Towards Asian integration

Mari Pangestu and Shiro Armstrong Asia can strengthen the global economy

Dhiraj Nayyar India’s Asian integration strategy

Wendy Dobson and Tom Westland Climbing the value chain ... and more

ASIAN REVIEW – Yu Yongding: The Trump test and the renminbi

Sheila A Smith: The impact of Trump’s America First agenda on Asia
From the Editors’ desk

The Trans-Pacific Partnership (TPP) is dead; the largest free-trade zone in the world, the European Union, has splintered; and the global economy is on the way to notching up a decade of sub-par growth in trade and output following the global financial crisis. Given the backlash in developed polities against globalisation, the economic and political juncture at which Asian countries find themselves may not seem conducive to a push for further integration. But it is imperative that integration proceed. Given slower growth elsewhere, Asia’s place as the dynamic heart of the world economy must be entrenched and reinforced by a regional commitment to lowering barriers to the movement of goods, services, capital and people—and, crucially, by investing in the infrastructure that makes integration and connectivity a practical reality. That is as important now to the global trade regime as it is to the success of the Asian development enterprise.

The form that this integration will take is still open. With the eclipse of the TPP, the Regional Comprehensive Economic Partnership (RCEP) spearheaded by ASEAN looks to be the only game in town for plurilateral trade and investment liberalization. Hopefully RCEP will be seen as a platform for ongoing cooperation rather than merely another addition to the ‘noodle bowl’ of Asian economic agreements. On the infrastructure front, China’s Asian Infrastructure Investment Bank is a welcome initiative, but the sums required to finance the kind of connectivity that Asian economies require are immense, and coordination is more important than ever. China’s ongoing financial liberalisation and outward investment will also put the region’s markets and regulators to the test in managing the risks while supporting the financial integration of the region.

The essays in this issue of EAFQ have been adapted from the forthcoming 38th Pacific Trade and Development Conference volume on Asian integration. It brings together some of the region’s most prominent analysts to take stock of integration efforts to date and to chart a course for Asia’s future. Our regular Asian Review section features essays on what President Donald Trump means for Asia, the US-China economic relationship, and the future of the global monetary system and Chinese investment.

Shiro Armstrong and Tom Westland

Shiro Armstrong and Tom Westland

From the Editors’ desk

The Trans-Pacific Partnership (TPP) is dead; the largest free-trade zone in the world, the European Union, has splintered; and the global economy is on the way to notching up a decade of sub-par growth in trade and output following the global financial crisis. Given the backlash in developed polities against globalisation, the economic and political juncture at which Asian countries find themselves may not seem conducive to a push for further integration. But it is imperative that integration proceed. Given slower growth elsewhere, Asia’s place as the dynamic heart of the world economy must be entrenched and reinforced by a regional commitment to lowering barriers to the movement of goods, services, capital and people—and, crucially, by investing in the infrastructure that makes integration and connectivity a practical reality. That is as important now to the global trade regime as it is to the success of the Asian development enterprise.

The form that this integration will take is still open. With the eclipse of the TPP, the Regional Comprehensive Economic Partnership (RCEP) spearheaded by ASEAN looks to be the only game in town for plurilateral trade and investment liberalization. Hopefully RCEP will be seen as a platform for ongoing cooperation rather than merely another addition to the ‘noodle bowl’ of Asian economic agreements. On the infrastructure front, China’s Asian Infrastructure Investment Bank is a welcome initiative, but the sums required to finance the kind of connectivity that Asian economies require are immense, and coordination is more important than ever. China’s ongoing financial liberalisation and outward investment will also put the region’s markets and regulators to the test in managing the risks while supporting the financial integration of the region.

The essays in this issue of EAFQ have been adapted from the forthcoming 38th Pacific Trade and Development Conference volume on Asian integration. It brings together some of the region’s most prominent analysts to take stock of integration efforts to date and to chart a course for Asia’s future. Our regular Asian Review section features essays on what President Donald Trump means for Asia, the US-China economic relationship, and the future of the global monetary system and Chinese investment.

Shiro Armstrong and Tom Westland

From the Editors’ desk

The Trans-Pacific Partnership (TPP) is dead; the largest free-trade zone in the world, the European Union, has splintered; and the global economy is on the way to notching up a decade of sub-par growth in trade and output following the global financial crisis. Given the backlash in developed polities against globalisation, the economic and political juncture at which Asian countries find themselves may not seem conducive to a push for further integration. But it is imperative that integration proceed. Given slower growth elsewhere, Asia’s place as the dynamic heart of the world economy must be entrenched and reinforced by a regional commitment to lowering barriers to the movement of goods, services, capital and people—and, crucially, by investing in the infrastructure that makes integration and connectivity a practical reality. That is as important now to the global trade regime as it is to the success of the Asian development enterprise.

The form that this integration will take is still open. With the eclipse of the TPP, the Regional Comprehensive Economic Partnership (RCEP) spearheaded by ASEAN looks to be the only game in town for plurilateral trade and investment liberalization. Hopefully RCEP will be seen as a platform for ongoing cooperation rather than merely another addition to the ‘noodle bowl’ of Asian economic agreements. On the infrastructure front, China’s Asian Infrastructure Investment Bank is a welcome initiative, but the sums required to finance the kind of connectivity that Asian economies require are immense, and coordination is more important than ever. China’s ongoing financial liberalisation and outward investment will also put the region’s markets and regulators to the test in managing the risks while supporting the financial integration of the region.

The essays in this issue of EAFQ have been adapted from the forthcoming 38th Pacific Trade and Development Conference volume on Asian integration. It brings together some of the region’s most prominent analysts to take stock of integration efforts to date and to chart a course for Asia’s future. Our regular Asian Review section features essays on what President Donald Trump means for Asia, the US-China economic relationship, and the future of the global monetary system and Chinese investment.

Shiro Armstrong and Tom Westland
Asia best placed to strengthen the global economy

MARI PANGESTU AND SHIRO ARMSTRONG

Japan, China and the rest of East Asia enjoyed rapid development and rising living standards by opening their economies and becoming integral parts of the global trade and economic system. Their openness was underpinned by international commitments, like signing up to the WTO and joining regional agreements that were supported by and reinforced that global system.

Globalisation is now under threat. Expanding global trade outpaced and buoyed a growing global economy in the decades leading up to the global financial crisis in 2007 and 2008. The advanced industrial world, led by the United States and Europe, created and sustained that system until then but the slow recovery in industrial economies since the global financial crisis (GFC) has seen them preoccupied with domestic challenges and showing signs of turning their back on globalisation.

Populist anti-trade and anti-immigration sentiments seem to be capturing the North Atlantic. Brexit was a major turning point for the United Kingdom and Europe. Europe’s internal challenges are unresolved, and the election of Donald Trump has already seen the United States effectively kill the 12-member Trans-Pacific Partnership (TPP) that was signed, sealed and waiting to be delivered.

After bouncing back from a sharp decline during the GFC, world trade grew by less than 3 per cent in 2012 and 2013, compared with the pre-crisis average of 7 per cent. Chinese trade growth has slowed dramatically, from 22.6 per cent a year in the decade since WTO accession in 2001 to less than 6 per cent in 2014. It has since slowed further. Global services trade has held up better than goods trade but for China and the rest of the world, the growth in trade is now slower than growth in GDP. Some slowdown is to
be expected for China as it transitions from an investment and export-led growth model to one focused on services and consumption.

About three-quarters of the structural slowdown in trade is due to the stagnation of global economic growth and low investment. The rest is due to rising protectionism, the maturation of global value chains and China sourcing more intermediate goods domestically. One silver lining is that we may not have a proper understanding of how to measure the impact of the new digital economy and e-commerce, which have been booming.

Even with China's rebalancing towards a slower more sustainable growth model, Asia is still growing at a higher rate than the world on average, and than any other region. There are large, poor and young populations concentrated in India and Indonesia but also elsewhere in Southeast and South Asia, and that means that growth potential will be high for decades to come.

But economic development in a hostile external environment will make a difficult job much harder. A great deal is at stake, given that much of South and Southeast Asia are yet to attain the middle or high incomes of some of their Asian neighbours, and given that there is still much poverty to eradicate. But it is also the more prosperous Asian economies in East Asia that need an open international economy to sustain the march towards higher incomes. Deepening reforms is a much harder task in a global trading system that is in retreat. Asia's major economies face difficult structural reform challenges, including the third arrow of Abenomics in Japan, China's supply-side reforms and India's Make in India initiatives. Having an external environment that facilitates these and other reforms in Asia and globally is helpful to success.

Developing and developed Asia needs a well-functioning and open global economy, and given that Asia is still growing faster than the rest of the world it now has a particular responsibility to protect that global system. Asian economies need to lead the push-back against protectionism and the tendency to look inward, whether they are ready or not.

There are important ways in which Asia can provide leadership. Asia can champion unilateral reforms. The reforms that many countries now need to undertake are the more difficult behind-the-border and institutional reforms, not just reforms that remove border barriers. These are the types of reforms that are only achievable by building domestic coalitions for change instead of forced change through external agreements. International agreements can help reinforce these reforms but they are deeply dependent on winning domestic support. Asian economies can focus on implementing domestic reforms unilaterally or in concert with willing partners in the region— it is in their own interest. A more dynamic and open Asian economy will be a strong fillip to the global economic system.
Many of these reforms can help create a more conducive investment environment. With investment stagnating in advanced economies, but also on the wane more broadly, there is an urgent need to mobilise infrastructure investment to serve development needs in Asia. The Asian Infrastructure Investment Bank, China’s Belt and Road Initiative and Japanese Official Development Assistance should be welcomed but can be extended.

Initiatives in the multilateral arena, such as the implementation of the WTO’s Trade Facilitation Agreement, need support. If the era of major single-undertaking multilateral rounds at the WTO is a thing of the past, then plurilateral agreements (among groups of countries in the WTO) and other initiatives that promote international commerce and support the global system are needed. Asia must be an active and positive force in delivering both.

The East Asian Regional Comprehensive Economic Partnership (RCEP) presently under negotiation provides a platform from which Asia can provide leadership. To do so RCEP needs to be credible and ambitious. Comprised of the ten ASEAN states plus Australia, China, India, Japan, New Zealand and South Korea, RCEP has potential to be a positive force globally. With huge diversity in levels development and systems, RCEP members need to take a different approach from the TPP and have creative and flexible ways to achieve ambitious targets. If those targets are not ambitious enough or if countries don’t bind themselves to meeting them, RCEP will not achieve its goal.

Because of regional diversity, RCEP or any other Asian agreement needs to have regional economic cooperation as its centrepiece. Whether that is building capacity, infrastructure or sharing experience, the cooperation agenda will be central to meeting the major challenges brought by implementing reforms, technological disruption, dealing with distributional issues, the movement of people, tackling new cross-border issues and energy transformation and climate change.

The global economy that acted as a tailwind for Asia in the past has turned to a headwind. Asia’s overriding interest today is to help anchor the global trading system and economy and reverse the headwinds of anti-globalisation.

Mari Pangestu is a former trade minister of Indonesia and currently a visiting fellow at Columbia University.

Shiro Armstrong is Co-director of the Australia–Japan Research Centre at The Australian National University and editor of East Asia Forum.

REGIONAL ARCHITECTURE

The institutions behind East Asia’s transformation

PONCIANO INTAL JR

NE remarkable development in East Asia over the past three decades is the emergence of a regional architecture—a coherent network of institutions that work together for prosperity and stability—that has revolved around small and middleweight countries with support from the Pacific’s big powers. What is equally important is that this regional architecture has been characterised by open regionalism—the removal of trade barriers within the region without discriminating against outsiders—and a cooperative multilateral perspective on security.

Region-building is a dynamic process, and the development of East Asia’s economic and security architecture has been shaped by a network of institutions in the region. Asia Pacific Economic Cooperation (APEC), ASEAN and its related arrangements like the ASEAN Regional Forum (ARF) have been among the most prominent. Non-official or semi-official institutions like the Pacific Economic Cooperation Council and Pacific Trade and Development (PAFTAD) have also been central to framing regionalism in the Asia Pacific.

The 1990s and 2000s saw ASEAN became the centre of East Asia’s regional architecture. The major benefit of ASEAN for the region during its first two decades of
existence was not economic but rather the engendering of peace, neighbourliness and cooperation among the founding countries. In a region once disparaged as the ‘Balkans of the East’, ASEAN built confidence and dispelled mutual suspicion between member states through frequent meetings and cooperative activities.

ASEAN’s success in the ending of the Cambodian conflict through the 1991 Paris Peace Agreement attracted diplomatic kudos, providing a foundation for the 1994 establishment of the ARF. This reflected ASEAN’s role as the primary interlocutor to the major regional powers, China, Japan and the United States.

The ARF was the first official-level security dialogue involving regular multilateral discussion on regional security and cooperation in the Asia Pacific after the Cold War. Most importantly, it employs a cooperative security approach to security, which is in sharp contrast to the then-prevailing realist ‘balance of power’ perspective. ARF reflects the view that, in the words of regional politics expert Alice Ba, ‘security is best gained not by working against others, but rather by working with them’.

The cooperative security approach is an institutional innovation to regional security architecture that is influenced by ASEAN’s emphasis on dialogue, diplomacy and consensus. The approach is workable because it represents a realistic means by which the small and middleweight powers can assume diplomatic centrality in security arrangements involving all major regional powers.

The years 2015–17 have been shaping up almost as a watershed period for the region. East Asian countries furthered their commitment to regional economic integration and connectivity, while at the same time, issues in the South and East China Seas markedly raised regional security uncertainty.

More recently, the ascendency of a more nationalist, less open ‘America First’ administration in the United States has drastically increased uncertainty in the Pacific economic and trade environment. This poses major challenges to future region-building in East Asia and puts tremendous pressures on the efficacy and credibility of current institutions in the region.

The emerging, more contentious relationship between the United States and China arguably makes East Asia’s regional economic and security architecture, relying on small and medium-sized countries espousing open regionalism, ever more relevant and important for the region.

The remarkable opportunities offered by a robustly growing East Asia to the region and the world demand the strengthening of both the current regional economic and security architecture in East Asia. As China transitions towards becoming a high-income country, many more Chinese households are entering the country’s already huge consumer market. The potential for expanded trade within the region as a result is tremendous. McKinsey projects that India’s middle class will increase from 50 million people in 2005 to 583 million people by 2025. The sheer magnitude of projected middle classes in India, China and ASEAN makes developing East Asia the world’s largest source of potential market growth.

The remarkable opportunities offered by a robustly growing East Asia to the region and the world demand the strengthening of both the current regional economic and security architecture in East Asia. As China transitions towards becoming a high-income country, many more Chinese households are entering the country’s already huge consumer market. The potential for expanded trade within the region as a result is tremendous. McKinsey projects that India’s middle class will increase from 50 million people in 2005 to 583 million people by 2025. The sheer magnitude of projected middle classes in India, China and ASEAN makes developing East Asia the world’s largest source of potential market growth.

The AsEAn-led Regional Comprehensive Economic Partnership (RCEP) currently under negotiation presents huge possibilities for liberalising regional trade and investment. For East Asia as a whole, successful RCEP negotiations could facilitate the ‘historic opportunity’, as economist Peter Drysdale puts it, ‘to secure its future as the dynamic centre of higher than average global growth’.

Despite large gaps among negotiating countries on a number of areas, including services, there appears growing resolve among RCEP members to finish the negotiations in 2017.

Contest over regional leadership between China, Japan and the United States means that the existing architecture, coupled with the ‘ASEAN way’... remains the most robust regional means of managing East Asia’s changing security landscape.
FINANCIAL DEVELOPMENT

Climbing the value chain

WENDY DOBSON AND TOM WESTLAND

Domestic financial liberalisation and market opening have progressed at different speeds in Asian economies over the past four decades. In the wake of financial crises, more attention has been paid to sequencing domestic reforms to financial markets with reforms to deepen integration through trade and investment.

In two major Asian economies—China and India—more financial liberalisation and market opening lie ahead. The Chinese financial system is largely state-controlled. Government policy and administrative guidance are extensive. Directed lending was heavily used in the depths of the global financial crisis (GFC) to offset the impact of external volatility and uncertainty. Bad loans have since been piling up on banks’ books. There are many possible scenarios for Chinese finance, ranging from bank failures to a Japanese-style malaise. These concerns are offset somewhat by arguments that the debt build-up is mostly held within China, where the savings rate is very high. Even so, loans to state-owned enterprises (SOEs) are numerous, and often to chronically unprofitable ‘zombie companies’.

What is not at issue are the potential impacts on China’s international trade and investment footprint. The slowing economy has been associated with a surge of deals by corporate China, both mergers and acquisitions, and greenfield investments.

This surge in outward investment has signalled some of the problems and risks associated with deeper Chinese financial integration. Since 2012, reported Chinese merger and acquisition activity in the United States and Europe has risen at very rapid rates. Some of these transactions are initiated by large, indebted enterprises, such as the highly leveraged SOE ChemChina’s bid for Swiss-owned Syngenta.

Domestic financial market development is a work in progress. Market forces determine interest and, to an extent, exchange rates. But as yet, there are few signs that the state will reduce its ownership—and with it, directed lending and moral hazard—of the five big banks.

Indian financial liberalisation is moving at a slower pace. One reason is that India passed through the GFC relatively unscathed due to capital controls and the small sizes of external linkages, which slowed the impetus for reform and opening. Although they have been eased in some areas, foreign-investing firms continue to face restrictions in many traditional industries.

Domestic financial development in India lags. The country’s financial system remains a hybrid, allowing market forces to operate but retaining high levels of government intervention and state ownership. The corporate

Towards the centre, especially in view of China’s rise.

Still, maintaining peace, stability and prosperity in East Asia calls for current and future big powers in East Asia and the Pacific—China, India, Japan and the United States—to remain wedded to a coordinated network centred around the region’s small and middleweight countries. Most importantly, the big powers must support ASEAN and ASEAN-related institutions and agreements, as well as APEC, which are imbued with the principles of open and cooperative regionalism and security multilateralism.

The remarkable economic transformation of East Asia has been underpinned by a relatively stable regional security environment. Contest over regional leadership between China, Japan and the United States means that the existing architecture, coupled with the ‘ASEAN way’ of dialogue, consultations, consensus and non-interference, remains the most robust regional means of managing East Asia’s changing security landscape.

In coming years East Asia will be the locus of opportunity, and to some extent uncertainty, for the region and the world. But is the current regional architecture up to the task?

Addressing the challenges and opportunities in East Asia would call for investing more in making the existing regional architecture more responsive to meeting the challenges ahead. East Asia’s regional economic architecture will need to work to better manage the challenges of a more integrated, open and fast-changing East Asia.

Ponciano Intal Jr is a Senior Economist at the Economic Research Institute for ASEAN and East Asia.
The bond market is heavily regulated and tiny in size. Equity markets are open and well-regulated, but capital controls still govern the flow of foreign funds into the debt market.

Many key supply-side restrictions remain to be tackled in most states, including land acquisition laws and the successful introduction of a national goods and services tax. Restrictive labour laws have limited firm size and formal sector employment.

As the Chinese and Indian cases make clear, maintaining the momentum of economic reform in developing countries requires movement on several fronts—financial sector reforms cannot be pursued in isolation from those in the real sector. It is important to understand the connections between policy strategies, hence the analysis of the relationship between financial reform and export sophistication.

Deeper understanding of this relationship is timely in view of concerns about slowing global growth: Asian growth can contribute to global growth by encouraging innovation and productivity growth. Many countries in the region are focusing their growth strategies on climbing regional value chains by bringing about structural changes in their economies. Does financial liberalisation help or hinder this goal?

There are several ways in which under-developed financial markets might impede efforts to increase export sophistication. Exporting products requires firms to pay large fixed costs of market exploration and development. It is reasonable to expect that only very profitable firms, or firms with secure access to financial markets, would be likely to enter sophisticated export markets.

Developed financial markets, in that sense, can be considered as somewhat analogous to factor endowments in trade. Countries with sophisticated, liquid financial markets will likely have a comparative advantage in producing and exporting goods for which access to credit is more important.

What about the sequence of financial reform? It is generally accepted that for reasons of macroeconomic stability, it is preferable to open the capital account only as the domestic financial system is strengthened and modernised. Sequencing of regulatory reforms governing domestic and international financial flows may be important for export sophistication—such sequencing could affect the ability of financial institutions to allocate credit to high-productivity firms.

These results are consistent with the following message for policymakers: developing the capacity and sophistication of domestic financial markets can yield positive results for upgrading export baskets to more sophisticated, higher value-added product lines.

Correctly sequencing future reform could be of help to China and India as they seek to move into markets with higher value-added products, hence climbing regional value chains and maximising the real economy gains from reforms.

Wendy Dobson is Professor and co-director at the Rotman Institute of International Business, University of Toronto.

Tom Westland is a graduate student at the Institut de hautes études internationales et du développement, Geneva, and at Bogazici Universitesi, Istanbul.
EAST ASIA FORUM QUARTERLY 
JANUARY — MARCH 2017

ECONOMICS MEETS POLITICS

Assessing the ASEAN Economic Community

SOMKIAT TANGKITVANICH AND SAOWARUJ RATTANAKHAMFU

AST Asia continues to sustain a high level of economic integration, yet a significant proportion of intraregional trade is still uncovered by agreements to guard against current and possible future protectionism. Without multilateral movement under the WTO, further regional integration can proceed only through agreements that reduce trade barriers within the region.

ASEAN appears to be leading the Asia Pacific in FTA formation. The ASEAN Free Trade Area was implemented in 1993 and the ASEAN Economic Community (AEC) was officially launched in late 2015. The AEC aspires to go beyond typical trade agreements, aiming to create a single market and production base with equitable development across its 10 member countries.

ASEAN will celebrate its 50th anniversary in 2017. While ASEAN has made some significant political achievements during the past five decades, its economic integration project is still very much a work in progress, and could remain so for many years or even decades to come.

The ASEAN Secretariat claims that the implementation of the AEC Blueprint 2015—the community’s formal agenda—has been substantively achieved in many areas. In reality, the levels of integration vary greatly by sector. The only clear success ASEAN can claim is the reduction of tariffs among member countries. Since the implementation of the Common Effective Preferential Tariff agreement in the 1990s, about 99 per cent of tariff lines between member countries have been reduced to zero.

Still, the free flow of goods among ASEAN member countries continues to be hindered by the use of non-tariff measures (NTMs). These may have adverse consequences on the sourcing decisions of firms and the structure of trade and related industries.

Countries such as Indonesia or Malaysia that employ active ‘industrial policy’ apply more NTMs. Car assemblers in Thailand, for example, have long complained about Malaysia’s restriction of the number of cars imported into Malaysia.

While minimising non-tariff barriers is an action target in the AEC Blueprint, ASEAN has relied on a voluntary approach to reduce them—with very limited success. Under the voluntary approach, member countries can have an adverse incentive to under-report the barriers they are using. What’s more, there is no effective monitoring system to keep track of the changes of NTMs among member countries.

ASEAN has been negotiating services liberalisation since the creation of the ASEAN Framework Agreement on Services in 1996. The AEC Blueprint has established clear

A Vietnamese technician sorts through phone lines in central Ho Chi Minh City. Behind-the-border issues like telecommunications interconnection are largely overlooked in ASEAN service liberalisation commitments.

PICTURE: DARREN WHITESIDE / REUTERS
targets to remove all restrictions on trade in services by 2015. But some ASEAN countries, including Thailand, the Philippines and Indonesia, could not meet their targets by the deadline.

Critically, service liberalisation under ASEAN contains no commitment to address behind-the-border issues, such as interconnection for telecom services or access to ATMs for banking, which are crucial to the creation of competitive markets. The difference in laws and regulations among member countries is also problematic.

Service liberalisation under ASEAN in its current form would fail to create a single service market. Thailand, the Philippines and Indonesia, still could not meet the targets by the 2015 deadline. Indonesia and Thailand’s specific commitments under the latest offer contain many services that are inconsequential or even useless.

In terms of promoting cross-border movement of labour, ASEAN has achieved very little. From an economic development perspective, the opening up of unskilled labour markets through FTAs would be a useful policy option, given the relative abundance of unskilled labour in many ASEAN countries, but the AEC Blueprint attempts to facilitate only the mobility of skilled professionals, currently comprising just eight professions. The arrangement to facilitate the movement of these professionals is also problematic. In the case of Thailand, for example, the requirements imposed on ASEAN professionals are the same as those of the non-ASEAN countries.

To critical observers, ASEAN integration has so far produced very few tangible results. The Asia Trade Centre’s Deborah Elms concludes that ‘ASEAN officials shifted the rhetoric as the deadline loomed to argue instead that the AEC itself should be viewed as process and not a destination’. In September 2016, The Economist mockingly wrote that ‘[w]hen it comes to elevating form over substance, and confusing a proliferation of meetings and acronyms for a deepening of ties, ASEAN is the Zen master’.

The lack of momentum to deepen regional integration in ASEAN is largely a consequence of most member countries’ protectionist stances, perhaps with the sole exception of Singapore. Many ASEAN countries view one another as rivals in their pursuit of exporting to the global market or attracting foreign direct investment.

DOMESTIC political conflicts, along with a lack of strong and stable government, have led political leaders in many ASEAN countries to look inward and lose their appetite for regional integration. Without confronting the core problems of its integration project squarely and urgently, ASEAN will not realise the AEC Blueprint vision of a single market and single production base.

ASEAN prides itself on being the ‘hub’ of bilateral FTAs in East Asia. The concept of ‘ASEAN centrality’ espoused in the group’s initiatives emphasises its role in facilitating economic integration in the region. But the economic integration among ASEAN countries has so far focused on creating a more attractive package for multinationals looking to operate in the region, rather than on creating stronger bonds between member economies.

When it comes to economic integration, ASEAN has to aim at achieving critical targets while ignoring trivial ones. In other words, ASEAN needs to be much more focused than it is now. Its current agenda is overly ambitious considering its limited resources. The AEC Blueprint has established 17 core elements and set 176 priority actions, covering the free flow of goods and capital, movement of skilled labour, equitable development and protection of intellectual property rights, to name just a few.

A sharper focus would help ASEAN to deliver meaningful and tangible results without depriving member countries, especially less developed ones, of their limited resources. This requires ASEAN to return to the core missions of an FTA: reducing barriers to trade and facilitating cross-border trade in goods, services and the movement of labour and inputs to production.

Yet the real challenge for ASEAN is not economic but political. Full national sovereignty and economic integration are incompatible. The success of the EU’s trade integration, for example, is based on pooled sovereignty.

The idea of ‘pooled sovereignty’ is not all-or-nothing in nature. When started, the EU was a comparatively modest project. It had few members and only one policy area for pooling sovereignty: a common market for coal and steel. Only gradually did it expand its membership and its mission.

Unless ASEAN countries are willing to increasingly pool their sovereignty and meet political challenges head on, the AEC project will go nowhere and ASEAN will be little more than a talking shop.

Somkiat Tangkitvanich is President of the Thailand Development Research Institute (TDRI).

Saowaruj Rattanakhamfu is a Senior Research Fellow at TDRI.
The new US Secretary of State, Rex Tillerson, with US President Donald Trump after he was sworn in at the Oval Office in the White House on 1 February 2017. Tillerson’s ‘tough talk’ during his confirmation hearing signals a ‘more hawkish and unprofessional approach’ to disputes in the South China Sea.

The Trump test and the renminbi

YU YONGDING

DONALD Trump’s rhetoric during his campaign shows that he is seeking to turn back on established US policy towards China. Tough talk by his secretary of state nominee, Rex Tillerson, and White House spokesman Sean Spicer signals a more hawkish and unprofessional approach to the territorial disputes in the South China Sea. If the new administration carries through with its threats and pushes China into a corner, the consequences are unforeseeable and potentially disastrous.

China won’t bow to the Trump administration’s bullying. But it doesn’t want a US–China military clash. Mitigating the danger of a confrontation while protecting its fundamental interests is a daunting challenge indeed for the Chinese government.

A ‘trade war’ between China and the United States is a more real and imminent threat than military confrontation. While no one knows if Trump himself truly wishes to provoke a military clash in the South China Sea, it is certain that to fulfil his campaign promises, Trump will have to implement a range of protectionist measures. To impose a 45 per cent import tax on Chinese products, as Trump has suggested, implies that many US imports will become 45 per cent more expensive for American buyers. Certainly, China’s exports will
The renminbi should not be a weak currency due to its large current account surplus, but current devaluation pressure on the currency will not disappear quickly.

propping up the renminbi—an amount larger than the total resources of the IMF and all the money spent during the Asian financial crisis of 1997–98.

Trump vowed to instruct the Secretary of the Treasury to label China a currency manipulator on his first day in office. This promise was not honoured. But if Trump does decide to follow through, the People’s Bank of China (PBoC) can respond immediately by leaving the foreign exchange market entirely, and let the market decide where the renminbi should sit. Why should China continue to promote US competitiveness at its own expense without getting anything in return?

The US Federal Reserve’s exit from quantitative easing will lead to a stronger dollar, while Trump will probably be hoping for a weaker dollar to bolster US exports. From the US point of view, the only way to weaken the dollar while interest rates in the United States are rising is to force other countries to appreciate their currencies.

China has no intention of devaluing the renminbi for trade purposes. It has no intention of bowing to US pressure to appreciate the renminbi artificially either. The only solution lies in concerted action in the foreign exchange market by major trading nations. A new Plaza Accord—the 1985 agreement to devalue the US dollar against the yen and Deutsche mark—may be necessary.

For China, the true problem is that the PBoC is striving to achieve several conflicting goals: stabilising the exchange rate, preserving foreign reserves, maintaining an independent monetary policy and honouring its international commitments to free flows of funds on current and capital accounts. But it is impossible to achieve these four goals at the same time. Something has to be given up.

Initially, the PBoC did not hesitate to use foreign exchange reserves to prop up the renminbi exchange rate. Chinese economists supplied two less-than-consistent arguments to support this policy. First, they argued that the very purpose of holding foreign exchange reserves is to use them to maintain the stability of exchange rate—there should be no concern about the loss of foreign exchange reserves in defending the renminbi. Second, they put forward that Chinese people should be happy about the depletion of foreign exchange reserves, because the depletion means that wealth is being transferred from the PBoC to the private sector. The advocates of this view coined the process as ‘storing the foreign exchanges in the people’.

However, alarmed by the astonishing speed of foreign exchange reserve depletion, the PBoC turned resolutely to capital controls in the second half of 2016. ‘We are all supporters of capital control now’ summed it up, although until recently, the opposite was true.

China is bound to face more
challenges in 2017. If China wishes to achieve exchange rate stability and contain the losses in foreign exchange reserves at the same time, unless something happens that leads to a sudden disappearance of the devaluation pressure, it has to tighten capital controls even further. At the moment, China’s capital controls have already been very tight. Any further tightening may mean backtracking on many of its commitments to residents and non-residents on cross-border capital flows. This will substantially damage its international credibility.

Fundamentally, the renminbi should not be a weak currency due to its large current account surplus, but current devaluation pressure on the currency will not disappear quickly. Even with the world’s largest foreign exchange reserves, China cannot afford to continue to conduct one-way intervention in the foreign exchange market. This persistent one-way intervention is a huge waste. In my view, the least important goal of the four is stabilising the renminbi exchange rate.

Many in China are worried that if the PBoC relinquishes control of the renminbi exchange rate, a vicious cycle of devaluation could spin out of control. This is highly unlikely. Is there any precedent in global economic history of a currency falling excessively and persistently in a country with the largest trade surplus and fastest growth rate in the world? China still has the world’s largest foreign exchange reserves and a strong ability to implement capital controls.

If the PBoC stops intervention, the renminbi will fall. But due to its strong fundamentals, the fall will be limited and after a relatively short period of time it will rebound in line with its fundamentals. If the PBoC fears that a further depreciation could lead to a financial crisis, it could set a secret ‘bottom line’. If the PBoC feels that the devaluation has fallen below the bottom line, it can step in and easily stop a further devaluation.

In short, 2017 will be a year of uncertainty and full of challenges. Among them two stand out: Trump and the renminbi. But China should be able to face these challenges full of confidence.

Yu Yongding is a Senior Fellow at the Chinese Academy of Social Sciences and former member of the monetary policy committee of the People’s Bank of China.
In his first weeks in office, President Trump has moved quickly to implement his America First agenda through a slew of executive orders. Trade and immigration are his foreign policy focal points.

These first steps have prompted protest within the United States and abroad. The consequences of globalisation, it seems, have become intolerable to many in the United States. But Trump’s solution to close borders has drawn passionate criticism. Even former president Barack Obama weighed in as thousands of Americans protested at airports against the sudden detention of immigrants on suspicion of terrorist intent.

With his cabinet still being confirmed, and with reports of contention within the White House, President Trump’s administration is off to a rocky start.

Without a doubt, the 2016 election revealed deep fissures in how the US public perceives its economic future as well as frustration over the ideas that have largely supported embracing the effects of globalisation. Trump took aim at the corporate and governing elite that espoused—and benefited from—a rapidly globalising world, and invited and encouraged an electoral backlash against politicians in both political parties.

This has several implications for the Trump administration’s foreign policymaking. First, the ideas that motivate foreign policy will now need to meet the criteria of providing concrete benefits to the United States. The metric so far seems to be the creation of American jobs, and Trump’s outing of companies rumoured to be moving jobs offshore...
FOREIGN policy has traditionally been seen as the prerogative of the executive branch of government, but already it seems that Congress and the judiciary will claim authority in shaping the president’s choices if he runs up against existing treaties or laws. Senators John McCain and Lindsey Graham, for example, have initiated hearings on Russian hacking. Along with Senate Foreign Relations Committee Chair Bob Corker, McCain and Graham also weighed in on the 27 January executive order, opposing the idea of a ‘Muslim ban’.

Two aspects of the America First platform have particular impact in Asia. The first was Trump’s ambition to remove the United States from the Trans-Pacific Partnership (TPP). This now has been done. On 23 January, just three days after his inauguration, President Trump ordered the United States Trade Representative to initiate withdrawal from the 12-nation trade pact negotiated during the Obama presidency.

The US shift on trade does not end with its withdrawal from the TPP. Amplifying the Trump administration’s retreat from free trade agreements is a host of other policies that will have considerable impact on relations with Asia.

Renegotiating the North American Free Trade Agreement will affect all Asian companies in the United States, Canada and Mexico. It is likely that a Trump tax reform package would include an import tax. The infrastructure for punishing trade policy offenders will be bolstered by a White House National Trade Council led by economist Peter Navarro, a policy voice critical of Asia in Trump’s campaign for president.

The second aspect of the Trump administration’s America First platform is the closing of the US border to immigrants. On the surface, this may seem to have little import for Asia, but it has stirred memories of past laws that barred Chinese immigrants, as well as the unlawful detention of Japanese-Americans during World War II on the grounds that they were helping the enemy.

The 27 January executive order prevented individuals from Yemen, Iraq, Iran, Sudan, Somalia, Libya and Syria from entering the United States for 120 days as the Trump administration reviewed counter-terrorism vetting procedures. Interpreted as Trump’s promised ‘Muslim ban,’ protests across the country erupted at airports as reports of detentions grew. Prominent Japanese-Americans spoke out, reminding the country of their internment and of the promise Congress made to never allow this to happen again.

The new president has already demonstrated preferences for how he would like to pursue diplomacy in Asia. First, he has made it clear that the United States will step back from multilateralism. The rejection of the TPP is one obvious example. Trade policy seems destined for bilateralisation and this could put US allies in a difficult spot. With the norms and rules of the TPP now abandoned, these bilateral negotiations would likely focus on difficult market access issues—many of which had already been tackled during the TPP negotiations.

The metric of producing American jobs suggests greater scrutiny of Asian companies doing business in the United States. Already two Japanese companies have been in the spotlight. Masayoshi Son, the CEO of Softbank, jumped in early to meet with the president-elect, laying out his plans for US$50 billion in investments. Toyota also drew the president-elect’s attention for its plans to build a new plant in Mexico. In fact Toyota was not shifting jobs from the United States to Mexico, as Trump claimed, but rather planning itself a 10 billion-dollar investment strategy over the next five years.

Japanese direct investment in the United States has long been welcomed, especially in manufacturing, but the political climate now has overtones of risk. President Trump singled out China and Japan as currency manipulators, suggesting the Trump administration might insist on the inclusion of currency in any future trade talks. Prime Minister Shinzo Abe will undoubtedly feel this new pressure. When questioned in the Diet, Abe bluntly stated that such criticism ‘misses the mark’.

In the security realm too this penchant for bilateralism could also affect the Asia Pacific. At the very least, it suggests a diminished US role in the East Asia Summit or any of the other ASEAN-centred efforts to discuss regional security.

Perhaps the United States will think twice about recent initiatives with allies and partners to strengthen maritime security. Instead of an
appeal to norms and the rule of law, narrow US interests may rule the day. At worst, this type of approach hints at a return to overt and perhaps unrestrained military competition between the major powers and beggar-thy-neighbour trade politics.

US Asia policy could very quickly become politicised and its alliances subjected to greater popular scrutiny, with little or no strategic assessment of their value to the region. Reports of a confrontational phone call between Trump and Australian Prime Minister Malcolm Turnbull have aggravated concerns about the new administration’s treatment of major regional alliances. Republicans and Democrats have differed on how to solve a range of foreign policy issues, but not on the benefits to the United States of its leadership in Asia.

Today the Republican Party has far more dissonance within its ranks on trade. Bipartisanship has diminished considerably in Congress as the Tea Party movement has challenged the traditional internationalists who led in the House and the Senate. As foreign policy expert Walter Russell Mead argued, today’s Republican Party—led by Trump—is now the vehicle for a Jacksonian populist revolt, a far cry from the Reagan and the two Bush administrations that saw America’s global leadership as directly benefitting the American people.

Democrats too are in disarray after Hillary Clinton’s electoral defeat, and are in the minority in both the House and the Senate. For the next two years, until the midterm elections bring opportunity to increase their numbers, the Democrats will have little influence over the Trump administration’s policies.

Asia policy has always reflected a tug and pull between the White House and Congress. Trump’s White House will be no different. One relationship is of particular interest to US legislators—the US relationship with the People's Republic of China.

Since the Nixon administration pursued normalisation of relations in the 1970s, US China policy has been contentious on Capitol Hill. Many argued for the US relationship with Taiwan even as the Nixon administration recognised the Chinese Communist Party leadership in Beijing as representing ‘one China.’

The Taiwan Relations Act was imbued with the promise of US military assistance as a result of an uneasy compromise between the executive and legislative branches of government. President Trump’s decision to accept a congratulatory call from Taiwanese President Tsai Ing-wen suggests the potential for this debate to reignite.

Similarly, in the 1980s, Congress took a much harsher stance vis-à-vis Japan and its trade surplus with the United States, leading to a shift in legislation that favoured the Omnibus Foreign Trade and Competitiveness Act. That act gave the executive branch better instruments for monitoring and punishing unfair trade practices.

In contrast to the Obama administration’s ‘rebalance’ to Asia, it may be that no discernible Asia policy will emerge from this administration.

Many of Trump’s Republican colleagues on the hill supported the TPP and continue to advocate deeper US integration with Asian economies. Far more Americans today reap direct benefits from Asian investment in the United States.

Finally, US legislators have historically limited diplomacy with those it sees in violation of human rights. To date, China, Myanmar and North Korea have been sanctioned as a result of congressional activism. The America First agenda reflects little interest in human rights or promoting democracy abroad and thus leaves open the question of whether Congress might step in to assert its interests when necessary.

Will China policy replace Asia policy? As the US election drew to a close, it was difficult to find a Trump Asia policy in the making. Now there are a few more signposts indicating how the new president and his team will organise a strategy for Asia, though the contours of that approach have yet to be defined.

Already there are signs that the United States will organise its approach to Asia around its antagonism towards China. As president-elect, Trump tweeted several times about being willing to rethink the ‘one China’ policy in the wake of his phone call with President Tsai. Some of those associated with the campaign have also written about the need for a harder line towards Beijing, both in advocating a different approach to reducing the trade deficit as well as upping US naval power in the region to contend with China’s maritime expansion.

In his confirmation hearing, Secretary of State Rex Tillerson made it very clear that the United States would challenge Chinese behaviour in the South China Sea. Tillerson said:
We're going to have to send China a clear signal that, first, the island-building stops and, second, your access to those islands also is not going to be allowed.

This drew a quick reaction from China. Ministry of Foreign Affairs spokesperson Lu Kang quietly discouraged the United States from getting involved in the dispute, stating, ‘The situation in the South China Sea has cooled down as countries in the region have come around to the agreement. We hope that countries outside the region will respect such an agreement that serves the common interests of the region and beyond.’

The more pugilistic writers at Chinese newspaper Global Times went further. ‘Unless Washington plans to wage a large-scale war in the South China Sea, any other approaches to prevent Chinese access to the islands will be foolish.’

Secretary of Defense James Mattis’ visits to Seoul and Tokyo in early February demonstrated that US allies in Asia are a high priority. North Korea’s threats of launching an intercontinental ballistic missile (ICBM) capable of reaching the United States demand close cooperation with South Korea and Japan.

South Korea’s decision to introduce Terminal High Altitude Area Defence (THAAD) this year will be welcomed, but so too will Japan’s ballistic missile defences. Tokyo is concerned about the new US administration’s commitment to grey zone contingencies, a priority in the alliance after the Chinese deployment of coast guard vessels around the Senkaku/Diaoyu Islands.

For some of Trump’s advisors, Ronald Reagan’s call for ‘peace through strength’ still resonates. This approach is largely welcomed by Washington’s Asian allies who rely on US military might for deterrence. But an escalation in tensions with China, especially over the sensitive issue of Taiwan, could make the already difficult military relations between Beijing and Tokyo far more unpredictable.

Equally difficult would be a US trade war with China. It may be too early to determine what tools the Trump administration will bring to bear on reducing the trade deficit. Overt protectionism, including taxes on imports, will affect more than China. The broader ambition of bringing manufacturing back to the United States will disrupt global supply chains, again affecting the complex array of ties with China for many Asian economies.

In contrast to the Obama administration’s ‘rebalance’ to Asia, it may be that no discernible Asia policy will emerge from this administration. Rather, the America First agenda will take one relationship at a time and define it in terms of President Trump’s priorities.

The political resistance this could provoke may engender another wave of anti-American sentiment in Asia. Alternatively, governments in the region, along with interests within the United States, may find common cause in persuading the new president of the costs of abandoning the regional order that Washington and its allies worked so hard to build. In either scenario, China will loom large—either as a spoiler or as a partner in regional cooperation.

Over the longer term, the question will be how Asia responds to the Trump administration. Will the countries that signed on to the TPP, for example, continue on without the United States? Will they urge the new US administration to return to the deal? Or will they succumb to the allure of bilateral deals that ensure market access?

US allies in Asia will want to make sure that the new administration understands their contributions to regional stability, as well as their
The global monetary system from sterling to the renminbi

PAOLA SUBACCHI

At times of big turmoil, currencies take the hit, but economic transformation can also create currency winners. Nowhere is this more apparent than when we compare the prospects of British sterling and China’s renminbi.

The difficult relationship between Britain and the EU that last year escalated and resulted in the UK’s decision to go solo has taken a toll on the pound sterling. Between February 2016, when the referendum on the UK’s membership of the EU was announced, and the end of January 2017 sterling fell by 14 per cent against the US dollar. In the aftermath of the Brexit vote, the value of sterling dropped by 9 per cent. Then, at the beginning of October, when the UK government appeared to signal a preference for a clear break with the EU—a ‘hard Brexit’—sterling dropped again by 6 per cent. After some recovery in the last weeks of 2016, at the beginning of January 2017, when details of the speech that UK Prime Minister Theresa May delivered in London on 17 January were leaked in advance, the pound went down by more than 3 per cent against the US dollar.

As the British government is preparing to serve notice on the membership of the EU, it is not yet clear what the future relationship will look like. Will Britain remain a member of Europe’s single market—an option that has been labelled a ‘soft Brexit’? Will it step out of the single market but remain a member of the customs union? Or will it embrace a totally independent trade policy in order to maintain control at its borders—given that the free movement of individuals is one of the pillars of the EU?

The uncertainty that is surrounding the political debate and the fundamental lack of clarity on the way forward is what is keeping the value of the pound down.

Currencies not only reflect geopolitical dynamics, but also patterns of trade and debt, so there is more to this story than just short-term exchange rate movements. A weak currency is not much help for an economy that imports more than it exports. The UK has a significant deficit in its current account—roughly, it consumes more than it produces—at almost 6 per cent of GDP. Of course, a weak currency would lower the prices of exports, but only if these goods are produced with limited inputs from imports.

In a world of global supply chains this is questionable. Even assuming that weak sterling would help shift the perspectives on the sources of instability in Asia. But if US tensions with China increase, will Asian states join the Washington bandwagon against Beijing? Or will America’s allies and friends attempt to distance themselves from Washington?

For now, as the new administration assembles, tempering some of the more worrisome impulses of President Trump seems to be the most comfortable strategy for US allies. But public opinion in many countries is highly sensitive to the way the new US president behaves.

Early interactions with Mexican President Enrique Peña Nieto and British Prime Minister Theresa May offer cautionary tales. Forced into a corner on the question of who will pay for the proposed wall along the Mexican border, Peña Nieto cancelled his trip. May artfully used the prospect of a US–UK trade deal to help leverage her difficult Brexit negotiations. Both, however, face intense domestic criticism at home for their responses to Trump.

Many in Asia still seek close economic and strategic cooperation with the United States. Yet Asian leaders may find their publics less inclined to compromise with Washington if the Trump administration hews too closely to an America First agenda. US power cannot be ignored, of course, but the status of the United States in Asia derives not only from its brute strength but also from its commitment to the ideals of democratic practice. Without popular support, the United States will find that governments in Asia will be far less ready partners in regional cooperation.

Sheila A Smith is Senior Fellow for Japan Studies at the Council on Foreign Relations.
UK model of growth from domestic demand to exports, this adjustment will take time and is unlikely to cushion the adverse impact of Brexit on real GDP growth in the next few years.

And a weak currency is problematic for an economy with a high level of debt, both in the private and public sectors. In the UK the household debt ratio is approximately 87 per cent of GDP and the government debt ratio is 108 per cent. Attracting and absorbing high levels of foreign capital—and foreign labour—are critical to maintain financial stability and to support the UK’s consumption-led model of growth—surely until a new model is in place.

The UK model of growth needs to be assessed against all the possible options that the government is considering for its new relationship with the European Union. The ‘hard Brexit’ option, by reducing market openness, will affect investors’ confidence, have an adverse impact on capital inflows and undermine growth.

If the UK becomes less attractive as an investment destination, and stricter immigration policies cause the labour force to shrink, then Britain may find it difficult to attract the quantity of foreign capital and labour necessary to sustain a domestic demand-driven economy. Sterling will continue to suffer as a result.

Sterling has been on a downward trend over the past 80 years, beginning in 1931 when Britain left the gold standard. Yet a lack of alternative assets and the importance of London’s capital market have maintained sterling in the group of the key reserve currencies—the IMF’s Special Drawing Rights (SDR) basket of international reserve currencies. To some extent sterling has been a proxy of British global influence: on the way down, but still ‘punching above its weight’. But sterling’s protracted weakness coupled with the inclusion of the Chinese renminbi in the SDR basket—in effect from the beginning of October 2017—may result in downgrading the pound when the composition of the basket is reassessed in 2020.

For Britain this will be the last step in a long process of diminishing economic dominance, while Brexit represents the abdication of the active role in international economic policy coordination that Britain has played since the establishment of the Bretton Woods system in 1944.

If currencies are an expression of national sovereignty, they also epitomise the limits of such sovereignty in an open economy. Exchange rate dynamics tend to reflect divergences between domestic politics and global markets. Thinking that domestic policymaking can be insulated from the rest of the world, so that no coordination or cooperation is needed, is deeply fallacious. Sterling’s troubles are a reminder that foreign investors have an indirect say—and interest—in how a country is managed. Depending on foreign investors sets a natural limit to sovereignty for any country that needs steady and abundant capital inflows.

The inclusion of the renminbi among the currencies that compose the SDRs—the US dollar, the euro, the yen and the sterling—is a ‘milestone’ for China, as IMF Managing Director Christine Lagarde said when she presented the IMF executive board’s decision on 30 November 2016. It is also hugely symbolic for the Chinese leadership.

The renminbi’s inclusion, in fact, recognises the work that China’s monetary authorities have done in the last five years to push the renminbi’s transformation into an international currency—a currency that can be used to invoice and settle international trade and that is traded in international capital markets. The outcome of this process has been
remarkable: approximately 25 per cent of China’s trade is now settled in renminbi—it was less than 1 per cent in 2009. It is now the second most-used currency in international payments.

In addition, the inclusion somehow addresses the contradiction that China has faced for years: being the world’s second largest economy and the largest exporter without a currency that reflects that role. For years the dollar has been the currency used in China’s trade and investments, and this is still largely the case. This has suited China well throughout its transformation from a poor and isolated nation into an industrial powerhouse that is well integrated in regional and international supply chains.

But China’s dollar dependence no longer reflects Beijing’s ambitions for playing a more engaging and assertive role in international economic and financial affairs and governance. If ‘great nations have great currencies’, to paraphrase Nobel laureate Robert Mundell, then it is understandable that the Chinese leadership would push to turn the renminbi into a ‘great currency’.

Finally, and even more critically, being part of the SDR basket implicitly recognises the role that the renminbi, going forward, can play in the international monetary system. The issue, and the aspiration of how the international monetary system will look in the coming years, was raised by China’s central bank governor Zhou Xiaochuan in 2009, a few months after the global financial crisis erupted, when he questioned whether a dollar-centred system remained suitable for a more complex, multi-polar world economy where large emerging market economies increasingly drive growth along with the advanced countries.

The reform of the international monetary system and its governance continues to be a key concern for Beijing and will remain at the core of its engagement with the international financial institutions and fora like the G20.

The hype that has surrounded the IMF decision—the SDR made headlines beyond the financial press, perhaps for the first time since its creation in 1969—should not obscure the fact that the development of the renminbi is not a linear process, even if it is heavily policy-driven, and there is no guarantee that progress will continue at the same remarkable pace. The renminbi remains a currency with limited international circulation because of obstacles that are still in place to constrain capital flows into and from China’s domestic market. As a result, it is fully convertible only in designated financial centres with an offshore renminbi market, such as Hong Kong, Singapore and London. This is not the case for trade transactions, where the renminbi has been fully convertible since 2001 when China joined the WTO.

But what is the incentive for foreign businesses to hold renminbi if liquidity is constrained and therefore so are investment opportunities? In addition, the renminbi seems to have reversed the appreciation trend that until late 2014 had supported demand.

To make the renminbi into an international currency that foreigners want to hold as a store of value—one of the three functions of money—the Chinese leadership needs to continue the pace of reforms. Top of the list is the exchange rate and the abandonment of the system where the central bank intervenes every time the value of the renminbi moves outside a predetermined range. Until foreign investors believe that the renminbi is as liquid and trustworthy as the other key currencies in the SDR basket, then it will remain of limited international use and circulation.

Until then, any suggestion that the renminbi may one day rival the dollar and seriously threaten the greenback’s dominance within the international monetary system remains wishful thinking. The Chinese leadership is conscious of the limits of their currency and there has been no hint to the possibility—or ambition—that the renminbi will eventually replace the dollar as the key international currency. Instead, what policymakers in Beijing openly discuss is the transformation of the current system into a multi-currency one that reflects the main regional trading blocs—America, Europe and Asia.

The inclusion of the renminbi in the SDR basket is a step in the right direction, but much more needs to be done to make it into a pillar of this multi-currency system.

Paola Subacchi is Director of Economic Research at Chatham House, London.
China's economic rise is one of the factors straining the international financial order. China is already the largest trading nation and the second-largest economy, and if current trends continue, China will become the largest net creditor around 2020.

After controlling for market size and natural resource wealth, foreign direct investment is strongly attracted to better governance environments. Chinese overseas direct investment (ODI) differs from other investment in that it is uncorrelated with the index of property rights and the rule of law. There is actually a slightly negative relationship between how much ODI a country receives and economic governance, but it is not statistically significant. Chinese ODI appears indifferent to the governance environment.

China is not seeking out poor governance environments. It is a major investor in the well-governed countries that are the largest recipients of investment globally. But it does appear to be indifferent to the governance environment to the extent that it is making major investments in weak governance environments where other investors fear to tread.

There are a number of plausible explanations for this pattern of investment. Many large investments from China are made by state-owned enterprises (SOEs). SOEs do not feel the same pressure as private firms to earn good returns on their investments. Their investments in poor governance environments are often part of state-to-state deals and they may feel insulated from the local economic environment.

It is also the case that China is a relative newcomer on the global investment scene and Chinese firms may have underestimated the risks involved in some investments. There is evidence that some natural resource investments in poor governance environments are turning out badly.

China's pattern of global investment raises two policy issues, one for China
and one for the world. First, from China’s point of view, is it getting the best return on its investments? Chinese SOEs, by definition, are playing with the people’s money. If they waste tens of billions of dollars in poor investments, that is a real loss for China. From a global point of view, there is the question of whether China’s state-to-state financing is sustaining poor governance in some countries. The projects in the worst governance environments may not be returning economic benefits, but China’s money is going somewhere.

A second issue raised by China’s emergence as a major global investor concerns environmental and social safeguards. China is a major funder of mining and infrastructure projects. Such projects normally carry significant environmental risks and often involve the involuntary resettlement of large numbers of people. So far, China has been reluctant to subscribe to any international standards for environmental and social safeguards. China’s position is that it follows the laws and regulations of the host country. This is a reasonable point of view, consistent with China’s general position that countries should not interfere in each other’s internal affairs. The problem is that the implementation of environmental and social regulations is often weak, especially in the countries with weak governance. Private financial institutions from Western countries have generally subscribed to international environmental and social standards, but large Chinese banks have not been willing to join.

Given this situation, the emergence of China as a major funder of mining and infrastructure projects has been welcomed by most developing countries. China is seen as more flexible and less bureaucrat. It completes infrastructure projects relatively quickly so that the benefits are seen sooner. But China’s approach of relying on the recipient country’s own laws and regulations also has its risks, particularly in regards to the environment.

China is likely to evolve in the direction of current investment norms—that is to favour better governance environments. Part of China’s motivation for investing in countries such as Venezuela and the Democratic Republic of the Congo was to access natural resources. In the 2000s, China’s growth model was very resource intensive and global prices for most commodities were rising. That made it tempting to look for resources, even in risky environments.

That has all changed this decade. A lot of new supply has come online in sectors such as oil and gas, iron and copper. Meanwhile, China’s growth model is shifting away from resource-intensive investment towards greater reliance on consumption.

Concerning environmental and social safeguards for infrastructure projects, China has identified an issue that resonates with other developing countries. The World Bank and other multilateral development banks have been imposing environmental and social standards that reflect the preferences of electorates in rich countries. Developing countries have been voting with their feet and have turned away from those banks as important sources of infrastructure financing. In general, they welcome Chinese financing of infrastructure.

China has clearly tapped into an important sentiment in the developing world that infrastructure is key to growth and that private finance and existing development banks are not sufficient. Part of the problem is that the existing banks are not large enough; a second issue is that they have turned away from infrastructure as a core business. On this issue, the smart thing for the United States would be to find a way to say ‘yes’ to China’s standing offer to join the Asian Infrastructure Investment Bank.

More importantly, given the United States’ leadership role in the World Bank and regional banks, it should accelerate governance reform that would strengthen developing countries’ shares and roles in these institutions. If the next president of the World Bank were a successful reformer from the developing world, that would be a powerful statement and a real change. More developing-country voices in the existing development banks are likely to result in their getting back into infrastructure in a major way.

David Dollar is a Senior Fellow in the John L. Thornton China Center at the Brookings Institution.

This article is a digest of the author’s chapter from the publication for the latest ANU China Update conference. A free e-book is available at http://press.anu.edu.au/node/1906.
GLOBAL VALUE CHAINS

The evolution of production networks in the Asia Pacific

HUBERT ESCAITH, SATOSHI INOMATA AND SÉBASTIEN MIROUDOT

As production activities became increasingly fragmented and relocated across borders, a number of observers started to use the expression ‘global value chain’ (GVC). The term is often used without knowing what a value chain really is or looks like. What is clear is that GVCs as they are usually described do not reflect the international production networks that we see around the world today.

In 1985 there were only four key economic players in the Asian region: Indonesia, Japan, Malaysia and Singapore. The basic structure of the production network was that Japan built up supply chains from countries such as Indonesia and Malaysia.

By 1990 the number of players had increased. Japan, the first regional giant, had extended its supply chains of intermediate products to South Korea, Taiwan, China and Thailand. While still relying on the productive resources of Indonesia and Malaysia, Japan also started to supply products to other East Asian economies, especially to the group known as the ‘newly industrialised economies’ (NIEs), namely Hong Kong, Singapore, Taiwan and South Korea. During this phase, Japan relocated production bases to neighbouring countries quickly, due to the yen revaluation agreed to in the Plaza Accord of 1985.

In 1995 the United States came into the picture as the second regional giant. It drew on two key supply chains originating in Japan, one via Malaysia and the other via Singapore. These two countries came to bridge the supply chains between East Asia and the United States.

In the year 2000, on the eve of its accession to the WTO, China began to emerge as the third regional giant. The country entered the arena with strong production linkages to South Korea and Taiwan. It gained access to Japanese supply chains through the latter. The United States also brought a new supply chain from the Philippines.
In this way the basic structure of the tri-polar production network in the Asia–US region was completed.

By 2005 the centre of the network had completely shifted to China, pushing the United States and Japan to the periphery. The shift of supply chains towards China typically had a high degree of fragmentation and sophistication, incorporating substantial value-added input from each country in the production network. The competitiveness of Chinese exports was not only attributable to that country’s cheap labour force, but also to the sophisticated intermediate products that the country imported from other East Asian economies, embedded in goods labelled ‘Made in China.’

The organisation of international production networks has so far been mostly regional, producing in a given region and selling to consumers in that same region. This is especially the case in Europe, with Western Europe absorbing the manufactures produced in the eastern part of the continent; and in North America, where the main source of final demands is the United States.

A

SIA presents a slightly different picture. The ‘supply’ part of the networks is regionally concentrated, yet when it comes to the ‘demand’ side, the networks become fairly global. This configuration stems from the early days of the export-led growth strategy espoused by Japan in the second half of the 20th century and later by the NIEs in the 1970s. The evolution took a dramatic turn with China’s accession to the WTO in 2001. The irruption of one billion Chinese workers into the global economy had a tremendous impact on the redefinition of comparative advantages in the region (and beyond).

The net impact of global value chains on employment has been the subject of a heated debate in years since the global crisis of 2008–09, in view of the high rate of unemployment affecting many open economies. The debate has intensified mainly in developed countries, where lower-skilled workers are exposed to higher chances of job losses. In contrast, countries with large labour surpluses and low wages have observed relatively strong job growth following their GVC integration.

Developed countries specialise in services, particularly research and development or business services, where they have so far maintained comparative advantage. Employment in these countries tend to be mainly in services, with only marginal employment being generated by primary sectors. But there are exceptions. Australia, despite being a developed economy, has a strong primary-based export sector.

Strength in basic commodities does not always mean large employment impact: Chile, the world’s largest exporter of copper, employs relatively few in its mining sector considering its gross export strength in that area. This apparent paradox reflects the fact that modern mining industries are highly capital-intensive and thus generate relatively low employment. Most of the jobs indirectly related to extracting operations are in supporting activities such as maintenance, energy supply and transportation, which are classified in the service sector rather than the mining sector itself.

When it comes to considering the performance of non-exporting sectors, some firms may participate in export efforts indirectly by providing intermediate products to exporting lead firms. This mode of GVC participation is particularly important for providers of services (which were traditionally considered ‘non-tradeable’) or for small and medium-size firms which do not have the capacity to engage in global market operations. Compared with the previous import-substitution industrial policies that underpinned the development of large-scale industries, the utilisation of more flexible networks of second-tier suppliers is one of the distinctive features of the new mode of industrialisation.

I

RRESPECTIVE of an economy’s development status, the export-related demand for low-skilled jobs has gone down in all countries, while demand for higher-skilled positions is on the rise.

Over the past few decades, cross-border production networks have evolved and continually expanded according to countries’ comparative advantages. This process was intrinsic to the development of Japan and China, as well as the newly industrialised economies in Asia. It has also shaped income distribution across the Asia Pacific. As Asian integration goes forward, understanding the nature and dynamics of these production networks will be more important to securing stable and fair growth throughout the region. EAF

Hubert Escaith is WTO’s Chief Statistician.

Satoshi Inomata is Chief Senior Researcher at the Development Studies Center, Institute of Developing Economies, JETRO.

Sébastien Miroudot is Senior Trade Policy Analyst at the Trade in Services Division of the OECD Trade and Agriculture Directorate.
Asia’s integration has been reshaping the global economic landscape. The emerging economies in East and Southeast Asia (grouped together as emerging East Asia) now account for about 25 per cent of total global trade and 21 per cent of global GDP, compared with about 10 per cent and 5.8 per cent, respectively, in 1985. Is this formidable growth of integrated Asia now independent of growth rates in major developed economies?

The idea that emerging East Asia is economically independent of shocks in major industrial countries is sometimes called the ‘decoupling hypothesis’. It’s based on the observation that the region’s sustained high growth in the early 2000s was seemingly unaffected by the ups and downs of major advanced economies. Emerging East Asia’s economic performance has been solid despite visible slowing in most advanced economies since the global financial crisis (GFC). This performance has been underpinned by dynamic growth in China.

Emerging East Asia has achieved rapid economic expansion underpinned by strong export performance over the past few decades. The region’s high reliance on exports has been accompanied by a significant diversification of its export base: the G3 economies (the EU, Japan and the United States) collectively accounted for 29 per cent of emerging East Asia’s total exports in 2015, down from almost 50 per cent in 1990. This greater diversification in the destination of Asian exports suggests that an idiosyncratic demand shock from a single market may be mitigated by stronger growth in others.

At the same time, the share of intraregional trade in emerging East Asian economies’ total exports has risen dramatically. China, in particular, now accounts for around 30 per cent of intraregional exports. Strong growth in intraregional trade—including with China—could constitute evidence for emerging East Asia’s greater resilience to cyclical fluctuations in the major extra-regional trading partners.
But changing demand conditions in the world’s major economies—particularly the United States—still seem to represent a dominant driver behind East Asia’s export growth. Underlying this strong linkage between emerging East Asia’s growth and old industrial country growth is the nature of intra-Asian trade: the final output is often destined for markets outside the region. The growth of intraregional trade share in total emerging East Asian exports does not automatically imply its independence from an external demand shock. Emerging Asian exports remain highly sensitive to economic shocks from outside the region.

As the region’s main production base, China has been at the centre of this growing intra-industry and intraregional trade. China has recently emerged as a major importer of primary commodities, while processed intermediate and capital goods, rather than consumer goods, are leading its exports. Research has suggested that China has increasingly internalised the manufacturing input supply in the global value chain. It also exports a large and growing share of capital goods, suggesting that Chinese manufacturing production has become more sophisticated and higher value-added.

Strong trade and foreign direct investment linkages can be channels for transmitting economic shocks. As China has emerged as an important hub for intra-industry and intraregional trade and investment in Asia, it is likely that economic interdependence between China and the rest of Asia has also increased.

What are the effects of international finance on ‘decoupling’? In theory, financial integration offers many benefits, such as risk-sharing, more efficient allocation of capital for investment and enhanced macroeconomic and financial discipline. In practice tighter financial linkages also generate a higher risk of cross-border financial contagion, as illustrated by the episodes of financial crisis in 1997–98 and 2007–08.

With greater capital account openness, international portfolio assets and liabilities held by Asian economies have increased. The United States and EU also comprise the major share of emerging East Asia’s financial liabilities, which makes the region vulnerable to changes in their financial conditions. For example, during the global financial crisis (GFC), tightening credit conditions in the United States and the EU prompted repatriation of their investment funds in emerging East Asia.

The relationship between emerging East Asian and G3 equity returns strengthened after the Asian financial crisis of 1997–98 and has continued since then.

The relationship between emerging East Asian and G3 equity returns strengthened after the Asian financial crisis of 1997–98 and has continued since then. The relationship between emerging East Asian and G3 equity returns strengthened after the Asian financial crisis of 1997–98 and has continued since then. The relationship between emerging East Asian and G3 equity returns strengthened after the Asian financial crisis of 1997–98 and has continued since then. The relationship between emerging East Asian and G3 equity returns strengthened after the Asian financial crisis of 1997–98 and has continued since then.

Cyn-Young Park is Director of Regional Cooperation and Integration at the Economic Research and Regional Cooperation Department, Asian Development Bank.
Lifting global free trade from the ‘noodle bowl’

SHEN MINGHUI

Free trade agreements (FTAs) in East Asia have proliferated rapidly in the past two decades. By the end of February 2016, there were 133 FTAs in East Asia, of which 79 were signed and in effect. Economic integration in the region has been driven mainly by market forces since before the 1990s and strengthened by a number of institutional initiatives since then. With the US-led Trans-Pacific Partnership (TPP) in the background, ASEAN initiated the Regional Comprehensive Economic Partnership (RCEP) in 2012. RCEP now offers a major framework within which to integrate the region’s economies.

ASEAN has been a pioneer of regional FTAs in East Asia. By insisting on the principle of ‘ASEAN centrality’, the grouping has gradually upgraded its own association from a free trade arrangement to an economic community with more comprehensive economic liberalisation targets. At the same time, it has developed FTAs with other partners in East Asia based on the ‘ASEAN+1’ formula.

FTAs in East Asia have developed rapidly in terms of quantity, but most of them embody a low degree of liberalisation. Although traditional issues of tariff reduction, rules of origin, inspection and quarantine, and dispute settlement are covered, issues such as performance requirements for investment, intellectual property rights, competition policy, e-commerce and environmental policy are seldom incorporated. Sensitive issues like state-owned enterprise regulation, which had been a feature of the TPP agreement, are not a feature of the region’s FTAs.

Facing the challenge of the TPP, ASEAN decided to initiate RCEP for all the ASEAN members and six other countries—China, South Korea, Japan, India, Australia and New Zealand. RCEP intends to create an open market with a higher degree of liberalisation than the five ‘ASEAN +1’ FTAs. The agreement aims to integrate East Asia’s complex FTA networks and remedy the ‘noodle bowl effect’ of FTA proliferation in the region. These complex FTA arrangements complicate rules of origin and include red tape and cross-border procedures that increase transaction costs, reduce enterprises’ operational efficiency and ignite trade protectionism, producing a negative impact on East Asian production networks.

Complex FTAs can disrupt cross-border production networks, which have been central to the...
region’s successful integration. Uncoordinated proliferation may lead to varying ‘phase-in’ timeframes for tariff concessions, as well as varying preferences across different FTAs. This can hamper the process of developing production networks across economies. RCEP is designed to deal with this noodle bowl effect. As trade economist Richard Baldwin writes, these noodle bowls could be the ‘building blocks on the path to global free trade’, where the unwieldy political economy of FTAs ultimately recommends bigger, multilateral initiatives as a solution.

East Asia’s economic success has been built upon an open and supportive global environment. The region’s growing global integration has contributed significantly to the growth of international trade, and its commitments to the WTO and other international institutions could further deepen its integration.

Although East Asia needs to be cautious about its export-oriented growth model, its interest in the global market will not fade, as its future will be closely associated with the global market environment. The world economy is currently threatened by anti-globalisation sentiments. East Asia needs to fight against trade protectionism including Trump’s ‘America First’ trade and industry strategy which directly harms regional production networks. The region must insist on unilateral liberalisation and regional integration to support free trade.

China has become more and more active in forging FTAs with partners in East Asia and other regions of the world. So far, China has signed 14 FTA agreements, which include 12 implemented agreements and cover 22 countries and regions. China has also taken a leading role in promoting the FTA for the Asia Pacific (FTAAP) under the APEC framework.

In a 2013 speech at Nazarbayev University, Kazakhstan, Chinese President Xi Jinping praised the role of the ancient Silk Road in building close economic, social and cultural links between China and the outside world and called on China and Kazakhstan to build a modern belt together. The proposal, later known as the Silk Road Economic Belt, is slated to build the transportation and economic corridors that connect China to Europe.

Speaking to the Indonesian parliament one month later, Xi put forward the idea of building the 21st century Maritime Silk Road, which intends to broaden trade and other economic connections between China and other maritime countries of Southeast Asia, South Asia, the Middle East, East Africa and the Mediterranean.

These two proposals, together known as the Belt and Road Initiative (BRI), form a package that links both land and maritime regions with comprehensive agendas ranging from infrastructure to industrial parks and port networks to cultural exchanges.

China considers the BRI as a new step to further integrate its economy with the global market by investing abroad. As BRI is oriented towards development cooperation, it enables China to look for new economic opportunities by developing infrastructure projects with countries across the region. While many of the labour-intensive manufacturing factories in China need to reallocate to low-cost places to maintain competitiveness, the developing countries in Asia and Africa have a great demand to develop their own manufacturing capacity by using their low-labour-cost advantages.

Differing from the traditional model of moving ‘dirty industries’ out, China will build new industries together with the local countries. This new kind of development cooperation differs from the traditional aid and market-based reallocation of outdated production capacities.

BRI is designed in the spirit of open regional cooperation and characterised by equality based on consultation, cooperation and sharing. According to an official document, it will be ‘open to all countries and international and regional organisations for engagement’.

Through RCEP, BRI and other initiatives, East Asian countries will continue to push for integration and free trade. But reconstructing the trade system on a global level is unlikely to succeed without consensus and cooperation between China and the United States. The multilateral trading system remains the ideal trading platform on which to accommodate these two major economies. In this sense, the WTO is the most important economic connection between China and the United States. The most worrying challenge? The future of US trade policy under President Donald Trump.

Shen Minghui is Professor at the National Institute of International Strategy, Chinese Academy of Social Sciences (CASS).
India’s Asian integration strategy

DHIRAJ NAYYAR

The Indian economy is experiencing rapid growth of between 7 and 8 per cent a year. To sustain that growth rate and for India to achieve its development potential, it must open up its economy and have a strong export sector. It may not be easy, but given the global trade slowdown and the paralysis of multilateral trade negotiations, India’s best bet is to seize those opportunities for integration closest to home.

Thanks to its strength in the service sector, India’s trade to GDP ratio is around 25 per cent, close to that of China or Indonesia. But in terms of merchandise trade, India simply does not match up to the region’s other big players, accounting for just 1.7 per cent of global merchandise exports. In comparison, the United States accounts for 9 per cent, the European Union for 13.5 per cent and China for 14 per cent.

Unlike its East Asian neighbours, India is in a region characterised by remarkably little intraregional trade. Just 5 per cent of South Asian trade takes place within the region, compared to 25 per cent for ASEAN or 55 per cent for Asia as a whole.

What are the roadblocks to greater economic integration with India’s neighbours, dynamic East Asia and the global economy? And what can be done?

Some ingrained domestic opposition to openness can be explained by historical factors. Socialist development policies and...
Import substitution industrialisation strategies are within living memory for many in India. Then there are contemporary obstacles. India trades less than its East Asian neighbours in part because its manufacturing and agricultural sectors are relatively less competitive, and in part because of its big domestic market. The dynamics of liberalisation are also a factor—opening up to trade usually leads to a sharper rise in imports than exports in the short run.

What’s more, trade agreements tend to mainly affect goods, with less attention paid to services, India’s most competitive sector. Services are particularly vulnerable in international markets to non-tariff barriers like visas or complex regulatory requirements.

For India, the path towards economic integration begins at home. The implementation of a goods and services tax (GST), scheduled for April 2017, will create a single market within India. Yet as it stands, the GST requires critical reform. 40 per cent of India’s indirect taxes come from oil, tobacco and alcohol. These industries will remain outside the federal GST and in the hands of the country’s 29 states.

Since the early 1990s, India’s economy has risen on the strength of services while manufacturing has declined. This emphasis is now changing in policy debate. The government’s flagship Make in India initiative—a suite of proposed reforms aimed at boosting the competitiveness of Indian manufacturing—must follow through on the policy vision it offers. India needs a strong manufacturing sector because of the size of its low-skilled population and high demand for jobs. At present, manufacturing firms migrating out of China are more likely to set up shop in Southeast Asia than India.

Improving ease of doing business is a worthy policy priority that is receiving growing attention as part of the Make in India initiative. Making it quicker and easier to register a business, cutting red tape and simplifying the tax return process are areas flagged for reform. Following a public commitment by the prime minister, the Department of Industrial Policy and Promotion announced in late 2016 that it wants to see India reach the global top 50 in the World Bank’s ease of doing business index.

India’s infrastructure potential is all too often limited by bureaucratic bloat. Major ports are causing shippers frustration as smaller, private ports increase their efficiency and market share. Railways charge firms more in order to cross-subsidise fares for passengers, an arrangement which has long affected competitiveness. That means more goods are transported by road, the efficiency of which is marred by state-specific taxes and poor road quality. The good news is that the current government is approaching infrastructure upgrading with renewed focus.

One promising strategy is the use of ‘coastal employment zones’ in the style of the special economic zones in Shenzhen and Guangdong, China. By
Southeast Asia borders India’s least developed states, posing opportunities for the country’s relatively poorer east and northeast.

Southeast Asia borders India’s least developed states, posing opportunities for the country’s relatively poorer east and northeast.
INFLUENCE THE REGION’S FUTURE
Be part of Asia’s economic integration

Join our international public policy community.
crawford.anu.edu.au

Crawford School of Public Policy
ANU College of Asia & the Pacific