

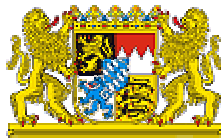
**ASEAN plus three
(China, Japan,
Korea) – towards an
economic union in
East Asia?**

edited by

**Karl-Peter Schönfisch and
Bernhard Seliger**

**Hanns Seidel Stiftung
Seoul - Singapore**

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Foreword

Economic integration has come to the forefront of economic policy making in East Asia, finally. After lagging behind in forming a comprehensive regional integration area for various historical, political, cultural and economic reasons, today the discussion ranges from the introduction of bilateral Free Trade Agreements through currency and financial market cooperation to a full fledged economic community. Heterogeneity of East Asian states and divergences in economic size and economic development are not longer seen purely as obstacles to integration, but also as potential complementarities. This has been the background of the conference series on economic integration in East Asia with special respect to the concept of a closer community, “ASEAN plus three (China, Japan, Korea)” in Seoul in December 2004, organized by Hanns Seidel Foundation Seoul and Singapore/ASEAN office in cooperation with Korean partners and sponsored by the Bavarian Ministry of the Economy, Transport and Technology. The first conference was organized with the Institute of East and West Studies of Yonsei University on December 1st, and the second with the Seoul ASEM Institute for International Relations and the Association Coréenne des Etudes Politiques Françaises on December 2nd. Both were generously funded by the Bavarian Ministry of the Economy, Transport and Technology.

The papers of these conferences have been revised and put together in this book. It aims at contributing to the ongoing discussion process on the “how” and “when” of economic integration, after the question of “if” seems to have been resolved in a largely affirmative way by the states of Southeast Asia and Northeast Asia. If we look back on the last years in regional integration in East Asia, we can see important changes, most obviously in the more active role that Northeast Asia, and here especially China, begins to play. This leads to possibilities before not explored for economic integration, but also to renewed competition between the states of the region. The attempts to establish a regional or sub-regional ‘hub of East Asia’ by various countries in the region, among them Singapore and Korea, is one aspect. In this respect, it is important to see trade integration not as a zero-sum game, where one location loses if another wins, but as a positive sum game, where enhanced capacities of one participant also benefit others. And this not only concerns the economic and business sphere itself, but also the equally

important additional political stability brought by greater unity in the region. Clearly, the economic benefits of economic integration are not independent from the methods of integration. While in the early 1990s the idea of ‚open regionalism‘ and the lack of institutionalization characterized the approach of many countries in the region towards economic integration, today greater institutional ties – for example, in form of binding FTA agreements - seem to be around the corner. It is important to discuss how these ties can be designed without stifling spontaneous evolution of private economic initiative. Therefore, this book takes a comparative view, by comparing European experiences of different institutional regimes of economic integration with the East Asian possibilities. Due to the political obstacles to integration in East Asia, businesses have been often been the initiators of economic cooperation. For businesses, domestic as well as foreign, a politically stable and economically free and prosperous environment is of utmost importance for success. This explains why the business partners of East Asia, among them the German region Bavaria, are equally interested in the integration process of East Asia – they are stakeholders in the process of East Asian integration.

The publication of this book would not have been possible without generous funding from the State Ministry of the Economy, Infrastructure, Technology and Transportation of Bavaria. Special thanks go to Professor Alex Gordon of Seoul National University for editing the texts. If this book helps at stimulating the discussion among practitioners of integration, businessmen, academics and government officials alike, it has achieved its goal.

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1. Introduction - Economic integration in East Asia and Europe

Bernhard Seliger, Hanns Seidel Stiftung, Seoul Office

It has long been noted that economic integration in East Asia had not only a different speed, but also led to other forms of integration than those known in Europe. Since many theories of economic integration since the mid-twentieth century were modelled after the European integration experience, the different development path in East Asia was difficult to be reconciled with those theories. Here, integration as an evolutionary process seemed to be more able to allow for the spontaneous development of market forces (Herrmann-Pillath 1998). However, recently East Asia moved again more in the direction of a closer community, as also Europe did in the last fifty years. Therefore, a renewed interest in the possible lessons of the European integration process followed, not only by academics, but also by politics and business of the region. The first calls for closer regional integration came from the business community, which long time already cooperates in informal institutions, but now expects a more formal arrangement, overcoming obstacles to free trade and investment throughout the region. This has been the background of the conference series on economic integration in East Asia with special respect to the concept of a closer community, “ASEAN plus three (China, Japan, Korea)” in Seoul in December 2004, organized by Hanns Seidel Foundation Seoul and Singapore in cooperation with Korean partners and sponsored by the Bavarian Ministry of the Economy, Transport and Technology. The first conference was organized with the Institute of East and West Studies of Yonsei University on December 1st, and the second with the Seoul ASEM Institute for International Relations and the Association Coréenne des Etudes Politiques Françaises on December 2nd. Both were generously funded by the Bavarian Ministry of the Economy, Transport and Technology, and for the first conference additional funding from the Asia Research Fund is gratefully acknowledged.

When in November 2001, the leaders of the Southeast Asian and Northeast Asian states met for the ‘ASEAN plus three (China, Japan and Korea)’ meeting in Bandar Seri Begawan in Brunei, President Kim Dae-Jung of South Korea proposed the

exploration for an East Asian Free Trade Area (EAFTA) and thereby opened a new chapter of East Asian integration. The special Northeast Asian perspective on regional co-operation became clear by the simultaneous agreement with the Japanese Prime Minister Junichiro Koizumi and the Chinese Prime Minister Zhu Rongji to hold annual meetings among their finance and trade ministers. At the same time, bilateral agreements like a free trade area between Japan and Singapore, the tentative large free trade area between ASEAN and China and the work-in-progress on a Korean-Japanese Free Trade Area show the devotion and sometimes even obsession of current policy-making with reaching regional trade agreements. It seems regional integration is finally on the Northeast Asian agenda.

After researchers as well as politicians maintained throughout the 1990s that economic integration in East Asia was something apart from integration processes in Europe or America, namely “open regionalism” or a search for “de facto” instead of “de jure” integration, now it seems that the race for integration based on free trade treaties is unstoppable.¹ This is another change in the process of East Asian integration, which in the last decade saw already two major changes. In the early 1990s, East Asian regionalism, which before only existed rudimentarily, was discussed as a collective answer to growing regionalism elsewhere. Existing organizations like ASEAN focused more on economic issues. The Asia Pacific Economic Co-operation (APEC) emerged as the leading, trans-Pacific organization for economic integration, but also inter-regional co-operation in the form of the Asia-Europe Meeting (ASEM) was explored. Today, this trans-Pacific approach in the wake of serious trade conflicts and difficulties with an ever-growing membership of APEC lost much of its appeal.

When the Asian crisis broke out in 1997 and the national responses to the crisis were quite heterogeneous, many observers predicted an end of East Asian regional integration. While this did not happen, nevertheless the crisis was a turning point. While before the crisis the flows of goods and factors had been the focus of economic integration, afterwards increasing macro-economic co-operation and a common

¹ For the distinction see Yamazawa (1998, pp. 181-182) and Higgot (1998, pp. 339-340); For a comparison of the European and Asian forms of integration see Seliger/ Gordon (1999).

framework for financial stability were sought after. The results of that discussion were until now limited, namely an extension of a network of regional currency swap and repurchase agreements. But in the long run, especially the aspect of monetary co-operation could change the previous direction of integration.

Nevertheless, the Northeast Asia integration can only be called nascent, since until now, no exclusive regional trade agreement binds China, Japan, and Korea together. South Korea is geo-politically in an exposed position between Japan and China. Until now, the trilateral political problems made economic integration, comparable to Southeast Asia's AFTA (Asian Free Trade Area) impossible. The division of the Korean peninsula and the precarious situation of the Russian Far East add to the unresolved problems in Northeast Asia. Economically and politically, the dependence on the United States and the fear of Japanese dominance are factors determining South Korea's interest in regional economic integration. China and Japan again watch each other, potential hegemonies in the East Asian region, with a mixture of interest and mistrust. And, other countries' free trade agreements have also a strong domestic policy impact, since popular support for free trade is limited, as the difficulties to conclude even minor bilateral negotiations like a Korean-Chilean FTA (Free Trade Agreement) show.

Economic integration is not only an economic phenomenon, but closely related to political developments. Therefore, the geo-political situation in East Asia is a determining factor for economic integration. East Asia has been a latecomer in economic regionalism and it developed its specific form of 'open regionalism', based on voluntary integration and non-intervention in domestic affairs. Political factors led first to co-operation in Southeast Asia. The South East Asia Treaty Organization (SEATO) of 1954 as well as the ASEAN of 1967 were motivated not by common features of the political systems of these countries, but by common external threat. Domestically, the countries were autocracies of different degree. The common threat was the existence of communist movements and the possibility of a spill-over of the Vietnam War. The possible 'domino effect' from Vietnam was more important than the goals first mentioned by ASEAN, namely wealth, growth, and the peaceful

development of the region. Economic development and the development of a Southeast Asian identity ('think ASEAN') were instrumental in stabilizing the ruling regimes in ASEAN states.

Two additional factors were catalysts of ASEAN integration, namely the importance of the Japanese economy for all ASEAN states and the existence of ethnic Chinese trading networks. The role of Japan is founded in its size as the by far biggest economy in the region with a weight of around 80 percent in East Asia until the mid-1990s. Since the 1980s, Japanese capital flows and Japanese technology played a growing role in economic development of the region. Rising labor cost in Japan and the yen appreciation made Southeast Asia a main target for Japanese Foreign Direct Investment (FDI). Not only did Japanese multinationals invested in Southeast Asia, but they were followed by a number of smaller enterprises producing intermediate products for the multinationals (Yamashita 1991; Tokunaga 1992; Doner 1993). Investment led to a transfer of Japanese technology and Japanese management know-how. The 'look East' policy of Southeast Asian states furthered the transfer of Japanese management style, seeing it as a role model of non-Western economic development.² Besides Japanese FDI flows, Japanese lending made Japan the biggest investor in the region, for example, accounting for around 40 percent of all Indonesian debts in 1998, compared to 8 percent for the United States (Asia Wall Street Journal 1998, p. 1). Investment and lending often targeted state companies and Chinese trading companies, which increased its influence in the region.

The trading networks of ethnic Chinese in Southeast Asia are a second factor leading to 'de facto' integration in the region. While the share of ethnic Chinese in the population is often tiny, between two percent in the Philippines and thirty percent in Malaysia, their share in private business is much higher, between forty percent in the Philippines and eighty-five percent in Thailand. Networking between their companies also leads to increased demand for regional institutional integration. However, in times

² Originally, this has been a policy of Malaysia, which preferred looking to Japan as an Asian model of development rather than to the equally successful policy of Singapore and Taiwan, two countries dominated by ethnic Chinese; cf. Smith (1996).

of crisis like the Asian Crisis, the situation of the Chinese minority is endangered. In Indonesia, the alleged co-operation of Chinese companies with the Soeharto regime led to ethnic tensions. Despite of these, overall, the role of ethnic Chinese has been important for economic integration in Southeast Asia.

In Northeast Asia, the political situation has been much less conducive to integration³. In Southeast Asia communist threat and civil war in some peripheral states like Vietnam, Laos and Cambodia led to closer integration of the rest of the region. In Northeast Asia, tensions existed directly in the center, namely in China, and on the Korean peninsula. Political confrontation among the People's Republic of China, and Taiwan and the United States as well as Maoist central planning made economic integration impossible. Even after the economic 'open policy' in China, increasing economic ties, and FDI, the political problems remained where institutional integration giving the same political status to Mainland China and Taiwan was unacceptable to the former. Only semi-official contacts in the APEC were tolerable. At the same time, the People's Republic until the mid-1990s was sceptical about economic imperialism of Japan and the United States in form of their dominance in regional organizations. On the Korean peninsula, China's role is important as the only important partner for North Korea. For South Korea's economic relations with China, increasing ties with China in the Yellow Sea region are the positive side, while increasing competition especially after the WTO accession of China in 2001 is the negative side.

From an economic point of view, China until very recently seemed content with secured domestic economic growth and record FDI. However, the sheer size does not guarantee continued growth and, indeed, it seems that the Chinese transformation process until now left out problems, which one day painfully have to be solved. The most important of these problems is the dual economy problem with the thriving private sector, and the large, bankrupt state-owned sector whose transformation will bring mass unemployment and unresolved debt problems, and the end of current pump

³ While geographically, Southern China including Hong Kong and Taiwan are part of Southeast Asia, here they are treated as part of Northeast Asia, since they are part of the Northeast Asian geopolitical situation.

priming measures (Jha 2002). Therefore, the recent shift in policy to a free trade agreement with ASEAN can be explained. However, integration with rivalling Japan and Korea will be much more difficult, not so much for economic but as for political reasons. Also, embracing regionalism would open the possibility for China to become a regional hegemon, in sharing its power with Japan.

The role of Japan in Northeast Asian integration is still hampered by the historical legacy of the Japanese concept of a “Greater East Asia Co-Prosperty Sphere” (*Daitoa Kyo-eiken*) under Japanese leadership from World War II.⁴ The colonial experience of South Korea, Taiwan, and parts of Mainland China add to the problem, making a ‘look East’ policy impossible. Japanese economic engagement suffers from still lingering suspicion. So Japan’s relation to the neighbouring countries is extremely complex. Since it is by far the largest economy in the region and the most successful and first Asian modernizer instead of westernizer among the countries in the region, Japan could play a more important role, even a leading role in economic integration in the area. But as well ancient fears as the recent decade of economic stagnation seem to prohibit such a role for Japan.

In terms of culture, while in many ways related to China and Korea (which has been a cultural bridge to the mainland)⁵, nevertheless Japan qualifies in the terms of Huntington as a “lonely” state, not part of any larger cultural area.⁶ This also means a lesser amount of trust into Japan by the neighbours. While a role as regional hegemon becomes improbable for this reason, Japan has according to Huntington has four different strategic possibilities: to become the “United Kingdom of East Asia”, to take

⁴ It is not possible here to discuss the still debated role of Japan’s imperialism in detail here. Growing out of an desire to maintain autonomy vis-à-vis the other Imperial powers (Crowley 1966), it embraced all of East Asia in a more and more aggressive way, belying the intentions of creating a more harmonious East Asia liberated from Anglo-American imperialism; see Jones (1974), Beasley (1987), Peattie (1988). While the experience of Southeast Asia was brutal, but short (Benda 1967; McCoy 1980), especially in the colony Korea and to some extent in the quasi-colony Manchuria/China it was a form of integral colonization, with the ultimate goal of complete assimilation.

⁵ See Sasse (1988).

⁶ Huntington (2001, p. 139) He refers, in the general context of his theory of the role of culture for international relations in the post-Cold War times, to the specific shintoist background of Japan. However, this view contrasts with the view of Japan as part of a larger Chinese-centered Confucian culture. The role as part of a “Chinese World Order” is at least historically justified.

the role of France, Switzerland, or Germany in East Asia. The first option would mean a close alliance with the U.S. and would in the regional context mainly be interpreted as an anti-Chinese solution. Indeed, after some relaxation of relations in the 1990s, now the alliance between Japan and the US became strengthened (Green et al. 1999). The second option would be a close alliance with China (like the French alliance with Germany) and a common strategy for the future of East Asia. This option is regarded not only sceptically by Japan, which according to Professor Yukiko Fukagawa is reluctant and cautious about closer economic ties with China (Korea Herald 2002). Even more, it is also viewed extremely sceptical by the Chinese, which after a phase of admiration for Japanese modernization in the early 1990s and a willingness to accept Japanese capital and development aid by now more and more fears the possibility of regional hegemony, also through regional institutions (Moore et al. 1999; Rozman 2002).

The third strategic possibility is the role of a neutral, benevolent state like Switzerland, outside the quest for regional integration, but eager to keep good relations with all neighbours. The last role is that of Germany in Europe, namely to develop an active diplomacy – with the help of considerable funding as an incentive for more reluctant partners – to achieve a form of integration acceptable to all partners. While until now, the close alliance with the US was the cornerstone of Japan's foreign policy in East Asia, Japan recently becomes “reluctantly realist” (Green 2001) about its role in East Asia.⁷

The geopolitical role of South Korea did not become easier in the last years. China is no longer a political enemy, but now a potential rival in many markets, including its rise as a shipbuilding nation in the next decade. After the end of the Cold War, Japan has greater political ambitions, for example, the recent changes of the defence policy shows. For South Korea, the situation between two economically and politically far bigger countries poses a historical trauma. Occasional nervous reactions,

⁷ It should be noted that the choice of a role is not an autonomous choice of the country's leaders, as Huntington sometimes seems to assume, but decisively influenced by the people, as Rozman shows for the Chinese attitude towards Japan in the 1990s (Rozman 2002, pp. 98-101).

like in the textbook conflict or in a trade conflict about garlic with China, show the growing South Korean uneasiness. However, this could also lead to a greater South Korean desire for regional economic integration.

Despite its Far Eastern provinces with huge raw material potential, Russia plays no role in East Asian integration. The political relations with Japan and South Korea improved dramatically after the end of the cold war, but the hope for economic integration did not yet materialize (Seliger 1999). This is partly due to the unresolved problem of North Korea, partly due to the internal instability in Russia. De facto, there has been disintegration between the European part of Russia, which dominates the Federation, and the Far Eastern provinces, leading to a sometimes chaotic situation concerning the administration of the Far Eastern provinces. This was a major problem in attracting Korean and Japanese FDI, even in highly profitable business like the oil and gas exploitation at Sachalin Island. Territorial dispute about the Kuril Islands also affecting South Korea's fishery industry adds to the problem. APEC membership and the improved economic and administrative situation under the Putin government did not change the prospects for the Russian Far East so far.

The United States is an indirect political and economic factor in Northeast Asian integration. Politically, as a guarantee power for Taiwan and South Korea they are indispensable for these states but pose a problem to greater integration. Economically, still most states of the regions are concentrated on the United States as the single most important market for exports. This common interest in East Asian states can lead to closer co-operation, but also puts the East Asian states in a competitive situation. Also, the importance of the American market shapes the form of regional economic integration, making more protectionist forms of integration impossible. 'Open regionalism' therefore is partly a result of trade dependence.

Overall, the geopolitical situation in Northeast Asia is much less conducive to the economic integration than the situation in Southeast Asia. Political and territorial conflicts are unresolved, regional factors facilitating integration do not exist and the increasing political role of Japan as well as the increasing economic power of China

pose a challenge. Both states can either attempt to lead economic integration in the region or to prevent it, while South Korea, who is in the middle, can only try to take an active role as a catalyst for regional integration. However, the attempt of “ASEAN plus three” to put together Northeast and Southeast Asia could solve some of the problems related to Northeast Asian integration. The size of countries in a larger union would be much more diverse and neither China nor Japan would play such an overwhelming role. A coalition of mid-size economic powers, among the Korea as the biggest, than Thailand, Malaysia, Singapore and others, could emerge which could tame the two Leviathans, China and Japan. The small countries in the region, like the Indochinese countries, would again be able to be protected from dominating neighbours in a larger region.

Being a question of geopolitical relevance, economic integration in East Asia also offers important potential benefits for the institutional regimes in countries. As Europe experienced, countries as regional integration areas can become subject to institutional sclerosis (Seliger 2001a). Also, in Asia, Japan is a prominent example for “Asia-sclerosis” (Seliger 2001b). To overcome sclerosis, economic integration stimulates competition, not only on goods markets, but on institutional markets, for better policies. The effects of this can be already now observed in the efforts of East Asian countries to improve their respective investment environment.

The conference series in Seoul in December 2004 organized by Hanns Seidel Foundation Seoul and Singapore addressed important questions related to these developments. The conferences, which were organized with the Institute of East and West Studies of Yonsei University on December 1st, and with the Seoul ASEM Institute for International Relations and the Association Coréenne des Etudes Politiques Françaises on December 2nd, addressed a wide variety of topics related to economic integration in East Asia and also exhibited a wide variety of opinions among the participants. For example, the question, if bilateral FTAs are helpful or harmful to economic integration in the region or the question, if sectoral exceptions from trade integration facilitate or hamper integration, are still disputed. This book wants to share the diverse opinions and make them available to a large audience, so that the ongoing

process of opinion building on regional integration in East Asia has a more firm foundation. The papers can be divided largely in three kinds, namely those discussing the East Asian integration process in the light of European experiences, those discussing the specific role of Southeast Asian Integration and Southeast Asia in the ASEAN plus three process and lastly, those, which discuss the future of ASEAN plus three and the possible emergence of an East Asian Community. In his keynote speech, Pengiran Mashor Pengiran Ahmad, Deputy Secretary-General of the ASEAN Secretariat, acknowledges the heterogeneity, which makes East Asian integration particularly difficult, but also stresses the motivation of East Asian countries to integrate, especially for the smaller countries to integrate with their bigger and economically more potent neighbours.

The first group of papers looks at the European integration process and the possible lessons of Europe for the integration of East Asia. Werner Pascha from Essen/Duisburg university in his paper distinguishes three forms of economic integration: Market integration is a de facto process and spontaneous, functional integration is the tearing down of barriers to trade by coordinated political action, for example by forming a free trade area and institutional integration goes beyond this, through setting up mechanisms or organizations for specific fields. Especially in the last field, the problem of government failure becomes inherent, as the European experience shows. Departing from a very different historical setting, as well East Asia as Europe developed specific forms of integration. In Europe, after World War II the issue of stability became very important and led to strong institutionalization of the integration process. In East Asia, the heterogeneity of countries in terms of size, economic development, political systems and cultural background led to a process of voluntary agreements (“open regionalism”) with no institutionalization. However, both approaches reached a point, where new decisions are necessary, to improve as well regional as multilateral progress on trade liberalization. In Europe, the institutionalization brought adverse political effects (government failure), in East Asia, the search for a stronger community just has begun.

Gerhard Prosi from Christian-Albrechts-University at Kiel in his paper again takes up the issue of heterogeneity. While it is sometimes described as an obstacle to integration in the sense of something undesirable, Prosi makes the case for competition, i.e. the case for a world cherishing heterogeneity. Indeed, Prosi maintains, without heterogeneity, the differences in tastes, preferences and resource endowment, there would be no economic progress. The European integration process has been moved forward by a competition process resulting from heterogeneity, but also resulting in heterogeneity. Only an institutional competition process of different solutions rather than a uniform, top-down process of development, allowed for an institutional “trial and error” - process and showed in a spontaneous process the advantages of specific institutional regimes. The sclerosis of economic systems, as is observable in the case of the European welfare state, can only be solved by institutional competition to find innovative solutions. For Europe, this means that competition rules are necessary, but no uniformity, with the result of a Europe of different speeds.

Jinwoo Choi from Hanyang University in his comparative analysis of EU and East Asian integration looks at integration processes in Europe and East Asia through the light of political theories. The recent moves towards economic and political cooperation and integration are somewhat of a puzzle as well from the point of view of realism as of functionalism and culturalism. Compared to Europe, the preconditions for integration in East Asia just seem not to be in place. However, a closer view on the European integration process shows that also in Europe the integration process has been far from smooth. Important lessons can be learned from the way, Europe had to deal with distributional questions and questions of legitimacy. When East Asian states are determined to overcome the problem of adverse initial conditions to integrations, as they seem to do now, Jinwoo Choi writes, then they should look at the way, Europe deals with the problems of distribution of gains of integration and problems of eroding legitimacy.

European integration from the beginning has not only been an economic problem, but also had political relevance, not the least in the field of security cooperation. This is the topic of the paper of Sangtu Ko from Yonsei University. In

East Asia, numerous bilateral security problems (like territorial conflicts among many Southeast and Northeast Asian states), the division of the Korean peninsula as well as multilateral problems, especially proliferation of WMD, exist. To contain or solve these problems is not only a political imperative, but also important for the prospects of economic integration. Security integration can, as the example of the ASEAN members show, precede closer political and economic cooperation, and, eventually, integration. This was the experience in Europe, where first in the Western part and then for the whole of Europe security cooperation led to economic integration and political cooperation. For Northeast Asia, security cooperation is a new trend, which lacks firm institutions. The six party talks and the common interest of states in the region to contain North Korea's nuclearization could initiate closer security cooperation in a regional, multilateral framework.

Jongwon Lee from Suwon University in his paper returns to the economic perspective of East Asia in comparison with Europe. Until ratifying an FTA with Chile in February 2004, Korea had been together with Mongolia one of only two countries among the WTO countries not having any FTA. Also Japan only recently began active regional trade policy. Now, however, trade integration is high on the political agenda. Compared to NAFTA (more than 45 percent) and the EU (more than 60 percent), intra-regional trade is low as well in ASEAN countries as in Northeast Asia (China, Japan, Korea – lower than 25 percent). Since tariffs are highest in China, medium in Korea and lowest in Japan, gains of free trade will be asymmetric. This can be compared to regional and national differences in the European countries joining the integration area. As in Europe, a form of compensatory regional policy, for example by a Northeast Asian development bank, or a “Mini-Marshall plan” from Japan could not only be used to achieve economic convergence, but also to overcome the historical legacy of Japan's involvement in World War II.

A second group of papers deals more specifically with the issues of Southeast Asian integration and the role of Southeast Asia in a wider East Asian community. This is important, since there is a wide variety as well in country size (from giant China to tiny Singapore) and in economic development (with levels of per capita income varying

more than 30 times between the highest and lowest level). Jose Tongzon from National University of Singapore looks at ASEAN plus three (China, Japan, Korea) versus ASEAN integration. He argues that both processes are not contradicting each other, but should be viewed as complimentary. Indeed, in such a big community as ASEAN plus three smaller, sub-regional integration projects can help to organize the integration process of the wider community more smoothly. At the same time, economically, the major players of Northeast Asia are indispensable for growth and development of Southeast Asia. In this sense, stronger ASEAN ties are not an impediment, but helpful to integration. A stronger ASEAN allows its member states to view the gains of integration with the big neighbours more equally. At the same time, ASEAN plus three integration fosters intra-regional trade and investment.

Nattapong Thongpakde from the National Institute of Development Administration in Thailand takes a Thai perspective on East Asian economic integration. Comparing the economic structure of East Asia, as well trade and investment structures are similar in the region. For multinational companies, the production process is often located in various countries and strongly complementary between Northeast and Southeast Asia. A wider, ASEAN plus three integration area could avoid the “Spaghetti bowl effect” of an intransparent tariff structure of a network of bilateral agreements and thereby avoid trade diversion to some extent. The strong dependency on the USA regarding trade and in some countries the strong political ties with the USA, a new definition of the role of China and Japan in East Asia, overcoming long-lasting distrust as well as faster economic development in Southeast Asia are problems to be overcome in the integration process.

The first proposal for economic integration in a wider, East Asian community, the proposal of an East Asian Economic Caucus, originated in Malaysia. Mohd Hafilah Piei from the Malaysian Institute of Economic Research in his paper reconsiders this proposal, urging for stronger ASEAN ties with Northeast Asia. This would not only increase the bargaining power of East Asian states in the world economy, but also signal commitment to economic reform and policy credibility as well as exerting peer pressure for bolder reform among the countries until now less developed. Additionally

market enlargement promises static and dynamic gains and the investment environment, especially for ASEAN, would be dramatically improved. However, adjustment costs from the loss of tariff revenue and industry restructuring can occur. Because of the potential effects of trade diversion in an integration area with many exceptions, the East Asian economic community should preferably include all sectors of the economy.

As mentioned before, Southeast Asia is characterized by heterogeneity in terms of size, population and economic development. For some of the smaller and newer ASEAN member states, integration is a huge challenge to be mastered. Pham Quoc Tru from the Central Institute for Economic Management, Vietnam looks at implication of the East Asian economic integration process for CLMV Countries (Cambodia, Laos, Myanmar and Vietnam). They are especially interested in reaping gains from integration in terms of a more secure investment environment through peace, political and economic stability and the mitigation of bilateral conflicts prevailing in CLMV. However, the fear the possibility of incurring large trade deficits and being finally politically dominated by the large neighbours in Northeast Asia, including the dismal perspective of excessive exploitation of natural resources in low-regulated CLMV. Moreover, CLMV have to overcome important internal challenges to fully participate in ASEAN and ASEAN plus three integration, Institutional transformation and institution building are necessary in the economy as well bureaucracy of the country, often riddled by the problems of corruption and red tape. The state owned sector in Vietnam and Laos is still plagued by low efficiency. But also the investment in human capital, by raising the experience and skills in terms of language, negotiation and professional management are necessary to enjoy a favourable position in East Asia.

A third and last group of papers tries to evaluate the perspectives for East Asian integration in the future. Jae-seung Lee of the Institute for Foreign Affairs and National Security in Seoul asks the question, if there is a perspective beyond economic community. He highlights the politics of economic integration in East Asia. From the beginning of integration, a political process was necessary to tear down barriers to trade and investment. Afterwards, Lee reviews various aspects of the integration process, namely ASEAN-AFTA versus Northeast Asian economic cooperation and the role of

financial cooperation, which after the Asian crisis has become a sort of second leg of integration. Concrete steps for economic integration are proposed by the East Asian Vision Group, of which Jae-seung Lee is a member, a government-sponsored effort to define goals and ways of integration in East Asia. Steps of economic and financial integration might lead to an East Asian community, which however, is not uniform, but characterized by multi-layer integration, including projects on the regional and sub-regional level. Among the problems to overcome is the lack of clear regional leadership, especially after Japan's "lost decade" of economic recession.

Young-jong Choi of the Catholic University of Seoul sees the East Asian integration process hampered by two forms of "underdevelopment" of the region: East Asia is as well "under-identified" as "under-institutionalized". The regions needs as well a closer regional identity as closer institutional ties to achieve the vision of an East Asian community. The Asian crisis has in this respect been a catalyst, leading to the search for new forms of integration, like in the field of financial policy. ASEAN plus three is now emerging as a new body of economic and political cooperation. However, strong ties to the USA in some states and unresolved problems like the Korean division make bolder integration approaches for now impossible. Bilateral FTAs, as they are now negotiated among many East Asian states, might finally facilitate through a form of "domino effect" region-wide integration like in the European Union.

Seokwoo Kim from the University of Seoul looks at prospects and limitations of ASEAN plus three. The heterogeneity of countries in the region, hegemonic competition between Japan and China, China's understanding as center of the world order in East Asia inherited from the 19th century, but also economic obstacles like overlapping industrial structures challenge the integration process. More important, there has to be a change of minds, from a "mercantilist" perception of trade (with the ultimate goal of a large trade surplus) to a perception of mutual beneficial trading relations. To overcome problems of policy formulation and coordination on the way to integration, as Korea experienced in the difficult ratification process of an FTA with Chile, special negotiation powers for governments regarding the economic integration process are a possible solution. Also, Seokwoo Kim proposes to begin with sectoral

integration processes in uncontested sectors. Like the European integration process began sectorally with the ECSC, so the reasoning, a beginning of integration in some sectors would lead to more comprehensive agreements and finally in an East Asian community.

The process of economic and, possibly, political integration in East Asia has a considerable impact on business and the economy of the region, but also of the region's relations to their partners in the outside world like Bavaria in Germany. A prosperous and stable region able to mitigate political conflicts will have enhanced chances to attract foreign investment as well as be a more attractive trading partner. Economic competition stimulated across the region will also benefit – through innovations, through larger market size and, given successful economic development in the region, through higher purchasing power – the rest of the world. In this respect, the discussion of possible trajectories of integration (Seliger 2002), with the help of respective experience from other world regions, notably the European Union with a similar number of countries and similar experiences, is most important. This book will have fulfilled its purpose if it can add to this discussion.

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2. Keynote Speech - The East Asia Economic Community: Prospects and Implications

**Pengiran Mashor Pengiran Ahmad, Deputy Secretary-General,
ASEAN Secretariat, Singapore**

To the organizers of this event,
Distinguished guests and participants,
Ladies and gentlemen,

First of all, allow me to thank the organizers for kindly inviting me to this event. Indeed, it gives me great pleasure to address the participants of this conference on a very important topic – the East Asia Economic Community.

The last decade has seen a dramatic rise in the number of regional trading arrangements notified to the World Trading Organization (WTO). The new millennium has also seen a spate of bilateral free trade arrangements negotiated and concluded across the globe. From 1948-1994 (46 years) only 124 RTAs were notified to the GATT; but, after the creation of the WTO in 1995, more were established. In fact, by May 2003 (after 8 years), over 265 had been notified to the WTO; and as of July 2003, only three WTO members –Macau China, Mongolia and Chinese Taipei – were not party to any regional trade agreement.

Rising regionalism is a global phenomenon because countries – big and small alike – have used this to respond to global challenges and developments. They integrate because they do not want to lose out in the global competition for export markets and foreign direct investments. Also, because of the dynamics in multilateral trade negotiations, small nations resort to regionalism to enhance their bargaining leverage and to gain some degree of international political influence.

Economies in East Asia have joined the bandwagon of regional trading arrangements after having experienced a dramatic change in the region's economic landscape over the last few years. What really prompted the economies of East Asia to seriously consider forging closer economic integration? There are of course several reasons but, to my mind, the following would be among the most important.

First and perhaps the most compelling of all is the financial and economic crisis of 1997 which devastated most East Asian economies causing some of them to fall into serious recession. The crisis was to be East Asia's wake up call and it catalyzed efforts towards greater integration which was essential to make the region more resilient and less vulnerable to similar attacks in the future.

Second, trade liberalization within the ambit of the WTO and the APEC were not making substantial progress and this would be compounded by the rapid expansion of economic integration in Europe and the Americas. The European Community was expanding and about to welcome Central and East European countries into the fold. The Free Trade Area of the Americas is also about to be a reality. East Asian economies are all highly dependent on exports and the benefits brought about by closer economic integration, i.e. enhanced competitiveness, greater bargaining leverage, among others, offered means to safeguard their continued access to these markets.

The idea of an East Asia Economic Community was first mooted in the East Asia Vision Group (EAVG) Report of January 2001 entitled "Towards an East Asian Community: Region of Peace, Prosperity and Progress." In this report the "integration of the East Asian economies ultimately leading to an East Asia Economic Community" was envisaged and trade, investment and finance will be the catalysts in the community-building process. Specifically, the EAVG called for the establishment of the East Asia Free Trade Area (EAFTA) and the East Asia Investment Area (EAIA), among other new bodies.

Indeed, as acknowledged by the East Asia Study Group, which was subsequently given the task by the Leaders to assess the EAVG recommendations, the

creation of the EAFTA, which can take the form of “encompassing bilateral and sub-regional free trade areas in the region”, will “help boost intra-regional trade and investments among East Asian countries.”

All countries in East Asia, which for the purposes of this address would only allude to the ASEAN members plus China, Japan and South Korea, are parties to, or in the process of negotiating, one or more free trade arrangements not only with countries within the region but outside the region as well. Experts on regional integration observe that the free trade arrangements in East Asia are looming to take the “hub and spoke” characteristic, for example, ASEAN-China, ASEAN-Japan and ASEAN-South Korea, and Japan-Singapore, Japan-Thailand and Japan-Philippines. Whether this would be detrimental or beneficial to a wider EAFTA would of course require careful and deeper analysis. For now, allow me to focus on what are the likely challenges, prospects and implications of East Asia’s quest for an economic community.

We have just seen that there are strong reasons which motivate East Asia to integrate. But how prepared are the East Asian countries? What could impede such desire to close ranks and form a community, an East Asia Economic Community? When confronted with these questions for sceptics, most especially, the answer is almost automatic – diversity. The countries in East Asia are probably the most diverse compared to any regional grouping across the globe. Diversity occurs in almost every aspect: historical background, political system, economic structure, religion, social and cultural dimensions. Allow me to give a few examples: (i) in terms of economic structure East Asia groups the highly industrialized (Japan) with the highly agricultural (Laos and Cambodia); (ii) in terms of political structure, East Asia has a mix of democracies and socialist systems; (iii) and, regarding religion East Asia has a combination of Muslims, Buddhists, Christians, etc.

The list could go on and on but my next few examples could be the most telling of all as these could be an indication of how prepared countries in East Asia are to move towards an East Asia Economic Community:

- (i) Level of national income and economic development. Based on World Bank figures, in 2000 the gross national income per capita of Japan was US\$ 27,080; Singapore, US\$ 24,910 and South Korea, US\$ 17,300 compared to Viet Nam, US\$ 2000; Laos, US\$ 1,540 and Cambodia, US\$ 1,440.
- (ii) Degree of integration into the multilateral trading system. Most of the ASEAN+3 countries are founding members of the WTO, two (China and Cambodia) have recently joined the WTO, while another two (Laos and Viet Nam) still have to complete their accession process.
- (iii) Degree and experience in economic integration. While it can be claimed that ASEAN member countries have vast experience in economic integration having implemented a preferential trading arrangement since 1977 and the free trade area since 1992, the rest are relatively late-comers in the RTA game.

Ladies and gentlemen,

As a Southeast Asian coming from Brunei, I cannot help but underscore the value of small countries banding together with our bigger neighbours. We have seen that, compared to our neighbours in Northeast Asia, i.e. China, Japan and South Korea, the economies of ASEAN are relatively small in terms of market size and level of development. On a global scale powerful regional blocs have emerged in Europe and are emerging in the Americas but none in Asia. Somehow East Asia has to respond and to show the world that, even in the face of complex regional diversity, there is an avenue for closer cooperation, coordination and integration. In fact the diversity itself could be capitalized and turned into strengths. There could be no better response than to establish the East Asia Economic Community.

An East Asia Economic Community, stemming out from linking existing free trade areas in the region, would bring about a combined market of 2 billion people or almost a third of humanity, with combined GDP of US\$ 6.3 trillion or almost 20% of global GDP in 2002, and a total trade volume of US\$ 2.2 trillion or about 17% of global trade in 2001. Trade flows within East Asia over the years have showed increasing economic interdependence among the thirteen countries. The share of intra-

regional exports increased from 28.4% in 1998 to 34.5% in 2001. As the various RTAs within the region come into fruition these trade flows are likely to increase and become more important. This augurs well towards the creation of an East Asia Economic Community.

East Asia comprises several tiers of membership, i.e. developed (Japan - Singapore and South Korea), developing (China and ASEAN 5¹) and less-developed (Cambodia, Laos, Myanmar and Viet Nam). Such disparity in levels of development need not deter the formation of the East Asia Economic Community; rather, this should be used to the region's advantage. For one, specialization and the regional division of labour could be promoted as manufacturing companies take advantage of the economies of scale in production. Those with lower-skilled labour requirements could relocate from the more developed countries to the lesser developed ones. This in turn would, among other development lead to the following: (i) increase trade flows not only on finished goods but intermediate inputs and capital goods as well; (ii) encourage domestic investments; and (iii) advance the growth of supporting industries.

No doubt, ASEAN integration with the Northeast Asian countries will bring about great business potentials and significant benefits to the peoples of East Asia, not to mention the sense of belonging to a bigger regional community and the increased political clout and bargaining leverage in the multilateral trading arena such integration could bring. But then, again, the East Asia Economic Community is still an ultimate challenge for how do you integrate thirteen countries with fundamentally different political systems, ideologies, historical background, economic structure, and economic development?

Several studies made on regional integration have revealed that the success of NAFTA and the EU could be attributed to the member economies' strong drive to move ahead in integrating their markets. For example, the EU's original motivation was never again for there to be war on the European continent while, for NAFTA, there was just this keen desire to form a single North American market. The EU and NAFTA

¹ Brunei, Indonesia, Malaysia, the Philippines and Thailand.

were also driven by prime movers, i.e. France and the United States. Historical support, strong motivation and natural leadership seem to be lacking in East Asia, although it is a natural integration entity by virtue of the countries' geographic proximity.

Ladies and gentlemen,

I do not think East Asia lacks the strong motivation. There could not be any stronger motivation than the aspiration for peace, stability and prosperity in the East Asian region. The seemingly lack of leadership should not be an obstacle either. Among the thirteen economies ASEAN's integration is the most advanced and therefore it could play a pivotal role in building the East Asia Economic Community. The Economic giants China and Japan will surely have a defined role. But, as in ASEAN, it is likely that East Asia will not thrive on hierarchies. Rather, each member country will be treated as a partner and together they would work towards sustainable growth and development that would guarantee an overall environment of peace and stability.

The creation of the East Asia Economic Community may take years to materialize. Fusing the various FTAs to form a single East Asia Free Trade Area could be a complex exercise as the sensitivities of each country will have to be taken into account. Notwithstanding, East Asia should aspire for a comprehensive and high quality EAFTA in order to fully benefit from it. The EAFTA should not only involve the elimination of tariff and non-tariff barriers. Over and above these first negative economic steps trade facilitation, including the harmonization of standards, the simplification and harmonization of customs procedures, and the protection of intellectual property rights are all necessary to form an integrated business environment in the East Asian region. However, the formation of the latter would not be complete if the areas of services, investment, finance, and the movement of people, among other important developments are not adequately addressed.

Ladies and gentlemen,

The path towards the East Asia Economic Community may be long and bumpy. There may be stumbling blocks ahead, but the potential gains are also aplenty to ignore. For now all that is needed to start this community-building process would be a strong political commitment and a genuine political will. After all, we owe it to our children and our children's children to leave them the legacy of an East Asian region that is peaceful, secure, stable, progressive and prosperous.

Finally, allow me to conclude by wishing you all a successful and fruitful conference.

Once again, my sincerest gratitude to all of you.

Thank you.

Part I: East Asian Integration in the Light of the European Experience - The Valuable Lessons

3. Economic Integration in East Asia and Europe – A Comparison

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1. East Asia and Europe – comparing “apples and pears”?

There are two good reasons to compare East Asian and European economic integration, despite their remarkable differences in starting conditions, historical paths, and present challenges. The first is that multilateral integration and regional integration in various world regions are intricately interrelated. To understand why East Asia has recently shown a great deal of interest in introducing free trade areas (FTAs), or even closer forms of regional integration, it is necessary to understand recent trends in the multilateral field, the progress of WTO negotiations in particular, and in other regions like the Americas and, indeed, Europe. (From this perspective we should not be too concerned about which countries to include when we speak of “Europe” and “East Asia”. We are interested in rather dense networks of economic, business and political interaction, so “East Asia” encompasses North East and Southeast Asia, for instance).

A second point is that East Asia may be able to learn from European economic integration – both in a positive and in a negative sense. So either East Asian countries may find suitable solutions and approaches or they may realise what to avoid. In this context, it is important not to superficially hypothesize that “more” integration is necessarily “better.” There may actually be too much integration of a wrong type or a possible dangerous trajectory implying significant opportunity costs. In view of these problematical aspects of East Asian integration taking already achieved European integration as its positive model we should therefore first have a look at the economics of integration.

2. Some theoretical considerations

It is easy enough to draw a multitude of distinctions between integration processes in East Asia and Europe – or in other world regions. However, the crucial questions that

need to be asked are: which differences are meaningful, what consequences do they have, and what does this imply for the future?

Integration can

- either happen spontaneously as *market integration*;
- take the form of *functional integration*, i.e. the tearing down of barriers making possible further market integration (Sannwald and Stohler 1961);
- or consist of an *institutional integration* involving the set-up of mechanisms and organisations to support and take care of different kinds of integration.

Market integration is the most uncontroversial type to deal with, because the positive welfare effects are usually quite straightforward. As all parties engage in free exchange (to the extent they are allowed to), they will do so as long as they hope to gain. All actors involved can play out their competitive advantages. One issue, though, is how to measure the degree of market “integration.” Just pointing to an increase in trade volume may not be very meaningful because the export and import propensities of trading parties may change as well as their sizes and because world trade in general may rise (or fall) due to a shift in transaction cost or other changes. Frequently, measuring the size of absolute interaction is distinguished from relative and even double-relative indices of integration, the latter relating actual trade figures to all trends mentioned above.

Looking at such figures (e.g. Pascha 1995), it is interesting to note that, compared to Europe, Pacific-Asia’s double-relative trade intensity was very low in the early post-war years. Pre-war connections had been cut and the development up to the 1990s can be read as a catching-up process to reach an economic exchange commensurate with geographic proximity. In this regard, intensifying relations in East Asia were not miraculous, but just a return to normality (Pascha 1995). Of course, it is difficult to interpret these developments separately from functional integration through multilateral trade rounds (GATT) and unilateral trade policy shifts (reorientation from inward-looking or import-substituting policy regimes).

We therefore turn to functional and institutional integration now. Both can be bedevilled by two critical points in particular:

- Is the *level* adequate? Do schemes make sense on the level of unilateral action, bilateralism, pluralism/regionalism, or multilateralism?
- Are the economic benefits of an enhanced integration (over-) compensated by *government failure*?

Functional integration is usually considered less problematic for two reasons pertaining to government failure. First, it does not involve continuous government action, which reduces the possibility of repeated government failure through vested interests, misuse of policy discretion for temporary gains, etc. Second, it does not prescribe a certain action, but leaves choices within certain boundaries; this should increase the possibility of mutually beneficial interchange. Still, functional integration has a serious “level” issue, namely the well-known problem of trade creation vs. trade diversion. Conversely, institutional integration involves the strong possibility of government failure, and one also has to make sure to find the adequate level: does action make sense on a regional level, or would the global, multilateral level be more appropriate? To give answers to such questions we must consider why government action, i.e. supplying a public or collective good, is sensible in the first place. There are four major legitimizing arguments (Vaubel 1986 on the former three):

- International/regional economies of scale for providing a (public) good;
- International/regional externalities;
- International/regional cooperation failures;
- Non-economic goals like external security.

While this may sound rather abstract we can illustrate it with respect to trade liberalization. For two given countries it may offer either of them few advantages, possibly even disadvantages, to liberalize unilaterally, while the other country stays protectionist. If both remain protectionist because of this “game” structure, they will both face significant disadvantages and forego important benefits from liberalization.

This is a prisoners' dilemma situation (Krugman and Obstfeld 2003, pp. 235-237) that can be overcome through cooperation. A binding agreement would be preferable to keep either party from cheating, i.e. profiting from the other's opening while keeping its own economy somewhat protected through intransparent non-tariff barriers or else.

3. The Historical foundations of economic integration in East Asia and Europe

Looking at the history of integration schemes – beyond market integration – in East Asia and Europe, a striking and well-described difference emerges. A core of six European countries has come together in the so-called “European Economic Community” (EEC) already in the 1950s (Treaty of Rome 1957), later referred to as the European Community (EC), finally leading to the EU of the 15 as of today, the 25 as of 2004, or the 27, probably including Bulgaria and Romania, of 2007. It developed from functional integration, a customs union with some important aspects of institutional integration, as in agriculture, to a deeper and wider integration scheme. An important step was the Common Market project of 1992, and combining the real economy EU with a monetary union in the form of the common currency Euro (not to forget the somewhat ill-fated earlier European Monetary System [EMS]). The “institutionalization of integration” has meanwhile reached the level of drafting a constitution contract that might, if passed, state the supremacy of EU over national law.

There were other moves towards regional club building attempts in Europe. Examples are the now defunct Comecon group of Central and Eastern European communist countries, the earlier EFTA European Free Trade Association of independent, smaller European countries, or the more recent European Economic Area (EEA) of smaller EFTA countries with the EU. Still, they all more or less reflected and reacted to the EEC-EC-EU process and can be treated in passing here (see, for instance, Pelkmans 1997, chapter 18).

In East Asia by contrast it has taken much longer to develop noteworthy beyond-market integration (for a helpful survey of issues, see Fischer 2003 or, more encompassing, Kwon 2002). The 1967 ASEAN (Association of Southeast Asian

Nations), later enlarged, tried institutional integration despite some inner conflicts, and an attempt at functional integration, the Asian Free Trade Area (AFTA), is still not fully realized, particularly with respect to the more painful obligations. Attempts such as the PBEC (Pacific Basin Economic Council) were rather loose, and the 1989 APEC (Asia-Pacific Economic Cooperation) is inter-regional, covering almost the whole Pacific Basin including the US. Its liberalization attempts under the slogan of “open regionalism” and “concerted unilateralism” have remained a partial success at best, its organizational structure weak, mainly consisting of committee work (Pascha and Goydke 2000). There are few binding agreements; the decision-making style is consensual.

Different types of integration (market-based in East Asia, functional and institutional in Europe) and dominant decision-making mechanisms have led to other differences as well, for instance concerning the prime movers of integration (table 3-1).

Table 3-1 East Asian and European integration

	East Asia	Europe
Integration Type	Market integration dominant	Functional and institutional integration
Rules	Flexible, consensus	Binding agreements
Moves	MNEs	National politicians, EU bureaucrats
Government role	Facilitator	Leader
Members	DCs, NICs, LDCs, LLDCs	DCs as core, NICs and LDCs recently
Trade	World market, intra-trade growing	Intra-regional
Investment	Production network growing	Dense links
Monetary Integration	Still weak	Tight (Euro)

Why do we find such striking differences? In Western Europe the established countries with a long tradition of inter-state treaty systems at least going back to the

Westphalian Peace of 1648 hoped to avoid a reoccurrence of war and fascism by all means, leading to a dense treaty network with strong obligations. The content was economic, but the spirit political. This aim could not be achieved without binding commitments. In Asia, on the other hand, all countries in the early post-war period were more tied to the United States than among each other. Deep mutual mistrust led to rather weak interaction. This is in line with expectations from the realist school of international relations (Chan 2001): It expects that states mistrusting each other will prefer non-binding agreements, not putting all “eggs in one basket” so to speak. This also helps to explain the multitude of such weak, overlapping cooperation schemes in East Asia.

Moreover, the heterogeneity of states is more pronounced in East Asia than in Europe. While the 2004 EU enlargement somewhat changes matters, earlier EU members are closer together in terms of GDP per capita level than in East Asia, the latter ranging from rich Japan to LLDCs like Burma and Papua New Guinea. In addition, at least the leading European countries – Germany, France, Great Britain, and Italy - are rather similar in economic strength, thus neutralizing each other somewhat. Again, from the perspective of the realist school (Chan 2001) one might expect that the more asymmetric the distribution of assets and power (East Asia), the less inclined such countries would be to commit themselves with little leeway to defend their sovereign rights.

Another, more economic factor is that intra-regional trade in Western Europe was – and still is – bigger than in East Asia (table 3-2). This raised the prospect for trade creation effects in a regional scheme for Europe, while East Asia with its high exposure to the world market naturally expected much more from multilateral liberalization.

Table 3-2 Exports of the EU and East Asia to major economic regions

Export shares of East Asia in %	1980	2000
East Asia (Intra-regional)	33.4	42.4
US	21.1	23.7
EU	13.4	15.2
Rest of the World	32.1	18.6

Export shares of EU in %	1960	1980	2000
EU (Intra-regional)	47.4	61.0	62.1
US	7.5	5.4	9.3
Asia	6.5	4.0	7.3
Rest of the World	38.6	29.6	21.3

Source: Barrell and Choy (2003), p.5, p.12, based on Direction of Trade Statistics, IMF.

In table 3-3 the realist regime of East Asia is juxtaposed with the “liberalist” European integration path based on binding commitments. Given the explanatory power of the mentioned factors, it seems unnecessary to refer to an “Asian way” to explain the different origin and contract style in European and East Asian integration schemes. Such references rather resemble aspects of “symbolic politics” to defend the fairly weak mechanisms in place to overcome possible prisoners’ dilemma situations.

Table 3-3 Liberal and Realist Positions on Regional Integration

Liberalism	Realism
Pursue Binding, Long-term Agreements	Seek Flexible, Short-term Agreements
Focus on a Few Homogeneous Partners	Diversify among Many Heterogeneous Partners
Foster Cross-Linkages among Issues	Avoid Cross-Linkages among Issues
Maximize Absolute Gain	Attend to Relative Gain

Source: Chan (2001), p. 15.

Is there something to learn for East Asia, despite the different regimes both regions have been operating in? If countries truly want deeper integration binding commitments can hardly be avoided. Large groups of countries will find it very difficult to make such a choice, though. The European experience suggests that it is more promising to start with a small number of countries and that an early success story is needed to motivate reluctant partner to move on.

4. Recent developments in the trade arena

In recent years the stumbling new WTO trade round has put Asia in an awkward situation. North East Asia was, peculiar among the developed world, not endowed with traditional regional trading schemes such as free trade areas or customs unions. Another disturbing factor is the tendency of the United States to substitute multilateral trade liberalization by bilateral agreements. From the United States point of view this practice allows it to avoid the, to some extent, unwelcome WTO rules and mechanisms of conflict settlement. Furthermore, it gives the United States a chance to bargain for additional rights in agreements with the much weaker partners of the Southern Hemisphere.

In order not to be left out in the cold North East Asia has also started work on bilateral free trade agreements (for the more encompassing context: Park 2002, Seliger 2002). This process is complicated by at least three factors. First, a detectable competition between Japan and upcoming China to consolidate their spheres of influence has led to hasty moves, possibly well beyond what economic logic would suggest. Second, the question of how to treat lagging, weak sectors that may suffer from across-the-board free trade has not been solved. Consequently, the FTAs considered frequently encompass many exceptions, making them a dubious instrument to achieve significant trade creation (while also putting their WTO conformity in question). Third, as customs unions seem out of question for the time being, because they would involve even more painful decisions, free trade agreements need to involve complicated rules-of-origin, raising fears of a “spaghetti bowl” of intransparent, cross-cutting FTAs that might lead to noticeable efficiency losses.

What does this imply for the old question of whether regional integration is a stumbling block or a building block for multilateral integration? Recent developments in East Asia suggest that the faults of the regional arrangements – particularly the lack of binding rules – may lead to very unwelcome paths once the multilateral process stumbles. A patchwork of bilateral agreements may be evolving that is at best third best, but may also lead to troublesome instabilities.

In Europe the situation was rather different, regional integration always centred on the EU. Even for countries not wishing to join the union, for whatever reasons, the European Economic Area gave an opportunity to realise most benefits of economic sphere membership. The Common Market Project did not turn Europe into a “Fortress,” as many observers had feared. Arguably, some interested parties cultivated that fear as a bargain chip in the GATT Uruguay round and to make the EU a more sought-after partner in market-based activities. During the early 1990s there was indeed a noticeable peak of incoming foreign, extra-regional investment in many member countries, including Germany.

In more recent years the upcoming enlargement towards the East has taken up much of the EU's energy. What characterized Germany with its emphasis on reunification may now, to some extent, happen to the EU as a whole. With their much more "Southern-type" comparative advantages, the East European economies will become an important "workbench" for the richer part of Europe, and trade diversion may be an issue not to be dealt with lightly. With this regional consolidation progressing it is difficult for the EU to keep up the same interest in multilateral progress, as there would be without the prospects of the European East.

Summing up, Europe is in a more comfortable situation than East Asia, as its high degree of intraregional trade isolates the EU from the rougher world trade climate. It is understandable that East Asia tries to follow European precedence under these circumstances. However, it should not be carried away to prepare an over-cooked "spaghetti bowl" of efficiency-impeding, criss-crossing regional trade agreements.

5. Deepened economic integration beyond trade

Both regions, in due time, took greater interest in issues beyond trade policy, for instance in terms of lowering the transaction costs of trade (trade facilitation) or making it easier to undertake FDI (direct investment liberalisation and facilitation). That might involve not only goods markets but also important factor markets for labour, capital, energy and else. The tariff rates are already quite small due to several successful multilateral trade rounds. Tariffs are not the most important trade impediment any more. If further progress in exploiting comparative advantage is to be achieved more daunting issues affecting national sovereignty have to be tackled. Another reason for this is the trend of economic globalization with shrinking communication and transaction costs as well as the new, complex inter-organizational structures of multinational enterprises. To make use of these potential gains one would have to go beyond simple trade liberalization, and a regional level for some issues did make sense, as geographical proximity offered some advantages (positive externalities) to utilize the new options.

Still, Europe and East Asia took rather different routes. In Europe, the existing policy-making channels took up deeper integration, giving more importance to the central bureaucracy (institutional integration), relying on binding agreements among members, the most important of which was the 1992 Common Market Project. One reason may have been simple path dependence, as the organizational devices such as the European Commission and the Council of Ministers got more entrenched and structured the agenda as well as the decision-making processes. Another factor is suggested by the neo-functional approach (Haas 1971). Interdependence among policy issues leads to an increasing demand for further institutional integration, and if such schemes have gained some reputation for reliability it will be easier to supply new and deeper schemes. Moreover, different issues may offer more chances to strike bargains. However, this comes at a cost, because the danger of governmental failure also rises. Politicians and bureaucrats realize ever-deeper institutional integration as a means to raise their power and influence. For instance, national politicians may be tempted to delegate “dirty work” such as agricultural subsidies to the European level, while Euro bureaucrats may be happy to take over additional work to increase their budgets and career opportunities (Vaubel 1986). Such a public choice-view offers a helpful explanation of the frustration of many citizens with the European bureaucracy, creeping into every life sphere and spreading a thick blanket of stiffening regulation over the continent. “Euro sclerosis” (Herbert Giersch) was a well-used catchword of the 1980s.

With hindsight, though, one has to admit that the EU has somewhat improved its image. This holds when looking at recent competition supervision, for example. Moreover, the Commission has been praised by many economists for insisting that Germany and France should stick to the limit of an additional fiscal burden of 3 percent p.a. under the statutes of the European Stability and Growth Pact. One gets the impression that the European level has become an important force to help pushing reluctant member states towards painful structural reform. At the same time, costly, grossly inefficient policies like the Common Agricultural Policy stay in place. How can this be explained? Pursuing a “self-interested dysfunctionality” on the European level comes at a certain cost for policy-makers, as the efficiency losses become ever more obvious to the citizens, finally undermining this mechanism. During the 1990s the EU

was shaken by a number of scandals, most prominently during the years of the Santer-led Commission. To repair their shaken image it was a sensible approach for the EU authorities to visibly follow at least some policies that could muster public approval, at the same time weakening national governments that try to keep the regional authorities at bay.

In East Asia deepened integration was kept within the mechanisms of a “soft regionalism” (Robert Scalapino). Due to the eventual development of regional production networks, the necessity of such integration became ever more obvious, so we need some additional explanation of why a mechanism similar to the neo-functional approach would not work in Asia to overcome possible prisoners’ dilemma situations. Employing a realist perspective once again, it is understandable why countries living in rather asymmetric power structures would be hesitant to give up sovereign decision-making power in such sensitive issues. Deeper integration almost by definition covers policy fields with significant domestic sensibility, such as competition, exploitation of the sea given certain territorial claims, communication standards, media access through satellite systems, etc. Moreover, it was always feared that deepened production networks, e.g. by Japanese enterprises, would be used to gain monopoly power in weaker factor and goods markets, supported by superior finance, ODA or else. It is not surprising that there has been a vast number of projects and mechanisms in the area, for instance under the umbrella of APEC, but there is little effort to objectively measure what progress has actually been achieved already (Pascha 2003).

6. Coverage of countries

With respect to the economies covered by regional arrangements, there are noticeable differences between Europe and East Asia. European institutional integration has grown in almost concentric circles, with few setbacks so far. In East Asia, in contrast, there is a multitude of groupings, their respective boundaries criss-crossing the region. The most important arguably are the South-East Asian ASEAN and the trans-pacific APEC. Since the 1990s there have been discussions of a Pacific-Asian grouping (encompassing both North East and South East Asia). While earlier calls for an East

Asian Economic Caucus (or even Group; EAEC, EAEG) by Malaysia's Mahathir did not lead to concrete results, the financial crisis of 1997/98 led to new attempts. ASEAN+3 was the outcome of these discussions.

It is doubtful whether the patchwork of organizations is anywhere close to being efficient. For instance, the membership of the United States in APEC and in the Asian Development Bank (ADB) is largely based on its interest to make its influence felt in the region. Is there an economic rationale as well? It would be difficult to argue that an "optimal club" defined by common Asian interests, needs and externalities would have to encompass the United States. Without the latter's membership, though, the question of intellectual and strategic leadership would have to be raised. For international organizations supplying a public good there is always the issue of members hoping to take a free rider position. Which member would be willing and capable to take over an additional burden? So far Japan has not made a particularly convincing job of supplying such able leadership in organizations like the ADB, even though it wields a lot of influence (Pascha 2002). Apart, it is an open question whether the rivalry between Japan and China can be a productive force – or whether it will rather be a destructive force – in such processes.

Yet another issue is whether East Asian organizations would want to compete with multilateral or arguably "Western-minded" organizations. When an AMF was proposed such considerations gained a lot of prominence. While such competition may be considered fruitful as a search process for the best solutions to deliver international public goods, it may still lead to perverse results. If an AMF would compete with the IMF for regional "customers" to accept aid recipient countries may choose the help with the easier conditions attached and not take the "bitter medicine" with better long-term prospects. Reference to regional peer pressure rings is somewhat hollow in this context. Such pressure may indeed work if neighbours are influenced through externalities ("regional contagion") and are thus deeply concerned about making their regional mechanism work. However, there may also be cases of regional collusion in which neighbouring countries try to hide disturbing information.

In the European case the process of “concentric growth” may seem smoother in retrospect than it indeed was; it actually encompassed some rather unstable periods. There was a dominant logic, however, namely the goal of the advanced member economies in Western Europe to enlarge their sphere of stability, and for the more peripheral newcomers to gain secure access to markets – and to transfer payments, in the case of poorer economies. This came at a price because the stability hindered the refreshing wind of global challenge to blow through many laggard sectors. The ultimate challenge has been to steer the enlargement process to include ten more Central and Eastern European countries, most of them formally communist and more recently so-called transformation economies. The tendency for the EU to grow seems to have reached its apex. Possibly, there are already net diseconomies of scale – for two reasons: First, the necessity to finance structural and regional assistance seems almost beyond the means of even the richest Western EU economies. It is still open to what extent EU help will be enough to raise Eastern European income levels fast enough to avoid a huge outpour of labour to Western Europe once migration will be fully liberalized. Second, the decision-making mechanisms of the EU have to be revised significantly to be workable with twenty-five – or even more – member countries with vastly diverging interests and resources.

Whenever the EU circle gets larger new boundaries and sources of potential instability are touched, anyway. In the EU’s case the major open issues are Russia and Turkey. While Russia is so big and so different that it stretches the imagination to consider it ever joining the EU, it will be very important to find ways not to make it feel an outsider. As for Turkey, it is a poor and rather large neighbour in Southeast of Europe. In some respect relations with the EU are already close, for instance in terms of labour migration, but mainly for political reasons the task of integrating Turkey seems formidable. It may be just as dangerous to leave Turkey out of the EU as to let it join.

With respect to the necessity of reforming decision-making mechanisms, the EU has taken up the challenge to prepare a constitutional contract. There is a draft, prepared by an EU Convention under the chair of Valéry Giscard d’Estaing. Unquestionable the enlargement has made it more difficult to reform the EU, but the

enlargement has at the same time proven beyond doubt the necessity of reform and may thus have even hastened the process to deliver a draft. Currently, it is still too early to tell what its fate may be. While important issues seem to have been agreed upon, such as a considerable extension of majority voting, other key questions are still hotly debated. This holds for how to define “majority” (the “double majority recommended by the convention involves a majority of countries, representing three-fifth of the total population), and for the number of commissioners. The constitution will have to pass an inter-governmental conference, national parliaments, and even referenda in several member countries.

At the time of writing, the European Summit of Brussels of December 2003 has just taken place. It did not lead to the adoption of the draft and is generally considered a painful failure. Some countries (Spain, Poland), whose voting weights would be lower under the double majority rule than under the Treaty of Nice, found it impossible to agree. Other countries, namely the net contributors to the EU budget, have reasoned that the future budgets should be capped at one percent of GDP. This has been understood as a more or less open threat directed at Spain, currently the top beneficiary of EU funds, and at Poland, the largest economy of the new entrants and thus presumably the largest beneficiary in the future. While a lot of political manoeuvring is involved, these developments do show how the enlargement is linked to the critical importance of reforming decision-making processes.

There has been a debate on whether there should be clear clauses when to leave the EU. Intuitively, one would expect a better performance of a “club” if there were an exit clause. However, this raises moral hazard issues and can significantly strengthen the blackmailing power of individual countries (topical discussions of issues such as voting rights and exit clauses by German institutional economists can be found in Cassel and Welfens (eds.) 2003).

As for another point of recent interest, France and Germany have signalled ever-closer cooperation, possibly in order to pressure smaller countries not to overplay their bargaining position. This echoes the tendency that if an enlarged EU becomes

inflexible smaller clubs within the EU may move ahead. From an economic point of view this seems sensible as long as it is not discriminatory to other EU members and as long as other members are allowed to join if they obey the rules of the sub-club. In an extreme case a move towards various, possibly criss-crossing sub-clubs may undermine the stability of the EU. However, it may also develop into a flexible mechanism experimenting with innovative organizational schemes (after all, each individual country can be understood as a sub-club anyway that came into existence due to historical idiosyncrasies).

7. Monetary integration

Another topic that can only be shortly covered here is monetary integration. Europe is obviously much further down this road than East Asia. Even in Europe with its background of real sector integration since the 1950s, discussion is still occurring as to whether it was ripe for a common currency in the late 1990s – and whether it is still at the time of writing. In terms of the theoretical basis for an “optimum currency area” it is quite clear that the current EU (with Denmark and the UK not participating in the Euro scheme) is not such an area (Jochimsen 1998). Giving up the exchange rate adjustment mechanism only makes sense as long as there are enough other channels to react to asymmetric shocks and divergent conditions in various parts of the union (labour mobility, possibility of fiscal transfers, etc.). After several years of experience it is still doubtful whether the EU has reached such conditions.

For instance, given sluggish German growth, the EU interest rate is too high to make Germany grow stronger. It cannot be lowered, though, because there is stronger growth and inflationary pressure in other, more dynamic European economies. Low German growth has led to significant unemployment as labour is not flexible enough to clear the labour market through real wage adjustment or labour mobility.

Another well-recognized problem is the Stability and Growth Pact. It is indeed an important addition to the Maastricht Treaty rules on monetary union because, without the pact, member countries could avoid the stringency of a tight monetary

policy by ever more pronounced deficit spending. From a market-based point of view even without a pact each government should be controlled by the financial markets: If it engages in too much deficit-spending the interest rates on its bonds should rise and debt financing should become ever more costly. According to Maastricht, the European Central Bank (ECB) is not allowed to bail out a national government so this market mechanism should be able to put strings on national politicians. However, one cannot but observe that the interest rates on the national debt of the different Euro economies show only minor differences. It can be inferred that financial markets do not expect the EU or the ECB to let a member country of the Euro scheme go bust. Hence, financial markets actually do not penalize irresponsible fiscal spending, and some mechanism like a stability pact is indeed necessary. Recent experience shows, though, that it is very hard to make powerful member countries like Germany and France comply by the decided rules of the pact in times of economic trouble. (It should be noted in passing that, without monetary union, national governments are indeed forced by financial markets to consider their steps carefully. Irresponsible fiscal spending would soon have an impact on the interest rate and on the exchange rate, forcing the government to stop such an irresponsible policy.)

Given the enlargement of the EU, more problems can be expected in the future, as all new members have a right (and an obligation) to join the Euro scheme once they meet the agreed conditions. It was hoped that the pressure of the common currency would force member countries to make their (other) markets more flexible. However, this has not happened so far, and national governments have found it a convenient strategy to simply blame others (e.g.: the European Central Bank) for the emerging imbalances.

In Asia attempts at monetary integration are significantly more limited so far. The financial crisis of 1997/98 was arguably a sea change for such ideas. The contingency effects of currency devaluation spread through the region. While South Korea's exchange position was weak in 1996/97, one might venture to argue that its situation was not critical enough to have necessarily led to a full blown crisis – if not

for the contagion effect from other devaluation crises (Indonesia, Thailand) in mid and the autumn of 1997.

Steps towards further integration have been rather slow – but noticeable – after the ill-timed proposal to set up an AMF. The Cheng Mai Agreement to establish an enlarged swap agreement was a step in the direction of further integration, and so was the recent move towards a stronger East Asian bond market. Stronger currency cooperation could at some stage take a similar course as the EMS, namely trying to stabilize currencies within certain corridors. Given the different trade, capital, asset and liability structures of East Asian countries, it will not be easy to find a suitable position between the US Dollar, the Japanese Yen, and – possibly – the Chinese Yuan. Moreover, it will be an issue whether with highly liquid international financial markets, such a scheme would truly be trustworthy in times of asymmetric shocks in one member currency.

The idea of a common currency is distant, as the characteristics of heterogeneous East Asia are even more removed from an optimal currency area than the EU. The experience of the EU, then, is not necessarily only positive.

8. Towards regional peer monitoring mechanisms (ReMMs)?

There is another possible interpretation of recent (financial and monetary) developments in East Asia, though – namely, that it points towards the ultimate goal of a well-developed regional peer monitoring mechanism (ReMM). There has recently been a lot of interest in ReMMs in various world regions (e.g. Williamson 2003). One reason is that the possibility of regional contagion seems to have increased. A further reason is that global monitoring seems clumsy, intransparent and faces concerns of legitimacy. Another factor is that of similarities in regional circumstances giving regional partners more competence to evaluate neighbours than distant peers. However, there are also problems to take into account. Firstly, is there really an additional role for ReMMs sandwiched between multilateral surveillance and the monitoring by free markets? Secondly, the possibility of contagion does not only offer an incentive for

mutual monitoring, but also for behaving collusively by legitimizing each other's policies. Drawing convincing institutional rules for such ReMMs is thus both critically important and far from easy.

The European Growth and Stability Pact can be understood as an early example of a ReMM. As happened so frequently, the EU is an early mover with respect to global trends, and other regions have ample reason to watch European developments carefully. As has been pointed out above, the rules governing the Pact are far from satisfactory. Firstly, one cannot trust them to work in times of stress, as has been recently proven with respect to France's and Germany's fiscal deficits. They depend on the states actually enforcing them and the very fact of regional interdependence – or dependence on the major EU powers of Germany and France, in this case – lowers the possibility of doing so. Rules that are more automatic may be well worth considering in order to improve the Pact. Secondly, rules and trigger points seem to be arbitrary to some extent. This holds for the famous “three-percent-rule” in particular. Such arbitrariness makes it more difficult to publicly legitimize tough reactions in times of stress. Thirdly, even the economics of the rules seem somewhat dubious. For instance, an unconditional three-percent-rule, irrespective of the situation in a business cycle and of the shares of cyclical and structural fiscal deficit, is difficult to defend with basic economic reasoning.

ReMMs in East Asia, based on ASEAN, ASEAN+3 or else, are still in a nuclear stage. It is to be hoped that careful consideration is given to the question whether rules which seem workable in fair weather conditions, can also be expected to function in times of stress and crisis.

9. Some tentative conclusions

As could hardly be expected otherwise, differences between European and East Asian economic integration are manifold. It is interesting to note that the divergent starting conditions and decision-making mechanisms have led to rather different “landscapes” of integration mechanisms. Against the background of NATO and the Helsinki Process,

EU integration has brought forward a deep trust in political stability. Another war among the former European archrivals, France, and Germany, drawing the rest of Europe yet once again into a nightmare of destruction, has become unthinkable. The EU has also developed considerable economic stability along its path, offering a high degree of intra-regional economic activity, at the expense of dynamism and possibly an eventual overreach of its capabilities.

East Asia still has rather liquid mechanisms. In an age of progress on a multilateral level this offered the chance to exploit the options of cooperation flexibly, going hand in hand with relying on world markets. With progress of a new WTO round still dubious and the United States turning unilateral and bilateral, East Asia reacts with an increasing intransparency of smaller moves on several levels. Both regions have in the past successfully played out the respective advantages of their peculiar regional integration patterns. Both have now reached an end on this road. What might be the next step overcoming the limits of the earlier paths and noting how difficult it has become to achieve progress on the multilateral stage?

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4. Integration through Competition: The European Experience

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1. Introduction

After the Second World War, the original motivating purpose of European integration was to make war in Europe again impossible. Economic interdependence and political mutual dependence are approaches to limit economic conflicts, to stabilize economic interaction, and to assure some degree of multinational security. Considering this objective, European unification is one of the great political successes of the last century, despite some developments which deserve critical analysis.¹

We can distinguish two basic methods of integration regarding the allocation of resources: competition and centralized political planning or “harmonization” by government command. With respect to competition, we can distinguish between competition of firms in markets and competition of governments or of policies. For harmonization we shall distinguish the “harmonization by politics” and the “harmonization of politics.”

2. The Case for Competition

The “European Union’s Single Market” is frequently considered to be one large unified homogeneous market in which all firms are competing for the purchasing power of all consumers. However, in reality the “Single Market” is just a political label to indicate a system of interrelated and interdependent local, regional, national, and supranational markets without *artificial, political barriers* to entry and exit. *Natural barriers* – transport and information costs, cultural differences and different consumer preferences – still exist and cannot be eliminated by political decree. To abolish or reduce all market segmentations, therefore, is not a reasonable policy objective. The Single

¹ For more detailed analyses see Prosi (1991, 1994, 1996 and 1999).

Market itself is part of another integrated system of different markets, which is called by another political label the “world market.” The international division of labour, the global allocation of resources and implicitly global economic integration are not always to the benefit of national governments, which therefore occasionally want to stifle autonomous integration and blame “globalization” for all political shortcomings.

Since the emergence of the Common Market there have been fears of competition: domestic firms and labour unions demanded protection against “unfair” competition from low-wage countries, protection against “social dumping,” “environmental dumping” etc. This discussion is now repeated with respect to the addition of the Middle and East European countries. The Germans are terrified because they believe that they are not competitive anymore. Probably they are right and that is one good reason why they need more competition – to wake them up and get to work again!

In general, negative integration – the reduction of all kinds of trade barriers – opens up new opportunities for all export-oriented firms. Problems may arise for those import competing firms and for jobs too – which previously enjoyed protection against foreign competition and which are less productive. This, however, implies that they are protected at the expense of the consumer thus reducing the welfare for all. To discover who is competitive the firms really have to compete. You will not find out how fast you can run by arguments and whining in political pressure groups or being pampered in protected reservations, but only by running!

To avoid misunderstandings some remarks are necessary on the concept of competition: frequently it is maintained that competition leads to zero taxation, zero regulation and policies and, consequently, to non-government. Since we need government (to cope with security problems) it is argued that we cannot permit integration by competition down to the zero-level, but need to limit competition by “political harmonization” – i.e. to pass treaties to avoid rivalries between nations to attract mobile resources, to restrain locational competition, tax competition etc.

The academic argument about competition to a zero level is based on the theoretical model of perfect competition in which no qualitative differences and no transaction costs are permitted. If we are more realistic we introduce a variety of economic and political preferences for firms, for consumers, for workers, and for other people with respect to public and private goods, to climate, for siesta and fiesta, and for blue-eyed blondes or dark haired southern beauties. This world permits a highly differentiated spectrum of political regulations – and tax systems – preferred by shifting majorities in the different countries, and tolerated by most of the rest because of the substantial individual disutility and opportunity costs of “voting with their feet,” of moving to another country. Since the preferences of Europe’s citizens are highly differentiated, since there do not yet exist and hopefully never will exist the standardized *homunculi oeconomici* cloned according to a harmonized Euro-norm, substantial differences in the tax systems, the supply of public goods, and the social security systems are possible and highly desirable. In a non-homogeneous world there is room for individuality, differences, and no need for uniformity as some “social engineers” in political bureaucracies often demand. Diversity opens up discretionary spaces to experiment, to innovation and so progress. It grants the freedom to be different, and it creates opportunities to fit the policy mixes to the multitude of political preferences in pluralistic societies. If we permit institutional innovations by competing political agents uniformity, however, is never achieved. Differences always exist in a dynamic, progressing society. They need to be tolerated, even encouraged!

It is this – in the theoretical sense – very imperfect real world competition on which the following observations are based. According to price theory, it contains monopoly elements, which are “contestable,” and because of “voice” and “exit,” potential competition for government monopolies is effective continuously, not only at election time. Competitive markets are systems to solve conflicts of economic interests in a mutually beneficial way. This, of course, does not mean that all are satisfied with the benefits they get or with the distribution of benefits. As long as goods are scarce, most people want more and are not satisfied, not even with “fair” deals. However, dissatisfaction stimulates the search for better alternatives. Scarcity and dissatisfaction are the parents of innovation in a competitive economy.

Despite all the evidence on the advantages of competition, Europeans are still discussing whether further integration of their highly diverse economies requires rigid central guidelines by the European Commission for most of the laws regulating the economy – *ex ante* harmonization – or if a competitive process of trial and error should develop the most appropriate organization for the different areas of the community. In the latter case, the individual countries maintain the freedom to search for the best solution to their problems. In the case of *ex ante* harmonization integration is the result of central planning; in competition it is an open ended, spontaneous process in which future developments can be included without nationalistic political bickering. However, because of permanent innovation a final unification is not possible. To get there, freedom, the right, to be different must be abolished, and the basic concepts of European culture – freedom and tolerance – are destroyed.

The political and special interest demands for harmonization and equality – the level playing field – as preconditions for integration demonstrate a basic misunderstanding of the processes of integration and development as can be shown by a very simple observation: To achieve progress in economic, social and political evolution, measured by an increase of the average, performances above average are required; evolution implies inequalities, forced equality results in stagnation. Where everything is equal, everything is just average!

Development and progress require, first, innovation, i.e. individuality, originality, and the ability to bear risk; it requires, secondly, imitation, i.e. incentives to be as good as the best. While improvements are imitated voluntarily, a change for the worse is only accepted by force. Applied to political integration, better policies will be copied freely; only worse solutions need “harmonization *by* politics” or coercion by central decrees. In competition it is the voluntary imitation of better policies which result in a spontaneous “harmonization *of* policies.” No central political power and cumbersome compromises and log rolling to harmonize by politics are needed.

But creative destruction, new methods, endangers old privileges and entitlements. This creates opposition, even animosity against new approaches to do things. If competition does not force innovation then the quiet life in protected zones without change and its frictions and stagnation may be preferable to evolution. Competitive systems promote plurality and permit differentiated policy approaches. Multiple policy choices threaten the status of the political establishment and provoke “unification.” Centralized systems, for example bureaucracies designing industrial or technology policies, try to standardize and harmonize the future according to some political master plan. But the new and unforeseeable development cannot be planned and standardized *ex ante*. The future can be planned only in so far as it is already known. Usually the knowledge available in government agencies is only yesterday’s state of the art, but the breakthrough, the revolution in knowledge, does not conform to the generally accepted state of the art or even the mainstream thinking of the experts. Therefore, neither a bureaucracy nor a commission or group consensus can decide what really innovative developments are. They decide on priority lists based on their present knowledge and promote projects which are evident to the majority. In most cases these are not the most innovative because basic innovations that require major adjustments and structural changes are more difficult and provoke more resistance than marginal changes of the present standard. The developments and present situation of the European welfare states can serve as warning examples (e.g. the “reform politics” of the health and pension insurance systems in Germany).

It is to be expected that really creative activities are not promoted by bureaucracies, commissions, and majority decisions. Outsiders with fundamentally new ideas have no opportunities because their ideas are considered “utopian, unrealistic, and crazy” and do not deserve any support. But imagine our world without those “daydreaming nuts” of the past who, *ex post*, became the great inventors and created new industries, who initiated a major change in a scientific discipline, or who changed the course of a nation’s political direction! What would have become of Germany without Ludwig Erhard who introduced free markets against the will of the allies and the majority of the political class?

Governments and political parties are usually not suited to be the driving forces of innovation also because of the political decision-making processes in representative democracies by majority rule. Innovators are always a minority. The state may lose billions in tax money maintaining unproductive jobs in old firms and old industries, but if tax money is lost trying to create new jobs by supporting the foundation of new firms with new, still experimental technologies, the politicians responsible will be criticized as irresponsible speculators with public funds. The opposition will immediately jump on this opportunity and use it as an argument for the next election campaign. Members of the political opposition always know better what had to be done – at least *ex post!* – and exploit the slightest mistake to discredit their opponents. Majority governments, therefore, prefer politically risk free, socially acceptable subsidies of existing jobs in old industries, conserving non-competitive structures of the past instead of “prospecting the future”! Since the jobs of the future have no vote, the past is subsidized and possible future options are neglected.

Innovation, progress, and inequality are inseparable, only stagnation permits equality. In addition, inequalities because of natural differences or because of long run historical economic developments cannot be eliminated by political decision or even by subsidies. In most cases the citizens involved do not even want it, because very often facts politically considered as detrimental are connected to positive aspects, e.g. a low level of industrial activity with low environmental damages, which may be preferred by the majority.

The European Union pays dearly for its follies of “harmonization” with its programs of “social cohesion” and several regional and structural programs, which excel mainly through waste and corruption. Looking at the record of German unification –political harmonization on the level of West Germany – it is a gigantic project of redistribution, unfortunately without backing in the real economy. Imposing the overregulation of West Germany on the East instead of deregulating the West produced the impression of formal equality and unification but stifled the process of real economic and social integration at very high expense for all. Politically to raise competitors’ costs always backfires in the form of ever higher unemployment and

subsidies. One of the consequences of policy mistakes is that the very desirable fact of unification undeservedly gets the blame for all negative developments.

Private spontaneous integration in open markets by trade and factor movements, investment and transnational enterprises was very successful. The “country of origin principle” – originally introduced by the European Court in the *Crème de Cassis* decision – opened national markets to innovations in other parts of the community by tearing down all kinds of artificial barriers. Competition does not need a supranational political bulldozer to produce a “level playing field” with a tremendous redistribution of chances and wealth, and the restraint of competition to protect national special interests. All this leads to the conclusion: integration is best served by the freedom of choice, of voice and exit, and by decentralization to the smallest possible decision unit instead of centralization for a political monopoly.

Europe – and any country that wants to progress – needs a competitive system, needs to protect economic freedom, and needs free trade and the free movement of its people and resources. To protect freedom of competition – economic and political, and this includes the right to secede, to leave the union – should be the main objective of a European Constitution.

3. The case for Supranational Cooperation

To determine the necessary level of centralization or the limits of institutional competition we have to develop criteria to indicate where supranational cooperation tends to be harmful and where it helps to avoid superfluous conflicts and the waste of resources. Similar to the economic distinction between private and public goods according to internal and external effects, one can identify policy areas with mainly domestic or national effects and areas with strong supranational, external effects. National independence should be maintained for policies with mainly national effects to permit competing political instruments and innovation. Here competition can help to discover better solutions while political *ex ante* harmonization stops progress. Most fields for which harmonization and standardization are demanded fall into this category.

Private special interests are placated as the national interest with the risk that private conflicts of interest which are best handled in markets escalate to political conflicts which stifle further integration.

On the other hand, in fields with strong external effects supranational cooperation is useful to avoid serious conflicts when the external effects are negative, and to limit free riding and waste of resources when the effects are positive. Supranational solutions of these transnational “rationality traps” or “prisoners’ dilemmas” can be beneficial for all participants. Examples for multinational public goods are defense and international security, in the classical sense as well as in the fight against terrorism. Obviously, with free movement of people, including all kinds of criminals, coordinated police forces are needed, and the judicial systems have to cooperate in enforcing the law.

But there also exist several fields in environmental policy where damages are externalized beyond the national borders. Supranational rules of liability, which define territorial integrity and enforce remuneration for damages would help to limit damages. The verdict on the European monetary union, the Euro, is still out. How very questionable the results of political harmonization can be is presently demonstrated by France and Germany with regard to the “stability and growth pact.” But one wonders what would happen with the public deficits in Berlin, Paris, and Rome without the independent European Central Bank and the moral suasion of the “stability pact”? Probably it would be much worse!

Demanding supranational cooperation, one should not forget that systems of harmonization and of supranational redistribution involve increasing socialization of private relations and growing regulation. They require the representation of special private interests by national governments and the supra-nationalization of private conflicts of interest which should and could be solved privately in markets. The affected citizen and companies are usually dissatisfied with the political compromises, for which they do not blame their own lack of performance but the incompetence of the political representatives. Just look at the bargaining in the World Trade Organization

and the discontent of all involved! New fields for political rent seeking exist, and it may be much more profitable to invest in politicking, even corruption, than in innovation and higher productivity. The damages for further development and integration are obvious. European experiences with agricultural policies, structural funds, and most of the industrial policy should warn against centralization, especially since it seems to be impossible to reverse mistakes, even after the effects of government overload become obvious as the causes for demoscclerosis, and politicians and governments are forced to reduce the burden by deregulation, reducing tax rates, and decreasing spending in the social security systems. There always is public resistance since somebody profits even from the worst political mistakes, and effectively fights for the maintenance of the “entitlements” in the media. Very strong popular resistance can be observed presently in different European democracies, making urgent reforms next to impossible. The motor of integration, therefore, is competition in markets. However, after competitive integration is a fact, political integration must follow by setting and enforcing the rule of law across national borders.

4. Political Competition and the Welfare State

If competition is the European motor for development and integration, why is Europe in such a critical state of affairs with overregulation, high tax burdens, and ruined social security systems? Why do the majorities of voters tolerate these disastrous policies? One reason is that nearly everyone somehow profits from government handouts – the phenomenon of legitimate corruption. Additionally, has tax resistance decreased with increasing nominal income and automatic tax increases because of progressive income tax schemes. By the automatic shift to higher tax brackets, continuous tax increases were possible without any political discussion or action, even in cases when real income declined because the rate of inflation was higher than the increase in nominal income. On top of this, the personal burden and involvement of the individual are hidden by indirect taxes and contributions. The real costs of government services are not transparent.

In the efforts to gain re-election by catering to their special clientele, the members of parliament do not fulfil their classical duty of controlling the executive branch of government to keep the tax burden as low as possible. Quite to the contrary, in the permanent race for re-election the members of parliament promise ever-higher benefits and new programmes. This reverses the function of democratic control: not the parliament as the representative of the people reduces the spending of the government, but the finance minister limits the expenditures of the parliament to keep the budget deficit on a constitutionally just barely acceptable level. Instead of minimizing the expenditures and the burden for the taxpayer it is common to exploit the uppermost limits of spending and debt, and to shift these limits continuously to higher levels. These results are not caused by irresponsible behaviour of immoral politicians, but are the consequences of rational decisions in the framework of modern party dominated democracies.

To keep political competition effective and to compensate for these deficiencies in the institutional control of government spending and taxation by parliament the citizens need to be able to compare benefits and costs of government activities. Therefore, taxes and contributions need to be direct. Indirect taxation distorts the information on the tax burden, and taxation at the source, the practice of withholding taxes by the employer, shifts the actual payment further from the citizen. By using these indirect methods politicians can distribute benefits and election gifts; they can claim all kinds of merits, hiding the costs in indirect and less noticeable taxes.

Until recently, competition between political parties did not search for new ideas to limit the budget and the tax burden, but it degenerated to a system to discover new groups and new areas for new benefits. By distributing other people's money for "good" purposes, politicians gained "social acceptance" and "social competence" for their parties. This is the "Robin-Hood-syndrome" of politics in representative democracies, which in severe cases leads to societal paralysis. By shifting decisions – and the blame – to the centre, to the bureaucracies in Brussels, the voters' influence becomes even smaller. More decentralized political decision-making with more direct involvement of the voters would promote political competition and enforce the

correction of mistakes. With a growing number of alternatives the costs of exit are decreasing and voice, the threat of exit, is more effective.

Since the autonomy of decentralized government probably will not be introduced or strengthened by already centralized systems – it results in a loss of influence and power for the centre and its representatives – it is necessary to maintain decentralized decision-making and the competition of political concepts on the European level and to avoid its restraint by political cartels and “harmonization.” That at least is the lesson to be learned from the historical errors and failures of bureaucratic centralism! Free movements of people and resources as stipulated in the European Treaties make sense only when alternatives, a multitude of different opportunities exist, and mobile citizens can choose the political setup that comes closest to their preferences concerning structure and level of taxation, government spending, and public services. Harmonization would eliminate these differences and the freedom of choice.

The integration of Europe is a fundamental political innovation, and competition is the most efficient method to discover new knowledge. However, elected politicians and bureaucrats have strong temptations to stop competition and to promote political harmonization. In permanent bargaining sessions and resulting treaties they can boast that they effectively represent the “national interest.” Mistakes and economic disadvantages are part of “necessary compromises,” and the complicated supranational agreements, which in no case may be endangered by national eccentricities, serve as reasons for inactivity. Even very severe mistakes then can persist as “European Unification Policy.” The notorious Common Agricultural Policy (CAP) demonstrates that harmonization induces disharmony and continuous national and supranational political bickering for compromises, which satisfy nobody. The CAP is a substantial impediment to integration because it is politically so easy to blame those bureaucrats in Brussels – Europe – for all mistakes, and to claim to have avoided even worse results. “Euro-opportunism” can lead to “Euro-sclerosis” when all members regularly demand more from their partners than they are willing to contribute.

Innovation is not only a problem of technology and economics. It concerns the organization of society in general. Should change be promoted, only tolerated, or even retarded? Who gains, who loses income, influence, status, power? If opposition to innovation is strong and regulation and bureaucratic barriers are high mobile innovative resources will move to countries which are open for the future. The recent history of microelectronics and biotechnology in Germany can serve as examples for the costs of avoiding the risks of innovation and having to catch up as an imitator. They are also typical of political *ex post* management which, first, does everything to stop the “job killer microchip” and “unnatural genetic engineering.” Then, after succeeding with this policy and forcing the unwanted activities abroad, one suddenly observes a deficit of innovation in these “industries of the future,” blames incompetent management and globalization, and spends tax money to repatriate these activities by promising huge subsidies. Let this and the flops of European industrial policy be a warning for the “wisdom” of governments shaping the future!

Important for the competitive discovery of better policies and of political and economic stability in Europe are general rules of political conduct and of the consequences of political misbehaviour – the rule of law applied to governments, for example with respect to subsidies, nationalistic protectionism, and destabilizing budgetary policy. The rules have to apply equally for large and small member states. Subsidies, the doping in international competition should be prohibited *per se*, because it eliminates the incentives to innovate and raise productivity.

Of growing importance will be the right of individual member states not to participate in political harmonization efforts. The larger the number of participants in the Union, the less effective is the unanimity-rule, and therefore most important is the freedom to opt-out of majority decisions. The fear that the Union would dissolve if not all members move at the same speed towards integration is unfounded. The damages of premature integration and the loss of confidence in the European idea could be much higher than the disadvantages of a slower process of convergence. Occasionally it helps to remember that without a “policy of different speeds” in the past (6, 9, 12, 15 member states) there would not even be a European Economic Community. Progress is caused

by the advance of minorities, subsequent adaptation, and finally imitation. If integration follows the “convoy-principle.” the slowest and weakest member determines its speed. This creates no new incentives to accelerate the consolidation of the budget and to reduce differences in development. The pressures to improve come from the more advanced who move ahead without waiting for the approval by the less dynamic members.

Obviously, there is no need for standardization; the individual member states of the union are no homogeneous entities either. There exist large differences between different groups in one member state and many common properties between groups beyond national boundaries. What, then, does integration or political convergence mean? That all policies are equally unbearable for all? How absurd the demand of total convergence by “political harmonization” could become shows the demand to harmonize the legal systems. For the implicit – still hypothetical – demand to harmonize the national constitutions it must be decided if all members should abolish the monarchy, like Germany and France, or if they all should introduce the monarchy, following the United Kingdom, Belgium, the Netherlands, Spain, and the Scandinavian Countries.

Finally, let me make a confession: I prefer the beautiful diversity of people, of ideas and policies, which resulted from the diversity of Europe. I prefer competition and the many chances it offers, not only to shake off the yoke of the monopolistic “tax and spend welfare state”! I agree with Lewis Mumford, who wrote: “Any philosophy of history that takes account of natural and human diversity must recognize . . . that any mode of organizing human activities, mechanically or institutionally, which limits the possibilities of trial, selection, emergence, and transcendence, in favour of a closed and completely unified system, is nothing less than an effort to arrest human cultural evolution.” (Lewis 1970, p. 159)

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5. The European Union and East Asian Integration - Lessons for Dealing with the Costs of Success

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1. Introduction

Regional trade agreements are in vogue around the world. According to an OECD report published in 2000, 119 regional trade arrangements are in force as of 1999. Since the creation of the WTO in 1995, 80 regional trade agreements covering trade in goods and services have been reported (OECD 2000, pp. 23-24). The impetus for regional integration around the globe comes in large part from Europe. Europe has been the forerunner in this movement of regional integration ever since the creation of the ECSC (European Coal and Steel Community) in 1952 and the establishment of the EEC (European Economic Community) in 1957. Following these new European enterprises the first wave of integration ensued in the 1950s and 1960s. The Renaissance in European integration in the 1980s again stimulated in two ways countries in other parts of the globe to reinvigorate their attempts for regional integration: First, Europe's success story shows the possibility that regional integration can be a very effective growth strategy; second, European integration and its spillover effect into other regions awakened many formerly unorganized countries to the risk of becoming victims of negative externality in the form of "trade diversion effect," which results from being alienated from regional trade arrangements.

However, East Asian countries have long remained as exceptions to these global trends. The Republic of Korea, Japan, Hong Kong, China and Mongolia were listed as the only countries that are not included in any preferential trading relations (OECD 2000 p. 24). To be sure, it would be unfair to say that suggestions and actions for regional cooperation had been lacking in East Asia. Nevertheless, past initiatives did not go far enough to bring about any meaningful changes in the trading arrangements among countries in this region.

Why had there not been fruitful attempts for regional integration in East Asia for so long, while other regions such as Europe and North America have accumulated impressive achievement in building up integrated economies? There exists an array of diagnoses imbued with pessimism with regard to the factors for the underdevelopment of regional integration in East Asia. The identified causes include: too much hegemonic power (Crone 1993), instability in the distribution of power (Grieco 1997) the diversity of the region (Foot 1995), reluctance to institutionalization (Kahler 1995), unresolved tension stemming from the historical memory (Foot 1995), the mode of transnational economic activities (Mattli 1999, pp. 174-178), etc. From these perspectives, it can be said East Asia is so different from Europe that there is not much to learn from its experience.

And yet, what is happening in East Asia these days defies such pessimistic portrayals. The mood is changing fast now in East Asia. Long being lackluster in envisaging, let alone developing, formal arrangement for economic cooperation among countries in the region, East Asia now suddenly appears to appreciate the virtue of regional integration and the peril of going alone. So they gathered in Bangkok in early October 2003 and discussed the roadmap for strengthening ties among ASEAN+3 countries especially in the economic area. And the trend was reinforced at the APEC summit in Bangkok later in the month. Besides, a flurry of academic research and government reports authored by scholars and government officials in East Asian countries point to the desirability and necessity of bilateral or “mini-lateral” free trade agreements. Encouraged and urged by those studies and reports, governments of East Asian countries are shopping around for their trade agreement partners within East Asia and in other areas. A series of free trade agreements were either signed, or in the process of negotiation, or in the stage of feasibility test among South Korea, Japan, China and the ASEAN. South Korea is finally about to ratify an FTA (Free Trade Agreement) with Chile, and has agreed with Japan and Singapore respectively to conduct a research for the desirability and feasibility of an FTA. Japan is also in the process of negotiating a bilateral FTA with Singapore and Mexico.

The reasons for the surge of interests in economic integration among East Asian countries are many. Above all, it fits commercial interests. A free trade area promotes trade among countries and it accompanies economic growth. Second, regional integration in other regions stimulates East Asian countries. It brings up the notion that FTA is an effective tool and an inevitable option for surviving and prospering in this competitive world, and that the negative externality of other regional groupings might adversely affect their economies (Mattli 1999, p. 166). Third, as the process of globalization spreads, opportunities to contact foreign people and new cultures either through media or through movement of people dramatically increase. As a result, familiarity with foreigners, new modes of thinking, and new life styles also has been enhanced, so that historical animosity among neighboring countries and ethnocentric sentiment becomes significantly diluted.

Recent efforts to step up economic integration, however, does not mean that East Asia has successfully overcome or bypassed all the constraints and obstacles that hitherto hindered attempts for economic integration. Quite contrary, although East Asia may be able to remove a hurdle in the initial stage, it will certainly have to face further difficulties.

In this paper a detailed analysis of the expected economic gains of regional integration and their political and social effects is not pursued, because such studies have been exhaustively done by many economists and political scientists elsewhere. Instead, drawing on Europe's experience, I will focus on possible problems that could arise as a result of economic integration. Before turning to Europe's lessons theoretical accounts for the hitherto sluggish pace of regional integration in East Asia are presented with critical remarks on them first. Then I will proceed to discuss what the European experience tells us. I will conclude considering why Europe's experience is valuable for East Asia.

2. Theories of International Relations and Integration in East Asia

1. Realism

From the realist point of view conditions for regional integration in East are wanting. The power-centered view of realist accounts suggests at least five factors that are likely to bear on the emergence and sustenance of regionalism: the relative gains problem, alliance politics, the magnitude of hegemony, changes in relative disparity, and the existence of common external threats. First, if states are accorded the asymmetric distribution of gains from cooperative exchanges among states, states benefiting less than others will have a lower incentive to join regional agreements designed to promote economic cooperation. Second, states tend to trade more freely with partners that are less threatening to their security, because states are naturally concerned with the possibility that gains accrued to adversarial trade partners could well be used to beef up their military capabilities. Therefore, regional integration would be easier among allies. Third, a willing hegemon greatly enhances the likelihood of institutionalized cooperation among states, according to hegemonic stability theories. But not always, says Crone. He questions the linear relationship between hegemonic power and the institutionalization of international order. His comparative study of Europe and Asia demonstrates that not only too little hegemony, but also too much hegemony works as an adverse condition for regime formation. Fourth, changes in the relative disparity among states are also important. According to Grieco, the level of institutionalization of international cooperation varies depending on the “amount of change taking place in the relative capabilities of partners” (Grieco 1997, p. 176). If relative disparity shifts rapidly the likelihood of institutionalization is low. Where the relative position among states is stable over time, institutionalizing is more likely. Fifth, as the European experience demonstrates, a high level of common military threat from outside enhances the likelihood of emergence of multilateral institutions. For East Asia all these factors identified by realism pose grave challenges.

First, in East Asia, suspicion among states still runs high. In East Asia many countries are still suspicious of Japanese intention and Chinese ambition due to the

historical memory of colonialism and imperial China. Japan and China also consider each other more as an archrival than as a trustworthy partner in the realm of security. Japan's failure has been to convince other East Asian countries that it is a "normal state" and that it would not repeat its prewar and wartime orientation in which it tried to impose its idea of the Great East Asian Co-prosperity Zone on other countries. China's growing power in the economic and military areas also does not relieve the concerns of other countries. Rather, it causes the anxiety for neighboring countries about a hegemonic China. Among neighbors suspicious of each other the relative gains problem is brought into relief. States are more wary of changes in power disparity among competitors than allies. Therefore, the configuration of power politics in East Asia is not conducive at all to regional integration.

Second, the politics of hegemonic stability in East Asia augur ill for regional integration too. As many observers point out, the non-communist Asia during the Cold War is characterized by the "hub-and-spokes" bilateralism between the United States and Asian countries where the asymmetry of power distribution was extreme. While the lack of hegemonic power is also antithetical to regime formation, the predominance of the United States power has deterred, rather than facilitated, institutionalization of interstate relations in East Asia. The extreme hegemony of the United States "inhibits regime formation by shaping the incentives of both superordinate and subordinate actors away from joint solutions." In East Asia, because of hegemony, "a fragmented, bilateral system of relations, rather than multilateral regimes, was formed" (Crone 1993, p. 504). Moreover, the status of the United States as a lone superpower in the post-Cold War world, and its even upgraded relative power position resulting from a decade-long robust economic growth during the 1990s that outpaced the growth rate of all other industrial powers, are not expected from this viewpoint to affect the prospect of regime formation positively in East Asia.

Third, Grieco hypothesizes that "when the relative disparities in capabilities within a region are shifting over time, disadvantaged states will become less attracted to institutionalization and the latter will become less likely to occur" (ibid). That is,

institutionalization is more likely when the distribution of power is stable than when the distribution of power is changing. Grieco says:

if less powerful countries in a region have experienced or are experiencing a significant deterioration in their relative capabilities then they might be concerned that the enhancement of regional economic ties brought about by institutionalization could accentuate regional imbalances in capabilities even further in favor of the relatively stronger partners. From the viewpoint of the less powerful regional states, closer institutional ties and the thickening web of economic transactions they facilitate and foster might thereby yield a more domineering partner in the future. Concerned in this way about trends in relative capabilities and potential bargaining power, the relatively weaker partners might shy away from institutionalization of regional relationships with stronger partners in the area. From this perspective, the surge of Chinese power in recent years, be it economic, military, or both, does not bode well for regional cooperation. Wary of a fundamental change in the power configuration in East Asia caused by China's rise, lesser powers in East Asia might well shrink from institutionalization.

Fourth, no common perception of threat has existed in East Asia since 1945 (Foot 1995, pp. 229-30). Sharing an external enemy could lead countries to cooperate with each other because common security concerns make them iron out the differences more easily in issue areas of less significance. But East Asian countries have not had common external threats as Europe had in the formative years of European integration during the early Cold War period. It means countries in East Asia simply do not share common security interests. As a matter of fact, they rather regard each other as security threats, as shown in the rivalry between Japan and China. The lack of common threat perception among East Asian countries results in the underdevelopment of international institutions in this region.

In short, from the power-centered view of realism, prospects for regional trading arrangements should remain bleak. Nevertheless, as mentioned above, the wave of regionalism finally seems to have reached East Asia. Realism may be able to provide

plausible accounts for the long period of under-institutionalization, but it does not seem to fit the recent trends in East Asia.

2. Neo-functionalism

Neo-functionalism provides another explanation for European success and East Asian failure in regional integration. Neofunctionalism, rooted in the liberalist tradition of theorizing international relations, starts from the recognition of the significance of interdependence, not only between states, but also between areas of human activity. The main thrust of neo-functionalism is its emphasis on the logic of the spillover effect and the role of transnational actors and supranational authority.

First, the spillover effect reflects the expansive logic of integration. This logic is set in motion as it is recognized that policies made pursuant to an initial task and grant of power can be made real only if the task itself is expanded (Mutimer 1989, p. 79). The spillover process can be divided into two parts: economic and political. Economic spillover relates to the process of further incorporation of various areas of economic activity that have initially remained outside the integration framework. Political spillover relates to the political effect of economic integration, leading to incorporation of politically sensitive issue areas which have been untouched in the initial integration project. From the neo-functionalist view political spillover is likely to take place as integration in the economic sphere proceeds because politics and economics are not separate spheres of social life, but are intimately and inextricably intertwined (Mutimer pp. 75-56). Therefore, what has started as a somewhat modest economic integration project, once launched could ultimately lead to political integration, the point at which most functions normally performed by national governments were transferred to international authorities (Puchala 1988, p. 204). Even if the integration process has been launched purely as an economic growth project (based on *laissez faire* ideology), the need for political integration will emerge because of their interdependence.

Second, the integration process promotes, and is nurtured by, the emergence of interest groups, notably industrial groups – business and labor – which tend to unite

beyond their former national confines in an effort to make common policy and obtain common benefits (Haas 1958, p. xiii).¹ Even interest groups organized within national boundaries including firms and local governments will become more responsive to the effects that Euro-policies have on them and will try to find ways to make the Euro policy-making process operate in their favor. The integration process thus contributes to the proliferation of transnational actors. In other words, integration is accompanied by the Europeanization of the scope of interest group activity.

The movement toward further integration also entails a greater role for supranational authority. The integration process creates, and is facilitated by, supranational bureaucrats who can, and do, deliberately engineer links among tasks and sectors in efforts to enhance their own authority and to push toward the complete political unification of countries to which they are committed (Puchala 1988, p. 205). The creation of more powerful EC institutions in turn promotes the sense that national governments are not the only places to find solutions to distributional conflicts. The extended scope of policy competency and the enhanced institutional power given by institutional reform packages such as the SEA and the Maastricht treaty would endow the EC institutions with the capability to mobilize fresh demands and supports from transnational actors for enacting further integrationist policies.

From this perspective the process of European integration is the process in which spillover pressure is borne out by newly empowered supranational actors and transnational actors awakened to the benefit of integration. Important factors for the progress in integration are, therefore, whether there exists functional linkage between policy areas and whether supranational and transnational actors have enough ability and incentives to expand the scope of integration into new areas. For these dynamics to come into force background conditions for initial institution-building should exist: “pluralistic social structures, substantial economic and industrial development, and common ideological patterns among participating units” (Rosamond 2000, p. 69).

¹ This vision of integration, as Streeck and Schmitter point out, in many ways bears “strong resemblance to a model of interest politics that . . . came to be known . . . as neocorporatism” (Streeck and Schmitter 1991, p. 135).

Europe seems to have had all these. While it is hard to say that West European countries were more or less homogenous in their politics and economy, they all shared the traits of advanced capitalist democracy. They also have religious commonality – belief in Christianity.

Unlike Europe, East Asia does not enjoy such fortune. East Asian countries could not be more diverse at the levels of economic development, political system, and religious orientation. Some are rich, and some others are very poor. Japan is a member of G-7, while some countries in this region are ridden with extreme poverty. Politically, democratic countries such as South Korea, Japan, and Thailand coexist with Socialist countries like China and Vietnam, and an authoritarian state like Myanmar. While Confucian influence remains strong in some parts of the region, there are others where Buddhism, Catholicism, or Islamism dominates the religious life of their peoples.

In sum, no optimistic prospects for regional integration in East Asia can be expected from the neofunctionalist view.

3. Culturalism

The pessimistic accounts by realism and neofunctionalism of East Asia's prospect for economic integration resonate in the culturalist perspective as well. Institutional underdevelopment in East Asia is often attributed to the cultural traits of the countries in this region. Contrary to Westerners who are said to tend to "define relationships in legally binding form, thus giving them a fixed and enforceable character," Asians are known to prefer "the loosest possible form of relationship in order to secure the maximum amount of room for maneuver" (Soesastro and Nuttall 1997). The reluctance of Asians toward the institutionalization of inter-state relations, it is said, stems from such cultural backgrounds. In addition, for the people of the ASEAN countries, many of who still have vivid memories of sufferings imposed upon them by European powers during the colonial period, institutional formalism is identified with Western values so that it could well conjure up emotional resistance to international institutionalization in general. In this regard it may not be an accident that Thailand, the country never

subsumed under a colonial power, is most eager and active in accommodating international organization among Southeast Asian nations. Therefore, cultural the dimension also works against regional integration in East Asia.

3. What Europe Means for East Asia

The question that arises from the investigation so far is, then, what makes East Asia geared for FTAs? Is the answer that the conditions that have impeded the creation of preferential trade zone in this region are changing? Or, are there any new developments that force or entice East Asian countries to pursue tightened cooperative framework in the area of commerce, while the existing conditions are unchanged? And even if countries in East Asia are more groping for regional integration now than before, are there not going to be any new obstacles that hinder the project? What should East Asian countries be prepared for? It seems that in response to these questions the European experience provides fertile ground for investigating a roadmap for East Asia.

Needless to say, Europe means several things for East Asia. First of all, Europe is an entity to deal with, whether as a competitor or as a partner for cooperation. Europe is a trading partner of East Asian countries and its importance is growing. It is also a destination of foreign direct investment and portfolio investment by East Asians. Money flows the other way around as well, so Europe is also an origin of investment money that goes to East Asia. In some international organizations such as the World Trade Organization the European Union acts as one entity. As European integration deepens, the collective voice of Europeans becomes louder and it has more impact. As such, Europe is both a challenge and an opportunity. The spread of integration movements around the world attests to this fact. An ever more tightly integrated Europe in the 1980s and 1990s spawned a sense of urgency among countries in other continents that they lagged behind a bigger and stronger Europe. Such fear was a driving force of integration in other parts of the world. An integrated Europe can be a bigger market for East Asia on the one hand, but its enhanced market power carries a bigger leverage in international negotiations.

Secondly, Europe is an example to be imitated. Europe boasts politically stable democracies, a prosperous overall economy, and an attractive and stimulating cultural heritage. Above all, its experiment in regional integration has been a tremendous success. It brought about peace and prosperity on the European continent. It also consolidated democracy in countries where the political system was fragile and capitalism was feeble. As such, Europe provides a rationale for East Asia to pursue regional integration as a way to stabilize the political situation and to improve economic conditions. Further, it could show a strategic roadmap for economic integration in East Asia. Europe's goal was ambitious from the beginning, but its approach has been quite practical all along, adjusting flexibly to changes in the international environment and the needs of the member states and peoples. Steps taken were modest and gradual most of the time, but the steady accumulation of them for fifty years has yielded the most extraordinary phenomenon in the history of international relations: the voluntary and substantial transfer of sovereignty by nation-states to supranational authority.

Thirdly, Europe also shows East Asia what to beware of. The process of European integration was far from smooth, as illustrated in the EPC/EDC fiasco in 1954 and the empty chair crisis in 1965. European integration also stagnated during the 1970s when member states failed to forge a community-level solution and tried to cope with the worldwide economic downturn in a fragmented way. In the past, the fault line that caused such troubles was usually drawn between nationalism and supranationalism. While tension between these two forces still hovers, new challenges arise from the very success of Europe's market-oriented economic integration – those of distributional problems and democratic deficit. It is these aspects that I will consider below.

As theories of international relations point out, neither system-level factors nor unit-level conditions are favorable to economic integration in East Asia. The non-existence of security community among countries and a strong United States presence in the region renders the task of economic integration very demanding. The heterogeneity of the constituent countries in political, economic, and cultural terms will

make it even more daunting. Compared to Europe, East Asia definitely has tougher obstacles to overcome. Difficult as it may be, regional integration should not be an impossible enterprise in East Asia. If new circumstances arise and the incentive structures of East Asian countries change, and if a strategy for economic integration is drawn carefully enough to overcome both, then integration can take-off. However, even if East Asia passes both system-level and unit-level tests and succeeds in building a preferential trading arrangement thanks to circumstantial changes, the European experience leads us to anticipate that East Asia will have to encounter more challenges – again the two problems already mentioned.

1. Distributional Problems

After a long period of “Eurosclerosis” and “Europessimism” in much of the 1970s and the early 1980s, which coincided with the “dark age” of the European Community (now the European Union), Europe relaunched an ambitious economic growth project, culminating in the Single European Act (hereafter the SEA) and the 1992 project, thus spawning a sense of “Euro-optimism.” It has been emphatically and repeatedly pointed out that the fully developed internal market of the European Community would bring aggregate benefits to the EU as a whole, to a level that is unattainable without integration – hence so much talk of the “cost of non-Europe” (Cecchini 1988).²

Accompanying this elevated hope was the concerns about the distributional consequences of a fully integrated and barrier-free internal market in which capital, services, goods, and people can freely move. The worry has been voiced that the implementation of the 1992 project in the newly emerging “frontier-free Europe” would produce both winners and losers, at least in the short run. Faced with the possibility of uneven distributional consequences, the EU has attempted to develop various policy measures to cope with the problem. Two of them deserve special attention: the regional policy for reducing disparities between regions and the social policy to close the gaps between classes.

² Indeed, it has been suggested that the European countries would not sustain their relative status in the world political economy if combined efforts to reassert themselves were absent.

It has been widely acknowledged that the integration of the European Market can lead to either of the following two directions. On the one hand, the increased mobility of capital in the internal market of the EC might result in further concentration of industrial investment in the already highly industrialized regions. Since these regions have sophisticated infrastructures and well-trained labor forces, and are hence able to command higher productivity, it is possible that investment capital is attracted to the fertile resources for industrial activities these regions offer. This is what Streeck calls “the agglomeration effect”³ (Streeck, 1991). If it occurs then more industrialized countries will benefit from it while the relatively poor, less industrialized countries will suffer. If this happens the already impoverished regions will get even poorer.

On the other hand, unrestrained capital movement also might result in the flight of capital from the core to the periphery. While lacking the developed infrastructure and skilled labor compared to the core countries, the peripheral countries do have their own competitive edge in luring firms: the lower wage level. Seeking more cost-efficient methods of business operation investors might be tempted to escape from the high wage regimes of the core and move to the periphery. This is what can be called “Delawarization” or the “Sunbelt effect.” If it happens the result will be the growth of industry in the periphery and its decline in the core. If this happens workers in the core countries will end up either losing their jobs or earning lower wages and working under worse working conditions.

Regional policy and social policy were the EU’s response to these concerns. To be sure, what the EU is doing may not be enough. The EU budget allocated to close the gap between rich and poor regions – structural funds – is considered too small to remedy the existing disparities. The problem of regional disparities will further widen after the EU’s eastward Expansion in 2004, but the EU does not seem to have sufficient resource to deal with the problem. As to the EU’s effort to protect labor’s interests,

³ This is also called ‘backwash effect.’ According to Leonardi, the backwash effects entails the attraction of capital, skilled labor, entrepreneurship, technology, etc. towards core areas and discouragement of the movement of production factors from the developed core to the less developed periphery. Leonardi further notes that this notion provides the major theoretical argument that has been used in the development of regional policy in the EC. See Leonardi 1993, pp. 496-497.

even more criticism could be raised. EU social legislation has been characterized as “no more than a statement of principles” (Coombes and Rees, p. 217) or even as “non-binding and heavily diluted declaration of principles” (Rhodes 1991, p. 246). As such, EU social policy has been declared to be “a major defeat for European labor and an obstacle rather than an aid to the development of the social dimension” (Lange 1992, p. 12).

Nevertheless, what is important about the EU for East Asia on this matter is that it is taking these distributional problems seriously and trying to do something about them. As a matter of fact, regional policy and social policy legislation at the EU level is not an easy task. First, to aid backward regions, the EU needs to raise money first, but it is already spending more than a third of its total budget for structural funds,⁴ and the EU budget was constrained by EU law not to exceed 1.27% of total GNP as of 1999 (Begg and Grimwade 1998, p. 68). With this ceiling on the budget in place, the EU does not have much room for the increase of the amount allocated to regional policy. Second, as to social policy, harmonization in this area is extremely difficult because each member state has long developed its own social system that has been tailored to the changing needs of its people for long time. The national social system has also developed vested interests, and these vested interests often are keen to preserve the current system. Any attempt at creating a European level social system, therefore, is an anathema to these vested interests, and will face serious resistance from the citizens of the member states.

Given these limits placed on EU-level legislation in the regional and social policy areas, it would be too much to expect the EU to develop an effective mechanism for dealing with the distributional consequences of market integration. Maybe what the EU is doing cannot be the solutions to its problems, but at least it succeeds in addressing the regional and social issues and in setting the agenda. By doing so, it summons support for further integration from the trade unions and regional political bodies.

⁴ About half of the EU's total budget goes to CAP (Common Agricultural Policy). The share of the CAP is declining steadily.

2. Legitimacy Problems

In the Treaty on European Union the EU member states stipulate that they are attached to "the principle of liberty, democracy and respect for human rights and fundamental freedoms and of the rule of law." While all member states of the EU are undoubtedly well-developed democratic political systems, however, the EU is being criticized for not being democratic enough. The debate on the "democratic deficit" illustrates the point. The outcry is that while a growing number of policy areas are falling under the purview of the EU and an increasing number of decisions are made at the supranational level there is no concomitant development of a democratic mechanism to ensure an adequate level of public participation in EU affairs. The same goes for the accountability of decision-makers and the transparency of the decision-making process. Such problems stem from many sources: qualified majority voting in the Council of Ministers; the direct effects of EU law; and the secrecy of the Council and the Commission meeting (Martin 1993).

The efforts to remedy the problem of the democratic deficit come from two directions. One is the effort to strengthen the power and authority of the European Parliament and the other is the attempt to apply the principle of subsidiarity to EU decision-making. They represent, respectively, supranational and national solutions. It remains to be seen how effective these measures are in improving democratic practice in the EU. The current situation does not seem to allow us to have an optimistic expectation. One of the prominent problems is the low turnout in elections for the European Parliament. The turnout has progressively declined since the introduction of the popular vote in 1979 as is seen in [Table 5-1]. The low turnout in European elections and the resulting lack of legitimacy of the European Parliament as a representative body of Europeans indeed bodes ill for democracy in the EU and its legitimacy. However, again, what attracts attention here is that the problem of the democratic deficit was recognized to be a serious impediment on the way to further integration and concrete measures are put in practice to correct the situation.

Table 5-1 Turnout in European Parliament Elections

Year	1979	1984	1989	1994	1999
Turnout (EU average, %)	65.9	63.8	62.8	58.3	49.0

Sources: Smith 1995, p. 210 for 1979-1994 data; and International Herald Tribune for 1999 data

4. Conclusion

What can we learn from the experience of European integration? The comparison of initial conditions for institution-building in Europe and Asia is more likely to lead us to a pessimistic and defeatist view with regard to the prospect for economic integration in East Asia, than to drive us to find a useful roadmap for future steps toward regional integration. The move towards integration is now gaining momentum anyway. The driving force may come from sources that are different from Europe's case. Indeed, neofunctionalists admit that "it was also possible that locally specific conditions (or 'functional equivalents' to the background conditions in Western Europe) might be sufficient for the generation of integrative potential in other regions (Rosamond 2000, p. 70).⁵ Once an integration process starts up, however, it is possible that the process resembles European experience more and more, because it is the logic of market that works at the core. That is, once the economies of East Asia are integrated, the market force unleashed by integration will propel economic growth in this region on the one hand, and will possibly worsen inequality problem on the other. Such market failures could in turn engender strong anti-integration sentiment in quarters of the participating countries that question the legitimacy of the whole integration project, throwing the

⁵ This is basically to say that there exist regionally specific background conditions for economic integration. If so then neofunctionalism may have to give up being a general theory of regional integration, as far as the initial stage of regional integration is concerned. In this sense neofunctionalism should be regarded not as a theory about how regional integration starts, but as the one about how regional integration proceeds once it gets started.

enterprise of economic integration into disarray. Such negative sentiments also can be mobilized for electoral purposes, further making it hard to sustain a cooperative framework among states. The point here is that Europe shows the significance of being attentive to the consequences of economic integration – that is to the distributional problems and resulting erosion of legitimacy.

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6. Security Cooperation: European Experience and the Asian Way

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1. Introduction

For the last decade the Korean peninsula has experienced nuclear crisis twice. The first round of the crisis in the early 1990's was peacefully settled after Pyongyang made a concession to the United States demand to suspend its nuclear development program and concluded the Geneva Agreed Framework with the United States. in October 1994. This headed off possible strikes by the United States against DPRK nuclear facilities. At that time Pyongyang was worried that it could be the next target after the victory of the United States in the 1991 Gulf War. The second round of the nuclear crisis has recently shown signs of danger. After Pyongyang and Washington exchanged belligerent rhetoric, the prospect for a peaceful resolution of the crisis is now more encouraging, though tentatively so. But it is too early to expect a peaceful resolution of the crisis for now.

Against this summary background, it is the main idea of this paper that a new security concept should be applied to address the crisis with the aim of dramatically changing the security environment surrounding Korean peninsula. Seeking for the most suitable security concept requires discussing the emerging security cooperation in East Asia. In this light the purpose of this paper is to examine the roles of multilateralism in the process of forging a new security order in the region. Thus I will explore the usefulness of security cooperation in the concrete with the case of the North Korea nuclear issue. This paper is composed of the following sections.

The second section discusses different concepts of multilateral security arrangements. The European experiences in security cooperation help us conceptualize the emerging security arrangements in East Asia. The third section deals with the existing security cooperation in the region. ASEAN is taking the lead in this field. In

the fourth section I will examine how the security cooperation will be able to contribute to resolving the North Korea nuclear issue.

2. Contending Security Concepts

Peace is regarded as the maximum condition to enhance national security interests. Nevertheless, the pursuit of security interests does not always lead to peace; rather it often causes wars among nations. Wars would break out if one actor attempts to pursue its competing security interests by suppressing those of others, the outcomes of which could be – and are – frequently costly and devastating for both the victors and the defeated.¹

The Cold War period was dominated by the conception that security would have to be achieved through competition and confrontation. Indeed, the United States envisioned collective security as a new security concept after the Second World War. Collective security is a type of multilateral security cooperation, which implements a collective military enforcement against member states that break peace. As history tells us, this global mechanism of collective security however has never been fully put into practice. Collective defense has been implemented in the form of the military alliance instead.

Actually, the UN Charter reflected this situation and allowed regional security arrangements to be a legal right of defense. During the Cold War the security concept was associated with the balance of power and was based on military alliance. Many alliances, both bilateral and multilateral mechanisms of collective defense, composed of the broadly defined regional arrangements in many regions of the world, which enhanced the Cold War confrontation between two allied camps.

¹ Hoshino, Toshiya. 1998. "Multilateralism in East Asian Security Order: Track I and II Experiences" Kwang Il Baek (ed) *Comprehensive Security and Multilateralism in Post-Cold War East Asia*, (Seoul: KAIS), p. 132.

Alternative security concepts have received attention after the end of confrontation between the two military blocs. The various types of conceptions regarding security relations, such as security regimes or security communities, have awaked the interest in the academic world after the end of the Cold War. For example, Krasner defined the regime as sets of implicit or explicit principles, norms, rules and decision-making procedures around which actors' expectations converge in a given area of international relations.² According to Jervis security regime is perceived to better foster peace and stability because individual states are always motivated to pursue cooperation viewing the individualistic pursuit of peace as too costly.³

A security community shares many of the basic assumptions of the security regime. The concept launched by Karl Deutsch in the 1950s has been less frequently applied during the Cold War. However, experience a revival when it was used to understand the security integration of the European Union. A pluralistic security community is defined as a region of states whose peoples maintain a dependable expectation of peaceful evolution. The main difference of a security community from the security regime lies in whether there exists the developing sense of shared identity that induces constituent states to foster peace and stability. The transition of ESDI (European Security and Defense Identity) to ESDP (European Security and Defense Policy) in the European Union and the accession of East and Central European countries to EU suggest that a pluralistic security community has been developing in the region.⁴

While the states in the security regime model seek to build legal constructs and its institutional expression, the states in the security community regard identity as a driving force for strengthening mutual cooperation. The concept of a security community, however, does appear applicable to East Asia because a sense of

² Krasner, Stephen D. 1983. "Structural Causes and Regime Consequences: Regime as Intervening Variables," in Stephen D. Krasner (ed.) *International Regimes*, (Ithaca MA: Cornell University Press) p. 2.

³ Jervis, Robert. 1982. "Security Regimes," *International Organization*, vol. 36, no. 2, p. 360.

⁴ Waever, Ole. 1998. "Insecurity, Security, and Asecurity in the West European Non-war Community," Emmanuel Adler and Michael Barnett (eds.), *Security Communities* (Cambridge: Cambridge University Press)

community is altogether currently lacking. Unlike Europe, even during the Cold War period no region-wide anti-communist security alliance could be created in the Asia-Pacific mainly due to the diverse histories and cultural roots and the peculiar local patterns of rivalry and enmity in the region. Historically there has been military rivalry between continental China and maritime Japan. The colonial legacy of South Korea and China has promoted enmity toward Japan. This is part of the reason why neighboring countries express their concern about the marginally more active role Japan could play in regional contingency.⁵

The concept of a security regime is also not suitable to be applied to Northeast Asia. Only primitive forms of institutional mechanism exist in the region mainly as security consultation and discussion on a possible general security agenda – for example the ARF (ASEAN Regional Forum) and CSCAP (Council for Security Cooperation in the Asia-Pacific).

The European experience teaches us that there are various levels of security cooperation, namely cooperative security, security regime and security community. The first and realistic step of security arrangement in Northeast Asia involves cooperative security. This cooperative approach to security can help to create an international regime. Generally, cooperation can be instrumental in promoting international regimes. The security community as the most developed stage of security cooperation will offer the best opportunity to keep peace among member nations. Europe has been experiencing a security regime with the CSCE as well as a security community with the E.U. Northeast Asia should begin with its experience from cooperative security, which is made up of dialogue and consultation about security issues among nations.

3. Emerging Security Cooperation in East Asia

The new approach to security has been emerging in East Asia manifest in regionalism and security cooperation. The regional and cooperative approach to security gradually

⁵ Kim, Ki-Jung and Yongho Kim. 2002. "Alliance versus Governance: Theoretical Debates Regarding Security of Northeast Asia," *Pacific Focus*, vol. 17, no. 1, p. 15.

appears to be taking root, although the existing bilateral security arrangements still play a vital role in maintaining stability in Northeast Asia. This change suggests the shift of security structure from bilateralism to multilateralism in Northeast Asian security arrangements.

The security structure in Northeast Asia has admittedly been characterized by bilateralism. The United State has been playing a leading role based in its bilateral security alliances with South Korea, Japan and Taiwan respectively. However, the changed security environment has been demanding a multilateral security arrangement. The question arises then: why are more governments showing increased interest in the development of cooperative measures on a regional basis to address challenges to their security? In reply to this question it needs to be acknowledged, firstly, that the concept of security has broadened since the end of the Cold War. There is a growing realization that if the unconventional threats to national security such as transborder air pollution, international criminal activities and the mass flow of refugees and the like can not be addressed, they may easily escalate into military violence. These problems can be effectively solved through multilateral and cooperative means. The existing bilateral relations in the region are not sufficient to solve the problems.⁶

Secondly, there is an emerging view that cooperative and multilateral mechanisms can provide less costly and more fruitful solutions to such conventional security concerns as territorial and ethnic disputes and the regional arms race. A great number of states in East Asia spend more money annually on defense in the post-Cold War period than before. The competitive acquisition of arms has been stimulated particularly by strategic uncertainty in the region. To address this problem more reassurance has to be gained than from the strategy of deterrence because multilateral a

⁶ Hong, Kyudok. 1996. "Northeast Asia Security Cooperation: A False Promise or A Sine Quo Non for a New Non-Conflictual International Order in the 21st Century?" Myong-Moo Hwang and Yong-Sup Han (ed) *Koran Security Policies Toward Peace and Unification*, (Seoul: Tajo) p. 35.

security framework will work as a measure to enhance confidence, alleviate possible tensions and reduce political uncertainties.⁷

Lastly, the interest in regional security arrangements has been stimulated by the economic factor. Economic cooperation in Northeast Asia has become the basis for the countries in the region to promote cooperative and better political relationships. In addition, the end of the Cold War has removed the immense ideological barrier that had given rise to distrust and enmity among states for decades. This new situation has catalyzed an interest in regional security cooperation in Northeast Asia.⁸

Although security cooperation is growing in importance, it is faced with the varied attitudes of the major powers in the region. The United States in principle maintains a skeptical position. It has placed limits to regional cooperation because of its concern with its shrinking influence in the region. Multilateral cooperation requires the assumption of equality or non-discrimination. But the United States recently views a security dialogue as rather acceptable, because it is regarded offering an additional method of engagement. Indeed, the American shift toward a gradual acceptance of multilateralism proceeded under the condition that the multilateralism would not replace the existing bilateral security relationship with the allies in the region. Therefore, the United States still remains passive towards launching multilateral arrangements.⁹

Japan has a positive attitude towards security cooperation. It views multilateral security forums as opportunities for getting more actively involved in regional security matters. Japan has been seeking to be a “normal state” which exerts a political or security role in the international arena commensurate with its economic clout. There is

⁷ Lee, Seo-Hang. 1997 “Multilateral Security Regime in Northeast Asia: Policies and Attitudes of Four Regional Powers” Yong-Soon Yim et al (ed) *Security Environment in the 21st Century and Korea’s Strategic Options*, (Seoul: RIIA), p. 159.

⁸ *Ibid*, p 163.

⁹ Hong, Kyudok, *op. cit.*, p. 49.

no doubt that Japan will not take risks associated with security initiatives that might weaken the military ties with the United States.¹⁰

China has an ambivalent position towards multilateralism. It initially refused to participate in regional multilateral security forums, assuming that a bilateral basis is more advantageous for China in negotiating with smaller neighboring countries. With the emergence of the ARF and the growing importance of multilateral forums China has been confronted with an international environment that it can no longer ignore. Indeed, China places limits to regional cooperative arrangements, which deal with domestic issues such as Taiwan and Tibet.¹¹

Russia has a welcoming position on multilateral forums because these provide opportunities to engage in Northeast Asian security issues. For its part, Moscow has already signaled its desire to become more directly involved in multilateral security dialogue in East Asia since the Gorbachev era. The participation in the forging of a regional order has been the long-term goal of Russian foreign policy in East Asia. Russia has always suggested international forums if conflicts occurred. Despite its active interests, Russia possesses little leverage over North Korea and remains distrusted by Japan due to territorial disputes.

From the beginning of the 1990's the skepticism toward multilateralism has receded and efforts have been made to establish security cooperation in East Asia. The Council of Security Cooperation in the Asia Pacific (CSCAP), known as a Track II or unofficial channel was launched in 1992. The main focus of CSCAP activity is policy-oriented studies on specific regional political-security problems. It was followed by the ASEAN Regional Forum (ARF). The other notable initiatives include the issue-specific forums aimed to curtail the North Korea's suspected nuclear programs, the Four Party Talks, the Six Party Talks and the KEDO.

¹⁰ Inoguchi, Takashi. 2000. "Possibilities and Limits of Regional Cooperation in Northeast Asia: Security and Economic Areas." Tai-joon Kwon and Dong-Sung Kim (ed) *World Order and Peace in the New Millenium*, (Seoul: UNESCO), p. 297.

¹¹ Lee, Seo-Hang, p. 173.

Southeast Asian countries, despite their differences and even conflicts over many issues including territorial ones, have long steered the ASEAN to success. At the outset the ASEAN claimed not to deal with security issues. After the end of Cold War the ASEAN started to consider political and security issues. As a result the ARF and the CSCAP have emerged as the key forums for dialogue on security issues at the Track I and II respectively.¹²

These security arrangements, however, are not the proper ones that will guarantee peace and stability in Northeast Asian area, because such multilateral arrangements are tailor-made to the larger Asia-Pacific region. The security environment of Northeast Asia seems much more intricate. For example, no multilateral arrangement can endure without the express support of the United States and China. And no security cooperation can be expected without the participation of North Korea.¹³

4. Security Cooperation and the North Korea Nuclear Issue

The foreign policy team of the Bush administration is divided into hawkish and dovish groups regarding the strategy to solve the North Korea nuclear issue. The regionalists seek to tailor strategies that pay due regard to regional characteristics and the sensitivities of allies and friends. They prefer multilateral and diplomatic approach. But the globalists try to defend the non-proliferation regime of weapons of mass destruction at any cost. This dualism of the United States policy towards North Korea has caused concern and some confusion among its allies.¹⁴

It is evident that there is consensus on dismantling the nuclear program as the main goal. How to achieve this goal, however, has catalyzed a continuing policy debate within the Bush administration. A similar pattern of such a competition appears

¹² Paik, Jin-Hyun. 1998. "Security Multilateralism in the Asia-Pacific: Merits and Limitations" Kwang Il Baek (ed) *Comprehensive Security and Multilateralism in Post-Cold War East Asia*, (Seoul: KAIS), p. 306.

¹³ Patterson, Dennis. 1998. "Security in Post-Cold War Northeast Asia" Kwang Il Baek (ed) *Comprehensive Security and Multilateralism in Post-Cold War East Asia*, (Seoul: KAIS), p. 11.

¹⁴ Quinones, Kenneth. 2003. "Dualism in the Bush Administration's North Korea Policy," *Asian Perspective*, vol. 27, no. 1, 203.

transposed onto the international level between the United States and South Korea. The South Korean Government has been unhappy with the Bush administration, because the hawkish approach of Washington towards North Korea has slowed the pace of Korean reconciliation significantly and an eventual military strike would provoke North Korea to launch a devastating counterstrike.

The strategy of the United States seems to be clear. It is composed of three steps. The first step is to put diplomatic pressure on North Korea. To this purpose the Bush administration launched its initiative to bring Beijing and Moscow together to solve the problem. This preference was reflected in its earlier efforts to rally multilateral support at the TICOG, KEDO and IAEA. The recent Six Party Talks can be evaluated as the result of the successful effort to launch a multilateral mechanism to resolve the nuclear problem. The United States aims to tackle the nuclear problem by offering a security guarantee to North Korea. If this initiative is successfully implemented North Korea could be brought to the 1994 Agreed Framework aimed at resolving Washington's nuclear concerns.

The second step of the United States strategy is to choke off the North Korean Regime. This step seems to be motivated by an assessment that the Kim Jongil regime will not survive for a long time. The United States forecasts that the North Korean regime would collapse, whether North Korea could stockpile significant nuclear arsenal or not. The focus of United States policy, therefore, is shifting to both slowing the DPRK's nuclear acquisition and blocking the inflow of hard currency into North Korea from missile sales and drug smuggling. Tokyo supports Bush's policy of economic sanction against North Korea and prohibits North Korean vessels from coming to Japan.

The military option as the last step remains open into the future. It depends partly on whether President Bush can afford to make peace in Iraq and come up as winner at his reelection this year. Anyway, the United States is trying to improve its military options toward North Korea in the long run by repositioning its armed force. If the first and second steps will not work well the military attack would be the final option to solve the nuclear problem.

In this context the impetus to Northeast Asian security cooperation could come from the North Korea issue that has had a tremendous impact on the security thinking in Northeast Asia.¹⁵ There emerges a consensus on the need to create a new multilateral forum among nations interested in the nuclear issue, but it will be not sufficient to launch cooperative security measures like the Six Party Talks. Even if the latter were successful a multilateral arrangement like security regime will be needed to resolve the issue completely. One of the security regimes that can be recommended to solve the North Korea nuclear problem is establishing a no-first-use regime in Northeast Asia.

In 1978 the United States and the Soviet Union already promised not to use nuclear weapons in any conflict. In 1964 and in 1978 China also pledged not to use nuclear weapons first. In 1993 China even called for an international convention on unconditional no-first-use of nuclear weapons.¹⁶ But such position of the major powers has dramatically changed. The Putin administration put the first use option of nuclear weapons into the new military doctrine of 2000. In 2002 President Bush announced a new doctrine of preventive war and named North Korea one of the United State nuclear targets. This trend shows that the Korean peninsula has become vulnerable to threats of nuclear capable neighbours.

To justify the NPT treaty and to persuade North Korea to give up its nuclear program all nuclear capable nations surrounding the Korean Peninsula should guarantee safety from nuclear attack to small and middle powers in the region, including North Korea itself.

¹⁵ Yamamoto, Yoshinobu. 1998. "Japanese Relations with Korea in Multilateral Perspective" Chae-Han Kim (ed) *Domestic Politics, Trade Negotiation and Regional Integration: the US, Japan and Korea*, (Seoul: Sowha), p. 179.

¹⁶ Kim, Woosang. 1996. "Multilateral Efforts for Korean Unification: South Korea's Perspective" Byong-Moo Hwang and Young-Kwan Yoon (ed) *Middle Powers in the Age of Globalization*, (Seoul: Orom), p. 434.

4. Conclusion

During the Cold War era security interests in the region of East Asia were pursued by competition and deterrence, not by cooperation. Moreover, the competitive security structure was constructed on the basis of bilateral alliances. East Asia has been rather unfavorable to the notion and practice of multilateralism. No region-wide security mechanism was forged until the ARF and CSCAP were established in the early 1990's. The emergence of security cooperation has been hindered by a number of barriers; by rivalry and enmity; by divergent historic and cultural roots in the region; and by ambivalent and skeptical attitudes of major powers in the region.

Multilateral security cooperation has increasingly received greater attention as a supplement to the existing bilateralism. Military Alliances will remain as they do today. However, new practices of security can take further root in a multilateral fashion. The North Korean nuclear issue provides an opportunity for such forums as security dialogues through which the transparency of the North Korean nuclear weapons program will increase.

The CSCE successfully contributed to settling sensitive security issues in Europe in the 1980's because it provided a forum for dialogue. Due to the lack of such a security forum in Northeast Asia, states in this region should always reach an agreement on membership, format, and procedure of negotiation first, whenever a security problem occurs. The North Korean nuclear problem meets the case.

East Asia today witnesses the two types of security arrangements. The first one is the set of bilateral military alliances, the so called "hub and spokes" mechanism. This type was originally established in the Cold War era to contain the Soviet expansion. The second type is the security forum of ARF and CSCAP. This new approach of cooperative security is gaining more importance. The nuclear problem on the Korean peninsula strengthens this trend further. The Six Party Talks are the example of new multilateral security cooperation. Moreover, a security regime will be necessary and

possible in the process of dismantling the North Korean nuclear program in the long run.

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7. The Possibility of and Prospects for a China-Japan-South Korea FTA: The Lessons from European Integration

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1. Introduction

Unlike other regions of the world, Northeast Asian countries have, until recently, not devoted much energy to the establishment of regional trading blocs. Today, however, this is changing and a new emphasis on Free Trade Associations (FTAs) among Northeast Asian nations has emerged. This new focus on regional FTAs can be attributed to the following factors: the Asian financial crisis, long-term economic recession in Japan and China's accession to the World Trade Organization (WTO). Amongst North East Asian countries Japan was the first to conclude a FTA with the signing of the Japan-Singapore Free Trade Agreement in April of 2002. Further, a China-ASEAN FTA has also been agreed to in principle with negotiations still on going toward the goal of implementation by 2010, while South Korea signed an FTA with Chile which has not yet taken effect. In October 2003 in Bali, Indonesia, South Korea and Japan agreed to start negotiations towards the formation of a FTA from next year.

Apart from these bilateral relations the three countries of Northeast Asia (China, Japan and South Korea) are actively strengthening regional economic cooperation, and discussing the possibility of FTA. But the positions of the three countries are quite different; particularly between the two biggest countries of East Asia which have competing interests in East Asia, a situation that makes economic integration and FTA difficult in the short term. Given the worldwide trend toward globalization and economic integration, East Asian economic integration seems inevitable in the future. It should also be noted that this competition between China and Japan does create a unique opportunity for South Korea to act as a regional mediator.

With a view toward fostering a deeper understanding of the dynamics behind the relationship that exists between Northeast Asia's largest countries, I will begin the

following analysis with a review of economic integration trends in Northeast Asia, followed by an analysis of trade and investment in the region. This paper will then consider the possible effects of China-Japan-South Korea (CJK) FTA and compare the positions of the three countries: suggesting possible future scenarios. Finally an attempt will be made to take some possible lessons from the experiences of European integration.

2. The Recent Trend of FTA in Northeast Asia

The Asian financial crisis prompted serious discussions regarding regional trade in Northeast Asia. Prior to the onset of the crisis in 1997, ASEAN (the Association of Southeast Asian Nations) was the only economically integrated body in East Asia. East and Northeast Asian countries tended to pursue trade through multi-lateral organizations like GATT/WTO. According to the WTO, however, almost all member countries of the WTO are affiliated with one or more regional trading blocs with the exception of Northeast Asian countries.¹

Japan was the first in Northeast Asia to break this trend by signing the Economic Agreement for a New Age Partnership with Singapore in November 2001.² At present, Japan is actively pursuing FTAs with Mexico, South Korea, Canada, Australia and New Zealand. South Korean negotiators have had serious discussions with Chile and Japan in the hopes of inking agreements. As well, **Korea** is also considering New Zealand, Mexico and Thailand as future FTA partners. At the ASEAN+3 summit held in November 2001 Korea initiated dialogue on the creation of an East Asian economic community or EAFTA (East Asia Free Trade Area). It was also during the ASEAN+3 Summit that China and ASEAN announced that they had decided to create a FTA within ten years.

Many researchers and academics have proposed the idea of a regional FTA between China, Japan and Korea that had originally surfaced during discussions on a Korea-Japan FTA. More recently, several Chinese economists have proposed a

¹ WTO, *Focus Newsletter*, December 2000, p. 14.

² Excluded agricultural sector.

trilateral FTA. Admittedly, these proposals are still quite new even in academic circles; however, it is noteworthy that Chinese scholars proposed the idea, a position that seemed unlikely until very recently.³ Perhaps the most significant development with regard to economic cooperation has come from the leaders of these three countries. It was at the ASEAN+3 Summit Meeting in Manila in November 1999 that the leaders of China, Japan and Korea had their first historic meeting. At the Singapore meeting in November 2000 they agreed to make the three-way summit an annual event. At these Summit Meetings the leaders of the three countries agreed upon some proposals that could help lay the foundations for future trilateral cooperation.

First, based on an agreement reached at the Manila Summit Meeting, in which China, Japan and Korea committed to conducting joint research on economic cooperation, the Development Research Center (DRC) of China, the National Institute for Research Advancement (NIRA) of Japan, and the Korea Institute for International Economic Policy (KIEP) embarked upon a joint research project in November 2000. Their joint report and policy recommendations on “Strengthening Trade Relations between China, Japan and Korea” were presented to the respective leaders prior to their Brunei Summit Meeting held on 5 November 2001. At the Brunei Summit Meeting the three leaders agreed to hold regular meetings of their economics, finance and foreign ministers. These ministerial meetings now serve as venues where major trilateral economic cooperation issues are discussed – discussions that will be the precursor to formal economic integration in Northeast Asia,⁴

These new movements toward economic integration in Northeast Asia can be explained by several factors. First, Northeast Asia can be regarded as a “natural economic territory”. Professor Scalapino defined this term as a multilateral sub-regional entity which takes advantage of natural economic links. This was originally used to describe the economic characteristics of the Tumen River area where North

³ Professors Hai Wen and Zhang Xi proposed a trilateral FTA and Professor Hu Angang proposed an FTA between China, Hong Kong, Japan and Korea.

⁴ Changjae Lee, “Long-Term Visions and Policy Directions for Regional Economic Cooperation in Northeast Asia”, prepared for presentation at the China, Japan and Korea Joint Project Symposium on Institutionalization of Northeast Asian Economic Cooperation, held in Seoul on 20 December 2001, pp 178-180.

Korea, China and the Russian Far East meet. But this concept can be extended to the entire Northeast Asian region.⁵ Second, through the Asia financial crisis, these countries realized the need for close cooperation in economic and financial affairs. Third, China's accession to the WTO in 2001 has necessitated numerous policy changes including significant reductions in China's tariffs, the removal of non-tariff barriers that currently impede neighboring country's exports to China, the opening up of its service sector and the further protection of intellectual property rights. China's globalization and reform policies stimulate economic integration in these areas. Fourth, Japan's economic recession and its positive efforts toward regional integration as a countermeasure to domestic decline has also stimulated economic cooperation in Northeast Asia.

3. Analysis of Trade and Investment: China, Japan and South Korea (CJK)

1. CJK in the World

In general, the larger the scale of economic integration the more probability it has to include the lowest cost firms. In addition, the effects of economic integration will widen due to the international divisions of labor and the effective allocation of resources. In this context, if we compare the size of China-Japan-Korea with the EU and NAFTA, though their aggregate population is as much as double that of the EU and NAFTA combined, their total GDP is much less than that of the EU and NAFTA separately(see table III-1). In the case of China's GDP if we calculate it at the purchasing power parity exchange rate it will be 3-4 times bigger than at the official exchange rate. Considering the economic dynamics of China, the GDP of CJK will reach almost the same level as other regional blocs within 10-20 years.

⁵ Choongyoung Ahn, "Newly Emerging Economic Order in Northeast Asia and a Vision for Korea's Business Hub", prepared for 10th International Conference of Korea Economic Association, 12-13 August 2002, Seoul, p .2.

Table 7-1 CJK compared with EU and NAFTA (2000)

	Population (Million)	GDP (Billion USD)	Area (1,000 km ²)
EU	375	7,897	3,132
NAFTA	402.6	11,151	20,289
CJK	1,441	5,201	9,802
-China	1,267	1,029	9,326
-Japan	127	3,798	377
-Korea	47	374	99

Source: IMF, International Financial Statistics, 2002

The export volumes of China, Japan and Korea are increasing. In Korea's case its export weight in the world was only 1.9% in 1990, but it has steadily increased to 2.4% in 1995 and 2.7% in 2000. China demonstrated outstanding export growth over the same period. Its proportion was only 1.8% of world exports in 1990 but that more than doubled to 3.9% in 2000. The total exports of CJK occupied around 12.1% in 1990 but it has increased to 14.2%. Likewise, the weight of imports amongst the three countries is now at 11.5% due to the steady increase of imports of China and Korea.⁶ Considering the weight and increasing trend of trade volume, the possibility of the integration of CJK is highly expected. All three countries enjoy a trade surplus owing their strong international competitiveness.

⁶ In contrast, the weight of Japan in export and import has decreased from 1990 to 2000 in a small proportion.

Table 7-2 Volume and Weight of Trade of CJK in the World (2000)

(Unit: Billion Dollars US, %)

	Export						Import					
	Volume			Weight			Volume			Weight		
	1990	1995	2000	1990	1995	2000	1990	1995	2000	1990	1995	2000
China	62.1	148.8	249.3	1.8	2.9	3.9	53.4	129.1	206.1	1.5	2.5	3.2
Japan	287.6	443.1	479.3	8.4	8.5	7.6	235.4	335.9	379.5	6.7	6.5	5.8
Korea	65.0	125.1	172.3	1.9	2.4	2.7	69.8	135.1	160.5	2.0	2.6	2.5
Sub tota 1	414.7	717.0	900.9	12.1	13.8	14.2	358.6	600.1	746.1	10.2	11.6	11.5
World	3,438. 6	5,190. 2	6,332. 8	100.0	100.0	100.0	3,532. 2	5,189. 8	6,512. 8	100.0	100.0	100.0

Source: Same as the above Table 7-1.

2. Intra-Regional Trade

China and Korea doubled their import/export volumes between each other from 1995 to 2000, with China's trade deficit with Korea growing. Japan's trade with China increased by about 50% over the same period, but Japan's trade deficit with China deteriorated at the same time. When we look at trilateral trade balances Korea suffers a trade deficit with Japan, while Japan suffers a trade deficit with China and China suffers a trade deficit with Korea.⁷

⁷ The statistical discrepancy between Korea and Japan is tolerable but the cases of China-Japan and China-Korea are much greater than normal statistical tolerance. This phenomenon mainly arises from the 'intermediary trade' through Hong Kong.

Table 7-3 Intra-Regional Trade between CJK

(Unit: Million Dollars US)

		China			Japan			Korea		
		Export	Import	Balance	Export	Import	Balance	Export	Import	Balance
China	1995	-	-		28,466	29,007	-541	6,688	10,288	-3,600
	2000	-	-		41,654	41,152	502	11,293	23,207	-11,914
Japan	1995	21,934	35,922	-13,938	-	-		31,292	17,330	13962
	2000	30,356	55,156	-24,800	-	-		30,703	20,454	10,249
Korea	1995	9,192	7,395	1,797	17,088	32,597	-15,509	-	-	
	2000	18,455	12,799	5,656	20,466	31,828	-11,362	-	-	

Source: Same as Table 7-1.

However, the share of intra-regional trade between CJK remains small compared to other regional economic entities. In 1999 the EU, occupied over 60% of world trade and is an exception, the intra-regional share of MERCOSUR was 20.0%, while the shares of ASEAN, ASEAN+3 and NAFTA were 21.6%, 35.7%, and 46.5%, respectively (see Figure 7-1).

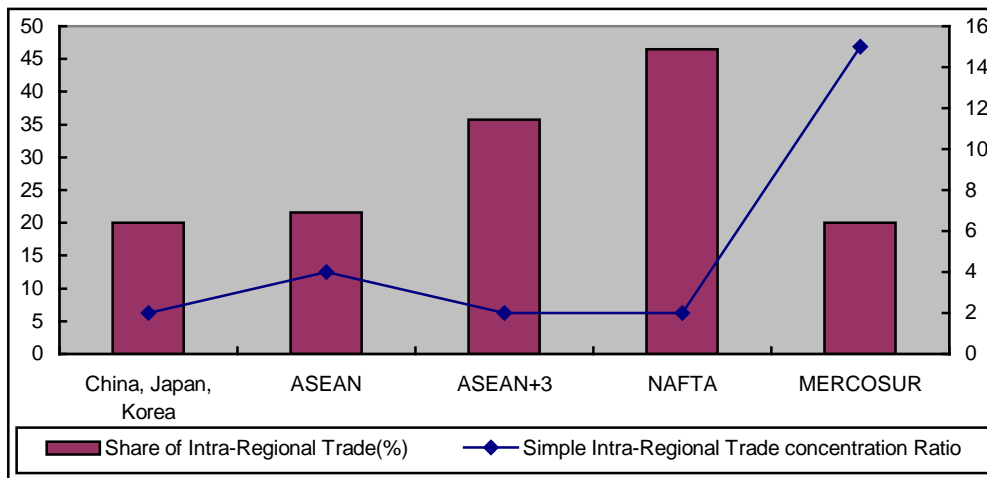


Figure 7-1 Comparison of Intra-Regional Trade

Sources: Changjae Lee, “East Asian Economic Integration: A Northeast Asian Perspective”, Prepared for presentation at the RIETI International Symposium on *Asian Economic Integration* at the United Nations University in Tokyo, on 22-12 April 2002, p. 11.

Of course, the bigger the economic grouping, the higher the share of intra-regional trade. To obtain a better measure of regional concentration we need to adjust intra-regional trade share by the region’s share of world trade to obtain a simple intra-regional concentration ratio. For China, Japan and Korea the movement of the concentration ratio does not differ significantly from that of the intra-regional share over the last ten years.⁸ As shown in Figure III-1 in 1999, however, the simple intra-regional concentration rate of the three countries (1.7) was lower than those of NAFTA (2.2), ASEAN+3 (2.0), ASEAN (3.6) and MERCOSUR (14.6). Over 20% of Korea’s and China’s exports go to the neighboring two countries. Korea and China import around 30% of their total imports from these same neighbors in 1995 and 2000. In the case of Japan the trade volume of total export and import are much smaller than that of the other two countries.

⁸ Changjae Lee, “East Asian Economic Integration: A Northeast Asian Perspective”, prepared for presentation at the RIETI International Symposium on *Asian Economic Integration* at the United Nations University in Tokyo, on 22-23 April, 2002, p. 12.

Table 7-4 Intra-Regional Trade Dependence Ratio of CJK

(unit: Million \$ US, %)

	China		Japan		Korea	
	1995	2000	1995	2000	1995	2000
Total Export(A)	148,797	249,297	443,116	479,249	125,058	172,268
Export to the rest 2 countries(B)	35,154	52,947	53,226	61,059	26,280	38,921
B/A	23.6	21.2	12.0	12.7	21.0	22.6
Total Import(C)	129,113	206,132	335,882	379,511	135,119	160,481
Import from the rest 2 countries(D)	39,295	64,359	53,252	75,610	39,992	44,627
D/C	30.4	31.2	15.9	19.9	29.6	27.8

Source: same as Table 7-1.

According to Table III-5 Korea's first rank export partner is the US which receives 17.2% of Korea's total exports, Japan is second with 11.0% and China ranks third with 9.5%. 24.4% of China's exports go to the Japan, 20.8% to the US, and 4.0% to Korea. 30.5% of Japan's exports go to the US market, 6.6% to Taiwan, 5.6% to Korea and 5.5% to China. In the case of China and Korea the regional export volume outweighs that to the US, but in the case of Japan intra-regional exports amount to only one third of that which goes to the US; the dependence of Japan's trade to neighboring two countries is relatively low. It exports around 10% of its export to China and Korea, while it imports almost 20% of its total imports from China and Korea.

Korea imports 21.9% of its total imports from the US, 20.2% from Japan, and 7.4% from China. For Korea the importance of intra-regional imports outweighs the US. China mainly imports from Japan (20.4%), the US (12.1%), Taiwan (11.9%) and Korea (10.4%). However, just like the case of exports, Japan's imports from its two neighboring countries are less than that of the US. In conclusion, in the case of Korea

and China intra-regional trade is bigger than that done with the US, but in the case of Japan the US is their most important trade partner.⁹

Table 7-5 Trade between CJK and USA (1999)

(unit :%)

	Weight of Trade	Export	Import
China	With Japan	24.4	20.4
	With Korea	4.0	10.4
	Japan+Korea	28.4	30.8
	With USA	20.8	12.1
Japan	With China	5.5	13.9
	With Korea	5.6	5.2
	China+Korea	11.1	19.1
	With USA	30.5	23.9
Korea	With China	9.5	7.4
	With Japan	11.0	20.2
	China+Japan	20.5	27.6
	With USA	17.2	21.9

Source: Korea International Trade Association, *Main Trade Indicators*, 2001

3. Intra-Regional Investment

Considered together China, Japan and Korea's share of investment in the world is much lower than that of trade.¹⁰ As well, the level of trilateral investment amongst these three countries is also lower than that of trade. China is the main recipient of investment, with Japan being the main investor. Korea is both a recipient of Japanese investment as well as an investor in China. Korea and Japan's investment into China increased rapidly to the mid-1990s (Japan peaked in 1995 and Korea peaked in 1996) and then

⁹ All three countries greatly depend on the US market. Japan exports 30% of its total exports to the US, while China and Korea export around 20%. All three countries' trade balances with the US are surpluses.

¹⁰ As of 2000 Japan's share of outward investment in the world was 2.9% and inward investment was 0.6%, Korea was 0.35 and 0.8% and China was 0.2% and 3.2%.

began to slowdown. After the Asian financial crisis both countries' investment into China dropped dramatically. For example, Japan's direct investment into China as a share of Japan's overall FDI dropped dramatically from \$4.47 billion in 1995 (8.8% of total FDI) to \$995 million in 2000 (2.0% of total FDI).

Table 7-6 Direct Investment Flows from Korea and Japan to China

	Korean Investment in China		Japanese Investment in China	
	Amount (US\$ mil.)	Share of Korea's FDI(%)	Amount (US\$ mil.)	Share of Japan's FDI(%)
1993	264	20.9	1,691	4.7
1994	632	27.5	2,565	6.3
1995	824	26.8	4,473	8.8
1996	836	19.7	2,510	5.2
1997	633	19.6	1,987	3.7
1998	631	16.2	1,065	2.6
1999	308	12.1	751	1.1
2000	307	8.3	995	2.0

Sources: The Export-Import Bank of Korea, *Trend of Outward FDI of Korea & Japan External Trade Organization, JETRO White paper, 2001.*

Korea's direct investment into Japan and Japan's direct investment into Korea represented only 1.7% of their total FDI in 2000. Bilateral investment between the two countries lags far behind their bilateral trade.

Table 7-7 Direct Investment Flows between Korea and Japan

	Korean Investment in Japan		Japanese Investment in Korea	
	Amount (US\$ mil.)	Share of Korea's FDI(%)	Amount (US\$ mil.)	Share of Japan's FDI(%)
1993	6.0	0.5	245	0.7
1994	58.0	2.5	400	1.0
1995	105.1	3.4	445	0.9
1996	80.6	1.9	416	0.9
1997	63.7	2.0	442	0.8
1998	22.7	0.6	303	0.7
1999	48.3	1.9	980	1.5
2000	60.7	1.7	814	1.7

Sources: same as the above Table 7-6.

Correspondingly, in 2000, the share of Korean and Japanese investment of China's total inward FDI was 3.7% and 8.2%, respectively. For Korea, in 2000, the share of Japanese investment as a percentage of total inward FDI amounted to 15.6%.¹¹

4. Forecasting: Empirical Projections of a CJK FTA and the Positions of the Three Countries

1. Empirical Results of CJK FTA

As is shown in Table 7-8 there are great differences in the average tariff rates among China (16.8%), Korea (7.9%) and Japan (3.6%). Even when looked at by sector, the differences are much greater than the average tariff. For example, in transportation equipment, Japan and Korea apply very low tariff rates, but China still maintains a

¹¹ Changjae Lee, "East Asian integration: A Northeast Asian Perspective", prepared for presentation at the RIETI International Symposium on *Asian Economic Integration* at the United Nations University in Tokyo, on 22-23 April 2002, p. 12.

44.3% of tariff rate. Therefore, when CJK FTA is formed, the effects of integration will vary according to pre-existing tariff inconsistencies.

Table 7-8 Comparison of Tariff Rate in CJK(%)

	China	Japan	Korea
Average Tariff	16.8	3.6	7.9
Textile Products	23.8	6.4	8.4
Chemical Products	13.8	5.9	7.6
Iron & Steel Products	8.4	2.5	3.9
Nonferrous metals	23.1	2.1	6.0
Metal products	15.1	2.2	8.0
General Machinery	13.8	0.4	7.5
Electric Machinery	25.5	0.0	7.8
Transportation Equipment	44.3	0.0	3.6
Precision Machinery	14.7	0.0	7.6

Sources: KIET, *A Study on Free Trade Agreement and Investment Agreement as a new External Economic Policy Instrument*, 2001.

Table 7-9 shows the expected increases in intra-regional exports under the assumption that Korea, China and Japan eliminate tariff barriers. As for the trade creation effect Korea, Japan and China are expected to increase their intra-regional trade by USD 22.7 Billion, USD 60.6 Billion, and USD 24.0 Billion respectively, amounting to a USD 107 Billion total trade creation effect. Japan, with its strong international competitiveness in the manufacturing sector, would enjoy the highest trade creation effect, which means it will obtain the greatest gains under a trilateral FTA.

Table 7-9 Impact of Removal of Tariffs in the Northeast Asian Region on Intra regional Exports

(Unit : Million Dollars US)

Origin/Destination	Korea	Japan	China	Total
Korea	-	332.00	22,385.67	22,717.67
Japan	8,506.73	-	52,122.21	60,628.94
China	4,664.93	19,310.44	-	23,975.37
Total Intra-regional trade increase				107,321.98

Sources: Inkyo Cheong, *Economic Integration in Northeast Asia: Searching for a Feasible Approach*, KIEP Working Paper 99, 25 December 1999, p. 20.

The expected increase in exports by region is, in Korea's case, USD 332 million, and USD 22.4 billion exports to Japan and China respectively. In China's case its exports to Korea would increase by USD 4.7 billion and its exports to Japan would increase by USD 19.3 billion. With the highest trade creation effect predicted Japan is expected to increase its exports to Korea and China by USD 8.5 billion and USD 52.1 billion respectively.

Table 7-10 Impact of Removal of Tariffs on Trade Balances in Northeast Asia

(unit : Million Dollars US)

	Korea	Japan	China	Expected variation of Intra- regional trade balance	Trade balance in 1997
Korea		-8,173.73	17,620.74	9,546.01	-9,680
Japan	8,174.73		32,811.77	40,986.47	-6,999
China	-17,720.74	-32,811.77		-50,532.51	16,679

Sources: Inkyo Cheong, same as the above Table IV-2, P.21.

Table 7-10 presents the variations in the trade balance of the three countries when tariffs are eliminated. While the formation of a trading bloc can be expected to improve the intra-regional trade balances of Korea and Japan, the trade balance of China is likely to worsen by the exact amount that Korea and Japan's trade balance improves. Korea's trade balance with Japan will deteriorate by USD 8.2 billion, while that with China will improve by USD 17.7 billion. Japan will improve its trade balance with Korea and China by USD 8.2 billion and USD 32.8 billion respectively. This, in fact, means that China will experience a deterioration of its trade deficit in the amount of USD 50.5 billion.

If we relate the results shown in Table 7-10 to the relevant trade balances for a recent year trilateral FTA can be expected to change the pattern of the intra-regional trade balances. In Korea's case its trade deficit, which amounted to USD 9.7 billion in 1997, would be reversed to a surplus. Also, the patterns of trade balance of China and Japan would reverse. Japan would experience a trade surplus of USD 41 billion, which would be a reversal of its 1997 position; in 1997 it recorded a trade deficit of USD 7.0 billion. In comparison, in 1997, China suffered a trade deficit of USD 3.5 billion with Korea but enjoyed a trade surplus of USD 20 billion with Japan, which resulted in a

USD 16 billion trade surplus. In the simulation China would experience a USD 50.5 billion in trade deficit from the surplus.¹²

As shown in Table 7-11 according to the KIEP (Korea Institute for International Economic Policy) free trade among China, Japan and Korea, will cause a reduction of agricultural, mining and metal production in Korea, but the production of textiles and transportation equipment, both of which have a comparative advantage against China, will increase. In Japan the production of textiles will increase 8.02% but there will be minor changes in the rest Japan's industries. Most industries in China, except agriculture and services, will decrease. Particularly, a reduction of 62.32% in transportation equipment sector can be expected. The analysis offered by the KISDI (Korea Information Society Development Institute) is quite different from that of the KIEP except for agriculture. In the agriculture and textile industries China is expected to increase its production. In most industries Japan will increase its production, while Korea will decrease production in five industries and gain in four industries.

¹² Inkyo Cheong, Economic Integration in Northeast Asia: Searching for a Feasible Approach, KIEP Working Paper 99, 25 1999. 12, pp. 20-21.

Table 7-11 Impact of CJK FTA on Industries

(unit: %)

	Korea		Japan		China	
	KIEP	KISDI	KIEP	KISDI	KIEP	KISDI
Agricultural products	-0.37	-0.62	-0.73	-0.21	0.58	0.57
Mining Industries	-0.58	-0.19	-0.8	0.11	-0.58	0.71
Food&Beverage Industries	-2.46	1.83	0.45	0.16	-0.45	0.41
Textile Products	21.91	1.84	8.02	0.09	-3.82	5.29
Chemical Products	2.55	-0.21	0.31	0.03	-1.61	0.52
Metal Products	-0.77	-0.30	0.15	0.06	-1.33	-0.18
Transportation Equipment	19.9	0.13	-0.73	0.06	-62.32	-1.34
Machinery Equipment	-8.17	-0.28	0.57	0.06	-2.35	-0.16
Service	0.08	0.01	-0.02	0.00	0.38	0.02

Source: KIET, op. cit, 2001, p. 149.

As shown below Table 7-12, when we consider trilateral trade liberalization in both the agriculture and manufacturing sectors Korea's real GDP will increase 2.8%, Japan 0.07% and China 1.1%. Among the rest of the world the US and the EU will be influenced little, but production amongst ASEAN countries will decrease 0.61%. In the case of model 2 (model 1 + service) the magnitude of the increase is slightly more.

With CJK free trade the overall welfare of Korea will increase the most. The impact of a CJK FTA on the welfare of the rest of the world will be minor with the exception of ASEAN. When we add the service sector the analysis does not change much.

Table 7-12 Macroeconomic Effect of CJK FTA

(unit : %)

	Model 1 (Agriculture+Manufacturing)	Model 2 (Agriculture+Manufacturing+Service)
GDP		
Korea	2.80	2.99
Japan	0.07	0.11
China	1.10	1.27
USA	-0.15	-0.15
EU	-0.13	-0.14
ASEAN	-0.61	-0.64
Welfare		
Korea	2.82	3.11
Japan	0.30	0.35
China	1.05	1.24
USA	-0.17	-0.18
EU	-0.14	-0.15
ASEAN	-0.76	-0.80

Source: Soonchan Park & Myungho Park, “Welfare Effect of Korea · China · Japan Trade Liberalization through the CGE Model, *International Regional Economy*, Volume 6 no.1, April 30, 2002, p. 49.

5. Positions of the Three Countries

1. China

After declaring economic reform and openness in 1979, China introduced the market economy system and finally participated in the WTO in 2001. Around that same time China also announced its intention to form a China-ASEAN FTA within ten years. China's accession to the WTO opens a new chapter of cooperation between China, Japan and Korea. The industries of Japan and Korea with comparative or competitive

advantage can grow at a faster pace than ever due to their expanding trade frontiers in China, as will China's industries with comparative or competitive advantage. Geographic linkages together with more open borders to goods, services and capital flows will facilitate economic restructuring in these three countries. Therefore, if we take advantage of this historic opportunity, the level of cooperation among three countries will reach a new high.¹³

China is positive toward trilateral economic cooperation; its fundamental principle of cooperation is a win-win-win strategy based on mutual interests.¹⁴ China has taken the position that East Asia FTA is desirable in the long run; however, as it may not be possible to implement in the short run, progressive dialogue is ideal for the time being. To do this, Cao suggests the formation of China-ASEAN FTA and Korea-Japan FTA in the medium term and the integration of these two FTAs at the next stage. The best way toward integration is the merger of two FTAs, but if the merger is difficult to realize Korea and Japan can join the China-ASEAN FTA separately.¹⁵ Through this system ASEAN can absorb Korea and Japan after China, taking a leading position in East Asian integration.

From a long-term perspective there are necessities and needs of CJK FTA, but they are next to impossible to realize under the current circumstances. Furthermore, it is difficult to proceed with regional negotiations for the time being: the fundamental obstacle being Japan. In the course of Northeast Asian integration, where the US is excluded, but China is inside, Japan cannot ignore America's views. Under the situation where the 'Flying Geese Development Model' led by Japan is no longer valid, Japan would still like to control 'the development of China' and maintain economic leadership in this region. Furthermore, Japan is concerned about opening up its sensitive sectors like agricultural products. This is another reason why China is

¹³ Chen Dong and others, "China, Japan and Korea: Economic Restructuring and Cooperation in the context of Globalization", prepared for presentation at the China, Japan and Korea Joint Project Symposium on *Institutionalization of Northeast Asian Economic Cooperation*, held in Seoul on 20 December 2001, p.13.

¹⁴ Chen Dong and others, *ibid*, p. 29.

¹⁵ Cao, Shi Gong, "The Rapid Development of Free trade Area in East Asia and the Countermeasure of China", prepared for 2002 International Forum on *North East Asia Trade Policy Cooperation & Overseas Conference*, Nanjing China, 5-8 July 2002, p. 52.

focusing more energy on implementing a China-ASEAN FTA.¹⁶ However, even with these obstacles, close economic integration among CJK is inevitable as they represent most of Northeast Asia.¹⁷ Indeed, without CJK FTA there will not be a Free Trade Area in Northeast Asia and East Asia.

According to Cao,¹⁸ there are several Chinese problems that must be resolved regarding CJK FTA. First, China should demonstrate its resolve toward trade liberalization in Northeast Asia as well as China-ASEAN FTA. Any Northeast Asian FTA will co-exist and compliment China-ASEAN FTA. Therefore, while China is focusing on China-ASEAN FTA, it should not lose sight of CJK FTA. Second, China should be optimistic and support Korea-Japan FTA. Even though Japan and Korea are forming an FTA to countermeasure the development of China, China regards Korea-Japan FTA as a step toward closer economic cooperation in Northeast Asia. One thing clear is that China will not join the K-J FTA as a third participant. Third, China should study the Japan-Korea FTA and pursue it in the framework of Northeast Asia FTA. Beginning with CJK FTA would have many obstacles; it is better, therefore, to take the easy option. That is, first construct K-J FTA and later K-C FTA and finally K-C-J FTA thus integrating the two blocs over the long run. It would be better to initiate K-C FTA in 2005, for example in the atmosphere CJK FTA.

2. Japan

After WWII, under the GATT system, Japan emerged as world's largest trade surplus country on the back of its rapid growth in the export sector. In the 1970s and 1980s Japan experienced trade conflict with the US and European countries in major export commodities (textiles, TVs, automobiles and semiconductors). Japan, realizing the limits of their bargaining power, tried to block the diffusion of protectionism, maintaining the liberal flow of goods through multilateral agencies like GATT. Japan, perhaps the largest beneficiary of multilateralism, was negative toward regional trade

¹⁶ Ibid, p. 54.

¹⁷ CJK three countries occupy over 90% of East Asia GDP.

¹⁸ Cao, op cit., pp. 55-57.

arrangements. Instead of regionalism Japan pursued multilateral negotiations instead.¹⁹ One of the most important factors shaping Japan's initiatives toward multilateralism came from the US.²⁰ Until the mid 1990s the basis of Japanese external economic policy was multilateralism, but this principle changed in the late 1990s. From 1998 Japan adopted regional trade arrangements and bilateral agreements as a part of its external economic policy. Among these movements the review of Japan-Korea FTA on October 1998 was the start.

The White Paper on International Trade of MITI²¹ of 1999 suggested four possible approaches to Northeast Asia FTA:

- i) Japan-Korea FTA: There is little economic benefit for Japan but Korea will gain quite a lot.
- ii) Japan-Korea-China FTA: China will not join because its GDP could contract.
- iii) Japan-Korea-Taiwan FTA: China will oppose.
- iv) Japan-Korea-China-Taiwan FTA: All participants will gain from FTA but not realistic due to political conflict between China and Taiwan.

Before the above White Paper the idea of an AMF (Asian Monetary Fund) was proposed by Japan at the ASEM Finance Ministers' Meeting in Bangkok in September 1997. Japan expressed its willingness to contribute more than half of the fund amounting to USD 100 billion. Hong Kong, Taiwan and Singapore have showed their intent to participate in the AMF. Korea and most other East Asian countries agreed with the idea. Even China, which was against the idea at first, has changed its attitude. Nonetheless, the AMF has still not made any tangible progress, due to strong opposition by the United States.²²

¹⁹ Okuda Satoru, "A Study on Japan-Korea FTA: The Change and Background of Recent Japanese External Trade Policy", prepared for 2002 International Forum on *North East Asia Trade Policy Cooperation & Overseas Conference*, 5-8 Nanjing China, July 2002, .

pp. 6-7.

²⁰ Mohamad Mahathir, the Prime Minister of Malaysia, proposed East Asia Economic Group (EAEG). but the proposal has not been pursued, largely because the United States strongly objected and the proposed countries, Japan and Korea in particular, were reluctant in the face of the objection of the United States.

²¹ Ministry of International Trade and Industries in Japan, White Paper on International Trade, 1999.

²² Peter J. Lloyd/Hyun-Hoon Lee, "Subregionalism in East Asia and its Relationship with APEC", *the Journal of Korean Economy*, Vol. 2, No. 2, Fall 2001, p. 215.

As mentioned above, Japan altered its external policy and assumed a more multi-layered approach utilizing multilateralism and regional trade arrangements at the same time. The background to this change involved the complexity and non-effectiveness of multilateral negotiations, the diffusion of regionalism as an alternative of multilateralism and increased losses which are a product of being an outsider to regional trade arrangements. Further, long-term economic recession can be considered a major factor as the relative importance of exports rises during a recession.

The following are policy implications for Japan proposed by Ushijima Shunichiro.²³ First, the challenge of worldwide regionalism because it has become a major world trend for economic integration. Most industrialized and developing countries in the world have committed themselves to some regional trade agreement. At present more than one-third of world trade takes place under such agreements, but so far there is not a trade bloc amongst Northeast Asian countries. Second, strong ties in trade among China, Japan and Korea: The degree of trade ties, measured by the trade intensity index among China, Japan, and Korea has been strong. These existing strong ties may reflect the geographical proximity of the three countries. For the past ten years, however, complementarity has diminished in the trade among the three countries. In fact, the structures of Sino-Japanese trade and Sino-Korean trade have demonstrated a tendency towards convergence. As a result, intra-industry trade has become more prevalent. The amount of trade need not decline, as an increase in intra-industry trade may compensate the decrease in trade based on complementarity. Third, simulation results on an FTA in Asia: The simulation using an Applied General Equilibrium Model suggests that the benefits in terms of GDP and economic welfare become larger in the case where all three countries form an FTA, as opposed to the case where only two countries form it, as is shown in Table 7-13. As indicated by the great rise in the intensity indexes in the simulation, the three-country-FTA case will intensify trade ties the most.

²³ Ushijima Shunichiro, "Toward Trade and Investment Liberalization among China, Japan and Korea-China's WTO Accession and Regional Integration in Northeast Asia-", prepared for presentation at the *China, Japan and Korea Joint Project Symposium on Institutionalization of Northeast Asian Economic Cooperation*, held in Seoul on December 20, 2001, pp. 53-134.

Table 7-13 Changes in Real GDP and Economic Welfare for Each Country in Three-Country FTA

(GDP in percentage and Economic Benefit in Millions of Dollars)

	Three-Country FTA		Japan-China FTA		Japan-Korea FTA		Korea-China FTA	
	Real GDP	Economic Welfare	Real GDP	Economic Welfare	Real GDP	Economic Welfare	Real GDP	Economic Welfare
Japan	0.2	12265.1	0.2	10289.8	0.0	2184.7	0.0	119.9
China	1.3	8191.2	1.1	7335.3	0.0	-358.0	0.2	917.0
Korea	3.2	12664.5	-0.2	-1189.6	1.1	3682.8	2.4	10687.8

Note: This simulation is effectuated using GTAP Data Base version 5.0%

Sources: Ushijima Shunichiro, "Toward Trade and Investment Liberalization among China, Japan and Korea- China's WTO Accession and Regional Integration in Northeast Asia, prepared for presentation at the China, Japan and Korea Joint Project Symposium on Institutionalization of Northeast Asian Economic Cooperation, held in Seoul on 20 December 2001, p. 119.

The benefits, however, will involve adjustment costs due to the dislocation of employment required for optimizing the allocation of limited economic resources. A so-called "industrial hollowing-out" or de-industrialization inside Japan will occur. The economies need to expedite economic reforms to help bring up new industries to absorb such a dislocated labor force. A simulation is also undertaken concerning a hypothetical FTA composed of the three countries plus ASEAN. The benefits are, as expected, the largest. All three countries, as well as ASEAN, will gain large increases in GDP and economic welfare. While such an arrangement is outside the short-run scope, the benefits should be emphasized.

Fourth, Japan-Korea FTA and the necessity for further study: Between Japan and Korea the governments have discussed the possibility of an FTA. If an agreement

is made in the future the economic integration of the two countries will change trade and investment structures throughout Asia. The simulation result in this case shows a smaller macroeconomic benefit than the three-country-FTA case. But, it may be noted that, as the industrial structures of Japan and Korea are similar, there might be a better chance to lead to a horizontal division of labor, together with firm-level integration. Several existing studies have suggested that the most significant feature of a Japan-Korea FTA would be measures to promote the integration of firms, rather than the reduction of tariff rates. This type of integration might involve lesser degrees of painful adjustment processes. Thus, a Japan-Korea FTA might be considered as the first step toward a larger FTA.

3. South Korea

Unlike East Asia where the institutionalization of regional economic cooperation is under way with the ASEAN+3 framework, Northeast Asia has yet to start institutionalizing regional economic cooperation. However, given the difficulties facing some of the ASEAN countries and a limited number of Northeast Asian countries, a Northeast Asia FTA between China, Japan and Korea could be realized before an East Asia FTA. China-Japan-Korea FTA is crucially important for the formal regional economic integration of both Northeast Asia and East Asia. Due to disparate levels of economic development, diverse political systems and unresolved historical issues, however, the formation of a C-J-K FTA in the near future is still unlikely.

Therefore, first, the three countries may start building an institutional framework to accelerate ongoing economic cooperation in Northeast Asia by establishing a regional economic cooperation body, for example, the Council for Northeast Asian Economic Cooperation (CNAEC). A Northeast Asia FTA can be reached through one or two bilateral FTAs along with a trilateral economic cooperation body. In this regard, a Korea-Japan FTA will be the first candidate. As mentioned earlier, albeit in the absence of official negotiations, discussions are under way at various levels. Given the importance of Japan and Korea in terms of economic size,

when an FTA between them is realized it may create an environment leading directly to the formation of a Northeast Asia FTA.

It is possible that a Korea-Japan FTA may delay the formation of a C-J-K FTA by isolating China. This eventuality could be prevented if Korea forms an FTA with China. Since one of the most serious obstacles to the formation of an FTA is the disparity in the levels of economic development, a China-Korea FTA would be easier to realize than a China-Japan FTA. In fact, while the idea of a C-J-K FTA is relatively well received in Korea many Japanese seem to be at best lukewarm toward the idea as they regard it as unrealistic, at least in the foreseeable future.²⁴ Youngmin Kwon points out three possible problems of a CJK FTA.²⁵ First, the benefits of economic integration should be distributed impartially. If one or two countries are not to be substantial beneficiaries then Northeast Asian cooperation will confront more difficult obstacles than before. In this case, people and industries of such countries are not going to support economic integration.

Second, the elimination of tariff and non-tariff barriers of CJK will increase the volume of trade for the three countries due to the trade diversion effect, but in the end the net effect of trade creation will be positive. The elimination of tariff and non-tariff barriers, however, does not result in balanced outcomes. Korea's deficit with Japan will worsen while the surplus against China will improve. Therefore, before the launch of a formal FTA the coordination of the structure of industries and trade will be necessary. For example, the reduction and the shift of common facility, strategic alliance, direct investment and technical transfer are important for this coordination.

Third, it is more desirable to pursue Korea-China or Korea-China-Japan FTA at the same time as pursuing Korea-Japan FTA, as this will allow Korea to play an interlinking role in the Northeast Asia. Yongdae Shin emphasizes the agreed division of

²⁴ Changjae Lee, "Long-term Visions and Policy Directions for Regional Economic Cooperation in Northeast Asia", prepared for presentation at the *China, Japan and Korea Joint Project Symposium on Institutionalization of Northeast Asian Economic Cooperation*, held in Seoul on 20 December 2001, pp. 183-184.

²⁵ Youngmin Kwon, *Northeast Asian Economic Integration and Business Cooperation*, Korea Economic Research Institute, 2002, pp. 528-532.

labor among Korea, China and Japan.²⁶ The agreed division of labor consists of cooperation concerning structural adjustments and the advancement and enlargement of horizontal divisions of labor. First, there is an over facility problem in electronic and petrochemical industries due to over investment by Korea and Japan. With the CJK FTA, the problem will spread to other sectors like steel, shipbuilding and semiconductors. Second, the structure of the division of labor can deteriorate under the FTA system. Therefore, before the creation of FTA, the advancement of horizontal and strategic alliances will be effective instruments for success.²⁷

According to KITA (the Korea International Trade Association), three countries have two common items among ten major export commodities in 2001 but there were none in 1996. Korea and Japan have five common items and Korea and China have four common items.²⁸ The report of KITA backs up the above mentioned industrial coordination of three countries.

6. The Prospects for a CJK FTA: Some Lessons from European Integration

Though all three countries do not oppose the idea of CJK FTA, this program is not being pursued as actively as it could be, and it is unlikely to succeed in the short run. Cao, a Chinese scholar, accuses Japan of having a negative attitude, while China has never expressed its official position regarding CJK FTA at the governmental level. There have been many discussions in Northeast Asia so that one begins to feel ‘Seminar Fatigue’ but there has still been no official agreement. An important reason for this comes from people’s regional animosities arising from unresolved historical issues. There are also other intra-regional problems like the difference between developmental stages and income, China’s adherence to a communist political regime, as well as hegemonic conflicts between China and Japan. There are also extra-regional

²⁶ Yongdae Shin, *Towards the Development of Economic Cooperation among Korea, China and Japan*, Korea Institute for Industrial Economics and Trade, 2000. pp. 224-226.

²⁷ Kwon (2002) also argues that three countries should cooperate in regional industrial restructuring among themselves by analyzing HS 6 digits of OECD statistics. According to him, the Export Similarity Index (ESI) not only between Korea and China but also between China and Japan has increased.

²⁸ *Korea Trade Daily*, 12 September 2002.

problems to be considered such as opposition by the United States. The United States, which is the largest export market for Korea and Japan, and the second largest for China, is opposed to any discussions concerning integration in Northeast Asia and East Asia, perhaps for fear of losing its dominance in the region. However, natural integration of the three countries, which have geographical proximity and cultural similarity, has progressed. In particular, economic cooperation between many civil sectors has been remarkable.

In sum, Japan has a rather pro-US attitude and has not taken a leadership role in Northeast Asia. China appreciates the pan-China economic circle and is showing a reserved attitude toward CJK FTA, while Korea has taken only a limited role. Considering the above positions of the three countries, there is little possibility of success for the time being. In contrast with the short-term pessimistic prospects, all three countries believe that CJK FTA is essentially needed in the long-term. The results, based on an empirical analysis, strongly support this belief. Therefore, while China and ASEAN will be negotiating toward an FTA, substantive negotiations between Korea-Japan toward their own FTA are recommendable.

In this case, Japan has the only one problem: agriculture,²⁹ while Korea will have to tackle increased trade deficits with Japan in many sectors.³⁰ Okuda also indicates Japanese non-conciliatory attitudes on sensitive items (agriculture and forestry) and Korea rigid labor customs to induce more FDI from Japan. In addition, he argues the elimination of exchange rate risk as a pre-step toward monetary integration for the stable economic relations between two countries. Trade and monetary cooperation between two countries except China would probably face less resistance from the US.³¹

²⁹ *The Japan Times* of 9 July 9 2002 reported that Farm Minister Takabe suggested that Japan should not exclude the farm and fisheries sector when it negotiates free-trade agreements.

³⁰ Younghan Kim argues for the introduction of compensation system as a side-payment, for example higher technology transfer from Japan to Korea. "Formation of FTA and Optimal Negotiation Strategies in North East Asia", prepared for 2002 International Forum on *North East Asia Trade Policy Cooperation & Overseas Conference*, Nanjing China, 5-8 July 2002, pp. 276-277.

³¹ Wansoon Kim, who studied at Harvard University, mentioned several times on the attitude of the United States in his recent paper. "Issues and Prospects of Regional Economic Cooperation in Northeast

Recently, the Korea International Trade Association (KITA) announced a survey report of 188 Korea firms that are operating in Japan.³²

- i) When asked, “Which country should Korea pursue a FTA with?” 38.8% were in favor of Japan, USA (26.3%), ASEAN (21.7%) and EU (8.5%).
- ii) With which country is a FTA most possible? 46.5% of the firms indicated Japan, ASEAN (21.5%), USA (16.5%) and EU (5.1%).

Both Korea and Japan recognize that K-J FTA is mutually beneficial and the effects of integration are bigger than any other bilateral FTA. Therefore, K-J FTA is the only possible alternative in Northeast Asia. If so, K-J FTA will be a springboard for CJK FTA or East Asia FTA in the long run. Even though many Korean researchers suggested the accession of China to K-J FTA, it is not realistic because China is too proud to be a third participant. Therefore, I think the integration of K-J FTA and K-C FTA (if it is possibly formed) is more realistic. Otherwise, the integration of K-J FTA and China-ASEAN FTA is a second best solution.

In conclusion, I would like to suggest several lessons learned from the experience of European integration, which might be applicable to Northeast Asian integration.

First, like the EU that started its economic integration from coal and steel, Northeast Asia can start toward substantial economic cooperation in some key industrial sectors.³³

Asia: A Political Economy Approach”, prepared for the 2002 International Forum on *North East Asia Trade Policy Cooperation & Overseas Conference*, Nanjing, China, 5-8 July 2002, pp. 15-27.

³² Sangkil Park, “The impact of Korea-Japan FTA on Korean Industries”, Prepared for *Globalization and Regionalization*, 2002 National Conference of International Trade Scholars, 21-23 August 2002, pp. 361-381.

³³ Youngmin Kwon (2002) and Yongdae Shin (2000) emphasize the importance of industrial cooperation in depth.

Second, to solve the problem of the unbalanced distribution of gains from integration, the ‘compensation scheme’ should be introduced. According to Article 2 of the EC Treaty that stipulates “the harmonious and balanced development of economic activity” and “economic and social cohesion and ties”, the EU established many structural funds and the EIB. The EU also established the EBRD to grant financial assistance to the Eastern European countries that have applied for EU membership. In this context, many authors have proposed the construction of the Northeast Asia Development Bank.³⁴

Third, European integration has been developed under the multilateral body like the OEEC (later the OECD), the CSCE (later OSCE), the Council of Europe and the various institutions of the EU. In addition, in Northeast Asia there needs to be an institutional approach for substantial cooperation not a ‘talk shop’.³⁵

Fourth, the Japanese role is very crucial in Northeast Asian regional cooperation as Germany did in Europe. After WWII Germany reconciled with its past, but the same has not happened in Northeast Asia. Japan never officially apologized for its invasion during the imperial period. Japan financially contributed little to regional development. In 1992 Choongyoung Ahn, a Korean scholar, and Nishikawa, a Japanese scholar, suggested a mini-Marshall Plan for the construction of an infrastructure in Northeast Asia but it never came about.

Fifth, stable and better monetary coordination is needed, similar to the EMS (later the EMU). The AMF plan in 1997 was not realized with the opposition of the United States and the IMF. The Miyazawa Initiative (a Japanese liquidity support plan)

³⁴ Caewon Kim, “Vision and Problems of Northeast Asian Economic Integration: Lessons from European Experience”, prepared for 10th International Conference of Korea Economic Association, 12-13 August 2002, Seoul, pp. 16-17.

Jongwon Lee, “EU and Northeast Asia: Economic Integration and Economic Cooperation, *European Economy*, Vol. 2 No. 1, Fall, 1995, p. 89.

Hiroshi Kakagu, “The Possible Organizational Structure and Funding Sources of Northeast Asian Development Bank (NEADB) in *Regional Economic Cooperation in Northeast Asia*”, Hawaii Asia-Pacific Institute, 26-28 September 1993, p. 54.

³⁵ For this Caewon Kim (2002) suggests a Northeast Asia Economic Cooperation Council (NAECC), Changjae Lee (2001) suggests a Council for Northeast Asian Economic Cooperation (CNAEC) and Heeyeon Song (2002) suggests a Northeast Asia Economic Community (NAEC).

was not successful due to problems with yen internationalization, but monetary cooperation under the name of the “Chiang Mai Initiative” (currency swap cooperation) in 2000 has enjoyed some success.

Sixth, European countries began to cooperate with environmental issues from the early 1970s. Considering that Chinese yellow sands and sulfurous acid gas, among other pollutants, are seriously polluting the environment in this region, these three countries should establish a super-national environmental institution as soon as possible. Otherwise, the environmental cooperation in this region will be very difficult because of defensive attitudes of China and the negative position of Japan toward financial support.

Finally, even though three countries accept the importance of economic cooperation, mutual distrust is the most crucial factor impeding the political decision making.³⁶ Therefore, as the European Countries did, the Northeast Asian Countries should make efforts to build trust among themselves as the first and most urgent thing to do.³⁷

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³⁶ Inkyo Cheong, “An East Asian FTA: Recent Development and Policy Implications”, prepared for International Conference on *Prospects for an East Asian Free Trade Agreement*, organized by Korea Institute for International Economic Policy, 27 September 2002, Seoul, Korea, p. 42.

³⁷ Ohnishi and Yin (2002) point out that “building trust among the people of Japan and Korea, rather than presenting the economical calculation of benefits, is the necessary step to realize the Japan-Korea FTA and CJK FTA.” Especially, issues regarding border conflicts have distorted Japanese history school textbooks, and the pursuit of hegemony by China and Japan damages the mutual trust among the three countries. Thus the governments of this triad of Northeast Asian countries must make an effort to resolve such political and social conflicts. However, FTAs; sometimes they emphasize the necessity of concluding an FTA. For example, it is well known that the EU was initiated with the purpose of preventing war again between Germany and France through strengthening economic cooperation.

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**Part II: Southeast Asia and the Process of East Asian Economic
Integration**

8. ASEAN + 3 and ASEAN Economic Integration

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Abstract

The decision to establish an ASEAN Free Trade Area (AFTA) in 1992 and the recent attempts by the ASEAN countries to forge an effective East Asian wide grouping for economic cooperation and eventual integration within the framework of ASEAN+3 can be seen as two approaches adopted by the ASEAN countries to deepen their level of economic integration as well as to expand their economic size and influence by involving the three Northeast Asian neighbours in their quest for greater economic cooperation in the region.

These two approaches can be seen as complementary rather than competitive from the ASEAN perspective if one understands that an economic integration within ASEAN is not a sufficient condition for achieving an economic and political security within the region without the cooperation and involvement of the other major East Asian neighbours. However, it must also be argued that the realization of an East Asian economic cooperation and eventual integration is not likely to be realized without a strongly unified and economically integrated ASEAN.

Keywords: AFTA, ASEAN integration, ASEAN+3

JEL: F15, F10

1. Introduction

The decision to establish an ASEAN Free Trade Area (AFTA) in 1992 and the recent attempts by the ASEAN countries to forge an effective East Asian-wide grouping for economic cooperation and eventual integration within the framework of ASEAN+3 can be seen as two approaches adopted by the ASEAN countries to deepen their level of

economic integration as well as expand their economic size and influence by involving the three Northeast Asian neighbours in their quest for greater economic cooperation in the region. These two approaches can be seen as complementary rather than competitive from the ASEAN perspective if one understands that an economic integration within ASEAN is not a sufficient condition for achieving an economic and political security within the region without the cooperation and involvement of the other major East Asian neighbours. However, it must also be argued that the realization of an East Asian economic cooperation and eventual integration is not likely to be realized without a strongly unified and economically integrated ASEAN.

In view of the importance and complementary roles of these two approaches, this paper aims to present the benefits and factors working in favour of an East Asian economic cooperation and integration and assess the importance of an ASEAN economic integration to the success of an East Asian economic integration. Before assessing the benefits and factors of ASEAN+3 and ASEAN economic integration, firstly the history and rationale of these two policy initiatives will be briefly compared.

2. History and Rationale of ASEAN+3 and ASEAN Integration

The ASEAN Free Trade Area (AFTA) was formed in 1992 with the primary objective of establishing a regional market free of tariffs and non-tariff barriers for all the commodities traded between member countries. It was in part a reaction to the perceived growth in protectionism in ASEAN countries' major trading partners in the form of emerging regional arrangements and the growing competitive pressures from the emerging markets. It was primarily a regional cooperation in the area of trade in goods although the agreement later covers trade in services and lays down rules for other areas of economic cooperation.

ASEAN+3, on the other hand, was formed sometime later in the aftermath of the 1997/1998 Asian crisis with the primary objective of forging financial cooperation. The idea of ASEAN+3 was itself not new. It was first officially proposed by the former head of an important Asian state, ex-Prime Minister of Malaysia Mahathir, during a

dinner with the former Chinese Premier Li Peng and fellow ASEAN leaders in December 1990 as the formation of an East Asian Economic Grouping (EAEG) between the ten countries of ASEAN and the three northeast Asian countries of China, Japan, and South Korea.¹ While it was not taken lightly, it was not however greeted with overwhelming enthusiasm. In October 1991, mainly as an attempt to mitigate United States objections, ASEAN ministers changed the name from EAEG to the East Asian Economic Caucus (EAEC), a term suggested by the Indonesian political scientist Hadi Soesastro (1993). The term suggested that the new grouping would only function as a discussion forum.

Perhaps it can be said that the importance and relevance of the EAEC was sidelined by the creation of AFTA in 1992 and APEC. For at the ASEAN Summit in 1993 it was decided that EAEC would be placed under the umbrella of APEC with support of the three Northeast Asian countries (Ichimura, 1998). However, the onslaught of the 1997/98 Asian crisis, the slow progress of the WTO and APEC, the positive inspiration provided by the European integration, and the broad dissatisfaction with the behaviour of the United States and the EU especially during the 1997/98 Asian crisis have resurrected the relevance of the EAEC.

The 1997/98 crisis has provided an impetus for the first ASEAN+3 dialogue among leaders. Plans for the economic integration of ASEAN+3 have developed rapidly since the summit of leaders in Manila in 1999. An East Asia Vision Group was set up to work out what the vision of the group should be. By 2000 the group had proposed an East Asia wide free trade arrangement or closer economic partnership to include liberalization of trade in all goods, services, investments, technology, and mutual recognition arrangements. Separate agreements and cooperation on anti-dumping, competition policy, investment principles, dispute settlement, and capacity building were also proposed. The Vision Group submitted in mid-2001 a draft vision of an East Asian community with a common regional currency and free trade and investment among its members. Decisions would generally be made through consensus among the members. In addition, the vision also provided for a

¹ Consulate General of Malaysia, *East Asia Economic Group (EAEG)* (1991).

“2+2” mechanism whereby a developmental project proposed by at least two ASEAN countries would proceed if at least two of the three northeast Asian members agree to fund it. The progress made since Manila have given many hope that an economic integration of ASEAN+3 would become a reality in the near future.

More progress has been achieved in the area of financial cooperation than in the area of trade. This is because of the preoccupation among the East Asian countries to avoid another financial crisis and because monetary arrangements can proceed without discriminating against outsiders and without directly hurting the highly sensitive agricultural sector. Some of the achievements in the financial cooperation area include the establishment of a region-wide system of currency swaps to help them deal with future Asian crises, the proposal to establish an Asian Monetary Fund (AMF) and a common currency system.

Factors In Favour of ASEAN+3 Economic Integration

A number of benefits and factors are working in favour of economic integration in East Asia. The following are the major factors that need to be highlighted.

On "Natural" Integration: The Increase in Intra-Regional Trade

History has shown that economic integration always begins with trade, then increases with foreign direct investments (FDI) or cooperation in production inputs, and finally through the coordinated harmonization of economic policies to attain economic integration (Liao, 1993). That is, economic integration is the natural eventuality for a region that trades and invests within itself intensively relative to other countries outside of the region.

Since the 1980s trade among the East Asian economies has increased significantly. Intra-regional exports rose from US\$128 billion in 1986 to US\$630 billion in 1995, representing an increase from 30.65% to 48.10% of total exports to the world. Intra-regional imports, as a share of total world imports, increased from 40.56%

to 50.01% in the same period. Thus overall intra-regional trade in East Asia has increased from 34.99% to 49.02% (Lau, 1997/98).

The increase was largely due to the increasing trade between ASEAN and the three Northeast Asian economies rather than within ASEAN itself. Indeed, intra-regional trade within AFTA itself has remained at only around 20% since 1985.² Correspondingly, the relative importance of trade with the rest of the world, from the perspective of East Asia, has declined. In 1986 the United States, Japan, and the then European Community (EC) absorbed 60.5% of the exports from East Asian developing countries while other Asian developing countries absorbed only 29.4%; by 1992, however, the shares had changed to 46.3% and 40.6%, respectively. Their share of exports from the developed countries has also increased from 7.6% to 10.4% and in the same year, the East Asian developing countries absorbed about half of China's exports, more than 20% of the total exports of ASEAN-4, and 21.4% of Japan's exports. Indeed, the increasing interdependence within East Asia, and the corresponding decline in the dependence on the United States and the EU, has led Chi Lo to comment that "Today . . . East Asian growth no longer needs to depend on exports to developed countries as much as it did in the past."³

On "Natural" Integration: The Increase in Intra-Regional Investments

With regards to investments, Hong Kong, Japan, and Taiwan are currently the top investors in China; Singapore, Taiwan and South Korea are among the top five investors in Indonesia, Malaysia, the Philippines, and Thailand. The opening up of China and the Indo-China economies have further increased the scope for FDI from Japan and the Asian NIEs. Indeed, Taiwan, and Singapore were already the largest foreign investors in Vietnam by the mid-1990s (Liao, 1993; Chi, 1995).

² A study by an NUS group demonstrated that, even if all customs duties were eliminated, intra-regional trade would increase by only 3.1%.

³ Drawn from Chi Schive (1995), *Taiwan's Role in East Asia* (CSIS, Washington D.C.), pp. 7 and from International Monetary Fund, *Direction of Trade Statistics Yearbook 1993* (IMF, Washington D.C., 1994).

According to Langhammer (2000), the Asian financial crisis of 1997 has increased the urgency in the region to hasten what is known as deep integration in the financial markets as compared to only shallow integration in the goods markets. The focus is increasingly moving towards liberalization of the capital account over and above the liberalization of the current account and the adoption of a common currency system. Langhammer however noted that the Asian Exchange Rate Mechanism (AERM) that was suggested has three potential problems. The first is that the large disparity in income levels, industrial development, and rates of growth means that asymmetric shocks are likely to be large. Secondly, an AERM reduces the availability of a buffer to asymmetric shocks, that is, nominal exchange rates. In the absence of a flexible and integrated labour market within the group there would be differences in unemployment rates among the member countries and this would lead to calls for inter-country transfers in order to prevent the AERM from collapsing. Thirdly, there are no good choices among the currencies in ASEAN+3 to act as the region's anchor currency.

The proliferation of sub-regional growth centres in East Asia based on economic complementarities, economies of scale in production, geographical proximity, and available facilitating infrastructure has been both a result and a cause of increased trade and investments (Chia, 1995). Some examples are the Yellow Sea Economic Zone, the Taiwan-Fujian Economic Zone, the Hong Kong-Shenzhen-Guangzhou Economic Zone, the Northeast Thai Zone (with Yunnan and Northeast Myanmar), the South Vietnam Economic Zone, the South Thai-Penang Zone, the Johor Bahru-Singapore-Batam Growth Triangle, the Jakarta-Surabaya Megalopolis, the Manado-Mindanao Zone, and the joint development of the Tumen Basin.

On the Economic Benefits of Integration: The “Flying Geese” Theory

As early as the 1930s Dr Akamatsu (1962) had propounded a “catching-up product cycle” theory, predating Professor Vernon's “product cycle” thesis. It was originally called “the wild geese-flying pattern” (Ganto Keitai) of industrial development, and it has since become widely used to explain the dynamics of trade and investments in East Asia.

According to the “flying geese” theory, economic changes in the more developed countries are repeated in the less developed ones, with time lags. In particular, the Asian NIEs of Hong Kong, Singapore, South Korea, and Taiwan were deemed as the first wave after Japan; the original ASEAN member countries of Indonesia, Malaysia, the Philippines and Thailand were the second wave; and China and the Indo-China states have formed the last wave. This is in accordance with each country’s changing factor endowments and comparative advantage.

An important inference that might be drawn from this theory is that FDI from the more advanced countries can help trigger improvements in the factor endowments of the less developed ones, accelerating structural changes in the latter’s economic structure. Economic integration would also certainly lead to an increase in the amount of intra-regional FDI. Further, an ASEAN+3 grouping would enjoy other benefits like an increase in the efficiency of the labour market. There would be more migration from the countries with excess labour, such as China and most of ASEAN, to those with labour shortages such as Japan and increasingly, the NIEs. Less developed members of the grouping would also benefit from the influx of skilled labour which brings with it technical or managerial expertise (Mosk, 2000). In addition, economic integration would facilitate information sharing and reduce research and transactions costs. Close cooperation would also build ties and lead to more homogeneous preferences, which might have positive externalities. An example would be the growth in the region’s support for GATT and the WTO (Harris, 1993). In this case, an ASEAN+3 grouping could be seen as an intermediate step towards eventual free trade.

Finally, we can refer to a study comparing the gains to the various ASEAN countries of an extension of AFTA. Using a modified Computational General Equilibrium (CGE) model Tan Kong Yam (2000) showed that the real GDP gains for ASEAN from an ASEAN+3 grouping would be 4.3 times larger than the real GDP gains from the present AFTA. The increase would not be evenly spread of course; Indonesia, the Philippines, and Thailand could be expected to enjoy a greater increase while Singapore would have the smallest increase in ASEAN. But the point remains

that enlarging AFTA to include the three northeast Asian countries would bring about an increase in the standard of living for ASEAN as a whole.

On the Ineffectiveness of APEC

Based on the study by Tan Kong Yam (2000) the real GDP gains for ASEAN from extending AFTA to ASEAN+3 would be 4.3 times that of the gains from AFTA alone. However, the real GDP gains from an extension to APEC would be 5.4 times that from the present AFTA.

The problem with APEC is mainly that of a general lack of commitment and urgency. Throughout the history of APEC commitments in trade and investment liberalization have been voluntary and non-binding. These commitments partly explain the loss of much momentum in APEC since the high points in Seattle and Bogor. Its weakness was most recently seen in its ineffectiveness, indeed irrelevance, during the Asian financial crisis (Tan Kong Yam, 2000).

On the Challenges Posed by the EU and NAFTA

With the end of the Cold War, Bergsten (1990) predicted the emergence of a tripolar world consisting of the United States, the EU, and Japan. "The Big Three of economics would displace the Big Two of nuclear power," he wrote. Similarly, Lester (1991) predicted the decline of the economic hegemony of the United States, as she is unable to serve as an engine of economic growth in times of worldwide recession due to her persistent trade and budget deficits. In addition, the United States would be unable to function as the primary world market for the world exports since the country has only about 20% of the world GNP, and it cannot purchase two-thirds of the combined exports from the developing countries.

To a certain extent they were right about the decline in United States preponderance and the corresponding rise of a tripolar world. NAFTA and the EU were formed in 1989 and 1993, respectively. Japan, which has largely been committed to

multilateral trade liberalization since the end of WWII, began an unprecedented shift towards bilateral negotiations in 1998. The formation of the other two blocs, and the lethargy of the United States economy has prompted Japan to seek its own partners and FTAs, “both as a contingency plan and as strategic pressure on the U.S. Congress” (Dobson, 2002).

Similarly, in the rest of East Asia, the formation of NAFTA and the EU has brought about intensified competition for exports and a fall in the market shares notably in the United States. For example, Asia’s market share in United States apparel imports fell from 68% in 1990 to 40% in 1996, while that of Mexico, Canada and the Caribbean increased from 16% to 37% (Tan Kong Yam, 2000). Thus there was an imperative for East Asia to move economic cooperation and integration to centre stage to provide for alternative export markets and to provide a safe haven for continued development (Chia, 1995; Young, 1993).

If nothing else, the fear of an inward-looking ASEAN+3 trade bloc would serve to “maintain discipline in NAFTA” (Young, 1993). A case of interest would be Japan’s MITI Minister Hashimoto warning to the United States that Japan would have to turn to EAEC if NAFTA remained a closed bloc (Korhonen, 1998).

On United States’ Criticisms and EU Indifference

It has been noted that American criticisms of East Asian countries have increased since the end of the Cold War. In particular, the western liberal concepts of liberty, individualism, and the free market appear to be incongruent with the so-called Asian values of social responsibility, communalism, and the need for a strong and competent government. Indeed, the interventionist and/or authoritarian governments in East Asia have often been openly criticised by United States’ politicians and economists alike (Friedman et al., 1991; Krugman, 2003).

As for the EU, the problem is not one of criticism but one of indifference. Geographically distant and socio-economically different, the EU generally does not see any important role for itself in the development of East Asia. This is reflected in the

pyramid of recipients of EU public funds and of trade preferences, which are biased against Asia. In contrast, preferential treatment is accorded to states with a strategic leverage such as the Balkans, and to nearby countries from which negative externalities might arise – in the form of illegal migrants, organized crime, and unsafe nuclear plants, all of which are the results of poverty. This is of course in addition to the overriding EU priority of helping their Eastern neighbors integrate into the existing system first (Langhammer, 2000).

On Improving Relations and Opening to Trade

On the other hand, the demise of Cold War geopolitics has also allowed for improvements in international relations in East Asia. Of particular significance was the simultaneous normalization of diplomatic ties between the United States, Russia, and China. The improved ties among all three actors for the first time since the end of WWII enabled the emergence of a new Asia-Pacific environment devoid of superpower confrontation (Ni Shi-Xiong, 1993). Other developments include the rapprochement of China and South Korea.

In contrast to the increasing antagonism of the United States, China's relations with ASEAN have improved dramatically since the latter was formed in 1967. Then China had condemned it as “an anti-communism alliance of anti-China, anti-revolution, and anti-people” countries. However, in 1979 the late patriarch Deng Xiao Ping announced a fundamental policy shift for China to work towards a socialist market economy. With the new focus on trade and economic reforms, diplomatic and economic relations were established with most of the ASEAN states by the mid-1980s; soon after, in 1986, China entered the Pacific Economic Cooperation Conference. It was also then that China began viewing the member countries of ASEAN as potential partners for economic cooperation, and less as political and ideological enemies (Kazuko, 1988). Similar shifts in policy were seen in Vietnam, albeit with a slight lag.

On the Economic Ascendancy of East Asia: The Region in General

The Economist (1993) declared that, based on PPP figures, China has overtaken Japan to be the second largest economy in the world; that Singapore and Hong Kong have already attained the standard of living of Japan; and that Malaysia's standard of living was approaching South Korea's.

Later studies also pointed out that the East Asian countries, inclusive of Japan, were of roughly equal economic size as the EU or NAFTA. United States trade with East Asia has already exceeded its trade with Europe in the 1970s, and European trade with East Asia has exceeded that with the United States since 1994. In addition, Japan's trade with the region has also exceeded that with the United States since the 1980s. In short, the "Pacific Asia has become the world's economic centre by the early 1990s (Soesastro, 1991; Korhonen, 1998; Mahathir and Ishihara, 1994). With an economy that is comparable in size to the EU and NAFTA, it is arguable that East Asia should have a formal institution of similar status.

On the Economic Ascendancy of East Asia: China in Particular

According to World Bank estimates, per capita income in China in 1995 was \$650 in nominal terms and \$2920 in terms of purchasing power parity (PPP). This, coupled with the sheer size of the Chinese market and the abundance of natural resources, makes China extremely attractive to investors from Japan and increasingly the NIEs (Ichimura, 1998; Wei Yan-Sheng, 1993). For example, ever since Taiwan relaxed controls in 1985 and 1988 trade with and investments in mainland China has soared. Taiwan, even after the Asian financial crisis, has an enormous trade surplus and foreign reserves, but the economy has limited outlets for capital. This, coupled with increasing labour costs and environmental standards, has prompted many Taiwanese firms to relocate to China.

But, more than just a manufacturing and processing centre, China is emerging as a key end-user market for Asia and the key force driving Asia's exports. For example, in 2002, China accounted for 14% of Asia's total exports; in comparison, Japan's share was only 11%. The point is that the global rise in demand for Chinese

and Asian goods will trigger a chain reaction in Asia's intra-regional trade since, increasingly, Asia exports to China for manufacturing and processing before exporting to the final destination (Chi Lo, 2003). The high-profile China-ASEAN Free Trade Area (CSFTA), endorsed by both sides in November 2001, is set to take shape within a decade. This should give ASEAN exports a boost into the Chinese market and allay any fears of her economic ascent (Chi Lo, 2003).

On Security Issues

It is said that ASEAN was established as a single vessel by member governments having different dreams for it, and that it was not created to pursue formally stated objectives. Rather, the formation of ASEAN was largely to affirm a common understanding that the member countries would attempt to resolve disputes through dialogue rather than through armed conflict. It was a symbol for seeking regional peace and the security of the member countries (Susumu, 1988). Similarly, by extrapolation, it could be argued that an ASEAN+3 grouping would serve as an important symbol of a general desire for peace in East Asia.

In addition, the increase in intra-regional trade and investments that would follow economic integration represents an increase in each member's stake in the well being of his fellow members. This would be a very real deterrent against aggression for both member states as well as other countries outside of the grouping. Indeed, the security-enhancing consequences of trans-national production is said to be a functionalist approach to peace and security (Acharya, 2002).

3. ASEAN Integration: A Catalyst for East Asian Economic Integration

Although there are indeed several benefits and positive factors working in favour of East Asian integration, there are also disadvantages and negative factors working against it. Some of these negative factors, however, are likely to dissipate with the eventual realization of ASEAN economic integration. It is argued that the progress in ASEAN economic integration will have a positive impact on the prospect for East

Asian integration by acting as a catalyst for economic integration in the region. Let us not some of the arguments about this.

First, Weatherbee (1989) has argued that, while there are diverse opinions within ASEAN, the general consensus is that the member states would be opposed to any regional community that would undermine the integrity and cohesion of ASEAN itself as a formal grouping and dilute its bargaining power, perpetuate ASEAN dependence, weakens existing patterns of intra-regional, bilateral or multilateral arrangements, or compromise political non-alignment. Thus, a strong and cohesive ASEAN can facilitate the formation of a larger Asian economic grouping.

Second, one major stumbling block in any economic integration is the perception that there would be an inequitable distribution of gains and costs in the process of economic integration. This occurs when countries are of dissimilar levels of economic development. A successful ASEAN integration, by improving the economic development levels of the member countries and by reducing the development gaps within the grouping, should contribute to the realization of an East Asian economic integration.

Third, another obstacle to ASEAN+3 economic integration would be the large disparities in the trade structures of the various countries. With the exception of Hong Kong and Singapore, most of the East Asian economies continue to maintain highly protectionist measures in various sectors. For example, Japan and South Korea protect their agriculture to the extent that the price of rice in the former is some four times its international price; Malaysia continues to guard its automobile industry fiercely; and Indonesia protects her domestic producers from a large number of industries. The structural changes required would not be acceptable to countries that have hitherto maintained high tariff walls. The realization of the ASEAN economic integration will act as a building block towards the formation of an East Asian economic community.

Fourth, a fully integrated ASEAN will make it easy for China, Japan, and South Korea to forge a free trade area with the ASEAN countries. Without a fully integrated

ASEAN it would take time to realize a regional economic integration as the ASEAN countries would have to negotiate individually with each of their Northeast Asian neighbours. Although the framework agreement for the China-ASEAN Free Trade Area has been agreed, the specific terms and conditions are still to be decided. Further, China is still viewed by some quarters as a strong competitor for ASEAN countries in third country markets and for foreign investments.

Although significant progress has been made in terms of tariff reduction, there has been little progress made in eliminating or harmonizing the non-tariff barriers (NTBs) that have been prevalent in their trade regimes. Some countries have not yet completed their identification of NTBs which are supposed to be submitted to the ASEAN Secretariat. To expedite this process the ASEAN Secretariat has recently issued a list of NTBs to the ASEAN member countries for verification. Licensing procedures are still unclear and not transparent. Customs procedures remain uncoordinated and unharmonized. The use of a common ASEAN tariff nomenclature, which has been long agreed, has not yet been implemented by all countries. Mutual recognition agreement for technical standards has been signed, but the harmonization of technical standards for twenty priority groups (consisting of electronics and electrical appliances, rubber products, and machinery) is still to be completed and the conformance with the internationally acceptable standards has yet to be met by all ASEAN countries. Liberalization in the services sector which are complementary to the liberalization of trade in goods has been quite slow (The Straits Times, 11 July 2003, p. 20).

The slow progress in economic integration is also partly due to the lack of a supranational institution with powers to enforce the principles and decisions made in relation to regional economic integration. Although the commitments made by individual countries with regards to AFTA are legally binding, there is no mechanism within ASEAN whereby sanctions and punishments can be meted out for members which fail to comply with their AFTA obligations. However, creation of a supranational institution with enforcement powers may run counter to the age-old principle of non-interference and consensus which still has some appeal and support from some member countries. One of

the challenges, therefore, for ASEAN is to set up some kind of supranational institution that may not have exactly the same structure as that in the EU, but with strong support and endorsement from the member countries.

The cautious approach (i.e. by deferring the phasing in of important products until the deadline, which is also called “bunching of tariff rates”) adopted by the CLMV countries in implementing their AFTA commitments is motivated by the growing concern that, as their economies are fully liberalized in accordance with the AFTA guidelines, their respective industries will not be sufficiently prepared to face the forces of regional competition and unable to take advantage of the economic opportunities provided by AFTA. Much of this concern is related to their infant industries including agricultural products and other processed foods, which they think will face greater competition from their ASEAN neighbours particularly from Thailand and Vietnam. There is also a lack of confidence in their growing garments sector, which will face greater foreign competition upon the abolition of the Multi-fibre Agreement in 2005. Another source of concern for the CLMV countries in the process of tariff liberalization is the anticipated reduction in their tariff revenues, as they are particularly highly dependent on international trade as their source of government revenue.

This concern has so far resulted in some degree of ambivalence in their policy initiatives or slower implementation of their AFTA commitments. Tongzon (1999) has discussed this ambivalence in great detail with respect to Vietnam, the first CLMV to join ASEAN. Consequently, this strategy has resulted in a delayed implementation of AFTA commitments, which could lead to the “bunching of tariff rates” – the AFTA Council has required all members to avoid in the process of tariff reduction. Given that the other CLMV countries have almost the same levels of economic development and have similar economic backgrounds, it is understandable that the most recent members – Cambodia, Laos and Myanmar – could face similar difficulties in implementing their AFTA commitments.

4. Conclusion

The two approaches adopted by the ASEAN countries in their pursuit for economic regionalism can be complementary rather than competitive. There are a number of benefits and factors working in favour of East Asian economic integration. There are also, however, negative factors working against East Asian economic integration. The realization of ASEAN integration will act as a catalyst for this Asia-wide integration by addressing some of these negative factors.

Regional economic integration under AFTA can provide an important building block for the establishment of an East Asian integrated market by allowing the free flow of goods and services among member countries which AFTA is aimed to achieve. Apart from providing opportunities for greater regional trade and investments and other economic spill-over effects of trade liberalization, a successful AFTA is vital for maintaining regional peace and security, which is essential for long-term economic progress in the Asian region.

Recent empirical evidence suggests that, despite the anticipated short-run costs of trade liberalization, the ASEAN countries have remained determined to realize their vision to establish a regional free trade area by 2015. Already significant progress has been made in the implementation of their tariff reduction commitments under AFTA, despite the growing economic and political difficulties faced by some member countries engendered by the recent economic crisis and other inherent structural and institutional weaknesses. However, the second phase of economic integration, which entails the removal or harmonization of NTBs, poses a more challenging and difficult task due mainly to the significant differences that exist between these countries in terms of economic development, national priorities and levels of efficiency.

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9. East Asian Economic Integration - A Perspective from Thailand

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The proliferation of economic cooperation and Free Trade Areas (FTAs) is notable. The mega block of Free Trade Area of the Americas (FTAA) is being formed and EU has been strengthened. While North America, EU and East Asia (EA) are the world three economic pillars; the development of EA economic integration has been very slow. However the aggressive move toward EA economic integration has been shown after the eruption of the Asian financial crisis. Given the development in EA region, this paper aims to examine rationales and challenges for EA integration and to discuss strategic issues from ASEAN perspective with special reference to Thailand.

1. Exploring Potential of East Asian Integration

1.1. Economic Structure of East Asia

This section observes the economic structure of East Asian countries. Comparisons with other major economic groupings are made for the sake of examining EA's position in the world economy.¹ With regard to size of GDP and population, ASEAN is quite small compared to other economic groups. However, the size of the economy increases significantly if ASEAN integrates with Northeast Asia (NEA). EA establishes remarkable economic power. With the combined population of 2 billion persons and gross domestic product of US\$ 6,427 billion. China is the most populated while the Japanese economy is the largest in output. In the same year, the population of EU was 378 million persons and that of NAFTA and FTAA was 416 and 825 million persons, respectively (Table 9-1). Whereas EA is notable in size compared to those of other

¹ In this paper, the East Asian economy consists of Southeast Asian, i.e. ASEAN 10 and Northeast Asian (NEA) economy including Japan, China, Hong Kong and Korea.

groupings, leaving out China the size of population would reduce to 703 million persons and the economy would be US\$ 4,725 billion. The shares of export and import in the world reduced to 21.3 percent and to 20.7 percent, respectively. This suggests a prominent position of China in the region.

Compared to EU and NAFTA, EA is more diverse. Japan is an industrial and fully developed country. Korea, Hong Kong and Singapore are NIEs. ASEAN 6 and China are developing countries and Cambodia-Laos-Myanmar-Vietnam (CLMV) are less developed countries. In 2001, the income per capita of Japan was US\$ 32.6 thousand, 117 times that of Cambodia (US\$ 277). Shares of manufacturing sector ranged from 7 percent for Myanmar to 35 percent for China. For higher income countries, service sector is a dominant sector as presented in share of GDP. ASEAN is even more diverse than NEA. The structures of production in ASEAN are mixed; some countries are still dominated by the agricultural sector. Income is highly varied among members as can be seen in coefficient of variation of GDP per capita. The coefficient of variation of GDP per capita of ASEAN was 1.94 in 2001 and that of EA was 1.51 in 2001, compared to 0.34 of EU and 0.68 of NAFTA (Table 9-2).

ASEAN is opened to the international market. Among ASEAN members, only the ratio of trade in GDP of Indonesia and Laos were less than one. NEA is less opened with the exception of Hong Kong. This ratio of EA as a group was 0.5 less than that of EU but higher than NAFTA's. ASEAN, though, is not the big player in the world; its share of world export was 7.3 percent and import was 6.7 percent. But EA is; export of EA totaled US\$ 1,588 billion in 2001. Its export share in the world was 26.3 percent while the share of import was 25.4 percent. This figure was still lower than other groups; NAFTA share of export and import were 26.1 and 33.3 % respectively. The highest is EU.

1.2 Trade and Investment Structure

As trade and investment are fundamentals to economic integration, this section explores trade structure of East Asian economies. Intra- and inter- regional trade will be

measured. Trade indices will be calculated for the analysis of trade competition and complementarity among countries in the region. Data of FDI in the region will also be presented.

Intra-Regional Trade

Intra-regional trade within economic groups sees an upward trend (Table 9-3). Recently, NAFTA trades with its own group amounted to 54.8 percent in 2001, a big increase from 33.6 percent in 1980. In the same year, trading within upcoming FTAA was also at 60.1 percent, an increase from 43.4 percent in 1980. EU trades with its groups was about 60 to 65 percent. Trade within ASEAN rose to 22.4 in 2001 from 17.4 in 1990, a small increase compared to trade within EU, NAFTA and FTAA. Since the economic crisis erupted in 1997, Intra-ASEAN exports got smaller, from 24.2 percent in 1997 to 21.6 percent in 1999, and rose again in 2001 to 22.6 percent. ASEAN depends on each other to the lesser extent with regard to imports; since its intra regional share of import was only 21.1 in the year 2001. (Tables 9-4 and 9-5)

Intra-regional trade of EA has been growing but the importance of external trade remains especially in the case of ASEAN. Further investigation of direction of exports indicates that ASEAN destination is still important for ASEAN exports; however, its exports to NEA is higher and its share is increasing; while that to EU is declining and to US is high and stable. Intra-regional trade in NEA is essential especially in the case of China which exports mainly to Hong Kong and Japan. ASEAN is less influential as export destination for NEA compared to the US and EU. Korea and Japan export shares to ASEAN are higher than to China and to Hong Kong, which could be explained by the link between trade and investment.

With regard to import structure, ASEAN depends more on outsiders for imports than for exports. NEA, especially Japan, is the major source of imports for ASEAN. China and Hong Kong import more from NEA than from ASEAN. Hong Kong's, Japan's, and Korea's shares of imports from ASEAN and EU are not that much different while their shares of imports from the US is higher. This may illustrate trade

and investment linkage between ASEAN and NEA that subsidiary companies import parts and machinery from parent companies. Furthermore with different level of development from ASEAN and China, Japan and Korea need to import capital- and technology-intensive goods from the US.

Kobsak Putrakul and others (2003) conducted analysis of the contribution of export growth within EA (excluding Japan that was included in G-3). The results indicated that during 1990-2002 the major source of greater intra-regional trade was the increase in the exports across North East Asia countries remarkably among China, Hong Kong, Taiwan, and Korea contributing 50 percent of intra-regional export growth. Trade among South East Asia countries amounted to 20 percent. The rest was trade between NEA and SEA. However, the highest growth rate was between ASEAN and NEA.

Export and Import Products of East Asia

Tables 6-10 present data on export and import products of ASEAN and NEA countries, based on two-digit HS classification. The similarity of their major products can be seen. With respect to export, from 1997–2001, electrical and electronic equipment (HS 85) and machinery (HS 84) were major export products for ASEAN, Korea and Japan. These two products were also major imports for all three countries. Another principal export of ASEAN was mineral fuels, oils distillation products (HS 27). HS 87 (vehicles apart from railway or tramway) was the third highest export product for Korea and Japan, while the main import products for both countries was HS 27 (mineral fuels, oils distillation products). Major export products of China in 2001 were HS 85 (electrical and electronic equipment) followed by HS 84 (machinery) and HS 62 (article of apparel, accessories, not knit or crochet). Top three import products of China in the same year were HS 85 (electrical and electronic equipment), HS 84 (machinery), and HS 27 (mineral fuels, oils distillation products) accounting for 47 percent of total China import value (Table 9). Hong Kong's chief merchandise exports were quite different for others in the region. The top three export products between 1997-2001 composed of HS 62 (article of apparel, accessories, not knit or crochet) followed by HS 61 (articles

of apparel, accessories, knit or crochet) and HS 85 (electrical and electronic equipment). The main import products were HS 85 (electrical and electronic equipment) followed by HS 84 (nuclear reactors, boilers and machinery), and HS 39 (plastics and articles thereof). (Table 9-10)

Machinery and electronics are dominant export products in the region. Garment is major product for some countries. Some studies show that EA trade has the product cycle pattern. Export production has been shifting from high-income countries such as Japan to NIEs and later to South East Asian countries. Countries in the region have been up the product ladder, from labor-intensive goods such as garment to more technology- skill-intensive goods like electronics and machinery.

Export Similarity

The trade pattern reflects competition and complementary between countries. To further investigate trade competition, export similarity index has been calculated², based on 6-digit HS. The index indicates the similarity of the export commodity structures of selected two countries. Two countries' export structures are the same when ESI takes the value of 100. The opposite is true when ESI is 0. The calculation results are shown in Table 11. Comparing the export structure of individual NEA countries and NEA as a group shows that Japan, China and Korea export structure were closer the NEA group much more than the case of Hong Kong whose index was only 26 in 2001. However, the index of Japan declined from 74.5 in 1996 to 69.3 in 2001. Within NEA region, Japan's index exhibited a closer tie to Korea more than to China and Hong Kong. The Japan-Korea's index ranged from 42-46 for from 1996 to 2001. In 2001, the index was only 18 and 36 for Korea-Hong Kong and Korea-China respectively. In the same year, export similarity index of Japan-China was 29 and that

² Trade Similarity Index is $S(ab, c) = \left(\sum_i \text{Minimum}[X_i(ac), X_i(bc)] \right) * 100$ where $S(ab, c)$ is Trade Similarity Index between country A and country B in market C, $X_i(ac)$ is weight of commodity i in A's trade to C, and $X_i(bc)$ is weight of commodity i in B's trade to C.

of Japan Hong Kong was 19. China had export pattern closer to Korea than to Japan. It is apparent that, overtime, the export pattern of individual NEA countries became closer to others in NEA with an exception of Hong Kong.

Comparing ASEAN and NEA, export similarity index of ASEAN and NEA increased from 43.6 to 47.9 from 1996 to 2001, illustrating a much closer export structure. All indexes for each NEA country compared to ASEAN went up with the exception of Hong Kong's. In 2001, the index of ASEAN-China was 42 and ASEAN-Korea was 40, while that of Japan-ASEAN was 36. These values were less than that of individual NEA country compared to NEA as a group. Reviewing individual ASEAN members and each NEA country, it can be seen that the index increased for each case with the exception of Hong Kong. Hong Kong's index declined compared with every ASEAN country but Indonesia. Another exception is the declining index between Singapore and Japan. However, among ASEAN members, Singapore and Japan, as well as Singapore and Korea, showed the closest export similarity. The highest index was Thailand compared with NEA group and with China. For the Philippines and Indonesia, the similarity of export structure with NEA was small.

Within ASEAN, all index values increase when comparing individual members to ASEAN export structure. Malaysia's index was the highest, while that of Indonesia was the lowest. Comparing across ASEAN member, Singapore and Malaysia illustrated the strongest ties. Indonesia structure was less similar to others although the index was increasing. The Philippines index, relative to other members but Singapore, marginally declined. Thailand index indicated the stronger export similarity with Malaysia than other ASEAN members. It can be concluded that NEA countries had a closer export structure than ASEAN members and vice versa. Competition in own groups seems to be more evident than between groups. Japan and Korea are more rivalry in term of export structure than with China. Compared with other ASEAN members, Singapore's export structure is closer to Japan and Korea while Thailand is closer to China.

Intra-Industry Trade

The above analysis illustrates the competition structure between ASEAN and NEA. It also indicates that the export pattern of Thailand is close to ASEAN more than to NEA. However, the networking of MNCs reveals the structure of complementarity in trade across countries. One major phenomenon explaining international trade is intra-industry trade. This comes about by the trade of similar products with similar countries (especially border trade) or by a division of labor. In the latter case product parts have been produced in many locations out of the location advantage; the parts will, then, be traded for final production. To investigate this issue, intra-industry trade index³ (IIT) is calculated to capture the complementary structure, that is, capturing the trading of two countries within same product group. High IIT shows high trade proportion in that particular product group. For countries with a low IIT index, trading is less in that product group and a possibility to compete in the third country. The products are classified by ISIC as shown in Box 1.

³ IIT=where E_{ij} is the value of country i 's export of product j to the market under investigation, and M_{ij} is the import value of in country of product j from the market under focus.

Box 1: International Standard Industrial Classification (ISIC)*ISIC Rev.2**1 - Agriculture, Hunting, Forestry and Fishing**2 - Mining and Quarrying**3 - Manufacturing**31 - Manufacture of Food, Beverages and Tobacco**32 - Textile, Wearing Apparel and Leather Industries**33 - Manufacture of Wood and Wood Products, Including Furniture**34 - Manufacture of Paper and Paper Products, Printing and Publishing**35 - Manufacture of Chemicals and Chemical, Petroleum, Coal, Rubber and Plastic Products**36 - Manufacture of Non-Metallic Mineral Products, except Products of Petroleum and Coal**37 - Basic Metal Industries**38 - Manufacture of Fabricated Metal Products, Machinery and Equipment**39 - Other Manufacturing Industries*

Table 9-12 shows that the sector that Thailand involved in intra-industry trade, in 2001, was ISIC 38; Manufacture of Fabricated Metal Products, Machinery and Equipment. Countries that show high IIT against Thailand were NEA, Malaysia and the Philippines. Table 13 shows that IIT for ASEAN and selected countries. Sector that experience high IIT was ISIC 38; Manufacture of Fabricated Metal Products, Machinery and Equipment. ASEAN had high IIT with every NEA countries and also with the US and EU.

The data presented above indicate that Thailand trade structure and comparative advantage are similar to ASEAN, China and Korea. ASEAN and NEA are more similar its own group than with different region. This similarity shows that they can be competitors. However, intra-industry trade also increases. This shows the complementarity structure with the rising networking of production and trade in the region especially in the case of computers and machinery. Evidence from Khobsak Putrakul and others (2003) also shows that, in recent years, division of labor and

product internationalization has been a key feature of trade structure in EA. During 1991 and 1998, countries in EA, with the exception of China and Hong Kong, experienced higher level of intra-industry trade especially for Thailand and the Philippines.

The important of intra-industry trade can be emphasized by the quote from the 2002 OECD Economic outlook, as cited in Kobsak Putrakul and others (2003) that, “The growing internationalization of production system, which increasingly involve vertical trading chains spanning a number of countries, each specializing in a particular stage of production, is an important feature behind the changing nature and the increasing scale of world trade. The extent of the intra-industry trade is typically much higher across categories of manufactured goods than it is across trade in non-manufactured goods and highest for the more sophisticated manufactured products such as chemical, machinery, transport equipment, electrical equipment, and electronics. This is because sophisticated manufacturing products are more likely to benefit from economies of scale in production and are easier to differentiate to the final consumers, and so facilitate trade in similar products. More complex manufactured products that rely on many components and/or processes many also benefit more readily from splitting up production across countries. ... Furthermore of particular interest when considering intra-industry trade and the internationalization of production are those countries where exports and imports account for a very high proportion of GDP ... although there is far from a perfect correspondence, these countries all tend to have a relatively high intra-industry trade.”

Foreign Direct Investment

With internationalization of production, direct investment from abroad is a crucial mechanism pushing for economic growth. The leading investors are US, EU and Japan. Table 9-14 shows the distribution of net foreign direct investment. FDI still concentrated in industrial countries, like the US and EU. However, China shares of FDI rose significantly in 1995 to 11.03 percent although it declined to 5.92 percent in 2001.

ASEAN share of FDI declined sharply since 1995 from 7.3 percent to 1.76 percent in 2001.

1.3. Asian Trade and Financial Agreements

While ASEAN trade and investment integration has been implementing for some time, financial cooperation in the region has been weak. Initiation of EA integration, on the other hand, was originally from the financial cooperation EA cooperation began with Finance and monetary policy unlike ASEAN and other economic blocks. The financial cooperation may result from the realization that APEC and ASEAN were not in a position that would cope and manage crisis well and the resentment of IMF practices and conditionality was getting stranger. The EA financial cooperation schemes include ASEAN swap arrangement, surveillance and early warning mechanism, regional financing facility under the Chiang Mai Initiative, as well as Asian bonds. Furthermore, proposals and ideas have been raised in various forums to deepen financial integration for EA such as macroeconomic policy coordination, exchange rate coordination, formation of Asian Monetary Fund, development of long-term capital market, and monetary union in the long-term along the lines of the European model.

Another development is rampant trade negotiations. Never before that bilateral FTAs and regional economic cooperation in Asian countries have been more flourished. The basic form is free trade Area; however, many are Closer Economic Cooperation Agreements that are comprehensive and involve more than the tariff reduction. Many agreements are underway the completion in a few years is expected (Box 2). This trend indicates that countries in the region focuses on export-led growth and is uncertain on the completion of WTO agreements. These countries are afraid of being left out of the group and are outsiders. The case of Japan is a good example, as she changes the position in integration with ASEAN when China launches the ASEAN-China FTA. The joint Declaration of the Leader of ASEAN and Japan on the Comprehensive Economic partnership was announced one day after the signing of the China-ASEAN economic integration.

Singapore is the most active player in the region. Japan and Singapore concluded the Japan-Singapore Economic Partnership Agreement in January 2002 and came into effect in November 2002. It covers tariff cuts and a broad agreement on movement of people, investment rules and technical cooperation between two countries. However, the scope is still partial and too limited to be employed as a framework for ASEAN trade negotiation.

Thailand direction in regional agreement is quite evident under the leadership of the current government. Bilateral trade is pushed ahead regardless of the size and location of trading partners. At the same time AFTA and RTA with ASEAN and others are also pursued. The main objective of Thai government is to open up market for exports. It is arguable whether bilateral trade creates equal trade negotiating power between small and big countries. The negotiation always avoids sensitive issues and focus on issues on big country's interest. Western countries focus more on trade in services, investment and IPP and ignore agriculture issues. However, bilateral is good for the NTB discussion and technical assistance which is not the focus and not easy to implement on the multilateral level.

Box 2 Preferential Trading Arrangements in Asia

Partners	Type of Arrangements	Status	Year
ASEAN	Free Trade Area	Implemented	1993
ASEAN-China	Comprehensive Economic Partnership	Signed	2003
AFTA-Australia/New Zealand	Closer Economic Partnership	Official discussion/study	1999
ASEAN-Japan	Closer Economic Partnership	Official discussions	2002
ASEAN-South Korea	Free Trade Area	Official discussions	2001
ASEAN-India	Comprehensive Economic Cooperation	Official discussions	2003
ASEAN-USA	Trade and Investment Framework	Proposal	2002
Singapore-New Zealand	Comprehensive Economic Partnership	Implemented	2001
Singapore-Japan	New Age Economic Partnership	Signed	2002
Singapore-EFTA	Free Trade Area	Signed	2002
Singapore-Mexico	Free Trade Area	Under negotiation	1999
Singapore-Australia	Free Trade Area	Under negotiation	2000
Singapore-Canada	Free Trade Area	Under negotiation	2001
Singapore-US	Free Trade Area	Under negotiation	2000
Singapore-Chile	Free Trade Area	Under negotiation	2000
Singapore-Taiwan	Free Trade Area	Proposal/Study	2002
Singapore-South Korea	Free Trade Area	Proposal	
Thailand-China	Free Trade Area	Signed	2002
Thailand-Bahrain	Comprehensive Economic Partnership	Signed	2002
Thailand-USA	Trade and Investment Framework	Signed	2002
Thailand-Australia	Closer Economic Relations Free Trade	Under negotiation	2003
Thailand-Sri Lanka	Free Trade Area	Under negotiation	2003
Thailand-India	Free Trade Area	Under negotiation	2003
Thailand-Croatia	Free Trade Area	Proposal	2001
Thailand-Czech Republic	Free Trade Area	Proposal	2001
Thailand-South Korea	Free Trade Area	Proposal/study	2001
Thailand-Japan	Closer Economic Partnership	Proposal/study	2002
South Korea-Chile	Free Trade Area	Under negotiation	1998
South Korea-US	Free Trade Area	Under negotiation	2001
South Korea-Mexico	Free Trade Area	Official discussions/study	2000
South Korea-New Zealand	Free Trade Area	Official discussions/study	2000
South Korea-Australia	Free Trade Area	Official discussions	2000
South Korea-China	Free Trade Area	Proposal/study	
Japan-Chile	Free Trade Area	Official discussions/study	2001
Japan-Mexico	Free Trade Area	Official discussions/study	1998
Japan-South Korea	Free Trade Area	Official discussions/study	1998
Japan-South Korea-China	Free Trade Area	Official discussions/study	
Japan-Canada	Free Trade Area	Proposal/study	2000
Japan-Philippines	Closer Economic Partnership	Proposal	2002
Hong Kong –New Zealand	Closer Economic Partnership	Official discussions	2001
P-5	Free Trade Area	Proposal	1998
US-Philippines	Free Trade Area	Proposal	2002

Note: EFTA-Switzerland, Iceland, Liechtenstein, Norway.

Pacific-5-Singapore, Australia, New Zealand, United States and Chile

Source: Manzano and Avila (2002).

2. Rationales for East Asian Economic Integration

The above discussion illustrates regional economic structure and economic cooperation environment. This part of the paper assesses the advantages of East Asia economic integration, from ASEAN perspective with special reference to Thailand.

Enhancing size and location advantage

The above information on economic and trade structure leads to the suggestion that ASEAN is too small to engage only in its own grouping. Crisis also showed that integration in ASEAN is not enough to prevent the adversity. Thailand, a small country, and ASEAN, a small economic group, cannot wait for the conclusion of multilateral agreements for freer trade. Under the situation that there will be large trade blocks, Thailand and ASEAN are too small to stand alone. Thus, deeper integration with NEA is logical; some even say it is necessary. The analysis also shows that Thailand economic structure is similar to ASEAN members, so trade expansion with NEA will complement Thailand economic structure. A gravity model employed in Kobsak Putrakul and others (2003) confirms that there are potentials for bilateral trade expansion between Thailand and Japan, China, Taiwan and India. Therefore, EA integration is good for Thailand trade.

The paper also concludes that "...With the rise of East Asia in the world economy, intra-regional trade will play an increasingly more important role for each country within the region. For the case of Thailand, not only we are likely to gain in the short-run driven by export growth to country such as China, but in the medium and longer term, as long as the regional keeps expanding faster than the G3 countries, prosperity within the region will help propel momentum for the intra-regional exports which will be instrumental in providing additional engine of growth to the Thailand for the medium-term."

Larger group offers more benefit to countries involved. The simulation by Scollay R. and J. Gilbert (2001) indicated that ASEAN + 3 will increase welfare more

than ASEAN +1 and for only NEA FTA. Including agriculture in FTA is also important since it will greatly increase welfare (Table 9-15). China has been emerging as a major market for ASEAN and EA as well. While it is true that since 1998 China became major exporter of EA (next to Japan) and other countries' export growth were either declining or slowing down. Still, the much increase in China exports occurs along with the noticeable increase of EA export to China. It increased from \$2.6 billion in 1998 to \$50.5 billion in 2002. Thailand's exports to China in the first five months of 2003 increased by 6.8 percent. Thus, there is an obvious advantage for the region when China comes out as a new market for ASEAN and NEA with large number of population that income is increasing. High growth rate of FDI to China also induced intra-regional trade form production chain in the region. China also provides location advantage based on her lower cost and abundant resources for production.

EA integration can improve region competitiveness. Internationalization of production brings about FDI as MNCs searching for the most efficient location producing parts or components. The EA integration can make the region into a strategic production network, especially as China becomes visible. The free flow of trade and investment in the region, thus, strengthens regional competitiveness as well as country's competitiveness.

Avoiding spaghetti-bowl tariff structure

To prevent the confusing overlapped trade agreements, EA integration can avoid spaghetti-bowl tariff system. With many trade agreements, many tariff rates can be imposed on one product depend on the origin of imports. Even imports from the same origin, tariff rate on specific product can be different due to different local contents. If each ASEAN member forms FTA with NEA separately, there will be 40 agreements instead of one agreement when EA FTA is created. Thus, if the trend of bilateral continues, the region will face with tremendous amount of free trade agreements

Favorable existing foundation

With respect to existing institution, EA integration does not start from zero. Framework on ASEAN+3 is built and can be expanded into the framework for EA integration or EA FTA. Measures recommended in the Final Report of the East Asia Study Group can be scrutinized and carried out measures that are timely and appropriate. Furthermore, though there are some trade agreements across continents far and wide, it is easier to integration with countries in close proximity. FTAs always start with neighboring countries. EA has closer historical and cultural relations with each other than with the west. It should be easier to buildup based on existing familiar institutions and market environment.

Box 3. 26 Measures Recommended by the East Asia Study Group

- **Short-term measures**
 - Form an East Asia Business Council
 - establish GSP status and preferential treatment for the least developed countries
 - foster an attractive investment environment,
 - establish an East Asia Investment Information Network,
 - develop resources and infrastructure jointly,
 - provide assistance and cooperation in infrastructure, information,
 - cooperate through technology transfer and joint technology development
 - develop information technology jointly
 - build a network of East Asian think-tanks
 - establish an East Asia Forum
 - implement a comprehensive human resource development program
 - establish poverty alleviation program
 - take concerted steps to provide access to primary healthcare for the people
 - strengthen mechanism for cooperation on non-traditional security issues
 - work together with cultural and educational institutions to promote a strong
 - promote networking and exchange of experts in the conservation of arts
 - promote East Asian Studies in the region
- **Medium-term and long-term measures**
 - form an EAFTA
 - promote investment by SMEs
 - establish an East Asia Investment Area
 - establish a regional financing facility, and coordination.
 - Pursue a more closely coordinated regional exchange rate mechanism
 - Pursue the evolution of the ASEAN+3 Summit into an East Asia Summit
 - Promote closer regional marine environmental cooperation
 - Build a framework for energy policies and strategies
 - Work closely with NGO in policy consultation

Source: Hiratsuka D. (2003)

Greater resources for development

When an economic group includes lower income economies, development assistance is imperative. CLMV are ASEAN members with much lower income than other members in the group. However, ASEAN has limited resources, especially after the crisis, to carry out this duty effectively. EA, which include industrial high-income countries, can introduce adjustment fund to facilitate trade liberalization. Furthermore, CLMV can get support in the form of Special and Differential Treatment (S&DT), technical assistance for capacity building, infrastructure development from EA cooperation. This will make the adjustment to FTA easier and more acceptable.

Improving trade negotiation position

Lastly, advantage of EA grouping is to strengthen position on multilateral negotiation. EA grouping can also enhance trade negotiation position better than bilateral or individual country in multilateral negotiation. Its size will be compatible to EU and NAFTA. However, the influence on multilateral negotiation will also depend on the consensus building in the group.

3. Challenges of EA Integration

Importance of inter-regional trade

While expanding ASEAN seems reasonable, EA integration has marked shortcomings. One shortcoming is that intra-regional trade in EA is smaller compared to other large groupings like EU and NAFTA. Thus, final demand in EU and USA remain significant for exports. Inter-regional trade is also imperative especially with respect to imports.

The significance of the US and EU demand is more apparent if the linkage of the industry is considered. Some export products within EA is not for the final demand in the region but for processing to reexport to the US and EU. Thus, the growth rates of these two regions are still notable for intra-regional trade growth. Monetary Authority of Singapore published a study in 2003, as cited in Kobsak Pultrakul and others (2003),

that about 36 percent of total export in the region (Japan excluded) is intra-regional exports. Of which 22 percent were demand in the region as final products and intermediate products for regional demand. The remaining 14 percent were reprocessed and sent to the US, EU, Japan and the rest of the world. This notes the significance of G-3 economic growth to the region. The implication is that EA must not form close regionalism. Multilateral trade agreements are nonetheless important for trade expansion. Furthermore, it is inevitable that slow down in the US and EU economies will affect EA exports.

Political issues

While ASEAN has notably experience in cooperation and close relationship among its members, which has come into existence for some time, political situation in NEA is not as tranquil as ASEAN due to historical background. As mentioned in Cheong Inkyo (2003), "Historically, China has been known to avoid formal economic/political cooperation initiatives that can influence its internal policy decisions. Also there still remains antagonism and competition among East Asian countries stemming from Japan's past imperialism. Japan's refusal to make an official apology impedes East Asia's regional integration." Mutual distrust among the Northeast Asian countries is the greatest impediment to the political decision concerning economic integration. However, Cheong Inkyo (2003) also points out that the politically antagonistic relationships in the Northeast Asia is, to some extent, has been alleviated. Also, the integration needs strong leaderships especially from major economic countries like China, Japan, and Korea.

Furthermore, forming FTA requires public support. However, China is emerging as a major competitor with some countries. The analysis of export structure indicates that Thailand and China are competing in many sectors. Apichat Pongsirirushakun et. al. (2002) investigated exports products in major markets. The finding is that there were many products which Thai share of export experienced a decline where Chinese shares of export were rising. This makes it harder to ask for

public support for EA Free trade Area. It also reveals the necessary of adjustment in each country to order to be competitive.

Complex trade agreements

As mentioned above that there are many bilateral FTA implementing and under negotiation in the region. The bilateral agreements may be in conflict with regional integration. It will dilute EA integration. One may argue that bilateral FTAs can be building blocks for regional FTAs since integration across a member of countries may create difficulties than negotiation in a small group, like between two countries or ASEAN. Bigger groups have different interests, more diverse economic structures, much different political systems and culture, wider range of issues to be settled. However, the complicated tariff structure and resources devoted to bilateral FTA negotiation can easily outweigh the benefits, if any, and undermining regional integration. It will be more difficult to standardize many bilateral FTA agreements into a regional agreement.

Regionalism can also weaken multilateral trade negotiations. Bilateral and regional integration require resources and time to accomplish. When these resources are committed, less resources and concentration will be devoted to multilateral trade negotiation. There are not enough qualified manpower in developing countries to go places for meetings nor resources to do research nor time for consensus buildings. Consequently, multilateral negotiation will get lower priority when bilateral and regionalism is the focal strategy. Policymakers will feel contented as if they perform enough freer trade when they sign some bilateral FTAs and do not feel the need to pursue multilateral negotiations.

4. Strategy for EA Integration

The previous section points out the shortcomings of EA integration, nevertheless the advantages are quite substantial. Thus, we should be aware of the limitations and get

the best results out of the integration. With the importance of production networking to enhance export, EA integration must be designed to enhance the competition position of the region comparing to others regions in the world. It is important that the regional integration formed to attract FDI and to link with production and trade networks under the trend of global production. Regionalism must not intend to protect producers. With closer economic integration in East Asia each country in the region will need to develop its own niches based on its realistic comparative advantage.

To attract FDI and improve competitiveness, ASEAN also needs more integration. As stated in Chalongphob Sussangkarn (2003a) "ASEAN needs to become much more serious in fully implementing AFTA to make the region more attractive as an investment destination. This also requires the harmonization of the rules, procedures and regulation that will lower the cost of producing, transporting and generally doing business in ASEAN." Every country in the region still needs to streamline trade and industrial policy. Although Thailand's AFTA tariff rates are low. Her MFN's tariff rates remains high even for agricultural products. Since trade with non-ASEAN is crucial for Thailand, MFN. Tariff rates should not be a drastic departure from AFTA rates. Maintaining those very high rates induces trade diversion and inefficiency. Furthermore, domestic producers that use imported parts from outside ASEAN will face the difficulty in competing with AFTA products. Under the globalization pressure, the industry upgrade by raising technological capability is vital. It will significantly enhance competitiveness. Thailand needs to restructure her economy more than other ASEAN members, since the earlier analysis reveals that China's export competition is more pronounced to Thailand than to other ASEAN countries.

The Role of China and Japan will be crucial for the success of economic group. Countries in the region cannot deny that China, to some extent, is a competitor but she also generates opportunities to enhance respective country's competitiveness and market access. China will be important in market source and low cost production, as seen above. Roles of Japan will be noteworthy in assisting industrial upgrading. Japanese firms can create production networking in the region and transfer technology

via subcontracting and training. This will increase country's competitiveness as well as company's efficiency.

To avoid waste of resources integration should be built on existing institutions. East Asia Free Trade Area (EAFTA) should be formed as a medium term target. Framework on ASEAN+3 should be created and expand to be the framework for EAFTA. It is possible that ASEAN can introduce the separate arrangements with China, Japan, South Korea and the Closer Economic Partnership (CEP) with Australia and New Zealand under an overall CEP framework. This will greatly reduce the problem and complication for ASEAN to manage its future external economic relations and integration in East Asia. To get benefit from integration EA should be comprehensive and broad. It is important to include sensitive sectors in the liberalization process in a timely manner . Elek (2003) stated that it is hard to deal with sensitive sectors in small groups. Sensitive issues can be dealt in bigger groups because of the possibility of cross sector negotiation. Thus, bilateral is not working in this issue and it is possible to achieve it in the RTA or multilaterals. Issues on Agriculture and service sectors cannot be avoided. The agreement should at least set the timeframe for including sensitive sectors in the FTA.

Nipon Pouponsakorn (2003) emphasized the importance of the agriculture in the ASEAN Japan Closer Economic Partnership. "...since agriculture is still the most important sector in many ASEAN economies especially CLMV. It is not only providing bread and butter and safety net for the majority of their population, but it is also the sector that they have comparative advantage. Trade in agriculture will, therefore, significantly contribute to their economic growth and improve the living standards of millions of ASEAN farmers." In other words, opening up the agricultural market may yield greater benefits than financial assistance to developing countries.

He also suggests the adjustment measures required for ASEAN and Japan to cope with the agricultural issue. For ASEAN, it should set up programs enabling farmers to shift away from inefficient non-competitive agricultural production, set up social protection program to protect vulnerable farmers and build up capacity of

farmers and food processors in meeting SPS standard for exports. For Japan, she needs to find a more innovative means of food security, which are less market distorted and to bring down price support. To cope with multi-functionality of agriculture issue, she should provide direct and cost effective mechanisms to support agriculture production as a public good. This will lower social cost and reduce international trade barriers.

Regional financial cooperation should be developed in line with trade and investment integration. Chalongphob Sussangkarn (2003a) concludes that there are four rationales for EA's financial cooperation; to prevent financial crisis, to better manage a crisis, to influence the financial environment affecting the region, and to support the economic integration in the region. He concludes that the region can greatly gain from greater financial operation since it has potential to make the region resilient from the volatilities and risk from international market. The cooperation will strengthen the region position to influence the global financial system.

Chalongphob Sussangkarn (2003b) also recommended "To make progress on financial cooperation, a specific focal point for technical work to support the ASEAN Plus Three process may need to be developed. This would be in the form of a financial and monetary organization for East Asia that would be complementary to the IMF. The main function of the agency would not be on crisis management, but rather on work to support policy coordination dialogues for crisis prevention and the promotion of regional financial and capital markets. These types of cooperative and development issues will also support the goal of a much deeper financial and economic integration in East Asia in the longer term."

While ASEAN+3 and EA financial cooperation are moving ahead, each member also actively negotiates and concludes bilateral FTAs. These can complicate the EA integration since the bilateral agreement may be in conflict with regional arrangements such as exclusion of sensitive sectors. There is tendency to employ one bilateral agreement as a modality for other bilateral negotiations such as the case that Japan that uses Singapore's agreement to negotiate with Thailand. It is not possible to deter bilateral FTAs under the atmosphere today. However, there should be an

organization to explore the possible regional conflicts. Bilateral agreement negotiations should be aware of the regional vision. This trend also emphasizes the need to speed up ASEAN plus Three process.

EA integration is sensible to Thailand and ASEAN. It should be formed with the clear vision of what we want to achieve, and to accomplish by the most efficient way to reach its fullest potentials. Utilizing existing institutions and infrastructure is better than to create new ones. East Asian countries must adjust their economies and institutions to cope with the dynamism of globalization for which EA integration will be an essential mechanism.

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Table 9-1: Economic Indicators for selected East Asian Countries 2001

	Population (Million)	GDP (current Bil.US\$)	GDP capita (current US\$)	per % of GDP			Exports of goods and services			Imports of goods and services			Degree of openness
				Agricultur e	Manufacturing	Service and others	Bil.US\$	% GDP	% of export	% of world	Bil.US\$	% GDP		% of world import
Brunei	0.3	..	..	..	..	..	..	..	..	..	..	..	..
Cambodia	12.3	3.4	277.5	36.9	..	..	1.8	53.2	0.0	2.1	61.3	0.0	1.1
Indonesia	209.0	145.3	695.3	16.4	26.1	57.5	59.7	41.1	1.0	47.3	32.6	0.8	0.7
Lao PDR	5.4	1.8	325.9	50.9	17.7	31.4	0.5	36.3	0.0	0.6	47.6	0.0	0.6
Malaysia	23.8	88.0	3,698.8	8.5	30.6	60.9	102.4	116.3	1.7	86.2	98.0	1.5	2.1
Myanmar	48.3	..	..	57.2	7.2	35.6	..	0.5	..	..	1.1	..	..
Philippines	78.3	71.4	912.2	15.2	22.4	62.3	35.2	49.3	0.6	33.9	47.4	0.6	1.0
Singapore	4.1	85.6	20,733.0	0.1	23.4	76.4	148.6	173.6	2.5	130.0	151.8	2.3	3.3
Thailand	61.2	114.7	1,874.4	10.3	32.0	57.7	76.0	66.3	1.3	69.0	60.2	1.2	1.3
Vietnam	79.5	32.7	411.5	23.6	19.6	56.8	17.9	54.7	0.3	18.6	56.8	0.3	1.1
ASEAN-10	522.3	543.0	1,146.5	11.8	26.6	61.6	442.1	81.4	7.3	387.8	71.4	6.7	1.5
China	1,271.9	1,159.0	911.3	15.2	35.4	49.4	299.4	25.8	5.0	271.3	23.4	4.7	0.5
Hong Kong	6.7	161.9	24,073.7	0.1	5.9	94.0	233.0	143.9	3.9	224.4	138.6	3.9	2.8
Japan	127.0	4,141.4	32,600.7	1.4	21.6	77.1	432.5	10.4	7.2	406.4	9.8	7.1	0.2
Korea, Rep.	47.3	422.2	8,917.2	4.4	30.0	65.6	181.1	42.9	3.0	171.2	40.6	3.0	0.8
NEA	1,453.0	5,884.5	4,050.0	4.3	24.5	71.2	1,146.1	19.5	19.0	1,073.3	18.2	18.6	0.4
EA	1,975.2	6,427.5	3,336.3	4.9	24.7	70.4	1,588.2	24.7	26.3	1,461.2	22.7	25.4	0.5
EU-15	378.2	7,889.9	20,862.6	2.2	19.9	77.9	2,829.4	35.9	46.8	2,735.3	34.7	47.5	0.7
NAFTA	415.8	11,377.6	27,361.8	1.8	17.4	80.7	1,578.0	13.9	26.1	1,920.4	16.9	33.3	0.3

Source : World Development Indicators, World Bank. 2003.

Table 9-2: Coe-efficient of Variation of GDP per capita, 1980-2001

	1980	1990	1995	2000	2001
EU-15	0.37	0.34	0.37	0.35	0.34
NAFTA	0.58	0.70	0.74	0.68	0.68
NEA	0.98	0.96	0.94	0.89	0.86
EA	1.52	1.33	1.33	1.54	1.51
ASEAN-9*	1.73	1.54	1.52	1.98	1.94
ASEAN-6	1.73	1.17	1.15	1.56	1.53

* exclude Myanmar

Source : Calculated from World Development Indicators, 2003.

Table 9-3 Percent of Intra-regional trade

	1980	1985	1990	1995	1999	2000	2001
NAFTA	33.6	43.9	41.4	46.2	54.6	55.7	54.8
FTAA	43.4	49.7	46.6	52.5	60	60.8	60.1
EU	60.8	59.2	65.9	62.4	63.3	62.1	61.2
ASEAN	17.4	18.6	19	24.6	21.7	23	22.4
APEC	57.9	67.7	68.3	71.8	71.8	73.1	72.5

Source : UNCTAD Handbook of Statistics On line, www.unctad.org/

Table 9-4 Share of exports by selected countries, 1997-2001 (Percent)

Exporters	YEA R	Destinations								
		ASEAN-10	China	Hong Kong	Japan	Korea	NEA	EU	USA	The rest of the world
ASEAN-5	1997	24.2	3.0	6.7	12.9	3.3	25.9	15.0	19.1	15.8
	1998	21.5	3.2	5.9	11.3	2.5	22.9	16.8	21.3	17.6
	1999	21.6	3.1	5.5	12.2	3.3	24.2	15.9	20.7	17.5
	2000	23.2	3.6	5.5	13.2	3.7	26.0	14.3	19.4	17.0
	2001	22.6	4.1	5.8	13.5	3.8	27.2	14.5	18.3	17.4
China	1997	6.6	0.0	24.0	17.4	5.0	46.4	13.1	17.9	16.1
	1998	5.7	0.0	21.1	16.1	3.4	40.6	15.3	20.7	17.7
	1999	6.0	0.0	18.9	16.6	4.0	39.5	15.5	21.5	17.4
	2000	6.7	0.0	17.9	16.7	4.5	39.1	15.3	20.9	17.9
	2001	6.6	0.0	17.5	16.9	4.7	39.1	15.4	20.4	18.5
Hong Kong	1997	8.5	30.2	0.0	5.0	1.1	36.4	17.4	26.1	11.7
	1998	6.3	29.4	0.0	3.4	0.8	33.7	18.8	28.8	12.4
	1999	6.0	29.1	0.0	3.2	0.9	33.2	19.3	29.6	11.9
	2000	6.9	29.6	0.0	2.8	1.0	33.4	18.0	29.7	12.1
	2001	5.6	32.2	0.0	2.6	1.2	36.0	16.4	30.1	11.8
Japan	1997	16.5	5.2	6.5	0.0	6.2	17.8	15.6	28.1	21.9
	1998	12.0	5.2	5.8	0.0	4.0	15.0	18.5	30.9	23.7
	1999	12.9	5.6	5.3	0.0	5.5	16.3	17.9	31.1	21.8
	2000	14.2	6.3	5.7	0.0	6.4	18.4	16.4	30.0	20.9
	2001	13.4	7.7	5.8	0.0	6.3	19.7	16.0	30.4	20.5
Korea	1997	14.8	10.0	8.6	10.8	0.0	29.4	12.4	16.0	27.3
	1998	11.4	9.0	7.0	9.2	0.0	25.3	13.8	17.4	32.2
	1999	12.1	9.5	6.3	11.0	0.0	26.9	14.1	20.6	26.3
	2000	11.5	10.7	6.2	11.9	0.0	28.8	13.6	21.9	24.2
	2001	10.7	12.1	6.3	11.0	0.0	29.3	13.1	20.8	26.0
EU	1997	2.7	1.0	1.2	2.1	0.8	5.1	67.0	8.3	17.0
	1998	1.7	1.0	1.0	1.8	0.5	4.2	67.8	9.0	17.3
	1999	1.6	1.0	0.8	1.9	0.6	4.3	69.4	9.7	14.9
	2000	1.8	1.1	0.9	2.0	0.7	4.8	67.8	10.4	15.2
	2001	1.8	1.3	0.9	1.9	0.7	4.8	66.6	10.0	16.7
USA	1997	7.0	1.9	2.1	9.7	3.8	17.5	20.6	0.0	54.9
	1998	5.8	2.2	1.8	8.6	2.5	15.2	22.1	0.0	56.9
	1999	5.8	2.0	1.7	8.5	3.4	15.6	22.2	0.0	56.5
	2000	6.2	2.2	1.7	8.5	3.7	16.1	21.5	0.0	56.3
	2001	6.1	2.7	1.8	8.0	3.1	15.6	22.2	0.0	56.1

Source: Calculated from PC-TAS, UN.

Table 9-5 Share of imports by selected countries, 1997-2001 (percent)

Sources of Import											
Importers	YEA	ASEAN-10	China	Hong Kong	Japan	Korea	NEA	EU	USA	The Rest of The World	
ASEAN-5	1997	18.5	3.6	2.4	20.5	4.2	30.7	14.5	16.1	20.2	
	1998	20.5	4.1	2.6	18.8	4.5	30.0	13.5	17.8	18.2	
	1999	20.9	4.5	2.5	19.0	4.8	30.8	12.2	16.4	19.7	
	2000	21.8	4.8	2.4	19.6	4.4	31.2	10.9	14.6	21.4	
	2001	21.1	5.6	2.3	17.6	4.2	29.7	12.0	14.9	22.2	
China	1997	8.7	0.0	4.9	20.4	10.5	35.8	13.5	11.5	30.6	
	1998	8.9	0.0	4.7	20.2	10.7	35.6	14.8	12.0	28.6	
	1999	8.9	0.0	4.2	20.4	10.4	34.9	15.4	11.8	29.0	
	2000	9.8	0.0	4.2	18.4	10.3	32.9	13.7	9.9	33.6	
	2001	9.5	0.0	3.9	17.6	9.6	31.0	14.7	10.8	34.1	
Hong Kong	1997	10.3	36.8	0.0	13.5	5.1	55.4	11.2	7.7	15.4	
	1998	10.0	40.1	0.0	12.5	5.1	57.7	10.7	7.4	14.1	
	1999	9.9	43.3	0.0	11.6	4.9	59.8	9.3	7.0	13.9	
	2000	10.4	42.9	0.0	12.0	5.0	59.8	8.8	6.8	14.2	
	2001	10.8	43.3	0.0	11.2	4.6	59.1	9.7	6.7	13.7	
Japan	1997	14.8	12.4	0.7	0.0	4.3	17.3	13.3	22.4	32.2	
	1998	14.1	13.2	0.6	0.0	4.3	18.1	13.9	24.0	29.8	
	1999	14.9	13.8	0.6	0.0	5.2	19.6	13.8	21.8	30.0	
	2000	15.6	14.5	0.4	0.0	5.4	20.3	12.3	19.1	32.6	
	2001	15.5	16.6	0.4	0.0	4.9	21.9	12.8	18.3	31.6	
Korea	1997	8.7	7.0	0.6	19.3	0.0	26.9	13.1	20.8	30.5	
	1998	9.7	6.8	0.5	17.8	0.0	25.1	11.6	21.7	31.8	
	1999	10.2	7.4	0.7	20.2	0.0	28.3	10.5	20.8	30.1	
	2000	11.3	8.0	0.8	19.8	0.0	28.6	9.8	18.2	32.0	
	2001	11.2	9.4	0.9	18.9	0.0	29.2	10.6	15.9	33.1	
EU	1997	3.0	2.2	0.8	4.1	0.9	8.1	62.9	9.2	16.8	
	1998	2.9	2.4	0.9	4.3	1.0	8.5	63.2	9.3	16.1	
	1999	2.9	2.6	0.9	4.4	1.1	9.0	62.8	9.3	16.1	
	2000	3.0	3.1	0.9	4.3	1.2	9.4	59.5	9.3	18.8	
	2001	2.8	3.2	0.8	3.7	1.0	8.7	58.9	9.1	20.5	
USA	1997	8.1	7.3	1.2	13.8	2.6	25.0	18.1	0.0	48.8	
	1998	8.0	8.0	1.2	13.2	2.6	25.0	19.3	0.0	47.8	
	1999	7.5	8.3	1.0	12.7	3.1	25.1	19.0	0.0	48.3	
	2000	7.2	8.6	1.0	12.0	3.3	24.8	18.0	0.0	50.0	
	2001	6.6	9.3	0.9	11.0	3.1	24.2	19.2	0.0	50.0	

Source : Calculated from PC-TAS, UN.

Table 9-6 Share of ASEAN -5's Top 10 Products, 1997-2001

Export							
Rank	Code	Product	1997	1998	1999	2000	2001
1	85	Electrical, electronic equipment	27.81	29.26	31.44	33.31	31.19
2	84	Nuclear reactors, boilers, machinery, etc	20.33	21.01	21.61	20.82	20.27
3	27	Mineral fuels, oils, distillation products, etc	8.83	7.35	8.02	10.19	9.40
4	39	Plastics and articles thereof	1.75	1.87	1.99	2.27	2.35
5	99	Commodities not elsewhere specified	2.98	3.34	1.39	0.86	2.14
6	90	Optical, photo, technical, medical, etc apparatus	1.57	1.61	1.56	1.64	2.00
7	44	Wood and articles of wood, wood charcoal	2.98	2.11	2.37	2.04	1.95
8	29	Organic chemicals	1.31	1.33	1.77	1.59	1.91
9	62	Articles of apparel, accessories, not knit or crochet	1.74	1.79	1.84	1.81	1.85
10	15	Animal,vegetable fats and oils, cleavage products, etc	2.53	2.74	2.33	1.63	1.66
Total share of top 10 export			71.82	72.41	74.32	76.15	74.70
Total export			100	100	100	100	100
unit : Million US\$			340,475	315,087	341,319	405,024	363,338
Import							
Rank	Code	Product	1997	1998	1999	2000	2001
1	85	Electrical, electronic equipment	27.72	32.01	32.53	33.46	30.47
2	84	Nuclear reactors, boilers, machinery, etc	20.01	18.92	16.86	17.13	17.66
3	27	Mineral fuels, oils, distillation products, etc	7.91	7.02	8.20	10.99	11.18
4	87	Vehicles other than railway, tramway	3.48	1.73	2.15	2.75	2.85
5	39	Plastics and articles thereof	2.61	2.67	2.82	2.88	2.74
6	29	Organic chemicals	2.24	2.31	2.36	2.42	2.47
7	90	Optical, photo, technical, medical, etc apparatus	2.42	2.45	2.52	2.64	2.42
8	72	Iron and steel	3.32	2.35	2.56	2.40	2.25
9	88	Aircraft, spacecraft, and parts thereof	2.21	2.11	1.88	0.65	1.90
10	73	Articles of iron or steel	1.81	2.15	1.87	1.38	1.61
Total share of top 10 import			73.73	73.72	73.76	76.71	75.56
Total import			100	100	100	100	100
unit : Million US\$			353,598	260,728	282,881	344,608	313,459

Source: PC - TAS, UN.

Table 9-7 Share of Korea's Top 10 Products, 1997-2001

Export							
Rank	Code	Products	1997	1998	1999	2000	2001
1	85	Electrical, electronic equipment	25.01	24.05	26.71	26.91	25.14
2	84	Nuclear reactors, boilers, machinery, etc	10.69	9.74	12.93	17.26	15.66
3	87	Vehicles other than railway, tramway	9.05	8.64	9.15	8.86	10.24
4	89	Ships, boats and other floating structures	4.79	6.06	5.21	4.78	6.45
5	27	Mineral fuels, oils, distillation products, etc	3.93	3.47	4.04	5.44	5.32
6	39	Plastics and articles thereof	4.23	4.26	4.16	4.23	4.41
7	72	Iron and steel	3.65	4.85	3.66	3.46	3.39
8	29	Organic chemicals	2.62	2.51	2.45	2.88	2.77
9	54	Manmade filaments	4.61	3.80	3.21	2.79	2.55
10	60	Knitted or crocheted fabric	1.47	1.45	1.51	1.46	1.65
Total share of top 10 export			70.05	68.84	73.03	78.08	77.58
Total export			100	100	100	100	100
Unit : Million US\$			136,151	132,302	143,685	172,267	150,435
Import							
Rank	Code	Products	1997	1998	1999	2000	2001
1	27	Mineral fuels, oils, distillation products, etc	18.93	19.51	19.10	23.73	24.15
2	85	Electrical, electronic equipment	16.82	20.82	22.82	22.13	20.48
3	84	Nuclear reactors, boilers, machinery, etc	14.03	10.52	11.69	13.01	11.59
4	90	Optical, photo, technical, medical, etc apparatus	4.07	3.70	3.95	4.21	3.95
5	72	Iron and steel	4.31	3.52	3.72	3.73	3.50
6	29	Organic chemicals	3.48	3.64	3.32	3.09	3.17
7	39	Plastics and articles thereof	1.70	1.78	1.87	1.69	1.80
8	71	Pearls, precious stones, metals, coins, etc	4.86	5.05	3.11	1.82	1.65
9	26	Ores, slag and ash	1.21	1.83	1.57	1.31	1.56
10	76	Aluminium and articles thereof	1.44	1.50	1.53	1.33	1.42
Total share of top 10 import			70.85	71.86	72.68	76.04	73.24
Total import			100	100	100	100	100
Unit : Million US\$			144,614	93,281	119,751	160,479	141,097

Source: PC - TAS, UN.

Table 9-8 Share of Japan's Top 10 Products, 1997-2001

Export							
Rank	Code	Products	1997	1998	1999	2000	2001
1	85	Electrical, electronic equipment	22.47	22.18	23.26	25.09	22.41
2	84	Nuclear reactors, boilers, machinery, etc	23.66	22.33	21.16	21.30	20.69
3	87	Vehicles other than railway, tramway	19.01	20.32	20.02	18.64	20.29
4	90	Optical, photo, technical, medical, etc apparatus	6.18	5.95	6.45	7.02	6.87
5	99	Commodities not elsewhere specified	2.65	3.02	3.17	3.51	3.99
6	72	Iron and steel	3.05	3.07	2.72	2.70	2.77
7	29	Organic chemicals	2.61	2.66	2.59	2.48	2.68
8	39	Plastics and articles thereof	2.24	2.17	2.32	2.34	2.32
9	89	Ships, boats and other floating structures	2.34	2.61	2.38	2.14	2.10
10	73	Articles of iron or steel	1.56	1.58	1.29	1.13	1.42
Total share of top 10 export			85.77	85.90	85.37	86.36	85.52
Total export			100	100	100	100	100
unit : Million US\$			421,053	388,136	417,610	479,248	403,364
Import							
Rank	Code	Products	1997	1998	1999	2000	2001
1	27	Mineral fuels, oils, distillation products, etc	18.56	15.43	16.10	20.40	20.16
2	85	Electrical, electronic equipment	10.51	11.22	11.95	13.23	12.77
3	84	Nuclear reactors, boilers, machinery, etc	9.79	10.57	10.69	11.09	10.98
4	90	Optical, photo, technical, medical, etc apparatus	3.31	3.73	3.76	3.63	3.92
5	03	Fish, crustaceans, molluscs, aquatic invertebrates nes	3.78	3.80	3.99	3.37	3.19
6	62	Articles of apparel, accessories, not knit or crochet	2.69	2.72	2.82	2.74	2.94
7	44	Wood and articles of wood, wood charcoal	4.46	3.27	3.49	2.97	2.82
8	87	Vehicles other than railway, tramway	3.20	2.91	2.91	2.73	2.81
9	29	Organic chemicals	2.20	2.26	2.36	2.13	2.31
10	61	Articles of apparel, accessories, knit or crochet	2.03	2.30	2.22	2.16	2.22
Total share of top 10 import			60.51	58.22	60.29	64.45	64.12
Total import			100	100	100	100	100
unit : Million US\$			338,842	280,634	309,994	379,663	349,300

Source: PC - TAS, UN.

Table 9-9 Share of China's Top 10 Products, 1997-2001

Export

Rank	Code	Products	1997	1998	1999	2000	2001
1	85	Electrical, electronic equipment	13.43	14.66	16.90	18.49	19.28
2	84	Nuclear reactors, boilers, machinery, etc	7.50	9.07	9.82	10.76	12.62
3	62	Articles of apparel, accessories, not knit or crochet	9.26	8.47	7.99	7.57	7.12
4	61	Articles of apparel, accessories, knit or crochet	6.41	6.28	6.03	5.39	5.06
5	64	Footwear, gaiters and the like, parts thereof	4.67	4.56	4.45	3.95	3.79
6	95	Toys, games, sports requisites	4.11	4.22	3.95	3.69	3.41
7	27	Mineral fuels, oils, distillation products, etc	3.82	2.82	2.39	3.15	3.16
8	94	Furniture, lighting, signs, prefabricated buildings	2.08	2.35	2.77	2.82	2.84
9	42	Articles of leather, animal gut, harness, travel goods	3.05	2.86	2.69	2.64	2.63
10	39	Plastics and articles thereof	2.65	2.81	2.63	2.56	2.52
Total share of top 10 export			57.00	58.10	59.62	61.02	62.43
Total export			100	100	100	100	100
unit : Million US\$			182,792	183,809	194,931	249,203	266,098

Import

Rank	Code	Products	1997	1998	1999	2000	2001
1	85	Electrical, electronic equipment	15.45	18.80	21.27	22.54	22.94
2	84	Nuclear reactors, boilers, machinery, etc	17.40	17.56	16.80	15.30	16.64
3	27	Mineral fuels, oils, distillation products, etc	7.27	4.84	5.39	9.19	7.19
4	39	Plastics and articles thereof	7.16	7.46	7.01	6.42	6.26
5	72	Iron and steel	4.26	4.17	4.32	4.25	4.50
6	90	Optical, photo, technical, medical, etc apparatus	2.56	2.84	3.03	3.23	4.01
7	29	Organic chemicals	2.14	2.48	3.32	3.69	3.67
8	74	Copper and articles thereof	1.52	1.59	1.86	2.07	2.01
9	88	Aircraft, spacecraft, and parts thereof	2.27	2.26	1.92	0.96	1.87
10	87	Vehicles other than railway, tramway	1.33	1.43	1.43	1.60	1.86
Total share of top 10 import			61.35	63.42	66.33	69.26	70.96
Total import			100	100	100	100	100
unit : Million US\$			142,370	140,237	165,699	225,094	243,553

Source: PC - TAS, UN.

Table 9-10 Share of Hong Kong's Top 10 Products, 1997-2001

Export							
Rank	Code	Products	1997	1998	1999	2000	2001
1	61	Articles of apparel, accessories, knit or crochet	15.95	18.93	20.79	20.58	22.89
2	62	Articles of apparel, accessories, not knit or crochet	17.87	20.15	21.69	21.28	22.36
3	85	Electrical, electronic equipment	21.06	18.43	17.39	20.17	17.34
4	71	Pearls, precious stones, metals, coins, etc	2.74	3.84	5.51	5.38	6.46
5	90	Optical, photo, technical, medical, etc apparatus	5.41	6.42	6.63	7.07	5.93
6	84	Nuclear reactors, boilers, machinery, etc	5.66	4.99	4.86	4.14	3.57
7	52	Cotton	3.08	3.14	3.42	3.12	3.31
8	39	Plastics and articles thereof	3.17	2.91	2.54	2.61	2.44
9	49	Printed books, newspapers, pictures etc	1.83	1.69	1.75	1.79	1.83
10	48	Paper & paperboard, articles of pulp, paper and board	1.78	1.74	1.41	1.63	1.71
Total share of top 10 export			78.54	82.25	86.01	87.77	87.85
Total export			100	100	100	100	100
unit: Million US\$			27,307	24,587	22,381	23,537	20,273
Import							
Rank	Code	Products	1997	1998	1999	2000	2001
1	85	Electrical, electronic equipment	23.65	23.66	24.92	28.36	28.00
2	84	Nuclear reactors, boilers, machinery, etc	10.76	11.55	11.82	12.45	13.23
3	39	Plastics and articles thereof	4.36	4.45	4.64	4.71	4.23
4	90	Optical, photo, technical, medical, etc apparatus	2.81	3.03	3.30	3.44	4.09
5	61	Articles of apparel, accessories, knit or crochet	3.08	3.58	3.99	3.68	4.08
6	71	Pearls, precious stones, metals, coins, etc	4.37	3.27	3.51	3.62	3.67
7	62	Articles of apparel, accessories, not knit or crochet	3.48	3.60	3.69	3.31	3.40
8	95	Toys, games, sports requisites	3.09	3.36	3.62	3.54	3.27
9	64	Footwear, gaiters and the like, parts thereof	3.47	3.11	2.95	2.65	2.55
10	27	Mineral fuels, oils, distillation products, etc	1.93	1.71	2.04	2.12	2.00
Total share of top 10 import			61.00	61.33	64.46	67.88	68.52
Total import			100	100	100	100	100
Unit: Million US\$			213,300	186,759	180,711	214,042	202,008

Source: PC - TAS, UN.

Table 9-11 Export Similarity Index

	NEA		China		Hong Kong		Japan		Korea		ASEAN-6		Indonesia		Malaysia		Philippines		Singapore		Thailand	
	1996	2001	1996	2001	1996	2001	1996	2001	1996	2001	1996	2001	1996	2001	1996	2001	1996	2001	1996	2001	1996	2001
NEA	100.0	100.0	44.9	57.2	31.6	25.9	74.5	69.3	54.4	58.0	43.6	47.9	21.1	29.2	31.4	37.0	26.2	27.7	42.2	40.0	36.6	42.6
China	44.9	57.2	100.0	100.0	32.0	26.3	25.0	29.4	28.0	35.8	37.4	41.9	28.2	33.5	27.5	31.8	23.7	25.2	28.0	31.8	35.4	39.6
Hong Kong	31.6	25.9	32.0	26.3	100.0	100.0	24.0	19.2	19.6	18.1	29.7	24.9	14.5	16.2	24.7	20.5	23.4	18.9	28.4	23.0	28.6	23.1
Japan	74.5	69.3	25.0	29.4	24.0	19.2	100.0	100.0	41.7	46.4	34.9	35.7	11.2	17.2	27.0	30.5	19.9	20.8	39.5	35.4	27.2	30.1
Korea	54.4	58.0	28.0	35.8	19.6	18.1	41.7	46.4	100.0	100.0	32.7	40.3	16.9	22.5	24.6	36.3	24.4	26.6	33.5	41.5	26.8	35.4
ASEAN-6	43.6	47.9	37.4	41.9	29.7	24.9	34.9	35.7	32.7	40.3	100.0	100.0	37.6	41.5	62.0	68.0	36.1	45.3	64.0	61.2	54.7	54.5
Indonesia	21.1	29.2	28.2	33.5	14.5	16.2	11.2	17.2	16.9	22.5	37.6	41.5	100.0	100.0	27.6	31.6	17.1	19.1	17.0	18.9	24.5	29.1
Malaysia	31.4	37.0	27.5	31.8	24.7	20.5	27.0	30.5	24.6	36.3	62.0	68.0	27.6	31.6	100.0	100.0	31.0	39.3	45.3	48.8	37.5	41.1
Philippines	26.2	27.7	23.7	25.2	23.4	18.9	19.9	20.8	24.4	26.6	36.1	45.3	17.1	19.1	31.0	39.3	100.0	100.0	30.0	37.7	29.5	31.0
Singapore	42.2	40.0	28.0	31.8	28.4	23.0	39.5	35.4	33.5	41.5	64.0	61.2	17.0	18.9	45.3	48.8	30.0	37.7	100.0	100.0	38.7	36.0
Thailand	36.6	42.6	35.4	39.6	28.6	23.1	27.2	30.1	26.8	35.4	54.7	54.5	24.5	29.1	37.5	41.1	29.5	31.0	38.7	36.0	100.0	100.0

Source : Calculated from PC-TAS, UN.

Table 9-12 Intra Industry Trade Index of Thailand, average 1997-2001

	China	Hong Kong	Japan	Korea	Indonesia	Malaysia	Philippines	Singapore
ISIC 1	0.08	0.00	0.03	0.02	0.19	0.03	0.02	0.02
ISIC 2	0.62	0.00	0.00	0.00	3.72	0.04	0.00	0.01
ISIC 31	0.27	0.02	0.15	0.09	0.18	0.32	0.26	0.21
ISIC 32	1.15	0.65	0.30	0.60	0.40	0.25	0.13	0.41
ISIC 33	0.11	0.01	0.09	0.01	0.01	0.15	0.01	0.03
ISIC 34	0.10	0.13	0.08	0.09	0.49	0.15	0.04	0.13
ISIC 35	1.38	0.56	1.73	1.56	2.25	2.06	1.20	4.26
ISIC 36	0.12	0.01	0.37	0.06	0.10	0.28	0.04	0.06
ISIC 37	0.39	0.20	0.52	0.07	0.20	0.60	0.02	0.34
ISIC 38	16.06	3.02	15.78	16.92	2.38	29.09	31.04	29.70
ISIC 39	0.09	0.53	0.58	0.15	0.00	0.12	0.01	0.01

Source : Calculated from PC-TAS, UN.

Table 9-13 Intra Industry Trade Index of ASEAN-6, average 1997-2001

	China	Hong Kong	Japan	Korea
ISIC 1	0.11	0.00	0.03	0.01
ISIC 2	1.57	-	0.01	0.02
ISIC 31	0.90	0.66	0.17	0.08
ISIC 32	1.19	0.68	0.25	0.77
ISIC 33	0.27	0.02	0.11	0.05
ISIC 34	0.31	0.19	0.26	0.13
ISIC 35	2.48	0.74	1.66	4.81
ISIC 36	0.27	0.01	0.25	0.19
ISIC 37	0.80	0.15	0.48	1.01
ISIC 38	20.66	7.02	20.42	22.87
ISIC 39	0.21	0.54	0.53	0.14

Source : Calculated from PC-TAS, UN.

Table 9-14 Foreign Direct Investment, net inflows (%)

	1975	1980	1985	1990	1995	1998	1999	2000	2001
USA	10.98	29.54	36.10	24.15	17.78	26.13	26.70	21.00	17.50
NAFTA	28.10	43.33	42.13	29.20	23.58	31.19	30.11	26.48	24.49
EU-15	42.25	37.10	28.57	48.39	35.91	37.90	46.19	54.49	47.61
ASEAN-10	5.58	4.25	4.01	6.05	7.30	2.91	1.99	0.75	1.76
China	..	..	2.99	1.74	11.03	6.39	3.58	2.62	5.92
Hong Kong	..	..	..	..	..	2.16	2.27	4.23	3.06
India	0.36	0.14	0.19	0.12	0.66	0.38	0.20	0.16	0.46
Japan	..	0.49	1.15	0.89	0.01	0.48	1.14	0.56	0.83
Korea	..	0.01	0.42	0.39	0.55	0.79	0.86	0.63	0.43
World	100	100	100	100	100	100	100	100	100

Source : World Development Indicators, World Bank. 2003.

Table 9-15 Effect on economic Welfare of various regional trade agreements
% of annualGDP (% of GDP excluding agricultural liberalization)

Agreement	ASEAN	China	Korea	Japan	USA
China+Korea+Japan	-0.26 (-0.16)	+0.1 (-0.2)	+1.0 (+0.6)	+0.1 (+0.2)	+0.0 (+0.0)
ASEAN-China	+0.9 (+0.5)	+0.0 (+0.1)	-0.1 (-0.1)	+0.0 (+0.0)	+0.0 (+0.0)
ASEAN-Japan	+1.1 (+0.2)	-0.1 (-0.1)	-0.2 (-0.1)	+0.0 (+0.1)	+0.0 (0.0)
ASEAN+3	+1.5 (+0.6)	+0.1 (-0.2)	+1.1 (+0.8)	+0.2 (+0.2)	-0.1 (+0.0)
ASEAN+3+CER	+1.3 (+0.6)	+0.0 (-0.1)	+1.1 (+0.9)	+0.2 (+0.2)	-0.1 (+0.0)

Source : R. Scollay and J. Gilbert (2001)

10. The East Asian Free Trade Agreement – An ASEAN Perspective¹

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1. Introduction

It has been slightly more than a decade since the concept of the East Asia Economic Group (EAEG) was first mooted by Malaysia's Prime Minister. It was originally conceived of as an informal regional organisation to serve as a loose consultative forum where East Asian economies consult each other on issues of common concern as and when the need arises. It was also meant to serve as a defensive strategy to counter the creation of a single Europe and the North America Free Trade Area (NAFTA), as well as to lobby for ASEAN interests in the then ongoing Uruguay Round of the GATT negotiation. At the time, the East Asian economies were growing at a very rapid rate of 8.1 per cent per annum on the average (between 1987-91), such that the region had eventually assumed a new role as the regional grouping consisting of some of the most dynamic economies in the world. This growth performance even surpassed those of the developed economies and other parts of the developing world. The NIEs of the East Asian economies had achieved an average annual growth of 8.3 per cent, roughly three times the growth rate of the world economy at 2.9 per cent while ASEAN's growth rate, excluding the Philippines, was 6.9 per cent, more than

¹ An earlier version of this paper was presented at the International Conference on the Prospects for an East Asia Free Trade Agreement, organised by the Korea Institute for International Economic Policy, September 27, 2002. the Fifth China-ASEAN Research Institutes Round Table, organised by Centre of Asian Studies, University of Hong Kong, October 2002 and International Conference on East Asian Cooperation: Searching for an Integrated Approach organised by the Institute of Asia-Pacific Studies (EAPS), CASS and Centre for APEC and East Asia Cooperation, Beijing, September 2003.

In this paper, East Asia includes China, Japan, South Korea, Taiwan, Province of China (POC) and the ten ASEAN member countries.

twice the growth of the world economy. This phenomenal growth performance continued until the Asian economic crisis struck the region in mid-1997.

Rapid growth in the region's economies had been matched and reinforced by their strong trade performance which was characterised by its increasing contribution to world trade, as well as intra-regional trade. Intra-East Asian trade, for example, had grown rapidly from US\$196.4 billion in 1987 (a year after the 1985-86 recession) to US\$405.4 billion in 1991, thus registering a growth of 106 per cent. Meanwhile, exports from the NIEs as a whole, grew 73 per cent, while their exports to the ASEAN countries grew by 125 per cent. Total trade between ASEAN and NIEs increased by 156 per cent, while Japan trade with ASEAN increased by 85 per cent. Intra-ASEAN trade, in the absence of AFTA which was launched later in 1993, expanded by 114 per cent over the same years. This phenomenal growth, much higher than the world average of 46.9 per cent was testimony to the increasing economic linkages between the East Asian economies. The degree of East Asian economic interdependence was further enhanced by the increasing flow of foreign direct investment (FDI), technology and labour into, and among, countries in the region. All these processes evolved without being based on any co-operation framework of any kind, regional or bilateral, and was completely market driven.

These developments have led to the rapid emergence of regional production networks. The enhanced trade integration that had already been achieved by the region's economies created further pressures for regional policy co-ordination, especially in those areas that would facilitate even further trade integration in the region. These policies that would enable the regional process to develop further, extend well beyond trade liberalisation. In short, regionalisation in East Asia had created the need for a regional policy framework that would maintain the momentum of regionalisation, and hence Malaysia's EAEG proposal.

However, the proposal was met with intense objection and criticism, and was a source of extreme controversy. Critics of the initiative² argued that the EAEG proposal threatened to “divide the Pacific region in half,” and that politically and economically, it was not feasible. Supporters of the proposal which included former Japanese foreign minister, on the other hand, argued that EAEG would “counter balance emerging organisations in Europe and North America and improve the bargaining positions of Asian countries”. Many Japanese business leaders also criticised the sharp repudiation of the EAEG idea, especially by the US, by pointing out that “the United States was in fact drawing a line down the Pacific by signing the NAFTA”. It was only after a lengthy debate and intense exchanges between the opposing sides that the proposal was later accepted, albeit after being substantially reshaped, diluted and renamed as the East Asian Economic Caucus (EAEC). The EAEC, later accepted as a caucus within APEC, had in effect been kept in the doldrums since then by the latter.

The re-emergence of the idea of creating some form of regional economic co-operation among East Asian economies arguably, came about in the aftermath of the Asian crisis. It was only after this that the EAEC idea began to be taken more seriously. First, there was the Chiang-Mai Initiative of ASEAN+3³ which mainly involved regional financial co-operation between and among members of ASEAN, China, Japan and Korea. As a result, to date, at least twelve bilateral swap arrangements (BSAs) between China, Japan and Korea and several of the ASEAN members has been concluded and signed with a combined size of US\$31.5 billion. Four more BSAs are being negotiated. Following this, there was an offer from China’s Premier Zu Rongji of a Free Trade Agreement between China and ASEAN (ASEAN-China FTA) to be effective in 10 years time. This offer is of great historical significance and importance, as well as an

² See Harry Harding, "International Order and organisation in the Asia-Pacific Region," Robert S. Ross (ed.) *East Asia in Transition: Towards a New Regional Order*, Institute of South East Asian Studies (ISEAS), Singapore, 1995

³ This initiative was the result of a meeting between the ASEAN Finance Minister and Finance Ministers of China, Japan and Republic of South Korea in Chiang Mai, Thailand on 6 May 2000.

unprecedented political move by China to signal its desire for a long term friendship and economic co-operation with ASEAN⁴.

China's offer has sparked a round of similar offers by other major East Asian economies. For example, the ASEAN-China FTA has sparked intense discussion in Japan on ways to strengthen its own links with ASEAN, and not to be left behind, it proposed an initiative for a ASEAN-Japan Comprehensive Economic Partnership (Japan-ASEAN CEP)⁵. South Korea has also signalled an interest in establishing closer links with ASEAN. At the ASEAN Summit in Brunei, President Kim Dae-Jung agreed to set up a study group to review a possible ASEAN-ROK FTA. The Report of the East Asian Vision Group, an initiative launched by President Kim recommended several "key proposals and concrete measures to broaden East Asia co-operation. These include the proposal for the establishment of the East Asia Free Trade Area, and the liberalisation of trade well ahead of the APEC goals"⁶. In order to promote this initiative further, a proposal was made at the 5th ASEAN+3 Summit to establish an ASEAN+3 secretariat. To signal its support, there was an offer by Malaysia to host the secretariat in Kuala Lumpur, and to meet its expenses for the first three years of its operation.

⁴ The agreement to form ASEAN-China FTA was signed by ASEAN member countries and China at the ASEAN Summit at Phnom Penh, Cambodia, 2002. "The Agreement shall commence in early 2003 and be concluded by 30 June 2004 in order to establish the ASEAN-China FTA covering trade in goods by 2010 for Brunei, China, Indonesia, Malaysia, the Philippines, Singapore and Thailand, and by 2015 for the newer ASEAN Member States". See *Framework Agreement on Comprehensive Economic Cooperation between the Association of South East Asian Nations and the People's Republic of China*.

⁵ The objective is "... that the implementation of measures for the realisation of the partnership, including elements of a possible free trade area, should be completed as soon as possible within 10 years..." See *Joint Declaration of the Leaders of ASEAN and Japan on the Comprehensive Economic Partnership*, ASEAN-Japan Summit, 5 November 2002.

⁶ Subsequently, the East Asian Study Group (EASG) was established to assess the recommendation of the EAVG. In its final report, the EASG strongly supported the EAVG proposal "to form an EAFTA well-ahead of the Bogor Goal of trade liberalisation set by APEC". See *Final Report of the East Asian Study Group*, ASEAN Secretariat Jakarta, 2002.

A more recent initiative is the creation of the *East Asia Community of Cooperative Peace and Prosperity* proposed by Malaysia's Prime Minister, Mahathir Mohamed at the First East Asian Congress in Kuala Lumpur on August 2003.

At the same time, a number of individual ASEAN economies are pursuing bilateral trade agreements with the north-east Asian countries, Japan, China and Korea, Singapore, for example, had signed a Closer Economic Partnership Agreement with Japan in January 2002. Thailand has conducted a joint Study with South Korea looking into the feasibility of forming an FTA between the two economies and it has also agreed to set-up a joint task force to study how to promote closer economic cooperation with Japan. Even Malaysia, which was strongly critical of the trend towards bilateral FTA, is now in negotiations with Japan to form an Economic Partnership Agreement.⁷

Against this background, some questions immediately comes to mind. First, what exactly triggered off this new interest in the East Asia economic co-operation, something that was deemed not feasible in 1990, but that suddenly became a matter of significant concern to countries in the region? Second, what are the new circumstances and challenges that caused this turn-around in policy stance and direction? Third, what would be the most appropriate architecture, principles and modalities of the proposed EAFTA? These are some of the crucial questions that this paper attempts to address mainly from the perspectives of the ASEAN member countries.

This paper is organised as follow. The next section will highlight some of the major features of the ASEAN economies with special emphasis on its economic relationship with the East Asian countries, China, Japan and Korea. Given the current and potential challenges and circumstances facing the ASEAN member countries, it is argued that it will make good economic sense for ASEAN countries to establish a framework agreement to strengthen its economic co-operation with the three East Asian economies. The next section will discuss the possible architecture of the proposed regional economic co-operation framework which focus, among others, on the modalities, principles and scope of the

⁷ See Christopher Findley, Mohd Haflah Piei and Mari Pangestu, *Trading with Favourites: Risks, Motives and Implications of FTAs in the Asia Pacific*. Paper prepared for the Workshop on Trade Policy Issues in East Asia, Australia National University, Canberra March 2003 and at the Centre for Strategic and International Studies, Jakarta, March 2003.

proposed initiative. This is to be followed by a discussion on the merits and demerits of the proposed initiatives. The last section will summarise some of the major policy implications of this paper.

2. The ASEAN Economy

The ASEAN region has a population of about 0.5 billion, a total area of 4.5 million square kilometres, a combined gross national product of about US\$570 billion and a total trade of about US\$780 billion in the year 2000. In terms of its total GDP, it is about 11.9 per cent and 52.5 per cent of those of Japan and China respectively, and about 25 per cent higher than Korea's GDP in year 2000. As for its growth rate, the region has definitely done comparatively well, if not better, than those registered by the three East Asian economies. The average annual growth rate for all the ASEAN member countries, with the exception of the Philippines, had been well above 5 per cent during the period just before the ASEAN crisis struck the region. Growth was badly affected by the crisis with most countries in the region, particularly in Indonesia, Thailand and Malaysia, and to a lesser extent Philippines and Singapore which were registering negative or very low growth during the two years following the crisis, i.e. 1998 and 1999. Since then, most economies have shown sustainable recovery although they are still well below their pre-crisis levels.

With regards to its GNP per capita, it is quite diverse and may be categorised into three groups of economies with Singapore and Brunei in the highest per capita income group. The four new member of ASEAN (Cambodia, Lao PDR, Myanmar and Vietnam) are in the lowest income group with per capita income of less than US\$300, while the remaining countries (Malaysia, Thailand, Philippines and Indonesia) constitute the middle income group with per capita income ranging from US\$680 in the case of Indonesia to about US\$3,600 in the case of Malaysia (Table 10-1).

Table 10-1 Basic Economic Indicators of East Asian Countries

Country	Population (million) 1998	GDP annual growth rate 1990-2000	GNP/kapita (US\$1998)	GDP (US\$ billion) (2002)	Inflation (2000, %)	Current account (% of GDP, 2001)	Unemployment (%)
Japan	126.3	1.3	32380.0	4746.0	-0.7	2.2	5.0
Korea	46.4	5.7	7970.0	457.0	3.4	1.0	3.7
China	1238.6	10.3	750.0	1080.0	1.5	2.6	n.a
ASEAN							
Brunei	0.3	n.a	21962.0	n.a	2.1	71.2	4.3
Indonesia	203.7	5.8	680.0	153.0	10.8	3.2	6.1
Malaysia	22.2	7.7	3600.0	90.0	1.3	7.3	3.9
Philippines	75.1	3.3	1050.0	75.0	6.5	6.4	11.2
Singapore	3.2	8.0	30060.0	92.0	1.5	21.0	3.2
Thailand	61.1	7.4	2200.0	122.0	2.5	4.4	3.6
Cambodia	10.7	5.5	280.0	3.1	n.a	n.a	7.4
Lao PDR	5.0	6.7	180.0	1.7	27.1	n.a	7.3
Myanmar	44.4	6.3	n.a	n.a	10.3	n.a	7.1
Vietnam	77.6	8.6	180.0	31.0	4.3	1.3	7.4
ASEAN +3	1914.6	-	-	6868.1			

Source: ASEAN Secretariat

Most of the ASEAN economics, particularly with regard to the original six member countries of ASEAN, (ASEAN 6) are generally open economies which are outward-oriented and trade dependent. This is shown by the high total trade to GDP ratios (Table 10-2).

Table 10-2 Trade Dependencies Ratio, 1996-1999

Country	1996	1997	1998	1999
Brunei	1.328	0.985	0.770	0.909
Indonesia	0.442	0.460	0.798	0.514
Malaysia	1.485	1.540	1.903	1.872
Philippines	0.583	0.743	0.903	0.858
Singapore	2.648	2.797	2.572	2.691
Thailand	0.703	0.800	0.788	0.855

ASEAN's trade registered modest increment over the 1995-2000 period growing at the rate of 4.0 per cent per annum, compared to 17.3 per cent and 15.5 per cent over the 1980-90 and 1990-95 periods. The share of total ASEAN trade in world trade had increased to about 6 per cent during the 1995-1999 period from a level about 3.5 per cent during the 1980-90 period (Table 10-3). ASEAN as a region is more of an exporter to the world rather than an importer, inasmuch as its trade balance with the world has mostly been positive. This trend has been more distinctive in the years after the crisis due to import suppression and/or export enhancing policies that the crisis-affected economies implemented.

Together with the three East Asian countries Japan, Korea and China, the East Asian regional shares of world total trade had increased rapidly from 12.8 per cent in 1980 to 17.8 per cent in 1999. This regional trade share is slightly higher than those of the US, but is only half of EEC share of 37.9 per cent in 1999 (Table 10-3). Another interesting trend has been that the region is fast becoming an important source of world export where the regional export share had increased from 13.0 to 20.0 per cent of world exports (Table 10-4) and its trade balance had been showing an increasing surplus during the same time period.

Table 10-3 Total Trade of East Asian Economics, the US and EEC

(US\$ billion, %)

	1980		1985		1990		1995		1999	
	(US billion)	(%)	(US billion)	(%)	(US billion)	(%)	(US billion)	(%)	(US billion)	(%)
World	3751232	100.0	3850429	100.0	6898949	100.0	10208754	100.0	11473636	100.0
United State	477740	12.7	574767	14.9	910126	13.2	1354423	13.3	1739124	15.2
EEC	1595103	42.5	1432805	37.2	3027329	43.9	3932463	38.5	4352347	37.9
Japan	271719	7.2	307705	8.0	522985	7.6	779074	7.6	729940	6.4
Korea	39502	1.1	61347	1.6	142217	2.1	260940	2.6	263387	2.3
China	37644	1.0	69809	1.8	116569	1.7	281118	2.8	360649	3.1
Singapore	39390	1.1	50806	1.3	120266	1.7	215462	2.1	232191	2.0
ASEAN 9	92686	2.5	89691	2.3	193902	2.8	440163	4.3	452682	3.9
ASEAN +3	480941	12.8	579358	15.0	1095939	15.9	1976756	19.4	2038849	17.8

Note: Figures in percentage represents total share in world trade

Table 10-4 Export of the World, East Asia, the US and EEC**(US\$ billion, %)**

	1980		1985		1990		1995		1999	
	(US billion)	(%)	(US billion)	(%)	(US billion)	(%)	(US billion)	(%)	(US billion)	(%)
World	1832508	100.0	1874505	130.8	3381690	111.7	5070827	128.9	5663310	130.1
United State	220781	13.8	213146	14.9	393106	13.0	583451	14.8	690680	15.9
EEC	751159	47.1	708197	49.4	1488305	49.2	2018290	51.3	2208491	50.7
Japan	130435	8.2	177189	12.4	287678	9.5	443047	11.3	419207	9.6
Singapore	19377	1.2	22812	1.6	52753	1.7	118187	3.0	114730	2.6
Korea	17439	1.1	30289	2.1	67812	2.2	125588	3.2	143647	3.3
ASEAN 9	52169	3.3	49692	3.5	91612	3.0	204417	5.2	255046	5.9
China	18139	1.1	27329	1.9	62760	2.1	148955	3.8	194931	4.5
ASEAN +3	237559	14.9	307311	21.4	562615	18.6	1040194	26.5	1127561	25.9

Note: Figures in percentage represents total share in world export.

Table 10-5 Import of the World, East Asia, the US and EEC**(US\$ billion, %)**

	1980		1985		1990		1995		1999	
	(US billion)	(%)	(US billion)	(%)	(US billion)	(%)	(US billion)	(%)	(US billion)	(%)
World	1918724	100.0	1975924	100.0	3517259	100.0	5137927	100.0	5810326	100.0
United State	256959	13.4	361620	18.3	517020	14.7	770972	15.0	1048435	18.0
EEC	843944	44.0	724609	36.7	1518964	43.2	1914173	37.3	2143856	36.9
Japan	141284	7.4	130516	6.6	235307	6.7	336027	6.5	310733	5.3
Korea	22063	1.1	31058	1.6	74405	2.1	135352	2.6	119740	2.1
China	19505	1.0	42480	2.1	53809	1.5	132163	2.6	165718	2.9
Singapore	24013	1.3	26237	1.3	60954	1.7	124394	2.4	111071	1.9
ASEAN 9	40525	2.1	39999	2.0	53809	1.5	235746	4.6	197636	3.4
ASEAN +3	247390	12.9	270290	13.7	478284	13.6	963682	18.8	904898	15.6

Note: Figures in percentage represents total share in world import

East Asia, United States (US) and European Union remained the major trading partners of ASEAN in 2000. They accounted for almost 60 per cent of the total global trade of ASEAN with East Asia being the largest trading partners of ASEAN contributing about 30.5 per cent well above the US and EU shares of 16.6 and 12.3 per cent respectively. Table 6 indicates the relative position of ASEAN with respect to other selected regional arrangements.

Table 10-6 Global Trade of ASEAN Countries in 2000

(US\$ billion)

	East Asia	USA	EU	Taiwan	Hong Kong	R.OW	Total Global
Singapore	55.8	44.0	33.5	14.2	14.4	110.7	272.6
Malaysia	79.1	33.8	22.3	8.4	6.7	30.2	180.5
Thailand	35.4	22.2	17.3	5.4	4.3	47.5	132.1
Indonesia	29.7	11.8	8.5	3.6	1.8	40.2	95.9
Philippines	28.0	16.6	9.8	4.8	3.1	7.2	69.5
Vietnam	9.9	1.1	4.1	2.7	0.9	10.3	29.0
Cambodia	0.4	0.5	0.3	0.3	-	1.5	3.0
Lao PDR	0.1	Neg.	0.1	Neg	Neg.	0.3	0.4
Total	238.4	130.0	95.9	39.4	31.2	247.9	782.7
Percentage of Global Trade	30.5	16.6	12.3	5.0	4.0	31.7	100.0

3. ASEAN-East Asian Trade Relations

In 2000 ASEAN-East Asian total trade amounted to about US\$200 billion (approximately 30.5 per cent of ASEAN global trade), growing by about 30 per cent since 1993 when the amount of ASEAN-East Asian trade was about US\$150 billion. Roughly 56.5 per cent of ASEAN total trade with the East Asian economies were contributed by Japan, another 30 per cent by China, and the remaining 20 per cent by Korea. (Table 7)

On the export side, ASEAN exports to the three East Asian economies had expanded by more than two-fold from about US\$41.6 billion in 1993 to US\$99.9

billion in 2000. China has been the fastest growing export market for ASEAN followed by Korea and Japan. In 1993, ASEAN exported only US\$4.5 billion to China (or equivalent to 1.8 per cent of ASEAN global export), but by year 2000, ASEAN exports to China had increased by about 7.5 times to about US\$33.8 billion. Similarly, ASEAN's proportion of China's total imports too has been showing rapid increase from 6 per cent in 1991 to 9.9 per cent in 2000 (Table 7).

On the import side, ASEAN imports from the East Asian countries had remained at around US\$100 billion per year between 1993-2000 except for 1998 and 1999 when it contracted significantly to about US\$67.1 billion and US\$75 billion, respectively, during the crisis years. The balance of trade between ASEAN and the three East Asian countries a group has always been negative, increasing rapidly in 1997 from -US\$28 billion in 1993 to a peak of -US\$37.8 billion in 1997, before it dropped sharply to -US\$15.4 billion, -US\$7.6 billion and -US\$0.9 billion during the three years after the crisis struck the region (Table 7). This has been mainly due to export expansion, as well as import suppression policies implemented by the crisis-hit countries in ASEAN.

The biggest trade deficit registered by ASEAN has been its trade with those of Japan, and to a lesser extent, Korea. Trade balance with China however has been registering positive amounts in the last three year since the crisis. However, with rapid recovery taking place in ASEAN, it is to be expected that the trade balance with the East Asian economies would worsen, particularly trade balance with Japan. This may have some critical bearings on the effort to establish a free trade area in the region in the sense that the initiative must not worsen ASEAN trade balance vis-à-vis the East Asian economies.

4. The Structure of ASEAN-East Asian Trade

In the early 1990s, the top five ASEAN export to East Asian countries were electrical equipment, oil and fuel, computer, machinery, wood, and fish products. Together they form 75.7 per cent, 72.2 per cent and 67.7 per cent of ASEAN exports to China, Korea and Japan. By 2000, the share of the top five products in

the export of ASEAN had slightly changed where there had been a slight reduction in the share to about 70 per cent in the case of China and increase to about 77.9 per cent and 71.34 in the case of Korea and Japan respectively. These indicate that ASEAN export had become more diversify whereas the export to Korea and Japan had become more specialised and concentrated.

Another feature observed in the ASEAN export pattern of the three East Asian economies was that the order of importance of its export items had changed quite distinctively, away from commodities and more towards manufactured products. For instance, in the case of ASEAN exports to China, 'lubricant and fuel', 'wood', as well as 'fats and oils' were the top three export of ASEAN. Together they contributed 63.3 per cent towards ASEAN's exports to China. By 2000, their export shares had sharply contracted to only 17.7 per cent. Their positions were taken over by computers/machinery and electrical equipment, which collectively amounted to 48.4 of all ASEAN exports to China. (Table 8a) A similar shift in the pattern of ASEAN exports to Japan and Korea can also be observed, with the exception of 'lubricants, fuel and oil' which still remains the top ASEAN export to Korea, and ASEAN's second most important export item to Japan. This situation will remain for a longer time considering that Japan and Korea are lacking in these natural resources.

With the exception of Japan, ASEAN imports from East Asia can be said to be more diversified than its exports, based on the share of the top 10 or top 5 of ASEAN's import items from the three economies. In 1993, ASEAN's top 5 import items, together, contributed about 36 per cent and 55.6 per cent toward ASEAN total imports from China and Korea, respectively, compared to 74.3 per cent in the case of Japan. By 2000, ASEAN imports from these countries have become less diversified with the share of the top five import items increasing to 56.8 per cent, 70.2 per cent and 75.54 per cent of ASEAN imports from China, Korea and Japan, respectively.

Table 10-7 ASEAN Trade with Japan, China and Korea**(US\$ million)**

	1993			1994			1995			1996		
	Expt	Imp	B of Tr	Expt	Imp	B of Tr	Expt	Imp	B of Tr	Expt	Imp	B of Tr
China	4529	4326	193	5304	5759	-455	6201	7130	-922	7474	9218	-1744
Japan	30952	55703	-27751	34300	67302	-33002	42681	78535	-35864	43150	73310	-30160
Korea	6126	7148	-1022	7005	9036	-2031	8574	11346	-2772	9446	13294	-3848
Total	41607	108794	-28580	46609	82097	-35488	57456	97011	-39548	60070	95822	-35752

	1997			1998			1999			2000		
	Expt	Imp	B of Tr	Expt	Imp	B of Tr	Expt	Imp	B of Tr	Expt	Imp	B of Tr
China	9168	13482	-4314	9204	11212	-2008	26407	19184	7223	33783	24985	8798
Japan	42009	71264	-29263	34717	46693	-11976	37629	51244	-13615	51982	61404	-9422
Korea	10668	14857	-4189	7813	9267	-1454	10878	12110	-1232	14145	14471	-356
Total	61845	99603	-37766	51734	67172	-15438	74914	65338	-7624	99910	100860	-950

Source: Asean Secretariat, Jakarta.

The above shifting pattern in ASEAN trade relations with the three East Asian economies implies the increasing extent of intra-industry trade with the region and the emergence of a regional production network. This phenomenon is more distinctive in the case of ASEAN's trade with Japan where electrical equipment, computer and machinery together contributed more than 70 per cent of ASEAN exports to, and imports from, Japan. In the case of ASEAN-China and ASEAN-Korea, trade in these products are also high, but they do not reflect a strong regional production network emerging among ASEAN, China and Korea. Most of the machinery and electrical appliances exported by China to ASEAN are those for general or special uses. On the other hand, a substantial part of the machinery and electrical appliances that China imports from ASEAN are electronic components and devices. For example, of the US\$2.88 billion worth of machinery and electrical appliances that China imports from Malaysia, more than half of them were kinescope, transistors and integrated circuits, and more than 40 per cent were machinery and electrical appliances.

However, recent trend suggests the possibility that China is emerging as major trade and production hub for the East Asian region, drawing in imports on the basis of China's own domestic demand as well as inputs for the production of its exports to the US and other developed market.¹

¹ For a more elaborate discussion on this see World Bank, Looking Beyond Short-term shocks, East Asia and Pacific Region, April 2003

Table 10-8 ASEAN Export and Import with China**a. Major ASEAN Export to China**

(%)

HS chapter	Sector	1993	2000
85	Electrical equipt.	6.01	31.77
84	Computer/machinery	6.39	16.63
27	Lubricants/fuel/oil	32.30	13.17
38	Misc. chemical products	0.61	5.68
44	Wood	22.64	2.75
29	Organic chemical	1.52	2.10
48	Paper and paper board	0.47	1.86
15	Fats and oils	8.38	1.78
37	Photographic goods	0.01	1.34
	Total	78.33	77.08

b. Major ASEAN Import from China

(%)

HS chapter	Sector	1993	2000
85	Electrical equipt.	11.08	35.96
84	Computer/machinery	9.70	15.69
27	Lubricants/fuel/oil	8.98	4.75
52	Cotton	5.59	2.56
90	Optical/medical instruments	1.03	2.24
88	Iron and steel	2.09	2.13
10	Cereal	3.74	2.08
39	Plastics	0.84	1.84
71	Jewelry	0.12	1.39
28	Inorganic chemicals	2.98	1.39
	Total	46.15	70.03

Table 10-9 ASEAN Export and Import with Japan**a. Major ASEAN Export to Japan**

(%)

HS chapter	Sector	1993	2000
85	Electrical equipt.	13.06	26.02
27	Lubricants/fuel/oil	28.15	23.08
84	Computer/machinery	7.49	18.8
44	Wood	11.72	3.44
3	Fish	7.29	2.86
89	Ships,boats	0.01	2.08
94	Furniture	2.03	1.68
39	Plastics	0.75	1.86
26	Ores	2.18	1.61
87	Cars, trucks and autos	0.29	1.35
	Total	72.97	82.78

b. Major ASEAN Import from Japan

(%)

HS chapter	Sector	1993	2000
85	Electrical equipt.	30.00	34.57
84	Computer/machinery	23.88	23.39
87	Cars, trucks and autos	11.65	8.61
88	Iron and steel	5.45	5.1
39	Plastics	3.29	3.87
90	Optical/medical instrument	3.68	3.67
73	Articles of iron or steel	3.42	2.12
29	Organic chemical	1.95	1.88
91	Jewelry	0.36	1.45
40	Rubber	0.97	1.03
	Total	84.65	85.69

Table 10-10: ASEAN Export-Import with Korea**a. Major ASEAN Export to Korea**

(%)

HS chapter	Sector	1993	2000
27	Lubricants/fuel/oil	36.44	30.86
85	Electrical equipt.	9.99	26.15
84	Computer/machinery	7.79	17.16
44	Wood	17.17	2.04
26	Ores	0.89	1.70
29	Organic chemical	1.48	1.54
38	Misc. chemical products	1.70	1.34
39	Plastics	0.53	1.04
40	Rubber	2.61	1.14
74	Copper	1.27	1.23
	Total	79.87	84.20

b. Major ASEAN Import from Korea

(%)

HS chapter	Sector	1993	2000
85	Electrical equipt.	30.39	43.55
84	Computer/machinery	11.96	11.25
27	Lubricants/fuel/oil	4.74	6.20
29	Organic chemical	2.43	4.73
39	Plastics	6.04	4.47
88	Iron and steel	8.70	4.33
87	Cars, trucks and autos	0.98	2.60
89	Ships,boats	0.87	1.91
73	Articles of iron or steel	3.37	1.76
55	Man-made staple filament	5.05	1.32
	Total	74.53	82.12

There are several reasons for the rapid growth of ASEAN-East Asia trade during the 1990s, some of which have been discussed earlier. One important factor was the dynamism of the economies in the region as reflected in the rapid growth rate of the real GDP in most regional economies. Another factor was the falling MFN tariff rates in most economies in the region, particularly in ASEAN and China. At the beginning of 1993, China reduced its tariff on 3,371 import items and abolished import controls on more than 367 commodities. At the 1995 APEC Summit, China's President Jiang Zemin further made a commitment to cut average tariffs to 15 per cent by 2000. This new liberalisation effort includes substantial tariff cuts on 4,998 tariff lines. China has also eliminated quotas, licensing and import controls on 176 tariff lines, or more than 30 per cent of commodities subject to these restrictions. As part of China's commitment for its accession to the WTO, it has agreed to make further cuts in tariffs and NTBs. Table 11 provides data on the weighted average tariff rates for 2001, and the agreed Chinese bound tariff rates reported in the Protocol of Accession to be implemented starting from the date of accession. The decline in China's average tariff rate between the time of its accession and the final year is expected to be from 13.7 per cent to 5.7 per cent.

Table 10-11 Post-Accession Reduction in Weighted Tariff Rates for China's Main Imports^a

Product group	Tariff rate	
	2001 (MFN)	final ^b (bound)
Cereal grains	91.1	3.0
Oil seeds	96.9	3.9
Beverages and tobacco products	57.8	10.4
Electronic equipment	10.6	2.3
Vegetable oils and fats	39.3	10.2
Wood products	10.0	3.4
Paper products, publishing	9.3	3.3
Crops	21.7	8.4
Textiles	20.5	8.7
Plant-based fibres	84.3	37.7
Motor vehicles and parts	31.6	14.1
Dairy products	19.0	8.9
Vegetables, fruit, nuts	25.9	12.6
Machinery and equipment	13.4	6.6
Meat products	18.6	9.9
Sugar	77.9	43.8
Processed rice	114.0	65.0
Paddy rice	114.0	65.0
Wheat	114.0	65.0
Ferrous metals	9.1	5.2
Chemical, rubber, plastic products	14.1	8.1
Forestry	2.3	1.3
Food products	16.8	9.8
Fishing	14.2	8.5
Metals	7.0	4.2
Wearing apparel	23.8	14.9
Leather products	11.6	8.0
Meat	14.1	9.9
Transport equipment	5.0	3.6
Metal products	9.7	7.4
Mineral products	14.4	11.4
Petroleum, coal products	8.4	6.7
Manufactures	19.5	15.8
Animal products	9.4	8.0
Average of above	14.6	6.1
All goods	13.7	5.7

Source: UNCTAD, Trade Analysis and Information System (TRAINS) database,
based on WTO figures.

a. Weighted by China's imports of relevant items in 2000.

b. At the end of the transition period.

Similar trade liberalising processes have been taking place in ASEAN in the context of the Uruguay Round commitments, as well as in the AFTA process. Table 12 shows ASEAN post UR-MFN tariff rates. It ranges from as low as 3.12 per cent in the case of Brunei to 43.18 per cent for Thailand. Tariff rates for Malaysia, Indonesia and Philippines were less than 10 per cent, while Singapore is a tariff free city-state.

Table 10-12 Average MFN Tariffs

Sector	Brunei Darussalam	Indonesia	Malaysia	Myanmar	Philippines	Thailand
Live Animals	0.00	4.74	3.96	8.12	20.00	49.28
Fruits and Vegetable Product	0.00	4.63	2.45	7.50	11.19	48.27
Fats and Oils	0.00	4.86	2.11	2.05	8.45	31.35
Prepared Foodstuffs	0.05	17.57	10.85	13.43	18.76	49.91
Mineral Products	0.00	4.05	2.04	1.42	3.54	18.05
Chemicals	0.64	5.76	1.86	2.34	4.06	32.23
Plastics	2.14	11.14	15.05	2.65	8.43	46.13
Hides and Leather	1.36	6.25	6.91	7.28	8.42	46.67
Wood and Wood Articles	10.44	3.42	1.42	11.21	11.73	36.59
Pulp and Paper	0.00	6.94	9.51	2.78	8.61	32.34
Textiles and Apparel	0.44	13.90	16.70	10.54	18.24	72.07
Footwear	5.33	16.54	19.25	7.41	15.47	79.64
Stone/Cement/Ceramics	0.65	7.26	16.91	3.68	11.01	47.38
Gems	2.41	10.76	2.87	13.65	7.07	33.4
Base Metal and Metal Articles	0.12	9.70	9.36	3.18	8.14	25.37
Machinery and Electrical Appliances	9.22	4.86	8.12	2.77	5.68	36.25
Vehicles	21.24	39.28	52.55	4.68	11.48	47.57
Optical, precision & musical instruments	7.79	7.38	1.82	5.84	4.60	36.75
Arms	0.00	9.29	15.00	9.47	19.00	37.65
Miscellaneous Manufactured articles	2.26	14.70	14.64	7.15	11.23	53.28
Antiques and works of art	0.00	12.86	1.96	4.25	15.00	31.67
AVERAGE	3.12	9.34	9.42	5.55	10.08	43.18

A number of the ASEAN countries have also embarked on deregulation and liberalisation measures over the 1990s.

- Brunei's applied tariff rates are low, averaging 3.1 per cent in 2000, zero for agriculture, and 3.6 per cent for non agricultural products.
- Indonesia has undertaken a significant reduction of applied tariff rates, with the lowering of rates going well beyond its WTO commitments.

Applied MFN tariffs have been reduced from an unweighted average of about 20 per cent in 1994, to 9.5 per cent in 1998. Further unilateral tariff cuts are scheduled up to 2003 in accordance with a clearly defined program of tariff reduction. By 2003, the maximum applied tariff for nearly all products will not exceed 10 per cent. Already in 1998, tariffs on goods items, have been reduced to a maximum of 5 per cent.

- Malaysia has cut its import tariff by almost one half since 1993, reducing protection for most agricultural and manufactured goods. The average applied tariff rate has declined from 15.2 per cent in 1993, to 8.1 per cent in 1997. Furthermore, whereas only 13 per cent of tariff lines were exempt from import duty in 1995, over half of all lines now bear duty-free applied rates.
- In the Philippines, tariffication and reduction in tariff over the past six years have significantly opened the economy. Applied tariffs were more than halved between 1992 and 1999 from 26 per cent to just over 10 per cent. The Philippines is in the midst of a tariff rationalisation program that will in effect create a uniform tariff structure for manufactured products of no higher than 5 per cent.
- For Thailand, applied MFN tariff rates averaged 18 per cent in September 1999, compared with 23 per cent in 1995. Tariff peaks were reduced to 60 per cent down from 100 per cent in 1995.

5. The ASEAN Free Trade Area (AFTA)

Arguably, the decision taken during the Fourth ASEAN Summit in 1992 to establish the ASEAN Free Trade Area (AFTA) by the year 2008 is the most significant and ambitious step taken by ASEAN so far in terms of regional economic integration. The treaty establishing AFTA was signed in Singapore by the five original founding members, Indonesia, Malaysia, Philippines, Singapore, Thailand, and Brunei. In mid-1995, Vietnam gained admission as the seventh member of ASEAN. Laos and Myanmar followed suit two years later in 1997 with Cambodia joining to bandwagon in 1999. The main calculus behind the creation of AFTA was the laying of a framework and forum for ASEAN member-states to cooperate with each other whilst moving towards deeper economic integration not only among themselves but also with the world. AFTA's creation will also help member-economies to lock-on and manage trade reforms more effectively to meet the WTO initiatives collectively. The ASEAN economies that are primarily export-oriented already figure as the central entity in regional trade platforms involving Asia-Pacific economies. Nevertheless, the purpose of AFTA is not simply to promote an increase in intra-regional trade. By increasing and facilitating the free flow of goods within the ASEAN region, the AFTA is also expected to promote a greater degree of market integration.

The critical tools used to promote trade and liberalisation within the region is through the elimination of intra-regional tariffs and the limitation of non-tariff barriers (NTBs). ASEAN's approach to liberalisation is one of "open regionalism". This may be characterised as the promotion of regional trade expansion through facilitation and the reduction in the official barriers to regional trade through multilateral reductions in protection. Simply put, it is regionalism with a global orientation (Piei & Abubakar 1998). Apart from promoting and enhancing trade, the AFTA framework also endeavours to promote greater intra-ASEAN investment and foreign direct investment in the region. Simultaneously, AFTA has, since 1995, gone beyond being a traditional Preferential Trading Arrangement and expanded and deepened into other important aspects such as the development and integration in "non-border" areas of co-operation. This is

expected to further strengthen the links among ASEAN national markets (Chee 1997). Ultimately, it is also hoped that the region's attractiveness for trade and foreign investment will increase, and thus augment ASEAN's competitive edge as a production base geared for the world market.

The main mechanism for the implementation of AFTA is the Common Effective Preferential Tariff (CEPT). The CEPT is an agreed effective tariff which is preferential to ASEAN member-states, and is to be applied to goods that have been identified for inclusion under the CEPT scheme originating from member-states.

To be eligible, several criteria need to be fulfilled, namely, that

- the product must already have been included in the 'Inclusion List' of the CEPT scheme of both the exporting and the importing countries. All other categories of products which include those in the 'Temporary Exclusion List' will not be eligible.
- the tariff rate in the exporting country for the same product must be at or less than 20 per cent. However, if the tariff in the exporting country is above 20 per cent, concessions can only be given when the CEPT of the importing country is also above 20 per cent.
- the product in question must be of ASEAN origin and it must have at least 40 per cent domestic ASEAN content. This refers to a single country or cumulative ASEAN content.

The original schedule required the CEPT tariffs to be reduced to between 0-5 per cent within 15 years, i.e. by 2008, while non-tariff barriers were to be eliminated beginning 1 January 1993. In September 1994, ASEAN agreed to accelerate the establishment of AFTA by reducing the initial time frame from 15 to 10 years. Under the 1994 amended timetable, the full realisation of AFTA with tariffs falling between zero and 5 per cent was expected by the year 2003 for the original ASEAN five: Indonesia, Malaysia, Thailand, Singapore and the

Philippines as well as Brunei. The deadline for Vietnam was 2006 and for Myanmar and Laos, 2008.

To help ameliorate the effects of the regional crisis and to speed up the recovery efforts, ASEAN members announced a further acceleration of the AFTA schedule during the 6th ASEAN Summit in Hanoi in December 1998. The six original signatories have agreed to advance the implementation by one year from 2003 to 2002. The six also agreed to achieve a minimum of 90 per cent of their total tariff lines with tariffs between 0-5 per cent by the year 2000. In theory, this would account for 90 per cent of total intra-ASEAN trade (ASEAN Secretariat 1999). At the same time, each member-state would individually commit to achieve a minimum of 85 per cent of the Inclusion List with tariffs of 0-5 per cent by the year 2000. Following this, there is to be an increase to a minimum of 90 per cent of the Inclusion List in the 0-5 per cent tariff range by 2001. By the year 2002, 100 per cent of the items in the Inclusion List would have tariffs of between zero and 5 per cent (with some flexibility). It was not until the Singapore meeting in late 1999 that the target of zero tariffs as the ultimate target of AFTA was explicitly endorsed. At this meeting, the Ministers agreed “to eliminate import duties on all products and to target to achieve this objective by 2015 for the six original members and by year 2018 for the new members of ASEAN”.² Furthermore, as a first step towards this ambitious goal, they agreed that the six original members would eliminate tariffs on 60 per cent of their products by the year 2003.

What has been the progress in this direction so far? As of 11 April 2002, the CEPT Scheme had covered 98.09 per cent of all tariff lines for the ASEAN-6. Average tariff rates on these products have fallen to 3.89 per cent which is well in advance of the agreement that 85 per cent of the Inclusion List will have tariff of 0-5 per cent. (Table 13 and 14). For the four new members of ASEAN, about half of their total tariff lines (49.94 per cent) are in the Inclusion List, 46.88 per cent of

² These target dates were further accelerated to 2010 for the ASEAN 6 and 2015 for the new members of ASEAN.

total tariff lines are in the TEL, 2.18 per cent of the total tariff lines are in the GEL, and 1.02 per cent of the total tariff lines are in the Sensitive List.

Progress in the level of deepening notwithstanding, tariff reductions under the CEPT scheme alone may not be sufficient to enhance intra-ASEAN trade if other non-tariff barriers (NTBs) remain in place. This is because the existence of NTBs may limit or perhaps negate the trade liberalising effect of the CEPT mechanism. To address this issue, the CEPT agreement call on member countries to eliminate quantitative restrictions with respect to products under the CEPT scheme in addition to other non-tariff barriers on a gradual basis within a period of five years, respectively.

Table 10-13 CEPT Product List for the Year 2002

Country	Inclusion List (IL)	Temporary Exception List (TEL)	General Exception List (TEL)	Sensitive List (SL)	Total
Brunei Darussalam	6276	0	202	14	6492
Indonesia	7176	21	68	4	7269
Malaysia	8867	233*	63	73	9236
Philippines	5606	35	16	62	5719
Singapore	5821	0	38	0	5859
Thailand	9104	0	0	7	9111
Total ASEAN-6	42850	289	387	160	43686
Percentage	98.09	0.66	0.89	0.37	100.00
New Members of ASEAN:					
Cambodia	3115	3523	134	50	6822
Laos	1247	2142	74	88	3551
Myanmar	2387	3017	47	21	5472
Vietnam	3573	1007	196	48	4824
Total	10322	9689	451	207	20669
Percentage	49.94	46.88	2.18	1.00	100.00
Total Asean-10	53172	9978	838	367	64355
Percentage	82.62	15.50	1.30	0.57	100.00

Source: ASEAN Secretariat

* Covers group of automotive products whose inclusion being deferred to 2005.

Table 10-14 ASEAN: Average CEPT, 1999-2003

Country	Year 1999		Year 2000		Year 2001		Year 2002	
	Tariff Lines	Average	Tariff Lines	Average	Tariff Lines	Average	Tariff Lines	Average
Brunei Darussalam	6264	1.55	6264	1.26	6264	1.17	6264	0.99
Indonesia	6931	5.36	7176	4.76	7176	4.36	7176	3.71
Malaysia	8374	3.22	8417	2.79	8417	2.6	8417	2.43
Philippines	5431	7.36	5431	5.88	5431	5.24	5431	4.95
Singapore	5739	0	5772	0	5772	0	5772	0
Thailand	9062	9.58	9067	7.29	9067	7.26	9067	5.98
ASEAN-6	41801	4.8	42127	3.89	42127	3.67	42127	3.18
Cambodia	-	-	3115	10.39	3115	10.39	3115	8.85
Laos	1247	7.54	1247	7.07	1247	6.58	1247	6.15
Myanmar	2356	4.45	2356	4.38	2356	3.32	2356	3.31
Vietnam	3570	7.09	-	-	-	-	-	-
ASEAN-4	7173	6.3	6718	7.67	6718	7.2	6718	6.42
Total ASEAN-10	48974	5.02	48845	4.41	48845	4.16	48845	3.63

6. ASEAN-East Asia Investment Relations

ASEAN had been the top 10 regional FDI destinations in the 1990s, albeit up to the point when the crisis hit the region. The original 5 member countries i.e. Indonesia, Malaysia, Thailand, Singapore, and to a lesser extent the Philippines, had been in the top ten FDI receiving countries during the 1990's. Table 15 shows the net FDI inflow into ASEAN (on a balance of payment basis) between 1995-1999. It is observed that the extra-ASEAN FDI had been more significant than intra-ASEAN investment flows. It can be observed that inflow of total, intra- and extra-ASEAN investment had contracted sharply in 1998 and 1999 (the years immediately after the crisis hit the region). The intra-ASEAN investment share of ASEAN's total investment had contracted from as much as 10.7 per cent to 7.2 per cent. In 2000, though the regional economies have shown some recovery, and while global FDI flows increased to US\$1,270 billion compared with US\$1,075 billion in 1999, investment inflows into ASEAN remained on a declining trend at 5.8 per cent to US\$13.8 billion compared with

US\$14.7 billion in 1999. In contrast, China and Taiwan recorded an increase in inflows of FDI to US\$40.7 billion and US\$4.9 billion respectively. FDI into Korea recorded a marginal decline to US\$10.2 billion.

Table 10-15 ASEAN Net FDI on a Balance of Payment basis (US million)

	Intra ASEAN	Total Extra ASEAN FDI	Total ASEAN FDI	Share of Intra-ASEAN FDI in Total FDI
1995	4,653.0	16,668.0	21,321.0	21.8
1996	2,777.7	23,238.4	26,016.0	10.7
1997	5,537.5	22,597.5	28,135.0	19.7
1998	2,019.8	17,575.2	19,595.0	10.3
1999	1,217.5	15,693.5	16,911.0	7.2

Source: ASEAN Secretariat: ASEAN FDI Database

Table 16 shows the stock of FDI in the period 1980-1999. It is observed that the stock of FDI in the region had grown ten-fold from US\$24 billion in 1980 to US\$249.8 billion in 1999. The bulk of the inflows were absorbed by Singapore, Indonesia, Malaysia and Thailand. Together they accounted for 88 per cent of ASEAN FDI. By the end of 1999, ASEAN share of Asian DFI has been showing a sharp decline since the crisis struck to about 29/5 per cent in 1999.

Table 10-16 Inward Foreign Direct Investment Stock in ASEAN

(US\$ billion)

	1980	1990	1998	1999
ASEAN	24.0	89.9	232.6	249.8
Brunei	0	0	1.0	1.0
Cambodia	-	0.2	0.7	0.6
Indonesia	10.3	68.8	68.2	65.2
Laos PDR	0	0.14	0.472	0.551
Malaysia	5.2	10.3	45.2	48.77
Myanmar	0	0.1	2.1	2.4
Philippines	1.3	3.3	9.3	11.2
Singapore	6.2	28.6	82.4	79.4
Thailand	1.0	8.2	20.5	26.5
Vietnam	0	294	13.4	15.1
South, East and South East Asia	58.8	181.4	673.9	769.5
Asia	56.7	211.6	741.3	846.7
Developing Countries	131.2	377.4	1,241.0	1,438.5
ASEAN's share of South, East and South East Asia FDI Stock (%)	0.7	9.6	34.5	32.5
ASEAN's share of Asia FDI Stock (%)	42.3	42.5	31.4	29.5
ASEAN's share of Developing Countries FDI Stock (%)	19.7	23.8	18.7	17.4

Source: ASEAN FDI Database

Table 17 shows the inflow of DFI into ASEAN by country of origin in the period 1985-1999. The US, Europe and Japan remained the major source of FDI for ASEAN. Together, they contributed more than 60 per cent of the total FDI to ASEAN. However, since the crisis, inflows of FDI from Japan had declined sharply from as much as 21.0 per cent in 1997 to 5.4 per cent in 1999. The share of the three East Asian economies in total ASEAN FDI inflows reduced accordingly to just 9 per cent in 1999, from as much as 24.1 per cent in 1997. However, on a cumulative basis, the share of the three East Asian economies in ASEAN FDI stock between 1995 – the first half of 2002 remains substantial at 19.2 per cent, higher than the US at 12.9 per cent.

Table 10-17 Net FDI Inflow to ASEAN by country of origin (%)

	1995 (%)	1996	1997	1998	1999	1995 – 1 st half of 2000
USA	14.4	15.0	9.3	12.2	15.4	12.9
Europe	23.5	30.0	22.4	23.5	33.2	26.2
Japan	19.5	19.6	21.0	13.2	5.4	15.7
Korea	2.3	2.1	2.9	4.6	2.8	2.8
China	0.6	0.4	0.2	1.5	0.8	0.7
Total (billion US\$)	21.3	26.0	28.1	19.6	16.9	112.6

7. The Potential Effects of the EAFTA

Based on our discussion in the previous section on the economic features of the ASEAN countries and its linkages with the three East Asian economics, it can be concluded that the proposed EAFTA will make both good political and economic sense. The reasons for this are as follows:

Increased bargaining power

The proposed FTA will strengthen the bargaining position of the region, particularly ASEAN, as ASEAN countries would be able to negotiate as a collective, both regionally and multilaterally in areas of common interest to them. Indeed, the use of regional integration to strengthen the bargaining power of members against a perceived stronger negotiating partner is based on the belief that there is strength in members. A prime example is the EEC, whose formation is believed to have been partly motivated by the desire to increase the member countries' bargaining power against the US. Needless to say, one of the prime objectives of the formation of ASEAN, and AFTA, is to enable the consolidation of its regional bargaining position in its dealings with stronger economies and regional grouping. As a group, ASEAN has managed to negotiate better deals from its negotiating counterparts, something which could not have been achieved if individual member countries negotiated individually.

Signaling the region's policy credibility and commitment to reform

The proposed EAFTA will also serve as a signaling device as to the region's policy credibility and commitments to reform. It would send a strong message to other regions, and sub-regions, of each of the EAFTA member country's strong commitment to policy reform including trade liberalisation, and thus enhance its position as a credible trade partner. Such a commitment also signals to current and prospective investing firms the advantages of locating their long-term investments in an area committed to open markets and stable macroeconomics. From the perspective of ASEAN, there is an urgent need to regain, and to enhance foreign investor's confidence in the stability and credibility of policies of member countries in the region. The need is even stronger now than ever before, especially since the advent of the ASEAN economic crisis which had badly damaged the region's economic standings.

Preparation for bolder reforms and future challenges

Membership in the proposed EAFTA would prepare prospective member countries in the region to undertake even bolder policy reforms, and confront the challenges of other countries and regional groupings in the future. Country experiences have shown that the first steps toward undertaking policy reforms are often the most difficult, as they are usually strongly resisted by those with vested interests. The fact that policy reform in the EAFTA is circumscribed within a limited number of member-countries would help to overcome the initial difficulties of undertaking the reform. Furthermore, an FTA with China would enable ASEAN member countries to reap an "early harvest" of China's post-accession commitment to liberalise its economy, and this would place ASEAN member countries in a better stead compared to the rest of the world in their economic relationship with China. The fact that the proposed EAFTA would also include two members of the OECD countries, Japan and Korea, will give ASEAN member countries an invaluable experience in their future dealings with the rest of the OECD members. In short, all these will prepare and enhance member countries confidence to embark on bolder policy reforms in response to the onslaught of globalisation and liberalisation process of the world economies.

Market enlargement

The proposed EAFTA would lead to an expansion of ASEAN's market size as producers could pool together the markets of the other three East Asia economies. The combined EAFTA market would be about US\$6868.1 billion, that is about 12 times the current market of ASEAN which stands at about US\$570 billion. A better measure of the market potential of the EAFTA is the size of the "effective demand" that would be created. This can be gleaned from the per capita income levels of the member countries as shown in Table 1. It is estimated that China would be the country that would provide most of the additional markets for ASEAN, considering that its population is six times of Indonesia with per capita income which is 10 per cent of Indonesia. Effectively, this means having seven Indonesia's instead of just one in ASEAN/AFTA.

Trade creation and trade diversion

These are the traditional static effects of a regional economic integration. Trade creation refers to the shift in expenditure or imports of a member country from more expensive domestic sources to a cheaper source within the region. The creation of more trade also refers to the addition and increased variety of exports to other member countries. These exports may be new and non-existent before the integration due to high and restrictive tariffs in the importing member countries. Trade diversion, meanwhile, refers to the shift in imports from a cheaper source outside the region to a more expensive source within the region. Trade creation is welfare enhancing, while trade diversion causes a deterioration in the welfare of the importing member countries. Intuitively, the creation of an EAFTA would be dominantly trade creating as far as ASEAN is concerned. The scope for trade creation is larger than in the case of ASEAN/AFTA, because EAFTA would include lower cost producing countries in a wide range of products, particularly Japan, and to a lesser extent, Korea and China. Conversely, the scope for trade diversion resulting from EAFTA is smaller than in the case of AFTA since the latter would include larger and more developed member countries.

Efficiency and enhanced competitiveness

With the formation of the EAFTA, and with the trade barriers among member countries eliminated, competition among enterprises in member countries would increase, thus

promoting specialisation, efficiency, productivity and economic welfare. Not only would competition be intensive between and among enterprises of member countries, but strategic alliances between them would also be created in many sectors. The surviving enterprises might become globally competitive too.

Effects on the volume and pattern of Investment

With the removal of barriers to trade, and eventually, of barriers to capital flows within the region, this would result in a more conducive investment climate within the region. There will be more certainty and uniformity in investment policies within the region, besides having an enlarged regional market. All these would be important factors in attracting investors to the region and having them invest. A more efficient pattern of production would emerge, drawn along the lines of comparative and competitive advantages. As the EAFTA would comprise of member countries lying across a spectrum of factor endowments and economic development levels, production rationalisation would thus take place in consideration of such differences in factor endowment as well as in effective demand across member countries. This could effectively spur growth in agriculture, manufacturing and services. As a result, the proposed EAFTA could have profound implications on investment activity in the region.

8. The Economic Cost

While the effects of the EAFTA are generally beneficial, it is nevertheless expected to bring with it attendant costs. In particular, the preferential reduction of trade barriers among members of the FTA can bring with it some diversion of trade as explained earlier. From the perspective of ASEAN, the choice is between trade diversion resulting from AFTA only, and trade diversion resulting from ASEAN's integration with Japan, Korea and China in EAFTA. Theoretically, trade diversion resulting from EAFTA should be smaller than those resulting from AFTA. Indeed, the scope for trade diversion is smaller,

- the bigger is the regional integrated economies
- the higher the intra-regional trade is vis-à-vis its extra regional trade
- the more developed are the new members of the regional economic integration
- the lower the cost of production in member countries compared with those in non-member countries.

Based on our earlier discussion, EAFTA fulfils all the above criteria. Hence, trade diversion would be small and could be kept minimal by taking some pre-emptive measures.

Decline in tariff revenues

The reduction of tariff barriers against member countries following the formation of the EAFTA may lead to some loss in government revenue in some member countries. This will occur as tariff revenues previously collected from import (from non-members) declines as imports are diverted to member receiving preferential treatment at low or zero tariffs. Within the ASEAN countries, the most affected countries would be the new members, Cambodia, Laos, Myanmar and Vietnam. This is mainly due their high differential between MFA and CEPT tariff levels. However, this does not constitute real economic losses because it simply amounts to redistribution of welfare to consumers who now may be able to enjoy a lower price for imported goods. Moreover, ASEAN's experience in implementing AFTA has shown that these countries have managed to mitigate these problems by looking for alternative source of revenue elsewhere in the economy. For example, Cambodia used to receive 56 per cent of its total tax revenue from customs duties prior to joining AFTA, two

thirds of which were levies on imports from the other ASEAN countries. However, membership in ASEAN/AFTA gave the Cambodian government the impetus to introduce a value-added tax in 1999. This has likewise been the experience of other ASEAN countries in the wake of the AFTA implementation. Likewise, the same experience will take place resulting from the formation of EAFTA.

Adjustment costs due to EAFTA

Adjustment costs “encompass a wide variety of potentially disadvantageous short term outcomes that might result from trade liberalisation which may include a reduction in employment and output, the loss in industry-specific and firm-specific human capital, and macroeconomic instability resulting from balance of payment difficulties or reduction in government revenue.” It must be acknowledged that the formation of EAFTA would result in a dislocation in member economies as proven in the case of AFTA. But these effects would occur as a result of any other policy changes undertaken by an economy such as trade liberalisation, and its long-term effect is shown to be relatively small. More advanced member countries may even provide technical assistance and aid to help the affected countries in their effort to readjust to new economic and trade regimes, as was the practise by the more advanced ASEAN countries when implementing the AFTA programme. Moreover, the adjustments undertaken by the less-developed member countries would be done more easily and quickly by being members of the EAFTA, compared to them undertaking the reforms individually.

9. The Architecture of the East Asia Free Trade Area

In the event that ASEAN and the three East Asia economies, China, Korea and Japan agree to establish a free trade area, there are several modalities to choose from.

These include:

- a region-wide FTA involving all the thirteen countries concerned
- an EAFTA comprising a network of FTAs: ASEAN-China FTA, ASEAN-Japan FTA, ASEAN-Korea FTA, Japan-China FTA, Japan-Korea PTA, and China-Korea FTA
- an EAFTA involving ASEAN and North East Asia FTA similar to the proposed ASEAN/AFTA-CER FTA.

Needless to say, the first modality is the first best option as it would involve region-wide economic integration of thirteen separate entities into a single and unified market. The gains from such a comprehensive liberalisation, to the region as well as to individual member countries, are expected to be large, while the adjustment process easier, and less costly. Though this choice of regional integration is the most difficult to achieve at the moment, it must be adopted to be the ultimate modality to strive for in the long run. The second modality is to “weave a web of free trade agreements and areas together across the thirteen economies to finally form a huge East Asia Free Trade Area”. Altogether, it would involve six FTAs. To start with, there is already a strong commitment to create an ASEAN-China FTA in 10 years time, and there is good prospects for an ASEAN-Korea FTA to follow soon. The signing of a bilateral free trade agreement (BFTA) between Japan and Singapore may act as catalyst for the other ASEAN countries to negotiate a FTA with Japan either individually or as a region as explained earlier. By doing so, it may neutralise whatever advantages and preferences Singapore may be enjoying in Japan’s market, and hence eliminate the bias against them. This phase of the EAFTA evolution is progressing well with ASEAN appears to act as the "hub" in its relation with the individual Northeast Asian countries China, Japan, South Korea.

A more difficult phase is to carve-out three more FTAs among the three East Asian economies. The first one is a Japan-Korea FTA¹. This initiative which has already been

¹ Japan prefers an early start of its FTA negotiation with Korea. However it may not be easy either for Korea to entertain Japan's request, unless Korea is assured to benefit from the FTA with Japan. Furthermore Korea is not in a hurry to conclude an FTA now whereas Japan is badly in need of an FTA with Korea to escape from the

announced is potentially the most influential one of the three possible bilateral FTAs among the East Asian economies. The timing is most opportune given the current improvement in the bilateral relationship between the two economies. There have been suggestions that the Japan-Korea FTA “should logically be extended to include China as well because it otherwise would create serious political tensions” or the Japan-Korea FTA to design with China in mind as a potential member. The inclusion of China would effectively rule-out the need to create bilateral FTAs (the China-Japan FTA and China-Korea FTA). Indeed, this would transform the exercise in the direction of a bigger undertaking, that is, the formation of a North East Asian sub-regional arrangement that would eventually be linked to the one already in existence, the ASEAN/AFTA. This represents the third route that may be pursued. Irrespective of the modality to be preferred modality, several parameters governing the proposed framework of co-operation need to be clearly spelt-out and adopted. These include, among others, the time frame of implementation, guiding principles, scope and coverage, special and differential provisions.

Time frame

The time frame for implementation will need to consider existing benchmarks. On the one hand, there is the APEC vision to create free trade in the area by 2010 for developed countries and 2020 for developing countries. The proposed EAFTA needs to achieve liberalisation of goods earlier than that which has been agreed upon under APEC, or else this initiative will be made redundant by the latter. This means that the developed countries of EAFTA, Japan, Korea and possibly Singapore, should proceed at a faster pace than APEC i.e. earlier than 2010, while the remaining countries should proceed not later than 2020. For the ASEAN-6, this should not be much a problem because under AFTA they are targeting CEPT zero tariff by 2010. Subject to any new arrangements pertaining to AFTA², the pace of liberalisation of EAFTA should not normally go beyond the pace of liberalisation to which ASEAN members have already agreed under AFTA i.e. elimination of tariff by 2010 for ASEAN-6 and 2015 for the new members. Consideration is to be given to the CLMV countries which need more

difficulties from its economic recession and industrial adjustment; and to cope with China's aggressive FTA policy. See Inky Cheong "An East Asian FTA: Result Progress and Policy Implication.

² Presently, there is intense discussion on the initiative to form the ASEAN Economic community by year 2020 proposed by Singapore Prime Minister, Goh Chok Tong. This will involve natural extension of the AFTA process.

time to adjust to the required market-opening policies. Hence, they should be accorded some amount of flexibility and differential deadlines in their liberalisation commitments.

Scope

The EAFTA should be as comprehensive as possible to cover trade in all goods, services, investments, tariff liberalisation, non-tariff barriers, technical barriers to trade, mutual recognition arrangements (MRAs). Other areas could possibly be included as and when the need arises. This is to ensure that the FTA is trade-creating, and hence would lead to efficiency gains for the region as a whole, and the member countries individually. In the case of trade in goods, agriculture will be one sector that could pose some problems³ due to its sensitivities in almost all economies, except for Singapore. The ASEAN/AFTA approach in phasing in the agricultural products into its CEPT scheme may be used as a model for the three East Asian countries to adopt. Under the AFTA, agricultural raw materials and unprocessed agriculture produce are categorised into two: sensitive and highly sensitive unprocessed agricultural products (UAPs). All sensitive UAPs (altogether 181 tariff lines) would have to be included by 2005, and their tariff rates to be reduced to 0-5 per cent by 2010. Meanwhile, the highly sensitive UAPs, which are relatively few in number, need to be phased in by 2005 and their terminal tariff are allowed to be greater than 5 per cent by 2010. As for rice, which is considered as highly sensitive in most ASEAN countries, the indicated terminal tariff would be less than 20 per cent.

Tariff

Subject to the time frame discussed earlier, the overall objective is to achieve free trade in goods by 2010 for the ASEAN 6 and China, Japan and Korea and 2015 for the new members of ASEAN. As a guide, ASEAN could consider extending the AFTA tariff rates to the three East Asian (China, Japan and Korea) countries and the latter would progressively reduce tariff for ASEAN from the conclusion of negotiation, reaching free trade by 2005. For Japan, and to a lesser extent Korea, the fact that they are developed economies makes them in a better position to achieve free trade vis-à-vis ASEAN at an earlier date. For the new members of

³ The issue on agriculture will be most critical in the case of ASEAN-Japan FTA but less so in the case of ASEAN-China FTA since most of the "down payment" offered by China involved agricultural products.

ASEAN, the rest of the EAFTA would consider to offer them a special preference similar to the ASEAN Generalised Scheme of Preference for their product to enter the rest of the EAFTA.

Rules of Origin

To avoid the possibility of trade deflection, FTAs normally adopt rules of origin (ROO) which specify the degree of value added the goods must embody before they can be considered as a regional product which entitled them preferential treatment when traded within three FTA. In the case of AFTA, the ROO is 40 per cent domestic and/or regional cumulative content for all goods and for all member countries. It is too simplistic and favours the more developed member countries. In the case of the EAFTA, ROO of 40 per cent is too low as input from Japan, China and Korea will be considered as local or regional input. A higher percentage of regional content is preferred, and it should be varied by the type of goods traded, and by the country that produced the goods. Sensitive products, where there is greater possibility of trade deflection to occur, are assigned a higher percentage of local/regional content. Similarly, more developed countries like Japan, Korea and Singapore may also be assigned a higher percentage of regional content.

Non-tariff barriers

Under the AFTA process, member countries are obliged to eliminate all NTBs, upon enjoyment of the CEPT treatment. Similar rulings need to be instituted in FTAs with the three East Asian countries.

Technical Assistance

The EAFTA would need provisions on technical assistance particularly from the more developed members.

Such technical assistance should cover the following areas

- technical assistance in the development, strengthening and diversification of the production and export bases of the new member of ASEAN in particular

- assisting of the ASEAN new members in their capacity building
- facilitating the transfer of know-how to the ASEAN countries

It is to be acknowledged that the more developed members of the EAFTA have been the major providers of technical assistance to the less developed member of ASEAN either bilaterally, or through collaboration with ASEAN and other multilateral agencies, particularly in the Greater Mekong Development Projects. With the establishment of the EAFTA, this initiative would be enhanced further in a sustainable manner.

Trade Facilitation

The EFTA should include trade facilitation activities to enhance the effect of the trade liberalisation process. Trade facilitation activities are already underway in AFTA, as well as in the APEC. What is needed is to ensure that these activities are strengthened so as to bear some tangible benefit in the short term. These activities include harmonisation of customs nomenclature and procedures, harmonisation of standards, MRAs, and SPS Conference etc.

Investment

The EAFTA should contain a framework of investment principles and rules which would increase and secure capital flows to and within the region. This aspect has already been taken care of in the case of ASEAN under its Framework Agreement of the ASEAN Investment Areas (AIA, 1988) whereby all barriers to investment in ASEAN are to be removed by 2010. Non-ASEAN investors would enjoy the same privileges by 2020. The ultimate aim is to promote the ASEAN region as a single international destination for investment. To accommodate the non-ASEAN members of EAFTA, the implementation could be accelerated. and in return the latter could consider reciprocal arrangement for the ASEAN investors. There are other aspects that need to be covered by the proposed EAFTA, but they are beyond the scope of this paper. These include among others such matters concerning the inclusion of the services sectors, intellectual property rights, e-commerce, etc.

10. Conclusion

This paper has highlighted salient features of the economic relationship between ASEAN and the three East Asian economies, China, Korea and Japan for the last decade or so. It has showcased the growing strength of economic interdependencies within, and among, members of the regional economies concerned, and the further scope for greater regional economic integration that exists. If the member economies have benefited from this development, and more gains are expected if regional economic co-operation strategies are to be pursued via the EAFTA proposal. This paper has also outline the possible modalities of the proposed EAFTA as well as its objectives, principles and coverage and several special provisions that need to be instituted for the efficient implementation of the proposed EFTA.

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11. East Asian Economic Integration and Implications for the Newer ASEAN Member Countries

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The idea of an East Asian Free Trade Area is not a new one and can be traced back to Mahathir's proposal for an East Asian Economic caucus in the 1980s. Yet, if in the 1980s, such an idea was mainly justified on grounds of common Asian values, calls for closer cooperation through an EAFTA have, in recent years, had more to do with the reality of increased interaction in trade, capital and human flows among countries in the region. In particular, following the 1997 Asian financial crisis, East Asian countries have been increasingly aware of the need to construct their own mechanisms of regional self-help to cope with the negative impacts of unprecedented levels of such regional interactions. To show the feasibility of an EAFTA this paper will demonstrate the increasing economic interdependence among regional countries and the existence of a wide array of regional institutions favorable to its functioning and thus it highlights the bright prospect of an EAFTA in the future. The paper will also shed light both on the negative and positive implications of the EAFTA for CLMV countries.

1. Increasing economic interdependence among economies in the region:

1.1 Intra-regional trade

Increasing intra-regional trade has served as a strong foundation for the establishment of an EAFTA. Trade is one of the main features of economic cooperation between countries in East Asia. Intra-regional trade has become more and more important for most countries in the region. Trade data supports this observation. In the case of ASEAN's trade with China, Japan and South Korea, for example, we can see in Tables 11-1 and 11-2 how important ASEAN's trade with key partners in the region has become.

Table 11-1 ASEAN 8⁴ Exports to North East Asia

(Value in million US \$)

Cou\year	1993	1995	1997	1999	2000	2001
China ⁵	4,528.7	6,200.9	9,167.8	26,472.9	35,034.7	31,552.1
Japan	30,952.2	42,680.7	42,008.6	37,687.1	54,743.9	48,311.2
Korea	6,125.9	8,574.4	10,667.8	10,890.8	14,528.6	14,734.5

Source: ASEAN Secretariat

Table 11-2 ASEAN 8 Imports from North East Asia

(Value in million US \$)

Cou\year	1993	1995	1997	1999	2000	2001
China	4,528.7	7,129.7	13,482.9	19,407.9	26,481.0	23,883.1
Japan	55,702.9	78,535.2	71,264.2	51,466.0	65,627.2	53,326.6
Korea	7,148.1	11,345.5	14,857.4	12,277.9	15,458.2	13,457.6

Source: ASEAN Secretariat

The intra-regional trade dependence index in East Asia increased from 22.35 % in 1985 to 45.37 % in 1999⁶ though trade flows in Table 3 were not only within the East Asian region. However, the economies in the Table are major Asian trading economies. Hence, most of intra-Asian trade is among these economies. Looking at the data presented in the table we can see most of East Asian major trading economies have traded more and more with their partners in the region. In particular, China's accession to the WTO has created greater market access and opportunities for ASEAN in China and vice versa – directly through trade liberalization measures, and indirectly through the rise in trade flows as a result of higher income gains on both sides. Moreover, China's trade penetration remains comparatively limited. Its trade to GDP ratio was still comparatively low at 44 per cent during 2000; the corresponding ratio being over 136 per cent for ASEAN-10 and 87 per cent in the case of Asean-4. Thus there is a lot of room for expanding ASEAN and China's trade relations. This

⁴ Including Brunei, Cambodia, Indonesia, Malaysia, Myanmar, Philippines, Singapore, Thailand.

⁵ Including Hong Kong for the period 1999-2001.

⁶ Xu Mingqi, "East Asian Economic Integration: China's Perspective and policy," paper presented at the Joint ANU/Fiscal policy Institute Conference held in Bangkok on 31 October-1 November 2003.

has added further impetus to the establishment of the prospective EAFTA.

Table 11-3 Intra-Asia Trade (percent of total trade volume %)

Economies\ Direction	Exports to Asia		Imports from Asia	
	1990	2000	1999	2000
China P.R.	68.8	46.0	50.9	60.7
Hong Kong, China	44.1	53.5	73.2	78.3
Indonesia	66.6	58.0	46.3	65.8
Korea, Republic of	37.3	43.0	38.9	46.0
Malaysia	59.0	53.8	53.6	64.9
Philippines	35.9	42.1	42.6	53.8
Singapore	48.4	57.2	50.1	57.0
Taipei, China	41.4	56.4	49.0	65.1
Thailand	38.6	48.9	56.6	60.8

Sources: ADB, Key Indicators 2001.

1.2 Intra-regional capital flow

For many years FDI flows have been increasing within the region. Numerous data testify to this tendency. In 1990 China attracted 54% of her total FDI from Japan, Hong Kong, Taiwan and Singapore; the ratio rose to 58% and 61% in 1996 and in 1999 respectively. Japan's FDI outflow into East Asian Economies increased from 712 billion Yen in 1990 (27.8% of her total FDI outflow into the world) to 1305 billion Yen (equivalent to a rise of 52.7% in term of ratio). During 1990s South Korean FDI outflow in Asia increased to reach more than 43% of her total FDI outflow into the world⁷. In ASEAN most of the FDI flow received by its members was from East Asian economies. In the case of Vietnam around 70% of the total FDI inflow into the country was from East Asian economies.

On the one hand, increasing intra-regional capital flows have reflected and facilitated increasing trade flows among countries in the region. On the other hand, this has made this region vulnerable to capital volatility, especially in the absence of a region-wide supervisory

⁷ Ibid.

and management mechanism. It is for this reason that the 1997 Asian financial crisis served as a wake-up call for Asian countries to take more seriously the need to institutionalize their cooperation so as to cope with the inevitable volatility and vulnerabilities of their increasing trade and capital interaction.

1.3 Intra-regional flow of people

In recent years the movement of persons (tourists, workers, investors and business people) between the East Asian economies has strongly increased. Most workers and students in Japan and the East Asian NIES are now from countries in the region. Many ASEAN member countries receive today more Asian tourists than those from other parts of the world. More than 80% of foreign arrivals in Vietnam in 2002 were from Asian countries, especially China, Japan, South Korea, Taiwan, Hong Kong, and Singapore. This tendency has become obvious due to several reasons. One is that higher trade and income growth in East Asia has delivered a positive impact on trade in services, ASEAN-North East Asia tourism especially. In particular, as China has liberalized many of its sectors and sub-sectors in line with its WTO commitments and ASEAN is in the process of speeding up its liberalization process, the potential is great for a substantial increase in two-way tourist flows between ASEAN and China as well as the rest of East Asia. Secondly, East Asian countries could also benefit from the growing markets for eco-tourism, thematic tourism, adventure tourism, and multiple-destination tourism.

1.4 Cooperation in other areas

Over the past decades, especially since the end of the Cold War, multi-faceted cooperation in the areas of politics, security, economics, cultural and social affairs among countries in East Asia has been strengthened creating a solid foundation for the closer ties among countries in the region. ASEAN has now become the center of regional economic and cooperation and others areas of cooperation in East Asia. In particular, financial cooperation has been well advanced, reflecting a high level of economic integration with the agreement to set up a bilateral swap arrangement between ASEAN and Japan, China, and South Korea in addition to the regional ASEAN swap arrangement. Many efforts have been made to move forward the establishment of the Asian Monetary Fund.

2. Regional Economic Cooperation Institutional Arrangements in East Asia

While there is a lot of debate as to the desirability and feasibility of an EAFTA, the process of institutional building in East Asia has actually started. Over the past few years a variety of regional economic arrangements and linkages have come into being. In this process ASEAN has been playing a vital role.

- **AFTA and other ASEAN Economic integration institutions** (AIA, AFAS, AICO, E-ASEAN Agreement Framework). Currently, ASEAN is in the process of developing the ASEAN Economic Community (which represents a higher level of economic integration than AFTA and other on-going economic mechanisms toward a common market).
- **ASEAN + 1 arrangements:** including economic linkage between ASEAN and each East Asian country, in particular:
 - **ASEAN – China:** In November 2002 the two sides signed the Framework Agreement on Comprehensive Economic Cooperation under which the establishment of the ACFTA was proposed by 2012/2015.
 - **ASEAN – Japan:** The ASEAN-Japan Comprehensive Economic Partnership Framework (AJCEP) was signed in October 2003, which envisages the establishment of the AJFTA by 2010/2015.
 - **ASEAN – South Korea:** The two sides have begun to make efforts to develop the current economic consultation mechanism into the establishment of the ASEAN-South Korea Free Trade Area (AKFTA).
- **ASEAN + 3:** Economic cooperation within this framework has been established for many years with increasingly significant projects. Consultations which have taken place at three levels (senior officials, Ministers and high-ranking leaders) have been institutionalized on a regular basis.
- **APEC:** The Asia-Pacific Economic Cooperation was created in 1988. It is a comprehensive economic linkage mechanism, encompassing the whole Asia Pacific in which most of East Asian economies have participated.
- **ASEM:** is an inter-continental Asia-Europe economic forum in which East Asia participates almost as a group.

- **EAEG/EAEC, EAVG/EASG and EAFTA:** At the initiative of Former Malaysian PM Mahathir to create the East Asia Economic Group in the 1990s, namely the **East Asia Economic Caucus (EAEG/EAEC)**, in 1998, ASEAN and the + 3 countries (China, Japan, South Korea) set up the **East Asia Vision Group (EAVG)**, consisting of eminent intellectuals from those countries, and then the **East Asian Study Group (EASG)** consisting of government officials in 2001 with the aim to study the feasibility and measures to implement the East Asian vision of cooperation, including the establishment of **East Asia Free Trade Area (EAFTA)**. In 2002 the ASEAN + 3 Phnom Penh Summit adopted the Report made by the EASG which recommended seventeen short-term measures and nine medium/long term measures for the enhancement of East Asian cooperation towards an EAFTA. Two very important recommendations to note in this report are first the establishment of an EAFTA and second the holding of East Asian Summit.
- **Bilateral Free Trade Agreements between East Asian economies:** Recently, two BFTA were signed between Japan and Singapore, Hong Kong and China; some other BFTAs are under negotiation (Thailand-Malaysia, Thailand-China, Thailand-Singapore, Thailand-Japan, Thailand-South Korea, Philippines-Japan, South Korea-China, South Korea-Japan, Singapore-Taiwan, Singapore-South Korea).

East Asian economies are linked closely not only in terms of levels of integration and institutional arrangements but also through what is known as sub-regional and/or transnational economic integration. This kind of integration has been widely developed in the region for more than one decade in the form of *growth triangle/ growth area*. SIJORI⁸, GMS⁹, BIMP-EAGA¹⁰, IMT-GT¹¹, WEC¹² are good examples of this cooperation. The process of institutional building has reflected three things. First, it reflects the desire of participating countries to cooperate to benefit from each other's market, to increase productivity via economy of scale, to reduce transaction costs through harmonization of technical standards and regulations, as well as to cope with common problems. Second, it also reflects the fact that regional countries are under peer pressure to join these arrangements otherwise they may

⁸ Growth Triangle comprising Singapore, Johor State of Malaysia and Riau region of Indonesia

⁹ Great Mekong Subregion Cooperation including Laos, Myanmar, Cambodia, Thailand, Vietnam, China.

¹⁰ East ASEAN Growth Area consisting of regions from Brunei, Indonesia, Malaysia and Philippines.

¹¹ Growth Triangle consisting of regions from Indonesia, Malaysia and Thailand.

¹² West East Corridor consisting of regions along the West East Transportation Corridor linking Thailand, Myanmar, Laos, Cambodia and Vietnam.

face discrimination if they fail to. Lastly, this reinforces the belief that no single above-mentioned arrangement but an EAFTA could fully meet the needs of East Asian countries.

With the rise of Japan, China, South Korea and Asian NIC East Asia has in fact overcome the initial economic challenge. Its task now is increasingly becoming institutional, especially in face of EU and NAFTA. Two recent developments have led to the urgency of forming an East Asian institutional identity. Firstly, the 1997 financial crisis has exposed East Asian's weakness in coping with the consequences of the financial crisis. A chief lesson of this crisis was that this region – accounting for about one third of the world economy and more than half the world's monetary reserves – was excessively dependent on the international financial institutions based in Washington, the authorities of the United States, and the private (predominantly Anglo-Saxon) markets that took their cues from both. In contrast, the EU handled its own crisis successfully with minimum economic costs without resorting to an outsider like the IMF. Secondly, the global trading system, whose openness and dynamism were critical to the emergence and maintenance of the “Asian miracle,” has been slowing down since the conclusion of the Uruguay Round in 1994. Both the United States and the EU have become increasingly unwilling and/or unable to maintain the needed momentum of liberalization. Moreover, both the United States and the EU are very eager to expand their own FTAs. This has given rise to East Asia's determination to force its own institution as a liberalization alternative.

The picture of East Asian cooperation we have seen above shows a very promising future for pan-East Asian economic integration. Despite the difficulties and challenges faced by the economies in the region in realizing their closer cooperation towards the establishment of an EAFTA, it is a reasonable projection to say that East Asian economies need and can go together in forming an EAFTA by the early next decade. The political will of the leaders in East Asia, the economic and institutional foundations established, and the considerable gains for almost all countries in this region are important reasons that reinforce the conviction of the bright prospect of an EAFTA.

3. CLMV with East Asian Economic Integration and its implications

As newer members of ASEAN, CLMV has participated in the regional economic integration process for a shorter period of time. Vietnam has participated in AFTA and other economic

cooperation mechanisms of ASEAN (including economic cooperation between ASEAN and external partners) since 1996. Laos and Myanmar have done so since 1997 and Cambodia since 1999. In addition, CLMV have and will continue to participate in some other regional economic linkages such as APEC, ASEM which East Asia is part of.

Any prospective EAFTA will bring both gains and losses for CLMV. In terms of major gains CLMV will gain important benefits in terms of trade, development assistance and greater bargaining power as well as political and security benefits. Regarding trade, CLMV will have the opportunity to tap into the Northeast Asian markets (especially those of Japan and South Korea which are less competitive than CLMV) so as to increase exports in areas that CLMV has the strong competitive edge (including labor- and raw material-intensive products such as agriculture, forest and fishery products, textile, footwear, and handicrafts etc). Concerning investment, CLMV will be able to attract more investment inflows (FDI, ODA and short-term capital) from regional countries especially from Northeast Asian countries so as to take advantage of their strengths and thus produce exports to Northeast Asian markets. Regarding services, CLMV will have more chance to harness the low-end services markets in Northeast Asia which CLMV countries have certain advantages in.

On the matter of development assistance CLMV will have the chance to receive more support and assistance in various forms from Northeast Asia in order to strengthen their own capacity. Regarding greater bargaining power for CLMV, a more united and vigorous economic group in East Asia will add more strength to and create more favourable conditions for CLMV in international negotiations and their relationships with other partners. Concerning politics and security matters, deepening economic linkage in East Asia will contribute to the safeguarding of peace, stability and mitigating conflicts/confrontation in the region. Yet, on the other side of the same equation, CLMV may suffer from potential losses resulting from the prospective EAFTA. Firstly, loss of significant budgetary revenues due to tariff liberalization vis-à-vis Northeast Asian goods are inevitable. Secondly, as the competitiveness of CLMV's goods and services remains low, these countries may experience the risk of increased trade deficits from Northeast Asia due to the removal of tariff and non-tariff barriers (in the trade relationship between CLMV and Northeast Asian countries, almost all CLMV have suffered from trade deficits). Thirdly, CLMV may lose ground in important markets (like capital market, the high-tech market and high-level services market) to Northeast Asian companies. Fourthly, there is a real risk of getting an unfavourable hitch in the regional

division of labor. CLMV may continue to develop mainly low-value added products. There is also an additional risk of the excessive exploitation of natural resource and thus increased environmental degradation in CLMV if the CLMV governments fail to adopt adequate measures and policies to deal with this situation. Finally, in terms of politics, the sovereignty and role of CLMV may be reduced considerably within an East Asian group in which great powers play a leadership role. Moreover, that CLMV may fall into the trap of a power game by strong member countries should not be ruled out.

Yet, on balance, the benefits of an EAFTA outweigh its risks for CLMV countries for three reasons. First, we need to look at the benefits for CLMV countries from a dynamic perspective in terms of greater market access, higher production and management efficiency, and stable political relationship. Second, the history of European integration shows that smaller member countries have tended to benefit significantly from such a grouping despite potential losses and risks. What is more important is related to the supply-side capacity of the CLMV countries. That is even when potential opportunities do exist from the EAFTA, do CLMV countries possess sufficient capabilities in terms of management techniques and physical infrastructure to take advantage of them and to cope with the negative side of greater exposure to outside competition?

Despite all this, there is no denial that there are real hurdles to CLMV in the process of East Asian integration. One, these countries remain poor with low levels of development (per capital income in CLMV is over 300 USD a year). CLMV is basically agriculture-based with low levels of industrial development, low competitiveness of the economy, weak scientific and technological base and poor infrastructure. Two, in terms of institutional development, almost all CLMV countries have not completed their transition from the planning subsidized economy to the market economy with full integration into the regional and world economy. On the other hand, CLMV also have diverse social and political systems which are very different from those of other countries in the region. In particular, legal enforcement in these countries remains weak. Thus, their socio-economic institutions leave much to be desired (they are either insufficient, inadequate with weak legal enforcement and not suitable with the reality and relevant international standards). This requires CLMV to double their efforts in law making and refinement, simplification of administrative procedures as well as enhancement of law enforcement. Three, state officials and business persons still have low levels of foreign language expertise and general knowledge, especially professional and

management skills. Red tape, administrative obstructionism, and corruption remain rampant in these countries. In addition, the labor force in CLMV still has certain disadvantages such as low education levels and lack of skill and foreign language. Finally, local enterprises are mostly small- and medium-sized with little capital, low technology and competitiveness; the state-owned enterprise sector in some countries (Vietnam and Laos) have played a key role in the economy but with low efficiency. This is one of the main obstacles facing these countries in international economic integration.

In conclusion, it can be confidently surmised that, despite numerous difficulties, the prospect of East Asian economic integration in the form of an EAFTA is bright given the political will of its leaders, the already established economic and institutional foundations, and the inevitable gains from the prospective EAFTA. CLMV countries can not afford to isolate themselves from this trend of economic integration in East Asia. CLMV will have much to gain from EAFTA. Yet, how much CLMV will gain or lose from this initiative depends on their supply-side capacity, their efforts to design their appropriate liberalization roadmap, and the preferential treatment and support from other countries.

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Part III: Towards an East Asian Economic Community?

12. East Asian Economic Community and the Scope of East Asian Cooperation

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I. Introduction

Regional Cooperation in East Asia

Regional cooperation in East Asia has become one of the most frequently discussed issues in recent years. A number of bilateral and multilateral Free Trade Area (FTA) agreements have been established or are being negotiated. The ASEAN Free Trade Area (AFTA) already constituted a subregional trade linkup, and an ASEAN+3 (i.e. Japan, China and South Korea) FTA was also proposed to build an East Asian Free Trade Area (EAFTA). China and Japan are actively pursuing FTA negotiations with ASEAN countries. On the financial side progress has been made after the Asian financial crisis in 1997. A number of bilateral swap agreements have already been signed and many more are being negotiated. Many East Asian countries have established a surveillance mechanism to monitor their economic performance.

The post-Cold War world has increased the importance of economic power *vis-à-vis* ideological, political and security issues.¹ Since the 1990s ASEAN has increasingly been looked upon as a vehicle for deepening regional economic cooperation. Northeast Asian countries did not want to be left out of worldwide regionalization and actively joined in the regional cooperation process. East Asian economic integration is expected to accelerate economic development by increasing the flow of capital and technology while expanding production and export capacity. It would also bring a convergence of business cultures and the common “rule of the game.”² Political cooperation is a more challenging task. The most visible progress is the ASEAN Regional Forum (ARF) in which South Korea, Japan, China, and European representatives participate with ASEAN countries. It endeavors to increase influence on the stabilization of regional security. At the private level (track II) the Council for Security Cooperation in Asia-Pacific (CSCAP) accompanies the ARF framework.

¹ Chang Li Lin, Ramkishan S Rajan, “Regional Responses to the Southeast Asian Financial Crisis: A Case of Self-Help or No Help?,” *Australian Journal of International Affairs*, Vol. 53, No.3 (November 1999).

² Dajin Peng, “The Changing Nature of East Asia as an Economic Region,” *Pacific Affairs*, Vol.73, No.2 (Summer 2000).

There are currently multiple institutions and forums to deal with regional cooperation in East Asia. A number of cooperative bodies – ASEAN, ASEAN+3, APEC, ASEM, and ARF – are overlapped in East Asia. Most East Asian countries belong to different regional groups and organizations, and they are party to several regional trade arrangements.³ ASEAN worked toward the broad goals of regional cooperation laid out by the “Vision 2020,” which is a roadmap for ASEAN in the 21st century.⁴ APEC was moving towards implementing the programs aimed at achieving the 2010/2020 targets for free trade and investment in the Asia-Pacific region. More recently, the East Asia Vision Group (EAVG) has provided a roadmap for an “East Asia community,” and subsequently the East Asia Study Group (EASG) has worked to implement the suggestions from the EAVG Report.⁵

Evolution of ASEAN+3 Cooperative Framework

ASEAN+3 has become the most active regional institution in recent years. While ASEAN consists of 10 Southeast Asian countries, ASEAN+3 includes three major countries from Northeast Asia – China, Japan, and South Korea – and thus represents the entire “East Asia.”⁶ ASEAN+3 summit provides an opportunity for a series of bilateral and multilateral summits between the heads of state. ASEAN+3 has a further advantage, at this stage, of not including Hong Kong and Taiwan, which would complicate ties with China in other groups such as the APEC.⁷ The first ASEAN + 3 summit meeting was held in Kuala Lumpur on December 16, 1997, and the leaders discussed ways to cope with financial problems. At the second summit meeting in Hanoi on December 16, 1998 the creation of a regional financial mechanism, including the Miyazawa Plan, a Japanese proposal to create an Asian monetary mechanism to prevent future crises, was discussed. The establishment of the East Asian Vision Group (EAVG) was decided in this summit. At the third summit meeting held in Manila on November 28, 1999 a Joint Statement on East Asian Cooperation was adopted, and the

³ Bowles labels this phenomenon a “multiple regionalism.” Paul Bowles, “ASEAN, AFTA and the ‘New Regionalism’” *Pacific Affairs*, Vol.70, No.2 (Summer 1997).

⁴ “The People’s ASEAN,” Report of the ASEAN Eminent Persons Group (EPG) on Vision 2020; Lin and Rajan, *ibid.*

⁵ Both EAVG and EASG were proposed by the South Korean President Kim Dae-Jung. EASG is a government-level organization to discuss further regional cooperation while EAVG is composed of non-governmental experts.

⁶ The geographical boundary of East Asia is quite debatable. In this paper East Asia means Northeast Asia and Southeast Asia.

⁷ F. Pierre Goad, “Asian Monetary fund reborn,” *Far Eastern Economic Review* (May 18, 2000).

leaders agreed to hold ASEAN+3 ministerial meetings.⁸ The Manila meeting has particular significance in that the leaders from three Northeast Asian countries began to hold a tripartite summit.⁹ At the fourth summit meeting in Singapore on November 24, 2000 the leaders discussed the ways to advance East Asian cooperation in the region, including ways to turn the ASEAN+3 meeting into an East Asian summit.¹⁰ EAVG Report was reviewed by the national leaders during the summit in 2001. The East Asia Study Group was then established to examine the feasibility of EAVG recommendations and to adopt the implementation measures.

Two processes were added to ASEAN+3 mechanism in recent years: Network of East Asian Think-tanks (NEAT) and East Asia Forum (EAF). The NEAT was created as track II of East Asia cooperation with tasks to provide intellectual support to and policy recommendations on important issues and the directions of the East Asia cooperation, and to do research on the issues raised during the ASEAN+3 Summit and from the EASG. The first annual conference of the Network of East Asian Think-tanks (NEAT) was held in Beijing, China from 29 to 30 September, 2003 in which 100 scholars from ASEAN, China, Japan and the ROK (10+3) attended the conference. During the ASEAN+3 Summit in Brunei Darussalam in 2001, the EAVG's recommendation of the establishment of an East Asian Forum (EAF) received support from the leaders of the ASEAN countries, China, Japan, and South Korea. In addition, the EASG recommended the establishment of the EAF as one of the twenty-six concrete measures in its Final Report, which was approved by the leaders of the ASEAN+3 Summit in Cambodia in November 2002. The EASG suggests that details of the establishment of the EAF be discussed in the ASEAN+3 process. In the EAVG Report, submitted to the ASEAN+3 Summit in 2001, an East Asia Forum (EAF) was recommended to "serve as an institutional mechanism for broad-based social exchanges and, ultimately, regional cooperation." The EAF is expected to provide a vehicle for discussions and recommendations among representatives of governmental, business and academic circles in ASEAN, China, Japan and Korea with a view to deepening the understanding of mutually beneficial issues for the sake of peace, prosperity and progress across East Asia. The EAF was

⁸ The Joint Statement covers major areas of East Asian cooperation: economic cooperation, monetary and financial cooperation, social and human resources development, scientific and technical development, culture and information, development cooperation, political security and transnational issues.

⁹ At the Singapore meeting in November 2000 they agreed to make this three-way Summit Meeting an annual event.

¹⁰ Lee, Chang-Jae, "China, Japan and Korea Facing the Challenge of Worldwide Regionalism." Paper presented at the International Symposium on Strengthening Trade Relations between China, Japan and South Korea: Assessment and Prospects, held in Seoul, on September 24, 2001, p.25.

included as one of the seventeen short-term recommendations in the EASG Final Report, which was submitted to the ASEAN+3 Summit in Cambodia, in 2002. The Republic of Korea, at that juncture, proposed that the inaugural meeting of the EAF be held in South Korea. Accordingly, the EAF 2003 is scheduled to be held in Seoul, South Korea on December 14-16, 2003 under the theme of *Peace, Prosperity and Progress in East Asia: Challenges and New Visions*. Officials of vice-ministerial level, business leaders, and distinguished scholars from ASEAN plus three countries will honor the EAF with their presence

Plan of Study

This paper examines the efforts to build an East Asian economic community and its prospects. However, East Asian economic cooperation cannot be explained solely by economic logic. The dynamics of regional economic cooperation also entail political elements from the beginning. While this paper examines the recent developments of regional economic cooperation in East Asia, the scope of this paper will expand to the political arena, and in doing so I will emphasize the significance of a “politically sustainable” regional economic community. The paper also focuses on the evolution of ASEAN+3 framework and the EAVG/EASG Report to explain the developments of ASEAN+3 cooperation. Part II and III examine the progress of East Asian economic cooperation – trade and finance. Part IV and V surveys the vision and economic agenda in the EAVG Report and EASG Report that proposed an “East Asian community.” Part VI evaluates ongoing East Asian economic cooperation and discusses major obstacles and problems during the regional cooperation process. Part VII provides the prospect of East Asian economic cooperation in terms of new geopolitics in the region.

II. Toward a Common Market in East Asia

Regionalization of trade has become a worldwide phenomenon in recent decades. Recent regionalization of global trade originated partly from the disappointment from the existing multilateral agreements such as WTO and partly from the United States’ conversion from a devoted multilateralist to an ardent regionalist pursuing NAFTA and FTAA.¹¹ There has been a series of debates on whether regional trade regime is beneficial to free trade. For advocates

¹¹ Richard Baldwin, “The Causes of Regionalism,” *The World Economy*, , Vol. 20, No. 7 (1997).

of regionalism removal of trade barriers, no matter how it happens, is good for free trade. They think that regionalism has a largely benign effect on the multilateral system. Trade liberalization through regional trade agreements is politically easier than multilateral or unilateral liberalization.¹² Those who are against regionalism argue that the member countries of trade blocs will be less interested in multilateral liberalization talks and that this will pose a serious threat to the world trading system. Regionalization may even provoke an inter-bloc trade war. They also point out that small countries will be in a disadvantageous position when they negotiate with a large country.¹³

Despite these debates most countries began to think that joining regional trade agreements would be beneficial at least to themselves.¹⁴ East Asia was not an exception in this trend. Richard Baldwin explains this proliferation and expansion of regionalism with the domino theory. If the bloc enlarges, the cost to the non-members increases, since they now face a cost disadvantage in an even greater number of markets. This second-round effect will bring the more pro-regional political activity to non-members and thus may lead to further enlargement of the bloc.¹⁵ Economically, a regional FTA can bring a larger market, competitive environment, and more economic efficiency. FTA can be a political instrument to help lock in domestic reform policy. As shown in the European experience after the Second World War, economic cooperation can also be used as a strategic means to prevent a regional conflict.

¹² Jeffrey A. Frankel, ed., *The Regionalization of The World Economy* (Chicago: The University of Chicago Press, 1998); World Trade Organization, *Regionalism and the World Trading System* (1995); "Regionalism and the World Trading Systems" in Larry Summers ed., *Policy Implications of Trade and Currency Zones* (Federal Reserve Bank of Kansas City, 1991).

¹³ The Bhagwati school emphasizes this discriminatory liberalization. Jagdish Bhagwati, Pravin Krishna and Arvind Panagariya, eds. *Trading Blocs: Alternative Approaches to Analyzing Preferential Trade Arrangements*. (Cambridge: The MIT Press, 1999); Arvind Panagariya, "The Regionalism Debate: An Overview." *The World Economy*. Vol.22, No.4, (1999); Jagdish Bhagwati and A. Krueger, *The Dangerous Drift to Preferential Trade Agreements* (Washington: American Enterprise, 1995).

¹⁴ Although Bhagwati thinks that the revival of regionalism is unfortunate, given its political appeal and its likely spread, he believes that it is important to contain and shape it in the ways so that it becomes maximally useful and minimally damaging, and consonant with the objectives of arriving at multilateral free trade for all. Jagdish Bhagwati, "Regionalism and Multilateralism: An Overview." In Jagdish Bhagwati, Pravin Krishna and Arvind Panagariya, eds. 1999. *Trading Blocs: Alternative Approaches to Analyzing Preferential Trade Arrangements* (Cambridge: The MIT Press, 1999), pp. 26-27.

¹⁵ Richard Baldwin, "A Domino Theory of Regionalism." in Jagdish Bhagwati, Pravin Krishna and Arvind Panagariya, eds. 1999. *Trading Blocs: Alternative Approaches to Analyzing Preferential Trade Arrangements* (Cambridge: The MIT Press, 1999), p. 500; Richard Baldwin, "A Domino Theory of Regionalism," in R. Baldwin, P. Haaparanta, and J. Kiander eds., *Expanding Membership of the European Union* (Cambridge: Cambridge University Press, 1995).

Development of ASEAN Free Trade Area (AFTA)

The Association of Southeast Asian Nations Free trade Area (AFTA) has been by far the most advanced effort to create a common market in East Asia. AFTA was launched in 1992 at the Fourth ASEAN Summit in Singapore to eliminate tariff barriers among Southeast Asian countries. Over the course of the next few years the program of tariff reductions was broadened and accelerated. From 1993 to 1997, the intra-ASEAN trade volume almost doubled, from less than US\$44 billion to more than US\$85 billion, or from less than 21 percent to almost 25 percent of total trade.¹⁶ These figures dropped (to US\$71 billion and 22 percent in 1998) due to the financial crisis in 1997 but rose again in 1999 and stayed well above the pre-AFTA levels. The financial crisis has brought more difficulties to some specific industries in individual ASEAN countries but the funds for the relief of such industries were strictly limited as to scope, timeframe and other conditions.

The AFTA initiative received a further boost at the ASEAN summit in Bangkok, December 1995 when the ASEAN countries signed framework agreements for the intra-regional liberalization of trade in services. The ASEAN leaders also decided to advance AFTA's completion date to the beginning of 2003. Subsequent to the December summit an industrial complementation scheme designed to encourage intra-regional investment was approved, and discussions were held on creating an FTA within the region. ASEAN also adopted the ASEAN Industrial Co-operation scheme, (AICO), through which products of companies operating in two or more countries would enjoy the full AFTA treatment immediately. "AFTA Plus" activities were initiated, and they included the efforts to eliminate non-tariff barriers and quantitative restrictions and harmonize customs nomenclature, valuation, and procedures. At their summit in December 1997, the leaders of the ASEAN countries issued "the ASEAN Vision 2020" statement. They committed themselves "to moving towards closer cohesion and economic integration" and resolved to "advance economic integration and co-operation" by fully implementing the AFTA.¹⁷ At their summit in Hanoi in 1998 the ASEAN leaders again advanced the completion date of AFTA to the beginning of 2002 for the six original signatories to the AFTA agreement, with the later signatories given a few more years to adjust to regional free trade.

¹⁶ Intra-regional export rose from 30.9% in 1986 to 49.5% in 1994 while the export dependency of East Asia on the US fell from 34% to 22.8% in the same period. If imports are also included intra-regional trade in East Asia already exceeded 50% in 1995. Peng, *ibid*.

¹⁷ "The People's ASEAN," Report of the ASEAN Eminent Persons Group (EPG) on Vision 2020.

The Common Effective Preference Tariff (CEPT) was aimed at reducing tariffs on manufactured items between the ranges of 0 to 5 percent by the year 2002.¹⁸ It was also aimed at reducing tariffs to a minimum of 90 percent of the tariff lines by the end of 2001 for the original six members. Raw agricultural goods were to be phased in by a target date of 2010. Members submit tariff lines to be included or excluded from the CEPT scheme, with an increase of 90 percent of intra-regional trade covered by the CEPT.¹⁹ By 2010 all tariffs among the original six are to be abolished. By 2015 other four newcomers are expected to do the same. The Hanoi Plan of Action was adopted at the Sixth ASEAN Summit.²⁰ The Hanoi Plan is the first in a series of plans of action leading to the actualization of ASEAN Vision 2020, adopted in the Second ASEAN Informal Summit held in December 1997. The Hanoi Plan has a six-year time-frame stretching from 1999 to 2004. However, no such follow-up actually seems to have taken place as yet and skepticism regarding the usefulness of the Hanoi Plan abounds.²¹

Following a 10-year tariff reduction schedule AFTA was finally put on effect on January 1, 2002. At present only 1,683 items (3.8%) out of 44,060 in the CEPT-included list of the original six are not in compliance with this target. Vietnam is expected to reach its tariff

¹⁸ The CEPT is the mechanism by which tariffs on goods traded within the ASEAN region, which meet a 40% ASEAN content requirement, will be reduced to 0-5% by the year 2003 (2006 for Vietnam, and 2008 for Laos and Myanmar). The tariff reductions are moving ahead on both the "fast" and "normal" tracks. Tariffs on goods in the fast track will be reduced to 0-5% by the year 2000. Tariffs on goods in the normal track will be reduced to this level by 2003. Currently, about 81% of ASEAN's tariff lines are covered by either the fast or normal track.

ASEAN members have the option of excluding products from the CEPT in three cases: 1) Temporary exclusions; 2) Sensitive agricultural products; 3) General exceptions. The CEPT scheme will cover nearly 98 percent of all tariff lines in ASEAN by the year 2003; by then, the only products not included in the CEPT Scheme will be those in the General Exceptions category and sensitive agricultural products. <http://www.us-asean.org/afta.htm>.

¹⁹ Jeffery Heinrich and Denise Eby Konan, "Prospects for FDI in AFTA," *ASEAN Economic Bulletin* (August 2001).

²⁰ "Hanoi Plan of Action" *ASEAN Economic Bulletin*, Vol.16, No.1 (April 1999). The Hanoi Plan of Action includes the following objectives:

- Strengthen macroeconomic and financial cooperation
- Enhance economic integration through measures such as acceleration of the implementation of AFTA and implementation of the Framework Agreement of the ASEAN Investment Area
- Promote science and technology development and developing information technology infrastructure
- Protect the environment and promoting sustainable development
- Strengthen regional peace and security
- Enhance ASEAN's role as an effective force for peace, justice, and moderation in the Asia-Pacific and the world.
- Promote ASEAN awareness and its standing in the international community
- Improve ASEAN's structures and mechanisms.

²¹ Lin and Rajan, *ibid*.

elimination target in 2006, Laos and Myanmar in 2008 and Cambodia in 2010.²² The attempt to establish AFTA stemmed from the changes in the international economic environment during the 1980s. In most of the 1960s and 1970s the four largest ASEAN nations (i.e. Indonesia, Malaysia, the Philippines and Thailand) had pursued import substitution policies. The world economic slowdown in the early and mid-1980s, the reduction of capital transfers, the rise of protectionist sentiment in the US posed fundamental challenges for the ASEAN countries. All of the ASEAN-4 needed to find ways to boost exports and maintain foreign exchange earnings.²³

In 1986 the Philippines formally proposed to expand intra-ASEAN trade through further cooperation measures, including a phased reduction in intra-ASEAN tariffs and an external common tariff (i.e. a customs union). However, this proposal did not invite favorable reaction from other ASEAN member countries. Indonesia rejected the proposal on the ground that no deadlines should be involved and Singapore objected to a customs union on the ground that it did not want to raise its external tariffs. Economic cooperation schemes and the Preferential Trading Agreement were attractive to ASEAN countries because they offered the possibility of a larger market to support domestic industries, but they were also problematic in that each nation wished to guard its internal market for its own firms, and cooperation schemes were often bogged down at the implementation stage.²⁴ Market-sharing compromise was hard to achieve. It was Thailand's proposal for an ASEAN Free Trade Area which was unanimously adopted five years later. Changes in the international political economy in the latter half of the 1980s helped ASEAN countries engage in trade liberalization.²⁵

While AFTA initially targeted tariff reduction and trade liberalization, a concurrent goal was to attract inflows of foreign direct investment (FDI) to ASEAN by enhancing market access and creating a more attractive market environment.²⁶ Individual countries adopted

²² "Markets move toward zero rates" International Herald Tribune, 2002.1.31.

²³ Paul Bowles, "ASEAN, AFTA and the 'New Regionalism'" in *Pacific Affairs*, Vol.70, No.2 (Summer 1997), p.221-222.

²⁴ *Ibid.*

²⁵ *Ibid.*

²⁶ Tariff reductions are not enough to provide sufficient rationale for deeper economic integration. In fact, the welfare enhancing benefits of trade creation are of little relevance in Southeast Asia. Intra-ASEAN trade is a relatively minor proportion of total ASEAN trade. It accounts for less than 20 percent of total ASEAN trade and considerably less if Singapore's trade is omitted. For details of intra-ASEAN trade, see P. Bowles and B. MacLean, "Understanding Trade Bloc Formation: The Case of the ASEAN Free Trade Area," *Review of International Political Economy*, Vol.3, No.2 (Summer, 1996); A. Panagariya, "East Asia and the New Regionalism in World Trade," *The World Economy*, Vol.17, No.6 (1994).

policies more favorable to FDI in an effort to attract the foreign capital needed to spur continued industrialization.

Since the mid-1980s the primary economic objective of ASEAN trade cooperation was no longer trade creation but the avoidance of investment diversion to other parts of the world economy. ASEAN faced increased competition for more and more scarce global capital. Bigger economies in Asia – China, Japan, and South Korea – were all opening up to foreign investment, providing stiff competition. Southeast Asia needed to invest more in infrastructure, technology and human capital resources. The need for a regional trading arrangement became more compelling in that the ASEAN countries as a group could offer investors more advantages that no member individually possessed.²⁷ An awareness that FDI contributes to industrial performance, growth, competitiveness, and human capital development began to prevail. In 1987 ASEAN countries adopted the Agreement for the Promotion and Protection on Investments and guaranteed ASEAN-based firms fair and equitable treatment. The agreement also protected regional firms from expropriation and guaranteed the unhindered repatriation of capital and earnings.²⁸

The ASEAN region attracted about one-third of FDI flows to developing countries in 1991 and has remained an important destination in the 1990s. ASEAN's share of total inflows to developing countries, however, has consistently fallen during the 1990s, to become less than 8 percent in 1999. This is, in part, due to the recent emergence of China as an important FDI host. The financial crisis in East Asia revealed the problems of capacity constraints, rising costs of labor, infrastructure shortfalls, and political transparency. The financial crisis involved a sharp decrease in private external capital flows, most especially in Indonesia, Malaysia, Philippines, and Thailand.

In December 1995 the ASEAN summit endorsed the concept of an ASEAN Investment Area (AIA) in which barriers to intra-regional investment would be lowered and removed, regulations would be liberalized, streamlined, and made more transparent, and incentives would be offered to boost regional investment. The basic concept was to substantially

²⁷ Bowles explains the necessity of building preferential trade arrangement in terms of inducing more investment. "T[he] increase in capital flows since the mid-1980s has led to the situation where capital importers and capital exporters are in need of institutional mechanisms to facilitate the continued flow of capital across their borders... Regional trading arrangements between capital-exporting and capital-importing countries are one way of bringing developing countries into this process. Such arrangements are an institutional mechanism for reducing the risks of investment by providing multi-country credibility to regulations concerning trade and capital flows." Bowles, *ibid.*, p.229.

²⁸ Heinrich and Konan, *ibid.*

increase the flow of investment into ASEAN from both ASEAN and non-ASEAN sources by enhancing the region's competitiveness. The AIA would encompass three broad principles, namely, cooperation, facilitation, and liberalization. ASEAN officials have indicated that the AIA may be modeled along the CEPT lines, wherein different sectors would be opened to investment and national treatment on different time-frames, depending on each country's particular situation.²⁹

The stated objective of the AIA is to attract greater FDI into the region from both ASEAN and non-ASEAN sources with the goal of a liberal and transparent investment environment for ASEAN investors by 2010 and all investors by 2020. Under the ASEAN Investment Area agreement, each ASEAN country opens itself to investments from other ASEAN countries and extends national treatment to those investments. An enlarged market would attract investments much more effectively than the much smaller national domestic markets. It would thus be a further stimulus for growth. It would also raise, for ASEAN members, the stakes in one another's purchasing power and economic progress.³⁰ By forming AFTA, the ASEAN countries were not only able to offer multinational corporations a larger regional market for production and consumption but also increased the credibility of their commitment to trade openness by providing a joint guarantee of this.³¹ ASEAN countries also attempted to strengthen the industrial infrastructure in AFTA. These measures included a more efficient customs system, transportation, energy supply. Attention has also been directed to enhancing the investment climate, such as governance, the rule of law, the judicial system, and transparency.

Beyond AFTA

While intra-ASEAN trade volume is not high compared to ASEAN's total global trade volume as stated above, the trade volume between ASEAN countries and China, Japan and South Korea grew by 27.5 percent between 1999 and 2000, or from \$158.2 billion to \$201.7 billion.³² AFTA can be a more effective regional trading arrangement when linked to

²⁹ <http://www.us-asean.org/afta.htm>.

³⁰ Rodolfo C. Severino, "Regional economic integration: The challenges ahead," *ASEAN Economic Bulletin* (August 2001); Rodolfo C Severino, "The ASEAN free trade area: Moving ahead on regional integration," *ASEAN Economic Bulletin* (August 2001).

³¹ Bowles, *ibid*.

³² "Beyond AFTA: Where does Northeast Asia fit in?" Interview with Han Sung Joo, *International Herald Tribune*, 2002.1.31.

Northeast Asia through bilateral arrangements (i.e. ASEAN-China, ASEAN-Japan, ASEAN-South Korea) or within the framework of ASEAN+3.³³ At a bilateral summit held in November 2001 on the sidelines of the ASEAN+3 summit, ASEAN and China agreed to create a Free Trade Area within 10 years. ASEAN-China trade totaled \$39.5 billion in 2000. ASEAN's share in China's foreign merchandise trade has been continuously on the rise, increasing from 5.8 percent in 1991 to 8.3 percent in 2000. Meanwhile, the share of China in ASEAN's trade has grown from 2.1% in 1994 to 3.9% in 2000. China – including Hong Kong – is now ASEAN's fourth biggest trading partner.³⁴ The establishment of a FTA between ASEAN and China will create an economic region with 1.7 billion consumers, a regional GDP of about \$2 trillion and a total trade volume estimated at \$1.23 trillion. It will also tie Southeast Asia even more closely to China.

Japan is stepping up FTA negotiations with ASEAN. The Japanese Prime Minister Koizumi wants to keep pace with China in forging FTAs in East Asia. Japan and the ASEAN agreed to establish an expert group to examine comprehensive economic cooperation, including FTA. As a first step toward a closer Japan-ASEAN relationship, Japan signed an FTA with Singapore in January 2002. This FTA agreement is rather symbolic because Singapore has no agricultural exports and does not threaten Japan's powerful agricultural lobby. However, Japan hopes that this agreement will facilitate the signing of FTAs with other ASEAN, countries including agricultural exporters such as Thailand.³⁵ The South Korean President Kim Dae-Jung proposed an East Asian Free Trade Area (EAFTA), which was suggested in the EAVG Report, as a medium- and long-term objective of trade facilitation in East Asia. South Korea is actively seeking FTA partners among ASEAN countries and is examining the feasibility of an ASEAN-South Korea FTA.

Northeast Asian Cooperation

Economic cooperation in Northeast Asia – China, Japan and Korea – is another key for foreseeing the future of East Asian cooperation. In terms of economic volume the three

³³ *Ibid.*

³⁴ The biggest trading partner of ASEAN is the United States. Japan and the EU are the next. China is currently a distant fourth. South Korea is also an important trading partner next to China. <http://www.aseansec.org/menu.asp?action=4&content=16>

³⁵ Robyn Lim, "Japan re-engages Southeast Asia" in *Far Eastern Economic Review* (January 24, 2002)

countries represented 19.8% of the world's total GDP in 2000. With regard to trade volume their share of the world's total trade amounted to 11.8% in 1999. Under the framework of ASEAN+3 the three countries' shares in terms of GDP and trade volume were 91.2% and 67.9%, respectively, in 2000.³⁶ Since the ASEAN+3 summit meeting in Manila in November 1999 the leaders of China, Japan, and South Korea have held the three-way summit meeting. These summit meetings will be reinforced by economic ministers' meeting and business forums as agreed in the recent ASEAN+3 summit in Brunei. China, Japan, and South Korea began to show interest in forming an FTA in recent years. In particular, South Korea and Japan started negotiations to create an FTA between the two countries. Apart from these official negotiations there are many proposed FTAs involving Japan, South Korea, and China at different stages of development.

During the past ten years trade among the three countries has steadily increased. The share of intra-regional trade between China, Japan, and South Korea grew substantially from 14.1% in 1992 to 20.2% in 1996. It fell abruptly to 16.9% in 1998 after the Asian financial crisis, and then made a remarkable rebound to 20.0% in 1999 before falling slightly to 19.8% in 2000.³⁷ However, formal economic integration in Northeast Asia seems hard to achieve in the near future despite the burgeoning interest in regional cooperation. The particularities of Northeast Asia such as diverse political and economic systems, lingering thorny political issues, historical remnants and disparate levels of economic development are restricting and setting conditions to the nature of Northeast Asian economic cooperation. Given these considerations, not many serious attempts have been made to consider Northeast Asian economic cooperation as a case of formal economic integration.³⁸

III. Financial Cooperation in East Asia

The Asian financial crisis in 1997 revealed the necessity of closer financial cooperation among East Asian countries. East Asian economic cooperation is actually proceeding more

³⁶ Lee, "China, Japan and Korea Facing the Challenge of Worldwide Regionalism," p.27.

³⁷ *Ibid.*, p.28. However, the intra-regional share between the three countries remains small compared to other regional economic entities. In 1999, the intra-regional share of MERCOSUR was also 20.0%, while the shares of ASEAN and NAFTA were 21.6% and 46.5%, respectively. In 1999, the simple intra-regional concentration rate of China, Japan and Korea (1.69) is lower than those of NAFTA (2.15), ASEAN (3.64) and MERCOSUR (14.61). *Ibid.*, p. 30.

³⁸ *Ibid.*

rapidly on financial issues than on trade, unlike the European Union and other big precursors. Monetary agreements can proceed without discrimination against outsiders while trade arrangements are politically difficult and slow to organize. Besides, financial problems are more vividly remembered by many of East Asian people.³⁹ Finance ministers in the region have regular meetings at APEC, ASEM, ASEAN+3 meetings and central bank governors already have held meetings since the early 1990s.

Events in other parts of the world provided an impetus for East Asian countries, especially Japan, to enhance regional financial cooperation.⁴⁰ The successful launch of the euro pushed the Japanese currency down to a distant third after the dollar and the euro. To give itself a bigger voice in the new international financial architecture Japan has to raise the status of the yen in the East Asian region. The successful introduction of the Euro after decades-long monetary cooperation provided a role model for regional monetary and financial cooperation. There have been some substantive regional initiatives proposed in response to the crisis in East Asia, preventive as well as curative in nature. Financial cooperation in East Asia includes measures to prevent future crises by preparing sufficient liquidity as well as to strengthen macroeconomic fundamentals at the regional level. Financial cooperation has been discussed in various mechanisms, including the ASEAN, ASEAN+3, APEC, ASEM, and other ad hoc bilateral frameworks. The Asian Monetary Fund (AMF) and the Miyazawa Plan represented the Japanese initiative to recover the crisis-hit Asian economies. The Chiang Mai Initiative, which is associated with bilateral swap agreements, is by far the most visible achievement in the establishment of a regional financing arrangement. Discussions on regional surveillance system and exchange rate coordination constitute additional pillars of financial cooperation. The ASEAN Action Plan on Social Safety Nets and the APEC (Manila) Framework for Enhanced Asian Regional Cooperation to Promote Financial Stability are also being discussed in the context of regional financial cooperation.

Chiang Mai Initiative

The creation of a regional liquidity fund has been the first step for the enhancement of the region's ability to weather financial crises. It also aims to provide a functional basis for

³⁹ C. Fred Bergsten, "Towards a Tripartite World," *Economist*, Vol.356, No.8179, 2000, p.23.

⁴⁰ Kwan Chi Hung, "The Possibility of Forming a Yen Bloc Revisited" *ASEAN Economic Bulletin*, Vol.17, No.2 (August 2000); "The Theory of Optimum Currency Areas and the Possibility of Forming a Yen Bloc in Asia" *Journal of Asian Economics*, Vol. 9, No. 4 (Winter 1998).

further cooperation. In fact, East Asia has the financial means to implement a regional liquidity fund. In March 2000 the central banks of the ASEAN countries, together with China, Japan and South Korea, collectively had foreign reserves of well over \$800 billion. Including Taiwan, this figure tops \$900 billion.⁴¹ By introducing the ability to mobilize liquidity in the region East Asia could significantly improve the regional capacity to deal with financial crises. The region has been on a rapid learning curve since the financial crisis.⁴² The ASEAN+3 finance ministers launched the Chiang Mai Initiative and financial self-help and support mechanisms at the regional level at their meeting held in Chiang Mai, Thailand, in May 2000. The Chiang Mai Initiative expanded the existing ASEAN swap arrangement to include all ASEAN members⁴³ and augmented the ASEAN swap arrangement by a network of bilateral swap arrangements and repurchase agreement facilities among ASEAN countries, China, Japan and South Korea.⁴⁴ These mechanisms aim to provide liquidity support to members in the event of temporary balance of payment difficulties. Bilateral swap arrangements (BSA) would be complementary and supplementary to IMF facilities. The terms and modalities of the BSA would take into account the different economic fundamentals, specific circumstances and financing needs of individual countries.

The progress of the Chiang Mai Initiative was reported to the heads of state at the ASEAN+3 Summit in November 2000. The Fifth ASEAN Finance Ministers' Meeting held in Kuala Lumpur in April 2001 and the ASEAN+3 Finance Ministers' Meeting in Honolulu in May 2001 reconfirmed the progress of the Initiative.

Japan has taken the lead in this initiative.⁴⁵ China itself has no urgent need for additional liquidity from the region but participated in this framework. Together with Hong Kong's monetary authority, its central bank has reserves of \$250 billion, more than enough for an economy that enjoys the additional safety net of comprehensive capital controls.⁴⁶ The Chiang

⁴¹ Heribert Dieter, "Asia's monetary regionalism," in *Far Eastern Economic Review* (July 6, 2000).

⁴² *Ibid.*

⁴³ Only 5 ASEAN countries (i.e. Indonesia, Malaysia, Philippines, Singapore and Thailand) have been the signatories of the existing ASEAN Swap Arrangement. Under the Chiang Mai Initiative, Brunei Darussalam has agreed to join the ASEAN Swap Arrangement. For Cambodia, Lao PDR, Myanmar and Vietnam, some flexibility were given for their gradual accession into the ASEAN Swap Arrangement. Details on this phasing-in mechanism shall be worked out later.

⁴⁴ Under the existing currency swap agreement among the five original members, each country contributes \$40 million for a total of \$200 million. In times of emergency, countries can withdraw up to twice their input in foreign currency funds. The total swap amount was increased to \$1 billion under the Chiang Mai Initiative.

⁴⁵ Bilateral Swap Agreements were made between the dollar provided by Japan and local currencies of recipient countries. It shows that Japan is in the position of donor country.

⁴⁶ Heribert Dieter, "Asia's monetary regionalism," in *Far Eastern Economic Review* (July 6, 2000).

Mai Initiative removed two important roadblocks to closer economic cooperation in Asia. Now China is on board and a credible framework for future discussions is in place.⁴⁷

Japanese Proposals

Since the breakout of the Asian financial crisis Japan has taken a pro-active approach in responding to the crisis. About one-third of bank loans to Southeast Asia, on average, have been made by Japanese banks, and Japan has been the single largest country contributor to the IMF-orchestrated financial assistance packages to the crisis-hit Southeast Asian economies. The AMF proposal in August 1997 suggested creating a pool of available funds to be quickly disbursed to alleviate acute selling pressure from the regional currencies, as well as to provide emergency balance of payment support to the crisis-hit economies. The AMF proposal was never realized due to a strong objection from the United States and IMF.

In the following year the Japanese Finance Minister Kiichi Miyazawa announced a \$30 billion package of measures to aid the crisis-hit Southeast Asian economies. The (New) Miyazawa Plan was expanded to include Vietnam and possibly other transition economies in Southeast Asia. Compared to the earlier AMF proposal it is primarily funded by Japan on a bilateral basis. The United States, other G-7 countries and international economic agencies have all supported the measures this time. At the Hanoi Summit in December 1998 Prime Minister Keizo Obuchi announced, the establishment of a special facility amounting to \$5.15 billion over three years with preferential interest rates. Japan also announced that it will contribute some \$4.2 million to a UN human security fund to help the region overcome the social aftermath of the economic crisis.

In total, Japan has pledged about \$44 billion of ongoing aid since 1997, and it has been very generous on paper. However, the effectiveness of those aids is doubtful since there have often been an extremely long time lag in implementation.⁴⁸

⁴⁷ Goad, *ibid.*

⁴⁸ Lin and Rajan, *ibid.*

Financial Surveillance Process

Financial surveillance process became an effective mechanism for monitoring the economic and financial developments in the region. The ASEAN surveillance process has been active while discussions on regional surveillance mechanisms were ongoing in APEC, ASEM, and ASEAN+3 meetings. Since 1999 the ASEAN finance ministers have exchanged views on the recent economic developments and discussed key policy issues to prevent the recurrence of a crisis. The ASEAN finance ministers have set up a surveillance mechanism through which the ASEAN governments would monitor macroeconomic developments in the region and encourage one another, through a process of peer review, to strengthen their economic fundamentals and to push for necessary economic reforms such as consolidating the fiscal budget and restructuring private corporate debt.

The surveillance process was envisaged also to examine the regulatory and supervisory functions in the financial sector, corporate governance issues and various measures of external indebtedness.⁴⁹ Technical capacity, human resource training, transparency, and the timeliness of economic data were also important issues of discussion. The finance ministers also reached an agreement to initiate an early warning system (EWS) in the region, as proposed by South Korea in November 1999. To support surveillance activities capacity-building measures were also strengthened with the establishment of local surveillance units in some ASEAN countries in addition to the continued strengthening of the ASEAN Surveillance Coordinating Unit at the ASEAN Secretariat. ASEAN's commitment to further strengthen macroeconomic and financial stability in the region is well reflected in the various activities under the ASEAN Finance Work Program. Since the program was implemented in 1999 considerable progress has been made in the areas of insurance, liberalization of financial services, corporate governance, and capital market development. Negotiations on financial sector liberalization under the ASEAN Framework Agreement on Services (AFAS) have progressed. Efforts to develop the infrastructure, institutions, and the instruments that will deepen capital markets in ASEAN have also been intensified. However, the ASEAN Secretariat's inability to manage and supervise the mechanism, and the reluctance by some member countries to reveal too much information and data, have been the primary reasons for the slow progress.⁵⁰

⁴⁹ *Ibid.*

⁵⁰ *Ibid.*

APEC Measures for Financial Cooperation

APEC has focused on trade and investment liberalization, business facilitation and economic-technical cooperation. At the Fifth APEC Summit in Vancouver in November 1997 the APEC leaders endorsed and called for quick implementation of the “Manila Framework for Enhanced Asia Regional Cooperation to Promote Financial Stability.” The Manila Framework includes 1) a cooperative financing arrangement that would supplement IMF resources; 2) enhanced economic and technical cooperation, particularly in strengthening domestic financial systems and regulatory capacities; and 3) a mechanism for regional surveillance to complement the IMF’s global surveillance. However, no substantive steps seem to have been taken since to follow up on the implementation of any of these initiatives. Apart from vague statements about the need to strengthen the international financial architecture little else has been achieved that is directly related to the regional financial cooperation.⁵¹

Ad Hoc Unilateral and Bilateral Measures

The lack of formalized institutional structures has led East Asia, especially Southeast Asia, to depend heavily on ad hoc unilateral and bilateral relations to solve problems. For instance, Singapore has provided financial and in-kind humanitarian aid to Indonesia during and after the financial crisis. The Malaysian and Philippine central banks signed a bilateral trade payment arrangement. Malaysia has attempted to reach similar bilateral payment agreement schemes with Indonesia and Thailand. While these measures are well-intended, they are really more symbolic than substantive.⁵²

Toward Deeper Financial Cooperation

Most financial cooperation measures in East Asia have been focused on the recovery from the financial crisis and the prevention of its recurrence. The Chiang Mai Initiative has most notably increased this capacity by providing a regional liquidity fund. However, these

⁵¹ *Ibid.*

⁵² *Ibid.*

measures are far from sufficient to enhance the overall level of financial capacity within the region. The Chiang Mai Initiative is a rather loosely connected swap agreement and the amount of the fund is far short of what is needed to deal with financial crises. Efforts to strengthen financial fundamentals through a regional surveillance system and capacity-building measures did not bring an intended outcome, either.

Successful financial cooperation, beyond the level of crisis management, requires substantial macroeconomic coordination and a synchronization of business cycle. Several proposals of monetary integration were made and a series of research is being conducted to examine whether East Asian financial cooperation can move to exchange rate coordination and ultimately to an economic and monetary union such as the EMU. Although ongoing research shows diverse results, the overall degree of economic heterogeneity in East Asia seems much higher than that of the EMU. Macroeconomic coordination among East Asian countries is still at an inchoate stage. Although financial cooperation in East Asia is proceeding quite successfully, financial integration will take much more time and might not even be possible. Forming a monetary union like the EMU seems unrealistic at the current stage.

IV. The EAVG Report: Roadmap for East Asian Community

Activities of the East Asia Vision Group

The East Asia Vision Group was established to help chart the future of East Asian cooperation. First proposed by President Kim Dae-Jung of South Korea at the ASEAN+3 Meeting in Manila in 1998, the first EAVG meeting was convened in the following year in Seoul, Korea.⁵³ Composed of prominent scholars, former high-level government officials and entrepreneurs, the EAVG has sought for the suggestions which would provide a roadmap for East Asian cooperation. The EAVG meetings were held five times, twice of which were in Seoul, and one each in Shanghai, Tokyo, and Bali. The final EAVG Report was adopted after

⁵³ The EAVG proposal reflected the South Korean aspiration to increase her diplomatic role in East Asia. It also reflected President Kim's interests in regional cooperation. South Korea and other East Asian countries had participated in a number of similar vision group activities – APEC, ASEM – and the EAVG could be a relatively easy and practical step to enhance the discussion on East Asian cooperation.

the fifth meeting in Seoul in May 2001 and was submitted to ASEAN+3 summit held in Brunei, November 4-6, 2001.⁵⁴

The Vision of East Asian cooperation

The EAVG aims at building an *East Asian community*.⁵⁵ The EAVG Report stipulates three main objectives of an East Asian community—regional peace, common prosperity and human progress. The Vision Group envisions East Asia moving from a region of nations to a *bona fide* regional community with shared challenges, common aspirations, and a parallel destiny. The economic field, including trade, investment, and finance, is expected to serve as the catalyst in the comprehensive community-building process.

Guiding principles

- Inclusiveness
- International Norms
- Regional Thinking
- Progressive Institutionalization
- Harmony with the Global System

Background of East Asian cooperation

East Asia is quickly becoming a distinctive and crucial region of the world. In the new millennium, irrevocable trends such as globalization, the information revolution, and growing interdependence among nations will present East Asia with new challenges and opportunities for regional collaboration. Globalization of the world economy, together with the trend towards regional trading blocs, brings new challenges such as the need to define global

⁵⁴ “Toward an East Asian Community” East Asia Vision Group Report, 2001.

⁵⁵ Be careful in using small “c” for “community.” At first “East Asian Community” was used which was more similar to “European Community.” However, the term has been changed after the Fourth Meeting in Bali. It reflects the nature of regional cooperation in East Asia. Is it heading toward an economic and political integration or simply a closer economic cooperation? Small “c” means more like “cooperation” even though it will evolve into integration in the future. Basically, the time horizon of EAVG Report is around 2020 or even more. It provides long-term cooperative projects that East Asian countries will pursue in various stages.

standards, harmonize regulations, and engage in multilateral trade negotiations. These issues call for more deliberate regional cooperation and coordination as well as a united voice to advance the region's common interests. In the past, political rivalries, historical animosities, cultural differences and ideological confrontation posed barriers to cooperation among East Asian nations. Disparities in stages of development, trade and economic policies, and financial and legal frameworks have also impeded closer economic cooperation. In the social and cultural realms, significant poverty and illiteracy still plague the lives of millions in the region.

However, East Asian nations share geographical proximity, many common historical experiences, and similar cultural norms and values. In particular, the Asian financial crisis of the recent past has provided a strong impetus to strengthen regional cooperation. This has given rise to the recognition that East Asia needs to institutionalize its cooperation to solve similar problems and prevent new ones. But East Asia lacks an institutional framework for region-wide dialogue and cooperation. There is a growing awareness among East Asian countries of the need for a framework at the regional level to manage the dynamic changes ahead.

Agenda for Economic Cooperation

Objective

The progressive integration of the East Asian economy, ultimately leading to an East Asian economic community.

Trade

- The formation of an East Asia Free Trade Area (EAFTA) and liberalization of trade well ahead of the Bogor Goal set by APEC.
- The establishment of a ministerial committee to oversee the development of an EAFTA.
- The establishment of GSP status and preferential treatment for the least developed countries in the region.

Investment

- The establishment of an East Asian Investment Information Network (EAIIN) to stimulate intra-regional investment and to improve the transparency of investment-related regulations.
- The establishment of an East Asia Investment Area (EAIA) by expanding the Framework Agreement on ASEAN Investment Area (AIA) to cover East Asia as a whole.

Developmental and Technological cooperation

- The joint development of resources and infrastructure for growth areas in the region and the expansion of financial resources for development.
- Greater cooperation and assistance be extended to countries at lower levels of development in three priority areas: infrastructure, information technology and human resources development.
- Technology transfers and joint technology development.

New Economy

- The creation of a large pool of well-educated, adaptable and innovative human resources in the New Economy.
- East Asian Internet Project
- Trans-East Asian Information Superhighway
- Regional Software Technology Development and Multimedia Content Centers
- East Asian Venture Capital Network
- Harmonization of Internet and e-commerce issues

Agenda for Financial Cooperation

Objective

A staged, two-track approach towards greater financial integration: one track for establishing a self-help financing arrangement and the other for coordinating a suitable exchange rate mechanism among countries in the region. In the long run, the Vision Group envisages the possibility of East Asia evolving into a common currency area, if and when economic, political, social and other linkages develop to a point where tighter forms of monetary integration become feasible and desirable.

Regional Financing Arrangements

- The adoption of necessary steps toward the establishment of a full-fledged regional financing facility such as the East Asian Arrangement to Borrow or an East Asian Monetary Fund.
- The reinforcement of the regional monitoring and surveillance process within East Asia, which would supplement the IMF's global surveillance and Article IV consultation.

Regional Exchange Rate Coordination

- A more closely coordinated regional exchange rate mechanism.
- East Asian countries should work out in stages an appropriate exchange rate regime consistent with not only financial stability but also economic development.
- Flexible but stable exchange rates are more compatible with long-term steady economic development than a pure float.
- Much closer macroeconomic policy coordination on the monetary and fiscal policy.

V. The EASG Report: Toward Concrete Measures

The EASG has succeeded the EAVG since 2001 and submitted its report in 2003. The EASG tried to clarify the measures to implement the recommendations from the EAVG Report.

Unlike the EAVG, the EASG consisted of government officials and discussion was made at Track I (intergovernmental) level. The EASG proposed following 26 concrete measures:

Short-term Measures

- Form an East Asia Business Council;
- Establish GSP status and preferential treatment for the least developed countries;
- Foster an attractive investment environment for increased foreign direct investment;
- Establish an East Asian Investment Information Network;
- Develop resources and infrastructure jointly for growth areas and expand financial resources for development with the active participation of the private sector;
- Provide assistance and cooperation in four priority areas: infrastructure, information technology, human resources development, and ASEAN regional economic integration;
- Cooperate through technology transfers and joint technology development;
- Develop information technology jointly to build telecommunications infrastructure and to provide greater access to the Internet;
- Build a network of East Asian think-tanks;
- Establish an East Asia Forum;
- Implement a comprehensive human resources development program for East Asia;
- Establish poverty alleviation programs;
- Take concerted steps to provide access to primary healthcare for the people;
- Strengthen mechanisms for cooperation on non-traditional security issues;
- Work together with cultural and educational institutions to promote a strong sense of identity and an East Asian consciousness;
- Promote networking and exchanges of experts in the conservation of the arts, artifacts, and cultural heritage of East Asian countries;
- Promote East Asian studies in the region.

Medium and Long-term Measures

- Form an East Asian Free Trade Area;
- Promote investment by small and medium enterprises;

- Establish an East Asia Investment Area by expanding the ASEAN Investment Area;
- Establish a regional financing facility;
- Pursue a more closely coordinated regional exchange rate mechanism;
- Pursue the evolution of the ASEAN+3 Summit into an East Asia Summit;
- Promote closer regional marine environmental cooperation for the entire region;
- Build a framework for energy policies and strategies, and action plans;
- Work closely with NGOs in policy consultation and coordination to encourage civic participation and state-civil society partnerships in tackling social problems.

VI. Discussion

Obstacles in East Asian Cooperation

It will undoubtedly take time for East Asia to convert its desires and proposals into meaningful institutional arrangements. Common market and currency unions require both extensive technical cooperation and sustained political determination. However, the actual regional integration in East Asia does not seem to follow the track of an exclusive regional bloc, either *de jure* or *de facto*, but to move toward an open economic region. Can East Asian countries overcome the enormous obstacles during the cooperation process? The obstacles in East Asian cooperation can be categorized into structural and institutional problems.

Structural problems include political and economic rivalry, dependence on the United States, differences in political and economic systems, cultural and social differences, etc. First, China and Japan are competing with each other for leadership in East Asia. South Korea and Taiwan, Hong Kong and Singapore, are economic rivals. Countries view one another largely as economic competitors rather than potential collaborators. Second, the United States influence has critical importance in East Asia. Many East Asian countries have looked to the United States for markets, investment and protection rather than banding together to provide these by themselves. Heavy reliance on the United States in political and economic affairs has made the United States intervene directly or indirectly in East Asian cooperation. The negative United States' response obstructed Mahathir's EAEG proposal a decade ago and the AMF proposal more recently. The United States would resist excessive "Asianization" to secure her national interests in this region. Third, differences in political system, which varies from democracy to authoritarianism and socialism, also hampers efficient East Asian

cooperation. Differences in economic system are often related with North-South problem within East Asia. Fourth, cultural and social differences among countries slow down the regional cooperation. Cultural heterogeneity also extends to much broader categories like consumption behavior, business practices, management methods, and so on.⁵⁶ Moreover, security tension still remains in many parts of East Asia, and historical antipathy among the participating countries still linger. Together, these heterogeneities in the region result in trade resistance. Furthermore, the informal nature of trade barriers in the region renders formal institutions rather weak in dealing with these trade barriers.⁵⁷ All these structural problems become obstacles that East Asian cooperation should overcome.

The high level of heterogeneity increased transaction costs of building formal regional institutions for economic integration. Political diversity stems from the differences in political systems.⁵⁸ Economically, the level of development varies among East Asian countries. Institutional problems involve the effectiveness and legalization of regional institutions in East Asia. It was not the lack of institution itself but the lack of clear goals and visions as well as proper functioning of these institutions that hindered further regional cooperation in East Asia. Institution building accompanies a redefinition of the traditional concept of state in a new regional context.⁵⁹ Interaction within these institutions creates path dependence and vested interest in these settings and arrangements where priority is attached to process and social learning through iteration.⁶⁰ In this sense, institutions are important to Asians as a kind of socio-political cement that mitigates self-interest and opportunism.

The biggest problem of East Asian economic cooperation would be the lack of a strong and centralized institution which has a proper mandate and legal capacity. Among the multiple regional cooperative bodies, none has enough capacity or mandate to play a central role like the European Commission. The idea of developing the ASEAN+3 summit into East Asian summit and establish a permanent secretariat is still under discussion. AFTA has been criticized for its inefficient decision-making system. The veto power of an individual country

⁵⁶ Peng, *ibid.*

⁵⁷ *Ibid.*

⁵⁸ So far, all free trade agreements have been reached among countries of similar political systems.

⁵⁹ Institutions are, according to the widely accepted definition, "organized rules, codes of conduct and structures that make gains from co-operation possible over time by solving collective actions problems." Axelrod R. and Keohane, R.O., "Achieving Cooperation under Anarchy: Strategies and Institutions," in Kenneth Oye ed., *Cooperation Under Anarchy* (Princeton: Princeton University Press, 1986)

⁶⁰ Richard Higgot, "The International Political Economy of Regionalism: The Asia-Pacific and Europe Compared," in William D. Coleman and Geoffrey R.D. Underhill eds., *Regionalism and Global Economic Integration: Europe, Asia and the Americas* (London & New York: Routledge, 1998).

often delayed and blocked the discussion of sensitive issues and limited the agenda for discussion. Due to the lack of proper institutional structures, no clear guidelines or binding legal framework has been provided to the member countries.

APEC, one of the region's focal institutions, has revealed a need for a much clearer definition and demarcation of its roles. The overlapping of membership and lack of clear demarcation of responsibilities has resulted in some confusion. APEC is still a rather loose, young and geographically elusive organization. The non-binding nature of APEC limited the institutional development of the regime. Due to the increase of member states decision-making became more difficult. Open regionalism, which is what APEC stands for, precluded any discriminatory function toward outside countries and dissipated the regional tint.⁶¹ As a result of these institutional weaknesses the relative effectiveness of the global institutions often obviated these regional institutions.

Regional institutions in East Asia have so far shown low legalization and even an aversion to legalization. The density of institutions spanning the region remains far lower than that in Europe or the Americas. The regional institutions constructed with significant East Asian participation remained highly informal and lacked a legal framework in their design. Formal rules and obligations were limited in number; codes of conduct or principles were favored over precisely defined agreements; and disputes were settled without delegation to third-party adjudication.⁶² Without regional institutions with supranational authority East Asian economic cooperation has been led by intergovernmental negotiations rather than by the leadership of centralized regional authority.⁶³ Regional economic integration has often been achieved by informal means such as regional production networks, ethnic business networks and subregional economic zones.

National choices for or against legalization vary according to the context of bargaining. Only ASEAN has embraced increased legalization. Other institutions such as APEC, ARF,

⁶¹ It has been said that open regionalism was introduced by the US to prevent the Japan-dominating East Asian economy.

⁶² Miles Kahler, "Legalization as Strategy: The Asia-Pacific Case" *International Organization*, vol. 54, No. 3 (Summer 2000), p. 549.

⁶³ For a discussion on intergovernmentalism, see Andrew Moravcsik, "Negotiating the Single European Act: national Interests and Conventional Statecraft in the European Community," *International Organization*, Vol.45 (1991); "Preferences and Power in the European Community: A Liberal Intergovernmental Approach," *Journal of Common Market Studies*, Vol.31, No.4 (1993); "Liberal Intergovernmentalism and Integration: A Rejoinder," *Journal of Common Market Studies*, Vol. 33, No. 4 (1995).

and ASEM all lack the elements of legalization. Regional cooperation in East Asia has represented the development of similar discursive strategies by different groups of actors with multi-level regional agendas.⁶⁴ East Asian governments need to make clear their willingness to employ legalized global institutions to resolve both economic and political disputes.⁶⁵ Institutionalization of East Asian cooperation should also be accompanied by the development of policy communities encompassing key elite actors from the corporate, government, and research communities.

Implications from European Integration⁶⁶

Proposing regional integration is much easier than its implementation. It took almost four decades for the Europeans to launch a common market and half a century to introduce a common currency. Considering that European countries have shared more economic, political, and even religious similarities, East Asian integration will be much harder to achieve. More differences than similarities could be found between the experiences of European integration and East Asian cooperation.

The East Asian case is quite different from the European case in targeting trade liberalization and its implementation. While Europe has pursued synchronized regional trade liberalization, East Asian trade liberalization is based on concerted unilateral trade facilitation. While Europe has pursued “across the board” liberalization, East Asian trade liberalization will likely be a sectorally differentiated one. In removing tariff and non-tariff barriers, European trade liberalization was far more comprehensive. While European trade liberalization has been achieved under a legal framework, the East Asian case is still based on peer pressure. Finally, while the European common market was based on free movements of persons, labor migration is still limited in East Asia.⁶⁷

As for financial cooperation, the European experience can hardly be transferable in East Asia, either. First, heterogeneity in East Asian economies is much larger than that in the

⁶⁴ Higgot, *ibid.*, p. 58.

⁶⁵ Kahler, *ibid.*, p.550.

⁶⁶ Jae-Seung Lee, “In Search of East Asian Monetary Cooperation: Implications from the European Monetary Integration (in Korean),” *IFANS Policy Research*, No. 6 (January 2002).

⁶⁷ Rolf J. Langhammer, “Regional Integration APEC Style: Lessons from Regional Integration EU Style,” *ASEAN Economic Bulletin*, April 1999.

EU. The emergence of asymmetric shocks⁶⁸ will directly test the credibility of exchange rate binding in East Asia. Second, no Asian currency is prepared to take the anchor currency role so that any monetary arrangement in East Asia could gain enough credibility from the market. Third, the East Asian labor market is not flexible to buffer asymmetric shocks. In fact, East Asian economies do not seem to sufficiently satisfy the major elements of an optimal currency area – homogeneity, flexibility, mobility, and fiscal transfers.

Two important implications can be drawn from the experience of European integration. First, fast regional economic integration would be extremely hard to achieve in East Asia and it is strongly recommendable to adopt less ambitious strategies in which feasibility might be the key to enhancing regional cooperation – a “community” with small “c.” Future East Asian cooperation may look more like NAFTA or Mercosur rather than EU. Second, East Asian cooperation would be advanced largely by political rationale rather than economic interests.⁶⁹ That is, an East Asian community should be a “politically sustainable” economic community. Economic rationale is not sufficient to replicate European economic integration in East Asia. Regional cooperation is impossible without proper political will even with proper economic reasons. Therefore, a series of political dialogue (ASEAN+3, APEC, ASEM, etc.) is important to build an East Asian economic community.⁷⁰

Who will take the lead in East Asian Cooperation?

Japan used to be regarded as the leader of East Asian community. Japan is still a dominant player in East Asia. Japan alone accounts for 70 percent of East Asia’s aggregate gross domestic product.⁷¹ Japan’s \$4.7 trillion economy is eight times larger than all ASEAN economies combined and it is almost five times larger than the Chinese economy. Japan is the top aid donor to ASEAN members – Malaysia, Indonesia, Thailand, Burma, Cambodia, the Philippines, Vietnam, and Laos – and to China. Even after a decade of slow growth, Japanese firms invested more than \$2 billion in the ASEAN economies in 2000.⁷² Japan also proposed the AMF and other regional financial institutions.

⁶⁸ The stronger likelihood of asymmetric shocks resulting from the current account and the capital account – “Dutch disease” problems.

⁶⁹ Bergsten points out that the new Asian challenge will be political, especially institutional. C. Fred Bergsten, “The New Asian Challenge,” Working paper 00-4, Institute for International Economics (2000).

⁷⁰ *Ibid.*

⁷¹ David Druger and Murray Hiebert, “Battered but still on top” in *Far Eastern Economic Review* (January 24, 2002).

⁷² *Ibid.*

However, the slump in the Japanese economy, especially the huge volume of bad loans, is posing a threat to its regional leadership. Japanese investments in ASEAN have gone down in value, and their share in total foreign direct investment flows into ASEAN has diminished. This downturn has had an impact on trade between ASEAN and Japan. Its share of ASEAN's trade has diminished since the early 1990s. By 1999 Japan had slipped to the third place among all of ASEAN's trading partners, behind the United States and the European Union. Even in financial cooperation, Japanese leadership does not always bring positive resonance. Instead, the weight has moved to China quite rapidly in recent years. China occupies the central geographical position in East Asia and possesses the size as well as demographic weight. With its steady growth, massive market, cheap labor and recent entry into the World Trade Organization, China certainly poses a challenge to the Japanese dominance in the region. The recent figures released by the United Nations Conference on Trade and Development show that foreign investment in China has continued to grow strongly since its accession to the World Trade Organization.⁷³ It is important to note that ASEAN declared its first FTA with China at the last ASEAN+3 meeting in Brunei. Chinese membership in the WTO will also increase her influence in the Southeast Asian region while Japan is still suffering from a decade-long economic recession.

Japan's endeavor to tighten the ties with Southeast Asian countries attests the growing strategic tension between Japan and China. Fearing the erosion of Japan's influence, Koizumi sought to remind the region that China is not East Asia's only great power.⁷⁴ Japan may have to enlist the U.S. on its side. It is becoming clear that Japan would be able to exert influence in East Asia through its alliance with the United States. An offshore Japan may not be able to balance Chinese power on its own.

ASEAN is an important actor comprising ten Southeast Asian countries. However, ASEAN has been far inferior economically compared to the three Northeast Asian countries. The ASEAN countries have enthusiastically sought for investment, but since ASEAN+3 cannot last forever simply as a "financial lender" to ASEAN countries, ASEAN countries need to make an effort to restructure their own markets to attract more private investors from other East Asia countries. To meet the economic challenges of China's attractiveness to

⁷³ "Markets move toward zero rates," *International Herald Tribune*, 2002.1.31.

⁷⁴ Lim, *ibid.*

foreign investment the ASEAN countries had to combine their markets in an ASEAN Free Trade Area. It will be tough to compete against a homogenous China that is likely to grow rapidly in the foreseeable future.

Domestic instability among the ASEAN member countries is a big problem that must be solved. Indonesia, ASEAN's de facto leader, has been so plagued by internal political problems that it is unable and seemingly unwilling to be in a position to lead Southeast Asian integration. Singapore may not be able to be more assertive due to its size and various geographical considerations. Singapore had played an active role in launching ASEM. However, Singapore has to go through internal discussion and approval of ASEAN countries to make a proposal at the ASEAN+3 level, which could refrain Singapore from making an aggressive proposal. Malaysia's troubled national car industry and the presence of Islamic fundamentalism may hamper its active participation in accelerating economic integration in Southeast Asia.

South Korea has made a number of initiatives and is still very active in enhancing regional cooperation. South Korea expects several kinds of benefits from regional integration – bigger market, trade facilitation, financial stabilization, etc. South Korea also wants to increase her diplomatic capacity in East Asia. Even though the economic size and political influence of South Korea may not be equal to Japan and China, the role of South Korea is important in that both China and Japan are not in a position to assume overt leadership. They fear each other and other East Asia countries do not want to see a regional superpower. Co-leadership of China and Japan might be necessary in the future (like France and Germany), but it is still premature to imprint a picture of these co-leaders. There still remain tensions and conflicts between the two countries and the difference in economic and political systems between the two countries further complicate the problems. Under these circumstances South Korea may be in a better position to make proposals and facilitate future regional cooperation. Another advantage for South Korea is her geopolitical ties with the United States. The United States does not want to see any significant progress toward united East Asia where the United States is excluded as an outsider. The United States objection to the Malaysian proposal of regional cooperation (EAEC) a decade ago is a good example of this policy line. Prime Minister Mahatir's reaction to East Asian financial crisis further complicated this matter. Since South Korea has maintained a firm alliance with the United States during past few

decades its proposal of regional cooperation may avoid over-sensitive reactions from the US *vis-à-vis* the proposal from Malaysia.

VII. Conclusion: new geopolitics in East Asia

East Asian cooperation will be accelerated in the next few years with dynamic negotiations on trade liberalization and financial cooperation. FTA negotiations will follow as the most visible progress in the future. Financial cooperation also deserves a closer observation. Once again, the role of China and Japan, and which of the two countries ASEAN prefers, will be the keys to driving East Asian regional cooperation. As ASEAN revealed its preference for China at the last ASEAN+3 summit, Japan is vigilantly seeking a new alliance to vie with the ASEAN+China bloc. South Korea, Singapore, Hong Kong, Taiwan – the four East Asian NIEs – would be indispensable partners for Japan. Meanwhile, these four NIEs will also seek an enhanced relationship with China and the ASEAN countries. East Asian economic cooperation will bring a new geopolitical structure in the region.

The ambitions of Asia's two largest economies would prevent either one from taking the lead in regional economic cooperation. China has long been suspected of wanting to increase its political hegemony in the region and is not willing to cede regional economic leadership to Japan. South Korea, too, is unwilling to play second fiddle to either Japan or China.⁷⁵ For Southeast Asian countries, which have been variously colonized, invaded, or pushed around by China or Japan in the past, the prospect of either country expanding influence in the region is a highly sensitive issue.⁷⁶

East Asian cooperation will be activated at the sub-regional level as well.⁷⁷ In sub-regional cooperation the cost of negotiations is minimal and participants can reach a consensus more easily. Considering the limited negotiation capacities of East Asian countries sub-regional cooperation will be a very feasible agenda. Favorable public opinion for regional cooperation will be an important precondition and will constitute a background for sustainable development of the East Asian community. However, it is crucial to achieve at least certain

⁷⁵ Goad, *ibid.*

⁷⁶ Paul Markilie, "Survey: South East Asia: Living together" *The Economist* (February 12, 2000).

⁷⁷ Sub-regional level, here, means a specific area smaller than entire East Asia but possibly larger than a single country. It may indicate a more functional economic region. The Mekong River Project might be an example of sub-regional cooperation.

“tangible” and “substantial” progress in regional cooperation at the beginning. Without this East Asian cooperation will just be a feast of rhetoric.

13. Regional Integration in East Asia

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I. Introduction

Regionalism is a global phenomenon. Almost every member of the World Trade Organization (WTO) joins at least one regional trading arrangement. Even East Asia, which existed outside this global trend for a long time, is actively seeking regionalism of its own, particularly after the financial crisis in 1997. East Asia is now more identified as a region, whose membership includes ten ASEAN members plus three Northeast Asian countries, China, Japan, and South Korea. This “ASEAN plus Three” (APT) process, which was dormant after its birth in 1990 by Malaysian Prime Minister Mahathir, finally came to life in 1997. East Asian regionalism made a big stride particularly in the monetary field with a web of bilateral currency swap arrangements in place. Besides, East Asia is witnessing an outpouring of proposals for preferential trading arrangements at regional, sub-regional, and bilateral levels.

The prospect for an East Asian community or East Asian Free Trade Area (EAFTA), the professed goals of the ATP process, is however not so promising since so many actors are involved. Moreover, there is a huge gap in East Asia at the level of economic and political development, as well as in national preferences toward regional integration. For similar reasons, sub-regional groupings, especially the one involving the major economic powerhouses in Northeast Asia such as China, Japan, and South Korea (i.e., Northeast Asian Free Trade Area or NEAFTA) have difficulties in making headway. On the contrary, bilateral FTAs hold great promise since they involve only two like-minded actors. It is also possible for the participants to design FTA agreements according to their economic and political needs. Therefore most of the East Asian countries are actively seeking FTAs with their trading partners.

This paper aims to examine the current state of East Asian regionalism, particularly the rise of regionalism in East Asia after the economic crisis of 1997-8, and evaluate its future prospect. The focus is on exploring the implications of the growing interests in bilateral FTAs for the development of East Asian regionalism.

II. The Recent Take-off of East Asian Regionalism

East Asia has been “under-identified” and “under-institutionalized” as a region in spite of a high level of economic interactions. The financial crisis of 1997 was a watershed in the history of East Asian regionalism. The long-dormant EAEC proposal had finally come back to life in the aftermath of the financial crisis. The first annual APT heads of state summit was held in Manila in November 1999. At present, numerous monetary cooperation initiatives are on the table in East Asia. Moreover, the enthusiasm for free trade agreements is sweeping through the East Asian region.

Since that crisis there have been heated debates about the limitations of an East Asian development model based on individual states’ capacity to exploit the open international trading system outside through domestic mobilization of national resources. Regionalism or regional free trade has been seriously discussed as an alternative in East Asia, not only to prevent the recurrence of financial crises but also to regain the momentum for economic development. The economic crisis also created a functional demand to manage monetary matters jointly. Consequently, regional cooperation was most notable in the financial sector. The crisis drove East Asian countries to pool their political power against international financial institutions like the IMF and the United States. The IMF and the United States dictated much of the East Asian response to the crisis, and the “Washington consensus” was imposed upon the crisis-stricken countries as a condition for help. The widespread view that the IMF programs deteriorated the situation made the East Asians even more resentful, thereby driving them further in the direction of regionalism.

In addition, the crisis fostered a sense of common identity, particularly “the image of a region in adversity besieged by outsiders ‘ganging up’ in their attempts to exploit the difficulties that East Asian governments faced” (Ravenhill 2002: 175). This sense of common destiny must have pushed them to act together and facilitated the process of institutionalization in East Asia. For the first time in history Japan and China worked together to come up with a financial arrangement to prevent the recurrence of financial crisis, and both of them became active participants in the talks to build regional institutions.

III. Whither East Asian Community?

Currently, the APT process is at the center of East Asian regionalism. As a direct descendant of Mahathir's EAEG/EAEC proposal it is the most elaborate form of regional integration initiative in terms of regional boundary, identity, and institutions. Informal APT summit meetings began in 1997 in the aftermath of the East Asian economic crisis, and they became an official gathering in 1999. At the first annual APT summit held in Manila in November 1999 the participating leaders agreed to strengthen cooperation with a view to advancing East Asian cooperation in priority areas of shared interest and concern even as they look to future challenges. Its ultimate goal was to form an East Asian Free Trade Area by 2020. The level of institutionalization is low in the APT process which is without an independent secretariat. It remains basically a consultative forum of thirteen member governments, and bureaucrats have frequent meetings at various levels to discuss various issues of concern. Its future blueprint is well elaborated in the works of the two commissioned groups, i.e., the East Asian Vision Group (EAVG) and, its successor, the East Asian Study Group (EASG).

In its annual summit meeting in November 2001 the APT member countries agreed to launch an East Asian Summit (EAS) in the foreseeable future, as well as to scrutinize a plan for East Asian Free Trade Area on the basis of the EAVG report. An East Asian community, though poorly defined, appeared in sight considering the great enthusiasm and strong rhetoric exuded by participating leaders. When the EAVG handed in its final report to the 2002 APT summit most of the key proposals contained in the EAVG report were either watered down or relegated to long-term goals. The EASG final report did not receive much media attention due to the high publicity of the China-ASEAN framework agreement on bilateral FTA. Major actors of the APT, particularly Japan, were more interested in assessing the repercussions of the possible China-ASEAN economic alliance and figuring out countermeasures against it.

These two reports are very optimistic about the possibility of an East Asian community. East Asian cooperation, according to the EASG report, is "both inevitable and desirable, and that such integration in East Asia will evolve over time" (p. 5). The reality, however, does not justify this optimism. There is a serious leadership problem in East Asia. Right now, neither China nor Japan is willing to play a leadership role. A kind of dual power structure emerged in East Asia. More specifically, secondary powers like ASEAN and South Korea are leading the APT process; major powers like China and Japan are in the backseat.

The United States is not an enthusiastic supporter of East Asian regionalism. The United States government is casting a watchful eye on the APT process, and it is certain that the United States will act resolutely to abort any East Asian initiative that may seriously undermine its strategic and economic interests. Japan and South Korea, two major allies of the United States in East Asia, cannot be overly enthusiastic about the emergence of a strong East Asian identity or an East Asian community. Moreover, the United States still accounts for the lion's share of trade flows, investment flows, electronic bank transfers, telephone calls and travel of nearly all East Asian countries.

Transnational societies and transnational institutions, the prime movers of regional integration according to neofunctionalism, are still underdeveloped in East Asia. A neoliberal consensus, which has propelled regional integration in other regions, is weak. Domestic political conditions are not favorable to the community-building in East Asia either. Democratization, liberalization, and power shift from protectionist to pro-liberalization forces are still weak. Although East Asia has a stronger common identity now than a decade ago, question still remains regarding the extent of newly forged collective identity as well as the magnitude of its impact on regional integration. The divergence of historical experiences, cultural and linguistic diversity, and differing political ideologies still pose formidable barriers to regional cooperation. All these factors indicate that an East Asian economic community is still way ahead.

IV. Monetary Cooperation in East Asia

While East Asian community initiatives are stagnating, regional monetary cooperation is proceeding rapidly. Since financial problems lay at the heart of the economic crisis of 1997 it is not surprising that regional cooperation has proceeded more rapidly on monetary issues than on trade. Moreover, monetary cooperation, unlike most of trade deals, does not create powerful domestic losers. This is why Japan, a hegemonic defector from regional cooperation, has played a leadership role in monetary cooperation.

In the aftermath of the regional financial crisis, Japan proposed an Asian Monetary Fund in September 1997. Although the proposal was rejected immediately by the United States on the ground that it might undermine the IMF, it was just the beginning. The Japanese government not only provided liquidity to the crisis-hit economies through the Mayazawa

Plan but also proposed the “Chiang Mai Initiative” in May 2000, which was basically an effort to set up a region-wide currency swap arrangement to prevent currency crises and the escalation of such crises in the case of recurrence in the future.

The current talks of regional currency swap arrangements have so far created a series of bilateral swap arrangements between East Asian countries. East Asia has yet to see a genuine regional institution on monetary issues. As the European experience shows, monetary integration poses more threats to national sovereignty and is therefore more difficult to be carried out than market integration. Monetary integration, however, has much less spillover effects on societal integration than market integration. Consequently, monetary and financial cooperation so far made in East Asia, notwithstanding its symbolic value, will have limited impact on the actual progress of regional integration.

V. Bilateral FTAs and East Asian Regionalism

East Asian regionalism had long been represented by both trans-Pacific cooperation and sub-regional cooperation in Southeast Asia. The former, the Asia-Pacific cooperation endeavors that can be traced back to the pre-World War period, had been unproductive until 1989 when APEC, the first-ever intergovernmental institution in the Asia-Pacific region, was formed. It has yet to make a quantum leap to accomplish its professed goal of regional free trade. The latter, represented by ASEAN, could exert only a limited impact on growth of East Asian regionalism partly due to the lack of its internal cohesion and partly to due its puny economic strength. The common problem to them was that too many and too different actors are involved to make any significant progress toward integration.

The region had not known bilateral FTA until recently, which is basically a deal between the two like-minded countries. Bilateral FTAs are not just more feasible than any other forms of regional integration, they may also trigger a “domino effect” of regionalism throughout East Asia. The evolution of the EU from a five-member grouping into a soon-to-be twenty five-member entity and the development of North American integration from a bilateral FTA between the United States and Canada support this reasoning. In this sense, the rise of interests in bilateral FTAs in East Asia may facilitate the emergence of an East Asian community if major regional economies join the trend.

14. The theoretical foundations of ASEAN + 3: Prospects and Limitations

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1. Introduction: From Multilateralism to Regionalism in the International Political Economy

“Regionalism rules.”¹ Since the beginning of the 1990s, we have noticed the new global wave or regional integration. Countries competitively try to formulate diverse types of regional institutions to enhance economic gains and to countervail against regional movements in other parts of the world. We expect this trend will continue in the future. The dominating norm in international trade relationships had been multilateralism since 1945 up to the 1980s. There was a common belief among major trading countries that multilateral trade liberalization would bring economic gains, improve social welfare and promote international peace. And lessons from bad experiences of competitive protectionism in the 1920s and 1930s contributed much to this belief. Based upon this belief, major trading countries were successful in making several multilateral trade liberalization agreements within the framework of GATT. However, a relatively new trend occurred in some regions of the world during the 1980s. As the European countries speeded up their economic integration process, other countries tried to follow suit.²

Three things strongly contributed to the rise of bilateralism or regionalism in the 1990s. One was the end of the cold war. In the post cold-war era, states regarded economic competition as a major war, and some of them began to make an economic alliance to promote national interests. Competitive formation of bilateral and regional trading blocs is regarded as an “economic security dilemma”, where countries are forced to join as many as regional trading blocs as possible to prepare for the worst case of being left out of exclusive trading blocs of other countries. The second factor was the change in the US trade policy from multilateralism to a so-called ‘multi-track’-policy. With this policy, the U.S. applied all the strategies of multilateralism, regionalism and unilateralism in a way to maximize its gains. As

¹ Ethier, Wilfred (1998) “Regionalism in a Multilateral World”, in: *Journal of Political Economy*, Vol. 106, pp. 1214-1245, here p. 1214.

² Mansfield, Edward D. - Helen V. Milner (1999), “The New Wave of Regionalism”, in: *International Organization*, Vol. 53, no. 3, pp. 589-627.

American hegemonic power waned, the United States lost some of its control over management of the international trade system and this stimulated regionalism in the world economy.³ One of the results of this U.S. policy change was the NAFTA. After that, the number of regional trading blocs has increased exponentially. The third factor is related to governance within the WTO. As the number of key players in trade negotiations grows fast, it became harder to achieve any important agreements within the WTO. For example, many different groups of countries argue for different negotiation agendas in the process of DDA (Doha Development Agenda) negotiations. Many countries suspect that no meaningful results will be achieved from the DDA negotiations. Instead, countries shifted toward regional cooperation, which can be achieved relatively more easily than multilateral cooperation.

The number of regional trade agreements notified to the WTO since 1995 is more than one hundred. And the total number of regional trading blocs is more than two hundred. Almost all of the major countries hurried up to make FTAs (Free Trade Agreements) with other countries. Formulating FTAs with foreign countries has become one of the top foreign policy priorities of many countries. Despite this general trend, there are some exceptions. Northeast Asia still remains the only region in the world without any strong regional integration forces and institutions. For example, Korea is one of the few countries in the world which did not make any single FTA with foreign countries.⁴ It is interesting to see only a few FTAs among East Asian countries despite the fact that intra-regional trade flows have been rapidly increasing in East Asia during the past 40 years.⁵ For the past 40 years, East Asian countries preferred the multilateral framework to regional agreements, because it was considered to be the best way to achieve trade liberalization at the global level, and because East Asian countries used to be among the largest beneficiaries of the multilateral open trading system.⁶ However, as other states were in a rush for FTAs, East Asian countries' strategies had to be changed, too.

³ Ibid., p. 608.

⁴ There are only two WTO member countries which do not have any FTAs, Korea and Mongolia.

⁵ For example, intra-regional trade flows in East Asia grew from 19,9% in 1965 to 29,3 % in 1990; see Mansfield and Milner (1999), op. cit., p. 599.

⁶ Sohn, Chan-Hyun - Jinna Yoon (2001), *Korea's FTA Policy: Current Status and Future Prospects*, KIEP Discussion Paper 01-01, Seoul: KIEP, here: p. 9.

2. Limitations to Regionalism in East Asia

In discussing the prospects and limitations of regionalism in East Asia, we need to focus on positive explanations rather than normative statements. That is, we have to “explain” what can or cannot be done in East Asia, rather than just “say” what has to be done and what is desirable. It has been pointed out that there are some obstacles for a regional trading bloc in Northeast Asia. First, we can point out differences in many aspects among East Asian countries. For example, ASEAN + 3 includes very poor countries of the world such as Laos and Cambodia, and very rich countries such as Japan. ASEAN + 3 countries have maintained different political and economic system. Some of them are democracies, and others authoritarian regimes.⁷ The Chinese population is more than 1.2 billion, while the population of Singapore is less than 5 million. East Asian countries have different religious traditions. They include Catholicism, Protestantism, Confucianism, Buddhism and Islam. The list of differences among East Asian countries is much longer than this. Differences in political, economic and cultural traditions will hinder the establishment of common principles and norms in the process of negotiations for regional blocs.

Second, East Asian countries inherited a unique historical tradition. One outstanding historical tradition in East Asia was an authoritative international order. Until the end of the 19th century, the authoritative order was organized by China and in the early 20th century, many Asian countries became Japanese colonies. Because of this tradition, East Asian countries lack experiences in multilateral cooperation among themselves. This will be an obstacle for East Asian regionalism in the future.⁸

Third, there is a hegemonic competition between Japan and China. Japan has long been predominant in East Asia, at least economically for the past 30 years. It has provided a great amount of Official Development Assistance (ODA) to the region and has also made significant amounts of Foreign Direct Investments (FDI). Japan’s predominance, however, started to diminish because of the sluggish economy since the early 1990s. Meanwhile, China, on the strength of the rapid economic growth, is aggressively making inroads into East Asian

⁷ Mansfield and Milner pointed out that „In Asia, the scarcity of regional trade arrangements is partly attributable to the wide variation in the constituent states’ political regimes...”; see Mansfield and Milner (1999), *op.cit.*, p. 607.

⁸ Kim, Seokwoo - Shin Wookhi (1996), „Possibilities and Limitations of Multilateral Cooperation in East Asia“, in: Institute of International Studies (ed.), *The Vision of the World Order in the 21st Century*, Seoul National University: Institute of International Studies, pp. 47-69.

countries. Hegemonic competition between Japan and China is in a stark contrast with the experience of the European Community, where France and Germany collaborated to counter against the U.S. influence.

Table 14-1 shows the trend of some ASEAN countries' exports to Japan and China.

Table 14-1 South East Asian countries to Japan and China (Unit %)

		Singapore	Malaysia	Thailand	Indonesia	Philippines	Vietnam
Export to Japan	1990	8.7	15.3	17.2	42.5	19.8	13.4
	1995	7.8	12.5	16.6	27.0	15.8	26.8
	1997	7.0	12.7	15.2	23.3	16.6	18.2
	2000	7.5	13.0	15.7	23.2	14.6	18.4
	2001	8.0	14.0	16.2	22.5	16.5	17.5
Export to China	1990	1.5	2.1	1.2	3.2	0.8	0.3
	1995	2.3	2.6	2.9	3.8	1.2	6.6
	1997	3.2	2.3	3.0	4.1	1.0	5.2
	2000	3.9	3.1	4.3	4.5	2.5	4.8
	2001	4.3	3.8	4.4	4.7	1.9	6.8

The table shows that while exports from ASEAN countries to Japan slightly decreased, exports to China steadily increased. China has become a more important partner for all the ASEAN countries than before. Even more, it is expected that the trend continues in the future. Recently, both Japan and China declared that they would achieve an FTA with ASEAN countries in the near future. Unless bilateral agreements on principles and norms of a regional trade bloc between Japan and China are achieved, it is hard to realize the formation of a regional trading bloc in East Asia.

Fourth, as one of the obstacles for regionalism in East Asia, we can point out a unique internal consensus structure in many Asian countries. Most of the ASEAN + 3 countries have maintained a so-called "statist" capitalism, where the state plays a dominant role in economic operation. Formulation of an effective regional trading bloc needs inclusive internal consensus structure between states and interest groups. Most of the ASEAN + 3 countries lack this.

Fifth, U.S. influence in the region is an obstacle for regionalism in East Asia. Many of the ASEAN + 3 countries are very highly dependent on the United States, economically, politically and militarily. Because of this, it will be very difficult for the ASEAN + 3 countries to formulate a regional trade bloc among themselves and excluding the United States. Though it is a somewhat different issue from a regional trade bloc, the failure of an Asian Monetary Fund (AMF) proved American dominance in economic affairs of East Asia.

Regardless of these limitations, there have been very strong arguments for FTA formation in East Asia, especially among business people, academic people and government officials. They argue that it is time to join the world of FTAs, because ASEAN + 3 countries need to secure export markets and to accelerate restructuring of the economy by way of liberalization. Also, it is argued that ASEAN + 3 countries need to join the race for FTA formation to countervail current regional blocs in other parts of the world. The time is ripe for East Asian countries to join the world of FTAs. But, questions remain. With which country do these countries have to formulate FTAs to maximize economic and political gains? What kinds of selection criteria have to be applied? Which has to be an ordering principle, multilateralism or “mini-lateralism”? If we confine our analysis only to the ASEAN region, the intra-trade share of ASEAN has steadily increased during the 1990s, as the following table 14-2 shows.

Table 14-2 Intra-Trade Share of ASEAN, 1990-01

Destination Origin	Year	ASEAN(10)	All Other Regions	World
ASEAN(10)	1990	20.1%	79.9%	100.0%
	2001	23.5%	76.5%	100.0%

This means that there is a high possibility for ASEAN to become a “natural” regional trading bloc. However, ASEAN countries and Korea, Japan and China all want to expand the scope of regionalism to the whole East Asia. ASEAN countries want to go eastward to join with Korea, Japan and China. And Korea, Japan and China want to go westward to join with ASEAN. Will the efforts be successful? Is it desirable, or feasible? We will deal with these questions in the next section.

3. Prospects of Regionalism in East Asia: Theories of FTA

There are at least four theories on the selection criteria for FTAs. Two of these are economic theories and two others are political theories. The first economic theory is originally proposed by Jacob Viner and later developed by J.E. Meade, R.G. Lipsey and H.G. Johnson among others.⁹ According to the theory, FTAs or RTAs will have both trade creation effects and trade diversion effects. And the size of trade creation and diversion will be decided by the structure of comparative advantage among FTA member states. That is, if industrial structures of FTA member countries are complementary to each other, participating countries can expect economic gains from trade creation effects. Meanwhile, if many of their industries are competing with each other, trade creation effects will be small. The degree of complementarity or competition depends largely on factor endowments.

The second economic theory is called the “gravity model”.¹⁰ The model proposes that economic size, distance, population size and GDP per capita affect the possibility and desirability of FTA formation. According to the model, large, developed and adjacent countries are fascinating FTA partners, because FTAs in this case will expand business opportunities in larger markets, and because firms can utilize economies of scale. In addition to these, common language and cultural similarities are regarded as important factors which facilitate “natural trading blocs”.

Among the political theories, one focuses on domestic politics. The theory argues that preferences, interests and demands of some organized interest groups decide the direction and contents of public policy, including FTA policy. Contributions and votes can be exchanged for certain policies. According to this theory, a government’s political stance will reflect the relative political power of organized special interests and also the extent of the governments’ concern for the plight of the average worker.¹¹ Robert Putnam would rather regard this situation as involving two distinct stages of strategic interaction. One is international negotiation between states over possibility and contents of an FTA. The other is domestic

⁹ Viner, Jacob (1950), *The Customs Union Issue*, New York: Carnegie Endowment for International Peace.

¹⁰ Sohn, Chan-Hyun - Jinna Yoon (2001), *Does the Gravity Model Fit Korea’s Trade Patterns?*, KIEP Working Paper 01-01, Seoul: KIEP; Gilbert, John et al. (2001), *Assessing Regional Trading Arrangements in the Asia-Pacific*, UNCTAD Policy Issues in International Trade and Commodities, Study Series no. 15, Geneva: UNCTAD.

¹¹ Krueger, Anne (1974), „Political Economy of the Rent-Seeking Society“, in: *American Economic Review*, Vol. 64, no. 3, pp. 291-303; Magee, Stephen P. - William A. Brock - Leslie Young (1989), *Black Hole Tariffs and Endogenous Policy Theory: Political Economy in General Equilibrium*, New York: Cambridge University Press.

negotiation between the government and interest groups over ratification.¹² In this situation, the autonomy of the government, election procedures, the level of democracy and other political institutions will be major variables in the decision to join an FTA and the viability of an FTA.

The second political theory is about international politics. According to the theory, in selecting FTA partners, states have to consider power distribution between states, the level of economic interdependence, externalities of trade on security, trade implications on other issues such as human rights and democracy, and general diplomatic relations.¹³ For example, the theory argues for formation of FTAs within alliances and with democratic partners to minimize external diseconomies of security and to reduce risks accompanied with international businesses. Overall, all these economic and political theories on FTAs are about desirability and viability (or feasibility) of FTA formation. For example, to secure economic gains, states need to search for FTA partners which are differently endowed, and nearly located to big and rich states. But to secure domestic political support and to maintain social stability, states need to seek FTA partners which are similarly endowed and small states. On the other hand, to promote international political purposes, states have to search for democratic alliance countries as FTA partners. The problem is that economic purposes and political purposes compete in many cases. Also, in other cases, domestic political and international political purposes are in conflict. In short, economic desirability and political feasibility are often in conflict in the FTA negotiation processes. If this is the case, what is the optimal combination of these two values and which countries are the best FTA partners? And what to these theories on selection criteria tell about the feasibility and desirability of FTA formation among ASEAN + 3 countries?

¹² Putnam, Robert (1988), „Diplomacy and Domestic Politics: The Logic of Two Level Games“, in: *International Organization*, Vol 43, no. 3, pp. 427-460; Grossman, Gene M. - Elhanan Helpman (1995), “The Politics of Free-Trade Agreements”, in: *American Economic Review*, Vol. 85, pp. 667-690.

¹³ Gowa, Joanne (1994), *Allies, Adversaries, and International Trade*, Princeton: Princeton University Press; Mansfield, Edward D. (1997), “Alliances, Preferential Trading Arrangements, and International Trade, in: *American Political Science Review*, Vol. 91, no. 1, pp. 94-107; Remmer, Karen L. (1998), “Does Democracy Promote Interstate Cooperation? Lessons from the Mercosur Region”, in: *International Studies Quarterly*, Vol. 42, pp. 25-52.

4. Feasibility and Desirability of FTA among ASEAN + 3

In this section, we will empirically investigate feasibility and desirability of FTA formation among ASEAN + 3 countries. Based upon the theories above mentioned, we try to extract as many variables as possible to assess feasibility and desirability of FTA among ASEAN + 3 countries. The industrialization index will show how industrial structures of ASEAN + 3 countries differ from each other. In addition to this variable, we will show the specialization index of ASEAN + 3 countries in major economic sectors to assess whether their industries are complementary or overlapping. These variables will also show potential domestic opposition to FTAs in ASEAN + 3 countries. To discuss the gravity model, the population size, the GDP size, and the GDP per capital of ASEAN + 3 countries are investigated. To see aspects of international politics, we will investigate military alliance patterns and the democracy level of ASEAN + 3 countries. In addition to these variables, we included two other variables: average tariff rates and existing bilateral FTAs of ASEAN + 3 countries. The existing average tariff rates will show how much economic gains can be expected from FTAs. That is, if existing tariff rates are high, ASEAN + 3 countries can expect more economic benefits from FTAs. The variable is indirectly related to the feasibility of FTA formation in ASEAN + 3 countries. The countries who had an experience in FTA formation are more likely to repeat it. It also implies that there was no fierce domestic opposition to FTA formation in the past. Data for these variables are shown in the next two tables.

Table 14-3 Specialization Index of ASEAN+3

Value=Rank (Revealed Comparative Advantage)

Country	Minerals	Fresh Food	Processed Food	Wood Products	Clothing	Textiles	Leather Products	Basic Manufacturing	Cons. Electronics	Electronic Components
Malaysia	82(0.84)	148(0.39)	85(1.22)	48(1.38)	78(0.71)	76(0.50)	-	90(0.40)	1(3.14)	7(2.36)
Indonesia	50(2.46)	106(1.53)	89(1.15)	18(3.36)	45(2.37)	19(2.18)	28(2.62)	80(0.60)	20(0.97)	52(0.39)
Philippines	128(0.18)	137(0.61)	107(0.68)	96(0.38)	49(2.05)	96(0.30)	65(0.79)	107(0.24)	9(2.03)	3(4.83)
Singapore	81(0.86)	156(0.25)	117(0.41)	112(0.16)	94(0.41)	99(0.25)	-	102(0.30)	4(2.61)	5(3.00)
Thailand	102(0.42)	100(1.85)	39(2.52)	74(0.76)	59(1.72)	38(1.12)	34(2.11)	76(0.67)	11(1.74)	10(1.53)
Brunei	15(7.27)	-	-	-	43(2.68)	-	-	-	-	-
Cambodia	-	126(0.87)	-	53(1.18)	2(25.20)	-	10(6.40)	-	-	-
Laos	140(0.09)	102(1.68)	-	9(5.18)	19(8.67)	48(0.91)	75(0.56)	-	23(0.67)	64(0.22)
Myanmar	86(0.73)	56(5.31)	124(0.31)	7(5.82)	13(12.58)	-	51(1.12)	97(0.33)	65(0.05)	90(0.06)
Vietnam	51(2.40)	70(4.00)	74(1.41)	79(0.62)	32(3.83)	53(0.81)	3(15.95)	101(0.31)	57(0.08)	53(0.39)
China	112(0.33)	123(0.93)	106(0.68)	81(0.54)	29(4.49)	14(2.50)	14(4.92)	51(1.09)	16(1.40)	24(0.93)
Japan	-	-	-	111(0.17)	-	72(0.58)	-	61(0.88)	18(1.29)	9(1.73)
Korea	99(0.48)	159(0.24)	137(0.19)	103(0.34)	70(0.90)	10(2.85)	47(1.22)	56(0.98)	10(1.81)	8(1.78)

Source: International Trade Center UNCTAD/WTO

This index measures each country's revealed comparative advantage in exports. The index compares the share of a given sector in national exports with the share of this sector in world exports. Values above 1 indicate that the country is specialized in the sector under reviews. Rank 1 indicates that the country has the highest specialization index in the world for the sector under review. Shaded sectors clearly reveal the overlapping, not complementary, specialization of industries among ASEAN + 3 countries. Especially, many of the ASEAN + 3 countries possess export competitiveness in such economic sectors as clothing, textiles, consumer electronics and electronic components. This means that there may not be much expected economic gain from an FTA among ASEAN + 3. This assessment is partially supported by the industrialization index in the next table. The industrial structure of Korea, Japan, Thailand, Malaysia and Singapore is similar. Meanwhile, the industrial structure of poor countries like Vietnam, Laos, Myanmar and Cambodia are also similar to each other. Similar industrial structures mean that there can be severe domestic opposition to FTA in many countries because lots of industries may be forced to exit from the market after FTA.

Table 14-4 Some Economic and Political Data for ASEAN+3

	① Population (Millions, 2000)	② GDP (Millions of dollars, 2000)	③ GDP/PC (dollars)	④ Democracy Level	⑤ Official alliance	⑥ Industrializa- tion Index (%)(2000)			⑦ Average Tariff Rate (%)(2000)	⑧ Bilateral FTA
						1	2	3		
						Korea, Rep.	47	457219			9728	4F(Free)	U.S	5	44	51	8.6('99)	-
China	1261	1079954	856	13NF(Not Free)	N. Korea	16	49	34	16.3	-
Japan	127	4677099	36827	3F	U.S.	2	36	62	4.5	Singapore
Thailand	61	121927	1998	5F	-	10	40	49	16.6	-
Malaysia	23	89321	3883	10PF(Partly Free)	-	12	40	48	9.3('97)	-
Indonesia	210	153255	729	10PF	-	17	47	36	8.4	-
Vietnam	79	31344	396	14NF	-	25	34	40	15.2('99)	-
Singapore	4	92252	23063	10PF	-	0	34	66	0.0('95)	New Zealand, Japan
Philippines	76	75186	989	5F	U.S.	17	30	53	7.6	-
Brunei	328	-	-	12NF	-	-	-	-	무	-
Lao PDR	5	1709	341	13NF	-	53	22	25	9.6	-
Myanmar	46	-	-	14NF	-	60	9	31	무	-
Cambodia	12	3207	267	12NF	-	51	15	35	무	-

Source: World Development Report, Freedom House, KOTRA.

According to the table, it is not very clear whether ASEAN + 3 is a desirable „natural“ trading bloc based upon the gravity model. There is a huge variation in the population size, the GDP size, and the level of economic development across countries. Because ASEAN + 3 is confined to 13 countries, geographical vicinity is guaranteed. As for domestic politics, one of the big obstacles to FTA in some countries, especially in Korea and Japan, has been opposition from the agricultural sector. The fact that some of the ASEAN + 3 countries are still predominantly agricultural and that they possess competitiveness in food production and exports, will hinder the process of FTA formation in the region. And as above mentioned, industrial compatibility among several member countries may be an obstacle to regionalism in East Asia.

As table 4 shows, most of the ASEAN + 3 countries are still partly-free or not-free countries. This means that there can be more risks accompanied with foreign economic relations. Because differences in political regimes imply different decision making procedures and norms, it will be harder for ASEAN + 3 countries to agree upon principles, norms, rules and decision making procedures of future regional institutions. As for the number of existing bilateral FTAs, no country has an experience of formulating FTAs with foreign countries, except Japan and Singapore. As mentioned above, no experience implies domestic opposition and low reliability.

5. Conclusion

The data shows that an FTA among ASEAN + 3 countries is not very desirable nor feasible. There is no clear economic and political rationale for ASEAN + 3 countries to achieve an FTA. Industrial structures are overlapping. We can expect strong opposition to FTA from both industries and agriculture in some countries. Many countries are politically unstable. Most of the countries are highly dependent on the United States. And there is hegemonic competition between Japan and China. Despite these facts, there is a growing consensus among ASEAN + 3 countries that Asia needs its own regional trading bloc to counter against regionalism in other areas. Therefore, it will be useful to consider how we can overcome the obstacle.

We can come up with several things. First, institutional change may be needed in a way to give more autonomy and power to the government administration, for example the

main trade negotiation authority. By this, severe bureaucratic policy problems can be lessened and also the government can be freer from pressure groups. The government has to play a role of a so-called “rational dictator”, pursuing national interests rather than sectoral or parochial interests.¹⁴ Second, there must be a change in culture in ASEAN + 3 countries. Culture refers to a set of beliefs, attitudes, ideologies and norms in a society. Most of the ASEAN + 3 countries and their people have adopted a kind of mercantilistic culture in their international trade relationships for a very long time.¹⁵ Many people in the region always think that the ultimate goal of any trade policy is to secure a trade surplus by all means. This is not a rational policy and this kind of mercantilistic policy and thinking cannot be accepted by trading partners. All of the related sectors, including business, government, and mass media need to change their way of thinking on trade in a way to adopt a more liberal orientation. The role of mass media is especially important in educating people. Third, regional and bilateral trade agreements typically exclude a few politically sensitive sectors and specify prolonged phase-in periods for some others.¹⁶ ASEAN + 3 countries need to utilize this option in a process of FTA negotiations. By this, these countries can secure economic interests related to the FTA without hurting domestic political interests.

In lieu of conclusion, the future of ASEAN + 3 regionalism is not so bright. There are so many obstacles to overcome. The negotiation process will last a long time, maybe more than 10 years. Its success cannot be guaranteed. The more realistic alternative is to negotiate bilateral FTAs among some ASEAN + 3 countries.

¹⁴ Kim, Seokwoo (1998), *The Political Economy of International Trade*, Seoul: Hanul.

¹⁵ Deyo, Frederic C. (ed.) (1987), *The Political Economy of the New Asian Industrialism*, Ithaca: Cornell University Press.

¹⁶ Grossman, Gene M. - Elhanan Helpman (1995), “The Politics of Free-Trade Agreements”, in: *American Economic Review*, Vol. 85, pp. 667-690.



ASEAN plus three (China, Japan, Korea) – towards an economic union in East Asia?

Economic integration has come to the forefront of economic policy making in East Asia, finally. After lagging behind in forming a comprehensive regional integration area for various historical, political, cultural and economic reasons, today the discussion ranges from the introduction of bilateral Free Trade Agreements through currency and financial market cooperation to a full fledged economic community. Heterogeneity of East Asian states and divergences in economic size and economic development are not longer seen purely as obstacles to integration, but also as potential complementarities. In this book, which collects the contributions of two international conferences held in Seoul in December 2003, authors from the region as well as from Germany explore the future of economic integration in East Asia in a comparative regional perspective.

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