions)

	East Asia		Latin America		Sub-Saharan Africa		South Asia	
	1980	1990	1980	1990	1980	1990	1980	1990
Total resource flows	12.4	24.6	29.4	18.7	11.0	16.8	5.8	8.4
Net disbursements of long term debt	10.4	11.4	22.9	8.1	7.9	4.9	3.2	5.2
Grants	0.6	2.1	0.4	2.5	3.1	11.1	2.4	2.9
Foreign direct investment	1.3	11.1	6.1	8.1	0.0	0.8	0.1	0.3

Source: IECDI.

Table 14: *East Asia is relatively well insulated from interest rate fluctuations in international markets*

The Impact of Interest Rate Changes on External Interest Payments, 1990 a/
(as a percent of exports)

	US$	FF	DM	LSTG	YEN	TOTAL	Memo item: Interest payment to export ratio
East Asia	-1.2	0.0	-0.1	0.0	0.0	-1.4	5.9
of which:							
China	-1.2	0.0	-0.1	0.0	-0.1	-1.5	4.6
Indonesia	-0.1	0.0	0.0	0.0	-0.1	-1.9	
Korea	-0.3	0.0	0.0	0.0	-0.1	0.0	3.5
Malaysia	-1.8	0.0	0.0	0.0	-0.1	-2.2	4.0
Thailand	-0.6	0.0	0.0	0.0	-0.1	-0.1	6.0
Philippines	-5.3	-0.2	-0.1	-0.2	-0.1	-6.2	13.0
Sub-Saharan Africa	-2.3	-0.9	-0.3	-0.4	0.0	-3.8	9.0
Latin America	-9.3	-0.2	-0.3	-0.2	-0.2	-11.0	13.6

a/ See text for explanation on method of estimation.

Source: IECDI

37. A similar simulation exercise was done to gauge the impact of exchange rate changes on the dollar value of external debt. From 1985 to 1989, all major currencies appreciated against the dollar. The depreciation of the dollar translated into a higher dollar value of debt denominated in other currencies. The upper bound of the exchange rate effect on this value is calculated by taking the difference between the peak and trough exchange rates of the Deutsche Mark, Japanese Yen, Pound Sterling and French Franc, and applying it to the value of outstanding debt in these currencies (Table 15). For East Asia, which had a substantial proportion of its debt denominated in Japanese Yen, the incremental effect on the dollar value of external debt amounted to about 12 percent of exports. Countries such as Indonesia and the Philippines were affected by changes in both exchange rates and commodity prices. Indonesia's debt-service ratio, for example, rose from 10 percent in 1980 to 37 percent in 1986 largely as a result of the appreciation of the Japanese Yen and the fall in international oil prices. While developing countries can hedge against future exchange rate changes by purchasing currency futures or other hedging instruments, most (including Indonesia) have not done so due to institutional and credit constraints. The least difficult avenue open to these countries is to adjust the currency composition of their debt portfolios through swaps or by altering borrowing patterns, to achieve a desirable balance of currencies in their debt obligations.

Table 15: *The appreciation of the Japanese yen raised the dollar value of external debt in several East Asian countries*

The Impact of Exchange Rate Changes on the Dollar Value of External Debt, 1990 a/ (as a percent of exports)

	FF	DM	LSTG	YEN	Total	Memo item: Debt to export ratio
East Asia	1.0	1.4	0.4	11.8	11.8	88.2
of which:						
China	0.2	1.1	0.3	11.2	11.8	77.4
Indonesia	3.4	4.3	1.4	30.9	30.4	229.5
Korea	1.2	0.5	0.1	4.2	3.5	44.0
Malaysia	0.6	2.4	0.3	8.8	10.3	55.9
Thailand	0.2	0.8	0.1	9.3	9.7	82.0
Philippines	1.6	1.2	1.1	31.1	29.5	229.2
Latin America	4.0	5.5	1.7	5.7	5.6	261.4
Sub-Saharan Africa	23.8	9.9	9.2	5.9	-17.2	329.5

a/ Exchange rate movement is estimated as peak-to-trough changes during theperiod 1985-89.
Source: IECDI

The External Environment and Economic Performance in East Asia

38. East Asia's linkages with the global economy through trade, investment, and finance, determine the pattern of exposure to risks that may originate outside the region. These risks could include changes in the growth of industrial country markets, the international cost of capital, the terms of trade, and the availability of external capital, notably foreign direct investment.

39. Growth in industrial countries affects growth in developing countries, and this is particularly true in the case of East Asia (Table 16). A one percentage point per year decline in OECD growth in the 1990s could lower the

growth of all developing countries by 0.7 percentage points per year (Table 15). [11] The primary channel through which lower OECD growth translates into lower developing country growth is through demand for exports. A decrease in OECD growth of one percentage point a year sustained over three years would lower developing country exports by US$60 billion a year. East Asia, however, could be expected to experience a lower GDP growth rate by a full percentage point a year. In fact, a one percentage point decline in industrial country growth is estimated to engender more than a one percentage point deterioration in the growth rate of Indonesia, Korea, Malaysia, and Thailand. This amplified transfer of a slowdown from industrial countries to the East Asia region is a measure of the integration that these countries have achieved with the world economy, their industrial base, and the rising share of capital goods in their exports. Other regions are neither so well linked nor possess such a large manufacturing base. Sub-Saharan Africa, for example, would be affected relatively little from lower growth in industrial countries because the income elasticities of demand for its exports are low. Latin America is also relatively dependent on commodity exports, and a slow down in OECD growth would have a significant effect on GDP growth only in Mexico and Chile, and to some extent Argentina.

Table 16: *East Asia stands to benefit most from increased global growth and integration*

Estimated Effect of Changes in the External Environment on GDP Growth of Developing Countries
(percentage point deviation per year)

	OECD growth decreases by one percentage point	Real LIBOR increases by 100 basis points	Trade and private finance decreases a/
All developing countries	-0.7	-0.2	-1.3
East Asia	-1.0	-0.2	-1.5
Sub-Saharan Africa	-0.5	-0.2	-0.8
South Asia	-0.7	-0.0	-1.4
EMENA	-0.8	-0.1	-1.1
Latin America	-0.5	-0.4	-1.1

Note: Data do not incorporate feedback to industrial countries or any indirect effects through linkages among the developing countries. Policy responses of the developing countries to the given external changes are limited to management of the external finance constraint.

a/ The level of foreign direct investment in developing countries is double that of the baseline (an average of about $27 billion a year more than in the baseline), and a combination of favorable trade-related supply effects and a more liberal trading system adds two percentage points to the rate of growth of exports of developing countries.

Source: World Bank 1991a

40. The impact of higher international real interest rates on growth in East Asia would be in line with most other developing regions (except Latin America). A one percentage point increase in LIBOR over the 1990s could be expected to slow growth by about 0.2 percentage points a year. This is despite the fact that East Asia's variable rate debt is over 40 percent of its total debt, and reflects the strong external payments position of most of the large East Asian economies (except the Philippines). The growth impact in Sub-Saharan Africa would be as high even though it holds a smaller share of variable rate debt, and this is because its external payments position is relatively weak.

11 These simulations are cast over a ten year period. Thus, the rate of growth of developing countries and regions are based on ten-year averages.

Table 17: *East Asia's biggest export gains from industrial country trade liberalization would arise in clothing and footwear.*

Estimated Effect of a 50 percent Liberalization in Trade Barriers by Japan, the EC, and the U.S. on Imports from East Asia

	Japan		EC		U.S.	
	1988 level (US$ billion)	export expansion (in percent)	1988 level (US$ billion)	export expansion (in percent)	1988 level (US$ billion)	export expansion (in percent)
Food	6.2	36.8	3.1	13.7	2.3	21.6
Beverages and tobacco	0.1	13.7	0.1	4.2	0.1	3.3
Crude materials (except fuels	6.4	2.6	2.8	0.3	1.3	0.9
Mineral fuels	10.5	8.2	0.2	2.4	2.0	1.0
Animal and vegetable oils	0.2	12.5	0.6	6.0	0.3	-0.5
Chemicals	1.4	3.5	0.8	2.2	0.6	7.6
Basic manufactures	6.8	16.1	4.0	13.7	4.7	19.8
Machinery and transport equip.	1.9	-1.0	4.6	11.4	14.3	5.6
Miscellaneous manufactures	6.9	40.3	10.0	83.4	19.4	72.1
- Clothing	4.4	56.0	4.8	139.2	7.7	121.6
- Footwear	0.5	49.4	1.0	65.2	3.2	74.1
- Other						
All goods	40.6	17.8	26.2	37.5	45.1	36.1
Manufactures	16.0	24.4	19.2	49.3	38.8	40.5

Source: World Bank 1992.

41. East Asia would also be the region most likely to be hurt if foreign direct investment decreases generally and is accompanied by a worsening in the international trading system. The region's strong physical and institutional infrastructure, its outward-oriented trade policies, and its well-developed human resource base, has attracted a large share of incremental private capital flows to developing countries. Were this flow to dry up, East Asia's rapid transformation into a competitive producer of manufactures would probably slow.

42. The region's close links to industrial country markets and its comparative advantage in labor intensive manufactures would make it especially sensitive to changes in the level of industrial country protection. For example, if protection levels in the EC, the United States, and Japan were to be halved, developing country exports could rise by 15 percent or US$50 billion in 1988 prices. East Asia would be the region to benefit the most, accounting for more than half of the increase. Sixty percent of East Asia's incremental exports would be in textiles and clothing, although the rise in exports of transport and equipment as well as food and feeds would also be significant (Table 17). East Asian exports would tend to grow in all three major markets -- Japan, the EC, and the

U.S. Clothing exports to both the EC and the U.S. would more than double. Exports of footwear would also be expected to rise sharply in all three markets.

43. By the same token, East Asia would be the most seriously affected developing region were industrial country protection to rise rather than fall. The stalling of the GATT negotiations under the Uruguay Round, increased trade friction between the EC, the U.S., and Japan, and the accelerating trend toward regional trading arrangements makes this a possibility that cannot be dismissed lightly. The creation of the EC single market by the end of 1992, for example, will probably have an adverse impact on the larger exporters of manufactures in East Asia -- even if the EC's common external trade barriers did not rise. This is because trade creation in the EC post-92, although high (assuming higher EC growth and high income elasticity for manufactures) would be eclipsed by even higher trade diversion. The EC's estimates indicate that imports would fall by about 10 percent as a result of the reforms -- 2.5 percent from removing internal barriers to trade and a further 7.5 percent from removing cost-raising regulatory barriers. The greatest trade diversion would be in services and technology intensive manufactures, and in these areas the immediate effect on East Asia would not be significant. But trade diversion would also be large in the case of labor intensive manufactures. The removal of internal trade and regulatory barriers within the EC would increase the competitiveness of exporters of labor intensive manufactures within the EC -- particularly in Portugal, Spain, and Greece. And this could have a substantial adverse consequence for East Asian exports in the short term.

44. Another less well advertised effect of EC92 will be the diversion of investment flows away from developing countries and toward the EC. Japan's large foreign direct investment in the EC (and in the U.S.) has been driven, in part, by the concern that the regionalization of trading arrangements may lead to higher trade barriers vis-a-vis third countries. Similarly, EC member countries' foreign direct investment in developing countries will likely be affected as a result of new investment opportunities within the enlarged common market. The East Asian economies, traditionally important recipients of FDI (among developing countries), could expect to find FDI inflows from these sources to grow less swiftly than in the past.

45. The effect of EC92 on East Asia is likely to be amplified by the EC's recent association arrangements with Czechoslovakia, Hungary, and Poland. These agreements, which establish a free trade area between the EC and each of these three countries, are likely to lead to substantial increases in foreign direct investment by EC member countries once the uncertainties in the region diminish. These countries, with their plentiful skilled and educated labor and their proximity to the EC market, could compete successfully with the East Asian economies for FDI flows and production of labor intensive manufactures. Moreover, the reforms in the FSU, Romania, and Bulgaria, if successful, could add to the growing number of East Asia's competitors in Eastern Europe and Central Asia. Offsetting the adverse effects of these trends on the export prospects for East Asia is the possibility of faster growth in the economies of Eastern Europe and of the Asian FSU Republics, which make them potentially important markets for East Asian exporters.

46. East Asia would also need to keep a close watch on developments in the North American continent. The NAFTA agreement between Canada, the U.S. and Mexico has yet to be approved by the U.S. Congress, but an initial assessment of the proposed agreement's salient features suggests that the immediate effect on East Asian exporters would be minimal. For example, in the textile and clothing sector, current quota and tariff restrictions on U.S. imports from Mexico will be replaced by rules of origin designed to maintain the protective effect of the current trade regime (Bannister and Low, 1992). Mexican exports will enjoy improved access to the U.S. market under the NAFTA in exchange for sourcing commitments which ensure that most inputs into textiles and clothing originate within North America. Rules of origin achieve this through a multiple transformation requirement that identifies the origin of intermediate inputs. Under triple transformation, for example, a cotton shirt would have to be made in the NAFTA region from yarn and fabric also of NAFTA origin. In the case of Mexico, however, proximity to the U.S. market and long-standing production agreements have already created a high level of dependence on inputs of U.S. origin. Only 7 percent of Mexico's exports to the U.S. uses imported inputs (outside

production arrangements), and only 8 percent of this (or 0.6 percent of apparel exports) uses inputs imported from non-NAFTA countries.

47. The longer term effect of the formation of regional trading arrangements on East Asia's trade prospects will depend on whether regional trade blocs help or hinder global multilateral trade liberalization. Were trade barriers to rise or trade frictions escalate to the point of a trade war, one of the principal casualties in terms of lower growth and lost opportunities would be the relatively open economies of East Asia. As important, the trend toward regionalization is being accompanied by increased constraints on foreign direct investment. For example, the output of Japanese automobile production units in the EC is limited to established production ceilings, and in some cases voluntary export restraints agreed with the U.S. restrict the option of relocating production in other countries for final export to the U.S. market. Similarly, East Asian FDI in Mexico to take advantage of access to the U.S. market under the NAFTA would most probably be curtailed. These restrictions would limit the flexibility of all economies, including the East Asian ones, to adjust to changing market constraints and opportunities, and to promote growth through increased trade and technology transfer.

Conclusion

48. East Asia's impressive economic performance can be explained, in part, by its rapid integration with the world economy, the diversification of its markets and production base, its ability to absorb new technologies and gain increased market access through the promotion of foreign direct investment, and its prudent handling of its external finances. The relative openness of East Asia's economies, the recent trend toward more liberalized policies, stable macroeconomic management, and a well-developed social and physical infrastructure have helped its economies to adjust rapidly to external shocks. At the same time, East Asia's strong trade and financial links with the global economy have closely aligned its economic fortunes with the performance of the industrial countries. This has made it more vulnerable to external economic risks arising from changes in the international trading system than other developing regions, though it is in a better position to adjust to changes in global economic conditions. In the coming decade, the East Asian economies would need to be watchful of the trend toward regionalization around the world, especially in Europe and North America. If multilateral trade liberalization were to slow or be reversed as a result of this trend, the consequences for East Asia could be more serious than for other developing regions. As far as external financial shocks are concerned, East Asia is *less* vulnerable than other developing regions because of the higher state of development of its capital market, the prudent share of variable rate debt in its overall debt portfolio, and its strong creditworthiness in international capital markets.

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