

# **Building East Asia Community Learning from Europe**

November 2004

Kiyohiko FUKUSHIMA

## **Table of Contents**

### **Introduction**

#### **1. Implications of the East Asia Community**

##### **(1) Four Implications**

- 1) Turn around in diplomatic strategy**
- 2) A major shift in foreign economic strategy**
- 3) Need for Japan-China**
- 4) Community aiming at more than economy**

##### **(2) Historic Recovery of East Asia**

- 1) Weight of the Population**
- 2) Restoration**

#### **2. Changing Japanese Economy and the East Asia Community**

##### **(1) Demographic Change**

- 1) Supply side**
- 2) Demand side**

##### **(2) Technology Transfer**

#### **3. Lessons from Europe**

##### **(1) Stark Difference**

##### **(2) Short History of EU Monetary Integration**

- 1) Werner Report and the snake**
- 2) European Monetary System**
- 3) Delors Report**
- 4) European Monetary Institute**
- 5) European Monetary Union**

#### **4. Tasks Ahead for East Asia**

## **Introduction**

On December 10<sup>th</sup> and 11<sup>th</sup> 2003, Prime Minister Koizumi has convened all the heads of the 10 ASEAN member countries in Tokyo for the first time in history. The summiteers in Tokyo have adopted the Tokyo Declaration and agreed to build the East Asia Community. Though it is a historic declaration and has immense implications for Japan and East Asia, little analysis has been made on the EAC and the numerous tasks ahead for building the EAC.

This short paper tries to describe 1)economic, historic, and political implications of the EAC, 2)the changes in the Japanese economy that triggered the Japanese move to greater regional economic integration, 3)some lessons from Europe, and 4)challenges ahead for East Asia.

### **1. Implications of the East Asia Community**

Prior to the Tokyo Declaration, heads of the 13<sup>1</sup> countries in East Asia have already agreed that it is the common goal of the 13 countries in East Asia to build the East Asia Community. The Tokyo Declaration is a confirmation and commitment of Japan to the agreed goal, specifically for the developing countries in East Asia.

#### **(1)Four Implications**

Japan's commitment for the EAC has at least four implications:

##### **1) Turn around in diplomatic strategy**

Heretofore, Japan's foreign policy was based, almost solely and entirely, on the solid US-Japan alliance, while keeping equal distance with all the other countries. By making the building of the East Asia Community its strategic goal, Japan now has chosen a group of countries as the priority group for concentrating its diplomatic efforts. Japan's diplomacy will henceforth stand on a more stable foundation based on the two pillars of the US and the EAC, instead of relying on the one big US pillar alone.

---

<sup>1</sup> Thirteen countries are the ASEAN 10 (Indonesia, Malaysia, Singapore, Philippines, Thailand, Brunei, Vietnam, Laos, Cambodia, and Myanmar) and the 3 countries in North East Asia, Japan China, and Korea.

This change can imply some difficult issues. Among the 12 member countries of the 13 countries group other than Japan, China looms huge. With the rise of China, US-China arms race is gaining speed, because China is seen as 'strategic competitor' by many US policy makers. Japan is the cornerstone in the American strategy of containing the rise of China.

From the Japanese perspective, China is both the indispensable partner in building the East Asia Community and at the same time, 'strategic competitor' to be contained in terms of national security. It may not be easy to handle this dilemma.

## 2) A major shift in foreign economic strategy

Before the Tokyo Declaration, Japan has been trying its best in trade policy to strictly adhere to the old GATT principle: free, non-discriminatory, and multi-lateral. By declaring that building the free trade area, coordinating macro economic policy, and even envisaging the introduction of the common currency as proclaimed goals of the EAC, Japan has effectively begun to renege from the WTO/GATT principles. It is going to treat the 12 member countries more favorably, discriminating the rest of the world with unfavorable terms.

The reason for Japan's historic adherence to the GATT rules was that because Japan had the comparative advantage in many manufacturing sectors, it opposed to any exclusionary, preferential trade agreements anywhere in the world for the fear that the Japanese products might be discriminated against by any such regional blocs. However, with the world trade under some kind of preferential trade agreement coming close to 50%, Japan had to change the strategy. It must build its own and participate in some preferential trade agreement, otherwise it will face discrimination and be in disadvantage in the world trade.

## 3) Need for Japan-China Rapprochement

In order to build a workable community in East Asia, Japan and China must reconcile. Several issues are involved. The current, ongoing ones include, The Senkaku islands, Yasukuni Shrine, and Japan's history textbook, while the views

on the past cover issues like Nanjing massacre, the biological weapons warfare conducted by the troops 731, recognition on Japan's history during the Japan-China war of 1931-45, and others.

This short paper does not try to analyze those thorns dug deep in Japan-China relations. Suffice it here to say that if the top leaders of the two countries take actions based on the strategic national interests of Japan and China, tensions can be mitigated.

#### 4) Community aiming at more than economy

The Tokyo declaration contains such phrases like "The rule of law", "Protecting and Promoting Human Rights", "Fair and Democratic Environment", and "Honoring Asia's Tradition and Value".

Though the specific actions to be taken for implementing the aforementioned goals are never clearly mentioned in the Declaration, except for holding more international conferences, the intentions are clear. The East Asia Community is not a mere large free trade area. It will strive for defining shared ideas and values, separate from the desire for more financial gains.

## **(2) Historic Recovery of East Asia**

### 1) Weight of the population

Table 1 shows the profiles of the three major economic regions in the world economy. Though East Asia outstands in terms of population, its per capita income remains extremely low compared with the other two regions, the North America and the European Union. This is mainly due to the fact that China, with its huge population, is pulling down the average income. (Table 1)

However, if we make some projection into the future, the picture can be different. With its growth potential higher than the other two regions, East Asia can become the largest economic area in the world by 2050, if its potential will be realized.

In 2050 East Asia's share in the world population could dwindle to 26%, down from the 33% in 2000. (Table 2) Still with more than a quarter of the global population, the East Asia's combined GDP could be the largest in the world if per capita income of

East Asia reaches par with the global average by the year 2050.

Table 1 EAC13, North America, and EU Compared (2003)

	Currency	Population (million)	GDP (\$ bil.)	per capita GDP (US\$)
EAC 13	US\$, Yen, others	1,991	5,897	2,962
North America 3	US\$	478	11,405	23,884
EU 15	EURO	376	7,955	21,157

Source: Meti, White Paper on Trade 2003

table2 Future Population of the EAC

	(million)		
	2000	2025	2050
EAC 13	1,970 (32.5%)	2,343 (29.5%)	2,421 (26.0%)
North America 3	413 (6.8%)	514 (6.5%)	584 (6.3%)
EU25	451 (7.4%)	432 (5.4%)	402 (4.3%)
EU15	377	361	339
World	6,057 (100.0%)	7,937 (100.0%)	9,322 (100.0%)

Notes 1) numbers in ( ) are ratio to the global population.

2) EU25=old EU15+Poland, Czech, Slovakia, Hungary, Slovenia, Estonia, Lithuania, Latvia, Malta and Cyprus.

Source) United Nations, *World Population Prospects: The 2000 Revision*

## 2) Restoration of East Asia's natural place in the world

The process of East Asia's recovery in the world economy can be seen in another historic perspective. According to a study by economist Mr. Angus Maddison made at the OECD, in 1820 the GDP of China was 199 million dollars (1990 price) with a population of 381 million<sup>2</sup>. The second largest economy in the world in those days was France, with 38 million dollars GDP and 31 million population, followed by Britain with 35 million dollars and 19.83 million population. China's share in the world GDP, using Mr. Maddison's figures and the author's estimate, was about 30% in 1820, by far the largest economy in the world.

However, in 2004, though China's share in the world population is about 20%, its economic size is \$1.3 trillion; it makes China's share in the world economy (\$33 trillion) only 4%. If during the next 50 years, China keeps on maintaining its population share

<sup>2</sup> Angus Maddison, *Monitoring the World Economy 1820-1992*, OECD Development Centre studies, 1995

at 20% while making rapid economic catching up and increase its per capita GDP to 50% higher than the global average, China's share in the world economy will be 30% in 2050. The share of 30% of the world GDP makes China the largest economy in the world again. This is the process of restoration of China's economic status in the world that China has held until around 1820.

The main factor behind the rise of the East Asian economy is the rapid catch up of China leading to the restoration of its due place in the world economy.

## **2. Changing Japanese Economy and the East Asia Community**

Among the numerous factors the most important one that has caused Japan's major shift from its traditional global approach to the recent regional approach is the change in the Japanese economy. Japan now needs East Asia for maintaining its economic momentum, and even for its own economic survival.

Two factors seem to have played important roles for Japan's shift toward regional economic integration: demographic change and successful technology transfer.

### **(1) Demographic Change**

#### **1) Supply Side**

The working population of Japan, those between age 16 and 60 has already peaked out in 1997 at 67.9 million. The number of workers has been declining since then and could come down to some 50 million by 2050.

A country's economic output is determined by the following equation.

$$\text{Total Production(A)} = \text{number of workers(B)} \times \text{output per worker(C)}$$

In this definition,  $A = B \times C$ , when B (number of workers) starts to decline, A (Total Production) will tend to decline unless C (productivity) begins to rise at a faster pace than the decline of population (B). Corporations have always been trying hard to raise productivity. It is impossible for corporations to suddenly raise the pace of productivity

increase every year just because the number of workers began to diminish.

We can conclude that Japan has reached its supply side constraints in 1997.

In order to find new workers and keep growing, Japan must find some new sources of labor. The new labor supply can be sought from the women, the elderly, and the foreign workers to be brought into Japan. Because there are inherent limitations for each of those new source of labor, Japan must approach else where. The new source is the East Asian nationals working in the subsidiaries of Japanese corporations operating in East Asia. According to the survey by the Japanese government, the number of workers working in Japanese corporations in Asia has jumped from 605 thousand in March 1989 to 2,038 thousand in March 2001. In just 12 years the number of Asian workers working in Japanese affiliates in Asia has grow by more than three times. This dramatic rise has helped mitigate Japan's labor shortage and strengthened Japan's economic tie with its neighboring countries in East Asia. (Table 3)

Table 3 Workers in Japanese Subsidiaries Overseas

	North America		C&S Am	Asia			M East	Europe		Oceania	Africa	Total
	USA			ASEAN	NIES	EC						
1989 . 3	316,278	293,047	142,891	605,439	267,234	337,905	7,802	137,322	132,425	53,129	11,834	1,326,101
Ratio	23.9%	22.1%	10.8%	45.6%	20.2%	25.5%	0.6%	10.4%	10.0%	4.0%	0.9%	100%

	North America		C&S Am	Asia				M East	Europe		Oceania	Africa	Total	
	USA			China	HongKong	ASEAN	NIES		EU					
2001 . 3	783,417	743,729	138,198	2,038,210	657,865	108,453	1,003,987	259,016	10,999	401,891	368,075	55,837	24,316	3,452,868
Ratio	22.7%	21.5%	4.0%	59.0%	19.1%	3.1%	29.0%	7.5%	0.3%	11.6%	10.7%	1.6%	0.7%	100%

Source: Miti report on Japanese Overseas Subsidiaries, 1990 & 2003

## 2) Demand side

The total population of Japan is forecasted to peak out in 2007 at 127.7 million and will dwindle to 100.6 million in 2050. This will create the demand side constraints.

The size of a country's domestic market is explained by the following equation.

$$\text{Total Domestic Consumption(D)} = \text{Total Population(E)} \times \text{Per Capita Consumption(F)}$$

When the total population(E) begins to decline, total consumption tends to decline, unless per capita consumption(F) begins to rise dramatically. Frantic consumption binge is highly unlikely in Japan because the population is aging. In 2003 those age over 65 was 20% of Japan's total population and those elderly people tend not to spend too much.

This will result in the dwindling domestic market. For Japanese corporations looking for sales growth, they must look out for overseas market. East Asia with its almost 2 billion consumers in 2000 growing to 2.4 billion in 2050 has become the natural target for the expansion of Japanese corporations.

The demand side constraints in the Japanese market is another factor that has contributed to the stronger economic linkage between Japan and the countries in East Asia.

## (2) Technology Transfer

Another factor that had contributed to the economic integration in East Asia is the successful technology transfer from Japan to the developing countries in Asia stage by stage. In many manufacturing sectors such as textiles, chemicals, machineries, audio-visual products, and electronic components, Japanese production technology has been transferred first to the Asian NIEs (newly industrialized economies such as Korea, Taiwan, Singapore and Hong Kong), second to the ASEAN4 (Malaysia, Philippines, Indonesia, Thailand), then to China and other countries. The technology transfer has been done mainly through foreign direct investment from Japan. Through these series of successive transfers, Japan's neighboring countries have succeeded in industrialization from the low value added industries to the high value added ones.

Seen from Japan's side, Japanese corporations have successfully extended their production system from within Japan inland to outside Japan in the other countries in East Asia, stage by stage. As the rising wage cost and higher exchange rate of the yen weakened the comparative advantage of Japanese corporations in certain manufacturing sectors one by one, Japanese companies have shifted some of their production base of low value added products overseas, while strengthening and



upgrading the production base in Japan to a higher technology products.

From the view point of the developing countries, inward foreign direct investment (FDI) from Japan worked as a spring board for industrialization. Almost all the manufactured products started from imports in many countries in East Asia. After some technology transfer in country A, domestic production begins and it rises fast. Soon after ward, domestic production becomes more competitive and replaces imports in the domestic market (import substitution). Then, domestic products become so competitive that those products are exported; eventually production of that product could become a leading export industry in the country A.

However, over the years, another less developing country B might succeed in industrialization through a similar process through FDI. Country B could outperform country A, and country A will have to find another industry to establish its new comparative advantage.

This process of imports domestic production export exports decline and imports rise, is a well established pattern in the industrialization of developing countries. The pattern is called as the flying geese pattern. (This model is close to the so-called catch-up type product life cycle thesis.

East Asia has been the textbook model of industrialization step by step and country-by-country based on the flying geese pattern. Japan has succeeded in technology transfer to its neighboring countries in East Asia, thereby establishing the solid economic foundation for the East Asia Community.

### **3. Lesson from Europe**

#### **(1) Stark Difference**

The Stark difference between the European integration and emerging East Asia integration is that the European project is a political project. It is the product of the strong political determination to build eternal peace in Europe based on the solid foundation of France-German alliance. Whereas the drive for the East Asia

Community that came up in recent years is based on economic interest first and foremost. The political determination and mutual trust of the two most important member countries in the EAC, Japan and China, is yet to come.

The interdependence in the real economy of trade and investment has already moved far ahead enough to justify the project for regional economic integration as an official policy goal. The overlapping networks of EPAs (economic partnership agreement) and FTAs (free trade agreement) can develop into a big region-wide umbrella FTA by the 13 member countries.

In the meantime the EAC member countries are moving toward building the Asian capital market and eventually, to the creation of an Asian common currency through regional currency cooperation. Creating a regional common currency (arguably the highest stage in regional economic integration) was achieved in Europe in 2002, 45 years after signing the Treaty of Rome. Talking about the introduction of a common currency at this stage is indeed a far fetched goal for East Asia.

## **(2) Short History of EU Monetary Integration**

Perhaps we can take some lessons from Europe's experience with regional currency cooperation.

Introduction of the common currency, euro, was done in the official transaction in January 1999 and the actual bills and coins began to circulate in 2002. Advent of euro is the most advanced form of the regional currency cooperation in the world.

However, it should be noted that it took more than 30 years for Europe to create and use the common currency. The road to euro was a bumpy, uphill road and there were moments when Europe's incessant search for a stable, common regional currency appeared to be almost collapsing.

### **1) Werner Report and the snake**

It was as early as in 1969 that the concrete plan of monetary cooperation among the member countries of the European Economic Community was first agreed. In 1971 the so called Werner Report on monetary union came out, and based on the Report, EEC's

Council of Ministers adopted a resolution which declared the establishment of an economic and monetary union as the political goal.

In 1972 the “snake in the tunnel” system was adopted. It included the original six members of the EC as well as the UK, Ireland, Denmark, Sweden, and Norway; the member countries’ exchange rate could fluctuate within the + or – 2.25 per cent. However, due to the continuous, international financial instability in the early 1970s, first the UK, and then France, Italy and Sweden left the snake cooperation; with the departure of those important countries, the snake lost much of its significance.

## 2) European Monetary System

In 1979 through the French-German initiative, the snake was replaced by EMS, European Monetary System, while the UK and the Norway stayed out of the EMS. Under the new EMS, the parity grid of + or –2.25% was maintained, and the participating countries were obliged to intervene in the exchange market to keep their currencies within the grid. In reality the strong German Mark was the anchor currency and the Bundes Bank often intervened in the market in favor of the other central banks with the weak currency.

## 3) Delors Report

In 1988 again through the French-German cooperation, it was agreed to set up a committee to prepare a report for reinvigorating the drive for further regional currency cooperation. The result was the Delors Report which outlined the three stage development plan for an enhanced economic and monetary union. The first stage was from July 1<sup>st</sup> 1990, and the Maastricht Treaty, ratified in 1992, provided the legal basis. Denmark voted against the Maastricht Treaty and the French referendum on the Treaty was won by a very thin majority. It was this weak support and hesitation of many Europeans toward further currency cooperation that triggered the speculation on major European currencies in 1992-93.

As a result, in August 1993 the band of currency fluctuation was widened to 15% and it stemmed off the attack on the EMS. The first stage narrowly survived.

#### 4) European Monetary Institute

Despite those setbacks, Europe moved to the second stage of the monetary union in January 1994 with the establishment of the EMI, European Monetary Institute. The EMI was to monitor the public budget of the member countries; the budget deficit should be within 3% of the country's GDP.

#### 5) European Monetary Union

In December 1996, the European Council, the gathering of the head of the European countries, decided that in January 1999, the monetary union should move to the 3<sup>rd</sup> stage, by replacing the EMI with the EMU, European Monetary Union and should fix the exchange rate among the member countries permanently and unalterably. The new currency was named euro.

Three years later, the euro was introduced as actual currency for daily use.

#### **4. Tasks ahead for East Asia**

Many observers attribute the success of euro to two factors: 1) the political determination to pursue the European integration as the utmost national priority project, and 2) the benefit of introducing euro outweighed the economic and political cost associated with euro. The benefit of euro is calculated to be the cost saving of "0.3 to 0.4% of GDP for EMU countries"<sup>3</sup>, and the elimination of the exchange rate uncertainties among the EMU countries has created better conditions for business. Important among the cost side is the loss of independent monetary policy for individual countries; in the event of an asymmetric shock hitting only one country, with the lack of a country-specific monetary policy tool to mitigate the shock for individual country, the cost of adjustment for that country could be greater.

---

<sup>3</sup> Jorgen Drud Hansen and Finn Olesen, 'Monetary Integration: Old Issues-New Solutions' in edited by Jorgen Drud Hansen, *European Economic Integration: An Economic Perspective*, p. 167, Oxford University Press, UK, 2001

In economic theory, the area in which the benefit of currency union is greater than the cost is called the optimum currency area. Prof. Robert Mundell articulated this concept of the optimum currency area in his articles<sup>4</sup>.

Compared with East Asia, EU is more homogeneous in terms of income level, political system, culture and shared history. Those conditions made the currency cooperation in Europe easier.

Asia could learn from Europe that even under those favorable conditions that had facilitated currency cooperation, the road to monetary union was fraught with risks and animosities. The political will, the practical compromise and the real economic benefits seem to have been the most important factors that made the euro project an eventual success.

---

<sup>4</sup> Mundell, R.A. (1961), 'A Theory of Optimum Currency Areas', *American Economic Review*, 51: 509-17