



RIETI Discussion Paper Series 02-E-007

Whither East Asian Economic Integration?

MUNAKATA Naoko
RIETI



Research Institute of Economy, Trade & Industry, IAA

The Research Institute of Economy, Trade and Industry
<http://www.rieti.go.jp/en/>

Whither East Asian Economic Integration?

Naoko MUNAKATA*

Abstract

This paper looks back on the evolution of institutional frameworks for economic integration in East Asia, which accelerated after the Asian financial crisis, analyzes its dynamics and future prospects, and identifies Japan's roles in the process that are consistent with the institutional transformation of its economy and society as well as the fundamental interests the United States have in Asian integration and constructive roles it can play in the process. In Section I, it analyzes the forces influencing the development and performance of various regional frameworks. In Section II, the paper assesses the prospects for Asian economic integration in light of these forces as well as perceived obstacles. Section III examines the link between Japan's policy efforts to overcome economic and political challenges, and the development of various institutional frameworks for East Asian economic integration. In Section IV, this paper presents positive implications for the U. S. policy for Asia.

Key words: Economic integration; Free trade agreement; Japan-Singapore Economic Agreement for a New Age Partnership (JSEPA); Asia Pacific Economic Cooperation (APEC); ASEAN + 3; East Asian Community; Asian financial crisis

JEL classification: F02, F13, F15

* Senior Fellow, Research Institute of Economy, Trade and Industry (E-mail: munakata-naoko@rieti.go.jp)

The author wrote this paper when she was a Visiting Fellow at the Center for Northeast Asian Policy Studies (CNAPS), The Brookings Institution and published it as a CNAPS Working Paper (http://www.brook.edu/fp/cnaps/papers/2001_munakata.htm) in June 2002. She thanks various supports from Brookings. The author is grateful for helpful comments and suggestions by Dr. Bates Gill, Dr. Catharin Dalpino, Dr. Edward M. Graham and seminar participants at The Brookings Institutions, Columbia University, The George Washington University, New America Foundation and Research Institute of Economy, Trade and Industry.

East Asian economies, long known to be ambivalent toward regional integration, are dramatically changing their ways. This new approach began in the late 1990s.¹ Since 1998, East Asian capitals have actively explored the possibilities of various bilateral free trade agreements (FTAs), while, in late 2001, the East Asia Vision Group reported to the leaders of ASEAN + 3 (grouping the ten Association of Southeast Asian Nations members, plus China, Japan and South Korea) meeting on the vision of “an East Asian Community.” The current situation can be characterized as “talking regional, acting bilateral”, a reflection of competitive impulses as well as pragmatism for steady progress. These important developments have major implications for both Japan and the United States. This paper analyzes the dynamics of East Asian economic integration and its future prospects, Japan’s role in the process, and how the United States can constructively influence the process.

In the first section, this paper analyzes the forces influencing the development and performance of various regional frameworks. Second, the paper assesses the prospects for Asian economic integration in light of these forces as well as perceived obstacles. The third section examines the link between Japan’s policy efforts to overcome economic and political challenges, and the development of various institutional frameworks for East Asian economic integration. In the concluding section, this paper presents positive implications for the U. S. policy for Asia.

¹ On Japan’s situation when it started considering bilateral FTAs and its policy thinking behind Japan-Singapore Economic Partnership Agreement, see Naoko Munakata, "Evolution of Japan's Policy Toward Economic Integration", CNAPS Working Paper, December 2001 (http://www.brook.edu/fp/cnaps/papers/2001_munakata.htm)

I. Underlying Forces: Drivers vs. Obstacles

Driving Forces

The pace of de facto economic integration in East Asia increased in the latter half of 1980s. East Asian capitals in late 1980s started to explore institutional frameworks to further promote economic integration in the region, cautiously at first, but then more actively toward the end of 1990s. Three major driving forces have been at work.

The first force was East Asian economies' growing concern about regionalism gaining momentum particularly in Europe and North America after the end of the Cold War. Naturally, they had a desire to overcome differential treatment created by the European Union (EU), the North American Free Trade Agreement (NAFTA)(and eventually the Free Trade Area of the Americas (FTAA)) or other preferential agreements and to strengthen their negotiation leverage against these regional groups. This force (henceforth referred to as "*counter-regionalism factor*") has steadily strengthened over time as the trend toward regionalism expanded geographically as well as functionally. East Asian economies thus became more anxious to promote integration among themselves.

Another force was East Asian frustration with unilateral approaches by the United States and "market fundamentalism" symbolized as "the Washington consensus." They felt the need for greater negotiation leverage vis-à-vis irreconcilable pressure from the United States and U.S.-dominated institutions. This force (henceforth referred to as "*leverage-seeking factor*") does not necessarily work constantly and tends to be driven by particular events, such as trade friction with Washington or initial mishandling of the Asian financial crisis.

The third underlying factor was the region's desire to have an effective mechanism for cooperation based on geographic proximity, de facto integration and challenges of

“compressed development” through rapid industrialization, and institutional transition to adapt to globalization. They have an incentive to reduce transaction costs among neighbors where dense business networks are already in place, and to promote sustainable economic development. This is a different experience from the process of European integration, which began as a result of shared geographic, cultural and political concerns. In Europe, the economic reality of increased interdependence came later. In East Asia, the partners for regional economic integration are based on intensity of economic interaction and less on geographic factors as in Europe. Not all of geographic “East Asia” takes an active part in the economic integration process. This force (henceforth referred to as “*local economic factor*”) has also strengthened over time. As de facto economic integration further deepened, and change was accelerated by globalization and technological progress, a stronger impetus for creating an effective local mechanism (in addition to global institutions) to provide prompt and focused solutions to immediate regional problems was energized.

Ambivalent Attitudes

In spite of these forces, the path to creating an institutional framework in this region has never been straightforward. This is primarily because East Asian economies have always had ambivalent attitudes towards the process.

First of all, East Asian economies are ambivalent towards each other. On the one hand, there is a centripetal force driven by the three factors identified above that gives momentum to a pan-East Asian framework. On the other hand, there is also centrifugal force driven by economic competition and political rivalry among regional powers, and a diversity in developmental stages, political systems and relations with countries outside the region. This gives momentum to bilateral agreements in and outside the region or for a larger framework to diffuse tension among East Asian economies. Until the Asian

financial crisis, the Association of Southeast Asian Nations (ASEAN) played a central role in developing various regional fora as a benign mediator among regional powers. In the late 1990s, Northeast Asian economies in turn started to explore ways to strengthen relationships among themselves on their own.

Secondly, their attitude towards the United States, a global as well as an “Asia Pacific” power with a strong desire to open Asian markets, has also been ambivalent. On the one hand, the “leverage-seeking factor” is at work, giving momentum to a pan-Asian framework. On the other hand, they know that they need to anchor U.S. interests in the region since they need the U.S. security presence, U.S. technology and capital, and must accommodate their biggest customer. When these considerations are emphasized, a pan-Asia Pacific framework or bilateral arrangements with the United States gain momentum. U.S. policy has a large influence in which direction regional economies will tilt. When U.S. policy accommodates East Asian common interests and demonstrates a strong commitment to regional stability and prosperity, momentum for Asian-only fora will likely decrease, and vice versa. At the same time, the level of cooperation among East Asian economies affects their attitude towards the United States. When there is no effective channel for cooperation among East Asian economies, they feel uncomfortable with a strong U.S. role that could “divide and rule”. When East Asian economies are comfortable with the level of their internal cooperation, they tend to be more relaxed toward U.S. leadership.

Thirdly, until late 1990s East Asian countries were ambivalent about institutionalization itself. While they appreciate problem solving, they exhibit inherent skepticism towards rigid, top-down institutions, and tend to prefer consensus building over confrontation. They tend to avoid institutionalization and opt for easier, more flexible and (occasionally) less fundamental solutions. On the other hand, when they are faced with serious regional problems that require effective solutions, institutionalization

will gain momentum, including legally binding agreements that constrain sovereignty and may have discriminatory effects vis-à-vis non-members. As East Asian economies became more mature in dealing with regional frameworks and began to appreciate the efficacy of institutional agreements in giving political momentum to domestic reforms, they overcame knee-jerk rejections of institutionalization and started choosing the most effective ways to solve particular problems.

Efforts to build institutional frameworks in the region have so far developed in four distinct stages. The three driving forces as well as ambivalent attitudes in the region have persisted throughout most of these periods. As noted above, however, different forces and different balances in the spectrum of attitudes came into play at each stage, thus determining the developments in a particular period. History tells us that ignored or frustrated factors or interests will eventually catch up and affect ensuing developments. Stable development of regional institutions in East Asia requires a careful design that takes the different dynamics into consideration.

1st Stage: Competition and Interaction among Various Proposals

The first period, between 1985 and 1992, saw active competition amongst different regional framework proposals. It is in this period, that the “local economic factor” formed. In the wake of the sharp appreciation of the yen after the Plaza Accord in 1985, economic interdependence among East Asian economies was substantially increased through foreign direct investment (FDI) by Japanese companies, mainly in ASEAN, as well as by companies in newly industrializing economies (NIEs) that suffered from the subsequent appreciation of their currencies against the U.S. dollar. Development of trade and investment in the region prepared policymakers to create regional forums to strengthen interdependence, albeit with strong tendencies to avoid preferential trade agreements at this point, and to nurture joint efforts to protect their emerging common

interests as a region.

The first actual stimulus for economic integration came from the United States, which proposed an FTA with ASEAN in 1985. The U.S. government was under pressure from a growing trade deficit with Asian countries despite the depreciation of the U.S. dollar, and tried to promote exports through market opening arrangements. ASEAN member economies, for their part, had been focused on developing export industries through free trade zones while largely protecting their domestic markets and, therefore, were not ready for drastic trade liberalization with the United States. Proposals for a U.S.-Japan FTA as well as a U.S.-Korea FTA were also considered in U.S. policy circles in the late 1980s.

These U.S. proposals left Asian policymakers concerned about U.S. “hub and spoke” approach to trade policy that could leave “spoke economies” at a disadvantage. Trade friction with the United States was also prevalent. At the same time, they were concerned about developments towards regionalism in Europe and North America. These situations prompted Australia and Japan to come up with the idea of the Asia Pacific Economic Cooperation (APEC), which was established in 1989. It was hoped that U.S. participation would help restrain its “hub and spoke” FTA initiatives as well as its unilateral trade sanctions. Also, there was uncertainty about the future of the U.S. security presence in post-Cold War Asia and East Asian capitals felt a strong need to anchor U.S. interests in the region. At first, however, to Washington’s dismay, a trade liberalization agenda was avoided in consideration of sensitivity among ASEAN members and, hence, APEC focused on economic cooperation projects to promote development and trade expansion.

In late 1990, frustrated by APEC’s apparent inability to check North American regionalism as well as difficulties in concluding the Uruguay Round of trade negotiations, Malaysian Prime Minister Mahathir Mohamad proposed the East Asian

Economic Group (EAEG) consisting of ASEAN countries, Japan, China and Korea, as a more direct response to trends in Europe and North America towards increased regionalism. At the beginning, it was presented as a possible trading bloc. Later it was renamed the East Asian Economic Caucus (EAEC) and presented as a forum to discuss issues of common interests among East Asian neighbors. At this time, China was not yet an APEC member, and Japan was at the height of its economic might. The proposal met strong objections from Washington as something that would draw a dividing line in the middle of the Pacific and did not have the support of East Asian economies. While East Asian economies did not have compelling interests to promote this idea in particular as they felt the need to anchor U.S. interest, the strong U.S. reaction left East Asian policy makers with a feeling that they should be able to choose for themselves with whom they meet and talk. There was also a feeling that the United States, which had already agreed with Mexico to start negotiations for what would become NAFTA, was behaving hypocritically.

After the EAEC setback, ASEAN started an economic integration initiative, which was the ASEAN Free Trade Area (AFTA) in 1992. ASEAN had been promoting programs to increase interdependence through various programs² without much success due to the political sensitivities of their domestic industries. Since the end of the Cold War, however, Eastern European countries and China emerged as competitors for FDI. And there was also a concern that ASEAN could be absorbed in APEC and would lose bargaining power. Thus, an enhanced sense of urgency enabled ASEAN members to agree on the first framework of comprehensive regional economic integration in East Asia.

In 1991, China, Chinese Taipei and Hong Kong simultaneously joined APEC.

² For example, there were programs based on Agreement on ASEAN Preferential Trading Arrangements (1977), Basic Agreement on ASEAN Industrial Complementation (1981), Basic Agreement on ASEAN Industrial Joint Ventures (1983).

Hereafter, the importance of APEC increased significantly. The EAEC proposal persuaded Washington that APEC was the way to prevent Asian-only frameworks. Under the Clinton Administration, the United States renewed its interest in opening up Asian markets through APEC. This began the transition to the second period. The possibility of creating an APEC FTA was suggested by the Eminent Persons Group tasked to draw up a vision for APEC.

In this first period as described above, the main driving force was the “counter-regionalism factor” and the “leverage-seeking factor”. Attitudes towards each other (“local economic factor”) did not play a large role. While there was an impulse to get together, there was little focus or substance. Also, China’s lukewarm reaction to regional fora proved to be another centrifugal force.

In this period, with an absence of a region-wide framework, there was a tendency to try to find a single formula that would accommodate all of these forces. Competing proposals were viewed as inconsistent with each other. This explains the focus on membership, rather than on core objectives and specific measures to be taken, under each framework.

2nd Stage: Primacy of APEC

The second period started in 1993 when the United States chaired APEC and ended in 1997 when East Asia was hit by a major financial crisis. In this period, APEC came out as the primary vehicle for regional cooperation. U.S. leadership, Asian economies’ confidence in their economic dynamism as well as competition for FDI and other forms of capital finally persuaded members to overcome resistance to pursue liberalization in APEC. The United States hosted the first leaders’ meeting in Seattle, an important mechanism to overcoming bureaucratic resistance to liberalization. At the same time, with East Asian economies’ concern about preferential trade arrangements, as well as

political difficulties hindering trade liberalization at a pace set by negotiations, there was no agreement to form an APEC FTA. In 1994, under the Indonesian chair, the leaders adopted the Bogor goal of liberalization in APEC by 2010 for developed economies and 2020 for developing economies. In 1995, APEC leaders agreed on the Osaka Action Agenda as a mechanism to achieve the Bogor goal, which was essentially based on members' voluntary efforts and peer pressure to encourage each other.

While APEC became the primary economic forum in the region, it did not fulfill most of the expectations that its members had at the forum's inception.

First, while concern about the U.S. "hub and spoke" approach to trade policy was eliminated for the time being, APEC was not effective in checking the increasing momentum for regionalism in North America, not to speak of Europe. The U.S. and other Western Hemisphere leaders met in December 1994 in Miami and agreed to construct FTAA, in which barriers to trade and investment would be progressively eliminated, and to complete negotiations for the agreement by 2005. After the successful completion of the Uruguay Round and the establishment of the World Trade Organization (WTO), where the perceived threat of an APEC FTA played a constructive role in persuading EU to make a compromise, the trend toward regionalism was still intact. As for U.S. unilateral trade sanctions, WTO dispute settlement mechanism, instead of APEC, provided the solution.

Second, U.S. desire to open Asian markets was eventually frustrated. While liberalization became a central focus on APEC's agenda, implementation was not effective, as it was left to voluntarism and peer pressure, which did not produce much progress. The limitations of the APEC mechanism for liberalization later became clear with the failure of the U.S.-sponsored initiative of Early Voluntary Sectoral Liberalization (EVSL). Despite the name, it was essentially an initiative to negotiate a package of sector-specific liberalization among APEC members. Japan and some

developing country members, particularly those hit by the Asian financial crisis, were not ready to liberalize politically sensitive sectors. The United States, for its part, did not have fast track authority for trade agreements and put pressure to exclude sensitive U.S. sectors from liberalization, notably textiles. When members were saddled with political difficulties, unilateral liberalization that would allow free riding by non-APEC members was too ambitious, while, at the same time, APEC members were too diverse to forge an APEC-wide FTA.

Third, the Asian countries' desire to have an effective framework of cooperation was not satisfied either. Economic cooperation as opposed to trade and investment liberalization was given a lower priority in APEC. Project proposals proliferated under the rotating chair system that changed every year, but there were few efforts to systematically follow up on those proposals. Frustration culminated when the EVSL was determined to be the primary item on the 1998 APEC agenda in late 1997, shortly after the eruption of the Asian financial crisis.

The ASEAN desire to be a viable organization was satisfied outside APEC by accelerating the schedule of AFTA and taking the initiative in creating forums centering on ASEAN such as the ASEAN Regional Forum (ARF)(1994) and the Asia Europe Meeting (ASEM)(1996), as well as expanding dialogues with various countries in the "ASEAN + " format and post-Ministerial Conferences (PMC) which have existed since the 1970s. It should be noted that ASEM opened up opportunities for East Asian countries to meet in preparation before meeting with Europeans, though Chinese Taipei and Hong Kong were not included due to the political issues included in the ASEM agenda. While these fora satisfied Asian countries' desire to try out various types of fora and promoted mutual understanding between members, they were not necessarily successful in achieving specific, substantive results.

The fundamental problem of APEC was that it grew too fast without solidifying its

core objectives, and its members differed on what APEC should do. Rather than closing the gap, it added to the agenda, knowing that some issues would not be addressed fully. Instead of solving problems it avoided conflict, thus ignoring some of the key motivations of its members. The lessons from APEC experiences are that they cannot expect APEC to solve all problems and should have complementary fora, that consist of smaller members whose interests converge.

At the same time, APEC has incubated regional cooperation in Asia. It has brought government and business together in the region through many meetings and projects. It has made them aware of common problems, new measures for cooperation as well as different priorities. And all these experiences laid the groundwork for the next period.

3rd Stage: Formation of ASEAN+3 and Proliferation of Bilateral FTAs

The transition to the third period started with the Asian financial crisis that erupted in July 1997. It was a major turning point for the development of regional frameworks in Asia by changing both the local landscape and mindset. The crisis shattered the confidence among ASEAN economies and significantly weakened ASEAN's cohesiveness.³ Korea's economic policy was revolutionized and its economic structure became much more open. The Japanese economy's problems became all too clear, and people began calling the 1990s Japan's "lost decade".

³ The influence of ASEAN, which had had a central role in developing various regional fora as a benign mediator among regional powers, was sharply reduced in the wake of Asian financial crisis. China's relatively stable economic performance throughout the East Asian economic crisis, the surge of FDI into Korea, and the collapse of domestic demand and slow progress of economic reform in ASEAN tempered the commonly held perception of ASEAN member countries as attractive investment destinations. The addition of four new members widened the intra-regional economic gap, and compounded with the diversity of political systems, put pressure on ASEAN's cohesiveness. In Indonesia political turmoil caused economic stagnation, and the lack of Indonesian leadership and members' preoccupation with domestic economic problems dealt a severe blow to proactive ASEAN initiatives present before the crisis. Thus the decline of ASEAN's influence in these aspects and shift of gravity to Northeast Asia prompted Singapore to strike out on its own and strengthen relations with countries

In this period, two major changes took place. First of all, the “ASEAN + 3” format ceased to be a taboo. Secondly, preferential trade agreements such as FTAs ceased to be taboo for Northeast Asian economies as well. With these two constraints gone there was enormous excitement to try various alternatives.

One of the main reasons behind this change was frustration with the United States and the “Washington consensus” (the “leverage-seeking factor”). Asian economies were deeply disappointed by U.S. insistence on EVSL in the middle of the Asian crisis, initial U.S. reluctance to provide financial assistance to Thailand, and IMF “conditionality” that initially exacerbated the crisis.

In addition, the acute sense of interdependence aroused by the financial “contagion” convinced not only ASEAN but also Northeast Asian countries that they need a regional forum for economic cooperation, one that reflected their common interests and priorities as well as increased their voice in the global arena (“local economic factor”).

On the other hand, the reduced momentum for liberalization through APEC disappointed Washington, and depression in Asian economies dampened U.S. enthusiasm in the region’s markets. The focus of U.S. trade policy interest in Asia shifted to the negotiations for China’s WTO accession. At the same time, Washington renewed its interest in FTAs and floated a “P5” initiative among the United States, Chile, Singapore, Australia and New Zealand, the five “like-minded” countries. These developments convinced Asian capitols that they did not always have to involve the United States in a particular regional framework other than APEC. And a forum among East Asian economies ceased to be a taboo.

Against this backdrop, ASEAN + 3, a gathering of the governments of ASEAN members, China, Korea and Japan that were Asian members of ASEM, had its first leaders’ meeting in December 1997. After the idea of an Asian Monetary Fund failed due

outside ASEAN.

to U.S. and Chinese opposition, East Asian countries started to develop a network of currency swap agreements through the “Chiang Mai Initiative”.

Regionalism in Europe and North America maintained momentum and continued to expand geographically and functionally. Asian economies, worried about these trends as well as intrigued by regional institutions’ effect on accelerating domestic reforms in member economies, came to think that since there was no way to stop it, they should also get involved in preferential trade agreements (“counter-regionalism factor”). Thus skepticism towards regional institutions in general and Northeast Asian economies’ rejection of preferential trade arrangements was finally overcome.

ASEAN + 3, however, lacked enough cohesiveness to adopt a preferential trade agreement that would cover them all, though they later started discussions on the East Asian FTA proposal. Interest in bilateral FTAs or economic agreements suddenly became prevalent in the region as a more practical vehicle of liberalization, a more effective way to avoid being marginalized in the global trend towards regionalism, and a more focused approach to solving specific problems.

After Japan and Korea started to explore the possibility of an FTA between them, bilateral negotiations for FTAs rapidly became active. New Zealand and Singapore spearheaded these trends. Singapore’s moves, independent of other ASEAN members, indicated that ASEAN (at least temporarily) lost the driving force it used to command to create larger institutional frameworks. Japan and Korea changed their long-standing policy of exclusive multilateralism and adopted a multi-track policy, where bilateral and regional preferential arrangements have roles to complement the WTO. Korea started FTA negotiations with Chile, and Japan concluded an Economic Partnership Agreement with Singapore, which includes various measures for cooperation to expand bilateral economic relations in addition to the traditional elements of FTAs.

Japan’s decision to negotiate an FTA with Singapore on October 22, 2000 had a

energizing effect in and outside the region. Singapore, which started to pursue a strategy of becoming “a hub of FTAs,” actively explored the possibility for FTAs with major economic powers, such as the United States, Europe and China. Washington, which had been inactive on the “P5” initiative, increased its interest in an FTA with Singapore. The U.S. President Bill Clinton and Singapore Prime Minister Goh Chok Tong unexpectedly announced their agreement to start negotiations on a bilateral FTA on November 16, 2000, at the margin of the APEC leaders’ meeting. Since Asian countries have started their own preferential trade arrangements, fear of the US “hub and spoke” approach ceased to be a common concern. Singapore’s move motivated ASEAN reaction to explore FTAs with other Asian economies, first with Australia and New Zealand and then with China, Korea and Japan. China, having closely watched Japan’s trade policy shift, decided to join the regional trend of exploring FTAs. At the ASEAN-China Summit on November 25, 2000, China’s Premier Zhu Rongji proposed an ASEAN-China Expert Group on Economic Cooperation to look into the implications of China’s accession to the WTO and recommend measures on how to further enhance ASEAN-China economic cooperation and integration, including the possibility of establishing a free trade area between the two. This move was the precursor to China’s active efforts to seek an FTA with ASEAN and its leadership role in East Asian frameworks during the 4th stage.

4th Stage: China’s Active Participation

The fourth period is characterized by a change in Beijing’s attitude towards regional cooperation. The transition to the fourth period started in the summer of 1999, when China began attaching more importance to its relations with neighboring countries. In the wake of the U.S. bombing of the Chinese embassy in Belgrade in May 1999, Sino-U.S. relations were particularly tense. China started to view East Asian cooperation as a

vehicle for “multi-polarity” –the reduction of U.S. dominance. Beijing, well aware of the perceived "China threat" –both economic and military– felt by its neighbors, has been making efforts, through its support for regional political and economic structures, to reduce regional anxiety about its strategic intentions. In addition, in view of increased competition with imports after the accession to the WTO, China was interested in expanding export markets and thus worried about the trend for preferential trade agreements, which had spread even to Asia as it was about to join the WTO. In light of this, Prime Minister Zhu proposed an FTA with ASEAN in November 2000. After a year of review, China and ASEAN agreed in November 2001 to negotiate for an FTA to be completed within 10 years. For ASEAN members, except for advanced economies such as Singapore, China's exports present a competitive threat. Therefore, China's offer of “early harvest,” where China would reduce tariffs of interest to new ASEAN members early on, had a decisive role in persuading ASEAN to accept China's FTA proposal.

Since the completion of negotiations for WTO accession, China has become markedly more active in engaging in regional frameworks. Thus, this period started in 2001 when China joined the WTO.

China's rapid growth and steadily increasing economic integration in the region aroused further interest in regional frameworks. On the one hand, China's neighbors are concerned about the "hollowing out" of their industries; on the other hand, they are eager for a slice of the ever-growing Chinese economic pie. These concerns and interests grew as exports to other regions were radically reduced in the recent global recession. Thus, China's active participation in regional agreements has activated competitive impulses within East Asia and added momentum for regional bilateral FTAs. Two months after China and ASEAN announced their agreement to negotiate an FTA to be concluded in ten years, Japanese Prime Minister Koizumi Junichiro made a trip to ASEAN countries in January 2002 and proposed an Initiative for Japan-ASEAN

Comprehensive Economic Partnership though it may not necessarily include an FTA. Japanese government officials are in fact welcoming China's move since it helps them overcome domestic resistance to liberalizing trade in sensitive sectors. Shortly after Prime Minister Koizumi's proposal, Japan and ASEAN started to consider specific measures to realize it. Korea is also considering an FTA with ASEAN. Thus, "competition to cooperate" has become the modus operandi.

For several reasons, Washington has begun to pay more attention in the region: China's rise, when Japan --the primary U.S. ally in Asia-- was stagnating, combined with its active regional economic diplomacy vis-à-vis ASEAN including promoting an FTA, indicated a potential shift in the regional balance of power. At the same time, a weakened ASEAN led to increased security concerns, such as ASEAN becoming a hotbed of terrorism. The United States agreed with Thailand in April 2002 to begin work on a Trade and Investment Framework Agreement, which will set up a permanent joint consultation system to study elements of a bilateral FTA and solve trade problems. The United States, urged by business interests, also looked into the idea of an FTA with ASEAN in a U.S.-ASEAN economic ministers meeting held early in April 2002, while admitting it is premature to enter into negotiations with ASEAN as a whole. In the meantime, Senator Lugar (R-Indiana) introduced a bill on March 11, 2002 that would authorize negotiation of an FTA with the Philippines.

Meanwhile, Japan and Korea, after more than three years of consideration by think tanks and a business forum, finally agreed to start official discussion for a bilateral FTA during the Japanese Prime Minister's trip to Seoul in March 2002. Taiwan and Hong Kong are also considering various FTAs. Thus, in the fourth period, all East Asian economies are engaged in various bilateral free trade efforts.

Bilateral FTAs include not just those within East Asia but also cross-regional ones. East Asian economies are seeking opportunities where the benefit is large enough or the

hurdle is low enough to overcome domestic resistance. For example, Korea is negotiating an FTA with Chile and Japan is studying an FTA with Mexico. Singapore is negotiating an FTA with the United States and has concluded one with European Free Trade Association (EFTA, an arrangement consisting of Switzerland, Iceland, Liechtenstein and Norway). Thus, they are actively trying to overcome discrimination in other regions and to enhance their leverage in negotiations. They also expect that new round of WTO trade negotiations will reduce the margin of preference for preferential trade arrangements.

At the same time, there was a conceptual leap in the regional front. The East Asian Vision Group submitted a report on “an East Asian Community” to the leaders of the ASEAN + 3 meeting, which was recognized in the press statement by the chairman of the 5th ASEAN + 3 summit, November 5, 2001.

As regional economies started to deepen bilateral relations with each other, they were empowered with more effective measures to address specific problems without waiting for consensus in a larger group, where not all the members share the same sense of urgency regarding particular problems. Previously, the forum came first and the substance was taken up only when it fitted the forum. Now, substance comes first and the forum is tailored to deal with the substance as chosen or devised if necessary. Bilateral arrangements have become available as the smallest alternatives among various fora from which to choose. Thus, a multi-layered approach where bilateral, regional and global frameworks are developed in parallel is firmly in place in East Asian policy circles.

II. Prospects for East Asian Economic Integration

The first section identified underlying forces that largely determined how institutional frameworks for regional integration evolved in the region. With this background in mind, the following section assesses the challenges and opportunities for Asian economic integration in the future.

Momentum for an East Asia-wide Framework

While East Asian experiences creating various regional institutional arrangements have been a process of trial-and-error, there has always been momentum for creating a pan-East Asian framework. The recent surge in this momentum has largely been driven by China, with its vast economic potential (an element of the local economic factor) from which all its neighbors wish to benefit. Even countries not yet ready to consider an FTA with China are eager to somehow maximize their gain and minimize their losses in their economic relations with China.

At the same time, China tries to use East Asian cooperation as a vehicle to promote multi-polarity in the world (an element of the leverage-seeking factor). Other regional economies also see the benefits of a region-wide framework since it is more powerful than a web of bilateral FTAs in terms of the “counter-regionalism factor” and the “leverage-seeking factor”.

Another powerful element of the local economic calculation is the recognition within East Asian capitals that extreme dependence on the U.S. market, when the United States has accumulated huge current account surpluses, makes Asian economies vulnerable. The U.S. current account deficit has ballooned to the level of 4% of GDP even during recession. When U.S. imports further increase in the coming boom, there is a risk that political pressure behind protecting U.S. industries will strengthen and that

the dollar could sharply depreciate, which would destabilize Asian economies. The U.S. safeguard measures recently imposed against steel imports are an ominous sign. In view of this, East Asia must reduce its dependence on exports outside the region and base its economic growth more firmly on domestic or regional demand in order to stabilize the regional and global economy. This requires external policy initiatives in addition to solving domestic problems such as deregulation or clearing up bad debt. To stimulate regional demand, it will be critical to eliminate barriers to cross-border movement of corporate resources, thereby integrating long-fragmented regional markets and, in turn, enhancing the profitability of business activities to serve regional demand.

Thus, there is a hope among East Asian economies to eventually establish an “East Asia Community” as proposed by the East Asian Vision Group. While engaged in competition to forge bilateral FTAs, many East Asian capitals hope that independent moves will eventually converge to form an East Asian FTA.

Obstacles

Despite strong momentum for creating an institutional framework for regional integration in East Asia, its realization is far from easy. There are several powerful obstacles, which can also be turned into new opportunities.

1) Sensitive Sectors

First, there is a practical difficulty in liberalizing trade among East Asian countries consistent with WTO stipulations that preferential trade agreements have to eliminate trade barriers of “substantially all the trade” (Article 24-8(b) of the General Agreement on Tariffs and Trade (GATT)). Products from politically sensitive sectors for developed economies, such as agriculture and textiles, are often competitive and could be a source of precious income for developing economies. For East Asian economies to overcome

political sensitivities in trade issues, it is extremely important for Japan, the most developed economy in the region, to take the initiative.

Unfortunately, however, Japan has particularly sensitive agriculture, forestry and fisheries sectors. While these industries comprise only a fraction of Japan's economy, they have taken on a disproportionate weight within Japan's overall trade policy. In its post-War development process, Japan relied on a limited number of competitive sectors to earn foreign currency and tax revenue while protecting and subsidizing low productivity sectors. These sectors have not only been protected from international competition but also from domestic competition (i.e. some large corporations are not allowed to enter agriculture). Shielded from tough competition, these sectors have lagged in productivity growth and their international competitiveness has deteriorated. But the population involved in these sectors remains important voters for powerful conservative politicians representing rural areas. This situation makes trade liberalization all the more difficult. Japan has to reengineer its agricultural policy to encourage viable agricultural business and effectively address problems such as environmental and safety concerns. Recent incidents, such as false labeling of where meat was produced, as well as the government's failure to prevent the spread of mad cow disease, have substantially reduced consumer confidence in agricultural policy and have opened an opportunity for a major policy review. After all, it is high time that Tokyo analyzes the cost associated with an inability to conclude FTAs to nullify the effect of rapidly proliferating preferential trade agreements that place Japanese businesses and workforce at a substantial disadvantage.

As will be discussed in the next section, Japan's deliberate one-by-one choice of FTA partners, with a goal of steadily overcoming political resistance, making it more likely that bilateral, rather than region-wide, FTAs have more momentum in the region at least for a while.

2) Diverse Developmental Stages

Second, different developmental stages among East Asian economies also make extensive trade liberalization difficult. Developing economies need industries to raise income levels and tariffs cannot be eliminated overnight when these economies strive to develop viable industries. Development assistance should, in addition to directly dealing with poverty alleviation, focus on enhancing infrastructure, policy design, and human resource development in government and business, so that they are more prepared to liberalize their economies. Liberalization is not an end in itself, but a means to achieve economic prosperity. Developing economies need the capability to maintain a competitive business environment and economic and social stability in order to capitalize on the benefits of liberalization. Development assistance to “prepare economies for liberalization” needs to be incorporated into regional integration frameworks that involve developing economies.

This is an area where Asia has the potential to make an intellectual contribution to the global community since Asia is the only region in the world where so many developing economies have succeeded in industrialization in a short period of time. If Asian economic integration can successfully combine liberalization and rule making with assistance to developing economies, which will help them participate in regional economic integration, it will also provide some insight on how to integrate poorer countries into the global economy. Making those countries viable players in the global market is preferable to making them dependent on assistance.

Diversity in developmental stages means that there are different sets of problems between each pair of East Asian economies. If an FTA is viewed as a set of solutions to real problems, rather than a legal template, it is more important to study bilateral economic relations closely and work out essential elements for respective FTAs rather

than to think of big, conceptual, pan-regional frameworks without knowing which specific issues will be addressed by such frameworks.

3) Lack of Confidence in Japan's Leadership among Its Neighbors

After the Japanese economy's decade-long stagnation, many question Japan's capacity to lead East Asian economic integration. This issue will be discussed in section III.

In addition, Japan's "history problem" with its neighbors could get in the way of developing institutional frameworks to promote economic integration in Asia. Japan did not play an active role in formulating the postwar world economic order, while concentrating on economic reconstruction. Tokyo refrained from taking the initiative in formulating regional frameworks in light of its wartime legacy. In addition, since the end of the Cold War, the nature of the history problem has changed. Asian people freely express their concerns about Japan's recognition of "history" issues and bring up individual claims for compensation for their wartime sufferings. Government-to-government settlement of the history problem does not guarantee public support for reconciliation, upon which the ultimate solution of this problem depends. When Tokyo and Seoul started to explore the idea of an FTA, both were extremely sensitive about the possibility that it could evoke memories of Japanese colonization given that their reconciliation was incomplete.

The solutions to the history issues are directly linked to trust. Many Asian policy makers have pointed out that if Japan hopes to gain confidence among its neighbors, it needs to articulate its national strategy and the role it is willing to play in the region. This will involve a long-overdue comprehensive review of Japan's national strategy given post-Cold War realities and Japan's decade-long economic stagnation.

4) Japan-China Relations

The surge of the Chinese economy throughout the 1990s when Japan was suffering from economic stagnation and de facto integration of the Japanese and Chinese economies have fueled the debate in Japan that China is an economic threat. However, others recognize the still largely complementary nature of bilateral economic relations and see huge opportunities in China's market and abundant labor force. At the same time, China's enhanced economic power has allowed increased annual Chinese military expenditure, which, together with issues related to Taiwan and the activities of Chinese research ships in Japanese waters, creates a growing sense in Japan of a security threat from China.

On the other hand, from China's point of view, Japanese views regarding its history as well as the Taiwan issue, are nurturing Chinese grass-roots suspicion of Japan and justify Beijing's repeated demand for Japan's apology, which in turn provokes Japanese public resentment. China worries that the US-Japan security alliance is a part of a U.S. strategy to encircle China. At the same time, Beijing appreciates that the U.S. security presence in the region prevents Japanese rearmament. China aspires to be the Asian leader in the future and has tried to check Japan's political leadership in the region as well as in the global arena.

Asian neighbors worry that this mutual suspicion and distrust between Japan and China will hinder the development of regional cooperation and put pressure on them to choose sides. Often compared to Germany and France, Japan and China will both remain regional leaders, while cooperating and competing at the same time. It is crucial for the two regional powers to find a way to eliminate their sources of distrust and build a stable and cooperative bilateral relationship.

Likely Process of Asian Economic Integration

As described above, competition among regional powers still seems stronger than cooperation, preventing a full-fledged, European-style economic integration. After all, this region lacks the kind of overwhelming geopolitical challenge that helped postwar Europe to cohere. In addition, regional frameworks have to be able to accommodate the practical need to overcome political resistance or to work out details in light of regional diversity and these considerations are driving bilateral or sub-regional agreements. Therefore, it will take a long time for region-wide institutions such as the East Asian Free Trade Area to move beyond political statements.

Thus, it is probable that competitive bilateral or smaller, multilateral agreements in and outside the region will be developed in parallel, together with regional, cross-regional and global frameworks just as we see them today. And there will be ongoing feedback among these various fora. Bilateral solutions that were worked out based on clarified common interests may be applicable to other members and thus have a potential to become a model for larger forums. New ideas discussed in larger fora may become legally binding agreements among like-minded economies. At the same time, channels such as ASEAN + 3 as well as APEC are available to promote common interests with a stronger influence than what bilateral channels can command.

This model of competitive regional cooperation, or multi-layered regional frameworks, can find its counterpart already in Europe and North America where some of the most influential players in the global rule-making process, capitalizing on their local efforts toward creating a more business-friendly environment, interact and stimulate global efforts.

The open and dynamic nature of these multi-layered frameworks in the region also serves in accommodating U.S. engagement in the region. As Asian economies depend heavily on the U.S. market, technology, investment, not to mention regional stability

enabled by the U.S. security presence, the evolution of regional frameworks was partly born of the process of struggling to find the solution to a dilemma: how to anchor U.S. interests in the region while at the same time create a regional mechanism to deal with common interests among Asian economies that do not always have the same interests as the United States, and to have some bargaining power vis-à-vis the most influential superpower in the region. Now, bilateral or smaller multilateral agreements with the United States will be a part of the multi-layered frameworks in the region. U.S. efforts to conclude FTAs with East Asian economies will accelerate its partners' economic liberalization and enhance the transparency of their economic systems, thereby preparing East Asian economies for economic integration among themselves as well.

Through interaction among various fora, a primary region-wide framework, such as an East Asian Community—as well as a sense of community or regional identity—will eventually evolve, while competition will stimulate regional economies to overcome domestic resistance to reform and liberalization so as to avoid marginalization. How long this evolution takes depends on how the challenges identified above are overcome. The membership of such a primary forum may not necessarily be the same as ASEAN + 3 and depends on how other economies will interact with current members of ASEAN + 3, how the business and the economic environments interact and affect the pattern of interdependence in the region and how core interests and priorities of the economies involved will converge in the future.⁴ Its nature also depends on the process of its

⁴ In this connection, Japanese Prime Minister Koizumi proposed the creation of a “community that acts together and advances together” whose core members he expects to be the countries of ASEAN, Japan, China, the Republic of Korea, Australia and New Zealand. See, Speech by Prime Minister of Japan Junichiro Koizumi, “Japan and ASEAN in East Asia – A Sincere and Open Partnership,” January 14, 2002, Singapore. Koizumi started to refer to his proposal as “an initiative for a growing East Asian community” in his opening statements at the Joint Press Conference with Prime Minister Helen Clark of New Zealand, 2 May 2002. (http://www.mofa.go.jp/region/asia-paci/pmv0204/op_0502.html)

evolution.

Key Questions

There are several elements that will largely affect the evolutionally process described above, including the following:

1) Will Japan regain its economic vitality and gain trust among its neighbors?

If yes, Japan can play a leadership role in the region, along with China. A revitalized and trusted Japan is instrumental in maintaining regional stability during transition while China transforms itself into a liberal democratic society or at least becomes perceived to be a benign power. If not, Japan will be marginalized, China will be the only dominant player among East Asian countries, and regional stability will be largely influenced by the ups and downs in China's economic, social and political transformation.

It is unlikely that Japan can regain its economic vitality while remaining the object of distrust and suspicion. As detailed in the next section, the institutional transformation (to become an attractive destination for highly productive economic resources), which Japan has to go through to regain economic strength, requires Tokyo to deal with the sources of mistrust among its neighbors. In other words, needed changes in Japan's social and economic systems have "institutional complementarity" with Japan's deeper integration with Asia. Without overcoming this historical animosity and lingering suspicions, it is unlikely that Japan, which has long finished the catch up phase and is now faced with the challenge of an aging population, will have a strong enough appeal to attract competitive professionals.

Aside from the Koizumi proposal, it is natural that Hong Kong and Chinese Taipei, which are also the member economies of APEC and the WTO signatory, join the future pan-East Asian economic framework.

2) Will China become a liberal democratic society (or be perceived as a benign power) after achieving economic development or remain an authoritarian regime?

I assume that the Chinese economy will continue to grow despite difficult challenges with occasional shocks and adjustments. At the same time, the degree of its enforcement of the WTO rules will largely determine the level of institutional integration with neighboring economies. In other words, while it cannot fully implement WTO rules, it is unlikely to be able to enforce additional bilateral or regional agreements.

If China becomes a liberal democratic society, neighboring countries will be much more comfortable with China's leadership. While there will be economic competition with the United States, bilateral tension will be manageable.

As long as China remains an authoritarian regime, the United States as well as other liberal democracies in East Asia, will feel uneasy about the region being dominated by China. The United States will effectively play the role of counter-balance vis-à-vis China, leaving the region in a state of tension. In this case, while China will be an economic power that enjoys interdependence with its neighbors, the scope of its leadership will be limited. Also, the scope of economic rules that can be harmonized with its neighbors will be limited as well. It is likely that economic interdependence as well as China's focus on economic growth will keep the tension manageable while China's economic growth and increasingly affluent population allow for greater sociopolitical freedoms. Hopefully, this process will lead to a more benign China. Thus, it is desirable to integrate China into regional institutions to enhance its interdependence with its neighbors. However, China's political system and external posture will affect its neighbors' willingness to strengthen institutional relations with it.

3) Will the United States play a constructive role in East Asian integration?

If the United States plays a constructive role as described in section IV, the U.S. influence, regardless of its membership will further increase in the region. If not, it is likely that U.S. behavior will stimulate the “leverage-seeking factor” among East Asian economies.

III. Japan’s Role in East Asian Integration

As the largest economy in East Asia⁵, Japan has a crucial role in determining the course of East Asian regional frameworks for the foreseeable future. Success or failure of Japan’s policy efforts determines whether the challenges identified in the previous section can be overcome. Japan’s economic vitality and Asian dynamism are mutually dependent. Despite current economic difficulties, hopefully the positive experience of competition and cooperation with its neighbors will give Japan the energy to move forward.

Japan’s Economic Challenges

There are differing points of view about how Japan can get out of its decade long stagnation. Neither massive pump priming nor zero interest rate policy solved the problem. Many argue that the ultimate solution is to separate non-performing loans (NPLs) from bank balance sheets, to close down nonviable businesses and to free up resources for more productive uses. While NPL disposal and macroeconomic stimulus to cushion its deflationary impact is important to prevent an economic crisis in Japan, they do not guarantee Japan’s economic recovery.

⁵ Japan’s share in East Asian income is 67% in 2000.

A more fundamental problem of the Japanese economy is the erosion of Japanese corporate competitiveness and profitability. Increased competition from China only makes its task of substantial industrial adjustment all the more urgent.

Japan's economic model in the post-War period was based on a dual structure consisting of a limited number of competitive industries and a large number of protected, inefficient industries. This duality created a high-cost structure in Japan's business environment. At the same time, business practices such as lifetime employment and the "main bank" system (that were successful during the high growth era) largely ensured a stable supply of a loyal workforce and low cost finance within each closed business network, hampering development of open markets for corporate resources.

Globalization and information technology brought about a new competitive environment where corporate resources go beyond organizational and national boundaries to wherever they can maximize their value. At the same time, the Japanese population is aging and shrinking, limiting the prospects of domestic demand growth. High-performing industries, increasingly under competitive pressure from developing Asia and elsewhere, started to shift their operations overseas, while inefficient industries remain at home demanding protection and subsidies. Japan can no longer afford to have protected sectors that depend on the earnings from a few competitive sectors. Thus, the dual structure has simply become unsustainable.

The Japanese economic system and corporate behavior have not yet adapted to this new competitive reality. Lack of adequate external markets for corporate resources makes Japan's transformation all the more difficult. The challenge of today's economic policy is to create an innovation-friendly environment, where efficient and flexible markets --conducive to utilizing the best globally available resources and turning innovations into business-- are in place. In addition, regulatory reform is needed to eliminate policy interventions that keep nonviable businesses alive and hinder business

innovation. Consistent messages have to be sent that good performance will be rewarded. And more fundamentally, the Japanese economic and social system needs to become open and attractive to foreigners as well as its own people in order to capitalize on globally available competitive resources.

Building Capacity to Gain from Asia

Japan's future economic prospects fundamentally depend on its capacity to gain from new opportunities arising from Asian development. Businesses can substantially enhance their competitiveness by capitalizing on close and abundant, cheap labor and other strengths available in the region by focusing on higher value-added activities that can be sold globally, including in rapidly growing regional markets. Consumers will gain from lower prices. Regional developing economies can enjoy stronger growth thanks to increased export to Japan and, in turn, provide larger markets for Japan.

The dual structure as described above, however, conflicts with Japan's deeper integration with Asia. It led to a contradictory policy of promoting Asian industrialization through substantial official development assistance (ODA) as well as encouraging external investment on the one hand, and, on the other hand, of discouraging cheap imports in sensitive sectors through the imposition of quotas and high tariffs. Conscious policy initiatives to promote East Asian economic integration must urge Japan to face this issue of sensitive sectors as described in the previous section.

In addition, increased interaction of people and information will put pressure on Japan to eliminate lingering sources of mistrust with its neighbors, despite its peaceful national policy and economic contributions to the region as well as the global community throughout the post-WWII era. As discussed in the previous section, Japan will be required to clarify and articulate its national strategy and the role it is willing to play in

the region, one that is widely supported by its people. Whether Japan can overcome this historic challenge and whether its people can regain a healthy sense of pride and confidence in their own country, one that corresponds with its neighbors' respect and trust, will have a large impact on psychological health and vitality of its citizens and thus its quality and attractiveness as a society, which will fundamentally affect Japan's capacity to gain from Asia.

FTAs as a Vehicle of Reform

The policy measures to deal with the new economic environment discussed above could have stronger public support since competitive pressure is widely felt among Japanese people. More and more Japanese know that they cannot afford to pay the cost of protecting "sanctuaries" forever. Focused efforts to liberalize "sanctuaries" with relatively weak resistance have a larger chance of success than before.

One such example was the Japan-Singapore Economic Partnership Agreement (JSEPA). It was natural that Japan negotiated its first FTA with Singapore, which does not have many sensitive exports to begin with. Instead of just avoiding the problem, however, Japan capitalized on this situation to create a pinhole in the barrier surrounding "sanctuaries." Japan eliminated tariffs on items such as petrochemical and textile products, then difficult to liberalize. Unlike what many critics claim, JSEPA does not exclude the agriculture, fishery and forestry sectors. Japan agreed to bind 0% tariffs on items in these sectors (typically considered as "sanctuaries") whose tariffs are already 0% on a de facto basis but not bound by its WTO commitments. This was the first step to break the norm of treating these three sectors as "sanctuaries" and to start item-by-item considerations.

The second country with whom Tokyo officially began considering an FTA was Mexico, a non-Asian country. The rationale behind this choice was to overcome

discrimination caused by NAFTA and the EU-Mexico FTA, combined with Mexico's high tariffs on a most-favored-nation (MFN) basis. With real damage visible, inability to eliminate tariffs needed for an FTA has high costs in the eyes of the public. In addition, Mexican produce is relatively complementary rather than competitive with Japanese produce. Therefore, on balance, there seems to be a chance of success.

The third country is Korea, which actually has always been first priority. It is located right next to Japan, and both are U.S. allies and OECD members. There is a desire to focus on common interests and to overcome historical antagonism. Incidentally, neither has a very competitive agricultural sector.

While it is not clear whether Japan can eventually succeed in these cases, it is fair to say that the process is carefully designed so that no particular challenge is too overwhelming or politically sensitive, but instead is highly rewarding, so that political resistance can be overcome. The successful experience of relatively easy reforms would change expectations and open up opportunities for more difficult reforms down the road.

At the same time, efforts were made to incorporate a wide range of innovative policy measures to reduce transaction costs between the two countries into the JSEPA.⁶ The creative process of designing the JSEPA gave Japanese officials new confidence that a focused process would enable them to identify specific problems and practical solutions as well as to learn from the countries, with whom they negotiate, about their policy "best practices", the unique challenges of transforming economic and social structures as they become more developed and exposed to pressure of globalization, and their aspirations as well as perceptions and expectations for Japan and the region as a whole. This

⁶ Salient features of the agreement between Japan and Singapore include mutual recognition of technical conformity assessment for electrical and electronic products and telecommunications equipment, customs cooperation to improve customs procedure through more extensive IT use, legal recognition of certified digital signature in both countries, mutual recognition of IT skills certification, and facilitation of movement of business persons. (Agreement between Japan and the Republic of Singapore for a New-Age Economic Partnership (JSEPA))

experience had a tremendous psychological effect on those officials, giving them a sense of achievement, opening up new ways of thinking about trade and economic policy, and energizing them to move forward.

Thus, concluding an FTA or economic partnership agreement (EPA)⁷ is essentially a process of self-initiated opening up as opposed to exposure to traditional external pressure, or *gaiatsu*, since Japan has to choose which countries to conclude FTAs with and their contents. JSEPA was just the first step for Japan. It is considering EPAs with Mexico, Korea and ASEAN. It is hoped that these EPAs will actually bring about much-needed reform momentum in Japan. At the same time, FTAs and EPAs have flexibility that nicely complement the WTO, and thus enriches Japan's trade and economic policy. In summary, FTAs or EPAs will urge Japan to focus on its relations with its neighbors and gradually help it prepare to play a more consistent role to contribute to prosperity and stability in Asia.

IV. Implications for U.S. Policy in Asia

Having assessed the prospect of Asian economic integration, in view of underlying forces as well as perceived obstacles, what are the implications for U.S. policy for Asia?

U.S. Membership Not the Dividing Line

Since the EAEC proposal met strong U.S. objections, the criteria to determine whether regional frameworks are in the U.S. interest or not has been whether the United States was included or not. Those frameworks without the United States have been regarded as "exclusive." U.S. reactions to Asian regional frameworks, however, are

⁷ Japanese policy makers refer to economic partnership agreement as "FTA+" or agreements with broader scope that could potentially cover the entire economic systems as opposed to something that covers just border measure or so-called "trade-related"

quickly changing. At least, the Bush Administration seems to face the reality of the trend toward institutionalizing economic integration in Asia and to actively and effectively engage itself in the trend, rather than trying to criticize from outside and hinder developments in Asia. U.S. Trade Representative, Robert B. Zoellick, reportedly made a positive comment on ASEAN's intention to promote a free trade area with Japan, South Korea and China, saying the Bush Administration favored promoting free trade bilaterally, regionally and globally.⁸ This change in Washington's approach may have been caused by the fact that ASEAN + 3 was created despite its objection to EAEC and subsequent warnings against possible "exclusive" regional arrangements in Asia.

U.S. Interest in East Asian Economic Integration

More fundamentally, however, Washington has a clear interest in helping East Asia become more mature and integrated via regional frameworks regardless of U.S. membership. Here are some reasons:

1) Japan's economic prospects hinge on Asian economic dynamism

First, as noted in the previous section, Japan's future economic prospects substantially depend on its capability to benefit from East Asian economic dynamism. It is in the interest of the United States to encourage Japan to proactively take up competitive challenges from Asia and to promote reform of its economic structure so that it can build its capacity to turn Asian challenges into new opportunities.

2) Interdependence reduces tension and U.S. security burden

Second, as was described in section II, there are competitive tensions and anxiety

measures.

⁸ "Thailand, US mull steps to bilateral arrangement, Zoellick talks of 'building blocks'" April 5, 2002, *Bangkok Post*, April 5, 2002

about each other's strategic intentions among Asian regional powers. Economic integration that started without regional institutions, however, has already increased business contacts through trade and investment and brought about changes in the relations among regional economies. In addition, the process of institutional development --that is, increased interaction among government officials at various levels through series of meetings in multiple forums, focused effort to come up with trade and financial arrangements, and domestic political process to authorize them-- all have substantially enhanced mutual understanding between governments and people in general. With adequate institutional frameworks to promote economic integration, cross-border flow of not just goods and capital, but also people, services and information (including ideas and culture) will further accelerate this process. Economic integration will engage regional powers in stable regional interdependence where one's prosperity is in the interest of others, and make them more predictable and reliable to each other. Successful development of poorer countries in Asia through integration in regional economic dynamism will help political stability and reduce the possibility that these countries will become hotbeds of terrorism. East Asian economic integration, thus, will help reduce regional tension and lighten America's security burden in the region.

3) Japan as a regional leader will be more valuable as a U.S. ally

Third, there is a question whether the United States can have confidence in Japan as a regional leader. Since Washington is not yet prepared to accept China as the sole leader in Asia, therefore, it needs Japan, its primary ally in Asia, to be one of the leaders in any pan-Asian (as opposed to pan-Pacific) framework at this time.

After World War II, Japan depended on the United States for its security as well as diplomatic strategy and focused on economic reconstruction. Japan was successful in rapid economic development and even became regarded as an economic threat in the

late 1980s. On the other hand, due to its constitutional restraint, Japan has failed to share the responsibility of preserving regional and global security commensurate with its growing economic power. It has been reactive in dealing with the history problem and has failed to face it proactively. Tokyo has not clearly articulated its security policy, as it has been shielded, under the U.S. security umbrella, from direct pressure from its neighbors. This posture breeds suspicion among Japan's neighbors or frustration with Japan, which in turn weakened Tokyo's political power despite its active efforts to provide economic assistance to its neighbors. Regional frameworks without the United States will put unique pressure on Japan to deal with the problems it has left behind in its post-War history. Japan, if it becomes more open, embedded, and trusted in the region through its efforts to overcome these challenges during the process of regional collaboration, can become a more effective and valuable U.S. ally. Acknowledging and encouraging Japan's leadership in the region is not to reduce U.S. power and influence in the region. Rather, it will enhance the effectiveness of U.S. alliances in dealing with diverse threats in post-Cold War Asia.

U.S. Roles in Asian Economic Integration

With greater confidence about East Asian regional integration as argued above, Washington can take several steps to promote its interests as well as healthy developments in Asia.

The first is the global leadership. Washington should take the initiative in strengthening global institutions. As the only global economic superpower, many hope that the United States will lead the world in completing the Doha WTO Agenda and will refrain from resorting to protectionist measures in its own trade policy. It is also important that Washington lead efforts to reform international financial organizations to give East Asian economies a larger voice, one that corresponds to their increasing

significance in the global economy.

The second is to strengthen key bilateral relations in East Asia. To capitalize on the benefit of economic integration in East Asia, it is important for the United States and Japan to strengthen two-way policy coordination in regional affairs. In addition, stable U.S. relations with Japan and China are crucial to fostering broad understanding within the United States that Asian integration can promote U.S. interests. Washington can also stimulate Asian integration by pursuing its own bilateral FTAs with economies in the region. As noted above, USTR seems to be on the right track in this regard.

Third, while Asia is different from Europe in its diversity and geopolitical challenges, Washington could play a more active role just as it helped realize European reconciliation and integration after World War II. For example, Washington can support the various building blocks of regional integration that will ultimately form a more comprehensive and institutionalized framework for regional integration. U.S. active encouragement for the Japan-South Korea economic partnership arrangement --a significant step forward for two of the world's most important economies and U.S. allies who are also divided over painful historical memories-- will give a significant push for this bilateral initiative. Washington can also help accelerate integration within ASEAN. At the same time, the United States can encourage Japan to become a more independent and responsible ally and, at the same time, to become able to command trust by its neighbors by clarifying its security policy and overcoming history issues. After all, a trusted Japan will be the key to reducing political tensions in Asia and an indispensable element in the future multilateral security framework in Asia.