

*East Asia in Transition*

The most dynamic region in the world today is East Asia, with one-third of the planet's population and one-fifth of its gross domestic product (GDP).<sup>1</sup> The regional economy sprang back to life in the 1980s, when deepening interdependence began spreading economic benefits throughout the region after a century of wars and ideological struggles between various powers, which eventually saw greater sense in development and cooperation. Even the socialist countries among them were introducing some market reforms before the end of the cold war. This focus on economic development, together with the security presence of the United States, has defused potential sources of conflict and maintained regional peace and prosperity.

East Asia now faces a historic geopolitical transition, however, owing to the rise of China and relative decline of Japan. The continued stability and prosperity of the region, not to mention the world, will depend on the course of this transition. If the violent anti-Japanese demonstrations on the streets of major Chinese cities in the spring of 2005 are any indication, managing it will be no easy task.

In response to the challenge, there has been a surge of political interest in the vision of an East Asian community. Such an entity could help accommodate China's growing power and influence, stabilize Sino-Japanese relations, and maintain regional peace and prosperity. But enormous difficulties stand in the way of its realization. East Asia is not a monolith. Regional economies differ widely in their stages of development. And deep-rooted distrust and historical antagonism bedevil relations between Japan and China.

As a result of these and other factors, including the reactions of extraregional powers, political support for East Asian cooperation has wavered greatly. A growing concern, especially now that Japan is slipping from its earlier position, is that China could dominate the region, using East Asian institutions as a vehicle of influence, which would make it difficult to maintain a stable balance of power within the region. In reality, there appears to be no immediate prospect of Chinese domination, for it is commonly understood that any East Asian community should be based not on hierarchy but on equality and mutual respect. Nonetheless, concern about the potential for Chinese hegemony continues to curb the political momentum behind East Asian cooperation.

As this book argues, these difficulties should not deter the countries of East Asia from promoting regional cooperation as part of a multilayered approach to international cooperation. Initially, their efforts should focus on economic issues. The development of dense production networks across the region has already deepened economic interdependence and given local governments a clear common interest in reducing transaction costs for businesses operating in East Asia. By acting on this common interest, they can make the region more disposed to competition and innovation. It will not be easy to negotiate the necessary reforms, owing to domestic political resistance to economic liberalization. Nonetheless, such an effort can have a large payoff by helping to focus the region's attention on economic development, rather than on political power plays.

In the early stages of reform, regional governments should be flexible and choose the most appropriate forums for dealing with particular problems. At present, this may mean working within the framework of ASEAN + 3 (the Association of Southeast Asian Nations, China, Japan, and South Korea), as well as through other bilateral, regional, plurilateral, and global institutions.<sup>2</sup> (Note that plurilateral agreements involve more than some but not all members of a larger multilateral agreement and differ from subregional or regional agreements in that the membership is not tied to a particular region.) Eventually, when regional leaders are ready to articulate common goals and agree on the membership, they can take further steps toward building an East Asian community.

Although the vision of such a community is still somewhat vague, its realization is an important goal. East Asian countries need institutions that will allow them to deal with the region's unique problems on their own. Though they still lack the mutual trust necessary for such institutions to work, the alternative—having outside powers act as a counterbalance in the region—

would only intensify tension and rivalry. By contrast, greater regional cooperation can help overcome lingering distrust and antagonisms and turn East Asia into a more comfortable place to live.

## **Institutional Economic Integration**

Over the past fifteen years, enthusiasm for an East Asian community has increased dramatically. At the beginning of this period, the region was already benefiting from *de facto* economic integration induced by market forces—a process I call “regionalization.” Up to 1998, however, East Asian governments shunned formal free trade agreements (FTAs) in the region, instead pursuing liberalization in the global arena on a most favored nation (MFN) basis. They also hesitated to create East Asia–only intergovernmental forums to promote regional economic integration.

By the fall of 2000, however, all the powers in the area had embarked on bilateral FTAs. In addition, at the ASEAN + 3 summit that year, East Asian leaders started to explore such ideas as an East Asian free-trade area and an East Asia summit. Since then, the rise of China has accelerated the process of regionalization and strengthened its neighbors’ incentives to promote “regionalism”—meaning the pursuit of regional economic integration through intergovernmental institutions—and to integrate this huge country into rule-based systems at both the global and the regional level. Also, China’s decision to conclude a free trade agreement with ASEAN accelerated the race for bilateral FTAs and compelled interest in adopting a more coordinated approach to liberalization.

What direction are these developments likely to take? I see East Asian regionalism as a dynamic process of transformation. Over time, the region will evolve from a group of countries separated by residual protectionism and bureaucratic inefficiency into an open and integrated market. As domestic demand increases, the region will become less dependent on U.S. markets, and trade with the United States will become more balanced. Now handicapped by weak market institutions and vulnerable to economic shocks, the region’s economies will develop solid institutions conducive to competition and innovation. Instead of being divided by political rivalries and historical animosities, East Asia will become a regional community bound by common interests and aspirations.

Despite frequent comparison with the European Union (EU), an East Asian community is unlikely to achieve the EU’s level of institutionalization. Instead, its institutions and arrangements will be suitable to East Asian real-

ity and thus be more akin to the North American Free Trade Agreement (NAFTA). Countries will conclude bilateral agreements that are later combined to form a regionally seamless agreement. Regional governments will therefore be able to participate in various international arrangements and explore institutions that differ by membership and scope, depending on the particular problems they face.

Ultimately, if the vision of an East Asian community is to become reality, each member country must reform its domestic economic and political institutions in ways that make its economy and society more free and open. In addition, governments must become more sensitive to their neighbors' concerns and priorities. Given the scope of these tasks, East Asia may not fully achieve the vision described here. Even so, any effort in that direction is a force for positive change.

## **The Feasibility and Efficacy of a Regional Community**

Unfortunately, the current trend toward institutional economic integration in East Asia is not necessarily welcome in other parts of the world. According to some critics, the obstacles to East Asian regionalism are so great that hardly anything significant can be achieved. Others see the momentum toward integration building but fear this might turn East Asia into a closed, inward-looking bloc. This book questions these negative views and provides an alternative perspective.

Despite formidable challenges, East Asia has made significant progress in promoting trade and investment liberalization at the regional level, which would have been considered impossible in the past. Both Japan and South Korea have concluded and started to enforce bilateral free trade agreements with third countries that involve the liberalization of agricultural products—a highly sensitive issue—and negotiations for a Japan-Korea free trade agreement have begun. As already mentioned, China and ASEAN have also concluded, and now started to implement, an FTA. Japan, Korea, and China are contemplating a trilateral investment agreement. And ASEAN + 3 has expanded its scope, adding ministerial meetings in a variety of sectors. These rapid developments of the past few years suggest that these countries may eventually overcome the remaining obstacles to further integration.

One of the largest obstacles is the political rivalry and deep-rooted mistrust between Japan and China, as illustrated by the great tension between the two in the spring of 2005. Regional frameworks were vital in keeping channels of dialogue open when bilateral relations became thorny. Fortunately, in the

future, the region's deep economic interdependence, regular summit meetings in regional and international forums, and the involvement of extraregional powers, notably the United States, should continue to help diffuse tensions and keep regional efforts on track.

In the following chapters, I highlight East Asia's progress toward regional integration, arguing that it is not likely to become a closed economic bloc. The economic frameworks being pursued are not fundamentally different from the regional frameworks proliferating around the world. If anything, they are likely to be more open and outward looking than similar arrangements in other regions because East Asia's dependence on extraregional markets gives it a strong interest in increased trade liberalization on a global level. Significant changes in the behavior of Japanese firms, which some regard as closed and inward looking, also strengthen the prospects for openness. Note, too, that East Asian regionalism does not rest on exclusivism rooted in anti-Western or anti-American sentiment among some individuals in the region, but rather on pragmatic calculations of economic interest, as well as a desire for mutual trust and a sense of community. Far from turning inward, as skeptics fear, East Asian regionalism will no doubt serve as a valuable pillar in the framework of institutions that govern the international economy.

## **Plan of the Book**

Since this book is about the evolution of institutional economic integration in East Asia, the central concern is cooperation in trade and investment rather than in finance or political security. However, the forces at play cannot be fully assessed without examining the political aspects of East Asian regionalism, such as the debate over the East Asian summit and East Asian community.

The discussion opens in chapter 2 with the breakthrough events presaging regionalism and the ensuing controversy as to whether free trade agreements are "building blocks" or "stumbling blocks" en route to global liberalization. The focus here is on the significance of East Asian regionalism and the major factors that have promoted it (defensive regionalism, intraregional economic interdependence, and intraregional competitive dynamics), as well as hindered it (the lack of cohesiveness, extraregional dependence, and hesitancy about institutionalization).

Chapter 3 concentrates on the process of regionalization since the latter half of the 1980s and its role in promoting both cooperation and competition in East Asia. Regionalization has not only created a common interest in reduc-

ing transaction costs in the region, remaining open to the outside, establishing a common front toward protectionism in other regions, and promoting the growth of regional domestic demand. It has also stimulated a desire to become a regional center for business activities, spurring competition particularly among countries with similar economic structures. Some influential factors in the evolution of regionalization are the international environment, the activities of businesses, government policies, and above all ASEAN, a major player in shaping East Asian regionalism, particularly in its early stages. Production networks—with their fragmentation, modularization, and agglomeration—have also contributed to the regional economy and help explain its uneven integration by product type, prevalence of extraregional linkages in terms of markets and sources of investment, and growing domination by China. Recognizing the need to adapt to the regional environment, Japanese business networks have begun delegating more decisionmaking authority to local subsidiaries instead of extending their “closed” domestic system into the region.

In chapters 4–7, the discussion turns to the four distinct stages of East Asian regionalism since the mid-1980s. The first stage, between 1985 and 1992 (see chapter 4), is marked by four competing proposals for greater regional emphasis: bilateral FTAs with the United States, Asia Pacific Economic Cooperation (APEC), the East Asia Economic Caucus (EAEC), and the ASEAN Free Trade Area (AFTA). Between 1993 and 1998, as outlined in chapter 5, APEC established its primacy and, over time, nurtured cooperative relations among the countries in the region. However, APEC’s limitations became evident after the failure of the Early Voluntary Sectoral Liberalization (EVSL) initiative, which awakened the region to the need for a multilayered approach to international economic institutions. Chapter 6 deals with the third period, which began in the wake of the 1997–98 Asian financial crisis and ran until late 2000. During this period, the region’s governments experimented with arrangements that were formerly taboo, such as FTAs as opposed to liberalization on an MFN basis and East Asia–only forums. The fourth period (covered in chapter 7), from late 2000 to the present, is marked by China’s growth and impact on East Asian regionalism, as well as acceleration of an FTA race. In addition, East Asian governments have developed a greater interest in pursuing pragmatic regional cooperation through various channels, notably ASEAN + 3.

Several findings emerge from the analysis. First, East Asian regionalism sprang from defensive motivations but then was largely shaped by the intraregional desire to deal with common concerns. Second, on balance,

intraregional competition has promoted cooperation rather than conflict by encouraging countries to pursue bilateral FTAs. Third, although historical obstacles to regionalism persist, countries are overcoming them. Fourth, as chapter 8 explains, the course and pace of East Asian regionalism depends in large part on the policies of three countries: Japan, China, and the United States. Chapter 9 summarizes the de facto and institutional impact of economic integration on the region. It also provides some policy suggestions for Japan, China, and the United States, especially in view of the political uncertainties surrounding East Asian regionalism.