

Building an East Asian Community Through Trade and Investment Integration

Hadi Soesastro

April 2003

Economics Working Paper Series
<http://www.csis.or.id/papers/wpe067>



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WPE 067
April 2003

ABSTRACT

In the Fifth Summit of the ASEAN Plus Three (APT) Leaders, the vision for an East Asian community – i.e., an East Asia that moves “from a region of nations to a bona fide regional community with shared challenges, common aspirations, and a parallel destiny” was articulated. Various motivations underlie this effort, namely, the need to establish a regional (institutional) identity in view of other existing regional arrangements; the need to amplify an East Asian voice on regional and global issues; and the need to promote regional peace and prosperity through cooperation, given the region’s own internal dynamics.

Yet, this effort faces various obstacles. Among others, three are identified: great diversities and the large gaps in levels of economic development; the lack of a mechanism for regional cooperation in Northeast Asia, and the prevailing politico-security problems in the region. This paper analyses possible ways to go about these obstacles through the economic means of trade and investment integration.

Keywords: *East Asian community, trade, investment, East Asian Vision Group (EAVG), Association of Southeast Asian Nations (ASEAN), ASEAN Plus Three (ASEAN+3)*

Hadi Soesastro
hadi_s@pacific.net.id
Department of Economics
CSIS Jakarta

BUILDING AN EAST ASIAN COMMUNITY THROUGH TRADE AND INVESTMENT INTEGRATION

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Introduction

The vision for an East Asian community has been articulated by the East Asian Vision Group (EAVG) in its Report, “Towards an East Asian Community”, submitted to the ASEAN Plus Three (APT) Leaders at their Fifth Summit in Brunei Darussalam in November 2001. The vision is of an East Asia that moves “from a region of nations to a bona fide regional community with shared challenges, common aspirations, and a parallel destiny.” Furthermore, the Report also stated that “[t]he economic field, including trade, investment, and finance, is expected to serve as the catalyst in the comprehensive community-building process.”

In the field of economic cooperation, the vision is that of a progressive integration of the East Asian economy, ultimately leading to an East Asian economic community. Economic integration is to be pursued through the liberalization of trade and investment, development and technological cooperation, and information technology development.

In trade, it recommended the formation of an East Asia Free Trade Area (EAFTA), and the liberalization of trade should be well ahead of the Bogor Goal set by APEC. In investment, it proposed the establishment of an East Asian Investment Area (EAIA) by expanding the Framework Agreement on ASEAN Investment Area (AIA) to cover East Asia as a whole. In the area of finance, the recommendation towards greater financial integration was to adopt a staged, two-track approach, namely for the establishment of a self-help arrangement (e.g. an East Asian Monetary Fund) and for coordinating a suitable exchange rate mechanism amongst countries in the region.

The EAVG has also listed the various motivations for the development of an East Asian community. A great deal has been written on this. Three considerations have stood out. First, the need to establish a regional (institutional) identity, in view of the fact that other regions (Europe and the Americas) have established or are developing their own regional arrangement. Second, the need to amplify an East Asian voice on regional and global issues, in view of East Asia’s increased stakes in regional and global developments. Third, the need to promote regional peace and prosperity through cooperation, given the region’s own internal dynamics.

Despite this compelling rationale, difficulties and obstacles in creating an East Asian community have also been recognized. Three problems have been identified. First, the great diversities amongst countries in the region, and especially the large gaps in levels of economic development. Second, the lack of a mechanism (and tradition) for regional cooperation in Northeast Asia. Third, the prevailing politico security problems in the region (China-Taiwan, the Korean Peninsula, and to a much lesser extent the South China Sea).

The ASEAN Plus Three Process

With the development of the ASEAN Plus Three (APT) process, it can be said that ASEAN has taken the lead in establishing the foundation for eventual East Asian economic integration. This process, as suggested by its name, is supposed to be driven by ASEAN. In fact, if ASEAN had not taken the lead, this process may not have emerged. A Japanese or Chinese initiative and leadership would have killed it. Until today the main APT meetings take place in conjunction with ASEAN meetings. Some see this as a possible obstacle to the creation of a truly East Asian regional arrangement (Jayasuriya, 2000).

The APT process began as a modest undertaking. Foreign ministers from the three Northeast Asian countries initially came for an informal meeting over lunch during an ASEAN meeting. There was no specific agenda for those meetings. This process attracted the involvement of the heads of state. The first (informal) APT Summit was held in December 1997 in Kuala Lumpur. The Asian financial crisis appears to have provided the impetus for this Summit. The APT process became more serious. Although the process has been and is essentially driven by ASEAN, the agenda setting was not monopolized by ASEAN.

In the Second APT Summit in Hanoi in November 1998, Korea's President, Kim Dae-jung, made his mark by proposing the establishment of an East Asia Vision Group (EAVG) to craft out a mid- to long-term vision for the cooperation. The Third APT Summit in Manila in November 1999 was held under the banner of "East Asian Cooperation". The meeting discussed various ways to promote cooperation and to cope with the new challenges of the 21st Century. APT heads of state adopted the "Joint Statement on East Asian Cooperation" suggesting cooperative measures in various areas including security, economy, culture, and development strategy. This agreement led to the launching since 2000 of a series of APT meetings of finance and economic ministers, in addition to those of foreign ministers.

In May 2000, at the APT Finance Ministers Meeting, discussions on the need to build a regional financial framework led to the adoption of the so-called Chiang Mai Initiative (CMI). This initiative aims at creating a network out of existing currency swap arrangements of ASEAN and bilaterally between ASEAN members and the other Three countries.

In the Fourth APT Summit in Singapore in November 2000, Chinese Prime Minister Zhu Rongji came up with suggestions that the APT should focus on the following areas of cooperation: the development of Mekong River Basin transportation and communication infrastructure, IT (information technology), human resources development, agriculture, and tourism. China also took the initiative to convene an APT agriculture and forestry ministers, and offered to host and agricultural technology and cooperation business forum. Korean President Kim Dae-jung proposed the establishment of an East Asia Study Group (EASG), consisting of officials, with the mandate to assess the recommendations of the EAVG, and from that assessment, sort out a practical number of concrete measures that should be given high priority and are relatively easy to carry out. Its other task is to explore the idea and implications of an East Asian Summit.

The Singapore Summit concluded with a public statement by Prime Minister Goh Chok Tong, highlighting the “two big ideas” that emerged from the discussion, namely the development of institutional links between Southeast Asia and Northeast Asia, and the setting up of a working group to study the merits of an East Asian free trade and investment area. In response to suggestions of transforming the APT Summit into some kind of East Asia Summit, he recommended a gradual evolution. He noted, however, that what was important was that the leaders of the thirteen countries were starting to think as “East Asian.”

At the Fifth APT Summit in Brunei Darussalam in November 2001, leaders endorsed the Report by the EAVG, including the development towards an East Asian Economic Community, among other means through the creation of an East Asian Free Trade Area. However, this meeting and the agreements reached were overshadowed by China’s “surprising” proposal for an ASEAN-China Free Trade Agreement. The Sixth APT Summit in Phnom Penh in November 2002 was also overshadowed by global terrorism issues as well as the signing of the Framework Agreement on ASEAN-China Comprehensive Economic Cooperation, which provides the basis for negotiating an ASEAN-China Free Trade Agreement (ACFTA). In addition, the

leaders of ASEAN and Japan also issued a Joint Declaration on the Comprehensive Economic Partnership between ASEAN and Japan, which may include a FTA element.

The above development shows that the APT process appears to have moved its main attention away from financial cooperation to developing FTAs in the region, seen as building blocks for an eventual region-wide free trade area, the East Asian Free Trade Area (EAFTA). Indeed, the EAVG Report made the suggestion that the establishment of an EAFTA could be achieved by adopting a building block approach, and consolidating the existing bilateral and sub-regional FTAs in the region.

Trade Integration or Fragmentation?

It has been speculated that the ASEAN-China initiative was largely politically motivated. Strengthening of ASEAN-China relations is indeed a critical element in the development of an East Asian community. The search for an institutional identity in East Asia, as in other regions, tends to be dominated by ideas about regional trade structures, in particular FTAs. In a region as diverse as East Asia it will not be easy to establish a regional-wide free trade arrangement. There are suggestions that perhaps such a regional arrangement can result from the development of bilateral or sub-regional trading arrangements as its building blocks. Recent initiatives to form bilateral FTAs may be inspired by that idea.

There are various possible routes to developing an East Asian institutional identity (Soesastro, 2001). One possible route is through the formation of a Northeast Asian subregional FTA that subsequently could be linked to the one already in existence in Southeast Asia (AFTA), resulting in an East Asian Free Trade Area (EAFTA). A modified version of this is to extend AFTA's CEPT (common effective preferential tariffs) to the other Three. The other option, focusing on development cooperation, is to develop an OECD-type institution. This will require large resources to establish and to operate, and takes away much of the limelight from the political leaders. This option is a desirable one but not likely to be pursued in East Asia.

Still another route, as will be examined later, is through financial cooperation. The route that is currently being taken, namely along the pragmatic, develop-as-you-go approach, is perhaps the politically preferred one. However, there needs to be a clear vision and strategy as to how the APT process can be strengthened by the bilateral initiatives.

The ASEAN-China agreement and the ASEAN-Japan initiative will now take the center stage. A great deal of energies and attention will be devoted by the ASEAN bureaucracies to these initiatives. ASEAN will effectively become a “hub”. In September 2002, a Joint Ministerial Declaration on Closer Economic Partnership (CEP) has been signed between ASEAN and the CER countries (Australia and New Zealand). In late October 2002, at the occasion of the APEC meeting in Mexico, President Bush also proposed the “Enterprise for ASEAN Initiatives” that will provide a framework for the US to negotiate both bilateral and regional free-trade agreements with Southeast Asia. At the First ASEAN-India Summit in November 2002, India too has offered to start free trade talks and to have a free trade agreement (FTA) working within 10 years. Australia has also courted ASEAN to have an ASEAN-Australia Summit.

Can one conclude that the region has effectively embarked on bilateral agreements as building blocks towards an East Asian Community? ASEAN appears to have become more inclined to develop bilateral initiatives. A region-wide initiative does not seem to be the preferred option. Perhaps there are concerns in ASEAN that in a region-wide arrangement it would be overwhelmed by the much larger Northeast Asian region. The combined GDP of the three Northeast Asian countries is currently about 13 times larger than ASEAN’s GDP. At the ASEAN Economic Ministers Meeting in September 2002, Singapore Trade and Industry Minister, George Yeo, stated that “[i]t has long been a position of ASEAN that we deal separately with China, with Japan, with Korea in order to secure a certain position for ourselves.” (*The Sunday Times*, 15 September 2002). It is not immediately clear what this statement exactly means, but the preference for bilateral initiatives is unmistakable.

Indeed, ASEAN’s strategy seems to have been reinforced by the favorable response from a number of its economic partners. All of a sudden ASEAN has been brought to the lime light (again). ASEAN will definitely exploit this opportunity in order to be able to come out from the back stage, where it has been pushed to since the financial crisis. As has been reported, Singapore’s Prime Minister Goh Chok Tong is now talking about “[t]he ASEAN jumbo jet [that] has one wing in the making in the East, through agreements with China and Japan. India’s proposal provides the second wing. With this, we can take off” (*The Strait Times*, 6 November 2002). In fact, an ASEAN-US initiative will be much more significant for ASEAN. Singapore officials have also speculated that Korea, which has not offered to enter an FTA with ASEAN, may get into the act next year (*The Straits Times*, 6 November 2002). This may be the case. At

the APT Economic Ministers Meeting in September 2002 in Brunei Darussalam, it was reported that South Korean Trade Minister Hwang Doo-yun stated that his country was doing a study on the pros and cons of entering into such an agreement with ASEAN (*The Sunday Times*, 15 September 2002). Lee Yock Suan, a minister in the office of the Singapore Prime Minister, believes that “[s]lowly but surely, we are seeing the emergence of an East Asian community.” (*International Herald Tribune*, 4 November 2002).

In addition to going bilateral, it appears that there has emerged an ASEAN understanding that any economic cooperation arrangement today, be it bilateral, sub-regional or inter-regional, cannot have a narrow agenda. Any FTA initiative today will have to be of a “new age” type. It can be given any label, FTA, CEP (Closer Economic Partnership) or EPA (Economic Partnership Arrangement), but whatever it is called it is going to have a broad, comprehensive agenda that covers a host of non-border measures in addition to border liberalization efforts.

ASEAN's Role

As ASEAN has come to the center stage, and as it emerges as a hub, the big question is whether ASEAN can effectively manage the process. Prime Minister Goh of Singapore rightly asked the question of whether ASEAN can sustain the interests of its partners (*The Straits Times*, 6 November 2002). It is clear that ASEAN has to put its home in order first. It has to formulate a comprehensive and coherent AFTA Plus as the basis for developing external, bilateral, and inter-regional linkages. He has proposed to accelerate ASEAN's economic integration towards an ASEAN Economic Community (AEC) as a common market, along the lines of the European Economic Community, by 2020. This, it is argued, is simply a “logical extension of AFTA”.

There is as yet insufficient confidence in the region itself that ASEAN can effectively take up this new agenda. Comments refer to the fact that ASEAN “remains so fragmented that any meaningful package within the region seems elusive” (*The Jakarta Post*, 6 November 2002). The outgoing ASEAN Secretary General, Severino, in his report to the ASEAN Summit called for political commitment within ASEAN to achieve economic integration. He suggested that ASEAN “seems to have become stuck in framework agreements, work programmes and master plans”, and it needs to translate them into concrete actions.

ASEAN must have a strategy for creating both an ASEAN Economic Community and the East Asian community. They have to be pursued in parallel. In essence, it needs to assure that: (a) bilateral initiatives become building blocks towards an East Asian community; (b) the various bilateral and sub-regional arrangements will strengthen economic reform efforts within the ASEAN economies. This strategy has to be supported by other East Asian countries. In fact, it should be adopted as an East Asian strategy.

Elements (and principles) of such a strategy have been formulated first by a high-level Task Force on an AFTA-CER FTA, which was headed by Cesar Virata. In addition to WTO consistency, the elements include:

- a. *Comprehensiveness*: it must cover trade in all goods, services (covering all modes of supply), investment, technical barriers to trade, and mutual recognition agreements (MRAs);
- b. *Speed*: the pace of liberalization should proceed faster than that of APEC;
- c. *Flexibility*: some elements of the agreement can be achieved earlier than others (early harvest);
- d. *Simplicity*: the rules of origin in relation to the FTA element must be as liberal as possible and should be simplified and standardized;
- e. *Facilitation*: trade and investment facilitation are to be pursued continuously;
- f. *Capacity building* is an integral part of the arrangement.

Comprehensive coverage is illustrated by the Singapore-Japan New Age Partnership (JSEPA), which was signed in January 2002. It has two main components. The first is *liberalization and facilitation*. This component covers: trade in goods (including elimination of tariffs), rules of origin, MRAs, trade in services, investment, movement of natural persons, intellectual property rights, paperless trading, competition policy, government procurement, and customs procedures. The second is *closer economic partnership*, which includes: ICT, human resources development, trade and investment promotion, SMEs, tourism, financial services, science and technology, and broadcasting.

The ASEAN-Japan bilateral initiative, as proposed by Prime Minister Koizumi in January 2002, has also led to a Joint Declaration on Comprehensive Economic Partnership, signed at the Sixth APT Summit in November 2002. The declaration proposed the comprehensiveness not only of sectors but also of *countries*, although allowing for the development of bilateral economic partnerships between Japan and

individual ASEAN countries. In addition, it stipulated the following guiding principles: reciprocity and mutual benefits, special and differential treatment (and additional flexibility to the new ASEAN members), to begin in areas where implementation is feasible. The declaration stated that the Partnership agreement would include “elements of a possible free trade area” that “should be completed as soon as possible within 10 years, taking into account the economic levels and sensitive sectors in each country”. A framework agreement is to be endorsed by the leaders in 2003.

It may well be that the ASEAN-Japan Framework Agreement be modeled and expand on the Framework Agreement on Comprehensive Economic Cooperation between ASEAN and China, signed in Phnom Penh on 4 November 2002. The Agreement consists of 16 Articles. Article 2 lists the measures for comprehensive economic cooperation to establish an ASEAN-China FTA within 10 years. These include:

- a. progressive elimination of tariffs and non-tariff barriers in substantially all trade in goods;
- b. progressive liberalization of trade in services with substantial sectoral coverage;
- c. establishment of an open and competitive investment regime that facilitates and promotes investment within the ASEAN-China FTA;
- d. provision of special and differential treatment and flexibility to the newer ASEAN members;
- e. provision of flexibility in the negotiations to address their sensitive areas in the goods, services and investment sectors with such flexibility to be negotiated and mutually agreed based on the principle of reciprocity and mutual benefits;
- f. establishment of effective trade and investment facilitation measures, including, but not limited to, simplification of customs procedures and development of mutual recognition arrangements;
- g. expansion of economic cooperation in areas as may be mutually agreed upon that will complement the deepening of trade and investment links and formulation of action plans and programs in order to implement the agreed sectors/areas of cooperation; and
- h. establishment of appropriate mechanisms for the purposes of effective implementation of the Agreement.

Substantive articles in the Agreement are: Article 3 on Trade in Goods and Article 6 on Early Harvest. Negotiations in the area of goods trade will involve a gradual

reduction or elimination of substantially all products. In the *Normal Track*, the listed products will have their respective applied MFN tariff rates gradually reduced or eliminated in accordance with specified schedules and rates (to be mutually agreed upon) over a period from 1 January 2005 to 2010 for ASEAN 6 and China, and from 1 January 2005 to 2015 in the case of the newer ASEAN members. In regard to the *Sensitive Track*, the respective MFN tariff rates will be reduced (and eliminated) in accordance with the mutually agreed end rates and end dates or timeframes. The number of products in the Sensitive Track is subject to a maximum ceiling. The negotiations will also cover other detailed rules, e.g. reciprocity; rules of origin; treatment of out-of-quota rates; non-tariff measures; safeguards; subsidies and countervailing measures and anti-dumping measures; as well as facilitation and promotion of effective and adequate protection of TRIPs.

An Early Harvest program has been agreed upon. The products covered by this program include all agricultural products (chapters 01 to 08) at the 8/9 digit level (HS Code), except those in the Exclusion List. Additional, specific products, negotiated bilaterally, have also been included in the program (a number of ASEAN countries have not concluded their negotiations). Products under this program are divided into 3 categories for tariff reduction and elimination:

- a) Category 1: products with MFN tariff rates higher than 15% for China and ASEAN 6, and 30% or higher for the newer ASEAN members.
- b) Category 2: products with MFN tariff rates between 5% and 15% for China and ASEAN6, and between 15% and 30% for the newer ASEAN members.
- c) Category 3: products with MFN tariff rates lower than 5% for China and ASEAN 6, and lower than 15% for the newer ASEAN members.

Table 1: China-ASEAN 6 Early Harvest Timeframes

Product category	Not later than 1/1/04	Not later than 1/1/05	Not later than 1/1/06
1	10%	5%	0%
2	5%	0%	0%
3	0%	0%	0%

For the newer ASEAN members the timeframe is stretched out to 1 January 2010. Vietnam will begin the process before 1 January 2004, while Laos, Myanmar and Cambodia before 1 January 2006. Cambodia's elimination of tariffs will be slower

than that by Laos and Myanmar (by one year).

Many observers have expected that the Early Harvest program will be more substantial than finally agreed upon. The program covers about 10% of all tariff lines, involving 600 products that belong to the following categories: live animals, meat and edible meat offal, fish, dairy produce, other animal products, live trees, edible vegetables, edible fruits and nuts. Trade between ASEAN and China in products covered by the program amounted only to about US\$ 860,000 in 2001.

The fact that the Early Harvest program was not a major “bang” suggest how difficult the follow-up negotiations will be. Future negotiations will be conducted by the ASEAN-China Trade Negotiation Committee (ASEAN-China TNC). One wonders whether the Committee has the ability to deal with the total package covered by the Framework Agreement so as not to get bogged down in the FTA negotiations and yet still be able to produce a significant outcome. This is why the broad-based, comprehensive agreement is so critical to the success of the undertaking. The institutional arrangement must match this task.

The initiative by China to negotiate a FTA with ASEAN, which was politically attractive to ASEAN, could be the deciding factor in ASEAN’s decision to go into such bilateral agreements. China is the first country that concluded a framework agreement with ASEAN as a group. This could provide a strong incentive for ASEAN to act as a group in developing similar agreements with Japan and Korea or other countries. If ASEAN can become a strong hub and introduce some consistency in its various bilateral agreements, it can turn them into a comprehensive, region-wide agreement. This will make the bilaterals a redundancy. It is one way to make the building block approach operational.

It is puzzling and also rather disturbing that several ASEAN countries have embarked on bilateral FTA negotiations with the same country that ASEAN has concluded or will conclude an agreement. Thailand is negotiating a bilateral FTA with China, the Philippines, Thailand, and Malaysia are separately also interested in concluding a bilateral FTA with Japan. Thus a further fragmentation is currently being observed in East Asia.

Financial Cooperation and Integration

East Asia may become an interesting laboratory to test whether monetary and financial, rather than trade and investment, cooperation can become the main drivers

for regional economic integration. The prevailing wisdom, inspired mainly by the European experience, suggests a sequencing with trade cooperation far preceding monetary and financial cooperation. As surveyed by Rana (2002), the argument for focusing on trade cooperation is that the benefits from monetary and financial cooperation increase with the level of trade integration. The counter argument is that joining a monetary union could have significant multiplier effects on trade. This argument is supported by a study that shows that trade between countries that share a common currency is on average more than three times what would be predicted from a gravity model of trade.

Proponents of monetary and financial cooperation argued that this kind of cooperation does not require potentially de-stabilizing socio-political measures that accompany more traditional forms of regionalism. They also suggest that monetary and financial cooperation provide participating members more opportunities for “win-win” situations, since it does not involve loss of competitiveness vis-a-vis trading partners and trade diversion as could cooperation in trade and investment (Rana, 2002).

Higgot (2000) enthusiastically argued that a “new monetary regionalism” is emerging in East Asia, which may well become “the first region that builds a grouping based on monetary and financial co-operation rather than increased inter-regional trade concentration”. The origins of the new monetary regionalism in East Asia can be found in the debate on the creation of an Asian Monetary Fund (AMF) in late 1997 and the agreement between the ten ASEAN countries and China, Japan and Korea to adopt the so-called Chiang Mai Initiative (CMI) in May 2000. These two initiatives, one aborted and the other one taking off, were both a response to the Asian financial crisis. Monetary regionalism aims at enhancing the region’s ability to weather financial crises. This could be seen as the region’s response to the challenges of globalization.

Before the financial crisis, economic integration was essentially market-led. As a response to the crisis, are we seeing the gathering of a momentum for a policy-led integration? (Wang, 2002). The crisis was definitely a major catalyst in East Asia’s search for an institutional identity. As observed by Stubbs (2002), the crisis has added to the sense of common history that has emerged in the region: “..... nearly every government in East Asia felt its reverberations and had to deal with the fallout of the crisis”. It also demonstrated the ineffectiveness of APEC and ASEAN as neither was in the position to help the crisis-hit countries. Furthermore, there was resentment with the way the International Monetary Fund (IMF), in conjunction with the US

government, handled the crisis by imposing a set of solutions that only served to exacerbate the situation.

Countries in East Asia thus looked to the emerging ASEAN Plus Three (APT) process as the best vehicle for developing a strategy for dealing with future crises. In May 2000, on the sidelines of the annual meeting of the Asian Development Bank (ADB) in Chiang Mai, the finance ministers of the APT agreed to pool their hard currency resources. The hope is that this Chiang Mai Initiative (CMI) will become the cornerstone of East Asian cooperation. Can the region build on the CMI to promote further financial cooperation and integration? In turn can monetary and financial cooperation become the driver for regional economic integration?

Ito (1999?) has not come to a conclusion whether monetary and financial integration can precede trade integration. His hunch is that it may not. More importantly, he is also not convinced that the APT is the right grouping. At present, region-wide processes in East Asia are undertaken mostly under the APT framework. The APT is all what the region has.

The EAVG Report did not single out financial cooperation as a core activity towards the establishment of an East Asian Community. It is one of the six areas of cooperation that the Vision Group has recommended. In total, it recommended 57 concrete measures encompassing the six areas of cooperation. The EASG recommended 26 “implementable” concrete measures, composed of 17 measures for possible immediate implementation and 9 measures for possible implementation in the medium-term or long-term.

In the area of financial cooperation, the EAVG proposed that East Asian governments adopt a staged, two-track approach towards greater financial integration: one track for establishing a self-help financing arrangement and the other for coordinating a suitable exchange rate mechanism among countries in the region. Key recommendations by the Group included the following:

- Establishment of a self-help regional facility for financial cooperation.
- Adoption of a better exchange rate coordination mechanism consistent with both financial stability and economic development.
- Strengthening of the regional monitoring and surveillance process within East Asia to supplement IMF global surveillance and Article IV consultation measures.

Recommendations by the EASG may become official policy. Financial cooperation is placed amongst the medium-term and long-term measures. The Group selected two measures, namely to undertake further study (with high priority) on (a) the establishment of a regional financing facility; and (b) the pursuance of a more closely coordinated regional exchange rate mechanism.

The EASG left out the Vision Group's recommendation to strengthen the regional surveillance and monitoring process perhaps because such a process is already in place as manifested in the APT Economic Review and Policy Dialogue Process. Indeed, the past few years have seen a number of initiatives to promote financial cooperation and integration in East Asia by groups such as ASEAN, the APT, and ASEM (Asia Europe Meeting).

In his survey, Rana (2002) identified the two main areas of financial cooperation in East Asia, namely: (a) information exchange and surveillance processes; and (b) resource provision mechanisms. The former is seen as a weaker form of cooperation, allowing individual countries to make policy choices in a more informed environment. The latter is in contrast a stonger form of cooperation, ranging from the negotiation of bilateral swaps to the creation of a permanent common reserve pool administered by a secretariat.

Surveillance

The first regional surveillance process was established in November 1997, the Manila Framework Group (MFG). Higgot (2000) saw this as a significant exercise in the recognition of the "East Asianness" of the region. The Agreement to "Enhance Asian Regional Cooperation to Promote Financial Stability" was "very much part of the wider exercise of soul searching that took place both within ASEAN and between ASEAN and its other East Asian partners." The Group, consisting of deputies from the finance ministries and central banks of 14 Asia Pacific countries, meets twice a year. The ADB, IMF and World Bank provide surveillance reports to these meetings. In addition to surveillance, the Framework included other initiatives: (a) economic and technical cooperation in the financial area ("financial ecotech"); (b) measures to strengthen the IMF's capacity to respond to financial crises; and (c) development of cooperative financing arrangements to supplement the resources of the IMF and other international financial institutions. In its meeting in December 2001 the MFG discussed the proposal by a working group (led by Australia) to establish a "regional financing facility" under this Group.

The MFG is seen by some observers as the preeminent forum for regional surveillance and peer pressure. Wang (2002) is of the view that the MFG has not been very successful as a mechanism for regional financial cooperation. First, because the MFG has not yet clearly specified the objectives of information exchange and surveillance. Second, there is no actual peer review process in the MFG. Third, issues related to financial sector reform are only discussed cursorily.

In its response to the crisis, ASEAN held a special meeting of finance ministers in Kuala Lumpur in December 1997. The ministers did not come up with any ASEAN financing agreement to assist crisis-affected members. They agreed to renew the ASEAN Swap Arrangement that was due to lapse in August 1999, but did not appear to have examined the reasons why this arrangement had not been used during the early stages of the crisis. Another meeting of ASEAN finance ministers was held in Jakarta in February 1998. The most concrete step taken was to agree on the establishment of a regional surveillance mechanism within ASEAN. It was only in October 1998, eight months after it was agreed on, when the ASEAN finance ministers signed a Terms of Understanding that established the ASEAN Surveillance Process. In fact, the agreement to develop a surveillance mechanism was watered down to a surveillance process. This process is based on the principles of peer review and mutual interest. ASEAN finance ministers meet twice a year for policy coordination under this Process. The ADB provided the surveillance report, but the report as well as the results of the meeting are kept confidential. The effectiveness of the surveillance process has been questioned.

Under the APT process, a peer review meeting, the Economic Review and Policy Dialogue Process, was first held in May 2000 in the sidelines of the ADB annual meeting. This process is similar to the ASEAN Surveillance Process. Finance Ministers of the 13 countries also meet twice a year for policy coordination. A template to monitor short-term capital flows has been finalized and implemented by several countries under a Japan-ASEAN technical assistance. In May 2001 a study group was established to enhance the process. It recommended a two-phase approach: the first phase is to strengthen the existing process by organizing an additional informal meeting of the APT deputies, and in the second phase an independent surveillance unit is to be established.

The latest development is the establishment of an APT Early Warning System (EWS). This was agreed upon at the APT finance ministers meeting in Honolulu in May 2001. An EWS is being developed with the assistance of the ADB.

Regional Financing Facility

The idea of a regional financing facility was first proposed by Japan. The financial crisis provided an occasion for Japan to play an important role in the creation of new mechanisms in East Asia through a mix of policies, including financial assistance (Kikuchi, 2002). It was Japan that proposed to ASEAN to hold an ASEAN-Japan summit to commemorate the thirtieth anniversary of ASEAN in 1997. ASEAN responded with a proposal to invite the leaders of China and Korea, and this became the first APT (informal) summit. When the crisis hit Thailand, Japan attempted to respond with emergency assistance through the existing framework centering on the IMF. Thailand's liquidity shortfall was estimated at US\$ 14 billion. The IMF and Japan provided US\$ 4 billion each, but through additional bilateral support, the total package reached US\$ 17.2 billion. These additional funds came from multilateral institutions (such as the ADB) and countries in Asia (including Australia). This showed that the countries in Asia could work together to deal with this kind of crisis. This recognition led to the stepping up of moves within the Japanese government to build a mechanism for a regional financing facility.

The idea of a regional mechanism to stabilize Asian currencies began to be launched in Japan in the autumn of 1996, before the crisis struck. This arose from the 1994 Mexican crisis. The view in the Japanese ministry of finance (MOF) was that if a similar crisis would occur in Asia, the US and the IMF might not respond as swiftly as they did in the Mexican case. With their combined foreign reserves, countries in Asia could respond to such a crisis if a mechanism exists. A tentative proposal was drafted but before it could be discussed with other countries in the region, the Thai crisis struck (Kikuchi, 2002).

It was at the ASEM finance ministers meeting in September 1997 that Japan's concept of an Asian Monetary Fund (AMF) was first discussed. It was also informally discussed at the joint annual meeting of the IMF and the World Bank in Hong Kong in that same month. The idea of an AMF, which would have a nucleus of US\$ 10 billion in capital from the Japanese government, was immediately supported by the finance ministers of Indonesia, Malaysia and Thailand. Opposition to this idea came from the United States, China, and the IMF. As a result Japan was unwilling to pursue the idea further. Instead, the Manila Framework, adopted by a subset of APEC economies in November 1997, was seen as a substitute for the setting up of a regional monetary institution.

As the crisis unfolded, the Japanese government provided large amounts of funds to the crisis-affected countries, mainly through bilateral arrangements. By November 1998 the amount of this funding reached US\$ 44 billion. As its regional approach failed to materialize, Japan stepped up on its bilateral cooperation through the New Miyazawa Initiative that was launched in October 1998. The main elements of this Initiative are as follows: (a) US\$ 15 billion in short-term support for Asian countries; (b) US\$ 15 billion in funds to meet their medium- to long-term financial needs; (c) provision of credits by the Exim Bank of Japan; (d) purchase by the Exim Bank of Japan of bonds issued by Asian governments; and (e) provision of concessional yen loans by the Japanese government. As part of this Initiative, Japan entered into currency swap arrangements with Malaysia and Korea, which guaranteed the provision of foreign currency reserves in the case of a crisis but without any linkage to IMF conditionality. The second phase of this New Miyazawa Initiative was announced in May 1999. One of its elements is the active use of private sector funds. Another element is to build a regional fund-raising system. Proposals for a regional monetary fund did not die down. They were raised not only from within East Asia, but also by Europeans and even from the US (Rana, 2002).

The desire to develop mechanisms for resource provision within the region led to the adoption of the Chiang Mai Initiative (CMI) by the APT finance ministers in May 2000. In addition to reiterating the need for strengthened policy dialogues and regional cooperation activities, the CMI called for:

- An expanded ASEAN Swap Arrangements (ASA) that would include all ASEAN countries and a network of bilateral swap and repurchase agreement (BSA) facilities among ASEAN countries, China, Japan, and Korea.
- Use of the APT framework to promote the exchange of consistent and timely data and information on capital flows.
- Establishment of a regional financing arrangement to supplement existing international facilities.
- Establishment of an appropriate mechanism (the EWS) that could enhance the ability to provide sufficient and timely financial stability in the East Asian region.

The ASEAN Swap Arrangement (ASA) was expanded in November 2000 to cover all ASEAN members and the total amount was increased from US\$ 200 million to US\$ 1 billion. The contribution of ASEAN-6 (Brunei, Indonesia, Malaysia, Philippines, Singapore and Thailand) amounts to US\$ 150 million each. That of the rest varies: Vietnam US\$ 60 million, Myanmar US\$ 20 million, Cambodia US\$ 15 million, and

Laos US\$ 5 million. The maximum drawdown amount by each participating member is limited to twice their committed amount under the ASA. The swap transactions have a maturity not exceeding 6 months, subject to rollover for a period not exceeding 6 months.

The network of Bilateral Swaps and Repurchase Agreements (BSA) is designed to provide short-term liquidity assistance in the form of swaps of US dollars with the domestic currencies of a participating country. Participating countries can draw on the BSA for a period of 90 days. The first drawing may be renewed seven times. The interest rate applicable to the drawing is the LIBOR plus a premium of 150 basis points for the first and the first renewal drawings. Thereafter, the premium is increased by an additional 50 points for every two renewals, but not exceeding 300 basis points.

The disbursement of funds under the BSA is tied to IMF conditionality. However, it allows for automatic disbursement of up to 10 percent of the maximum amount of the drawing without any linkage to an IMF program or conditionality. This limit will be increased as the region develops its own surveillance capacity. The BSA will be reviewed in 2003 (or 2004), with Malaysia's objection to the IMF conditionality as one of the issues likely to be on the agenda. APT members may also decide to make it permanent or even to multilateralize it.

As of end of February 2003, 12 BSAs have been concluded with a total amount of US\$ 31.5 billion. A few others are still under negotiations (See Table 2). Japan has been playing a leading role in terms of both number and amount. As stated in the EASG Report, the CMI is seen as a significant step as it is the first concrete agreement among ASEAN countries, China, Japan, and Korea to strengthen cooperation in the financial area. The CMI is also seen as a launch pad from which to broaden and deepen their cooperation and coordination to ensure financial stability.

East Asia has definitely moved ahead rather significantly in terms of monetary and financial cooperation. The APT has established semi-annual peer review meetings of finance ministers, efforts to establish an EWS are under way, and through the CMI East Asian countries have begun to develop mechanisms to share resources among each other.

Under the APT framework, the region has developed two of the three pillars of regional financial cooperation, namely mutual surveillance and liquidity assistance.

The one pillar it has not developed is exchange rate coordination. Both the EAVG and the EASG have recommended that the region pursue a more closely coordinated regional exchange rate mechanism. This item has been put on East Asia's agenda.

Table 2 Progress on the Chiang Mai Initiative
(as of end of February 2003)

BSA	Currencies	Conclusion Date	Amount
Japan-Korea	USD/Won	July 4, 2001	US\$ 7 b (*)
Japan- Thailand	USD/Baht	July 30, 2001	US\$ 3 b
Japan-Philippines	USD/Peso	August 7, 2001	US\$ 3 b
Japan-Malaysia	USD/Ringgit	October 5, 2001	US\$ 3.5 b (*)
Japan-China	Yen/Renminbi	March 28, 2002	US\$ 3 b equivalent
Japan- Singapore	-----	under negotiation	-----
Japan-Indonesia	USD/Rp	Febr.17, 2003	US\$ 3 b
China-Thailand	USD/Baht	December 6, 2001	US\$ 2 b
China-Korea	Won/Renminbi	June 24, 2002	US\$ 2 b
China- Malaysi	USD/Ringgit	October 9, 2002	US\$ 1.5 b
China-Philippines	-----	under negotiation	-----
China-Indonesia	-----	under negotiation	-----
Korea- Thailand	USD/Baht	June 25, 2002	US\$ 1 b
Korea-Malaysia	USD/Ringgit	July 26, 2002	US\$ 1 b
Korea-Philippines	USD/Peso	August 9, 2002	US\$ 1 b
Korea-Indonesia	-----	under negotiation	-----

Note: (*) The US dollar amount include the amounts committed under the New Miyazawa Initiative, US\$ 5 Billion for Korea and US\$ 2.5 billion for Malaysia.

Despite great progress, the region has not as yet established the network of institutions to evolve into what Bergsten (2000) has suggested: an East Asian economic bloc.

As clearly described by Wang (2002), regional financial institutions range along a spectrum from simple information exchange and informal consultation forums to a supranational entity like the EMU. At the early stage of no institutional integration, governments take note of the policies of other governments without making any attempt to influence them. In view of potential policy spillovers it may still be useful for governments to exchange information and consult with each other.

ASEAN has moved beyond this stage when they agreed to institute surveillance based on a peer review process, to monitor "developments in ASEAN member countries and in the international economy that could affect individual ASEAN economies and the region". For ASEAN this was the first instance in which ASEAN members will make comment on internal developments. This was seen as a first step in ASEAN's transformation as a regional organization (Soesastro, 1998). However, the ASEAN

Surveillance Process has been poorly implemented thus far.

In the next stage, when mutual liquidity provision is introduced, it is imperative that monitoring and surveillance mechanisms are in place to control the moral hazard involved. This is the reason why the CMI relies on the IMF and may develop its own independent surveillance mechanism. The final stage, involving exchange rate coordination, would require monetary policy coordination. Wang (2002) also noted that in the absence of exchange rate coordination, incentives for mutual surveillance will be limited because a member country facing a speculative attack may be free to float its exchange rate vis-à-vis those of other neighboring countries. Under the current APT framework, the purpose of the CMI and mutual surveillance is mainly to prevent the occurrence of financial crises and contagion in the region.

How will and can the region move ahead? Wang (2002) believes that the APT framework is the appropriate grouping for regional financial cooperation because this group has begun to develop a common vision for East Asia. The annual APT summits provide a basis for strong political support. In addition, through the ASEM framework, in January 2001 the finance ministers have launched the so-called Kobe Research Project. The project is designed to facilitate inter-regional research cooperation on issues of monetary and financial cooperation in East Asia, taking into account the lessons learned from the European integration experience.

Strengthening the surveillance mechanism is a key task for further financial cooperation and integration. As reviewed before, the next major task for the APT finance ministers is to develop an early warning system (EWS). As argued by Wang (2002), it may be difficult to construct a credible EWS given the lack of reliable statistics in most developing countries. An EWS consists of leading indicators that signal in advance the onset of a crisis. However, not all crises are alike, and thus a “one size fits all” system will not be useful. The MFG and the APT Surveillance Process need to be strengthened. In the MFG, which is based on information provided by the IMF, the World Bank and the ADB, no new or region-specific analysis is presented beyond what is readily available. The process is also felt to be dominated by the US and the IMF. Similarly, discussions in the APT Surveillance Process do not focus on issues of concern and emerging problems.

Malaysia’s opposition to linking the CMI to the IMF has led to the establishment of a Study Group to examine how the CMI can develop an independent monitoring and surveillance mechanism. The first meeting of the APT Study Group proposed a two-

phased action agenda. The first phase enhances the existing APT process of economic reviews and policy dialogues. The second phase constructs a new strengthened policy dialogue mechanism. The second meeting of the APT Study Group, held in Myanmar in April 2002, failed to reach an agreement on the surveillance issues, except for institutionalizing the APT meetings of deputies for informal policy reviews and dialogues. There is not likely to be an effective surveillance mechanism soon.

A Role for ASEAN and Korea

The issue of leadership is a critical one in the region. As shown before, Japan has provided a de facto leadership in the implementation of the CMI as a key provider of financial resources. If the CMI is to become the launch pad for further cooperation, the number and amounts of the BSAs need to be increased. Japan is the only party that has agreed to increase the amounts of the bilateral swaps in order to make the CMI a more credible financing scheme. However, Japan needs to be given greater assurances that their short-term lending will be repaid. As a minimum condition for expansion of the BSAs, Japan wants to see the development of an effective surveillance mechanism in which it can exercise its influence commensurate with its financial contribution. Japan and China have not been able to agree on a number of operational issues, including the surveillance mechanism. China may not want to grant leadership to Japan in any regional initiative in East Asia. This may be the most serious roadblock to the further development of the CMI (Wang, 2002) as well as to the APT process in general (Stubbs, 2002). There is also this strong underlying competition between China and Japan also in developing bilateral trade arrangements with ASEAN. The region's preoccupation with the large number of FTAs definitely diverts attention away from the efforts to promote monetary and financial cooperation and integration. More importantly, however, they may also divert governments from the task of developing the APT process and the building of an East Asian community.

It should be in the interest of ASEAN and Korea to see that the APT process be strengthened. Korea can play a critical role in the development of an East Asian community by assisting ASEAN. Korea has been the most consistent member of the APT to promote regional economic cooperation towards an East Asian community through an overall regional, multilateral efforts. Will Korea be forced to follow China and Japan to embark on a bilateral initiative as well? This may be of some symbolic significance. However, Korea's role should be focused on maintaining and strengthening the overall East Asian perspective. At the non-official level, Korea can help and play a critical role in the development of a regional think tank of sorts. This can be formed on the basis of network institutions, but will need to have an

institutional home. This could be set up jointly by a number of Korean and ASEAN institutions. In fact, this should be promoted as an ASEAN-Korea initiative. But the agenda should go beyond bilateral ASEAN-Korea cooperation to focus on the East Asian region as a whole, and be based on East Asian perspectives.

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