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# Prospects for Economic Cooperation in East Asia in the 1990s

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An Intelligence Assessment

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# Prospects for Economic Cooperation in East Asia in the 1990s

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**An Intelligence Assessment**

This paper was prepared by Office of East Asian Analysis. Comments and queries are welcome and may be addressed to the Director, Regional Issues, OEA

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# Prospects for Economic Cooperation in East Asia in the 1990s [redacted] 25X1

## Scope Note

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Our assessment is based on analysis of current trading patterns and commercial policies of East Asian countries, and an exercise in which country analysts in the Directorate of Intelligence simulated the responses of finance and foreign ministers of their respective countries to various economic and political developments. The scenarios presented to the analysts in the simulation exercise were chosen not necessarily because we expect them to occur, but rather to test how a wide range of forces would affect the policies of East Asian countries and to identify those events that might intensify interest in regional economic cooperation.

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# Prospects for Economic Cooperation in East Asia in the 1990s

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## Key Judgments

*Information available as of 5 January 1987 was used in this report.*

Economists recognize that close cooperation by East Asian states could accelerate the eastward shift of global economic influence—a potential assured by East Asia's plentiful supplies of labor and natural resources. In particular, Washington's influence in Asia would be reduced sharply if regional governments joined together in a customs union or other formal arrangement for coordinating trade policies. Instead of being able to negotiate separately with area governments for adjustments in commercial policies, Washington would have to deal with an agenda set by the East Asian union. As a worst case, US exports to the region would plummet, the trade deficit would grow, pressure for depreciation of the dollar would build, and US economic leverage would be offset in the rest of the world by the combined resources of Asian states.

If East Asian countries formed a customs union—eliminating tariffs on trade among members and maintaining uniform tariffs against nonmembers—the most efficient enterprises would displace higher cost producers in the region, allowing East Asia to utilize its vast resources most productively and allowing consumers to purchase products at lower prices. Increased competition among members might also accelerate the shift in industrialized countries in East Asia away from low-value-added, labor-intensive industries—such as cotton textiles—to high-tech, capital-intensive production. With regionwide trade rising in response to reduced trade barriers, the efficiency gains might propel rapid, inward-focused growth in East Asia.

Although the potential benefits to East Asian countries from formal economic cooperation are large, in our view, differences in economic structure and political interest will block the formation of regionwide institutions such as a customs union or a free trade association. East Asian countries are more likely to react to challenges to their economic interests by entering into bilateral discussions with the United States—or other East Asian states—rather than regional multilateral arrangements:

- The industrialized countries in East Asia depend heavily on sales to the United States and Western Europe. They probably fear that forming an Asian customs union would provoke trade protectionism in the West.

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- The natural resource exporters—Australia, New Zealand, and the Southeast Asian countries—could expect few new sales from an East Asian customs union, because present exports of oil, coal, and rubber are not very restricted.
- Most East Asian states would be reluctant to enter agreements that would enhance the economic or political influence of Japan or China.

The probable continued lack of a coordinated, multilateral East Asian response to future developments has important implications for the United States. First, the United States not only would retain strong influence in East Asia in the 1990s, but it would be able to press East Asian governments individually to accept US commercial or strategic interests, rather than having to negotiate with a regional organization. At the same time, however, many East Asian states would continue to expect the United States to bail them out of economic difficulties. The US Government would periodically come under strong pressure from countries such as the Philippines and Thailand to grant trade concessions and step up aid and investment.

Several international developments could spark changes in bilateral relations among East Asian states that would adversely affect US commercial interests. We believe successful economic reform in China or increased protectionism in the West, for example, would cause Japan and China to boost bilateral trade significantly, thereby reducing Japanese imports of US coal, soybeans, cotton, fruit, and petroleum products and Chinese imports of US plastics, fertilizers, electrical equipment, and computers. Heightened protectionism in the West might in extreme circumstances also cause Taipei to overcome its political and security reservations and formally permit direct trade with China. Finally, the transformation of Japan into an increasingly service-oriented economy might cause Beijing to upgrade its relations with Seoul in hopes of replacing declining commodity sales to Japan with increased exports to South Korea.

Tokyo is not likely to enter into formal regionwide economic cooperation schemes in the 1990s. Japan will continue to view the West as the primary market for the high-tech manufactures it wants to promote during the next

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decade. And the shift away from "smokestack" industries will lessen its dependence on East Asian raw material suppliers. Nevertheless, we believe that Japan's interest in regional stability will cause it to expand its economic ties in East Asia. Japan will respond to calls by Southeast Asian countries for increased financial assistance, but will demand concessions, such as improved terms for Japanese direct investment. East Asian countries' dependence on Japanese loans and investment, and Japan's position as a large net capital exporter, will give it leverage to exact concessions.

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**Appendixes**

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# Prospects for Economic Cooperation in East Asia in the 1990s

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## The Potential for East Asian Economic Cooperation

East Asian nations [1] traditionally have pursued their economic interests primarily through bilateral negotiations rather than multilateral cooperation. In the past 20 years, however, a few institutions for multilateral economic cooperation, such as the Association of Southeast Asian Nations (ASEAN), have been established, and economists from governments, businesses, and universities have increasingly touted the benefits of regional cooperation. Closer economic integration would allow East Asian states to utilize fully their abundant supplies of labor and natural resources. Given the skilled labor forces and managerial expertise available in the industrialized countries in East Asia, and with Japan acting as a source of financial capital, the region might attain rapid, inward-focused growth. With protectionist sentiment in the developed economies increasing, Western commentators have questioned whether Asian nations might increasingly look toward each other for growth opportunities—thereby giving the move for regional cooperation in East Asia new momentum.

An East Asian regional economic cooperation scheme could assume a variety of forms. At the least it probably would involve agreements among neighboring countries to give each other's goods preferential treatment, while discriminating against products from nonmembers such as the United States and West European countries.

*Possible Forms of Economic Cooperation*

- *A Trading Club. East Asian countries in such an arrangement would reduce tariffs on goods from other members. Each country would maintain its own set of tariffs on goods from nonmembers, such as the United States or European countries.*
- *A Free Trade Association. East Asian countries would abolish tariffs on goods from members. Each country would maintain its own set of tariffs on goods from nonmembers.*
- *A Customs Union. East Asian countries would abolish tariffs on goods from other members and—to moderate trade with countries outside the union—maintain a common set of tariffs on goods from nonmembers.*
- *A Common Market. East Asian countries would form a customs union in which members allowed unrestricted movement of labor and capital among member countries.* 25X1
- *An Economic Union. East Asian countries would form a common market in which members agreed to conduct unified fiscal and monetary policies.*

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Proponents of economic cooperation believe that countries in the region can attain increased trade, better allocations of resources, and higher standards of living by lowering barriers to trade and resource flows among selected neighboring countries. If East Asian countries formed a customs union, for instance, the most efficient enterprises would displace higher cost producers in member countries. This would allow the region to produce more, thereby giving consumers products at lower prices. For example, China—which because of its large population has an advantage in producing labor-intensive goods—might displace other producers of handicrafts. Thus, resources in other countries that had been devoted to handicraft industries could be reallocated, and less expensive handicrafts would be available throughout the region.[2]

[1] The East Asian states considered in this study were limited to: Japan, South Korea, China, Taiwan, Hong Kong, Singapore, Indonesia, Malaysia, Thailand, the Philippines, Australia, and New Zealand.

[2] Economic well-being may be lowered, however, if the common tariff structure prevents firms outside the union that are more efficient than those in the customs union from exporting to member countries. 25X1

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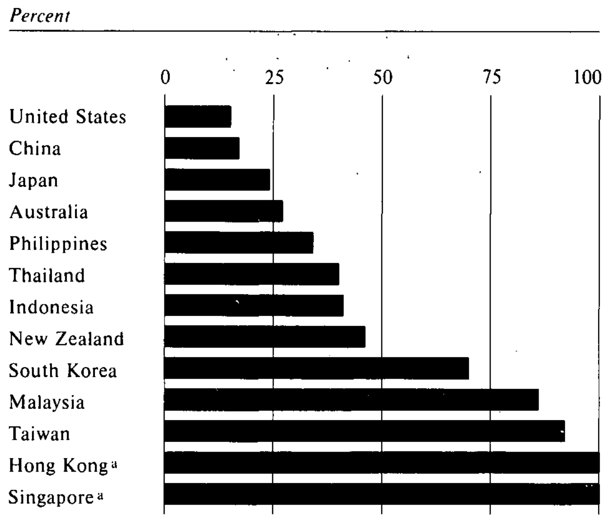
**Figure 1**
**Total Trade as Percent of GDP, 1984**




[a] Because of reexports, the percentages for Hong Kong and Singapore exceed 100.

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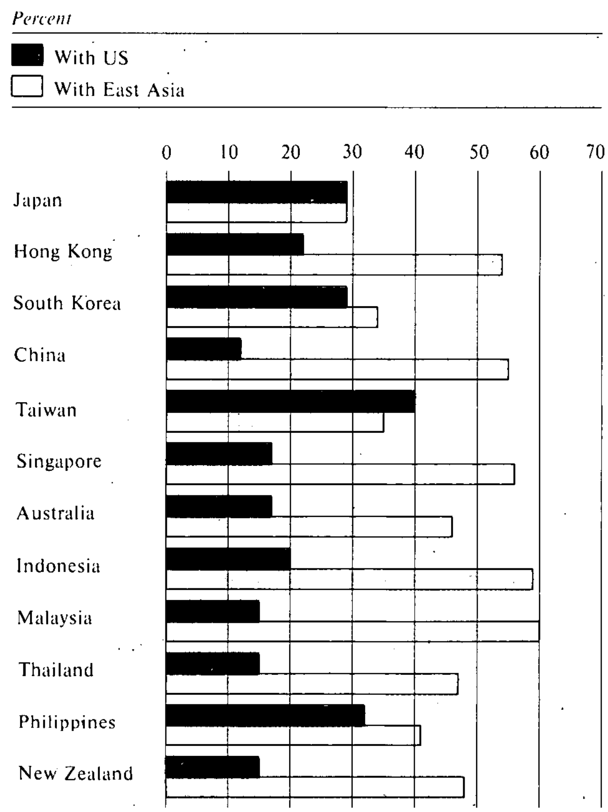
**Figure 2**
**Share of Total Trade, 1984**

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Apart from gains caused by changes in resource allocation, some East Asian countries might benefit because low-cost production methods can be used in many industries only when output is relatively large. For example, Singapore could not develop a cost-efficient automobile industry if it only sold cars domestically. But by removing barriers to trade, a customs union would greatly expand the potential market. Governments and businesses might then be willing to undertake investment to increase the scale of operations and obtain low-cost production, and also might spend more freely on research and development. [redacted] 25X1

East Asian exporters would take advantage of reduced trade barriers within the customs union to enter new markets and expand sales in previous markets—boosting trade among members. Japan and the other industrialized countries probably would increase somewhat purchases of raw materials from members—at the expense of sellers outside the region. Intensified competition within the union probably would accelerate the shift in industrialized countries in East Asia away from low-value-added, labor-intensive industries—such as cotton textiles—to high-tech, capital-intensive production. Industrialized countries in the union probably would try to sell high-value-added consumer and capital goods to each other, while investing in labor-intensive industries in Southeast Asian countries and China to take advantage of lower wage rates in those states. [redacted] 25X1

The United States—which sells about one-quarter of its exports in East Asia—and Western Europe would be hurt by the formation of an East Asian customs union. In particular, over 60 percent of US exports of transistors, cotton, and wood—and about one-third of US exports of wheat, corn, soybeans, chemicals, petroleum products, and plastics—are sold in East Asia. Sales of those products, as well as computers, office machinery, industrial equipment, and coal, would plummet if East Asian countries switched their purchases from the United States to countries within the union. Consequently, US foreign exchange earnings would fall, and pressure for depreciation of the dollar would increase.

Furthermore, a decrease in purchases of exports from the United States and Western Europe might cause the price of those goods to fall—shifting the terms of trade against nonmembers. For instance, if US wheat sales to Asia decreased because of the formation of a customs union, the price of US wheat might fall. Faster technological development or the growth of larger, cost-efficient enterprises within the union probably would hurt nonmembers.

More broadly, Washington's influence in Asia would be reduced if East Asian states formed a customs union. Instead of being able to negotiate separately with area governments for adjustments in commercial policies, Washington would have to deal with an agenda set by the East Asian union collectively. And US economic leverage in the rest of the world would be offset by the combined resources of Asian states.

### Factors Mitigating Against an East Asian Customs Union

Notwithstanding the significant benefits to East Asian countries of forming a customs union, diverse economic and political interests have prevented formal economic cooperation in Asia. One of the principal barriers to regional cooperation is the wide divergence in economic structures in these countries. The region contains a major economic power—Japan; newly industrialized countries (NICs)—South Korea, Taiwan, Hong Kong, and Singapore; less developed countries (LDCs) in Southeast Asia that rely heavily on exports of natural resource-related products—Indonesia, Malaysia, Thailand, and the Philippines; industrialized countries that also export natural resource commodities—Australia and New Zealand;

***Characteristics of East Asian Countries Necessary for a Customs Union***

*East Asian countries have some of the characteristics economists have identified as important to successful regional cooperation. First, countries such as Japan, South Korea, Taiwan, Hong Kong, and Singapore produce similar manufactured goods:*

> *Economists believe that benefits from a customs union are greatest when members' economies are "competitive"—in the sense that each produces a wide range of similar manufactured goods—and when demand patterns do not vary much between countries. Then, when tariffs are lowered within the union, cost advantages cause widespread substitution of one member's goods for another, increased specialization, and a surge in intraunion trade. On the other hand, the gains from a customs union are small if the economic structures of member countries are too different. For instance, if one country produces mostly high-tech manufactures while another produces mostly handicrafts, the pattern of specialization between the countries probably would not be altered, and the countries would trade the same goods with each other as they did before the union was formed.*

*Second, Asian nations conduct a brisk trade with each other—over 40 percent of East Asia's world trade occurs within East Asia:*

> *Economists believe that benefits will be higher when members already conduct a large share of their trade with each other. Then, members are less likely to suffer economic losses if trade with nonmembers is disrupted when the customs union is formed.*

*Finally, most governments in the region believe that rapid expansion of international trade is necessary for continued economic well-being, economic policy in these countries is geared toward promoting exports to stimulate economic development, and these countries generally trade a high proportion of their output.*

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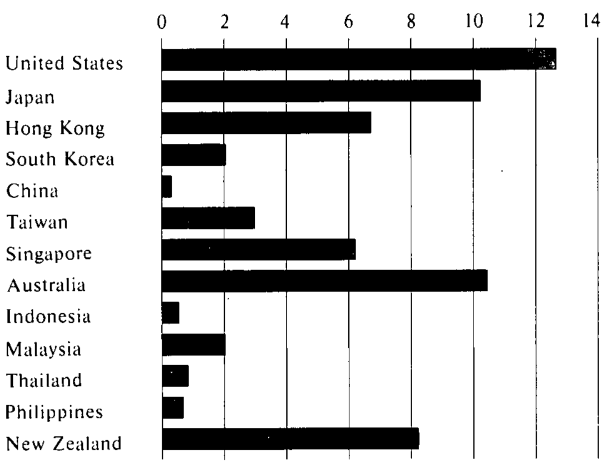
**Figure 3**
**Real Per Capita GDP in 1984**

*1980 thousand US $*

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and a resource-rich country with a very low per capita income, China. Other important factors inhibit the development of regional cooperation.

***The Importance of Trade With the United States.*** Trade patterns suggest that some East Asian countries would be reluctant to enter a cooperative scheme that might jeopardize their trade with the United States. Five Asian states—Japan, Hong Kong, South Korea, Taiwan, and the Philippines—sell over one-third of their exports to the United States. These countries probably fear that, if the United States responded with protectionist measures to an East Asian union, they would not be able to replace US sales with increased exports to members. For instance, Japan sells over one-half of its top export,[3] cars, in the US market. Because per capita gross domestic product (GDP)—a crude indicator of demand patterns—is generally much lower in Asian countries than in the United States, it is unlikely that Japan could transfer a substantial share of its car sales from the US market to Asia. Taiwan is particularly dependent on US trade—about half of its foreign sales are in the United States—while it sells less than 20 percent of its top five exports within Asia. 25X1

The United States is also an important source of imports for Asian countries. Japan, South Korea, Taiwan, Australia, and the Philippines each purchase more than one-fifth of their imports from the United States. In our view, the prospect that customs union tariffs might divert imports from US suppliers to higher cost Asian suppliers might cause these countries to have additional reservations about regional cooperation. Customs union tariffs, for example, might make US machine parts prohibitively expensive for Australian firms, forcing them to import those parts from Japan at prices above what they had to pay US firms before the union was formed. 25X1

***The Natural Resource Content of Asian Trade.*** Natural resources—such as crude petroleum, minerals, and agricultural products—constitute a predominant share of the exports of Indonesia, Malaysia, Thailand, the Philippines, Australia, and New Zealand. For instance, Indonesia's top three exports—crude petroleum, natural gas, and petroleum products—account for over 80 percent of total export earnings, and almost 80 percent of total sales of these products are to East Asian nations. For Malaysia, sales of crude petroleum and wood make up about 45 percent of export earnings, and almost all of these goods are sold within Asia. In our view, these countries, in particular, believe that the potential for increasing exports by joining an East Asian customs union is limited. 25X1

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***The Dominance of Japan.*** Japan's real gross national product (GNP) is about 15 times greater than the average GNP of the other Asian states, and its foreign trade accounts for over 40 percent of East Asia's world trade. We believe that many Asian countries would be hesitant to form a customs union with Japan because of apprehension that Japan would dominate

[3] Appendix A lists the top exports and imports of the East Asian countries.

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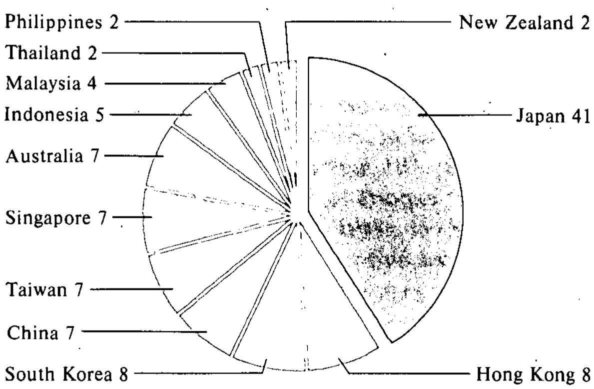
**Figure 4**
**Total Trade by East Asian Countries: Relative Shares in 1984**

*Percent*[a]

**Total: $708.9 US billion**




[a] Rounded to nearest percentage point.

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the union. Newly industrialized countries such as South Korea and Taiwan probably believe that, if they removed tariffs on Japanese goods, Japan would flood their markets with high-tech manufactured products—thereby preventing them from developing similar industries. Less developed countries—such as Malaysia, the Philippines, and Thailand—are counting on development of electronic components and similar light manufacturing industries to drive export growth. If they removed barriers to Japanese goods, the much larger Japanese producers might drive their industries out of business before they became firmly established.

***Concerns About Increased Chinese Influence.*** We believe that Singapore, Malaysia, Indonesia, and Thailand would be reluctant to enter into an Asian union that included China. They have deep concerns about China's long-run intentions in Southeast Asia, which are based, in part, on past Chinese support to Communist insurgencies and fears that with closer economic ties China would be able to manipulate their sizable ethnic Chinese populations, and on the realization that China would be producing the same labor-intensive goods that they want to market. Taiwan—which does not officially allow direct trade with China—would have even stronger objections to regional cooperation schemes that included China.

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***Political and Cultural Impediments.*** We believe the diversity of Asian cultural, political, and ideological systems inhibits regional economic cooperation. Moreover, some Asian states gained their independence recently and still have sharp memories of the colonial experience and of Japanese occupation. We believe many of these countries fear that closer cooperation might diminish their autonomy, and would reject any arrangement that seemed to return them to colonial status. 25X1

**Wild Cards**
Notwithstanding the impediments to formal regional cooperation, economic and political relations are changing rapidly in East Asia, and international developments may strengthen common interests, propelling economic cooperation forward. In the past few years, for instance, China has committed itself to an ambitious economic reform program to introduce market elements into its ossified Soviet-style planning system and expand contacts throughout Asia. The Philippines is in the throes of political transition. Export-oriented policies of Asian countries increasingly are clashing with protectionist-minded governments in the West, depressed prices for minerals and agricultural products are hurting export earnings of Asian LDCs, and growth rates in Asia have slowed.

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To identify which, if any, international developments might promote regional cooperation, we constructed six scenarios. The first four—political instability in a key East Asian state, changing Japanese foreign

*The Case of ASEAN*

*In our view, the Association of Southeast Asian Nations (ASEAN) exemplifies both the most successful effort at regional cooperation in East Asia and also the difficulty of reaching consensus on fundamental economic issues among states that have divergent interests. When ASEAN was founded in 1967 by Indonesia, Malaysia, the Philippines, Singapore, and Thailand (Brunei joined in 1984), its objectives were primarily political—and its most significant achievements have been in the political realm. Since Vietnam installed the Heng Samrin regime in Phnom Penh, ASEAN has successfully lobbied UN delegates to prevent the regime from occupying Cambodia's UN seat. And ASEAN's annual meeting of foreign ministers is often attended by counterparts from the United States, Canada, Japan, Australia, and New Zealand (and a representative from the European Economic Community)—providing an important forum for discussion of East Asian issues.* 25X1

*In 1976 the ASEAN states formally decided to pursue economic cooperation. Since then tariffs have been reduced on thousands of goods, and several industrial joint ventures have been started. The preferential tariff arrangements, however, apply to only about 2 percent of intra-ASEAN trade. And although trade among ASEAN members increased 50 percent from 1973-83, it still constitutes only about one-fifth of members' total trade. We believe these statistics, however, are somewhat misleading. Over one-half of intra-ASEAN trade is in crude oil and petroleum products and occurs primarily between Singapore and Indonesia and Malaysia. Trade between ASEAN countries other than Singapore is relatively low. Trade with the Philippines, for instance, makes up about 2 percent of Malaysia's total trade, and trade with Thailand constitutes less than 1 percent of Indonesia's trade.* 25X1

*At a meeting in October 1986, ASEAN states decided to delay the goal of free trade among members until the year 2000. Although all of the states are eager to increase their exports to other members, many fear the increased competition that would occur if tariffs were eliminated on trade within ASEAN. Most ASEAN states export the same types of natural resource products—Indonesia and Malaysia, in particular, export almost exactly the same mix of raw materials. Moreover, most ASEAN states hope to develop clothing, consumer electronics, and other light manufactures as export industries. Indonesia, however, with its sizable domestic market, would be reluctant to allow duty-free imports of Thai clothing or Philippine radios. Although Singapore is a strong proponent of reduced trade barriers within ASEAN, it does not want to jeopardize its free trade status by joining the other states in setting tariffs on goods from nonmembers. Without a common tariff structure, however, goods would enter the region via the low-tariff state—Singapore—and then would be sold duty free to higher tariff members. We believe that reluctance to reduce mutual tariff barriers (and to set common tariffs on goods from nonmembers) will continue to inhibit ASEAN from forming a customs union.* 25X1

policy goals, transformation of Japan's economic structure, and economic reform in China—involve developments within the region. The last two—a return to higher oil prices and heightened Western protectionism—consider events originating outside of East Asia. Our conclusions regarding how East Asian countries would respond to the six scenarios are based on a combination of our analysis of current trading patterns 25X1

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***Scenario 1: Increased Political Instability in East Asia.*** *Sudden political change in East Asia might alter the calculations of area governments regarding economic cooperation. The region's response to sudden political change in the past, however, has varied widely. The increased cohesion of ASEAN in the 1980s, for example, has been largely a response to Vietnam's invasion of Cambodia. Recent political turmoil in the Philippines, however, has produced little in the way of economic concessions from Manila's neighbors. To consider how area governments would react to much more far-reaching change, we simulated the response of East Asian states to the overthrow of a pro-Western government in the Philippines by a Communist-led insurgency.*

On the basis of Japan's response to the reduced American presence in Asia following the Vietnam war, we believe that, if Communists came to power in the Philippines, Japan would initiate an aid program for the market economies in Southeast Asia that included increased direct grants and stepped up investment spending on industrial development projects. Japan, however, would be unlikely to alter its commercial policy and open its markets to manufactured goods from East Asian countries. South Korea and Taiwan would follow Japan's lead. The Southeast Asian LDCs would call for increased regional cooperation but would be unlikely—during a period of heightened concern that political instability might increase in their own countries—to offer each other the trade concessions necessary for increased formal economic cooperation. Most of the East Asian states—particularly the Southeast Asian LDCs—would ask the United States to increase aid.

***Scenario 2: Emerging Japanese Leadership in East Asia.*** *Since the end of World War II, Japan has been content to let other countries, particularly the United States, exercise political leadership in East Asia while it has steadily boosted bilateral trade with Asian countries. Japan's reluctance to exert political influence commensurate with its economic power stems largely from its desire not to revive memories of the Greater East Asian Co-Prosperity Sphere held by its trading partners. As a new generation assumes power, however, Tokyo may become more assertive. To consider how increased Japanese assertiveness would affect prospects for economic cooperation, we simulated the response of East Asian states to new Japanese policies designed to signal Tokyo's intention to exercise greater leadership. Specifically, we assumed that Japan opened its market somewhat to goods from East Asian countries by lowering tariff duties and reducing bureaucratic obstacles to imported goods, and also eased restrictions on technology transfer, especially to China.* 25X1

We believe that Asian countries would be wary of Japanese policy designed to increase Japan's political leverage by lowering import tariffs and other restrictions on East Asian goods. Although they would welcome the opportunity to sell more to Japan, they would be worried about greater economic dependence on Japanese markets. China probably would be the most enthusiastic supporter of Tokyo's new policies, and would push hard for increased sales of oil and petroleum products, coal, silk, soybeans, and light manufactures to Japan. The Southeast Asian LDCs would boost sales of raw materials to Japan, and Malaysia and the Philippines might even respond to the Japanese initiative by offering better terms for Japanese direct investment in local industries—with the understanding that a large share of the output could be sold in Japanese markets. Hong Kong and Singapore would support Tokyo's initiative—expecting to gain somewhat by increased sales to Japan, and even more by new sales to other Asian countries that have benefited from Tokyo's new policies. South Korea and Taiwan, however, would be concerned that their competitive position in East Asia would be eroded by Tokyo's policies. Australia and New Zealand would fear that their sales of raw materials would be hurt by increased access of Chinese exporters to the Japanese market. East Asian countries

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**Table 1**
**Major Trade Partners, 1984**

*Percent of total trade with partner*

| **Japan** | **Hong Kong** | **South Korea** |
|---|---|---|
| United States (29) | United States (22) | United States (29) |
| Saudi Arabia (7) | China (21) | Japan (21) |
| Indonesia (5) | Japan (14) | Saudi Arabia (4) |
| China (4) | Taiwan (5) | Hong Kong (3) |
| **China** | **Taiwan** | **Singapore** |
| Japan (24) | United States (40) | United States (17) |
| Hong Kong (23) | Japan (17) | Malaysia (16) |
| United States (11) | Saudi Arabia (5) | Japan (14) |
| West Germany (3) | Hong Kong (5) | Indonesia (7) |
| **Australia** | **Indonesia** | **Malaysia** |
| Japan (24) | Japan (38) | Japan (24) |
| United States (17) | United States (20) | Singapore (17) |
| United Kingdom (5) | Singapore (11) | United States (15) |
| New Zealand (5) | Saudi Arabia (4) | West Germany (4) |
| **Thailand** | **Philippines** | **New Zealand** |
| Japan (21) | United States (32) | Japan (18) |
| United States (15) | Japan (16) | Australia (18) |
| Singapore (8) | Malaysia (5) | United States (15) |
| Saudi Arabia (6) | Hong Kong (4) | United Kingdom (9) |

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would use Japan's new policies as a lever to press for similar trade concessions from the United States.

***Scenario 3: Decreased Demand for Raw Materials in East Asia.*** *Japan's economy is evolving slowly into a high-tech, service-oriented economy in which heavy industry plays a diminished role. This economic transformation is already altering the structure of Japan's imports—diminishing the raw material content relative to higher technology and service-related imports. Most East Asian countries, however, are heavily dependent on sales of industrial raw materials to Japan. Sales of coal and iron ore to Japan account for about 15 percent of Australia's total export earnings, sales of wood and crude oil to Japan constitute over 15 percent of Malaysia's total export earnings, and sales of crude oil, natural gas, and petroleum products to Japan account for more than 50 percent of Indonesia's total export earnings.*[6] *To consider the long-run consequences of Japan's economic transformation, we simulated the reaction of East Asian states to a decrease in Japanese imports of minerals and other raw materials and the resulting fall in commodity prices.*

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[6] Sales of these products constitute about 50 percent, 75 percent, and 90 percent, respectively, of Australian, Malaysian, and Indonesian exports to Japan.

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A shift in Japan's import pattern would prompt East Asian natural resource exporters to look for new markets outside Asia and probably would intensify efforts by the Southeast Asian LDCs and China to develop light industries. The possibility that East Asian resource exporters would form a customs union is remote, because they sell the same types of commodities. The less developed resource exporters also would be reluctant to establish a formal cooperation scheme with South Korea and Taiwan for fear that those more developed countries would flood their markets with light manufactures—thereby inhibiting them from developing similar industries. China might react to decreased Japanese demand for raw materials by strengthening economic ties to South Korea—even if it meant heightened tensions with North Korea. In return for increased South Korean purchases of crude oil and coal, China would agree to import more steel, chemicals, and capital equipment. The resource exporters in East Asia would press the United States to increase investment in industrial development projects in their countries and to reduce barriers to the sales of their manufactures in the US market.

***Scenario 4: Successful Economic Reform in China.*** *Since 1978 China has pursued a policy of economic liberalization at home and increased trade and political contacts abroad. In the past six years, China's total trade has more than doubled. In 1985, China was Japan's second-largest trade partner—after the United States—while Japan was China's number one partner. Although Beijing does not have formal political relations with South Korea or Taiwan, bilateral trade with each exceeded $1 billion in 1985, according to US Consulate estimates. Although leaders of most East Asian states have publicly praised China's economic reform program, many undoubtedly worry about the long-run consequences for their economies. To consider the impact of sustained successful economic reform in China, we simulated the response of East Asian states to continued rapid growth in Chinese imports and exports. Specifically, we assumed that Chinese exports of clothing and textiles would double in the next 10 years, and foreign sales of coal, ships, consumer electronics, machine parts, and manufactures of low- to mid-level technological sophistication would also expand rapidly. We also assumed that Chinese imports of industrial supplies, capital goods, and high-tech equipment would grow as China modernized.* 25X1

Facing growing competition from Chinese exports of clothing, textiles, and other light manufactures—in both domestic and international markets—we believe East Asian LDCs would consider joining a customs union with Japan and/or South Korea if it guaranteed a protected market for their products. Japan and South Korea, however, would benefit from the success of China's reforms by increasing sales of industrial supplies, capital goods, and consumer goods to China and would not be interested in joining such a union if their membership prompted China to retaliate against their exports. We believe that Taipei would come under intense pressure from Taiwan businesses to allow expanded economic contacts with China. If Taipei refused, Taiwan probably would be one of the big losers from successful reform in China. In hopes of maintaining their shares of the US market, some East Asian countries—Taiwan and the Philippines, in particular—would lobby the United States to maintain strict quotas on imports of Chinese products.[7] 25X1

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***Scenario 5: A Return to High Oil Prices.*** *When crude oil prices quadrupled in 1973-74, East Asian states were forced to make sharp adjustments in economic policies. South Korea, for instance, devalued its currency, and Japan implemented conservation measures and began to switch to alternative energy sources. Oil-rich countries, such as Indonesia, experienced a sudden increase in government budget revenues. Although the oil price hikes during the 1970s did not spark increased regional cooperation, we considered whether a return to relatively high energy prices in the 1990s would cause East Asian states to boost regional ties. In this simulation we assumed that by the mid-1990s the real price of oil will return to the level it was at in the late 1970s.* 25X1

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We believe that, just as in the 1970s when the first oil price shocks occurred, each East Asian country would go its own way in response to new oil price hikes. Regional governments would have to contend with all of the factors currently inhibiting regional cooperation, plus the additional problem that some countries—such as Indonesia, Malaysia, and China—probably would benefit from higher oil prices, and thus would feel less need for formal multilateral cooperation. East Asian LDCs hurt by the oil price hike—the Philippines and Thailand—would press the United States for trade concessions and increased loans and financial aid.

***Scenario 6: Increased Protectionism in the West.*** *East Asian states export a large proportion of their total output,[8] and most of these states plan to fuel economic growth with expanded sales abroad—particularly to the United States. Few economic issues, therefore, cause such concern among East Asian countries as the specter of heightened protectionism in the West. In our final simulation we considered the probable response of East Asian states to increased trade barriers in Western countries. Specifically, we assumed that in the 1990s East Asian exporters would face higher tariffs and quotas on sales of textiles, clothing, steel, shoes, automobiles, consumer electronics, and agricultural products.*

We believe most countries in the region would look to Japanese markets to make up sales lost because of heightened protectionism in the West. Japan, however, would be skeptical of its ability to increase exports in East Asia, and would prefer to make concessions in bilateral negotiations with the United States rather than in negotiations with East Asian governments over forming a customs union. Tokyo's bargaining position probably would be to accept higher US tariffs on labor-intensive manufactures, make selected tariff cuts of its own, and boost investment in US industry in exchange for reduced US tariffs on high-tech products. To increase pressure on the United States, Japan probably would shift some of its purchases of natural-resource-related products from the United States to Asia—particularly China. China would retaliate against Western protectionism by slashing imports selectively to match the value of lost sales in the United States and Western Europe. China also would increase its purchases from Asian countries—particularly Japan—and would probably boost trade with the Soviet Union and East European countries. With growth slowing, unemployment rising, and export prospects worsening, Taipei might decide to loosen restrictions on trade with China. Other East Asian countries probably would enter bilateral negotiations for trade concessions with the United States, while using international forums to criticize the US and West European governments for protectionism. 25X1

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[8] Table 2 shows that exports as a percent of gross domestic product range from 9 percent for China to 133 percent for Singapore (counting Singaporean exports and reexports).

**Prospects for Economic Cooperation in East Asia**

Judging from current trade patterns and our simulation exercise, we believe that the East Asian states will not be likely to establish formal multilateral arrangements for coordinating their trade policies during the 1990s. Factors that inhibit regional cooperation today—such as economic diversity and varied political interests—will be significant barriers in the next decade. In particular, the developed countries in East Asia produce an export mix that is best suited to US and West European markets and do not see significant potential in increasing sales to the lower income countries in East Asia. Even if protectionist measures are enacted in the West, Southeast Asian LDCs have little to offer the developed countries in East Asia that they are not already getting without regional institutions for economic cooperation. 25X1

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Although regionwide economic cooperation is unlikely, future international developments might cause increased cooperation among some states. We view stronger Sino-Japanese economic cooperation as the most likely possibility. China and Japan are important trade partners, and Japan has much to offer China—eased restrictions on sales of goods in Japanese markets, increased direct investment in China, and greater technology transfer. Japan has been reluctant to grant substantial concessions on any of the three, however, preferring to limit its economic relationship to commodity trade. 25X1

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Our simulations indicate that successful economic reform in China or heightened protectionism in the West could cause Japan to alter its relationship with China significantly. Japan probably would be the biggest beneficiary in East Asia of successful reform in China—expanding its exports of industrial supplies and capital and consumer goods to meet China's development needs. If Japanese businesses became convinced that the reforms were permanent, they would aggressively exploit investment opportunities in China. In response to Western protectionism, Japan might shift some of its purchases of natural resources from the United States to China, and China would boost purchases of high-tech and capital goods from Japan.

Future international developments are also likely to heighten Japan's economic importance to the other nations in East Asia. We believe that, although Tokyo is much more likely to maintain its present course—granting development aid, but denying technical transfers and limiting imports of regional manufactures—than to agree to formal multilateral cooperation, Japan's interest in regional stability might prompt it to begin to play the role of pacesetter and caretaker in East Asia. In response to political instability or worsening trade balances, Southeast Asian governments would call on Japan to step up aid. Given the heavy exposure of some Japanese banks to the debt of Southeast Asian LDCs, and Tokyo's determination to protect its sources of raw materials from those countries, Tokyo probably will boost its scale of imports, direct investments, and aid. In turn, however, Japan will demand concessions such as eased restrictions on direct investment. East Asian countries' dependence on Japanese loans and investment will give Tokyo leverage to exact concessions, as will its position as a large net capital exporter. 25X1

Increased protectionism in the West would also increase the NICs' dependence on exports to Japanese markets. And if protectionism caused a sharp deterioration in the trade balances of the NICs, countries such as South Korea might increase their borrowing from Japan. 25X1

**Implications for the United States**

In our view, the United States not only will retain strong influence in East Asia during the 1990s, but will be able to press its commercial and strategic interests individually with East Asian countries—rather than having to negotiate with an East Asian trade bloc. Instead of strengthening multilateral ties in response to political or economic developments, East Asian states will look to the United States (and Japan) for aid and investment and as a market for exports. This suggests that US policy might be a more potent unifying force in East Asia than regional calls for multilateral cooperation. 25X1

Some developments, however, could alter bilateral relations in Asia in a way that would be detrimental to US economic interests. If successful economic reform in China or heightened protectionism in the West strengthened trade ties between China and Japan—US exports of coal, soybeans, cotton, fruit, and petroleum products to Japan and of plastics, fertilizers, electrical equipment, and computers to China would be reduced. If Japan became an increasingly service-oriented economy, Beijing might decide to upgrade relations with Seoul in hopes of transferring exports of petroleum and coal from declining Japanese markets to South Korea. Finally, heightened Western protectionism might force Taipei to allow open direct trade between Taiwan and China. 25X1

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# Appendix A

**Key Exports and Imports of Asian Countries, in Rank Order by 1982 Data**

| | Exports | Imports |
|---|---|---|
| Japan | | |
| | Cars (8%) [a] | Crude petroleum (23%) |
| | Ships (14%) | Natural gas (36%) |
| | Steel tubes and pipes (20%) | Petroleum products (48%) |
| | Trucks (23%) | Coal (42%) |
| | Sound recorders (14%) | Wood (48%) |
| | Steel sheets, plates (52%) | Fish (48%) |
| | Telecommunications equipment (23%) | Iron ore (45%) |
| | Electric machinery and switchgear (37%) | Unwrought aluminum (19%) |
| | Textile fabrics (41%) | Clothing (76%) |
| | Cameras (13%) | Organic chemicals (13%) |
| | Other metal manufactures (35%) | Corn (2%) |
| | Road motor vehicle parts (27%) | Meat (38%) |
| | Other electric machinery (33%) | Soybeans (7%) |
| | Transistors (42%) | |
| Hong Kong | | |
| | Clothing (9%) | Textile fabrics (91%) |
| | Toys, sporting goods (11%) | Petroleum products (90%) |
| | Watches and clocks (22%) | Clothing (85%) |
| | Miscellaneous consumer goods (25%) | Watches and clocks (72%) |
| | Textile fabrics (67%) | Transistors (75%) |
| | Radio (12%) | Precious stones (15%) |
| | Transistors (56%) | Meat (87%) |
| | Electric domestic equipment (11%) | Miscellaneous consumer goods (71%) |
| | Other textile products (36%) | Other yarn and thread (72%) |
| | Office machinery (18%) | Fish (70%) |
| | Precious stones (37%) | Plastics (52%) |
| | Electric machinery and switchgear (34%) | Paper (69%) |
| | Telecommunications equipment (50%) | Other textile products (88%) |
| | | Electric machinery and switchgear (69%) |

[a] Number in parenthesis indicates the share of the product sold to, or bought from, other East Asian countries.

## Key Exports and Imports of Asian Countries, in Rank Order by 1982 Data (continued)

| | Exports | Imports |
|---|---|---|
| South Korea | | |
| | Clothing (17%) | Crude petroleum (10%) |
| | Ships (13%) | Ships (33%) |
| | Textile fabrics (43%) | Organic chemicals (41%) |
| | Footwear (10%) | Coal (39%) |
| | Other metal manufactures (25%) | Petroleum products (33%) |
| | Fish (74%) | Wood (69%) |
| | Transistors (35%) | Transistors (42%) |
| | Steel sheets, plates (57%) | Cotton fiber (2%) |
| | Miscellaneous consumer goods (15%) | Telecommunications equipment (25%) |
| | Ingots of steel (74%) | Iron ore (30%) |
| | Other textile products (18%) | Electric machinery and switchgear (46%) |
| | Toys, sporting goods (13%) | Corn (2%) |
| | Television (10%) | Wheat (0%) |
| | Steel tubes and pipe (10%) | |
| China [b] | | |
| | Crude petroleum and petroleum products | Steel sheets and other steel products |
| | Textile yarn and fabrics | Wheat and other cereals |
| | Clothing | Nonelectric machinery |
| | Military firearms | Transport equipment |
| | Fruits and vegetables | Electrical machinery |
| | Miscellaneous manufactured articles | Textile fibers |
| | Textile fibers | Textile yarn and fabrics |
| | Metal manufactures, n.e.s. | Nonferrous metals |
| | Organic and inorganic chemicals | Plastics |
| | Crude animal and vegetable materials | Fertilizers |
| | | Organic and inorganic chemicals |
| | | Wood |

[b] Rank order based on 1983 data. Asian share of China's trade is not available.

**Key Exports and Imports of Asian Countries, in Rank Order by 1982 Data (continued)**

| | Exports | Imports |
|---|---|---|
| Taiwan | | |
| | Clothing (14%) | Crude petroleum (7%) |
| | Miscellaneous consumer goods (19%) | Transistors (65%) |
| | Footwear (11%) | Organic chemicals (33%) |
| | Toys, sporting goods (14%) | Aircraft and parts (0%) |
| | Telecommunications equipment (15%) | Electric machinery and switchgear (69%) |
| | Textile fabrics (65%) | Steel sheets, plates (84%) |
| | Transistors (51%) | Wood (94%) |
| | Plywood manufactures (20%) | Soybeans (0%) |
| | Fish (74%) | Plastics (53%) |
| | Vegetables (52%) | Cotton fiber (0%) |
| | Furniture (27%) | Telecommunications equipment (44%) |
| | Radio (12%) | Corn (0%) |
| | Other electric machinery (30%) | Other electric machinery (66%) |
| | Electric machinery and switchgear (43%) | Textile machinery (57%) |
| | Other metal manufactures (23%) | Coal (51%) |
| Singapore | | |
| | Petroleum products (74%) | Crude petroleum (22%) |
| | Transistors (42%) | Petroleum products (17%) |
| | Crude rubber (22%) | Transistors (53%) |
| | Clothing (7%) | Ships (29%) |
| | Radio (13%) | Textile fabrics (91%) |
| | Electric machinery and switchgear (27%) | Electric machinery and switchgear (45%) |
| | Ships (9%) | Crude rubber (97%) |
| | Animal and vegetable oils (11%) | Steel tubes and pipe (75%) |
| | Construction, mining machinery (64%) | Construction, mining machinery (37%) |
| | Television (22%) | Other metal manufactures (60%) |
| | Telecommunications equipment (26%) | Other electric machinery (60%) |
| | Textile fabrics (34%) | |

**Key Exports and Imports of Asian Countries, in Rank Order by 1982 Data (continued)**

| | Exports | Imports |
|---|---|---|
| Australia | | |
| | Coal (80%) | Crude petroleum (33%) |
| | Wheat (31%) | Petroleum products (38%) |
| | Meat (34%) | Trucks (78%) |
| | Other textile fibers (42%) | Cars (74%) |
| | Iron ore (87%) | Electric machinery and switchgear (30%) |
| | Inorganic chemicals (3%) | Paper (25%) |
| | Petroleum products (46%) | Textile fabrics (66%) |
| | Sugar (66%) | Ships (26%) |
| | Uranium thorium ores (0%) | Organic chemicals (19%) |
| | Other cereals (50%) | Construction, mining machinery (22%) |
| | Fish (49%) | Road motor vehicle parts (37%) |
| | Other unwrought metals (20%) | Computers (23%) |
| | Dairy (60%) | Miscellaneous consumer goods (52%) |
| | | Plastics (23%) |
| | | Clothing (80%) |
| New Zealand | | |
| | Meat (11%) | Petroleum products (84%) |
| | Dairy (29%) | Crude petroleum (54%) |
| | Other textile fibers (34%) | Cars (82%) |
| | Fish (69%) | Textile fabrics (64%) |
| | Unwrought aluminum (99%) | Plastics (39%) |
| | Other chemicals, n.e.s. (27%) | Steel sheets, plates (91%) |
| | Paper (74%) | Inorganic chemicals (70%) |
| | Hides (21%) | Trucks (85%) |
| | Pulp (99%) | Crude minerals (8%) |
| | Fruit (24%) | Organic chemicals (23%) |
| | Wood (94%) | Books (39%) |
| | Leather manufactures (33%) | Other textile products (46%) |
| | Vegetables (68%) | Electric machinery and switchgear (42%) |
| Indonesia | | |
| | Crude petroleum (74%) | Petroleum products (98%) |
| | Natural gas (98%) | Crude petroleum (0%) |
| | Petroleum products (88%) | Steel sheets, plates (88%) |
| | Crude rubber (31%) | Steel tubes and pipe (67%) |
| | Wood (83%) | Construction, mining machinery (47%) |
| | Unwrought tin (55%) | Trucks (82%) |
| | Coffee (28%) | Electric machinery and switchgear (49%) |
| | Plywood manufactures (50%) | Organic chemicals (44%) |
| | Fish (97%) | Plastics (50%) |

**Key Exports and Imports of Asian Countries, in Rank Order by 1982 Data (continued)**

| | Exports | Imports |
|---|---|---|
| Malaysia | | |
| | Crude petroleum (94%) | Transistors (29%) |
| | Wood (85%) | Petroleum products (97%) |
| | Animal and vegetable oils (30%) | Crude petroleum (0%) |
| | Transistors (26%) | Construction, mining machinery (66%) |
| | Crude rubber (38%) | Other metal manufactures (76%) |
| | Unwrought tin (31%) | Cars (82%) |
| | Plywood manufactures (59%) | Steel sheets, plates (92%) |
| | Clothing (11%) | Electric machinery and switchgear (50%) |
| | | Steel bars and rods (91%) |
| Thailand | | |
| | Rice (38%) | Crude petroleum (18%) |
| | Vegetables (16%) | Petroleum products (85%) |
| | Sugar (54%) | Electric machinery and switchgear (24%) |
| | Fish (54%) | Steel sheets, plates (84%) |
| | Crude rubber (83%) | Organic chemicals (46%) |
| | Clothing (9%) | Road motor vehicle parts (90%) |
| | Corn (75%) | Plastics (38%) |
| | Unwrought tin (19%) | Fertilizers (42%) |
| | Electric machinery and switchgear (52%) | Auto engines (85%) |
| | Textile fabrics (36%) | Construction, mining machinery (58%) |
| | Precious stones (45%) | |
| | Fruit (34%) | |
| Philippines | | |
| | Sugar (58%) | Crude petroleum (17%) |
| | Animal and vegetable oils (10%) | Petroleum products (51%) |
| | Fruit (45%) | Organic chemicals (41%) |
| | Ores of copper (91%) | Electric machinery and switchgear (47%) |
| | Clothing (10%) | Wheat (0%) |
| | Wood (66%) | Dairy (50%) |
| | Other nonferrous ores (84%) | Ingots of steel (88%) |
| | Plywood manufactures (34%) | Steel sheets, plates (86%) |
| | Fish (41%) | Plastics (51%) |
| | Miscellaneous consumer goods (24%) | Other metal manufactures (72%) |
| | Transistors (38%) | |

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**Table 2**
**Selected Economic, Demographic, and Political Characteristics, 1984**

| | Japan | Hong Kong | South Korea | China | Taiwan | Singapore | Australia | Indonesia | Malaysia | Thailand | Philippines | New Zealand |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Real GDP *(billion 1980 $)* | 1,226.6 | 36.2 | 83.0 | 306.3 | 56.6 | 15.5 | 161.7 | 83.3 | 30.7 | 41.6 | 35.6 | 26.3 |
| Real per capita GDP *(1980 $)* | 10,222 | 6,704 | 1,917 | 297 | 2,888 | 6,200 | 10,432 | 492 | 2,020 | 822 | 628 | 8,219 |
| Total merchandise trade *(billion 1984 $)* | 292.3 | 56.9 | 53.7 | 52.9 | 52.4 | 49.1 | 46.5 | 36.0 | 29.9 | 16.6 | 11.5 | 11.1 |
| Exports as percent of GDP | 14 | 89 | 35 | 9 | 53 | 133 | 14 | 26 | 49 | 18 | 16 | 23 |
| Imports as percent of GDP | 10 | 89 | 35 | 8 | 39 | 149 | 13 | 15 | 37 | 22 | 18 | 23 |
| Population *(millions)* | 120.0 | 5.4 | 43.3 | 1,032.7 | 19.6 | 2.5 | 15.5 | 169.4 | 15.2 | 50.6 | 56.7 | 3.2 |
| Literacy rate *(percent)* | 99 | 75 | 90 | 75 | 94 | 84 | 99 | 62 | 72 | 84 | 88 | 98 |
| Labor force *(millions)* | 59.3 | 2.6 | 15.4 | 476 | 7.5 | 1.2 | 7.2 | 67.0 | 5.9 | 26 | 20.6 | 1.4 |
| Labor force in agriculture *(percent)* | 9 | 1 | 30 | 68 | 20 | 1 | 6.5 | 55 | 33 | 73 | 47 | 10 |
| Unemployment rate *(percent)* | 2.7 | 3 | 4.1 | NA | 2.4 | 2.7 | 7.8 | NA | 6.2 | 4.5 | 6.2 | 5.7 |
| Ethnic composition of population *(percent)* | 99 Japanese, 1 other | 98 Chinese, 2 other | Korean | 93 Han Chinese, 7 other | 84 Taiwanese, 14 mainland Chinese, 2 other | 76 Chinese, 15 Malay, 6 Indian, 3 other | 99 European, 1 Asian and Aboriginal | 74 Malay, 26 other | 50 Malay, 36 Chinese, 10 Indian, 4 other | 75 Thai, 14 Chinese, 11 other | 92 Christian Malay, 4 Muslim Malay, 1 Chinese, 3 other | 87 European origin, 9 Maori, 2 Pacific islander, 2 other |
| Political system | Constitutional monarchy | British dependent territory, will revert to China in 1997 | Republic with military rule | Communist state run by party | One-party (KMT) rule | Republic ruled by one man since 1959 | Parliamentary democracy recognizing Elizabeth II as Head of State | Republic ruled by one man since 1968 | Constitutional monarchy with bicameral parliament | Constitutional monarchy with weak parliamentary system | Republic/participatory democracy | Parliamentary democracy recognizing Elizabeth II as Head of State |

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