

CHINA AND EAST ASIAN ECONOMIC INTEGRATION AND COOPERATION

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China's role in the East Asian economic development has grown increasingly important since China becomes a rapidly growing market for other regional economies. China's participation is essential to the progress of the East Asian economic integration. Due to its great diversity, East Asian trade and investment arrangements have to be gradual and flexible. The foundation of East Asian FTA have been gradually built up beyond "functional integration" as observed in intra-regional FDI flow, a new regional network of production and services. A pragmatic approach is to negotiate East Asian FTA on the bases of three FTAs of China-ASEAN, Japan-ASEAN, and Korea-ASEAN, the combination of which are likely to serve the modality of the future East Asian FTA. The three separate agreements need to be integrated into one by harmonizing various degrees of liberalization of agricultural sector, labor mobility, rule of origin and other factors.

Keywords: Economic Integration, China, ASEAN, FTA

JEL classification: F15, F42

1. INTRODUCTION

China has achieved great success by maintaining high economic growth for more than two decades following implementing reform and opening its doors to the outside world policy in 1978. Generally, China's global interest began as external economic relations closely linked it to the world market, which in turn caused China to become an official member of GATT/WTO. A 15-year bid and hard negotiation did not dampen its interest and discourage its effort.

Immediately after 2001 accession to the WTO, China started to adopt regional

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strategy, which seemed generally based on such assessments: WTO accession is essentially in China's global interests, but world market fragmentation as a result of numerous regional trade arrangements (RTAs) rendered it insufficient. China also needs to participate and promote its own RTAs.

Geographically, China belongs to the East Asian region where it has fundamental interests and where its main economics and political influence lies. The Chinese economy has increasingly integrated with East Asian economies through a trade - investment network. This tells why China started negotiations on its first RTA in the East Asian region with ASEAN.

Based on its dynamic economic growth, China's role in the regional economic development has become increasingly important since China becomes a growing market for other regional economies. Thanks to its active participation and promotion, East Asian cooperation has achieved noticeable progress. China's participation and active role is essential to the progress of the East Asian cooperation.

This article intends to analyze China's economic interest in East Asia, its regional strategy and role in the East Asian cooperation process.

2. CHINA AND THE EAST ASIAN ECONOMY

Chinese economy has achieved steadily high growth for more than a decade, since 1990s. Although external market change affect the economy as exports play an important role in generating growth, the strong push on domestic demand mobilized by active fiscal policy, as well as increasing inflows of FDI have saved the economy from a spiraling downturn despite declining external demand.

China has sustained higher economic growth higher than those of the East Asian region as a whole, that means that China has a significant positive impact on the regional economy. China's contribution to the regional economies has been mostly through increased regional trade. According to a World Bank report "other East Asian economies have been finding their niches within China's markets and increasing their shares of China's imports."¹

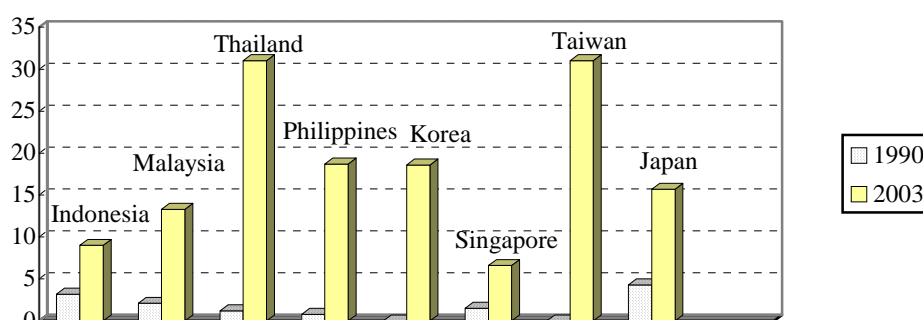
In 1990s, all East Asian economies increased their export share in the Chinese market. This trend has become more striking in recent years. For example, exports to China from East Asian 8 economies accounts for almost 40% of their total export growth, with growth rate more than 30%. The share of exports to China from these economies rose from 8% in 1990 to 16% in 2002, higher than to Japan, and closing to the United States.² Based on large FDI inflow, China is emerging as a major trade and

¹ Kathie Krumm and Homi Kharas (ed.), *East Asia Integrates-a Trade Policy Agenda for Shared Growth*, World Bank and Oxford University Press, 2004, p.xxii.

² The World Bank, *East Asia Update*, p.15.

production hub for the East Asian region. The strength of China's imports comes from two sources: one is increased domestic demand due to the expansion of consumption; another is the surge of exports, i.e. imports for exports. From the future perspective, the increase in internal demand will be more significant along with rising level of Chinese income since there is a clear positive linear linkage between import increase and per unit of GDP in China.

For many economies in the region, like Japan, Korea, Taiwan, China's import becomes a key factor in sustaining economic growth.³



Note: The share represents the export percentage of total export.

Source: www.mofcom.gov.cn; www.aseansec.org; www.jetro.go.jp

Figure 1. Export Share to China

China's market has great potential. Experts estimate that by 2020, China's foreign trade size may nearly equal that of the U.S. and significantly exceed Japan. For more than half of its imports, China will rely on East Asia. By 2005, China became Asia's largest individual importer. Importantly, China will play a critical role in recycling capital through its trade balance in the East Asian region. According to the simulation done by Holst, Aziz and Liu, in the next two decades, China will continue to gain huge trade surplus with the US and the EU while at the same time, large trade deficit with East Asia.⁴ China plays a unique role in creating a new production network in East Asian region by exporting to developed countries since its exports are highly integrated

³ Korea refers to Republic of Korea. China refers to People's Republic of China, while Taiwan represents an economic region in this paper.

⁴ David Roland-Holst Iwan Aziz, Li Gang Liu., "Regionalism and globalism: East and Southeast Asian trade relations in wake of China's WTO accession", ADB Institute Research Paper Series No. XX, January 2003, p.19.

with the productions of other East Asian economies through FDI-trade networks. Nevertheless, the challenge to this recycle pattern has become evident. China has increasing pressure from the US and EU to be a processing and assembly center of the region exporting to the world.

Table 1. China's Trade Balance Scenario in 2020 (In billion US dollars as 1997 dollars)

| Partner | Japan | NIEs | ASEAN | US | EU | ROW |
|---------|-------|------|-------|-----|----|-----|
| Balance | -5 | -135 | -41 | 166 | 66 | 71 |

Source: Regionalism and Globalism: East and Southeast Asian Trade Relations in Wake of China's WTO Accession, p.19

Chinese economy will continue to maintain its dynamic growth trend for another decade or two.⁵ While China will rely on the external market to support its economic growth, the internal factors will certainly play a more important role in generating economic dynamism. Among others, there are at least three potentials that will be sustained for about two coming decades: general improvement of income level, urbanization, as well as "the western development strategy." Seeing from all positive factors, it should be reasonably optimistic about China's economic sustainability for the coming two decades. Thus, China may continue to be an important engine for regional economic growth in the future.

As a developing country, China may not like Japan as a major FDI resource for the region in the near future even though its FDI outflow will increase significantly. As mentioned above, what is significant is the network based on exchange of trade and capital in East Asian region, is that China plays the role as a regional hub. The network has and continues to impact East Asia's economic future development since it has created a kind of "parallel development" for the region which seems different from the traditional "flying geese model" that based on the vertical and hierarchic transfer of technology.⁶ This was called as a phenomenon of "bamboo capitalism" in East Asia since this culminating feature of FDI-driven supply chain has created diverse and vibrant local industries around the East Asian region. The further supply chains (the root system) are decomposed and extended geographically, the faster and more profuse will be the proliferation of new enterprises.⁷ China is considered to be "a central player in

⁵ For the optimistic conclusion, see Wanda Tseng and Markus Rodlauer (ed.), *China: Competing in the Global Economy*, IMF, Washington D.C, 2003, p.23.

⁶ Chen Yu-shi, p. 10.

⁷ David Roland-Holst Iwan Aziz, Li Gang Liu., "Regionalism and Globalism: East and Southeast Asian trade relations in wake of China's WTO accession", ADB Institute Research Paper Series No. XX, January 2003, p.16

production networks.” For example, in 2001 while Japan provided about 30% of components for assembly in East Asia, China provided about 20% of components for the region. For some economies, the shares of parts and components imported from China are very high, for Japan, 36.7%, for Korea, 21.1%, for Hong Kong, 45.5%. The current shares should be even higher following further development of the production networks.⁸ This helps East Asia to reduce its production cost and to build up a new strength for its future economic dynamism.

3. CHINA AND ASEAN

China started its regional strategy from China-ASEAN FTA (CAFTA). Questions regarding China’s motivation were raised about: why China initiated the China-ASEAN FTA (CAFTA).

Study shows that the benefits created by a larger scale FTA are greater than a smaller one. The reason for China chose CAFTA as a start is mainly following an “easier first” practical approach on the one hand, and the geo-political interests on the other hand.⁹

China and ASEAN have shared increasing interests in trade and economic relations. From China side, a FTA with ASEAN could facilitate Chinese companies’ entrance into the ASEAN market, and in general. It is also an experiment in participating and promoting regional integration and cooperation after joining WTO. China is more confident in signing an FTA with ASEAN partners than with Japan or Korea since it shares greater similarity with ASEAN countries. Political gains are also important for China since a closer economic relationship (CEP) helps to smooth the comprehensive relations between the two sides, which has significant dimension in creating a peaceful environment surrounding China. Table 2 shows the positive result of CAFTA for all involved. These are only static gains based on the CGE model. The dynamic gains are much greater.

Table 2. Macro Economic Effects on CAFTA Member Nations*

| Region | GDP (%) | Exports (%) | Imports (%) | Employment (%) | Welfare (%) |
|-----------|---------|-------------|-------------|----------------|-------------|
| China | 0.58 | 3.02 | 4.75 | 0.83 | 6,136 |
| Indonesia | 0.58 | 2.77 | 5.67 | 1.44 | 1,356 |

⁸ Kathie Krumm and Homi Kharas (ed.), *East Asia Integrates : A Trade Policy Agenda for Shared Growth* (2004), p. 24.

⁹ Gu Xiaosong argued that China’s regional strategy should follow three steps: first step CAFTA, second step EAFTA, third step APEC FTA. *China-ASEAN Free Trade Area and Guangxi*, 2002, Guangxi Publisher, p.4.

| | | | | | |
|------------|------|------|-------|------|-------|
| Malaysia | 5.89 | 6.13 | 8.65 | 9.31 | 5,517 |
| Philippine | 0.87 | 1.88 | 3.77 | 1.72 | 883 |
| Singapore | 2.32 | 3.96 | 5.30 | 4.65 | 3,577 |
| Thailand | 1.96 | 3.94 | 10.41 | 4.71 | 3,414 |
| Vietnam | 5.31 | 3.93 | 10.85 | 9.66 | 2,971 |

* CGE modeling results.

Source: The author's project on EAFTA.

From the ASEAN side, with a rising Chinese economy, market become ever more important. Although great concern was raised on China's WTO entry, since China would become more competitive and attractive for FDI, the best choice is to meet the challenges by integrating with China since this will bring more opportunities to ASEAN with a more liberalized and prosperous Chinese market. Generally, a united ASEAN will give Southeast Asian countries more confidence to engage China. A conclusion made by the official joint study group stated that "the removal of trade barriers between ASEAN and China will lower costs, increase intra-regional trade and increase economic efficiency" and "the FTA will lead to greater specialization in production based on comparative advantage, ...With a larger market, more intense competition, increased investment and economies of scale, enterprises will invest more in research and development, hence promoting technological innovate on."¹⁰

Trade relations are key linkages between China and ASEAN economies. Since the late 1980s, the average annual China-ASEAN trade volume growth has exceeded 20%. China's export to ASEAN increased from the US\$ 4.1 billion in 1991 to US\$ 42.9 billion in 2004, and its import from ASEAN increased from US\$ 3.8 billion in 1991 to US\$ 62.9 billion in 2004, with total trade exceeding US\$ 100 billion. Most China-ASEAN trade goods are manufactured products. Based on new regional FDI network relations, China has imported more manufactured parts from ASEAN. China has increased imports of intermediate products from ASEAN significantly. Since China has become a major place for the final process of production network in the Asia-Pacific region, China's labor-intensive export oriented industries are also raw material- and intermediate product-intensive. Thus, China's export surge has generated rapid imports from network link economies either from FDI home economies, or FDI guest economies, like ASEAN. Since late 1990s, China's imports from ASEAN have grown faster than those from the rest of the world.

With new industrial adjustments in China and the East Asian region, as well as corresponding FDI allocation, China and ASEAN have established a new relationship based on the regional production network. This, to some extent, helps to mitigate the

¹⁰ A Report submitted to the ASEAN-China Expert Group on Economic Cooperation, by Joint Research Team, 27 September, 2001

similarity between the industrial structures of China and ASEAN and hence to increase cooperative capacity between the two sides.

However, China's increasing competition has also meant challenges to ASEAN countries. China's cheap products ranging from labor intensive to capital-intensive products have exerted significant competitive pressure on ASEAN companies, especially small and medium sized ones. ASEAN's export increases to China do not necessarily represent its competitiveness, but are rather a result of the division of the labor in the production network created by multinational companies. This may be unstable if FDI strategy restructures. Due to some similarity of exports, they also compete on the third market. Although generally, China's export surge did not reduce the export increase of other developing economies, for some products, competition exists.

The US, Japan and EU are the three major export markets for both China and ASEAN. For example, ASEAN's share in these three markets decreased from 5.6% in 1996 to 5.5% in 1999 while China's share increased from 4.2% to 5.4% in the same period.¹¹ The main reasons why ASEAN's share has remained stagnant in these markets are the decrease in Japan's imports and the decline of ASEAN's own export capability as a result of the financial crisis. China's exports of textiles and garments to the above major three markets have increased significantly. As a matter of fact, the real impact comes from NAFTA. The main beneficiary of the NAFTA is Mexico, whose export of garments grew at an average annual rate of 33% in the 1990s and which has finally replaced China's first place in the USA's import of garments.¹² Now, both the US and EU have taken restrictive measures to control China's exports of textiles and clothing. This may release the competition pressure to ASEAN.

FDI flow to China has contributed significantly to China's economic dynamics and competitiveness. China is regarded as a competitor of ASEAN in attracting foreign investments. Seeing from the trends before the financial crisis, both FDI flows to China and ASEAN increased significantly. The contraction of FDI to ASEAN recent years is clearly a result of the negative impact of the financial crisis. FDI flows to China have steadily increased since the early 1990s. However, before the financial crisis, the rate of FDI increment in ASEAN grew faster than that to China. The declining confidence of foreign investment in East Asia caused by the financial crisis caused the share of FDI flowing into developing countries to greatly decrease. The contraction of FDI to ASEAN was not just caused by the decrease of investment from developed countries, but also by sharp decline of the intra-ASEAN investment. The positive trend of FDI flow to ASEAN gradually resumed following the improvement to the economic and political environment. Considering investments to China and to ASEAN are generally based on different strategies, FDI to China seems not to create a clear substitutive effect to

¹¹ Source: United Nations HS COMTRADE Data.

¹² WTO, *International Trade Statistics 2000*, p.152.

ASEAN.

With enhancement of its economic strength and also the need for industrial restructuring, China's investment abroad has started to increase. Currently, most of China's FDI outflows are resource related, i.e., for meeting its increasing resource demand. But investments in capital-intensive productions are growing. Increasing numbers of Chinese successful color tv set, refrigerator, washing machine, as well as telecommunication companies have already set up factories in some ASEAN countries though total amount of the investments are still not substantial. Most of the investments go to four ASEAN new members, i.e., Vietnam, Laos, Cambodia and Myanmar. In terms of future perspectives, ASEAN will be one of the greatest potential markets for Chinese FDI flow based on closer economic relations. Due to the geographical linkage and advantage, southern parts of China will form closer economic integration with ASEAN members, like Vietnam, Laos, Cambodia, Myanmar, and even Thailand, which will surely attract more investments from China.

CAFTA began with trade in goods from July of 2005 and it will be fully established by 2010 for China and ASEAN 6 and by 2015 for 4 new ASEAN members. It is possible that liberalization may occur faster than planned and that the "fast track" may be pursued with some ASEAN members (for example, Singapore, Thailand) within the framework of the general agreement.

As for liberalization of trade in services, it will have substantial sectoral coverage and aim at "progressive elimination of substantially all discrimination." Investment liberalization is "to promote investments and to create a liberal, facilitative, transparent and competitive investment regime", "to strengthen co-operation in investment, facilitate investment and improve transparency of investment rules and regulations and to provide for the protection of investments."¹³

FTA is just one core part. For example, in the framework agreement, it also listed as the other areas for broad cooperation. Several areas are listed as priority sectors for cooperation: agriculture; information and communications technology; human resources development; investment; and Mekong River basin development. Cooperation has been extended to other areas, including banking, finance, tourism, industrial cooperation, transport, telecommunications, intellectual property rights, small and medium enterprises (SMEs), environment, bio-technology, fishery, forestry and forestry products, mining, energy and sub-regional development. In order to adjust their economic structure and expand their trade and investment with China, the capacity building programmes and technical assistance have been enhanced, particularly for new ASEAN members.¹⁴

A profound significance of economic integration between China and ASEAN is to establish the legal based systems for trade, investment and service following WTO rules and international standards. Economic integration, thus, interdependence itself will help to

¹³ Framework Agreement, Nov.4, 2002, p.8

¹⁴ Framework Agreement, Nov.4, 2002, p.8

build up political confidence. Both China and ASEAN realize the significance of political relations. A stable and cooperative relationship with its close neighbours well serves China's grand strategy for a long-term peaceful environment for development. We have witnessed a fast progress in China-ASEAN political relations in recent years. In 2003, China as the first foreign partner joined ASEAN initiated Treaty of Amity and Cooperation (TAC) and the two sides established "a strategic partnership for peace and prosperity", which intends to forge "a comprehensive and forward-looking cooperation focusing on politics, economy, social affairs, security and international and regional affairs".¹⁵ As a positive result of this commitment, for example, China, the Philippines, then Vietnam signed an agreement on cooperation in marine resource research in South China Sea area despite their dispute on the islands in that area.

4. CHINA AND NORTHEAST ASIA

Three economies of China, Japan and Korea account for the vast majority in Northeast Asia regional economy. Their economies have increasingly become integrated. This has been reflected by the fast increase of trade and other economic exchanges between three bilateral ways, i.e., between China-Japan and China-Korea and Korea - Japan.

Table 3. Trade Relations between China, Korea and Japan
(In billion US dollars, export and import)

| | China-Japan | China-Korea | Korea-Japan |
|------|-------------|-------------|-------------|
| 2000 | 83.1 | 34.5 | 52.3 |
| 2001 | 87.8 | 35.9 | 43.1 |
| 2002 | 101.9 | 44.1 | 44.0 |
| 2004 | 167.9 | 90.1 | 53.6* |

* for 2003.

Source: *China Statistics*, JETRO, Statistics and Surveys

Importantly, the integration is created by FDI led intra-trade and relating service activities. FDI flow becomes a focal factor in making three economies more and more integrated since increasing shares of trade between three countries are FDI related. For example, for about 40% of Japanese and Korean companies invested in China, their intra-firm trade share is as high as 75%, almost half of Japanese companies invested in

¹⁵ Joint declaration of the heads of states/government of the Association of Southeast Asian nations and the People's Republic of China on Strategic Partnership for Peace and Prosperity, 2003.

China have over 75% of their products sold back to Japan.¹⁶ Although FDI flows are currently mainly from Japan and Korea to China, the economic integration finds its rationale through efficient restructuring of the manufacturing industries. This intra-industrial division of production and also services help to build up a network, which made three economies highly interdependent and beneficial to each other. The restructuring of manufacturing industries has created new business of services, like finance, transportation, logistics and also encouraged more and more movements of human resource among the three economies. Seeing from the future, following China's economic progress, capital flow from China to Japan and Korea will also increase, which will help to create a more balanced structure of the economic integration.

China has benefited largely from receiving FDIs from Korea and Japan that has helped China to develop its modern manufacture industries and to build up competitive capacity for export and also domestic markets. At the same time, both Korea and Japan have benefited from timely restructuring of their economies that help to improve competitiveness for the long-term. This complimentary structure of economic linkages among three economies may continue far into the future.

Economic integration calls for institutional transparency and stability, market liberalization as well as close macro-economic coordination. Market driven integration is not stable. If without institutional arrangement, the business transactions may be still blocked by all kinds of barriers, both tariff and non-tariff measures. In China, Korea and Japan, non-tariff restrictions still largely exist.

China is active to promote the regional cooperation by calling for an early Northeast Asian FTA. However, Korea and Japan initiated it. Their FTA negotiation started from 2003 and may be concluded by the end of 2005. China and Korea initiated a FTA feasibility study in 2005 and the negotiation is expected to start in 2006. China and Japan have not put FTAs on their agenda yet. Japan is calling for a bilateral investment agreement first, but China hopes to negotiate a close economic partnership agreement including trade, investment and service. The joint study group on the trilateral FTA submitted to the Trilateral Summit Meeting in 2003 "a report and policy proposal on strengthening the trilateral cooperation" evaluating mainly the economic effects of a feasible trilateral free trade agreement, with a conclusion that the trilateral free trade agreement, would bring about substantial macroeconomic effects favorable to the three countries. Table 4 is the CGE modeling result that shows the trilateral FTA will generate significant benefits fore all three countries.

¹⁶ Zhang Qi, Major Impediments to Intra-Regional Investment between China, Japan and Korea, paper presented at symposium on "Strengthening Economic Cooperation in Northeast Asia", Beijing, Sept. 29, 2002.

Table 4. CGE Simulation Result of CJKFTA

| | GDP% | EV*(Million \$US) |
|-------|------|-------------------|
| China | 0.30 | 3,349 |
| Japan | 0.37 | 16,760 |
| Korea | 3.55 | 12,446 |

Source: Kazutomo Abe: General and Cross-Sectoral Economic Effects of China-Japan-Korea FTA (CJKFTA), a study report for international symposium on "Towards a CJKFTA: Vision and Tasks, Beijing, 2005,9,26.

A joint study on possible modality of trilateral investment arrangements was also conducted and the Joint Study Group held several meetings, with the common understanding that the promotion of trilateral investment would increase the dynamism of the three countries' domestic economies, and strengthen trilateral economic cooperation. The Joint Study Group Report suggested that a legal framework should be explored concerning the trilateral investment. But considering the differences of the policy priorities and interests, the CJKFTA seems not on the immediate agenda yet.¹⁷

Three countries have their broad economic cooperation under the framework of the trilateral leaders dialogue along with the process of "10+3". The leaders of three countries have held regular informal meetings since 1999. The cooperation among the three countries demonstrates the gratifying momentum for the development of their relations.¹⁸ The departments of various areas have established mechanisms for meetings at the ministerial, senior official and working levels. An important progress is the joint declaration on promotion of tripartite cooperation signed in Bali, Indonesia on October 7, 2003 by three leaders of China, Japan and Korea. The areas of cooperation include trade and investment facilitation measures ranging from ccustoms, transportation and quality supervision, inspection and quarantine.¹⁹ For examples, the customs authorities have developed dialogue and cooperation for trade facilitation. Bilateral meetings on customs have been held and have exchanged views on measures on swift customs clearance. The customs mutual assistance agreement (CMAA) between China and Korea has been

¹⁷ Michael G. Plummer argued that rising levels of interregional trade and investment flows in Northeast Asia derive mainly from interaction with China, rather than between both Japan and South Korea. He suggested that "if the flag is to follow trade, the agreement should be three-way". See Yoon Hyung Kim, Chang Jae Lee (ed.), *Strengthening Economic Cooperation in Northeast Asia*, KIEP, Seoul, 2004, p. 174.

¹⁸ Declaration on promotion of tripartite cooperation among three countries, Bali, Indonesia on October 7, 2003.

¹⁹ The leaders agreed in the Joint Declaration the promotion of cooperation in 14 areas including economy and trade, culture, people-to-people exchanges, and politics and security, as well as the establishment of the Three-Party Committee, which is headed by the foreign ministers of the three countries to study, plan, coordinate and monitor the cooperation activities. See Joint Declaration on the Promotion of Tripartite Cooperation, Trilateral Summit, 2003.

already in place, a Korea-Japan CMAA will be ready and a China-Japan CMAA is now under negotiation. In the transportation area, the Northeast Asia Port Directors-General Meetings have been held since September 2000. They conducted the joint studies on promotion of cruising, investment and free-trade zones as well as the new design method of port facilities. In the information and communications technology area, the trilateral ICT Ministers' Meetings were formalized and the ministers agreed on a closer trilateral cooperation and the framework of "East Asia (CJK) ICT Summit". The working groups were set up for cooperation on six areas (the next generation Internet (IPv6), 3G and next generation mobile communications, network and information security, telecommunication service policies, digital TV and broadcasting, open source software) and they held meetings respectively. Environmental cooperation is another important area that has achieved progress: a comprehensive sub-regional environmental cooperation mechanism in Northeast Asia, and the monitoring and early warning network system for dust and sand storms, the Acid Deposition Monitoring Network in East Asia, the Northwest Pacific Action Plan for the protection of the regional marine and coastal environment, the North East Asia Sub-regional Program for Environmental Cooperation. Cooperation for sustainable development for East Asia seas has been made in the framework of the "Partnerships in Environmental Management for the Seas of East Asia". The cooperation in the IT area among the three countries has been developing through both company initiatives and governmental efforts. Three countries now are cooperating in developing the Northeast Asian IT R&D standard and network (new generation internet, phone system etc.). It was proposed that an IT common market should be firstly developed by three countries which forms an important foundation for the Northeast Asian real FTA.²⁰ In the areas, like education, cultural exchange, tourism promotion etc., the cooperation among China, Korea and Japan has also been developed. However, China as a late emerging economic power, both Korea and Japan worry about potential competition in the areas of electric and electronic goods for which they have the competitive edge. This places pressure on the two countries to upgrade their industrial structures.

Northeast Asia cooperation may follow a functional approach, i.e., cooperation focusing on issues (areas). This is easier way to start and make progress. However, this functional approach has its limitation since in the long-term, pressure still exists and the crucial role is participating in and promoting the East Asian framework (currently '10 plus 3'). At the same time, major efforts for Northeast Asia cooperation in the near future can also be more focused on projects such as, regional designing and working on infrastructure, telecommunication, and energy as well as business network establishment. As a first step for CJKFTA, one option is to start from trade and investment facilitation through official arrangements, for example, signing a framework document for trade and

²⁰ Kim Yong Ho, "New pattern of economic cooperation in Northeast Asia and the cooperation among Korea, China and Japan," *Journal of Northeast Asia Studies*, No. 1, 2005, Tianjin, China, p.8.

investment facilitation, which may set up the foundation for future FTAs.

5. CHINA AND EAST ASIAN COOPERATION

The idea for East Asian cooperation was firstly raised by Mr. Mahathir Mohamad, then Prime Minister of Malaysia, who called on East Asia to unite to balance the international economic order by “comprising economies in East Asia and establishing an “East Asian Economic Group” (EAEG) in 1990, which was later changed into “East Asian Economic Caucus” (EAEC). China expressed its clear support for this proposal.

However, East Asian cooperation started after the 1977 financial crisis with the newly emerging spirit of regional cooperation between ASEAN and three Northeast Asian countries. “ASEAN +3” framework provides a large platform for cooperation among East Asian countries, ranging from economic to political cooperation. The foundation for the new cooperative spirit is increasing economic interdependence through trade, investment and financial activities within the region. So, the regional cooperation initiative was intended to achieve two major objectives: market liberalization and financial stability. FTA is the major vehicle for realizing market liberalization, while regional financial architecture, for example starting with the Chiang Mai Initiative, creates a possible financial stabilizer.

East Asian FTA movements started with a multi-layered approach. The first FTA proposal was put forward in 1998 for a Japan-Korea FTA, which is now still under negotiation. Later more FTAs will be negotiated in the region, both within East Asia and other countries. Some will be concluded, and some are still under negotiation. Japan-Singapore CEP (JSCEP) pioneered in making a new kind of FTA in the region covering more areas than traditional trade liberalization including trade, investment, services, dispute settlement mechanism, and economic and technical cooperation on various functional levels between the two countries.

China has been active in participating and promoting the process of East Asian cooperation. China took the lead in making a large scale FTA between China and ASEAN as a group. China-ASEAN CEP Agreement was signed in 2002, which started with an early harvest program focusing on liberalization of agricultural trade in goods and an agricultural cooperation agreement, and the FTA agreement for trade in goods was signed in November of 2004. In 2003, Japan signed the CEP framework agreement with ASEAN, is now negotiating bilateral FTAs with some individual ASEAN economies (Thailand, Malaysia, Philippines) and is preparing an overall agreement with ASEAN. Aside from the negotiation with Japan, Korea also decided to follow China and Japan to start negotiations with ASEAN in 2005.

The degree of FTAs or CEPs varies. Aside from liberalizing goods for trade, most of them are committed to facilitating trade, harmonizing quality and other regulatory issues, building infrastructure and streamlining customs procedures. Liberalization of trade in services and investment are also considered. Usually, CEP by nature, also have

provisions for human resource development (HRD) and technical assistance.

Importantly, the role for East Asian FTA or CEP is to make rules and to develop legal mechanism among countries in the region. The arrangements and agreements both on the bilateral or sub-regional levels are rules making in nature in considering the principle of international standards, or “WTO consistent”. In East Asian relations, there has been a profound significance since both “rule of standards” and “rule of law” will help to improve the systems of the regional members and to create a reliable foundation for the regional cooperation process. Thus, the regional arrangements will help to develop a new regional system based on increasing common or shared interests and rules among all parties. The institutional building in the region creates “public property” for countries in the region to maximize their interests.

The East Asian multi-layered approach provides incentives for individual countries and the sub-region group like ASEAN in realizing their best-expected gain. However, it may also create new barriers in regional trade and investment. For example, the regional market becomes divided because of different arrangements, which will reduce the gain from the scale of the regional market. Business cost will increase due to the complicated or contradicting regulations (for example, rules of origins), which seems counter-productive to network based economic integration.

All theoretical studies show that a broad FTA can create more benefits than a narrow one. Our CGE model simulation result shows that benefits of EAFTA exceed any other FTA, either bilateral FTA, or AFTA, or any “10+1” FTA. The foundation of EAFTA lies in the high level of integration characterized by FDI-trade network relations. But the potential of the integration is far from realized fully due to the barriers either by tariff or non-tariff measures.

Table 5. Welfare Change in Various FTA Scenarios (million US\$)*

| | ASEAN Total | China | Japan | Korea |
|-------------------|-------------|--------|--------|--------|
| ASEAN-China | 17,718 | 6,136 | -5,380 | -972 |
| ASEAN-China-Japan | 20,669 | 9,502 | 52,969 | -3,342 |
| ASEAN-China-Korea | 19,216 | 7,856 | -6,194 | 40,709 |
| EAFTA | 21,900 | 11,050 | 57,209 | 38,714 |

* CGE modeling results

Source: The author’s project on EAFTA.

The foundation of EAFTA has been gradually built up. Regional economic integration is increasing. Close economic integration has resulted in economic interdependence, creating common interests, and a desire for market liberation so as to expedite and streamline economic transactions. Currently, based on increasing intra -

regional FDI flow, a new regional network of production and services has been developed, which has further enhanced the level of integration and common interests. Economic integration also calls for strengthening governmental cooperation in providing a better economic development environment and reducing the market risk and preventing from the crisis. Business community becomes active in pressing the governments to move forward on conclusion of the regional FTA.

Practically, a multi-layered framework of sub-regional and bilateral FTAs may serve as a means of capacity building for regulating and good governance for the region that is essential for future pan-regional FTAs, since almost all countries in the region have no experience in forging regional trade and investment arrangement. Due to its great diversity, East Asian trade and investment arrangements have to be gradual and flexible. Currently, we have witnessed three different structures in the regional arrangements: the developed-the developed economies, represented by Japan-Singapore CEP, Japan-Korea (to be concluded); the developed-the developing economies, represented by Japan - ASEAN countries (with individual economies as well as with ASEAN as a whole in the future) and the developing-the developing economies, represented by China-ASEAN FTA. These different types of arrangements provide rich experiences for negotiating an integrated regional FTA in the future.

The above factors help East Asian countries to build up consensus on moving toward an EAFTA. As a matter of fact, this consensus already exists. What needs to be done is to design, and transform the consensus conscience into actions in order to quickly establish EAFTA as soon as possible. A pragmatic approach is to negotiate EAFTA on the bases of three "10+1" FTAs (China-ASEAN FTA, Japan-ASEAN FTA and Korea - ASEAN FTA). The three FTAs will set the basic structure, principles and contents for an EAFTA. This means that the modality of the future EAFTA will be a combination of three FTAs. This may be the most feasible approach for establishing EAFTA.

Considering the economic development level of ASEAN and China, CAFTA may be a feasible model for the future EAFTA, which is characterized by a gradual approach: liberalization of trade for goods first, investment and service second; more developed economies moving faster, and less developed economies slower; liberalization of competitive sectors first, sensitive sectors later. Until 2010, the majority trade goods will be liberalized (zero tariff).

As mentioned above, since the best approach to EAFTA may be to combine three "10+1" FTAs, it is appropriate to negotiate a comprehensive EAFTA based on them. Within three ready "10+1" FTAs, all difficult problems, like liberalization of the agricultural sector, labor mobility, rule of origin, as well as special treatment of less developed countries, was settled in a separate agreements. EAFTA is actually to restructure the three agreements into an integrated one.

If taking three "10+1" FTA as the foundation, the time-table for negotiation of the "10+3" based EAFTA will be after 2007 when all three FTA negotiations are concluded.

It is desirable to conclude the negotiation of EAFTA by 2010 and to be completed before 2020.²¹

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²¹ We consider two important events in setting this time table: one is ASEAN Economic Community, another is APEC Bogor goal for trade and investment liberalization in the Asia-Pacific.

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