

PASCN Discussion Paper No. 2002-06

**Torn Between Two Lovers:
ASEAN and its Evolving Economic Relations
with China and Japan**

John Lawrence Avila



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ABSTRACT

Last November, ASEAN Leaders met with the Chinese Premier in Brunei and endorsed a proposal for a Framework on Economic Cooperation and to establish a free trade area within the next ten years. Ahead of such an arrangement, the two sides agreed to explore the idea of an “early harvest”, which will precede comprehensive market access negotiations on industrial goods and services between the two sides.

And in early January 2002, Japan Prime Minister Junichiro Koizumi toured the Southeast Asian region and proposed the Initiative for Japan-ASEAN Comprehensive Economic Partnership. Koizumi hinted that a free trade arrangement could form part of this enhanced relationship. The Koizumi initiative has been viewed by not a few as a bid by Japan to counter China’s intensified dialogue with ASEAN members.

Once fearing increasing irrelevance amidst developments in APEC, the WTO and other regional arrangements, ASEAN is suddenly thrust into limelight. These two initiatives compel its members to consider moving towards closer integration with the two of the biggest economies in the world. Indeed, the evolving economic relations between ASEAN and China and Japan directly impacts on the future of the ASEAN Free Trade Area, APEC, and the position of Asia in the world economy.

This paper examines the developments behind these twin proposals, particularly taking the ASEAN perspective. This study will survey the various political, economic and strategic issues that impinge on these arrangements. The paper will conclude with an assessment of the prospects of an expanded free trade area between these countries.

Torn Between Two Lovers: ASEAN and its Evolving Economic Relations with China and Japan*

INTRODUCTION

Last November 2001, the heads of government of China and ASEAN entered into a new Framework on Economic Cooperation including an agreement to establish a free trade area within the next ten years. This was shortly followed by a proposal, referred to as the Initiative for Japan-ASEAN Comprehensive Economic Partnership, by Japan Prime Minister Junichiro Koizumi during an official tour of the region in mid-January 2002. The Koizumi initiative likewise called for the creation of an FTA to be modeled after an accord that Japan concluded with Singapore at the end of the prime minister's visit.

These developments coincide with the dramatic resurgence of bilateral and regional trade initiatives including proposals to create free trade areas (FTA) and/or closer economic partnerships (CEP) covering the Asian region. ASEAN is likewise negotiating a CEP arrangement with Australia and New Zealand and, more recently, an FTA with the United States is being explored. Outside of ASEAN, South Korea has proposed a grouping including itself and economic powerhouses China and Japan in a Northeast Asian FTA.

There has likewise been a proliferation of bilateral initiatives across the region. Singapore has been particularly aggressive. It has recently concluded a CEP with New Zealand and an FTA with Japan. And it is currently negotiating similar arrangements with the US, Canada, EU, Australia, Chile, and Mexico. Singapore has also been pushing the idea of the Pacific-Five (P-5) FTA Initiative, which includes itself, the US, Australia, New Zealand and Chile. Not to be left behind, Thailand is also exploring similar arrangements with Australia and South Korea. On a bilateral level, Japan has held extensive consultations with Korea and Mexico on the possibility of entering free trade negotiations within the next few years. Korea has likewise entered into FTA negotiations with Chile and discussed possible FTAs with Mexico, New Zealand, Thailand, and Singapore.

The rise of Asian FTAs has been viewed by not a few with deep concern. The spread of sub-regionalism in the Asia Pacific region could serve to undermine the multilateral trading order under the World Trade Organization (WTO). Such initiatives could likewise negatively impact on other regional arrangements such as APEC and AFTA. What are the political and economic motivations behind these various schemes? What are the probable implications of these initiatives on existing regional associations and the international trading system? This paper briefly attempts to examine this subject by focusing on the twin proposals confronting ASEAN. This study seeks to look into the possible rationale and motivations behind the China and Japan proposals to establish an

* A paper presented at the 2002 APEC Study Center Consortium Meeting, "From the Asia Financial Crisis to a Global Recession: Towards a More Proactive Role for APEC?" in Merida, Mexico. 22-24 May 2002.

FTA with ASEAN. The paper will then conclude with an assessment of the repercussions to ASEAN, APEC and the WTO. Indeed, the evolving economic relations between ASEAN and China and Japan directly impacts on the future of Asian regionalism.

THE POLITICAL ECONOMY OF ASIAN REGIONALISM

In the past, Asian countries, particularly in the Northeast, have been averse to formal economic arrangements. Asian regionalism has primarily evolved through a market-led process, with the movement of trade and investment deepening economic interdependence. However, the institutionalization and expansion of regional inter-state cooperation developed at a much slower pace.

Peter Drysdale (2000) summarized the reasons why Asian countries traditionally avoid joining formal preferential arrangements. Firstly, he contends that the trading interests of Asian economies largely depend on countries outside the region like the US and Europe. These markets remain the principal export destinations and sources of investment capital for most Asian countries. Secondly, a free trade area could unnecessarily lead to trade diversion and potential trade conflicts within and outside the region. And thirdly, the different levels of development, the lack of trade complementarity, and the social, political and cultural diversity of the Asian region make it difficult to set up and operate regional cooperative institutions.

The basic framework for regional cooperation in the Asia-Pacific is the APEC forum. Since its launching in 1989, APEC's membership and economic agenda has grown. In 1994, members committed to the goal of free trade and investment by 2010 for developed economies and 2020 for developing countries. Member economies have since been lowering and removing their trade and investment barriers on a voluntary manner based on their respective Individual Action Plans (IAPs). The principle of open regionalism ensures that APEC complements rather than ran counter with the objectives of the multilateral trading order under the WTO.

The only other attempt at regionalism is the ASEAN Free Trade Area (AFTA), established in January 1992 as a means of strengthening members' competitiveness and encouraging investment inflows into the region. Since its formation, ASEAN members have accelerated the timeframe to reduce regional tariff rates to 0-5 percent and eliminate non-tariff barriers by 2002. More significantly, the grouping also agreed to target zero ending tariff rates on all products by 2010 for the original six members, 60 percent of which should be duty-free by 2003. In addition, ASEAN is working to reduce non-tariff barriers, harmonize standards, and improve access to services trade, among others.

Until recently, no Northeast Asian country belonged to any trade bloc. Japan has hitherto been a staunch multilateralist and has long spurned the preferential route to trade liberalization. This reluctance to participate in exclusive regional arrangements primarily stems from fear of offending the United States, its main trading partner. Tokyo's

participation in APEC and the principle of open regionalism has been consistent with this policy stance of inclusion rather than exclusion. While continuing a policy based on strengthening the WTO-centered multilateral trading system, Japan has now begun to consider bilateral agreements and free trade arrangements.

Since China embarked on its open door and modernization policy, Beijing has been primarily preoccupied with domestic economic restructuring and national development. The outcome of these reform policies has positively impact on the domestic economy and produced high growth rates. Moreover, the reintegration of Hong Kong and Macao was a major concern till the end of 2000. Its entry into APEC and its accession into the WTO were subsequent steps in this seemingly rational process of opening up to the outside world and speeding up the pace of economic modernization. Beijing's interest in pursuing a regional approach forms part of this strategy.

There have been previous attempts at forming pan-Asian economic arrangements. One such proposal was the East Asian Economic Caucus (EAEC) put forward by Malaysia. The EAEC would have included ASEAN with Japan, China, Korea, Taiwan and Hong Kong in an exclusive Asian bloc. EAEC was intended to provide the region an insurance against the anticipated market closure arising from the formation of NAFTA and the European Single Market. However, the idea was perceived to be exclusionary and hence received little support.

The traumatic experience of the Asian financial crisis provided added impetus for Asian regionalism. The ASEAN+3 arrangement evolved as Asian countries sought for regional solutions for the problems they confronted between 1997-1999. ASEAN+3 dialogue informally began in the context of ASEM, where ASEAN, China, Japan and Korea had to coordinate their positions in negotiations with the European Union. This eventually progressed and took a more institutionalized form at the first ASEAN+3 Summit, which took place in December 1998, with leaders agreeing to deepen relations between themselves. The Manila Summit held the following year subsequently adopted a Joint Statement on East Asia Cooperation, committing members to build upon existing consultative and cooperative activities in the areas of economic cooperation, monetary and finance, social and human resource development, scientific and technical development, security and transnational issues. China, Japan and Korea continue to be engaged in the ASEAN + 3 process, where institutionalization has since been proceeding quite rapidly.¹

EXPLAINING ASIAN BILATERALISM

What factors contributed to this shift towards bilateralism or regionalism? Theory offers different explanations as to why countries join PTAs.² The international political economy of regionalism shows that systemic changes can encourage countries to establish preferential arrangements. Structural changes in the global economy induce

¹ In May 2000, ASEAN established a network of bilateral swap arrangements with China, Japan and South Korea under the Chiang Mai Initiative.

² See Hurrell (1995), Haggard and Simons (1987), and Mansfield and Milner (1997).

states to cooperate to reduce collective action problems. Moreover, the growing interdependence between economies creates spillover effects and, consequently, fosters a desire to cooperate in other areas. Countries benefiting from the relationship will seek to reduce transaction cost and expand economic cooperation. From a political perspective, shifts in the distribution of economic wealth can lead states to create alliances to enhance their bargaining power. Cooperation builds mutual support on issues of common interests to its members. Finally, regionalism may be a manifestation of the national leadership's response to their domestic situation. International commitments can be used to maintain outward-looking policies and push forward much needed economic reform at home. These represent some of the possible motivations behind regime-formation and will be further discussed below.

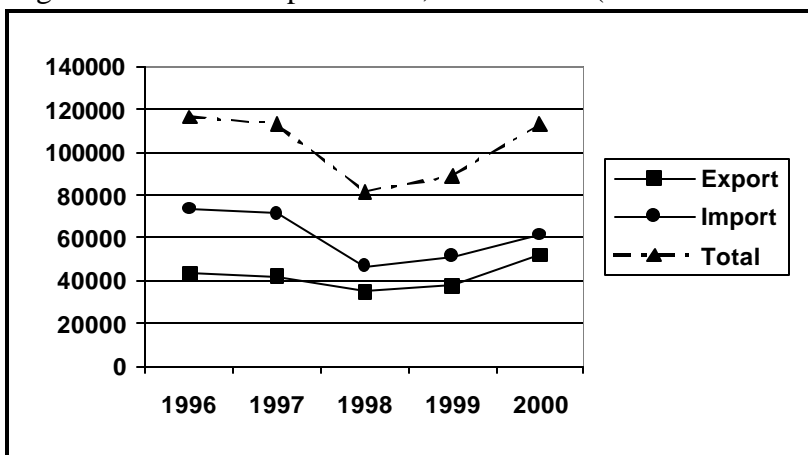
Increasing Interdependence

There are varied reasons why countries desire to establish or join preferential trading arrangements. For one, cooperation stems from the expectation of benefit derived from increased economic interdependence within the region. Consequently, states will seek to lower barriers to entry and facilitate greater intra-regional exchange to further growth. In fact, growing intra-Asian trade and investment has been a key factor in the rapid growth of Asian economies. Over the past few decades, Asian countries have traded and invested more with neighboring states increasing their market shares in their respective economies. This has created an expanding network of commercial relationships, which in turn, fostered greater inter-governmental cooperation to facilitate such transactions.

ASEAN economic ties with China and Japan have deepened in the past few years. Starting in the 1960s, Japanese investments in Southeast Asia's manufacturing sector help build region-wide production networks linking the two economies together. The appreciation of the yen in the 1980s and Japanese ODA, particularly in heavy industries and infrastructure, has further stimulated Japanese FDI in ASEAN. Japanese capital inflow into ASEAN and intra-industry exchange among Japanese subsidiaries operating throughout the region has directly contributed to the increase in intra-regional trade.

ASEAN has been Japan's important supplier of raw materials, production base for manufacturing industries and market for manufactures. ASEAN supplies both industrial and agricultural raw materials, at reasonable prices, which have been instrumental in Japan's rapid economic development. Japan also uses ASEAN as an important production base for her manufacturing industries, which have succeeded in penetrating international markets (Lim, 1994). Trade between Japan and ASEAN amounted to US\$113.4 billion in 2000, slightly below pre-crisis levels (see Figure 1). Japan commonly enjoys a trade surplus with ASEAN. However, the gap has significantly narrowed with ASEAN exporting more to Japan. In 2000, ASEAN mostly exports machinery and electrical appliances, mineral products, agriculture and prepared foodstuffs, and wood and wood articles (see Annex).

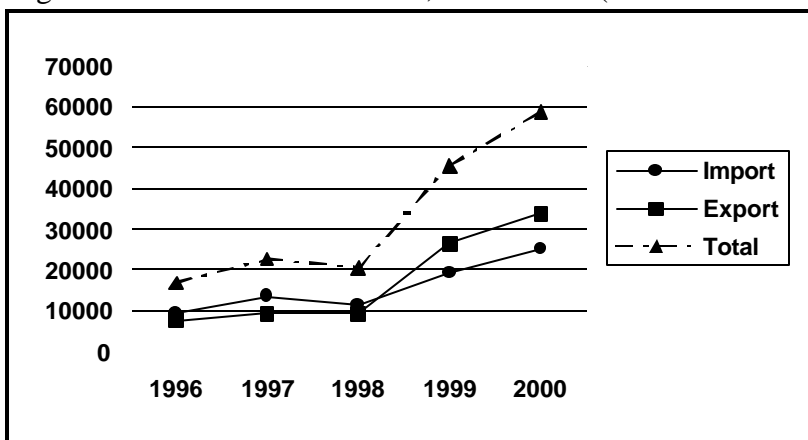
Figure 1: ASEAN-Japan Trade, 1996-2000 (in US\$ million)



Source: ASEAN Secretariat

China's economic relations with ASEAN have likewise grown. Two-way trade reached US\$58.8 billion in 2000, growing by two and half times between 1996-2000 (see Figure 2). ASEAN main exports to China include machinery and electrical appliances, mineral products, agriculture and prepared foodstuffs, plastics, and textiles and apparel (see Annex). The Chinese market enabled ASEAN economies to export itself out of the recession with exports amounting to US\$33.8 billion in 2000, more than triple compared to levels in 1996. Meanwhile, the share of China in ASEAN's trade has grown from 2.1 percent in 1994 to 3.9 percent in 2000.

Figure 2: ASEAN-China Trade, 1996-2000 (in US\$ million)



Source: ASEAN Secretariat

Japan is still a major investor in ASEAN. With the recent weakening of the Japanese yen, however, fewer companies are shifting out and investing overseas. On the other hand, the Chinese government has been encouraging local firms to "go outside" and invest overseas, particularly in Asia. Though still modest in absolute terms, Chinese investment is growing at a rapid pace. In 2000, the Chinese Government approved

US\$108 million in new investment to the ASEAN region, a 50 per cent higher than the previous year's. Reports speculate that the actual figure might be higher as many Chinese companies try to circumvent official foreign currency controls by investing through offshore entities.³ An arrangement with ASEAN could further encourage foreign investor interest, put off by the Asian financial crisis, from within and outside the region.

The prospect of greater commercial gain from deeper economic exchange is a good reason for moving towards an FTA. Countries join a PTA to enhance the region's welfare if these arrangements create more trade among its members than they divert. Initial assessments made by the ASEAN-China expert study group of the welfare effects of an ASEAN-China FTA calculate that ASEAN's exports to China would grow by 48 per cent and China's export to ASEAN, by 51 per cent. A China-ASEAN grouping would have a combined GDP of at least US\$ 1.6 trillion. There are no similar studies to calculate the effects of an ASEAN-Japan FTA, but such an arrangement would have a combined GDP of more than US\$5.5 trillion (see Table 1). A PTA can likewise increase market power and attract greater foreign investment to the region.

Table 1: Comparative Economic Indicators

	GDP (in billion US\$)	GDP per head (in US\$)	Exports (in billion US\$)	Imports (in billion US\$)
China	902	860	249	225
Japan	4,812.1	38,160	479	380
ASEAN	580	1,121	425	354

Source: WTO, ASEAN Secretariat

Coping with Structural Change

Countries also join a PTA to cope with changes in the international economic environment. Rising pressures from globalization affect all countries compelling them to find new ways to address these external challenges and improve their economic well being. Globalization has made it more difficult for countries, particularly small economies, to attract foreign capital and maintain export competitiveness. States cooperate to reduce collective action problems posed by the globalized economy.

One particular change in the world economy is the rise of preferential trading arrangements (PTA). The number of regional trade agreements notified to the WTO has soared over the last decade. There are now around 113 separate arrangements with many countries, both developed and developing, now participating in one form or another. According to the WTO, approximately 43 per cent of all trade takes place within regional trade agreements between two or more countries. It projects this to rise to 51 per cent by 2005, with the number of PTAs growing to more than 180.

³ See Dhume and Lawrence (2002).

In response to regionalism in Europe, North America and elsewhere, Asia has initiated its own regional mechanism aimed at economic integration and securing their terms of trade. Faltering faith in the ability of the multilateral trading system to further sustain the momentum of trade liberalization demonstrated by the failure to launch a new round of multilateral trade negotiations in Seattle also contributed to bloc formation. Japan and China, already suffering from trade diversion from other trading groups, may feel being left out of this trend. The fear of market closure and increased discriminatory policies brings about bloc formation as an insurance policy.

The Council on Economic and Fiscal Policy, Japan's top economic policy advisory body composed of government and private sector leaders, has urged its government to pursue bilateral free trade agreements to enable the country to cope with increased global economic competition. According to Yamamoto and Kikuchi (1998), the domestic recession, increasing hostility from the US, and the near collapse of the Uruguay Round caused a shift in thinking in Tokyo. In its 2001 White Paper, Japan's METI declared,

“The broadening and deepening of regional integration around the globe, as well as the development of alliances among regional groupings, is a manifestation of nations' efforts to respond to the evolving global economy. In this sense, a multi-layered perspective will also become increasingly important in terms of Japan's trade policy. While the baseline of Japan's policy is the strengthening of the multilateral trade system, centered around the World Trade Organization, on top of this we need to develop an appropriate combination of multilateral efforts such as trade and investment liberalization and the creation of international rules; regionalism, in the form of bodies such as the Asia-Pacific Economic Cooperation forum; and bilateral relations with the United States and countries in Europe, East Asia and elsewhere, creating an international economic system geared to the speed of change and the sheer diversity of the global economy... In light of the economic development of other regions, Japan stands to gain economically from pushing further ahead with regional integration.”

Commensurate with its rise in world status, an increasingly confident China is eager to play a more active leadership role both at the global and regional levels. Successes in domestic economic reform have encouraged a more dynamic Chinese trade diplomacy in both the global and regional fora (Drysdale, 2000). Since its membership in 1991, Beijing has been actively participating in APEC culminating with its hosting of the 2001 Leaders Summit in Shanghai. China has demonstrated its support in APEC by undertaking unilateral and voluntary liberalization of its trade and investment regime (Zhang, 1998). Its entrance to the WTO demonstrates Beijing's desire to take a more active role in the multilateral trading system. China aggressively pursued its accession into the WTO in order to gain representation and influence the formulation of the trade rules and disciplines. Membership in the WTO also becomes necessary in the further development of China's trade relations with other countries.

An FTA with ASEAN is a manifestation of this trade strategy. China seeks to deepen its economic relations with its Southeast Asian neighbors and diversify its export markets away from dependence on its traditional markets and play a leadership role in Asia. Partnership with ASEAN will also give China a stronger voice and influence in multilateral negotiations under the WTO.

Contesting Regional Leadership

Politics, rather than economic reasons, may very well underpin the motives of China and Japan. Realist explanations of international relations emphasize the self-interests of contending nation-states and the balance and shifts of political and economic power. China and Japan have had a long history of conflict each looking upon the other with suspicion. Both still regard one another as a security threat and power rival in Asia. Hence, ASEAN may be viewed as the arena of China-Japan rivalry over regional leadership. The Koizumi initiative, coming only two months after top Chinese and ASEAN leaders agreed to conclude an FTA, has been viewed by not a few as a bid by Japan to counter China's intensified dialogue with ASEAN members.

There are domestic concerns that Japan was seeing its status as the regional leader usurped by an emerging China. For much of the post-war period, Japan has been the leading economy in the industrial development of the East Asian region. The flying geese paradigm of regional specialization characterized this structure that centered on Japan. The flying geese pattern of economic development fostered industrial specialization and location thereby creating greater complementarity in the region. Japan has also played a leading role in the promoting Asia Pacific economic cooperation. Yamamoto and Kikuchi credits Japanese MITI for the initiation of APEC.

The Japanese model, which centers on strategic industrial policy, has however lost favor particularly after the Asian financial crisis. Government intervention in the economy and the keiretsu-type of economic structure in many Asian countries was partly blamed for the economic downturn following the banking and exchange rate crisis that spread throughout the region in 1997. Moreover, continued recession in Japan stemming from its own financial problems and weak domestic demand prevents it from acting as an engine for regional growth. As many have observed, Japan's leadership position, so closely related to its economic success in the post-war period, has progressively declined over the past decade.

Meanwhile, China is rapidly making gains on Tokyo's once-dominant position as Asia Pacific's economic leader. The Chinese economy continues to expand at phenomenal growth rates. China has recently emerged as the fourth largest trading nation in the world (if we include Hong Kong). The country also continues to take in the lion's share of foreign direct investment drawn by its huge market. FDI in China now account for almost a third of the cumulative FDI that goes to developing countries. Japan's Ministry of Economy, Trade and Industry, in its 2001 White Paper, noted increasing competition from China:

“Changes have also been appearing in the behavior of foreign affiliates using East Asia as a production bases. In recent years, some companies have been shifting their production bases from the NIEs and the ASEAN 4 to China, or moving directly out of their home countries and bypassing the NIEs and the ASEAN 4 to set up production bases in China. China’s share has grown substantially in all cases. A look by industry at the total asset value of foreign affiliates in China also indicates that companies are investing in both labor-intensive industries such as textiles and technology-intensive industries such as machinery...China is not only pushing up its production and export volume, but has also increased its international competitiveness from the comparatively labor intensive textile industry through to the comparatively technology-intensive machinery industry.”

Imports from China now have an enormous impact on Japan. In the last five years alone, Chinese imports have risen by 76% and now account for 15% of Japan's total imports. Last year, the two countries almost figured in a full-scale trade war. The dispute began in April 2001 when Japan slapped 256% import tariffs on a range of Chinese agricultural exports, including mushrooms, leeks, and straw, worth about US\$100 million. Chinese exports of fresh and frozen vegetables to Japan, which enjoy a greater price competitiveness compared to Japanese like products, have significantly increased. The following June, China retaliated with punitive 100% tariffs on a range of Japanese imports, including mobile telephones, cars and air conditioning units, worth US\$700 million a year. A trade war was averted only after Japan withdrew but the incident foreshadows the future economic relations between the two countries.

Japan has resorted to devaluing its currency to improve its terms of trade and export its way out of its decade-long economic slump. The current weakness of the yen will further slow Japanese companies' investments in ASEAN and may reduce Japanese demand for Southeast Asian exports. One may recall, the Japanese yen's sharp slide against the US dollar and the subsequent devaluation of the Chinese renminbi contributed to the Asian financial crisis. The renewed weakness of the Japanese yen is again greeted with much concern in Asia. Fears of a weaker yen could prompt China to devalue the yuan and trigger another round of competitive devaluations around Asia. China has joined a chorus of Asian countries warning Japan that the weakness of the yen was jeopardizing economic and currency stability in the whole region.

Locking In Domestic Reform

Domestic factors may offer another explanation for this growing Asian regionalism. PTAs help reinforce domestic economic reforms and market-based policies. Trade liberalization facilitates the entry of new services and products thereby fostering a more competitive domestic market. Governments can carry out crucial structural reform by carrying out its trade commitments. These legal commitments, whether at the regional or global level, can be used to counterbalance vested interests and open protected markets.

China's foreign policy is essentially driven by how to promote domestic market reform and further modernize its economy. The Chinese government has recognized for a number of years that economic reform and open markets are cornerstones of sustainable economic growth. Since adopting its open door policy, Chinese leaders have sought to let the market play a more dominant role in their economy (Jin, 1993). This policy includes reducing entry barriers in trade and investment and expanding foreign economic relations. China's accession to the World Trade Organization is expected to further advance this process. As Drysdale observed, China's entry into the WTO will secure its commitment to further liberalization and discipline according to its obligations under the accord. China membership in WTO will bring the reduction and elimination of tariffs and prompt the international flow of goods, as well as improve the efficiency of China's domestic market. In addition, trade liberalization would force the pace of reform in other areas, particularly in the management of the state enterprise sector and financial and foreign exchange markets.

Robust growth figures have so far allowed China wide latitude in absorbing foreign competition. Once the economy falters and unemployment surges, domestic support for reform may fall. Government at the central, provincial, and local levels has sought to protect emerging or noncompetitive sectors from foreign competition. Resistance at the provincial and local levels of government has restricted the central government's ability to implement trade reforms. Import barriers, a nontransparent and inconsistent legal system, and limitations on market access combine to make it difficult for foreign firms to compete effectively in the domestic marketplace. While China today has a more open economy, substantial entry barriers remain in place.

Beijing fears that further market adjustment could further exacerbate unemployment and lead to social unrest. Many Chinese enterprises, particularly lumbering state-owned enterprises that employ around 55 per cent of urban workers, are not competitive. The entry of foreign firms and increased import competition may lead to widespread factory closings and worsen high levels of unemployment. Already, there have been widespread reports of labor protests across China, some of which apparently stem from government efforts to close down unprofitable state enterprises.

Nicholas Lardy (2002), senior fellow at the Brookings Institution, assesses that as China implements its WTO commitments, it will be faced with rising domestic unemployment particularly in agriculture and other capital-intensive industries subject to drastically increased competition. Lardy contends that unless China increases significantly its exports of apparel and other labor-intensive goods in which it has a strong comparative advantage, it is unlikely to be able to maintain unemployment at politically acceptable levels. China has lately been experiencing excess supply capacity in its domestic market and is seeking export outlets for its products. Hence, an FTA with ASEAN will enable China to maintain its export levels particularly amidst sluggish demand in the US, Japan and Europe.

Japan faces a similar, if not, more daunting dilemma. For the past two decades, Japan remains mired in economic stagnation, due to weak domestic demand and a deeply distressed financial system. The country has experienced steady deflation since the mid-1990s giving it the distinction of being the only effectively shrinking economy among industrialized countries. Its economic problems are further exacerbated by rising debt that now account to 130 per cent of gross domestic product. Japan's leadership position has also somewhat eroded by its shrinking trade surplus indicating a general loss of international competitiveness. Japan's trade surplus with the rest of Asia in 2001 fell to a less than half from the previous year because shipments of semiconductor products fell amid a worldwide IT slump.

More fundamentally, Japan's competitiveness have progressively eroded over the past years partly due to competition from Korea and, more significantly, low-cost China. Chinese factory workers work only at 5 percent of Japanese wage levels and they are narrowing the quality gap prompting many Japanese MNCs to transfer to the mainland. Over the years, Japanese firms have been moving their production bases overseas prompting fears of "industrial hollowing-out" or de-industrialization in Japan. Japanese firms, particularly in textile, consumer-electronics, agriculture and retailing industries, have moved production offshore to skirt high costs at home.

Government attempts at reflating the economy with higher public spending have so far failed to produce positive results. The Bank of Japan has also lowered short-term rates effectively to zero interest to encourage business activity. However, the Japanese government has been reluctant to undertake more fundamental reform of its financial system and open up its agriculture sector to foreign imports. Basically, Japan's problems stem from its reluctance to reform its certain distinctive features of its economy, including the keiretsu networks, bureaucratic interference in the economy, and the hold of vested economic interests on party politics.

Instead, as mentioned earlier, Japan has decided to export itself through its weak yen policy out of its recession instead of stimulating more domestic demand. The Initiative for Comprehensive Economic Partnerships between Japan and ASEAN (ICEPJA) was partly conceived to enhance the international competitiveness of Japan. The Initiative does not really propose anything new but rather reaffirms Japan's typical attitude towards ASEAN, i.e. regarding the region as an export market, as a production base, and as a source of raw materials.

ASEAN RESPONSES TO REGIONALISM

ASEAN has generally been receptive of both initiatives. They view this development as a natural progression of the dialogue partnerships with these countries. The ASEAN Dialogue process has been going on for several years and involves information exchange, facilitation and promotion, and technical cooperation in a broad range of areas including economic, social, political, and security issues. The Dialogue mechanism has essentially been a political process under the auspices of the foreign

affairs ministries until a parallel structure was set up for economic cooperation. ASEAN formally began its dialogue with Japan in 1973 and with China in 1999 (though consultations have been taking place since the 1980s). Relations have deepened over the years with consultations and exchanges taking place at both the government and private sector levels.

ASEAN and China

ASEAN Leaders accepted the proposal of Chinese Prime Minister Zhu Rongji and agreed to establish an FTA within 10 years or by 2010 at the latest. The event was significant as it departed from the usual norm. This was a political decision by the heads of government without the benefit of the usual preparatory work by senior economic officials. The norm would have had junior officials discuss and negotiate the proposal first, which they would later endorse to their ministers for approval by their respective leaders. This unprecedented decision underlines the importance that ASEAN Leaders place on their relations with China. Both sides also agreed to an “early harvest”, which will precede comprehensive market access negotiations on industrial goods and services.

Earlier, a joint China-ASEAN Expert Group on Economic Cooperation was formed to examine the prospects of economic cooperation and recommend the possible scope of the FTA. The report was released in October 2001 endorsing the establishment of an FTA. A Trade Negotiating Committee (TNC) has since been formed and will be the primary negotiating forum between ASEAN and China. The TNC recently met in Beijing to begin discussions on the scope of the Framework Agreement and the modalities of the negotiations (see Table 2). It has been recommended that the mechanism of the CAFTA might follow the process and timeframe followed by the ASEAN under the AFTA-CEPT scheme, which involves drawing up product lists and progressively working out their tariff reduction.

By 2010, average duty within the ASEAN-China FTA, if realized, will vary between zero and 5 per cent, and internal trade and investment barriers will be eliminated. According to the report by the ASEAN-China Expert Group (2001), an FTA between ASEAN and China would have a combined regional GDP of about US\$2 trillion and total trade estimated at US\$1.23 trillion. The deal would create a huge single production base for FDI to take advantage of cheap labor and resources.

There is considerable apprehension in the ASEAN region over the proposal to set up an FTA with China. Malaysia, the Philippines and Indonesia are reportedly less than enthusiastic about the plan while Singapore and Thailand are its leading advocates. In fact, the ASEAN Free Trade Area was partly conceived with China in mind. AFTA was to enhance the region’s attractiveness to foreign investment that has been moving at greater numbers away from Southeast Asian and into China. The diversion of FDI to China has been further aggravated by the structural weakness of ASEAN countries brought to light during the financial crisis.

Unable to match its low labor costs, many also fear being overwhelmed by the competitive pressure from China. Domestic industries are terrified of being flooded by cheap Chinese goods. ASEAN countries also face a huge competitive challenge in third country markets because their export structure is much more similar to China, particularly in the textiles and clothing and electronics sector. On the other hand, some see China's huge consumer market as tempting and anticipate opportunities from growing demand in China. The region's exporters, hard hit by slump in demand in industrialized countries, have increasing look towards the Chinese market to compensate for sluggish growth in Japan, US and Europe. China's demand for low-cost agricultural products, particularly tropical and sub-tropical goods, is likely to increase. The demand for raw materials, particularly oil, gas and other minerals are also expected to increase (Adhikari and Yang, 2002).

In entering into an FTA with ASEAN, China is trying to ease somewhat the association's anxieties about its emerging economic power. Chinese pronouncements try to reassure ASEAN that the FTA is a positive relationship of mutual benefit. They contend that a China-ASEAN FTA would help re-direct some of the foreign investment flowing to the mainland to benefit the rest of the region. The economic downturn and social turmoil following the Asian financial crisis has undermined investor confidence in the region and an FTA with China could revitalize foreign investor interest and help crisis-hit economies gradually rebuild their economy. Recent rise in Chinese investment in the region is also meant to reassure ASEAN countries that China also seeks to channel some of this capital to the region. However, China's overwhelming advantage will lead ASEAN members to seek greater concessions or compensations from the Chinese side such as the provision of a special safeguard condition in the agreement similar to what China accepted for its membership in the WTO.⁴

ASEAN has been trying to engage China for many years. Its sheer size, military power and ideological posture are causes for concern about China's regional ambitions. Unease about Chinese intentions is also founded on Beijing's past support of indigenous communist movements and its ties to ethnic Chinese residing across the region. Rather than confront, ASEAN has tried to include China in political and security dialogue in an attempt to get the Middle Kingdom constructively involved in ensuring regional peace and stability. For instance, ASEAN has sought Chinese participation in trying to resolve overlapping territorial claims in the Spratlys and Paracel Islands. The ASEAN Regional Forum (ARF) has been the principal multilateral forum used to constructively engage China in regional security dialogue.

Economic diplomacy has also been employed to enhance the political and security relationship with China. Since the 1980s, individual ASEAN countries have sought to expand bilateral trade and investment ties with China. The formation of APEC was also partly conceived as a way of integrating China's socialist economy into the world

⁴ As a condition to its admission to the WTO, China had to accept a transitional product-specific safeguard clause that allows other WTO members to limit imports of Chinese goods. China also agreed to a longer phase-out period for quotas on imported Chinese clothing and accepted for 15 years discriminatory WTO-plus terms in anti-dumping cases brought against its goods.

economy. A rich and prosperous China would have an interest in a stable and peaceful security environment and would avoid encouraging or supporting destabilizing elements in the region. ASEAN is also keen to convince Beijing that a prosperous and stable Southeast Asian region offers the greatest security for China. Hence, an FTA with China is within ASEAN's economic and political interest.

ASEAN and Japan

The ICEPJA is at a much earlier stage of discussion but no less significant. Since the announcement of Prime Minister Koizumi, officials from both sides met last January in Thailand to discuss the work program that will outline economic cooperation between ASEAN and Japan. There was an agreement to create an expert group, similar to the one that completed the China-ASEAN report, to study the matter further and submit their recommendations for the consideration of their leaders at their scheduled summit this November.

There is, however, some skepticism about the Koizumi initiative. Some quarters within ASEAN feel that the proposal was rather hastily put together and was short of any new ideas. Both sides already cooperate in a wide range of areas included in the Koizumi proposal, which offered to deepen existing relations but gave little detail. Usually, such an important policy speech would have gone through months of study by the bureaucracy in Tokyo, who would have also sought ASEAN receptiveness of the proposal before an official declaration is made. Koizumi's policy pronouncement seems more like a defensive response to counter China's FTA initiative rather than a genuine plan aimed at deepening trade and investment ties with ASEAN. Moreover, many are doubtful about Japan's seriousness for further liberalization given its own inability to carry out much needed reform of its domestic economy. With an economy in dire straits, ASEAN does not expect any bold gestures from Japan.

In fact, Japan is rather ambivalent in developing an FTA with ASEAN as a whole. Rather, it seeks to engage individual ASEAN members in an FTA as they have done with Singapore. This is part of a two-pronged strategy of Japan's regional policy, dealing with ASEAN at regional and bilateral levels. The proclaimed reason for this strategy is that the different levels of economic development of ASEAN's members necessitates differential approaches to the creation of an FTA. However, this may also be viewed as a strategy of divide and rule thereby limiting any concerted ASEAN response to Japan. After concluding an FTA with Singapore, Japan is currently pursuing a similar agreement with Thailand and the Philippines.

Japan has indicated its readiness to accept an early harvest before free trade negotiations with each ASEAN country that will form part of the regional CEP. At this stage of the discussions, Japan has not excluded any matter from the agenda (see Table 2). While expressing its willingness to include agricultural goods in the scope of negotiations, there are concerns that Japan's insistence on maintaining agricultural protection could cause negotiations to bog down. Japanese earlier reluctance to open up this sector caused the EVSL negotiations in APEC to falter. According to the WTO, the

agricultural sector remains relatively well protected from foreign competition. The average tariff on imports of agricultural products remains high, tariff quotas can be intricate, and a number of these products receive domestic support. Overall level of government assistance for agriculture (as measured by producer and consumer support estimates) is reported to be well above the OECD average.

ASEAN wants to include agricultural products in any FTA with Japan. In the face of strong pressure from domestic farm lobbies and their supporters within the ruling Liberal Democratic Party, Japan seeks to establish special safeguard measures in order to counter sudden import surges. In establishing a free trade arrangement, Japan also seeks sufficient flexibility in the time frame for liberalization. In addition, Japan wants the arrangement to accord national treatment to Japanese investors in pre-establishment and post-establishment of investments as well as to prohibit measures that hinder such investment (such as export performance requirements and local content rules). Such a proposal may encounter resistance from ASEAN countries unwilling to open up key industries to foreign ownership and competition.

Table 2: Scope of Negotiations

Possible Areas of Cooperation	ASEAN-China FTA	ASEAN-Japan CEP
Trade and Investment Facilitation	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
Rules of Origin	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
Customs Procedures	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
Standards and Conformity Assessment	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
Trade in Services	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
Movement of Persons	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
Intellectual Property	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
Investment Agreement	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
Government Procurement		<input checked="" type="checkbox"/>
State Trading Enterprises	<input checked="" type="checkbox"/>	
Competition Policy		<input checked="" type="checkbox"/>
Promotion Measures	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
Science and ICT	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
SMEs	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
Education, HRD, and Cultural Exchange	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
Capacity Building and Technical Cooperation	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>

Both initiatives will take time to negotiate and we should expect more details later. In entering into such negotiations with China and Japan, ASEAN will have to address some problems of its own. ASEAN's diverse levels of economic development and cultures would make any FTA difficult to implement at a regional level. For instance, the developmental gap between the original ASEAN members and the CLMV countries is considerable and efforts to bridge the gap will take some time. Confronted with such

problems, trade liberalization in AFTA has slowed down. The economic gap among ASEAN countries indicates that individual countries will have different processes and requirements on advancing an FTA with either China or Japan. Hence, flexibility will certainly be an important consideration in the negotiations and may dilute the substance of the FTA.

The China and Japan initiatives could distract ASEAN from advancing its own regional integration under AFTA. The 1997 Asian financial crisis has already dampened somewhat ASEAN's drive towards AFTA and work on the Chinese and Japanese proposal would further divert its attention. On the other hand, an FTA with either China or Japan would force ASEAN to move more rapidly in developing its own regional FTA and perhaps advance towards a common market. Certainly, ASEAN needs to act more concertedly in promoting regional economic integration for its own merits. Ironically, unilateral actions on the part of some of its members to conclude bilateral FTAs with non-members and moves at excluding sensitive sectors from tariff reduction could undermine progress in AFTA.

ASEAN also faces a more basic problem of a shortage of negotiating capacity. Resources and personnel are already spread too thinly to cover the various trade forums. With a new WTO trade round, members will be preoccupied with the work program in Geneva. Moreover, much remains to be accomplished in AFTA particularly in non-tariff barriers and trade in services to keep trade official busy. Though not in the form of formal binding negotiations, the official meetings of APEC no less make demands on the capacity of ASEAN countries.

The plethora of trade liberalization efforts could likewise lead to free trade fatigue and erode domestic support for market reforms. Some have questioned the benefits of membership in the WTO and their Uruguay Round commitments, particularly among developing countries. Further market opening pressures arising from FTA arrangements could encounter stiff resistance from sectors already reeling from import competition. Many industries throughout Southeast Asia have yet to recover completely from the devastating effects of the Asian financial crisis. The potential of a political backlash among domestic constituencies in developing countries could lead to a reversal of trade reform efforts and a return to protectionist policies.

IMPLICATIONS FOR APEC AND THE WTO

This new Asian regionalism can distract political attention away from the rules-based multilateral system. After the Seattle debacle, the regional route to trade liberalization has become an attractive option. And despite an agreement to begin a new round of multilateral trade negotiations after the WTO Ministerial Meeting in Doha, Asian countries have decided to proceed in establishing preferential arrangements. Moreover, these Asian FTAs may also divert attention away from APEC. Some feel that APEC has simply lost its momentum after its membership has grown too big and its scope become too broad. APEC's failure to play a constructive role during the Asian financial crisis and the unsuccessful EVSL negotiations has dampened enthusiasm for the

association. Slow progress in the WTO and APEC and rising regionalism elsewhere has led to renewed interest in forging bilateral preferential pacts as an alternative route to trade liberalization.

To be sure, issues of WTO-consistency and complementarity with APEC and AFTA objectives and goals will be relevant in structuring these bilateral FTA arrangements. They should remain outward oriented and avoid protectionist tendencies to ensure that they do not become stumbling blocs to multilateral trade liberalization. The fact that many of these initiatives are CEPs or FTA-plus arrangements give good reason that they can act as building blocs in the international trading order. The scope of these so-called “new age” FTA initiatives includes discussions on investment, competition policy, human resources development, technology exchange, capital market development, etc. Hence, these bilateral FTAs can provide positive pressure on WTO negotiations and help sustain global trade liberalization.

China’s decision to enter into an FTA agreement with ASEAN soon after its admission in the WTO and its continued participation in APEC is illustrative of a multi-layered approach to trade liberalization that many Asian countries have now adopted. Trade diplomacy in Asia is increasingly being conducted at the multilateral, regional and bilateral levels. While regional free-trade agreements may seem to be attracting greater interest in Japan, these initiatives does not depart from it's commitment to the multilateral trading system. Koizumi made it clear that Japan-ASEAN cooperation should be linked to East Asian cooperation as a whole, involving other countries such as China, Korea, Australia, and New Zealand. Nevertheless, Japan’s pursuit of bilateral trade pacts represents a significant departure from its traditional multilateral policy stance.

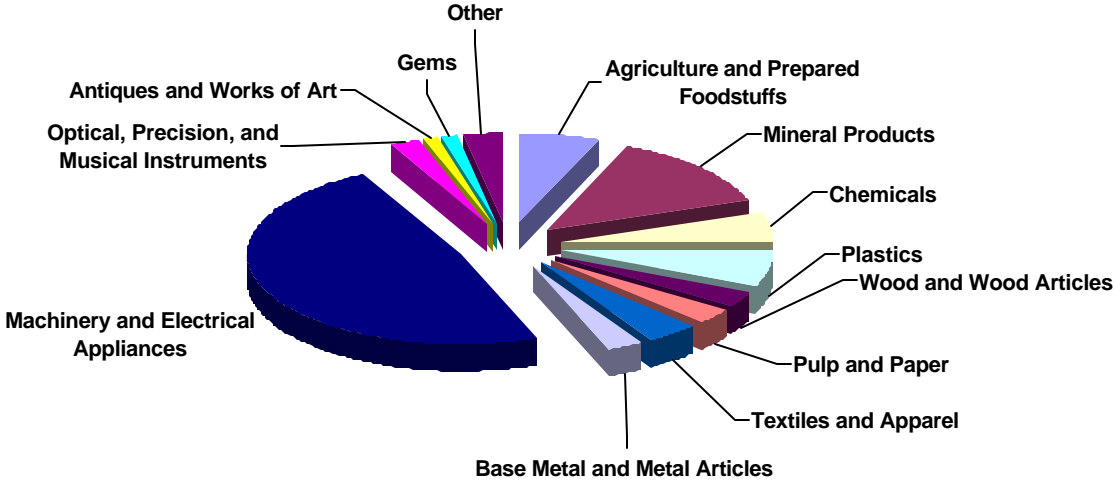
This multi-layered approach should be appropriate for Asia, given its diversity and different levels of development. Most likely, we will continue to see bilateral, regional and multilateral agreements develop in parallel with each other. The negotiations in the new WTO work program and discussions on the new issues will probably bring talks beyond 2005. Sheer bureaucratic momentum will guarantee continued work, though at a sluggish pace, in APEC and AFTA. Moreover, deliberations on both FTAs are still very much at the early stage. Hence, Asian governments will seek to safeguard their interests at different levels of the international economy.

But if ASEAN FTAs with China and Japan were realized, they would have enormous market power difficult to ignore. Such economic alliances will also make for stronger negotiation leverage at the multilateral forum. These FTAs can be more forward-looking and far-reaching in scope and coverage. In addition to accelerating the process of eliminating tariffs, these FTAs can also set out new trade rules that are still being discussed or not yet raised at the WTO. The initiatives by China and Japan may be a means of building political momentum for APEC, AFTA and the new trade round launched in Doha. Indeed, Asian regionalism will reverberate throughout the entire world economic system.

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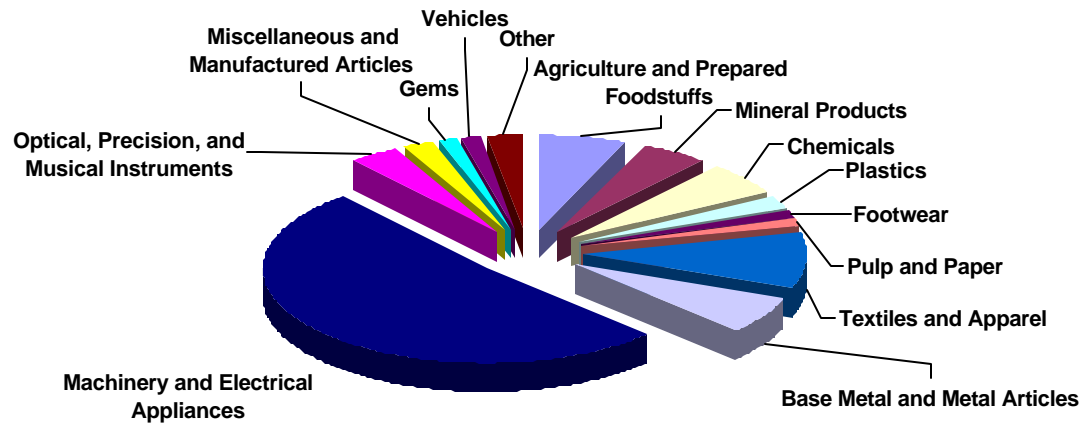
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ASEAN Export To China by Product Section 2000



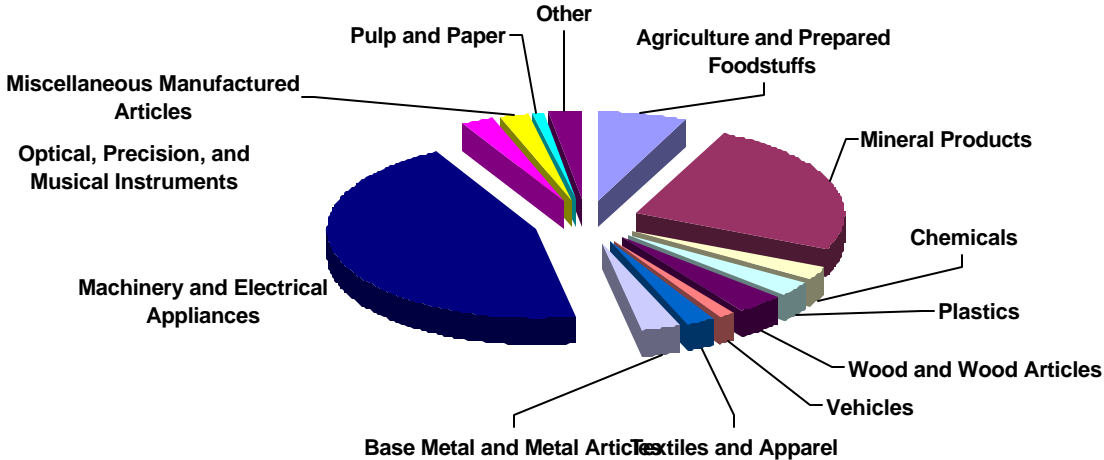
Note: Agriculture and Prepared Foodstuffs include Live Animal, Vegetable Products, Fats and Oils product sections. Other includes the product sections Hides and Leather, Footwear, Stone/Cement Arms, Vehicles, Miscellaneous Manufactured Articles among others.
 ASEAN countries cover only Brunei Darussalam, Indonesia, Malaysia, Philippines, Singapore and Thailand.
 Source: www.aseansec.org

ASEAN Import from China by Product Section 2000



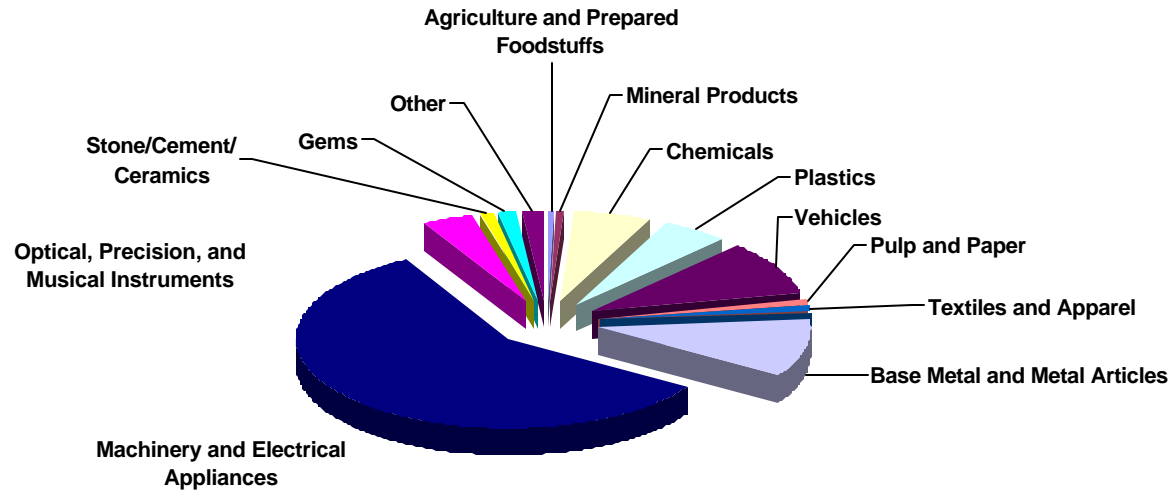
Note: Agriculture and Prepared Foodstuffs category include Live Animal, Vegetable Products, Fats and Oils product sections. Other category includes the product sections Hides and Leather, Wood and V Arms, Antiques and works of art, Stone/Cement/Ceramics among others.
 ASEAN countries cover only Brunei Darussalam, Indonesia, Malaysia, Philippines, Singapore and Thailand.
 Source: www.aseansec.org

ASEAN Export to Japan by Product Section 2000



Note: Agriculture and Prepared Foodstuffs category include Live Animal, Vegetable Products, Fats and Oils product sections. Other category includes the product sections Hides and Leather, Wood and V Articles, Arms, Antiques and works of art, Stone/Cement/Ceramics among others.
 ASEAN countries cover only Brunei Darussalam, Indonesia, Malaysia, Philippines, Singapore and Thailand.
 Source: www.aseansec.org

ASEAN Import from Japan by Product Section 2000



Note: Agriculture and Prepared Foodstuffs category include Live Animal, Vegetable Products, Fats and Oils product sections. Other category includes the product sections Hides and Leather, Wood and Wood, Arms, Antiques and works of art, Miscellaneous Manufactured Articles among others.
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