

A Comprehensive Analysis of Economic Community in East Asia: Japan's
Leadership in the Regional Development on both Economic and Financial Sides

May 2005

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Abstract

East Asian nations are currently undertaking the future development of an economic community by creating a viable framework for closer cooperation and deeper integration. However, the intractable problem is that there are a lot of diversities and heterogeneity that have prevented the East Asian nations from reaching coordinated policies for the promotion of regional cooperation and combining efforts on integrating their economies with each other. This paper thus presents that a successful process of forthcoming regional integration on the economic side would accompany with strenuous efforts to create a common market among ASEAN, China, South Korea, and Japan by establishing a free trade area covering the entire region. As the two major countries in the region, in the arrangement, China and Japan would have centered roles in promoting economic cooperation in East Asia. However, it is practically impossible to decide either China or Japan is capable of taking the initiative in the development without providing various rationales for economic cooperation and examining economic challenges facing the both nations. In the development, in addition, Japan's agricultural policy could be defined as the essential part of assessing its regional and bilateral measures consistent with the rules of the WTO, in particular, GATT Article XXIV requirements that raise the problem of the concise interpretation of "substantially all the trade." East Asian Financial Crisis of 1997-98 also serves as a catalyst in considering the issues of regional integration on the financial side, the principle of which is to sustain an economic recovery and minimize the risk of another crisis. The important point is how the East Asian nations foster a regional financial framework under ASEAN+3 in which there has been ongoing debates on the development. This paper thus discusses possible approaches to enhance regional financial cooperation and provides various rationales for developing regional financial schemes while examining Japan's assistance measures shortly after the financial crisis, which became a significant step toward attaining the economic recovery of the crisis-affected countries and bringing the financial stability to the region. In order to sustain the economic growth in the region, the East Asian nations are currently considering the issue of monetary integration in the feasibility of introducing a common currency basket regime that is best understood as the willingness of jointly working toward a full currency union. The evidence supports my conclusion, while answering the question of how Japan should exercise its leadership in developing regional integration on both economic and financial sides, that the creation of the economic community resulting from the common market with the full currency union would bring the huge prosperity to the region.

I would like to express my great appreciation for my parents, my sister, my friends, and all those have supported me in New York and Tokyo, especially at a time when unfortunately I had to suspend this task due to my health problem. Without their numerous help, this paper could have never completed with the profound analysis and robust evidence in the big issue of regional integration in East Asia. Also, I would like to thank Professor Howard S. Schiffman, J.D., LL.M., the Center for International Affairs, New York University, for giving me a number of advices and providing invaluable suggestions on the essential part of this paper, the issue of GATT Article XXIV. Bearing in my mind that there are still continuous work in the research, I strongly believe that this paper would lay the foundation for whole my life.

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I. Introduction

In recent years, a new regionalism in East Asia has been rapidly proceeding on the future development of an economic community in the region. Why have the East Asian nations taken a significant step toward pursuing the new regionalism? There are the three main factors relating to the world economy that are relevant to this issue. The first factor is increasing uncertainty about the future of a multilateral framework under the World Trade Organization (WTO). The Doha Development Agenda held in Doha, Qatar in November 2001,¹ still fails to reach an agreement for concluding negotiations among the 148 members of WTO (as of February 2005).² The second factor is the strengthening and expansion of the European Union (EU)³ in Europe, and the creation of the North America Free Trade Agreement (NAFTA)⁴ in North America and the enlargement of Pan-Americanism.⁵ The deepening and widening of trade blocs in Europe and North America caused the East Asia nations huge concern that their exports would face fierce competition due to the large markets of EU and NAFTA. The third factor, which is a catalyst in considering issues of the new regional integration in East Asia, is East Asian Financial Crisis of 1997-98. The financial crisis fostered a new belief that the East Asian nations need to band together so that the contagious spread of crises could be minimized by creating a regional financial framework.

In order to make the development of their economic community more crucial and advanced, the East Asian nations are currently beginning to deepen economic and financial partnership with other nations in the region. However, there are so many obstacles to be overcome in the region before such a regional collaboration could become a reality. As East Asia is described as the “heterogeneity,” there are enormous diversities among the nations in terms of country size, ethnicity, religion, language, social and political structures, and the economic development in the region.⁶ Compared to Europe, for example, East Asia is characterized by greater diversity in term of size, the level of economic development, industrial structures, the depth of financial markets, and broad institutional frameworks. In addition, political rivalries, historical animosities, cultural differences and ideological confrontation still continue to provide the region with

¹ At the Fourth World Trade Organization Ministerial Meeting held in Doha, Ministers launched a comprehensive set of multilateral trade negotiations and a work programme, the mandate of which is referred to as the Doha Development Agenda. See WTO Website, *The Fourth WTO Ministerial Conference*, http://www.wto.org/english/thewto_e/minist_e/min01_e/min01_e.htm.

² See WTO Website, *Members and Observers*, http://www.wto.org/english/thewto_e/whatis_e/tif_e/org6_e.htm.

³ On May 1st, 2004, the Accession Treaty enters into force and the European Union's biggest enlargement ever in terms of scope and diversity becomes a reality with 10 new countries – Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, the Slovak Republic, and Slovenia. See EU Website, <http://europa.eu.int/>.

⁴ NAFTA, comprising Canada, the United States and Mexico, went into effect in January 1994. See NAFTA Website, <http://www.nafta-sec-alena.org>.

⁵ Agreement has been reached among 34 countries in North, Central and South America to negotiate for the Free Trade Agreement of the Americas (FTAA), which will take effect in 2025. See FTAA Website, <http://www.ftaa-alca.org/>.

⁶ Sakakibara and Yamazawa (2003a) pp. 30

barriers to regional integration.⁷ Regardless of a wide range of diversities and difficulties emerged in the entire region, however, the East Asian nations are now undertaking its development of the future regional integration that would bring the huge prosperity to the region so that they could benefit from such a regional collaboration by creating a viable framework for closer cooperation and deeper integration.

This paper argues in the two directions that, first a successful process of forthcoming regional integration would be achieved in the development of an economic community resulting from a common market with a full currency union, and in the development, second, Japan should exercise its leadership in developing regional integration on both economic and financial sides. In this regard, this paper is organized as follows. Section II, in order to provide the plausible explanation for adding to the plus-three nations in the preferential trade arrangements, analyzes an ineffectiveness of ASEAN's trade liberalization scheme that would establish a focal point of the creation of the common market in the region. Section III and IV try to compare China and Japan from the perspectives of the positive and negative effects on the region, which would serve the blueprint for how regional economic cooperation should be promoted among ASEAN, China, South Korea and Japan. Section III assesses the potential effects of China's economic growth and WTO accession, both of which bring a variety of implications to the region, and identify China's economic challenges needed to be examined in order to evaluate China's presence in the region. Section IV examines the Japan's external economic policy centralizing on FTAs and EPAs through which Japan promotes economic cooperation in the region, attempts to criticize the Japan's reluctance of opening its agricultural markets, which is a vital element for Japan to exercise its leadership in developing regional integration on the economic side, and answers the question of why Japan must accelerate its economic and social structural reforms for the sake of the development in the region as a whole. Section V explores the nature of East Asian Financial Crisis of 1997-98 so as to lay the groundwork for subsequent regional financial cooperation, with a view to promoting sustained economic growth and creating a stable financial environment for East Asia. Section VI considers a number of financial issues facing East Asia after the financial crisis along with Japan's assistance measures, clarify various rationales for fostering a regional financial framework, such as Chiang Mai Initiative, that provide the basis for a primary impetus for the development of regional integration on the financial side under the ASEAN+3 framework, and finally attempts to assess significant financial schemes through which East Asian nations would explore the feasibility of monetary integration that would be a definitive step toward a full currency union in East Asia. Section VII concludes the paper and provides the future prospects.

⁷ East Asian Vision Group (2001)

II. Trade within ASEAN

The Association of South-East Asian Nations (ASEAN)⁸ has a significant role in developing a regional framework for the creation of a common market in the region because ASEAN could be regarded as a unique position at the center of a whole series of preferential trade arrangements in the region. ASEAN has experienced a remarkable economic recovery after the financial crisis of 1997-98, attained a high real GDP growth rate⁹ and succeeded in maintaining its economic presence not only in the region but also in the worldwide. When it comes to foreign direct investments (FDI) into ASEAN, it is likely to gradually increase its total amounts after the financial crisis.¹⁰ These recovery patterns with respect to GDP growth rate and FDI into ASEAN could be seen as a basis for continued economic growth and orderly economic development of ASEAN. Given these economic aspects, ASEAN is currently negotiating bilateral and regional free trade agreements with countries in and outside the region.¹¹ In the arrangement, the ASEAN Free Trade Area (AFTA)¹² has been the most advanced and proactive effort to lead to the creation of the common market in East Asia.

AFTA has three main objectives – reducing tariffs, trade liberalization and attracting inflows of FDI to the region.¹³ In terms of FDI that is indispensable for further economic growth and development, AFTA has succeeded in attracting inflows of the FDI to ASEAN by enhancing market access and creating a more attractive market environment with a view to the fact that the enlarged market is likely to attract investments much more effectively than the much smaller national domestic markets. It has thus been a further stimulus for economic growth. By forming AFTA, in addition, the ASEAN members are not only able to provide multinational corporations (MNCs) with an environment where their resources are allocated more efficiently but also to increase the credibility of their commitment to trade openness. However, an ineffectiveness of tariff reduction and trade liberalization scheme has impeded a further success of AFTA. Under AFTA, the Common Effective Preferential Tariff (CEPT)¹⁴ Scheme¹⁵ was set up for tariff reductions so that tariffs on goods within the ASEAN region that meet at least 40% ASEAN

⁸ The Association of South-East Nations (ASEAN) was established among Indonesia, Malaysia, the Philippines, Singapore and Thailand on 8th August 1967. See ASEAN Website, *Bangkok Declaration (1967)*, <http://www.aseansec.org/1629.htm>.

⁹ ASEAN has successfully attained high real GDP growth rates, after the financial crisis of 1997-98, over 1999-2003 (3.6%, 5.9%, 3.3%, 4.5% and 5.0%, respectively). Source: ASEAN, *Statistical Indicators Table 2.1*.

¹⁰ Source: ASEAN, *Statistical Yearbook 2003 Table VI.2*

¹¹ China, Japan, India and Australia-New Zealand. See ASEAN Website, *Other Free Trade Areas under consideration*, <http://www.aseansec.org/13999.htm>.

¹² The framework for ASEAN Free Trade Area (AFTA) was signed in the Forth ASEAN Summit, Singapore, 27-29 January 1992. See ASEAN Website, *Framework Agreement on Enhancing ASEAN Economic Cooperation (1992)*, <http://www.aseansec.org/12474.htm>.

¹³ Lee (2002) pp. 9

¹⁴ See ASEAN Website, *Agreement on the Common Effective Preferential Tariff Scheme for the ASEAN Free Trade Area (1992)*, <http://www.aseansec.org/12475.htm>.

¹⁵ There are four products lists under the CEPT scheme. These are Inclusion List, Temporary Exclusion List, Sensitive List and General Exception List.

content¹⁶ would be reduced to no more than 5 percent by 2003¹⁷ for the original six members, ASEAN 6.¹⁸ According to the original schedule, all tariffs are also to be abolished by 2010 for ASEAN 6 and by 2015 for the other four members.¹⁹

Despite intra-regional tariffs that are already under 5 percent for most items in AFTA,²⁰ however, actual effectiveness of the scheme still remains at a low level. There are the three main reasons for responding to the ineffectiveness of AFTA. Compared to other region such as EU or NAFTA, first, ASEAN has obviously lower levels of intra-regional trade. In 2002, ASEAN's intra-exports accounted for 24.0 percent of its total exports and its intra-imports accounted for 23.6 percent of its total imports whereas EU and NAFTA intra-exports accounted for 61.6 and 56.5 percent and its intra-imports for 61.9 and 38.1 percent, respectively of its total exports and imports.²¹ Second, AFTA makes it difficult for the ASEAN members to take advantage of its tariff reduction and trade liberalization due to its economic size. In fact, none of the ASEAN members' shares of global GDP is greater than 0.50 percent, and ASEAN's GDP is only 1.75 percent of world wide GDP even in the aggregate.²² Third, intra-regional trade might not be the best measure to evaluate the effectiveness of AFTA. ASEAN's intention for AFTA is not only to increase intra-ASEAN trade but also to make its products internationally competitive by increasing the ASEAN region's competitive advantage as a single production unit.²³ These reasons clearly indicate that AFTA could be a more effective trading arrangement by linking to the Northeast Asian nations – China, South Korea and Japan – through bilateral arrangements and with the framework of ASEAN+3 that represents the entire East Asia region. From this standpoint, the ASEAN members now resolve to promote economic linkages among the East Asian nations toward integrating the ASEAN region with the plus-three nations so as to reap the benefits from the tariff elimination, abolishment of other trade barriers, and trade liberalization scheme in the entire region. It is conceivable that, in the movement, China and Japan have centered roles in influencing an agenda for promoting economic cooperation in the region by taking into consideration their economic presence. How China and Japan get involved in strengthening and deepening their economic relations with ASEAN, and develop regional integration on the economic side while dealing with a variety of their challenges facing the both nations are thus critical to foreseeing the future creation of the common market in the region.

¹⁶ ASEAN (2003b) Rule 3 (a)(i) and ASEAN (2003a) pp. 26

¹⁷ Lee (2002) pp. 7

¹⁸ ASEAN 6 refers to Brunei Darussalam, Indonesia, Malaysia, the Philippines, Singapore and Thailand

¹⁹ ASEAN (2002): The four new members are Cambodia, Lao PDR, Myanmar and Viet Nam.

²⁰ JETRO (2003) pp. 11

²¹ Source: ASEAN, *Statistical Yearbook 2003 Table I.9*

²² Sakakibara and Yamazawa (2003a) pp. 35

²³ See ASEAN Website, *Overview – Association of Southeast Asian Nations*, <http://www.aseansec.org/147.htm>.

III. The Rise of China

a. The Economic Growth of China

Growing at a GDP rate of 7-8 percent between 1998 and 2002,²⁴ China has achieved remarkable economic growth even in the new decade and sustained record rapid expansion in both trade and inward investments. China also has increased its political and economic presence due to this outstanding performance and thus posed a sentiment of “China is threat” to the region. When it comes to China’s growing international trade, China has experienced tremendous export expansion. China’s export grew fivefold from US\$62.1 billion in 1990 to US\$325.6 billion in 2002,²⁵ making China the fifth largest exporter in the world.²⁶ In the case of China’s exports to the U.S., EU and Japan, it accounted for 21.6, 15.2 and 14.9 percent respectively of its exports in 2002.²⁷ Compared to Japan, furthermore, China has increased the importance as a trading partner for the U.S. and EU. For example, the market share of U.S. imports from China has risen from 6.3-11.1 percent during 1995-2002 whereas Japan has declined from 16.5 to 10.4 percent.²⁸ The market share of EU imports from China has also risen from 1.8 to 3.1 percent while Japan has decreased those figures from 3.6 to 2.6 percent during the same period.²⁹ In addition, China has encouraged foreign investment into the Chinese market and had opened and expanded the scope for the investment by carrying out a series of reforms of its investment regimes.³⁰ FDI inflows into China had grown more than tenfold from US\$3.5 billion in 1990 to US\$53 billion in 2002,³¹ which is now overtaking the U.S. as the biggest FDI recipient in the world. In an environment for the economic growth and export expansion facilitated by FDI into China, MNCs that take advantage of China’s competitive wages and incentives offered through trade liberalization measures now account for more half of the nation’s total exports.³² The economic growth of China represented by growing its exports and imports, and expanding inward investments underscores the need for an examination in details as to whether China would be capable of taking the initiative in developing regional integration on the economic side while dealing with the formidable tasks of reforms in the wake of China’s WTO accession and China’s internal problems, both of which have concerned the process on which China develops its economy consistent with the global trading system.

²⁴ A GDP rate of China during 1998-2002 was 7.8%, 7.1%, 8.0%, 7.3% and 8.0%, respectively. Source: *ADB, Key Indicators 2003 pp. 102*

²⁵ Source: *ADB, Key Indicators 2003 pp. 159*

²⁶ Source: *WTO, International Trade Statistics 2003 Table I.5*

²⁷ Source: *IMF, Direction of Trade Statistics Yearbook 2003 pp. 138*

²⁸ Source: *WTO, International Trade Statistics 2003 Table III.16*

²⁹ Source: *WTO, International Trade Statistics 2003 Table III.37*

³⁰ WTO (2001) para.41

³¹ ASEAN (2001a) pp. 4

³² Yang (2003) pp. 6

b. China's Relations with ASEAN

A major reason for the dynamism of the economies of ASEAN and China has been the rapid growth of ASEAN-China trade because foreign trade could be defined as an important driving force behind the economic development of both regions. During the period from 1990-2000, China's export grew by an average of 14.5 percent, and ASEAN's regional export was growing at an annual average rate of 17.0 percent before the occurrence of the financial crisis of 1997-98.³³ During the same period, both China and ASEAN also achieved high growth rates in foreign trade between two regions. ASEAN-China trade grew from US\$8.9 billion in 1993 to US\$45.5 billion in 2001.³⁴ In contrast to Japan whose imports and exports share in ASEAN's market decreasing by 15.0-13.0 percent and 24.9-16.8 percent, moreover, the share of ASEAN's imports and exports accounted for by China has risen over the same period, 1.9-6.4 percent and 2.2-6.8 percent.³⁵ The evidence thus suggests that it is clear that China's role in East Asia become increasingly significant. As a result of China's emergence proven to be a major positive impact on a preparation for further economic development, more importantly, it is encouraging that there would be a need in an effort to foster strong economic relations between ASEAN and China.

At the ASEAN-China Summit held in November 2001, leaders of the two sides reached an agreement aimed at concluding a free trade agreement within ten years,³⁶ and the ASEAN-China Summit held in November 2002, they signed the Framework Agreement on ASEAN-China Comprehensive Economic Cooperation³⁷ that includes an establishment of ASEAN-China Free Trade Area (ACFTA)³⁸ under which the deadline for implementation of tariff eliminations is 2010 for ASEAN 6 and China, and 2015 for the new ASEAN members,³⁹ with a view to giving the members a special and differential treatment and flexibility.⁴⁰ This agreement also stipulates a strengthening and enhancement of economic cooperation between ASEAN and China by covering a wide range of areas, such as elimination of tariffs and non-tariff barriers in substantially all trade in goods, liberalization of trade in services with substantial sectoral coverage, establishment of an open and competitive investment regime facilitating and promoting investment, provision of special and differential treatment and flexibility to the newer ASEAN members,

³³ Source: *COMTRADE, Handbook of Statistics 2002 Table 1.2A and 1.2B*

³⁴ China's exports to ASEAN also grew from US\$4.3 billion to US\$ 20.2 billion over 1993-2001, while its imports from China grew from US\$4.6 billion to US\$25.3 billion over the same period. Source: *ASEAN, Statistical Yearbook 2003 Table V.11 and V.13.*

³⁵ Source: *ASEAN, Statistical Yearbook 2003 Table V.12 and V.14*

³⁶ See ASEAN Website, *Press Statement by the Chairman of the 7th ASEAN Summit and the Three ASEAN + 1 Summits Brunei Darussalam, 6 November 2001*, <http://www.aseansec.org/2756.htm>.

³⁷ See ASEAN Website, *Framework Agreement on Comprehensive Economic Co-operation between the Association of Southeast Nations and the People's of Republic of China*, <http://www.aseansec.org/13197.htm>.

³⁸ The ACFTA will create an economic region with 1.7 billion consumers, regional GDP of about US\$ 2 trillion and total trade estimated at US\$ 1.23 trillion. See ASEAN (2001a) pp. 30.

³⁹ ASEAN (2001b) Article 3(4)(a)(i)

⁴⁰ ASEAN (2001b) Preamble

provision of flexibility to the negotiations to address their sensitive areas, and establishment of appropriate mechanism for the purposes of effective implementation of this agreement.⁴¹ The agreement also stipulates an implementation of an “Early Harvest”⁴² program that promotes progressive liberalization of certain agricultural items in line with the schedule set out in the agreement.⁴³ In addition to the cooperation in agricultural industry, the agreement is also addressing further cooperation in the areas of information and communications technology (ICT), human resources development, Mekong River basin development,⁴⁴ banking and finance, transportation, telecommunications, industrial cooperation, forestry and fisheries, energy, and others.⁴⁵

It is expected that there would be significant effects on the economies of both ASEAN and China by deepening economic linkages, and establishing open and competitive invest regimes facilitating trade,⁴⁶ however, the framework of cooperation must recognize the difference in levels of development among the members who are the least developed countries in order to adjust their economic structures with China and facilitating the increasing participation of the members in the framework. In addition, the removal of trade barriers between ASEAN and China, which leads to increasing intra-regional trade and economic efficiency, and creating a larger market, would adversely affect each region’s domestic market due to intensifying competition. Going beyond the obstacles and difficulties, however, the adoption of this framework of economic cooperation between ASEAN and China would be successful in bridging the development gap among the participating nations, and moving ASEAN-China relations forward. More meaningfully, it would establish a solid foundation for the East Asian growth and stability, and represent a significant step toward a more ambitious vision of the common market in the region, encompassing ASEAN, China, South Korea and Japan.

c. China’s WTO Accession and its Impact on the Region

It is also important to note that China’s WTO accession⁴⁷ have major implications for China and the East Asia nations, and present both opportunities and challenges for the region as a whole. In the

⁴¹ ASEAN (2001b) Article 2

⁴² ASEAN (2001b) Article 6

⁴³ See ASEAN (2001b) Annex 3

⁴⁴ ASEAN (2001b) Article 7(1)

⁴⁵ ASEAN (2001b) Article 7(2)

⁴⁶ ASCFTA will increase ASEAN’s exports to China by 48 percent and China’s exports to ASEAN by 55.1 percent. ACFTA also increase ASEAN’S GDP by 0.9 percent or by US\$ 5.4 billion while China’s real GDP expands by 0.3 percent or by US\$ 2.2 billion. Source: *ASEAN (2001a) Annex 2*

⁴⁷ China participated in the WTO on December 2001, and the accession of the seventh biggest exporter in the world to the WTO is also expected to have significant impact on the international trading system. See WTO Website, Press/243, 17 September 2001, *WTO successfully concludes negotiations on China’s entry*, http://www.wto.org/english/news_e/pres01_e/pr243_e.htm.

negotiation of the entry into the WTO, China has agreed to undertake a series of important commitments⁴⁸ and market liberalization measures⁴⁹ that have been crucial in promoting China's integration with the global trading system and offering a more predictable environment for trade and inward investments in accordance with the WTO rules.⁵⁰ Accession to the WTO is also expected to produce significant benefits to China in terms of additional economic growth generated by trade and investment reforms that are part of the accession agreement. In addition, China's recent commitments on trade in services represent the most significant part of China's accession package, and would generate enormous productivity gains, otherwise China's services sector still remains closed to foreign competition both from domestic and foreign services providers.⁵¹ Reforms of China's manufacturing encompass the removal of quotas on China's textiles and clothing exports to North America and EU.⁵² As a consequence of its WTO accession, China has formally been included in the Uruguay Round Agreement on Textiles and Clothing (ATC)⁵³ would eventually obtain unrestricted access to textiles and clothing export markets.⁵⁴ After the removal of quotas, textiles and clothing industry would still face formidable barriers to market access in both developed and developing countries' markets in the form of high tariffs and perhaps safeguard measures,⁵⁵ however, there is no doubt that China would substantially increase its world market share in the textile and clothing industry following the elimination of quotas agreed under the ATC.⁵⁶ As a matter of fact, several indicators already point to the potential for a substantial increase in China's exports when quota restrictions are eliminated.⁵⁷ In addition to the market liberalization measures, one more factor contributing to this outstanding performance is the high level of FDI inflows driven by the relocation of labor-intensive manufacturing sectors from advanced economies into China.⁵⁸ Investment liberalization in China would make it possible for MNCs to further rationalize their production process within East Asia, such as lowering production costs.⁵⁹ Also, there would be direct benefits on China's consumers in the long run through efficiency gains

⁴⁸ China is given about 5 years to fulfill its commitments. See ASEAN (2001a) pp. 17

⁴⁹ These measures, which took place over a 15-year period, have included substantial tariff reductions and the dismantling of most nontariff barriers. See IMF (2004) pp. 5

⁵⁰ See WTO (2001)

⁵¹ Plans include the opening of key services sectors, where foreign participation was previously nonexistent or marginal, notably telecommunications, financial services, and insurance. See IMF (2004) pp. 10

⁵² Ianchovichina and Walmsley (2003) pp. 10

⁵³ The Agreement on Textiles and Clothing (ATC) terminated on January 1, 2005. The expiry of the ten-year transition period of ATC implementation means that trade in textile and clothing products is no longer subject to quotas under a special regime outside normal WTO/GATT rules. See WTO Website, *Explanation of the WTO Agreement Textiles and Clothing*, http://www.wto.org/english/docs_e/legal_e/ursum_e.htm#cAgreement.

⁵⁴ IMF (2004) pp. 11

⁵⁵ Acharya and Daly (2004) pp. 19

⁵⁶ Nordas (2004) pp. 30

⁵⁷ Rumbaugh and Blancher (2004) pp. 11

⁵⁸ WTO (2003e) pp. 4

⁵⁹ Ianchovichina and Walmsley (2003) pp. 7

and promoting industrial progress that China's WTO accession contributes.⁶⁰ Given the development, WTO membership would have significant implications for promoting China's economic growth by enhancing its economic efficiency and promoting its industrial progress.

The potential impacts of China's WTO Accession on the ASEAN members would be identified on the following three important aspects. First, ASEAN would increase its access to China's domestic market as a consequence of China's accession commitments. Second, it would thus cause fierce competition in both regions. Third, the possible impact on FDI inflows into ASEAN in light of China's admission to the WTO would be witnessed. These three aspects provide the basis for understanding the blueprint for the future economic relations between ASEAN and China. An important consideration for the ASEAN's benefits in favor of China's WTO accession commitments is that the ASEAN members would gain market access to China and thus expanding its exports to China rapidly. However, it is an identical argument that there would be increased competition from Chinese exporters in the world market, which is leading to great concern about forthcoming disruptive effects on domestic producers. The sectors where the greatest challenges are anticipated are textiles and clothing, labor-intensive manufactures and electronic industries in which it becomes apparent that China would show its increasing competitiveness in the global export markets, and thus pose a more direct competitive threat to the ASEAN's economies in the future.⁶¹ In order to minimize the negative impacts on ASEAN's economies in the wake of China's WTO accession, some ASEAN members are supposed to undergo significant adjustment aimed at competing with China in the export of labor-intensive products.⁶² The ASEAN's economies might also have to adjust to a greater share of FDI in the region going to China, and need to take steps to facilitate their own liberalization measures and technological innovations in order to improve resource allocation and enable them to pursue their own comparative advantage. In the international capital market, in addition, competition for FDI is likely to be intensified as the China's market becomes more open to foreign investment. For these reasons, it is widely expected that China's accession to the WTO would make it more attractive to a large amount of FDI and, as a result, it might further divert investment away from other developing countries in particular the ASEAN members. There is thus a need to take some measures enhancing the economic relations between ASEAN and China otherwise it is likely to cause considerable concerns among the ASEAN members. Another important concern is that the WTO commitments by China would not be enjoyed by the three non-WTO members of ASEAN – Cambodia, Lao PDR and Viet Nam. In addition, the ability of the four

⁶⁰ Rumbaugh and Blancher (2004) pp. 12

⁶¹ ASEAN (2001a) pp. 20

⁶² Rumbaugh and Blancher (2004) pp. 14

new ASEAN members to quickly shift resources to their export sectors to take advantage of any market opening in China is likely to be limited. In this regard, positive consideration in the form of promotion measures such as provision of capacity building and technical assistance to these countries should be given to the non-WTO members of ASEAN in order to expand their trade with China.

d. China's Economic Challenges

The analysis so far has highlighted the China's presence, the main source of which is arising from the fact that its economy has been expanded rapidly and economic relations between ASEAN and China have been enhanced strongly through a broad range of economic perspectives, is open to a primary interpretation that China would take the initiative in developing regional integration on the economic side. However, it would be suspect to the likely outcome with respect to the initiative unless China overcomes a large number of economic challenges and difficulties currently facing China. The main concern is whether China is capable of undertaking trade reforms and commitments made as a part of the WTO accession agreements that have been critical in promoting China's integration with the global trading system otherwise it might pose huge burdens on China.

Regardless of whether it would be great expense on its economic development in the future, as a WTO member, China must strictly adhere to all WTO rules and ensure conformity of its domestic laws and regulations with the WTO rules so as to fully perform its international obligations. The essential change with regard to China's legal system exists at the center of the assessment of its compliance with its WTO accession commitments. In fact, China's policies and regulations needs to be corrected so that it would become more transparent and accountable, and be conducive to creating a favorable and fair environment for foreign traders and investors.⁶³ As the essential component of reforms, in addition, China should strengthen the legislative framework of the enforcement of intellectual property rights consistent with the WTO agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS).⁶⁴ Significant critics have also proposed a wide range of reforms, especially the liberalization of its currency, renminbi. China that consolidated its renminbi rate moved to a managed floating rate system in 1994. After 1996, furthermore, the renminbi has been liberalized for current transaction, including for imports and exports. However, despite consistent dollar surplus which has been caused by the current account surplus and inflows of direct investment, the renminbi has been pegged to the dollar since 1994.⁶⁵ In light of China's

⁶³ ASEAN (2001a) pp. 17

⁶⁴ See WTO Website, *Agreement on Trade-Related Aspects of Intellectual Property Rights*, http://www.wto.org/english/tratop_e/trips_e/t_agm0_e.htm.

⁶⁵ METI (2003b) pp. 49

accession to the WTO and subsequent decision to promote liberalization in trade and investment as well as the need to reduce the cost of capital transaction management, it is encouraging that China need to liberalize its exchange rate regime in the near future. Associated with these changes in its legal and monetary system, China would also face the formidable economic challenges in that there would be import surges forcing a number of inefficient small- and medium companies to go to bankrupt by experiencing the fierce competition due to the substantial increase in the entry of foreign goods, firms and investment into the country in the wake of its acceleration of market liberalization measures consistent with the WTO requirements. Also, the challenge to China's agricultural sectors arises from the pressure of cheaper imports and reduction of government subsidies to farmers, which might cause a decline in rural incomes.⁶⁶ Of more importance is to promote reforms of state-owned enterprises (SOEs) so as to be consistent with the market economy. The deterioration in management of SOEs has resulted in the emergence of large non-performing loans by financial institutions that have provided funding to SOEs over many years.⁶⁷ In order to enhance the competitiveness of SOEs, China must stop the continuing governmental influence on the management of SOEs and no longer directly administer operational activities such as production, supply and marketing so as to be determined by the market forces, otherwise the deterioration of non-performing loans would be a long-term issue in China.

China is also facing increased regional disparity and growing gaps in the income level, which is one of the most serious social problems arising from the development process. The acceleration of liberalization and competition arising from China's implementation of its WTO commitments might make those problems worse, and it thus remains intractable unless China facilitates the implementation of adequate reforms. Income disparity is now rapidly widening between those people living mainly in urban areas by enjoying the benefits of the economic development and those people living in rural areas. In 2002, for example, the income disparity between urban and rural areas was 3.1 times, and the income disparity between the two areas is currently further increasing.⁶⁸ Furthermore, the same phenomenon in economic disparity has been witnessed between the eastern regions and the central and western regions. Looking at the GDP per capita, in 1991, GDP per capita in the eastern region was twice that of the central and 2.2 times that of the western regions. By 2001, this gap widened to the extent that the GDP per capita in the eastern region was 2.4 times and 3.0 times that for the central and western regions, respectively.⁶⁹ In order to correct such regional disparities, the government should make a transition from the previous policy of

⁶⁶ ASEAN (2001a) pp. 18

⁶⁷ METI (2003b) pp. 40

⁶⁸ METI (2003b) pp. 170

⁶⁹ IMF (2004) pp. 52

prioritizing development on coastal regions to a policy that focuses on the development of the central and western regions, and undertake a policy designed to promote balanced regional economic development. Those efforts must include a relaxation of the restrictions on moving from rural to urban areas in order to eliminate surplus labor forces in rural areas under the household registration (*hukou*) system.⁷⁰

IV. Japan's Leadership on the Trade Side

a. Japan's FTA and EPA Strategies

With regard to Japan's trade policy, although its main framework is through the multilateral trading system centered on the WTO, Japan began to place high emphasis on a multi-layered external economic policy that utilizes various approaches, including regional and bilateral measures.⁷¹ Being free trade agreements (FTAs) and economic partnership agreements (EPAs) important tools for invigorating the economy in the global trading system, in this regard, Japan has been intensifying its pursuit of reaching economic partnership with its trading partners in East Asia where it is rapidly gaining bigger economic presence in the world, and other regions with which Japan has close interdependent economic relations, such as Mexico.⁷² In addition, it is a vital importance for Japan to further commit to preferential trade arrangements in the region when considering the observation suggesting that the East Asian nations become an increasingly important trading partner for Japan. Ensuring that all East Asian nations could benefit from tariff reduction, trade liberalization, and further inflows of investments and services, there are some possible ways of promoting economic cooperation in East Asia. As a means to foster such a regionalism and develop regional integration on the economic side in East Asia, the most notable and significant means is to create a common market in the region, which would be prerequisite in building an economic community in East Asia. In the formation of the common market, Japan should place high priority on strengthening the ASEAN-Japan relations as well as the individual ASEAN members. The ASEAN-Japan Economic Partnership proposed by Prime Minister Junichiro Koizumi in January 2002 emphasized its relations with ASEAN. Japan's first free trade agreement, the Japan-Singapore Economic Partnership Agreement concluded in January 2002,⁷³ could be seen as a prompt response to the

⁷⁰ The *hukou* system was set up in the mid-1950s to control the movement of the population and effectively constrained the development of a national labor market. An urban *hukou* was needed to stay in cities and gain preferential access to city services as education, health and social security. Moreover, urban enterprises were restricted from recruiting labor from another province unless labor could not be found locally. See IMF (2004) pp. 52

⁷¹ METI (2003a) pp.9

⁷² See MOFA Website, *Joint Press Statement – the Agreement between Japan and the United Mexican States for the Strengthening of the Economic Partnership*, <http://www.mofa.go.jp/region/latin/mexico/joint0403.html>.

⁷³ See METI Website, *Joint Announcement of the Japan and Singapore Prime Ministers at the Signing of the Agreement between Japan and the Republic of Singapore for New-Age Economic Partnership (Towards Dynamism and Prosperity for the 21st Century)*, http://www.meti.go.jp/policy/trade_policy/jsepa/html/seimei-e.html.

regionalism, which reflects Japan's willingness to take the initiative in the development. In order to pursue the ASEAN-Japan Comprehensive Economic Partnership in line with a partnership with ASEAN as a whole, Japan also continues to pursue bilateral measures for the individual ASEAN members in parallel to accelerate this overall partnership in that it would not be easy to establish FTAs networks in East Asia where there are so many challenges and difficulties to be overcome. From this standpoint, Japan is thus now negotiating with Thailand,⁷⁴ the Philippines,⁷⁵ Malaysia⁷⁶ and Indonesia⁷⁷ to conclude economic partnership agreements as bilateral measures. Japan is also engaged in advanced efforts to conclude an FTA with South Korea,⁷⁸ in addition to these nations, which would be a significant step toward concluding a FTA under ASEAN+3.⁷⁹

It would be highly effective to coordinate efforts on regional and bilateral measures in parallel towards the realization of the common market in the region while taking into consideration the diversities and heterogeneity, both of which have prevented the East Asian nations from reaching coordinated policies for the promotion of economic cooperation and combining efforts on integrating their economies with each other. In this regard, Japan should exercise its leadership in promoting regional economic cooperation through economic partnership agreements that cover a broad range of areas, including elements of free trade agreements, while assuring that regional and bilateral measures would become building blocks toward the overall FTAs networks in the entire region so as to narrow the development gap identified in the region. In the formation of the common market, furthermore, those efforts must include principles that its regional and bilateral measures would be fully consistent with the principle of the multilateral trading system centered on the WTO so that trade liberalization could be achieved at the multilateral level. In the efforts to be consistent with the rules of the WTO, especially Article XXIV of the General Agreement on Tariffs and Trade (GATT), Japan thus should open its agricultural markets, which would be also subject to the benefits for other East Asian nations that likely to have large agricultural sectors. In order to bring the

⁷⁴ See METI Website, *Joint Announcement of the Japanese and the Thai Prime Ministers on the Initiation of Negotiations for Establishing the Japan-Thailand Economic Partnership Agreement (December 11, 2003)*, <http://www.meti.go.jp/english/information/downloadfiles/JapanThaiFTA/announcee.pdf>.

⁷⁵ See METI Website, *Joint Announcement of the Japanese Prime Minister and the Philippines President (December 11, 2003)*, <http://www.meti.go.jp/english/information/downloadfiles/JapanPhilFTA/announcee.pdf>.

⁷⁶ See METI Website, *Joint Announcement of the Japanese and the Malaysian Prime Ministers on the Initiation of Negotiations for Establishing the Japan-Malaysia Economic Partnership Agreement (December 11, 2003)*, <http://www.meti.go.jp/english/information/downloadfiles/JapanMalayFTA/announcee.pdf>.

⁷⁷ See MOFA Website, *Joint Announcement by the Prime Minister of Japan and the President of the Republic of Indonesia on the Possibility of the Economic Partnership Agreement between Japan and Indonesia*, <http://www.mofa.go.jp/region/asia-paci/indonesia/pv0306/economy.pdf>.

⁷⁸ See MOFA Website, *Joint Announcement on the Japan-ROK Summit Meeting (20 October 2003, Bangkok)*, <http://www.mofa.go.jp/region/asia-paci/korea/joint0310.html>.

⁷⁹ At the Japan-China-South Korea Summit Meeting held in Phnom Penh in November 2002, Chinese Prime Minister Zhu Rongji proposed a study on the feasibility of a Japan-China-ROK FTA. See ASEAN Website, *Press Statement by the Chairman of the 8th ASEAN Summit, the 6th ASEAN+3 Summit and ASEAN-China Summit, Phnom Penh, 4 November 2002*, <http://www.aseansec.org/13188.htm>.

mutual benefits in both Japan and the region as a whole, in addition, Japan is also urged to undertake its economic and social structural reforms that would lead to the increase in its FDI into the region.

b. Japan's Relations with ASEAN as a Whole

In its relations with ASEAN, Japan has been engaged in advanced efforts on both regional and bilateral levels on the trade side. As a basis for the promotion of regional integration, in the engagement, the high priority should be given to an conclusion of both a regional agreement with ASEAN and several preceding bilateral agreements with the individual ASEAN members with a view to the future creation of the common market by establishing a free trade area under which tariffs and other trade barriers would be eliminated or liberalized between all ASEAN members and Japan. ASEAN and Japan have complemented each other and could reap the benefits of mutually reinforcing the economic development through strong relations in private sectors by promoting partnership and cooperation in a broad range or areas, including trade and investments. Japan was ASEAN's primary trading partner in both imports and exports through 1980s and before the occurrence of the financial crisis of 1997-98. However, the importance of the relations had declined significantly with the share of ASEAN' exports to Japan dropping to 13.0 percent between in 2001, which made Japan drop its position of exports' share below that of the U.S. (17.0 percent) and EU (15.3 percent).⁸⁰ Despite the structure and changing pattern of trade between ASEAN and Japan over the last decade, however, Japan remains a very major and important trading partner for ASEAN in the region, in particular, the main import source of ASEAN and FDI inflows into ASEAN.⁸¹ Given the background, a process of closer cooperation and deeper integration underscores the importance of ASEAN and Japan relations, which have been mutually beneficial for both sides. As a means of developing economic integration among the East Asia nations, Japan's regional and bilateral measures in parallel would serve a coordinating function between Japan and ASEAN, and the individual ASEAN members, while contributing to efforts of narrowing the development gaps emerged in the region. In order to enhance Japan's cooperation at bilateral and regional levels, in this regard, there is a need to examine the recent Japan's relations with ASEAN in details, represented by the AJCEP and JSEPA that provide the basis for Japan's willingness to develop the creation of the common market in the region.

The Joint Declaration was announced at the Japan-ASEAN Summit Meeting in November 2002 with the objective of translating into concrete measures the initiative for ASEAN-Japan Comprehensive

⁸⁰ Source: *ASEAN, Statistical Yearbook 2003 Table V.12*

⁸¹ In 2001, Japan accounted for 16.8% of ASEAN's total imports whereas China accounted for 6.4% of ASEAN's total imports, and, with respect to FDI, accounted for 15.7% of total FDI inflows into ASEAN over 1995-2001 whereas China accounted for 0.6 % of total FDI inflows into ASEAN. Source: *ASEAN, Statistical Yearbook 2003 Table V.14 and VI.4*

Economic Partnership Agreement (AJCEP) proposed by Prime Minister Junichiro Koizumi in January 2002.⁸² Based on the report of the ASEAN-Japan Closer Economic Partnership Expert Group submitted at the consultation between the ASEAN Economic Ministers and the Minister of Economy, Trade and Industry of Japan held in September 2002,⁸³ it is stated that the implementation of measures for the realization of the comprehensive economic partnership, including elements of a possible FTA between ASEAN and Japan, would be complemented as early as possible within ten years. Going beyond an FTA, the AJCEP is also expected to produce various benefits, such as liberalization and facilitation of investments and services, protection of intellectual property rights, elimination of market entry regulations, promotion of technological transfer, expansion of human exchange, facilitation of the movement of natural persons and business people, implementation of customs cooperation, promotion of capacity building and technical assistance programmes, establishment of standards and conformance systems, and dispute settlements, development of hard and soft infrastructure, securing of markets, cooperation for securing stability and sustainable development, enhancement of intra-regional procurements, optimization of distribution of production bases, cooperation in individual industrial sector, and improvement of corporate earnings performance through cost reduction of enlarged regional transaction.⁸⁴ As a result of the realization of the AJCEP covering a wide range of areas for economic cooperation, including element of a FTA, it is expected that there would be significant economic effects on the economies of both ASEAN and Japan.⁸⁵ It would also give rise to the free movement of various factors related to economic and cultural activities under a more open and transparent environment, with a view to the establishing a future free trade area in the entire East Asian region. In order to further deepen the complementarity of ASEAN and Japan, and to facilitate economic development, however, there are several challenges and obstacles to be overcome. First, due consideration should be given to the different levels of economic development and to sectors in the ASEAN members, particularly the new ASEAN members. In order to avoid increased competition pressure in the non-competitive sectors, structural adjustment should be implemented in line with the WTO rules that allow the members of FTA to take ten years to complete FTA.⁸⁶ Second, the

⁸² See METI Website, *Joint Declaration of the Leaders of ASEAN and Japan on the Comprehensive Economic Partnership*, http://www.meti.go.jp/policy/trade_policy/asean/html/j-asean_summit_0211e.html.

⁸³ See METI Website, *The Ninth Consultation Between the ASEAN Economic Ministers and the Ministers of Economy, Trade and Industry of Japan (13 September 2002, Bandar Seri Begawan, Brunei Darussalam) Joint Press Statement*, http://www.meti.go.jp/policy/trade_policy/asean/html/aem_meti_0209e.html.

⁸⁴ ASEAN (2003a) 4.1.1-4.2.4 and METI (2003b) pp. 302

⁸⁵ GDP will increase by an amount equivalent to 1.99% to 0.07% of corresponding GDP from the base year of 1997, for ASEAN and Japan, respectively. The export value from ASEAN to Japan will increase by US\$ 20,630, which is equivalent to 44.2% of the corresponding export value in 1997, and the export value from Japan to ASEAN will increase by US\$ 20,002 million, which is equivalent to 27.5% of the export value in 1997. Source: ASEAN (2003a) 5.2.1

⁸⁶ *Understanding on the Interpretation of Article XXIV of the General Agreement Tariffs and Trade 1994* defines that the period for the completion of FTAs is in principle 10 years. See *Understanding on the Interpretation of Article XXIV of the*

establishment of an FTA should be consistent with the WTO Agreements, especially Article XXIV of the General Agreement on Tariffs and Trade (GATT)⁸⁷ and Article V of the General Agreement on Trade in Services (GATS).⁸⁸ It is very important to promote the AJCEP in conformity with the WTO rules because the AJCEP should be regarded as a step toward achieving the multilateral trade liberalization under the WTO. In the connection to these suggestions, third, Japan should open its agricultural markets in which ASEAN is trying to expand its exports to Japan. However, the argument raised in this context would make it still difficult to provide a considerable insight into how Japan should address its agricultural issue for the regional development without analyzing the definitive shortcoming in its trade policy. In order to ensure whether Japan's approaches at regional and bilateral levels would be conducive to promoting economic cooperation, thus, there is in need of examining the JSEPA that might provide a useful model case for assessing Japan's principles of regional integration on the economic side.

As an illustration of Japan's willingness to take the initiative in the formation of the common market in the region, the JSEPA provides a valuable case for understanding of how Japan should address the FTA negotiations with the individual ASEAN members. In 2001, Japan negotiated with Singapore the conclusion of an economic partnership agreement,⁸⁹ and the Japan-Singapore a New-Age Economic Partnership Agreement (JSEPA)⁹⁰ came into effect on November 2002.⁹¹ Covering customs duties on goods representing 98.5 percent of trade between two countries,⁹² the JSEPA is Japan's first free trade agreement consistent with Article XXIV of GATT⁹³ and also provides for free trade and investment in services in accordance with Article V of GATS.⁹⁴ Going beyond commitments of both countries under the WTO on liberalization of trade in goods and services, and investment, the JSEPA covers a wide range of key growth areas distinguished from rules of origin, paperless trading, mutual recognition, movement of natural persons, and intellectual property in liberalization and facilitation areas, information and

GATT 1994, para.3, http://www.wto.org/english/docs_e/legal_e/10-24_e.htm.

⁸⁷ The GATT authorizes the WTO members to enter regional trade agreements by justifying exemptions to the Most-Favored Nation Principle stipulated in GATT Article I under GATT Article XXIV, which says that a group of nations can form a free trade area or customs union by eliminating trade barriers among the nations. See Frankel (1997) pp. 3

⁸⁸ Under Article V of GATS, an agreement to liberalize trade in the service sector can only be concluded once the following conditions have been satisfied: (a) that the agreement has "substantial sectoral coverage," and (b) that it provides for the absence or elimination of substantially all discrimination. See WTO Website, *GATS: Article V*, http://www.wto.org/english/thewto_e/whatis_e/eol/e/wto06/wto6_17.htm#note1.

⁸⁹ Japan and Singapore are important partners of trade and investment each other on the grounds that Singapore is Japan's 9th largest trade partner and 4th largest recipients of Japan's foreign direct investment, and Japan is Singapore's 3rd largest trade partner. Source: METI (2002)

⁹⁰ See MOFA Website, *The Japan-Singapore Economic Partnership Agreement (JSEPA)*, <http://www.mofa.go.jp/region/asia-paci/singapore/jsepa.html>.

⁹¹ See METI Website, *Joint Announcement of the Japan and Singapore Prime Ministers at the Signing of the Agreement between Japan and the Republic of Singapore for New-Age Economic Partnership (Towards Dynamism and Prosperity for the 21st Century)*, http://www.meti.go.jp/policy/trade_policy/jsepa/html/seimei-e.html.

⁹² This accounts for 93.8% of Singapore's exports to Japan and 100% of Japan's exports to Singapore. See WTO (2003a) I.4

⁹³ WTO (2003a) I.2

⁹⁴ WTO (2003b) I.2

communication technology (ICT), human resource development, and small and medium enterprises in co-operation areas, and establishment of disputes settlement procedure in general provisions,⁹⁵ and thus the Japan and Singapore could benefit from strengthening bilateral economic ties in the global economy where transactional movements of goods, people and information are advancing. However, whether Japan could utilize the JSEPA as a valuable model case for becoming proactive in regional and bilateral agreements hinges on its ability to address the major restriction of the JSEPA. Those efforts, needless to say, must include the principles that regional and bilateral agreements cover trade liberalization in Japan's agricultural sectors. The major restriction of the JSEPA is to avoid the agricultural issue partly because Singapore has basically no agricultural sector while agriculture is a particularly sensitive area for Japan.⁹⁶ The JSEPA thus could safely cover "substantially all the trade"⁹⁷ that is one of the requirements of GATT Article XXIV for the WTO members entering in regional trade agreements. Furthermore, the Japan's argument that the JSEPA fulfills the requirements of GATT Article XXIV⁹⁸ and tariff elimination in agricultural products would not lead to significant trade expansion⁹⁹ should not be interpreted as a rationale for excluding its agricultural sectors in the agreement. In response to the exclusion of Japan's agricultural sectors, in fact, the U.S. points out that "Japan's schedule contained significant tariff-line carve outs and omissions concerned agricultural products."¹⁰⁰ For these reasons, it appears reasonable to conclude that the JSEPA might be limited as a valuable model case for Japan to become proactive in regional and bilateral agreements with other East Asia nations where agriculture is very important issue.

c. Opening Japan's Agricultural Markets to the Region

The analysis so far has suggested that it is less likely that Japan's approaches in regional and bilateral measures, such as the AJCEP and JSEPA, would serve as a coordinating function in the formation of the common market in the region, on the grounds that the approaches have failed to address the major critical issue for the further development of the East Asia nations. The issue is, needless to say, trade liberalization in Japan's agricultural sectors and tariff elimination of its agricultural products. The question of whether Japan is able to exercise its leadership in developing regional integration on the economic side, in this regard, requires a more concrete assessment of Japan's agricultural policy that is a vital element of economic cooperation in the region where a number of nations have large agricultural sectors. The

⁹⁵ METI (2002) pp. 6-22

⁹⁶ Singapore's agriculture contributed only 0.1% of its GDP in 2002. Source: *ADB, Key Indicators 2003 pp. 286*

⁹⁷ See Article XXIV 8 (a)(i) of the GATT

⁹⁸ WTO (2003c) Reply to Question II.1(a)

⁹⁹ WTO (2004a) Reply to Question II.1

¹⁰⁰ WTO (2004b) para.5

important point identified in this context is thus whether Japan is capable of opening its agricultural markets, which is a critical issue in the negotiations of regional and bilateral measures. The argument with Japan's agricultural policy is exposed to the two suggestions stemming from its reluctance to lower tariffs and eliminate other trade barriers in its agricultural markets; first, Japan should promote regional economic cooperation consistent with the WTO rules so that it could become building blocks toward trade liberalization at not only bilateral and regional levels but also multilateral level; second, Japan should seek to prepare for the tariff reduction and trade liberalization in its agricultural sectors, thereby it would be conducive to not only narrowing the gap of the development but also the poverty reduction in the region.

In order to complement Japan's approaches in regional and bilateral measures with the WTO rules, it would be a vital importance for Japan to ensure that the preferential trade arrangements in the region remain consistent with Article XXIV of GATT that demands that the WTO members enter into regional trade agreements (RTAs) to cover a "substantially all the trade"¹⁰¹ between the entities. For this reason, Japan must substantially reduce tariffs and other trade barriers in its agricultural markets. However, the interpretation of "substantially all the trade" highlights an ambiguity, which has caused ongoing debates on examinations of RTAs, and thus this issue has remained enormously contentious.¹⁰² The Committee Regional Trade Agreements (CRTA)¹⁰³ has currently indicated that two interpretations of "substantially all the trade" requirement have emerged. One is a quantitative approach that favors defining "substantially all the trade" as a statistical benchmark to indicate whether s RTAs trade coverage fulfills the "substantially all the trade" requirement.¹⁰⁴ The problem with the quantitative approach is that nations can use this provision to exclude the liberalization of sensitive sectors, such as agriculture, as long as the trade volume of the RTAs is quantitatively liberalized. The other is a qualitative approach that means that RTAs cannot exclude any sectors from the intra-RTA trade liberalization.¹⁰⁵ Under the qualitative approach, "substantially all the trade" is viewed as preventing the exclusion of any sectors where the amount of trade was small. As identified in these arguments, a lack of consensus on the concise interpretation of "substantially all the trade" has resulted in an intractability of the compatibility of RTAs with the WTO rules. In defining

¹⁰¹ "Substantially all" barriers among the members be removed while neither stopping short at partial preferences nor excluding major sectors in line with Article XXIV: 8, which defines a customs union and a free trade area. Article XXIV: 8 (a)(i) states that a customs union is an entity in which duties and restrictions of commerce are eliminated with respect to substantially all the trade between the members of the union except those restrictions permitted under Article XI, XII, XIII, XIV, XV and XXX. See: GATT Article XXIV:8(a)(i)

¹⁰² WTO (2000b) paras.53-54

¹⁰³ Under the WTO Agreement, the CRTA is mandated to monitor regional trade agreements. The WTO members are obliged to notify such agreements and the CRTA is supposed to examine the compatibility of the treaty with the WTO rules. See WTO Website, Regional Trade Agreements: Committee, *Work of the Committee on Regional Trade Agreements (CRTA)*, http://www.wto.org/english/tratop_e/region_e/regcom_e.htm.

¹⁰⁴ WTO (2000b) para.54(a)

¹⁰⁵ WTO (2000b) para.54(b)

“substantially all the trade” in the context of a customs union, the Report Panel and Appellate Body in *Turkey-Textile Case*¹⁰⁶ held that ordinary meaning of the term “substantially” in the context of Article:8(a) appears to contain both qualitative and quantitative elements for customs unions.¹⁰⁷ Australia also argues that “substantially all the trade should be defined in terms of coverage by a free trade agreement or an agreement establishing a customs union of a defined percentage of all six-digit tariff lines listed in the Harmonized System.”¹⁰⁸ Australia further elaborates that “such a percentage criterion should be established at a sufficiently high level to prevent the carving out of any major sector.”¹⁰⁹ Regardless of the suggestions that the WTO members provides so as to resolve the issue in the context of Article XXIV:8, it is still controversial whether the concise interpretation of the “substantially all the trade” represents a qualitative or a quantitative approach, or a combination of both approaches. In addition, the EU case in which exclusion of the agricultural sectors is permitted in the preferential trade arrangements seems to reflect an difficulty of the implementation of trade liberalization in sensitive sectors, which would lead to further expand trade barriers and thus still create substantial trade diversion and distortion for developing countries in which it is likely to have a comparative advantage in their agricultural sectors. As the only country that promotes the preferential trade arrangements in multilateral, regional and bilateral measures, however, Japan should substantially reduce tariffs on items in sensitive sectors for the sake of the developing countries in the region in which opening Japan’s agricultural market is expected for their economic growth and the development of trade, by ensuring the consistency of its regional trade agreements with the principle of the multilateral trading system centered on the WTO, in particular, the requirements of GATT Article XXIV stipulating that RTAs cover “substantially all the trade,” otherwise Japan would fail to reach the agreements in the FTA negotiations of both regional and bilateral measures. Furthermore, results in trade diversion and distortion caused by an ambiguity of the interpretation of “substantially all the trade” would undermine the goals of the multilateral trading system in the WTO.

Based on the food security, Japan’s argument that the flexibility be left to the nation that secures the agricultural markets to maintain the certain level of domestic agricultural production¹¹⁰ could be recognized as an excuse for Japan’s unwillingness to open its agricultural markets in favor of the developing countries in the region because the issue of the food security could be resolved in more

¹⁰⁶ *Turkey-Textile Case* became the first dispute settlement case that addressed the issue of GATT Article XXIV. See WTO (1999a) paras.1-20

¹⁰⁷ WTO (1999b) para.9-148

¹⁰⁸ WTO (2002b) para.8

¹⁰⁹ WTO (2002b) para.9

¹¹⁰ MAFF (2002) pp. 6

integrated economy¹¹¹ and, in this sense, Japan should undertake its agricultural policy reforms that would be not only essential for the WTO and FTA negotiations but also conducive to the poverty reduction in the region where agriculture is the main industry for the poor countries. As an alternative method to replace tariffs to farmers who have enjoyed high percent tariff, such as the rice sectors protected by 490% tariff, it would be inevitable that Japan open its agricultural markets by ceasing price supports backed by tariffs on products and introducing direct income payments to compensate for income losses of farming households, who are likely to be affected by reduced prices, similar to those in EU, otherwise it remains incapable of overcoming the obstacles in the WTO and FTA negotiations and thus Japan would fail to exercise its leadership in developing regional integration on the economic side. EU maintained regional market prices higher than international level through tariffs and other measures, and then managed surplus with export subsidies. Due to the agricultural policy reform carried out in 1992, however, regional support prices have been decreased and direct payments to farmers have been introduced in order to compensate them for income losses.¹¹² EU is thus able to supply food to consumers at a low price and guarantee international competitiveness while maintaining farmers' income. The evidence suggests that Japan facilitate the implementation of direct income payments to get away with the trade diversion and distortion existed in its agricultural sectors for the sake of the regional development even though it is skeptical that the new agricultural policy conducted by Japan is best explained as a method of trade liberalization in its agricultural sectors because there is a possibility of "loophole" for domestic support payments stipulated in the WTO rules.¹¹³ Apart from the possible loophole that might be identified in the WTO rules, the opening of Japan's agricultural markets would bring a considerable insight into another aspect of benefits, such as the positive effect that Japan's real GDP gains would largely come from the trade liberalization in its agricultural sectors.¹¹⁴ Additional support for the trade liberalization in Japan's agricultural sectors also comes from the observation that reduction of trade barriers is also particularly important for the poverty reduction in East Asia where agriculture is the main livelihood for poor households in both low- and middle-income countries in the region.¹¹⁵ With nearly three quarters of the world's poor concentrated in rural areas of developing countries and depending heavily on agriculture for their livelihoods, trade liberalization in agriculture is crucial to the poverty reduction.¹¹⁶ In Cambodia and Viet Nam, for example,

¹¹¹ See WTO Website, WTO News: Speeches – DG Supachai Panitchpakdi, *Why trade matters for improving food security*, http://www.wto.org/english/news_e/spsp_e/spsp37_e.thm.

¹¹² See RIETI Website, *Only Japan Left Behind by International Standards*, March 23rd 2004, <http://www.rieti.go.jp/en/papers/contribution/yamashita/02.html>.

¹¹³ Josling and Hathaway (2004) pp. 4

¹¹⁴ Kawasaki (2003) pp. 6

¹¹⁵ World Bank (2003b) pp. 102

¹¹⁶ Acharya and Daly (2004) pp. 13

most of the poor households earn a living by growing rice, and the rice culture spreads over the entire region.¹¹⁷ The trade liberalization in Japan's agricultural sectors and substantial decline in tariffs of its agricultural products, especially rice, are thus indispensable in allow the developing countries in the region to improve food security, access a stable food supply, and gain the opportunity to raise income levels through their economic growth.

In addition to the agricultural issue, Japan is also urged to promote its economic and social structural reforms that would be conducive to the development of East Asia through Japan's FDI that has contributed significantly to the rapid economic growth of East Asia until the financial crisis after which inflows of Japan's FDI into the region have been declined. This decline is largely due to unfavorable financial circumstance of Japan's companies and banks, which become one of the reasons for a long recession in Japan. The declining trend is likely to be reversed in the near future, however, because a large number of Japan's companies are interested in expanding and strengthening their overseas operations.¹¹⁸ Facing a prolonged recession, many Japan's companies have found overseas markets attractive by considering the overseas production as an effective way to reduce production costs and taking advantage of lower wages in these countries, both of which would lead to increasing competitiveness in international markets. In addition, Japan's companies show their interest in responding to local market demand. In the survey of Japan Bank for International Cooperation Institute (JBICI), in fact, "responding to expanding markets" was the most commonly cited reason for expanding and strengthening operations.¹¹⁹ As a basis for expanding and strengthening operations in ASEAN, Japan's companies also show their interests in AFTA¹²⁰ that would cause the expanding trade within the region mainly due to reduced tariffs.¹²¹ These results with regard to the reasons for expanding and strengthening overseas production and the expectations for AFTA could be viewed as evidence that it is likely to increase Japan's FDI into the region.

An important consideration for the future increase in Japan's FDI into the region is that critics have proposed that in order to reap the benefits from Japan's FDI, the East Asia nations provide an attractive

¹¹⁷ In fact, Rice is a central feature of lie in Cambodia and Viet Nam. More than 80 percent population in both countries is rural, and most of the rural population produce rice. See World Bank (2003b) pp. 201

¹¹⁸ Of the 489 responding companies into the question, the most numerous answer with respect to the current top priority issues for domestic and overseas business operation was "strengthen and expand the overseas production" at 54.6%, followed by "strengthen and expand the customer base by the company's own efforts" at 37.8% and "review and improve efficiency of the management of group companies" at 32.5%. See JBICI (2003) Table 7

¹¹⁹ In response to the question on the reasons for expanding and strengthening operations in East Asia, Japan's companies indicated their interest in "responding to expanding markets" (60.4%). This is followed by "forming a supply system for an important client" (38.2%) and "developing new clients" (31.5%). See JBICI (2003) Table 18

¹²⁰ More than half of the responders (53.6%) said "liberalization of intra-regional trade due to the functioning of AFTA can be expected." See JBICI (2003) Figure 19

¹²¹ The most common reason for cited for this was "expanding trade within the region due to reduced tariffs (78.9%)." This is followed by "simplifying the customs clearance procedure (38.2%)" and "benefits enjoyed by scale merit due to market expansion (37.0%)". See JBICI (2003) Figure 20

FDI environment and liberalize FDI policies, both of which could become important driving forces behind an economic recovery and sustainable economic growth. In fact, the results of the JBICI survey have shown the importance of open trade and invest climate, stable economic environment, well-established and well-established soft and hard infrastructure, effective legal system and secured local personnel.¹²² In addition, the increase in FDI is also expected to contribute to the progress of production technology in recipient countries and enable foreign investors to introduce a package of highly productive resources into the host economy, including production and process technology, managerial expertise, accounting and auditing standards, and knowledge of international markets while MNCs are playing an prominent role in the recipient countries by bringing a lot of implications for the countries pursuing an export-oriented development suitable for the East Asian economies.¹²³ More importantly, the critics have also suggested that there be Japan's long-term efforts to implement economic and social structural reforms, including a progress on disposal of non-performing loans, financial and corporate sector reform, pension reform, strengthening of competition policy, trade liberalization and others, in order to help its private sectors revitalize and restore consumer confidence, thereby making an important contribution to sustained growth of the East Asia economies and stimulating the development of Japan's economy.¹²⁴

Thus far I have discussed the most plausible explanation for Japan's willingness in developing regional integration on the economic side. In support of Japan's approaches in regional and bilateral measures, such as the AJCEP and JSEPA, which would become a highly effective method of addressing the major critical issue of the East Asia economies, the development gap, abundant evidence supports the conclusion that Japan with its strong interest in the importance of a leadership in economic cooperation must open its agricultural markets and promote its economic and social structural reforms for the sake of the regional development because overwhelming majority of the nations in the region could benefits from both trade liberalization in Japan's agricultural sectors and the increase in its FDI into the region. The conclusion contained two elements of the observations. First, the observation that trade liberalization in sensitive sectors, such as agriculture, would be achieved at the multilateral level centered on the WTO supports the conclusion that Japan's regional and regional measures should be complied with the requirements of GATT Article XXIV that stipulates "substantially all the trade." Second, the observation that closer economic relations with the East Asian nations would significantly contribute to the economic growth of Japan supports the conclusion that the factors that have suppressed the Japan's economy since

¹²² JBICI (2003) pp. 50-55

¹²³ ADB (2004) pp. 217

¹²⁴ WTO (2004d) pp. 12

the burst of the bubble economy should be eliminated so as to benefit the entire region. In order to create the common market that would bring the economic prosperity to the region, Japan should be willing to exercise its leadership in developing regional integration on the economic side by addressing the major critical challenges identified in Japan.

V. The Nature of East Asian Financial Crisis

East Asian Financial Crisis of 1997-98 highlighted the importance of financial cooperation in the region. The financial crisis triggered by massive reversals of private short-term capital flows provides the best illustration that the occurrence of the crisis spread quickly to other countries in the region in which there has been growing regional economic interdependence in terms of trade and investment.¹²⁵ The painful lessons of the financial crisis have been thus a primary impetus for considering the issue of how regional integration on the financial side should be developed so as to minimize the risk of another crisis and thereby sustain economic growth in the region. In this sense, there is a need to analyze the nature of the financial crisis that could be viewed as the most important rationale for the promotion of financial cooperation in the region.

The Thai baht crisis spread to Malaysia, Indonesia, the Philippines and eventually South Korea within a few months. On July 2, 1997, the Thailand abandoned the peg and thus introduced a managed float of the baht, which subsequently depreciated about 20 percent against the US dollar.¹²⁶ After Thailand devaluation the baht, the Philippines allowed the peso to freely float on July 11¹²⁷ and Malaysia abandoned the defense of the ringgit peg on July 14. When an IMF package was signed with Thailand on August 14,¹²⁸ Indonesia allowed the rupiah to float. An IMF rescue package for Indonesia signed on November 4,¹²⁹ but failed to stop the depreciation of the rupiah. South Korea was forced to widen its exchange rate band in November, which made the stock price and the won sharply fell. South Korea officially abandoned its exchange rate band following the signing of an IMF financial package on December 4 and moved to a floating system.¹³⁰ These events show how the crisis spread from one country to another, and how the crisis and contagion dampened economies of the entire East Asian region. In addition, devastating effects

¹²⁵ Sakakibara and Yamazawa (2003b) pp. 45

¹²⁶ See IMF Website, Press Release Number 97/37 August 20, 1997, *IMF Approves Stand-by Credit for Thailand*, <http://www.imf.org/external/np/sec/pr/1997/pr9737.htm>.

¹²⁷ See IMF Website, Press Release Number 97/33 July 18, 1997, *IMF Approves Extension and Augmentation of EFF for the Philippines*, <http://www.imf.org/external/np/sec/pr/1997/pr9733.htm>.

¹²⁸ See IMF Website, Press Release Number 97/37 August 20, 1997, *IMF Approves Stand-by Credit for Thailand*, <http://www.imf.org/external/np/sec/pr/1997/pr9737.htm>.

¹²⁹ See IMF Website, Press Release Number 97/50 November 5, 1997, *IMF Approves Stand-By Credit for Indonesia*, <http://www.imf.org/external/np/sec/pr/1997/pr9750.htm>.

¹³⁰ See IMF Website, Press Release Number 97/55 December 4, 1997, *IMF Approves SDR 15.5 Billion Stand-by Credit for Korea*, <http://www.imf.org/external/np/sec/pr/1997/pr9755.htm>.

of the financial crisis that resulted from the reversal of private capital flows provide a plausible guidance why the crisis could be identified as a “capital account crisis” in contrast to the more typical “current account crisis” that could be characterized by poor macroeconomic fundamentals such as high inflation and large fiscal deficits.¹³¹ As there is evidence indicating that Thailand succeeded in achieving high economic growth rate and attracting a large volume of FDI,¹³² in fact, the crisis-affected countries sustained sound fiscal positions, high saving ratios, low inflations and high economic growth before the occurrence of the financial crisis.¹³³ It could be thus concluded that unsound macroeconomic policies could not be identified as a primary factor in the financial crisis. There is indeed observation bringing a valuable insight into the nature of the financial crisis based on the case in which the IMF provided financial supports for three of the most seriously affected countries, Thailand, South Korea and Indonesia. A particularly striking common feature of the three countries was the very high ratio of short-term foreign debt to reserves, which became the basis for the reason that the three countries had to adopt many fiscal, monetary and structural policy reforms such as increased prudential standards, improved governance, foreign access and privatization.¹³⁴ Designed to help to restore confidence and sustain an economic recovery of the affected countries, in this regard, the IMF rescue packages serve as an important driver for igniting discussions on financial cooperation in the region.

East Asian Financial Crisis of 1997-98 provides an essential mechanism for understanding of why there is a need to create a robust regional framework for financial cooperation so as to prevent resurgence of another crisis and attain economic growth, both of which could be identified as key aspects of the development of regional integration on the financial side. In addition, the occurrence and contagion of the financial crisis gives a straightforward explanation for a support of the new belief that the East Asian nations should enhance a regional financial infrastructure by addressing various weaknesses and thus lessening the negative impacts on the regional economies that are supposed to be vulnerable to geographic fluctuations. Given the nature of the financial crisis, the challenges facing East Asia would be to ensure how the nations foster a regional financial framework by developing various financial schemes, including a regional financing facility, strong financial institutions, development of bond markets, appropriate exchange rate policies, and monetary integration, all of which would be conducive to sustaining economic growth in the entire region.

¹³¹ Kuroda and Kawai (2003) pp. 2

¹³² An average GDP rate of Thailand during 1985-1990 and 1990-1995 were 11.2% and 9.2%, respectively. Source: *ADB, Key Indicators 2003* pp. 319

¹³³ Sakakibara and Yamazawa (2003b) pp. 45

¹³⁴ Sussangkarn and Vichyanond (2004) pp. 8

VI. Japan's Leadership on the Financial Side

a. Japan's Commitment to the Region shortly after the Crisis

In order to help East Asian nations recover economic growth and reduce the risk of another crisis, Japan has committed to regional financial cooperation through a number of assistance measures for the region on the basis for its close economic ties with the East Asian nations.¹³⁵ In the arrangement, Japan announced Asian Monetary Fund (AMF) in September 1997 so that it could bring the financial stability to regional currencies and financial markets, and work toward prevention of the recurrence of another crisis by making available a pool of funds to be quickly disbursed as a means of emergency balance of payments support for economies of the affected countries.¹³⁶ However, the U.S. opposed the idea of the AMF on the ground that there is a potential for moral hazard and duplication in a circumstance where the affected countries could avoid the tough conditionality of the IMF and thus receive easy money from the AMF, which would undermine an international effort to strengthen domestic policy reforms on the part of the borrowing countries due to the soft conditionality associated with the AMF financing. New Miyazawa Initiative (NMI), announced in October 1998, was also implemented by Japan as a bilateral support mechanism in order to stabilize the regional economies and support the economic recovery of the affected countries. The support package totaled US\$30 billion, half of which would be set aside for short-term capital needs during economic restructuring and reforms, and the rest of which was earmarked for medium- and long-term reforms.¹³⁷ Although the NMI was implemented shortly after Japan's unsuccessful attempt to form the AMF, the distinction between the two assistance measures is that the AMF was a multilateral scheme focused on the stabilization of currency as opposed to the NMI serving as a bilateral initiative for recovery assistance.¹³⁸ The idea of the AMF was dropped, however, in November 1997, the East Asian nations, together with the U.S., Canada, Australia and New Zealand, agreed to establish the Manila Framework Group, the object of which is to develop a concerted framework for regional financial cooperation in order to restore and enhance the prospects for financial stability in the region, and its initiatives include the establishment of a new mechanism for regional surveillance to complement global surveillance by the IMF; enhancement of economic and technical cooperation, particularly in strengthening domestic financial systems and regulatory capacities; strengthening the IMF's capacity to respond to

¹³⁵ Japan's exposure to Thailand at the height of the crisis was extremely high compared to that of EU and the U.S., standing at around 25% of lending to all developing countries. Japan's financial institutions also lent the most in absolute terms – around \$38 billion compared to \$20 billion for EU and \$4 billion for the U.S. Thus, Japan's banks stood at the greatest risk in the event of a major conflagration. See Lipsy (2003) pp. 98

¹³⁶ Rajan (2000) pp. 1

¹³⁷ See MOF Website, *A New Initiative to Overcome the Asian Currency Crisis – New Miyazawa Initiative –*, <http://www.mof.go.jp/english/ifa/e1e042.htm>.

¹³⁸ Sakakibara and Yamakawa (2003) pp. 59

financial crises; and development of a cooperative financing arrangement for the region to complement IMF resources.¹³⁹

Since the occurrence of the financial crisis, Japan has played a leading role in responding to the crisis and contributed to prevention of the capital account crisis. The assistance measures announced by Japan have thus had important implications for subsequent establishment of a well-designed regional financial framework through which the East Asian nations could benefit from the economic recovery, reduction of another crisis, and stability of currency and financial systems. Apart from the measures to stabilize the East Asian economies, in addition, initiatives implemented by Japan with the objective of preventing currency crises also help stabilize Japan's economy by reducing currency exchange-related risk in trade and capital transactions. In order to promote the restructuring of financial sectors, foster a regional financial facility, and thus ensure the financial stability in East Asia, Japan should vigorously promote regional financial cooperation together with other ASEAN+3 countries. As a first step toward establishing a robust financial framework in the region, Japan's efforts should be put on the process of enhancement of regional financial schemes, the main principle of which is to both prevent resurgence of another crisis and sustain economic growth in the entire region.

b. Going Beyond Chiang Mai Initiative

The IMF, the main responsibility of which is to provide loans to countries experiencing balance of payments problems so that the countries could rebuild their international reserves, stabilize their currencies, continue paying for imports, and restore conditions for strong economic growth through an IMF loan provided under an "arrangement" that stipulates the specific policies and measures that a country has agreed to implement in order to resolve its balance of payments problem, has been seen as playing a major role in helping economies of the member countries overcome balance of payments problems through conditional lending.¹⁴⁰ In the case of the East Asian nations seriously affected by the financial crisis, however, the IMF was incapable of enabling the affected countries to overcome their difficulties in the economies because of a false examination of the nature of the crisis and regional dynamics. As a result, the borrowing countries were required to accept rather tight conditionality that discouraged these countries to receive adequate amount of liquidity and precipitated the capital account crisis. Prescriptions of economic and structural reforms by the IMF thus failed to help restore investor's

¹³⁹ See MOF Website, *A New Framework for Enhanced Asian Regional Cooperation to Promote Financial Stability – Meeting of Asian Finance and Central Bank Deputies – Agreed Summary of Discussions Manila, Philippines 18-19 November 1997*, <http://www.mof.go.jp/english/if/if000a.htm>.

¹⁴⁰ See IMF Website, *A Factsheet, IMF Lending*, <http://www.imf.org/external/np/exr/facts/howlend.htm>.

confidence and prevent the affected countries from deteriorating their economies during the financial crisis.¹⁴¹ Reflecting the recognition that the IMF has a limited role as a last lender resort, the process of financial cooperation in East Asia has concerned the effective method of enhancing regional financing schemes without establishment of a regional financing facility that could play a useful in crisis prevention and its management. At this point, the important clarification is to establish a regional financing facility that works in accordance with the IMF but only substitute to the IMF's lending facility so that the facility could lessen mistakes that might jeopardize the regional economies in times of crisis.

As a regional financing arrangement supplementary to existing international arrangements to come out the crisis, Chiang Mai Initiative (CMI) was established by the ASEAN+3 Finance Ministers held in Chiang Mai, Thailand, in May 2000.¹⁴² The CMI comprises of two elements: one is ASEAN Swap Arrangements implemented in 1977,¹⁴³ which is now to expand to all ASEAN members, and the other is Bilateral Swap Arrangement (BSA), the purpose of which is to provide short-term financial assistance in the form of swaps to a country in need of balance of payment support or short-term liquidity support among the ASEAN members, China, South Korea and Japan. The BSA is complementary to the IMF's assistance in that countries drawing from the facility are required to accept an IMF program for macroeconomic and structural adjustment. The BSA, however, allows a disbursement of up to 10 percent of the maximum amount of drawing without any linkage to an IMF program or conditionality.¹⁴⁴ The remaining 90 percent is provided to the requesting member under an IMF program. The linkage of disbursements to IMF conditionality is meant to ensure that the major part of these swap arrangements is not independent of IMF assistance, and to ease the fears of countries that are concerned with potential conflicts with IMF conditionality and moral hazard problems.¹⁴⁵ By the end of December 2003, sixteen BSAs had been concluded in line with the main principles, reaching a total of US\$44 billion.¹⁴⁶ There are currently nine BSAs for a combined total of \$18.5 billion that have been signed and several more BSAs are under negotiations. In the arrangement, Japan is currently taking the lead in the negotiations of agreements with the East Asian nations. As of April 2005, Japan has concluded the BSAs, a dollar-won swap arrangement worth \$2 billion in addition to the present framework of \$5 billion with South Korea, a dollar-baht and a dollar-yen swap arrangement worth \$3 billion with Thailand, a dollar-peso swap

¹⁴¹ IIMA (2004) pp. 60

¹⁴² See ASEAN Website, *The Joint Ministerial Statement of the ASEAN+3 Finance Ministers Meeting 6 May 2000, Chiang Mai, Thailand*, <http://www.aseansec.org/1026.htm>.

¹⁴³ See ASEAN Website, *Memorandum of Understanding On The ASEAN Swap Arrangements Kuala Lumpur, 5 August 1977*, <http://www.aseansec.org/2364.htm>.

¹⁴⁴ Rana (2002) pp. 9

¹⁴⁵ Sussangkarn and Vichyanond (2004) pp. 21

¹⁴⁶ IIMA (2004) pp. 65

arrangement worth \$3 billion with the Philippines, a dollar-ringgit swap arrangement worth \$1 billion in addition to the present framework of \$2.5 billion with Malaysia, a yen-renminbi swap arrangement worth \$3 billion with China, a dollar-rupiah swap arrangement worth \$ 3 billion with Indonesia, and a dollar-Singapore dollar swap arrangement worth \$1 billion with Singapore,¹⁴⁷ and has stated that it continues negotiations with other ASEAN members to build a network of swap arrangements. Japan should continue to make its proactive effort to create a network of bilateral swap agreements between the countries of ASEAN+3 on the grounds that the development of such a regional financing facility under the ASEAN+3 framework is extremely meaningful for the stability of financial markets and the stimulus of economic growth in the entire region.

The financial crisis highlights the importance of establishing an effective regional financing facility so that the affected countries are able to respond effectively to financial assistance measures necessary to sustain the economies. In this regard, the establishment of a network of bilateral swap agreements under the CMI is considered an important step toward successful regional financial cooperation in East Asia. However, further steps should be taken so as to expand and deepen the CMI arrangement. Those effort must include reduction of moral hazard, increase in the sizes of the BSAs, and multilateralization of the CMI. In order to reduce moral hazard problems, first, it is essential to strengthen the surveillance process, improve the capacity to formulate appropriate adjustment policy in the formation of adjustment and financing in times of crisis.¹⁴⁸ In order to better cope with sudden market irregularities and meet the needs of the potential recipients, in addition, the size of the BSAs should be expanded by increasing the amount of existing bilateral commitment and concluding new BSAs among the ASEAN members.¹⁴⁹ Finally, it would be very important for the East Asian nations to strengthen and deepen the existing regional financing facility by making bilateral swap arrangements under the CMI multilateral with substantial enhancement of available resources.¹⁵⁰ Multilateralization of swap arrangements would be useful from two perspectives. One is that multilateralization ensures smooth disbursement of committed resources. Another is that even though individual bilateral arrangements might be small in terms of the size, pooling them together in a multilateral framework could increase the total amount of liquidity available.¹⁵¹ In order to make the CMI more effective and crucial, furthermore, an institution under the ASEAN+3 framework to coordinate the financing mechanism of the expanded and deepened CMI needs to be established.

¹⁴⁷ See MOF Website, *Japan's Bilateral Swap Arrangements (BSA) under Chiang Mai Initiative*, <http://www.mof.go.jp/english/ifa/pcmie.htm>.

¹⁴⁸ IIMA (2004) pp. 118

¹⁴⁹ See MOF Website, *The Joint Ministerial Statement of the 8th ASEAN+3 Finance Ministers' Meeting 4 May 2005, Istanbul, Turkey*, http://www.mof.go.jp/english/ifa/as3_050504.htm.

¹⁵⁰ JCIF (2004) pp. 51

¹⁵¹ IIMA (2004) pp. 117

Establishing such an institution that operates in accordance with an agenda of the ASEAN+3 framework would also facilitate the coordination of indispensable work to develop various schemes for promoting financial cooperation in East Asia, such as development of regional bond markets, promotion of surveillance mechanism, or coordination of macroeconomic policies. Going beyond the CMI that is essentially a short-term liquidity support mechanism in times of crisis, in addition, the CMI would lay the foundation for further regional financial cooperation that would be a potential vehicle for future monetary integration in East Asia.

c. Fostering Bond Markets in the Region

In order to achieve sustainable economic development and consolidate the remarkable accomplishment in the region, it is essential to reinforce a regional capital environment so as to provide private sectors with stable supplies of long-term capital. As an effective and feasible method to develop the capital environment, the primary focus should be to foster regional bond markets so that the development of deeper and more liquid regional bond markets would be a significant step toward reducing the reliance of corporations and financial institutions on short-term borrowing, and providing an allowance for a better diversification of risk in the economy.

There are two types of mismatches that became critical causes of the occurrence of the financial crisis. First is the maturity mismatch that is likely to happen in a financial circumstance where the reliance on short-term loans leads to an explosion in short-term debt of a country, and there are not enough foreign currencies left in the country to support these debts.¹⁵² Second is the currency mismatch that refers to the case that banks in emerging market countries borrowed in the US dollars and lent in local currencies, and corporations in the emerging market countries borrowed in the US dollars and invested in the assets that had cash flows in the local currencies.¹⁵³ Related to the two types of mismatches, the underdevelopment of capital markets in the region was also an important factor behind the financial crisis in which there was the collective withdrawal of global banks from their lending activities in East Asia. In an immature capital market where corporations were incapable of raising directly from the lenders, the corporations must rely on short-term bank loans to support their business. However, the banks would collectively tighten their credit in the case of economic instability, which lead to insolvency of some financial institutions and corporations, thus jeopardizing the regional banking and economic systems. In this regard, a major lesson learned from the financial crisis is that an effective regional long-term capital market needs to be

¹⁵² Sussangkarn and Vichyanond (2004) pp. 25

¹⁵³ IIMA (2004) pp. 71

developed so that private sectors could easily access long-term investment financing.

In order to solve the double mismatch problems and over-reliance on the banking sector, bond markets in East Asia would serve as an important financing scheme for the region because long-term bonds that match the economic conditions could reduce the risk of a liquidity crisis. Recognizing the need for a regional financial framework for the development of bond markets that provide a better method of financing instruments and facilitate a better risk management, there is thus a need to explore ways to facilitate the provisions. ASEAN+3 agreed to develop regional bond markets under Asian Bond Markets Initiative (ABMI) endorsed at the ASEAN+3 Finance Ministers Meeting in Manila, the Philippines on August 2003, the object of which is to develop efficient and liquid bond markets in the region, enabling better utilization of savings for investments, and contribute to the mitigation of currency and maturity mismatches in financing.¹⁵⁴ Also, ASEAN+3 have discussed a number of initiatives about the development of efficient and deep regional bond markets that would be a conducive for the active participation of both issuers and investors. In this context, the following issues deserve to be considered:¹⁵⁵ 1) provision of credit guarantees through the active use of existing guarantors and the possible establishment of an Asian Regional Guarantee Facility; 2) strengthening of the rating system by enhancing the role of domestic rating agencies, as well as considering the possible establishment of an Asian Credit Rating Board; 3) establishment of a mechanism for disseminating information on issuers and credit rating agencies; 4) facilitating foreign exchange transactions and addressing settlement issues on cross-border transactions; 5) enhancing capacity building through conduct of market research and technical assistance programs for promotion of policy dialogue and human resources development among member countries; and 6) examining legal and institutional infrastructure, such as company/corporate laws, securities transaction laws and tax laws. In order to further assess the regional bond markets, working group have been set up as part of the ABMI on six major areas, such as creating new securitized debt instruments, credit guarantee mechanism, and issuance of bond denominated in a local currency by international organizations and multilateral corporations.¹⁵⁶

Well-functioned regional bond markets would serve to prevent the recurrence of the financial crisis and make a major contribution to attaining the sound development of capital markets while overcoming the double mismatch problems. In addition, dissemination of information about bond issuers and enhancement

¹⁵⁴ See ASEAN Website, *Chairman's Press Release on the Asian Bond Markets Initiative*, <http://www.aseansec.org/15031.htm>.

¹⁵⁵ See AsianBondOnline Website, ASEAN+3 Asian Bond Market Initiative, *Overview*, http://asianbondsonline.adb.org/regional/asean_plus_three_asian_bond_market_initiatives/overview.php.

¹⁵⁶ See ASEAN Website, *Chairman's Press Release on the Asian Bond Markets Initiative*, <http://www.aseansec.org/15031.htm>.

of bond markets infrastructure would facilitate the increase in transaction volumes by both issuers and investors, and thus promote a further development of regional bond markets.¹⁵⁷ However, a successful development of regional bond markets in East Asia requires more elaborate tasks of improvements, including efforts to provide a variety of bonds with different risk profile, and set a benchmark for the bond markets with transparent disclosure.¹⁵⁸ In addition, the banking sectors have played a significant role in its underdeveloped bond markets in East Asia. The rationale for this view is related to the particular difficulties that the East Asian nations face in their financial surroundings, including lack of credible and reliable information regarding companies, severe information asymmetry between issuing companies and public investors, lack of corporate governance leading to excessive dependence on inefficient financing, and the necessity to establish the legal and regulatory framework essential for sound capital markets.¹⁵⁹ These difficulties would hamper the development of bond markets in the region. Thus, one of the most crucial requirements for the development of robust bond markets is a stable and predictable macroeconomic environment.

In order to avoid the double mismatch problem in funding, in addition, it would be very important to issue bonds denominated in a local currency or at least a currency basket of the East Asian currencies that move closely together with the local currency. As a first step in the direction, Asian Development Bank (ADB),¹⁶⁰ which is a regional development bank (RDB) in Asia, should be encouraged to play a fundamental role in issuing the bonds denominated in the local currency because RDBs have extensive experience and expertise in dealing with the particular economic financial features of regions and identifying constrains for the effective implementation of the standards.¹⁶¹ More importantly, it would be meaningful to actively explore the issuance of bonds denominated in a currency basket on the grounds that discussions on the creation of bonds denominated in a currency basket would pave the way for seeking the approaches on monetary integration in the region.

d. The feasibility of Monetary Integration

Arising out of the financial crisis and related to the issue of regional financial cooperation, there are ongoing debates on approaches for even deeper monetary cooperation in the region, including

¹⁵⁷ See MOF Website, *The Joint Ministerial Statement of the ASEAN+3 Finance Ministers Meeting (15 May 2004, Jeju, Korea)*, http://www.mof.go.jp/english/if/as3_040515e.htm.

¹⁵⁸ IIMA (2004) pp. 80

¹⁵⁹ Sakakibara and Yamazawa (2003b) pp. 77

¹⁶⁰ The ADB is a multilateral development finance institution for Asia and the Pacific, established in 1966. The ADB is mandated to promote regional cooperation by its Charter, which provides that ADB should give priority to regional, subregional, and national programs and projects that contribute most effectively to harmonious economic growth of the region. See Devlin and Castro (2002) pp. 32

¹⁶¹ Rojas-Suarez (2002) pp. 25

macroeconomic policy coordination, appropriate monitoring and surveillance procedure, exchange rate coordination, provision of an early warning system, appropriate currency regime, and monetary integration in the long-term, all of which would be accompanied with enhancement of macroeconomic stability and financial systems in the region. In order to promote economic and financial stability by fostering orderly underlying economic and financial conditions, in this regard, the challenges would be to assure orderly exchange arrangements and promote a stable system of exchange rate. It is thus essential for the East Asian nations to discuss and implement concrete exchange rate coordination mechanism.

Before the financial crisis, nearly half of the East Asian nations adopted “managed float” exchange arrangements, four countries adopted “conventional fixed pegs,” and two countries were “independently floating.”¹⁶² However, the experience of the financial crisis reminds these countries of the fact that a fixed exchange rate system or the *de facto* dollar peg system was inadequate for the East Asian nations that have close economic relations with not only the U.S. but also European countries, Japan, and intra-regional countries because it is very difficult for governments to de-peg the currency, particularly when there is a need to devalue the currency.¹⁶³ In addition, the East Asian economies in which there is heterogeneity of the economic and financial characteristic would make it difficult for the nations to introduce a common currency regime stable with a vis-à-vis a single major currency. It is thus conceivable that, with respect to regional currencies, adopting a common currency basket regime is the feasible way to bring the stability and sustained economic growth to the region. In support of a common currency basket that is a system of maintaining the home currency’s exchange rate to a currency basket with a band, the East Asian nations should calculate the components of a currency basket based on weighted share of currency used in trade between the East Asian economies and, the U.S., EU and Japan.¹⁶⁴ Reflecting the extent weight of trade within various patterns on the currency basket would contribute to stabilizing the effective rate, which would result in the promotion of trade, FDI and economic growth in the region due to the reduction of transaction costs. In order to avoid a coordination failure when choosing their exchange rate systems, in this regard, it is preferable for the East Asian nations to stabilize its exchange rate of the currency basket system against the three major currencies, the US dollar: 6, euro: 2 and Japanese yen: 2.¹⁶⁵ By pegging to this basket and lessening the reliance on external currencies for transactions within the region, the currencies of the region could stabilize their effective exchange rates even when the exchange rates among

¹⁶² JCIF (2004) pp. 87

¹⁶³ Sussangkarn and Vichyanond (2004) pp. 36

¹⁶⁴ IIMA (2002) pp. 16

¹⁶⁵ IIMA (2002) pp. 22

the three currencies fluctuate.¹⁶⁶ In addition, elimination of exchange rate variability would reduce the risks and promote greater international trade while enhancing price stability.¹⁶⁷ What it is clear that, in the absence of more coordinated and elaborate efforts on integrating the economic and financial systems with each other, it becomes much more difficult for the East Asian nations to engage in the process of monetary integration that would become a definitive step toward a full currency union within the region. As a critical source of the promotion of financial cooperation in East Asia, however, the creation of stable regional currency with robust regional financial framework achieved in ASEAN+ 3 would ensure continued economic growth and financial stability in the region.

Starting with the analysis of the nature of the financial crisis that provides the most plausible explanation for the occurrence of discussions on regional financial integration, as a basis for the promotion of financial cooperation in East Asia, there have been sufficient reasons for creating a regional financial framework within which the East Asian nations could sustain economic growth by preventing another crisis and sustaining an economic recovery. In the development, Japan's assistance measures shortly after the financial crisis, such as the AMF, serves as significant catalyst for subsequent financial cooperation and has more valuable opportunities of bringing the financial stability to the region. As support for Japan's role in the promotion of financial cooperation in East Asia, the fact that Japan exercises its proactive effort in concluding the BSAs under the CMI that is a regional financing facility essential for the crisis times prevention could be viewed as evidence that Japan continues to lead the development of a regional financial framework under ASEAN+3 in which there has been various progress in the promotion of financial cooperation. In addition, drawing painful lessons from the financial crisis in which the IMF-led rescue packages failed to make the affected countries attain the economic recovery and thus restore investor's confidence supports the conclusion that there is a need to enhance regional financial integration within the region so that the possibility of risk generated in the involvement of international financial organizations could be minimized. Another opportunity to the promotion of financial cooperation comes from efforts to develop regional bond markets in which issuance of bonds denominated in a currency basket has been considered as the best equipment for exploring the feasibility of monetary integration in East Asia. Requiring a more complex effort on the promotion of financial cooperation in the region, though, it already suffices to note that there are a number of bases for the claim that the East Asian nations are currently making great progress in developing regional financial integration, a final goal of which is to realize a full currency union with monetary integration in the region.

¹⁶⁶ IIMA (2002) pp. 22

¹⁶⁷ Sussangkarn and Vichyanond (2004) pp. 31

VII. Conclusion and Future Prospects

As a significant step towards promoting well-coordinate economic and financial cooperation, there are various discussions and debates on forthcoming regional integration. In the arrangement, the most serious challenges reflect the fact that the regional economies are diverse and heterogeneous in term of per capita incomes, stage of economic development, institutional capacity, economic system and structures, and others. Such diversities and heterogeneity create obvious difficulties and obstacles for reaching coordinated policies for the promotion of regional cooperation and combining efforts on integrating their economies with each other. In East Asia, in addition, it is often said that there is no leading country that is essential to develop regional integration. No doubt, Japan-China relations would be the key to regional integration. Despite the observation that there are direct competition and fierce political confrontation between China and Japan, the two economies are currently playing complementary roles so as to reap the mutual benefits. If the two countries are successful in overcoming their differences and obstacles in an effort to cooperate in regional integration and build subsequent regional institutions, they would be relations between Germany and France that had leading roles in promoting European Integration. As a response to the deepening regional integration of EU and NAFTA, and growing the interdependence between the regional economies, Japan should exercise its leadership in promoting economic and financial cooperation for the sake of the regional development. In order for Japan to exercise its leadership in creating a viable framework for closer cooperation and deeper integration, the following points should be highlighted. First, how Japan should address the major critical issue while promoting its preferential trade arrangements in the region? The basic question in this context is how Japan deals with its difficult agricultural issue. There was thus a need to assess the Japan's agricultural policy from the perspectives as to whether the opening of its agricultural markets would become the essential source of developing economic integration in the region. Second, how Japan should promote its regional and bilateral measures so that they would be conducive to establishment of overall FTAs networks in East Asia, which would evolve into the creation of the common market in the region? Based on the observation that interdependence between the East Asian economies grows through deepening trade and investment, there was a convincing explanation for a successful process of accelerating the promotion of economic cooperation enhanced by China's reforms in the wake of its WTO accession, Japan's implementation of its economic and social structural reforms, and sustained economic growth of ASEAN. The experience of East Asian Financial Crisis of 1997-98 also serves a primary impetus for developing regional integration on the financial side. This paper looks at the various rationales for financial

cooperation in the region. Consistent with the observation that there is a need to enhance financial integration together with the promotion of trade, investment and other economic measures, it becomes apparent that building deeper and liquid financial markets are integral to enhancing financial stability, minimizing the risks of vulnerability to future crises and sustaining economic growth in the entire region. Going beyond the CMI, in addition, the East Asian nations are now seriously considering the issue of monetary integration in the feasibility of introducing a currency basket regime, the composition of which would be determined by the US dollar: 6, euro: 2 and yen: 2. Once the East Asian nations adopt the currency basket system, initiatives toward a full currency union must begin with a common objective of the development of fully economic and financial integration in the region. If China, South Korea and Japan together with ASEAN really make common efforts to promote both economic and financial cooperation in East Asia, it would not be impossible to integrate the regional economies under the economic community resulting from the common market with the full currency union. This future prospect would provide the strong foundation for continuing economic growth and more financial stability in the entire region.

It was the third ASEAN+3 Summit in Manila, Philippines on November 1999 that Leaders of ASEAN Member Countries, China, South Korea and Japan articulate what they hoped to achieve together in East Asia. In their Joint Statement on East Asia Cooperation, the Leaders said that: “They noted the bright prospects for enhanced interaction and closer linkages in East Asia and recognized the fact that this growing interaction has helped increase opportunities for cooperation and collaboration with each other, thereby strengthening the elements essential for the promotion of peace, stability and prosperity in the region.”¹⁶⁸ The main purpose of regional cooperation is to strengthen the regional economies through free trade and investment to raise the living standards of the people. In addition, the stability of financial environments and the creation of effective financial schemes are essential in the promotion of regional cooperation to sustain orderly economic growth in the region as a whole. It was the eighth ASEAN+3 Summit in Vientiane, Laos on November 2004 that Leaders of ASEAN Member Countries, China, South Korea and Japan agreed to convene the first East Asian Summit (EAS) in Malaysia in 2005.¹⁶⁹ The EAS would contribute to creating a common understanding in East Asia by addressing the issue of regional integration from various angles. This is the moment when the East Asian nations to come together to explore and participate in regional integration with a common conviction while tackling with so many challenges. It is because it would lay the foundation for the huge prosperity to the East Asian region.

¹⁶⁸ See ASEAN Website, *Joint Statement on East Asian Cooperation 28 November 1999*, <http://www.aseansec.org/2051.htm>.

¹⁶⁹ See ASEAN Website, *Chairman's Statement of the 8th ASEAN+3 Summit Vientiane, 29, November 2004*, <http://www.aseansec.org/16848.htm>.

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