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Regional Integration in East Asia. From Market-Driven Regionalisation to Institutionalised Regionalism?

By

Rolf J. Langhammer

I. Introduction

Until the end of the eighthies, East Asia had never been understood as an entity comprising countries with common economic targets and joint policy instruments. Individual achievement ruled over regional achievement. Reluctance towards and even resistance against any form of concerted actions were deeply rooted in Asian history and politics. Economic leadership defined as supplying international collective goods and widely accepted as a driving force of integrating regions in Europe and North America was denied to the economic forerunner, Japan, for historical reasons. Political segmentation paralysed the traditional pre-war economic ties between socialist and market-oriented countries. Post-war economic performance in industrial development induced the countries to look upon each other as rivals in external and domestic markets and not as units with a complementary resource endowment in a sequence of economic stages as the "flying geese" hypothesis proposes (Kojima 1977).

Such dichotomies began to vanish when Japan's rapid economic growth induced industrial restructuring in this country. Japan moved towards more sophisticated activities (product innovation) and stimulated foreign investment in sectors which had lost their competitiveness in the homebase after substantial real wage increases (locational

Remark: This paper reports on research undertaken in a project entitled "The Social Market Economy: Challenges and Conceptual Response." Financial support received by the Bertelsmann Foundation, the Heinz Nixdorf Foundation and the Ludwig Erhard Foundation is gratefully acknowledged. So are comments made by Ulrich Hiemenz and an anonymous referee.

innovation). Japanese foreign investment in neighbouring East Asian countries became a crucial factor for transmitting growth impulses, employment generation, market networking and technology to other countries, for instance the so-called newly industrialising economies (NIEs) Hong Kong, Republic of Korea, Singapore, and Taiwan (Chowdhury and Islam 1993, p. 101). These countries began to walk on the same road of exporting human and physical capital to less advanced countries in the region about 15 years later. Politically, China's gradual approach of transforming its economic system gave a strong impulse to supply-side adjustment and demand-side buoyancy in total East Asia.

It is the purpose of this paper to analyse, first, to what extent these developments have paved the way to enhanced intra-regional activities in trade and capital transactions and, second, whether prerequisites were fulfilled to qualify East Asia as the third participant in the so-called triad with Europe (EC) and North America (NAFTA) as the two other actors. Thus, it is discussed whether the two steps suggest a sequence of market-driven regionalisation first, followed by institutional consolidation (regionalism).

Section II recalls the basic characteristics of East Asian economies as concerns the sectoral and regional patterns of their trade and foreign investment. Section III analyses three types of driving forces of market-driven regionalisation in East Asia, i.e. endowment-induced, growth-induced and policy-induced determinants. Section IV turns to the question whether regionalisation has led to less market segmentation as it is proposed by the "law of one price" in fully integrated markets. Section V investigates the recent initiatives to form regional and sub-regional units of cooperation (common policy-making) and integration (removing intra-area barriers to trade and capital flows). Section VI concludes on the results.

II. Patterns of Trade and Foreign Direct Investment in East Asia

1. Outward Orientation and Intra-Area Trade Expansion

East and Southeast Asian Countries (ESACs) have often been described as being oriented towards rapid economic growth and world markets. The former is undoubtedly true as shown by real rates of growth which frequently exceeded those of OECD countries by more

Table 1 – *GDP Growth and Export Contribution to Growth in East Asia, 1970–91 (per cent)*

	Rates of growth of real GDP		Contribution of exports to nominal GDP growth[a]	Export growth/ GDP growth ratio		Export growth/ world trade growth ratio	
	1970–80	1980–91	1970–91	1970–80	1980–91	1970–80	1980–91
Japan	4.3	4.2	9.9	2.9	0.9	1.8	1.0
Korea, Rep. of	9.6	9.6	29.5	2.5	1.3	4.9	3.0
Hong Kong	9.2	6.9	143.7[b]	1.1	0.6	1.9	1.1
Singapore	8.3	6.6	189.1[b]	0.5	1.3	0.8	2.2
Taiwan	9.3	7.7	49.0	1.9	1.3	3.2	1.3
Indonesia	7.2	5.6	28.3	1.0	0.8	1.4	1.1
Malaysia	7.9	5.7	84.8	0.6	1.9	1.0	2.7
Philippines	6.0	1.1	31.4	1.0	3.0	1.2	0.8
Thailand	7.1	7.9	39.9	1.5	1.8	2.1	3.5
China	5.2	5.4	25.7	1.7	1.2	1.7	2.8
Total East Asia[c]	5.2	5.1	19.4	1.8	1.0	1.8	1.3
Memo: OECD	3.1	2.9	19.9	1.8	1.4	1.1	1.0

[a] Exports comprise goods and non-factor services. Contribution to growth is measured as the ratio between the absolute increment in nominal exports between 1991 and 1970 and the absolute increment in nominal GDP during the same period (both measured in US$). The ratio is expressed in percentage terms. – [b] Including re-exports. – [c] Based on the average of 1970 and 1991 GDP weights.

Source: World Bank (various issues); for Taiwan: Directorate General (various issues); own calculations.

than two times (Table 1).[1] So did export growth rates compared to growth of world trade. In the majority of cases, export growth rates were also higher than GDP growth rates, in particular during the seventies and except for Japan, Hong Kong and Indonesia also in the eighties. Thus, in general, openness to foreign demand proved to be an important driving force of economic growth. Yet, many ESACs experienced a setback when world-wide recession affected them during the early eighties. Only Thailand and China managed to accelerate growth once again.[2] The Philippines as the only country in the region facing a severe debt problem even had to pass through a number of

[1] In Table 1, the East Asian performance is compared to the OECD average. Other comparisons focus on differences in performance between East Asia and Latin America. They unanimously lead to frustrating results for Latin America. See, for instance Morawetz (1981), Sachs (1985), Lin (1988), and Naya et al. (1989).

[2] This performance refers to a decade basis. Splitting this decade into the recession half (until the mid-eighties) and the recovery part (the second half) yields that Singapore, Malaysia and Indonesia all rebounded strongly from the recession and thus documented a remarkable achievement, too.

stabilisation and adjustment crises in the eighties which led the country to much lower rates of growth than OECD countries.

An extraordinarily high degree of export orientation, however, cannot be confirmed without qualification if the contribution of exports of goods and non-factor services to GDP growth over two decades is taken as a yardstick (Table 1, third column). On average, this contribution amounted to about 20 per cent and was not higher than in OECD countries. This supports the view that ESACs enjoyed a relatively neutral incentive system satisfying both domestic and foreign demand at equal terms. The average, however, conceals enormous differences between three types of countries. Contrary to conventional wisdom, Japan as the first type was less export-oriented than many mostly smaller OECD countries. Japanese exports contributed to GDP growth by 10 per cent only so that the lion's share of growth came from domestic investment and consumption.

A second type comprises the majority of sample countries with "contribution shares" above the OECD average up to 40 per cent. It is important to note that within this group, both resource-rich economies with large domestic markets (China, Indonesia) as well as resource-poor NIEs emerge. A third group comprises the two city states and Malaysia for which export growth was a true driving force of GDP growth. Even if re-exports of Singapore and Hong Kong are taken into consideration, the outward-oriented nature of these economies remains unchallenged. Such outward orientation includes sizeable service exports (in the city states) as well as commodity-cum-manufactured exports in the Malaysian case.

In general, all sample countries have export diversification in common. The share of primary commodities in total ESAC exports dropped from 66 per cent in 1965 to 31 per cent in 1990 (World Bank 1993, Table 14). Diversifying exports helped to sustain an efficient scale of industrial production beyond the limits posed by domestic market size. It was also instrumental to generate foreign exchange earnings necessary to gain access to least cost supply of capital and intermediate goods (Riedel 1988, p. 7). Without export diversification, the unprecedented emergence of East Asia in world trade would have been as impossible as the rapid growth of intra-area trade (Table 2). Over the last decade, the dynamic element in world trade was first the ESACs (excluding China) which doubled their share in world manufactured exports from 7 to 14 per cent. Second, China added a further impulse as a latecomer by almost tripling its share in world manufactured exports from 0.8 to 2.2 per cent. Japan, as the

Table 2 – *Trade Shares of East Asian Countries, 1980 and 1988–91*[a]

	Shares in world exports						Shares of intra-area trade in total East Asian exports			
	developing East Asia excluding China		China		Japan		excluding Japan		including Japan	
	(1)	(2)	(1)	(2)	(1)	(2)	(1)	(2)	(1)	(2)
1980	7.2	7.0	0.9	0.8	6.5	10.8	24.0	21.7	37.0	27.0
1988	11.2	12.5	1.7	1.2	9.4	12.9	29.8	26.6	38.3	31.5
1989	11.7	13.1	1.7	1.8	9.1	12.5	31.2	30.1	39.8	34.2
1990	11.5	12.8	1.8	1.9	8.5	11.5	33.2	32.2	41.1	35.7
1991	12.9	14.4	2.1	2.2	9.2	12.2	35.8	34.9	43.2	38.6

[a] For statistical convenience, the region "East Asia" includes India, Pakistan and Sri Lanka which, however, accounted for 5.8 per cent of total East Asian developing economies' exports in 1990 only. Thus, the dynamics of export growth are entirely due to East Asian economies. – (1) Total exports. – (2) Manufactured exports (SITC 5+6+7+8–67–68).

Source: Compiled from UN (1993).

third entity and the forerunner among the countries was bypassed in volume terms by the ESACs but still enjoyed rising export shares from about 11 to 12 per cent.

The distinction made between total trade and trade in manufactures highlights that the dynamics were rooted entirely in manufactures. This sectoral focus is complemented by the changing regional composition of ESACs trade. Intra-area trade with or without Japan rose much faster than extra-area trade so that in 1991 intra-area trade accounted for 43 per cent of total trade including Japan and 36 per cent excluding Japan. 1991 was the first year in which East Asia became a more important market for Japanese exports than the US (World Bank 1993, p. 57). Given the complementarity in resource endowment between resource-poor Japan and resource-rich ASEAN countries, it does not come as a surprise that intra-area trade shares are higher in total trade of the entire area than in manufactures. This difference is insignificant in intra-area trade excluding Japan indicating that the dynamics of intra-area trade between NIEs, ASEAN economies, and China originate from the manufacturing sector rather than from trade in primary commodities. Whether or not Japan is included in the sample, the region emerged as a much more important destination for manufactures than for other goods, if the percentage

increase of intra-area trade shares during the period is taken as yardstick.

To put such rise of intra-area trade into perspective compared to other economic regions, it is impressive in terms of growth but still falls short of the level which, for instance, intra-EC-12 export shares achieved during the same period (increase from 56 per cent in 1989 to 61 per cent in 1991). As concerns the other emerging regional trading arrangement, the NAFTA, ESACs have arrived at the intra-NAFTA level (which is about 42 per cent of total NAFTA countries' trade) in a much shorter period than NAFTA did.

2. East Asian Economies: Are They "Natural" Trading Partners?

Intra-area trade shares have become relevant in assessing whether a regional cluster of trade constitutes the case of a "natural" grouping (see for the US and the EC, Wonnacott and Lutz 1989; Jacquemin and Sapir 1991). In such a grouping, supply structures are highly complementary. Trade-diverting elements are expected to be small and the comparative advantages of the member states are not believed to be distorted by discriminatory trade policies. In this view, third countries would not suffer from converting a "natural" trading partnership into a preferential trading arrangement.

Following Krugman (1991), the case of a "large" share of intra-area trade has been called a "natural grouping". The term "natural" suggests geographical proximity and low transaction costs. While there is no theoretical yardstick to determine the threshold level of a "large" share, a 50 per cent minimum share has been used as a rule of thumb (ibid.). According to this level, neither ESACs nor the NAFTA countries would qualify for "natural" trading partnership. Given the unsatisfactory nature of this rule of thumb, Kreinin and Plummer (1992) have suggested an alternative approach which focuses on the pattern of intra-area trade and not on its volume.[3]

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[3] They measure and compare indices for Revealed Comparative Advantages (RCA) defined as the share of individual commodities in a single country's total exports relative to the commodity share in total world exports. The "world" is alternatively defined to include in the narrowest definition only ASEAN-4 and the three NIEs ("world 2"), furthermore, world 2 plus Japan ("world 3"), and finally, world 4 (the world as a whole). Country specific RCAs are calculated for the two regional definitions of the world (world 2 and world 3) in 4-digit SITC categories (about 600 items). As a final step, Spearman rank correlation coefficients are computed for each country be-

Table 3 – *Spearman Rank Correlation Coefficients for Japan, ASEAN and Three NIEs Between RCAs Relative to Total World (W4) and Asian Regions (W2 and W3)*

		ASEAN-4+NIEs (excluding Taiwan)+Japan=W3		ASEAN-4+NIEs (excluding Taiwan)=W2	
		Total trade	Trade in manufactures	Total trade	Trade in manufactures
Japan	1990	0.79	0.68	–	–
Malaysia	1988	0.87	0.86	0.71	0.72
Indonesia	1989	0.90	0.92	0.81	0.85
Thailand	1990	0.89	0.90	0.77	0.77
Philippines	1988	0.92	0.91	0.82	0.81
Korea, Rep. of	1990	0.76	0.68	0.61	0.57
Hong Kong	1990	0.81	0.84	0.72	0.76
Singapore	1990	0.71	0.70	0.44	0.44

Note: For further explanations, see text.

Source: Kreinin and Plummer (1992).

The estimates yield high rank correlation coefficients which are statistically significant (Table 3). Thus, the RCA structures of individual countries do not change considerably if the "world" is defined regionally or globally. This could support the view that trading patterns are not distorted by discriminatory trade policies and that even a narrowly defined regional grouping (world 2) would be economically efficient in the sense of causing minimal distortion to the ranking

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tween the RCA ranking relative to the entire world (world 4) on the one hand and the RCA ranking relative to each of the alternative worlds 2 and 3. Following Kreinin and Plummer, a high coefficient means that the ranking of a country's industries by comparative advantages would be largely preserved if the country is included in an integration scheme comprising the world 2 and 3 countries. Then, a regional integration scheme is not expected to give rise to large trade diversion. Again, a rule of thumb statement is needed to determine how large a coefficient should be considered "high". Kreinin and Plummer chose 0.5 per cent as a critical value but this seems as arbitrary as Krugman's share of 50 per cent intra-regional trade. As concerns the data base one should note that Taiwan is excluded because of lack of data in UN COMTRADE statistics. This gap is important as Taiwanese data on bilateral trade between China and Taiwan report average growth rates of Taiwanese exports to China of 40 per cent and 30 per cent in the opposite direction between 1987 and 1992 (Kao 1993, Table 1). To put the 1992 trade figures into perspective, Taiwanese exports amounted to more than 50 per cent of Japanese exports to China and to 18 per cent of Hong Kong exports. China's exports to Taiwan were much lower. They amounted to 10 per cent of Chinese exports to Japan and to only 3 per cent of Chinese exports to Hong Kong.

of industries by RCAs in each of member countries. The only outlier with correlation coefficients below the threshold level of 0.5 is Singapore in the narrowly defined "world" excluding Japan.[4] Including trade with Japan, also Singapore, however, joins a "natural" economic grouping following this definition.

The normative approach of a welfare-enhancing "natural" trading partnership is open to a number of qualifications as concerns the concepts either based on pure trade volumes or on policy-distorted RCAs. However, the positive analysis supports a priori reasoning: The trading patterns of the region widely overlap with world trading patterns, and economic proximity (comprising both geographical and cultural factors) enhances competitive adjustment of domestic suppliers to changes in supply patterns of neighbouring countries.[5]

3. The Dynamics of Bilateral Trade Flows Within East Asia: "Three Chinas" and Intra-Industry Trade on the Rise

The expansion of intra-area trade has not been even among all trading partners. Primary commodity-based trade flows, between Indonesia and Japan, for instance, declined in importance when commodity prices fell. Two dynamic sub-regional factors in intra-area trade can be identified from comparing the shares of bilateral trade flows in total intra-area trade between 1980 and 1992 (Table 4).[6] First and above all, trade between China and Hong Kong grew most rapidly by more than 8 percentage points with respect to Hong Kong exports to China, and by more than 5 percentage points in the other direction. In 1990, almost 20 per cent of total intra-area trade re-

[4] Singapore's trade within the W2 region is strongly influenced by resource-based commodities, such as oil and chemicals, for which it is a major host of processing. This trade does not play such a role in trade within W3 or in its world trade dominated by manufactures. This discrepancy may explain the low W2 estimates for Singapore.

[5] In trade intensity analyses, a "country bias" which is driven by proximity has been found to be more important than complementarity. The results of these analyses were brought to the attention of the author by the referee. According to these estimates trade intensity increased particularly in Europe and North America between 1970 and 1991 rather than within East Asia. Yet, this may indicate the success of institutionalised regionalism rather than progress in reducing distance-related barriers to trade.

[6] The figures are incomplete, as specific trade flows were not recorded in 1980 for, for instance, Singaporean exports to Indonesia and the entire Chinese trade with Korea and Taiwan.

Table 4 – *Differences Between Shares of Bilateral Trade Flows in Total Intra-Area Trade in 1980 and 1992 (percentage points)*

From \ to	Japan	Hong Kong	Indonesia	Korea, Rep. of	Malaysia	Philippines	Singapore	Thailand	China	Taiwan*
Japan	–	0.5	−2.2	−1.0	−0.0	−0.9	−0.7	0.8	−2.2	0.2
Hong Kong	0.7	–	−0.5	0.3	0.0	−0.1	−0.1	0.1	8.3	0.9
Indonesia	−8.5	0.1	–	0.1	0.1	−0.1	−1.9	0.1	n.a.	−0.2
Korea, Rep. of	−0.1	0.7	0.1	–	0.1	0.0	0.6	0.2	n.a.	0.4
Malaysia	−1.7	0.2	0.1	0.1	–	−0.1	−0.1	0.2	0.0	n.a.
Philippines	−1.1	−0.1	−0.1	−0.2	−0.0	–	−0.1	0.0	0.0	0.0
Singapore	−0.9	−0.4	n.a.	0.1	−1.6	−0.1	–	−0.2	0.0	0.2
Thailand	0.5	0.1	−0.2	0.1	−0.1	0.0	0.2	–	0.0	0.1
China	−1.2	5.5	0.1	n.a.	0.0	−0.2	0.1	−0.1	–	n.a.
Taiwan	0.1	2.5	−0.2	0.0	n.a.	0.1	0.1	0.3	n.a.	–

* 1980 exports to Taiwan are compiled from Taiwanese Import Statistics 1980 and adjusted for c.i.f./f.o.b. differences.

Source: IMF (1993, 1987); Republic of China (1993).

corded in Table 4 was due to bilateral Chinese–Hong Kong trade flows compared to only 6 per cent in 1980 (see for the 1992 figures the Appendix Table). Trade between Hong Kong and South China with its special economic zones neighbouring Hong Kong and assembling inputs imported from Hong Kong is the major element contributing to trade expansion. About one forth of the total increase in intra-area trade was due to Chinese–Hong Kong trade. The second driving force in shaping the regional trade structure is intra-NIE trade primarily between Taiwan and Hong Kong, and to a lesser extent also including Korea and Singapore. Interestingly enough, Japan did not play a leading role as concerns direct trade. Indirectly however, Japanese companies can be expected to have major stakes in trade expansion via their subsidiaries in Hong Kong and Taiwan. Intra-ASEAN trade fell short of this growth and lost in importance. Viewed against the efforts of ASEAN countries to implement the ASEAN Preferential Trading Arrangement during this period, it is noteworthy that trade of ASEAN countries with non-member countries such as Korea and Taiwan rose faster than intra-ASEAN trade.

Growth of bilateral trade can be based on inter-industry or intra-industry specialisation. Inter-industry specialisation could be expected to contribute to growing trade if partner countries at different levels of income and with different resource endowments would join the Asian region while intra-industry specialisation could emerge as a result of fast growing per capita income, convergence in income

levels, and progressing industrialisation. Previous studies covering the 1965–85 period have shown intra-industry specialisation to be on the rise in East Asia, in particular between ASEAN countries and the NIEs, Japan and the NIEs, and Japan and ASEAN, but also at a much lower level including trade with China (Langhammer 1989a, Table 4). Fukasaku (1992) supported the empirical evidence of rising intra-industry trade as well as the importance of the underlying factors such as similarities in demand and production structures. A more detailed data set covering the period until 1992 also supports these findings. At the two-digit SITC level, the estimates yield increasing shares of intra-industry trade in total trade (Table 5, upper part).[7] Levels of intra-industry trade were the highest in trade between the three NIEs and Japan and between the NIEs and the ASEAN-4 countries. In contrast to these two bilateral trade flows, trade between Japan and the resource-rich ASEAN countries was still dominated by inter-industry specialisation. China's contribution is difficult to assess as data are only available until 1987. However, there is a striking difference between the NIE/China trade yielding high intra-industry trade levels and China's trade with the ASEAN countries and Japan in which the expected dominance of inter-industry trade between partner countries at different levels of income emerges. The former is probably influenced by very intensive assembly trade between Hong Kong and South China. Because of the distinct differences in the sub-regional patterns of China's foreign trade (coastal trade versus hinterland trade, and South China's versus North China's trade), overall per capita income differentials appear as a poor yardstick to determine whether intra- or inter-industry trade dominates in China's total trade with Asian neighbours.

Once the product coverage is limited to trade in manufacturing, the dynamics of intra-industry trade disappear. As concerns trade between the NIEs and Japan, as well as between the NIEs and ASEAN countries, intra-industry levels were already high in the first half of the eighthies and have not changed much since that time. The highest levels were observed for the NIE/China trade while inter-

[7] It is known that the absolute level of intra-industry specialisation depends on the aggregation level. There is no theoretically founded "optimal" level given the difficulty to define the relevant "industry" but most analyses either chose the two-digit level or three-digit level (see Aquino 1978). As it is the change over time rather than the absolute level of intra-industry trade which is of interest here, the two-digit aggregation (which was the only one available to the author) seems appropriate.

Table 5 – *Share of Intra-Industry Trade in Total Bilateral Trade in Manufacturing Within East Asia, 1983–92 (per cent)* [a]

Reporting country/ partner country	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992
	Total trade									
NIE/Japan	50.0	49.9	51.7	51.6	51.6	55.9	58.1	62.2	62.5	64.1
NIE/ASEAN-4	61.4	62.7	65.3	71.0	66.8	79.7	67.9	72.8	73.8	70.2
Japan/ASEAN-4	9.0	10.7	13.4	15.5	13.5	27.4	16.8	19.1	24.3	16.1
NIE/China	n.a.	76.6	51.3	70.9	78.5	n.a.	n.a.	n.a.	n.a.	n.a.
ASEAN-4/China	n.a.	22.6	16.5	19.2	10.0	n.a.	n.a.	n.a.	n.a.	n.a.
Japan/China	n.a.	11.5	12.1	17.1	16.6	n.a.	n.a.	n.a.	n.a.	n.a.
	Trade in manufacturing									
NIE/Japan	73.3	72.6	74.2	65.8	61.4	58.1	64.0	70.7	71.1	71.7
NIE/ASEAN-4	79.9	82.2	76.2	73.5	76.6	90.9	77.6	73.8	71.6	76.7
Japan/ASEAN-4	81.5	82.8	77.7	72.5	53.8	81.7	55.8	63.0	66.8	39.9
NIE/China	n.a.	87.7	56.3	77.6	88.1	n.a.	n.a.	n.a.	n.a.	n.a.
ASEAN-4/China	n.a.	75.4	41.5	23.3	13.4	n.a.	n.a.	n.a.	n.a.	n.a.
Japan/China	n.a.	34.8	39.7	42.6	35.9	n.a.	n.a.	n.a.	n.a.	n.a.

[a] The formula is given by $C_j = \frac{\sum_i (X_{ij}+M_{ij}) - \sum_i |X_{ij}-M_{ij}|}{\sum_i (X_{ij}+M_{ij}) - |\sum_i X_{ij} - \sum_i M_{ij}|} \cdot 100$, where $X_{ij}(M_{ij})$ = Reporting partner's j bilateral exports to (imports from) the partner country in product category i (i=SITC2-digit). The measure adjusts for trade imbalances. See for the discussion of adjustment terms in the estimates Aquino (1978, pp. 279–280). – NIE: Hong Kong, Singapore, Republic of Korea; ASEAN-4: Indonesia, Malaysia, Philippines, Thailand.

Source: UN Comtrade Databank; own calculations.

industry specialisation regained scope in the Japan/ASEAN-4 trade relations. As in total trade, China's trade with Japan and the ASEAN countries was dominated by inter-industry trade.

Linking these results to differences in trade growth between the various pairs of trading partners yields a clear and unsurprising result. Those sub-regions showed the highest gains in intra-Asian trade which specialised intra-industrially. This holds in particular for the NIE/China pattern, to some extent also for intra-NIE trade which is reported in Table 5. Again not surprisingly, Japan's export profile in high-tech products was not met by equivalent manufactured imports in the same categories from ASEAN and China. Therefore, inter-industry specialisation continued to dominate in those trade relations in which the technological gap between the trading partners was still large and perhaps even widening. For instance, in trading with Japan, ASEAN-4 countries and China were still specialised in relatively labour-intensive and low-skilled manufactures compared to the Japanese export supply in advanced machinery and transport equipment.

4. Intra-Asian Foreign Direct Investment: Shifts in Sub-Regional Patterns of Supply and Destination

Factor flows are much more difficult to record than trade flows. This holds in particular for Asia in which for a long time Japanese investment was the only major source of long-term capital outflows. Traditionally, Japan was strongly engaged in investment in developing Asia, much more than the US in Latin America or Europe in all developing countries (Langhammer 1991b). This engagement declined in relative terms after 1985. While in the fiscal year 1985, ESACs still hosted about 23 per cent of total Japanese accumulated foreign investment (on an approval base), this share declined to 15.2 per cent in fiscal year 1992 (Ministry of Finance, various issues).[8] Yet, this drop was almost entirely due to a single Asian country, Indonesia which declined from 10.1 per cent to 3.7 per cent in Japanese total foreign investment. The fall of commodity prices and finalisation of few large-scale investment projects in the commodity sector seem responsible for this decline.

During this period, two shifts, however, seem more remarkable than the decline of Japanese investment in Asia. First, other ESACs, in particular the NIEs, became major second-generation investors, and second, investment was diverted from Southeast Asia to China. Recent evidence underlines the importance of these shifts. Despite the decline of Japanese investment in Asia, it has been estimated that the share of intra-East/Southeast Asian investment in world's total investment rose from 3.9 per cent in 1987 to 10.7 per cent in 1990 (JETRO 1992 cited in: Taniuchi 1992, p. 15). According to JETRO Japan External Trade Organization, it was mainly Hong Kong and Taiwan which became major exporters of long-term private risk capital while the two other NIEs lagged behind somewhat. As concerns shifts in the direction of intra-Asia investment, it is reported that Taiwanese investment in the Philippines, Indonesia and Thailand fell sharply in 1992 while investment in China grew three-fold. Three years after Taiwan began to invest in China at a large scale, the country has moved to become China's third largest foreign investor on a cumulative basis, far behind Hong Kong, but close to the US and ahead of Japan which have been investing in China for over a decade (Kao 1993, Table 4). This was achieved at a time when no direct or official

[8] During the same period Europe raised its share from 11.9 to 18.3 per cent. The major gainer was the US/Canada region which raised its share from 32.2 to 43.9 per cent.

links were allowed between Taiwan and China. Investment into China also came from Indonesian, Malaysian and Thai conglomerates who are reported to be among the more aggressive investors in China itself. In 1992, Thailand and Malaysia were the eighth and tenth largest investors in China (Merrill Lynch 1993, p. 23).

III. Market-Driven Regionalisation of Economic Transactions in East Asia: The Driving Forces

1. "Natural" Factors: Complementarity in Resource Endowment and Economic Proximity

Functional Regions in East Asia

Richardson (1979, pp. 227–229) has defined regions either as functional or homogeneous. Functional regions are characterised by complementarity of countries in resource endowment and differences in size and income level. Due to such complementarity there are interactions between countries, subcentres and peripheries in goods and factor markets.[9]

In this respect, East Asia offers abundant opportunities for welfare-enhancing exchange. The two relatively resource-rich ASEAN countries (Indonesia and Malaysia) and China complement the resource-poor NIEs and Japan. It is true that such inter-sectoral patterns might lose their attractiveness with resource-saving technological progress proceeding within manufacturing and with the increasing importance of less resource-intensive services. Yet, complementarity does not end with commodities. Relative abundance in unskilled labour and the availability of land are further elements of complementarity and functional regions. ASEAN-4 and, of course, China offer such resources relative to the NIEs and Japan. The availability of unskilled labour and differences in labour costs has influenced inter-industry specialisation within manufacturing and fuelled, for instance, Japanese and NIE foreign investment in labour-intensive industries in ASEAN-4 and China. Such investment has also stimulated intra-Asian trade. For instance, between 1983 and 1989, Asia-directed sales of those Japanese affiliated manufacturers which were based in Asia rose relative to domestic and non-Asian sales (Table 6). While in 1983 sales to Japan and other Asian countries comprised 10.8 per cent and

[9] Homogeneous regions reveal strong similarities between the countries of the region, thereby enhancing intra-industry trade if the income level is high.

Table 6 – *Sales of Japanese Affiliated Manufacturers in Asia by Destination, 1983–89 (per cent)*

	1983	1986	1987	1988	1989
Domestic Sales	66.9	54.7	59.0	59.8	63.9
Exports to	33.1	45.3	41.0	40.2	36.1
Japan	10.8	15.8	16.7	13.7	15.8
North America	8.2	10.2	8.0	8.7	6.0
Asia	8.2	12.8	11.1	11.4	9.7
Europe	3.1	4.6	3.5	4.5	3.3
Others	2.8	1.9	1.7	1.9	1.3

Source: MITI (1991).

8.2 per cent of total sales of Japanese affiliates in Asia, these shares rose to 15.8 per cent and 9.7 per cent in 1989. In the eighties, Asia became the main source of exports of overseas Japanese affiliates to the home country. Recent MITI surveys yield that the share of Asia (as a host to Japanese affiliates) in total affiliates' exports to Japan ranged between 57 and 60 per cent in 1987–91 (MITI 1993, p. 6). The ratio between affiliated imports of Japan from Asia and the USA as the second-largest source jumped from 1.9 in 1980 to 2.8 in 1991 (MITI 1990, Chart 4).

An important "natural" driving force of regionalisation in Asia is the relative abundance of land. It has not only fuelled foreign investment from least land-abundant Asian countries in land-intensive industries of relatively abundant countries. It also gave rise to flows of goods and factors into services and foreign investment. To give three examples, traditionally, Japan, for instance, runs a large deficit in non-factor services, especially in travel and transport vis-à-vis developing countries (Langhammer 1989b, Table 2). Japanese tourists have spread over neighbouring Asian countries which offer services in leisure industries including competitive transportation services. In 1985/86, 51 per cent of Japanese import expenditures on transportation services and 30 per cent of travel services originated from developing countries, the majority of them in Asia (Langhammer 1989b, p. 254). Overall, Japanese service imports from developing countries accounted for almost one quarter of Japanese merchandise imports. In 1992, almost 44 per cent of total Japanese expenditures for international transport services was credited to Asian countries while this share amounted to even 60 per cent for travel expenditures. For all services, Asian countries accounted for 46 per cent of Japanese total

import expenditures in 1992 (Bank of Japan 1993, pp. 81–86). As concerns foreign investment, one of the largest individual flows of Japanese investment in the Asia-Pacific area has been in real estate in Australia and New Zealand. In the fiscal year 1992, stocks of Japanese investment in real estate in these two countries amounted to one third of total Japanese investment stocks in Asian manufacturing. Two years earlier, this share was four percentage points lower (Ministry of Finance, various issues). Should East Asian countries, in particular China, open their real state sectors as Australia and New Zealand did, Japanese and NIE investment would probably respond rapidly. A third example of the effects of complementarity between capital-intensive, labour-intensive and land-intensive production in various Asian countries is of sub-regional nature. It refers to the idea of so-called "growth triangles", e.g. production sharing in border areas of countries with different factor endowment and factor price ratios. The most well-known example is the Johore–Singapore–Batam project encompassing investment in land-intensive industries in the Indonesian island of Batam close to Singapore, relative labour-intensive production in Johore, the tip of the Malaysian peninsula, and human-capital-intensive production in Singapore (Yuan 1991; Arndt 1993). Other sub-regional projects comprise the North Sumatra/Thailand/Malaysia area and the Pearl River/Hong Kong area and some more are planned, for instance, in the Tumen River Delta where the borders of China, Russia and North Korea meet.

Economic Size and Proximity as Gravity Factors

Gravity models of trade flows usually find the income level ("size") and geographical proximity to be the major explanatory factors of bilateral trade between neighbouring countries. Amelung (1991) has tried to refine this type of analysis for the Asia-Pacific region by including independent variables other than size and geographical distance, for instance, proxies for cultural homogeneity, exchange rate fluctuations, sovereign risk (debt default risk), and black market/official market exchange rate margins. All variables can be related to costs of transactions as concerns bridging distances, closing information gaps and hedging against uncertainty and risk. Not surprisingly, distance and size remain important explanatory variables in this model. However, in addition, credibility (measured as "good debtors" behaviour or lack of sovereign risk) and cultural homogeneity (the transmission role of minorities in different Asian

countries which belong to the same ethnic group) contribute to bilateral trade intensity to a significant extent. Chinese minorities in ASEAN countries are often quoted as performing an important bridging function in inter-country trade.

Bilateral trade intensity as the roots of regionalisation in East Asia is identified in another study by the same author (Amelung 1992). In a hierarchical cluster analysis, he exposes pairs of neighbouring countries as the catalysts of strongly integrated countries. China/Hong Kong, Malaysia/Singapore are such strong economic entities. Countries joining these core groups are more loosely linked to each other and thus form wider circles with decreasing trade intensity. In East Asia, two groups emerge, the ASEAN countries with Singapore as a centrepoint stretching links to Indonesia and Thailand, too, and Northeast Asian countries, namely the Republic of Korea, Taiwan, Japan, China and Hong Kong (ibid., pp. 142–143). It is interesting to note that until 1987, the end of the observation period, the US still formed an integral part of the second group, even a core group with Japan and Korea. Meanwhile, with Asia having bypassed the US as the major single market for Japanese exports, there is reason to assume that bilateral trade intensity has risen for intra-Asian trade and decreased for US-Japan trade. Amelung shows that this change emerged already in the eighties compared to the seventies when the US still figured more prominently as a core country for bilateral trade irrespective of geographical distance. He also exposes South Asia as not taking part of regionalisation tendencies.

To conclude, both gravity models and cluster analyses find tendencies of regionalisation of trade and factor flows within East Asia, starting with small groups of core countries in East Asia and Southeast Asia. Driving forces were complementarities in resource endowment, comprising commodities, unskilled labour, and land as well as economic size, distance, and lower transaction costs because of less uncertainty and stronger inter-personal cross-border links (cultural homogeneity).

2. Growth-Induced Factors

Growth-induced factors comprise a number of influences such as income growth and expansion of domestic demand, structural change in domestic and export supply towards income-elastic products and the emergence of intra-industry trade (reported above). These factors have in common that there has not been a specific regional element

except for the fact that ESACs grew more rapidly and experienced more structural change than countries of neighbouring regions (South Asia and Oceania). However, regionalisation would have not necessarily benefited from growth unless additional factors were instrumental to dismantle market segmentation. Basically, these factors can be summarised as better endowment with physical and human infrastructure to enhance market networking by lower costs of information, communication, transport and technology diffusion. Underlying these factors is rising intra-regional trade in services which are increasingly supplied if rapid growth helps to pass a threshold level of minimum output. Some of these services are characterised by indivisibilities and lump-sum investment and are therefore not supplied by the private sector unless the threshold level is passed. In many cases, such services may be supplied first by multinationals for intra-company use and only later opened to non-affiliated parties after the pay-off period. Parts of the services are embodied in manufacturing production and thus are included in manufacturing investment of multinationals. Other services arise directly from foreign investment in tradable services. The pattern of intra-Asian foreign investment in such services might therefore be a proxy for achievements in dismantling the segmentation of markets for information. Japanese investment as the largest individual source of service investment in Asia can be taken as a yardstick.

Japanese Investment in Services in Asia

Japanese foreign investment in commerce, banking, insurance, services and transportation in Asia and also Oceania has been the largest growing segment of total investment. Shares in stocks of Japanese investment in Asia rose from 20 per cent in 1985 to 32 per cent in 1992. An analysis of the inter-temporal and intra-Asian allocation of the investment flows shows that some host countries can be identified which attracted investment at the same time while other countries revealed a different pattern either because of being excluded from investment or receiving it as latecomers (Langhammer 1991c, Table 2). The hypothesis is that costs of information declined overproportionately between those pairs of countries (or groups) where foreign investment was relatively equally allocated over time so that two-way bilateral transactions could enjoy lower costs of information than transactions with countries which did not or not yet attract investment. This proxy found ASEAN countries to be most homoge-

neous in attracting Japanese investment in services and that for the entire region (ASEAN, NIEs, China) the rhythm of investment inflows into individual countries became more even in the second half of the eighties relative to the first half. This could suggest that regionalisation of transactions was facilitated through the formation of sub-regions in which information-induced costs of transactions declined overproportionately.

Improving Physical Infrastructure within Asia

During the last two decades, one of the major growth industries in Asia has been air and shipping transport. Studies on air transport and tourism services report a rapidly growing number of Asian airlines operating successfully within Asia (and world-wide), while in shipping, liner and tramp services within Asia were extended (Findlay and Forsyth 1988; Chia and Trace 1988). Furthermore, both volume and quality of audio-services were improved through launching satellites which explicitly were geared at removing bottlenecks in intra-area communication. Costs of intra-area communication and transport have declined as a result of more intensive competition in tradable services.[10] It appears, however, that the improvement of inter-country communication networks has run ahead of better intra-country infrastructure. The latter is addressed as one of the major bottlenecks in Asian countries estimated to be equivalent to a shortfall of investment of as much as 2–3 per cent of GDP in some countries (World Bank 1993, p. 46). It might also impact negatively upon regional market integration if the productive capacities of individual countries would suffer from inadequate investment into physical infrastructure.

3. Policy-Induced Factors

"Good governance" and "developmentalist state" have been two characteristics with which policy-making in many ESACs has been associated in the past. In general, these labels comprised macroeconomic stability, prudence in supplying basic public goods efficiently, incentives to competition and structural change within the private sector, less priority given to distributional targets, formation of human capital not only at school but also "on the job", and, finally, the

[10] See for an analysis of declining costs of telecommunications in Singapore, Phang and Chng (1993).

ability to correct policy mistakes rapidly, thus putting the economy back on the growth path.

In all these achievements, there has been no explicit regional element except for the recognition that neighbours increasingly have become competing units for scarce resources. Scores in world competitiveness reports and rankings in international rating agencies were carefully taken into consideration, not only concerning the worldwide performance but increasingly with respect to neighbouring countries. Regionalisation, however, seems to have indirectly benefited from two liberalisation steps which were taken on a MFN basis but were instrumental to lower transaction costs particularly in intra-area trade and capital flows between "natural" trading partners. These steps comprise trade policies and policies to liberalise financial markets.

Liberalising Trade

An important common feature of recent trade policy reforms in many Asian countries has been a unilateral dismantling of tariffs and quantitative restrictions (QRs) independently from parallel negotiations in the Uruguay Round. Unilateral reforms are not subject to binding and thus allow for flexibility in autonomous tariff rate changes. They also give leverage in tariff bargaining in the Uruguay Round. Between 1986 and 1992, most GATT member states in the Asian region have lowered tariffs below the level of "bound" rates negotiated in the Tokyo Round. The two non-member countries, China and Taiwan, followed the example of their neighbours (Table 7). As a result, the countries were prepared to offer lower "binding" cuts in the Uruguay Round than the average target rate of 33 per cent. Thailand, for instance, offered "binding" cuts of only 26 per cent on average but could easily meet the target level because the bound rates were still higher than the actual rates charged (OBI 1993). Crucial elements of trade liberalisation such as cuts of peak tariffs and tariffication of NTBs were parts of the reform. They can be expected to have stimulated intra-Asian trade in the manufacturing sector in which peak tariffs were frequently imposed. It is important to note that unilateral cuts were non-discriminatory.

Overall, autonomous trade policy reforms were introduced particularly in those countries which were known for relatively high average levels of import protection, for instance, Indonesia, Thailand, the Philippines and the Republic of Korea. The other countries (Malaysia,

Table 7 – *Unilateral Tariff Trade Policy Reforms in Asian Countries, 1986–92*

	Tariff bindings/substantial reductions	Substantial liberalisation of qualitative restrictions (QRs)	Recourse to Art. XVIII: B (balance of payments (BoP) measures)
China	1992: import tariff reductions on about 3,600 items announced; in agreement with the US (October 1992) 75 per cent of import licenses, QRs and other non-tariff barriers (NTBs) are scheduled to be eliminated over a 2-year period; publication commitment for all trade regulations		
Indonesia	Tariff reductions between 1984–90 bringing average tariffs to 22 per cent down from 37 per cent. June 1991: tariff rates and surcharges were reduced on 860 items	QRs lifted on 311 items; reduced licensing restrictions from 32 to under 15 per cent of tariff items; export subsidies were reduced June 1992: export bans on wood, veneer, rattan and hides were ended; greater tariffication	
Japan	April 1990: tariff elimination on 1,004 products	Import quotas for specific food and beverages were eliminated	
Korea, Republic of	Average tariff reduced from 18.1 per cent in 1988 to 7.9 per cent by 1993	Import surveillance system abolished in 1988; QRs eliminated on 1,004 products in 1986–90; additional 102 items liberalised as of January 1991. Three-year import liberalisation programme announced for 1992–94; it is intended to phase out restrictions for 133 monthly agricultural products	BoP measures involved are agreed to be eliminated or brought into conformity with GATT by 1997
Malaysia	Tariff reductions on 445 items in September 1986		
Philippines	1991: announcement of a four-tiered tariff structure (rates of 3, 10, 20, and 30 per cent) to be implemented over five years. 9 per cent import levy reduced in August 1991 and eliminated in May 1992, except for a few items, levy on petroleum products removed in June 1992	1988–1992: import licensing was lifted or reduced, QRs on 178 tariff lines were converted into tariffs in July 1992 and are scheduled to be reduced	BoP restrictions were relaxed
Taiwan	Average tariff reduced by 50 per cent in 1984–89; average tariff was reduced to 4.97 per cent in 1991. Further cuts in tariff rates are scheduled	QRs and import bans have been reduced; so have been items subject to export permit requirements	
Thailand	1988/89: average tariff reduction from 12.6 to 11.1 per cent (tariff collection rate); statutory tariffs reduced from 30–35 per cent to 5 per cent; export taxes removed for most products	List of products requiring non-automatic import licensing has been streamlined; conversion of ten product categories from non-automatic to automatic licensing	

Source: Compiled from OECD (1991) and GATT (1993).

Singapore, and Hong Kong, for example) have concentrated on multilateral negotiations and the reciprocal dismantling of NTBs. As a result, levels of import protection have become more similar between Asian countries, and this may facilitate common initiatives in future.

Liberalising Private Capital Inflows

The eighties have seen a parallel trend in Asia to liberalise domestic capital markets and to open investment opportunities to non-residents, both in foreign direct investment and portfolio investment. Domestic capital markets were liberalised basically by deregulation, lowering access restrictions and abandoning interest rate manipulations. In the aftermath of these reforms, linkages between real rates of interest in domestic and US markets were found to be high. So were indices of capital mobility in some Asian countries which show the degree to which foreign interest rates determine domestic rates (Fischer and Reisen 1993, pp. 24–25). Yet, there were differences among Asian countries. Southeast Asian countries were generally more prone to opening markets while the Republic of Korea and Taiwan still seem to have retained some control over domestic monetary developments.

As concerns FDI, Taiwan (in the early eighties), the Republic of Korea (from 1984 onwards), China (gradually since 1978) and the ASEAN-4 countries (since 1985) have substantially revamped and modified foreign investment policies. Basic elements of reforms comprised the opening of "sensitive" sectors to FDI and the lowering of restrictions on profit repatriation. This has led to a convergence of FDI policies on a lower regulatory level and gave a major impulse to a rapid increase in intra-East Asian FDI in the second half of the eighties (Chen 1993). As discussed above, Taiwan and the Republic of Korea next to Hong Kong emerged as the major second generation home countries following the Japanese example. In 1991, 56 per cent of Taiwanese-approved outward FDI was directed to Asia, as compared with 10 per cent in 1985. For the Republic of Korea, the shares were significantly lower but again rising (from 19 per cent in 1986 to 31 per cent in 1990).[11] Such increases occurred during a period in which total FDI of the two countries rose rapidly: in Taiwan by 85 per cent annually and in Korea by 39 per cent, respectively. For Hong Kong, shares cannot be calculated because of lack of information on investment outside Asia. The picture is not as clear if sub-regional patterns of intra-ASEAN investment are considered. While for

[11] The figures are compiled from Chen (1993, Tables 4 and 5).

Thailand the share of ASEAN-originating FDI in total inflows increased from 3 per cent (1978–87) to about 10 per cent (1989–91), increases were much lower for Indonesia (from 2 to 4 per cent). For Malaysia and the Philippines shares even declined (Chia 1993, Table 8).

As concerns portfolio investment, Asian countries have steadily relaxed and removed foreign exchange controls and other regulations governing foreign portfolio investment (Greenwood 1993, pp. 124–132, in particular Tables 1 and 2). While the trend was basically the same in all countries (as world-wide), the starting point was different. Japan and Hong Kong are on the liberal side with virtually unrestricted transactions whereas the Republic of Korea and Taiwan began to liberalise from a high regulatory level. Typical regulations imposed upon non-residents comprise deposit requirements, maximum limits on share ownership, bans on investment in bonds or money market instruments, repatriation constraints, and limits on swap transactions between local institutions and foreign banks. Greenwood (1993, p. 125) reports anecdotal evidence that such differences made the two former countries the largest recipients of portfolio flows. However, it is only possible to record non-Asian investment into Asia across the board rather than intra-Asian flows. Flows from US pension funds, for instance, were stimulated not only by facilitated access to Asian portfolio markets but also by domestic deregulation. The latter allowed US public pension funds, for instance, to invest in non-US securities many of which originate from emerging Asian markets. In 1991, 33 per cent of US pension fund assets in international markets were allocated to Japan and other Far East countries (ibid., Table 3). On the other hand, so-called closed-end country funds traded on US exchanges recorded a decline of the share of pure Pacific Basin funds from 43 per cent in 1987 to 22 per cent in mid-1992. This slump occurred in the aftermath of the Japanese "asset bubble" experiences which led US investors to take a more cautious approach vis-à-vis investment in Japan (ibid., Table 8).[12] The only detailed information on intra-Asian investment flows relates to Japanese portfolio investment flows in bonds and equities in the Asian region (ibid. Table 13). This source of information reveals a modest build-up in Asian investment during 1989–91. In June 1992, only 0.3 per cent of

[12] This decline overrates asset diversification to the extent that only pure Pacific Basin funds are considered. These figures exclude the portion of global emerging markets or other fund categories which have Asia-Pacific commitments (Greenwood 1993, p. 136).

foreign investment of Japanese life insurance companies was allocated to the NIEs and ASEAN economies. However, again, the "true" exposure is much higher because Japanese institutional investors increasingly channel funds to Asia via offshore centres such as Luxembourg, Cayman, Netherlands Antilles and Virgin Islands.

Overall, portfolio investment data are even less accessible to regional disaggregation than foreign direct investment. It seems that the recent liberalisation of portfolio investment in Asian countries have not only stimulated inflows from the US, Canada, Australia and Europe, but also from Asia. A major source of inflows have been private as well as institutional investors, whereby investments by the latter have increased hand in hand with rising demand for construction, banking and insurance services in all ESACs. Intensified competition in these markets will lead to the creation of a wide range of funds with various degrees of risk in which emerging Asian host countries such as China may perhaps attract just those investors that are less risk-averse.

IV. Has Regionalisation Led to Less Market Segmentation?

Markets are segmented from each other by costs of transactions in goods and factor markets. Basically, such costs comprise policy-induced barriers, costs of bridging economic distance and costs of hedging against uncertainty. The former sections have supported the conclusion that such costs have decreased within Asia without showing the consequences. Once such costs decline, the major consequence is that prices between national markets converge.

In the following, two proxies are proposed to measure the validity of the "law of one price" for Asia: the spread of retail prices between Asian capitals and the volatility in nominal exchange rates.[13]

1. The Spread of Retail Prices Between Asian Capitals

Using various international price comparison surveys of the Union Bank of Switzerland for consumer goods and services pub-

[13] Estimates on a third measure, the degree of integration of Asian stock markets, have been provided by Lim and Lew (1993) for the November 1987–December 1990 period. They analyse patterns of co-movement of daily stock price indices between the US, Japan, Hong Kong, Singapore, Malaysia and Australia. The most interesting result is that during this period the emerging markets of Asia have followed the Tokyo stock price more closely than the New York stock price. This supports the hypothesis of declining market segmentation in East Asia.

Table 8 – *Comparisons of Retail Prices in Asian Goods and Service Markets*[a], *1979–91 (Index Zürich = 100)*

	Goods and services[b]				Services			
	1979	1985	1988	1991	1979	1985	1988	1991
Japan	106	185	159	115	87	129	148	103
Hong Kong	94	115	57	64	50	122	48	58
Korea, Republic of	n.a.	130	68	58	n.a.	92	58	39
Taiwan	n.a.	n.a.	n.a.	84	n.a.	n.a.	n.a.	83
Singapore	70	120	67	64	74	154	45	39
Indonesia	69	125	48	44	78	108	30	31
Malaysia	n.a.	107	48	44	n.a.	124	34	27
Philippines	46	83	49	40	42	76	24	24
Thailand	60	57	49	n.a.	50	81	41	n.a.
Coefficient of variation	0.52	0.32	0.55	0.39	0.29	0.24	0.74	0.57

[a] Data collected in the capital of the respective country. – [b] Basket of more than 100 goods and services weighted by consumer habits. The number of items ranges from 100 to 112, and includes about 20 services.

Source: Union Bank of Switzerland (various issues).

lished for prices in more than fifty capitals (including Asian capitals), one may calculate the spread of prices of different baskets over Asian capitals (Table 8). Estimates are based on converting national retail prices into an international currency (either dollar or Swiss francs) and published as indexes with the Zurich price as the base price (Union Bank of Switzerland, various issues). Apart from changes in cross-border and domestic taxation, the driving force of variations across the sample years are exchange rate changes. Shortcomings of this proxy are systematic. They are reflected in the price level and do not bias inter-temporal changes in the size of variation coefficients which are used as the relevant yardstick for inter-country spreads. With declining market segmentation, we would expect declining spreads and thus lower coefficients of variation. However, the picture for the entire basket which includes both goods and the less tradable consumer services is inconclusive. The spread declined between 1979 and 1985, then rose to the 1979 level in 1988, and again declined until 1991. Such volatility may be due to changes in country coverage, changes in indirect taxation (including tariffs) and diverging exchange rate paths. Not unexpectedly, parts of larger spreads are due to greater price variations in services. Thus, overall, the findings do not

reveal a clear trend towards declining spreads in intra-Asian prices for goods and services. As exchange rate changes are expected to be one of the major factors behind variations of retail prices, nominal exchange rate volatility is discussed next.

2. Nominal Exchange Rate Volatility

Uncertainty is an important barrier to cross-border trading and capital flows because it requires costly hedging against exchange rate risks, for instance. With declining trade barriers, in particular dismantling non-tariff barriers, more macro-economic stability as well as more flexibility in goods and factor prices, one could expect nominal exchange rates to become less erratic and volatile. If such smoothening of exchange rate changes could be observed in ESACs, this would be a relevant proxy for assuming that uncertainty-induced transaction costs have declined. Again, such decline would benefit extra-area and intra-area traders alike but would in particular benefit the latter if they were less experienced in hedging than the extra-area OECD-based traders. Table 9 presents annual variation coefficients based on quarterly exchange rates as a proxy for volatility in ESAC exchange rates. As concerns the level of fluctuations, countries differ substantially. Commodity-rich countries (Indonesia) and countries facing sta-

Table 9 – *Nominal Exchange Rate Volatility of ESACs, 1980–92*[a]

	Japan	Korea, Rep. of	Singapore	Taiwan	Indonesia	Malaysia	Philippines	Thailand	China, Rep. of
1980	6.34	5.60	1.84	0.20	0.17	1.34	0.95	0.39	1.57
1981	5.04	1.46	1.90	2.17	0.54	2.16	2.25	5.53	4.46
1982	5.05	2.15	1.89	2.58	2.28	1.28	3.07	0.00	3.99
1983	1.52	2.34	1.31	0.31	15.50	1.29	17.68	0.00	0.79
1984	3.54	1.38	1.42	1.08	3.08	1.92	15.52	5.41	11.78
1985	9.39	2.66	2.41	1.05	1.38	1.62	0.67	2.11	5.15
1986	8.45	0.94	1.26	3.35	19.19	2.54	0.96	0.64	8.33
1987	5.05	3.06	1.97	7.51	0.26	1.02	0.69	0.69	0.00
1988	3.04	4.30	1.38	0.55	1.47	2.15	0.93	0.62	0.00
1989	4.86	0.71	0.62	3.24	1.21	0.74	1.62	0.86	2.28
1990	7.08	1.67	3.95	1.85	1.43	0.26	8.71	1.37	2.55
1991	2.93	1.92	2.45	2.08	1.41	0.92	2.01	0.77	1.43
1992	2.71	1.23	1.02	0.67	0.96	2.36	2.57	0.47	1.65

[a] Annual ratio between the standard deviation and the mean of quarterly exchange rates (as percentage share). No data for Hong Kong because of fixed exchange rates.

Source: IMF (various issues); for Taiwan: see Table 4, own calculations.

bilisation crises (Philippines) show high singular volatilities while fast growing exporters of manufactures exposed to extra-area pressure and speculation for appreciation (Japan, Republic of Korea) faced generally higher levels of volatility. What matters for the change of uncertainty-induced costs is the trend of volatility for each country. For almost all countries (except for Taiwan), the trend has been declining if the average volatilities for the 1980–85 and 1986–92 periods are compared. The trend is distinct for the Republic of Korea, the Philippines, Thailand, and China whereas small changes on a constant level of volatility emerged for Japan, Singapore, Indonesia, and Malaysia. Declining volatility appears even more distinct if the "outlier" year of 1990 is disregarded. In 1990, foreign exchange markets destabilised temporarily as a result of the Kuwait crisis. Overall, a major factor supporting the decline in exchange rate volatility seems to be export diversification towards non-commodities. Each country has been successful to reduce the influence of commodity-induced instability in exchange rates by shifting incentives towards exports of manufactures.

Comparing the two proxies leads to inconclusive results. On the one hand, uncertainty-induced transaction costs seem to have declined and thus have fostered market integration. On the other hand, lowering all kinds of transaction costs in ESACs has not supported a clear trend towards the "law of one price" in goods and service markets. Obviously, differences in income levels and the size of the nontradable sector (including indirect taxation) are still large enough to sustain a considerable degree of market segmentation in ESACs. This result underlines that regionalisation has been more a by-product of world market orientation rather than its centre piece. Furthermore, heterogeneity in size and income level seems to have given more rise to diverging policy paths than to concerted policy actions or coordinated policy changes.[14]

V. Regionalism as a Companion Piece to Regionalisation?

For almost three decades, regionalism defined as regionally discriminatory trade integration was irrelevant in Asia. It was even anathema. While virtually all other regions embarked upon strategies

[14] National exchange rate policies, for instance, were neither regionally nor sub-regionally coordinated in the sense of a currency bloc or regional anchor currencies. See, for instance, Claassen (1992, p. 142) for the sub-regional view and Frankel (1992) for the regional view.

to implement preferential trading arrangements, free trade areas, customs unions and even common markets, all Asian countries (including South and Western Asia) abstained from such strategies. Unbridgable differences between various socio-economic systems, the legacy of the war period, political rivalry and border conflicts, and, finally, the heterogeneity in economic size and levels of development figured prominently among the most frequently cited reasons. Stagnation and failures of many schemes outside Asia did not enhance the appeal of regionalism even when political hurdles were removed after the gradual opening and transformation of Asian centrally planned economies. Early approaches on a sub-regional level as the so-called Bangkok Agreement of 1976 and the Preferential Trading Arrangement of ASEAN (1977) remained without a relevant impact on the partner countries' trade flows and their regional structure (Brockmann et al. 1991; Langhammer 1991a).[15] However, since the end of the eighties even East and Southeast Asia has become subject to serious debates on "regionalism". This debate was primarily fuelled by external factors such as the long period of stalemate in the Uruguay Round, the formation of NAFTA and the EC Single Market, concurrent fears of trade diversion, and the emphasis on bilateralism in trade policies of the major trading partners. In some circles, consolidating the achievements in regionalisation by stronger institutional backing was felt to be necessary. The debate manifested itself in two approaches of regionalism, on the one hand, the formation of a Free Trade Area (AFTA) comprising the six ASEAN member states and scheduled for finalisation until 2007, and on the other hand, the approach of the Asia-Pacific Economic Co-operation (APEC) comprising the East Asian region plus the Eastern Pacific Rim countries US and Canada as well as Australia and New Zealand. All other approaches (for instance, the plan of an East Asian Economic Caucus (EAEC), the non-official consultative body named Pacific Economic Cooperation Council (PEEC), and the private sector-influenced Pacific Basin Economic Council (PBEC)) fall short of measurable impacts either on trade integration or economic co-operation.

[15] For a long time, ASEAN has been primarily a co-operation scheme both politically and economically (with common industrial projects and industrial co-operation) rather than a trading scheme. Its impact upon regionalisation of transactions beyond a stage which would have been reached anyway "through the market" is of qualitative nature. However, the fact that over more than a quarter of a century economic and political disputes could be settled peacefully seems worth to be called a public international good.

The sub-regional AFTA approach follows the traditional trade-oriented sequence of converting preferential trading relations into a free trade area with a two-tiers tariff (member and non-members). It has to struggle with the well-known stumbling blocs, i.e. removing trade barriers between countries with different tariff levels and structures, rules of origin and speed and depth of tariff cuts (for detailed research on AFTA see Imada and Naya 1992 and Moellers and Mahmood 1993). From the very beginning, credibility has been an important issue. While the so-called Common Effective Preferential Tariff Scheme (CEPT) divided into a fast track and normal track tariff reduction programme was agreed upon to start equally for all members on 1 January 1993, member countries started differently. Singapore initiated CEPT tariff cuts on schedule, while Malaysia initiated notional tariff cuts to be made effective in 1995/96 and Thailand reduced tariffs unilaterally on an ASEAN CEPT basis (ASEAN Secretariat 1993). Parallels to delayed and finally abandoned schedules of stepwise tariff reductions within LAFTA in the sixties come to mind.

The only new phenomenon of regionalism and the major subject of controversies and misunderstanding is APEC. It has been labelled by Garnaut and Drysdale (1993) as "open regionalism" (no discrimination) or "open economic association" (based on voluntary understandings, no majority voting, no supra-national authority) or as an indicative and subtle policy dialogue without macroeconomic co-ordination (Yamazawa 1992; see also Elek 1992). Hughes (1991, p. 134) assesses APEC positively as it served to bring together the outward orientation of East Asia at a time when the strengthening and establishment of regional blocs in Europe and North America threatened a revival of protectionism in regional bloc guise. However, she fears that vested interest groups (politicians, international bureaucrats, academicians) could continue to seek to give APEC a permanent organisational format for very selfish reasons.

Much of the confusion on APEC stems from unclear phrasing and labelling.[16] Even after the 1994 Bogor Summit announcing an APEC-wide Free Trade Area for 2020, APEC seems far from being a regional institution. Nor is it a consultative body similar to the OECD. To qualify for a regional institution, APEC should not only command access to measures discriminating between members and non-mem-

[16] See for an extensive discussion of the various labels, definitions and possible contents centering around regionalism and regionalisation in Asia, Lorenz (1993) and – with respect to regionalism – Arndt (1993).

bers regardless of whether such measures are actually applied or used as a defense measure in global trade conflicts. It should also have clear guidelines for membership. To include Mexico and eventually Chile but no other South Eastern Pacific Rim country, makes APEC semi-global but not regional. Such semi-globalism would meet many criteria of openness, non-discrimination and loose consensus-making which were stressed to be relevant for APEC (Lorenz 1993). To be similar to the OECD, it would require rules, hierarchies, and structures which would lead to the kind of body criticised by Hughes (1991). There is reason to assume that the APEC meetings can be instrumental to reduce politically rooted frictions and thereby informal barriers and transaction costs.

In retrospect, therefore, the answer to the question whether regionalism was a companion of regionalisation in East and Southeast Asia must be denied. A decline in transaction costs comprising lower border taxes, transportation costs and costs of uncertainty was well achieved without regionalism. Interestingly enough, transactions grew particularly between those partner states which had unsettled political relations or no political relations at all. Inter-state co-operation on the sub-regional level, for instance, in the Dialogue Partner System of ASEAN countries with the major OECD trading partners was a useful tool in mutual bargaining but it was decoupled from powerful regional bodies and preferential treatment. Yet, what held in the past, could be subject to change in the future. Apart from external pressure, one might ask whether regionalism has internal economic merits which would justify to go the European or North American way. The preceding analysis suggests that there is very little to gain from trade preferences (see also Panagariya 1993). Unilateral and non-discriminatory cuts of tariffs and non-tariff barriers have provided substantial impulses to intra-area trade because complementarity of production structures was given. No preferential scheme would have been able to compensate for the lack of complementarity. There is no reason to assume that raising the intra-regional trade shares of about 40 per cent by means of trade preferences would be possible without incurring trade diversion which would violate the overriding principle of securing access to least-cost supply and thus would be efficiency-reducing. Therefore, the traditional form of regionalism via free trade areas will probably be pursued only if trade-diverting effects can be strictly contained. However, instead of concentrating on goods flows, regionalism could aim at factor flows, e.g. preferential rights of establishment for Asian-based companies or preference for guestworkers

from the region. Traditionally, factor mobility has been a sensitive issue as shown by the high degree of restrictions against migrants and relatively cautious approaches in many countries to dismantle restrictions against international capital flows. Thus, common markets in Asian sub-regions without having passed the stages of free trade areas or customs unions are very unlikely to emerge.

To summarise, if at all, regionalism within the region will arise from sub-regional approaches, based either on the AFTA type of conventional regionalism or the unconventional type of "growth triangles". Yet, compared to market-driven regionalisation, institutionalised regionalism is of minor relevance.

VI. Conclusions

The analyses have shown that ESACs unprecedented emergence in world trade and capital transactions has been accompanied by a growing share of intra-area transactions. At least for the goods sector, the evidence is clear. Intra-area transactions grew faster than those to the rest of world, and the latter rose faster than world trade. Given this "double growth" performance, there was no trade diversion in the static zero sum meaning. Driving forces of fast growing intra-area transactions were basically internal conditions, such as "natural" trading partnership (geographical and cultural proximity, size, and complementarity in resource endowment and production structure), rising income levels fostering intra-industry trade, the economic opening of China, and unilateral liberalisation of trade and capital transactions on a non-discriminatory basis. It cannot be denied that external factors as protectionism and recession in non-Asian OECD countries have also contributed to this performance. Yet, it seems safe to assume that even without the US and European recession in the early eighties and early nineties and without the spread on non-tariff barriers, intra-area transactions would have received sufficient fuels from the internal factors to grow more rapidly than transactions with the rest of the world.[17] Furthermore, a base effect of a low initial level of intra-area trade cannot be neglected.

[17] The decline of average annual per capita GDP growth in the period 1981–90 compared to 1971–80 was only 0.2 percentage points in the EC (2.1 to 2.3 per cent) and also 0.2 per cent in the more important US market (2.0 to 2.2 per cent), compared to growth differentials for China (7.5 to 4.0 per cent) supported by Japanese growth (3.4 to 3.3 per cent) (UN 1991, p. 209).

Capital transactions were first driven by the capital exporter Japan and later by the NIEs. The pattern of intra-area versus extra-area transactions is less clear than for trade. Portfolio investment widely escapes such distinction, and intra-area foreign direct investment was already relatively large at the beginning of the eighties due to strong Japanese investment in neighbouring resource-rich and labour-abundant economies. The important element behind sustaining a high level of intra-area transactions in FDI has been the follow-up role of capital-exporting NIEs on the supply side and the opening of the Chinese market to investment on the demand side.

Given the size of the "region" hosting different sub-regions, regionalisation comes close to parts of a globalisation process in which Asian Pacific rim countries have played an important role both as hosts and home countries. To simply extrapolate the ongoing trend over the next decade, however, is flawed for two reasons. First, there are bottlenecks to sustaining high growth rates in Asia, such as lack of sufficient infrastructure, delays in enterprise reform particularly in the public sector, still existing interventions in the financial sectors, environmental constraints, real appreciation of currencies, and, finally, uncertainty about how China's transformation process will proceed. It cannot be excluded that such bottlenecks will impede intra-area transactions more than extra-area ones, especially if different risk elements are taken into consideration. Secondly, non-Asian OECD countries with their neighbouring regions closely integrated to them (Latin America and Central and Eastern Europe) still have a potential for economic rejuvenation if they respond to adjustment challenges from their Southern and Eastern borders by more flexibility in their labour markets and more opening of goods markets. Such reforms would fuel the old engine and increase their attractiveness as export markets for Asia. Finally, some "aging" Asian countries could deliberately shift from export demand to domestic demand (for instance, due to political pressure for more equity) by not reversing trends towards real appreciation.

Over the next few years, however, the scope of intra-Asian exchange of goods and factors still seems sufficiently large to carry regionalisation to higher levels based on intra-industry trade without giving rise to gluts in Asian export markets.

Appendix

Bilateral Trade Shares in East and Southeast Asia, 1992
(per cent of total intra-area trade)

From \ to	Japan	Hong Kong	Indonesia	Korea, Rep. of	Malaysia	Philippines	Singapore	Thailand	China	Taiwan
Japan	0.0	5.7	1.5	4.9	2.2	1.0	3.5	2.8	3.3	5.8
Hong Kong	1.7	0.0	0.2	0.5	0.2	0.3	0.9	0.3	9.7	1.2
Indonesia	3.2	0.2	0.0	0.4	0.1	0.0	0.8	0.1	0.4	0.4
Korea, Rep. of	3.2	1.6	0.5	0.0	0.3	0.2	0.9	0.4	0.7	0.6
Malaysia	1.5	0.4	0.1	0.4	0.0	0.1	2.6	0.4	0.2	0.3
Philippines	0.6	0.1	0.0	0.0	0.1	0.0	0.1	0.0	0.0	0.1
Singapore	0.8	1.3	n.a.	0.4	1.6	0.2	0.0	0.7	0.3	0.4
Thailand	1.6	0.4	0.1	0.1	0.2	0.0	0.8	0.0	0.1	0.2
China	3.2	10.2	0.1	0.7	0.2	0.1	0.6	0.2	0.0	n.a.
Taiwan	2.4	4.2	0.3	0.3	n.a.	0.3	0.7	0.5	n.a.	0.0

Source: IMF (1993); Republic of China (1993).

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