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# INTRODUCTION TO SPECIAL ISSUE: Globalisation and Economic Integration in East Asia

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Globalisation or regionalisation is arguably the most popular concept used to describe the rapid growth of intra-regional trade and capital flows as well as the political and social linkages associated with increasing economic integration in the East Asian region. However, it might be a surprise to note that regionalisation is relatively a recent event in East Asia. In comparison with the European experience, regional integration in East Asia has occurred in the absence of a formal institutional framework, and is market-driven in nature. Policies such as preferential trading arrangements have traditionally not played much of a role in the integration of the region. Since the early 1990s, especially since the outbreak of the 1997 East Asian financial crisis, there has been a shift from non-preferential to a preferential route to trade liberalisation, and the East Asian region began moving towards more formalised preferential agreements and regionalisation.

The East Asian financial crisis of 1997-98 generated considerable turbulence. One important lesson learnt by these economies from the financial crisis is that it is important to establish both a more resilient domestic economic and financial system and a better functioning global financial system as keys to crisis prevention, management, and resolution (Kawai, 2009). Since the 1997 crisis, several initiatives have been taken to prevent this from happening in the future, including the active consideration of currency blocs and greater regional monetary integration.<sup>1</sup> As a matter of fact, studies have revealed that the degree of trade integration and asymmetry in the demand and supply shocks in East Asian countries were very much like the European Union member countries (see Zhang *et al.*, 2003; De Grauwe, 2009). So, why has monetary union not come about yet in East-Asia? The answer seems to be political. In contrast to the Eurozone, there is a widespread feeling in East Asia that the political obstacles to forming a monetary union are too large. These obstacles are themselves the result of historical developments that make it difficult for these countries to unite and to create a new supranational institution. The absence of

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<sup>1</sup> Monetary cooperation in the region can be dated back to the ASEAN Swap Arrangement in 1977. In the ASEAN + 3 (China, Japan and Korea) Finance Ministers Meeting on 6 May 2000 at Chiang Mai, participating countries agreed to establish a regional financing arrangement to supplement the existing international facilities through the “Chiang Mai Initiative”. The Initiative involves an expanded ASEAN Swap Arrangement that would include all ASEAN countries, and a network of bilateral swap and repurchase agreement facilities among ASEAN countries, China, Japan and the Republic of Korea.

the institutional infrastructure in Asia makes it difficult to envisage monetary union in the short and medium run (De Grauwe, 2010).

With the recent financial and economic crisis, globalisation and regional economic integration has become again the focus of intense global interest and debate. Led by the rapidly growing Chinese economy, the East Asian region is forging closer economic ties than ever before, and remains the most dynamic region in the world. According to ADB source, as of July 2011 there are 142 FTAs in effect, and another 85 in various stages of preparations in ASEAN and East Asia. East Asia has become the third most integrated region in the world after North America and the European Union.

Despite recent calls to reconsider the merits of openness, trade integration remains key to economic growth. It is well known that China and other emerging markets in the region, which account for over 40% of the world's population, are growing at an unprecedented pace, pulling much of Asia and the rest of the world with them. Global production sharing and intra-regional network trade have become an integral part of the economic landscape of East Asia and a new form of international specialisation in the region (Athukorala, 2010). A highly important recent development in the international fragmentation of production has been the rapid integration of the Chinese economy into regional production networks, which involves complicated combinations of intra-firm trade, arms-length transactions, and outsourcing (see Kimura and Ando, 2005). These networks have allowed firms to exploit comparative advantage by slicing up long production processes and allocating the production blocks throughout the East Asian region, with China being the manufacturing centre mainly for assembly by lower-skilled workers and exports of finished products throughout the world (Thorbecke and Smith, 2010).

With its three decades practice of economic reform and the "open-door" policy, the Chinese economy has benefited dramatically from the process of openness and globalisation, and become a major player in the global economy today. China has been the fastest growing economy in the world over the past three decades, expanding at 10% per year in real terms, and retained the world's largest current account surplus and foreign exchanges reserves. By June 2011, China's foreign-exchange reserves surged by a record to US\$3.2 trillion. China's foreign trade has been expanding, with export surpassed Germany and became the world's No. one exporter in 2009. Because of the global economic turmoil, China's trade surplus in 2010 is expected to shrink to US\$180 billion, down from US\$196 billion in 2009 and the historic peak of US\$300 billion in 2008.<sup>2</sup> China's economic growth is not only important to itself, but also a driving force of recovery in the Asia Pacific region and the rest of the world. During the recent crisis, China's US\$586 billion stimulus has contributed to a strong global recovery. China has been an increasing influence on world economic growth and trade.

The rapid rise of the Chinese economy is creating opportunities for many but also causing increasingly trade disputes with its major trading partners. The asymmetry of rapid integration with advanced countries in the real side of the economy through trade and tight control over financial market has been blamed as the main cause to rising financial and real imbalances in the global economy. The East Asian currencies, the Chinese Renminbi (RMB) in particular, have occupied a central role in the

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<sup>2</sup> Data used in this paper were adapted from China's MOFERT and the State Administration of Foreign Exchange, otherwise as indicated.

ongoing debate over the source of global current account imbalances. However, given the role that China has been playing in the East Asian vertically integrated production network or supply chain, it remains an interesting question to ask how effective the Chinese RMB revaluation will be on its trade balance. According to China's Ministry of Commerce, processing trade accounts for more than 60% of China's total exports, which normally contains low value added with an average profit margin of only 1.8% earned by the Chinese exporters (*the Washington Post*, 22 March 2010). It is therefore not a surprise to see the findings from some recent studies that an appreciation of the Chinese currency alone would be insufficient, and a generalised appreciation in both China and the rest of East Asia would be needed to switch expenditures towards US and European goods and to rebalance the world trade (see, for instance, Cheung *et al.*, 2007; Thorbecke and Smith, 2010; McKinnon, 2010; Zhang and Sato, 2011).

Rebalancing growth in developing Asia is an important component of the overall global rebalancing effort that will be required to stabilise the world financial and economic systems.<sup>3</sup> A challenge facing both policy-makers and academics is how to comprehend the many different dimensions of the rebalancing of the global economy and how they might relate to one another. How to understand the impacts and implications of globalisation and the regional economic and monetary integration? The theoretical and empirical analysis of economic integration and structural changes in East Asia has become of critical importance. The papers in this volume address these important issues from different perspectives.

In their contribution, Allen, Kramadibrata, Powell and Singh address the credit risk issue. The global financial crisis (GFC) has demonstrated the devastating effect that high credit risk can have on financial markets and economic stability. Whilst default probabilities of banks are generally low, this can change during extreme downturns such as in the GFC. During this period, impaired assets (problem loans) of banks more than trebled in the US and UK. Thus, the subject of credit risk in extreme circumstances has become one of the most important and intensely scrutinised topics in finance today. In this paper, the authors apply quantile regression to a structural credit model to investigate the impact of extreme bank asset value fluctuations on capital adequacy and default probabilities (PD) in the case of Japanese Banks. Quantile regression allows modelling of the extreme quantiles of a distribution which makes it possible to measure capital and PDs at the most extreme points of an economic downturn, when banks are most likely to fail. The authors find highly significant variances in capital adequacy and default probabilities between quantiles, and show how these variances can assist banks and regulators in calculating capital buffers to sustain banks through volatile times.

In their contribution, Pei, Tsui and Zhang employ the copula models with time varying parameters to investigate the effects of the 1997 East Asian financial crisis on asymmetric dependence in exchange rates returns and assess the asymmetric relationships between five currencies mostly hit by the crisis. By using the time-varying copula models, it is possible to identify the possible structural change when the dependence structure of two currencies changes due to political or economical turmoil. The finding of asymmetric dependence signals possible structure changes,

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<sup>3</sup> At the 2010 G20 Summit the G20 leaders committed to develop guidelines to address large current account and to undertake macroeconomic policies to ensure ongoing recovery and sustainable growth and enhance stability of financial markets.

which is confirmed by the structure break tests. The results show that in most cases a dominating tail change is found during the crisis from higher upper tail dependence to higher lower tail dependence and vice versa. These findings confirm the impact of the recent East Asian financial crisis on policy changes and asymmetric dependence.

The next three papers focus on economic and monetary integration in East Asia. As one important requirement for monetary integration is convergence in real exchange rates, Lim employs the hierarchical clustering and two different time series methods to test the converging trends and co-movements of real exchange rates and to assess the suitability of a monetary integration in the 10 East Asian countries. Differing from the existing studies, this paper also compares the role of the Chinese RMB and the Japanese yen as the anchor currencies in East Asia in view of the growing role of China as a hub of regional trade. The results from this study show that there is evidence of currency convergence for all 10 East Asian economies to the group average using the statistical test for converging trends with the exception of Hong Kong and Taiwan dollars, and all 10 currencies have a relatively stronger tie with the US dollar than with the Japanese yen or the Chinese RMB. The Chinese RMB is found to be more suited than the Japanese yen as the anchor currency in East Asia.

In order to assess the effectiveness of a generalised currency appreciation in emerging Asia on trade imbalances with the US, Zhang uses a multi-country macro-econometric model to examine the likely consequence of the joint appreciation of the emerging Asian currencies on the world trade balances. Based on the results of simulations, this paper finds that neither a drastic unilateral appreciation of the RMB, nor a joint appreciation of currencies in emerging Asia, would reduce the trade deficit in the US significantly. This finding seems to support the Stiglitz-McKinnon conjecture that a significant revaluation of the RMB brings mainly an adverse impact not only for China but also for the rest of the world. Instead, some alternative policy measures including an expansionary fiscal policy and/or expansionary supply side policies adopted in emerging Asia seem to be much effective in rebalancing trade with the US.

While most of the existing studies focus on the impact of economic integration on economic growth and intra-regional trade, Yap assesses the long-run relationships between economic integration and tourism exports. By using Johansen's Fisher panel cointegration test, the paper employs tourist arrivals data as a proxy for tourism exports and trade ratios as a proxy for the economic integration, and finds that tourist arrivals and trade ratios are cointegrated in four out of the nine selected ASEAN economies for the period 1996-2007. The paper concludes there is weak evidence that economic integration has significant influences on tourism exports in ASEAN.

The final paper by Kwan, Zhang and Zhuo examines the possible contributions of structural change, measured by labour reallocation from agriculture to non-agriculture, to the growth of total factor productivity (TFP) in China during the reform era. Building upon the framework developed by Temple and Wößmann (2006), this paper extends the framework in an attempt to better fit the reality of China which has experienced both rural industrialisation and urban industrialisation since the late 1970s. As there are substantial differentials of marginal product of labour in rural agriculture, rural non-agricultural and urban sectors, the authors in this study find that a three-sector model is theoretically more suitable to identify the role of labour reallocation to TFP growth in rural China.

The collection of articles in this special issue provides important insights into the ongoing transformation of the East Asian region. Hopefully these contributions will stimulate further research in issues related to globalisation and economic integration in this region.

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