

# “Extrovert Regionalism”

## – CEPEA Portends Direction of Japan’s New Trade Policy –

By Tamura Akihiko

### CEPEA – Harbinger of Japan’s New Trade Policy

The Chairman’s Statement of the Second East Asia Summit (EAS) held in the Philippines in January 2007 refers to two components of the so-called Nikai Initiative. One is the formulation of a Comprehensive Economic Partnership in East Asia (CEPEA), which is an EPA among ASEAN+6 countries (i.e. EAS participants). The other is the establishment of an Economic Research Institute for ASEAN and East Asia (ERIA), which is an OECD-like think tank to study East Asian regional integration. As for CEPEA in particular, leaders participating in the EAS agreed to launch a track-two (i.e. academic) study on this undertaking among EAS participants, and tasked the ASEAN Secretariat with preparing a time frame for the study. They also agreed to invite all the EAS member countries to nominate their respective participants in the study. The EAS encompasses not only ASEAN+3 countries (the 10 ASEAN members plus Japan, China and South Korea) but also Australia, New Zealand and India (*Chart 1*).

When Japan formally proposed CEPEA to other Asian countries in the summer of 2006, much skepticism was cast on Tokyo’s intention behind the proposal. In particular, pundits speculated that its real intention was to counter the growing influence of China in East Asia, especially taking into account the fact that in November 2000 China surprised many countries by proposing to ASEAN that they negotiate an FTA. In addition, China has been also active in a regional FTA in the context of the ASEAN+3 framework, the so-called East Asian

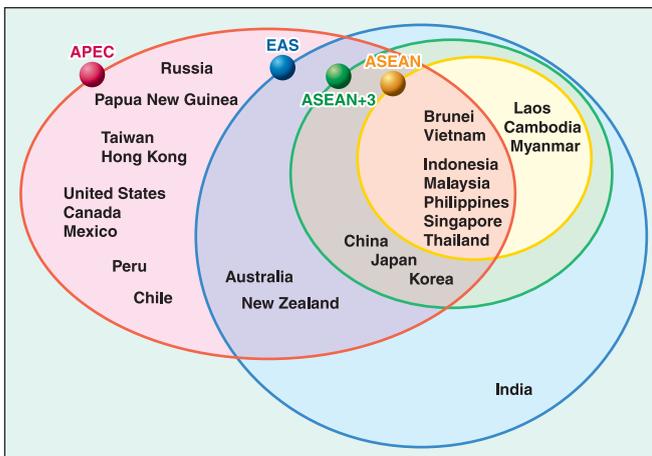
Free Trade Area (EAFTA). The foregoing skepticism was augmented by the fact that the ASEAN+3 framework as such had established itself since its inception in 1997 in contrast to the inchoate EAS process. In response to this skepticism, then Japanese Economy, Trade and Industry Minister Nikai Toshihiro, after he advanced the Nikai Initiative to his ASEAN counterparts in August 2006, rejected such speculation and explained that the initiative was based on his confidence that an FTA/EPA encompassing a population of 3.1 billion people with gross domestic product (GDP) of US\$9 trillion would have a great impact on the regional economy and global economy as a whole (*Ref. 1*).

It is explained that the rationale of CEPEA is also derived from the reality that at present ASEAN has signed or is negotiating an FTA or an EPA with each of all partners in the ASEAN+6 group. As these negotiations will supposedly have been completed by 2007, the CEPEA proposal, which aims to launch a study in 2007 and start negotiations in 2008 to conclude by 2010, fits well the state of play in this region (*Chart 2*). Indeed, as a web of FTAs/EPAs (and thus rules of origin) has been getting as intricate as a “noodle bowl,” the business community has started to express a vehement call for improvement of the situation.

It is noteworthy that CEPEA also elicited an interesting consequence – an official proposal by the United States on an FTA covering the APEC members, the so-called Free Trade Area of the Asia-Pacific region (FTAAP). The FTAAP proposal had been long advocated by some scholars such as C. Fred Bergsten and was recommended by the APEC Business Advisory Committee (ABAC) in 2004. But the US government had given it the cold shoulder until the US delegation formally forwarded the proposal at the APEC leaders’ meeting in November 2006. The APEC leaders agreed then to instruct officials to undertake further studies on ways and means to promote regional economic integration, including an FTAAP as a long-term prospect, and report to a 2007 APEC summit in Australia.

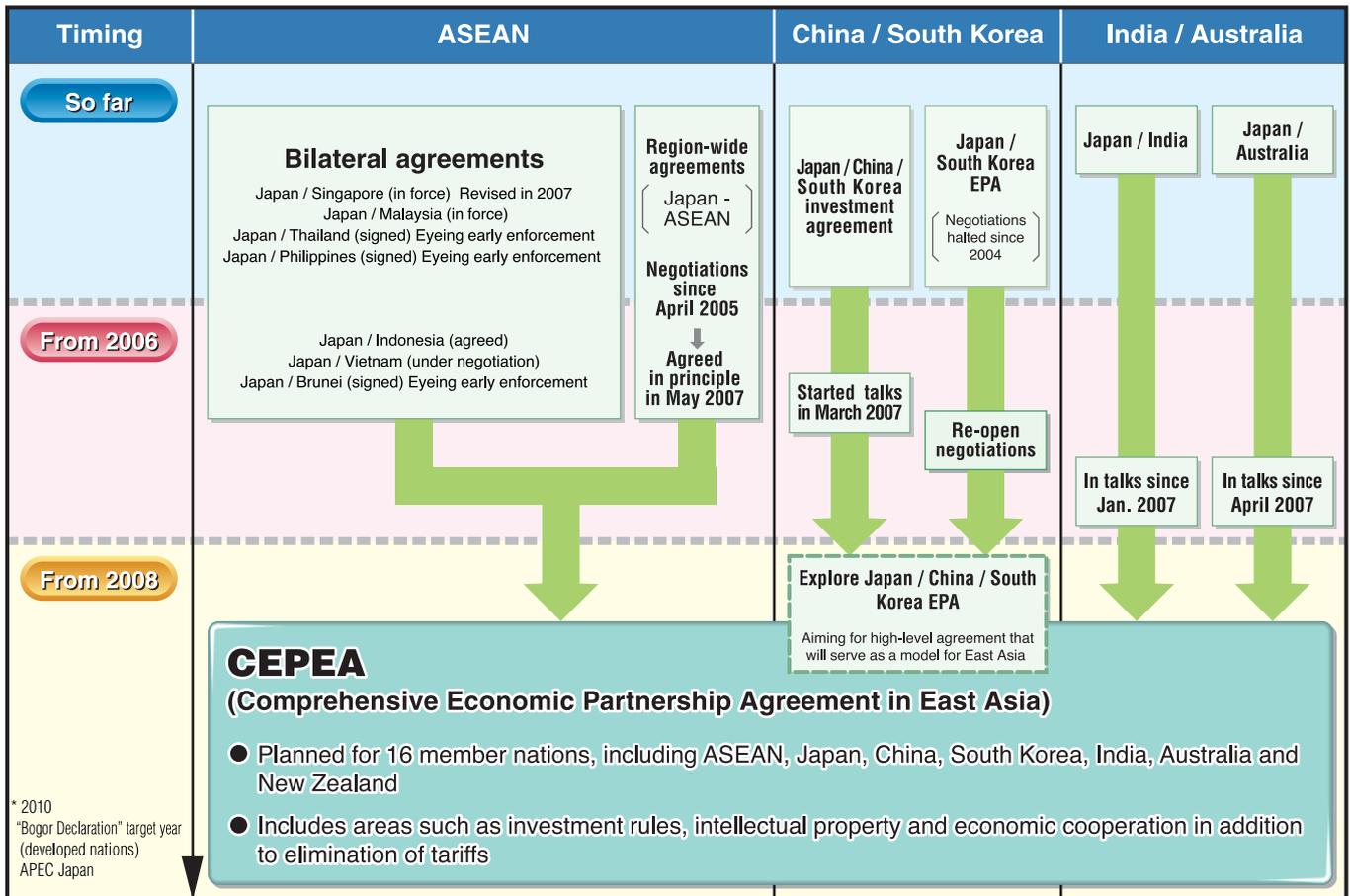
Furthermore, a similar reaction came from the European Union. In October 2006, the European Commission issued a report proposing a launch of FTA negotiations with six partners, three of which are in East Asia: ASEAN, India and South Korea. (The rest are Russia, MELCOSUR and the Gulf Cooperation Council (GCC).) Although it does not seem the EU reaction was driven solely by the CEPEA proposal, obviously it was elicited by the “FTA bandwagon” phenomenon in East Asia, consisting of completed and ongoing negotiations and considerations for bilateral and regional FTA/EPA negotiations, including CEPEA.

**Chart 1 Regional economic frameworks in East Asia**



Source : Tamura Akihiko

Chart 2 Asia-Pacific EPA road map



Source : Ministry of Economy, Trade & Industry (revised by the author)

No doubt CEPEA would have a significant value as an FTA/EPA encompassing a large number of populations and GDP. However, considering its traits and consequences, it is more important to note that CEPEA is premised on a different paradigm from previous economic arrangements in the region, which should be interpreted as a harbinger of Japan's new trade policy. That is, CEPEA seeks to transcend two major driving forces of East Asian regionalism to date: "defensive regionalism" and "intra-regional economic interdependence."

According to Munakata Naoko (*Ref. 2*), these two factors have so far played a major role as a driving force for the evolution of regionalism in East Asia. "Defensive regionalism" describes a situation in which a country, with fears of exclusion from institutionalized economic integration in other regions, reactively seeks an institutionalized economic integration with other countries in its own region. In respect of "intra-regional economic interdependence," it has been broadly believed that the high intra-regional trade ratio in East Asia – as high as the EU and NAFTA – largely warrants the relevance of having an institutionalized economic integration in this region.

I would argue that it is a new paradigm encapsulated in

CEPEA that makes this EPA transcend the foregoing traditional driving forces of East Asian regionalism. I call the paradigm "extrovert regionalism." This type of regionalism consists of two trajectories. One is a future-looking trajectory and the other is an outward-looking trajectory.

Unlike the thus far concluded or proposed FTAs/EPAs among the ASEAN+3 countries, CEPEA covers a country that is not necessarily a part of de facto regional integration at present but will arguably prove to be the most promising as a factory and a market – India. This future-looking nature is hereby called the quest for potentiality. The other trajectory, outward-looking, is hereby called the quest for geographical extensiveness. This is the idea that regional arrangements should aim to cover a maximized portion of one extended value chain, not just limited segments thereof built up or to be built up of a geographically defined contour. Moreover, for this purpose, CEPEA, as a regional arrangement, took advantage of dynamics called by Richard Baldwin the "Domino Theory of Regionalism" (*Ref. 3*), through which CEPEA elicited the important reaction from the United States and, to a lesser extent, the EU.

### Domino Theory of Regionalism

As above, the East Asian move concerning CEPEA nudged the United States into proposing the alternative. Interestingly, according to the FTAAP mastermind, Bergsten, this proposal per se aims to materialize the Domino Theory of Regionalism, or in his terminology, “Competitive Liberalization,” by which he means the prospect that bilateral, regional and global barrier reductions would naturally reinforce each other to stimulate market opening.

According to Baldwin, the Domino Theory of Regionalism consists of two stages: the immediate impact of an idiosyncratic deepening of integration in a preferential trade arrangement (PTA) and the knock-on impact implied by bloc enlargement. The theory assumes that whether or not a certain country decides to join a PTA is determined by its domestic political equilibrium that balances pro-membership and anti-membership forces. Moreover, the country’s exporters are considered as the pro-joiners as they gain from preferential access if the country joins and they suffer if the country stays out. The country’s import-competing industries are associated with the anti-membership force. According to this theory, once a certain nation (country A) joins a PTA, an idiosyncratic shock of this incident generates new political economy forces in a non-member country (country B) since the fact that B is not a member in the particular PTA and that thus its exports cannot enjoy preferential access to the markets of member countries raises a stake of B’s exporters in PTA membership. Once B joins the PTA, the PTA enlargement implies that discrimination facing the remaining non-members (countries C, D, etc.) expands and this again heightens the pro-membership political economy forces in these countries, producing a further expansion of the PTA.

According to another paper by Baldwin (*Ref. 4*), the domino effect of regionalism has been evident in East Asia, as it was triggered by China’s proposal for an FTA with ASEAN in 2000 and was followed by similar offers from Japan, South Korea, India and Australia/New Zealand. In a similar manner, apparently CEPEA prompted the United States to forward its FTAAP proposal in November 2006. It is reported that when the Nikai Initiative was made public in April 2006, US Ambassador to Japan Thomas Schieffer, expressing Washington’s concern, said this initiative to create such a free trade zone in East Asia could damage US regional interests (*Ref. 5*). Japanese trade officials also confirmed the United States informally expressed serious dissatisfaction when the initiative was formally forwarded to Asian counterparts in August. Bergsten argues that a trade bloc in East Asia will “draw a line down the middle of the Pacific” and will cost the United States \$25 billion in annual exports solely from the static discriminatory effects (*Ref. 6*). Thus, CEPEA successfully elicited an alternative, possibly warranting the US departure from its traditional “hub-and-spoke” engagement in this region and the

possibility of geographically more extensive preferential arrangements.

As a matter of fact, an FTAAP itself has been advocated as a catalyst for the domino effect. Bergsten argues that an FTAAP may be the “most likely catalyst” for restarting the WTO Doha Round as the discrimination resulting from the successful creation of an FTAAP would likely prompt outsiders (such as the EU, Brazil, India and some African countries) to return to the negotiating table (*Ref. 6*). He insists that this continuum is analogous to how the initial APEC summit at Seattle in 1993 played a crucial role in bringing the Uruguay Round to its ultimate successful conclusion.

It is almost impossible to estimate in advance the impact of a specific FTA/EPA proposal. However, the following seems to be valid. With regard to an FTA/EPA involving developing countries, there are two factors affecting the magnitude of the “leverage” equipped by the arrangement. First, there is a situation called “tariff binding overhang.” Baldwin explains that unlike the European and North American trade blocs, which lowered their MFN tariff rates so progressively that margins of preference never got too big, all of East Asian countries except Japan, South Korea and Singapore still maintain a significant gap between their MFN tariff rates and actually applied tariff rates (*Ref. 4*). Baldwin calls this situation “tariff rate overhang” and insufficient MFN liberalization could fuel inter-bloc trade tensions. He therefore insists that an East Asian trade framework should prioritize the task of convincing its developing country members to bind their applied rates in the WTO. Second, while it is not unusual for South-South FTAs to be signed but not implemented, North-North FTAs or even North-South FTAs are more disciplined and thus are to be more likely implemented as scheduled. It means that the latter could be more discriminatory to outsiders. By this token Baldwin expresses more concern about Japan’s FTAs with ASEAN countries than about AFTA, China-ASEAN FTA and South Korea-China FTA, as the former is expected to be implemented by the North-North FTA standard (*Ref. 3*).

It would be rational to assume that the relationship between the magnitude of discrimination to outsiders (and thus the probability of trade friction) and the magnitude of the leverage equipped by the FTA/EPA concerned is analogous to both sides of the same coin. Of course, the actual effectiveness of the leverage would be also affected by a number of extraneous factors, such as US domestic politics. In any case, the above implies that architects of an FTA/EPA, who aim to materialize the domino theory of regionalism through that regional arrangement, hold both the reasonable reins and significant responsibility for the impact of the arrangement on the architecture of the global trade system. Bearing this in mind, while CEPEA succeeded in materializing the domino effect of regionalism in the “first round,” Japan, the mastermind of CEPEA, is required to exercise careful calculation and management when it proceeds with its new trade policy.

## ■ The Quest for Extensiveness & Potentiality

### [The Quest for Extensiveness]

As stated above, to a great extent East Asian regionalism has been based on the premise that intraregional trade has been expanded, which is also described as a regional integration on a de facto basis. It is true that so-called product fragmentation has evolved in this region and thus has made this region “Factory Asia” (Baldwin ‡ Ref. 4). However, we must bear in mind that this does not mean that “Factory Asia” is self-sufficient. On the contrary, “Factory Asia” is actually much more heavily dependent on extra-regional trade for its growth dynamism than it is generally perceived.

Prema-chandra Athukorala makes this point by paying particular attention to the distinction between trade in components and trade in finished goods (‡ Ref. 7). He notes that in 2004 only 32% of finished goods exported from developing Asia found markets within the region, compared with 50% of total exports (i.e. exports encompassing both finished goods and components). As the gap between these two types of exports cannot be observed in North America or Europe, he concludes that the recent significant increase of intraregional trade in East Asia is due to the increase of intraregional trade in components and that the growth dynamism of such trade depends primarily on extra-regional demand for finished goods, such as from North America and Europe.

I agree with Athukorala in that the manufacturing networks woven in East Asia are in charge of particular segments of one extended value chain (or in Michael Porter’s term, “value system”), and that regional liberalization in East Asia should be attentive to the relationship with the upstream segments, including natural resources-producing nations and the downstream segments such as markets for final products. Also, it may be that regional liberalization in East Asia should be attentive to the reality that the settlement of intraregional transactions heavily relies on the functions provided by the nations outside the region. Furthermore, with the reasonable prospect that sooner or later the global imbalance between the United States and Asian countries must be adjusted, it may be that regional integration in East Asia should not be institutionalized in a manner harmful to adjustment of the imbalance. Therefore, the fact that the launching pad for the outward trajectory is embedded in CEPEA is remarkable and encouraging.

The quest for geographical extensiveness discernible in CEPEA is no surprise once we take into account other undertakings that have been already promoted by some East Asian countries. For example, as for the quest for markets for finished products, South Korea has agreed on an FTA with the United States because South Korea hopes to have not only a more competitive economy of its own but also open duty-free access to the world’s largest market and largest trader with East Asian countries (Jeffrey Schott et al., ‡ Ref. 8). (As the US MFN tariff rates are already extremely low, “open duty-free access” to this market is destined to include some disciplines on

trade remedies, which proved to be one of the most sticky points in the negotiations.) As for the quest for natural resources, China has been famously active in establishing a cooperative relationship with African countries, if not an FTA. Japan has been also engaged in cross-regional negotiations for FTAs/EPAs so as to secure both natural resources and final-product markets. The former example is the ongoing FTA negotiations with the GCC and the latter example is the already implemented EPA with Mexico. With regard to the latter, the targeted markets were not only the Mexican domestic market but also final-product markets in the United States and Latin America as Japanese production bases in Mexico, after importing equipment and parts on a duty-free basis under the aegis of the Japan-Mexico EPA, manufacture final products and export them to these markets under the aegis of NAFTA and FTAs with Latin American countries (‡ Ref. 9).

### [The Quest for Potentiality]

As it is considered that a preferential tariff arrangement has trade creation effect (as its positive effect, as opposed to its negative counterpart, i.e. trade diversion effect), it is rational for FTA negotiators to choose as an FTA partner a nation with which they hope to create more trade, even though the latter is not presently its significant trade partner. Here potentiality does matter. This point is made by Peter Drysdale in a China context, arguing that for China to realize its modernization ambitions over the next generation, the sensible and rational choice is a “global choice,” i.e. the acceptance and entrenchment of global obligations and responsibilities in a multilateral setting, as no region, not even East Asia including Japan, is big enough to serve this purpose (‡ Ref. 10).

Actually, Japan’s recent decision to launch an EPA negotiation with India is also a manifestation of its quest for potentiality, that is, it is not premised on any present conspicuous existence of bilateral trade, but rather on its confidence in the potentiality of larger and deeper economic exchanges. As of 2005, Japan ranks just 10th among India’s export destinations (share of 2.5%) and 10th among import sources (2.8%), and India ranks 26th among Japan’s export destinations (0.6%) and 28th among import sources (0.6%). The report of the India-Japan Joint Study Group, on which the EPA negotiation will be based, admits that “the current state of the economic relations between the two countries shows that their potential has not been fully harnessed.” (‡ Ref. 11) As stated above, CEPEA, which adds India (and Australia and New Zealand) to the ASEAN+3 members as its coverage, appears to be based on the same thought as well.

However, promising countries as a factory and/or a market are on all corners of the globe. According to a 2006 World Bank report (‡ Ref. 12), if the report’s central scenario materializes, global economic growth will be somewhat faster in 2006-30 than in 1980-2005, and as the growth is to be powered increasingly by developing countries, it will produce average per capita income in the developing world of \$11,000 in

2030, compared with \$4,800 today. More significantly, the World Bank report estimates that by 2030, 1.2 billion people in developing countries – 15% of the world population – will belong to the “global middle class,” up from 400 million today. It is significant because this group will have a purchasing power of between \$4,000 and \$17,000 per capita, and will enjoy access to international travel, purchase automobiles and other advanced consumer durables, attain international levels of education, and play a major role in shaping policies and institutions in their own countries and the world economy. It is estimated that this expansion of the “global middle class” will transpire all over the globe, although unevenly. (The “global middle class” share in population in East Asia and the Pacific increases from 1.3% in 2000 to 7.3% in 2030, while the equivalent in Sub-Sahara Africa increases from 0.2% to 0.5%.)

As trade liberalization and increased trade in goods and services are indispensable ingredients of the foregoing expansion of the “global middle class,” it would be rational to expect new Japanese trade policy, which apparently aims to quest for potentiality, to be formulated and implemented in light of this sea change. Japan has invaluable experience in contributing to the development of ASEAN and China since the 1970s through the synergy among ODA (especially, yen-denominated loan aid for the building of social-economic infrastructure), foreign direct investment (FDI) by Japanese firms relocating production bases from Japan to these countries, and intrare-

gional trade. Of course, it remains to be seen whether this formula effectively works in the case of emerging market countries outside East Asia. In addition, although Japan’s recent regional trade instrument contains not only an FTA element but also a development and cooperation element, which is why the instrument is called an “Economic Partnership Agreement” (EPA), there remains much room for further coordination between the trade policy element and the development policy element.

While we can anticipate remarkable performance by a number of developing countries by 2030, it is also projected that there are to be some parts of the globe which lag behind. The World Bank estimates the population share of the “poor” segment (i.e. the purchasing power is below \$4,000 per capita) will still remain 63% in 2030 as compared with 82% in 2000 (≠ Ref. 12). To the extent that Japan’s new trade policy aims to quest for potentiality, how to cope with this segment should be another challenge. This is the segment that has not and will not be able to share the fruit of globalization. C. K. Prahalad puts forth a very interesting thought in this respect (≠ Ref. 13). He proposes to multinational corporations to adopt innovative business models, which treat this segment, or in his terminology, “Bottom of the Pyramid” (BOP), as a potential market and a group of potential innovative entrepreneurs. His approach is to emphasize the importance of “building self-esteem and entrepreneurial drive” among the BOP people. No doubt, for his business models to work, relevant governments and international organizations must do their homework as well – buildup of the so-called Transaction Governance Capacity (TGC) – but his approach expects the entrepreneurship in both multinational corporations and BOP markets to play a much bigger role in development than the conventional approach.

On top of the TGC, however, apparently Prahalad leaves more room for contribution to materialization of his scenario by governments, particularly, trade policy. Prahalad posits: “(In the BOP market) traditional approaches to reducing prices by 5% to 10% will not suffice. We should focus on an overall price-performance improvement of 30 to 100 times.... However, these efforts can be justified only if the markets are very large and global and the returns are more than commensurate with the risks.....Only a few BOP markets are large – China, India, Brazil, Mexico and Indonesia. Most of the markets, such as the African nations, are poor and small.” As above, the innovative business models suggested by Prahalad would work better in a particular BOP market when the market sees economies of scale govern, that is, the market is sufficiently large. This means that an undertaking by plural nations to form a single larger market is an important recipe when it comes to smaller developing countries. Therefore, it would be rational for developed countries, including Japan, to support such an undertaking by developing countries, particularly when the former consider the latter as a potential FTA/EPA (or even bilateral investment treaty) partner. (It seems fair to believe that this strategy is applicable to not only BOP but also

Photo: PANA



Prime Minister Abe Shinzo shakes hands with his Thai counterpart Surayud Chulanont after signing a bilateral economic partnership agreement in Tokyo on April 3, 2007.

emerging economies.) This reminds us that the second pillar of the Nikai Initiative – ERIA – proves to be extremely relevant in this context. It was agreed that ERIA is to be established to carry out research and analysis on both ASEAN and Pan-Asian economic integration and to make intellectual input to support the ASEAN Secretariat in Jakarta. To the extent that Japan supports the integration of ASEAN, which does not include Japan as a member, through ERIA, the experience garnered through this support project would be important experience for Japan to apply to other cases outside the region in the future.

### ■ Epilogue

As stated above, CEPEA contains an “extrovert” trajectory that signifies Japan’s new trade policy, consisting of the quests for extensiveness and potentiality. I would like to take particular note of this both future-looking and outward-looking spirit embedded in CEPEA, but not discerned in any other bilateral FTA/EPA engaged in by Japan to date, because this “extrovert” spirit per se is particularly crucial for Japan, much more than individual trade agreements as collections of rights and obligations. It is this spirit that could tremendously affect the dynamism of the Japanese economy.

It is normally argued that a trade agreement, if properly formulated, could have a positive impact on the domestic regulatory reform of participants and thus would bring about further vigor in participating countries’ economies. However, it has to be acknowledged that trade agreements – which are basically collections of rights and obligations aimed at freeing up trade – have their limits.

Although the regulations on a number of industries might be subject to substantial adjustments, the sectoral regulations are only part of the causes of the insufficient dynamism in Japan’s economy. The horizontal regulatory schemes such as competition and labor laws, the educational system, etc. have significantly contributed to the lack of dynamism in Japan’s economy. Furthermore, it appears this lack of dynamism has been also caused by non-regulatory factors such as people’s deeply rooted complacent mindset, including Japan’s almost knee-jerk reaction to curb competition.

As a “royal road” to its long awaited reform, therefore, Japan instead needs to equip itself with a “global mind,” being mindful of the realities on the globe, not just within its territory, or even not just within East Asia, so as to help all quarters of Japan optimize their thinking and behavior in the global context. Jagdish Bhagwati observes the phenomenon called the “inversion of Hume’s concentric circles” (≠ Ref. 14). This concept refers to the discourse by David Hume that wrote of concentric circles of loyalty and empathy that declined as one went further from the center. Bhagwati argues that this phenomenon is transpiring due to CNN and the Internet, inducing immature youths to ill-advised anti-globalization advocacy. When it comes to Japan, however, it appears the “Hume’s con-

centric circles” still remain orderly and firm, even though the subject was expanded from “loyalty and empathy” into more generic “interest” or “curiosity.” Moreover, Japan’s “apathy” toward the realities outside its territorial border appears to be an underlying cause of its procrastination of long-awaited reform, as Japan is yet to write its own “recipe for metamorphosis.”

Therefore, the most effective, if not quick-acting, prescription that Japan needs to take is to take international economic policy that would irreversibly foster an “extrovert” mindset. Japan’s new “extrovert” trade policy, if appropriately and steadily implemented, would affect other public-policy fields and help transform Japan’s mindset, which is predominantly “introvert” at present. The Japanese economy thereby could undergo further reform and then discharge its responsibility for the development and prosperity of the Asian community and the global community as a whole. **JS**

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