

OVERVIEW

KIICHIRO FUKASAKU

Background

While most ASEAN and East Asian economies have emerged strongly from the global economic crisis of 2009, policy makers in the region are well aware that their economies need to move towards more resilient, balanced and inclusive growth paths¹. Given the OECD economies that will likely remain weak in the next few years, ASEAN and East Asian economies should take a full advantage of their endogenous growth potential through deeper economic integration. Assessment of regional integration and its impact is a prerequisite for well-crafted policy actions for facilitating further integration and alleviating possible bottlenecks. An important benefit of strengthening regional ties is the reduction of transaction costs that leads to higher efficiency of resource allocation and welfare gains through enhanced competition in the domestic market. The benefits of integration, however, should be discussed from a comprehensive viewpoint and measured not only by the degree of integration itself (for instance, increased trade and investment flows) but also by whether that integration brings about greater stability and social progress in the region.

The integration of international goods and services markets has significantly advanced from the second half of the 1980s, and Southeast and East Asian countries are among those that have reaped the full benefits of globalisation. Since the early 1990s, official initiatives to strengthen the region's market-driven integration have intensified within the ASEAN. More recently, several initiatives have been launched to foster the economic ties between ASEAN countries and their neighbouring economies, thereby leading the region to a distinct path towards integration².

¹ In this study, unless otherwise indicated, ASEAN and East Asia refer to 16 member economies of the Economic Research Institute for ASEAN and East Asia (ERIA).

² For further details, see OECD Development Centre (2010), *Southeast Asian Economic Outlook 2010* (Chapter 3), OECD, Paris.

Project Description

Against this background, the ERIA-OECD collaborative project began in April 2009 for two years with a view to developing a monitoring tool for the integration process of ASEAN and East Asia. The ERIA appointed Dr. Ponciano Intal Jr. as a coordinator for this collaborative project, and after initial discussions between the two institutions, it was agreed upon to focus substantive work on the following two areas: (1) regional integration and business cycle synchronization, and (2) regional integration and production structure.

The construction of comprehensive regional integration indicators requires a large amount of data and information covering different areas of the economy. For instance, concerning macroeconomic integration, it would be imperative to construct business cycle indicators for Asian countries by using the common methodology such as the OECD's "growth cycle" approach. It was also recognised that the ERIA had already examined integration in other areas, such as investment and trade. Therefore, the two institutions agreed to seek synergies in this collaborative project by exploiting the comparative advantage of each organisation and creating several indicators necessary to monitor the integration process.

Intermediate Output

According to the timetable set by the two institutions, the *ERIA-OECD Roundtable* on "Monitoring Regional Integration in Southeast Asia" was held in Jakarta on 30 November 2009. The results of the Roundtable discussions were incorporated into two intermediate reports submitted to the ERIA in March 2010. Subsequently, the ERIA published them as two Policy Briefs, summarizing the main results and policy messages of the first year's collaboration:

- Yamano, N., B. Meng and K. Fukasaku (2011), "Fragmentation and Changes in the Asian Trade Network", *ERIA Policy Brief* No. 2011-01, Jakarta, January; and
- Tanaka, K. (2011), "China's Ties with Southeast Asia: From Green Shoots to Sustained Recovery", *ERIA Policy Brief* No. 2011-02, Jakarta, January.

The main results of the second year's collaboration were presented at the *ERIA-OECD Seminar* on "Regional Integration in ASEAN and East Asia" in Jakarta on 31 January 2011. The seminar was opened by Mr. Hidetoshi Nishimura, Executive

Director, ERIA and Mr. Kiichiro Fukasaku, Head of Regional Desks, OECD Development Centre. The seminar was attended by about 35 participants, including Dr. Rizal Affandi Lukman, Vice Minister of Indonesia's Coordinating Ministry for Economic Affairs and officials from Indonesia's Ministries of Finance, Industry and Trade and BAPPENAS; representatives from Embassies of Australia, Cambodia, China, India, Japan, Malaysia and Thailand as well as the ASEAN Secretariat and the World Bank; and those from the private sector. The summary of this seminar was posted at the ERIA website in February 2011.

Final Report

The Final Report consists of three chapters, as follows:

Introduction and Overview (by Kiichiro Fukasaku)

Chapter 1 – “Monitoring Business Cycles and Macroeconomic Challenges in ASEAN and East Asia” (by Kensuke Tanaka)

Chapter 2 – “Recent Developments in Asian Economic Integration: Measuring Indicators of Trade Integration and Fragmentation” (by Kiichiro Fukasaku, Bo Meng and Norihiko Yamano)

Chapter 3 – “The Evolution of Production Networks in the Asia-Pacific and the Rest of the World: Measuring International Fragmentation Processes” (Norihiko Yamano and Bo Meng)

In what follows, the brief description and key findings of three chapters are presented.

Chapter 1 presents both composite leading and coincident indicators and historical diffusion indices that collectively serve as a tool for the regional monitoring of business cycles in a timely manner. The development of this monitoring tool, called the *Asian Business Cycle Indicators* (ABCIs), has been identified as a priority area of the ERIA-OECD collaborative project. It allows policy makers to trace Asia's business cycle synchronisation and discuss the near-term economic prospects and potential risks for Asian economies in five to six months ahead.

The ABCIs have been developed by the OECD Development Centre in co-operation with the OECD Statistics Directorate. The results of this work have been published on a quarterly basis, with accompanying indicators for five ASEAN countries (Indonesia, Malaysia, the Philippines, Singapore and Thailand) as well as China and India (see

www.oecd.org/dev/abcis). The early analysis of ABCIs indicates that while ASEAN business cycles have continued to be affected by the import demand from OECD countries, China is indeed leading ASEAN recoveries through trade linkages.

Recent macroeconomic challenges include large capital inflows and food price hikes. In this context the author discussed the importance of greater exchange-rate flexibility and macroeconomic co-operation. In particular, strengthening regional cooperation through monitoring and surveillance was emphasised in this chapter. Furthermore, the author argues that governments in the region need to strengthen their fiscal policy frameworks in order to meet the challenge of “rebalancing growth” in the medium term. Given the huge financial demand for infrastructure development, setting appropriate fiscal rules would be important to maintain strong medium-term growth targets without jeopardising fiscal health. Finally this chapter addresses the role of independent fiscal institutions and medium-term budgetary frameworks.

Chapter 2 analyses the contribution to and engagement in global supply chains of Asian emerging and developing economies by measuring several globalisation indicators based on the harmonised input-output and bilateral trade databases developed by the OECD (see Chapter 3 below). It focuses on major structural changes in the Asian trade network from the perspective of integration and fragmentation in global supply chains. It shows that greater fragmentation and higher dependence on supplies of intermediate goods and services from neighbouring countries have gone hand in hand and led to deepening economic integration in ASEAN and East Asia.

The empirical results presented in this chapter have important implications for strategies for regional economic integration in the Asia-Pacific region. In particular, ASEAN countries need to think the strategy for deeper integration from the perspective of the whole East Asian region and not just ASEAN *per se*. The current state of ASEAN-China trade provides a case in point. The sustained growth of China will likely intensify competition in global markets for manufactured goods³. While overall welfare consequences for other developing countries are relatively small, ASEAN countries tend to feel greater competitive pressures from China. These countries will need to raise the quality of their exports in textiles and apparel, as well as in electronics and more generally machinery and equipment. On the other hand, the relative decline in wood and other processing industries in China will leave space for expansion in resource-rich ASEAN countries. To exploit such trade opportunities, ASEAN policy

³ See Dimaranan, B., E. Ianchovichina and W. Martin (2009), “How will Growth in China and India Affect the World Economy”, *Review of World Economics*, 145: 551-571.

makers are required to address the challenge of sustainable development in these resource-intensive sectors, such as the depletion of natural resources and environmental degradation and their long-term impact on regional and sub-regional economies.

In conclusion, a key challenge for ASEAN policy makers is to strengthen the ASEAN's position as the hub of free trade agreements with outside partners. In this way ASEAN countries can foster overall trade growth and dynamism in the emerging post-crisis world. At the same time, they need to engage more actively in regional macroeconomic co-operation, with a shared view to reducing vulnerability and ensuring sustained growth. Regional macroeconomic co-operation remains at an early stage in Southeast Asia, but possibilities for further co-operation should be explored (see also Chapter 1).

Chapter 3 takes a further look at the Asian trade network which has been increasingly fragmented since the mid 1990s. Analysis of trade fragmentation in a consistent manner has been identified as another priority area of the ERIA-OECD collaborative project. The OECD has developed and maintained internationally-harmonized Input-Output and Bilateral Trade Databases, which includes 47 countries accounting for more than 90% of global GDP. These databases allow the authors to examine the recent evolution of global production networks involving Asian-Pacific countries at 2-digit industry level (see www.oecd.org/sti/inputoutput).

In this chapter the authors have developed bilateral trade data in end-use and constructed an inter-country, inter-industry model to measure various indicators of production fragmentation. Their results highlight major changes in the pattern of Asia's trade in intermediate goods and services since the mid-1990s, including among others,

- Significant changes in both industry and category components of exports were observed for most Asian emerging economies (e.g. China's machinery, textiles, etc). Larger countries (China, India and Indonesia) increased the product variety of their exports, while smaller economies changed their leading export bundles.
- Despite some recent changes, East Asia's production networks have kept close links with North America's. On the other hand, ASEAN countries have become more dependent on intermediate exports from East Asia. Turning to the case of Europe, the region's inter-industry structure has remained largely self-contained and stable since the mid-1990s.
- The amount of domestic value-added induced by unit value of exports tended to decline due to the increased import contents of exports for all regions. However, the

total value added from trade increased in Asian countries, as the total volume of exports rose.

- While larger economies and those rich in natural resources tended to induce higher value-added impacts on domestic economies, most of indirect effects were leaking into their neighbouring emerging economies, such as ASEAN and Eastern Europe. This reflects the fact that ASEAN and East European countries have become major suppliers of intermediate goods and services to East Asia and Europe, respectively.

In short, the inter-country, inter-industry model developed in this project has proven to be an effective tool to capture the role of intermediate trade in goods and services that has become increasingly important in respective regions (East Asia, Europe and North America).