

Embedding Pacific Asia in the Asia Pacific: The Global Impact of an East Asian Community

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Toward an East Asian Community

It seems clear that the countries of East Asia are heading steadily if slowly toward the creation of a regional community, or at least an East Asia Free Trade Area (EAFTA). It will take considerable time to reach that ultimate goal. The process will undoubtedly suffer setbacks along the way, as has happened in the parallel regional integration experiences in Europe and the Western Hemisphere. The eventual entity may not be formally called an “East Asian Community” or even an “East Asia Free Trade Area” nor be managed by a set of centralized institutions as in Europe. The final configuration may indeed be a messy combination of bilateral and subregional compacts rather than a single neat agreement *à la* European Union or even the North American Free Trade Agreement (NAFTA).

But the rest of the world, and many Asians themselves, may not realize the progress that East Asia is making toward construction of a functional regional economic zone. *Virtually every possible combination of the core Asian group—consisting of the original members of the Association of Southeast Asian Nations (ASEAN) along with China, Japan, and Korea—is already engaged in active integration efforts.* Some have already concluded free trade agreements (FTAs), such as Japan-Singapore and (much more importantly) China-ASEAN. Other FTA pairs are in advanced stages of negotiation, such as China-Thailand and Japan-Korea. More subregional compacts are likely as Japan and Korea compete to emulate China’s agreement with ASEAN as a whole. Intergovernmental and government-mandated studies have already developed blueprints for the most ambitious variants on the theme, a Northeast Asia Free Trade Area (comprising China, Japan, and Korea) and a full EAFTA.¹

¹ Variants on these themes include the engagement of India, Australia-New Zealand, Taiwan, and other geographical permutations. I will mainly ignore these for the purposes of the present discussion. A complete summary of the existing agreements and initiatives can be found in Gary C. Hufbauer and Yee Wong, *Prospects for Regional Free Trade in Asia*, Institute for International Economics, Washington, forthcoming working paper.

These steps toward regional trade integration are of course being complemented by parallel monetary steps. Contrary to the experiences in other regions, initial steps toward monetary integration have preceded trade integration in East Asia. The Network of Bilateral Swap Arrangements, which subsequently became the Chiang Mai Initiative, could eventually evolve into an Asian Monetary Fund (whether it is ever called that or not).² The recent adoption of a currency basket by China could pave the way toward the next phase in this process, adoption of a common currency basket by the main countries in the region.³

Understandably, the discussion of all this in East Asia has focused primarily on the purely regional aspects of the process. It will be a monumental task to knit together the disparate economies and political systems of the region so its leaders will have their hands full with the internal dimensions. A similarly inward preoccupation in Europe characterized the creation of the euro over the past two decades, with virtually no attention paid to the external implications of the initiative in its two founding documents (the reports of the Delors Committee and the Pöhl Committee of Central Bankers).

Likewise little global attention, in the United States or elsewhere, has been paid to the international implications of East Asian regional economic integration. Many outside observers are skeptical that it will ever amount to anything significant. Most believe the process will at best take a very long time, probably measured in decades, and thus need not be addressed now.

The Global Impact

The result has been a virtually universal “benign neglect” of the global impact of East Asian regional integration. It is clear that the creation of an EAFTA, however, would have a tremendous impact on the world economy and all other major countries, including the United States. Such a grouping would account for about 20 percent of global output.⁴ It would comprise close to 20 percent of world trade. Its members would hold well over 50 percent of international monetary reserves. It would be a major economic power on a par with the European Union and the United States (or a Free Trade Area of the Americas).

² See C. Randall Henning, *East Asian Financial Cooperation*, Institute for International Economics, Washington, October 2002.

³ See John Williamson, A Currency Basket for East Asia, Not Just China, *Institute for International Economics Policy Brief* 05–1, Washington, August 2005.

⁴ Using market exchange rates.

Such a grouping could have an enormously positive impact on the rest of the world. One former US Secretary of State has suggested to me that any agreement that made war impossible between China and Japan, as the European Union made war impossible between France and Germany, would represent the greatest possible contribution to global security. It could embolden and equip the Asian nations to assume a responsible leadership position in managing global economic affairs that has eluded them to date, including the provision of finance to deal with future problems both inside and outside the region. It could spur even faster economic growth and development in the region, creating huge amounts of additional trade and investment opportunities, which would benefit nonmembers as well as members. Its admitted trade diversion could have a positive effect, stimulating other countries—including the United States—to seek liberalization with EAFTA directly and/or in the WTO context in a dramatic example of “competitive liberalization.”⁵ Hence I strongly support the idea.

An East Asian economic bloc could also, however, generate major problems for the world economy. It would inherently create substantial trade diversion, which would reduce US exports alone by about \$25 billion per year immediately and much more as the group’s dynamic effects kicked in.⁶ It could undermine rather than support the multilateral economic institutions, notably the World Trade Organization (WTO) and the International Monetary Fund (IMF), by creating a three-bloc world in which those institutions became largely irrelevant. Taken in conjunction with the evolution toward a Free Trade Area of the Americas, which is also slow and halting but likely to eventually succeed, it could draw a “line down the middle of the Pacific” that would produce disintegration rather than integration of the Asia-Pacific region and a fundamental split between East Asia and the United States (and the rest of the Americas). Another former US Secretary of State opined to me that “East Asia will only ever be able to unite if it does so *against* the United States” and that such an outcome would have disastrous effects on both security and economic relations across the Pacific—a view that derives some credibility from the anti-United States focus of the original Mahathir proposal for an East Asian Economic Group in the early 1990s, which has now become the “10+3,” and the original Japanese proposals for an Asian Monetary Fund in 1997.

⁵ See C. Fred Bergsten, *Competitive Liberalization and Global Free Trade: A Vision for the Early 21st Century*, Institute for International Economics Working Paper No. 96–15, and C. Fred Bergsten, *Globalizing Free Trade*, Foreign Affairs, May/June 1996. See also then United States Trade Representative Robert Zoellick’s endorsement of the concept in “Unleashing the Trade Winds,” *The Economist*, December 5, 2002.

⁶ Derived from Robert Scollay, *New Regional Trading Arrangements in the Asia Pacific?* Institute for International Economics, Washington, May 2001.

The Global Policy Response

The crucial policy issue for the foreseeable future is thus the way in which East Asia pursues and ultimately achieves its regional integration. "Open regionalism" rhetoric, while important and desirable, is not enough.⁷ Close consultations on the process of hemispheric integration (in the Americas as well as in East Asia), preferably through the Asia Pacific Economic Cooperation (APEC) forum as well as in bilateral contacts among the key countries, will be necessary but not sufficient to obviate major difficulties. The East Asian project, like the European and North American regional integration projects before it, must be embedded in broader geographical initiatives to assure realization of its positive potential for the world at large and to assure other countries, notably the United States, that it is irrevocably headed in a constructive direction.

There are two major options. One is to link East Asian integration to a revitalization of the *global* trading and monetary systems, much as European integration throughout the second half of the 20th century and NAFTA in the early 1990s were linked to steady reductions of trade barriers around the world and globalization of world finance. The General Agreement on Tariffs and Trade (GATT) evolved into the more effective WTO. The IMF, with the G-7 as its informal steering committee, provided leadership for the overall world economy as seen most dramatically (for better or worse) in the international response to the Latin American and Asian financial crises in the 1980s and 1990s. Europe and North America cooperated actively in all those broader initiatives and their own integration undoubtedly played a key role in global trade opening in the most dramatic examples to date of "competitive liberalization."⁸

The "global institutions approach" could provide a viable external context for Asian integration only if it provided a much more central role for the key Asian countries in that process. At the IMF, for example, the Europeans would have to give up a large number of their "chairs and shares" so that Asia could be represented at a level commensurate with its economic weight.⁹ Yet the Europeans, at least for now, are resisting even modest moves in that direction. Moreover, the IMF has failed miserably to deal with some of the crucial issues now facing the world economy, notably

⁷ C. Fred Bergsten, "Open Regionalism," in *The World Economy: Global Trade Policy 1997*, Sven Arndt and Chris Milner, eds., Blackwell Publishers, Oxford UK, August 1997.

⁸ C. Fred Bergsten, *Fifty Years of the GATT/WTO: Lessons from the Past for Strategies for the Future*, Institute for International Economics Working Paper No. 98-3.

⁹ Jan E. Boyer and Edwin M. Truman, "The United States and the Large Emerging Market Economies: Competitors or Partners?" in *The United States and the World Economy: Foreign Economic Policy for the Next Decade*, C. Fred Bergsten and the Institute for International Economics, Institute for International Economics, Washington, January 2005.

the huge transpacific payment imbalances¹⁰ (as many argue that it failed miserably in its approach to the Asian financial crisis in the 1990s).

On the trade side, memories are still acute of the dramatic failures at Seattle in 1999 and Cancun in 2003, and the Doha Round at the WTO is faltering badly. The talks are hung up over agriculture, which represents a very small share of world trade, and have not even begun to address such real drivers of the global economy as services and investment (which was in fact excluded from the agenda at Cancun). Moreover, the whole WTO system, including the Doha Round, fails even to address the two most crucial drivers of current trade relations around the world: the proliferation of FTAs and the security concerns, triggered by fears of terrorism, that threaten to close borders whatever the “trade rules” may prescribe. The WTO is functioning well institutionally but its centerpiece dispute settlement mechanism is threatened with breakdown from both the quantity of its case load and the constant risk that it will be forced to substitute for the *negotiated* solutions which are needed so badly but fail to materialize.

It is therefore necessary to consider an alternative approach to promoting consistency between East Asian integration and the rest of the world: creation of a Free Trade Area of the Asia Pacific (FTAAP) that would evolve simultaneously with the EAFTA itself. Such an initiative would embed Pacific Asia in the Asia Pacific. Hence it would strengthen, rather than threaten, transpacific relations—especially between East Asia and the United States. It would avoid the risk that East Asian and Western Hemispheric integration will “draw a line down the middle of the Pacific.” For Japan, as well as Korea and other key US allies in the region, it would obviate the risk of having to choose between China, the inevitable leader over time of any Asian grouping, and the United States. In trade policy terms, it would subsume the proliferation of increasingly inconsistent FTAs within the region into a single coherent vehicle for implementing the liberalization goals of the countries involved.

There are additional, even more immediate and compelling, reasons to initiate FTAAP talks in the near future. The region’s (and world’s) two largest economies,¹¹ China and the United States, are headed toward a major clash as early as this fall. Unless China moves to reduce its soaring global current account surplus, which will probably hit 7½ percent of its GDP this year, by revaluing the renminbi by at least 10 to 15 percent and preferably 20 to 25 percent, the US Treasury Department will almost certainly (and justifiably) label China as a “currency manipulator” in October and then be

¹⁰ C. Fred Bergsten, “The Transpacific Imbalance: A Disaster in the Making?,” paper for the forthcoming 16th General Meeting of The Pacific Economic Cooperation Council, Seoul, September 7, 2005.

¹¹ With exchange rates calculated at purchasing power parity.

compelled by its legislative mandate to make a serious effort to rectify the problem. The Senate is very likely to pass the Schumer Amendment, which would impose an across-the-board surcharge of 27.5 percent on all imports from China. The House of Representatives has already passed anti-China trade legislation, in the run-up to its narrow passage of CAFTA in July, and the two bills could be meshed into legislation that would be very difficult for the President to veto if it reached his desk. Chinese retaliation against such a step by the United States, were it ever to become law, would be both probable and justified. *The result would be a trade war between the two chief locomotives of the world economy.*

Moreover, when President Bush visits Seoul after this year's APEC summit, the United States and Korea are likely to initiate negotiations for a bilateral free trade agreement. This would be the first FTA between the United States and any Northeast Asian, or indeed any large Asian, economy. Japan, in light of the significant trade diversion it would suffer as a result¹² but even more importantly the broad foreign policy implications of such a step, would then almost certainly seek and receive an FTA negotiation of its own with the United States. (Deputy Secretary of State Robert Zoellick, while the US Trade Representative, always said that the United States would be ready to open FTA talks with Korea and/or Japan whenever they were ready to put agriculture on the table.) The United States may simultaneously be launching FTA talks with one or more Southeast Asian countries, most likely Indonesia and/or Malaysia.

I support the pursuit of US FTAs with Japan¹³ and Korea but China is likely to perceive such a series of US initiatives as a "surround China" or "containment" strategy in the economic domain, intensifying its concerns over the "surround China" strategy that the United States is already pursuing in the security domain, raising fundamental problems for transpacific relations and severely exacerbating the more immediate United States–China conflict already noted. Early and substantial Chinese action on its exchange rate will be necessary to contain the immediate crisis but, since a China-US FTA is politically impossible for both countries at this time, only the launch of FTAAP talks which subsume the China–United States bilateral clash into a broader regional framework can address these more fundamental threats to Asia-Pacific harmony.

For all these reasons, it would be highly desirable to launch an FTAAP initiative in the near future—preferably at this year's APEC summit in Busan in November. Achieving Asia-Pacific free

¹² Inbom Choi and Jeffrey J. Schott, *Free Trade Between Korea and the United States?* Institute for International Economics, April 2001, especially pp. 67–70.

¹³ C. Fred Bergsten, "The Resurgent Japanese Economy and a Japan-United States Free Trade Agreement," Foreign Correspondents' Club of Japan, Tokyo, May 12, 2004.

trade, even over an extended period of time, would be a daunting challenge. It would be considerably less daunting than pursuing a similar goal through the WTO with its 150 members, however. It would also have much greater payoff than the incremental progress that is the *best* possible outcome of the Doha Round and its global successors in the WTO.

Fortunately, an FTAAP negotiation could be launched fairly quickly and thus, given the leisurely pace of integration in East Asia itself, rather quickly “catch up” with that process. APEC was of course initially created, and broadened from the original concept to include the United States, partly to counter the similar fears generated by Mahathir’s Asia-only proposals in the early 1990s.¹⁴ The APEC Leaders adopted the goal of achieving “free and open trade and investment in the region” as a whole in their Bogor Declaration in 1994 and have reiterated that commitment in every subsequent year. At last year’s summit in Santiago, the Leaders noted that their APEC Business Advisory Council (ABAC) “presented two relevant proposals... [including] a study of the feasibility and potential scope and features of a Free Trade Area of the Asia Pacific.” They “welcomed the reports from our business community, including ABAC’s resolve for expanding trade” and “invited ABAC to provide its views... on the benefits and challenges that arise for business from the increasing number of RTAs/FTAs in the region and ways that these can be addressed.” Leaders from Australia, Canada, Chile, New Zealand, Singapore, and Taiwan reportedly supported the FTAAP idea but the largest members—including China, Japan, and the United States—did not and hence no action was taken.

A careful study of an FTAAP has already been carried out by Robert Scollay of New Zealand from the Pacific Economic Cooperation Council (PECC) Trade Forum, taking account of comments from other members of the forum,¹⁵ so one key prerequisite for proceeding to negotiations exists. APEC itself is moving in the right direction, albeit too slowly and cautiously, by seeking to create an “APEC template” for FTAs that would set out best practices benchmarks as a standard for individual agreements and for consultations among member governments on their respective negotiations. Hence the stage is set for APEC to launch the critically needed FTAAP process.

If the Leaders are not yet ready to do so, the preferred fallback would be initiation of the two large transpacific FTAs already mentioned: between the United States and Japan, and between the United States and

¹⁴ Yoichi Funabashi, *Asia Pacific Fusion: Japan’s Role in APEC*, Institute for International Economics, October 1995.

¹⁵ The Trade Forum as a whole was regrettably unable to reach consensus on the paper so it was submitted on the sole responsibility of the author.

Korea, to augment the small trans-Pacific FTAs that are already in place (Japan-Mexico, United States–Singapore, Korea-Chile). These could provide an Asia Pacific foundation for the larger APEC effort in the future. They would be risky because of their impact on China and others in East Asia, as just described, but they might also galvanize support for an FTAAP launch in a new example of “competitive liberalization.”

The two suggested policy options could, and in practice probably would, be combined. As noted, the Doha Round and WTO more generally are faltering. An external jolt is needed to reenergize the talks and push the major countries, especially the European Union and several key developing countries, such as Brazil and India, to substantially expand their liberalization offers and thus enable the Round to move toward a substantively meaningful outcome. The launch of FTAAP talks would represent such a jolt, just as the Uruguay Round was galvanized to a successful result by the first APEC summit in 1993 and its declaration of intent to pursue free trade in the Asia-Pacific region.

If the FTAAP launch succeeded in promoting a sufficiently ambitious result for Doha, and continuing follow-on liberalization efforts in the WTO, it might not even be necessary to complete the FTAAP. The induced global result might suffice to ensure the compatibility of East Asian integration, and international perceptions thereof, with the international system. But the Doha Round could still fail and the FTAAP would then become a highly attractive alternative, and indeed virtually an imperative, to head off an uncontrolled explosion of FTAs around the Asia Pacific. It is clear that *APEC should begin the FTAAP process as soon as possible* and that Japan, along with the United States and China, will play a pivotal role in determining whether the promising prospects for an East Asian Community can be fully realized by embedding it in the Asia Pacific and the world economy as a whole.

Conclusion

East Asian economic integration is likely to happen. If it does, it will represent one of the most profound developments of the current era for the evolution of the world economy (and for global security as well). It will carry major implications for economic relations between East Asian countries, notably Japan, and the rest of the world including the United States.

It would be a grave mistake for Japan and the other countries of East Asia to fail to integrate these global considerations into their planning for completion of their regional initiatives. This is particularly true in light of the looming economic clash between the United States and China, the continued proliferation of FTAs in the region including a series of major new ones that may soon be launched by the United States, and the steady erosion of credibility and effectiveness of the global trade and financial systems and their designated lead institutions.

The Asia-Pacific nations, working both through their own institution (APEC) and the global bodies, should therefore initiate priority efforts to embed the emerging Pacific-Asia process into the broader Asia Pacific and global contexts. The most promising step is the launch of negotiations on a Free Trade Area of the Asia Pacific, to pursue the Bogor goals in a manner already endorsed by the ABAC and a number of APEC Leaders, which would both link the Pacific-Asia and Asia-Pacific initiatives and simultaneously galvanize the next round of global liberalization. I commend it to our governments and to the APEC Leaders at their upcoming summit in Busan.