Asia Is Weathering the Global Economic Storm, But Can It Do Better?

By Yukiko Fukagawa

The effects of the global financial crisis that exploded in 2008 are still painfully apparent. The fate of the euro is uncertain — as is the whole experiment in European integration — and the US economy is struggling to get off its hands and knees.

While Asia is doing reasonably well thanks to actions taken in the wake of the Asian currency crisis of 1997-98, deeper regional integration is needed, writes Yukiko Fukagawa. And don't count on China to protect Asia as the current crisis unfolds. It's too early for China to assume the regional leadership role it may one day acquire.

In retrospect, the East Asian currency crisis of 1997-98 was only a prelude to the global financial crisis of 2008, which effectively started with the collapse of Lehman Brothers, quickly devastated the US economy and precipitated Europe's sovereign debt crisis, which surfaced in 2010 and remains unresolved. The world has painfully learned the ways in which financial markets are integrated globally but lack a proper governance system.

East Asia has so far weathered the rounds of the global crisis reasonably well, thanks to the many reform efforts undertaken after 1997-98, as well as to the robust economic growth experienced by emerging markets, particularly in this region. But the crisis-driven mechanisms for regional co-operation that emerged after the Asian financial crisis need to be re-examined in light of the current global economic and financial situation. That includes intra-regional free trade agreements (FTAs), the Chiang Mai Initiative that established bilateral swap arrangements among countries in the region and the Asian Bond Market Initiative, which aims to tap Asia's large pool of savings.

Since the scale of the present crisis is unprecedented, the region needs to engage in pre-emptive efforts to enhance economic integration further in order to mitigate the outside risks posed by the problems in the European Union and the United States. In this article, I explore what should, or can, be done to achieve a level of deeper integration that would make East Asia more resilient in the face of the global crisis.

PUSHED TO GREATER INTEGRATION

It is noteworthy that the currency crisis of 1997-98 was the first experience in which Asian nations shared a common outside financial threat. The crisis highlighted the fragile nature of Asia's growth structure, which was unique to this region. Asian exports were highly dependent on outside markets such as the US and the EU, and as a result, not only trade but also capital transactions were all dependent on a single foreign currency, the US dollar. Therefore, the crisis awak-
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MEANWHILE, ENTER CHINA
While East Asian nations have been engaged in a series of efforts to institutionalize market-led integration, the region has also witnessed an unfolding structural change: the rise of China. China began to deregulate its foreign exchange market in order to more efficiently mobilize the high savings rates within the region.

The initial phase of the CMI was completed in 2003 and allocated $36.5 billion for currency swaps. From the beginning, however, the initiative was constrained by two factors: First, a country seeking currency swaps would have to negotiate with each national counterpart, which would be unrealistic in the midst of a fast-unfolding crisis. Second, even though the networks originate in East Asia, 90 percent of the swaps had to be linked with an International Monetary Fund program. Therefore, despite the desire for independence, the region’s program was under the virtual control of the IMF. Since then, steps have been taken to strengthen the CMI and create greater Asian control over it. In 2005, the portion of the program that was free of IMF links was lifted to 20 percent from 10 percent. And in 2009, the size of the currency swap fund was expanded to $90 billion. After the Lehman Brothers shock, a much bolder step was taken. The original CMI’s bilateral approach to currency swaps was largely replaced by a single, uniform swap facility that was, in effect, a multilateral swap arrangement — resulting in the so-called Chiang Mai Initiative Multilateralization (CMIM). The size of the fund was further enlarged to $120 billion.

In reality, the need to link the Chiang Mai Initiative to the IMF reflected the fact that together Asian countries that were parties to the agreement lacked the fully-fledged macroeconomic surveillance mechanism necessary for the CMI program to function smoothly. Against this backdrop, capital market monitoring was first introduced in 2001 with the establishment of the Economic Review and Policy Dialogue (ERPD), with participation a precondition for involvement in the CMI program. In 2011, ASEAN+3 Macroeconomic Research (AMRO) was established to institutionalize the monitoring and surveillance program.

While the developments just described were pushed along by various global crises, underscoring the need for more robust financial safety mechanisms and surveillance programs, progress in the development of the Asian Bond Market Initiative has been more uneven. AMBI consists of the following programs: 1) bond development by securitization; 2) credit guarantees; 3) foreign currency and settlement; 4) issuance of bonds denominated in local currencies; 5) promotion of credit rating agencies; and 6) technical cooperation. While the issuance of bonds denominated in local currencies has progressed relatively quickly, a number of challenges remain in the other areas. Since 2008, the need to link the Chiang Mai Initiative to the IMF was, therefore, a multilateral swap arrangement — resulting in the so-called Chiang Mai Initiative Multilateralization (CMIM). The size of the fund was further enlarged to $120 billion.
for the world to becoming a major consumer in its own right within this decade.

Figure 2 above shows China’s position change in the global production network. In 2000, China still exported mainly consumer goods (48.8 percent), while it imported intermediate goods. These developments have not changed the traditional pattern of open trade in the region. The only change has been that China has taken a greater lead in intra-regional trade. But the next major change, which will see China emerge as a net final goods importer, like more mature economies such as the EU, the US and Japan. The EU increased exports to China by 270 percent from $18.3 billion to $67.0 billion in the same period above, and Japan from $14.6 billion to $43.6 billion. For now, the major portion of final goods still consists of capital goods, not consumer goods, but with the pace of income improvement in China creating a larger and larger middle and upper-middle class, the import of consumer goods is set to rise dramatically in the future.

China’s growing position as an importer is also important for another reason — it will accelerate international use of China’s currency, the renminbi (RMB). China has recently started to use renminbi in trade settlement, starting with ASEAN. Even within the Chiang Mai Initiative mechanism, China has maintained a position to swap renminbi despite its restricted convertibility, and the willingness to internationalize the renminbi seems clear enough.

The third change is China’s emergence as a large player in the market for foreign direct investment including mergers and acquisitions. According to the Japan External Trade Organization, China’s outbound FDI in 2010 was 37 percent higher than the previous year, hitting a record of $60 billion and exceeding Japan for the first time. Since the Chinese government started to encourage outbound FDI, the accumulated amount of FDI between 2006 and 2009 reached $191 billion, nearly three times as much as the government targeted, and China has become one of largest sources of FDI in the world. FDI destinations are concentrated in Hong Kong, the Cayman Islands, Luxemburg, the Virgin Islands and Singapore, suggesting that investment in financial services is currently a priority. However, a closer look suggests that more is at play. Through these investments in financial companies, large-scale mergers and acquisitions have become very frequent, especially in the energy and mining sectors and the takeover of high-tech firms and well-known brand names. Chinese FDI has been directed through government initiatives, especially pushing resource, energy and agricultural security. In terms of the division of labor in the manufacturing sector, China remains an assembler of final goods, and unlike in Japan, South Korea and Taiwan, overseas production has not yet created complicated supply-chain networks. However, it has become obvious that China has shifted from being a pure FDI recipient into a major cross-border player. Although intra-company trade by multinational corporations (MNCs) based in China has led about half of Chinese exports, it looks certain that transactions by emerging Chinese MNCs will affect trade soon.

CHINA AS REGIONAL LEADER, BUT FRAGILE
As discussed, the rise of China has started to change intra- and inter-regional trade patterns,
and the emergence of the renminbi as a key regional currency seems likely to be a natural outcome. China has even pushed the IMF to adopt the renminbi as a currency for its Special Drawing Rights. However, China’s economy is still in a developing and transitional phase with its own fragilities, and it does not seem realistic to expect China to provide effective public goods or to become the architect of a co-operation framework to deal with the potential effects of the current global crisis on Asia. After all, China survived the last Asian financial crisis not because its domestic financial market was well developed and efficient, its financial supervisory mechanisms were functioning or its corporate governance was stringent. It survived because deregulation and market opening were relatively underdeveloped, foreign reserves were huge and external debt was negligible. Most of the crisis-affected countries in Asia have gone through comprehensive reforms to adopt flexible exchange-rate regimes with open capital markets under the support of the IMF, but Chinese reform has been delayed by its own sequencing of the process. As a result, the institutional settings in China are still often unique, which may constrain deeper integration, at least for a while.

For instance, to deepen its capital market, China has to start issuing government bonds of varying maturities to establish a benchmark yield curve for other bonds, such as corporate or mortgage-backed bonds. Without this, investors, including foreigners, can only use the optimal portfolio of Chinese and other bonds. Long-term and short-term capital account liberalization has to be carefully designed. The government must also reduce its ownership of commercial banks, so that financial supervisory authority can be independently enhanced to manage the deregulated markets with enough accountability. Implicit guarantees by government-controlled banks and financial institutions have to be screened, and credible deposit insurance and other schemes to deal with banking crises have to be devised. In order to internationalize the renminbi, China has to accelerate reform.

China also needs to do more to support regional economic integration. China has tried to lead the integration of ASEAN +3 through FTAs, but has not been very successful in achieving so-called high-level FTAs that are comprehensive in their scope and coverage and are consistent with WTO standards. The FTA between ASEAN and China is full of exceptions in its commitments to enhancing rights and liberalization. (For instance, trade liberalization is based on reciprocity. If an item is on one country’s liberalization list but is categorized by the counterpart as “sensitive” or “highly sensitive,” unilateral liberalization is not obligatory. Moreover, the target tariff reductions under the liberalization program are “0 percent to 5 percent,” instead of an instant abolition of tariffs to zero.) The only FTAs that China has concluded that are WTO-consistent are with Singapore and New Zealand, two countries where China does not have to worry about industrial adjustment. In contrast, South Korea opted to negotiate high-level FTAs with the US and the EU, while Japan, in expressing its support for the Trans-Pacific Partnership (TPP), has signalled its commitment to “liberalization without exceptions,” including Investor-State Dispute Settlement (ISDS). Japan has also sought to include the concept of “national treatment” of foreign companies and ISDS in its FTA discussions with China, but so far to no avail. China, meanwhile, has failed in its effort to get Japan or Western countries to recognize China as a “market economy.”

As the crisis in Europe has shown, deep integration involves the process of giving up large amounts of sovereignty, but China is still developing, and to make things more complicated, it has been growing through a process of gradualism, with a highly successful regime of government interventionism. As long as the reform of state-owned enterprises (SOEs) is not implemented at a higher level — that is, beyond clearing up negative assets and adhering to the WTO regime — it will be difficult for countries with mature markets to see a level playing field in China and to grant the country market economy status. However, high-level SOE reform won’t be easy. It will require the adoption of a fair trade law; independent institutions to monitor domestic competition; transparent authority in central-local government relations; modern, realistic and enforceable bankruptcy laws and related institutions to deal with big and massive failures.

**EAST ASIA MUST STAY THE PATH**

Given the challenges that China faces in political and social terms to bring its reform process fully in line with international standards, the rest of Asia cannot expect China to instantly emerge as a mature, fully-fledged regional leader protecting Asia from the current global crisis. China may be able to contribute to the CMI by increasing swaps in renminbi. It may be able to play a role as the importer, rather than the exporter, in the production network, which will help make the RMB attractive for settlement purposes. However, as long as financial reform at home does not see significant progress, the status of the RMB will still be limited to that of a local or regional currency to settle trade and FDI.

**HALFWAY THERE**

To conclude, the rise of China has changed the structure of the East Asian economy, but ironically, it has hindered the institutional reforms needed at home to respond to the opened regime. Thus, regional initiatives by China at the cost of domestic reform do not seem likely; the CMI may be further expanded by China’s contribution of renminbi swaps, but the seriousness of its commitment to the Economic Review and Policy Dialogue, which is meant to provide a level of surveillance of national economic policy and performance, is uncertain. The prospect of high-level FTAs, especially with Japan or South Korea also looks difficult, because rapid trade and investment liberalization, as well as protection for foreign investors, may challenge many domestic institutions and controls. Despite China’s growing presence in the region and the likely desire of its political leaders to take the initiative in regional integration, the reality is that China needs more time to prepare domestic institutional reforms. This means that the rest of Asia cannot expect strong, sound and positive leadership from China. Instead, it must count on having to balance the ad hoc and strategic participation by China in the process of integration.

The direction of the global financial situation is still very uncertain. The sovereign debt crisis in Europe has cast light on the inconsistent structure of integration in Europe, where the adoption of the euro has not been accompanied by a similar adoption of a single fiscal sovereignty or common oversight of national budgets. The US and Japan, too, have drawn attention to unsustainable public sector debt. The fiscal plight of the EU, the US and Japan will continue to weigh on emerging economies including here in Asia, not just because these economies are dependent on mature markets for their exports, but also for their financial intermediary and other services. Because the global economy is integrated more widely and deeply than many had believed before the crisis of 2008, the power of regional integration in East Asia may be limited, at least until China is prepared domestically and internationally to take a leadership role. In the meantime, the rest of Asia will continue to be strengthened by all of the reforms taken after the painful crisis of 1997-98, to “liberalization without exceptions” will become easier for further market integration. While China continues to grow, offering Asia and the world a larger and larger market, and the rest of Asia co-operates institutionally, the dynamics of East Asian integration seem, for now, enough to overcome the ongoing crisis outside the region.

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