

Intra-Industry Trade, Specialisation and Business Cycles in ASEAN

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Abstract

Recently, a new resolve for both increased economic integration and monetary and exchange rate cooperation has started to emerge in ASEAN, especially since the 1997-1998 Asian financial crisis. According to the optimum currency area theory, the degree of trade integration is one most important criterion for joining a currency union. The large increase in intra-ASEAN trade in recent years naturally raises the question of whether the ASEAN countries are becoming better prepared to form a currency union.

This paper sets to test whether the recorded increase in intra-ASEAN trade is leading the ASEAN members to closer economic integration and thus to better satisfy the criteria for a common currency. Two separate models are estimated for that purpose. First, a variation of the model of Frankel and Rose (1997) was estimated for the ASEAN members. As the results were not very significant, a new methodology that uses the whole sample period data instead of dividing the data into sub-periods was conducted. The results with our own model were very significant and robust, and showed a clear positive correlation between intra-industry trade and business cycle synchronization in ASEAN. This result has important implications for the prospects of the creation of a common currency in the region.

Keywords; Intra-Industry Trade; Business Cycle Harmonization; Economic Integration; Asean.

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1. Introduction

The Association of Southeast Asian Nations or ASEAN was established in Bangkok in 1967 and even if it seems unquestionable that it has been successful in containing intra-ASEAN conflicts and in providing a forum for the discussion of regional matters, it also seems consensual that ASEAN has failed in asserting itself as a political force on the world stage and has been disappointing in terms of tangible economic benefits for its members. This has led some authors to describe ASEAN as an enigma in Asia because of its longevity as a trading block which is always at the crossroads in the sense that “it fails to deliver and periodically something always needs to be done to revitalize the integration process”.²

Recently, however, a new resolve for both increased economic integration and monetary and exchange rate cooperation has started to emerge, especially since the 1997-1998 Asian financial crisis. In fact, and paradoxically, the Asian financial crisis increased economic disparities within the region making monetary integration more difficult while at the same time, by showing the flaws of unilateral exchange rate pegging, worked as a “wake up call for ASEAN”³ which increased the interest in a common currency arrangement for the region⁴. In fact, a full currency union in ASEAN has become an inevitability for some of the most ‘OCA-philes’, at least in the long run⁵. The recent popularity of the ‘hollowing-out’ hypothesis seems to leave no choice for ASEAN but to decide between fully flexible exchange rates or a common currency⁶.

Even though there has been a large increase in intra-regional trade in ASEAN since the beginning of the 90s it is not clear that it occurred as a direct effect of the tariff reduction

² Wilson (2002), p. 6. Pomfret (1996) is the author of the ‘always at the crossroads’ argument. The original five members of ASEAN or ASEAN5, Indonesia, Malaysia, Philippines, Singapore and Thailand have since been joined by Brunei Darussalam (1984), Vietnam (1995), Laos and Myanmar (1997) and Cambodia (1999).

³ Yong (2004), p.2.

⁴ Notable initiatives to promote regional financial stability and monetary policy cooperation include the establishment of ‘Manila Framework Group’ in 1997, the ‘ASEAN Surveillance Process’ in 1998 and the “Chiang Mai Initiative’ in 2000. Recent initiatives to promote economic integration include the ASEAN Free Trade Area (1992) and the adoption of the so-called “ASEAN’s Vision 2020” in 1997 where a timetable was established to create an ASEAN Economic Region.

⁵ Recently Mundell (2001), defended that Asia eventually needs a common currency even though it recognised that it cannot at present have a single currency, p.18.

⁶ See Eichengreen (1999) and Wyplosz (2001).

or a more general trend in the world markets⁷. It does, nevertheless, raise the question of whether the large increased Intra-Asean Trade in recent years is creating more harmonized business cycles amongst its members since in light of the existing literature on optimum currency areas (OCA) these are two of the most important criteria on the suitability of adopting a currency union (or other fixed or semi-fixed currency arrangements).

The degree of trade integration is believed to be an important OCA argument since it affects the likelihood of asymmetric shocks and their transmission between countries. The effect of more trade between two countries on the harmonization of business cycles is not, however, clear cut in the existing economic theory. Kenen (1969) was the first to suggest that well diversified economies, having a large share of intra-industry trade (IIT) in their total trade, will experience less asymmetric shocks. Conversely, Krugman (1991, 1993) warned that the potential for asymmetric shocks increases with greater integration among countries (and regions) since it increases their specialisation. These two opposing views on what would be the effect of closer integration on regional specialisation (and thus on the costs and benefits of joining an OCA) are what came to be known as ‘The European Commission View’ and ‘The Krugman View’⁸.

The European Commission view states that closer integration will lead to a situation whereby asymmetric shocks will occur less frequently. The reasoning is that since most trade between European countries is intra-industry trade, the more integrated they are, the more similarly they will be affected by disturbances and therefore the more synchronised their business cycles will be. Conversely, Krugman’s view, taking the United States as an example, is that increased integration leads to increased regional concentration of industries (in order to profit from economies of scale) and thus more trade will lead to more divergence between countries.

⁷ Sharma and Chua (2000) found empirical evidence that the “ASEAN integration scheme did not increase intra-ASEAN trade” and that “increase in ASEAN countries trade occurred with members of a wider APEC group”, p. 167. A more recent study by Elliot and Ikemoto (2003) reinforce these findings and even come to the conclusion that the degree of trade creation in the years immediately after the signing of the AFTA agreement in 1993 was actually lower than for the preceding period of 1988-1992.

⁸ De Grauwe (1997) was the first to use these denominations. The first accrues from European Commission (1990) and the second from Krugman (1991, 1993). Patterson and Amati (1998) quote Peters (1995) as dividing the same opposite approaches as the ‘Convergence School’ and the ‘Divergence School’.

The ambiguity in the economic theory on this matter has made this an essentially empirical matter. In two famous papers, Frankel and Rose (1997, 1998) argue that closer trade relations result in a convergence of business cycles, i.e., that both international trade patterns and international business cycles correlations are jointly endogenous and thus that any monetary union creates *ex-post* an optimum currency area⁹. Frankel and Rose report a significant and positive correlation between trade intensity and the correlation of business cycles as measured by four separate indicators of economic activity in a cross-section of OECD countries between 1959 and 1993. Kenen (2000) argues that Frankel and Rose's results should be interpreted cautiously. He shows in a framework of the Keynesian model that the correlation between two countries' output changes increases unambiguously with the intensity of trade links between these countries but this does not necessarily mean that asymmetric shocks are reduced as well.

A number of recent empirical studies seem to confirm a positive correlation between intra-industry trade and business cycles synchronisation, and that increased trade itself does not necessarily lead to business cycle harmonisation. Firdmuc (2004) found that when Frankel and Rose's model was augmented to include intra-industry trade there was no relation between business cycles and trade intensity. Intra-industry trade, however, was found to have a positive and significant relationship with business cycles for the OECD countries between 1990 and 1999. Shin and Wang (2003), applying a model which included a larger set of explanatory variables found that intra-industry trade is the major channel through which the business cycles of 12 East Asian economies become synchronised and that increasing trade itself does not necessarily lead to greater synchronisation of business cycles. Gruben, Koo and Millis (2002) show the instrumental variables used by Frankel and Rose in their study to be inappropriate and to result in inflated results. They develop an OLS-based procedure adding structure-of-trade variables to the model to separate the effects of intra- and inter-industry trade and to include a number of omitted variables for the countries. Their findings are consistent with

⁹ They conclude that "a naïve examination of historical data gives a misleading picture of a country's suitability for entry into a currency union, since the OCA criteria are *endogenous*", (1998, p. 1010).

Frankel and Rose's and conclude that specialisation does not asynchronise business cycles between the OECD countries.

These recent empirical contributions suggest that the effect of more trade between two countries on the harmonization of business cycles depends not only on the intensity of trade links but on the structure of that trade. If more trade means more intra-industry trade, we should expect more common shocks and thus, more business cycle harmonization. If, however, more trade means more specialization, we should expect more idiosyncratic shocks.

The contribution of this paper is to test this hypothesis in the special case of ASEAN, that is, to investigate whether the recorded increase in intra-ASEAN trade in recent years, measured at the highly disaggregated 4-digit industry level, is leading the ASEAN members to closer economic integration and thus creating better preconditions for policy integration and the creation of a common currency area. As will be discussed below, there is a lack of consensus on the correct methodology to use for this purpose and therefore several methods are employed.

The paper is structured as follows: The next section will explain the data and empirical methodology and present the empirical results. Finally, the last section concludes the paper.

2. Data, Empirical methodology and Results

To measure output co-movements, annual data on real GDP was collected for the ASEAN5 countries over the period 1962-1996 from the IMF International Financial Statistics CD-ROM. The period after 1997 is excluded because the data is likely to be distorted by the 1997-1998 Asian Financial Crisis. Data on the other ASEAN countries was not available and therefore these countries were excluded from this study.

Intra-Industry Trade in ASEAN was measured using the traditional Grubel-Lloyd (1975) Index. The IIT indexes were computed for all industries over the period 1962-1996 using

the ‘World Trade Flows, 1962-2000’ data compiled by Feenstra, Lipsey, Deng and Ma (2005) at the four-digit industry classifications following the Standard International Trade Classification, revision 2¹⁰.

Since there is no consensus on the correct methodology to apply, several models will be tested. Firstly, the variation of Frankel and Rose’s (1997) model first applied by Firdmuc (2004) will be estimated¹¹:

$$\text{Corr}(Q_i, Q_j) = \alpha + \beta \text{IIT}_{ij} + \varepsilon \quad (1)$$

where $\text{Corr}(Q_i, Q_j)$ stands for the correlation of de-trended real GDP and IIT_{ij} denotes the average four-digit level of intra-industry trade index between ASEAN5 countries i and j in each period and ε is the error term. The sign of the coefficient β if negative will indicate that the specialisation effect dominates in ASEAN (‘Krugman View’) and if positive will mean that more intra-industry trade leads to more output synchronisation in that region (‘European Commission View’). As stated above, most empirical evidence to date seems to be consistent with the latter possibility so that we expect a positive coefficient for IIT.

Frankel and Rose (1997) note that countries are likely to orient their monetary policy and fix exchange rates towards their most important trade partners. In the case of ASEAN it is well known that the US dollar has a large weight in the exchange rate policies leading them to pursue broadly similar monetary policies. As noted by Firdmuc (2004), it is quite possible that bilateral trade reflects the adoption of a common exchange rate policy and not vice-versa. This suggests the need to instrument the regressions by exogenous determinants of intra-industry trade. The instruments normally chosen for the two-stage least squares (TSLS) are the ones provided by the gravity models and include the log of distance between countries and a dummy for geographic adjacency. However, Gruben,

¹⁰ Originally, this study intended to include not only the Grubel and Lloyd (1975) intra-industry trade index but also the measures developed by Abd-el-Rahman (1991) and Fontagné and Freudenberg (1997) for vertical and horizontal intra-industry trade. That was not possible, however, as the sample included a significant number of zero observations which would greatly limit the analysis.

¹¹ All estimations were conducted with Stata version 8.2.

Koo and Millies (2003) suggested that these instruments might be inappropriate and results in inflated results. However, the authors also find when using an alternative OLS-based approach, that their results are consistent with those of Frankel and Rose's model. Accordingly, the results for both OLS and TSLS are presented for model (1).

Following Frankel and Rose (1997), the whole sample period is divided into four sub-sample periods: 1962-70, 1971-79, 1980-88 and 1989-96 in order to access time-series changes in intra-industry trade patterns and business cycles correlations. As there is no consensus on the proper de-trending method to apply, the four alternative methods of de-trending real GDP first applied by Frankel and Rose (1997) namely, first-differencing , HP-filtering, quadratic de-trending and HP-filtering on the residual of a regression of the real GDP on a constant and 5-year period dummies¹². Since the sample includes 5 countries, the number of observations will be 40 (10 country pairs each with four period observations).

Table 1 reports the results of eight separate specifications, corresponding to the four de-trending methods discussed above, applied to both OLS and TSLS estimations.

Table1: Intra-Industry Trade and Business Cycles in ASEAN – Model (1)

	(1)		(2)		(3)		(4)	
	OLS	TSLS	OLS	TSLS	OLS	TSLS	OLS	TSLS
Contant	0.28553 (4.09)	0.231486 (2.37)	0.496143 (5.82)	0.4719848 (4.01)	0.411791 (3.88)	0.2604285 (1.68)	0.868709 (21.90)	0.829763 (14.76)
IIT	0.003537 (0.64)	0.0100578 (1.02)	0.006479 (0.96)	0.0093942 (0.79)	0.013026 (1.55)	0.031288 (2.00)	0.003376 (1.08)	0.0080749 (1.42)
R-squared	0.0107		0.0238		0.0597		0.029626	
no. Obs.	40	40	40	40	40	40	40	40

Model: $\text{Corr}(Q_{it}, Q_{jt}) = \alpha + \beta \text{IIT}_{ijt} + \varepsilon_{ijt}$

(1) to (4) correspond to regressions of alternative data de-trending techniques, namely, first-differencing, HP-filtering, quadratic de-trending and HP-filtering on the residual of a regression of the real GDP on a contant and 5-year period dummies.

Intrumental variables for Intra-Industry Trade (TSLS results) are log of distance and dummy variable for common border.

Absolute value of standard errors in parenthesis.

Bilateral annual data from ASEAN5 countries, from 1962 to 1996 split into four sub-periods. IITij is the bilateral average fourth SITC IIT in each sub-period.

¹² Unlike Frankel and Rose (1997) the data frequency in the present study is annual. Therefore, some adjustments needed to be made, namely, first differencing instead of fourth-differencing and the use of 5-year period dummies instead of quarterly dummies for the quadratic de-trending and HP-filtering of a regression of real GDP on a constant and period dummies.

The results are very weak. Even though IIT yielded the expected sign in all specifications, it was found to be significant (and just marginally so) in only one case. Also, as expected, the TSLS versions of model (1) generate more robust results than the OLS estimates. However, the question of whether the variables used as instruments are valid instruments, i.e., uncorrelated with the error term, might cast some doubt on the results.

In order to investigate this matter, a procedure developed by Baum, Schaffer and Stillman (2003) is applied that allows for the determination of the Hansen test of overidentifying restrictions in TSLS¹³. The results are presented in Table 2.

Table 2: Hansen Tests to the Validity of the Instruments of Model (1)

	(1)	(2)	(3)	(4)
	TSLS	TSLS	TSLS	TSLS
Contant	0.231486 (3.78)	0.4719848 (4.95)	0.2604285 (1.46)	0.829763 (16.49)
IIT	0.0100578 (2.34)	0.0093942 (1.21)	0.0312887 (1.68)	0.0080749 (1.51)
Hansen J Statistic	1.467	1.036	2.492	2.221
Chi-Square(1) P-Val	0.226	0.308	0.114	0.136
no. Obs.	40	40	40	40

Model: Correlation Real GDP_{ijt} = α + β IIT_{ijt} + ε_{ijt}

(1) to (4) and IIT assume the same meaning as in Table 1.

Instrumental variables for Intra-Industry Trade (TSLS results) are log of distance and dummy variable for common border.

Absolute value of robust standard errors to both heteroskedasticity and arbitrary intra-group correlation in parenthesis.

The Hansen test included a specification that takes into account the possibility that observations might not necessarily be independent within the group of countries under analysis. As the null hypothesis of the Hansen test is that the instruments are valid, i.e., that the instruments are uncorrelated with the error term, the instruments can reasonably be accepted as being valid in all four specifications. Once again only one specification was found to be significant but in this case corresponds to the estimation of model (1) using first-differenced de-trended data (specification (1)) instead of the estimation using quadratic de-trending data (specification (3)) in Table 1. In any case, the size of the

¹³ Baum, Schaffer and Stillman (2003) developed a STATA module called ivreg2 for extended TSLS estimation and instrument validity testing.

estimated coefficient β (0.01) is much smaller than the results reported by Firdmuc (2004) for the OECD countries (0.175)¹⁴ using a similar methodology. The extremely low values of the R-squares suggest that there are other factors beyond intra-industry trade – like demand shocks - producing business cycle harmonisation, generating a problem of omitted variables.

The division of the sample period into sub-periods in model (1) raises a number of important issues. First, by creating sub-periods, we are in fact using small period averages of the variables which greatly reduces the number of observations in the estimations and its explanatory power, especially when using annual data. Second, the division of the whole sample period into four more or less arbitrary periods raises the question of whether these smaller periods are able to capture the business cycles.

In order to try to overcome these problems, the following model is estimated:

$$(\Delta Q_i - \Delta Q_j)^2 = \alpha + \beta IIT_{ij} + \varepsilon \quad (2)$$

Where Q_i , Q_j , IIT_{ij} and ε assume the same meaning as in (1). This alternative model has the great advantage of using yearly data and therefore of greatly increasing the number of observations. Due to the construction of the model, the sign of β now assumes the opposite significance of the previous models, that is, a negative sign implies that an increase in intra-industry trade will reduce differences in the growth rate of business cycles across ASEAN countries.

As stated before, OLS estimations of model (2) may be inappropriate in this case. Therefore, the regressions of model (2) will be estimated by TSLS using the same instruments used in model (1) as they proved to be valid in that case. Table 3 shows the

¹⁴ Firdmuc (2004) however, uses quarterly instead of annual data which might account for some of the difference. Also, in his study the IIT indexes were computed for three-digit SITC commodity groups. Immediate conclusions should, therefore, be avoided.

results for the TOLS estimates of model (2) using three alternative data de-trending methods, namely, HP-filtering, quadratic-de-trending and HP-filtering on the residual of a regression of the real GDP on a constant and 5-year period dummies¹⁵.

Table 3: Intra-Industry Trade and Business Cycles in ASEAN – Model (2)

	(1)	(2)	(3)
	TOLS	TOLS	TOLS
Contant	3.852631 (5.31)	6.675978 (6.62)	16.50695 (5.49)
IIT	-0.1550029 (2.09)	-0.3308083 (3.20)	-0.9298801 (3.02)
no. Obs.	340	340	340

Model: $(\Delta Q_{it} - \Delta Q_{jt})^2 = \alpha + \beta IIT_{ijt} + \epsilon_{ijt}$

(1) to (3) correspond to regressions of alternative data de-trending techniques, namely, HP-filtering, quadratic-detrending and HP-filtering on the residual of a regression of the real GDP on a constant and 5-year period dummies.

Intrumental variables for Intra-Industry Trade are log of distance and a dummy for common border.

Absolute value of standard errors in parenthesis.

The coefficient of IIT are highly significant and yield the expected sign in all three specifications suggesting that the increase in intra-ASEAN trade has led to more synchronised business cycles amongst its members. Furthermore, the fact that the results of the regressions of model (2) are more significant than the results of the regressions of model (1) reinforces the notion that splitting the sample data into sub-groups, as most studies do, might not be the most effective way to capture the effects of intra-industry trade on the synchronisation of business cycles.

In order to test for the validity of the instruments used in the TOLS estimations of Model (2), the Hansen test is once again conducted. Results are presented in Table 4. As before, the Hansen test included a specification that takes into account the possibility that observations might not necessarily be independent within the group of countries under analysis.

¹⁵ First-differencing of the data was excluded as it did not, in this case, remove the trend in the data.

Table 4: Hansen Tests to the Validity of the Instruments of Model(2)

	(1)	(2)	(3)
	TOLS	TOLS	TOLS
Contant	3.852631 (4.10)	6.675978 (3.93)	16.50695 (3.01)
IIT	-0.1550029 (2.14)	-0.3308083 (2.06)	-0.9298801 (1.80)
Hansen J Statistic	2.652	2.291	2.304
Chi-Square(1) P-Val	0.103	0.13	0.129
no. Obs.	340	340	340

Model: $(\Delta Q_{it} - \Delta Q_{jt})^2 = \alpha + \beta IIT_{ijt} + \varepsilon_{ijt}$

(1) to (3) correspond to regressions of alternative data de-trending techniques, namely, HP-filtering, quadratic-detrending and HP-filtering on the residual of a regression of the real GDP on a constant and 5-year period dummies.

Intrumental variables for Intra-Industry Trade are log of distance and dummy variable for common border.

Absolute value of robust standard errors to both heteroskedasticity and arbitrary intra-group correlation in parenthesis.

The results show that once again the instruments used can be considered valid as we cannot reject the null hypothesis that the instruments are uncorrelated with the error term.

Finally, in order to further test the robustness of the results, the three specifications of model (2) were estimated using as instruments not only the log of distance and a dummy for common border but also dummies for each period (minus one) of the whole sample period. Table 5 presents the results.

Table 5: Estimations for Model (2) with Year Dummies as Instruments

	(1)	(2)	(3)
	TOLS	TOLS	TOLS
Contant	0.942012 (0.52)	1.985692 (0.72)	4.795686 (0.63)
IIT	-0.1550029 (2.70)	-0.3308083 (3.80)	-0.9298801 (3.86)
R-squared	0.427	0.296	0.3829
no. Obs.	340	340	340

Model: $(\Delta Q_{it} - \Delta Q_{jt})^2 = \alpha + \beta IIT_{ijt} + \varepsilon_{ijt}$

(1) to (3) correspond to regressions of alternative data de-trending techniques, namely, HP-filtering, quadratic-detrending and HP-filtering on the residual of a regression of the real GDP on a constant and 5-year period dummies.

Intrumental variables for Intra-Industry Trade are log of distance, a dummy for common border and dummies for each year (minus one) of the sample data.

Absolute value of standard errors in parenthesis.

The results are identical with those of Table 3. The coefficients of IIT in all three specifications are highly significant and yield the expected negative sign. Furthermore, the reported R-squared are at a satisfactory level.

Together, the results of Tables 3 to 5 show clearly that the recorded increase of intra-industry trade in ASEAN has led to the synchronisation of business cycles among its members. This result is consistent with previous empirical studies in confirming the ‘European Commission View’¹⁶.

3. Final Remarks

Frankel and Rose (1997, 1998) found that business cycles synchronisation increases with trade intensities leading them to conclude that these two important OCA criteria – trade links and similarity of business cycles - are jointly endogenous. This argument is a source of contention and can be interpreted as an invitation to disregard the ‘static’ OCA theory and encourage the early introduction of a monetary union since a country is more likely to satisfy the [OCA] criteria for entry into a currency union *ex post* than *ex ante* due to lowered asymmetrical shocks.

Recent empirical studies have shown, however, that increasing trade itself does not necessarily lead to more synchronisation of business cycles. The effect of more trade between two countries on the harmonization of business cycles depends not only on the intensity of trade links but on the structure of that trade. More trade will mean more synchronised business cycles only if it is of the intra-industry type, as we should expect more common shocks across countries. Otherwise, more trade might mean more specialization, and we should expect more idiosyncratic shocks.

This paper sets to test whether the recorded increase in intra-ASEAN trade is leading the ASEAN members to closer economic integration and thus to better satisfy the criteria for a common currency. Two separate models are estimated for that purpose. Firstly, a

¹⁶ It should be noted that this is not necessarily a rejection of ‘Krugman’s View’. The specialisation effect is more likely to exist as regards to inter-industry trade than for intra-industry trade.

variation of the model of Frankel and Rose (1997) first used by Firdmuc (2004) was estimated for the ASEAN members. Following Frankel and Rose (1997) four alternative data de-trending techniques were applied in both OLS and TSLS regressions. The results were very weak, with only one specification out of eight being statistically significant even if all the results yielded the expected positive relation between intra-industry trade and the synchronization of business cycles. Therefore, a new methodology was implemented. Unlike previous studies, our own model uses the whole sample data instead of dividing it into sub-groups which greatly increases the number of observations in the regressions. The results with our own model, using three alternative data de-trending techniques were highly significant and showed a clear positive correlation between intra-industry trade and business cycle synchronization in ASEAN. This result is very clear even using the highly disaggregated SITC fourth-digit industry data for all reported trade unlike most previous studies that either use the three-digit level of data aggregation (Frankel and Rose (1997,1998), Gruben, Koo and Millis (2002), Firdmuc (2004)) or a limited number of industries (Shin and Wang(2003)). Also, it was shown that the instruments used in the two-stage least squares of both models included in this paper – log of distance and a dummy for a geographic adjacency – to be valid, which further strengthens our conclusions. This outcome contrasts with Gruben, Koo and Millies (2002) which report the instrumental variables used by Frankel and Rose in their study to be inappropriate and to result in inflated results.

These results have important implications for the prospects of the creation of a common currency in ASEAN. As intra-industry trade leads to business cycle synchronization, the costs of joining a currency union in ASEAN will diminish when intra-industry trade dominates. Therefore, even if we take the endogenous OCA criteria hypothesis as valid - that a monetary union creates *ex-post* an OCA - the ‘static’ OCA theory is still relevant since observing the initial conditions for a potential monetary union will give us an idea of how costly it would be for each member and how the economic policy can decrease the adjustment costs.

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