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The Rise of Regional Markets in East Asia

A European Perspective

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The construction of regional markets has been at the heart of the European integration process since the end of World War Two. The first major step was taken in the 1960s with the establishment of a customs union which eliminated internal border tariffs and adopted a common regional external tariff.

The next breakthrough came thirty years later when the old customs union was transformed into a common regional market. The internal market strategy of 1992 was based on major policy innovations designed to alleviate a wide range of non-tariff barriers (NTBs) that were behind the border. It also brought major institutional reforms that were essential trade facilitating measures without which the dynamic economic effects of the regional common market could not be achieved.

Thus, the 1992 programme was not just about technical economic issues. It also involved political measures to underpin the stability of the economic integration process, which paved the way for further integration. The next step involved the construction of regional financial markets and a common regional currency leading to a regional monetary union in 2001. The sovereign debt crisis which engulfed the Eurozone area in the wake of the global financial crisis is already leading to the next stage of integration—the construction of a regional fiscal union.

In summary, the making of regional markets in Europe has been a long-term, process of comprehensive and deep integration. It is only that kind of integration that can capture the dynamic benefits of regional trade and monetary policy. And it needs to be supported

by trade facilitating institutions to underpin the political stability of the whole process.

Professor Yamashita has been a discerning and critical observer of the regional integration process in Europe and what it might mean for East Asia.¹⁾ He has contributed a large volume of academic analysis and he has also been directly involved in the so-called 'Track-2' process of integration in East Asia giving him first hand experience of the political process (Yamashita, 2009). In honour of his retirement, I would like to contribute this European perspective on the rise of regional markets in East Asia.

Regional integration was not part of East Asia's early development. In the early post war period East Asian countries oriented their trade towards the global economy. Their major export markets were the United States and Europe. Japan, then the only industrialised country in Asia, was not a major export destination for the exports of its regional neighbours. East Asian countries looked to the multilateral trade system (MTS) as the preferred means to advance their economic growth and development. There was no interest in constructing a regional Asian market similar to what was happening in Europe.

East Asia's successful economic development strategy was the so-called 'Flying Geese' model — the basis of Japan's industrial modernisation. (Yamashita, 2007). Japan was the lead goose taking all the headwinds while shedding her labour-intensive industries and distributing them to her less developed neighbours. In this way, the Japanese model was transferred first to the newly industrialising countries of South Korea, Taiwan, Hong Kong and Singapore, later to the ASEAN countries of Indonesia Malaysia, Thailand and the Philippines and, more recently, to China and Vietnam.

The original flying geese model was transformed into the regional production networks (RPNs) of the 1990s (Yamashita, 2007). Triggered by massive outflows of foreign direct investment (FDI) by private Japanese companies in the late 1980s on, developing Asian countries responded by opening up their economies to fast track development through trade and investment.

Japan, architect of the flying geese model, became the architect of East Asia's regional supply chain. A dense network of vertically integrated production networks laid the foundation for East Asia's de facto regional markets. The RPNs were based primarily on intra-industry trade in intermediate products that led to rising intra-regional trade. East Asia's spectacular success of the past two decades has been based on its own special brand

1) In 2006, he organised a major conference on 'Asian Regional Integration by learning from Europe and the Euro: the possibilities of an East Asian Community' which provided for extensive exchange of knowledge between the two regions.

of market led integration. The rise of regional markets has been an integral part of the rise of Asia.²⁾

The objective of this paper is to assess the present situation of East Asia's evolving regional markets — from a European perspective. Section one will provide an overview of the current state of play regarding the rapid growth of free trade agreements (FTAs) in recent years by East Asian countries. Section two, will focus on the European response to this and, in particular, the proposed Economic Integration Agreement (EIA) with Japan. Section three will address the range of new issues that East Asia must face in the aftermath of the global financial crisis. The final section will attempt to draw conclusions on the way forward.

Section I : The rise of regional trade markets in East Asia

Over the past five decades East Asia has gone from being an underdeveloped agricultural region to a global industrial powerhouse. By 2007 Asia accounted for 24.5% of world GDP, 55% of world population and 66.8% of global official reserves. Maddison (2007) projects that by 2018 China will overtake the United States to become the largest economy in the world, with India number three. By 2030 Asia will account for 53% of world GDP whereas the US and Europe would account for only 33%.

• The rapid growth of FTAs

East Asia started to institutionalise its regional trade markets only recently.³⁾ But over the course of the past decade, the whole region has joined in a competitive process that has led to a tenfold increase of FTAs in the region. The number of agreements is constantly updated, but according to a recent study of the Asian Development Bank, East Asia had 45 FTAs in effect in 2010 and a further 84 FTAs in the process of negotiation. Confined to intra-regional FTAs in the past, East Asian countries are now going global and increasingly entering into inter-regional agreements.

The rapid expansion is led by the three large economies of North East Asia — China, Japan, and South Korea. The most advanced economy, Japan, is now the number one with eleven agreements concluded and implemented, while China has ten agreements and South

2) See Xinyi Li (2009) for an analysis of how the regional supply chain based on vertical specialisation in intra-industry and intra-product trade was facilitated by free trade agreements.

3) The Association of South East Asian Nations (ASEAN), which was founded in 1967, concluded a free trade agreement among its members only in 1992.

Korea has six. Collectively these three countries have a further thirty two agreements in various stages of planning and negotiation. The smaller countries of South East Asia have also joined the FTA process as they try to forge stronger ties with their larger neighbours. ASEAN has already concluded FTAs with the countries of North East Asia, while it also has a comprehensive FTA with Australia and New Zealand and a goods agreement with India.⁴⁾

What is fuelling this extraordinary energy for concluding FTAs? Each of the countries of North East Asia have different motivations. Japan's FTAs are primarily driven by the goal of maintaining favourable conditions for its large multinational companies (MNCs); China's overriding goal is to consolidate its position as the largest exporter of goods in the regional production chains. Korea has the ambition to become the trade and investment gateway of the West to East Asia. It is the first country in the region to pursue comprehensive FTAs with the European Union (EU) and the United States (US).

The stalled negotiations in the World Trade Organisation (WTO) is also an important driving force behind the proliferation of FTAs in East Asia. However, the value added of regional over multilateral trade liberalisation is not immediately obvious. East Asian countries had already engaged in extensive tariff cutting under WTO rules before the surge of FTAs. With such a low tariff environment already existing how much does private business utilise the FTAs? The fact that each FTA contains its own 'rules of origin' creates the risk of imposing higher transaction costs on business, leading to low utilisation rates of the FTAs by business.

A survey of firms conducted by the ADB in 2008 showed that the majority of firms do not use the FTA preferences in East Asia for a variety of reasons. However the study found that business has made more use of FTAs since the global financial crisis. They have recognised the value of the FTAs in the post crisis environment of latent protectionism.

• Assessing the quality of FTAs

How do we assess this situation of rapid proliferation with many overlapping FTAs from a European perspective? Our conceptual model for evaluating the quality of regional trade markets distinguishes between different levels of shallow or deep integration (Lawrence, 1996). The vast majority of FTAs in East Asia are shallow trade agreements

4) See the ADB study by Kawai and Wignaraja (2010) for comprehensive quantitative information and analysis of the present situation on FTAs in Asia.

focussing primarily on tariff liberalisation. With such agreements, the net economic gains from trade creations must be weighed against the welfare loss of trade diversion.⁵⁾

The most important economic benefits from FTAs do not come from the static effects of tariff cutting, but from the dynamic effects of creating a larger regional market. The latter triggers a dynamic process of creating economies of scale and enhanced competition. Increased specialisation, technological change and total factor productivity are all induced by the dynamic process set in motion. Deep integration is necessary to capture those welfare gains.

Deep integration goes beyond tariff liberalisation and involves policies and institutions that address behind the border barriers. In this framework, the benefits derived from deep integration depend on the extent to which it creates a common regional market. The creation of this regional market requires the removal of not only border tariffs but all discriminatory barriers in the form of technical and regulatory barriers behind the border (Gavin, 2008).

Therefore, an overall regional strategy to enhance the regional production networks, in East Asia would require this kind of deep integration. An increasing quantity of shallow FTAs will not be sufficient to construct a common regional market for trade in goods and services. Increasing intra-regional trade in this context must be viewed with some caution. The figures are impressive : between 1980 and 2008 intra-regional trade rose by 37%. During the period 1990-2006 intra regional trade grew faster than global trade. While global trade flows increased by 300% during that period, intra regional trade flows in East Asia increased by 500% (Kawai and Wignaraja, 2010).

But this intra-regional trade in East Asia relies heavily on trade in intermediate products within the regional production chains. And the emergence of China as the largest link in this chain and the largest exporting country in East Asia has dominated this situation. Moreover, East Asia still depends on exports of final products to the West. While the share of intra-regional intermediate good flows between the EA countries had increased to 65% in 2008, the share of intermediate goods flowing from emerging Asia to the rest of the world is only 30%. Therefore, East Asia still depends on the exports of final products to the industrialised countries. (Gavin, 2009).

What is the way forward? Of course, FTAs are overall beneficial and they have proved

5) Although FTAs are negotiated outside of the WTO they must be WTO-compatible. Article XXIV of the WTO, which sets the rules for FTA liberalisation, is based on tariff liberalisation and requires that 'substantially all trade' be liberalised by the partners.

their worth by keeping trade flowing in Asia in the wake of the global financial and economic crisis. But the future requires more effective deep integration that will transform the network of bilateral and plurilateral FTAs in a common regional market as advocated by Yamashita (2009). The bundling of existing FTAs into one region-wide FTA is a necessary but not sufficient condition for achieving that goal.

Section II : EU trade relations with East Asia

In view of East Asia's expanding network of regional trade agreements, and to counter their potential trade diversion effects, the EU has adopted a new trade strategy for developing its own FTAs with countries in the region.⁶⁾ The recently concluded FTA with Korea is considered as the first of a new generation of trade agreements and a benchmark that will set the standards for other future agreements. The most important innovative characteristics of the agreement include new rules for dealing with non-tariff barriers and a clear WTO-plus approach in the new areas of services and investment (Erixon and Lee-Makiyama, 2010).

Of more importance ultimately, however, will be the proposed economic and integration agreement (EIA) between the EU and Japan that is now on the table. Japan is already heavily involved in the regional integration process of East Asia where it has favoured Economic Partnership Agreements (EPAs) over the classic free trade agreements. It has already negotiated seven EPAs with countries in Asia, two with Latin American countries and one with a European country — Switzerland. Those EPAs contain elements of deep integration as they address rules about non-tariff barriers and are also WTO-plus as they include issues of competition, investment, and public procurement.

• An EU-Japan economic integration agreement

At the Japan-EU summit meeting in 2010, both sides agreed to set up a High-Level group to explore the possibilities for deeper economic integration. Since then, the EU has organised a public consultation with all stakeholders from private business and public sector bodies — both in Europe and Japan. These views, which will feed into the process of preparing a clear focus for the negotiations, give an indication of the major issues to be

6) The EU launched its 'Global Europe' strategy in 2006 in which it proposed to negotiate FTAs with Korea, ASEAN-10 and India as its top priorities. Negotiations with ASEAN started on a region-to region basis but were not successful. Bilateral agreements with individual ASEAN members are now being negotiated. The negotiations are now at an advanced stage with India.

addressed.⁷⁾ In summary, the overall feeling towards enhanced economic integration is favourable, but for EU stakeholders the problem of NTBs in Japan constitute a major stumbling block. So what are the prospects for success?

Japan now proposes a comprehensive Economic Integration Agreement (EIA) with the EU that would be based on the 'four freedoms' of the EU internal market, that is, free movement of goods, services, capital and labour. This could lead to joint collaboration between EU on a range of issues that would focus on fostering the innovation society by improving intellectual property rights, fostering environmental protection by joint activity on climate change rules, jointly working to improve the security infrastructure and mutual improvement of the business environment for trade and investment. Japan argues that such a comprehensive and deep EIA would open up perspectives for further cooperation on strengthening the multilateral trade system by expanding the WTO-plus agenda, by building a common front against protectionism, and by improving the international business environment.⁸⁾

There is, however, a significant divergence between the two parties on what should be the central focus of the proposed EIA. While Japan is primarily concerned to achieve the reduction of tariff barriers in the European internal market, the EU's main concern is the elimination of NTBs in Japan. Consequently, the EU requests a clear signal from Japan that it is willing to address this issue before any negotiations can even begin. Japan rightly rejects this position saying that the proposed EIA negotiations should be based on the WTO principle of 'a single undertaking', which implies a grand bargain or total package of trade liberalisation measures that has to be mutually acceptable to both parties at the end of the day.

At issue here is the problem of regulatory barriers, which are a major obstacle to deep integration. Regulatory barriers typically take the form of national regulations which were designed to achieve legitimate social goals but, nevertheless, have the effect of market segmentation. As such they impose costs on the trans-border movement of trade and impede competition in international markets. The regulatory barriers of most concern to the EU in Japan typically include health and safety regulations, consumer protection

7) The results were published in a non-official paper by the Directorate General for Trade of the EC on 17 February, 2011 : *'Summaries of Contributions to the Public Consultation on the future of EU Japan trade and economic relations'*.

8) Based on a presentation by Professor Y. Watanabe, Keio University, at the European Institute of Asian Studies in Brussels on 11 May, 2011.

standards, and the procedures for testing and conformity assessment for standards particularly in relation to sanitary and phytosanitary (SPS) issues for food products.

Regulatory barriers are not designed to discriminate between domestic and foreign producers. A good example of this is enforcement of product standards, requiring testing and conformity assessment procedures which apply to both domestic and foreign producers. But foreign producers will first have to comply with standards in their home market and then have to satisfy standards in the foreign market — which imposes additional compliance costs on exporters. Such regulatory policies may include outright bans on market access in the case of failure to comply with standards. The result is higher costs for exporters and creation of rents for domestic producers.

So, the main policy question is how to maximise economic welfare benefits and minimise economic costs from a deep integration agreement? How can regulatory barriers be eliminated or reduced so that they will lead to the greatest gains in economic welfare? Since regulatory barriers are more sensitive than tariffs, the overall political economy climate of the negotiations can play an important role. In this context, there is room for considerable improvement in EU-Japan relations.

During much of the post war period relations between Japan and the EU have been less than cordial. The relationship suffers from an ‘expectations deficit’ that has resulted from mutual ignorance and indifference (Tsuroka, 2008). The acrimonious trade disputes of the 1980s gave way to more cooperation in the 1990s. But despite the existence of a ‘Strategic Partnership’ since 2001 and a ten year Action Plan which includes provisions for strengthening economic and trade relations, little concrete progress has been achieved, But that could now be about to change.

Deepening economic interdependence between the EU and Japan creates an environment where both parties can develop wide ranging collaboration on a broad agenda for sustainable development. For example, collaboration on climate change policies and energy security have increasing economic significance for the global economy today. And, as Japan is heavily involved in the regional integration process of East Asia, it can profit from greater knowledge and experience of the European integration experience.

Section III : Regional financial markets in East Asia

The global financial crisis of 2008 exposed the fundamental problem of the financial system : we have a global financial market but we have no global financial governance and no global regulation. Financial markets are still regulated at the national level but the level

of interdependency is such that the problems can not be solved by countries acting alone. Reform of global financial governance is now in the hands of the G-20 but rapid progress is not expected. Convergence towards global standards will be slow and fraught with political conflict, so it is preferable to focus on regional convergence as a stepping stone towards reform at the global level.

The European Union is currently in the throes of radical regional reforms. Despite its relatively advanced level of financial and monetary integration the EU has suffered a major crisis of banking debt linked to sovereign debt. The fundamental cause of the crisis was easy credit lending by private financial institutions leading to excess spending and consumption. The policy response has brought forth institutional reforms at the macro and micro level that were unthinkable before the crisis—the establishment of a European Financial Stability Facility to manage the sovereign debt crisis in periphery countries and a radical overhaul of the regional financial architecture to prevent such crises recurring in the future.

East Asia too faces a number of challenges in relation to the reform of financial markets that have emerged in the aftermath of the global financial crisis. The key question now is, what model of finance for East Asia—given its comparative advantage of possessing the largest pool of financial reserves in the world? Sheng (2009) projects that Asian financial markets will become the largest in the world in the next ten years—but on the assumption that financial deepening continues to improve in the East Asian region and that Asian currencies appreciate relative to the dollar and the euro. Therefore, the successful rise of regional financial markets in East Asia will depend much on how the policy makers manage the situation.

East Asian countries have reached a level of deep integration in trade and investment that paves the way for financial and monetary integration.⁹⁾ Regional financial integration could contribute to a more efficient allocation of the huge surplus savings in East Asian countries and invest them in a more productive way for the benefit of the whole region. Monetary integration could help East Asia find an appropriate form of regional currency arrangement that would bring economic benefits and greater exchange rate stability. It

9) The trade intensity indicators for intra-regional trade between the ASEAN plus three countries shows a high and increasing level of trade integration and the creation of regional production networks show the deepening capital integration. However, East Asia would not fulfill the conditions for an 'optimal currency union' because of very low mobility of labour in the region. But the key question is whether they have the political will to take the necessary steps for deepening economic and financial cooperation.

would also contribute towards reform of the global monetary system.

• **The origins of regional financial cooperation**

Regional financial cooperation in East Asia was born from experience of the Asian Financial Crisis of 1997-98. As financial contagion spread throughout the region countries realised that the level of interlinkages between them had reached the stage where collective regional action was necessary. The other powerful factor fuelling regional cooperation was dissatisfaction with the way in which the International Monetary Fund (IMF) had handled the crisis.

The first major step taken was the Chiang Mai Initiative (CMI) establishing a regional liquidity support mechanism supported by ASEAN+3 countries. The mechanism aimed to protect small countries against excessive speculation and to prevent a situation where they would have to go to the IMF in the event of a future financial crisis. But CMI regional liquidity provisions were complementary to the global liquidity provisions of the IMF. The CMI would provide only 20% of resources for a country that might suffer a financial crisis without that country being a part of an IMF programme.¹⁰⁾

The establishment of the CMI had symbolic and political importance but its development into an effective economic mechanism has been very slow. The global financial crisis showed how quickly and unexpectedly a liquidity crisis could return to the smaller Asian countries. Korea, Singapore and Indonesia all faced severe dollar liquidity shortages. Still mindful of the AFC experience, the countries in need refused to go to the IMF and made alternative arrangements in the form of various swap agreements with different countries. So despite the existence of the CMI arrangement, it was not used much during the global financial crisis.

Since then, the CMI mechanism has been multilateralised (CMIM) and de-linked from the IMF. Its resources have been increased and in case the CMIM borrowing quota is not sufficient to deal with the problems of a country, it can be supplemented by additional contributions from other countries in the group.

It is expected that the borrowing facility will probably be supplemented by other kinds of swap agreements and facilities in the future. But is the existence of the CMI sufficient to prevent the return of a financial crisis in East Asia? For the moment, risks of future financial crises in East Asia have receded by the build up of large foreign reserves. But can East Asia

10) For a comprehensive discussion of the CMI from its origins to the present, see Sussangarn (2010)

be sure that it will not have another financial crisis as capital inflows into what is the most dynamic region in the global economy build up?

Therefore, the CMIM is just a first step and will need to be expanded to foster financial deepening and financial stability in the region. Most important will be the development of an Independent Surveillance Unit. It would not just carry out a regional role similar to the IMF at the global level but it should perform additional tasks and activities to foster long term regional financial and monetary integration. It should be supported by a strong professional secretariat so that it can provide high quality technical inputs into the regional surveillance practice.

The next phase of Asian financial integration should not be led by governments alone but will need to be more market driven through the removal of barriers to financial integration within the region. The entry of more Asian financial institutions into each other's domestic markets would make for concrete progress in the construction of a regional financial market. Some countries, like Malaysia, have already allowed a number of regional financial institutions into its home market. If this process continues and accelerates then there will be increased financial integration among Asian financial institutions.

• **What model of finance for East Asia?**

The AFC was a traditional banking crisis of a traditional commercial banking system and so the effects were largely confined to the region. The financial crisis of 2008 was a crisis at the centre of the global banking system led by very large innovative banks powered by excessive leverage and engaged in excessive risk taking. The failure of global financial governance was clear to all. As a result, the impacts of the crisis were felt world wide (Sheng, 2009).

Asian banks, however, proved to be resilient in the crisis. The overall situation of East Asia was financially sound when the crisis broke. East Asia had obviously learned lessons from the AFC. Both its financial and non-financial institutions had overall sound balance sheets. And the level of household sector indebtedness was very sound with a high level of savings in Asian households (Park, 2010).

But the large volume of savings in Asia are not invested in Asian capital markets which are weak at the national and regional level. Hence the need for establishing the conditions conducive to deeper and more liquid markets. To achieve the overall improvement of the regional financial infrastructure needs a broad agenda of regulatory reform. Measures aimed at financial deepening include strengthened prudential requirements, establish a

macroeconomic stabilisation framework, enhanced corporate governance and promotion of better cross border co-operation.

Financial systems in emerging and developing Asia are still dominated by banks. They provide bank loans as well as financing through bonds. Since the AFC the local currency bond markets have developed and the number of bonds issued by governments and the corporate sector have increased. But financial innovation still lags behind the West.

In East Asia the large banks that dominate the commercial banking system are still state owned or controlled. While this has solved the problem of 'too big to fail' which has seriously deterred reform efforts in the West, it has not solved the problem of innovation. How to make Asian financial institutions more innovative, but without falling into the pitfalls of modern western finance, is now the greatest challenge facing East Asia. This is essential for reform of the structural imbalances in the real economy.

Asian financial markets must change in response to fundamental changes in the demographic structure of their societies, consumer behaviour and industrial structure of their economies. They must respond to the problem of ageing societies, to greater consumption of the increasingly affluent middle classes, and to the situation of over investment in manufacturing industry that is overly dependent on exporting.

• The limits of export led growth

East Asia's development strategy has been based on export led growth (ELG) starting with Japan and then followed by neighbouring countries. The ELG strategy relies on high growth rates of manufactured goods that allows countries to generate domestic employment and trade surpluses—but without generating inflation. Therefore, it is preferable to domestic demand led growth.¹¹⁾

As East Asian countries recovered from the AFC they returned to ELG as economic engine of growth and the best offensive strategy against another financial crisis. For example in Thailand, where the AFC started, the ratio of exports of goods and services to GDP increased from about 40% prior to the crisis to about 70% after the crisis (Sussangarn, 2010). The ELG strategy was compounded by the arrival of China because of the sheer size of its labour force that could keep wages low for a very long time. From 2000 on China began to generate exceptionally large trade surpluses—while keeping its exchange rate

11) Criticisms of export led growth emerged soon after the AFC. It was the real economy factor of ELG that caused the crisis rather than the financial speculation. Felipe (2003) gives an overview of this early debate and how East Asia reacted to it.

pegged to the dollar.

As Asian countries collectively built up large surpluses, most of the foreign reserves were invested in the United States. Those funds then came back to Asia through leveraged financial institutions and multinational corporations. East Asia swapped capital inflows for exporting cheap goods with little inflation to the West. But this situation was unsustainable.

In the global context total current account surpluses must be matched by other countries' deficits. But deficit countries can not continue to increase their deficits indefinitely. The surplus countries of Asia had built up excessive savings which served to finance excessive consumption and asset bubbles in Western deficit countries. It was this 'savings glut', and its implications for financial markets, that caused the global financial crisis according to Bernanke (2005) — a thesis which continues to be controversial.

But the ELG strategy of East Asia, that was so successful in the past, will be severely constrained in the future. The level of demand in Western countries will remain subdued as they take the necessary measures to reduce their indebtedness. If the situation of global imbalances is allowed to continue, it will contribute to financial instability and the risk of another financial crisis. Hence the need for structural adjustment policies to address the underlying problems of global imbalances. There is need for a new growth model that relies more on domestic and regional demand and with greater emphasis on social equity and environmental sustainability.

Towards this end, the creation of common regional markets is of major importance. The creation of a regional economic market could stimulate demand though targeted public investment in infrastructure especially in the poorer, less developed countries where economic growth is not so spectacular. On the supply side, there is need for measures to promote long term growth through investment, deregulation and policy incentives for example in education, health and training, in services sectors and green growth. Socially inclusive growth means that it reaches all levels of society and promotes poverty reduction. Regarding environmental protection, Asia could now take a leading role in developing new green technology. In summary, the new development paradigm of Asia should foster strong regional cooperation and emphasise green growth.¹²⁾

• **Connecting regional and global governance**

A global crisis requires global solutions. It is the G-20 which has been tasked with

12) See Kawai (2010) for an exposition of the whole strategy for rebalancing growth in East Asia over the next decade

reform of the global financial architecture and to bring down trade imbalances. But as East Asia now builds its regional structures, it needs to keep them connected with global structures.

Under the current regional cooperation arrangements of CMIM, there is no mechanism to deal with exchange rate co-operation and co-ordination. But emerging Asian countries need increased exchange rate flexibility for Internal and regional development as well as contributing to global balancing. More flexible exchange rates would enable Asia to increase its efficiency, contribute to macro-economic stability and managing external shocks. In the absence of any regional arrangement, East Asia faces a major constraint for reform of the global monetary and financial system. In terms of global reserve currencies, it is likely that the dollar and the euro will remain the dominant reserve currencies for years to come. This will remain as long as East Asia can not decide on what is the best currency arrangement for the region.

In regional financial cooperation, the CMIM policy should not de-link itself from the global IMF system. East Asia does not have the technical knowledge, or the political experience necessary for effective surveillance, monitoring and credible implementation of large scale support programmes (Drysdale, 2010). The Eurozone crisis has shown that although surveillance, co-operation and analytical capacity are already well developed in Europe, close co-operation with the IMF was considered essential for success. And, in light of the European experience, it is a myth to believe that 'soft' regional conditionality can substitute for harsh IMF conditionality in the event of a financial crisis. In the European case, the harshest conditionality was meted out by the regional paymaster, which is Germany.

Paradoxically, the Eurozone crisis creates a new sense of urgency for East Asia to connect its regional and global structures. Emerging Asian economies with high growth rates are attracting increasing inflows of capital. So they could be subject to a build up of pressures similar to that of the 1990s. The 2008 crisis showed how quickly a liquidity crisis can arise in East Asia. Korea, for example, almost had a financial crisis, while Singapore and Indonesia had liquidity shortages.

In terms of trade strategy, the very strength of East Asia's position in global trade means that it must accept responsibility for greater leadership. China is now the world number one exporter and the world number 2 trading nation, it is the world number one destination for FDI and is the world number six source of outward FDI in the global economy.

The current account imbalances are just the symptom of a deeper problem. The real problem is how to get a better balance between regional and global economic growth. Asia will have to rebalance its trade strategies to achieve more regional growth and less global growth and to make progress in opening its markets through regulatory and institutional reform. This calls for renewed efforts to conclude the Doha round while further opening up of its markets by deep FTAs and promoting structural reforms.

Conclusions

This paper has attempted to assess the overall growth of regional markets and regional integration in East Asia by someone coming from a European background. We must be careful not to confuse the two different brands of regional integration in Europe and East Asia because of their different origins, development and cultural context. But in a globalised world, what unites us is increasingly greater than what divides us.

East Asia's modernisation has been built on export led growth and deep specialisation in trade and investment. The rapidly growing FTAs of the past decade attempt to consolidate this major achievement and to keep trade flowing in a global environment of nascent protectionism since 2008. But those FTAs are too shallow. East Asia will need to deliver more deep integration to open its markets and address regulatory barriers.

Japan and the EU are now embarking on a pathbreaking Economic Integration Agreement. Most people expect the formal negotiations to start this year but they will be lengthy and difficult. The main stumbling block on the Japanese side will be NTBs and for the EU, its remaining tariffs — especially in the automobile sector. However, this must be balanced against the common interests of both parties on a broad agenda of sustainable development issues.

East Asia has large financial reserves but it faces a whole set of new issues on how to manage them in the aftermath of the global financial crisis. Measures taken for the creation of a regional financial architecture and regional monetary cooperation, such as the CMIM, are just first steps but not enough. Market led moves are now necessary for concrete progress in regional financial markets that will have greater capacity to absorb the surplus savings in the region. This process needs to be supported by further institutionalisation.

East Asia can exercise leadership in the G-20 by connecting its regional to global structures. The legitimacy of the G-20 can be enhanced by this connection. By getting the balance right between regional and global governance, East Asia can contribute to the consolidation of the G-20 process.

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