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The Recent Development of East Asian Economy

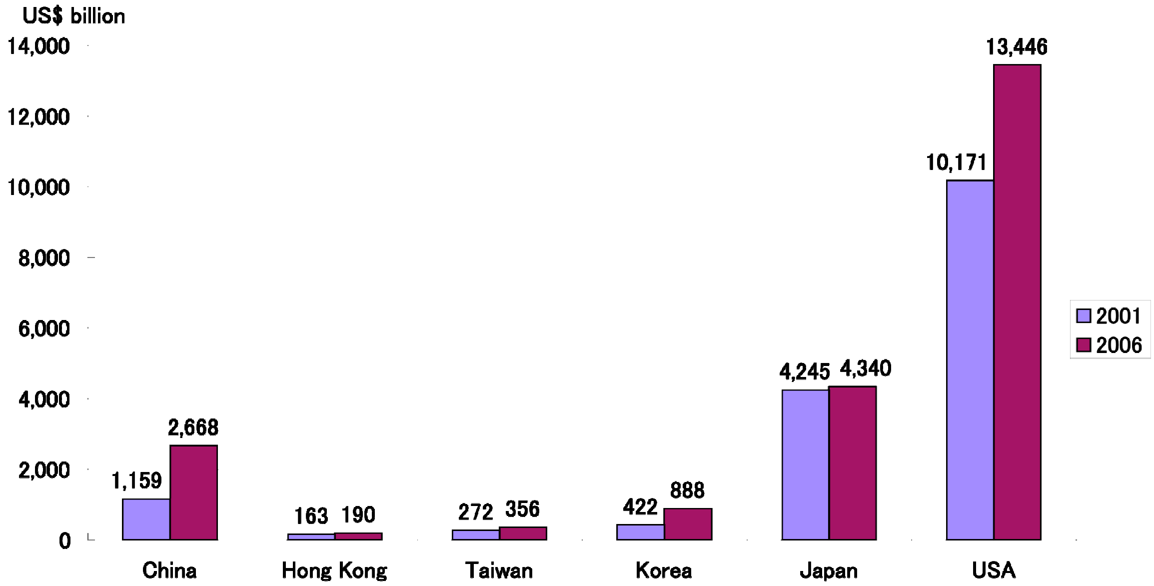
In this paper, I will try to draw a picture of trade and investment in East Asia through analyzing their change in these a few years. The most significant issue lies in the dramatic rise of Chinese economy in the region and the unexpected retreat of Japanese economy. Both phenomena were coincided with the change in trade and investment. Since Free Trade Agreements (FTAs) took the place of multilateralism in the 1990s, we have to pay more attention to the effect of the regional economic integration in East Asia. In the short run, we cannot talk about the future of the world economy, when we stay amid in sub-prime crisis. This phenomenon is exogenous for East Asia economy, but the policy makers cannot overlook the tidal change.

I Outlining East Asian Economy

In 2006, the world economy hit the highest growth rate in these two decades. In turn, the growth rate is expected to decline in 2007 and 2008 because of the sub-prime loan crisis. East Asia as a whole enjoyed steady growth affecting by the inflow of cheap products from China and robust demand in China and the US.

Figure 1 shows the magnitudes of economies that we are concerned. As noted, year by year comparison like the comparison of China's GDP between US$ 1159 billion in 2001 and US$ 2668 billion in 2006 is nonsense. In the respective year, the comparison economy by economy has a sense. In 2001, China's GDP was only 11.4% of the US GDP. After 5 years, it rose to 19.8%. As for Japan, this ratio changed from 41.7% to 32.3%. Japanese economy is said to have experienced 'the lost decade' after the crush of its bubble in 1991. In fact, even after the decade, it could not pick up in the international context.

Figure 1 Nominal GDP in US$

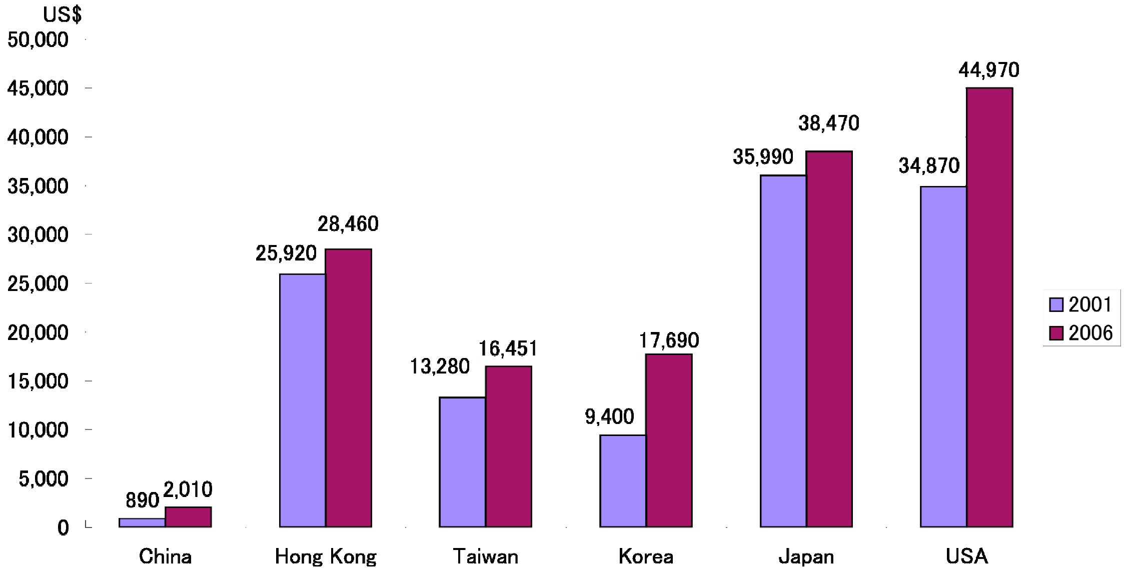


(Sources)Compiled by Yoshino from World Bank and Asian
(Notes)Since statistics depend on the exchange rates and the inflation rates, comparison between years is not significant.

China's striking growth is a fact, but the level of its economic development is not high enough compared to neighboring economies. Figure 2 shows the per capita GDP as an index of economic development. Put assumptions that the past five years' growth rates of Chinese per capita income, 17.7% annually, and the exchange rates will be unchanged from onward. China needs 50 years to achieve today's Taiwan's per capita income. Similarly, it takes 55 years, 118 years and 137 years, for Korea, Japan and the USA respectively. Even if Chinese renminbi will appreciate three times higher as Japan experienced since 1970's, China needs more than 15 years to become a developed economy.

These estimations are criticized that it misses the nature of the problem. If we turn to China's income disparity, we aware that the richer and outward looking group exploits from the workers who are obliged to admit low wage rates. Although cheap labor has been a source of China's strong growth, its return has seemed to belong to the richer stratum. But from the view point of East Asian trade and investment, we do not need to explore this topic deeply.

Figure 2 Per Capita Income

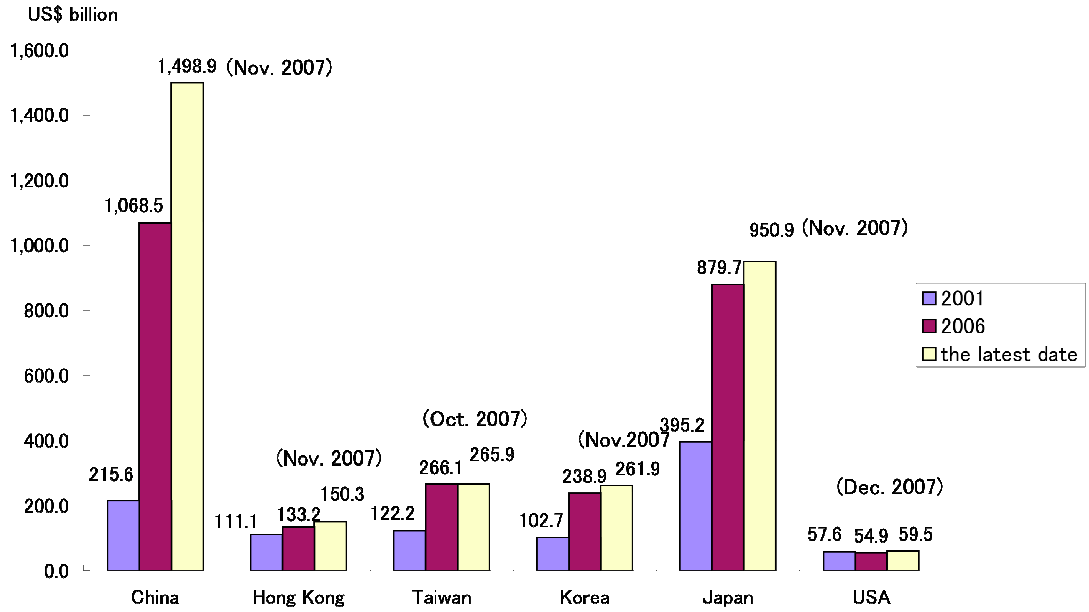


(Sources)World Bank, World Development Report, various

Only for Taiwan, Government materials.

Let's pick up two more figures in order to outline international aspect of East Asia. Figure 3 shows the latest foreign reserves as a stock variable. Change in Chinese reserve is remarkable. China has had the biggest reserve in the world since it exceeded Japanese reserve in February 2006. The ratio of the reserve to GDP in 2006 reached 40.0%. Considering the Japanese experience that the ratio hit 33.1% in 1988 when the Japan-US economic friction was amongst the highest tide, today's Chinese reserve is enormous. There are two reasons behind the facts. One relates to external environment. After the world wide fall of IT industry in 2001, advanced countries were positive to supply money. Consequently it made easy to increase reserves of the country like China and Middle Eastern countries that maintains overall surplus in its balance of payments. Another reason is domestic. China autonomously saved fund from the trade surplus and net capital inflow.

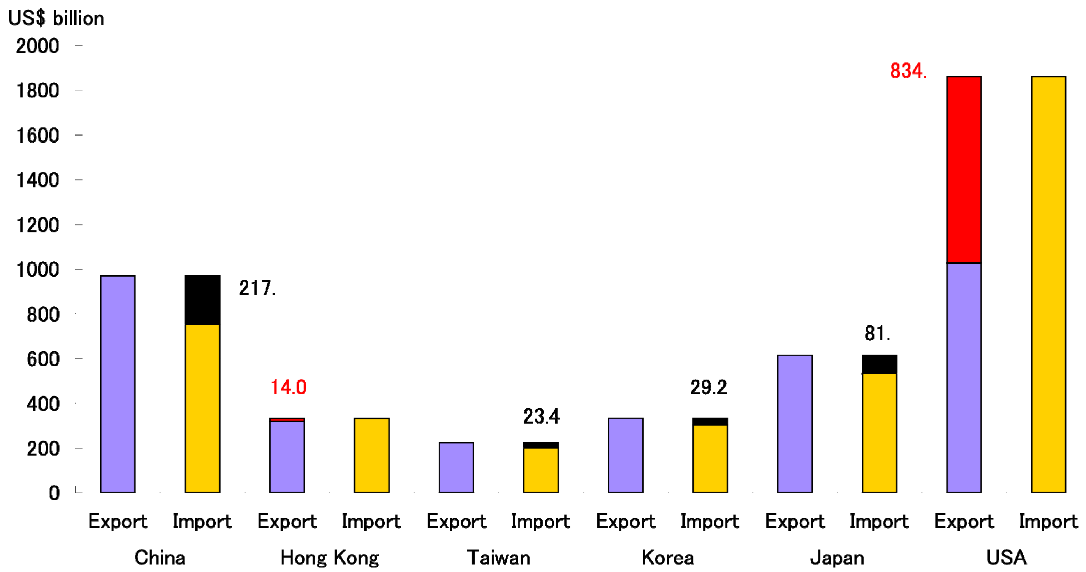
Figure 3 Foreign Reserves



(Sources)International Monetary Fund, *International Financial Statistics*, various
Only for Taiwan, *Financial Statistics Monthly*, Republic of China(Taiwan), various issues.

Figure 4 shows balances of trade in goods as a flow variable. We should be careful for the fact that this figure is differently defined from the current balance since this does not include trade in services as well as capital account. Taking no account of Hong Kong, East Asian economies record surplus. China shows tremendous gap. Its trade surplus reached 22.5% of its export. The ratios are 10.5%, 8.8% and 13.2% for Taiwan, Korea and Japan respectively. But the US cannot blame these imbalances, because its deficit reached 44.8% of its import. This is one of the aspects of the so called global imbalance.

Figure 4 Trade Balance, Export and Import



(Sources)International Monetary Fund, *International Financial Statistics*, various issues.
Only for Taiwan, *Financial Statistics Monthly*, Republic of China, November 2007.

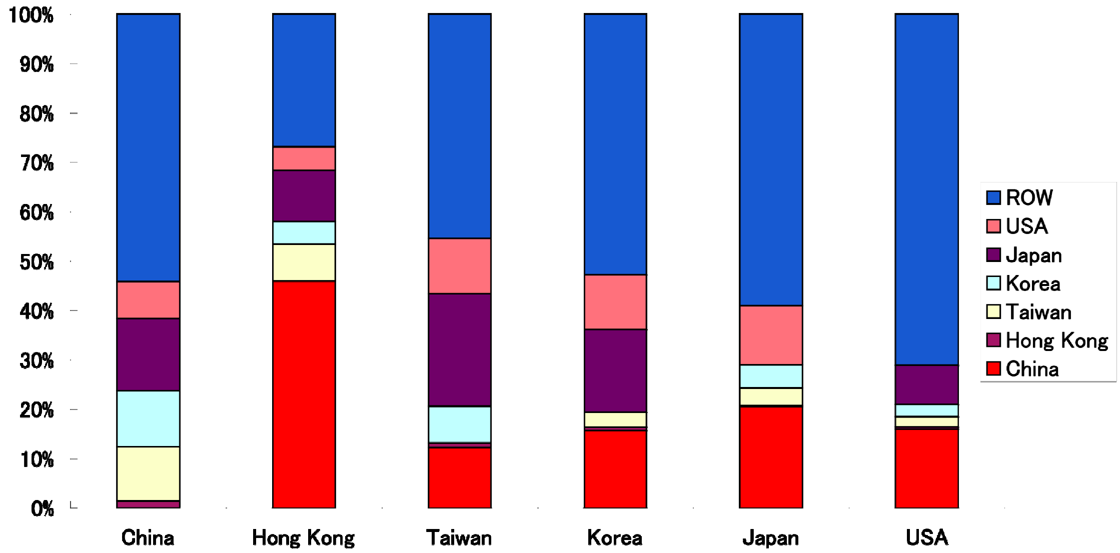
II Trade in East Asia

East Asian trade has changed dramatically in a decade after Asian crisis. The factors of the change include China's autonomous growth, US robust import, brisk investment from Japan and Korea, the adjustment in exchange rates and flourishing FTAs.

In 2004, China was ranked the third biggest exporter in the world in stead of Japan. Since then, the rank has been maintained after Germany and the US. In 2006, Korea is raked 11th, Hong Kong is 12th and Taiwan is 16th. East Asian growth is characterized as export led and outward looking. Even after Asian crisis, this characteristic is maintained.

Figure 5 shows East Asian country's import partners in 2006. Hong Kong's high dependency to China is geopolitically natural. As for China, Taiwan, Korea and Japan have similar share each other. Their shares are 11.0%, 11.3% and 14.6% respectively. Korea's share is getting higher after the resumption of diplomatic relations in 1992. In turn, Japan's share is declining year by year. Compare Japan with China as import origins. In the US, China exceeded to Japan in 2002. In Korea, Japan's share is 16.8% and China's is 15.7% in 2006. Looking at the tendency in a decade, China will get bigger share than Japan in these a few years.

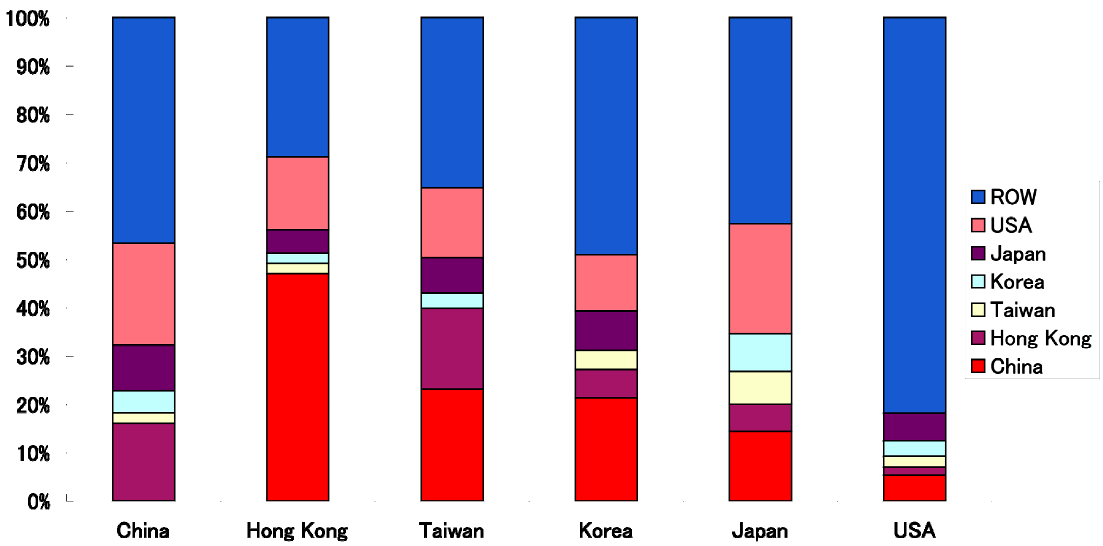
Figure 5 Composition of Import Origin (2006)



(Sources) International Monetary Fund, Direction of Trade Statistics Yearbook 2007.
Only for Taiwan, Government Statistics.

Figure 6 clearly suggests Chinese dominance in East Asian market. Putting Hong Kong aside, for Taiwan, Korea and the US, China's share is larger than Japan's. For China and Japan, the US remains at the largest export market. Japanese market got less attractive for East Asian countries.

Figure 6 Composition of Export Destination (2006)



(Sources) International Monetary Fund, Direction of Trade Statistics Yearbook 2007.
Only for Taiwan, Government Statistics.

For macroeconomic discussion, we should pay attention to the trade balances with each trade partner. Though it is theoretically imperfect, Table 1 shows the exporter's trade balance. For instance, the junction of China's column and Hong Kong's row indicates 93.1%. This is calculated by dividing China's trade balance with Hong Kong, US$ 145 billion, by China's export to Hong Kong, US$ 155 billion. If trade statistics are compiled in the international economics textbook, Hong Kong's trade deficit should be the US$ 145 billion. But in the real world, there are some discrepancies around the statistics, either intentionally or unintentionally. According to Hong Kong's report, its trade deficit is only US$ 5 billion. Since such discrepancy is common to trade figures, we have to lead to conclusion carefully with utilizing information sources.

Table 1 Exporter's Trade Balance Ratio to Total Export

(%)

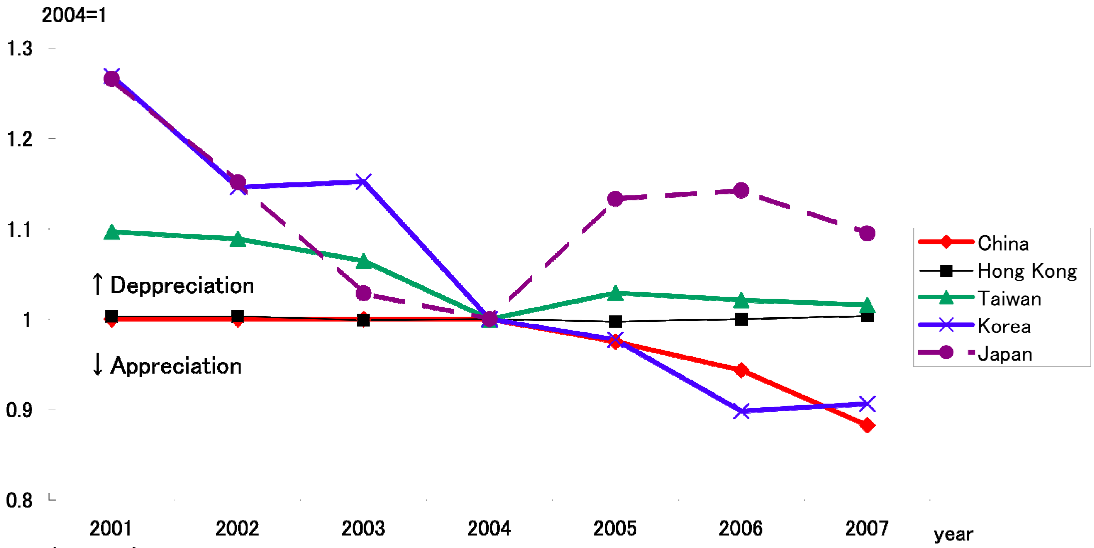
Exporter \ Importer	China	Hong Kong	Taiwan	Korea	Japan	USA	ROW	Total
China	0.0	93.1	−320.2	−101.6	−26.2	70.9	5.3	18.3
Hong Kong	−3.2	0.0	−272.9	−131.2	−123.0	66.5	1.3	−5.6
Taiwan	52.2	95.0	0.0	−109.7	−136.0	30.0	−16.6	9.5
Korea	30.3	88.9	27.6	0.0	−95.9	9.9	−2.3	5.0
Japan	−27.6	90.5	59.0	39.5	0.0	−3.4	−23.8	10.5
USA	−453.7	53.4	−72.9	−46.8	−155.2	0.0	−60.8	−85.1

(Sources) International Monetary Fund, *Direction of Trade Statistics Yearbook 2007*.
Only for Taiwan, Government Statistics.
(Notes) By definition, A's trade balance with B should have at least same sign as B's trade balance with A.
FOB/CIF factor and statistical discrepancy may distort the estimates.

According to Table 1, the fact that all countries record their trade deficit with Japan is remarkable. Conspicuous estimates are some of the US export. The US trade deficit with China, US$ 251 billion, is nearly five times more than its export to China, US$ 55 billion. As we found in Figure 4, the US total deficit is 85% of its total export. When the world second largest trader wants to maintain such large imbalance, its trading partners cannot achieve their trade balances by themselves.

China tackled to this difficult challenge. First of all, China began to move the renminbi rate to the US dollar in July 2005. Since its movement is completely managed by the authority, if we draw a chart with the origin of July 21, 2005, renminbi rate is plotted linearly. As in Figure 7 unfortunately drawn by annual data, the red chart is kinked. If the China-US trade is motivated by the relative prices factor, i. e., the US import from China because of its low price, the appreciation of renminbi eventually solves the enormous trade imbalance. But it does not seem to happen. Let's take Japanese example. Japanese yen appreciated from 240yen/dollar to 120yen/dollar for a year after September 1985. Thanks to that, Japanese trade surplus with the US decreased, but the extent was limited. As seen in Table 1, the US deficit with Japan persistently remains today. In China, the wage rate began to increase partly because the government loosened the wage control and raised the minimum wage. Prices, especially food prices, started to go up in the spring of 2007. These phenomena will have renminbi depreciated. Sooner or later, the Renmin Bank will be obliged to give up linear appreciation of its currency. We cannot be optimistic to the effect of adjustment of trade surplus by exchange rates policy.

Figure 7 Exchange Rates to the US Dollar



(Sources) International Monetary Fund, International Financial Statistics, February 2008.
Only for Taiwan, Financial Statistics Monthly, Republic of China(Taiwan), November 2007.
(Notes) Rates on the end of year (series ae in IFS). Only for 2007 of Taiwan, rate is that on the end of November 2007.

Chinese government positively started to make effort to resolve the trade surplus with advanced countries after its WTO accession in the end of 2001. This effort includes the tariff reduction, the raise in the export value added tax and the export tax and the dispatch of the delegate to purchase aircraft, machinery, software etc. The delegate to the US concluded the negotiations with US$ 16.2 billion and 32.6 billion in April 2006 and May 2007 respectively. These measures don't only narrow the trade gap but also have the domestic market more competitive and active. In the case of Japan, while searching the way out of the trade friction after yen's dramatic appreciation, unfortunately its economy dashed into the bubble. But it is true that some of the causes of the boom were attributed to the stimulus from the friction solution measures.

As shown in Figure 6, Japanese presence is recently declining in East Asian trade. The main reason of this phenomenon is the utilization of Asia-wide production network by Japanese companies. After the positive investment in Asia since 1980's, Japanese manufactures construct the production network in East and Southeast Asia. The slogans are 'optimum location,' 'China plus one,' and 'seamless production network.' Optimum location means the location strategy that makes the company its profit maximization by procuring the cheapest materials and selling to the market with the highest prices. China plus one strategy was suggested the Japan External Trade Organization (JETRO). Since

China has the potential risks such as anti Japan riot in spring of 2004, Severe Acute Respiratory Syndrome (SARS) in 2003 etc., Japanese company that commits to operate in China are recommended to develop at least one production site outside China. Seamless production network is a concept Asia-wide logistics that is expected to lower the transportation cost. After some years of these initiatives, Japanese companies abroad came to be possible to procure their materials and components not from Japan. This made the Japanese presence as an exporter lower.

III FTA in East Asia

Until China offered ASEAN to conclude FTA in November 2000, East Asia was called 'vacuum area of FTA. Entering 21st century, though the hub of FTA network is still ASEAN, East Asia turned to commit to FTA as a part of enhancement of institutional economic integration.

As for Korea, its trade situation cannot be dealt without its FTA strategy. Korea chose Chile, Singapore and European Free Trade Association (EFTA) as partners at the first stage. It moved to Association of Southeast Asian Nations (ASEAN), USA, European Union (EU) and China at the second stage. Now it launched negotiations with India and Southern Cone Market in South America (MERCOSUR). Korea got started simultaneously its FTA negotiations with various countries. But the negotiations with Japan and Mexico were suspended in November 2004 and June 2006 respectively. Among Korean FTAs, that with the US was controversial and critically important. For Korea, agriculture and automobile were the issues. It has an experience of the opening of agricultural market to China after their resumption of diplomatic relations. The inflow of cheap vegetable damaged Korean farmers in the late 1990s. They were afraid of a farther shock from abroad. The government took care of them. Consequently rice was excluded from the liberalized items. On the other hand, the tariff on beef will be eliminated after 15 years. For automotive, Korea at once eliminated its tariff rate of 8%, instead that the US eliminated the passenger car's tariff rate of 2.5% within 3 years and truck's tariff rate of 25% within 10 years. These measures are highly evaluated by the neighboring countries. If such measures are implemented, for instance, Japanese automobile manufacturers will be damaged in both markets.

China's FTAs that have been already implemented are those with Hong Kong, Macau, ASEAN, Pakistan and Chile. With ASEAN, after early harvest measures was implemented in 2002, commodity trade agreement came into effect. Consequently, the maximum tariff rates was set as low as 20% between China and ASEAN6, i. e., Brunei, Indonesia, Malaysia, Philippines, Singapore and Thailand. China is negotiating with Gulf Cooperation Conference (GCC), New Zealand, Australia, Singapore and Iceland and preparing the negotiation with Southern Africa Customs Union (SACU), India, Korea and Peru. As same as Korea, China's FTA partners are scattered all over the world.

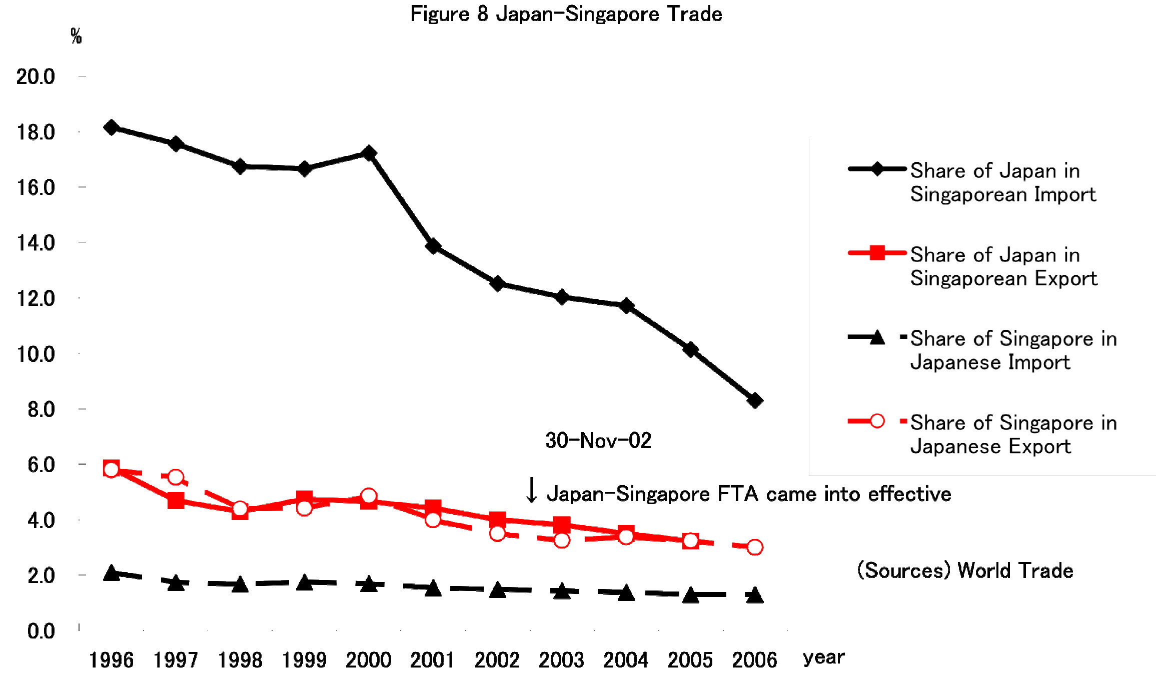
Japan delayed to deal with FTA compared to China and Korea, because its government strongly supported the multilateral trade negotiation, Doha round of negotiation[1]. For Japan, agriculture is the most difficult issues to be liberalized. Its self-sufficiency rate of cereal has been quite low. Agricultural productivity is also low because of the low level of harvested land availability. From the political viewpoint, since farmers have been strong supporters to the ruling conservative party, the government was not willing to liberalize this sector. It was natural for Japan to choose Singapore that had the substantive agricultural sector as the first FTA partner. After coming into effect the FTA with Singapore, Japan rushed into proceeding FTA negotiations with Mexico, Malaysia, Philippines, Chile, Thailand, Brunei, Indonesia and ASEAN. With ASEAN, Japan intends to conclude FTAs with each members as well as ASEAN as a whole, because of promotion of negotiations and maintaining the consistency. However, its strategy was backfired on Japan's intention. Let's take Malaysian case. Japan-Malaysia FTA decided to eliminate the tariff on some good within 10 years for Malaysia, on the other hand, Japan-ASEAN FTA eliminated to levy the tariff at once. Such contradictions are found in each FTA. As a consequence, Japanese companies' decision where they should build new lines and with which sales agents they should contract became too difficult.

Considering there emerged various types of FTAs, the effect of FTA should be

[1] Japanese government uses Economic Partnership Agreement (EPA) instead of FTA, because the former includes, for instance, the liberalization of investment and international human movement and the latter is limited within the liberalization of trade in goods following to the terminology of economics.

estimated in the right way. According to the estimation frequently quoted by Japanese government, Japan-Singapore FTA will increase Japan's GDP by 0.07% and Singapore's by 5.76% within 10 years[2]. Figure 8 shows the change in the trade share between Japan and Singapore before and after the implementation of the FTA. Through simple observation, we can find that after the implantation of FTA the trade relations have gotten weaker than before. That is partly because Japanese multinational companies invested in Singapore changed its procurement suppliers from Japan to the third countries as Japanese production network recently got enhanced. The weakened trade relations do not necessarily lead to the entire denial of FTA strategy. Since Japanese FTA covers from trade in goods to academic exchange, whole effects could be as same level as the estimate. However we cannot be entirely optimistic for the result of FTA.

Figure 8 Japan-Singapore Trade



In the same context, Korea-US FTA is expected to raise Korea's GDP by 0.32%, and increase its employment by 57,000 in the short run[3]. However, in the long run, in the case that the productivity rises GDP is expected to increase by 1.28% as compared with the case without the productivity rise that GDP is expected to

[2] Simulation was conducted by Tsutsumi Masahiko. See 'Economic Effects by Japanese FTAs: Nine Senarios,' in Urata Shujiro et. al eds., *Japanese FTA Starategy*, Nihon Keizai Shinbun, 2002.
[3] Simulation was conducted by Korean Institute for Economic Policy.

increase by 6.00%. The rise in the productivity will make the decrease of employment. That leads smaller expansion of GDP. This Korean estimate seems more feasible than Japanese counterpart.

FTA is not a panacea. We have to sincerely recognize that East Asian government adopted FTA initiative as a result of elimination process. After giving up betting on WTO multilateral liberalization, there were alternatives such as FTA, customs union, common market and even unilateral liberalization. In East Asia, there proceeded the APEC liberalization process at that time. FTA initiative was the easiest way to tackle with and the result was the most limited compared to other alternatives.

IV Investment in East Asia

As written in the former part, East Asian trade is strongly defined by investment. Japanese investment in East Asia led Japanese export of materials and components decreased. Chinese growth can be said to be mainly supported by the continuous inflow of foreign capital.

According to Chinese Ministry of Commerce, the share of foreign company is 58.2% in Chinese total export and 59.7% in import in 2006. Limited to the export of high technology products including IT, bio-industry and life science, the foreign company accounts for 84.2%. China has vigorously approved the foreign companies more than a decade. JETRO estimates the amount of investment in China was US$ 78.095 billion in 2006[4]. This accounts for 5.5% of the world investment and 42.9% of the capital inflow in Asia including Japan, East Asia, Southeast Asia and India. Considering the fact that the world main flow of capital concentrates in across Atlantic investment, China's share is quite large.

Hong Kong is also a large recipient of capital. Its capital inflow was US$42.894 billion in 2006. Small territory with the population of 7 million dominates ASEAN members with 550 million as investment recipients. Hong Kong is the largest investor in China, which account for 32.1% of the conducted investment in

[4] JETRO's estimation is based on the balance of payments, which is different from the approved based or committed based investment statistics released by each country's board of investment or the equivalent.

China in 2006. Since, needless to say, the capital is mutually exchanged between Hong Kong and China, special attention should be paid for analysis.

The common phenomena to China, Hong Kong and Taiwan is a significant presence of the so called the UK territory tax haven in Central America such as Cayman, Bermuda and Virgin. For China, Virgin is the second largest investor in 2006 and Cayman is the 8th. For Hong Kong, Virgin and Bermuda are ranked the first and the third respectively. In Taiwan's investment statistics, these tax havens are lumped together as UK territory in Central America. It shares 42.2% of the amount invested in Taiwan in 2006. Also for the outward investment by these three economies, the tax havens play a significant role. The largest investment destination is Cayman in 2006. After Hong Kong, the third destination is Virgin. Considering Hong Kong is also a tax haven, 80.0% of the total Chinese outward investment goes to the tax havens. The situation is similar to Hong Kong. Measured by invested stock, the largest investment destination is Virgin that account for 44.0% of all invested capital.

The utilization of the tax haven is the characteristic common to Chinese capital in East Asia. Both Korea and Japan are far from it. Needless to say, the utilization of the tax haven makes the flow of capital unclear. These three economies should be blamed that, in spite of the effort to make it transparent, which is made by international community, international organizations such as Organization for Economic Cooperation and Development (OECD), large share of the investment is committed to the tax havens.

V Implications for the US

The deeper the regional economic interdependence becomes, the closer the economic interests are shared by the region. In the case of poisoned imported food sold in Japan, the enhancement of export quarantine by Chinese government suffers Chinese farmers as well as Japanese consumers and trading companies. Korea-US FTA is expected to most seriously damage Japanese export[5]. The US should not overlook the economic interdependence and the shared interests with

[5] According to Okuda Satoshi's estimation, after the implementation of Korea-US FTA, Japanese export to both countries will decrease by US$ 585.1 million. See his *Korea-US FTA*, IDE-JETRO, 2007 in Japanese.

East Asia.

As for the trade with East Asia, the priority should be put on a macroeconomic aspect, i. e.., the enormous trade imbalance. The trade deficit with China is the most serious issue for the US. Looking back upon the experience of the trade friction with Japan, the US should bear in mind that the imbalance could not be resolved only through the adjustment of exchange rates. The US should strengthen its export competitiveness by itself and make effort to open Chinese market at the same time.

As for FTA initiatives flourishing in East Asia, the US had better utilize Asia-Pacific Economic Cooperation framework. APEC has been stagnated since the failure of Early Voluntary Sectoral Liberalization (EVSL) initiative in 1998. In 2008, the moratorium for new accession will be expired. In 2010 and 2011, the hosts are assigned to Japan and the US respectively. It is a golden opportunity to revitalize trade liberalization process. It could be possible to set a new agenda for trade and investment liberalization instead of old-fashioned Bogor process. Since East Asia achieved high economic interdependence and began to autonomously integrate, the US should not arbitrarily intervene in that process.

Finally, we have only ambiguous anticipation about the sub-prime loan crisis at present. Recognizing the crisis followed the Long Term Capital Management (LTCM) crisis in 1998 and Black Monday in 1987, the US authority should make every effort to solve it and avoid the coming turmoil from the US.

End of paper