1 Introduction

Something was stirring across East Asia in the opening years of the twenty-first century. A region that had been notable for its lack of internal economic links over the previous fifty years was talking actively about regional cooperation. Given the consolidation of the European Union, the formation of the North American Free Trade Area, and the rapid proliferation of bilateral free trade areas around the world, the talk was not surprising. Nevertheless, East Asia's relative lack of past action raises many questions about its emerging regionalism. Why has the region suddenly shifted from taking a global approach to economic issues to discussing a regional bloc? How fast and how far will the new regionalism progress? Will the region become a version of the European Union, or something far less? What is the probable impact on American economic and strategic interests—are the likely developments something that the U.S. government should encourage or discourage? This book takes up these questions.

Some advocates envision an East Asian equivalent of the EU—a region linked both by preferential trade and investment and by a common currency. The same vision underlies worries in the United States that if it is realized, East Asia may drift away from its strong trans-Pacific economic ties. Some may find this vision so unrealistic as to represent a straw man; nevertheless, the talk in East Asia makes it a straw man worth analyzing.

So far, nothing akin to the economic consolidation of Europe or North America has occurred in East Asia. However, regional institutions do exist, and others under discussion or negotiation could evolve in a manner that either aids or obstructs American interests in the Asia-Pacific region. The core issue is whether East Asia will drift toward a more exclusive economic regionalism that specifically shuts out the United States or continue to embrace broader regional and global institutions and their more liberal rules for economic interaction. Recent developments suggest that the region is indeed moving, albeit slowly and cautiously, toward a more exclusive regionalism that could have negative consequences for the United States. Certainly much of the rhetoric concerning East Asian regionalism has sounded a strong anti-Western or anti-American theme. Nonetheless, a principal conclusion of this book is that such moves are relatively weak and slow.

This book takes a skeptical view of regional groupings in general. Formal blocs involve distortions of trade and investment that generally are undesirable. Furthermore, a tight regionalism like that of the European Union can also involve an ethnic or racially inspired hubris that can complicate international relations more broadly. That might be especially true in East Asia, where there has been a tendency to emphasize "Asian values" and reject "Western" economic, political, or social principles. With notions of cultural superiority that are at least as explicit as those ingrained in the European Union, East Asian regionalism carries the potential for promoting an unhelpful divisiveness and tension in the region's economic and political relations with the rest of the world.

In addition, manufacturing technology, as well as the information technology that underlies much of the service sector, has been moving steadily toward larger economies of scale, which lead to global competition. Firms also are developing the personnel and technical capability to engage in global direct investment. As much as some interest groups in society may deplore globalism, economic activity should continue to move in that direction. To divide the world up into a variety of groupings, each with different rules of access, can only impede progress; an East Asian economic bloc therefore would not be desirable.

A fascinating disconnect has emerged between the growing American embrace of globalism as an economic and business concept and the rising Asian resentment of what some Asians view as American or European interference in their economies. Whereas twenty years ago, purchase of American companies or real estate by foreign investors generated media coverage, today most Americans appear to have abandoned a nation-centered view of the economy. While there is a "globaphobia" problem in the United States, the predominant world view among business people and policymakers has become much more open.[1] This openness includes less reliance on legal means to block foreign businesses from the U.S. market and a stronger global strategic view among corporate managers. But in Asia, concern over American influence or dominance continues to be a factor behind the interest in regional economic cooperation.

Resentment of the United States is not new, and it may be simply one of the costs of being the world's largest economy and having globally active firms. However, in East Asia resentment of the United States and the West more generally received a boost from the 1997 Asian financial crisis. From an Asian perspective, the crisis was precipitated by Western speculators. Some point out that the U.S. government initially downplayed the crisis in Thailand and Indonesia, in contrast to its swift engagement in some other crises, such as that in Mexico. Once engaged, the U.S. government worked with the International Monetary Fund (IMF) for solutions, but the IMF imposed conditions for its loans that many felt were unfair or wrong. Of course, criticism of the IMF has not been confined to Asians; however, they have argued that the IMF has tried to "force" Western or American capitalism on Asia. Some voices in the region have argued that therefore the East Asian nations need to band together to protect themselves from the ravages of Western speculators and the unfair demands of the U.S. government and the IMF. Feelings of frustration and angry words, however, do not always find expression in action. This book looks at what has been happening with trade and investment links and with the development of regional institutions. The fundamental conclusion is that far less movement toward a regional bloc is occurring than the rhetoric would suggest.

A conundrum faces the developing countries of Asia and those elsewhere. They, or at least the noncommunist nations in the region, liked the framework imposed by the cold war. During that era, most developing countries maintained stiff import and investment barriers that were tolerated by the United States, which wanted to humor its friends in the struggle against communism. Those barriers enabled these nations to develop on their own, reversing several centuries of foreign domination of their economies through colonialism, and because of that they were politically popular. On the other hand, protectionism resulted in weak or flawed legal and institutional systems for pursuing modern economic development and often promoted inefficient or corrupt business practices. For a time, these nations managed to maintain high rates of economic growth and industrialization anyway. But the 1997 financial crisis was a potent lesson in the problems that eventually befall flawed economic systems. So now these countries must deal with the contradiction between their nationalistic urge to keep foreigners (especially Americans and other Westerners) out of their core economies and the need to open up in recognition of the fact that their institutions and behavior must accommodate international trade and investment if they hope to underwrite more robust economic growth and industrialization. Even Japan faces this dilemma. The emergence of economic regionalism in East Asia is, in part, an attempt by these countries to find a middle path by creating a preferential opening up among themselves, thereby still keeping the West at some distance.

How great that distance should or will be remains debatable. A decade ago, Lester Thurow wrote of a coming competition between three large economic blocs—Europe, North America, and Asia.[2] That prediction has not come true. Nothing resembling an economic bloc has yet to emerge in Asia, but discussion in that direction has progressed over the past decade. Some now see it as a real possibility. Writing in 2001, C. Fred Bergsten stated that "East Asia, for the first time in history, is creating its own economic bloc, which could include preferential trade arrangements and currency cooperation in the form of an Asian monetary fund (AMF)."[3] The reality thus far appears to be less dramatic.

A number of Asian nations are involved in negotiations or proposals for regional or bilateral free trade agreements (FTAs). The Association of Southeast Asian Nations (ASEAN) is in the process of forming an ASEAN free trade area; China has entered negotiations for an ASEAN-China FTA; and Japan has signed a bilateral FTA with Singapore. Other ideas—including a proposal for a broader free trade area among ASEAN, China, South Korea, and Japan—have been floated informally. The change in Japan's trade policy, which until the late 1990s had been firmly rooted in globalism—that is, centered on the General Agreement on Tariffs and Trade (GATT) and the World Trade Organization (WTO) rather than on regionalism—has been dramatic, at least in terms of rhetoric. Analysis of these discussions and agreements, however, reveals that Asian nations face considerable difficulty in opening up, even among themselves.

On the currency front, the principal accomplishment has been a series of swap agreements among pairs of central banks that enable one bank to borrow foreign exchange reserves from another in order to intervene in exchange markets to defend its national currency. Some governments and individuals in the region have proposed tightening regional links in various ways: adopting some form of regional currency, pegging individual currencies to the yen, or at least adopting stronger regional cooperation strategies to protect their currencies from fluctuations in global currency markets. In the past, most countries in the region had pegged their currencies to the dollar. That strategy was flawed, as it is for any country that tries to peg its currency to that of another nation while liberalizing international capital flows but rejecting the stiff requirements to subordinate its macroeconomic policies to its currency policy. Strategies that involve pegging to the yen instead of the dollar entail the same problem. Indeed, any strategy short of freely floating currencies is vulnerable whenever international investors detect a disparity between the fixed or quasi-fixed exchange rate and the economic fundamentals of the economy.

Informal talk of a regional Asian monetary fund continues, as well as proposals for stronger coordination of regional exchange rates. The institutional setting for these discussions has been ASEAN+3 (the three being China, Japan, and South Korea), set up in 1997. To date, however, this group has not moved very far beyond the central bank swap agreements it endorsed in 1999, which are largely inconsequential economically. The larger reality is that a number of countries in the region that had pegged or heavily managed exchange rates now have floating rates. Swap agreements make sense only in the context of pegged rates, and even then their value is debatable. What has occurred in the region appears to be a largely symbolic move to demonstrate regional cooperation while pursuing a more practical shift to floating rates.

Neither the moves toward regional free trade nor the discussion of currency cooperation is likely to produce anything akin to the European Union or even to the North American Free Trade Agreement (NAFTA). This book argues that a variety of constraints will continue to impede the tightening of economic regionalism in East Asia over the next five to ten years. What happens more than ten years in the future is more uncertain and depends on future economic and political factors. Within the next decade, however, it is unlikely that strong policy steps will be taken toward an East Asian version of the European Union.

Furthermore, narrow economic regionalism is not in the interest of these nations. The region has strong trade and investment ties with the United States and Europe, ties that would be attenuated should the region turn inward. To the extent that the region wants a useful dialogue on trade and investment issues, the appropriate institutional setting for that discussion remains the Asia-Pacific Economic Cooperation forum (APEC), a grouping that includes the United States and other non-Asian participants. APEC is a somewhat unwieldy organization that will not yield dramatic progress on lowering trade and investment barriers, but it serves the interests of the region better than a narrower approach.

Nevertheless, the rising drumbeat of discussions around a narrow East Asian regionalism has raised alarm in Washington over the past decade. Discouraging Asian regionalism, however, presents a real dilemma for American international economic policy, which continues to grapple with the alternatives of globalism and regionalism. Current U.S. policy favors a mix of globalism, regionalism, and bilateralism on the presumption that movement toward lower trade and investment barriers is desirable in any of those contexts. Whatever approach is likely to yield more rapid progress, in this view, is worthwhile pursuing. The Bush administration, for example, is simultaneously pursuing the Doha round of global WTO negotiations, a regional free trade area of the Americas, and various bilateral free trade agreements. It is difficult for the U.S. government, having adopted a favorable view of regionalism over the past two decades, to discourage similar moves by other groups of nations.

Given this book's conclusion that significant obstacles to Asian regionalism remain, the dilemma for American policy is largely moot. The U.S. government need not adopt a strongly negative public stance toward the various discussions ongoing in Asia since they are unlikely to proceed very far. Instead, the U.S. government should focus on the following:

—*The WTO/IMF.* The WTO should remain the primary multilateral trade organization, putting primary emphasis on concluding the Doha round of negotiations. This helps keep American, European, and Asian regionalism at bay while producing nondistorting global progress toward more open trade and investment. A similar argument applies to the primacy of the IMF on the financial front. To the extent that the IMF has institutional flaws, the U.S. government should work to fix them so that the IMF retains legitimacy as the sole multilateral mechanism for addressing financial crises.

—*APEC*. If the U.S. government wants to discourage narrow East Asian economic regionalism, the most appropriate way to do so is to reinvigorate APEC, which currently is regarded as ineffective and a waste of time in Washington. APEC has the obvious advantage of including the United States as a member, as well as other nations (principally Australia, New Zealand, and Taiwan) that are routinely but inappropriately left out of the narrower discussions currently occurring in Asia. The imprecise goals adopted in 1994 to implement free trade and investment throughout APEC by 2010 for the developed members and by 2020 for developing members are unrealistic. However, APEC can pursue more modest steps that would help reinvigorate the process.

Organization

The starting point for any discussion of East Asian economic regionalism is a factual analysis of what is actually happening to trade and investment flows within the region and between Asia and the rest of the world. Such analysis, which is critical to any consideration of institutions, occupies the first part of this book.

Chapter 2 takes up the basic characteristics of the region. Asia, of course, is a diffuse geographical concept; it can be so broad as to include every country from the Middle East across the continent to Japan and others off the eastern shore of the continent. For the purposes of this book, East Asia is defined as the ASEAN nations plus Taiwan, Hong Kong, Macau, China, South Korea, and Japan. The various islands in the South Pacific might also be included, but their economies are tiny and are excluded here for reasons of convenience and clarity in analysis. The East Asian nations (or "economies" since neither Hong Kong nor Taiwan have formal status as nations) are much more diverse on a number of dimensions than the members of the European Union or NAFTA. The nations included range in population from the largest in the world to some of the smallest. Economic size varies enormously, with Japan alone representing some 70 percent of regional GDP at market exchange rates. Affluence also varies, from a very wealthy Japan to very poor developing countries. Some nations are highly open to both trade and investment; others are relatively closed. These nations also vary widely on noneconomic variables. History, culture, and religion vary much more widely among these nations than in Europe or North America. The baseline economic and social characteristics of this region therefore militate against the sort of economic integration that has characterized Europe and North America.

Chapter 3 considers trade flows. The basic reality here is that the trade links between the region and the United States (and to a somewhat lesser degree, Europe) will continue to be important. The widespread perception that intraregional trade is increasing relative to the share of trade between the region and the rest of the world is largely an artifact of the emergence of China. As China has become integrated into the global trading system over the past two decades, all nations have shown a rising share of trade (both exports and imports) with China. For other Asian nations, this takes on the appearance of rising intraregional trade. Stripped of this phenomenon, the trend toward intraregional trade has been mild.

Offsetting the increase in ties with China has been the decrease in ties with Japan. The relative decline in Japan's importance as a trading partner for Asian countries—as well as for the United States and Europe—has been a significant story over the past decade. Economic stagnation, which affected imports, and a stronger yen, relocation of some production to overseas subsidiaries, and a competitive stumbling in some leading export industries all have contributed to this outcome. In the 1980s, Japan appeared to be on track to become the hub of a regional trade network, but that vision has never materialized.

The mild increase in intraregional links has come largely at the expense of the region's *relative* links with other parts of the developing world rather than with the United States. The United States alone, for example, continues to absorb close to 30 percent of Japan's exports and just over 20 percent of the exports of the rest of the region—levels little changed since twenty years ago. These facts suggest that the image of coalescing trade ties among Asian nations is largely untrue, undermining the rationale for an institutional arrangement to ratify the trend. In addition, if the Asian nations do want a regional dialogue, given their strong trade relationship with the United States, it would be better to include the United States.

Chapter 4 takes up investment flows—defined broadly to include loans, portfolio investments, direct investment, and foreign aid. On a net basis, most countries in the region do not depend on inflows of capital from abroad, in contrast to common perception. Those that were dependent on net capital inflows in the first half of the 1990s reversed their position in the wake of the 1997 financial crisis. Nevertheless, various forms of gross capital inflow are sizable and important:

—*Bank lending.* The region has become less dependent on itself as Japanese banks have withdrawn from regional lending and American and European banks, despite the 1997 financial crisis, have remained engaged. Japanese loans to the region have dropped by almost 70 percent. Loans from other countries also fell but not as much, and while they eventually began to recover, those from Japan have not.

—*Foreign aid.* Japan has been the predominant source of funds to the rest of the region, but even on this dimension, change is under way. Japanese aid has stagnated since the mid-1990s and now is beginning to fall. Back in the 1980s, Japan's aid seemed designed to curry favor and gain economic advantages with other Asian nations, but today any such expectations appear to have been unrealized.

—*Direct investment.* Data are difficult to aggregate since each nation uses different criteria for measuring direct investment, but they indicate that intraregional connections are important, especially in the form of investments by Japanese firms. So, too, however, are investments from the United States and Europe.

A decade ago Japan appeared to be on the way to achieving dominance in all of these areas—bank lending, foreign aid, and direct investment. The story since the mid-1990s, however, has been one of a diminishing Japanese role that further lessens the rationale for a narrow East Asian economic regionalism. Put in the bluntest terms, why would other Asian nations choose to tie themselves more closely to a Japanese economy that has played a shrinking role as a source of capital and whose role, in relative terms, is likely to continue to shrink?

Chapter 5 takes up the history of existing broad institutional arrangements, among which APEC is now predominant. The creation of APEC capped a long process complicated by the cold war and its sharp division of the region into communist and noncommunist blocs. The journey began with the Asian Development Bank and the Pacific Basin Economic Council (PBEC), a discussion group of business leaders. The direct progression began with an academic discussion group known as the Pacific Trade and Development Conference (PAFTAD), formed originally to study ideas for a broad Asia-Pacific, government-level organization. That led to a nongovernmental organization, the Pacific Economic Cooperation Council (PECC) and finally to APEC in 1989.

Begun as a ministerial meeting with no overarching goals other than fostering a vague notion of "cooperation," APEC added a leaders' meeting in 1993 and adopted a long-term goal of free trade and investment throughout the region in 1994. That goal was expressed in the Bogor Declaration, which set 2010 as the date for the developed members of APEC to achieve open trade and investment and 2020 for the developing members. The Bogor Declaration speaks of "open regionalism." This phrase is often assumed to mean that market liberalization measures should be implemented on a most-favored-nation (MFN) basis rather than restricted to other APEC members, but it has never been defined by APEC. Without a definition of "open regionalism"and with a weak implementation process, APEC has made only marginal progress toward this goal over the past decade. In addition, however, APEC has pursued a variety of trade facilitation measures, trying to lower some of the other costs of doing business. All the Asian economies considered in this book belong to APEC, including both China and Taiwan, which have been excluded from many other regional forums. But enthusiasm for APEC, with its limited progress toward lower trade barriers and only minor accomplishments on trade facilitation, has waned in Washington and around the Asian region.

Chapter 6 considers the more narrow East Asian groupings of nations. The first among them, though it includes only a subset of East Asian countries, was the Association of Southeast Asian Nations, dating back to 1967. ASEAN's main purpose was largely political, not economic. Nevertheless, in 1992 ASEAN adopted the objective of establishing free trade among its members through the ASEAN Free Trade Area (AFTA), although the group remains incompletely implemented. In the late 1980s the Japanese appeared to be building a "soft" regionalism based on foreign aid, direct investment, and trade, but the effort included no formal regional institution. In the early 1990s, Prime Minister Mahathir Mohamad of Malaysia proposed creating an organization that was to be called the East Asian Economic Caucus (EAEC), but the proposal was dropped following American objections. In the wake of the 1997 financial crisis, however, the EAEC finally emerged in principle, dubbed ASEAN+3. ASEAN+3, which involves meetings of leaders, ministers, and some subcabinet officials, is now the main forum for East Asian dialogue. Whether the ASEAN+3 group will be a major force in regional economic integration remains to be seen. Its only policy initiative of any significance has been the central bank swap arrangements already mentioned.

Chapter 7 takes up the narrower trade arrangements that have come under consideration as interest in APEC has weakened. The AFTA group, as noted earlier, is still in the implementation stage. Meanwhile, Singapore has been quite active in forming free trade agreements with individual trade partners (including the United States and Japan), China is negotiating one with ASEAN, and Japan is negotiating one with Mexico while considering the possibility of negotiations with ASEAN or others in the region.

Perhaps the most interesting development has been the shift in the position of the Japanese government. Officially committed to a global approach until the late 1990s, Japan has now enthusiastically endorsed the rhetoric of bilateral and regional free trade areas. Its recent agreement with Singapore, however, is quite weak in a number of respects, especially in its exclusion of agriculture products due to intense opposition from Japanese farmers and the agriculture ministry. That exclusion has undermined the drive by proponents in the Japanese government to extend the bilateral free trade area to include other nations that have more substantial agricultural interests. The Japanese government has entered negotiations with Mexico and finally announced that it would begin negotiations with Korea, Thailand, and Malaysia as this book was going to press.

The inability to truly let go of domestic protection for the sake of closer relations with a limited set of nearby neighbors has plagued other agreements in the region as well, notably the ASEAN free trade area—where, to put it charitably, the definition of "free" has been quite flexible. In addition, the pattern of negotiations and agreements shows no exclusive focus on regional partners. Singapore has reached out to the United States and Australia. Thailand is negotiating with the United States, and Japan with Mexico. Overall, developments in regional and bilateral free trade show few signs of leading toward an East Asian regional bloc.

Chapter 8 turns to regional monetary cooperation. At the time of the Asian financial crisis in 1997, the Japanese government had advocated an Asian monetary fund to act as a regional parallel to the International Monetary Fund. That idea was quickly scuttled by opposition from the United States and others. In its wake, however, the Japanese government provided some added financial support to the countries most affected by the crisis. More important, finance ministers from around the region met as part of the ASEAN+3 dialogue, endorsing an expanded set of swap arrangements between their respective central banks to help individual countries engage in exchange market intervention to defend their currencies. In reality, this agreement has been largely moot since the region has begun to move to floating exchange rates, obviating both large, sudden exchange rate shocks of the sort that occurred in 1997—when fixed rates became untenable—and the need to defend against such large shocks. Loose talk of greater cooperation continues, including eventual formation of an AMF or even a common currency. Nevertheless, there is little evidence that any serious movement in that direction will occur, at least within the next decade.

Chapter 9 explores the broad question of regional leadership. If East Asia were to coalesce into a tighter regional bloc, the process would have to be led by one of the region's giants—Japan or China. For different reasons, neither country appears to be a convincing leader. Japan is hampered by its shrinking economic role in the region as well as its crumbling reputation for domestic economic success and astute economic policies. Japan also is hampered by continuing protectionism. Its somewhat demeaning attitude toward its neighbors also has been a problem, including its inability to sound sufficiently contrite about Japanese atrocities committed during the Second World War. Finally, Japan is hampered by its close ties to the United States. For all the rhetoric in favor of regionalism expressed by Japanese officials, they know they are tied closely to the United States, both economically and militarily.

China also has problems as a leader. China remains a socialist nation attempting to transform its economy to a market-based system, and that transformation remains incomplete. Meanwhile, the Chinese government still manages to arouse concern around the region with its foreign policies, of which one of the most important is its stance toward Taiwan. From an economic standpoint, Taiwan is an important member of the region, but institutionally it will continue to be excluded from any regional dialogue in which the Chinese have a strong voice, such as the ASEAN+3 dialogue. For those reasons, China, too, appears to be an unlikely leader of an East Asian economic bloc. With neither Japan nor China able to project a convincing image of leadership, evolution of a cohesive East Asian regionalism is much less likely.

The final chapter, chapter 10, tackles the question of American economic policy toward the region and the evolution of new institutional arrangements. The starting point for American policy is to maintain the primacy of a global approach through the WTO and IMF. Aside from the straight economic arguments concerning the desirability of a global approach in both trade and finance, this stance undercuts the East Asian regional impulse.

At the WTO, the key issue is to move forward with the Doha round of negotiations. Global negotiations absorb the negotiating energy of government officials at the expense of regional negotiations, and if trade barriers fall globally, it lessens the impact of any regional preference schemes. At the IMF, the issue is mainly one of reform. Nothing will ever eliminate resentment of the IMF; no nation likes to be given strong, unpleasant conditions for reform in exchange for a financial bailout. But the IMF policymaking process has been strongly criticized by many observers—including Americans. Reform at the IMF would help dampen the talk of an Asian monetary fund or other regional schemes to lessen the impact of IMF conditions, leaving any regional institutional arrangements with a supplementary role.

The strong conclusion of this book is that participation in APEC should continue to form the core of U.S. economic policy toward Asia at the regional level. The economic developments discussed in the early chapters indicate that a broader arrangement in which the nations of Asia continue to have an institutional involvement with the United States argues in favor of APEC. The same, by the way, applies to the inclusion in APEC of Australia and New Zealand—two countries with strong economic ties with their Asian neighbors that are left out of all the alternatives. And, of course, APEC includes Taiwan, which also is not included in the alternatives. In narrower terms of national interest, obviously institutional arrangements that exclude the United States could yield outcomes that put American firms at a disadvantage. Meanwhile, there is no reason for the U.S. government to adopt a highly critical stance toward the cooperative developments in the region. Most of these are either relatively harmless (such as the bilateral swap arrangements among central banks) or unlikely to proceed very far (such as Japan's new strategy of forging bilateral free trade areas). The rhetoric accompanying such initiatives may sound alarming, but most of them have little content.

All of this discussion has broader strategic implications as well. The rejection of the West that is implicit in much of the discussion of regionalism in East Asia has a divisive impact on diplomatic relations. At the very least, Asian efforts to limit the ability of American firms to do business in the region would undermine U.S. support for playing a regional security role. This eventuality, however, seems remote, for all of the reasons suggesting that the reality of Asian economic regionalism will be far less than the rhetoric. In addition, regional dialogue—whether in APEC or the narrower alternatives—produces discussions that help to quell tensions on noneconomic issues. Japan, for example, has perennial difficulties with its "history" problem, but mutual economic interests and dialogue keep the problem from spinning out of control and act as a brake on both Japanese behavior and Asian reactions to it. While APEC continues to stand out as the most desirable institutional format, from a strategic as well as economic standpoint, there is no reason to discourage East Asian governments from talking and acting among themselves.