

## CHAPTER 9

PECC, APEC and East Asian  
Economic Cooperation:  
**Prime Minister Ohira's Legacy  
and Issues in the 21st Century**

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## PECC, APEC and East Asian Economic Cooperation: Prime Minister Ohira's Legacy and Issues in the 21st Century<sup>1</sup>

Among the many legacies Japanese Prime Minister Masayoshi Ohira left, the seeds he had planted for Asia Pacific economic cooperation were extraordinarily important. He would be quite pleased – and probably a bit amazed – at the progress of his vision for such cooperation over the 25 years since his untimely death. He was one of the few leaders in Asia – or indeed the world – who understood the importance of improving economic, political, and security relationships among the Asia Pacific countries in East Asia, the South Pacific, and the Americas.

In 1980 there was little communication, much less economic interaction, among the various East Asian economies, and little perception of regional, as distinct from bilateral, interests and potential benefits. On the whole, the economies in the region were fixated on the United States, its market, and its leadership, and on the exigencies of the US–Soviet tensions popularly termed the Cold War. Prime Minister Ohira instigated, and in many respects epitomized, Japan's leadership in seeking Asia Pacific regional economic cooperation, both as an end and as a means to creating a more harmonious and peaceful Asia Pacific environment.

It is important to recall the context within which Prime Minister Ohira enunciated his vision. In 1980, there was major tension between China and the other Asian planned economies on the one hand and the region's market-based economies on the other. Japan was just completing economic catch-up, moving from being a less-developed country to being the

second largest economy in the world, with European standards of living. None of the other East Asian developing economies appeared to be on such a successful, long-run development path. We should never ignore those initial conditions, even as we should be incredibly impressed by the successful economic and political transformations that subsequently have been achieved throughout East Asia, and by the development of ever-deeper and mutually beneficial economic and political relations with the United States and the Western hemisphere.

Prime Minister Ohira, working with his Foreign Minister, Saburo Okita, the first implementer of his vision, sought to create institutional mechanisms whereby the countries and economies of East Asia could work constructively with the United States and other countries in the Western hemisphere. The initial institutional arrangement, first proposed by Prime Minister Ohira, was the Pacific Economic Cooperation Council (PECC), established in 1980. This tripartite grouping of business leaders, academics, and government officials in their private capacity provided the framework and informal mode of communication for future interactions. This framework proved to be extremely important for the eventual commitment by the governments of the economies of East Asia, the South Pacific and North America, and eventually the Pacific coast of Latin America as well, to work together to achieve the benefits of economic cooperation. PECC was the genesis of the governmental Asia Pacific Economic Cooperation (APEC) forum, established in 1989.

<sup>1</sup> This is an updated and somewhat expanded draft, especially the final few pages, of Patrick (2005). The author wishes to thank Andy Wanning and Sue Mathews for research and editing inputs, and Peter Kenen and Peter Drysdale for comments on an earlier draft.

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The contribution of academics, as participants in PECC and as advisors to their respective governmental members of APEC, has always been important. Academics had earlier become involved in policy analysis of Asia Pacific economic cooperation topics through the Pacific Trade and Development (PAFTAD) conference series begun under Japanese leadership in 1968. Saburo Okita, then the chair of the PAFTAD International Steering Committee, visualized PAFTAD providing PECC with objective analysis of relevant economic issues. That has indeed taken place, primarily on an informal basis, through the same economists, drawn from throughout the Asia Pacific region, being involved in PAFTAD, PECC, and APEC.

In addition, academic policy analysis and proposals have been generated through the APEC Study Centers established in a number of member economies, most notably Japan, South Korea and Australia. In 1993 the United States proposed that members establish APEC Study Centers in order to provide substantive analysis of important economic policy issues, and encouraged a number of American universities to set up centers. A few have done so, but their research output has been limited and their policy impact has been modest at best. Ironically, the US government has never provided any funding, and private sources and the universities have had other priorities.

With the seeds for Asia Pacific economic cooperation well planted by Prime Minister Ohira, the benefits of increased cooperation became increasingly obvious as trade by the East Asian economies with the United States and the rest of the world, and in due course with each other, burgeoned over the subsequent 25 years. During the past quarter-century the dramatic economic success of the East Asian economies has not only increased

their standards of living and well-being, but been an important contributor to global growth. This has been the fastest-growing region of the world – and it will continue to be for the foreseeable future.

While Prime Minister Ohira was prescient in understanding both the opportunities and the need for government-based regional economic institutional arrangements, the reality is that most of the substantial deepening of economic cooperation in the Asia Pacific region has been driven by private, market-based business interactions, in an integration process sometimes termed “regionalization”. The dimensions of regionalization include intra-regional trade in goods and services, foreign direct investment (FDI) originating within the region, regional financial and portfolio capital flows, and technology flows. Multinational companies have played significant roles in this process.

“Regionalism” or “economic cooperation” refers to the role of governments in developing and supporting these private-sector interests. These include domestic liberalization of imports and FDI rules, particularly by the Association of Southeast Asian Nations (ASEAN) and China; improvement of government infrastructure, exemplified by customs regulations and procedures; creation of industrial parks or clusters; and government support of domestic companies investing in the region, particularly significant in the case of Japan. Development of government economic institutions to provide an adequate infrastructure to enhance this private trade and investment growth has lagged. The creation of such institutions lies behind the efforts of governments in the last few years to seek new and better ways to interact in support of economic dynamism based on the private sector.

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There has been a transition of the locus of global economic growth from the North Atlantic to the Pacific, with the United States a participant in both. This shift in momentum of world affairs from the Atlantic to the Pacific has been very important, and it will continue to be even more important in the future. It is based on the extraordinarily successful economic development of all the East Asian economies since 1980. While there are many political and security issues creating tensions among the various East Asian economies, importantly this has been fundamentally a quarter-century without war in the region.

For some years "East Asia" was used to refer to what is now termed Northeast Asia, and Southeast Asia was considered separately. Now East Asia includes both, basically because of the current degree of economic integration. This new regional cohesiveness is probably broader than anything Prime Minister Ohira anticipated in 1980.

To understand Prime Minister Ohira's vision it is essential to realize that it was not a narrow East Asian vision, but one that encompassed Australia and New Zealand in the western Pacific, and the United States and other Western hemisphere countries in the eastern Pacific – a grouping called the Pacific Rim for a while. This was in expectation of specific benefits from taking a regional approach, rather than any intention to exclude the rest of the world. I suspect that Prime Minister Ohira's vision was due in substantial part to the development of the European Community and its own regionalism, and to the exigencies of the Cold War, with its seemingly stark dichotomy between blocs associated with the United States and those associated with the Soviet Union.

In this chapter I briefly consider, first, major global factors that have fundamentally altered the environment for Asia Pacific economic cooperation and, second, important regional factors. I next briefly trace the evolutionary development of APEC. I then take up the recent development of the concept of East Asian economic cooperation, which has been progressing rapidly, and the institutions that are beginning to arise to provide substance to that concept. After discussing these new forces in trade and finance as they have developed in the last five years, I discuss some of their potential implications both for Asia Pacific economic cooperation and for the global economic system.

### **Major Global Transformations**

In this section, I note five major transformations outside East Asia that have global implications. I consider major global impacts from within East Asia in the subsequent section.

The first, and perhaps the most important, transformation in the past quarter-century has been the collapse of the Soviet Union and the ending of the Cold War. The Soviet Union has now broken up into many separate countries. Unfortunately, many of these countries, including Russia itself, have had major difficulties in moving toward democracy and market-based economies. Nonetheless, the ideological conflict between communism and capitalism, and the security tensions of the Cold War, have come to an end. That certainly has improved the world condition, but it has also created the need for adjustments based on the development of new problems and opportunities.

Second, with the Soviet collapse the United States became the sole military hegemon and its status as the dominant global economic

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power was reinforced. While economic growth in East Asia and other parts of the world led some in the 1980s to think that the hegemonic power of the United States was declining, the resurgence of the US economy in the 1990s brought about a very different perception of the US economy. Its combination of rapid growth, high rates of technological innovation, and a higher rate of productivity growth than earlier not only transformed the US economy, but transformed the thinking of others about it.

Since 2000, the slowing of growth following the bursting of the 1990s high-tech bubble and subsequent stock market decline, the Enron and other corporate governance scandals, and the twin problems of a substantial budget deficit and huge and increasing trade and current account deficits, have again reshaped perceptions of the US economy. Nonetheless, it continues to be by far the strongest in the world.

Third, the 11 September 2001 terrorist attacks on the United States brought about a major transformation of US foreign policy. This has meant giving a high priority to defending against terrorist attacks, an emphasis on pre-emption rather than post-strike retaliation, and a willingness to act outside the scope of multilateral institutions when they have been unwilling to back US actions. This is well exemplified by the war in Iraq, and the intense debate it has engendered over means and ends.

Terrorist attacks, and terrorism more broadly, cannot be dealt with in the traditional nation-state context, and the United States and other countries are seeking ways to deal more effectively with this profound threat to national security. These security concerns, particularly in the United States, have added

a new dimension to the current environment for Asia Pacific economic cooperation.

The fourth major change has been the further development of the European Union as essentially a single economy, at least in principle, with common rules and a single currency for most of its largest members. Moreover membership has expanded to 25, incorporating East European states that were formerly in the Soviet orbit.

In many respects the efforts to create a European common market in the 1960s led to concerns within East Asia, especially Japan, about pursuing regional economic cooperation while maintaining close ties with the United States. Indeed, the first PAFTAD conference, held in Tokyo in January 1968, was designed to consider how the high-income Asia Pacific countries of Japan, the United States, Canada, Australia and New Zealand might effectively respond to the establishment of a free trade area in Europe by creating a Pacific Free Trade Area among themselves. This Japanese initiative was immediately rejected by the US participants, who insisted that, in principle, the United States supported a first-best global multilateral trading system based on the General Agreement on Tariffs and Trade (GATT), not a system of regional trading blocs. GATT, the dominant free-trade system, was based on multilateral trade liberalization with most favored nation treatment for all members.

However, the establishment of the North American Free Trade Agreement (NAFTA) by Canada, the United States and Mexico in 1990 signalled, certainly to many East Asian economies, that the United States was prepared to pursue regional, as well as global, trade-liberalizing initiatives.

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People in the United States recognized that NAFTA was a second-best approach, but there were several justifications for it. First, there were protectionist sentiments in the United States at the time because of the perceived overwhelming intrusion into the US market by, especially, Japanese companies and their exports. NAFTA was therefore seen as a better solution than the imposition of more protectionist measures by the United States. Second, Canada's main concerns were about the need for a dispute settlement mechanism which constrained unilateral US decisions regarding bilateral trade issues, as well as the need to seek ways to liberalize trade in areas not yet under the multilateral GATT system. Third, from the perspective of the United States, the major reason for including Mexico was to have it lock in by treaty the series of liberalizing policies it had been pursuing unilaterally for its domestic economy. Moreover, some thought that if Mexico were to grow more rapidly through increased trade and American and other direct investment in Mexico, Mexican migration into the United States would slow.

Nonetheless, multilateral liberalization also proceeded. One accomplishment for GATT was the successful completion of the Uruguay Round, which in 1995 created the World Trade Organization (WTO) as the successor to GATT and generated further trade liberalizations, though mainly in manufactures, as in prior liberalizations. The vexatious issue of national quotas on textile imports was negotiated, with their end set for and achieved in 2005, and in principle it was agreed to negotiate agricultural and services liberalization as well. The current Doha Round of trade negotiations begun in November 2001 is in major part an effort to implement commitments made in the Uruguay Round, as well as to make new strides forward.

A fifth, profound, global transformation has been the demographic transition from relatively high birth and death rates to low birth and death rates in many more countries than was previously the case. Life expectancy has increased dramatically, including in developing economies, and in most countries the population is ageing. It appears that, in all countries, as per capita incomes rise and people become better off, people shift priorities from the quantity of children to the quality of children. This is a basic change in family values, as parents seek to educate their smaller number of children as well as possible in order to better prepare them for a world of new opportunities and challenges.

In all of the economically advanced countries except the United States, the fertility rate now is below the 2.1 rate necessary to maintain the population level. The United States is an anomaly because it continues each year to have relatively large numbers of immigrants, both skilled and unskilled; and many have not yet made the shift to smaller family size. The trends of the demographic transition are perhaps most sharply exemplified by the case of Japan; those in the traditional working age group (15–64) have been declining in absolute numbers since the mid-1990s, and the population is due to peak in 2007. Importantly, a demographic transition is occurring rapidly in many poorer countries, such as China, where the fertility rate is now only 1.8. China may become the first country – say 20 years from now – that has a significant portion of its population older than 64 and is relatively poor on a per capita basis.

### Major Transformations within East Asia

The most important change that has taken place



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in the past 25 years within East Asia has been the extraordinarily successful economic development of virtually every economy in the region. This has occurred for the most part as a consequence of a market-based development strategy that combined strong export orientation, emphasis on the importation and utilization of foreign technology, rapidly increasing investment and savings rates, and increases in education. East Asian economies have successfully implemented the standard model of climbing the development ladder from unskilled to more skilled labor, from simple technologies to more sophisticated technologies, and from less capital per worker to more capital per worker. This has occurred in essentially market environments within most of these economies, and in the context of a global economic system in which, if they could produce efficiently and competitively, they could sell anywhere. The GATT multilateral system significantly benefited all the East Asian economies, first in their trade with the United States and Europe, then with Japan, and now with each other.

By 1980 Japan had established itself not only as a global economic power, but also as a possible development model and the East Asian economic leader. This was based on Japan's ability to catch up with the advanced industrial countries by effective importation of technology through licensing and learning, sharply rising business investment rates and household savings rates, an increasingly educated and skilled labor force, low rates of inflation and limited government claim upon resources, a strong commitment to economic growth for both political and economic reasons, and government leadership in economic policy. Japan's excellent economic performance in due course made obsolete many of the

institutions and policies that had initiated and sustained it. One consequence was the dramatic stock market and land market bubbles of the late 1980s. The bursting of these bubbles in the early 1990s, together with poor economic policies and the difficulties of finding and implementing appropriate new institutions and policies in the face of vested interests, among other factors, has engendered both Japan's mediocre economic performance since then and an enduring sense of economic malaise.

Two things should be noted about Japan since 1990. First, Japan's GDP has grown slightly more than 1 per cent a year on average, meaning that standards of living have been stable or have even increased slightly. Second, and perhaps more important, Japan has been transforming from its catch-up, rapid-growth phase to being a mature economy at the frontiers of world technology in most industries. As such, Japan has a wealthy economy and society in the advanced stages of a demographic transition; its long-term annual growth rate, like those of other advanced economies, will probably be no more than 2 per cent per capita at best.

Even so, Japan will continue to be a major global player and regional leader for the foreseeable future. It clearly is by far the most important economy in Asia, in terms of both its per capita income and standard of living and its high levels of technology. Its GDP is the second-largest in the world measured at standard foreign exchange rate prices. (In purchasing-power terms the levels are less outstanding: total GDP may be below that China, which is hugely populous but still quite poor in per capita terms.)

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**Table 9.1 Key economic indicators for the 21 APEC members  
and three other ASEAN members**

Region/category	Year joined APEC	Population (million) (2004) (1)	Area (‘000 sq km) (2003) (2)	GDP (US\$ bn) (2004) (3)	GNI/capita (US\$) (2004) (4)	GNI/capita ppp (US\$) (2004) (5)
<b>East Asian APEC members</b>						
<i>Major economies</i>						
Japan	1989	127.8	377.9	4,623.4	37,180	30,040
China	1991	1,296.5	9,598.1	1,649.3	1,290	5,530
<i>Newly industrialized economies</i>						
South Korea	1989	48.1	120.5	679.7	13,980	20,400
Taiwan	1991	22.5 <sup>a</sup>	36.0 <sup>a</sup>	307.5 <sup>b</sup>	13,359 <sup>c</sup>	n.a.
Hong Kong	1991	6.8	1.1	163.0	26,810	31,510
Singapore	1989	4.3	0.7	106.8	24,220	26,590
<i>ASEAN members</i>						
Indonesia	1989	217.6	1,904.6	257.6	1,140	3,460
Vietnam	1998	82.2	331.7	45.2	550	2,700
Philippines	1989	83.0	300.0	86.4	1,170	4,890
Thailand	1989	62.4	513.1	163.5	2,540	8,020
Malaysia	1989	25.2	329.8	117.8	4,650	9,630
Brunei	1989	0.4	5.8	5.2 <sup>b</sup>	14,352 <sup>c</sup>	n.a.
<b>Other East Asian countries</b>						
Myanmar		49.9	676.6	n.a.	est. < 735	n.a.
Cambodia		13.6	181.0	4.6	320	2,180
Laos		5.8	236.8	2.4	390	1,850
<b>Other APEC members</b>						
<i>Russia</i>						
Russia	1998	142.8	17,075.4	582.4	3,410	9,620
<i>Western Pacific</i>						
Australia	1989	20.1	7,741.2	631.3	26,900	29,200
New Zealand	1989	4.1	270.5	99.7	20,310	22,130
Papua New Guinea	1993	5.6	462.8	3.9	580	2,300



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<i>Western Hemisphere</i>						
United States	1989	293.5	9,629.1	11,667.5	41,400	39,710
Canada	1989	31.9	9,970.6	979.8	28,390	30,660
Mexico	1993	103.8	1,958.2	676.5	6,770	9,590
Peru	1998	27.5	1,285.2	63.4	2,360	5,370
Chile	1994	16.0	756.3	94.1	4,910	10,500

GDP = gross domestic product; GNI = gross national income; n.a. = not available; ppp = purchasing power parity.

Sources:

Columns (1) and (3) (except where otherwise indicated): data from the World Bank, 2004, reported from links on website <[www.worldbank.org/data/quickreference/quickref.html](http://www.worldbank.org/data/quickreference/quickref.html)>.

Column (2) (except where otherwise indicated): data from World Development Indicators 2005, reported in website table <[www.worldbank.org/data/wdi2005/index.html](http://www.worldbank.org/data/wdi2005/index.html)>.

Columns (4) and (5) (except where otherwise indicated): World Bank, World Development Indicators, 15 July 2005, reported in website table at <[www.worldbank.org/data/databytopic/GNIPC.pdf](http://www.worldbank.org/data/databytopic/GNIPC.pdf)>.

Notes:

(a) Data from *The Economist*, *Pocket World in Figures*, 2005 edition, reported in APEC's website table at <[www.apecsec.org.sg/apec/member\\_economies/key\\_economic\\_indicators.html](http://www.apecsec.org.sg/apec/member_economies/key_economic_indicators.html)>, accessed 14 December 2004

(b) Data from APEC Regional Trade and Investment 2004 reported in APEC's website table at the website shown above.

(c) GDP/capita; data source same as for (b).

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In 1980, few people thought that other East Asian economies appeared to have immense growth potential, but this perception turned out to be completely misplaced. First the four “tigers” – the newly industrializing economies of South Korea, Taiwan, Hong Kong, and Singapore – climbed the development ladder, even though all were relatively poor in natural resources. Next, the resource-rich economies of Southeast Asia – particularly Indonesia, Thailand, the Philippines, and Malaysia, as well as the special case of oil-rich Brunei – began successful development processes. Their potential to continue to achieve good growth remains strong, despite the 1997–98 financial crisis.

The financial crisis of 1997–98, by which many of the developing economies of East Asia were seriously adversely affected, has had important implications for the region and for regional economic cooperation. The immediate causes of the financial crisis were what have been termed “the two mismatches”. The mismatches were between currencies and between loan terms. Local financial institutions in many countries borrowed short-term dollars, yen, and other foreign currencies, converted them into local currencies, and lent to finance investments in long-term activities. Many of the investments could not be readily liquidated, particularly real estate developments. When it appeared that the domestic borrowers could not service their debts, a foreign exchange crisis not surprisingly erupted. Then came a domestic financial crisis, which in turn resulted in sharp slowdowns in economic growth rates. This crisis made evident the weaknesses of Asian financial markets, especially problems of collusion and corruption, in addition to inefficient

resource allocation.

Japan pursued policies to help the countries in distress, but that alone was not sufficient. Despite the seriousness of the financial crisis the United States responded slowly. The US government stated that the D’Amato amendment<sup>2</sup> barred the United States from using its Exchange Stabilization Fund to help Thailand as it had helped Mexico earlier; many Asians thought the United States could have found a way around that constraint. Fortunately the amendment expired before the Korean crisis in late 1997. Furthermore, with only some hindsight it can be seen that the initial conditions attached to IMF assistance were counterproductive. These two factors firmly planted the seeds of the need for regional financial cooperation.

It seems unlikely that in 1980 Prime Minister Ohira, or indeed anyone, perceived the degree and extent to which Chinese policy and economic development would change in the coming years. China has grown so rapidly over the past 25 years that it has become a major global player despite its still-low level of per capita income. The China development story is complex, not only because of sheer size and population, but also because of the efforts to move from a socialist planned economy to a much more market-based economy, while maintaining a political system whereby the Communist Party has a monopoly on political control.

One important feature of China’s development has been a commitment to internationalization, not only in trade and FDI inflows, but also in its

<sup>2</sup> The D’Amato amendment aimed to prevent any use of the Exchange Stabilization Fund in order to bolster any foreign currency.

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eventually successful efforts to join the WTO. China had become involved in APEC well before it was allowed to join the WTO, and recently it has become involved in negotiating regional trade agreements.

ASEAN has come to play a somewhat more significant, if still somewhat ambiguous, economic role in East Asia. Established to reduce political tension among its initial members and to deal with the Vietnam War, ASEAN also sought means of economic cooperation. Since most members export the same products, with the exception of Singapore as entrepot, trade among ASEAN countries has been small. In 1992 ASEAN established the ASEAN Free Trade Area (AFTA), but it has not gone far, because of its many exceptions and restrictions. ASEAN's main effectiveness is based on its ability to agglomerate the power of its members into a somewhat cohesive negotiating unit for governmental aid from Japan, in APEC, and now in trade negotiations with China, Japan, and South Korea. In the 1990s ASEAN expanded from 6 to 10 countries by adding Vietnam, Cambodia, Laos and Myanmar, so as to include all the Southeast Asian nations. How to incorporate these new members effectively has created additional economic and political difficulties for ASEAN.

Intra-regional trade and FDI flows have burgeoned among the East Asian economies. Initially predominantly bilateral flows from Japan, FDI has been rapidly changing to flows among all the economies, especially China. This has been due in significant part to the development of cross-country supply chain production networks by producers (as in electronics) or purchasers (as in clothing and shoes). With the ongoing reduction in national trade barriers, multinational companies have taken advantage of differences among East Asian economies

in labor and other costs of production for components and intermediate goods.

Cross-country sharing of the production process requires low trade barriers and tariffs to be successful and efficient. The nature and degree of such production networks depend on the industry, the degree to which low-wage labor is a significant cost factor, and opportunities for domestic sales as well as exports. Interestingly, Japanese production networks rely on Japanese supplier-affiliate producers elsewhere in East Asia, whereas US firms tend to rely on Asian suppliers that they do not own.

### **The Evolution of APEC**

APEC is the most ambitious effort ever to define and establish a region, at least conceptually, that is so huge geographically, immense in population, and heterogeneous in ethnicity, languages, religions, history, political and economic systems, and levels of economic development. What has brought the members together is a common interest in, and commitment to, mutual trade and FDI liberalization and facilitation in order to accelerate economic development and growth. Since there is an extensive literature on APEC, I limit myself to a few general comments.

Membership has always been a major issue. The original members were the major market economies in East Asia, the western Pacific, and North America. It was quickly recognized that it was essential to include the important economic actors China, Taiwan and Hong Kong, but politically that was extraordinarily difficult. The South Korean government was asked to negotiate an arrangement to include these three, and succeeded; in August 1991 all became members at the ministerial level, Taiwan under the strange nomenclature "Chinese Taipei". Since the accession of Hong Kong and Taiwan, APEC members have been referred to as economies rather than as countries.

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Following the establishment of NAFTA, in 1993 Mexico became the first Latin American member of APEC, followed by Chile in 1994 and then Peru, which joined in 1998 at the same time as Russia and Vietnam. The major players are Japan, China, the United States, and ASEAN as a group, even though three of ASEAN's members (Cambodia, Laos, and Myanmar) are not in APEC. Many of the new ideas and substantive input have come from South Korea and Australia. At its November 1997 meeting, APEC decided to place a 10-year moratorium on new members. Table 9.1 provides basic data on the APEC members and the other ASEAN nations.

APEC has four major distinctive features, described below.

The first is that APEC is a ministerial-level governmental voluntary forum, as distinguished from a treaty organization. This means that members have no legal obligations to APEC or each other. Decisions are consensual, with a strong emphasis on unanimity, and are not binding. Rather, policy decisions – and there are many – as well as their enforcement, are founded on voluntary actions by individual members. Implementation is based on the recognition that if each economy pursues the policies decided on, then all will benefit, a traditional example of a public good. The process is reinforced by member peer pressure, which makes it easier for some members to make domestically difficult policy decisions.

This informal, consensual approach is both APEC's strength and its weakness. The strength lies in the reality that this is the only way that all APEC members are willing to participate, even though some, led by the United States, prefer a treaty system with formal agreements and commitments, and penalties for non-

compliance. The weakness is that APEC has no effective compliance mechanisms to ensure that commitments agreed in principle are implemented in practice. ASEAN has maintained a policy of non-interference in the internal affairs of its members. Thus, formal surveillance of each other's economic policies and actions has not been possible.

The second major feature is that APEC focuses on trade and FDI liberalization and facilitation measures, and it has set extraordinarily ambitious targets. At the 1994 annual meeting in Bogor, it was agreed that the developed member economies would achieve free trade and investment in the region by 2010, and that developing economies would do so by 2020. Over time it became clear that firms engaging in economic transactions in the region would benefit as much from a range of trade facilitation and capacity-building programs as from reductions in import quotas and tariffs. This means such programs as harmonization of industry and customs standards, training of customs officials, and simplification of regulations in all areas affecting trade.

The predominant focus on trade has meant that financial relationships and issues have been addressed much less intensively. APEC finance ministers do meet, but they have perceived fewer benefits from voluntary collective action than have trade ministers. Trade and development issues inevitably overlap many government ministries, so there have also been APEC meetings of relevant ministries to address issues such as energy, transportation, agriculture, and health.

The third major feature is that APEC has been committed to open regionalism. This means essentially that when any economy liberalizes, it extends benefits to all countries, not just to

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APEC members on a restrictive basis. Liberalization under APEC was presumed to be unilateral; a number of countries engaged in unilateral liberalization in the 1980s, and China did in the 1990s, but that process has gone as far as it can and now is at an end. Members want trading partners to provide reciprocal liberalization benefits.

APEC's ideal of open regionalism has nonetheless signalled that the global WTO multilateral system is the best system, better than any regional or subregional preferential trade agreements (PTAs) which discriminate against non-members. Though APEC is only a forum, it had sufficient clout to push the Uruguay Round negotiations forward when they were stalled in the early 1990s. Similarly, APEC has been supportive of the current WTO Doha Round of trade liberalization negotiations, though in a different global and regional environment, which may make it less effective.

APEC's fourth major distinctive feature is the Leaders Summit meeting which immediately follows the annual ministerial meeting. This was initiated by US President Bill Clinton at the 1993 Seattle APEC ministerial meeting, and has been held every year since. Its participants are the heads of each APEC member country (thereby excluding Hong Kong and Taiwan).

Though not initially planned as part of the APEC process, the summit meeting arguably has become the most important contribution of APEC. It provides a mechanism by which the heads of state can directly make policy decisions, as well as get to know each other. It is also a convenient annual opportunity for leaders to have side meetings with the heads of other countries to pursue their own agendas. Normally, bilateral meetings between heads of state are difficult to arrange, particularly for the

president of the United States. Moreover, the fact that its head of state is participating in the APEC Leaders Summit meeting means that each country's governmental bureaucracy must be sufficiently knowledgeable about Asia Pacific economic issues to be able to provide briefings. This has been particularly important in the United States, where general knowledge and understanding of East Asia and the western Pacific had been limited. Now APEC offices operate not just in the Department of State but in every relevant US department.

APEC's record is mixed, but basically positive. It is generally recognized that it will not be able to directly achieve the Bogor vision of free and open trade and direct investment. The incentives to achieve these goals on a unilateral, voluntary basis are overwhelmed by domestic vested interests and by policy preferences to negotiate liberalization on a reciprocal basis with other economies globally, regionally, or bilaterally. Even so, the Bogor vision has established a very strong liberalization target and standard to which every member is committed, rhetorically at least.

With voluntary trade liberalization efforts slowing or even fading, it is appropriate that greater emphasis is currently being placed on trade facilitation and trade capacity-building measures. Such measures are less well analyzed by economists and less exciting to policy-makers, but in the long run they may reduce transaction costs and improve conditions for businesses in many sectors even more than further trade liberalization will.

The failure to give financial issues anywhere near the attention of trade issues has proven to be a major weakness. This became clear during the 1997–98 financial crisis, when many afflicted countries reacted negatively to the

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lack of active US involvement early on and to the IMF's initial conditionalities for its loans, which were mistakenly imposed due to earlier experiences of balance-of-payments crises based on trade rather than finance. Moreover, the 1997 Japanese initiative to develop a complementary "Asian Monetary Fund" was vetoed out of hand by the United States. APEC has not had an effective mechanism for developing financial cooperation. This is not the fault of APEC but is due to the unwillingness of member finance ministries to engage in the sorts of region-wide dialogues and commitments the trade ministries have undertaken. Nonetheless, APEC did contribute to the prevention of new trade barriers by its crisis-afflicted members.

The 11 September 2001 terrorist attacks on the United States brought about a major change in US objectives for APEC, as indeed it did for all US foreign policies. At the APEC Leaders Summit meetings since 2001, President George W. Bush has strongly urged comprehensive regional, as well as bilateral, approaches to combating terrorism. While Leaders Summit meetings have always had, implicitly at least, broader political agendas, this has been a major new thrust. APEC quite appropriately has focused on the economic dimensions of security. A major objective has been to develop much better information and security systems for the movement of exports by sea and air, particularly to the United States. While costly in the short run, it may well be that improved systems will reduce overall shipping costs, pilferage, and smuggling over the longer run.

APEC has made three major contributions to the Asia Pacific region since its formation. The first is the inauguration and institutionalization of the APEC Leaders Summit annual meeting. The second has been broadly educational, not

only for the heads of state but particularly for the government officials involved directly and indirectly in a vastly expanded dialogue process. The officials participating in the APEC process have come to know a great deal more about each member and its objectives, concerns, and style and means of policy making. While smaller members previously knew a great deal about the United States and Japan, they knew much less about each other. APEC has also provided a significant opportunity to learn much more about China. This greatly enhanced level of knowledge and understanding through dialogue on a wide range of economic issues continues to result in many useful programs and activities. However, APEC has yet to be highly visible to the citizens of its member economies. There is little public knowledge, much less awareness, of APEC.

The third major contribution is that prior to, and in preparation for, China's entry into the WTO, APEC played a particularly significant role in educating Chinese officials and policy-makers about the rules, norms, and procedures for engaging in both import and export activity. Through APEC China embarked on a series of unilateral, voluntary trade liberalizations, including tariff reductions, through the 1990s. This APEC learning-by-doing process was in practice very important in preparing not only China but all WTO members for its eventual entry into the WTO.

It has become increasingly obvious that APEC cannot meet its Bogor goals and that its predominant objective of unilateral, voluntary trade liberalization has stalled and is unlikely to proceed further; APEC therefore faces having to redefine itself or becoming marginalized. Redefinition is already taking place, as the November 2004 ministerial and leaders meetings in Santiago, Chile, signalled. The



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APEC May 2005 symposium provided a mid-term stocktaking on accomplishments and problems in light of the current political economy environment. It was agreed to draw up a roadmap as to how APEC should proceed for consideration of APEC leaders at their November 2005 meeting. While free trade continues as an objective, emphasis is being placed on trade facilitation, broadly defined to include such important issues as intellectual property protection, corruption, and secure systems for the shipment of exports. The importance of ongoing dialogue and networking has become well recognized.

APEC also faces challenges growing out of the East Asian economic cooperation movement that has developed over the past five years. This is discussed in the next section.

APEC has two unique strengths. First, it continues to be the only major governmental economic forum that includes both western Pacific and eastern Pacific members. Accordingly, it is the key institution for providing economic cooperation between the United States and East Asia at the governmental level. Second, it continues to support open regionalism, the WTO Doha Round, and WTO-consistent approaches to regional trade agreements.

Just as APEC is in the process of rethinking its most effective future path, so too is PECC, which, as is discussed at length elsewhere in this book, faces major internal challenges and apparently is engaged in a major restructuring. The 17th APEC annual meeting in Korea in November 2005, and the 16th PECC meeting in Korea in September 2005, may well have significant implications for how the APEC constituencies work together in the future.

### **East Asian Economic Cooperation**

Since 2000, a new approach to economic policy has become important in East Asia. Japan, and subsequently South Korea and China, have made major shifts in their international economic policy stances in both trade and finance, adding bilateral (and potentially regional) preferential trade arrangements – popularly termed FTAs (free trade agreements) – and regional financial cooperation mechanisms. In addition, Japan, China and Korea took the initiative to join with ASEAN to establish the ASEAN+3 Finance Ministers Meetings. The May 2000 meeting in Chiang Mai, Thailand, marked the beginning of meaningful East Asian regional economic cooperation.

There are many reasons for the ASEAN+3 countries to focus on East Asian economic cooperation. Some are defensive. The European Union has become a supra-national economy, larger than the Japanese economy, with a single currency, the euro, used by most members. Following the establishment of NAFTA, the United States has been vigorously negotiating bilateral and regional trade agreements, epitomized by the ongoing FTAA (the Free Trade Area of the Americas) negotiations. The Doha Round seemed stalled following the abysmal Seattle ministerial meeting in 1999. After 11 September 2001, US policy has become even more distrustful and dismissive of others' views. In addition, the disappointing response of the United States and the IMF to the 1997–98 Asian financial crisis propelled consideration of regional financial cooperation.

Positive reasons are more important. The huge share and burgeoning market-driven growth of intra-regional trade and direct investment – the economic fundamentals – have made the need for government-based supportive infrastructure



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development obvious. Deepening East Asian economic integration offers the sorts of economic benefits the European Union has been achieving. In this longer-run context, economic integration is a means to achieve deeper political and security cooperation and a peaceful and stable East Asian community.

I suggest two further motives. One is the desire to develop some space between the policies and approaches of the United States on the one hand, and Japan and other East Asian countries on the other, mainly in the economic sphere where opportunities have arisen. Economic regionalism provides a way to counter application of US hegemonic power. This is a matter of degree, not of kind. While many East Asians, including Japanese and others, are very critical of many US policies and behavior, they certainly want to see the United States continue to be actively involved in Asia, economically, politically and, especially, in terms of security. After all, for Japan the bedrock of national security is its alliance with the United States.

A second motive underlying East Asian regionalism is the extraordinary, rapid, sustained growth of the Chinese economy. It is now the second largest economy in the world in purchasing-power terms, though still with a very low standard of living for most of the population. China's growth challenges Japan's position as the economic leader of East Asia. As part of this, in just a few years China has become the principal driver of regional economic growth, a role previously filled by Japan and the United States. Combined with centuries-old Chinese feelings of regional hegemonic rights, this has completely overturned the very premises of past regional relationships.

To its great credit, China has demonstrated remarkable economic regional diplomacy. Its

proposal and successful negotiation with ASEAN for a regional FTA reduced the sense of threat, both economic and security, felt by a number of ASEAN countries. It has put both Japan and the United States on the defensive in terms of economic policy in Southeast Asia. The Chinese have rather cleverly stated that they are quite content to let the Japanese be the number one economic leader in Asia. I find that a remarkable statement. It says to me that the Chinese are very confident that they will eventually become the economic leader, so they can let the Japanese save face while continuing to lose relative position and status.

Two important aspects of East Asian economic cooperation should be noted. First, to the extent that ASEAN+3 is the main symbol of this regionalism, the definition of what comprises East Asia is fundamentally political rather than economic. Taiwan is a significant East Asian economic player, but it is excluded. So, too, is Hong Kong. Both are members of APEC. The deliberate focus on East Asia excludes not only the United States, but also Australia and New Zealand, both of which would like to be in a broader "Western Pacific" grouping. The exclusion of India is consistent with APEC membership and current thinking, but India will become a major economic player in the region relatively soon.

Second, as in APEC, economic cooperation is being pursued on two separate tracks: trade and finance. I interpret this as a regionalizing of what are essentially domestic bureaucratic interests in each East Asian country – that is, the need to avoid turf battles (ministerial jurisdictional disputes). The heads of East Asian states have yet to agree on a coordinated, comprehensive, balanced approach to economic cooperation. In many respects Japan exemplifies this bifurcated, two-track approach: trade

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negotiations are led by the Ministry of Economy, Trade and Industry (METI) together with the Ministry of Foreign Affairs, while finance negotiations are undertaken by the Ministry of Finance.

In trade, Japan thus far has pursued a bilateral approach. It successfully negotiated preferential trade arrangements with Singapore in 2002 and with Mexico in 2004. It has nearly completed negotiations with Malaysia, the Philippines and Thailand, and it is actively negotiating with South Korea. Badly upstaged by China, which in 2004 negotiated a trade agreement with ASEAN, Japan has rejected China's proposal, perhaps more political than economic, for a tripartite trade agreement which would include South Korea.

Although some Japanese envision a comprehensive East Asian Free Trade Area in the long term, that is not in the foreseeable future. Thus far, Japanese FTA initiatives have been constrained by powerful domestic vested-interest groups, especially in agriculture and health care (doctors, nurses, and other personnel). Singapore was selected as the first partner because agriculture and health care workers would not be significant issues. The Mexican negotiations were delayed for two years over the terms of Japanese pork and orange imports. Neither product is a Japanese core agricultural product, but only modest concessions were made. The issue of work visas for Philippine health care workers has been vexatious for Japan. The specifics of the proposed agreement are not clear, but it appears that only small numbers will be allowed in from the Philippines – or, by implication, from anywhere else in Asia.

In East Asian financial cooperation, Japan is less constrained by domestic political obstacles

than it is in trade. Europe's experience provides one vision for Japan and other East Asia policy-makers, particularly in finance. Thus, the very long-term vision promoted by some academics embodies a step-by-step process whereby a system of regional or subregional fixed exchange rates leads ultimately to a single Asian currency and, finally, the integration of domestic financial markets into a regional financial market comparable to the euro zone. More immediately, there is talk of an institution (an "Asian Monetary Facility", not a "Fund") to provide short-term liquidity to finance temporary imbalances of any member so as to avert the development of a financial crisis and its contagion. The dialogue now under way is important: these issues are new, and analysis and education of the participants are essential, but thus far rhetoric races far ahead of substance.

The Chiang Mai Initiative in currency swaps was a significant symbolic first step, but it has had little economic significance; indeed, it reflected how limited commitments were. The bilateral swap commitments are being doubled, but even those amounts appear to be subject to various constraints. At present only 10 per cent of the committed funds can be disbursed without IMF agreement. Even if that is raised to 20 per cent, the basic problem remains: the ASEAN+3 members have not yet agreed among themselves upon the forms and degree of monitoring and surveillance of a borrower government, which are essential in establishing creditworthiness requirements by the lender government. Instead members rely upon the standard IMF procedures and decisions. My guess is that it will be a long time before the ASEAN+3 countries agree to make political commitments to a credible surveillance mechanism among themselves. They are not even willing to use the term "surveillance", as

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that implies interference in the internal affairs of members, though of course mechanisms to establish creditworthiness are essential.

The major non-performing loan problems and the financial crisis of 1997–98, ongoing financial system difficulties in Japan, and a potential banking crisis in China have made everyone aware of the paramount need to reform and strengthen domestic financial systems throughout East Asia. That, however, is the basic domestic responsibility of each economy.

In developing economies it is virtually inevitable that businesses will have a high dependence on bank finance rather than on capital markets. Nonetheless, the development of domestic bond markets can contribute significantly to the finances not only of governments, but also of larger, creditworthy corporations. Bond markets in virtually all East Asian economies are underdeveloped – thin and weak. The Japanese government bond market is an exception. While they have improved significantly, Japanese corporate bond issue and secondary markets are not yet strong and deep.

The Asian financial crisis stimulated consideration of a regional bond market. The Asian bond market concept has been pursued simultaneously in two forums, both with Japanese leadership. First, for some years the Bank of Japan has organized quiet meetings of the 11 Asia Pacific central banks and monetary authorities of Australia, China, Hong Kong, Indonesia, Japan, South Korea, Malaysia, New Zealand, the Philippines, Singapore, and Thailand. This grouping, called the Executive Meeting of East Asia-Pacific Central Banks (EMEAP), only partially overlaps the ASEAN+3 membership. In early 2003, EMEAP decided to develop a regional bond market, creating

an Asian Bond Fund (ABF) to buy dollar-denominated government bonds. Second, within a few months Japan's Ministry of Finance proposed that ASEAN+3 establish a regional market for bonds denominated in a new accounting unit based on a weighted basket of some Asian currencies or in local currencies. This received strong support from both finance ministers and central bank governors throughout the region.

The two approaches are complementary; the central bank approach focuses on increasing demand for the new bonds, while ASEAN+3 focuses on institutional, legal and other arrangements to facilitate bond issuance and bond market development. In June 2003, as a first step, EMEAP successfully launched ABF 1, a \$1 billion fund in which the central banks and monetary authorities invest in US dollar bonds issued by government or quasi-government institutions in China, Hong Kong, Indonesia, South Korea, Malaysia, the Philippines, Singapore, and Thailand. In December 2004, EMEAP launched ABF 2, a \$2 billion fund its members initially financed to invest in domestic currency-denominated bonds issued by these eight economies. The challenge now is to sell units of this fund to private institutional investors as the next step in what is likely to be a long process of market development.

The learning experience of the specific institutional arrangements in each of the issuing economies has been substantial; it will help accelerate regulatory reforms in the bond markets of all the issuers, and purchasers as well. These are necessary steps, but only first steps, in the development of Asian capital markets. Development of a cross-border Asian bond market requires the creation of a regional financial infrastructure that includes a system of clearing and settlement, credit guarantee

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institutions, hedging facilities, and credit rating agencies. Moreover legal and regulatory systems, tax treatment and related institutions and practices will have to be made consistent and harmonized.

There has been no substantive progress on establishing fixed exchange rates among ASEAN+3 or any subgroup. In practice, exchange rates remain quite stable in real terms, in part because no economy wants to lose export competitiveness vis-à-vis the other economies, and in part because all the East Asian currencies have been either directly pegged to the US dollar (China, Hong Kong, Malaysia) or closely linked by government policies of exchange rate intervention (notably Japan and South Korea). East Asia continues to be on a de facto US dollar standard.

### Issues and Prospects

East Asia will continue to be the world's most dynamic, rapidly growing economic region for the foreseeable future. Within East Asia, the growth impetus has shifted from Japan to China, while growth continues in other East Asian economies. That growth process will continue to be private business market-driven, sustained and enhanced by ongoing participation in the increasingly open WTO-based international economic system, the IMF, and private global financial markets.

Tensions in East Asia and in the Asia Pacific region derive primarily from political and security issues. Successful economic development and growth based on increasing economic transactions and interdependence is a very cohesive force; it builds on the interests of businesses and peoples, not just governments. However, it also riles protected vested interests that see themselves as losers in the

process. Moreover, economic cooperation can be affected by how the major issues of North Korea, China and Taiwan, Japan and China, and terrorism are handled.

Japan is now a high-income, technologically sophisticated, mature economy whose population will soon begin to decline slowly. It will continue to be the economic leader in East Asia for the intermediate future in terms of high human skills, technological prowess, wealth, and high living standards. Even though its growth rate will be no faster than other economically advanced countries, its huge market size and the absolute amount of growth will continue to constitute a major global, as well as regional, economic force.

China's persistent very rapid economic growth and development is remarkable, especially since its population is the largest in the world. While income in the more advanced eastern regions has particularly risen, the more western provinces and rural regions have not progressed as far. China's labor surplus will probably persist for another two decades. While China is making progress in virtually all industries, it cannot have comparative advantage in everything. It will be important that both economies exporting to China and those competing in global markets with Chinese exports develop their own production niches and specializations.

While my guess is that China will continue to grow rapidly – say at a 7 per cent annual average rate – for another two decades, major potential domestic difficulties make this projection particularly uncertain. The banking system is inundated with non-performing loans, major politically powerful state-owned enterprises continue to operate at large losses, water shortages in northern China are becoming severe, and ongoing environment degradation

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is increasingly costly both for the economy and for people's health. But my greatest concern is political: as China's urban middle class becomes ever more numerous and powerful, how will the Chinese Communist Party respond to pressures to ease its political monopoly, and how will it deal with the extensive corruption the system makes possible?

The economic development and growth prospects for the other East Asian economies continue to be very good, though not as great as in the boom phase of the mid-1990s. The peaceful transitions from authoritarian to democratic states, notably in South Korea, Taiwan and Indonesia, have been very positive, a major element in the East Asian success story.

With recognition that the unilateral, voluntary, consensual approach to trade liberalization has reached its limits and that the Bogor commitments are unlikely to be achieved through its current procedures, APEC has seemingly declined in importance. That does not need to be the case, and I hope it will not be. It is an essential, indeed the only, governmental institution for supporting broad-based economic cooperation among its East Asian, western Pacific and Western hemisphere members. Its persistent support of the WTO and the Doha Round is important. Its Leaders Summit annual meetings are major policy venues. APEC's evolution from an organization with a primary focus on tariffs and quotas to one with comprehensive trade facilitation programs is an important step forward, which is underappreciated but particularly valuable in making markets more efficient and business transactions less costly. At the same time, APEC is under challenge from the East Asian economic cooperation movement.

Government-sponsored East Asian economic

cooperation regionalism is in the very early stages of what necessarily will be a very long-run process, probably of some 50 years or more. While economic interactions will certainly increase with economic development and growth, achieving significantly deeper economic integration – of policies and institutions – will require strong political commitments by its members. The process is sequential, from dialogue in order to enhance knowledge, understanding, and trust; to relatively small, incremental substantive steps; to eventual major commitments. While the European Community is an important model, it should be viewed with care: the ideal of a unified Europe dates at least to Charlemagne, while in East Asia no similar ideal has been widely shared.

The current dialogue process, while heavy on rhetoric relative to substance, is an important initial phase. East Asia's countries and economies have quite different histories and backgrounds, and still do not really know each other very well – or, sometimes, know each other too well. No East Asian country significantly trusts any other East Asian country. That, more than any alleged weak political leadership, is the main reason for the slowness in developing significant substantive modes of cooperation. Moreover, all East Asian economies benefit fundamentally from the global economic system. For each, the political and security – as well as economic – relationship with the United States is terribly important. Perhaps most fundamentally, the prospects for East Asian economic cooperation depend on whether and how Japan and China deal with their burgeoning rivalry. Given these difficulties, it is unclear whether East Asian regionalism will deepen significantly, or whether it will peter out or evolve into something different.

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As in APEC, and probably for the same domestic bureaucratic reasons, the East Asian economic cooperation movement is travelling on two distinct tracks, trade and finance. In practice, financial cooperation, and the rhetoric it has engaged in, has proceeded more rapidly, primarily through APEC+3. While the ASEAN–China Free Trade Agreement and AFTA are somewhat broader in membership, thus far virtually all FTAs and PTAs have been bilateral, with Japan and Singapore acting separately and jointly as leaders. East Asian trade cooperation at a more formally institutionalized, legally committed, level is in the distant future. If East Asian economic cooperation is to proceed efficiently and effectively, eventually the trade and finance tracks will have to merge.

By straight economic criteria, global free trade is by far the most efficient system for allocating resources so as to maximize world economic welfare; preferential regional trading systems are second best, and preferential bilateral arrangements are third best. In many cases, however, political goals – the search for community, or at least stability – impel countries to pursue the more narrow approaches to trade and investment liberalization. That certainly seems to be an important factor in the East Asian economic cooperation movement. Some policy-makers see bilateral and regional preferential agreements as a way to develop best-practice policies in areas not yet covered by the WTO, and as a tactic to move the always-slow global negotiating process forward. Thus far the evidence of FTAs involving East Asian economies does not support these claims.

One key issue for Japan, and indeed for all countries committing to FTAs or PTAs, is whether the arrangements will be complementary to, and supportive of, the WTO

system, or whether they will be in competition with, and undermine, the global system. I am somewhat pessimistic. Bilateral and regional negotiations divert scarce bureaucratic human resources from such global negotiations as the Doha Round. They are less effective in overcoming domestic vested interests, such as in agriculture, than broad-based, comprehensive liberalizations where benefits are substantial and accrue widely in every country. Indeed Japan's international trade policy is essentially on the defensive, regionally and globally, and will remain so until the country shifts to a fundamentally different agricultural policy, such as a system which guarantees farm household income for some long, defined period and at the same time opens up agriculture to free trade. South Korea has a similar problem, and in a decade or two it is likely that China will as well.

Nonetheless, in the short run FTAs do provide practical market-opening benefits for the exporters in the member countries, and that can be politically appealing, even though thereby the FTAs discriminate against the large number of trading partners that are not the members. My concern is that those specific benefits to the members will be overwhelmed in the longer run by the systemic costs of a burgeoning number of FTAs that embody incompatible specific bilateral rules and agreements. Perhaps the most important defect of FTAs is what my colleague Professor Jagdish Bhagwati has termed "the spaghetti bowl effect" (now called by some Asians "the noodle bowl effect"), where each FTA is so complex, with so many intertwined elements, that it becomes difficult to disentangle and generalize.

Rules of origin are a particularly difficult problem. Every preferential agreement has to stipulate that a significant proportion of any export to a



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participating member is produced in that country; otherwise countries could import from a non-member and re-export to a member on more favorable terms. Each FTA or PTA defines rules of origin differently, by industry or product, and by percentage of imported components allowed in the final export product. It is estimated that NAFTA has some 5,000 specific product rules of origin, and the recently signed US–Australia FTA is similarly specific and complex. FTAs, given their preferential essence, distort a country's ability to allocate resources efficiently by appropriate specialization. At particular risk are cross-border supply chains, a notable feature of East Asian efficiency in components production in textiles and garments, electronic goods, and, especially, automobiles. Rules of origin put smaller countries particularly at risk.

Nonetheless, the proliferation of FTAs in East Asia seems inevitable. Many policy thinkers have articulated a vision of a comprehensive, full-fledged East Asian or even broader Asian FTA. Why then begin negotiations on a bilateral rather than a region-wide basis? The answer is clear: East Asian countries lack the degree of trust to undertake such a comprehensive approach and each potential member lacks the underlying economic and policy conditions to do so. The approach now should be to design new state-of-the-art FTAs that have simple, liberal rules to which other potential members could readily join. While this is an ideal unlikely to be achieved, China's initial FTA with the ASEAN members seems to provide good guidelines, though the agreements are yet to be fully negotiated and are not yet transparent. In the initial agreements, China signed essentially identical FTAs with all 10 ASEAN countries and, importantly, agreed upon a quite liberal 40 per cent rule of origin. In their bilateral FTA negotiations, it would behove Japan and

South Korea – indeed all East Asian economies – to seek generally applicable rules rather than incorporating a large number of product-specific rules. However, given the realities of vested interest group pressures, I am not optimistic that this will be achieved. Instead, I anticipate that East Asian countries will negotiate and sign a series of highly specific FTAs that will build in incompatibilities sufficient to undermine the eventual development of an Asian FTA. Since I am not convinced that an Asian FTA would be good regionally or globally, that may not be such a bad outcome.

The same broad issue holds for East Asian financial cooperation: is it complementary to and supportive of, or is it competitive with, the global financial system? To date it has been complementary, and that is likely to continue. These are desirable trends. Complementarity is probably inevitable in finance. There may be national reasons for barriers to capital and financial flows, but specific bilateral or regional preferential financial benefits are outweighed by the costs.

The major exception is exchange rate policies. Some countries, exemplified by members of the European Union, have desired and benefited from agreements to fix their exchange rates with each other, but this was in large part for broader community-building purposes. Being on a fixed exchange rate system requires countries to adjust their fiscal and monetary policies to external conditions and circumstances. Thus far, there is little political will within East Asia, or even among some members, to commit exchange rate policy to some agreed norm, such as an exchange rate based on the weighted average basket of each national currency, or even of a dollar, euro and yen basket.



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The major common exchange rate problem for the East Asian economies at present is the weakening of the US dollar, and the attendant pressure for their currencies to appreciate significantly. No economy is willing to have that happen alone. Perhaps conditions are appropriate for a Tokyo Plaza Accord or Seoul Plaza Accord, whereby each East Asian economy agrees to a market-driven, more or less equal appreciation of its currency relative to the dollar while maintaining parity with each other. In July 2005 China and Malaysia each shifted from its dollar peg to a currency exchange rate basket system. Their initial appreciations relative to the dollar have been too small to be economically meaningful. Nonetheless, China's shift will lead to greater flexibility in East Asian exchange rates relative to the dollar in due course.

The IMF is the pre-eminent international financial institution for the provision of short-term liquidity to offset a country's balance of payments and foreign exchange pressures, under various conditionality requirements which by their nature intrude on a recipient's economic policies in order to bring about corrections. East Asia, the IMF and the United States learned from their initial misguided policies in the 1997–98 Asian financial crisis. Even so, East Asian skepticism persists regarding both IMF policies and implementation of the so-called Washington consensus, so the search for supplementary mechanisms will continue. However, it is unlikely that at any time soon the economies with large foreign exchange reserves such as Japan, South Korea, China, Hong Kong and Taiwan will be willing to provide reserves as pooled funding for a regional institution such as an Asian Monetary Facility. East Asia's trust and surveillance mechanisms are inadequate.

Progress in regional financial development depends critically on each economy

strengthening and deepening its financial system. The development of domestic bond markets and a regional bond market potentially will be significant in due course, though domestic stock markets – with all their volatility and sensitivity to foreign portfolio capital flows – are probably more important. Policy-makers would like to create financial systems that channel East Asian savings to East Asian investors without going through capital markets outside the region or using US or European multinational financial intermediaries. There is no reason the first of these cannot happen within the framework of a global system, and the size of the market will surely offer opportunities for regional and domestic intermediaries. However, the global system of financial intermediation is very efficient and low cost. It will not be easy to develop a better and cheaper East Asian regional financial system.

To date, substantive financial cooperation by East Asian countries has been small, limited, and non-threatening. That is not surprising since the dialogue (educational) process has only begun. Countries will have to develop much more trust in each other for East Asian financial cooperation to proceed very far. They will have to engage in extensive and intensive surveillance and monitoring of the internal economies and economic policies of their partners, and, when necessary, be willing to take preventive measures in order to protect their own financial interests. That possibility lies only in the distant future.

East Asia's search for ways to achieve economic integration – whether through APEC or through the newer economic cooperation movement – has been driven by the desire both to achieve the benefits of deeper economic integration and to create and maintain a peaceful and stable

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regional environment. Both APEC and the cooperation movement offer means to these desirable goals. One key issue will be the nature and extent of US involvement. Will the goal be an Asia Pacific community or a more narrow East Asian community? In the spirit of Prime Minister Ohira's commitment to advancing harmony in the region, let us hope that a broader, more inclusive vision will prevail.

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