



# An impact of economic integration through trade: on business cycles for 10 East Asian countries

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## Abstract

Many recent studies about East Asian countries discussed “natural” economic integration through trade, but there are few rigorous empirical studies on how their economies were affected by the evolution of economic integration within the region. This paper investigates the effect of bilateral trade dependence on the co-movement of business cycles for 10 East Asian countries. We find that economic fluctuations tend to be more synchronized within the region as trade interdependence among them deepens. This finding suggests the necessity of cooperative efforts to prevent or adjust unfavorable future economic crisis in East Asia. © 2001 Elsevier Science Inc. All rights reserved.

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## 1. Introduction

One characteristic of the recent East Asian countries (EACs) economic situation is an increasing trend in intraregional economic activities, including international economic activities through trade. Many studies on EACs have discussed the “natural” economic integration and concluded that the importance of intraregional trade has increased, or intraregional interdependence in trade deepened (e.g., Frankel, 1992; Petri, 1993; Langham-

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mer, 1995; Urata, 1999). For example, Urata (1999) showed for 10 EACs that intra-East Asian trade in total East Asian trade increased from 34.4% in 1981 to 50.4% in 1997.<sup>1</sup>

Frankel (1992) and Petri (1993) explained an intraregional bias, in which trade within the East Asian region grows more rapidly than the region's trade with the rest of the world. Kohsaka (1996) argued the economic integration through capital flows, including foreign direct investment, portfolio investment, official flows, etc. Langhammer (1995) discussed market-driven regionalization through trade, and Urata (1999) concluded that intraregional trade in EACs increased its importance, not only in relation to world trade, but also in relation to the total trade of EACs. However, these studies do not tell us how countries within the East Asian region were affected by their deepened economic integration through trade. One possible effect of economic integration is the synchronization of national business cycles (economic fluctuations) across countries, but there seems to be few rigorous empirical studies on this for the East Asian region.

In terms of an economic impact of trade dependence, Canova and Dellas (1993) did not find a robust significance of bilateral imports in the co-movement of business cycles for 10 major industrial countries.<sup>2</sup> In contrast, Frankel and Rose (1998) found that the Organization for Economic Cooperation and Development (OECD) countries with closer trade links tended to have more tightly correlated business cycles.<sup>3</sup> However, there are no rigorous empirical investigations of the relationships between international business cycles and trade links for EACs. Our paper provides empirical evidence, focused on the existence of trade-based international business cycles for EACs.

In this paper, we focus on the business cycles between 10 EACs, and ask if the synchronization of business cycles among EACs is affected by evolution of their economic integration through trade. To determine this, we empirically test the relationship between the co-movement of cyclical components of income and bilateral trade dependence, based on 45 pairs of cross-sectional data for the 10 EACs over the two periods, 1981–1990 and 1986–1995. Our empirical results show that increased bilateral trade dependence results in greater correlation of business cycles. In addition, results from developing EACs (excluding Japan), based on 36 cross-sectional data sets, suggest that Japan plays an important part in the synchronization of business cycles in the East Asian region, while the role of developing EACs themselves has become important since the late 1980s.

In response to the East Asian crisis, some observers argue that deepened intraregional dependence transmitted unfavorable economic effects within the East Asian economies. Our results suggest that as bilateral trade dependence among countries increases, economic fluctuations tend to be more synchronized within the region by rapidly transmitting macroeconomic shocks through trade. This gives us some suggestions for dealing with future economic crisis in East Asia. One of the suggestions relates to the necessity of cooperative efforts to prevent or adjust unfavorable economic crises, because deepened regional integration stimulates the rapid transmission of an unfavorable economic crisis from one EAC to another.

This paper is organized as follows. In Section 2, we provide a theoretical framework to empirically investigate the relationship between co-movement of business cycles and trade interdependence across countries. In Section 3, we explain the data and the empirical tests

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