Chapter Thirteen

The Asian Regional Economy

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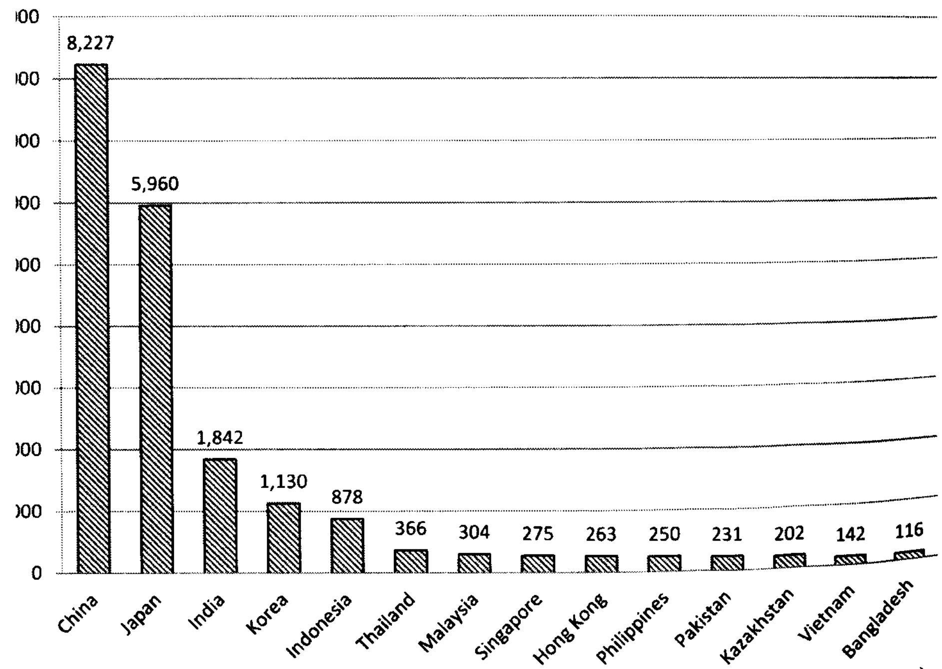
Asia captures the imagination as a dynamic part of the world, driven in part by very high growth in Japan for the first three decades after the Second World War and over thirty years of equally high growth in China since 1980. Today it is an engine of global growth.

Looking at the region as a whole, this chapter makes four major points. First, the region is characterized by extreme diversity in economic size and affluence among the various economies. That diversity makes the process of policy dialogue and cooperation more difficult (than, for example, in Europe). Second, while some economies in Asia have been the most dynamic in the world, economic growth has varied widely across the region. Still, growth in the region as a whole outpaced the world in the two decades from 1992 to 2012—as a consequence Asia as a whole expanded from 21 to 28 percent of global GDP over that time period. Third, many (but not all) countries around the region have had strengthening trade linkages with China. Interestingly, as ties with China have strengthened, those with Japan have generally weakened. Furthermore, broader trade linkages among the sub-regions of Asia are quite weak, and even within sub-regions, only East Asia is characterized by relatively strong intraregional trade ties. Fourth, regional policy dialogue and cooperation has expanded over the last two decades, but actual outcomes are generally weak and a plethora of overlapping dialogues characterizes the region, many of which include participants from outside the region.

THE ECONOMIC LANDSCAPE

One of the striking characteristics of this region is a huge range in size and affluence among the various economies. The common measure of economic output for a country is gross domestic product (GDP), the value of all goods and services produced in a country during a specific period of time (usually measured quarterly or annually). Figure 13.1 shows the size of annual GDP in the dozen largest Asian countries in 2012, with the output of each converted to US dollars at the average exchange rate between the local currency and the US dollar during the year. Market exchange rates provide an imperfect way to compare economies since these rates can sometimes make prices in a country seem unusually high or low. Nevertheless, market rates still provide a rough guide to comparing the size of countries in the region.

China has emerged as the economic giant of the region. At $8.3 trillion, China was the second-largest economy in the world, with a GDP that was 52 percent the size of the United States. China also represented a large 43 percent of the GDP of all of Asia. Japan, which had been the second-largest economy in the world for several decades, is now third, with a GDP of $6.0 trillion. Fundamentally, Asian GDP consists of the top five countries (China, Japan, India, South Korea, and Indonesia) and all the rest. For that reason,



gure 13.1. GDP, 2012, Measured in US Dollars at Market Exchange Rates (billions of dollars).
ırce: World Bank, World Development Indicators online database.

figure 13.1 reports the level of GDP for only twelve Asian economies, the rest ranging in size from $60 billion to only $6 billion. In relative economic terms, these smaller economies are truly tiny.

A second economic disparity in Asia is affluence. The region contains economies with high levels of economic affluence and very poor countries. The common measure that economists use is GDP divided by the total population (called GDP per capita), showing the total amount of goods and services produced in the economy per person. While GDP per capita is a crude method of measuring affluence (since not all of the output in the country ends up as household income), it provides at least a rough means of comparing countries. Figure 13.2 shows GDP per capita at market exchange rates for East Asian economies. Economists often prefer to use price-adjusted data

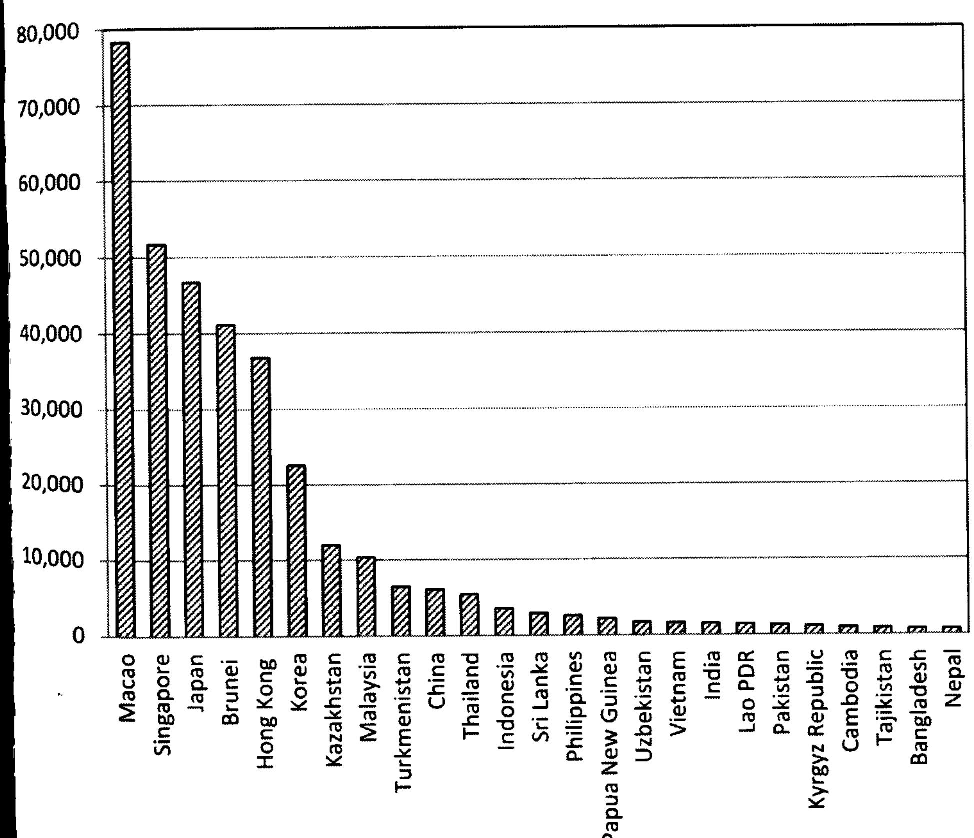


Figure 13.2. GDP per Capita, 2012 (US dollars at market exchange rates).
Source: World Bank, World Development Indicators online database.

(converting data from local currencies to dollars at what are called purchasing power parity exchange rates). The disparities in figure 13.2 would be somewhat smaller with this alternative approach, but the basic conclusions would remain the same.

Japan began modern economic development well before most other countries in the region and by the mid-1970s was by far the most affluent large economy in the region. Since then several other economies in the region have emerged as centers of affluence, and in 2012 the city-states of Macao and Singapore actually exceeded the level of GDP per capita in Japan. In 2012 Japan had a GDP per capita measured at market exchange rates of $46,720, or 94 percent the level of Singapore. At the bottom of the distribution are Cambodia, Tajikistan, Bangladesh, and Nepal, all below $1,000, placing them among the poorest nations in the world. China's GDP per capita was $6,091, placing it above many of the other countries in Asia.

These disparities matter when considering the possibilities for regional economic institution building. Economies that are somewhat similar in overall size or affluence share more common economic interests. Europe exemplifies a region where the disparities among the nations that originally formed the European Union were not very large. The very large disparities in Asia, on the other hand, have been an obstacle to developing institutions or region-wide economic cooperation. For example, affluent Japan (like all industrialized nations) protects its inefficient agricultural sector from imports. One particular source of friction between Japan and its Asian neighbors for many years has been Japan's policy of almost complete closure of its rice market to imports.

The final characteristic of the region is relatively high rates of economic growth. Economists argue that poor countries are capable of producing very high rates of economic growth if they can get the fundamentals for a modern market-based economy in place (along with other supporting factors such as political stability, strong education policies, and improved public health). Given the right institutional fundamentals, poor countries can accelerate growth by importing existing technology from abroad and combining it with inexpensive domestic labor. This process of "catch-up" can continue until available technology from abroad has been absorbed and growth has driven up domestic wages to levels similar to those in the advanced industrial nations. The experience of some Asian economies has provided the evidence for the possibilities for "catch-up."

The story of Asian growth begins with Japan. The process of industrialization in Japan stretches back to the 1870s, much earlier than most other economies in Asia. By the time of the Second World War, Japan had already come a long way, but it lost much of its industrial facilities in a wave of destruction

in the final year of the war. After the Second World War, a combination of rebuilding from wartime destruction and successful industrialization strategies resulted in the highest growth rate in the world—with an average real GDP growth rate (that is, after subtracting inflation) of almost 10 percent for the period from 1950 to 1973. This prolonged rapid growth brought Japan into the ranks of the advanced industrial nations, as noted earlier. Even after the mid-1970s, Japanese economic growth remained higher than that in the other advanced economies until the end of the 1980s.

Table 13.1 shows economic growth rates since 1980 for a number of Asian economies. The major story is the very high growth of China throughout this period, averaging at or close to 10 percent in all three periods shown in the table. However, since China was so poor when rapid growth began, it is still far from being an affluent nation, as indicated in the earlier discussion of GDP per capita. China ought to be able to continue its high growth for several

Table 13.1. Real GDP Growth Rates (percent)

	1980–1989	*1990–1999*	*2000–2012*
Bangladesh	3.2	4.8	5.9
Brunei	−2.4	2.1	1.6
Cambodia	NA	NA	8.0
China	9.8	10.0	10.0
Hong Kong	7.4	3.6	4.3
India	5.7	5.7	6.9
Indonesia	6.4	4.8	5.4
Japan	4.4	1.5	0.9
Kazakhstan	NA	−4.8	8.1
Korea, Rep.	7.7	6.3	4.3
Kyrgyz	NA	−3.4	4.0
Laos	NA	6.3	7.2
Macao	7.6	3.0	12.2
Malaysia	5.9	7.2	5.1
Nepal	4.1	4.8	4.2
Pakistan	6.9	4.0	4.4
Papua New Guinea	1.4	4.3	4.1
Philippines	2.0	2.8	4.8
Singapore	7.8	7.3	5.6
Sri Lanka	4.1	5.3	5.6
Tajikistan	NA	−9.3	8.2
Thailand	7.3	5.3	4.2
Turkmenistan	NA	1.2	8.4
Uzbekistan	NA	−0.3	6.9
Vietnam	4.5	7.4	7.0

Source: World Bank, World Development Indicators online database.

more decades, although it faces potential constraints from increasingly dysfunctional air and water pollution, as well as a population that is now aging rapidly.

Growth in Japan, in contrast, has been quite low for much of this period. As an advanced industrialized nation by the mid-1970s, Japan could no longer grow at high rates. But a series of problems—a real estate and stock market price bubble in the late 1980s, poor policy response to the collapses of the bubble, the 2008 global recession, and the devastating earthquake and tsunami in 2011—all conspired to keep Japanese growth below its potential for most of the period since the early 1990s.

India, the other population giant in Asia, has not grown as rapidly as China. From the 1950s until the mid-1990s, India favored a development strategy called "import substitution," in which the government establishes barriers to imports and to inward investment by foreign firms in order to stimulate the growth of domestically owned firms. This strategy was not very successful, as is the case in most developing countries that have tried it. Rather than promoting domestic growth, this strategy tends to produce very inefficient domestic firms that actually impede growth beyond a certain point. Since the mid-1990s, India has lowered import barriers and encouraged investment by foreign firms. As a result, table 13.1 shows that Indian growth has accelerated from an average of 5.7 percent in the 1990s to 6.9 percent in the 2000–12 period. This acceleration is encouraging, though still below the performance of China.

Growth in the rest of the Asian economies in this table is mixed. On average, they have grown relatively fast (and faster than the averages in other parts of the developing world in Latin America, Africa, the Middle East, and Eastern Europe), but not as fast as China. Some of these countries, and especially Thailand, Indonesia, and South Korea, were hit by the Asian financial crisis of 1997, although the negative impact of that crisis was short-lived. However, average growth in the years from 2000 to the present has been generally somewhat lower than in the decade prior to the crisis.

Growth in South Asian countries other than India has generally not been high, due to factors such as the political problems in Pakistan. Bangladesh has begun to emerge as a major exporter of textiles, and that boosted its growth to an average of 5.7 percent since 2000. The Central Asian nations experienced negative growth in the 1990s (probably due to the shock of the breakup of the Soviet Union) but recovered after 2000 as they developed exports of raw materials.

Trade Flows

A principal reason people think of Asia as an emerging cohesive region is rising intraregional trade linkages. However, much of that perception is due

to the rapid rise of China as a trading partner for all other nations in the region. This shift is due to both China's rapid economic growth (with an economy producing more goods to sell to the world, and absorbing more goods from the rest of the world) and to increased openness to trade as the ratios of both imports and exports to GDP increased substantially. China's rise as a trade partner actually affects many nations in the world, including the United States and others outside Asia.

While ties with China have risen for many economies around the region, the rest of the trade story does not suggest that Asia is becoming a more tightly knit economic bloc. Offsetting the rising importance of China has been an equally remarkable fall in the relative importance of trade with Japan. Furthermore, linkages among the several sub-regions of Asia remain weak. East Asia, for example, has had thin trade ties with South Asia. And the nations of Central Asia have their major trade ties with Russia and Europe (and now China), with relatively little trade with East Asia or South Asia. Even within these sub-regions, intraregional trade ties have been generally weak except in the case of East Asia.

The pattern of increased relative importance of trade with China is most evident when looking at Japan. Figure 13.3 shows Japan's imports. In the twenty-plus years since 1990, the share of Japan's imports coming from the

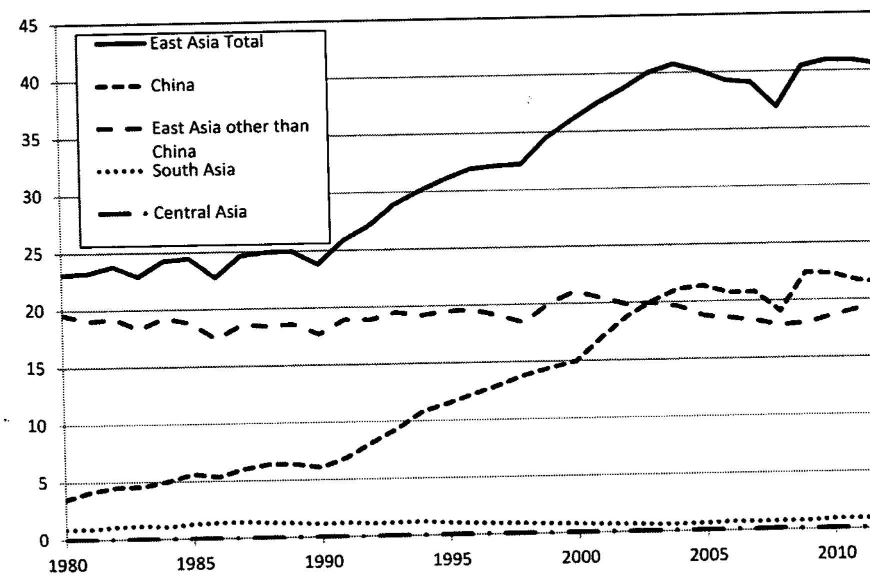


Figure 13.3. Japan's Imports from Asia (percent of total imports).
Source: International Monetary Fund, Direction of Trade online database.

rest of East Asia has steadily increased, from a level of 24 percent to almost 40 percent, a very sizable increase. However, all of that increase is due to imports from only one country: China. Japan's imports from East Asia other than China were no higher as a share of total imports in 2012 than they were in 1980. Equally important, imports from both South Asia and Central Asia represent a very low share of Japan's imports (1 percent for South Asia and less than 1 percent for Central Asia). The opportunity for expanding economic ties with India has been a major topic of discussion in Japan for the past several years, but these data indicate that virtually no change has occurred in the relative importance of India as a source of imports.

The picture for Japan's exports is essentially the same as for imports, as shown in figure 13.4. Once again, all of East Asia has been an increasingly important destination for Japanese exports, rising from 20 percent of total exports in the first half of the 1980s almost 45 percent by 2012. In this case, East Asia other than China absorbed an increasing share of Japanese exports, rising from 12 percent to 20 percent from 1980 to 1995, but no increase has occurred since then. These trends in Japan's trade help explain why the Japanese have been leaders in talking about the desirability of dialogue and cooperation among East Asian governments. The Japanese government has also

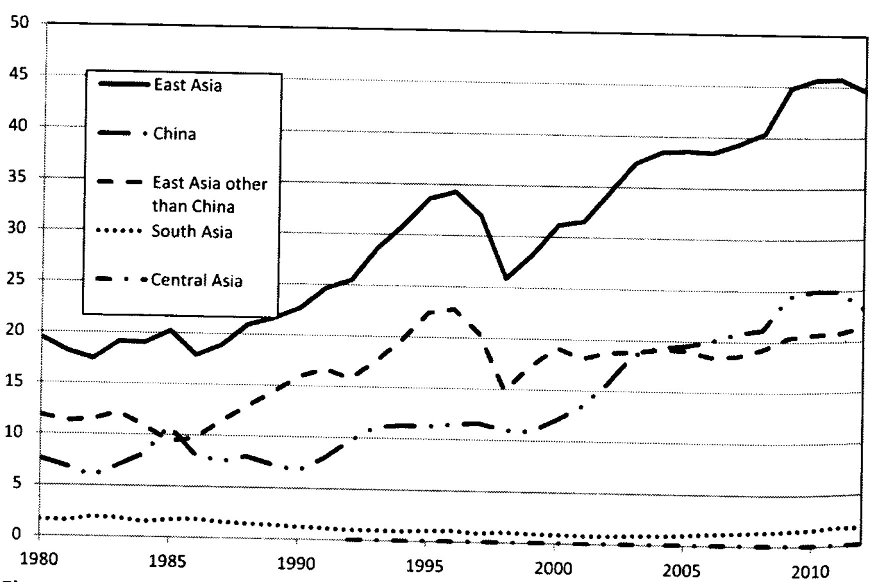


Figure 13.4. Japan's Exports (percent of total exports).

Source: International Monetary Fund, Direction of Trade Statistics online database.

expressed increased interest in promoting trade with both India and the Central Asian nations. However, as figure 13.5 shows clearly, very little of Japan's total exports goes to either South Asia or Central Asia. To be sure, exports to South Asia did increase a bit after 2005, but only from 1 percent of total exports to 2 percent.

Figure 13.5 shows ASEAN imports, a sub-region of Asia that has also experienced rising trade with China. For the sake of brevity, the discussion of ASEAN, South Asia, and Central Asia will focus on either exports or imports rather than both as in the case of the discussion above of Japan. Imports from China were only about 5 percent of total imports from 1980 through the early 1990s, but then began rising rapidly, reaching 18 percent of total imports by 2012. Imports from Japan, in sharp contrast, fell sharply after 1995, dropping from 26 percent to 13 percent.

Equally interesting is the rise of intraregional trade within ASEAN. Imports from other ASEAN countries as a share of total imports rose from roughly 15 percent of total imports in the 1980s to 27 percent by 2012. This rise is likely due in part to the implementation of the ASEAN Free Trade Area (AFTA) even though that agreement is generally considered by economists to be somewhat weak.

In contrast to the linkages with Japan and China, imports from South Asia are low (only 3 percent of total imports in 2012) while imports from Central

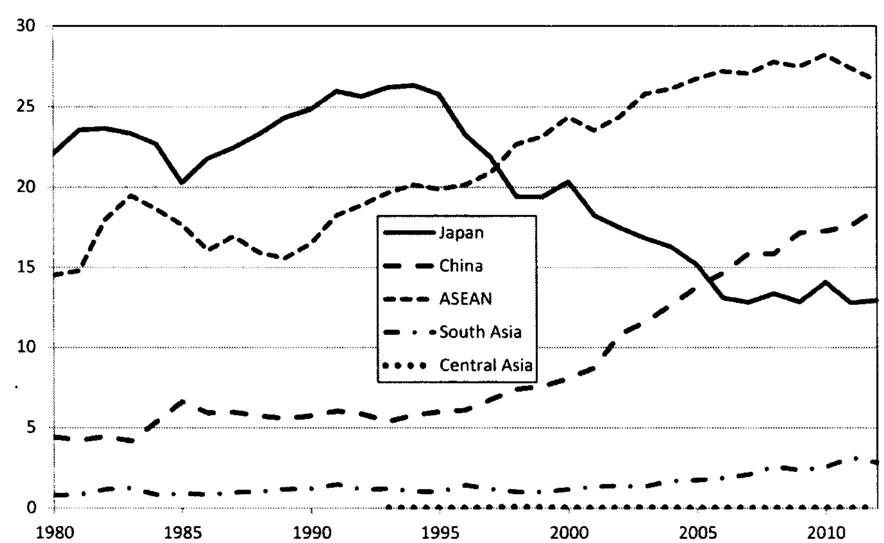


Figure 13.5. ASEAN Imports (percent of total imports).

Source: International Monetary Fund, Direction of Trade Statistics online database.

Asia were less than 1 percent. The weakness of trade ties with South Asia is somewhat surprising given the geographical proximity of at least some ASEAN members to South Asia.

Consistent with what the data for Japan and ASEAN show, export data for South Asia show relatively little connection to other parts of Asia. Figure 13.6 shows South Asian exports. East Asia as a whole absorbs a quarter of South Asian exports, but that share has not expanded over the thirty-plus years in the figure. Furthermore, neither Japan nor China individually are major export destinations. Exports to China have risen as a share of total exports, but not as dramatically as in the case of either Japan or ASEAN (rising from 5 percent to 10 percent of total exports over the 1980–2012 time period). Exports to ASEAN behaved very much like those to China, rising from 5 percent to 10 percent of total exports. The rise in the share of exports to China and ASEAN is more than fully offset by a drop in exports to Japan (which fell from a peak of 15 percent in 1990 to only 3 percent by 2012).

Trade among South Asian countries is also low, hovering around 5 percent of total exports throughout this long time period. The history of political tensions between India and Pakistan may partially explain this low ratio. Nonetheless, the contrast between rising intraregional trade within ASEAN and the

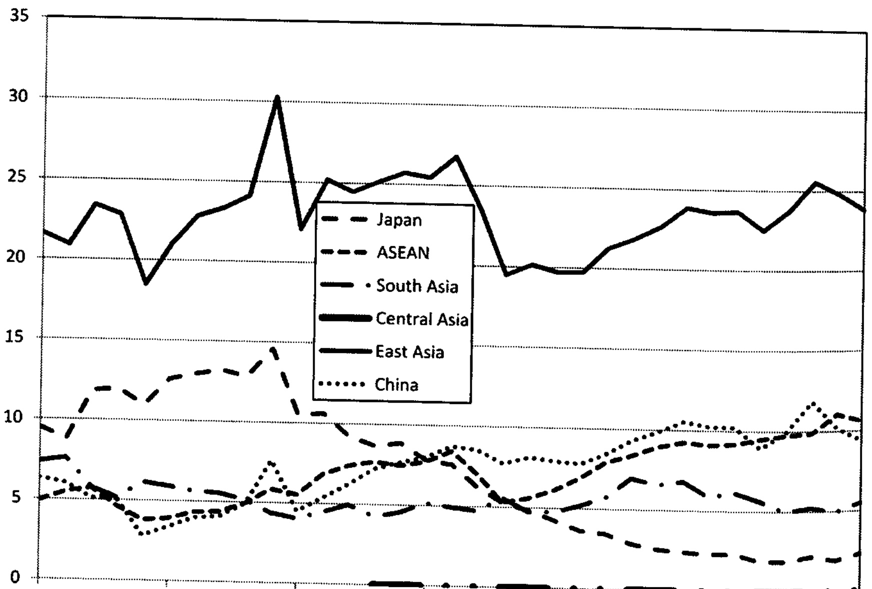


Figure 13.6. South Asia Exports (percent of total exports).

Source: International Monetary Fund, Direction of Trade Statistics online database.

lack of such trade within South Asia is quite striking. Finally, South Asia has virtually no exports to Central Asia, accounting for less than 1 percent of total exports.

Data for Central Asia confirm the lack of a strong connection to most of the rest of Asia, with the exception of China. In this case, statistical data go back only to 1992, when the Central Asian nations gained their independence with the breakup of the Soviet Union. As shown in figure 13.7, exports to Japan (only 1 percent of total exports in 2012), ASEAN (less than 1 percent), and South Asia (2 percent) are all very small shares of total exports. As is the case within South Asia, intraregional trade in Central Asia is also low. Central Asian exports to other Central Asian countries were only 5 percent of total exports in 2012, a lower share than in the 1990s.

The one exception to this picture of weak trade linkages with the rest of Asia is the rapid rise in exports to neighboring China. From a level of 5 percent in the late 1990s, the share of exports to China began rising rapidly after 2001, reaching 28 percent by 2013. Driving this increase has been China's rapidly increasing need for raw materials supplied by these nations (particularly metals, rare earths, and uranium) over the past decade.

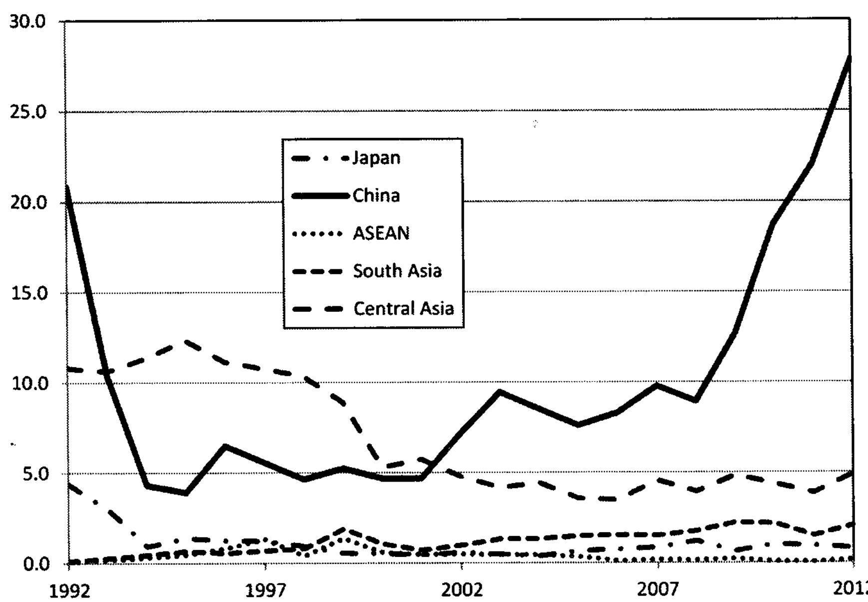


Figure 13.7. Central Asia Exports (percent of total exports).

Source: International Monetary Fund, Direction of Trade Statistics online database.

What about China itself? As other nations in the region have experienced rising trade linkages with China, has the same been true for China's ties to the rest of the region? Figure 13.8 shows the pattern of China's exports. China is defined as the sum of exports from China, Hong Kong, and Macao, with the trade among these three deducted from their global exports to avoid double counting. The principal reason for treating these three together as China is due to the very large share of trade for Hong Kong and Macao that is simply transshipment of goods destined ultimately for mainland China or the rest of the world. The data for China indicate two principal developments: the share of exports destined for Japan has fallen substantially since 2000, and the relative size of trade with the rest of Asia has not changed very much. The shares of exports to ASEAN, South Asia, and Central Asia have all risen since 2000, but only by one to two percentage points. The very low share of exports to Central Asia (only 1 percent of China's exports in 2012) can be explained partly by the small size of these countries. Thus, while exports from Central Asia to China have risen sharply as a share of Central Asian exports, the reverse increase in China's exports to these countries is small in the context of total Chinese exports. But it is more difficult to explain the very low share of exports to South Asia (only 4 percent in 2012). For two large economies

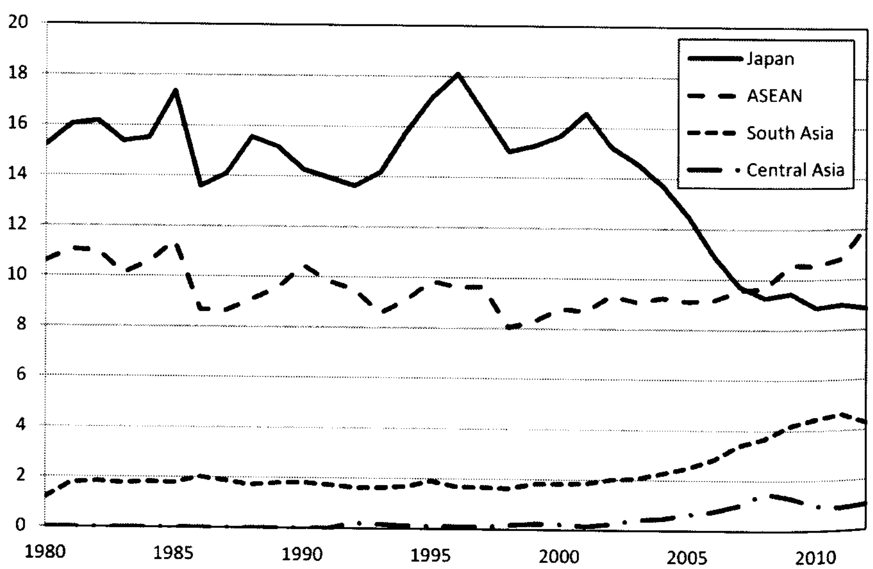


Figure 13.8. China's Exports (percent of total exports).

Source: International Monetary Fund, Direction of Trade Statistics online database.

this is a surprisingly low ratio, perhaps indicative of troubled political relations.

The same flat trend is true for China's imports, shown in figure 13.9. Imports from East Asia as a whole have fluctuated in a narrow band of 40 to 45 percent of total exports and were somewhat lower in 2012 than in 1985. That drop was due to a very sharp downward shift for imports from Japan, with the share of imports sourced from Japan peaking in 1985 at 37 percent (a very high ratio) and then falling rather steadily to only 10 percent by 2012. Imports from ASEAN, on the other hand, rose modestly from 8 percent in 1980 to 13 percent in 2012 (and, while not shown, the share of imports from South Korea also rose). As with China's exports, imports from South Asia and Central Asia have each remained in the range of 1 percent of total imports.

These trade data for countries and sub-regions of Asia lead to several conclusions. First, much of what appears to be a rising East Asian bloc is due to the very rapid rise of China as a trade partner. This, however, is true for all countries that trade with China, not just those in East Asia. The combination of very rapid economic growth and the expansion of both exports and imports as a share of GDP has resulted in this stunning growth of China as a trade partner. The only partial exception is South Asia, where the rise in the trade linkage with China was less dramatic.

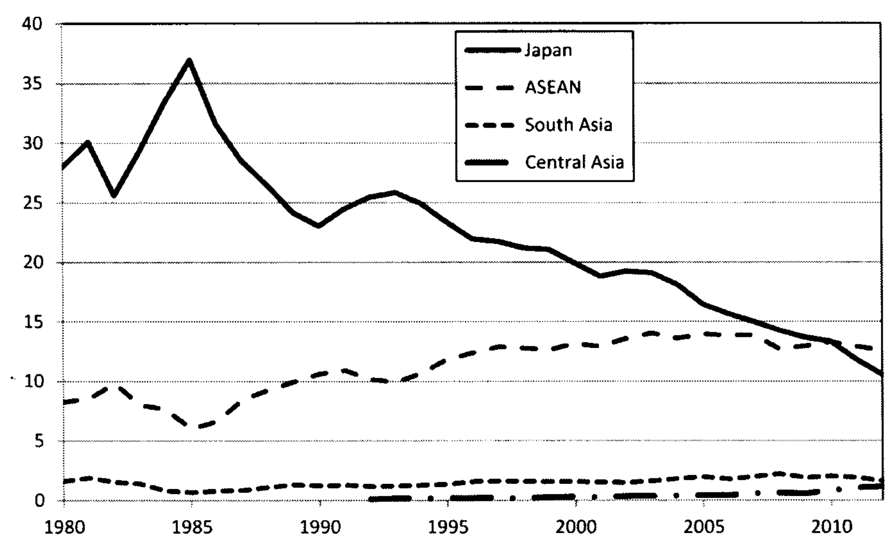


Figure 13.9. China's Imports (percent of total imports).

Source: International Monetary Fund, Direction of Trade Statistics online database.

Second, at the same time that China has become a more important trading partner, Japan has shrunk in relative importance. The rest of Asia is much less connected to Japan through trade today than was the case twenty years earlier. This trend is important because the initial American interest in an emerging East Asian region was driven by the notion of a region coalescing around Japan.[1] The Japanese certainly saw themselves as de facto informal leaders in the Asian region as a consequence of their economic size, affluence, and strong trade ties. That self-perception has diminished. Japan's slow economic growth since the early 1990s explains why it has become a less important export destination for regional exports (relative to the more rapid growth that has sucked in more imports in China and elsewhere). A rising value for Japan's currency (the yen) against other currencies since the mid-1980s also explains why Japan has declined relatively as a source for regional imports (as Japanese products have become more expensive due to the exchange rate movement).

Third, part of what is happening is the result of changing production location. The relocation of Japanese manufacturing production from high-cost Japan to lower-cost ASEAN, for example, should explain much of the decline of Japan as a relative source of China's imports since 1985 (with rising imports from Japanese firms producing in ASEAN substituting for imports directly from Japan). As a result, Japanese firms are still important in explaining regional trade developments even though Japan as a nation has become less important as a trade partner.

Fourth, implicit in the trade data is a continuing importance of nations and regions outside Asia. For the sake of clarity, the figures presented do not show trade with the United States and Europe. But for much of the region, both the United States and Europe remain vitally important trade partners. To provide just one example of this, in 2012, 12 percent of India's exports went to the United States, 17 percent to the EU, and 21 percent to the Middle East and North Africa. These percentages are larger than the share of India's exports to any individual country or sub-region of Asia. For the Central Asian nations, the picture is a bit different, with the United States somewhat less important, while Russia and Europe are the main trade partners.

Trade Policy

Global trade is loosely governed by the World Trade Organization (WTO), which presides over global trade negotiations in which all members agree to mutual reductions in trade barriers. A number of these negotiations have occurred in the years since 1947 when the organization was originally formed (then called the General Agreement on Tariffs and Trade). However, the

WTO permits pairs or groups of its members to negotiate so-called free trade agreements among themselves (not offered to all the other members of the WTO), as long as they remove substantially all the barriers among themselves. These agreements have become quite popular around the world in the past two decades. East Asia is no exception, especially in the years since 2000.

Some of these agreements have been within the region—the ASEAN Free Trade Area (AFTA), Japan-Singapore, and others. China, Japan, and India each have agreements with ASEAN. India has individual agreements with Japan and South Korea. Those agreements give the image of a region that is coming closer together as a distinctive economic bloc. Nevertheless, many of these individual agreements are between governments within the region and partners outside (South Korea–Chile, India-Chile, Japan-Mexico, Singapore–United States, and others). The real impact of such agreements in making the region a more cohesive whole, therefore, is still unclear.

This diversity of intra- and extraregional approaches continues. In 2013, there were two principal regional free trade negotiations occurring that involved Asian governments. One was the Trans-Pacific Partnership (TPP) negotiations, which involved eleven governments (Australia, Brunei, Chile, Canada, Japan, Malaysia, Mexico, New Zealand, the Philippines, Singapore, the United States, and Vietnam).[2] The other was the Regional Comprehensive Economic Partnership (RCEP), which involved the ASEAN members, Australia, China, India, Japan, South Korea, and New Zealand.[3] While RCEP was more clearly centered on governments in Asia, note that it included Australia and New Zealand, two countries not normally included as part of Asia. Note also that these two negotiations have a number of overlapping participants. Of the two negotiations, TPP is more likely to yield an agreement that will have a significant impact because of strong pressure and more participants in order for the agreement to be robust, in contrast to a number of the bilateral and sub-regional agreements worked out within Asia. The one major lack in TPP is the absence of China, but participants have been clear to indicate that other nations, including China, are welcome to join the agreement in the future.

The diversity of intra- and extraregional agreements and negotiations also reflects the simple reality of the trade data: with the United States, EU, and other economies outside Asia continuing as major trade partners for nations within Asia, there is no reason to limit free trade agreements only to partners within the region. What many countries want is better access to the US market, and they are aware that negotiations with China or Japan (without the US government as a participant) are less likely to yield agreements that fully open markets to their exports.

The same lack of geographical clarity exists for less formal discussions of economic policy. The oldest group, the Asia-Pacific Economic Cooperation (APEC) meetings, began in 1989 and includes the United States, Australia, Canada, and other governments not part of East Asia. APEC members discuss a number of broad economic issues, but the organization has worked through a principle of voluntary implementation of decisions (unlike a free trade area where the agreements are binding on the member countries). Since 1993, APEC has included an annual summit meeting (in addition to the existing ministerial and working-level meetings), often marking the one time a year that the American president travels to East Asia.

The ASEAN + 3 group (ASEAN plus Japan, China, and South Korea) began meeting at the ministerial level in 1995, added a summit meeting in 1997, and was deliberately begun to be a rival or alternative to APEC for East Asian governments. This purely (East) Asian grouping was motivated in part by both a general desire to foster a sense of Asian commonality and anger with the dominance of the United States (particularly over American and International Monetary Fund reaction to the Asian financial crisis in 1997). In structure the two groups are quite similar—discussing a number of economic issues but reaching non-binding decisions. The most substantial decision emerging from this group was the Chiang Mai Initiative (discussed later in this chapter).

Even though the ASEAN + 3 group was intended to be an East Asian alternative to the APEC discussion, it has evolved in a more inclusive direction. Beginning in 2005, an East Asia Summit meeting has been held immediately upon the annual ASEAN + 3 discussions. In addition to the ASEAN + 3 members, the initial East Asia Summit added Australia, New Zealand, and India. A key motivation for this new organization was the desire of Japan and some other governments to add another very large country (in terms of population and GDP) to the discussion to diminish the dominance of China. However, the membership of the East Asia Summit continued to expand. Beginning in 2011, both Russia and the United States were invited to join the group.

Note that none of these groups includes any governments in South Asia other than India, nor any of the Central Asian nations. China has its own dialogue with Central Asia, through the Shanghai Cooperation Organization (SCO), which also includes Russia as a member. This group began in 1996 (without Uzbekistan and under a different name) and became the SCO in 2001.

All of these groups have a strong focus on economic issues, although all of them have gained a substantial role in discussing diplomatic and security issues over the years. None of them have had major accomplishments on the economic front. The action on trade has been left to the plethora of free trade negotiations discussed earlier. These groups have mainly been forums for discussion and information sharing, with some action on trade facilitation (such as streamlining customs procedures) or development deals (such as highway construction in Central Asia).

Whether the institutional developments that bring the region together will proceed, predominantly through a broad approach that includes the United States, Australia, and others on the Pacific Rim (as in the APEC grouping) or more narrowly along an Asian format, remains unclear. Nonetheless, the gradual direction of evolution appears to be to include participants from outside Asia (such as Australia, New Zealand, the United States, and Russia). The desire to create organizations just for Asians, partly as a rebuke to American dominance, that was popular in the late 1980s and 1990s appears to have faded.

Direct Investment

Trade is not the only way in which economies interact. Foreign direct investment (FDI) is also important. This form of investment involves companies owning subsidiaries in other countries (in which they have a sufficient ownership stake to control the management, with 100 percent ownership the preferred format but not necessary for control). FDI data, much like the trade data, show some intraregional activity, but high levels of involvement by American and European firms as well.

Back in the 1980s and early 1990s, the main development was a new, large wave of Japanese investment around the region. Particularly after the yen had risen strongly against the dollar in 1985, Japanese manufacturers were eager to relocate production to countries with lower labor costs. East Asian nations were a natural choice (since investing there involved crossing fewer time zones, easing the task of managing factories abroad). Some Japanese firms are well known for having established strong regional production networks, especially in the electronics industry. However, the Japanese investment wave diminished after the early 1990s (with many firms facing difficulties at home in Japan due to the collapse of the stock market and real estate price bubbles and the subsequent period of very low economic growth). Furthermore, Japanese foreign direct investment within Asia was almost entirely located in East Asia. Meanwhile, other investors from outside the region have remained important, and China has now begun to emerge as a small but growing investor.[4]

China represents a somewhat exceptional case to the main pattern of inward investments in the region. Figure 13.10 shows cumulative foreign

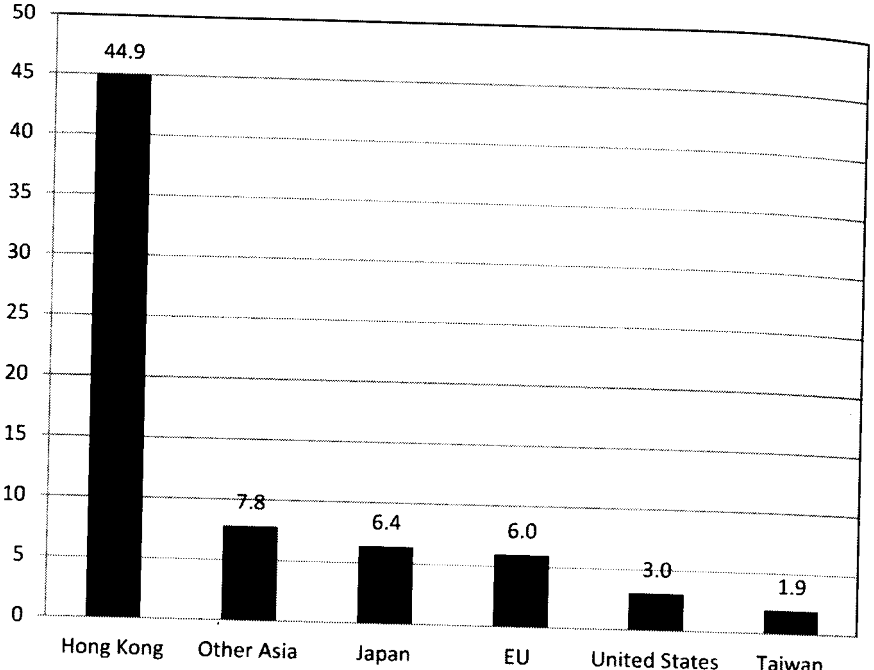


Figure 13.10. Cumulative Foreign Direct Investment into China, 2011 (percent of total).

Source: International Monetary Fund, Coordinated Direct Investment Survey online database.

direct investment in China for 2011. The main difficulty in evaluating these data is Hong Kong; it is the source of 45 percent of total investments into China, but much of that amount represents investments passing through Hong Kong (including Taiwan, which appears in the figure to be an improbably small investor in China at only 2 percent of total investments). One can cautiously conclude, though, that investments from elsewhere in Asia are important, forming another economic link between the region and China. But the uncertainty caused by the routing of money through Hong Kong makes it impossible to say anything about the relative importance of the nationality of investors.

Figure 13.11 shows foreign direct investment flows into ASEAN, comparing 1995–2000, 2001–2005, and 2006–2011. The largest investors in ASEAN are European firms (19 percent of the total value of foreign direct investment flowing into ASEAN in the 2006–11 period), followed by Japan (12 percent) and the United States (9 percent). The relative share of Japanese firms fell from the level of the 1990s (19 percent of inflows to ASEAN in the

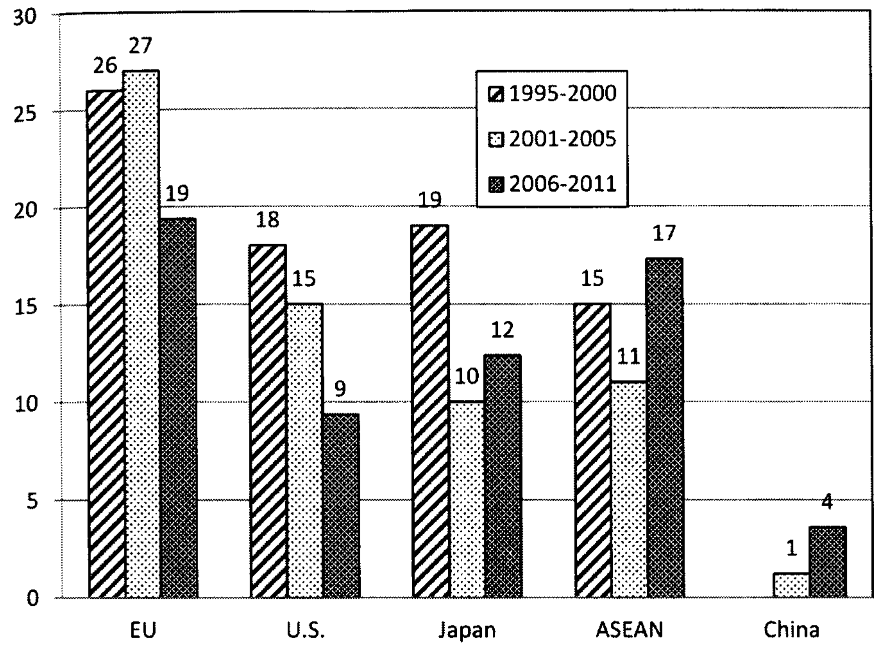


Figure 13.11. Foreign Direct Investment Flow into ASEAN (percent of total).

Source: ASEAN Statistical Yearbook 2010, 110; and ASEAN, Foreign Direct Investment Statistics, http://www.asean.org/news/item/foreign-direct-investment-statistics (accessed September 11, 2013).

1995–2000 period) and has not recovered to that level of importance. Whether the creation of the ASEAN Free Trade Area has had an impact on increased intra-ASEAN investment flows is somewhat unclear (since the share of investment from within ASEAN fell in the first half of the 2000s but then rose, reaching 17 percent of total inflows in the 2006–11 period). Most of the intraregional investment is from Singapore, the affluent member of ASEAN.

Investments in India also illustrate the importance of non-Asian sources of inward direct investment. Figure 13.12 shows the sources of cumulative direct investment in India. Evaluation is complicated by the fact that the largest source of investment is Mauritius, and clearly this represents money simply passing through for tax purposes. With that caveat in mind, the largest sources of investment in India are Britain (18 percent), the rest of the EU (20 percent), and the United States (17 percent). Japan (6 percent) and Singapore (5 percent) are the only significant Asian investors in India, and their shares of the total are far below those of the United States and European investors.

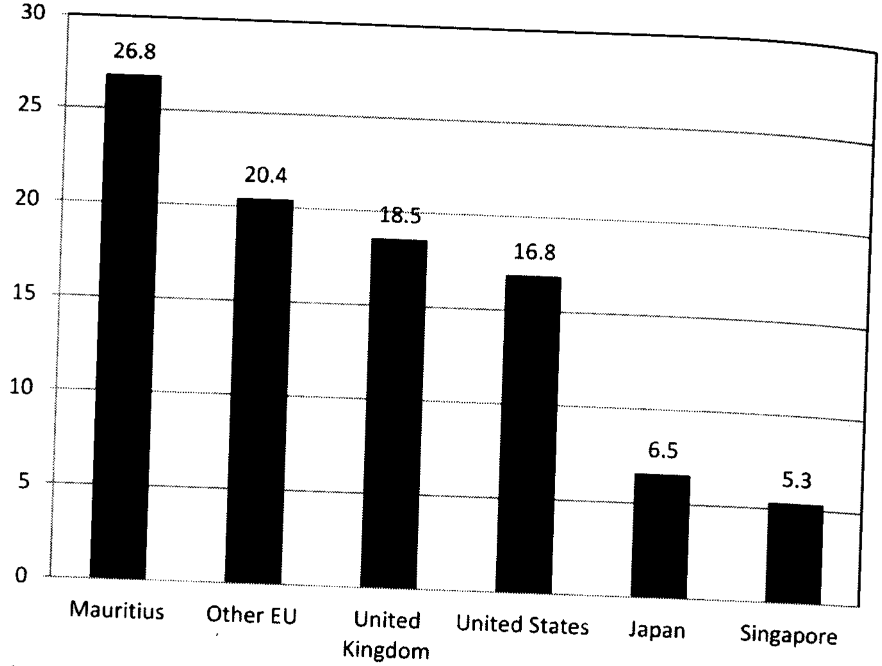


Figure 13.12. Cumulative Foreign Direct Investment in India (percent of total investment).

Source: International Monetary Fund, Coordinated Direct Investment Survey online database.

China, South Korea, and Hong Kong are each less than 1 percent of investments into India.

This same pattern applies to Central Asia, as illustrated by investments into Kazakhstan, the largest of the countries in the region. Figure 13.13 shows cumulative foreign direct investment in Kazakhstan as of 2011. Overall, foreign firms had cumulative investments in Kazakhstan of $96 billion, driven mainly by investments in raw materials (especially uranium). The big investors in Kazakhstan are from the Netherlands, and the total for all of Europe is a very high 55 percent. American firms come next at 15 percent. Although both Chinese and Japanese firms have invested in Kazakhstan because of their own interest in access to raw materials, neither represented a substantial share of inward investments.

The overall pattern of foreign direct investment should not be surprising. Firms of large industrialized countries dominate global direct investments. Japanese firms certainly fit in that category, and they have been active in investing, although the bulk of their investments are in other developed countries and within Asia are concentrated in East Asia. Other than the special

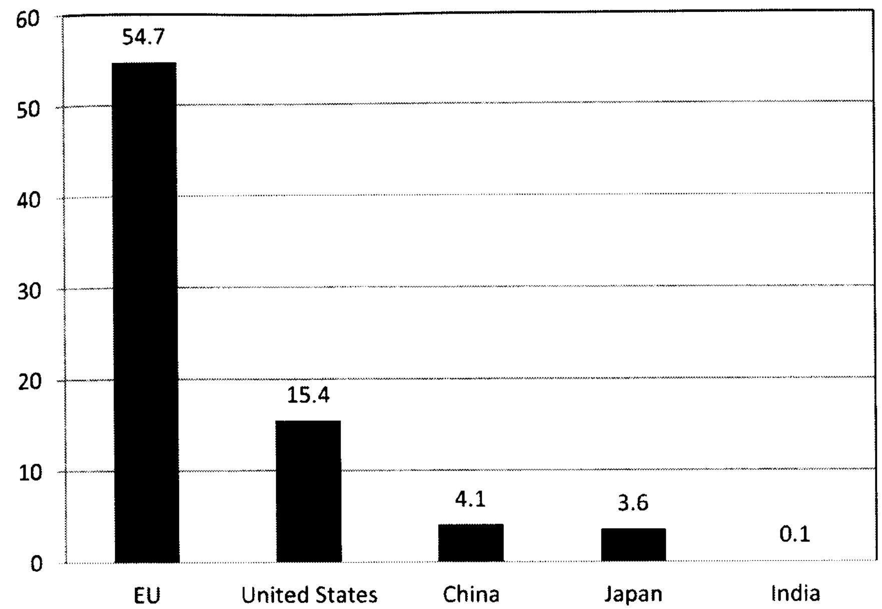


Figure 13.13. Cumulative Foreign Direct Investment in Kazakhstan (percent of total investment).

Source: International Monetary Fund, Coordinated Direct Investment Survey online database.

case of China, investments are dominated by American and European firms. The Chinese have very recently begun to invest abroad, mainly to gain access to raw materials. The Central Asian countries are an obvious geographically close source of some raw materials, but Chinese firms have lagged far behind the dominant European and American investors.

Financial Cooperation

The Asian financial crisis of 1997 resulted in drastic currency devaluations and a short but sharp recession in some countries (particularly Thailand, Indonesia, and South Korea). One consequence of that episode was a regional discussion of currency cooperation. The major outcome of that discussion was an agreement in 2000 for central banks in participating countries to expand "swap agreements" with various partners in Asia. A swap agreement is one in which the central bank of one country agrees that under certain circumstances it will lend foreign exchange reserves to another country for the purposes of intervening in foreign exchange markets to defend its currency. This agreement, called the Chiang Mai Initiative (CMI), meant for example that Thailand could borrow US dollars from the central bank of Japan in order to defend the Thai baht in currency markets.[5]

In the years since 2000, the CMI has expanded in amount and format. Originally the agreement concerned strictly bilateral swap agreements, but in 2010 the amounts were pooled in a common fund. Thus if Thailand wanted to borrow it could go to the common fund rather than individually to the central banks of Japan, China, and South Korea. As of 2013, the total amount in the pooled fund was $120 billion, of which 80 percent was pledged by China, Hong Kong, Japan, and South Korea. The other participants in the agreement are all of the ASEAN countries, whose small pledges make up the other 20 percent of the fund.

Optimists have seen the Chiang Mai Initiative as leading over a period of several decades to the kind of tight financial integration that characterizes the European Union, with its common currency.[6] A unified currency would remove currency fluctuations in the region and presumably thereby increase the flow of trade and investment (since exporters, importers, and investors would not need to worry about losing profits through an unexpected movement in exchange rates). However, there are several reasons for viewing the Chiang Mai Initiative as a very small step in regional cooperation.

First, participation in the CMI includes only some of the countries in Asia, entirely within East Asia. There has been no discussion of extending participation in this agreement to either South or Central Asian governments.

Second, the agreement has been entirely symbolic so far. In the thirteen years since the original CMI agreement was signed, the swap agreements have never been activated. During the global recession of 2008–9, the South Korean government asked the Japanese government to activate its bilateral CMI swap agreement, borrowing dollars from the Bank of Japan to defend a weakening South Korean won, but the Japanese government refused. Thus, the agreement stands as a symbol of the ability of Asian governments to reach an agreement on financial cooperation outside the framework of the IMF and without the United States, but it has had no real impact.

Third, as more countries in Asia move to floating (or at least flexible) exchange rates, the need for such an agreement has diminished. Swap agreements provide funds for governments to defend a fixed exchange rate (often unwisely), but in a market where exchange rates respond daily or at least frequently to market pressures, the usefulness of intervention is reduced. That is, foreign investors sometimes invest in developing countries with fixed exchange rates based on the belief that they face zero risk to their investments from currency fluctuation. They then pull their money out massively if they believe the fixed-rate guarantee is becoming untenable. But with a floating or flexible exchange rate, investors know they face currency risk and therefore

behave in a more prudent fashion. The kind of mass exodus of funds from a developing country as investors suddenly realize that their assumption of a fixed rate may be incorrect simply does not occur when exchange rates are continuously changing.

In the longer run, it is also difficult to envision anything resembling the Eurozone emerging in Asia, for two important reasons. First, the only way to manage currency unification is through a single central bank (the European Central Bank in the case of the Eurozone). It is difficult to imagine any of the governments in Asia ceding control over their domestic monetary policy to a common Asian central bank. This skepticism applies especially to the economic giants of the region, particularly to Japan and China, as they would struggle bitterly over political control of the bank.

Second, even if a common central bank could be created, the extreme diversity of economic growth rates, inflation, and levels of affluence all make a common currency virtually impossible. Fast-growing developing nations (such as China) and slow-growing mature economies (such as Japan) have very different macroeconomic conditions and needs for interest rates or inflation. Thus, aside from the purely political struggle over who would control the bank, the underlying divergent preferences or needs for monetary policy militate against strong cooperation. The only reasonable conclusion is that discussion of currency and other forms of financial cooperation in Asia will remain theoretical—the stuff of international conferences but not policy action.

CONCLUSION

The economic story of Asia over the past half century has been a remarkable one. Rapid economic growth, beginning with Japan and then spreading to a number of other countries in the region, has transformed the lives of hundreds of millions of people. Japan, of course, is not growing quickly now, but the main explanation lies in the fact that it is a mature, advanced industrial nation with a very high level of affluence. China has been the most remarkable growth story in recent decades, although it faces challenges in the near future from both environmental problems and an eventual decline in population. India appears to have shrugged off its economic sluggishness of the past as economic reforms have taken place and economic growth has accelerated.

Nonetheless, the economic success of Asia should not be exaggerated. While some economies have had remarkable success, others have not, and the region continues to have a wide disparity in levels of affluence as well as in rates of economic growth. In Central Asia, economic performance has improved over time, as these countries overcame the initial shock of becoming independent. In Southeast Asia, growth rates declined somewhat from the high averages that prevailed prior to the Asian financial crisis of 1997. In South Asia, some have shown accelerated growth (Sri Lanka and Bangladesh) while others have not (Pakistan and Nepal).

In general, those nations that have attained political stability, embraced reforms supporting market-based economic activity, lowered import barriers, and accepted inward foreign direct investment have been the most successful. Barring disruptions from military conflict or some unexpected global economic crisis, rapid growth should continue in much of the region in the coming decade. However, a number of countries are now facing adverse demographic change. In Japan the population is already falling and rapidly aging (with a very rapid increase in the share of the population aged sixty-five or above), all driven by a very low birth rate over the past several decades. South Korea has a similarly low birth rate and faces a shrinking population in the near future, although it has been more accepting of immigration than Japan as an offset to the low birth rate. China is the third country with a low birth rate. The population continues to grow, but the share of those aged sixty-five and above is rising and total population will peak within another decade or two.

The picture of regional economic interactions is mixed. In general the region has become more closely tied to China through trade (although even this growing interdependence is not characteristic of South Asian nations, which have quite limited trade ties with China). As trade linkages with China have risen, those with Japan have fallen. To be sure, Japanese firms have invested around the region, with local production substituting for trade in some cases. Nonetheless, the Japanese do not stand out as the dominant investors around the region, with investors from outside Asia often investing as much or more than the Japanese. As a developing economy, China has not played much of a role investing in the rest of the region except for some activity in Central Asia driven by raw material access. China's interest in raw material investments will probably grow in the next decade, but overall its role as a source of direct investment will not increase substantially until wages rise to a point where Chinese firms find it advantageous to relocate production abroad.

The picture of regional institutions and policy coordination is also mixed at best. Most regional organizations have been more important in fostering familiarity and discussion than in creating agreements that yield greater interaction. Even the one agreement that has attracted considerable attention, the Chiang Mai Initiative, has been entirely symbolic since it has not been used. To be sure, free trade agreements have proliferated, but many of these are

with partners outside the region. Even with organizations focused on general discussion, no clearly defined Asian approach has emerged. ASEAN + 3 began as a deliberate effort to create an organization that included only East Asian members, but now the East Asia Summit includes several non-Asian participants.

Forecasting what will happen to the region over the next decade is difficult. The demographic challenge certainly implies that Japan will continue to grow very slowly—perhaps no more than 1 percent per year on average. China's growth may slow too somewhat as the economy copes with aging, pollution problems, and a shift away from the most labor-intensive industries (as wages continue to increase). Southeast Asia should continue to grow rapidly, perhaps helped by relocation of some foreign investments away from China (as wages in Vietnam and some other Southeast nations look increasingly attractive to investors relative to China). India should continue to perform well, but its problem in providing sufficient infrastructure to support economic growth will probably hold growth below the Chinese level in the coming decade. For South Asia as a whole, an additional key element is peace or conflict, both within Afghanistan and Pakistan and between Pakistan and India. The potential gains from expanded intraregional trade in South Asia should be significant, but they have clearly been held back by conflict in the region. Central Asia may do well, driven in part by continued inward direct investments from Europe; the key for these nations is domestic political stability that encourages continued large inflows of direct investment from Europe, the United States, and increasingly China.

What should one conclude from all these developments? In its entirety, Asia has somewhat outperformed other parts of the world economically. But high growth is not characteristic of the whole region, and wide disparities in affluence will remain for decades to come. Trade and investment linkages within Asia, or even within sub-regions of Asia, give little indication of a region that is coalescing as an economic bloc, largely for the reasons of extreme diversity in size, affluence, and performance discussed early in this chapter. The forecast just presented is relatively optimistic. The potential for continued or accelerated growth in many parts of the region certainly exists.

NOTES

1. For an example of this view, see Walter Hatch and Kozo Yamamura, *Asia in Japan's Embrace: Building a Regional Production Alliance* (Cambridge: Cambridge University Press, 1996).

2. Office of the US Trade Representative, "Joint Press Statement TPP Ministerial Meeting Bandar Seri Begawan, Brunei Darussalam," http://www.ustr.gov/Joint-Press-Statement-TPP-Ministerial-Brunei (accessed September 12, 2013).

3. ASEAN Secretariat, "Regional Comprehensive Economic Partnership (RCEP) Joint Statement: The First Meeting of Trade Negotiating Committee," http://www.asean.org/news/asean-statement-communiques/item/regional-comprehensive-economic-partnership-rcep-joint-statement-the-first-meeting-of-trade-negotiating-committee (accessed September 12, 2013).

4. For further details on foreign direct investment flows in East Asia in the 1980s and 1990s, see Edward J. Lincoln, *East Asian Economic Regionalism* (Washington, DC: Brookings Institution Press, 2004), 72–113.

5. For analysis of the political and strategic issues in the early evolution of the Chiang Mai Initiative, see William W. Grimes, *Currency and Contest in East Asia: The Great Power Politics of Financial Regionalism* (Ithaca, NY: Cornell University Press, 2009).

6. For examples of enthusiasm in the early 2000s for eventual currency unification, see C. H. Kwan, *Yen Bloc: Toward Economic Integration in Asia* (Washington, DC: Brookings Institution Press, 2001); or Policy Council of the Japan Forum on International Relations, *Economic Globalization and Options for Asia* (Tokyo: Japan Forum on International Relations, 2000).