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Fact or Fancy? North Asia Economic Integration

Stephen Lavergne
Economic and Trade Policy Division (CPE)
Policy Staff

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Executive Summary

North Asia is not yet evolving into a trading "bloc". A combination of macroeconomic forces, strategic business decisions, governmental policies, political realism, cultural factors and security considerations are encouraging increased economic interdependence in North Asia, but rather more slowly in relative terms than the trade data might appear to indicate at first glance. Most importantly, the interaction is a natural phenomenon, driven by market forces and the pragmatic, informal actions of business and government.

Between 1980 and 1993, intraregional trade grew in both absolute and relative terms. With the exception of China-Hong Kong trade, however, bilateral exchanges between member countries expanded only modestly compared to trade with other markets. If entrepôt trade is factored out, the modest increase in intraregional commerce that is observed in relative terms does not support the thesis that economic integration is dramatically increasing in North Asia.

Intraregional flows of foreign direct investment (FDI) grew substantially during the past decade, as many companies from Hong Kong, Taiwan, Korea and Japan moved their labour-intensive operations to lower-cost China. There is no indication, however, of a trend to intraregional investment accounting for a greater share of total outward investment from the North Asian economies.

One can conclude that economic interdependence among the economies of the region will increase, that Japan will continue to play a large role in the region's commercial activity, that China provides much of the market expansion potential, and that the U.S. will remain the single most important market for North Asian goods. Japan's role in North Asia will be constrained by the historical hostility and mistrust the region's other economies feel towards it, and by the growing economic importance of mainland China. Japan's role could also remain constrained should the U.S. maintain, or enhance, its commitment and level of involvement in the region.

The increase in North Asian economic interdependence that is taking place is based on disparities in economic development, and is the result of a process that has seen the more advanced economies move their mature production to the less developed members of the region. Japan and Korea have followed the lead of Hong Kong and Taiwan in taking advantage of opportunities that have presented themselves in China as a result of that country's economic reform program. The strong and growing trade and investment linkages among the economies of North Asia could encourage further specialization, improve resource allocation and efficiency, and increase the flexibility, adaptability and dynamism of all the member economies.

There would appear to be little reason, however, to think that the economies of North Asia will form anything resembling an exclusionary, treaty-based bloc in the foreseeable future. While increases in trade among economies in the region should be expected given the growth rates in these countries, the economic fundamentals necessary for forming an exclusionary bloc are not present. Considerable obstacles to trade, investment and capital movements still exist. Moreover, infrastructure bottlenecks, environmental problems and shortages of trained personnel in China may constrain the region's prospects. It is in the region's self-interest to remain dynamic, export-oriented and fairly open to extra-regional inflows of foreign investment and goods.

Given the region's continued reliance on the U.S and other non-Asian markets, the area's first best strategy would be to support a strengthening of the world trading system and multilateral trade liberalization. Any formal regional integration plan should be viewed as a second-best option, the result of these economies perceiving that they had been left out of other regional arrangements. Moreover, any regional integration scheme would probably encompass the economies of East Asia rather than just those of North Asia.

The viability of this second-best strategy is debatable. The ongoing difficulties that most Asian economies are experiencing in their attempts to penetrate the Japanese market make it unlikely that Japan would be a realistic, or viable, alternative to the U.S. and other western destinations. Furthermore, given the continued importance of U.S. and EU markets to both Japan and the other North Asian economies, it would be difficult for Japan to go it alone with the region, despite its formidable financial resources and record of economic successes. Moreover, Japan would like to have the U.S. remain engaged in the region, to help mitigate the historical animosity between Japan and its immediate neighbours.

Many observers have suggested that it is vital to the long-term competitiveness of Canadian industry, as well as to Canadian commercial interests and policy, to be a part of the continuing transformation of the fastest growing region of the world. Competing in Asian, particularly North Asian markets, may be an important test of a company's ability to succeed globally. While some of Canada's largest firms may be well placed in the region, small and medium-sized Canadian firms are under-represented. Without an on-the-ground presence, Canadian firms will miss out on information about emerging technologies, products and competitors' activities. This not only reduces the ability of Canadian firms to compete in North Asian markets, but could eventually lead to Canadian producers being blind-sided at home by exports from that region.

The reason that Canadian firms have a lower presence in Asia than is desirable may relate mainly to the structure of the Canadian economy and Canadian corporate behaviour rather than to trade barriers in the region. Traditionally, most Canadian firms have focussed on penetrating the U.S. market. Canadian firms' focus on short-term earnings, a lack of familiarity with and lack of awareness about North Asian market opportunities, and complacency because of the large size of the North American market have, until recently, dampened interest in North Asia.

Regional factors that may also be dampening the interest of Canadian firms include: distance to these markets, a lack of familiarity with local business customs, and tariffs and non-tariff barriers. To the extent that practices of North Asian governments disadvantage Canadian suppliers, a combination of pressure for change and pragmatic reassessment of Canadian strategies may be in order. To the extent that the rationale for investing in the region is driven by barriers to Canadian exports, it may make more sense from a Canadian national interest perspective to seek the lowering of those barriers, rather than to encourage Canadian investors to set up shop in the region.

Increasing Canadian involvement in North Asia's fast-evolving business environment and still nascent economic institutions is both possible and desirable, particularly within APEC as it becomes more established. Canada should continue to work within APEC to ensure that it maintains its outward-looking orientation, including with regard to the prospects for achieving free trade within the 2010/2020 timeframe adopted by Leaders when they met last November in Indonesia. Such involvement would not only provide Canada with leverage to shape this institution at a crucial moment in its development, but would signal Canadian recognition of its substantial economic stakes in Asia and its intent to pursue a commercial agenda that is both broad and pro-active.

Résumé

L'Asie du Nord n'est pas encore un « bloc » commercial en puissance. Mais les forces macro-économiques, les décisions commerciales stratégiques, les politiques gouvernementales, le réalisme politique, les facteurs culturels et les considérations de sécurité se conjuguent pour favoriser l'intensification de l'interdépendance économique en Asie du Nord, même si la chose se fait relativement plus lentement que ce que les données commerciales pourraient nous laisser entrevoir. Facteur plus important, l'interaction est un phénomène naturel alimenté par les forces du marché et par les actions pragmatiques et informelles des secteurs privé et public.

Entre 1980 et 1993, le commerce intrarégional s'est accru en termes absolus et relatifs. À l'exception toutefois du commerce entre la Chine et Hong Kong, l'accroissement des échanges bilatéraux entre les pays membres n'était que modeste comparativement au commerce avec d'autres marchés. Exception faite du commerce d'entrepôt, l'accroissement relativement modeste du commerce intrarégional qui est observé n'appuie pas la thèse voulant que l'intégration économique progresse très rapidement en Asie du Nord.

Les apports intrarégionaux d'investissements étrangers directs (IED) se sont sensiblement accrus dans les dix dernières années, alors que plusieurs sociétés de Hong Kong, de Taïwan, de la Corée et du Japon déménageaient leurs opérations à forte intensité de main-d'oeuvre en Chine, où les coûts sont moins élevés. Mais rien n'indique que l'investissement intrarégional tend à composer une plus large part des investissements à l'étranger réalisés par les économies de l'Asie du Nord.

On peut en conclure que l'interdépendance des économies de la région s'intensifiera, que le Japon continuera à jouer un rôle important dans l'activité commerciale de la région, que la Chine compte pour une bonne part du potentiel d'expansion des marchés régionaux et que les États-Unis resteront le marché le plus important pour les biens de l'Asie du Nord. Le rôle du Japon en Asie du Nord sera limité par l'hostilité et la méfiance que les autres économies de la région manifestent depuis longtemps à son égard, et par l'importance économique croissante de la Chine continentale. Le rôle du Japon pourrait aussi rester limité si les États-Unis maintenaient ou accroissaient leur engagement et le niveau de leur présence dans la région.

L'intensification de l'interdépendance économique en Asie du Nord se fonde sur les disparités au niveau du développement économique et résulte d'un processus par lequel les économies plus avancées ont déménagé leur production mature dans les pays moins développés de la région. Le Japon et la Corée ont suivi l'exemple de Hong Kong et de Taïwan en tirant avantage des possibilités qui se sont naturellement présentées en Chine en raison du programme de réformes économiques entrepris dans ce pays. Les liens commerciaux et financiers de plus en plus solides qui unissent les économies de l'Asie du Nord pourraient encourager une spécialisation plus poussée, améliorer l'allocation et l'efficacité des ressources et accroître la flexibilité, l'adaptabilité et le dynamisme de toutes les économies de la région.

Mais il semblerait y avoir peu de raison de penser que les économies de l'Asie du Nord ressembleront même de loin à un véritable bloc commercial exclusif dans l'avenir prévisible. On peut attendre des accroissements du commerce entre les économies de la région étant donné les taux de croissance observés dans ces pays, mais les fondements économiques nécessaires à la formation d'un bloc exclusif sont

inexistants. Il existe toujours des obstacles considérables au commerce, à l'investissement et au mouvement du capital. De plus, le manque d'infrastructures, les problèmes environnementaux et les pénuries de personnel qualifié en Chine pourraient limiter les perspectives de la région, qui a intérêt à rester dynamique, axée sur l'exportation et relativement ouverte aux apports de capitaux étrangers et aux importations extrarégionales.

Comme la région continue de dépendre des États-Unis et d'autres marchés non asiatiques, sa stratégie la plus avantageuse serait d'appuyer le renforcement du système commercial mondial et la libéralisation multilatérale du commerce. Tout plan d'intégration régionale structurée serait probablement considéré comme la deuxième meilleure option, soit comme un choix découlant du fait que ces économies se seraient senties exclues d'autres arrangements régionaux. De plus, tout plan d'intégration régionale engloberait probablement les économies de l'Asie de l'Est, et non seulement celles de l'Asie du Nord.

La viabilité de cette deuxième meilleure stratégie peut être mise en doute. Les difficultés que la plupart des économies asiatiques rencontrent actuellement dans leurs efforts pour pénétrer le marché japonais rendraient improbable que le Japon puisse réalistement ou viablement remplacer les États-Unis et les pays européens. En outre, étant donné l'importance que les marchés des États-Unis et de l'UE continuent d'avoir pour le Japon et les autres économies de l'Asie du Nord, le Japon aurait de la difficulté à lier son sort à celui de la région malgré ses formidables ressources financières et ses grands succès économiques. Le Japon aimerait aussi que les États-Unis maintiennent leur engagement dans la région pour atténuer l'animosité que ses voisins immédiats entretiennent depuis longtemps à son égard.

Selon plusieurs analystes, il est vital pour notre compétitivité à long terme comme pour nos intérêts et notre politique en matière de commerce que le Canada continue de participer à la transformation constante de la région du monde qui connaît les plus forts taux de croissance. La capacité de soutenir la concurrence sur les marchés de l'Asie, et surtout de l'Asie du Nord, pourrait être un indice important de la capacité d'une société de réussir à l'étranger. Certaines de nos plus grosses firmes sont peut-être déjà bien positionnées dans la région, mais nos petites et moyennes entreprises y sont sous-représentées. Sans une présence sur place, les firmes canadiennes seront privées d'information sur les technologies naissantes, les nouveaux produits et les activités de leurs concurrents. Cela, en plus de réduire la capacité des firmes canadiennes de soutenir la concurrence en Asie du Nord, pourrait éventuellement amener les producteurs canadiens à se laisser évincer par les exportations depuis cette région.

Le fait que les firmes canadiennes ont en Asie une présence moins que souhaitable peut s'expliquer surtout par la structure de l'économie canadienne et par le comportement des entreprises canadiennes plutôt que par les obstacles posés au commerce avec la région. La plupart des firmes canadiennes se sont traditionnellement attachées à pénétrer le marché des États-Unis. L'insistance des firmes canadiennes sur les profits à court terme, le manque de connaissance des débouchés offerts par les marchés de l'Asie du Nord et la complaisance engendrée par la grande taille du marché nord-américain ont, jusqu'à récemment, réduit l'intérêt pour l'Asie du Nord.

Parmi les facteurs régionaux qui peuvent aussi réduire l'intérêt des firmes canadiennes, mentionnons: l'éloignement de ces marchés, le manque de connaissance des pratiques d'affaires locales, les droits de douane et les barrières non tarifaires. Dans la mesure où les pratiques des gouvernements de l'Asie du Nord désavantagent les fournisseurs canadiens, il pourrait être approprié d'exercer des pressions en faveur d'un changement et de réexaminer les stratégies canadiennes dans une optique pragmatique. Dans la mesure où la justification de l'investissement dans la région se fonde sur les barrières posées aux exportations canadiennes, il pourrait être davantage dans l'intérêt du Canada de tenter d'obtenir l'abaissement de ces barrières que d'encourager les investisseurs canadiens à établir une présence dans la région.

Il est à la fois possible et souhaitable d'intensifier la participation canadienne à l'activité commerciale dynamique et aux institutions économiques naissantes de l'Asie du Nord, surtout au sein de l'APEC — au fur et à mesure que ce mécanisme deviendra plus structuré. Le Canada devrait poursuivre sa collaboration avec les membres de l'APEC pour garantir qu'ils maintiennent leur orientation vers l'extérieur, surtout en rapport avec la possibilité d'obtenir le libre-échange d'ici l'échéance de 2010/2020 adoptée par les leaders, lors de leur réunion de novembre dernier en Indonésie. Une telle participation, en plus de permettre au Canada d'influencer l'évolution de l'APEC à une étape cruciale de son développement, montrerait que le Canada reconnaît ses importants enjeux économiques en Asie et qu'il entend poursuivre un programme commercial à la fois vaste et proactif.

1. Introduction

This Paper sets out to determine whether North Asia--Japan, China, Hong Kong, Taiwan, South Korea and eastern Russia--is becoming more integrated economically and, if so, at what pace. Trade, investment and other economic data for, as well as the commercial and development policies of, North Asian countries are examined to determine whether recent economic changes and policy measures are contributing to a merging of North Asia's markets for goods, services, capital and labour.

The paper will look at the trends in and conditions for trade, investment and economic integration in North Asia (including intraregional and extraregional trade and investment); host country policies and factors influencing those trends and conditions; the relationship between foreign direct investment in the region and the area's trade patterns with some of the world's major economies; energy needs and resources; environmental conditions, consequences and opportunities; and current and proposed regional institutional arrangements.

The Paper will also attempt to answer the following questions:

- Are the trade and investment trends in the "region" something that should concern the Canadian private sector and Government?
- Is there more that the Canadian private sector and Government could or should do to strengthen Canadian participation in North Asian growth?

Economic integration is encouraged by the progressive removal of policy and other barriers segmenting markets for goods, services, capital and labour, so that resource flows approximate what would be expected without policy or other constraints. Full economic integration is the effective merging of markets for goods, services, capital and labour.¹

Steps toward integration may be taken unilaterally, bilaterally or multilaterally, and can take the form of trade and investment liberalization, regulatory harmonization, or political cooperation on economic matters such as regional infrastructure development. In addition, firms can contribute to integration by rationalizing production across national borders.

¹ For a more detailed review of the literature pertaining to economic integration, see Julie Fujimura, "Towards Regional Economic Blocs: Are We There Yet?", Department of Foreign Affairs and International Trade, Policy Staff Paper No. 95/01, January 1995.

For the past two decades, four of the five Asian economies--Hong Kong, Taiwan, South Korea and Japan--examined in this paper have experienced good-to-spectacular economic growth, while the fifth, China, entered a period of rapid growth fifteen years ago. In recent years, they also have moved markedly toward increased economic interdependence, despite differences in language, culture, resource endowments and levels of income. Flows of trade and investment within the region have grown substantially. Discrete actions by private firms and individuals appear to be the driving force in this phenomenon, as businesses in the region strive to retain competitiveness in the wake of appreciating currencies, rising wages and land costs, and technological change. Government actions at a variety of levels have supported these moves. Already characterized by an outward orientation and policies to attract foreign investment, the North Asian governments have unilaterally liberalized, to varying degrees, their markets for goods and capital in recent years.

Increasing economic interdependence in the region has not led to the raising of new formal or informal barriers to economies outside the region. The growth in intraregional trade that has been observed in recent years has not come at the expense of foreign, including Canadian, access to and influence in the region. Increased regional interdependence, if it contributes to a lowering of trade and investment barriers, for example, can improve the business environment for all potential suppliers. Intensified intraregional ties can exist side-by-side with active trade and investment relations with other partners and can support the continued development and evolution of the multilateral trading system. Moreover, to the extent that interdependence is the product of the freeing of market forces in the region, it is both less likely to harm outsiders and less susceptible to new protectionist policy influences.

As the 1980s passed, Japan's and the NIEs' need for new sources of supply for land, raw materials and labour to maintain the competitiveness of their respective export-oriented economies increased.² Consequently, during this period, Japan followed by the NIEs invested heavily in Southeast Asia's manufacturing industries.³ Intraregional production and tariff reduction schemes attracted the interest of companies that wished to rationalize their operations in East Asia (North Asia less

² The NIEs are Korea, Taiwan, Hong Kong and Singapore.

³ For a more detailed discussion of direct investment in Asia by firms from Japan and the NIEs and the relationship between foreign direct investment and trade, see Seiji Naya and Eric D. Ramstetter, "Foreign Direct Investment in Asia's Developing Economies and Trade in the Asia Pacific Region", in Foreign Investment, Trade and Economic Cooperation in the Asian and Pacific Region, U.N./Economic and Social Commission for Asia and the Pacific, Development Papers No. 10, 1992, pp. 43-100.

China plus Southeast Asia) and/or integrate them with facilities at home. Small and medium-size enterprises from Japan and the NIEs sometimes invested in Southeast Asian countries to serve facilities established in the region by larger manufacturers. These firms have often benefitted from the extensive support services of government. Until recently, moreover, it appears that much of this investment in Southeast Asia was export oriented. East Asia's trade (both imports and exports) with Japan has increased significantly over the past 10-15 years, and will continue to do so.⁴ Japan is an important source of capital, technology and managerial experience and know-how for East Asia. This will continue as well.

Not surprisingly, Asia figures prominently in the industrial and foreign policies of Japan and the NIEs. The v-shaped "flying geese pattern" has been used to describe Asian economic development and patterns of increased interdependence. Japan leads the flock; the other economies follow and learn from Japan and, increasingly, each other. To date, the NIEs have flown most successfully. China has become, and eventually eastern Russia could join it as, a major supplier of many of the inputs that Japan and the NIEs need to maintain the competitiveness of their respective export-oriented economies. The movement of Japan and the NIEs into China as economic reforms in that country have opened it to the rest of the world is simply a continuation of the process that carried firms from these countries into Southeast Asia. China also holds the allure of a potentially huge domestic consumer market. As Japan and the NIEs increasingly interact with China, and eventually Russia, the interdependence of the North Asian economies will expand. China and eventually Pacific Russia will join the flock.

A failure by the Canadian Government and private sector to participate actively in the increasing economic interdependence of Asia, whether it be that of East Asia or North Asia, may, for practical and political reasons, reduce Canadian policy and business options, to the detriment of Canadian commercial interests. Canadian business is widely perceived as being less aggressive than Asian, European and U.S. firms in pursuing the region's market opportunities. If this remains true, the limitations faced by Canadians more probably will be the result of Canadian inaction,

⁴ Japan/East Asia trade has increased in absolute terms. Japan's exports to East Asia increased from approximately US \$33 billion in 1980 to US \$112 billion in 1992, while its imports roughly doubled from US \$32 billion to US \$66 billion over the same period. In relative terms, the region now purchases 33 per cent of Japan's exports, up from less than 25 per cent in 1980, and supplies roughly 25 per cent of Japan's imports, up from 20 per cent. On the other hand, Japan's role as a supplier of the region's imports has declined slightly from 24 to 22 per cent over this period. It now purchases roughly 15 per cent of the region's exports, down from 21.5 per cent in 1980. See Direction of Trade Statistics Yearbook, IMF, Washington, 1993.

rather than any particular protectionist or discriminatory policy by government in Japan or the other Asian economies.

2. North Asia: National Economic Strategies and Performance

North Asia has been one of the fastest growing regions in the world since 1980, with annual real gross domestic product (GDP) growth rates averaging 7.1 per cent per annum (7.9 per cent if Japan is excluded).⁵ This performance compares favourably with annual world real GDP growth of 3 per cent per annum during the same period, Asian APEC real growth of 4.7 per cent, 2.3 per cent real growth annually in North America and 2.2 per cent in the EU. North Asian economies had a combined GDP of US \$3,782 billion in 1990, which represented approximately 18 per cent of the world total, compared with 31 per cent for the NAFTA countries and 29 per cent for the EU states.

The economies of North Asia represent a diverse collection of economic and political systems, and a broad range of indigenous resources. Each has struggled to develop its economy, and each is struggling to modernize or restructure in the face of increased competition for international markets, usually with the assistance of some type of long-term planning or industrial policy. The exception may be Japan, which faces difficult decisions pertaining to economic restructuring, but which no longer relies on long-term industrial development planning to set the course for future economic development. While national priorities and political differences have shaped strategies, the overall trend in North Asia continues to be away from import substitution (where domestic industries are developed behind trade barriers to serve markets that would otherwise be supplied by imports) and towards export-led growth and, increasingly, investment liberalization.

The three newly industrialized economies (NIEs) located in North Asia are currently in a phase of economic restructuring.⁶ Rising land and labour costs, currency appreciations, the loss of preferential trading status under the U.S.'s

⁵ These figures were compiled from data from the World Tables 1994, World Bank, Washington, 1994; Taiwan Statistical Data Book, Council for Economic Planning and Development, Republic of China (1992); National Accounts, Main Aggregates, Volume I, OECD, (1994); and International Financial Statistics, IMF, Washington, 1994.

⁶ For the purposes of this report, North Asia includes three of the four Asian NIEs. They are: Hong Kong, Taiwan and Korea.

Generalized System of Preferences (GSP) program in 1989 and the desire to shift toward capital- and skills-intensive manufacturing have prompted governments to increase the pace of economic liberalization and to encourage, or at least to refrain from discouraging, the transfer of less competitive, labour-intensive industries to China and other East Asian nations. Japanese firms also follow this practice. This trend should continue, although political and economic factors could slow the pace of economic restructuring. As a result, the combination of continued rapid GDP, import and export growth, the focus on export-led growth strategies, and the further removal of barriers to trade and investment should all contribute to increasing economic interdependence among North Asia's economies.

There are certain factors, however, that could constrain future investment and economic growth and, consequently, increased economic interdependence. Infrastructure development has generally not kept pace with economic growth, and serious bottlenecks in communication and power systems, roads, ports and services are occurring. Tariffs on thousands of products have been reduced, but, in some cases, the reductions were made from very high levels and generally have not been applied to sensitive items.⁷ Nontariff barriers may pose more of a hinderance to commerce in the region, however, and the issue of intellectual property rights protection must be addressed further.⁸ Chinese investment performance

⁷ In 1989, Japan, for example, eliminated tariffs on over 1,000 manufactured products. This reduced its average tariff rate on industrial products to approximately two per cent. Most of Japan's remaining high tariffs are imposed on agricultural and food products and leather and leather goods. That said, as part of the Uruguay Round of multilateral trade negotiations, Japan agreed to bind tariffs on all agricultural products and to reduce the bound rate by an average of 36 per cent over a six-year period beginning in 1995. In 1994, Taiwan agreed to tariff reductions for almost 500 commodities. Nevertheless, high tariffs remain on certain agricultural products. Automotive parts are subject to an average duty of 20 per cent. In 1994, Korea finished a five-year tariff reduction exercise that reduced its average tariff rate to 7.9 per cent from 12 per cent. Nonetheless, duties as high as 30 per cent remain on a number of agricultural and fisheries products, and some industrial goods. China's import tariffs run from three per cent on promoted imports to over 200 per cent on discouraged imports. Tariffs for any particular product can vary if the product is eligible for an exemption. The unpredictability of tariff rates can make it difficult for firms trying to trade with the Chinese market. Source: 1994 National Trade Estimate Report on Foreign Trade Barriers, Office of the U.S. Trade Representative, Washington, 1994.

⁸ For example, Taiwan currently requires import permits or has banned imports of almost 1,000 commodities items. GATT/WTO contracting parties are requesting that Taiwan eliminate its import bans and non-tariff restrictions that are prohibited by international trading rules, and that it adhere to the Government Procurement Agreement, as a condition for Taiwan's entry into the GATT/WTO. Taiwan continues to restrict access to its financial services markets. All goods entering Korea require an import licence issued by the Foreign Exchange Bank. While 99 per cent of imported goods receive routine approval, the remaining tariff line items, which tend to fall in the agricultural and fishery

requirements, shortages of skilled professionals, and the absence of long-term capital markets that are essential for large-scale financing may also be constraints.

A brief overview follows of the five North Asian economies' individual development strategies, economic performance and other factors that could affect the prospects for regional integration. Growth and production trends, development strategies, recent changes in economic policy, remaining barriers to trade and investment and political factors that might influence further advancement of economic interdependence are briefly reviewed.

2.1 Japan

Japan is a country with a mountainous and often inhospitable terrain that has resulted in much of the population living in congested conditions and with a resource endowment that has forced it to source resources globally. Yet, Japan's economic successes are well documented.⁹ It would appear that Japan's trade successes have been built on a foundation of economic stability created by sound and well managed macroeconomic policies. Over the past 35 years, Japan generally has experienced good to exceptional real GDP growth, with low rates of inflation, unemployment and debt growth. It has successfully developed a skilled labour force that can develop and adopt both domestic and foreign know-how and technology. Its high savings rate has provided funds that could be channelled into investments in new technology that made rapid productivity growth possible. Japan, of course, also has focussed heavily on exports.

Over the last three decades, Japan's nominal GDP has grown from roughly 10 per cent of the U.S.'s to approximately 54 per cent. The pursuit of growth has been an overriding goal of Japanese economic policy. The broad structure of Japan's economy is similar to that of the other G-7 economies. Manufacturing generates approximately 30 per cent of GDP and services about one-half. The primary sector, including agriculture and mining, contributes less than three per cent of GDP. It is only

products categories, are subject to quotas or are banned. Korea maintains laws that empower ministries to make products subject to "recommendations" that can result in a quota or a ban. There are reports that Korea uses custom clearance procedures to slow imports that are not subject to restrictions under Korean law. Korea also maintains restrictions on foreign investment in some services sectors. Source: 1994 National Trade Estimate Report on Foreign Trade Barriers, Office of the U.S. Trade Representative, Washington, 1994.

⁹ For a detailed narrative on the topic of Japan's economic and trade successes, see I. Prakash Sharma, "Japan Trading Corp.: Getting the Fundamentals Right", Department of Foreign Affairs and International Trade, Policy Staff Paper 93/16, December 1993.

relatively recently that imports of manufactures, by value, have exceeded imports of oil and food products. Japan consumes a smaller proportion of GDP, while capital formation contributes a larger share of aggregate demand, than is typical for OECD economies.

Japan's manufacturing sector is the foundation on which the economy has been built. It has been challenged by protectionism elsewhere, a strong yen, the rise of the NIEs and the other industrialising economies of Asia, and the deadweight of an inefficient distribution system and certain other service industries. Competition from the newly industrialised economies has caused a shift in the structure of production in Japan towards higher value-added and the services sectors, and away from heavy industries. Japanese manufacturers are spending significant sums on R&D. They are also shifting production to overseas sites, both to lower costs and to reduce its trade surplus and the resulting protectionist sentiment in its major markets abroad. There is an ongoing re-location of manufacturing to lower cost sites both within the North Asia region, particularly China, and the economies of Southeast Asia.

There are concerns in Japan that this economic restructuring may lead to reductions in manufacturing employment at home that will not be offset by increased employment opportunities in the new industries. The Japanese government is attempting to reduce the country's dependence on exports as an engine of growth and to encourage the expansion of domestic, and particularly consumer, demand through deregulation and tax reforms. Moreover, it is hoped that the rise in import spending that will accompany the increase in domestic demand will reduce the country's ongoing trade surplus. The ability of Japanese firms to adapt quickly to changing economic circumstances has been one of the country's greatest economic strengths. It is now being challenged once again.

Japan's industrial structure is characterized by inter-firm networks, known as keiretsu. Traditionally, keiretsu were organized around one of the country's large trading houses. Today, these structures typically connect a large corporation with a network of suppliers, which frequently are small firms. Surprisingly, in the manufacturing sector almost 50 per cent of the labour force works in firms with less than 50 employees. Moreover, only one-third of all Japanese workers have "positions for life", a practice confined to the major corporations. Japan's large corporations increasingly are relying on parent-subsidiary relationships to expand (as opposed to multi-division conglomerate structures).¹⁰

¹⁰ I. Prakash Sharma, *op. cit.*

The keiretsu system has proven to be an efficient organizational structure that provides incentives to suppliers to remain efficient and flexible, and good at transferring information between economic agents within the entity.¹¹ In competitive market situations, where Japanese domestic markets are not distorted by trade restrictions, or by discriminatory or otherwise restrictive domestic regulations or practices, the keiretsu system may not reduce competition. In non-competitive market situations, where economic rents are available, the system would allow for collusive business practices. Many observers conclude that the keiretsu may make it more difficult for foreign firms (including firms from elsewhere in North Asia) to penetrate domestic Japanese markets.¹²

2.2 Korea

South Korea (Korea) is a densely populated country with few natural resources. It is also subject to an ongoing security threat from the Democratic People's Republic of Korea (DPRK). Over the past three decades, however, Korea has risen from the ranks of the poorest economies in Asia to stand on the verge of becoming an advanced industrial economy. Korea's recent economic performance has been impressive, with annual real GDP growth averaging almost 9 per cent between 1980-93.¹³

The first phase in Korea's economic development occurred after the military government of General Park Chung Hee took control in 1961. After a few years of poor economic performance, the Park government reversed the country's previous course favouring import substitution and introduced a five-year plan that adopted a more outward-oriented strategy. The state continued to play a major role in the economy, however, with export targets being formulated in considerable detail. The government encouraged the establishment of general trading companies along the lines of Japan's approach, and giant industrial conglomerates (called chaebol) similar to Japan's keiretsu.

¹¹ For a detailed narrative on the keiretsu system and the trade implications for foreign firms, see James McCormack, "The Japanese Way: The Relationship Between Financial Institutions and Non-Financial Firms", Department of Foreign Affairs and International Trade, Policy Staff Paper No. 93/16, June 1994.

¹² For example, see I. Prakash Sharma, *op. cit.* p. 26.

¹³ World Bank, World Tables 1994, Washington, 1994.

Korea's reliance on exports and state intervention was eased somewhat after an unsuccessful attempt to promote heavy and chemical industries during the 1970s. In the mid 1980s, the government altered its previous course of promoting strategic industries, and introduced measures for trade and financial liberalization. The process of import liberalization was continued under the Sixth Five Year Plan (1987-91). The simple average of tariff rates declined from 31.7 per cent in 1982 to 10.1 per cent in 1992.

The structure of the Korean economy has undergone significant change. Agriculture as a share of total output has declined from over 40 per cent in the early 1960s to less than 10 per cent in 1991. Conversely, manufacturing has increased from about 15 per cent of GDP in the early 1960s to roughly 30 per cent in 1991. Trade has played an increasing role in the Korean economy as well. Between 1965 and 1991, exports increased from about nine per cent of GDP to almost 30 per cent, while imports doubled from 16 per cent to 32 per cent. The U.S. continues to be Korea's primary export market, taking 24 per cent of its exports in 1992,¹⁴ while Japan, with 24 per cent of the market, is Korea's biggest supplier of imports. Korea registered an overall trade deficit of US \$6.7 billion in 1992, and a trade deficit of US \$2.9 billion with the North Asian economies.

Foreign direct investment has not played a major role in Korea's export industries. Most foreign investment in Korea has taken the form of commercial loans rather than direct investment. Inflows of foreign capital have been small when compared to flows into some other countries in North Asia such as China or Hong Kong.¹⁵

Recent economic problems experienced by Korea include declining industrial competitiveness, sluggish growth in its key export markets, sustained high inflation rates and a slowdown in GDP growth rates in recent years. Because of appreciation of the won since the mid 1980s,¹⁶ and rising labour and land costs, Korea is

¹⁴ IMF, Direction of Trade Statistics Yearbook, Washington, 1993.

¹⁵ Korea received an annual average US \$170 million in FDI in the first half of the 1980s. The annual flow increased to US \$812 million during the second half of the decade. This represented approximately 0.5 per cent of world flows. This compares to figures of US \$646 million and US \$2,037 for Hong Kong for the same periods. Sources: IMF, Balance of Payments Statistics; and UN/CTC, World Investment Report, 1994.

¹⁶ The Korean won has appreciated from an annual average of 881 won/US \$1 in 1986 to 733 won/US \$1 in 1991, although it slid back to 781 won/US \$1 in 1992. Source: World Bank, 'World Tables', Washington, 1994.

endeavouring to restructure its economy. One indicator which reflects this decision has been the rapid increase in the outflow of foreign direct investment from Korea. Between 1980 and 1990, the total stock of Korea's direct investment abroad increased by almost 600 per cent from 0.3 to 1.5 per cent of its GDP,¹⁷ with economies in North America (42 per cent) and the ASEAN group (27 per cent) being the principal recipients. The North Asian economies had received only 4.2 per cent of the stock of Korea's outward FDI flow as of 1990. These investments have tended to be focussed in the large-scale manufacturing sector and have been trade-related.

2.3 Taiwan

Taiwan has few resources other than a well-educated and hard-working labour force. Nevertheless, Taiwan's economic performance during the past decade has been strong, with real annual GDP growth averaging 7.4 per cent between 1980 and 1993. Taiwan is currently one of the richest nations in Asia, with a per capita GDP estimated at US \$10,100 in 1992 and foreign exchange reserves exceeding US \$90 billion at the end of 1994.

Taiwan's early postwar efforts at industrialization combined fairly heavy trade protection for domestic manufactures with an overvalued currency. The state also became involved in a number of heavy industries, such as chemicals. Small businesses played an important role, particularly in the more successful export sectors such as textiles and electronics. The program began to falter in the 1950s because of the small domestic market and the inefficiencies in the protected industries. Between 1958 and 1961, Taiwanese authorities introduced a reform program that included trade liberalization, a currency devaluation and export promotion measures. Free trade zones were established in 1965. Accompanying these reforms were efforts to promote strategic industries through preferential loans, tax exemptions and special tax holidays.

Trade has played a crucial role in Taiwan's economic development. Between 1963 and 1988, exports and imports as a share of GDP rose from 17.8 and 18.9 per cent to 57.0 and 47.4 per cent, respectively. The structure of Taiwan's economy has also undergone considerable change. Between 1953 and 1987, agriculture's share of GDP fell from 38.3 per cent to 6.1 per cent, while that of manufacturing increased from 17.7 per cent to 47.5 per cent. Traditionally, Taiwan's manufacturing activity was concentrated in labour-intensive industries, such as footwear and apparel.

¹⁷ World Bank, *World Tables*, Washington, 1994.

Taiwan's spectacular export success and high savings rate translated into mounting foreign exchange reserves and inflationary pressures in the mid 1980s. The U.S. strongly urged Taiwan to revalue its currency and to liberalise outward flows of capital. The ensuing appreciation of the New Taiwan dollar after 1987 and increased wages and land prices gradually eroded the competitiveness of Taiwan's labour-intensive industries relative to those of a number of South-East Asian economies, as well as China. The loss of trading privileges under the U.S. GSP scheme in 1989 accelerated this process. Traditional labour-intensive industries are now being phased out or transferred offshore and are being replaced by more capital- and skill-intensive industries, such as electronics.

Taiwan's pattern of trade reflects its industrial structure. Over 90 per cent of Taiwan's exports are manufactured goods, and trade is concentrated with developed countries, although trade with the Chinese mainland is increasing. The U.S. takes roughly one-third of Taiwan's exports, followed by the EU with 15-20 per cent, and Japan with 12 per cent. Exports to Hong Kong were also sizeable, although a significant portion was re-exported to China. Japan supplies about 30 per cent of Taiwan's imports, followed by the U.S. with 20-25 per cent and Hong Kong with 6-7 per cent. Taiwan's trade with the other Asian NIEs has been relatively modest. Taiwan registered an overall trade surplus of US \$9.1 billion in 1992, down from US \$11.7 billion in 1991. This surplus included a surplus of almost US \$11 billion with the U.S. and a deficit of US \$11.8 billion with Japan.¹⁸

Foreign investment, in a variety of forms and from different sources, has played an important role in Taiwan's economic development. Japanese firms invested in Taiwan during its colonization which ended with WWII. During the 1950s, the chief source of capital inflow was concessional aid from the U.S.. In the 1960s, foreign investment, principally from the U.S. and Japan, played a role in the shift to labour-intensive export manufacturing. Nevertheless, foreign direct investment in the 1950s through the 1970s never amounted to more than ten per cent of total funding of manufacturing. Foreign investment surged during the 1980s, reflecting new investor confidence following the ending of martial law in 1987, expectation of further appreciation of the New Taiwan dollar and the partial lifting of exchange controls.

Overseas Chinese accounted for approximately 30 per cent of foreign direct investment in Taiwan in the 1960s and 1970s, but this dropped to an average of ten per cent during the 1980s. Japan is the leading non-Chinese investor in Taiwan, accounting for approximately 30 per cent of total stock of inward foreign direct investment up to 1990, compared with 28 per cent for the U.S. and nine percent for

¹⁸ IMF, Direction of Trade Statistics Yearbook, Washington, 1993.

the EU states. Inward FDI flows have been heavily concentrated in the manufacturing sector, particularly the electronics industry. Taiwan's outward investment has been concentrated in the industrial sector, although the figure has declined from 85 per cent to 66 per cent. This has been offset by an increase in the share of Taiwan's outward investment that has been going to the tertiary sector.¹⁹

2.4 Hong Kong

Hong Kong is strategically located along international trade routes and possesses superb port facilities and an industrious labour force. Trade, and increasingly trade with China, is the lifeblood of the territory. Hong Kong is devoid of natural resources and almost entirely dependent on imports to meet the raw material needs of its industries. Exports generate the foreign exchange to pay for these imports. Hong Kong's success has relied principally on encouraging foreign direct investment and free trade. Recent economic performance continues to be impressive, with real GDP growth averaging 6.3 per cent per annum between 1980-93.

The current government maintains no manufacturing operations, imposes few business regulations and maintains virtually no controls on international trade. The government has largely limited its role to maintaining physical infrastructure, such as transportation, ports and housing, and to providing social services, such as education and health care. While Beijing has promised not to alter the economic system in place in Hong Kong after it repossesses the colony in 1997, the prospect exists that China will not intentionally kill the laissez-faire system that currently exists, but that it may, through bureaucratic meddling, cause the system's arteries to harden.

The principal challenge facing Hong Kong has been to shift from the production and export of labour-intensive products, such as textiles and apparel, to more capital- and skill-intensive goods, such as electronics. While the share of total exports occupied by textiles and apparel remained relatively steady during the 1980s--around 39 per cent--there has reportedly been a continual upgrading of goods within this sector to a higher value-added level. Most of Hong Kong's manufacturing activities, however, are still concentrated in light industries, such as electrical and consumer electronic products, toys, and clocks and watches.

China is currently Hong Kong's most important trading partner, reflecting the key role played by Hong Kong as a conduit for trade between China and the rest of

¹⁹ U.N./C.T.C., *World Investment Directory 1992, Volume I: Asia and the Pacific*, 1992. For further investment details, see section 4 below.

the world. Thirty per cent of Hong Kong's trade involves China, while 40 per cent of China's trade passes through Hong Kong. Total two-way trade between Hong Kong and China amounted to an estimated US\$60 to US\$80 billion in 1992.²⁰ Commercial links have surged since China embarked on its economic reform program in the late 1970s and introduced trade liberalization and the special economic zones in the early 1980s. Furthermore, indirect trade between Taiwan and China has been increasing rapidly in recent years.

Foreign direct investment has played a critical role in Hong Kong's development. Hong Kong welcomes foreign investment, and no official distinction is made between investments by foreign companies and those controlled by local interests. Estimates on cumulative foreign direct investment in Hong Kong suggest that Japan and the U.S. are the leading investors in Hong Kong, with each having supplied approximately one-third of the stock of inward foreign direct investment as of 1990.²¹ China's role as an investor in Hong Kong has been expanding rapidly, rising to about 10 per cent of the total stock in 1990 from nothing in 1980. Foreign corporations are attracted by Hong Kong's role as a future capitalist enclave within China.

2.5 China

China has experienced considerable turbulence in its efforts to develop its economy in the postwar period. While China's efforts to modernize since 1949 have brought the country from abject poverty to the ranks of the middle-income developing economies, it is during the post 1979 economic reform period that it has experienced truly dramatic economic growth and development. Political and foreign policy considerations have always played a crucial role in shaping China's approach to economic development and will continue to do so. Nonetheless, even before the reform period, Chinese decision-makers recognized the importance of trade for economic growth and development.

For most of the post-war period, there was little opportunity for private enterprise. State industries operating under China's central planning system dominated all facets of economic activity. Although this strategy helped to organize China's productive resources to meet many basic needs, the lack of incentives

²⁰ Hong Kong figures suggest the total value of two-way trade was US\$81 billion in 1992, with China enjoying a surplus of almost US\$10 billion. Figures for China indicate that the total was US\$58 billion, with China recording a surplus of US \$17 billion. Source: IMF, Direction of Trade Statistics Yearbook, Washington, 1993.

²¹ U.N./C.T.C., World Investment Directory 1992, Volume I: Asia and the Pacific, 1992.

eventually caused economic growth to stagnate. Moreover, China's economic development suffered serious setbacks as a result of the Great Leap Forward of the 1950s and the Cultural Revolution of the 1960s and 1970s. The leadership group led by Deng Xiaoping which took control following Mao Zedong's death realized, as does the next generation of Chinese leaders, that the survival of the Chinese Communist Party depends on raising living standards. Soon after ascending to power, Deng initiated China's economic reform program and opening to the outside world.²²

The Chinese economy achieved impressive results after the reform process was initiated, with real GDP growth averaging 9.4 per cent per annum since 1980. The economic reform period has been characterized by a recurring boom/bust cycle. Periods of rapid economic growth, accompanied by macroeconomic imbalances and high inflation, were only arrested when the central government imposed corrective austerity programs. The most serious episode took place in 1988 when soaring inflation, increasing corruption and a deteriorating trade balance, forced the government to introduce a comprehensive austerity program that sent the economy into recession in 1990. Concerns about declining output, state enterprise losses and growing unemployment forced the government to begin reflating the economy and led Deng to initiate the latest round of economic reform and rapid growth. Subsequently, the Chinese economy has been growing at a rapid pace, with GDP increasing at an average rate of about 11 per cent per annum since the last quarter of 1990.

The leadership cadre is now attempting, *inter alia*, to develop the instruments and institutions needed to conduct fiscal and monetary policy, renegotiate the fiscal relationship between the central and provincial governments, and address the issues of state enterprise reform and regional disparities. The leadership hopes that China can grow out of these problems. It has only moved to restrain economic growth when it appeared that the economy was in danger of 'overheating', and then only modestly and temporarily. The leadership is well aware of the precariousness of their position, that stability requires continued economic growth, and that continued growth requires stability.

The importance of trade to the overall structure of the Chinese economy has increased markedly over the course of the reform period. Exports as a percentage of GDP increased from 6.5 per cent of GDP in 1980 to 17.5 per cent in 1990, while

²² For a more detailed review of China's reform experience, see World Bank Country Study, Reform and the Role of the Plan in the 1990s, World Bank, Washington, 1990; or Stephen Lavergne, "China 2000: The Nature of Growth and Canada's Economic Interests", Department of Foreign Affairs and International Trade, Policy Staff Paper No. 94/10, May 1994.

imports rose from 5.9 per cent to 15.4 per cent during the same period.²³ Between 1980 and 1992, China's total exports increased from US\$18 billion to approximately US\$86 billion. Imports climbed from US\$19.5 billion to US\$82 billion during this same period.²⁴ Since the late 1970s, China has run trade surpluses only in years following the implementation of austerity programs.

China trades more with Asia than with any other region (Asian APEC accounts for 70 per cent of China's total trade, while the Asian economies of North Asia account for 57 per cent). Hong Kong is China's most important trading partner, although much of it takes the form of entrepôt trade. Following Hong Kong, which typically takes over 40-45 per cent of China's exports, China's most important export markets were the U.S. and Japan.²⁵ The same three economies are the three top suppliers of China's imports. China's trade with Southeast Asian economies remains modest, despite improving political relations with those countries.

Despite China's efforts to date to reform and liberalize its trade regime, a multilayered system of trade restrictions still exists. China's import licensing system covers 53 broad categories, or about one-half of China's imports by value. A lack of transparency has also proved to be a formidable barrier. Many of China's trade rules and regulations have been unavailable to foreign firms. In late 1992, in response to a U.S. Section 301 investigation of China's import barriers, China committed to reducing many nontariff barriers by December 1997.²⁶ Such continuing reform is also a prerequisite to China's accession to the GATT/WTO, with these negotiations perhaps nearing their conclusion.

China can be expected to continue to introduce new policies to liberalize its investment regime to attract foreign capital. The current wave of foreign investment that China is enjoying is by far the largest that it has experienced. Most foreign investment in China has gone to coastal areas, primarily Guangdong province. Foreign firms increasingly are looking to invest inland, however, as they set up production and distribution facilities designed to service China's domestic markets rather than export destinations. The increased flows of FDI also include a component that is actually

²³ World Bank, World Tables, Washington, 1994.

²⁴ IMF, Direction of Trade Statistics, Washington, 1987/1993.

²⁵ IMF, Direction of Trade Statistics, Washington, 1993.

²⁶ Office of the U.S. Trade Representative, 1994 National Trade Estimate Report on Foreign Trade Barriers, Washington, 1994.

investment by domestic Chinese firms.²⁷ This "round-tripping" is the result of efforts by Chinese firms to access the preferential treatment provided to foreign investors, as well as endeavours to stash assets off-shore. Chinese investors channel their investments through foreign intermediaries, generally located in Hong Kong. As the 1997 date for the return of Hong Kong approaches, however, the mainland investors may move their investment platforms farther afield. The exact size of this flow is unknown.

The main sources of foreign investment have been Hong Kong (including the somewhat misleading "round-tripping" component mentioned above), Taiwan, Germany, Japan and the U.S.. Foreign investment from Hong Kong and Taiwan has been concentrated in the southern and coastal provinces of Guangdong, Fujian and Jiangsu, although investors from Hong Kong are also leading the charge into the interior. Japanese investment has been concentrated in East and Northeast China, as has investment from Korea. Although the Japanese and Korean stakes have been largely in the light industrial sector, investment in larger-scale projects is beginning.

2.6 Russia/FSU

Russia inherited the remnants of the former Soviet Union's (FSU) centrally-planned economic system. While production and allocation decision-making authority notionally flowed down from the State Planning Committee through ministries at the industry and sector level to the various enterprises, economic decision-making was heavily influenced, if not actually controlled, by the Communist Party. All means of production and assets were owned by the state. The system stifled incentives and individual initiative, and eventually led to macroeconomic imbalances and suboptimal, if not perverse, microeconomic equilibria. The system was inefficient and unprofitable. The abundance of resources available in Russia may have masked these problems in the early years of the regime, but as the economy grew and developed, and growth became more dependent on the intensive rather than the extensive use of resources, the system could not cope.

Nikita Khrushchev first attempted to introduce reforms into the system in the early 1960s. He allowed some decision-making authority to devolve to the various regions, however, rather than to enterprise managers. The Kosygin reforms which followed in the late 1960s were reversed when it became apparent that partial change

²⁷ See C. Fred Bergsten and Edward M. Graham, Towards an Asia Pacific Investment Code: Issues and Options, Institute for International Economics, Washington, 1994, p.3. For an expanded discussion of this issue, see Nicholas Lardy, China in the World Economy, Institute for International Economics, Washington, 1994.

was not going to solve the country's existing economic problems, and in fact would create new ones. The decision was taken to retreat rather than to push forward. The piecemeal and very minor reforms that were implemented at the margins in the 1970s and early 1980s could not reverse the economic stagnation that had set in.

Mikhail Gorbachev initially believed that reform could improve the performance of the economic system without destroying the Communist Party. He realized, however, that reform was necessary, and his experimentation with reform led to ever more radical change. In August 1990, the reform cadre put together by Gorbachev came up with a plan to convert from the existing framework to a market system within 500 days. The plan was to stabilize the government's budget position and introduce a widespread and radical privatization program, followed by sweeping price liberalization. Under pressure from conservatives, the program was abandoned in the fall of 1990. A period of economic crisis followed: output dropped, while prices and the size of the budget deficit soared. The Soviet Union, of course, dissolved.

In late 1991, Russian President Yeltsin introduced a stabilization plan that was designed to liberalise most prices, reduce the central government's budget deficit and initiate a privatization program. The stabilization program was inconsistently applied (some observers might suggest that it was not implemented at all), leading to an acceleration of inflation and a further fall in output. This has led to an increasingly intense political struggle over the future of economic reform, with reformers often citing a lack of financial support from the West as one of the main obstacles preventing them from pushing ahead with further reform.

The inefficient collectivized agricultural system of the FSU promoted stagnation and waste. For the last 20-25 years, Russia has had to import large volumes of grain and animal feed. Estimates indicate that 25-30 per cent of total agricultural production is lost during harvesting, transport or in storage. For perishable products, the estimates for losses run to 70 per cent. Agricultural production has tended to decline throughout the 1980s and early 1990s. The government has responded by introducing market reforms, including price decontrol and de-collectivisation. Market reforms have made slow headway, with most farms still making obligatory deliveries to the state. The 1993 Presidential decree allowing the sale of land to farmers should eventually lead to the creation of a private agricultural sector.

Russia is a major producer and exporter of timber. The extensive resource use policies of the FSU have resulted, however, in Russia's forests being overexploited. Logging has moved steadily eastward in Siberia, which now accounts for one-third of Russia's sawn timber production. The economic crisis of the last three years has not missed this sector, however, with production declining since 1992. Production in the

paper and other associated sectors has also declined.

Russia's fishing industry ranks fourth in the world. Russia produces roughly one-quarter of the world's production of fresh and frozen fish and one-third of the output of tinned fish.

Russia is well endowed with mineral resources, particularly in the Ural mountain region, Siberia and the far east. That said, both output and exports, with the exception of aluminum, have declined in recent years. There is much potential for further development and exploitation of Russia's resources. But continuing uncertainty about the country's macro and microeconomic policies and performance have seriously undermined the attractiveness of Russia for domestic and foreign investors, including those from Japan and Korea.

The FSU was the world's leading producer of all major fuels and has significant proven deposits. In 1991, the FSU held 8-12 per cent of the global proven deposits of oil. 85 per cent were located in Russia. In that year, Russia accounted for 90 per cent of the FSU's production of oil and 80 per cent of its production of natural gas. Exports of oil and natural gas to Western Europe and the former CMEA economies of Eastern Europe have been the primary sources of foreign currency earnings for Russia. There is little trade in these products with North Asia. Moreover, there have been significant overall declines in both the output and exports of oil over the course of the past decade. In 1992, oil production was more than 25 per cent lower than it was in 1980. This decline has been the result of the depletion of existing oil fields, the deterioration in transport infrastructure and a lack of investment. The Russian government hopes to reverse this trend by increasing domestic energy prices and opening this industry to foreign investment. It probably will take until the end of the century to reverse the trend, if not longer. While the production of natural gas has flattened in the early 1990s, this sector has avoided the even deeper problems plaguing the oil sector.

While Russia accounted for over one-half of the FSU's exports and about 40 per cent of its imports, almost three-quarters of these exports and one-half of its imports were with other FSU republics. Both imports and exports with economies outside the FSU have fallen significantly during the 1990s. And the fact is that, with regard to extra FSU commerce, Russia trades primarily with economies in Europe. China is its leading trading partner among the economies of North Asia, but Russia clearly is not yet a significant factor in North Asian economic integration.

3. Regional Institutions and Integration Schemes

In recent years, the Asian economies have looked to regional organizations as a focal point for furthering common economic interests. A wide spectrum of organizations and proposals are now aimed at forging closer political and/or economic ties in the Asia Pacific region. These range from the evolving APEC forum for intergovernmental dialogue to the ASEAN group to the East Asian Economic Caucus.²⁸

The APEC appears to be evolving into the primary forum for promoting economic cooperation in Asia and the main multilateral medium for North American economies to engage the Pacific Rim economies as a group. The members generally recognize the need for a venue that can support, strengthen and push forward the multilateral trading and investment system, to assess and promote intra- and inter-regional trade, and to identify common regional trade and economic interests. Thus far, APEC has proved useful as a gathering point for Asia Pacific economies wishing to discuss regional economic issues. Indeed, APEC can go much farther as an institution, helping to address Asia Pacific economic issues under the framework of "open regionalism". The concept of "open regionalism" is still evolving, but generally implies the lowering of trade and investment barriers on a regional basis without erecting any new ones to economies outside the region, and in a manner that is consistent with the GATT/WTO. Some see a much larger role for APEC in the future, including the possibility of shaping it into an Asia Pacific version of the OECD (i.e., a key vehicle for information exchange and policy coordination in the region), or of transforming it into a free trade area over the longer term.²⁹ Others believe, however, that APEC's main role is to serve as a counter-weight to more exclusionary

²⁸ The East Asian Economic Caucus (EAEC) evolved from the East Asian Economic Group (EAEG) at the October 1991 meeting of the ASEAN economic ministers. Malaysian Prime Minister Mahathir originally envisaged the EAEG as a forum for East Asian economies to discuss and develop common positions on economic and trade issues, and to provide more leverage for the region in international negotiations. The name change was invoked to address concerns that a closed regional trading bloc was being proposed. It was later decided that the Caucus would work within the APEC context.

²⁹ The November 1994 Leaders' Communiqué adopted at the Summit held in Bogor, Indonesia sets the goal of establishing a trans Pacific free trade area, with a target of 2010 for the developed economies and 2020 for the developing economies.

proposals.³⁰

Japan has officially opposed the formation of exclusive trading blocs and encouraged western countries to expand their relations with the Asian economies. Furthermore, Japan appears committed to the "open regionalism" approach to economic cooperation and trade liberalization in Asia. Japan's views of, and relations with, APEC have evolved along with the organization itself. Japan originally signalled that it would prefer APEC to be a loose conclave. More recently, however, Japan has taken a greater interest in APEC as a regional institution. It would appear that Tokyo may be looking to APEC to be the forum for regional policy consultations and economic cooperation. Japanese ambitions to be the leader of an Asian grouping may be tempered by concern that a high diplomatic profile could resurrect fears of Japanese dominance. That said, APEC could provide the framework through which Japan might move toward a position of shared policy leadership with the U.S. in the Asia Pacific region.

The process of economic and political cooperation in the region is starting to quicken. While we do not foresee the Asian economies turning inward, they may eventually decide that they can better promote their interests by presenting their views from the standpoint of regional groupings. Continued rapid economic growth in North Asia, combined with continued economic reform in China which will encourage increased interdependence in the region, will provide further incentives to strengthen ties, but the institutional focus will likely remain on APEC as a whole rather than some form of North Asian caucus.

4. North Asia's Trade and Investment Patterns

The 1980s were a period of rapid growth in world trade, and North Asia was a strong participant in this trend, particularly China in the latter part of the decade. The dollar value of North Asia's global trade (exports plus imports for the group excluding Russia) roughly tripled to US\$1.3 trillion between 1980 and 1992. With exports of US\$702 billion and imports of US\$592 billion in 1992, this group of five Asian economies accounted for approximately 20 per cent of world exports and 15 per cent of world imports. Moreover, the region generated a surplus of US\$110

³⁰ If the APEC can embrace the concept of open regionalism and advance the multilateral trade and investment agenda, and still promote the interests of its members at their various stages of development, there will be no need for any group to form its own club to champion specific sub-regional interests.

billion on its global trade. The U.S. continued to be the most important export market for the North Asian economies. Japan continued to be the major source of imports for the three NIEs in the region and a growing, but relatively smaller, market for their exports. The U.S. was the largest source of imports for Japan and, via Hong Kong, for China.³¹

When looking at the issue of regional integration, it must be assumed that you are looking for more than just increases in the absolute levels of trade and monetary flows between member economies. There must be indications that the intraregional share of the member economies' total trade and financial flows exceeds, or is increasing more quickly than would be predicted by factors such as GDP growth rates of the member economies. If the data suggest that an economic or trade bloc is forming, one must then determine whether or not this trend is the product of deliberate policy measures by the governments of the respective member economies.

Between 1980 and 1993, intraregional trade grew in both absolute and relative terms. Total exports between the five Asian economies increased from approximately US\$40 billion in 1980 to US\$154 billion in 1990, to roughly US\$238 billion in 1993.³² The share of their exports going to the other members of this grouping relative to total world exports for these five economies increased from about 20 per cent in 1980 to approximately 30 per cent in 1990, to roughly one-third in 1993.³³ That said, however, while bilateral trade between member countries expanded during the 1980s, the increases were, for the most part, modest in relative terms (see Table 4.3). The exception was China-Hong Kong bilateral trade, which accounted for much of the increase in intraregional exchanges in relative terms. Much of their bilateral traffic is entrepôt trade that is ultimately shipped in or out of the region. Consequently, if entrepôt trade is factored out, it would appear that the widespread, but relatively modest, increase in intraregional trade in relative terms that is observed does not support the thesis that economic integration is dramatically increasing in North Asia.

Intraregional flows of foreign direct investment (FDI) also grew substantially during the decade, as many companies from Hong Kong, Taiwan, Korea and Japan moved their labour-intensive operations to lower-cost China. The total stock of FDI in the five Asian economies under study attributed to flows from other economies in

³¹ IMF, Direction of Trade Statistics (DOTS) Yearbook 1993, Washington, D.C., 1993.

³² See sub-section 4.1 below for a more detailed description of intraregional trade.

³³ International Trade Databank.

the North Asia region increased from US\$2.2 billion in 1980 to US\$17.2 billion in 1990, an increase of 681 per cent.³⁴ U.S. investment in the region also increased, but at a less spectacular pace than Japan's. As will be detailed in sub-section 4.3 below, however, there is no indication of a trend to intraregional investment accounting for a greater share of total outward investment from the North Asian economies.

The relationship between FDI and trade is often debated. In some cases the establishment of overseas subsidiaries, such as manufacturing facilities, can substitute for exports from the home country. In other cases, such as in wholesale distribution or parts assembly, FDI can enhance export opportunities. Foreign affiliates can be a source of information about overseas market opportunities and affiliates may be a source of demand for home-country produced capital goods.

4.1 Trade Patterns

North Asian intraregional trade has increased from roughly 18.5 per cent of total North Asian trade (exports plus imports) in 1980 to nearly 34 per cent in 1992, with intraregional imports totalling US\$221 billion in 1993. This increase reflects the rapid growth that the economies of North Asia have enjoyed over this period.

Japanese exports to the rest of North Asia of US\$71.6 billion (see table 4.1) in 1992 exceeded Japanese exports to any other individual country or region, surpassing exports to the U.S. by almost US\$20 billion and to the EU by US\$9 billion. The share of total Japanese exports going to North Asia was 21 per cent in 1992, up from 18 per cent in 1985 and 16 per cent in 1980. Japanese imports from North Asia quadrupled to US\$40 billion between 1980 and 1992. This compares to Japanese imports from the U.S. of US\$53 billion in 1992 and imports from the EU of US\$31 billion. The share of total Japanese imports originating in North Asia was 17 per cent in 1992, up from 11 per cent in 1985 and 8 per cent in 1980.

³⁴ As mentioned previously, however, an important component of the increased flow of FDI into China is actually investment by domestic Chinese firms. This "round-tripping" reflects efforts by Chinese firms to access the preferential treatment offered to foreign investors, as well as attempts to bury assets through off-shore connections. Chinese investors channel their investments through foreign intermediaries, generally located in Hong Kong. Round-tripping should be viewed as domestic investment and, if the exact size of this flow were known, the value of the flow from Hong Kong could be disaggregated. This would reduce the magnitude of the intraregional investment flow. See C. Fred Bergsten and Edward M. Graham, "Towards an Asia Pacific Investment Code: Issues and Options", Institute for International Economics, 1994, p.3.

Fact or Fancy?: North Asia Economic Integration

Table 4.1-1
North Asia (excluding Russia) Intraregional Trade-Exports

1980 Recipient							
Source	Exports	Japan	China	HongKong	Taiwan	Korea	
Japan		0	4032	908	2293	3032	
China		5078	0	1253	0	0	
HongKong		4761	4353	0	1597	823	
Taiwan		5146	0	615	0	212	
Korea		5368	0	227	313	0	
Total		20353	8385	3003	4203	4067	40011

1985 Recipient							
Source	Exports	Japan	China	HongKong	Taiwan	Korea	
Japan		0	5695	1274	3386	4543	
China		12480	0	7824	68	0	
HongKong		6538	6715	0	2671	1566	
Taiwan		5063	0	713	0	196	
Korea		7130	0	541	333	0	
Total		31211	12410	10352	6458	6305	66736

1990 Recipient							
Source	Exports	Japan	China	HongKong	Taiwan	Korea	
Japan		0	9011	4681	8496	12638	
China		6130	0	20336	3639	0	
HongKong		13072	26630	0	2671	3780	
Taiwan		15430	320	3463	0	1249	
Korea		17457	1260	1908	1452	0	
Total		52089	37221	30388	16258	17667	153623

1992 Recipient							
Source	Exports	Japan	China	HongKong	Taiwan	Korea	
Japan		0	11679	6262	9467	11599	
China		11926	0	35427	5866	2654	
HongKong		20734	37512	0	11246	5909	
Taiwan		21153	695	4239	0	2262	
Korea		17793	2405	1953	1315	0	
Total		71606	52291	47881	27894	22424	222096

Source: International Trade Database, selected years.
Note: Partner Country Data used for Taiwan.

Table 4.1-2
North Asia (excluding Russia) Intraregional Trade-Imports

1980		Source					
Recipient	Imports	Japan	China	HongKong	Taiwan	Korea	
Japan		0	5169	5144	5146	5838	
China		4323	0	4402	0	0	
HongKong		569	570	0	615	98	
Taiwan		2293	0	1597	0	313	
Korea		2996	0	776	212	0	
Total		10181	5739	11919	5973	6249	40061
1985		Source					
Recipient	Imports	Japan	China	HongKong	Taiwan	Korea	
Japan		0	14236	6821	5063	7531	
China		6483	0	7537	0	0	
HongKong		767	4451	0	713	492	
Taiwan		3386	68	2671	0	333	
Korea		4092	0	1060	196	0	
Total		14728	18755	18089	5972	8356	65900
1990		Source					
Recipient	Imports	Japan	China	HongKong	Taiwan	Korea	
Japan		0	7587	13271	15430	18574	
China		12054	0	30317	595	0	
HongKong		2173	14151	0	713	614	
Taiwan		8496	2255	7458	0	1452	
Korea		11707	684	3615	1249	0	
Total		34430	24677	54661	17987	20640	152395
1992		Source					
Recipient	Imports	Japan	China	HongKong	Taiwan	Korea	
Japan		0	13682	21486	21153	19458	
China		16926	0	45798	695	3725	
HongKong		2044	20534	0	4239	794	
Taiwan		9467	5866	11246	0	1315	
Korea		11568	2623	5784	2262	0	
Total		40005	42705	84314	28349	25292	220665

Source: International Trade Database, selected years.
Note: Partner Country Data used for Taiwan.

Fact or Fancy?: North Asia Economic Integration

Table 4.2-1								
North Asia (including Russia) Intraregional Trade-Exports								
1980								
Source	Recipient	Japan	China	HongKong	Taiwan	Korea	FSU	
Japan	Exports	0	4032	908	2293	3032	1703	
China		5078	0	1253	0	0	240	
HongKong		4761	4353	0	1597	823	33	
Taiwan		5146	0	615	0	212	0	
Korea		5368	0	227	313	0	9	
FSU		2778	228	15	0	2	0	
Total		23131	8613	3018	4203	4069	1985	45019
1985								
Source	Recipient	Japan	China	HongKong	Taiwan	Korea	FSU	
Japan	Exports	0	5695	1274	3386	4543	1307	
China		12480	0	7824	68	0	924	
HongKong		6538	6715	0	2671	1566	48	
Taiwan		5063	0	713	0	196	0	
Korea		7130	0	541	333	0	0	
FSU		2751	981	66	0	0	0	
Total		33962	13391	10418	6458	6305	2279	72813
1990								
Source	Recipient	Japan	China	HongKong	Taiwan	Korea	FSU	
Japan	Exports	0	9011	4681	8496	12638	3064	
China		6130	0	20336	3639	0	2012	
HongKong		13072	26630	0	2671	3780	90	
Taiwan		15430	320	3463	0	1249	55	
Korea		17457	1260	1908	1452	0	0	
FSU		2563	2239	113	65	0	0	
Total		54652	39460	30501	16323	17667	5221	163824
1992								
Source	Recipient	Japan	China	HongKong	Taiwan	Korea	FSU	
Japan	Exports	0	11679	6262	9467	11599	2279	
China		11926	0	35427	5866	2654	3526	
HongKong		20734	37512	0	11246	5909	63	
Taiwan		21153	695	4239	0	2262	494	
Korea		17793	2405	1953	1315	0	524	
FSU		2115	2730	245	72	487	0	
Total		73721	55021	48126	27966	22911	6886	234631

Source: International Trade Database, selected years.
 Note: Partner Country Data used for Taiwan

Fact or Fancy?: North Asia Economic Integration

Table 4.2-2
North Asia (including Russia) Intraregional Trade-Imports

1980 Source								
Recipient	Imports	Japan	China	HongKong	Taiwan	Korea	FSU	
Japan		0	5169	5144	5146	5838	3075	
China		4323	0	4402	0	0	251	
HongKong		569	570	0	615	98	16	
Taiwan		2293	0	1597	0	313	0	
Korea		2996	0	776	212	0	3	
FSU		1860	264	36	0	10	0	
Total		12041	6003	11955	5973	6259	3345	45576

1985 Source								
Recipient	Imports	Japan	China	HongKong	Taiwan	Korea	FSU	
Japan		0	14236	6821	5063	7531	3049	
China		6483	0	7537	0	0	1141	
HongKong		767	4451	0	713	492	73	
Taiwan		3386	68	2671	0	333	0	
Korea		4092	0	1060	196	0	0	
FSU		1429	962	52	0	0	0	
Total		16157	19717	18141	5972	8356	4263	72606

1990 Source								
Recipient	Imports	Japan	China	HongKong	Taiwan	Korea	FSU	
Japan		0	7587	13271	15430	18574	2819	
China		12054	0	30317	595	0	2253	
HongKong		2173	14151	0	713	614	125	
Taiwan		8496	2255	7458	0	1452	65	
Korea		11707	684	3615	1249	0	0	
FSU		3351	2140	99	55	0	0	
Total		37781	26817	54760	18042	20640	5262	163302

1992 Source								
Recipient	Imports	Japan	China	HongKong	Taiwan	Korea	FSU	
Japan		0	13682	21486	21153	19458	1280	
China		16926	0	45798	695	3725	2958	
HongKong		2044	20534	0	4239	794	270	
Taiwan		9467	5866	11246	0	1315	72	
Korea		11568	2623	5784	2262	0	536	
FSU		3317	3887	77	494	576	0	
Total		43322	46592	84391	28843	25868	5116	234132

Source: International Trade Database, selected years.
Note: Partner Country Data used for Taiwan.

During the 1980s, the share of Japan's exports going to China declined, while the shares going to the NIEs increased (see table 4.3). The share of China's exports going to and passing through Hong Kong increased dramatically, reflecting the increase in entrepôt trade as Chinese exports penetrated western, and particularly U.S. markets. Notably, however, the share going to Japan decreased by 50 per cent. Simultaneously, the share of Hong Kong exports and reexports going to China increased almost four-fold in percentage terms. The shares of Hong Kong exports going to Japan and the other NIEs increased marginally. While the increase in shares of Taiwanese and Korean exports to China did not increase as dramatically, they did grow. And, like Hong Kong, the percentage of Taiwanese and Korean exports going to Japan and the NIEs similarly increased. Korea's dependence on the Japanese market is almost twice that of Taiwan, which in turn is almost twice that of Hong Kong.

Table 4.3
Distribution of Merchandise Exports
(per cent)

1990 Importer	Exporter	Regional					Total Exports (US \$bns)	
		Japan	China	HongKong	Taiwan	Korea		Total
	Japan		2.20	4.40	5.40	6.10	18.10	297
	China	15.70		42.00	0.50	1.20	59.40	65
	HongKong	5.30	25.30		4.30	2.30	37.20	84
	Taiwan	11.90	3.20	10.50		2.00	27.60	71
	Korea	19.30	0.90	5.90	1.90		28.00	66

1980 Importer	Exporter	Regional					Total Exports (US \$bns)	
		Japan	China	HongKong	Taiwan	Korea		Total
	Japan		3.90	3.80	3.90	4.30	15.90	138
	China	22.40		22.80	0.00	0.00	45.20	19
	HongKong	4.40	6.40		3.00	1.10	14.90	20
	Taiwan	10.90	0.00	7.80		1.50	20.20	21
	Korea	17.30	0.00	4.70	1.30		23.30	18

Source: "FDI and APEC Economic Integration", Canada's submission to the Ad-hoc Group on Economic Trends and Issues, APEC Sixth Ministerial Meeting, Indonesia, 1994, Tables 15 & 17.

Between 1980 and 1990, the share of Japan's imports coming from each of the other four economies in the region increased (see table 4.3). Chinese imports coming from Japan decreased by about two-thirds, however, while the shares coming from each of the NIEs, and particularly Hong Kong, increased. While the percentage of Hong Kong's imports coming from Japan declined during this period, the shares coming from China in particular and the NIEs increased. Each of the four partner countries increased their claims on Taiwanese markets. Korean imports from Japan stayed constant in percentage terms, while its imports from the other economies in the region increased.

Table 4.4
Distribution of Merchandise Imports
(per cent)

1990		Importer					Regional	Total Imports
Exporter	Imports	Japan	China	HongKong	Taiwan	Korea	Total	(US \$bns)
	Japan		4.60	2.00	3.80	5.80	16.20	222
	China	11.50		37.40	4.00	1.00	53.90	57
	HongKong	16.40	34.00		9.30	4.90	64.60	80
	Taiwan	32.30	0.70	7.30		2.60	42.90	49
	Korea	28.30	1.20	3.00	2.30		34.80	64

1980		Importer					Regional	Total Imports
Exporter	Imports	Japan	China	HongKong	Taiwan	Korea	Total	(US \$bns)
	Japan		3.20	0.70	1.70	2.40	8.00	134
	China	30.50		7.50	0.00	0.00	38.00	18
	HongKong	23.50	19.60		7.40	3.80	54.30	23
	Taiwan	27.10	0.00	3.10		1.20	31.40	20
	Korea	28.20	0.00	1.10	1.50		30.80	21

Source: "FDI and APEC Economic Integration", Canada's submission to the Ad-hoc Group on Economic Trends and Issues, APEC Sixth Ministerial Meeting, Indonesia, 1994, Tables 14 & 16.

The possibility that a trade bloc centred on Japan is developing in Asia--whether as a natural occurrence, as a reaction to the perception that blocs are emerging in North America and Europe, or as the result of a concerted, but covert, effort on the part of Japan to dominate the region--is frequently raised. The concern is, of course, that an Asian trade bloc might erect barriers to international trade and investment. Given that the economies of North and Southeast Asia have experienced dynamic and

rapid internal growth, it seems natural that trade flows would have grown rapidly during the 1980s. A more appropriate question is whether intra-North Asian trade has grown more rapidly than it "should" have, given the rates of economic growth in each of the member economies, distances between trading partners, activities in which each economy possesses a comparative advantage and each economy's pattern of trade with the rest of the world. The Petri measure of intraregional trade bias for North Asia (which I shall explore somewhat further below) increased by 20 per cent between 1980 and 1992. I would suggest, however, that this measure has not only not increased by more than it should have, but that it may have risen by less than it should have given the criteria just listed above.

- **Trade with Russia/FSU**

Exports to the republics of the FSU have accounted for 3-4 per cent of China's exports since 1985; such shipments steadily declined from two per cent of Japan's total exports in 1980 to 0.5 per cent in 1993; and they were barely noticeable blips in the case of the NIEs. Merchandise imports from the FSU typically accounted for 1.5 per cent of Japanese foreign purchases between 1980 and 1992, 5 per cent of China's and, again, negligible shares for the NIEs.

In 1990, only 30 per cent of Russia's exports were purchased by economies outside the FSU, while roughly 50 per cent of its imports came from outside the FSU. Subsequently, both export and import levels fell substantially. With regard to Russia's trade with Asia, China is Russia's largest trading partner, taking only 6.4 per cent of its exports in 1992 and providing 4.5 per cent of its imports. Japan ranks second, taking 3.6 per cent of Russia's exports and supplying 4.5 per cent of its imports in 1992.³⁵

4.2 Intraregional Trade Intensity

There are a number of ways to measure intraregional trade intensity or bias.³⁶ A measure of trade bias, which Petri refers to as the "double-relative" coefficient of trade intensity, that takes the pattern of world trade into account is shown in table

³⁵ Source: World Bank, Statistical Handbook 1993: States of the Former USSR, Washington, 1994.

³⁶ See Peter Petri, "The East Asian Trading Bloc: An Analytical History", presented at the National Bureau for Economic Research Conference, April 1992; and Jeffrey A. Frankel, "Is a Yen Bloc Forming in Pacific Asia", in The AMEX Bank Review, New York, 1991, pp. 4-20.

4.5.³⁷ This measure suggests that there is no bias in international trade if each country's exports to a given region are equal to the share of world exports going to that region. For example, if North Asia received 20 per cent of world exports, and 20 per cent of China's exports went to North Asia, the double-relative coefficient to trade intensity would equal 1.00, suggesting that no bias exists in China's exports to North Asia.

Table 4.5
North Asia excluding Russia: Trade within the Region and with the World

Year	North Asian Intra-regional			North Asia with the World			Total World
	Exports	Imports	Total (A)	Exports	Imports	Total (B)	Trade (C)
1980	40011	40061	80072	206897	226617	433514	3842000
1985	66736	65900	132636	292557	250186	542743	3701000
1990	153623	152395	306018	562752	494238	1056990	6766000
1992	222096	220665	442761	702219	594983	1297202	7533000
	Intra-regional as a Percentage of the Region's World total (D=A/B*100)			Total North Asian as a Percentage of Total World Trade (E=B/C*100)			Double Relative Coefficient (D/E)
Year							
1980	18.47			11.28			1.64
1985	24.44			14.66			1.67
1990	28.95			15.62			1.85
1992	34.13			17.22			1.98

North Asia including Russia: Trade within the Region and with the World

Year	North Asian Intra-regional			North Asia with the World			Total World
	Exports	Imports	Total (A)	Exports	Imports	Total (B)	Trade (C)
1980	45019	45576	90595	247457	268569	516026	3842000
1985	72813	72606	145419	336543	304293	640836	3701000
1990	163824	163302	327126	609393	553046	1162439	6766000
1992	234631	234132	468763	751055	642969	1394024	7533000
	Intra-regional as a Percentage of the Region's World total (D=A/B*100)			Total North Asian as a Percentage of Total World Trade (E=B/C*100)			Double Relative Coefficient (D/E)
Year							
1980	17.56			13.43			1.31
1985	22.69			17.32			1.31
1990	28.14			17.18			1.64
1992	33.63			18.51			1.82

Source: Intra-regional trade—Tables 4.1 and 4.2 above. North Asia/World—International Trade Databank, selected years.
World Total—"Direction of Trade Statistics", IMF, selected years.
Note: Double Relative Coefficient = D/E

³⁷ The Petri measure is calculated by dividing North Asian intra-regional trade relative to total North Asian trade by total North Asian trade relative to total world trade. Neither Petri nor Frankel establish an algorithm for aggregation from the case of bias for a single country trading with a region to the case of bias for countries in a region trading with other countries in the region (as calculated in the text). It is possible that the coefficient of trade intensity in this situation may not equal one for the case of neutral intra-regional trade.

For the five Asian economies considered in this report, an increasing regional bias in North Asian trade is suggested by a rising double-relative coefficient of trade intensity. The coefficient increased from 1.64 in 1980 to 1.98 in 1992. When Russian trade is added to that of the five Asian economies, the coefficient increases between 1985 and 1992, but is lower than the coefficient for the five Asian economies alone for each of the four years for which coefficients were calculated.

There is an upward bias in the North Asian intraregional trade statistics because of double counting of goods transshipped through Hong Kong to and from mainland China that cannot be measured precisely. One might postulate that the upward bias increased during the last decade as transshipments increased.

Two conclusions can be drawn about North Asian intraregional trade. First, there appears to be evidence that North Asian trade has been biased toward its trading partners within the region. This finding is not unusual, since both North America and the EU also show similar intraregional trade bias.³⁸ Second, this bias may have been higher in 1992 than it was in 1980, although the role of Hong Kong as an entrepôt for China distorts the trend upwards.

4.3 Investment Patterns

Foreign direct investment patterns are more difficult to discern and analyze than trade patterns because governments do not report FDI data on a consistent basis.³⁹ Despite the data problems, it is possible to document some basic trends. Japanese FDI worldwide expanded rapidly in the mid 1980s, but the outflow dropped after 1989. Since the late 1980s, the NIEs have become increasingly important sources of FDI in other parts of Asia, but particularly for China. According to individual country statistics in the UN World Investment Directory 1992, the stock of U.S. FDI exceeded the stock of Japanese FDI in Hong Kong, Taiwan and China in the latest year reported (1987-89), while Japanese FDI exceeded U.S. FDI in Korea. The data indicates that Japan's relative presence in the region is increasing. Overall, the total stock of intraregional inward FDI stock appears to have increased from US \$2 billion

³⁸ See J. Frankel, "Is a Yen Bloc Forming in Pacific Asia?", in Finance and the International Economy: The AMEX Bank Review Prize Essays, New York, 1991.

³⁹ Data on FDI are reported by governments in a variety of ways and data from different countries are seldom comparable. For example, Japanese statistics on FDI by country are readily available only on what is known as an "approval" basis. These statistics represent intended FDI by Japanese companies approved by host governments. They can differ from actual (or realized) investment flows because actual investment may occur in a fiscal year after the year of approval and because intention and approval of an investment do not guarantee its realization.

in 1980 to US \$17 billion in 1990.

Table 4.6				
Share of Inward FDI in Gross Domestic Capital Formation				
Country	1971-75	1976-80	1981-85	1986-91
Japan	0.1	0.1	0.1	0.1
China	0	0.1	0.9	2.3
Hong Kong	5.9	4.2	6.9	12.1
Taiwan	1.4	1.2	1.5	3.5
Korea	1.9	0.4	0.5	1.1

Source: "FDI and APEC Economic Integration", Canada's submission to the Ad-hoc Group on Economic Trends and Issues, APEC Sixth Ministerial Meeting, Indonesia, 1994, Table 8.

Table 4.7				
Inward FDI Stock and Outward FDI Stock as Percentage of GDP				
Country	Stock of Inward FDI as % of GDP		Stock of Outward FDI as % of GDP	
	1980	1990	1980	1990
Japan	0.3	0.6	3.4	10.6
China	0.2	2.9	0	0.1
Hong Kong	1.9	4.2	21.3	28
Taipei	6.6	8.4	0.2	2
Korea	2.1	2.8	2.4	4.3

Source: "FDI and APEC Economic Integration", Canada's submission to the Ad-hoc Group on Economic Trends and Issues, APEC Sixth Ministerial Meeting, Indonesia, 1994, Table 9.

With the possible exception of Hong Kong, inward FDI comprises only a small share of total gross domestic capital formation in the Asian economies under study (see table 4.6). It is, however, playing an increasing and more important role in both China and Taiwan. There has been little investment penetration in either Japan or Korea. For Hong Kong, Japan and Korea, their stock of outward investment, expressed as a percentage of GDP, exceeds the claims on their own productive assets held by foreigners (see table 4.7). In the cases of Japan and Hong Kong, the stocks of outward FDI are significantly higher. The significant increases that took place in the 1980s would in part reflect the shifting of labour-intensive production to off-shore locations. We would expect the numbers to continue to increase for Taiwan and South Korea as well, as these countries move more production to China and other locations abroad. The governments of Taiwan and Korea only relatively recently eased restrictions that had limited outward investment.

Table 4.8
Distribution of Outward Foreign Direct Investment Stock
(per cent)

1990							Regional	Total Outward
Host	Home FDI	Japan	China	HongKong	Taiwan	Korea	Total	(\$US bn)
	Japan		0.9	3.2	0.9	1.3	6.3	311
	China	1.2		15.8	0	0	17	0.5
	HongKong	2.6	29.9		7.2	0.6	40.3	20
	Taiwan	0.3	0	1.9		0	2.2	3.1
	Korea	1.1	1.8	1.1	0.2		4.2	3.7
1980							Regional	Total Outward
Host	Home FDI	Japan	China	HongKong	Taiwan	Korea	Total	(\$US bn)
	Japan		0	3	1	3.1	7.1	36.5
	China	1.9		24.5	0	0	26.4	0
	HongKong	1.2	50		0.4	0.5	52.1	5.9
	Taiwan	1	0	4		0	5	0.1
	Korea	1.2	0	0.9	0		2.1	0.2

Source: "FDI and APEC Economic Integration", Canada's submission to the Ad-hoc Group on Economic Trends and Issues, APEC Sixth Ministerial Meeting, Indonesia, 1994, Tables 19 & 21.

The flows of Japanese investment into the region have been broadly consistent with the worldwide trends in Japanese FDI flows. The rapid rise in the flow of Japanese FDI worldwide began in Japan's 1984 fiscal year (FY) and reached a peak in FY 1989 at a level nearly five times that of the early 1980s, before dropping

significantly to three times the level of the early 1980s. Japanese FDI in the region shows a similar peak. The share of Japanese FDI going to North Asia was generally smaller after 1985 than it was before. North America has been the overwhelming destination for Japanese FDI since 1985, with Europe ranking as the second most important destination. We see no reason why there should be any change in the breakdown of the flow of Japanese FDI by region in the near term. The flow of Japanese funds to the NIEs in the region should continue to decline, as Japanese firms continue to look for low cost production sites elsewhere abroad. Concomitantly, flows to China should increase. (See table 4.8 for the distribution of intraregional investment flows.)

While the absolute flows of investment between Hong Kong and China have increased significantly, table 4.8 suggests that the relative share of each economy in the other's outward investment flow has declined. Given the surge of economic activity in China in the 1990s, and the increasing flow of economic activity between the two economies during this period, this trend may well have reversed itself. The flow from Korea to China probably will continue to increase, and the post 1990 numbers for Taiwan to China likely will be higher, since the government of Taiwan has loosened restrictions that had hampered investment on the mainland.

Table 4.9
Distribution of Inward Foreign Direct Investment Stock
(per cent)

1990	Host						Regional	Total Inward
Home	FDI	Japan	China	HongKong	Taiwan	Korea	Total	(\$US bn)
	Japan		0	2.8	0	0	2.8	18.4
	China	7.2		56.2	0	0	63.4	10.6
	HongKong	32.3	10.5		0.6	-3.9	39.5	3
	Taiwan	28.9	0	10.8		0	39.7	13.3
	Korea	49.7	0	1.9	0.1		51.7	6.7
1980	Host						Regional	Total Inward
Home	FDI	Japan	China	HongKong	Taiwan	Korea	Total	(\$US bn)
	Japan		0	2.5	0.6	0	3.1	3
	China	5.8		51.2	0	0	57	0.7
	HongKong	23	0		0.9	0	23.9	0.5
	Taiwan	18.5	0	12.5		0	31	2.7
	Korea	56.1	0	2.1	0		58.2	1.3

Source: "FDI and APEC Economic Integration", Canada's submission to the Ad-hoc Group on Economic Trends and Issues, APEC Sixth Ministerial Meeting, Indonesia, 1994, Tables 18 & 20.

While the share of Japanese investment flowing to the North Asian economies may be declining relative to that flowing to North America and Europe, Japan still maintains significant investment positions in these economies. With the exception of Korea, Japan's stake in terms of investment stock increased in each economy between 1980 and 1990. (See table 4.9.) The increasing interaction between China and Hong Kong are reflected by the increasing shares of inward FDI attributable to the other economy. Again, later numbers when available should reflect increasing flows from Taiwan and Korea to China.

Table 4.10
Sectoral Distribution of Inward and Outward FDI Stock for North Asia

Country		Inward FDI			Outward FDI			
		Primary	Secondary	Tertiary	Primary	Secondary	Tertiary	
Japan	1980	0	77.7	22.3	1980	21.9	34.4	43.7
	1990	0	63.9	36.1	1990	5.7	26.7	67.6
China	1983	66.9	20.4	12.7	1983	2	12.2	85.7
	1988	8.2	49.7	42.2	1985	37	20.3	42.7
Taiwan	1980	0	93.6	6.4	1980	4.2	85.8	10
	1988		88.3	11.7	1988	1.1	65.7	33.2
Korea	1980	1	66.8	32.2	1980	22.2	17.6	60.1
	1988	0.9	61.5	37.6	1988	43.7	34.6	21.8

Note: Figures for Hong Kong are not available.

Source: "FDI and APEC Economic Integration", Canada's submission to the Ad-hoc Group on Economic Trends and Issues, APEC Sixth Ministerial Meeting, Indonesia, 1994, Table 10.

North Asia's manufacturing industries continue to attract the largest share of FDI flowing into the region. (See table 4.10.) With the exception of China, however, the share flowing to this sector is declining. Neither Japan or the NIEs attracted investment in the primary industries. Electric machinery, chemicals and metal industries were the top recipients of FDI in the region among manufacturing industries. Services were the top recipients of FDI in the region among nonmanufacturing industries. Japan and Taiwan have increasingly focussed global outward investment in the tertiary sector. China and Korea have expanded investments in both primary

and secondary industries.

4.4 Subregional Integration

Greater China, or the South China Economic Zone, comprises south China, Hong Kong and Taiwan. Firms from Hong Kong and Taiwan have invested considerable sums in the southern provinces of China, and mainland Chinese firms have in turn invested significant amounts in Hong Kong. Moreover, Hong Kong firms appear to be leading the charge of foreign investors further into the mainland. This wave of foreign investment has seen the emphasis shift from investing in production for export to production for China's domestic markets. The proximity of China and its supplies of land and labour, as well as a common language and culture, have proven attractive to off-shore Chinese investors in Hong Kong and, more recently, Taiwan, who have seen the international competitiveness of their low-end manufactured goods decline as land and labour costs at home escalated. With investments of US \$22 billion by approximately 17,000 enterprises, Hong Kong firms employ as many as two million people on the mainland and account for approximately 60 per cent of total foreign investment there.⁴⁰ Actual Taiwanese investment in China has reached an annual level exceeding US \$1 billion, but this figure may considerably understate actual levels because of unreported indirect investment.

Most investment from Hong Kong and Taiwan has been conducted by small and medium-sized firms and has focused on low value-added manufacturing and assembly operations, such as textiles, toys and footwear. In many situations, inputs and/or semifinished goods are shipped in from Hong Kong, and the finished products are shipped back to Hong Kong for export to third countries. That said, investors are now expanding their investments into areas such as distribution systems and production for China's domestic market. Many Taiwanese firms still consider the risks associated with large-scale investment in China to be too great. This situation is not likely to change dramatically until an effective legal framework for business is established and more stringent legal protection for foreign firms in China is developed.

⁴⁰ A recent OECD report indicates that total actual FDI in China in the post 1979 period was US\$60 billion, including US\$26 billion in 1993. Hong Kong continues to account for roughly two-thirds of China's FDI inflow, while Taiwan continues to play an increasing role. The ratio of actual to contracted FDI has declined significantly since 1990 to about 20 per cent. See "China's Progress Towards an Open Economy", OECD, March 1995, or "Foreign Direct Investment in China", OECD, March 1995.

Economic activity within Asia is intensifying at both the regional and subregional levels. Changing economic circumstances and natural comparative advantages appear to be the driving forces behind this phenomenon. Cultural, linguistic and family ties also appear to be playing a role. The most notable point about emerging subregional economic integration/interdependence and the activities of the Chinese diaspora/business community is that they are based on almost pure economic interests rather than on a political agenda. Mini-blocs such as Greater-China, or mid-layer areas such as North Asia, while certainly contributing to closer ties among Asian economies, are primarily instruments for promoting economic interests through the exploitation of different factor endowments (land, labour, capital and entrepreneurialism). The process of economic restructuring going on in the NIEs naturally directs the attention of firms in those countries to the possibilities offered by their less developed, labour abundant neighbours, which in the case of North Asia is China.

Perhaps because this subregional phenomenon is generally recognized as a natural outgrowth of the interplay of market forces, and because Asian leaders see that tangible benefits can be gained, further integration is viewed quite positively. The benefits include employment and technology transfer, larger flows of foreign investment and increased infrastructural development. Increased economic interdependence at the subregional level may also be viewed as a step toward eventual integration on a larger scale. Moreover, as the subregions become more developed in terms of infrastructure, industry and employment, the effects of economic development could spread.

With more Asian economies seeking foreign direct investment to facilitate their economic development, intensified competition could lead to the formation of more subregional economic zones as groups of economies try to maximize their attractiveness to investors. Whether this competition will evolve into a force that works against regionwide integration or for greater specialization among the subregional zones is difficult to assess at the present time.

5. Factors Limiting Integration

5.1 Japan

Japan's international economic relations are dominated by two factors: its lack of natural resources and the lingering effects of its role in World War II. While Japan has remained in close alliance with the U.S. since the War, tension between the two have increased since the early 1980s because of two issues. The first is the U.S. perception that Japan does not play a role in maintaining global security that is commensurate with its position as an economic superpower. To counter these inferences, Japan made a significant financial contribution to the Gulf War effort, allowed its troops to serve abroad in non-frontline activities as part of the UN mission to Cambodia and steadily increased its expenditures on overseas aid.

The second is the persistent trade imbalance between the two countries. After voluntary export restraints and market opening measures on the part of Japan reduced the U.S.'s trade deficit vis-à-vis Japan only slightly, attention focussed on "structural" impediments in Japan against imported goods. Japan and the U.S. have conducted a series of negotiations pertaining to these impediments, as well as on the U.S. budget deficit and low savings rate. These negotiations have resulted in a series of pledges by the Japanese Government to open and stimulate its economy and by the U.S. Government to try to reduce the size of its budget deficit, including through the July 1993 agreement to establish the United States-Japan Framework for a New Economic Partnership, which in turn has led to a number of sector-specific, market opening agreements.

The primary focus of Japanese international economic relations for the foreseeable future will continue to be its ties with the U.S.. This will prevent it from taking a position at the head of any movement to integrate any formal grouping of Asian economies. That said, it will continue to play an integral and active role in the increasing economic interdependence of the North Asia region. This is because of the positive impact of unleashing market forces in China and, in due course, Russia.

Japan's identification with the U.S. and the western camp during the Cold War period constrained the development of relations with China and the former Soviet Union. Relations, particularly economic ties, between Japan and China have improved steadily since diplomatic ties were restored in 1972; the main exception being the temporary halting of aid flows for the year following the Tiananmen massacre. The relatively quick resumption of economic relations following Tiananmen was predicated on the view that a stable China is important for regional stability and Japanese

security (not to mention Japanese profits!). Japanese relations with Russia have improved. While the failure to resolve the Kurile Islands dispute is frequently cited as preventing any significant amelioration in or normalization of relations, should the domestic political situation in Russia become more stable and further market oriented reforms implemented, Japan would probably play a more active role in promoting trade with and investment in Russia by Japanese firms. Full normalization of relations, however, probably will not occur until the territorial dispute is resolved.

While Japan is viewed as a model for economic development by most of the economies in both North and Southeast Asia, its motives for trading with and investing in these same countries are frequently scrutinized by both their residents and governments. The perceived single-mindedness of purpose of the agents of "Japan Inc.", combined with often still vivid memories of the Japanese expansionist agenda before 1945, has occasionally provoked hostile reactions in countries such as Korea and China.

Japan's exports of goods and services continue to be dominated by shipments of manufactures (63 per cent in 1992); manufactures also account for continuously larger shares of imports.⁴¹ While trade with the economies of North Asia has expanded both in absolute and, although more modestly, in relative terms, Japan's exports to these markets have generally increased faster than its imports from them. Despite initiatives that have reduced its tariff and non-tariff barriers and efforts to stimulate import purchases, Japan continues to face pressure from both western and Asian trading partners to increase its imports. While Japan's large and ongoing trade surpluses alone do not necessarily demonstrate that its markets are unfairly protected, the continuing deficits and the perception on the part of the economies of North Asia that they are unable to penetrate Japanese markets because of barriers to entry, may cause trade frictions that will slow any initiative to integrate the economies of North Asia more formally.

Japan also has received a relatively small amount of foreign direct investment. During the 1981-86 period, it received 0.8 per cent of the total world flow of FDI,⁴² and since 1987 it has received a mere 0.1 per cent of the total flow per annum. The low levels of FDI appear to reflect the low level of import penetration in Japanese markets. If one assumes that multinational firms invest in a country because of

⁴¹ Nonetheless, Japan's imports represent only 3.2 per cent of GDP, less than one-half the average of 7.3 per cent for the rest of the G-7 economies. See IMF, Direction of Trade Statistics; and World Bank, The World Tables, 1994.

⁴² U.N/CTC., World Investment Report, 1993.

barriers to trade that prevent it from exporting to the host country, and that intrafirm trade follows this investment then, to the extent that foreign subsidiaries trade with their parent firms, the low levels on FDI would translate into losses of potential exports from foreign firms to their subsidiaries in Japan. One of the five baskets of issues that the Japan-U.S. "Framework" talks are addressing is competitiveness and the need for regulatory reform in Japan. Specifically, the negotiations are examining the barriers to foreign participation in the Japanese economy that are generated by Japanese laws, regulations, administrative practices and competition policies. The opening of the Japanese economy will be a long process, thus limiting, *inter alia*, the scope for fuller economic integration in North Asia.

5.2 Korea

A variety of factors could affect Korea's prospects for closer economic interdependence/integration with North Asia. Historically, Korea's contact with the other nations of North Asia has not been good. China has been seen as a threat to the independence of the Korean peninsula, and Korea has only recently established diplomatic relations with China. In response to this diplomatic shift, Taiwan severed relations with Korea and announced that all preferential economic and trade treatment granted to Korea in the past would be phased out. Secondly, Japan's occupation of Korea from 1910 to 1945 created an animosity that endures to this day. Concern over specifically Japanese investment has reportedly been a factor in the relatively slow liberalization of Korea's foreign investment regime.

Although Korea has made notable progress in removing formal restrictions to imports, more subtle barriers have effectively prevented fuller liberalization. Standards, testing, labelling and certification requirements have reportedly been used to block the entry of goods in such sectors as agriculture, cosmetics, chemicals and electronics. Continued use of such restrictions will place limits on Korea's economic links with its North Asian neighbours.

In addition to the barriers mentioned above, Korea has also undertaken several "frugality campaigns" in recent years, designed to curb imports and consumption of luxury goods. The government has consistently denied taking a role in such campaigns, maintaining that anti-import activities are grass-roots initiatives designed to reduce both conspicuous consumption and Korea's external debt.

Despite these impediments, several factors are leading Korea toward closer links with the region. Economic restructuring in Korea and consequent direct investment flows to East Asian countries and, more recently, China, have generated closer economic ties. Korea's direct investment in Asia remains mostly concentrated in

labour-intensive industries.

Korea's reaction to NAFTA and other regional groupings is also an important factor. The Korean government remains concerned about rising protectionism in the global trading system and the emergence of regional trading arrangements. While Korea does not appear to be pursuing formal regional integration within either East or North Asia to the exclusion of other ties, it would appear that the government may be promoting economic cooperation in the region as a method for remaining competitive. Promoting increased investment in NAFTA and EU countries, as well as China, would appear to be part of Korea's development strategy.

5.3 Taiwan

There are several important macroeconomic and policy-related factors to consider with regard to Taiwan's integration with other countries in North and/or East Asia. First, although Taiwan has made great progress in opening its economy, significant barriers to imports remain. Agriculture and some manufacturing industries are still highly protected. Taiwan maintains an import ban on 242 categories of products. Tariffs, an import licensing system, restrictive standards (particularly for agricultural products) and lack of intellectual property protection still hinder imports. Additionally, the state continues to play a dominant role in such sectors as power and telecommunications. Taiwan also maintains a list of industries not open to foreign investment.

These barriers pose an obstacle to closer economic integration with countries in North Asia. Recent developments indicate, however, that Taiwan is likely to pursue trade and investment liberalization as part of its overall strategy for continued development and growth. Concern over falling levels of both domestic and foreign investment has prompted Taiwan's authorities to take steps to improve the investment climate. In May 1992, they streamlined the application procedure--drastically cutting the processing time for both inward and outward investment. Additionally, Taiwan's authorities set aside approximately US \$10 billion in low interest foreign currency loans to encourage local industries to acquire sophisticated foreign capital goods and technology. Progress in lowering trade barriers is expected as Taiwan completes negotiations for accession to the GATT/WTO.

Concern about isolation and a desire to cement its role in any future Asian trading arrangement have led Taiwan to overcome quietly many of the official obstacles to trade and investment with China. Representatives from China and Taiwan met in Singapore in April 1993 for their first set of serious discussions on political and economic issues. The same concern has also prompted Taiwan to

become a member of the APEC forum, together with China and Hong Kong, under the name Chinese Taipei.

Taiwanese officials are not without some fear of economic domination by Japan. Recent concern over bilateral trade imbalances with Japan has prompted officials to emphasize the importance of trade relations with the U.S. and the EU.

5.4 Hong Kong

Hong Kong is a major regional trade and financial centre and plays a key role in Asian banking, investment, shipping and communications. The rapidly increasing trade and investment flows between the two economies following the introduction of economic reform in China have caused the economic boundary between Hong Kong and China largely to disappear. Hong Kong and China are now locked so tightly in a web of bilateral investments that progress toward reuniting the two economies is well underway. An investment consortium, which includes members from Hong Kong, Singapore, Taiwan and representatives from various Chinese ministries, has been formed in Hong Kong. Nevertheless, uncertainty about Hong Kong's economic future after 1997 persists, making the question of closer integration with Taiwan, Korea and Japan difficult to assess.

5.5 China

A variety of political and economic factors could have an effect on China's prospects for closer integration with other Asian economies. China must overcome its tendency toward isolationism when confronted with political or economic pressures. Further, tension between China and Japan, including a number of unresolved issues related to World War II, continues to constrain the development of bilateral relations.

The Chinese economy is at a crossroads, and while the prospects for continued rapid economic growth for the balance of this decade remain good, there are a number of potential danger areas. The trend towards marketization of the economy will continue. Nevertheless, China still carries many of the burdens of being both a non-market and a developing economy. These include an ailing state sector, a rapidly growing budget deficit, inadequate infrastructure, increasing regional disparity and the prospects of having to deal with a large contingent of unemployed people--located both in urban and rural areas. Superimposed, is a significant amount of uncertainty with regards to China's medium-term political future.

These structural and political dilemmas have implications for China's increasing economic interaction and interdependence with its North Asian neighbours, the wider Asian community and the global economy. Failure to address the economic problems listed above--for example, reform of the state enterprise sector--will eventually retard economic growth, which in turn will slow the rate at which North Asian economic interdependence can increase.

The reform process currently under way in China seems to be geared more toward multilateral liberalization than to entering regional arrangements. Although economic links with Hong Kong and Taiwan are particularly strong, and links with Japan and Korea are expanding quickly, the pace of trade and investment liberalization and reform in China will be heavily influenced by negotiations related to its GATT/WTO accession application and by bilateral relations with the U.S., its largest export market. China's dependence on exports of consumer products to developed economies and the need for investment capital from these same countries should work to ensure that China does not turn exclusively to developing relations with Asian economies.

5.6 Russia

The prospects for increased trade between Russia and the Asian economies of the North Asia region, and particularly Japan, would improve if the economic reforms undertaken to date were solidified and Russia's economic reform program were pushed forward. For example, the government will have to enhance the framework for business to engage in foreign trade. However, a broader political consensus that market-based reforms should proceed is a necessary precondition for this process to advance. Improved political stability also will be necessary if Russia is to attract more foreign trade and investment.

Ongoing macroeconomic problems continue to inhibit the production of some goods and services and, consequently, are suppressing exports and discouraging foreign investment. Concomitantly, exports of some commodities have increased as a result of a decline in domestic demand. One should note, however, that trade in some products (including fuels, timber and metals) must be undertaken through an authorised agent, who has to secure a licence from the Ministry of Foreign Economic Relations. Fluctuations in tax and tariff rates, as well as the ongoing evolution of commercial laws, have generated confusion for foreign traders and investors.

The main constraint on foreign investment is the instability of the Russian economy. Russia's bureaucratic requirements can be confusing and burdensome to investors (large scale ventures must be registered with the government), and

bureaucratic discretion often is capricious. Russian exporters, including joint ventures with foreign partners must surrender 50 per cent of any hard currency earnings. The concept, definition and delegation of property rights are still being developed and legislated. The lack of property protection is still a concern to investors. Crime and corruption in the commercial sphere are expanding problems. Given these considerable domestic economic problems and Russia's overwhelming European focus in terms of its economic relations, it is unlikely that Pacific Russia will be a major factor in increased North Asia economic integration into the foreseeable future.

- **Russian Far East**

Prior to the dissolution of the USSR, the Russian Far East (RFE) received a net transfer of resources to finance the military's presence in the region, the production of military equipment, and mineral, fuel and energy supplies required by state enterprises. The military presence in the region supported much of its economic activity. Consequently, the crumbling of the FSU sent a negative shockwave through the region's economy. Changes in the republic's price structure, particularly the prices of fuel, grain and raw materials which the region imports, have had a negative impact on the region's terms of trade. Professional and skilled Russian workers with connections in European Russia reportedly have left the region in large numbers.⁴³

As part of the USSR, the RFE had ties with the Soviet Central Asian republics, which were major export markets for its products and suppliers of both inputs and consumer goods. The weakening of these links has forced regional authorities to examine alternative economic development strategies, including more externally oriented schemes. Obviously, this requires increased interaction with the rest of the world, perhaps at the expense of ties to the rest of Russia. Increasingly, it would appear that the RFE's primary strategy will revolve around trying to attract foreign direct investment that will develop and process the region's natural resources, produce goods for export and assist with basic infrastructure development. The economic decline that Russia has experienced in recent years has caused the region to experience supply shortages that have, in turn, provided opportunities for both small private producers and traders. As a result of the ongoing unstable political and economic situation in Russia, however, the RFE has attracted traders and investors looking for quick turnarounds, rather than those prepared to make long-term investments in resource development projects.

⁴³ See Won Bae Kim, "Sino-Russian Relations and Chinese Workers in the Russian Far East: A Porous Border", in *Asian Survey*, Berkeley, Ca, Vol. XXXIV, No. 12, December 1994.

Moscow seems to be looking to improve relations with neighbouring Asia Pacific economies. Nevertheless, despite some increase in economic interaction between the RFE and neighbouring economies, particularly China because of a rapid increase in border trade, Moscow's motives are being questioned by local officials.⁴⁴ They sense that Moscow may be seeking to limit local officials' contact with representatives from neighbouring economies, and to skim off funds generated by the development of the RFE's resources, which, in turn, will hinder regional development. Increased interaction with the neighbouring economies of North Asia may be hampered by such central/local differences within Russia in the future.

5.7 National Policies and Integration

Rapid economic growth and structural reform have been the driving forces behind the development of closer links among North Asian economies. Physical obstacles to continued growth, such as infrastructure bottlenecks, and lingering trade and investment barriers, as well as political ones, will slow any move towards integration.

The three NIEs in the region will have to overcome a number of significant political and economic hurdles in the near future. Long a centre for Asian trade and investment, Hong Kong's future is dependent upon how the merger with mainland China will be managed in the run-up to 1997, as well as after. The flight of human and financial resources out of Hong Kong in recent years is indicative of the underlying currents of uncertainty pertaining to the future of the colony. Taiwan's economic future is also bound up with that of mainland China. China has already become an important economic hinterland for Taiwan's labour-intensive industries and an outlet for foreign investment. Political relations between the two economies will have an impact on their prospects for continued economic growth. Korea also faces serious impediments to regional integration. Although Korea has come to recognize the importance of trade and investment links with the rest of North Asia, Korean officials are reluctant to open key sectors of the economy to foreign influence. The Korean government has made little progress with regards to liberalizing its foreign investment regime and it continues to protect the role of state-owned enterprises.

While China's future economic prospects remain good, it will have to resolve a number of economic and political problems, probably before the turn of the century. China will likely emerge as the main stabilizing or destabilizing factor in the region. China has become increasingly economically interdependent with the other economies of North Asia because of its reform program, its open-door policies and its rapid

⁴⁴ See John Stephan, "The Russian Far East", in Current History, October 1994.

economic growth over the past 10-15 years. That said, China is not yet a stable component of the region because of its internal economic and political difficulties and its incomplete leadership transition. It remains to be seen whether the trend toward increased emphasis on market forces in the allocation of resources, particularly whether this emphasis will be extended to the state industrial sector, and on a more open economy will continue.

6. Energy and Environmental Issues Affecting Integration

Table 6.1
North Asia—Total Energy Consumption
(Million metric tons oil equivalent)

Country	1983	1984	1985	1986	1987	1988	1989	1990	Ave.
Japan	334	359	360	364	366	393	407	428	
China	460	498	540	568	594	619	637	633	
Hong Kong	7	7	8	9	10	10	11	10	
Taiwan	30	31	33	36	38	42	44	46	
Korea	47	51	55	60	66	74	80	92	
Total	878	946	996	1037	1074	1138	1179	1209	
% change		8	5	4	4	6	4	3	5

Source: OECD, "Energy Balances of OECD Countries", 1990, and "Energy Balances for Non-OECD Countries", 1990.

The rapid economic growth that the economies of North Asia have experienced has led to a concomitant increase in the region's demand for energy. The annual growth rate in total energy requirements for the Asian economies examined in this Paper averaged 4.7 per cent per annum during the 1980s (see table 6.1). This is roughly double the average growth rate for developed countries. Not surprisingly, the procurement of stable energy supplies and adequate generating capacity is considered a prerequisite for continued economic development. Shortages of energy supplies in China have already begun to threaten economic growth. Concerns about potential future shortages are the result of a lack of energy resources in some countries (e.g., Japan), the scarcity of capital and appropriate technologies, and inefficiencies in the power generation and distribution systems in other economies (e.g., China). Energy

production and consumption statistics are provided in table 6.2.

Table 6.2						
North Asia-1990 Energy Production and Consumption by Country						
(1,000 tons oil equivalent)						
Country		Oil & Products	Coal	Gas	Nuclear	Hydro & Other
Japan	Production	690	5770	1770	47660	8860
	Consumption	288510	73240	40510	47550	8860
China	Production	140796	529143	12494	na	9503
	Consumption	112897	498092	12494	na	9503
Hong Kong	Production	0	0	0	0	0
	Consumption	4689	5701	0	0	0
Taiwan	Production	118	486	1138	7388	575
	Consumption	21377	11617	1142	7388	575
Korea	Production	0	9561	0	12344	395
	Consumption	40024	24505	2630	12344	395

Source: OECD, "Energy Balances of OECD Countries", and "Energy Balances for Non-OECD Countries".

6.1 Energy Policies

Japan and the NIEs examined in this Paper, despite differences in energy resources and levels of development, have developed a similar set of basic policy objectives. These are: to diversify sources of imported crude and reduce their reliance on imports from the Middle East; to develop alternative energy sources; and to enact energy conservation measures and increase the efficiency of existing power generation and distribution facilities. These policies reflect their experiences with the oil price shocks of the 1970s. The second and third objectives would also apply to China.

The pursuit of these goals has resulted in two main developments. The desire to reduce their respective dependencies on Middle East oil has resulted in increased intra-Asian trade in crude oil and oil products. Japan, Korea and Taiwan increasingly have turned to Indonesia, Malaysia and China to supply these commodities. They have also led to increased efforts to develop alternative energy sources such as coal, natural gas, and hydroelectric and nuclear power.

These efforts have been only partially successful. Moreover, in China, economic growth continues to outpace the development of energy sources. Because energy resource development generally requires significant investment, increasingly advanced technology and a long lead time, and because the guarantee of steady demand is likely to produce a larger response from energy suppliers, regional cooperation in energy development will likely increase over the course of the next few decades.⁴⁵ We would expect to observe this phenomenon first in China, and then in Russia.

The Japanese government has joined with the private sector in a program to develop energy technologies. A joint private/public entity, known as the New Energy Development Organization (NEDO), serves as the mechanism by which a coherent and integrated approach to energy technology development and trade promotion is undertaken. This cooperation between the private and public sectors has proven effective in commercialising energy technologies and developing export markets. The Japanese strategy has been to coordinate programs with different objectives so that they are mutually reinforcing.

NEDO is tasked with renewable energy technology research and development. The Ministry of International Trade and Industry (MITI) has been responsible for the development of alternative energy supplies and for identifying new technology for the private sector. The Japan International Cooperation Agency (JICA) is responsible for technical assistance to and grant-aid cooperation with developing countries. The Overseas Economic Cooperation Fund (OECF) promotes the export of Japanese energy equipment through concessionary financing. Grants, mixed credits and concessionary loans have become increasingly important in the contract bid process in Asia.⁴⁶ Japan is positioning itself well to meet the energy challenge, thereby increasing over time its

⁴⁵ For an expanded narrative on this topic, see Tsuyoshi Okamoto, Energy Policies of the East Asian NICs and ASEAN Countries and the Role of Japan and the United States, Harvard University Press, 1987.

⁴⁶ U.S. Department of Commerce, "A Competitive Assessment of the U.S. Renewable Energy Equipment Industry", Washington, December 1994.

involvement in North Asia.

6.2 Environmental Conditions and Opportunities

With the possible exception of Japan, environmental issues have only recently been a focus of attention for governments in the region. The countries under study have been far more concerned with economic development than with matters related to environmental protection. Environmental regulations and standards have tended to be weak, or enforcement lax.

In the past few years, however, environmental protection and the development of environmental infrastructure have been the focus of considerable attention for these governments for a number of reasons. The rapid urbanization and economic development that these economies have experienced have caused substantial damage to their local environments. Air and water quality have been most affected. Common problems include waste water treatment, industrial waste and air pollution. Moreover, within the context of international environmental issues, such as global warming and the management of ocean resources, the region is coming under greater pressure to focus more attention on environmental protection.

Domestic and international pressures are moving the governments of these economies to developing coherent policy regimes that include environmental protection, and funding for monitoring and enforcement activities. Authorities in these countries must come to view environmental management as part of the larger process of industrial restructuring or economic reform. In the short term, the objectives of promoting economic growth, raising living standards and protecting the environment may not always be compatible, and governments often confront difficult choices in pursuing them simultaneously. Nevertheless, in the long term they are mutually supportive objectives. The formulation of such policies, standards and regulations has led to the development of markets for equipment, technology and services related to environmental protection and pollution reduction.

Japan currently may be the dominant supplier of pollution control equipment to the economies of the region. Its strength as a supplier of environmental products would appear to be based on market presence and financing. The market presence allows Japanese firms to develop relationships with local decision-makers and to introduce them to Japanese products and technology. Although OECF funding is no longer tied, Japanese firms reportedly still enjoy a certain degree of preference in bidding for contracts funded by OECF loans, particularly with regards to feasibility studies.

6.3 Implications for the Region

Both energy-related and environmental issues have relevance to the question of economic integration in North Asia. Economic growth has been the primary engine of increased economic interdependence in North Asia. Any impediment to continued growth is thus a threat to closer economic ties in the region.⁴⁷ Inadequate energy and environmental infrastructure is already beginning to slow economic growth in parts of China, the economy that is currently the main engine of economic expansion in the region. Environmental infrastructure, particularly in the area of air and water pollution control, has failed to keep pace with development in many parts of the region, and this could eventually have a detrimental effect on foreign investment flows. The economies in the region recognize the importance of improving both energy and environmental infrastructure as a means of ensuring continued economic growth. This concern over energy and environmental infrastructure will continue to present Canada with significant opportunities to take part in a growing market and, perhaps eventually, in a process of inter-regional cooperation. Canada has strengths and weaknesses in these areas. Japan's more aggressive use of concessionary financing and development assistance as a means of securing market share may be an issue for concern.

Improvement of energy and environmental infrastructure is a goal that the economies of the region have in common, and cooperation on these issues could form the basis for closer ties. Moreover, since most of the Asian regional institutions have already set up working groups to encourage a cooperative approach to energy and environmental matters, multilateral cooperation on energy and environmental issues could increase in the future.

7. Implications for Canadian Trade Interests and Policy

Interpretations of recent trends in trade, investment and business activity in Asia and its subregions including North and/or East Asia vary considerably. One can conclude, however, that economic interdependence among the economies of the region will increase, that Japan will continue to play a large role in the region's commercial activity, that China provides much of the market expansion potential, and

⁴⁷ For an interesting and more detailed discussion on the topic of linkages between environmental stress and national security concerns, see Robert T. Stranks, "A View of the Forest: Environmental Stress, Violent Conflict and National Security", Department of Foreign Affairs and International Trade, Policy Staff Paper No. 95/05 (April 1995).

that the U.S. will remain the single most important market for North Asian goods.

Economic interdependence in North Asia is taking place at a variety of levels and degrees. A "bloc" is not taking shape, but the economic interdependence of this subregion is increasing, although rather more by default than by design, and rather more slowly in relative terms than the trade data might appear to indicate at first glance. A combination of macroeconomic forces, strategic business decisions, governmental policies, political realism, cultural factors and security considerations are encouraging economic integration in North Asia. Most importantly, the integration is a natural phenomenon, driven by market forces and the pragmatic, informal actions of business and government. The need to remain competitive through the exploitation of different countries' comparative advantages appears to explain much of the increase in intraregional business activity and commerce during the past decade. The impetus for economic integration in both East and North Asia comes from the rapid economic growth of its countries, particularly China. Bilateral investment relations and trade in both products and services are both widening and deepening, although not yet to the significant detriment of North Asia's economic relations with the rest of the world, including North America.

North Asian economic interdependence is not based primarily on inter-industry patterns of trade, as is the case for the developed economies of the EU. Rather, integration is based on disparities in economic development, and is the result of a process that has seen the more advanced economies move their mature production to the less developed members of the region. In the case of North Asia, Japan and Korea have followed the lead of Hong Kong and Taiwan in taking advantage of opportunities that have presented themselves in China as a result of that country's economic reform program.

There would appear to be little reason to think that the economies of North Asia will form anything resembling an exclusionary, treaty-based bloc in the foreseeable future. Increases in trade among economies in the region should be expected, given the growth in these countries and the attendant rise in their importance in the world economy. The economic fundamentals necessary for forming an exclusionary bloc are not present in North Asia. Considerable obstacles to trade, investment and capital movements still exist. The region's diversity--social, political and economic--is also an impediment. Infrastructure bottlenecks, environmental problems and shortages of trained personnel constrain the region's prospects.

Given the region's continued reliance on the U.S and other non-Asian markets, the area's first best strategy would be to support a strengthening of the world trading system and multilateral trade liberalization. Any formal regional integration plan would

probably be viewed as a second-best option, the result of these economies perceiving that they had been left out of other regional arrangements. Moreover, any regional integration scheme would probably encompass the economies of East Asia rather than just those of North Asia.

The viability of this second-best strategy is debatable. The ongoing difficulties that most Asian economies are experiencing in their attempts to penetrate the Japanese market make it unlikely that Japan would be a realistic, or viable, alternative to the U.S. and other western destinations. Furthermore, given the continued importance of U.S. and EU markets to both Japan and the other North Asian economies, it would be difficult for Japan to go it alone with the region, despite its formidable financial resources and record of economic successes. Moreover, Japan would like to have the U.S. remain engaged in the region, to help mitigate the historical animosity between Japan and its immediate neighbours.

The main concern of many Canadians seems to be that Canadian firms are not taking full advantage of investment, trade and market opportunities in Asia, and particularly China, while those from Japan, Korea, Hong Kong and Taiwan are doing so. The implication is that Canadian firms will not be well placed to serve the growing consumer markets of the region. Many observers have suggested that it is vital to the long-term competitiveness of Canadian industry, as well as to Canadian commercial interests and policy, to be a part of the continuing transformation of the fastest growing region of the world. Asia is now the hub of industries such as electronics and a wide range of machinery, and an increasingly important source of new technologies and products. Competing in Asian, particularly North Asian markets, may be an important test of a company's ability to succeed globally. While some of Canada's largest firms may be well placed in the region, small and medium-sized Canadian firms are under-represented. Without an on-the-ground presence, Canadian firms may miss out on information about emerging technologies, products and competitors' activities. This not only reduces the ability of Canadian firms to compete in North Asian markets, but could eventually lead to Canadian producers being blindsided at home by exports from this region.

7.1 Japan's Role

Through a combination of private sector expansion, export promotion and foreign aid, Japan has established a significant presence virtually throughout Asia. The question remains, however, whether its efforts constitute an attempt to dominate the region, a drive to ensure continued competitiveness in light of changed domestic economic conditions, or just an effective business strategy. Whichever it is, Japan will continue to play some sort of leadership role in all regions of Asia, including North

Asia--a role that may be less acceptable to the other economies of North Asia over the long run than may be the case in other or larger Asian subregions. Japan's role in North Asia will be constrained by the historical hostility and mistrust the region's other economies feel towards it, as well as by the growing economic importance of mainland China, and by the importance for China of investors from Hong Kong, Taiwan and Korea. Japan's role could also remain constrained should the U.S. maintain, or enhance, its commitment and level of involvement in the region.

There is some concern that Japan is using its aid policies and trade promotion activities to stymie competitors' activities in the region, and that Japanese corporations will transfer their supplier networks (keiretsu), which are often perceived to be closed and difficult to penetrate, to the other economies in the area. Unfortunately, comprehensive empirical data to support or refute this claim are lacking.

7.2 A Role for Canada

Given Russia's resource endowments--timber, fish, mineral resources and fuels--it would appear that there is significant potential for increased competition for Canadian exports from Russian products in these sectors. A review of Japanese import statistics, however, suggests that Russian and Canadian exporters currently are major competitors in only a few markets. These would include: frozen fish, sawn wood and some unwrought mineral products.⁴⁸ Greater competition from Russian resource-based goods may have been limited by that country's recent economic problems, but could well increase should it be able to arrest the decline in economic activity in its export sectors.

Trade with Asia, and particularly the economies of North Asia, is important for Canada, and has been growing in importance in recent years. In 1993, Canadian exports to the economies of North Asia of C\$13.7 billion were only exceeded by Canadian exports to the U.S. of C\$150.5 billion. Canadian exports to North Asia in 1993 amounted to 7.3 per cent of total Canadian exports, up from 6.9 per cent in

⁴⁸ For example, during the 1988-93 period, Russia saw its share of the Japanese market for frozen fish (HS Code 03.03) increase from 1.1 per cent to 9.5 per cent, while Canada's share declined from 7.3 per cent to 4.9 per cent. Russia also was able to increase its share of the Japanese nickel market (HS Code 75.02), while Canada saw its market share decline by more than one-half. Canada, however, was able to increase significantly its share of the market for sawn wood (HS Code 44.07) during this period, while Russia's share increased only slightly. While Russia was able to triple its share of Japan's aluminum market (HS Code 76.01) from 3.2 to 10.4 per cent, Canada's market share increased marginally. See: Japanese Tariff Association, Japan Exports and Imports: Commodity by County, Tokyo, Japan, Issues 93.12/88/12, 1994/1989.

1985. Canadian imports from Asia exceeded Canadian imports from any other region of the world, except the U.S.. Canadian imports from North Asia amounted to C\$19.8 billion, or 11.7 per cent of total Canadian imports, up from 9.6 per cent in 1985.⁴⁹

Canadian companies have established affiliates and joint ventures in North Asia to conduct labour-intensive assembly for export to markets outside the region. Canadian companies also have affiliates in the region that are engaged in manufacturing for local consumption and resource extraction, among other activities, which are not necessarily export enhancing from a Canadian perspective.

If one assumes that the level of economic interdependence in North Asia will continue to increase, the appropriate business and policy responses should probably focus on increasing Canadian involvement in the region. Unfortunately, a country the size of Canada cannot emulate the approach of Japan, which has been so successful in establishing a commercial presence in Asia. The reason that Canadian firms have a lower presence in Asia than may be desirable may relate mainly to the structure of the Canadian economy and Canadian corporate behaviour rather than to trade barriers in the region. Traditionally, most Canadian firms have focussed on penetrating the U.S. market. Canadian firms' focus on short-term earnings, a lack of familiarity with and lack of awareness about North Asian market opportunities, complacency because of the large size of the North American market, and preoccupation with markets elsewhere have, until recently, dampened interest in North Asia. Regional factors that may be dampening the interest of Canadian firms include: distance to these markets, a lack of familiarity with local business customs and tariffs and non-tariff barriers. Furthermore, as one might expect given its relative size, Canadian government resources for information gathering and trade promotion and development are limited and not of the magnitude of those of Japan, the EU states or the U.S..

Most observers would suggest that establishing a strong presence in Asia is vital to the success of Canadian firms and to furthering overall Canadian objectives there. Canada cannot afford to ignore the increasing importance of these economies. The Government of Canada, provincial governments and Canadian firms must participate actively in Asia. Canadian firms must be urged to consider more seriously the opportunities that this region offers and to pursue them with vigour and patience.

Further efforts should be made to lower barriers to trade in goods and services, reduce subsidies, protect intellectual property and facilitate investment. There is a need for expanding Canadian trade promotion efforts in the region and improving

⁴⁹ IMF, Direction of Trade Statistics, Washington, 1994.

government-business cooperation. The Prime Minister's 1994 trip to China was generally viewed to have successfully promoted Canadian economic relations with that country, and acquainted Canadian companies with opportunities there. A strong follow-up program must be implemented to reap the full benefit of the Prime Minister's visit.

To the extent that practices of North Asian governments disadvantage Canadian suppliers, a combination of pressure for change and pragmatic reassessment of Canadian strategies may be in order. To the extent that the rationale for investing in the region is driven by barriers to Canadian exports, it may make more sense from a Canadian national interest perspective to seek the lowering of those barriers, rather than to encourage Canadian investors to set up shop in the region.

Increasing Canadian involvement in North Asia's fast-evolving business environment and still nascent economic institutions is both possible and desirable, particularly within APEC as it becomes more institutionalized. Canada should work within APEC to ensure that it maintains its outward-looking orientation, including with regard to the prospects for achieving free trade within the 2010/2020 timeframe adopted by Leaders when they met last November in Indonesia. Such involvement would not only provide Canada with leverage to shape this organization at a crucial moment in its development, but would signal Canadian recognition of its substantial economic stakes in Asia and its intent to pursue a commercial agenda that is both broad and pro-active.

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