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Post-crisis regionalism in East Asia and Strategic Significance of Japan-Korea FTA

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1. The impact of globalization in East Asia

In retrospect, the financial crisis in East Asia highlighted the difficulties of economic management in emerging countries, facing rapid globalization today. If one defines economic development as an integrating process of segmented markets and sectors of a premature economy, most developed countries could achieve a national economy for a nation state long time before this globalization. Contrarily, emerging countries are forced to adapt into globalization, while building a national economy at the same time. This is not an easy task if globalization has certain disintegrating impact, like East Asia experienced before the crisis. The crisis proved that globalization could cause "compressed retrogression", instead of "compressed growth" for emerging countries, if they cannot cope with it with proper institutions and policy choices.

Strong real economy vs. weak financial economy

The first disintegration appeared between real economy and financial economy. Real economy, especially manufacturing export, has been benefited fully by globalization: globalization provided massive FDI inflow with latest technologies and management, opening easier access to international markets. On the other hand, however, financial economy found it difficult to synchronize the speed of sophistication in real economy of which initiatives are taken mostly by global firms. Rather, financial economy was often positioned to serve real economy in the tradition of industrial policies.

Even though financial restriction and market distortion were less serious, industrial policies tended to leave certain government-business interface in each different set of political economy, making it difficult to design financial liberalization and opening in a consistent way. Then, East Asian cycle has been observed, that successful real economy invites trade friction to increase pressure for currency appreciation and early opening of financial/capital market, despite premature structure in financial economy. The cycle started with Taiwan and Korea in late 1980s, followed by ASEAN in 1990s, and recently by China.

Implicitly, industrial policies have a sequence that real economy should go first, followed by financial economy increasing the interface *gradually*, starting from banking system to evolve into market system. Indeed, most developed economy did follow this sequence historically. However, exposed to fierce global competition, East Asian firms could not afford to wait evolution at home. To survive, the options were limited, either to internalize financial economy in the business organizations to overcome market imperfections, or, to rely on global finance. To maintain high growth, the crisis-affected economies tried both. Big business groups extended their lines to add financial services, increasing internal transactions, and at the same time, they sought overseas capital aggressively, when the capital market started to be opened.

However, once opened the financial/capital market, each market was just too small as well as lacking in basic conditions and infrastructure to go stable against enormous volume of global capital. It takes times to secure them all ------ sufficient supply of listed firms, matured institutional investors, transparent accounting, experienced professionals including accountant, analysts, and lawyers and efficient supervision by authorities etc ---- in emerging markets. Big fluctuations are unavoidable in transitional period, but if it goes beyond their capacity, globalization may impose further *negative* moment on financial economy: family business owners may try to protect their empire by more complicated internal transactions, shareholding structure, and cosmetic accounting, or if worse, by simply losing incentives for further listing firms.

Globalized economy vs. local economy

The second disintegration appeared between globalized economy and local economy. Naturally, the gap tends to get bigger in later comers with larger countries, like China or India. Under globalization, not only goods and capital, but also other managerial resources could be mobilized relatively easily, including technologies, information, and even human capital across the borders. Therefore, with certain conditions to attract them, industrial concentration can be boosted rapidly in emerging markets, including the case of IT production in Southern China or software business in Bangalore in India. However, if their development is to be more closely linked with global economy, rather than local economy, whether this type of development will have positive linkage with other parts of the country should be carefully examined, like "export enclave" was criticized one time.

Marvelous development in globalized economy inevitably widens gaps with the other regions. To what degree the gap is politically tolerable depends, but at least it imposes heavier political burdens, which were not experienced by developed countries historically. Globalized economy needs to keep offering better business environments and opportunities for global investors, investing into infrastructure and human capital constantly. For their own survival among foreign competitors, they may be unable to or unwilling to support less developed areas with less potential. Or, as the gap in income as well as in living standards/lifestyle grows in the globalized economies, the difference in people's value may challenge social integrity as a whole.

The level of disintegration affects not only on domestic politics, but also on international relations. In fact, all international organizations, including WTO, still consist of "nation states", which preconditions integrated economy. However, if the "average" figures rarely represent the realities of China or India hosting borderless economies, it may be difficult to put them into the traditional negotiating unit, equally with nations such as Singapore or Netherlands. For instance, China maintains enhancing rights as a developing economy in the WTO, but many have already suspected its eligibility for the globalized economies in the costal areas. Since the crisis, East Asia has started to counterbalance these disintegrating pressures from globalization, which stimulated and encouraged interests for regionalism, but by this very background, the question remains big ----, how to institutionalize the framework?

2. Institutionalized regionalism complementing globalism

So far, efforts to institutionalize regionalism have never succeeded in East Asia, mainly for three reasons. First, "East Asian Miracle" by export led growth depended very much on global market as well capital, rather than regional markets. Therefore, WTO based multilateral negotiations were preferred to be more significant by almost all members of the region. Second, the intra-regional competition was fierce, while each member maintains industrial policies for gradual and voluntary liberalization. The coordination was difficult as was reflected in AFTA. Third, there has been explicit intervention from outside, mainly by the U.S. After cracking down the idea of EAEC, the U.S. also went against Asian Monetary Fund (AMF). Considering these, the discussions on the characters of institutions for East Asian regionalism seem to require following clarifications.

WTO consistency?

One of the recent important changes in the regional prospect is that China has emerged as an enormous absorber of Asian export. Although at the level of final goods, China herself is much dependent on the U.S. market, but for other countries, Taiwan, Korea, Singapore etc., China made the largest market exceeding the U.S. already, and most probably for Japan in the near future. More importantly, China has declared that she is ready to take absorber's role politically, which Japan could never do. This change has provided more incentives for regional integration, while negative prospects and frustrations for WTO based negotiations spreads.

However, being only as a sophomore member of WTO, China herself has a long list of homework to show her commitment toward the regime. Especially, liberalization of services, including distribution, logistics, and finance is expected to bring large impact on the whole economy. It could be in both positive and negative way, but will at least require intensive adjustment for less productive industries, including banking sector with gigantic non-performing debt, or state enterprises. Then, it is not certain, whether China will maintain the speed and intensity of economic liberalization that the rest of East Asia expects to see. This is going to be tested whether China-ASEAN FTA will be set upon the WTO 24th article, covering "substantially all trade".

Industrial policies?

The second points relates to the tradition of industrial policies, often combined with infant industry protection measures. ASEAN has experienced a series of failures in establishing division of labor within themselves. While AFTA remains outside the WTO 24th article, depending on enhancing rights, ASEAN has announced another division of labor program in early 2004. However, for instance, taking in the present accumulation of automobile parts industry, Thailand is unlikely to pass the industry easily to Indonesia, while starting space industry like in the program. Since the modern manufacturing in ASEAN is highly dependent on multinational firms, the market shall resist unrealistic programs. However, as long as each member stays in the tradition of industrial policies, which inevitably calls for gradualism and voluntarism in liberalization, the strictly institutionalized framework beyond APEC level seems to be difficult.

Open character?

Finally, institutional level will attract attention from outsiders, as well as contents. Above all, trade diversion effect and rule of origins will be of interest, for the region has already grown supported by global business. If all FTAs in the region ends up by patch-work type of liberalization as the result of each enhancing rights, the economic integration effect will not only be good enough to attract further FDI and other business interests from outside, but may also frustrate the outsiders with certain trade diversion effect. In addition, the combination of multi-leveled FTAs may have a risk of complicating the rule of origins. Taking in the fact that major part of intra-regional trade is led by assembling industries relying on the cheap labor, the complications may constrain the free business operations, which is the very goal of FTAs.

In fact, despite efforts by APEC committees, there seems to be technical constraints in implementing the rule of origin strictly in the region. Electric Data Interchange (EDI) system, which enhances necessary information exchange among the customs, has not been established in many countries yet. Especially in China, the integration of every local area into the system is expected to take time, if both hardware and human capital capacity are considered. Since the claims on trade diversion effects will relate to the rule of origins, strict institutions are significant in maintaining the open characters, preventing the suspicion from outsiders.

3. Strategic significance of Japan-Korea FTA

Based on the observation that there seems to be disintegrating vector in globalization, the institutional settings for regional integration should be the one to maximize the benefit, as well as to minimize the cost. In this regard, at least from Japan's point of view, Japan-Korea FTA, which has entered in official negotiation to be concluded in 2005, has a strategic significance as a model framework for deep integration. Partly due to the historical delicacy, the discussions in Korea has been still dominated by bilateral views, but as the only two OECD members in the region, Japan and Korea are in the position to architect sophisticated institutions for the region, which will benefit Korea beyond bilateral complicacy.

<u>WTO consistency</u>

Though Korea has never abandoned enhancing rights, recent economic development made it difficult to exercise them anymore. The struggles for FTA ratification with Chile has continued more than a year in Korea, which may risk diplomatic credit, but at least the agreed content was regarded to cover "substantially all trade". Korea also agreed to take WTO consistency in comprehensive FTA with Japan in the first meeting in December 2004. As long as Japan wishes to architect a model framework beyond voluntary liberalization, WTO consistency is the first principle to be confirmed with the partner, and the choice is limited to Korea after Taiwan's political sensitivity.

Besides the principle, Japan and Korea share close legal paradigm, as well as similar administrative mechanisms, which are expected to converge institutional arrangements effectively with smaller cost. For instance, the Bilateral Investment Treaty (BIT) agreement was made in 2002, guaranteeing national treatment to each other at OECD level. In terms of trade in goods, both have the most advanced EDI system in East Asia to provide information on the origin of traded goods, once the cooperation with each customs is established. Movement of natural persons has been promoted by several complementary measures, including mutual recognition of qualification in professional fields, such as IT, social security agreement, criminal extradition treaty etc., paving the way for Japan's visa deregulation.

One of the strategic values for Japan is to integrate these results of pragmatic measures into comprehensive package as "Economic Partnership Agreement", broader idea of "FTA+α". Since the development stages are so varied in East Asia, Japan has offered this idea to present "a la carte" menu for each counterparts. Based on the results, Japan hopes to achieve most sophisticated, best-institutionalized framework with Korea to show a model for the region.

<u>Beyond industrial policies</u>

Another strategic part of Japan-Korea FTA is that both Japan and Korea has virtually abandoned infant industry protection in various means already, which stagnated the progress of liberalization in East Asia. The nominal tariffs except agricultural goods are already low at both sides, but the three changes --- Korea's lift on import restriction on Japanese products, full opening of the capital market even to hostile M&A, and completion of currency exchange liberalization program --- have created full-fledged economic channels between Japan and Korea for the first time in the region.

Since industrial structures are competitive, the process of deeper integration will inevitably invite structural adjustment between the two, most likely to include coordination in competition policies. However, in the process, full-fledged channels are expected to enhance various options for the business, from strategic alliance, FDI to M&A, which were dynamically experienced by Europeans in integration process. Unfortunately, both Japan and Korea have shared more exclusive business culture as well as management system, probably even compared to Chinese, and skepticism will remain how rapidly the market will respond to the new environment if Japan-Korea FTA succeeded in arranging institutions comprehensively.

However, if the fact is taken that the problem of East Asian industrial policies lies in the weak exit system for the losers, the leading role by Japan and Korea should be significant in preparing it. The rivalries of Japan and Korea (Taiwan as well), followed by ASEAN, have created overcapacity problems without exit in the region, which triggered the crisis. After China entered into the competition, establishment of exit has turned to be even more serious issue for the region, as in the case of overcapacity around 2008 in major petrochemical products. As both Japan and Korea experienced the problem already, exit system needs broad range of financial services in addition to multi business channels, Japan-Korea FTA will benefit the rest of East Asia by its intellectual as well as pragmatic contributions on how to compile market-enhancing measures.

Open character

Finally, if beyond industrial policies, Japan-Korea FTA will inevitably bear open characters supported by institutions, not by political campaign. Since the size of integrated market is substantially large, about 65% of the U.S. market, many third parties will check the WTO consistency with business interests. Both Japan and Korea are notoriously minor in hosting FDI, who have just recently started to reverse the attitude, but in different view the potential remains large. The positive competition to improve investment climate and to increase business opportunity will contribute to structural reform, while the size of deeply integrated market will be an advantage to attract global firms.

Above all, the openness of financial/capital market will be significant, when both Japan and Korea are in the position to sophisticate financial services intensively with the help of global institutions. Not only financial sector, both are less productive in heavily regulated services, and the direction of reform by deregulations and market opening has already converged. Since the service market in Korea is limited, the integration with Japanese market will benefit Korea with better opportunities symbolized recently by Handa-Kimpo flights. Korean commitment towards improving service industries like telecom, logistics, tourism seem to be stronger than in Japan, which will give positive pressure, while increasing business chances towards the third parties.

If the stress by the third parties against the region came from the voluntary liberalization by industrial policies, the deeply integrated market of Japan-Korea with highly globalized institutional framework is expected to create new chances for the third parties, mainly through better business channels as well as opened service industries. Otherwise, two economies with such a high cost with aging population will be difficult to survive, just sticking to their traditional business. The openness inevitably chosen and supported by well-established institutions is another strategic significance, not only between Japan and Korea but also for the region as the whole.

Conclusion: J-K FTA as a stepping-stone for East Asian integration

While China has its own advantage to seek for market-led integration in the region, Japan has seen strategic significance in institutionalizing integration. For the purpose, Korea is regarded as the most important counterpart, who can ally for WTO consistency, transparent and well-coordinated institutions, and openness for the third parties. This is an alliance to cover the essential weakness of emerging markets in the region facing the issue of globalization and nation building at the same time, by taking try-and-error process first to show the model. The FTA building process at this moment should not be contextualized as the hegemonic rivalries between Japan and China. In fact, China would be benefited by another late-comer's advantage by following the institutions shown by leading economies, while being able to put more time and energy for national integration as well as to adapt into globalization.