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**Regional Cooperation in East Asia
and FTA Strategies**

Peter Drysdale

AUSTRALIA–JAPAN RESEARCH CENTRE
ASIA PACIFIC SCHOOL OF ECONOMICS & GOVERNMENT

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REGIONAL COOPERATION IN EAST ASIA AND FTA STRATEGIES*

The need for deeper financial and trade cooperation in East Asia became clear through the experience of the East Asian financial crisis. The imperatives of East Asian cooperation mean that the quest for East Asian influence and leadership on regional and international affairs through ASEAN + 3 will continue. However, the creation of an East Asian Economic Community requires leadership and a model that is consistent with East Asian (not European or American) circumstances.

Japan's changing role in the regional economy prompted policy initiatives such as espousal of bilateral free trade agreements (FTAs) aimed at closer East Asian regional economic and political links. This fundamental shift in Japan's trade policy diplomacy was effected without public debate in Japan and the reactions to it from partner countries, almost entirely unanticipated by Japanese policymakers, led to some confusion in policy strategy.

Discriminatory regional trade arrangements do not reflect the needs and circumstances of the East Asian economy at the beginning of the twenty-first century, and specifically the need to accommodate the growth and opening of the Chinese economy within the regional and global economic systems. The proliferation of FTA arrangements, with increasingly complicated rules of origin, is more likely to distort and derail rather than to encourage broader and deeper economic integration. The objectives of 'closer economic partnership' arrangements are better served by non-discriminatory trade agreements than by distorting and limited bilateral FTAs.

Many of the features of the East Asian economy have not fundamentally changed. It continues to be distinguished by its extra-regional trade and economic reach. Large flows of FDI, particularly into China, cement economic interaction with the global economy. Both economic and political considerations have influenced thinking among the Chinese leadership about the change in trade policy strategy. The sensible and rational choice for China is a global choice, the acceptance and entrenchment of global obligations and responsibilities in a multilateral 'pluralist' setting.

Introduction

The last decade of the twentieth century saw a marked shift in thinking about regional cooperation in East Asia and the Pacific. East Asia became the locus of interest in economic cooperation within the region. At the end of the decade, economic cooperation across the Pacific within the framework of APEC seemed on the wane. This was not simply a shift of direction in economic diplomacy. The wellsprings

of the change were also deeply political in character. Its timing had as much to do with how East Asia came to perceive the need for a new framework for managing the growing dominance of America as it did with the steady rise of East Asian economic power. But both economic and political forces drove the change. The policy attention devoted to East Asian cooperation has not abated, but rather intensified in the past few years.

This paper examines the rise of the new regionalism in East Asia and the changing shape of the regional economy that has been one of the forces encouraging it. It looks at the scale and character of regional trade and economic activity and how both provide grounds for giving new priority to East Asian regional cooperation. It notes Japan's changing role in the regional economy, and how that has prompted particular kinds of policy initiative (such as espousal of bilateral free trade agreements – FTAs – as a way forward with trade policy) aimed at closer East Asian regional economic and political links. At the same time it remarks that many of the features of the East Asian economy that led Japanese policymakers to eschew such initiatives in the past have not fundamentally changed. The contradictions in policy initiative and real economic and political circumstance have led to some unpredicted policy reactions and outcomes and to some confusion in policy strategies aimed at promoting East Asian cooperation more broadly. The paper reviews the state of regional economic diplomacy and how Japan is situated in its evolution. The imperatives of East Asian cooperation mean that the quest for it will continue. But what is feasible and desirable, and are Japan's current policy approaches likely to deliver something that is either feasible or desirable in terms of their stated aims? The creation of an East Asian Economic Community requires leadership and a model that is consistent with East Asian (not European or American) circumstances. Has Japan either to offer?

Origins of the new regionalism

The emergence of the new regionalism in East Asia was triggered proximately by events surrounding the 1997 East Asian financial crisis. Earlier, when former Prime Minister Mahathir of Malaysia proposed the formation of an East Asian Economic Caucus (EAEC), the aim was to stake out an East Asian position on the North American Free Trade Agreement (NAFTA). But Dr Mahathir's initiative, in the early 1990s, received no support from Japan and lay dormant.

The circumstances in the late 1990s appeared quite different, partly a product of the complex political response to Washington's role in the 1997 financial crisis: there was loss of faith in APEC's capacity to deal with the problems of the time; there was intensification of preferential trading initiatives elsewhere, including in North America; and there was the failure to launch a new WTO round of trade negotiations in Seattle, which had been so central to APEC's trade liberalisation agenda. All these

developments were used to justify heading off in a new direction to negotiate preferential trade arrangements in East Asia.

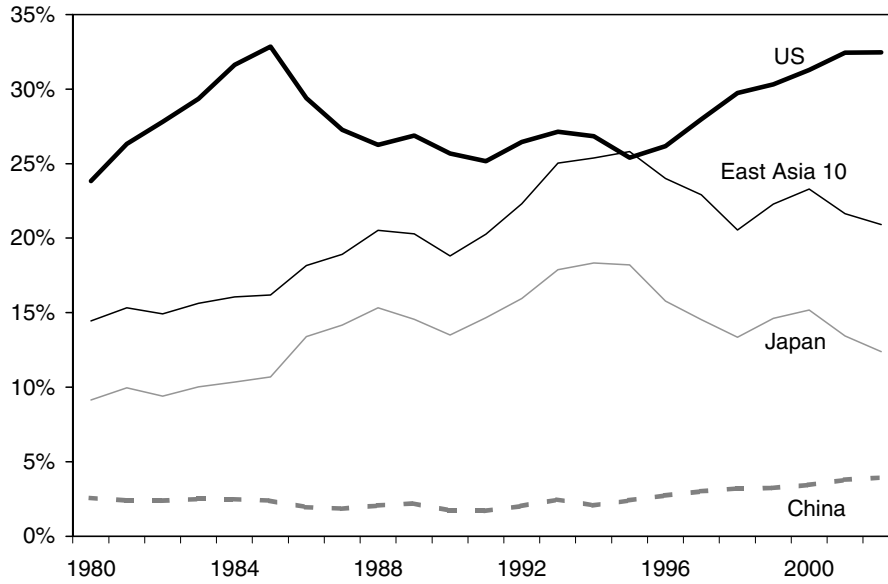
These circumstances also saw the emergence of a range of proposals for a new regional financial regime. The crisis shook East Asia's confidence in established policy positions and arrangements. Japan was notably on the back foot (Drysdale and Ishigaki 2002 pp.4–10). China appeared to be occupying the stage. Washington was alternately neglectful and triumphalist. Groping around for new ways forward within the region was a natural response. Aping the proliferation of 'free trade agreements' (FTAs) elsewhere appeared more and more attractive. So too did building a new framework for regional financial and broader economic cooperation.

The new regionalism in East Asia had long-term structural causes as well as these more proximate origins. The long-term forces that led the East Asian economies to begin to think about the construction of a new regional framework for cooperation revolved around two factors. The first and most important was the growth of economic and political interaction among the East Asian economies themselves. The second was the emergence of the new international economic and political environment after the end of the Cold War, in which the resurgence of US hegemonic power challenged perceptions of the growth of independence and national power within East Asia.

The growth and deepening integration of the East Asian economy is the result of three huge waves of trade and industrial transformation. The first came with the rise of Japan and its emergence as a major industrial power, especially in the first three decades after the Pacific War. The second was led by the newly industrialising economies (NIEs) of Northeast and Southeast Asia in the late 1970s and 1980s. Now a third great wave is sweeping the region, with the remarkable rise of China. These successive waves of trade and industrial transformation have created a new centre of East Asian economic power that has begun to rival North America and Europe in terms of its contribution to world output and world trade.

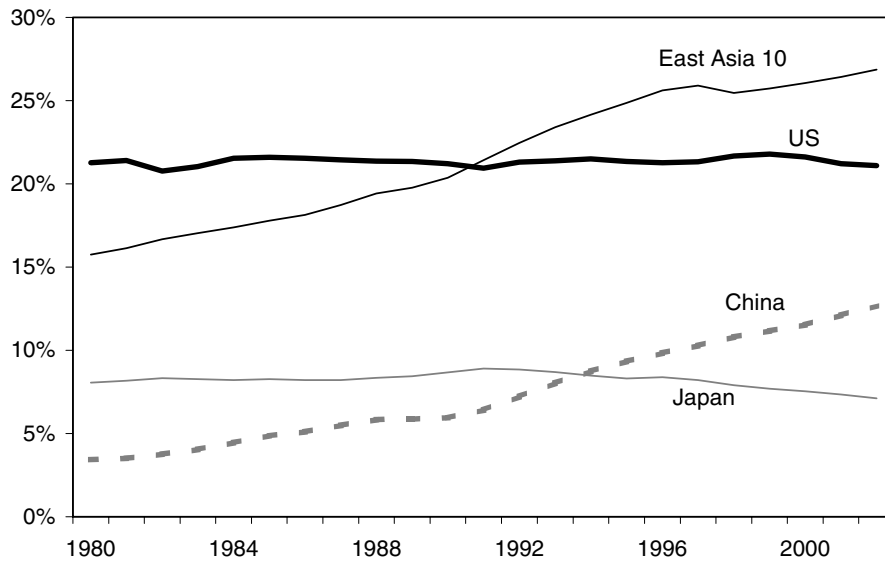
By one measure, the rise of East Asia in the world economy still has a long way to go. When national products are valued at current exchange rates, the United States economy appears resurgent against a flagging East Asian challenge (see Figure 1). Moreover, Japan – by this measure still the second biggest economy in the world – appears to dominate the East Asian economy, accounting for roughly two-thirds of the region's total output. But this is only one measure of the relative importance of East Asia in the world economy, and probably not the most accurate, because of the way in which current exchange rates, and short-term influences upon them, distort the underlying picture. A better measure uses purchasing power parity (PPP) valuations of national product to estimate the relative size of economies. In Figure 2 East Asia's share of world output can be seen to have risen substantially over the past two decades, from just over 15 per cent in 1980 to around 27 per cent in 2002, overtaking the United States by 1993. Moreover, within East Asia, China's share of world output had already surpassed

Figure 1 East Asian shares in world output: Take 1



Note: Output share valued at market exchange rates (per cent).
Source: Australian National University International Economic Database.

Figure 2 East Asian shares in world output: Take 2



Note: Output share valued at PPP (per cent).
Source: Australian National University International Economic Database.

that of Japan by 1994 and, by 2002 its share of world output was already more than half that of the United States. China's economy, of course, remains less sophisticated than that of Japan, but its sheer scale now gives it much larger weight in world output. While East Asia's share of world trade has not grown so strongly in the last decade (see Table 1), it more than matches that of North America. Within East Asia, the story is one of rising trade share for China and steadily falling trade share for Japan. (China's trade is measured here, appropriately, as China's trade plus the trade of Hong Kong net of intra-China–Hong Kong trade.)

These are the realities of the recent rise of the East Asian economy and the growing weight of China within it, driven by what can be called the third wave of East Asian trade and industrial transformation.

Japan and the region

The three waves of industrial and trade transformation that have swept the East Asian economy over the last half century or so were driven significantly by the commitment of governments to steadily more liberal trade and investment regimes throughout the region. The increasing openness of the newly industrialising economies of Northeast and Southeast Asia provided opportunities for their fuller participation in the international division of labour, spurred by foreign direct investment (FDI), and intensified regional economic integration. Now China's rapidly growing and more open market is further deepening regional trade and economic integration. China's accession to the WTO has

Table 1 China and East Asia: share in world exports (per cent)

	1991–1993	1994–1996	1997–1999	2000–2002
East Asia 10	22.3	23.8	22.8	22.5
China + Hong Kong	3.7	4.5	4.8	5.6
Japan	9.1	8.3	7.2	6.7
Korea	2.2	2.6	2.5	2.6
Taiwan	2.3	2.3	2.2	2.3
ASEAN 5	5.0	6.2	6.0	6.1

Source: Australian National University International Economic Database.

entrenched this process and is reinforcing, and giving confidence in, the longer term structural rise and integration of the East Asian economy.

Already more than half of China's imports is sourced from other countries in East Asia, with 30 per cent from Northeast Asia and 20 per cent from ASEAN countries. Lardy (2002) suggests that '(w)ithin a decade China's trade is likely to surpass that of Japan and Germany, making China the world's second largest trader'. Properly measured, by including Hong Kong's trade together with China's trade net of intra-Hong Kong-China trade, China is already the fourth biggest single trading nation in the world after the United States, Germany and Japan.

A central feature of deeper East Asian economic integration has been the remarkable growth of trade in intermediate goods and components, and China is now a major element in this process. The location of relatively labour-intensive component production and assembly within complex, integrated international production chains has been a growing feature of the international division of labour, especially in East Asia (Sharpton 1975, Helleiner 1973, Feenstra 1998, Athukorala 2003). The process began in the electronics and textile industries but is now common in many other industries. This process is sometimes called international product fragmentation. A recent and careful study of fragmentation trade in East Asia by Athukorala (2003) demonstrates just how important it is to the growth of, and economic integration within, the region. Athukorala reports that the intra-regional share in final trade was 48.3 per cent compared to 52.3 per cent of total trade. In 2000, over 60 per cent of 'final exports' from developing Asia went to countries outside the East Asian region, significantly North America and Europe, up from 55 per cent in 1992 (p.18). The fragmentation of the supply chain accelerates the growth of trade in components and makes the region more heavily dependent on extra-regional trade for 'growth dynamism' than is suggested by data that does not net out the trade in components (Findlay 2003, Findlay 2003a). The most notable feature of international product fragmentation in recent years, Athukorala shows, has been the rapid integration of China into regional production networks. This development, he argues, is an important counterpoint to the popular belief that China's global integration would crowd out opportunities for export-led growth for other economies within the region (p. 19).

In the manufacturing sector, FDI has been the driver of the substantial intra-industry and intra-regional trade growth, and the role of FDI is expected to rise, fostering deeper integration of the regional economy. The effort to cut production costs through improvement in productivity and more efficient procurement and out-sourcing has led to the relocation of some segments of multi-national firms' production processes within East Asia. The effect on trade and investment flows is significant. The increased fragmentation and specialisation in production and trade that has been promoted by the activities of multi-national firms in the region presents enormous opportunities for East Asian economies

to become integrated into international production chains and markets. It lifts productivity, output and trade growth. But there are also challenges in positioning policy to take advantage of these opportunities. Competition may be more intense among economies with similar output levels, factor endowments, and export structures. Similarity of export structure with China, it might be argued for example, is likely to increase the intensity of competition faced in taking advantage of the growth of fragmentation in regional trade in manufactured goods (Xu and Song 2002). In addition, McKibbin and Woo (2003) suggest that China's WTO accession could create significant welfare loss in the ASEAN 4 (Indonesia, Malaysia, Philippines and Thailand) if foreign direct investment is significantly directed away from these countries towards China, and if the ASEAN 4 countries are unable to take measures that prevent side effects from reduced FDI inflow. If the ASEAN 4 are not to fall behind technologically, then they have to find niches within lengthened international production chains. The evidence suggests that this is indeed what is happening and that China is providing a positive boost to Southeast Asia trade in the process (Deutsche Bank Research 2003).¹

Opening up the service sectors, such as banking, transport and communications, professional services and distribution services, to international participation and competition is also offering enormous opportunity. Trade and income growth, built on exports from the more labour-intensive segments of these industries for the less developed economies and from the more human capital-intensive segments for the more advanced economies, is generally faster than growth of industrial goods trade and output, within the region and globally.

Growing intra-regional trade, built on the opening, reform and rapid growth of the Chinese economy in the last two decades or so, has already profoundly changed the structure of the East Asian economy. China's WTO commitments have greatly strengthened the structural trend of the rise of China in the East Asian economy, and the already evident relative decline of Japan. A corollary trend is that the rest of the East Asian economy is becoming steadily more and more important to Japan and Japan relatively less and less important to the rest of East Asia, including China, but also to the other economies in Northeast and Southeast Asia. A simple measure of this trend is the rising share of these economies in Japan's trade and the falling share of Japan in their trade. This is true also for Australia, which is an integral part of the East Asian economy. China is an increasingly important part of this change. China has already overtaken the United States as Taiwan's largest export market. Within the next two decades, China alone is projected to overtake the United States as Japan's largest export market.

Already in the 1990s, there were some in Japan who worried about the implication of this development for Japan's role in the region. In the contest for regional leadership with China, Japan 'passing' emerged as a concern, importantly and symbolically in the context of US President Bill Clinton's 1998 historic visit to China without stopping over in Japan. The early atmospherics of the Bush

administration allayed those Japanese concerns at a diplomatic level, but the fundamental circumstance has not changed and is unlikely to change in the future.

East Asian economy in brief

The trade and industrial transformation of the East Asian economy, in brief, is a continuing dynamic. The scale of the change in China and its impact upon East Asian economic integration will work itself out, barring major reversals, over the next two to three decades, in the same way that the rise of Japan did in the last half of the twentieth century. The recovery of Japan's economic vigour (now in prospect but only assured if there is delivery of more and substantial economic and related reform) will greatly restore and enhance Japan's role and effectiveness in regional and international economic diplomacy. But China is already a major player regionally and globally, and its potential for growth is huge alongside that of Japan, an economy that is already economically and demographically mature. Whatever Japan's strategies for, and role in, regional cooperation, they must accommodate that reality.

Another feature of the East Asian economy noted above is its extra-regional trade and economic reach. A high proportion of the region's trade in intermediate, but especially in final, goods is destined for the major industrial country markets of North America and Europe, outside the region. Large flows of FDI particularly into China – now the largest recipient of direct capital inflows – cement economic interaction with the global economy. And East Asia is a major interest in the international financial market, as was discovered painfully in the 1997 East Asian financial crisis.

In these and other respects, the structure and dynamic of the regional economy is very different from that of Europe and North America, and it is likely to remain so for a very long time. India is also now on the rise and ties between the East and South Asian economies are growing. It has become fashionable to seek to emulate the European model of economic integration in East Asia, but there is a question about whether imposing the European model, or even the North American model, upon East Asia would reinforce or derail integration East Asian-style.

A new regional architecture?

The imperative of deeper financial and trade cooperation in East Asia became clear through the experience of the East Asian financial crisis. The crisis saw Japan's regional leadership on these issues in disarray. Japan's own financial market was in a mess. Japan's call for the establishment of an Asian Monetary Fund (AMF) lacked credibility even within the region. Japan was a major factor, though not

the only one, in failure to make progress on trade liberalisation within APEC. And Japan exercised no sway or leadership towards averting the US retreat from a new WTO Round in Seattle. In this context, the emergence of ASEAN + 3 reflected the interest in re-grouping and building a framework for substantive economic cooperation within the region.

The real significance of ASEAN + 3 is its inclusion of China and Japan in the same forum for high-level political dialogue. China came to this, at the initiative of Korea, embracing Japan within the same arrangement with unexpected enthusiasm. This was a deeply political decision, much more than an economic policy strategy (Drysdale and Ishigaki 2002 p. 10, Drysdale 2002 pp. 129–143). China's interest in ASEAN + 3 was encouraged by political events, like the Belgrade bombing and the 1999 Cox Report to the US Congress on China's military and commercial espionage in the United States, as an insurance against continuing problems in the US–China relationship (Drysdale and Zhang 2000). The international political environment has changed substantially since September 11 and the emergence of China's partnerships with America in the war on terror and in management of the Korean peninsula nuclear proliferation problem. But the political rationale in Beijing for fostering East Asian cooperation within the framework of ASEAN + 3 remains firmly intact.

ASEAN + 3 is not a regional trading arrangement but rather seeks to provide a framework for demonstrating East Asian influence and leadership on regional and international affairs. The initial focus was very much on regional financial cooperation. That was the hook on which the political-level dialogue began. In January 2002 in Singapore, Prime Minister Koizumi proposed an East Asian community encompassing cooperation beyond trade and financial issues (and including Australia and New Zealand) to promote regional integration. The agenda of ASEAN + 3 already extends far beyond the issue of financial cooperation and the ambition, stated more clearly at the recent meetings in Bali, is for the evolution of an East Asian Economic Community.

A parallel development was the rush towards bilateral or sub-regional FTAs. FTAs are preferential or discriminatory trade arrangements. Preferential trade arrangements within East Asia (including the participation of key regional economies such as Japan, China and Korea) had never before found favour. They would have inflicted costs on important economic partners, but also they were likely to elevate political tensions in predictable ways among countries that were included and those that were excluded from such arrangements. That was acknowledged explicitly in designing the architecture for APEC.

Yet over the last five or six years there has been a rash of new proposals and initiatives in East Asia to promote bilateral FTAs of an explicitly discriminatory kind.

Within the region, the Japan–Singapore Agreement has already been signed. Singapore has also signed agreements with Australia and the United States. The first significant proposal was for an FTA

between Japan and Korea at the time of President Kim Dae Jung's historic visit to Japan in 1998. Japan–Korea, Japan–Singapore (concluded in January 2002), Japan–Mexico, China–ASEAN, Korea–Chile, Japan–ASEAN, Thailand–Australia, Singapore–New Zealand, Korea–ASEAN, US–ASEAN, CER–ASEAN, Japan–Korea–China or Taiwan are some of the arrangements that have been mooted or are on the slipways. Except for the China–ASEAN proposal, so far the negotiation of arrangements with ASEAN countries has proceeded bilaterally rather than with ASEAN collectively (Ito 2003). However, the FTA negotiations between ASEAN and CER (Australia and New Zealand), which began in February 2005, also have multilateral negotiating teams on both sides.

At the centre of this shift in policy direction was Japan. Japan was then the only major economy in the world other than China or Korea that was not a member of any FTA or economic union. For Japan to choose a strategy of bilateral (or sub-regional) discriminatory trade arrangements was bound to have considerable reverberations within East Asia and the Pacific and throughout the world trading system. What is remarkable is that such a fundamental shift in Japan's trade policy diplomacy was effected without public debate in Japan and the reactions to it from partner countries were almost entirely unanticipated by Japanese policymakers. A central reference point in East Asian trade diplomacy – Japan's insistence on non-discrimination in international trade and economic dealings – has been lost. More specifically, the multilateral trading system is no longer Japan's central priority (Ito 2003).

One of the consequences of Japan's FTA initiatives was to encourage China to join the FTA game too. Most importantly China, in dealing with the sensitivities in Southeast Asia about its economic rise, was freed to propose an FTA with ASEAN. Because of a more open approach to agricultural trade it was able to trump Japan in its Southeast Asian diplomacy (Drysdale and Ishigaki 2002) and move forward with a bolder and more attractive schedule for negotiations and engagement with Southeast Asia more broadly.

The reaction in Australia was also of consequence. Advised that a comprehensive FTA was not possible with Japan because of agriculture, Australia's initial reaction was to try to secure an arrangement between CER and ASEAN. Rebuffed initially in that bid, Australia, significantly, scrambled to negotiate an FTA with the United States – with problematic effects on its East Asian interests – and sought to conclude FTA deals with Singapore and Thailand (both of which have been signed). The negotiation with the United States – a development made possible in the aftermath of September 11 and Australian support for the Bush Administration's campaign in Iraq (Garnaut 2003) – has been completed and the arrangement now in force. For Australia's, and perhaps also for Japan's, interests this outcome is fraught with economic and political problems the resolution of which is still unclear. Australia, despite its deep integration into East Asia, appears diplomatically adrift in the region. It is not a member of ASEAN + 3.

It shares this circumstance unenviably with Taiwan. The structure of its relations with the region and the way in which its economic interests deeply intersect with those of America (importantly but not only in agriculture) leaves negligible prospect of, or economic sense in, an FTA with any of its three major trading partners in the region.

State of regional economic diplomacy

Where is East Asia at, then, with FTAs as an engine for closer economic integration?

The rich countries in East Asia and the Pacific, such as Japan, Korea, Singapore, Australia, New Zealand and the United States, have all signed one or more FTAs with their trading partners in recent years. Developing countries in the region, such as China and ASEAN, have also shown growing interest in FTAs and a China–ASEAN FTA is already under negotiation and there are pre-commitments to an ‘early harvest’.²

The motivations for participating in FTAs vary from country to country (Findlay, Piei and Pangestu 2003).³ Despite their longstanding commitment to, and continuing fundamental strategic interest in, the non-discriminatory liberalisation of trade, economic and political circumstances have led East Asian countries down the track of discriminatory trade liberalisation.

The long-term rise in East Asian economic interdependence provided the background to this shift in policy thinking, even though East Asian trade and economic interests remain more globally oriented than those of any other major economic area in the world (Drysdale and Ishigaki 2002). In economic diplomacy, the multilaterally oriented institutions appeared to have faltered and failed to move forward quickly within either the WTO or the APEC framework. However mistakenly, given the complex structure of the regional economy, FTAs were seen to offer a way to more rapid progress. There was a decisive move away from working through multilaterally oriented regional arrangements like APEC towards the proposal and negotiation of bilateral FTAs, and the regional grouping, ASEAN + 3, also emerged in East Asia.

In Japan, where the move towards bilateral negotiation of FTAs in East Asia had its recent origins, the focus was first on forging an agreement with Korea as part of the process of political rapprochement in the late 1990s. The FTA proposal emphasised industrial integration and deliberately avoided hard agricultural trade issues. But thus far no substantive progress towards a deal has been made. A ‘New Economic Partnership Agreement with Singapore’ – where there were no major agricultural trade issues to deal with, except the famous goldfish and cut-flower exports from Singapore to Japan – was negotiated and legislated in 2002. The Singapore agreement broke Japan’s virginity on its long commitment to the

principle of non-discriminatory trade. Although the agreement was trivial in its impact on the Japanese economy, it came to be rationalised in Japan as a way of pushing the domestic reform agenda. But, like almost all such arrangements, it was a very doubtful instrument for achieving that objective.

The Japanese policymakers who initiated these moves had no comprehension of the reaction to them elsewhere in the region, especially in China. Beyond Japan, Korea was flirting with a broader bilateral FTA strategy, but even Korea's negotiations with Chile became bogged down. Australia moved rapidly to mimic Japan's deal with Singapore, then with Thailand, but Australia's formal negotiation of an FTA with the United States is much more significant not only for the region but also for the international trading system. At the Bali ASEAN + 3 summit in October 2003, China again seized the initiative in pressing for a broader East Asian trade arrangement, supporting the ASEAN strategy for deepening Southeast Asian integration and outflanking Japan's initiatives for more divisive bilateral agreements with Southeast Asian countries. The United States has done its own deal with Singapore and mooted bilaterals with other ASEAN countries.

Both economic and political considerations have influenced thinking among the Chinese leadership about the change in trade policy strategy. Findlay (2003a) and Lu (2003) provide the best interpretation of the background to China's evolving FTA strategy.

In the face of Southeast Asian fears about being crowded out by China's growth, China offered an FTA as a way of providing some reassurance and as a vehicle for cooperation. An FTA involving all these economies would also make the whole region more attractive to foreign investors: ASEAN members had been particularly concerned about the effect of China's WTO entry on patterns of FDI flows (Zhang 2003).

Zhang (2003) argues that an agreement between China and ASEAN could accelerate moves for Japan and Korea to form their own bilateral agreements with ASEAN, and push China, Korea and Japan themselves towards further progress on bilateral arrangements of their own and on a broader East Asian regional arrangement. In this view, the China-ASEAN FTA is seen as a building block for wider regional cooperation. But this view is contestable.

Zhang (2003) further argues that China's interest in a more formal institutional arrangement follows from its concern about the vulnerability of market-based integration and from the emergence of institutionally based integration in Europe and the Americas.

The ASEAN + 3 arrangement, apart from providing a framework for projecting East Asian influence and interests, includes an agenda for the establishment of an East Asian Free Trade Area, cooperation on macro-economic policy and financial market strengthening, and joint action in the provision of regional public goods. Zhang (2003) refers to the common interest in responding to

problems of drug trafficking, piracy, illegal migration, environmental disasters, money laundering and international terrorism, and to other trans-boundary issues. Beyond these issues there might be interaction in relation to defence and military affairs, but that cooperation involves a much longer time horizon (Findlay 2003).

The FTA strategy is designed, from this perspective, to contribute to China's capacity to 'form at some point a counter power comparable to the US and Europe by unifying Asian countries'.⁴ It is interpreted as part of an attempt by China to build a 'strategic partnership' within East Asia, a partnership that can be used to 'work closely on regional and international issues'. Whether the FTA component is actually required to achieve this goal is problematic, but certainly that is how it is presently viewed widely, both in China and Japan (Lu 2003).

Zhang (2003) admits that it is too early for China to consider a fully institutionalised East Asian arrangement, given that neither Japan nor Korea is yet ready to negotiate an agreement with China. There remains a large element of political schizophrenia in Japan about China, and moving into a highly institutionalised FTA or formal common market arrangement that included China would be difficult to digest, not only economically but also politically. Another reason is that the region is unable to confront the issues that would arise from the treatment of Taiwan in a larger arrangement. So the agenda in the immediate term is actually a sub-regional one, with the focus on China and ASEAN. How that will finally influence the shape of broader regional cooperation arrangements is yet to be seen, but certainly there is limited room for Taiwan in the growing institutionalisation of regional cooperation arrangements in East Asia.

The other important Chinese regional initiative is the Closer Economic Partnership Arrangement (CEPA) with Hong Kong, signed at the end of June 2003.⁵ This arrangement is still evolving but it provides for duty-free access to a broad range of goods imports that qualify in terms of specified rules of origin, and a for number of designated service providers. The agreement is deepening the integration of Hong Kong into the southern Chinese economy.

The stalling of the Doha Round of WTO negotiations at Cancun has given further impetus to the surge of preferential bilateralism in East Asian and international trade diplomacy. But none of the bilateral agreements that have been put in place so far has made any really substantial contribution to trade liberalisation (Adams *et al.* 2003).

In short, the confusion of FTA arrangements, with more and more complicated rules of origin, is more likely to distort and derail than to encourage broader and deeper economic integration of the kind that we saw above as so critical to continuing the momentum of East Asian trade and industrial transformation (Garnaut 2003, Garnaut 2003a, Garnaut and Bhagwati 2003, Findlay, Piei and

Pangestu 2003, Findlay 2003, de Brouwer 2003). All the analysis suggests that the bilateral FTAs in East Asia are in fact of limited economic value and can have quite damaging costs for those outside them. These include the economic costs of trade diversion but also the political costs of exclusion. The politics of FTAs in East Asia revolve around three poles: their impact on Southeast Asian political coherence; their impact on China's regional interests and relationships, including those with Taiwan; and their impact on relations across the Pacific with the United States. In both economic and political terms, a rapid move towards a broader East Asian FTA would be greatly preferable to the mess of arrangements that exists in the region now (Scollay and Gilbert 2001). But as already noted, that is not an objective on which there will be easy or rapid progress. What the end-point of this game will be is still an open question.

Another question is how emerging East Asian architecture and policy initiatives relate to APEC and whether they will complement or conflict with the trans-Pacific architecture for policy dialogue and initiative.

Prospects for an east Asian community

The trajectory of economic growth and the nature of trade and industrial transformation define both the special character of the East Asian economy and economic integration and the shape of regional cooperation arrangements that are feasible and will sustain this growth. East Asian growth and integration is now riding the third great wave of industrial transformation, at the base of which is China. A recent study for the Governor of Guangdong suggests that, between 2025 and 2030, Guangdong will attain per capita income levels equal to those in Japan today, and much higher in Guangzhou and Guangdong's other large cities.⁶

There are risks in all such historic events. The most important risk to Chinese success relates to political system reform.

The core of Chinese trade and economic success is the growth of the private sector, both private foreign-invested enterprise and domestic private enterprise. The private sector now accounts for two-thirds of China's trade and economic growth. It is the engine room of the Chinese economy's remarkable success. But the opaque relationship between the private sector and the state in a one-party political system is the root cause of endemic corruption and, at some critical point, is doomed to derail such economic success. Transparent, arms-length transactions under a strong and independent legal and regulatory framework inexorably become more and more important to economic success as an economy grows increasingly sophisticated, industrially and commercially. Openness, transparency and independ-

ence of legal rights and appeal are essential to capturing the full gains from deeper integration into the world economy and participation in global financial and other markets. Without timely political system change, there is danger of what I have called elsewhere the 'Latin Americanisation' of the Chinese economy and polity.⁷

The good news is that the Chinese leadership appears aware of the nature and the importance of this problem. President Hu Jintao's historic and carefully argued address to the joint sitting of the Australian Parliament on 24 October 2003 is encouraging in this respect. But the task is huge in a country of the size and complexity of China. And it is a task that will take some time to complete, when time is fast running out because of China's very success in reform, opening and growth.

In these affairs the development of close and extensive policy dialogues and the sharing of experience and knowledge between China and its advanced country neighbours can be very helpful in exploring, testing and experimenting with new institutional systems. This dimension – the facilitation of a wide range of routine and easy policy dialogues – is among the most fundamental and important interests at work in building cooperation arrangements in East Asia and in the creation of an East Asian Economic Community.

At the heart of the process of future East Asian economic integration will be the deeper and deeper integration of the Japanese and Chinese economies. This is reflected in the projected trade shares mentioned above. But it is also and already reflected in the strategic re-positioning of almost every leading Japanese corporation in the Chinese market, and in the rapid growth in the importance of China-related business to Japan and Japan-related business to China. Korea will be an important part of this story as well. So too will Southeast Asia and Australia, for which China is now assuming a role similar to that of Japan in the 1960s and 1970s.

Of course, the global economic and political environment will affect the degree to which there is a smooth economic and political transition towards an effective East Asian Economic Community. In terms of economic policy strategy, the United States is presently disengaged from East Asia, although the political contretemps over Chinese textiles and steel trade in the lead-up to the 2004 US Presidential election is a reminder that strategic disengagement is unlikely to remain benign. And how trans-Pacific political and security affairs evolve will depend, among other things, upon how quickly a sense of shared East Asian interests and an understanding of the political importance of what is happening in the East Asian economy develops, nowhere more so than in Tokyo. These elements will be critical to confident, open and constructive dealings with Washington. On this, there is a very long way to go.

All this might seem to suggest the development of a China-centred East Asian community. On current policy trends and strategies, one would have to conclude that this is the most likely outcome.

The weight and growing power of China, both economically and politically, means that an architecture of regional economic and, therefore, political relations designed around a system of bilateral and preferential arrangements, rather than rooted in rules and institutions that are multilateral in their obligations, will increasingly deliver China the whip hand. In this architecture China will become the natural hub in the economic and political structure of the region over the next generation or two. This is the architecture that Japanese policymakers have put in place over the last half dozen years, and it is precisely the outcome that the region is stumbling towards, should nothing be done to change it.

There is no evidence that this construct, of a web of limiting bilateral arrangements in which the big and promising always have superior leverage and power, is the choice that China would have made or would want to make unconstrained. Precisely the reverse. The sensible and rational choice for China is a global choice, the acceptance and entrenchment of global obligations and responsibilities in a multilateral 'pluralist' setting, as President Hu described it in Canberra in 2003. No region, not even East Asia including Japan, is big enough to accommodate the scale of China's economic ambition. The global theatre and the multilateral system, rationally, is crucial to China's realising its modernisation ambitions over the next generation.

These are the dangers in the course in trade and economic diplomacy upon which Japan is presently embarked. It is not that the ambitions for an East Asian Economic Community are not well founded, in the economic and political circumstances with which the region now has to deal. The emergence of an effective East Asian Economic Community should be an entirely positive development. But the priority for an East Asian Economic Community is to create a force for leadership within the global trade and financial system, to deliver real reform at home and maintain openness in the international economy. (A start would be to activate an East Asian coalition for making progress within the global trade negotiations.) The objectives of so-called 'closer economic partnership' arrangements are better served by non-discriminatory trade agreements than by distorting and limited bilateral FTAs. Much of the focus in East Asian cooperation needs to be on the joint provision of the institutional and physical infrastructure to facilitate trade, investment and people movement, and does not require the discriminatory baggage of bilateral or sub-regional FTAs. And the prerequisite is the creation of effective fora for policy dialogue and their development through an East Asian Economic Community.

Discriminatory regional trade arrangements might well have been the basis for building modern Europe or dealing with particular political and economic problems in North America. But they are reflective of another place and another age, not the needs and circumstances of the East Asian economy at the beginning of the twenty-first century, and specifically the need to accommodate the growth and opening of the Chinese economy within the regional and global economic systems.

Notes

* The paper will appear in Akio Watanabe (ed), *Twenty Five Years after Ohira's Initiative for Asia Pacific Cooperation: History and Prospects*, Ohira Foundation (in Japanese), Tokyo, June 2005.

- 1 The McKibbin and Woo conclusion follows from a simulation exercise which they are undertaking. See also Abeysinghe and Lu (2003).
- 2 China and ASEAN reached an agreement on a framework to establish an FTA at the end of 2001. Japan has also declared interest in forming an FTA with ASEAN countries (information on Japan's FTA strategy is available at the Ministry of Foreign Affairs of Japan's official website <http://www.mofa.go.jp/policy/economy/fta/strategy0210.html>. Accessed November 2003.)
- 3 See Findlay, Pici and Pangestu (2003) for an excellent discussion of risks and motivations behind FTAs.
- 4 Naoko Munakata from the Research Institute of Economy, Trade and Industry (RIETI) in Tokyo, quoted in the *Far Eastern Economic Review*, 17 July 2003, p. 29.
- 5 So far 273 tariff items are covered under the agreement. Other exporters of these products to China are subject to tariffs that range from 5 to 35 per cent. Other products will be added to the list at the request of manufacturers. In the initial phase of the agreement, the rules of origin requirements are spelt out for each product. Rules of origin requirements were not settled until September 2003. The criteria are that processing must involve either a change in the tariff heading or 30 per cent value added in processing. There is also accelerated access under WTO accession obligation for service providers in 18 sectors, including telecommunications, added after conclusion of the initial agreement (Findlay 2003, pp. 5–7).
- 6 *'Global Competitiveness and Guangdong's Future Development'* A Report for the Governor of Guangdong commissioned by BHP Billiton Petroleum and prepared in cooperation with Professor Peter Drysdale, Dr Ligang Song, Dr Tingsong Jiang and associates in the Asia Pacific School of Economics and Government at The Australian National University, October 2003.
- 7 In comments on Amartya Sen's paper at the Annual Conference, China Center for Economic Research, Beijing University, 11 July 2002.

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