

*Draft notes for paper*

*Not for Citation*

## **Regional Cooperation in East Asia: Rhetoric vs. Reality**

Wonhyuk Lim

Korea Development Institute

This paper was prepared for the conference on *The Evolving WTO Regime and Regional Cooperation: Implications for Northeast Asia*, held in Seoul, Korea, on 13-14 September 2002.

## ***1. Introduction***

- During the Cold War, most countries in East Asia belonged to one of the two competing hub-and-spoke alliances headed by the United States and the Soviet Union. Primarily due to historical reasons, there was very little multinational cooperation in Asia on the governmental level.
- Yet economic linkages among Asian countries were extensive. A regional division of labor saw Japan provide the lion's share of intermediate goods to Asia's outward-oriented industrializing economies, which exported final goods to the American and European markets. The 1985 Plaza Accord accentuated this trend, as the appreciating yen forced Japan to increase FDI in Southeast Asia and pursue a "flying-geese" pattern of development.
- Economic reform in transition countries and the end of the Cold War greatly enhanced the prospects for increased regional integration in Asia. Also, the formation of the European Union and the signing of the North American Free Trade Agreement seemed to justify a similar response from Asia. Finally, the 1997 economic crisis highlighted the need to create transnational institutions such as an Asian Monetary Fund to protect the collective interests of the countries in the region (Pempel 1999, Bergsten 2000).
- However, various proposals to promote regional cooperation in East Asia have led to few tangible results. There are several reasons for this lack of "progress."
  - The concept of "regional cooperation" was not properly defined in many proposals, which basically called for nothing more than "increased economic exchanges." A meaningful regional cooperation scheme should make a case for giving *preferential* treatment to its members, producing an outcome that deviates from the one obtained under nondiscrimination. Moreover, it should be shown that East Asia can actually benefit from such regional cooperation.
  - For some initiatives, such as the Tumen/Tuman River Area Development Project (TRADP) and the Northeast Asian Development Bank (NADB), "if someone pays, we'll join" seems to be the underlying logic. The benefits and costs of a regional cooperation initiative should be fairly distributed among the member countries if it is to be successful.

- The distribution of benefits and costs within each member country also presents serious political problems. Fearing the adverse impact of trade liberalization on internationally uncompetitive sectors, countries are unlikely to sign free trade agreements that have significant redistributive effects. Japan and Korea, in particular, have been trying to avoid any regional cooperation scheme that would shake up the vulnerable agricultural sector.
- Perhaps the biggest obstacle is the current balance of power in Asia. The United States has a strong incentive to maintain the existing hub-and-spoke system and is opposed to the creation of an exclusively Asian economic community. The possible emergence of China as a revisionist power concerns the United States in this context. Yet the inclusion of the United States (and other non-Asian countries) is likely to make regional cooperation not “regional” and produce a largely ceremonial forum for national leaders to exchange pleasantries. The challenge is to find an alternative that is effective in promoting regional cooperation in Asia but is at the same time non-threatening to the United States.
- This paper is organized as follows. Section 2 lays out a conceptual framework for regional cooperation, highlighting different modes of cooperation based on different objectives. Section 3 draws implications from other regions’ experiences with regional cooperation. Section 4 explores trajectories for regional cooperation in East Asia from both positive and normative perspectives. It emphasizes that the rise of China poses the greatest challenge for the region for next decades. While free trade agreements may be important in their own right, regional cooperation in East Asia should aim at minimizing the risks associated with a shifting balance of power. Energy-related issues are likely to receive a great deal of attention in this regard.

## ***2. A Conceptual Framework for Regional Cooperation***

- A meaningful regional cooperation scheme should clearly define its ultimate objective and show that preferential treatment for its members is essential to achieving this objective. It should explain why countries in a particular region should pursue a particular mode of cooperation.

- The relevant region for regional cooperation is defined more by political and economic considerations than by geographical proximity and cultural affinity.
- Similarly, the mode of cooperation is defined by the ultimate objective of regional cooperation. If complete union is the ultimate objective, regional disparities in income and institutional development must be effectively addressed. If peaceful co-existence falling well short of complete union is the objective, however, regional cooperation should probably focus on security-related issues (e.g., energy) that are essential to confidence building among the member countries.
- In economic theory, Viner's concepts of trade creation and trade diversion offer basic insights into the effects of regional cooperation. Balassa (1961) views economic integration as a process through which two or more countries form a single economic entity by removing barriers to the free flow of goods and services (including factors of production) and by establishing a unified system of economic institutions.
- In practice, however, political considerations tend to take precedence over purely economic calculations. Jean Monnet's vision for a unified Europe, for instance, seems to have had very little to do with trade creation or diversion.<sup>1</sup>
- Regional cooperation in East Asia should also give priority to political considerations if it is to succeed. In particular, it should provide a "big picture" for the relations between China and Japan and the role of the United States in the region. The resolution of the Korean problem also has to be an integral part of such a scheme.

### ***3. Implications from Other Regions' Experiences with Regional Cooperation***

- In this regard, it may be useful to draw lessons from the experiences of other regions. A thought experiment by analogy may be particularly useful.

---

<sup>1</sup> As "a first step in the federation of Europe," the Schuman Declaration of 1950 called for the pooling of coal and steel production and sought to "change the destinies of those regions which [had] long been devoted to the manufacture of munitions of war."

- In the case of Europe, the initial impetus for regional cooperation came from the historical failure to cope with Germany as a revisionist power. Emerging victorious from World War II yet continued to be concerned with Germany, France took the initiative to promote regional cooperation that included Germany, which, for its part, made efforts to become a trustworthy neighbor. The unification of Germany served as a major driving force for the creation of the European Union, as Germany and its neighbors agreed to make Germany an integral part of Europe rather than an unhinged revisionist power.
- Events took a rather different turn in East Asia after World War II. The historical failure to cope with Japan as a revisionist power had been broadly similar to the European experience with Germany, but China did not have a chance to patch things up with Japan, which established close relations with the United States after the war. Instead, China was trapped by the Soviet Union to side with North Korea and fight against the United Nations in the Korean War from 1950 to 1953. Although China normalized relations with the United States and Japan in the 1970s and steadily increased economic exchanges, China and Japan have yet to put forward a credible initiative to promote regional cooperation. If anything, there has been some tension between the two countries over security-related issues.
- In North America, the signing of NAFTA was prompted by several factors. The United States was concerned about the creation of “Fortress Europe” and frustrated with slow progress on multilateral negotiations for the Uruguay Round. Canada and Mexico sought to have preferential access to the huge U.S. market to which 70 percent and 85 percent of their total exports were headed, respectively. In addition, Mexico wanted to lock in its domestic policy reform through NAFTA.
- In East Asia, China certainly has the potential to become the largest market for its neighbors’ exports, but it has some way to go before the level of its institutional development catches up with that of the United States. As a result, a free trade agreement centered around China is likely to be limited in scope for the foreseeable future.

#### ***4. Possible Trajectories for Regional Cooperation in East Asia***

- If dependence on intra-regional trade is used as a measure of regional cooperation, East Asia had a much higher level of regional cooperation in the pre-war period.<sup>2</sup> In fact, the gravity coefficient for the East Asian trading bloc showed a secular decline between the mid-1930s and the mid-1980s, when it began to rise again. The gravity coefficient in the mid-1930s was more than twice the level in the mid-1980s (Petri 1993).
- There is little evidence that the relative decline in intra-regional trade adversely affected the economic performance of East Asian countries, which took advantage of increased opportunities for inter-regional trade in the postwar period. In fact, the relative decline in intra-regional trade coincided with the remarkable growth of outward-oriented industrializing economies in East Asia, which exported the bulk of their final goods to high-income countries in North America and Europe.
- In 1999, Japan's exports to the United States amounted to \$130.0 billion while its imports from the U.S. were only \$57.5 billion. AXJ 9 (Korea, Singapore, Taiwan, Hong Kong; Indonesia, Malaysia, Philippines, Thailand; and China) exported \$234.6 billion to the U.S. and imported only \$107.3 billion. By contrast, AXJ 9's exports to Japan were \$118.4 billion while its imports from Japan amounted to \$151.9 billion. This trade pattern shows the significance of the U.S. market as a source of final demand. Much of intra-regional trade in East Asia is derived from this final demand.
- Yet China's rapid economic growth offers great opportunities for East Asia to increase intra-regional trade. According to an estimate by the Japanese Economic Research Center (1996), China's share in Gross World Product is expected to rise from 1.8 percent in 1990 to 9.2 percent in 2020.
- The combined share of China, Japan, and Korea in Gross World Product is expected to increase from 16.9 percent in 1990 to 23.5 percent in 2020. In comparison, the share of EU and NAFTA regions is expected to be 21.1 percent and 25.1 percent in 2020,

---

<sup>2</sup> For instance, Japan and Manchuria accounted for 84.5 percent and 10.5 percent of Korea's total trade volume, respectively, in the 1930s. Both Korea and Manchuria were under Japanese colonial rule at the time.

respectively. In other words, Northeast Asia will form as large a market as Europe and North America in 2020.

- The rapid expansion of the Chinese market is leading China to play an increasingly prominent role in regional cooperation. For political as well as economic reasons, China has been making serious efforts to sign a free trade agreement with ASEAN countries, which see preferential access to the Chinese market as a possible solution to their present difficulties. Overseas Chinese in Southeast Asian countries are likely to help the two sides to reach such an agreement.
- Korea and Japan are moving toward a free trade agreement of their own to facilitate industrial restructuring and promote investment. Although some Chinese scholars have expressed reservations this agreement, a trilateral free trade agreement is not realistic at this point. As in the case of NAFTA, however, a bilateral agreement can develop into a trilateral agreement when the shock from liberalized trade can be contained at a manageable level.
- These two sets of free trade agreements should serve as the building blocks for more extensive regional cooperation in East Asia, which seeks to respond to the challenges posed by the rise of China. The risks associated with a shifting balance of power should be minimized through such cooperation.
- ASEAN + 3 is likely to provide a useful forum for East Asian countries to exchange ideas on regional cooperation and discuss pressing issues. It is informal enough to be seen as non-threatening to the United States, but not as loose as APEC, which lacks substance under the oxymoronic banner of “open regionalism.”
- One area of regional cooperation that must involve the participation of the United States is energy security. By 2010, Asia (mainly Northeast Asia) is projected to import twice as much oil from the Middle East as the U.S. and Europe combined. Yet the security framework for assuring stable access to oil is provided almost exclusively by the United States, which also enforces anti-proliferation safeguards with respect to nuclear power. Whether Asian countries will be content to allow the U.S. to continue to play such a role remains to be seen (Calder 1998).

- Northeast Asia is highly dependent on outside energy resources. While the region consumes approximately 20 percent of the world's annual supply of oil, its share of production and reserves is only 5 percent and 2 percent, respectively. China has become a net importer of oil since 1993. For natural gas, Northeast Asia's consumption share is 5 percent while its share of production and reserves is only 1 percent.
- Unless there is a regional forum (including the U.S.) to address energy security issues, the search for energy resources may well lead to conflicts in the future. The forum should set the rules on investment, transit, and trade involving energy resources. Europe's experience with energy cooperation may offer useful lessons in this regard.