

## **East Asian Economic Integration: Problems for Late-Entry Countries**

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The significant rise of many East Asian economies during the latter half of the last century was based on the change to a market-driven economy and the adoption of an open-door strategy. The close connection between these two factors has created a unique feature in economic growth in East Asia. The growth has been rapid, long-term, and sustainable and has spread swiftly into many economies in the region.

As conditions for worldwide and regional economic development have altered, these two factors have continued to play a key role in the region's economic prospects. This is clear from the structural adjustment process in many East Asian economies after the 1997–98 economic crisis and the great contribution of the emerging economies, especially China, to the region's current growth performance.

The conditions for growth and development in East Asia have, of course, undergone fundamental shifts since the period prior to the 1997–98 economic crisis. These shifts have exposed many new issues to the less-developed countries in the region. The opportunities and challenges are now quite different in terms of scope, nature, level of difficulty, and implementation. Meanwhile, the less-developed countries have been exerting a negative impact on the prospects for development and economic integration in the whole region. Experience has shown that less-developed countries often have negative impacts during the common integration process, thereby hindering more developed countries from growing more quickly.

To assess East Asia's growth prospects, one must identify the new conditions for growth in the region. It would then be possible to single out the problems faced by late-entry countries, and this could help elucidate the development process in East Asia.

### **The new context of development**

#### *The emergence of East Asia as a global economic hub*

Together with the dynamism of China, the rapid recovery of the region's economies since the 1997–98 crisis has turned East Asia into an enormous center of economic activity, especially in the role of the region as the industrial hub of the world. Industrial goods produced in East Asia, especially goods relying on mid-level technology, account for a large and expanding share of global industrial production.

The rapid increase in inflows of foreign direct investment to East Asia and the region's status as an industrial hub of the world have created a strong growth momentum. This has changed the position of East Asia in the global economy, but it has also changed the growth model (the "industrial wave") and the comparative advantages of the region's economies.

Before the 1997–98 crisis, economic development in East Asia followed a pattern called the flying geese formation, which was led by Japan. The participation of China and Vietnam in this formation contributed to maintaining this pattern of development following the crisis. It seems that this kind of orderly participation in development helped East Asia reduce competitive

risks, especially for late-entry economies. These latecomers could narrow the gap between themselves and their developed-country predecessors. Nonetheless, although all countries were subject to competition, the gap remained sufficiently wide so that the frontrunner might feel safely ahead.

However, under the impact of the economic crisis and the shifts in the movements of foreign direct investment, the rise of the Chinese economy—giant in terms of the scale and scope of its development—has altered the industrial wave and set East Asia's economic development process on a new course.

First, while the differences in *industrial* structure among countries in the region have persisted, technological gaps have narrowed. Second, there is a trend toward a division of labor based on a *value added chain* among countries in the region. This represents a *new model for industrial development in East Asia*. It is a fresh foundation for closer development links among countries. In principle, all economies that take part in this chain will have many opportunities to benefit from forces for development. Third, because of globalization and knowledge-based economic development, late-entry countries may attempt to catch up to developed countries by skipping over stages in industrial development and moving directly to a higher level of technological sophistication. Shortcuts exist in the development process. The Republic of Korea and Malaysia have demonstrated that such an approach is possible in Asia. China and India have repeated the experiment with considerable success. Of course, to take maximum advantage of this opportunity, there are a number of requirements, such as adequate financing, technology, human resources, markets, a sound strategy, and a degree of economic integration with the region and the world. Such requirements are not readily met by latecomers.

Depending on a country's specific situation and capabilities, the time needed to absorb *the structure wave* (in the *wave model*) and to move up the technological ladder (in the *value added chain* model) varies considerably. In general, the less-developed late-entry countries, notably, the Cambodia-Lao People's Democratic Republic-Myanmar-Vietnam group, have encountered difficulties in participating in the regional system for the division of labor under either industrial model. In the meantime, China, thanks to its economies of scale and its overall strength, has leapfrogged up the technological ladder. It has become a prominent example of the possibility of narrowing economic gaps with developed countries.

The long-term economic prospects of East Asia are bright, and there are many development opportunities for the whole region. The shifts in the development characteristics of countries in the region have already been enormous. The conditions for access and the ability to take advantage of economic opportunities still vary among countries, however. The weaker economies face bigger challenges and difficulties. Tight integration within the region must be an important goal if the weaker economies are to narrow the gap.

### *The rise of China*

The rise of China has given East Asia a new appearance. There is a new force for growth, and there have been dramatic changes in modes of operation. There is a *new competitive relationship* in the region. It has brought new, unprecedented development opportunities and challenges.

China plays the role of a *black hole*<sup>1</sup> in the development process in East Asia. From the perspective of the industrial wave, the emergence of China is having a strong impact in the spread of economic development throughout the region.

First, because of its giant scale and rapid growth, China has altered, on its own, the balance of development in the region. China's significant demand for inputs and its ability to supply outputs to the world's markets have altered the international supply-demand equation dramatically. China is exerting fierce competitive pressure on all countries and markets at various levels. This pressure is multidimensional in that it embraces quality, quantity, durability, and price.

For those countries in the region at a similar or lower level of development, the pressure has been especially furious in the short term and the long term. However, those countries that are at a similar or lower level of development and happen to be China's neighbors will also experience stronger positive effects. From this reasoning, the countries of the Association of Southeast Asian Nations (ASEAN) are certainly being directly and decisively affected by China's emergence as a powerful economic force.

Second, in general, the rise of China has upset the old balance. It has created new development opportunities that are significant for the region and the world. Unfortunately, most East Asian economies, but especially the weaker economies, have seen the situation as containing more challenges than opportunities. This has often precipitated a policy response that aims to protect the economy from the challenges, but fails to take advantage of the opportunities.

The world economy must adapt to the changes caused by China's rapid expansion. This may be achieved in three ways:

- Investing in China to produce goods in China, then selling the goods at a profit in China or on the world market
- Exporting machines, equipment, and modern inputs to China to take part in the production and export process in China, thereby benefiting from the economy's development
- Exporting raw materials and products to China for profit

Depending on its competitive level and strength, each economy will find among these three an appropriate method for adapting to China, taking advantage of the opportunities created by China, or competing with China. The United States and other developed economies have mainly chosen the first way. Middle-level developed economies with mid-level financial resources have followed the second way. The third way has been selected by less-developed economies that have natural resource advantages or that are at a level of competitiveness lower than that of China (Tran Quoc Hung 2004).

Relative to China, the development level of ASEAN countries is generally no higher. Some economies are less developed and in a weaker position financially. This is why ASEAN economies have mainly adapted to China's economic boom in either the second or the third way. The relatively more well developed ASEAN economies (Indonesia, Malaysia, the Philippines, Singapore, and Thailand) have followed the second way. Cambodia, Lao PDR, Myanmar, and Vietnam have chosen the third.

For ASEAN economies, the rapid growth of China has represented a huge opportunity, as well as a sort of challenge ASEAN has never faced before. As a united, integrated economic bloc, ASEAN is a potential rival to China. However, in terms of position and power, trends and prospects, ASEAN is generally at a disadvantage. ASEAN may become a supplier of raw materials to China in exchange for manufactured goods (the third way) (Thayer 2005). Moreover, ASEAN is involved in the new division of labor in the region, in which China has played a key role.

Vietnam is typical among the less-developed economies in ASEAN and East Asia. For Vietnam, the dangers are greater. Economic cooperation and exchange between Vietnam and China have evolved in the third way. While Vietnam has a surplus in exports with all developed economies (Europe, Japan, the United States), it has an import surplus with China, a developing economy. This seems to be a paradox for Vietnam, where there has been industrialization and modernization and where considerable effort has been taken to narrow the development gap with the rest of the world. For the long-term benefits of development, Vietnam has reason to worry about this paradox.

The reason for Vietnam's long-standing import surplus in its trade with China lies in the division of labor between the two economies: Vietnam has been specializing in providing raw materials, fuel, and primary agricultural products to China, while China has been exporting low- and medium-technology industrial products to Vietnam. The possibility that the trade and investment relationship between China and Vietnam may evolve toward a North-South model cannot be ignored. Vietnam might become caught in the low-wage trap and remain economically subordinate to China.<sup>2</sup>

There are good grounds for predicting that the economic relationship between the region's less-developed economies and China will also evolve in this way. Such a situation will be adverse for Vietnam and other less-developed countries, but also have a negative effect on the benefits of China's development, the course of East Asian economic integration, and the region's economic development prospects.

Third, because of China's huge scale, the industrial wave within China may be long-lasting.<sup>3</sup> It may possibly be generally confined within China's borders and not spread to less-developed neighboring economies like Cambodia, Lao PDR, Myanmar, and Vietnam (Tran Van Tho 2005). This is a real possibility given that China is more competitive than the region's less-developed economies. Thus, a normal course of development involving shifts in the structural waves across economies in the region will be blocked. A fact that has a decisive influence on the prospects for latecomer economies in East Asia should be stressed: the structure and inputs of products made in China and exported have been diversified from low-technology, labor-intensive items to high-technology, capital-intensive ones. This is similar to the situation in many economies in the region. This means there is a danger of destabilization in the division of labor in East Asia. Late-entry ASEAN countries (such as Cambodia, Lao PDR, and Vietnam) will encounter difficulties establishing a foothold in this system. Even more developed economies such as Japan, Korea, and Malaysia may have difficulty, though at higher product levels. Weaker economies, if they are unable to compete successfully with China, which is already the case for many products, will be eliminated from the regional labor market. This very real issue renders the economic prospects in East Asia less bright.

#### *New developments in regional economic integration*

Prior to the 1997–98 crisis, even within the flying geese model of development, the performance of East Asia was a simple sum of separate miracle-growth economies. Even ASEAN, the bloc with the most well integrated institutional structure in the region, did not enjoy close, effective economic links.

The 1997–98 crisis revealed the obvious: under normal growth conditions, East Asian economies did not seem to need each other very much (except Japan), and, during the crisis, no one country could save any other country. Malaysia and Thailand are neighbors, and both are

also ASEAN members, but, when they were caught up in the crisis, they could not assist each other even though assistance would have been timely and effective.

It can be seen that the three main weaknesses of the economic integration model of ASEAN are as follows:

- The inefficiency of integration the ASEAN way, wherein the key words are voluntary, consensus, and noninterference
- Lack of a powerful institutional body that is able to organize and supervise links among countries in the region so as to overcome national obstacles
- Absence of the driving force of a truly leading nation

Although ASEAN has launched many sound programs aimed at fostering integration and development, the implementation of these programs has often been slow and inefficient. Since the 1997–98 crisis, this state of affairs has been more or less superseded, but the results are still far from meeting expectations.

Recently, with China's participation, followed by Japan and Korea, the process of economic integration in East Asia and within ASEAN has become more dynamic. First, while weaker than many other players, ASEAN is a focal point for regional efforts at integration and is so regarded by ASEAN itself. Australia, China, India, and Japan have undertaken efforts to link with ASEAN and thereby establish long-term relationships with other countries in East Asia. New formulas and models that tend toward a close institutional structure in the region—ASEAN+1 (plus China), ASEAN+3 (plus China, Japan, and Korea), ASEAN+5 (plus China, Hong Kong [China], Japan, Korea, and Taiwan [China]), the Asia-Europe Meeting, and Asia-Pacific Economic Cooperation<sup>4</sup>—are mushrooming in the region. This process has created fresh forces for development in East Asia, increasing development opportunities in the region. The integrating process in East Asia is now fostering the construction and consolidation of economic and financial blocs through coherent institutional structures.

East Asia has also been attempting to build development corridors among ASEAN economies and between ASEAN and China. These programs have good prospects. The speed of implementation has been accelerating, especially in those programs directly related to China. However, it is important to note that, to create better development opportunities and facilitate access to these opportunities by less-developed economies in ASEAN (Cambodia, Lao PDR, Myanmar, and Vietnam) so as to narrow the development gap within the region, these programs must be carried out over a large area under especially difficult geographical, social, and economic conditions (including in southwestern China). In addition, the lack of regular, firm financial guarantees causes problems in implementing the programs rapidly and smoothly.

Bilateral integration processes have also been accelerated. Many countries are cooperating through a series of bilateral investment and trade agreements. Thanks to bilateral agreements, some developed economies (for example, Singapore and Thailand) have preferred to undertake integration and liberalization according to their own capabilities rather than adopt ASEAN's principles of integration. This has helped promote economic development in individual countries. It has also created stronger competition and allowed regional integration principles that are inefficient and obstruct the liberalization process to be ignored. ASEAN has been investigating and testing these effects, along with new integration formulas such as 10-X (any grouping under the 10 ASEAN members is sufficient for integration programs) and 2+X (only two countries are required).

However, accelerating the bilateral integration process may also have adverse impacts on regional integration efforts. Because they have to implement many bilateral agreements instead of only one multilateral agreement, governments and enterprises may suffer from the “Asian noodle bowl” effect or the “centrifugal” effect, whereby the orientation toward integration is skewed toward bilateral relationships. Increased transaction costs can widen the development gaps among economies.

The presence of outside partners in ASEAN’s integration formulas (ASEAN+1, ASEAN+2 [plus Australia and New Zealand]), ASEAN+5) and the trend toward an East Asian Economic Community have strengthened the centrifugal effect in ASEAN. ASEAN will become even weaker if it cannot overcome this problem given that it is at an inherent competitive disadvantage relative to China, India, and Japan,. Although the ASEAN Economic Community is considered a priority program for dealing with the centrifugal effect and creating a new development power and position for ASEAN, the history of the program and its current status clearly show that implementing it as intended will be extremely difficult (see box 7.1).

#### **BOX 7.1. The ASEAN Integration Gap**

ASEAN’s level of development as a region is much less than that of the European Union or the North American Free Trade Agreement. Because of the large development gap and low average level of development, ASEAN’s impetus toward economic links and integration has been weak, and ASEAN lacks a strong, capable engine for leading the integration process.<sup>5</sup> ASEAN lacks a strong guiding force at its interior. This has imposed huge obstacles on ASEAN integration, but also represents a challenge to ASEAN’s will. It is this objective weakness that has generated the trend among ASEAN members to escape from the regional bonds and become involved in establishing bilateral links and integration agreements with powerful partners outside the region, notably China, India, Japan, and the United States. This trend is having a negative impact on ASEAN’s prospects because it is eliminating the development advantages that may be fostered by regional integration.

*Source:* Tran Dinh Thien 2005.

Key ASEAN countries are facing political and social instability. Ethnic and religious conflicts and conflicts of interest have been heated in Indonesia, Myanmar, the Philippines, and Thailand. It is unlikely that these situations will be resolved in the near future. Instead of focusing more effort on ASEAN integration operations, these governments are obliged to assign more priority to these domestic issues. The ASEAN Economic Community—the loose institutional structure for ASEAN integration—is thus even more difficult to realize.

These difficulties are augmented by several other factors. These include cultural diversification, the differences in views on and the development of democratic foundations in the region, potential disputes and conflicts between ASEAN members and non-ASEAN countries (for example, the South China Sea conflict), and the lack of a force strong enough to lead the process.

This implies that, to maintain and consolidate their role in the East Asian development process and to increase their competitiveness, which has been lower than that of China, India, and Japan up to now, ASEAN economies need to achieve a breakthrough in their perception of and steps toward integration. The issue here is no longer the efficiency of ASEAN integration. Instead, it is the existence of ASEAN as a grouping involved in integration with respect to other

partners. Certainly, this is a most critical issue.

## **Late-entry countries and the prospects for East Asian economic integration**

### *ASEAN issues*

ASEAN plays a crucial role in the integration process, as well as in the development process, in East Asia, and it is also attempting to create links with the region's most powerful partners. Without this role, East Asian regionalism would be showing fewer successes. The development of the ASEAN economic integration process is therefore significant for the future of East Asia.

However, our analysis also shows that, first, ASEAN's competitiveness has not been high (McKinsey and Company 2003). It is increasingly difficult for ASEAN to compete with China both in absorbing foreign direct investment and in trading inputs and outputs. The product structure of ASEAN, from developed to developing economies, is generally similar to that of China, but ASEAN does not have the same strong potential of becoming a center for knowledge and of technology development. This suggests that China will surpass ASEAN in competitiveness in the long run. If ASEAN does not aim at becoming a center for the creation and development of knowledge and technologies, it will continue to be left behind.

Second, although the deadline for full implementation of the ASEAN Free Trade Area has matured for some ASEAN members (Indonesia, Malaysia, the Philippines, Singapore, Thailand, and Vietnam) and is approaching for the rest, there is no clear sign of any fundamental institutional reform process or of the establishment of the relevant cooperative and integrative mechanisms in ASEAN. Many serious political and social problems have arisen in ASEAN member countries that cannot be resolved quickly (particularly Indonesia, Myanmar, the Philippines, and Thailand). The governments of these countries have to focus their efforts on dealing with these problems rather than on regional integration and links with other countries. This encourages the centrifugal effect and slows the integration process.

Third, the attitude of Japan and the United States toward ASEAN development and China's strategic response to the region have not been clear. China is set to realize its "going South" strategy. This has also strengthened the centrifugal trend in the region.

At the same time, a strong ASEAN is the best guarantee that ASEAN as a whole and each member country will reap the benefits of cooperating together to compete with the world, but especially with China. In the long term, each ASEAN country will gain the most through cohesion in forming the best division of labor within the region. Besides accelerating the reform process and creating closer bonds, ASEAN should seek to establish a new division of labor in the region based on the principles of the supply chain. Under present conditions, this is the best way to form a movement toward economic integration and improving the competitiveness of ASEAN products internationally and regionally. This will enhance ASEAN's bargaining power relative to partners outside the region and create more consensus within the region.

### *Problems for late-entry countries in East Asia*

Cambodia, Lao PDR, Myanmar, and Vietnam are the four late-entry countries that are ASEAN members. In terms of the prospects for integration in East Asia, this group has two characteristics. First, the relative abilities and level of development of these countries are weak.

Second, these countries are still dismantling internal economic relationships that are backward. It is extremely difficult, even impossible, for these countries to enter the regional system for the division of labor as promising and equal members. Clearly, these economies face obstacles in improving their status by themselves.<sup>6</sup>

These four countries should accelerate their market reforms (especially, Lao PDR and Myanmar) and increase their participation in regional integration. This will require determination in the adoption of strategies and in decisive practical action internally in each country. These countries must also be given strong and steady support and encouragement from outside. All should aim at accelerating market reform and integrating with the regional economy. In East Asia's specific development context, both tasks are important, but cannot be achieved simultaneously. A breakthrough approach is required to position these economies properly for reform and integration. China and Vietnam offer good examples of how to conduct market reforms. The efforts of Cambodia to become a member of the World Trade Organization despite the difficulties show how decisive practical action might be undertaken.

The pressure exerted by the commitment of the late-entry economies to integration will be a powerful motivating force for internal economic reform. Meanwhile, the region's development programs (for example, the implementation of the ASEAN economic corridors) that include the participation of these economies will help create within them the foundations for more rapid growth.

## **Vietnam**

For Vietnam and for several other ASEAN members, a strong ASEAN is extremely important in helping to consolidate the foundations for comprehensive regional integration and integration within the global economy. Vietnam needs to have a specific partnership strategy based on a clear identification of the ideological, economic, political, and social benefits it seeks through ASEAN and elsewhere. Recent progress in improving the country's relationships with the United States and other Western economies needs to be accelerated, because these relationships bring substantial short- and long-term benefits.

Vietnam should assign priority to the process of ASEAN integration. Once strategic partners have been chosen, this process will become a way for Vietnam to increase its international appeal for investment and to enlarge its markets to improve its competitiveness.

Vietnam should take a leading role in supporting and participating in restructuring the ASEAN system for the division of labor according to the supply chain principle.

Finally, Cambodia, Lao PDR, Myanmar, and Vietnam individually and ASEAN as an association of countries should assist in formulating an effective economic development strategy for the whole bloc. The successful implementation of a good strategy will assist ASEAN and Vietnam in achieving a significant breakthrough in institutional reform and product competitiveness.

## **Notes**

<sup>1</sup> The black hole image is used here to describe China's role as a development center with an especially strong input pull. China represents great opportunities, but it may also come to represent a development vacuum for rivals.

<sup>2</sup> This North-South relationship may become more serious if China's growth model changes because of the impact of the appreciation of the yuan.

<sup>3</sup> Hu Angang (2003) divides China into four major regions. These "four worlds in one China" show extreme differences in income and development. The per capita income in the highest-income region is similar to that in high-income countries, while the per capita income in the lowest-income region is between 9 and 12 times less than the corresponding figure in the highest-income region and similar to that in low-income countries.

<sup>4</sup> Except for Asia-Pacific Economic Cooperation, the United States has not been represented within East Asian blocs aiming at economic integration. However, the big role that the United States is playing in the development of East Asia suggests that East Asian economic integration will not be successful if the United States takes no part. The United States is a key player in determining the prospects of the process.

<sup>5</sup> Only Singapore has reached the income standard of a developed country. Although its development level and gross domestic product per capita are rather high, Singapore's strength and size are small according to most parameters. The biggest ASEAN country is Indonesia, with some 230 million people. Its development level is low, and it has a long history of economic, political, and social instability. Neither country has the capability to lead ASEAN integration and development. Malaysia and Thailand have set themselves the goal of becoming developed countries by 2020.

<sup>6</sup> It is interesting to compare the prospects of Cambodia, Lao PDR, Myanmar, and Vietnam with those of the less-developed areas in southwestern China. Even these poorer areas of China are larger and have more people than the four ASEAN members. Moreover, the Chinese government clearly would support the efforts of these areas to establish links with the more well developed areas in eastern China and with other economies. Cambodia, Lao PDR, Myanmar, and Vietnam have not got such advantages.

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