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East Asian Regional Economic Integration
A Post-Crisis Update

Françoise Nicolas

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Executive Summary

Despite genuine attempts at regional cooperation in the wake of the Asian Financial Crisis of 1997-98 (hereafter AFC), realizations such as the Chiang Mai Initiative (CMI) have fallen short of initial expectations and East Asia was still characterized until recently by a lack of institutionalized economic cooperation. In parallel, however, different factors led to tighter *de facto* regional integration. In particular, as a result of the economic rise of China and its integration as a vital and final part in regional production networks, intra-regional trade linkages have become increasingly tight and given rise to a complex, vertically integrated structure involving most economies in the region (the so-called East Asian integrated circuit).

To the surprise of many analysts, the outbreak of the global financial crisis (GFC) in 2008 did not leave East Asian economies unscathed. The objective of the paper is to examine the implications of the GFC for the regional economic integration process in East Asia, taking into account both the *de facto* and the *de jure* dimensions. To that end, it starts by examining how the region performed during the GFC, before turning to analyze the impact that the crisis has had on various cooperative initiatives in the region, as well as on the direction and intensity of intra-regional trade linkages, with a focus on the potentially changing role of China.

The paper shows that the nature of pre-crisis regional economic integration contributed to the spread of the contagion in two major ways. First, the existence of regional production networks accounts to a large extent for the speed and magnitude of the contagion. Secondly, the CMI proved badly wanting in time of crisis, with countries such as Korea choosing to bypass the CMI and to resort to other forms of financial assistance.

The paper then turns to the analysis of the current situation and future prospects. In the trade area, there are preliminary signs suggesting that the nature of intra-regional linkages may be changing, thus making the case for government-led cooperation in the form of a genuine region-wide FTA perhaps more compelling. It remains to be seen, however, whether East Asian economies will choose this top-down path rather than stick to targeted tariff liberalization. The paper further suggests that, although regional financial cooperation has regained momentum in the wake of the crisis, numerous shortcomings still prevail and may hinder the evolution towards tighter monetary and exchange rate cooperation in the region, in particular as a result of China's lack of commitment.

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Introduction

Government-led (*de jure*) regional economic integration has traditionally lagged behind market-driven (*de facto)* integration in East Asia. While the Asian Financial Crisis of 1997-98 (hereafter AFC) was a watershed for pushing government-led regional cooperation, primarily in the financial sphere with the Chiang Mai Initiative (CMI) as a major achievement, results have fallen short of initial expectations. East Asia was still characterized until recently by a lack of institutionalized economic cooperation. In parallel, various factors led to tighter *de facto* regional integration. In particular, as a result of the economic rise of China and its role as a vital and final part in regional production networks, intra-regional trade linkages have become increasingly tight and given rise to a complex, vertically integrated structure involving most economies in the region and referred to as the "East Asian integrated circuit".

To the surprise of many analysts, the outbreak of the global financial crisis (GFC) in 2008 did not leave East Asian economies unscathed. This situation raises a series of questions. First, can the contagion of the GFC to East Asia be explained by the nature of pre-crisis regional economic integration? Secondly, since the cooperative schemes put in place in the wake of the AFC clearly proved ill-designed, will the new cooperative schemes be more successful? Moreover, with a protracted slowdown in industrial economies, there is scope for East Asian economies to try to switch away from being the factory of the world to emerging as a dynamic regional market. Another interesting issue is thus to explore the impact of the crisis on the structure of trade in East Asia, while a related question relates to the prospects for a region-wide Free Trade Agreement.

For all these reasons, the GFC may be expected to lead to a deep overhaul of intra-regional integration in East Asia. The objective of the paper is to examine the validity of this claim by examining different aspects of the economic integration process in East Asia. The remainder of the paper is organized as follows: the first section describes the way the GFC impacted East Asia, with a focus on the contagion mechanism through regional production networks. The second section examines the impact that the crisis has had on intra-regional trade linkages as well as on prospects for regional trade

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liberalization. The third section focuses on the latest developments in formal (*de jure*) regional cooperative initiatives in the financial sphere.

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East Asia and the Global Financial Crisis

The Spread of the Global Financial Crisis to East Asia

A Reminder on the GFC

Financial turbulence started in the US as early as 2007. Although the crisis was expected at first to remain confined to the US financial sector, it spread rapidly to the real economy and beyond US borders. In the fall of 2008, the financial crisis intensified dramatically in the wake of the Lehman Brothers' bankruptcy and became truly global. The failure of this reputed investment bank sent a shockwave throughout the global financial system, leading to a collapse in market confidence and to widespread panic, which caused a major liquidity crunch in the inter-bank market (Das 2010). Concerted international action through the G20 prevented a global financial meltdown, but demand and production declined sharply in most of the world economy as a result of falling asset prices, credit availability, and consumer and business confidence. As emerging countries' exports plummeted following the contraction of import demand in advanced countries, real economies slipped into recessions.

East Asian GDP growth slowed sharply in the second half of 2008. For the region as a whole, the economic contraction in the fourth quarter of 2008 was pronounced, with activity falling at an annual rate of nearly 7 percent. The fourth-quarter declines were especially dramatic in Taiwan and Thailand (more than 20 percent at an annual rate) and in South Korea and Singapore (more than 15 percent at an annual rate). Only three countries managed to maintain positive and relatively strong rates of growth, namely China, Indonesia and Vietnam (Table 1). One possible explanation is that countries with large domestic markets were in a better position to avoid too large a contraction of their growth during the crisis (Bernanke 2009) and to simply record a slowdown in their growth rate.

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Table 1: East Asia – GDP and Export Growth

	2006	2007	2008	2009	2010 (projections)
	Annual GDP Growth				
Japan	2.0	2.4	-1.2	-5.2	2.5
Indonesia	5.5	6.3	6.0	4.6	6.1
Malaysia	5.8	6.5	4.7	-1.7	7.2
Philippines	5.3	7.1	3.7	1.1	7.3
Singapore	8.6	8.8	1.5	-0.8	14.5
Thailand	5.1	5.0	2.5	-2.5	7.8
Vietnam	8.2	8.5	6.3	5.3	6.8
China	12.7	14.2	9.6	9.2	10.3
Hong Kong	7.0	6.4	2.3	-2.7	6.8
South Korea	5.2	5.1	2.3	0.2	6.1
	Annual Merchandise Export Growth				
Japan	8.2	10.1	8.9	-25.0	n.a.
Indonesia	19.0	14.0	18.3	-14.3	32.2
Malaysia	12.9	9.4	13.2	-21.1	26.4
Philippines	15.6	6.4	-2.5	-22.1	34.8
Singapore	18.0	10.3	13.1	-20.4	31.1
Thailand	17.0	18.2	15.9	-14.0	28.5
Vietnam	22.7	21.9	29.1	-8.9	26.4
China	27.2	25.8	17.6	-16.1	31.4
Hong Kong	9.7	8.9	5.6	-11.9	22.4
South Korea	16.1	15.8	11.6	-17.6	29.6

Source: ADB (2011)

The Contagion and the Role of Regional Production Networks

The propagation of the GFC to East Asia came as a surprise for a number of analysts who believed in the "decoupling hypothesis", according to which East Asia's business cycle had become increasingly desynchronized with Western economies' business cycles. Although East Asian economies had little exposure to sub-prime credits, and although they had not engaged in any risky activities, they did not remain unscathed. The contagion to East Asia occurred through two major channels: trade and finance.

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The financial channel played an indirect and minor role in the propagation of the crisis. Despite the limited participation of most East Asian economies in financial globalization and the minimal direct exposure of their banks to toxic assets (James 2008), they experienced deteriorating foreign currency supply and demand conditions as well as credit crunches, as funds flowed out due to deleveraging by overseas financial institutions in response to heightened concerns about credit risk (Lee 2009). Also countries such as South Korea and Indonesia, where a substantial share of corporate stocks is in the hands of foreign funds, further suffered from the so-called “flight to quality”.

However, the major channel of contagion was through the real economy and through trade. The trade channel was particularly important in the case of East Asia because of the existence of very tight regional production networks (RPNs). In China, the dependence on net exports as a major driver of economic growth was found to be a major source of vulnerability in a context of sharply falling demand in the US and European markets. This also holds true for the rest of East Asia but the negative shock was further compounded by the existence of vertically-integrated production networks. The drop in Western demand affected China very directly and, through spillover effects, the rest of East Asia. It is now a well-established fact that the sharp rise in intra-Asian trade has been fuelled by rapidly growing trade in parts, components and intermediate products based on the segmentation of the production process, with East Asian economies (excluding China) supplying parts and components to China, and China exporting final goods to the rest of the world, primarily the United States and the European Union.[1] The existence of such RPNs is further confirmed by the stronger rise in intra-East Asian imports rather than in exports. The smaller value of the latter is accounted for by China, which is being largely used as an outward processing region for goods developed elsewhere in Asia.[2]

The mirror image of China’s sourcing parts, components and intermediate goods in neighboring East Asia is the rising share of intermediate goods in East Asia’s exports to China. As can be seen in figures 1 to 4, for Japan, South Korea and Malaysia, the share of intermediate goods hovers between 65 and 80 percent of their total exports to China.[3] Moreover, parts and components of capital goods

[1] This is clearly the case for machinery trade as shown by Ando (2010).

[2] As a result, China runs a trade surplus with East Asia in consumption goods and a deficit in intermediate goods (Gaulier et al. 2005).

[3] Figures 1-4 show the breakdown of East Asian exports to China by product category, using the Broad Economic Categories (BEC) classification. Following Gaulier et al. (2005) commodities are aggregated by stages of production and a distinction is made between i) <u>primary goods</u> [food and beverages, primary mainly for industry (111), primary industrial supplies (21), primary fuels and lubricants (31)], ii) <u>intermediate goods</u> [processed industrial supplies (22), processed fuels and lubricants (32), parts and components of capital goods excl. transport equipment (42) and of transport equipment (53)] and iii) <u>final goods</u> [capital goods (41), and

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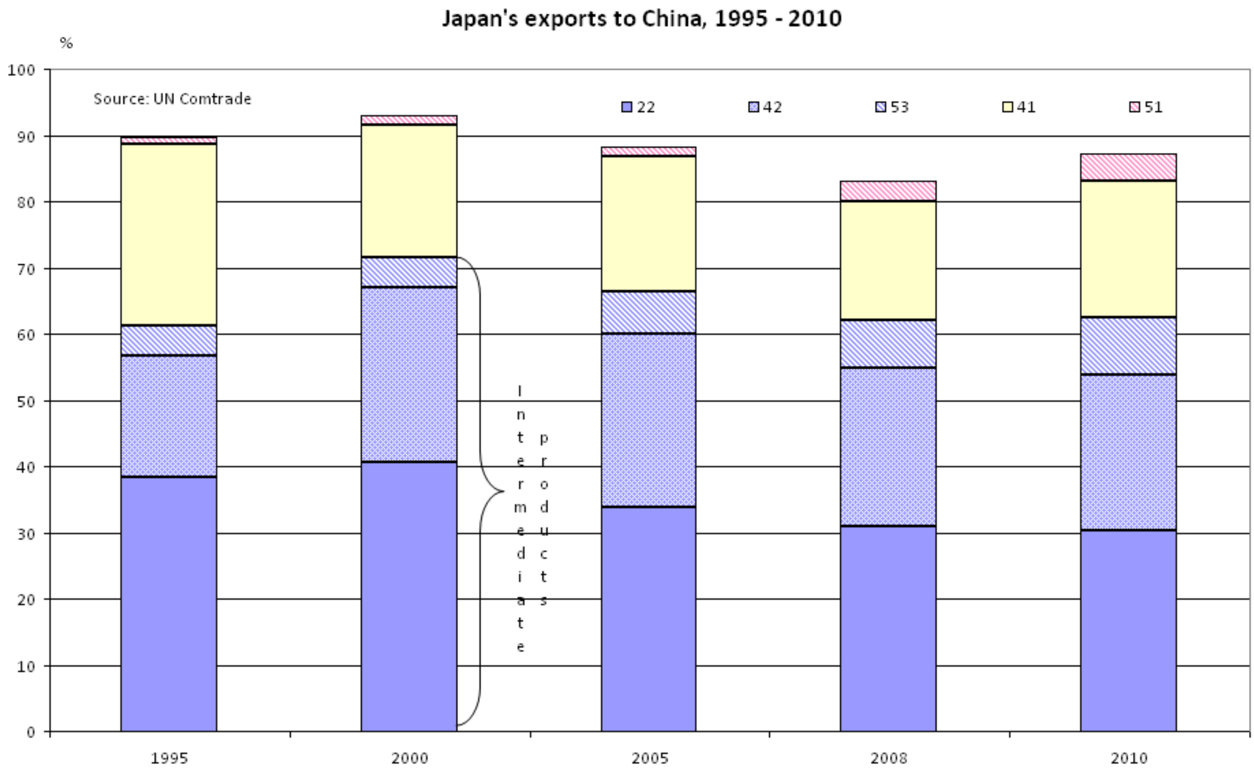
(excluding transport equipment) account for a substantial share (between 20 and 30 percent) of these intermediate goods. This is a clear indication of the existence of cross-border production-sharing systems based on the fragmentation of production processes in sectors that are particularly amenable to a modularization of the production process (namely electronics).

In the case of Indonesia, the share of intermediate goods is both smaller (60 percent maximum) and of a different nature (with processed fuels and lubricants accounting for approximately 10 percent), suggesting that Indonesia is not as tightly integrated in the regional production networks as other East Asian economies. These different situations explain the different performances at the time of the crisis and Indonesia's limited vulnerability.

Figure 1: Japan's exports to China, by product category, 1995-2010



consumption goods: food and beverages (112 and 122), passenger motor cars (51), consumer goods (61, 62, 63)].

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Figure 2: Korea's exports to China, by product category, 1995-2009

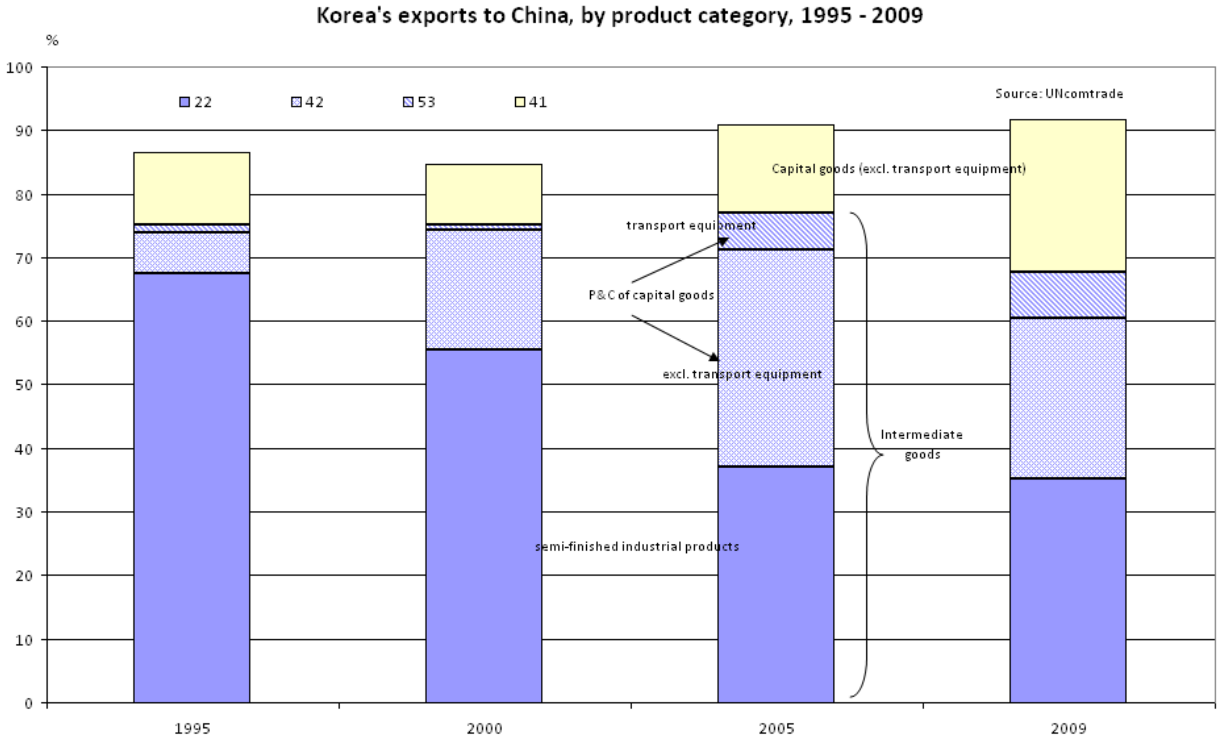

Figure 3: Malaysia's exports to China, by product category, 1995-2010

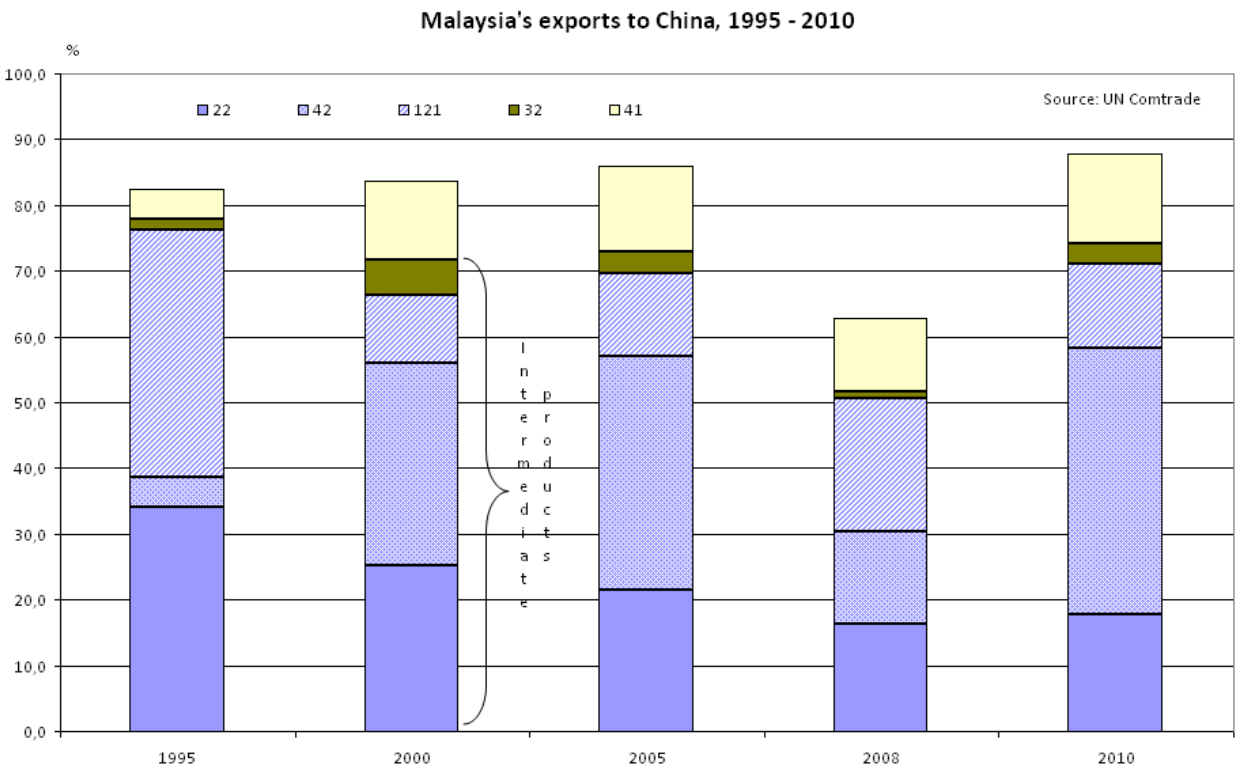

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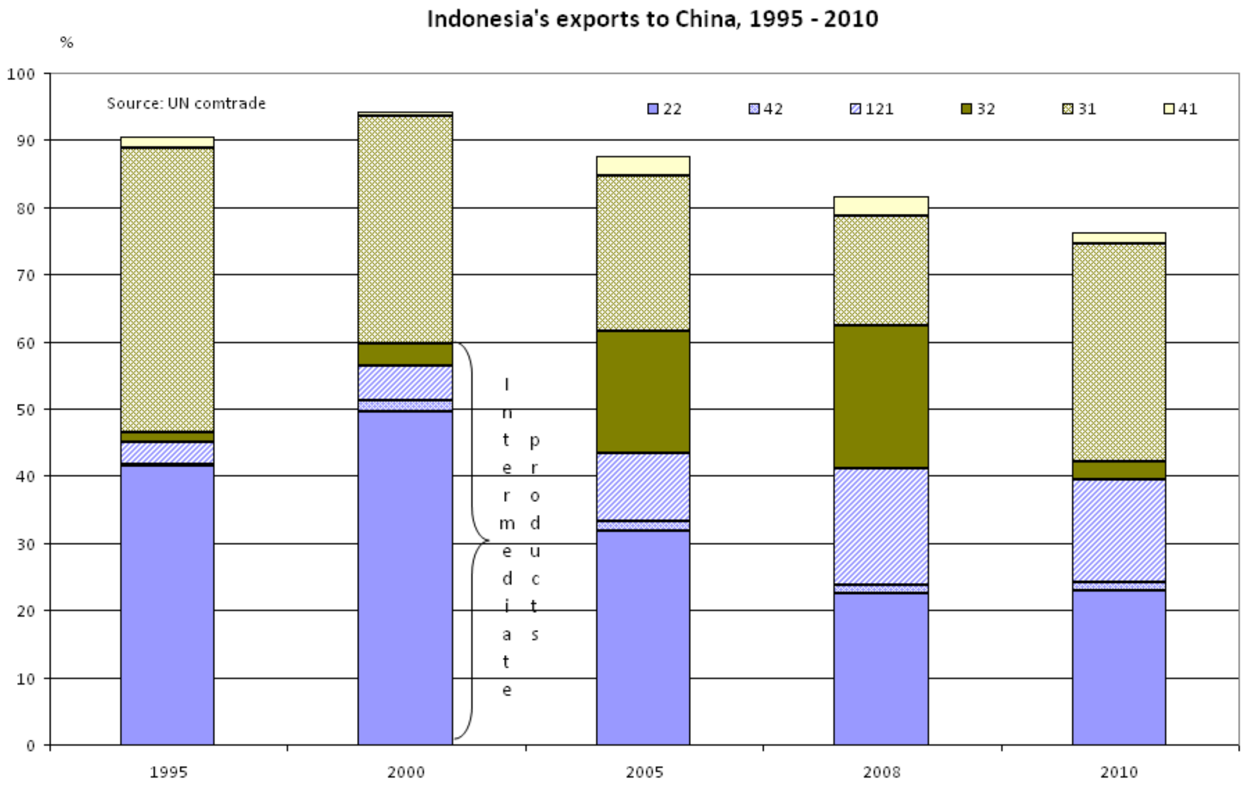
Figure 4: Indonesia's exports to China, by prodyct category, 1995-2010



The source of data for the figures 1 to 4 is: UN Comtrade

Figure 5: Chinese exports to the US and the EU, 1991-2010

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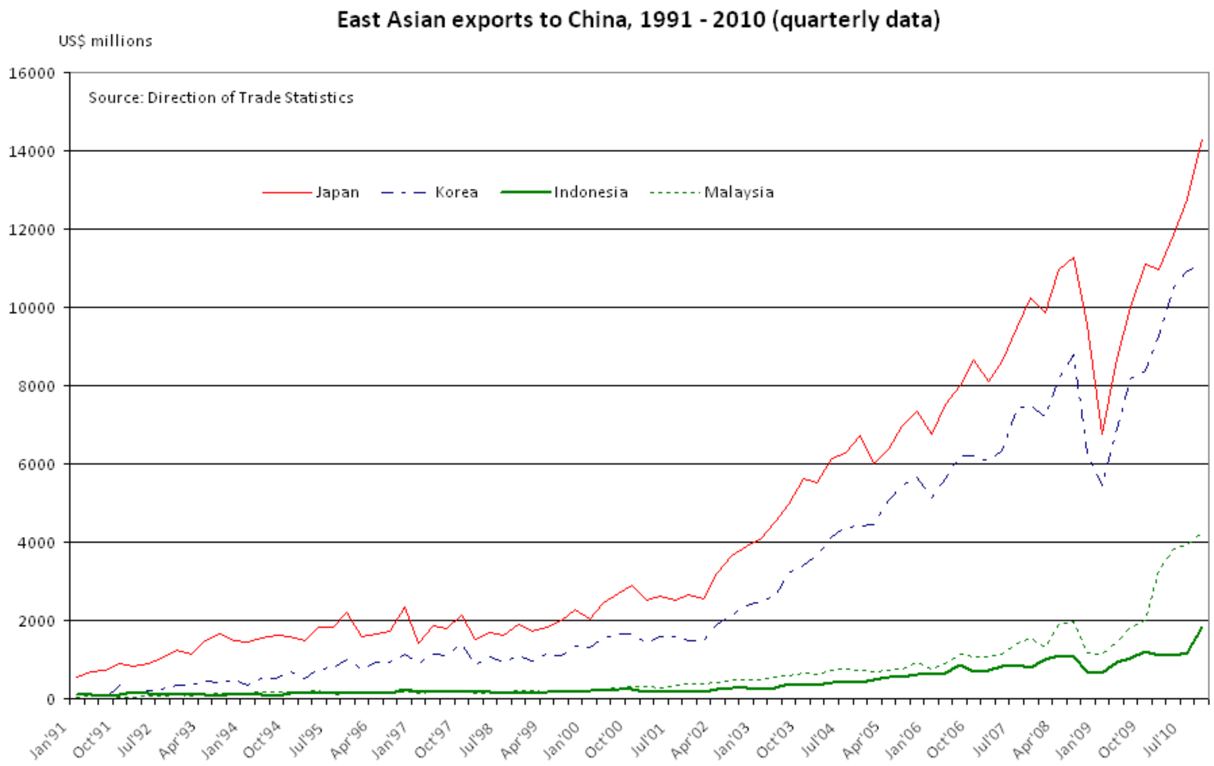
Figure 6: East Asian exports to China, 1991-2010



The source of data for the figures 5 and 6 is: IMF, *Direction of Trade Statistics*

At the aggregate level, China's exports to the US and the EU started to plummet in October 2008 and reached a trough in February 2009 before picking up again, as can be seen in figures 5 and 6. Over the same period of time, East Asian exports to China also dropped but at a much faster pace at first, but then were quicker to recover in early 2009. The recovery in exports to the US and the EU is slightly delayed compared to that of intra-regional trade. However, a simple calculation shows that there is a tight correlation between the evolution in Chinese exports to the US and the EU on the one hand and the changes in Japanese, Korean and Malaysian exports to China on the other hand (Table 2). Indonesian exports to China are apparently in a different situation with a non significant correlation with Chinese exports.

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Table 2: Correlation coefficients over the period Q1 08 – Q4 10

	Chinese exports to the US	Chinese exports to the EU
Japanese exports to China	0.69	0.71
Korean exports to China	0.63	0.60
Malaysian exports to China	0.63	0.53
Indonesian exports to China	0.41	0.40

Source: author's calculations, using IMF, *Direction of Trade Statistics.*

The impact of the GFC on intra-East Asian trade has been examined in detail by other authors such as Ando (2010) or Kuroiwa and Ozeki (2010). Using finely disaggregated data, they show that regional production networks have worked to the region's disadvantage at the time of the crisis, with exports of parts by all East Asian economies to the rest of the region dropping much more sharply than exports to the rest of the world.[4]

Policy Responses

Immediate, Individual Government Responses

From East Asia's perspective, by contrast with the Asian Financial Crisis of 1997-98, the GFC is an "imported crisis", thus calling for different types of policy responses. In response to the financing difficulties, East Asian governments embarked on substantial fiscal stimulus packages while central banks eased their monetary policies aggressively. Stimulus packages varied across East Asia: Indonesia and the Philippines injected $7.1 billion and $7 billion, respectively, followed by Malaysia with $12.1 billion, Thailand with $39 billion and South Korea with $53.4 billion. The most dramatic package was that of the Chinese: in November 2008 the State Council announced a RMB 4 trillion investment (about US$ 586 billion or € 460 billion) effort to be spent over more than two years (from the fourth quarter of 2008 to the end of 2010), with the aim of boosting economic activity.

The objective of each of the responses was to stimulate economic activity, to inject liquidity and, with a view to insulating the region from global turbulence, to reduce the region's export dependency and increase its economic – particularly financial – autonomy. As shown in figures 5 and 6, the recovery was quick and sharp in the

[4] The drop in exports was short-lived (from the fourth quarter of 2008 to the second quarter of 2009) and this is why it does not show in annual data.

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region with China's stimulus package contributing to lift neighboring economies out of trouble.

Lack of a Regional Response: The Failure of the CMI

In the financial sphere, the 1997 – 98 financial crisis brought about a clear awareness of the risks of contagion and the need for policy co-operation in the region. As the crisis spread from Thailand to other countries in East Asia, dissatisfaction with the IMF's handling of the crisis grew, leading to a revived interest in establishing a non US-dominated mechanism of financial cooperation. Asian countries' officials gradually met more and more systematically on an "ASEAN+3" basis, in which Japan, China and Korea joined the 10 ASEAN countries. A noteworthy outcome of these meetings is the Chiang Mai Initiative (CMI), which was adopted at the May 2000 meeting of the ASEAN+3 finance ministers in Chiang Mai, Thailand.

The CMI aimed at creating a network out of the existing currency swap arrangements that had been set up within ASEAN as early as 1977 (ASA), supplementing them with bilateral swap agreements (BSAs) between ASEAN members and the other three countries. The BSAs are facilities for short-term liquidity assistance in the form of swaps of dollars with the domestic currencies of participating countries. Since the CMI was initially conceived as supplementing existing international financing facilities, primarily those provided by the IMF, the maximum amount of drawing disbursed independently of the IMF was set at 10 percent. Beyond this threshold, countries were required to accept IMF conditions in the form of a program for macroeconomic and structural adjustments.[5] By October 2003, thirteen BSAs had been successfully concluded with a combined total size of roughly US$ 35 billion.

Over time, the CMI's effectiveness has been gradually enhanced in a number of ways. First, the number of BSAs rose to 16 and the total amount of the BSAs was raised in successive steps to reach US$ 90 billion as of April 2009.[6] Secondly, the draw-down mechanism was improved, with the maximum amount of drawing disbursed independently of the IMF raised to 20 percent. Thirdly, the participating countries agreed in 2005 to proceed with the multilateralization of the CMI.[7] As a first step, the collective decision-making procedure for CMI activation was adopted in May 2006. Although the principle for full multilateralization was further agreed to,

[5] This obligation simply means that negotiation with the IMF must have started when the funds are disbursed.
[6] This total does not include the funds provided within the New Miyazawa Initiative nor the ASEAN Swap Agreement.
[7] This means that all swap-providing countries can simultaneously and promptly provide liquidity support to any parties involved in bilateral swap agreements at times of emergency.

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turning it into a concrete decision proved very complicated and the step had still to be taken when the GFC broke out.

Prima facie the GFC provided a perfect opportunity to activate the CMI, but none of the member countries chose to do so when their currency came under pressure in the second half of 2008 and they were faced with liquidity shortage. Bypassing the CMI, South Korea first turned to Japan and China,[8] and eventually to the US, which provided a US$ 30 billion swap agreement in October 2008.

The reasons for not choosing to activate the CMI are many and highlight the shortcomings of the scheme. The first reason has to do with the "size" of financial assistance available under the mechanism. Under the CMI as it was in place in April 2009, Korea would have been able to exchange a maximum of US$ 23.5 billion (17 billion with Japan and China, and at most US$ 6.5 billion with the other ASEAN countries). In view of the magnitude of the potential problem, the size of the CMI was definitely too small to effectively contain currency speculation.

The second reason is more political in nature and lies with the reluctance of the Korean Government to accept IMF conditionality. The Korean government, as well as the Korean population, had still extremely vivid and painful memories of the 1997—98 financial crisis and of the way it was dealt with by the IMF.[9] As a result, they were particularly reluctant to go through the same kind of experience once again. In the absence of a stand-by agreement with the Fund, Korea would have merely accessed some US$ 5 billion and this would have been definitely insufficient even as a pre-emptive measure.

Policy Lessons from the GFC

The GFC has highlighted a number of weaknesses in the way the East Asian region operates. First, as explained above, the existence of RPNs may be held responsible for the speed and magnitude of the contagion. Moreover the dominant focus on exports to developed markets such as the US and the EU was also found to be a weakness, calling for a more balanced economic structure supported by domestic and regional measures. Lastly, the crisis also exposed the weaknesses of the CMI. The Korean experience described above shows very clearly that the effectiveness of the regional surveillance mechanism associated with the CMI[10] needs to be strengthened so as to avoid linking financial assistance systematically to IMF conditionality (Kawai 2010).

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[8] Korea's President first proposed a trilateral meeting of finance ministers of the three countries to coordinate policies to cope with the global financial crisis and later proposed to hold a summit among the three countries, suggesting that "the three countries can wisely overcome the financial crisis if they join forces" (Sosastro 2008). The three Northeast Asian powers have been meeting regularly ever since.

[9] In Korea, the 1997-98 financial crisis is traditionally referred to as the "IMF crisis".

[10] The mechanism is the Economic Review and Policy Dialogue (ERPD).

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The GFC has also made clear the need to change East Asia's trade and development policies and rebalance domestic economies so as to maintain stable growth in the region. As explained by Masahiro Kawai in a speech delivered at the ADBI in July 2009, "Asian economies benefited tremendously from export-led growth centered on US and European markets in recent decades. This growth model can no longer be relied upon to sustain the region's economic growth beyond the crisis."[11] A major post-crisis objective is to turn the region into an integrated consumer market. This would definitely contribute to shielding the region against another global crisis since an expanded East Asian market would cushion it against falls in global trade.

To that end, countries are expected to take the appropriate measures to facilitate intra-regional trade in a broader range of products than has been the case so far, and to enhance financial cooperation. Three directions of change may be identified. First, rebalance growth strategy away from a strong reliance on exports to the rest of the world and toward the local or regional demand. Second, promote intra-regional trade in final goods through a change in tariff structure. Third, improve the regional financial cooperative mechanism. The next section examines what East Asian countries have done so far and what remains to be done in these different areas.

[11] Available at: http://www.adbi.org/files/speech.2009.16.07.welcome.remarks.kawai.gfc.architecture.pdf.

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Post-GFC Trade Integration

Changing Patterns of Intra Regional Trade?

After the AFC (which was a home-grown crisis), East Asian countries managed to export their way out of the crisis since the rest of the world was not negatively affected. As a result, there was, at the time, a relative drop in intra-regional trade compared to extra-regional trade. Things played out differently after the GFC, and the drop in intra-regional trade was less important than the drop in extra-regional trade, resulting in a slight increase in intra-regional trade share.

As can be seen in Figure 6 above, East Asian exports to China picked up in the second quarter of 2009 and they had returned to, or even exceeded, pre-crisis level as early as the fourth quarter of 2009 (for Malaysia and Indonesia) or by the first or second quarter of 2010 (respectively for South Korea and Japan). East Asian exports of intermediate goods and of parts and components to China rose sharply but so did other types of exports, even if they still account for a relatively small share of total exports.

In terms of composition, as can be seen above in Figures 1 to 4, while there have been minor changes in Japan's, Korea's and Malaysia's exports to China, the change is more substantial in the case of Indonesia's exports. Overall, intermediate products still account for a very substantial share of East Asian exports to China after the crisis. They amount to 64 percent of Japanese exports, 72 percent of Korean exports and 75 percent of Malaysian exports. In contrast the share of such goods has dropped sharply (to around 42 percent) in the case of Indonesia, while exports of primary fuels and lubricants have shot up.

Within the intermediate goods category, however, a number of changes can be observed compared to the pre-crisis period. The largest changes can be observed for Japan and Malaysia: in the former case the share of parts and accessories of transport equipment has been rising to reach 9 percent (from 4.5 percent in 2000), and in the latter case parts and accessories of capital goods (excluding transport equipment) has exceeded 40 percent (from about 31 percent ten years earlier).

In parallel, South Korea, and to a lesser extent Malaysia, also managed to increase their exports of capital goods to China in 2009, while Japanese exports of capital goods picked up in 2010 (Figures 1- 4 and 7-10). These developments are most probably due to the rise in demand for such goods as a result of the Chinese stimulus package.

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Figure 7: Japan's exports to China, by product category, 1995-2010

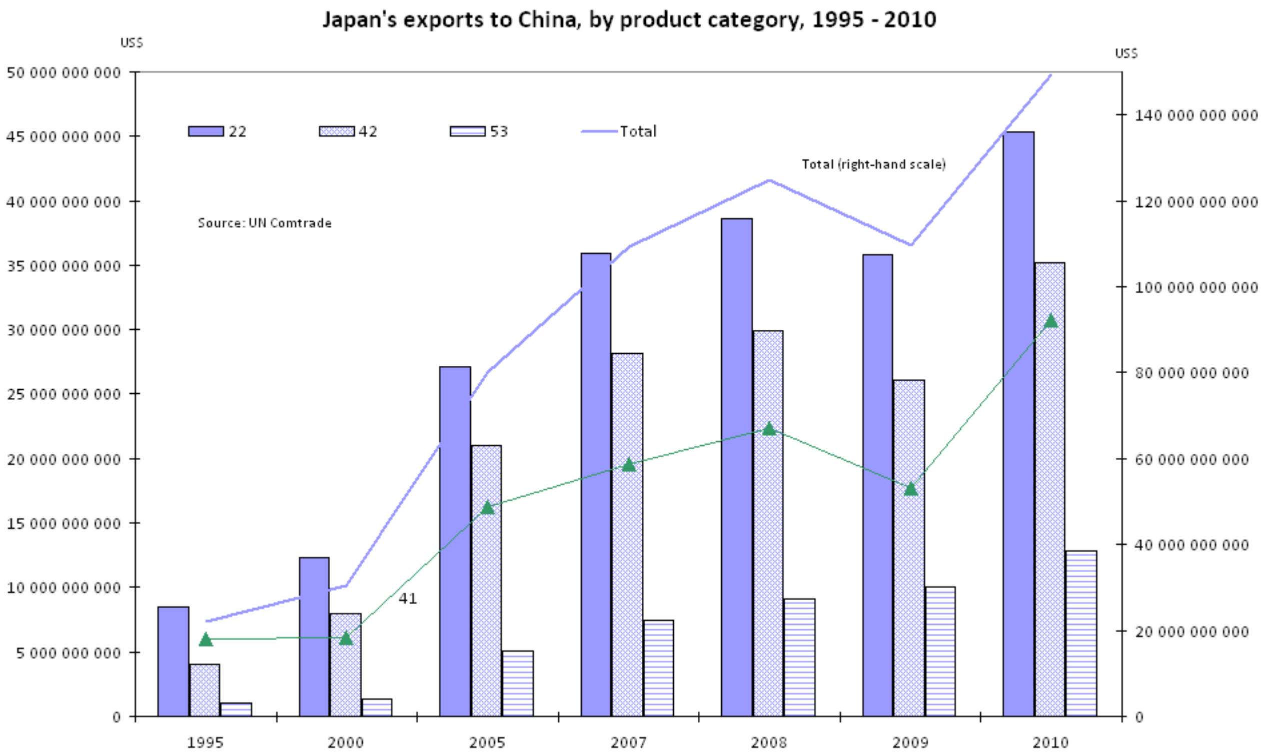

Figure 8: Korea's exports to China, by product category, 1995-2009

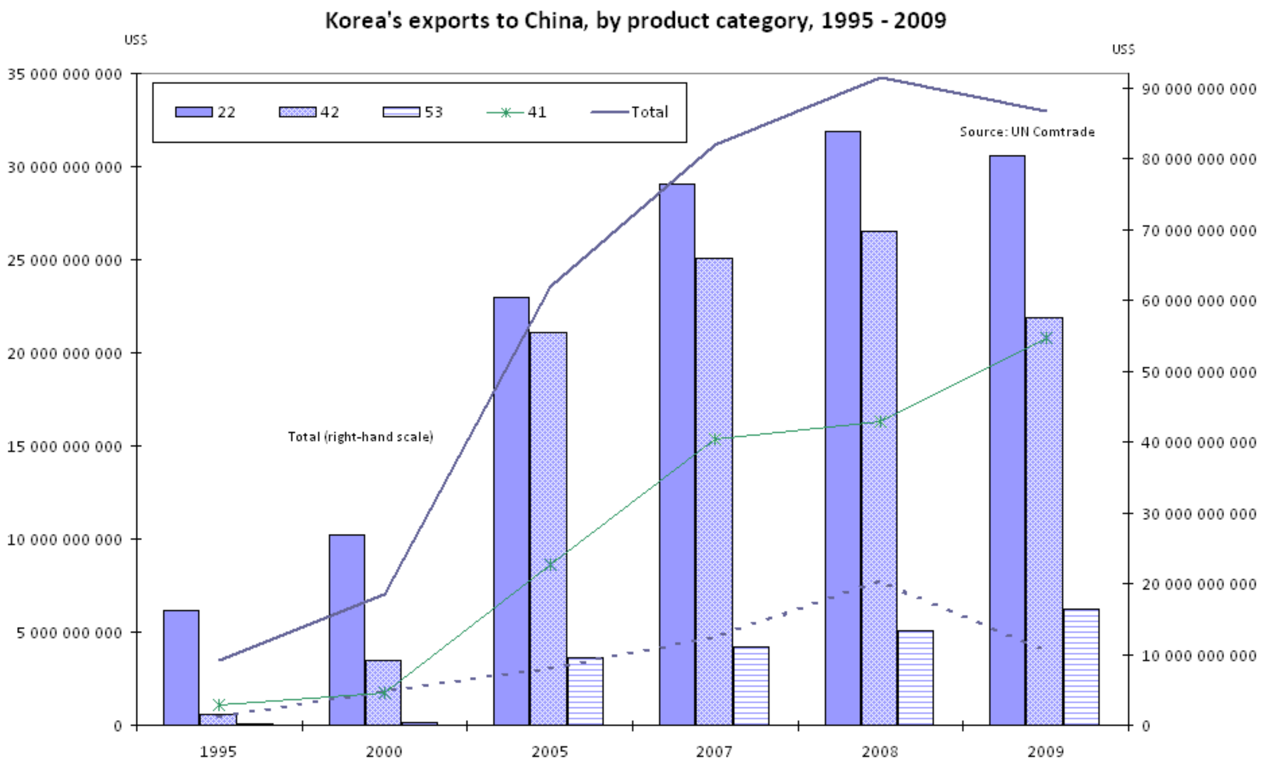

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Figure 9: Malaysia's exports to China, 1995-2010

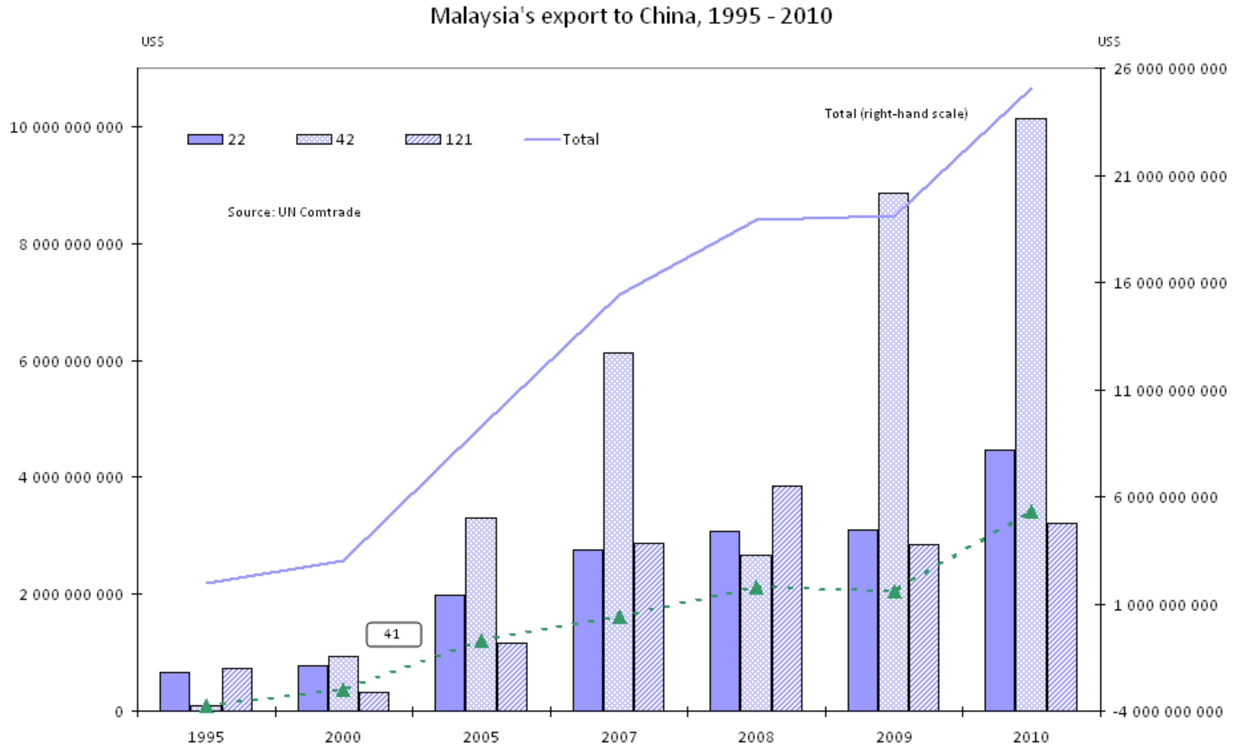
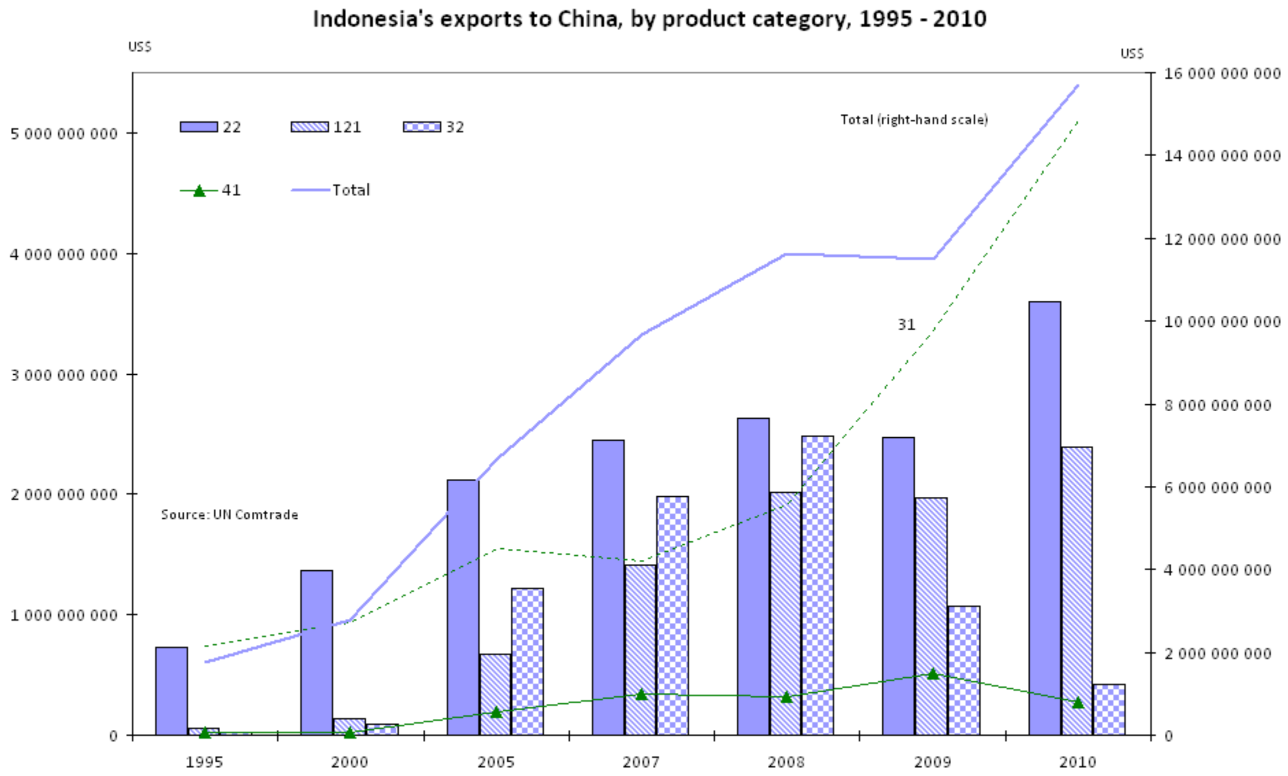


Figure 10: Indonesia's exports to China, 1995-2010



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The data source for the figures 7 to 10 is: UN Comtrade

As for Indonesia, although it did not increase its exports of capital goods to China, it also managed to take advantage of China's dynamism by supplying China with various semi-finished goods (primarily processed food and beverages for industry) as well as with primary fuels and lubricants. Post-GFC Indonesia's economic linkages with China have shifted even further away from those of other East Asian economies.

These observations suggest that East Asian exports increasingly target the Chinese domestic market, although Japan's, South Korea's and Malaysia's exports are still to a large extent aimed at fuelling the Chinese exporting machine. The changes observed in response to the shock of the crisis further suggest that economies in the region may benefit differently from a change in strategy on the part of China. Depending on their specialization patterns, neighboring East Asian economies may cater to the Chinese economy's needs in different ways, either through exports of capital goods, consumption goods or through the supply of raw materials or primary commodities.

Despite these preliminary changes, for the time being there are no obvious signs of a deep reorganization of trade patterns within East Asia, with China emerging as a market, rather than exclusively as a production base/factory. Actually, this should not come as a surprise since shifting away from supplying intermediate goods to supplying consumption goods will necessarily be a lengthy and costly process. Moreover as some of the products exported so far cannot be used domestically, a significant industrial restructuring may be needed to ensure a shift from export-led to consumption-led growth in the region. As explained by Ando (2010), the significance of East Asia as a market for final goods may be on the rise but expansion and further activation of intra-regional demand are essential for the production networks in East Asia in the future.

As a side effect, tougher competition can be expected among suppliers of parts and components, together with a possible reduction in the scope for division of labor and the number of segments in value chains through import substitution (Akyuz 2011). Lastly, and more importantly, if trade in final goods is to rise in the future within East Asia, substantial adjustments to the tariff structure will have to take place in the region.

Prospects for Further Intra-Regional Trade Liberalization

The Existing Intra-Regional FTAs

Although there was no serious attempt at pushing the creation of a regional FTA in East Asia before the GFC, a number of more

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geographically limited FTAs had been put in place between some countries in the region since the early 2000s. However, intra-East Asian agreements were mere complements to other agreements concluded with trading partners outside East Asia.[12] Through these various agreements, East Asian economies were aggressively pursuing their individual and collective strategies (Jang 2011).

The first of these intra-East Asian arrangements is the ASEAN Free Trade Area (AFTA). Launched in 1992, it was fully implemented in 2010. In addition to trade liberalization, ASEAN member countries have also engaged in the elimination of restrictions to trade in services (ASEAN Framework Agreement on Services – AFAS) as well as in the promotion of intra-regional direct investment (ASEAN Investment Area). The next step to be taken by ASEAN countries is the establishment of an ASEAN Economic Community by 2015, which requires more cooperation in a number of functional areas, such as trade facilitation.[13]

The second major FTA in the region is the China – ASEAN FTA (CAFTA), which was signed in November 2004 and entered into force in 2005, with full implementation in January 2010 for China and ASEAN-6 (Brunei, Indonesia, Malaysia, the Philippines, Singapore, and Thailand) and in 2015 for Cambodia, Laos, Myanmar and Vietnam. Before that, so-called "early harvest measures" (early tariff reductions) were put in place primarily for agricultural products.[14] Although there are still a number of sensitive products for which tariff elimination has not yet been completed (such as steel products), the agreement has been successfully implemented and probably contributed to the expansion of trade between the two parties.

Lastly, several ASEAN member-countries have also negotiated FTAs with South Korea and with Japan. The Korea-ASEAN FTA framework agreement came into force in June 2007 and the Japan-ASEAN Comprehensive Economic Partnership Agreement in December 2008.

The Disconnect Between FTAs and Trade Integration

Interestingly, none of these agreements should be held responsible for the expansion of intra-regional trade linkages. Actually, regional production networks could perfectly and correctly operate in East Asia even in the absence of a regional FTA. One of the major reasons has to do with the nature of intra-regional trade. Intra-East Asian trade in parts and components, in particular in the Information and Communication Technology (ICT) sector, could easily develop even in the absence of broad preferential trading arrangements because it

[12] See Nicolas (2008) for more details on the relative importance of the two categories of FTAs.
[13] The objective is to create a single market and production base and a highly competitive economy,
[14] Import duties for the products in the program were eliminated in January 2006.

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is already subject to low or zero tariffs as a result of special arrangements or under the Information Technology Agreement (ITA).[15] Similarly, imports for processing, such as hard disk drives for instance, are imported from East Asia into China duty free provided they are intended solely to produce goods for re-export.

More generally, as explained by Hale (2010), East Asian countries have tended to apply lower tariffs on products from the rest of the region than from outside, thus creating a "de facto Preferential Trading Area".[16] This holds true in particular for parts and components or semi-finished goods imported from neighboring economies. By contrast, trade in final goods and in particular in consumption goods is subject to substantially higher tariffs (compared to intermediate products, parts and accessories, as can be seen in Table 3 below), which likely hinders the expansion of this type of trade. Moreover, in East Asia, effectively applied tariffs tend to be systematically much lower than bound tariffs, suggesting that East Asian countries prefer a more liberalized regional trade system than is currently encoded in trade law (Hale 2010). Incidentally, these practices largely account for the disconnection between *de facto* and *de jure* regional economic integration in East Asia (Nicolas 2010).[17]

What Next?

The GFC has undoubtedly enhanced East Asia's interest in regional trade cooperation as it would now seem more appropriate than ever to develop an "Asian market". To that end, it is important to do away with some tariff barriers, in particular on final goods. As a result, trade initiatives in the region are likely to become more inward oriented, while they were so far very much outward oriented (and this is what accounted for the parallel rise in intra-Asian FTAs and wider PTAs).

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[15] As reflected in the table, however, tariff rates on parts and components of transport equipment are much higher than on other parts and components, such as in the electronics sector.

[16] On a similar point, see Mahbubani (2010) who argues that "agreements tend to follow actions" in East Asia.

[17] Kuroiwa and Ozeki (2010) make a related point, arguing that trade structure in East Asia is the result of a trade policy that facilitates the import of intermediate goods but discriminates against that of consumption goods.

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Table 3: Tariff rates effectively applied by China on different categories of goods*

	Japan	Korea	Malaysia
Semi-finished industrial products (22)			
2000	14.23 (n.a.)	14.61 (n.a.)	15.14 (n.a.)
2005	8.12 (8.25)	8.13 (8.24)	8.60 (8.68)
2010	7.91 (8.24)	7.69 (8.23)	0.62 (8.45)
Capital goods (excl. transport equipment) (41)			
2000	14.73 (n.a.)	14.75 (n.a.)	14.80 (n.a.)
2005	8.17 (8.22)	8.17 (8.30)	7.80 (7.88)
2010	8.06 (8.23)	7.81 (8.25)	0.16 (7.84)
Parts and accessories of capital goods (excl. transport equipment) (42)			
2000	9.99 (n.a.)	10.01 (n.a.)	10.40 (n.a.)
2005	6.28 (6.31)	6.27 (6.33)	6.01 (6.03)
2010	6.04 (6.48)	5.79 (6.46)	0.05 (6.29)
Passenger cars (51)			
2000	81.25 (n.a.)	88.57 (n.a.)	n.a.
2005	29.38 (25.0)	29.38 (25.0)	n.a.
2009	25.00 (25.0)	22.86 (25.0)	20.00
Consumer goods (6)			
2000	23.47 (n.a.)	23.50 (n.a.)	22.82 (n.a.)
2005	14.27 (14.31)	13.31 (14.15)	12.52 (12.65)
2010	14.21 (14.72)	12.6 (14.71)	0.45 (13.67)
Parts and accessories of transport equipment (53)			
2000	19.61 (n.a.)	21.07 (n.a.)	23.62 (n.a.)
2005	10.81 (10.12)	11.58 (10.86)	11.67 (11.03)
2009	10.24 (10.60)	10.44 (11.18)	1.29 (11.45)

Source: TRAINS database, UNCTAD, accessed on July 27, 2011.

*The given values are average tariff rates for product categories in the BEC classification. Bound tariff rates are given between brackets.

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As can be seen in Table 3, there has been a sharp drop in all tariff rates between China and East Asia, including on consumption goods -- even if the protection level remains relatively high, in particular for some sensitive products such as passenger cars. The drop is no doubt the result of China's accession to the WTO, which required substantial tariff cuts. The decline has been particularly large for imports from ASEAN countries (Malaysia for that matter). However, the reduction in effectively applied tariffs is not necessarily associated with a parallel reduction in bound tariffs. This suggests that China is following a liberalization strategy comparable to that of other East Asian economies where the binding overhang (i.e. the difference between bound and applied tariffs) is traditionally substantial.

Although the liberalization move is still recent, it can be expected to boost trade in consumer goods between the different partner countries, and a further reduction can be expected in the coming years as a result of the implementation of the CAFTA.[18] Moreover, similar reductions can be expected to take place through the implementation of other intra-regional FTAs, thus facilitating the expansion of intra-regional trade. As a result, substantial gains can be expected from negotiations of similar arrangements with Japan and South Korea.

A number of concrete steps have been taken in order to pave the way to more intra-regional FTAs. First, in the wake of the financial crisis Korea's attitude toward a Korea-China FTA has changed. Korea is seriously considering an FTA with China[19] in order to move into the Chinese domestic market further, to improve the trade structure and to establish a stable framework for economic cooperation. In October 2009, Chinese Minister of Commerce Chen Deming and South Korean Minister for Trade Kim Jong-hoon signed an agreement to increase economic cooperation between the two countries, and Seoul began to consider serious talks with Beijing about negotiating a FTA (Zhang 2010). The reasons for the change in Seoul's position are many. One factor has to do with Korea's fear of being left out of the wave of FTAs prevailing in East Asia of late. A clear illustration is the recent implementation (as of January 1st, 2010) of the China-ASEAN FTA highlighted earlier. Another important factor underlying Korea's interest in a Korea-China FTA is the signing of the Economic Cooperation Framework Agreement (ECFA) between China and Taiwan in early 2010. This agreement is likely to improve Taiwan's competitiveness in the Chinese market, possibly at Korea's expense.

Next to this bilateral move, a potential trilateral FTA (involving China, Japan, and South Korea) is also increasingly being envisaged.

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[18] Tariffs on sensitive products are to be eliminated in 2015.

[19] The two parties launched a joint study on the feasibility of a bilateral FTA in 2004 and eventually upgraded it to government-industry-academia research in 2007, but the decision to go ahead with negotiations did not materialize until 2010.

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While the three Northeast Asian countries agreed in October 2009 to examine the feasibility of a trilateral FTA, they further agreed at the trilateral summit held on Jeju Island in May 2010 to complete a joint study on this issue by 2012. As a result, a private council (the Korea, China, Japan Economic and Trade Forum) to support a Korea-China-Japan FTA and economic cooperation and integration among the three countries was established in Seoul on June 3, 2011.[20] Although these are concrete steps, the discussion is still confined to the academic level and actual negotiations cannot be expected to start before long. The two other meetings of the Forum, which are already planned before the end of this year, will provide useful information on the strength of the three countries' commitment to the project.

Lastly, the past few years have also seen a renewed interest in the establishment of an East Asian FTA, involving ASEAN+3 countries and possibly some other partners. In August 2009, ASEAN and its six major trading partners (China, Japan, South Korea, India, Australia, and New Zealand) reasserted their commitment to establishing an East Asia Free Trade Agreement (EAFTA) and Comprehensive Economic Partnership in East Asia (CEPEA) within the next 15 years.

Progress can be expected in these different negotiations in contrast to what has been the case so far, because it now appears to be in all the countries' interests to go ahead with the project of a region-wide EAFTA. However, from the foregoing observations it should be obvious that there is still substantial uncertainty as to the scope of the potential agreement, both in terms of geography and sectors. Moreover, the countries in the region may simply resort to unilateral tariff reductions (as has been the case so far) without engaging in formal FTAs. Lastly, it remains to be seen whether the economic rationale will prevail over persistent political tensions and frictions that have hampered the cooperative momentum up to this stage. Should these difficulties be overcome, East Asia might finally emerge as an integrated market fueled by government-led cooperation and no longer as a production base led by market-driven integration.

[20] A major advantage of such a trilateral scheme is to help defuse bilateral tensions, in particular between Japan and Korea, as well as ease China's suspicions vis-à-vis Japan's and Korea's attempts at containing its rise (Byun 2011).

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Post-GFC Financial Cooperation

The CMI Multilateralized

The Mechanism

The need for greater financial cooperation in Asia has been brought into sharp relief by the GFC. As a result, after years of hesitation, at a summit meeting held in May 2009 in Bali, the ASEAN+3 finance ministers decided to set up a "self-managed reserve pooling" arrangement governed by a single contractual agreement, the so-called CMI Multilateralized (CMIM). The CMIM agreement was signed on December 24, 2009 and took effect on March 24, 2010. The new mechanism is supposed to help financial authorities to make necessary arrangements easier and faster in the event of a liquidity crunch. The CMIM replaces the former network of bilateral swap agreements among the ASEAN+3 countries while the ASEAN Swap Agreement (ASA) remains in effect.

The CMIM departs from the CMI on a number of points. First, the CMIM is a multilateral currency swap arrangement among ASEAN+3 countries governed by a single contractual agreement, while the former CMI was a network of bilateral swap arrangements among the "+3 " and ASEAN5 countries' authorities.[21] Secondly, the total funds available under the new scheme have been raised to US$ 120 billion, and the CMIM is now designed as a US$ liquidity support arrangement. A third distinct feature of the CMIM is its geographic coverage. The multilateralization process allows the participation of the ASEAN countries that were not incorporated into the previous mechanism, namely Brunei, Cambodia, Laos and Vietnam. Also, Hong Kong is now participating next to Mainland China.[22] The contribution from Hong Kong is more than symbolically important because it also means that Hong Kong is from now on a full part of all the activities taking place under the CMIM umbrella.

The distribution of influence between the two potential leaders in the region (China and Japan) had been the main stumbling block in the negotiation. Under the pressure of the GFC, a clever and effective

[21] The ASEAN5 are Indonesia, Malaysia, the Philippines, Singapore and Thailand.
[22] It is worth noting that with the consent of the Central Government of Hong Kong SAR, the Hong Kong Monetary Authority (HKMA) has since 2005 participated as part of the Chinese delegation in the ASEAN+3 meetings related to the CMIM.

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compromise was finally found on this point, with Japan contributing 32 percent of the total to the CMIM (or US$ 38.4 billion of the US$ 120 billion pool), while the PRC contributes US$ 38.4 billion in total, namely US$ 34.2 billion from the Mainland and US$ 4.2 billion from Hong Kong. The remaining 36 percent (or US$ 43.2 billion) are split among South Korea and the ten ASEAN countries. At first, the Philippines had been asked a smaller contribution than the other ASEAN5 countries, but its contribution was revised at the Tashkent meeting in August 2010. The ASEAN5 are thus committed to a uniform contribution of US$ 4.5 billion.

As a result, Japan is the 'single largest single contributor' while at the same time the PRC (including Hong Kong) and Japan are the 'largest co-equal contributors'. Although China is not strictly speaking on a par with Japan, its contribution, and therefore influence in the CMIM is much more substantial than what is the case in other regional institutions such as the Asian Development Bank, for instance. Lastly, with a contribution amounting to 16 percent of the total, South Korea has a much larger say than its economic weight would imply.

Beyond these political considerations, the definition of financial contribution is of high importance because it also determines the amount of funds that a country is entitled to tap. Each CMIM participant is entitled to swap its local currency with the US$ for an amount up to its contribution multiplied by its respective purchasing multiplier (see Table 4). By way of illustration, Japan will be entitled to 38.40 times 0.5, or US$ 19.2 billion, Singapore to 4.77 times 2.5 or US$ 11.92 billion, Vietnam to 1 times 5 or US$ 5 billion, and Cambodia to 0.12 times 5, or US$ 0.6 billion. Because it is not a member of the IMF, Hong Kong is in a distinct position and is limited to the IMF de-linked portion of the Fund.

Although the CMIM still falls short of a full-fledged Asian Monetary Fund, it constitutes a major step on the way to tighter financial cooperation in the region.

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Table 4: The Chiang Mai Initiative Multilateralized

	Financial contributions		Borrowing agreements			Voting rights
	US$ billion	%	Multiplier	Maximum swap amounts (US$ bn)	IMF de-linked portion (US$ bn)	%
P.R. China	34.2	28.5	0.5	17.1	3.42	25.43
Hong Kong*	4.2	3.5	2.5	2.1	2.10	2.98
Japan	38.4	32.0	0.5	19.2	3.84	28.41
South Korea	19.2	16.0	1	19.2	3.84	14.77
Plus 3 Countries	**96.00**	**80**	**0.69**	**57.6**	**13.20**	**71.59**
Indonesia**	4.552	3.793	2.5	11.38	2.28	4.37
Thailand**	4.552	3.793	2.5	11.38	2.28	4.37
Malaysia**	4.552	3.793	2.5	11.38	2.28	4.37
Singapore**	4.552	3.793	2.5	11.38	2.28	4.37
Philippines**	4.552	3.793	2.5	11.38	2.28	4.37
Vietnam	1.00	0.833	5	5.0	1.0	1.85
Cambodia	0.12	0.100	5	0.6	0.12	1.22
Myanmar	0.06	0.050	5	0.3	0.06	1.18
Brunei	0.03	0.025	5	0.15	0.03	1.16
Laos	0.03	0.025	5	0.15	0.03	1.16
ASEAN	**24.00**	**20**	**2.63**	**63.1**	**12.64**	**28.41**
Total	120,00	100				100

Source: ASEAN Secretariat

*Hong Kong's borrowing is limited to the IMF de-linked portion because Hong Kong is not a member of the IMF.
** Initially, the Philippines were expected to contribute US$ 3.68 billion and other ASEAN4 economies US$ 4.77 billion each.

In addition, an independent regional surveillance unit (the ASEAN+3 Macroeconomic Research Office - AMRO) has been established to monitor and analyze regional economies and

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contribute to the early detection of risks, swift implementation of remedial actions, and effective decision-making of the CMIM.[23] This surveillance mechanism is expected to be developed further so as to loosen the link between the CMIM and the IMF. Once the independent surveillance mechanism is in place, the IMF-delinked portion will be increased above the 20 percent limit mentioned earlier.

Assessment and Prospects

Starting with the CMIM as it currently stands, it is worth stressing that the mechanism still exhibits a number of weaknesses that will probably hinder its efficiency.

Firstly, the CMIM is still faced with a leadership issue, with Japan and China competing for leadership without necessarily wanting to openly overtake the responsibility. The rivalry between the two powers was temporarily defused because of the sense of emergency generated by the GFC and this is why the decision to multilateralize the CMI was made possible. However, there is a risk that this rivalry will emerge again as the sense of emergency fades, and intense bickering as to who may head the AMRO does not bode well for the future.[24]

A second problem pertains to the strength of the participating countries' commitment to the cooperative mechanism. Here again, some signs clearly point in the wrong direction. ASEAN+3 member countries are not precluded to enter into separate bilateral currency swap arrangements if they consider it necessary to supplement the CMIM. As a result, the monetary authorities of the countries with large foreign exchange reserves, namely the PRC and Japan, have established their own respective bilateral swap arrangements using their own currency (yuan and yen) besides the CMIM. Although these moves are not aimed to undermine the efficiency of the CMIM, they do pose a risk. Moreover, alternative financing schemes such as the New Arrangements to Borrow also risk *de facto* sidelining of the regional mechanism. Lastly, with conditions for borrowing under the CMIM being the same for all countries, the mechanism appears relatively unattractive.

A third issue relates to the persistent problem of size: for example, in the absence of IMF support, Thailand could merely access 20 percent of its maximum swap amount, namely US$ 2.28

[23] As explained by the ASEAN Secretariat, "to support the CMIM, AMRO will be tasked to: (i) monitor, assess, and report on the macroeconomic situation and financial soundness of the ASEAN+3 Countries, (ii) assess macroeconomic and financial vulnerabilities in any of the ASEAN+3 Countries and provide assistance in timely formulation of policy recommendations to mitigate such risks, and (iii) ensure compliance of swap requesting parties with the lending covenants under the CMIM Agreement."

[24] After difficult negotiations, where China objected to the Japanese candidate, Wei Benhua, former Deputy Administrator of the State Administration of Foreign Exchange, China, has been appointed inaugural director of AMRO.

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billion, which is far from what was required in 1997 for instance. Similarly, even if the CMIM had been in place earlier, Korea would have certainly resorted to the US rather than to the CMIM because of the limited amount of funds to which it would have been entitled, namely a maximum of US$ 19.2 billion (much smaller than the US$ 30 billion obtained from the US) and even less without the IMF's approval.[25] As a result of these persistent weaknesses, the chances of success of the CMIM can be deemed relatively limited in the absence of major reforms in the way the mechanism operates.

In addition, and probably more importantly, the chance of having the CMIM evolve into a full-fledged Asian Monetary Fund (AMF) is also low because of persistent problems in the area of surveillance. The strong IMF linkage was definitely found to be a major weakness of the CMI, as exemplified by the failure of the scheme in the recent crisis. As a result, a strong but independent surveillance mechanism is absolutely necessary for the CMIM to play a distinctly different role, compared to the CMI. As explained earlier, with the creation of such a mechanism, the IMF-delinked portion of the CMIM could be raised well above the 20 percent or even be scrapped altogether. This would require tighter cooperation among central bank governors, as well as more rigorous peer pressure. *A priori*, establishing an independent regional surveillance unit such as the AMRO is a promising step and this should pave the way to independent lender of last resort activities and also allow for a regular dialogue on macroeconomic and financial stability challenges facing the region in much the same way as what is being done by the Financial Stability Board or the Ecofin in the European Union. However, it remains to be seen whether this will materialize. For that to happen genuine political will and commitment is warranted, but there are good reasons to believe that this may still be lacking.

And yet, the emergence of an AMF would be instrumental in contributing to global rebalancing in two ways: first by alleviating the pressure to run systematic current account surpluses and to accumulate foreign exchange reserves so as to respond to potential speculative attacks, and secondly by paving the way to exchange rate policy coordination in East Asia with a view to enhancing exchange rate flexibility.

Lastly, the previous remarks also suggest that the conditions are not yet met for the countries in the region to go ahead with exchange rate coordination. For the time being, while greater exchange rate flexibility is undoubtedly desirable for all countries in the region, they are all constrained by China's strategy in their exchange rate policy choices. Preliminary empirical evidence suggests, for instance, that a number of countries in the region tend to seek to avoid letting their currency appreciate vis-à-vis the

[25] Doubling the size of the CMIM to US$ 240 billion (as discussed at the Hanoi Summit of last June) may, however, help alleviate the problem.

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renminbi rather than against the dollar (Pontines and Siregar 2010), underlining the key role of the Chinese economy in the region.

As stressed earlier, in the wake of the GFC the rationale for exchange rate coordination/stabilization and for reducing the US$ dependence has never been stronger in East Asia, but China's exchange rate policy does not point in the right direction. The persistent reluctance to let the yuan appreciate vis-à-vis the dollar constrains the other economies in the region to do the same, lest they lose competitiveness. Unless Chinese authorities change their policy stance, prospects for exchange rate policy coordination will remain bleak and proposals for some co-ordination of exchange-rate policies will remain confined to academic circles and policy think tanks.

The Difficult Emergence of an Asian Bond Market

In the wake of the AFC, governments had also been taking steps to deepen regional bond markets with a twofold objective: first to avoid the double mismatch of maturity and currency experienced at the time of the crisis, and second to shelter the regional economy from the possible repercussions of future volatile capital flows originating elsewhere in the world.

Given the high level of savings in many Asian countries, there was an emerging sense that surplus savings from East Asia flowing out of the region to Western (primarily US) financial markets and then returning by way of loans to Asian borrowers made little economic sense. As a result, the creation of an Asian Bond Market and broader related efforts to stimulate local bond markets were seen by many Asian policymakers as serving the need to reinvest excess savings locally. The development of local and regional securities and derivatives markets would indeed be instrumental in mobilizing more stable long-term sources of financing from the region's high savings. Of course the development of a regional bond market requires both issuers of bonds and investors in those bonds. The Asian Bond Market Initiative (ABMI) is the answer to the first issue and the Asian Bond Fund (ABF) to the second.

The Japanese Government was active very early on in pushing for the development of regional and local bond markets in East Asia with the emphasis on the bond issuers. In December 2002, Japan officially proposed the idea of the ABMI at an ASEAN+3 meeting in Thailand. The aims of the ABMI are two-fold: to facilitate access to the market through a wider variety of issuers, and to enhance market infrastructure to foster bond markets in Asia (Katada 2009). In East Asia, bond markets are generally not very highly developed, although they have been growing rapidly. However, size, turnover, legal infrastructure, transparency, and variety of issuers and maturities remain deficient throughout the region. At an ASEAN+3

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finance ministers meeting in August 2003, participants endorsed the ABMI, which is designed to foster an active and liquid secondary market in local-currency bonds and to develop the infrastructure needed for the growth of local bond markets. Since then, ABMI Working Groups have been established so as to address key bond market development issues. In May 2008, ASEAN+3 member countries endorsed a New ABMI roadmap to further advance liquid and smoothly functioning bond markets and effectively channel the region's abundant savings into meeting increasing regional investment needs (Jang 2011).

Next to the ABMI, another move was made with the establishment of the Asian Bond Fund (ABF). The initiative was supported by then Thai Prime Minister Thaksin Shinawatra, who proposed that the members of ASEAN+3 contribute 1 percent of each country's respective foreign exchange reserves to launch a regional fund to purchase Asian bonds (Katada 2009). The idea was discussed at the East Asia Summit in Kuala Lumpur in October 2002 and adopted by the Executives' Meeting of East Asia Pacific Central Banks (EMEAP)[26] in June 2003. With a starting capital of US $1 billion, the fund initially would invest in sovereign and quasi-sovereign bonds issued by less advanced Asian governments (i.e. not Japan, Australia or New Zealand) in the international markets. At a first stage the bonds purchased by the Fund were all US$ denominated. As a next step it was supposed to extend the investment into the various local bond markets in local currencies.[27]

The ABMI and the ABF are clearly two complementary schemes, since the former addresses the issue of supply by fostering the emergence of an Asian regional bond market, while the latter addresses the issue of demand through the creation of a fund fuelled by the voluntary contributions of regional governments and designed to purchase regional bonds. An important point worth stressing at this stage is that cooperation to establish a regional bond market was actively supported by many political leaders in the region as a potential and welcome driver for domestic reforms (Amyx 2004). Cooperation at the regional level was also deemed very positive because it can help deepen and strengthen the domestic bond markets. To be fair, these schemes have also been supported (or at least not opposed to) by external players such as the US and the EU.

For the time being, although there has been no apparent loss of momentum in the cooperative effort (as exemplified in particular by the new ABMI roadmap), and although steady progress has been achieved in the development and deepening of the Asian bond

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[26] The EMEAP is a cooperative organization of 11 central banks and monetary authorities in the East Asia and Pacific region whose primary objective is to strengthen the cooperative relationship among its members.
[27] The ABF1 was set up in 2003 to invest in a basket of dollar-denominated bonds, and the ABF2 was launched in 2004 to invest in bonds denominated in local currencies.

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market, the level of bond market development still varies greatly from one economy to another and the level of Asian cross-border bond transactions conducted within Asia remains extremely low (Kawai et al. 2011), thus calling for sustained cooperative efforts.

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Conclusion

A number of weaknesses of intra-regional economic integration in East Asia were underscored by the GFC (excessive dependence on external markets and insufficient financial cooperation in particular). Over the past few years, various steps have been taken in the direction of a deeper financial cooperation, and more can be expected in particular on the way to the establishment of a region-wide FTA.

Unlike what was the case in the past, there is now a strong rationale to go ahead with a region-wide FTA, to further push the development of a region-wide bond market and to deepen intra-regional exchange-rate stabilization. While financial cooperation has attracted most of the attention, the deepest changes are likely to occur in the trade sphere. As argued in the paper, a number of major mutually reinforcing changes can be expected in East Asia. Firstly, the nature of *de facto* East Asian integration may shift toward more horizontal integration. Secondly, more top-down regional integration efforts in the trade area are likely to complement and reinforce the existing intra-regional linkages based on a bottom-up dynamics.

All these changes are still preliminary, however, and it remains to be seen whether East Asian economies will finally choose the top-down path followed by other regions such as the European Union rather than stick to the more flexible approach they have privileged so far.

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