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Report on East Asian Integration

Opportunities and Obstacles for Enhanced Economic Cooperation

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In November 1994 he joined the team in charge of rescuing Crédit Lyonnais, one of the major French banks. He was later appointed to the no. 2 position inside the bank.

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Notre Europe

Notre Europe is an independent research and policy unit whose objective is the study of Europe – its history and civilisations, integration process and future prospects. The association was founded by Jacques Delors in the autumn of 1996 and was presided by Pascal Lamy from November 2004 to August 2005. It has a small team of in-house researchers from various countries.

Notre Europe takes part in public debates in two ways. First, by publishing internal research papers and second, by collaborating with outside researchers and academics to contribute to the debate on European issues. These documents are made available to a limited number of decision-makers, politicians, social scientists academics and diplomats in the various EU Member States, and are systematically presented on the website.

The association also organises meetings, conferences and seminars in association with other institutions or partners. Proceedings are written in order to disseminate the main arguments raised during the event.

Foreword

The rapid growth in global trade is no reason to think that regional integration is no longer relevant. That, at any rate, is the lesson to be drawn from Asia, where the search for the causes of the financial and monetary crisis of 1997, and for ways of making sure it does not happen again, has been proceeding in the past few years in a number of different fora. The Kuala Lumpur conference, a gathering attended by the representatives of sixteen countries on December 14, 2005, is just the most recent of such events. This quest has led to a growing recognition of the part that regional cooperation mechanisms plays and will continue to play in the future.

The extraordinary expansion of the Chinese economy in the last twenty-seven years, an unprecedented duration, incidentally, for such strong economic growth, has been coupled with the increasing opening of the country to the rest of the world, something which is not all that common in the history of developing economies. Chinese exports, which accounted for 8% of China's GDP in 1980, now amount to almost 40%. Regional economic integration, in the area of trade as well as in the sphere of investment, has proceeded at an accelerated pace. Chinese trade surpluses with the United States are offset by deficits with its Asian partners, starting with Japan. Regional trade has expanded and today half the international trade of the region is regional.

The report commissioned by JETRO (the Japan External Trade Organisation) and produced by Notre Europe brings out the specific features of the Asian integration movement, and in particular those that distinguish it from its European counterpart. In the case of Asia, institutions and legal arrangements do not play the same key role they play in European integration. The process has more often been bottom-up than top-down, even though the regional cooperation movement does not benefit from the wide popular support we have observed in Europe. The leadership issue remains unresolved whereas, in the case of Europe, it had been addressed from the beginning thanks to the strong political will for reconciliation between France and Germany.

The future of the East Asian integration process is not easy to foresee. The *de facto* integration one is seeing today could continue, without displaying any further ambition. Alternatively it could at some stage seek a stronger institutional framework. In any event the efforts of East Asia and Europe in the creation of vast regional economies represent a major and positive development for the world economy.

Tommaso Padoa-Schioppa

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Abbreviations

ABC	Asian Basket Currency
ABF	Asian Bond Fund
ABMI	Asian Bond Market Initiative
ACU	Asian Currency Unit
ADB	Asian Development Bank
AFTA	ASEAN Free Trade Area
AMF	Asian Monetary Fund
AMS	Asian Monetary System
APEC	Asia-Pacific Economic Cooperation
APT	ASEAN Plus Three
ASEAN	Association of Southeast Asian Nations
ASEAN-4	Indonesia, Malaysia, Philippines, Thailand
ASEAN-5	Indonesia, Malaysia, Philippines, Singapore, Thailand
ASEM	Asia-Europe Meeting
ASP	ASEAN Regional Surveillance Process
BIS	Bank for International Settlements
CAFTA	Central American Free Trade Agreement
CAP	Common Agricultural Policy
CEN	European Commitee for Standardization
CENELEC	European Committee for Electrotechnical Standardization
CIA	Central Intelligence Agency
COMECON	Council for Mutual Economic Assistance
EADS	European Aeronautic, Defence and Space company
EAIP	East Asian Integration Process
EC	European Community
ECJ	European Court of Justice
ECSC	European Coal and Steel Community
ECU	European Currency Unit
EEC	European Economic Community
EFTA	European Free Trade Area
EIP	European Integration Process
EMCF	European Monetary Cooperation Fund
EMEAP	Executives' Meeting of East Asia and Pacific Central Banks
EMS	European Monetary System
EMU	European Monetary Union
ERM	Exchange Rate Mechanism
ERP	European Recovery Program
ERT	European Round Table of Industrialists
EU	European Union
FoBF	Fund of Bond Funds
FTA	Free Trade Area

FTAA	Free Trade Area of the Americas
GATT	General Agreement on Tariffs and Trade
IAS	International Accounting Standard
IFIs	International Financial Institutions
IMF	International Monetary Fund
ISI	Import Substitution Industrialisation
ISPA	Instrument for Structural Policies for Pre-Accession
MERCOSUR	Mercado Comun del Sur (Common Market of the South)
MNE	Multinational Enterprise
NAFTA	North American Free Trade Area
NIC	Newly Industrialised Countries
OCA	Optimum Currency Area
ODA	Official Development Aid
PAIF	Pan-Asian Bond Index Fund
PHARE	Poland Hungary Aid for the Restructuring of the Economies
RPP	Regionalisation of Production Process
RTA	Regional Trade Agreement
SAPARD	Special Accession Programme for Agriculture and Rural Development
TRIMS	Trade Related Investment Measures
TRIPS	Trade Related Intellectual Property Rights
UNICE	Union des Industries de la Communauté Européenne (Union of European Community Industries)

Executive Summary

This report seeks to identify the thrust behind the processes of economic integration that we are currently witnessing in Asia. Against the backdrop of the European integration process, the contributors examine the factors that are framing integration in East Asia and offer scenarios for the future of East Asian cooperation.

Richard Higgott sets out to examine the role of two neglected variables in explaining economic governance, namely institutions and leadership, in the case of the East Asian experience. He argues that East Asia is unlikely to replicate the European experience that more or less followed a neo-functionalist logic of integration. He distils several factors that account for the uniqueness of the East Asian cooperation scheme: primarily the financial crisis of the late 1990s, which proved to be a watershed for regionalism in East Asia. The crisis demonstrated the ineffectiveness of APEC and triggered initiatives for regional monetary cooperation. Higgott considers this sort of instrumental regionalism in monetary matters as a starting point for deepened regional integration in East Asia. The unprecedented degree of interaction in this field suggests a growing self-definition of 'East Asia' as a discernible voice in the region. The formation of a genuine East Asian identity is further fostered by the changing leadership role of the US, which functions as an exogenous catalyst in the "East Asianisation" of the Western Pacific seaboard: regional players no longer easily submit themselves to Washington's control and they are on the move to secure greater autonomy from the erstwhile hegemon. The dynamics of this process will be conditioned by the structures of regional leadership that emerge over the coming years, which the author considers to be "the single most important regional policy issue for the future".

The dynamics of integration are further explored in Heribert Dieter's article, in which various options for monetary regionalism in East Asia are discussed. In his analysis of the merits and drawbacks of different exchange rate regimes to be introduced at the regional level, he concludes that there is no win-win solution in monetary integration. The choice of scheme has to be based on a careful assessment of the respective advantages and shortcomings of the diverse regimes. For East Asian countries, the priority after the Asian crises seems to be the mitigation of vulnerability to financial market volatility, even if this comes at the cost of waiving some sovereignty. However, progress toward further monetary integration is hampered by Japan's ambiguous approach to regionalism and its unwillingness to assume the role of a stabiliser of the Asian Monetary System (AMS) – the part which Germany played in the European Monetary System (EMS). This in turn gives China more leeway to push its own agenda. The author therefore considers the most decisive obstacles to monetary and financial integration to be found at the political level, i.e. political will and leadership matter more than the technical intricacies of the various cooperation schemes.

In his contribution Jean-Christophe Defraigne outlines a possible institutional framework for the regulation of commercial integration in East Asia. He suggests that due to a number of factors, the East Asian Integration Project (EAIP) will not be modelled according to the European blueprint. First, echoing Higgott's view, Defraigne proposes that unlike in Europe, the states participating in the EAIP cannot count on America's benevolent hegemony. Another East Asian idiosyncrasy is the heterogeneity of the East Asian national economies, which precludes Japan from assuming the same integrationist role that Germany had in the European process. Nevertheless, according to Defraigne, Japan will play a crucial role in furthering the EAIP. Japan's current pursuit of bilateral economic initiatives could – upon completion – take the form of a dense web of relatively harmonized bilateral Regional Trade Agreements (RTAs) in the region. In order to keep China on board, the author suggests the creation of a supranational arrangement for the enforcement of the RTA commitments in which China and other East Asian partners would be accorded greater weight than the one they presently have in the region. With regard to the cognitive dimension of integration, the author maintains that a sentiment of shared "Asian values" has been slowly emerging in recent years, but that this nascent regional identity is still far vaguer than the Euro-federalist ideology of the early 1950s. Defraigne concludes by mapping out two scenarios for the future. A successful EAIP could either mark the emergence of a multipolar capitalist world, in which the US would have to yield to a coalition favourable to multilateralism formed by East Asia and Europe, or it could lead to the consolidation of separate trading blocs that could become less interdependent, a rather dangerous development.

Subsequently, Richard Higgott offers some prospects for the future of regional leadership in East Asia. The 'new regionalism' in East Asia is characterized by an enhanced economic dialogue both among the states of Northeast Asia (China, Japan, and South Korea) and between these states and the states of Southeast Asia through the development of the ASEAN Plus Three process. A decisive factor in shaping the future direction of this new regionalism is how the relationship between the major regional actors, i.e. China and Japan, will evolve. Higgott sketches out two possible scenarios – one in which Sino-Japanese tensions will prove irresolvable, and another one in which the intensification of the ASEAN Plus Three process will lead to an East Asian (Economic) Community. Moreover, Higgott suggests that a brand of 'regulatory regionalism' is emerging in Asia that is distinct from the European model in that it links national and global understandings of regulation via the intermediary regional level. Regionalism in East Asia is not trade-centred but rather develops most rapidly in the area of monetary cooperation, and does not carry the sovereignty-shedding baggage that is commonly associated with the European integration process.

In his concluding essay Pascal Lamy reiterates the finding that the European model is not being replicated in the East Asian integration process, where several factors that were at work in the European integration project are found wanting: the U.S. as a benevolent sponsor of regional integration, agreement among the main regional players over the future direction of the integration process, and a relative homogeneity among the various member countries. Lamy identifies three possible scenarios, the first being the continuation of present trends leading to a ‘soft’ and in many regards superficial integration, in which China as the biggest player would disproportionately benefit. The second scenario is a form of ‘interdependence of the willing’ that would entail the creation of new institutions. However, this scenario is predicated upon the willingness of Japan to move forward with a strong political initiative, which at present seems rather unlikely. The third scenario sees regional integration as a consequence of an external shock like the Asian crisis, which could trigger efforts to mitigate vulnerability by embracing stronger economic integration. Whatever the scenario, Lamy concludes that the process of regional integration in East Asia will be hamstrung if political elites do not manage to instil a sense of common regional identity in their populations.

Introduction

There is an open and on-going debate as to the timeliness of the issue of regional integration in this age of globalisation. Is regional integration a useful stepping stone, or a useful instrument, on the way to a globalised economy, because of the need to become a regional actor if one wants to keep playing a part on a stage featuring growing globalisation? Or should it be seen on the contrary as a rather passé idea, an idea the usefulness and relevance of which are perhaps past their prime, are perhaps no longer what they used to be, even a few years ago, precisely because an era of globalisation is dawning. The current British chancellor of the exchequer seems to subscribe to this second school of thought. My own view is that the case in favour of regional integration still deserves to be made, indeed that it may be more topical, more to the point, today than it ever was. I believe that regional integration may well be the best way to acquire the collective disciplines, leading to a sense of collective responsibility, that are necessary to become an effective global player, and that this is true at the company level as much as it is at the country level. Collective preferences come to mind more easily when one is reasoning in regional terms than if one is looking at the world as a whole. Countries can more readily define them in a regional context than in a global one, and once the definitions are in place it is only a small step to adopting the regulations necessary to uphold them.

Asia has long been in two minds as to the advantages and disadvantages of regional integration. JETRO, the Japanese External Trade Organization, commissioned this report to survey academic and practitioner literature on the comparisons between European and Asian economic integration. What one will find here is hence first and foremost a review of the existing literature as listed in the references section at the end of the report. The focus is on those factors which are framing Asian integration, with European integration in the background, and on the actual shapes being taken by Asian integration. Europe is positioned as a benchmark rather than as a model. The report will be analysing the situation in East and Southeast Asia, i.e. the countries that constitute ASEAN+3.

There are signs, especially since the 1997 crisis but also, more recently, of a move towards more economic integration in East Asia, going beyond standard trade integration policies, but its significance remains unclear. Country markets are blending into regional markets. Tarriffs are declining or are being eliminated and cross-border investments, notably through merger and acquisition deals, are fostering inter-regional cooperation. The Association of South East Asian Nations (ASEAN) seems to be giving way to ASEAN plus three (APT), i.e. ASEAN plus China, Japan and Korea as the most relevant integration promoting structure. An East Asian Community summit, bringing together the APT and three countries outside the scope of this report, Australia, India and New Zealand, is due to be convened in Kuala Lumpur. Are we facing a major, deep-seated, trend leading to the appearance of new, region-wide economic and social spheres, or is this just another rather meaningless rhetorical exercise, mainly for want of a strong will to build the necessary and appropriate disciplines? In some ways, in the monetary and financial fields in particular, the 1997 Asian crisis appears to be having similar effects to those that resulted from the 1973-1974 shock in Europe: the catastrophic volatility of exchange rates and capital flows observed eight years ago concentrated minds and led to useful policy prescriptions. Most of the surplus countries in East Asia, and in particular China on which international pressure for revaluation has been strongest, from both financial markets and policymakers, have actively managed the floating of their currencies or have pegged them to the dollar. The monetary and financial dimensions of regionalism have taken on a significance of their own, and there is a widespread feeling that the continued development of regional trade relations is predicated on a degree of regional stability in the monetary and financial fields. This amounts to a call for a collective arrangements in these fields. The purpose of this report is to delve beyond the many political statements that have been made on the issue of regional integration in Asia, and to take a closer look at the figures and vested interests involved. The forces at work in favour of regional cooperation as well as those working in the other direction in the case of Asia are identified and compared to those that were at the root of the European integration project.

The subject matter has been broken down into three sections, one on institutions and leadership, dealt with by Professor Higgott at the beginning and at the end of the report, another on monetary regionalism and financial markets, dealt with by Doctor Heribert Dieter, who also played the role of overall co-ordinator of the project, and a third on commercial integration, authored by Jean-Christophe Defraigne. Energy, an issue by and of itself, an issue which exists outside the questions related to regional integration, has been deliberately left aside. A spirit of academic freedom pervades the survey. The three contributors have been encouraged to express themselves quite independently and forcefully, if need be, on the subjects they address, editing being kept to a minimum. All three parts – and that is the connecting thread running through the report – attempt to determine what is the thrust behind the integration process in Asia, bearing in mind what happened in Europe.

I– Leadership and Institutions

Explaining economic integration now has a substantial theoretical pedigree and a wide range of empirical experience, especially but not exclusively European, on which to draw. While there is a range of salient factors in explaining the process of integration, economic factors are usually deemed the most salient, or the independent variable. Other, especially less easily quantifiable factors such as political leadership and institution building, and indeed historical influences, receive less attention. It is the aim of this section of the report to provide a corrective to this state of affairs by providing a critical evaluation of the extant theoretical-cum-policy oriented discussion on regional integration (with a focus on the European Union) and the role of institutions and leadership in economic governance and thus providing a necessary background for a discussion of the impact of these factors on the prospects of enhanced regional economic cooperation in East Asia in the early 21st century. It does so in four stages:

1. It will provide a brief overview of how we have thought about economic integration in earlier times. It will draw out some key aspects in the evolution of the EU with a view to assessing their salience for thinking about the prospects of enhanced integration in East Asia in the early years of the 21st century.

2. It will rehearse some of the important insights we have gained into the role of institutions and institutional theory and ask how this theoretical literature is salient in practical terms to an understanding of enhancing cooperation in East Asia. This will be no mere scholarly exercise. It will demonstrate that the debate over the role of institutions – especially in their capacity as transaction cost reducers and vehicles for the enhancement of transparency on the one hand, as agents to ensure the credibility of commitments and norm compliance on the other – casts an increasingly long policy shadow over current regional activities in East Asia.

3. At a quasi historical level it will provide a brief analysis of why the institutions of the late 20th century, especially the pan-regional institution of the Asia Pacific writ large (APEC) – seem to be failing to maintain the serious attention of East Asian regional leaders in the changing context of the global economic and political orders in the early 21st century. This will not be a detailed history. Rather it will provide an insight into those factors that provide the historical context within which contemporary institutional development in the region is evolving in the early 21st century.

4. The last section will explore the issue of regional 'leadership'. In the context of the East Asian regional dialogue, this is identified as the key issue for the 21st century. At its core, the degree and the nature of regional leadership in the emerging Asian integration process that can be provided by China *and/or* Japan will prove crucial to the success of the current endeavours to secure enhanced regional economic (and political) cooperation in the region.

1.1 Theorising Regionalism: Europe and Asia Compared

Policy-makers (rightly or wrongly) often conceptualise regionalism with reference to the European experience. But, while we are not dealing with functionally equivalent entities, it is clear that policy learning and the politics of emulation (or in many cases the politics of avoidance) are major features of current deliberations about regionalism in other parts of the world. This is especially the case in the contemporary global economy where regionalism is a political response to the internationalisation of the division of labour and production.

The time lag between European developments and the construction of regional orders elsewhere has meant that region-building elites have had the opportunity to learn from the European experience. As often as not this has led to a desire for avoidance of, rather than emulation of, the 'Brussels model'. The less institutionalised approach that emerged in Asia in the early 1990s represented a deliberate choice to avoid the perceived 'Cartesian' legal formalism of the EU (Higgott 1998a).

Therefore, whether viewed negatively or positively, the European experience looms large. It is, ironically, the EU as an exercise in regional integration that is a major obstacle to the development of analytical and theoretical studies of regional integration elsewhere. For example, the oft-repeated characterisation of Asian and Latin American regionalisms as 'loose' or 'informal' reflects a teleological prejudice informed by the assumption that 'progress' in regional organisation is defined in terms of EU-style institutionalisation.

There remains a latent assumption that the EU represents *the* paradigmatic case of regionalism against which all other regional projects are judged. For some, the Union's longevity, institutional complexity and policy reach means that it is more than just an international organisation. Indeed, Hix (1994 and 1999) argues that the EU is a political system rather than an integration project. This is an extreme position (see Rosamond, 2000), but it raises the issue of whether the EU is in fact an instance of integration, and thus of regionalism, at all and thus of any comparative use for trying to explain the direction of regionalism in Asia in the 21st century

This dominance of the EU on our mental maps imposes an understanding of regionalism as being bound up with 'formal institutionalisation'. To equate mature regionalism with the creation of supranational politico-institutional bodies equivalent to the European Commission, the European Parliament and the European Court of Justice automatically prejudices any conclusions we might want to make about the emergence of a world order based on alternative forms of regional organisation and co-operation. This approach also assumes that key political economy questions pertaining to economic cooperation can only be addressed in this context.

Thus, there remains in much analysis a tacit, if not explicit, assumption that in order for there to be 'proper regionalism' a degree of EU style institutionalism should be in place. This emphasis on institutional regionalism proceeding through a mixture of intergovernmental dialogue and treaty revision is at the heart of the now classic model of economic integration developed over forty years ago by Bela Balassa (1961).

1.1.1 Balassa's Five Stages

Balassa used the term 'economic integration' to refer to the creation of formal co-operation between states and the forward movement from a free trade area to a customs union, a common market, a monetary union and finally total economic integration.

- Free trade area (with the removal of trade restrictions).
- Customs Union (with a common external trade policy towards non-members).
- Common Market (with free movement of factors of production between member states).
- Monetary Union (Fixed exchange rates or single currency and harmonization of economic policies).
- Political Union (Joint political institutions).

This view of regionalism, with its teleological reasoning, also informed the neo-functionalist version of integration theory (Webb 1983). Despite scepticism about the virtues of unidirectional models of modernisation in the social sciences, this stagial model still frames discussion, even among those who eschew trade as the key spill-over dynamic (see Dieter and Higgott 2003).

However, the analysis of regionalism and regionalisation is extremely fashionable in the contemporary era. (Coleman and Underhill 1998; Fawcett and Hurrell 1995; Gamble and Payne 1996; Grugel and Hout 1999; Mansfield and Milner 1997; Mattli 1999). This has much to do with the resurgence of, or emergence of, regional projects in the 1980s and 1990s. In North America, scholarly attention was boosted by the creation of the NAFTA (North American Free Trade Agreement). In South America, the MERCOSUR (Southern Cone Common Market) was created in 1991. ASEAN (Association of South East Asian Nations) became more assertive in Asia during the 1990s and 1989 saw the birth of APEC (Asia Pacific Economic Cooperation). Meanwhile the SADC (Southern African Development Community) became a focal point for regeneration following the end of apartheid. Most prominently, the European Union's single market programme intensified economic and political integration in Western Europe from the mid-1980s. This process continued with the achievement of monetary integration among a majority of states in the late 1990s. In an era in which globalisation has become increasingly contested (see Higgott 2001), regions, regionalism and regionalisation have, once again, come to prominence. Thus, we need to ask two questions

- What explanations of regional integration are germane in the present era and to what extent do they meaningfully travel across different geographical regions?
- How are our understanding(s) of region, the practice of which might change going forward in the 21^{st} century, evolving?

In early explanations of regional cooperation, neo-functionalists saw 'spill-overs' leading to economic and (ultimately) political integration. They theorised the transcendence of the state system rather than its survival and the process of economic and political integration being driven by *rational actors*, be they supranational institutions or self-regarding producer groups. Neo-functionalists (Haas 1958 and 1964; Lindberg 1966; Schmitter 1971; Nye 1968 and 1971) used the European experience to generalise about the prospects for regional integration elsewhere. The emphasis on functional pressures, growing interdependence and the significance of non-state actors stood in contrast to the more orthodox realism in American international relations.

This was all short-lived. The publication of Haas's devastating auto-critique, *The Obsolescence of Regional Integration Theory* (1975), suggested the very idea of producing replicable models of *regionalism* was misconceived. Two problems with integration theory had emerged:

- The European experience from the time of the creation of the European Coal and Steel Community through to the achievement of the European Common Market had not been replicated elsewhere. Analogous projects such as the Latin American Free Trade Area and the East African Common Market failed.
- Integration theory in Europe had under-estimated the pervasiveness of nationalist sentiment and the intergovernmentalist direction European community policy making had taken (Wallace 1996; Moravcsik 1998).

Indeed, explanations of European integration remained complicated by the domestic politics of the member states. However, the dissolution of 'integration theory' was not just a consequence of the discrepancies between theoretical predictions and empirical 'reality'. It was also marginalised by a growing distaste for grand predictive social theory and a growing interest in explanations that privileged international 'interdependence' as the forerunner to globalisation (see Katzenstein, Keohane and Krasner 1998).

It was only with the emergence of the single market programme in the mid-1980s that we saw a partial revival of neo-functionalist integration theorising. An activist Commission, under Jacques Delors, offered an empirical reinstatement of the neo-functionalist idea of supranational activism. The single market was suggestive of a number of spill-overs into social policy, economic and monetary union and political integration more generally (Tranholm-Mikkelsen 1991). More traditional state-centric accounts of integration, clinging to outdated realist state theory, failed to capture the 'everyday' regulatory complexity of the European policy process and were unsatisfactory (see Rosamond 2000.)

Interestingly, this reawakening of European integration occurred more or less simultaneously with the appearance of regional free trade areas elsewhere. The appearance of schemes in North and South America, as well as in the Asia Pacific and Southern Africa areas, were suggestive of a new regionalised world order, which would be triadic, with Europe, the US and East Asia as the nodal points. The drivers of this process were twofold:

The revised geopolitical security structure that followed the end of the Cold War loosened the possibilities of trans-border activity and inter-state exchange.

The growth of globalisation, especially, but not only, in its key economic forms of the liberalisation of global trade and the deregulation of global finance,questioned economic relations founded on the premise of national territory (see Held et al 2000, Scholte 2005).

Both stressed the fuzziness of the distinction between the ‘domestic’ and the ‘international’. Regional cooperation was thought to be a spur to enhanced global competitiveness. This general assumption is crucial to comparative analysis of the European and emerging Asian experience. Nowhere did regionalism appear to be getting stronger throughout the first half of the 1990s than in East Asia and the Pacific. For many, the growth of ASEAN and the so-called ‘Asian way’ to regional co-operation was a new form of regionalism explained by the need to respond to globalisation. The development of APEC in the early 1990s strengthened this view (see Higgott, Leaver and Ravenhill, 1993). However, the financial crises of the late 1990s challenged this view.

1.1.2 Beyond Europe: Regionalism in Asia after the financial crises

The financial crises of the late 1990s proved to be a watershed for both the analysis and practice of regionalism in East Asia. It provided clarity of observation and represented a political reality check on a number of issues of regional and global economic management that had been obscured by, or at least seemed less obvious, in the heady ‘emerging market’, ‘Asian miracle’ era of the early 1990s. Most obviously, and despite the now well-known hype that accompanied its development throughout the 1990s, the much-vaunted APEC initiative seemed incapable of even delivering short-term palliative responses to the regional financial crisis. This posed serious questions about APEC's efficacy as emerging modes of regional organisation in the Asia-Pacific (Ravenhill 2001). This reading was further justified by the abortive Japanese initiative to establish an Asian Monetary Fund in the wake of the crisis. The collapse of this plan in the face of US opposition highlighted the fragility of a Pacific-wide regional project that seemed dependent on the hegemonic blessing of the US.

It can, of course, be argued that APEC was only ever a trade-led initiative, neither intended nor equipped to deal with financial crises (Harris 2002.) On the other hand, a powerful argument can be made that the crisis opened the way for much tighter, clearer and less idealistic thinking about regionalism in Asia (see Higgott 1998). In the longer term the crisis may have pushed states to think again about how best to build a regional order capable of preventing financial crises (or at least competent to deal effectively with those crises when they arise). As discussed later in this report, the creation of a network of currency swaps and other financial arrangements arising from, and subsequent to, the ADB (Asian Development Bank) meetings in May 2000 represent a new approach to regional cooperation.

Even if such initiatives amount to nought, this observation is a central component of this report. At the very least, the discussions that have taken place since that time suggest a growing regional self-definition of ‘East Asia’ as a valid economic space with a discernible political voice. Analytically, this suggests that such policy initiatives do not simply arise merely as rational spill-overs from financial integration. Rather they depend upon an emergent sense of collective identity that frames the way in which policy elites respond to exogenous shocks. This highlights the centrality of two important variables in the study of regionalism often over-looked in the economic literature on regional integration.

- The importance of identities in region building
- The catalytic impact on regionalisation of political as well as economic external challenges emanating from the rapid growth of globalisation

Regions, by their very existence, mediate between national and global effects. As this report demonstrates, recent events in Asia allow us to identify roles that nascent regional organisations play as mediating layers of governance between the nation-state and global institutions. In the Asian case, this is as likely to involve the deflection of dominant Western ideologies, preferences and economic models that are bound up with the philosophies and actions of the international financial institutions, as it is to accept such preferences. Even in Europe, a purpose of such a mediating layer, certainly in the late 20th century and possibly until the time of the collapse of the constitutional initiative in 2005, involved the protection of the 'European social model' against the assimilating tendencies of deregulated Anglo-American capitalism (Hay and Rosamond 2002).

We need to treat institutions (such as regular forums for regional dialogue) as 'social' venues rather than just capsules in which rational action takes place. Observers of regional cooperation in Asia need to recognise the salience of the relationship between institutionalised interaction on the one hand and the emergence of regional identities and interests on the other. Rationalists need not follow well-worn state-centric paths. Strategic action by state actors may be, indeed certainly is, still important, but such action must continue to be placed within a wider complex of actors (both state and non-state) and institutional venues that conspire to influence the development of regionalism (Hurrell 1995). It is in this context that the role of institutions and, indeed the theory that underpins institutional growth and activity is more important than has traditionally been thought to be the case in the dialogue on regionalism that prevailed in Asia prior to the Asian financial crisis.

1.2 Why Institutions Matter and Why Europe is different

> Institutions are the rules of the game in a society or, more formally, the humanly devised constraints that shape human interaction. … Institutions reduce uncertainty by providing structure to everyday life … institutions define and limit the set of choices of individuals' (Nobel Laureate Robert North 1990: 3-4)

> Institutions are '… persistent and connected sets of rules (formal and informal) that prescribe behavioural roles, constrain activity and shape expectations' (Princeton professor Robert Keohane 1989: 3)

As the processes of economic globalisation deepen, they need to be institutionalised if they are to avoid increased hostile and negative responses. The continued liberalisation of trade, the rational deregulation of finance and a limited and constrained role for the state in the overall process of market globalisation will increasingly require recognised, trusted and legitimated structures (institutions) if globalisation—by which I mean enhanced economic integration at the global level—is to continue. The level at which these institutions will flourish is yet to be fully determined. What is clear, however, is that this cannot be simply an either/or variation at the global or the regional level. It is a multi-level enterprise in which it is likely that the failure of institutionalism at the global level is probably enhancing institutional thinking at the regional level. Yet this is easier said than done.

We live in a most dangerous age. Much that we learned about institutions is in danger of being unlearned. We are correct to point to deficiencies in institutions such as the UN. Similarly, we are correct to want to reform the international economic institutions such as the IMF, World Bank and WTO. What I am concerned about is the willingness to question the very utility of institutions — as ways of organising behaviour — that is growing in some parts of the global policy community.

For the last 100 years, social scientists have been demonstrating the central theoretical and practical importance of institutions as the reducers of uncertainty and transactions costs and the importance of their role in making promises credible. In this regard, institutions are to international political interactions what merchants are to trade transactions. For example, estate agents play an important role in bringing together distinct, often distrustful actors (buyers and sellers). We may be cynical about estate agents and we never entirely trust them. Nevertheless, we know that a housing market would not work without them. International institutions are not so different. We may be cynical about them and distrust them but most of us recognise that if they did not exist we would be re- inventing them in one way or another. Institutions facilitate deal-making between actors that may be in adversarial situations. However, institutionalism as a trust-enhancing commitment to principled behaviour lacks support at the moment—at both global and regional levels.

Institutional Principles developed in the 20th century

- Institutions lower transactions costs by the provision and sharing of information
- Institutions reduce uncertainty
- Institutions help make promises and commitments credible
- Institutions facilitate deal-making
- Institutions enhance compliance
- Institutions are vehicles for learning and socialisation
- Institutions help shape collective identities.[1]

We are in danger of unlearning these principles, especially in the foreign policy community. All actors are guilty of this at times. It is a particular indictment of contemporary US foreign policy. It seems to be unlearning the message about the role of institutions at the very time when other parts of the world (including Europe, and notwithstanding the current problems with the constitutional settlement) are learning the importance of them. The need for institutions is particularly important in those regions of the world in which the market economy is less firmly embedded and where these questions, theoretical and philosophical as they may

[1] For discussions of institutions and institutional theory see Keohane 1984, 1989, 2002, Simmons and Martin 2002, Higgott 2006

be, cast and will continue to cast massive policy shadows. East Asia needs to learn the principles of institutionalism that have flourished in the 20th century. Whether it is likely to or not is addressed in the final section of this report.

If we look at the EU, then a major purpose of it as an institution, especially as a vehicle for sovereignty pooling and policy delegation has been to create 'credible commitments' (see Moravcsik 1998). It is this process of pooling and delegation of sovereignty that is the main difference between the EU and other integration/cooperation schemes, and especially those in Asia in the contemporary era. Pooling and delegating sovereign decision-making is what has given the EU institutional capacity. The key elements of the development of the EU that makes it different from other systems to date can be noted in point form:

1. Europe does have an integrated governance system, linking institutional structures, policies, legal instruments that bring together the national and supranational level of decision-making and policy-implementation. Such integration is key to the overall success of *any* governance system.

2. In individual policy areas (for example, trade and competition policy) Europe has a sophisticated regulatory framework that is unequalled at the global level. To date, only Europe has managed to develop a competition framework based upon the adoption by each state of common standards, procedures and laws. This is a framework that will not pass easily to the global trade community embodied in the WTO.

3. The EU governance model relies heavily on the rule of law (see Stone Sweet 2004). The role of the European Court of Justice (ECJ) is crucial in ensuring a system that is both effective and fair at the same time. The ECJ has a key role to play in ensuring the legal provisions of the Treaty of Rome (and subsequent amending treaties) are upheld by the member state governments, the supra-national institutions, and by organisations and individuals. In this regard, the ECJ is a political actor, as much as a legal one. It aims not only to produce more efficient governance in Europe. Increasingly, it is also the conduit through which individuals, organisations as well as states seek redress for infringement of their rights.

4. Access to the ECJ for private individuals as well as member states and the supranational institutions makes it distinctive from other international governance models. Contrast it with the WTO, where only states can make a complaint to the Dispute Settlement Body. If these legal principles of direct effect and supremacy were to be fully incorporated into other international agreements, and particularly in systems of global governance, there would be a radical change in the effectiveness, the capacity and the fairness of international and global governance.

5. The EU, for all its shortcomings, has managed to instil a spirit of cooperation amongst a diverse group of member states, succeeded in showing the benefits of cooperation for its members and proving that cooperation need not be zero-sum and can be learned. In essence, cooperation within the context of an international governance system produces results where the participants can perceive cooperative action as a public good. This is not

to suggest, of course, that cooperation among sovereign states or between states and non-state actors in the establishment of a governance system is either automatic or easy. Successful cooperation to-date has depended on a public-sector push and an emerging supranational structure.

6.The EU has evolved towards a model of governance with a degree of democratic legitimacy. Despite real criticisms and a literature on the democratic deficit (for a discussion see Bellamy 2005 and Moravcsik 2004) the EU continues to address the imbalance between the supranational and the national democratic structures.

7. Europe exhibits both common and distinctive features in its national social models. European models of the welfare state face common internal and external challenges arising from accelerated globalization. Within the academic and the policy communities, the debate about European socio-economic convergence versus national diversities, and stimulated by the "Lisbon strategy" (2000-2001), was aimed at building a competitive 'European knowledge society' consistent with social cohesion. Such a modernization process does impact (if only in a limited way) on the co-ordination of national social, economic, employment, research, technology, public health and enterprise policies.

8. The EU provides a rare example of a primarily economic organisation developing a strong trans-national social policy backed by law. For example, it has a long experience of gender politics (dating back to Article 119 on equal pay in the Treaty of Rome) and "gender mainstreaming" has been adopted, with the stated aim of incorporating gender awareness in all aspects of EU policy making and increasing the representation of women in key fora. These measures have been complemented by provisions to combat discrimination on grounds of race, ethnicity, age and other forms of disadvantage.

9. While the European Union has emerged as a major actor in the world economy, with a reasonably developed and coherent set of trade policies, it is not so successful as a global political actor. For the EU to be taken seriously in the international arena, and to exert influence in the international institutions that currently form the global governance system, it needs a regional political identity as an effective and legitimate actor able to represent the interests of all member states. But finding legitimacy among its citizens and in public discourse within the EU on the one hand, and among the actors and institutions of global governance on the other, has proved difficult and events can and do derail these processes (see Albert, *et al*. 2001; Reuber and Wolkersdorf 2002).

10. The European Union has built up a dense web of cooperative relations with countries and regions in other parts of the world. These form a set of bilateral and multilateral relations linked to trade, aid, investment and other forms of development cooperation. Determined by historical, political and geographical factors, these links demonstrate distinctive priorities, value systems and normative considerations in the negotiation processes and decision-making frameworks, all of which shape the European approach to reform of the global governance system. Inter-regional cooperation has increased both the scope and density of the agreements. Although often misunderstood, the Asia-Europe Meetings (ASEM), EU-Mexico, EU-Mercosur, and the Cotonou Agreements constitute

examples of the increased aspirations of regional groups to build a density of relations and foster trust and understanding fundamental to a global governance framework.

These developments, and the networking and bargaining surrounding them, provide many lessons for regional and global governance. European experience and EU scholarship can make a serious theoretical and practical contribution to the emerging notion of sovereignty. European approaches to governance have developed flexible and multidimensional concepts of sovereignty in the international system. As suggested earlier, these ideas of sovereignty contrast with the often bounded, state-based/intergovernmental characterisations of sovereignty and international relations as understood by most US practice and scholarship and reflected in many other parts of the world where state consolidation rather than sovereignty pooling remains a principle pre-occupation of a governing regime. Institutions, especially regional ones, are the essential conduits between the state and the global economic and political orders. Enhanced global economic integration requires innovation in thinking about governance.

It remains important to make an intellectual leap to overcome these more bounded notions of sovereignty that beset decision makers in all East Asian states. The repressive potential of the state remains considerable, especially in the post 9/11 context, given the changing dynamics of international security. We need to escape from a bounded notion of sovereignty and narrow definitions of security and state-interest if the global and regional integration process is to deliver better governance. Central to overcoming these limitations must be the recognition that sovereignty can be disaggregated and redistributed across institutional levels from the local to the global. Thus, the importance of institutionalism is no mere theoretical indulgence. How seriously, and in what domains we take it, will determine the nature of regional cooperation in the early years of the 21st century. Institutions will be important interlocutors in the relationship between globalisation and regionalisation, especially as the recourse to regionalism becomes an increasingly common response to globalisation.

Some early depictions missed the complex interplay in the relationship between the ‘global’ and the ‘regional’ in the foreign economic policy of states. These analyses made judgements on technical and economic change and then extrapolated from them into the socio-political sphere in a manner for which the evidence is, at best, flimsy. Nowhere is this better illustrated than in what is often called the ‘hyperglobalist’ literature (*pace* Ohmae 1990 and Oman 1999) which saw the declining salience of state actors and state borders in the rise of what Kenichi Ohmae (1995), with a breathless McKinseysque cartography, labelled ‘region states’. In so doing, he prematurely reduced the state to the role of mere passive actor and victim of cross-border processes. The ‘hyperglobalisation’ thesis misconstrued how economic space is politically and socially (re) constructed over time. Economic regionalisation requires governments to sanction the relaxation of barriers to trade and investment, or, more proactively, to facilitate the provision of incentives to investment and trade sponsorship.

We did not witness the end of the nation state although we have seen a transition in its role. States are reasserting themselves, but not in the same way in all parts of the world. In some parts of the world, regionalisation, as a meso-level process of state-led governance and regulation, has grown in influence, and will continue to grow in influence in the early stages of the 21st century, but this regionalism will not necessarily follow the European model leading eventually to some form of 'sovereignty pooling'. Europe's regional present is not Asia's regional future. Rather, we are seeing the rise of regulatory regionalism (Jayasuriya 2004) in East Asia as state actors develop regionally selective, issue-specific, strategies to manage regional stability and enhance regional competitiveness in the face of recognised limitations in the institutional structures of global economic and political management that emerged throughout the second half of the 20th century.

1.3. The New Regionalism: Some Important Lessons from and for East Asia

At the heart of the new regionalism is a recognition of the inseparability of what Wallace (1990) called informal and formal integration and Higgott (1997) identified as *de facto* and *de jure* integration. The former refers to integration via the emergence of transnational space among private market actors. The latter sees integration led by the formal authority of governmental actors through agreement or treaty. The concept of regionalism can also refer more specifically to the ideology of regionalism; that is region building as a political project. Regionalisation implies the formation of regions, whether by region building actors or processes that are more spontaneous. The process of regionalisation also has structural consequences beyond the region in which it takes place. Trans-regionalism refers to institutions and organisations mediating between regions. If this occurs in a formalised way, we speak of inter-regionalism.[2]

It is increasingly accepted that *regionalisation* refers to those processes of integration that arise from markets, private trade and investment flows, and from the policies and decisions of companies rather than the predetermined plans of national or local governments. *Regionalism* refers to those state-led projects of cooperation that emerge as a result of intergovernmental dialogues and treaties. But, as in the relationship between regionalisation and globalisation, these are not mutually exclusive processes. Failure to recognise the dialectic between globalisation and regionalisation can mean that we impose a regional level of analysis on something that is actually global or vice versa. We must, therefore, consider the salience of extra-regional relations whenever we are considering regionalisation. Failure to do this was a principal past deficiency of integration theory.

For example, the growth in intra-regional trade in East Asia is the consequence of the fragmentation of production across national boundaries. With components produced in factories across the region, the trade component in the production of a single commodity increases dramatically. The final goods produced as a result of this intra-regional trade still have to be sold somewhere, be it inside or outside the region. Is this regionalisation or globalisation? The dichotomy clearly does not help. The answer is both: the processes of

[2] The literature on regionalism cannot be reviewed here. See *inter alia*, Gamble and Payne 1996, Hettne *et al*, 1999, Breslin et al, 2002 and Higgott 2005b.

developing regional production networks are themselves driven by global processes and are contingent on global markets.

How we map economic and political space is also a concern. Strict national or sovereign parameters should be avoided when identifying regionalisation. In addition to looking for a correlation between the national state and regional membership, we should also examine the wider groups and classes of actors that are involved in processes of integration. The growth of transnational networks and alliances that integrate elites, but not usually the wider populations, of a given country is the key here. Nowhere is this better illustrated than in the context of the development of APEC, where throughout the 1990s and early 21st century there has been a clear disjuncture between the enthusiasm for the process amongst corporate and bureaucratic elites and the disinterest, if not hostility, towards the project in the wider communities in many of the member states.

New regionalisms are invariably defined in rejection of the old, 'old' in terms of both theory and practice. At the level of practice, the first key feature of the 'new' is the sheer number of formal regional arrangements. There are few countries that are not members of at least one regional organisation and most are members of more than one. This upsurge in regional activity can be explained in several ways:

The promotion of export growth strategies has advanced the reality of increased economic regionalisation. In this regard, the increased adoption of varieties of domestic neo-liberal policies is an explanatory variable for regional initiatives.

An understanding that state actors are but one set of agents among many is at the heart of newer approaches. Moving away from this old 'statist' approach is a defining characteristic of 'new regionalisms'. Newer perspectives recognise the complex cocktail of state actors, interstate and global institutions and non-state actors (especially multinational corporations, emerging civil society organisations and NGOs) that all have an effect upon regional outcomes.

The need to respond to globalisation or *participate* in the global economy is a driving factor for governments, both weak and strong.

Hence, it is at the meso (regional) level, between globalisation and the nation-state and especially in a European context, that most effort has been applied to the management of trans-territorial, or multi-territorial collective action problem solving. As demonstrated, moves toward regionally integrated problem solving have been more active in Europe than in other parts of the world. But this is not only a European phenomenon. Elsewhere, the growing linkages between different regional integration schemes, such as the FTA between the EU and Mercosur, or the development of the ASEAN Free Trade Area, for example, are evident (Sampson and Woolcock 2003.)

There is also a growing tendency to devolve competencies from state-level to local levels in countries participating in integration processes. As a result, political authority becomes increasingly dispersed while economic activities become more globalised. In addition, non-state actors become increasingly involved in governance. This is not simply an academic observation. It is also replete with policy implications. We should stop thinking in terms of hierarchical layers of competence separated by the subsidiarity principle. We cannot ignore the strong tendency towards networking arrangements at all levels of governance, shaping proposing, implementing and monitoring policy together. In this context, there are at least four different ways of trying to explain regionalism. :

I. De facto Regionalism: Informal, market-led and leading to enhanced economic integration. This is principally *rationalist-economic* in analytical orientation.

II. De Jure Regionalism: Formal, rule governed, state led and leading to enhanced institutionalised cooperation. This, is principally *legal-political* in analytical orientation.

III. Instrumental Regionalism: Initially informal, interest led. Built on the identification of the interest to be gained by the development of a common policy towards third parties in a given issue area. This is principally power politics *realist* in analytical orientation.

IV. Cognitive Regionalism: Initially informal. Built on shared cultural, historical and emotional affiliations that distinguish 'insiders' from 'outsiders'. This, is principally *socio-cultural* in analytical orientation.

Of course, the salience of these approaches varies. Trying to find a 'one size fits all' explanation is pointless and rather than building (or joining) regional arrangements to enhance independence from the global economy (as they once did), many developing states now see regionalism as a measure to ensure continued participation in the global economy. Thus, and by extension, the distinction between *de facto* and *de jure* regional activity also becomes more problematic in the second period. While markets are the key drivers of regionalisation, state-led initiatives to enhance integration into the global economy lead to the pursuit of more strongly strategic regional policies.

Moreover, cross-border micro-regionalism makes the picture more complex. The authority and efficacy of national governments in dealing with trans-boundary issues has been transformed, by a dual movement: both 'upwards' and 'downwards' that results in the transfer of national sovereignty. Asia provides a number of interesting insights; as in ASEAN's emphasis on free trade in the development of AFTA (ASEAN Free Trade Area) (see Nesadurai 2003) combined with a growing interest in increased bilateral agreements and a residual, if weak, interest in APEC's 'open regionalism' agenda. Macro-level economic regionalisation in East Asia proceeds through different overlapping micro-regional processes, yet this micro-regional integration is itself driven by globalisation. Thus, we need to consider not only the relationship between the regional and the global, but also the relationship *between* regions, albeit often differentiated by size and/or functions.

Explanations of the European experience with regionalism in the second half of the 20th century would offer a rank ordering of drivers in terms of the salience as I, II, IV, III. If we were to guess at the ordering of the drivers for Asia in the first half of the 21st century then evidence to-date would suggest a priority order as follows: III, I, II, IV.

Drivers of Regionalism	Europe (C20th)	Asia (C21st)
De Facto Regionalism	first	second
De Jure Regionalism	second	third
Instrumental Regionalism	fourth	first
Cognitive Regionalism	third	fourth

For a range of reasons that we are only just coming to understand, East Asia, notwithstanding a growing keenness for enhanced regional cooperation, is unlikely to repeat the five-stage sequential process of integration as described by Balassa in a European context and outlined earlier in this report. It is not necessary to accept the judgements of Kenichi Ohmae to recognise the manner in which globalisation has had the effect of enhancing trans-border activities and inter-state exchange. The security driven disciplines of the Cold War era that ensured tight bi-polarity have disappeared and the growth of a neo-liberal ideology (and practice) of freer trade and financial deregulation amongst global economic actors have combined to challenge traditional economic relations once founded on the premises of 'national economies'. In their place we had a growing recognition, especially in the last quarter of the 20th century, of the internationalisation of the division of labour and, increasingly in the developing world, a recognition of regional projects as a growing response (both defensive and offensive) to the size and power of global markets and the need to ensure the free flow of FDI in the ever increasing search for competitiveness.

The difference of the Asian regional experiment in the 21st century is that it is less trade-led than the European project of the 20th century. Such has been the success in liberalising trade in goods under the GATT that the need to free up trade on a regional basis has become less pressing. This is not to suggest that trade is not the motor of growth in East Asia. Clearly, it remains so. Rather, it is not the only motor of the East Asian regional economic discourse.

Much of the hyperbole surrounding the evolution of the Asia-Pacific Economic Cooperation (APEC) forum in the first half of the 1990s saw only the benefits of free trade. However, the export-oriented countries of East Asia have needed very little convincing of the virtues of trade. But discussions in APEC missed the major changes taking place in the global economy and the potentially adverse effects they could have. What was not understood until the financial crisis of 1997-8 was the manner in which dramatic increases in deregulated, unrestricted capital mobility could lead to the kind of catastrophic volatility of exchange rates and capital flows seen in this crisis.

Since that time, we have seen two seemingly opposing, but nevertheless compatible, trends. These trends are the gradual movement towards enhanced monetary cooperation in East Asia on the one hand, and the growing interest in bilateral trading arrangements on the other. What makes them compatible is that both are wrapped up in the wider recognition of the importance of 'East Asia', as opposed to the 'Asia Pacific', as the 'voice' of region.

Of course, the US remains the dominant presence in the region, defined as the Asia Pacific (in both economic and military terms), but it is also an unwitting exogenous catalyst in the 'East

Asianisation' of the Western Pacific seaboard. APEC, rather than being a potential instrument for trade liberalisation at the Asia Pacific level, has come to be seen in large sectors of the policy communities of East Asia as but an additional site at which the US might advance its own agendas, such as for further capital market liberalisation and, since 9/11 as a vehicle for advancing the US security agenda (see Higgott 2004 for an elaboration).

As is well known, since the late 1990s, regular ASEAN summits have been expanded by the participation of Japan, China and South Korea in ASEAN Plus Three (or APT) meetings. The first East Asian Summit is scheduled for Kuala Lumpur in December 2005. Asian policy elites appear no longer to want their policies controlled from Washington when economic crises occur; hence the search for 'purpose-designed', East Asian responses to economic policy uncertainty.

In this regard, instrumental regionalism is driving the growing regional interest in monetary cooperation. There is recognition of the need to cooperate in the face of the shared common problem of financial volatility. This is a stronger urge than a desire to liberalise trade on a regional level. Recent initiatives emanating from this mode of thinking, especially those in the monetary domain (discussed in Dieter's contribution in this report) include not only the 2001 Chiang Mai Initiative (CMI) to create a regional liquidity (swap) fund, but also the Asian Bond Fund Initiative (ABF), proposed in June 2003, and the suggestion of a regional stock exchange, both of which have the aim of reducing the distances between the individual national markets and exchanges. One clear benefit of this process would be the raising of standards and regulatory norms and practices in the region. The CMI and the ABF collectively enhance, although they do not guarantee, the regional capability of resisting financial volatility.

In terms of 'cognitive' influences on regionalism in East Asia, the changing leadership role of the United States is important. It represents a growing 'other' in the Asian regional foreign policy context as regional players move to secure greater autonomy vis-à-vis the erstwhile regional hegemon. The nascent nature of regional cooperation, when accompanied by the fear of being on the receiving end of asymmetrical agreements in times of low trust in the multilateral trading system, has also seen governments in Asia developing bilateral strategies. This can be seen in the proliferation of preferential trading agreements in the region.

Nevertheless, when looked at collectively the processes in train in East Asia may actually represent a more systematic package of regional governance activities than would at first sight appear to be the case. The whole will be greater than the mere sum of its parts. The APT process is being institutionalised through the evolution of an over lapping multi-dimensional process of regional conference diplomacy strengthening, and indeed creating, links between the states of Northeast Asia and Southeast Asia (Suzuki, 2004). Whether Asians will be successful or not in their endeavours, there can be little doubt that the continued exploration of cooperation as a way to combat vulnerability is an established item on the regional policy agenda in the early 21st century, as even the normally sceptical *Economist* in a recent editorial was prepared to acknowledge (March 26-27, 2005).

What the Asian crisis told us was that there was no consensus on how to manage the international economic order in the closing stages of the 20th and the early stages of the 21st centuries. The major financial institutions were caught between competing nationalist and liberal views of how the world should work. The international financial institutions (IFIs) were found wanting in both theory and practice by the events in East Asia. However, the economic crisis also provided a positive learning experience at the multilateral level—globalisation requires the development of institutional capability for prudential regulation and it does so at a range of different levels. While most regional policy analysts continue to recognise that regulation is best pursued at the global level, regional level initiatives of the type outlined in the Manila framework and in the discussion of an Asian Monetary Fund will continue to evolve.

Where early regionalism might have been identified as a defensive mechanism to reduce dependence on the international economy, the 'new regionalism' sees it as more pro-active. It is a means of greater access to global markets, not securing regional autarchy. Regionalism is also now more multifaceted and multidimensional than in the past. States engage in any number of overlapping endeavours without sensing contradictions in such a process. Where the defensive legacies of the earlier phase remain—among political elites sceptical of the unregulated nature of contemporary global capitalism—this does not imply a growing regional resistance to all elements of the globalisation process. Indeed, the extent to which regional organisations act as a spur to global economic liberalisation is an important question. APEC was designed to facilitate wider global processes and could be read as a (failed) attempt on the part of its Caucasian members to prevent the emergence of a specific 'East Asian' regionalism.

We should also consider the changing rationale for joining (or forming) regional organisations for many developing states. On one level, the formal criteria established for membership by organisations—*pace* EU requirements for its new members in 2004—forces policy change on aspirant members. In the very process of liberalising to meet EU standards, these economies have become more open to the global economy in general. In such cases, regionalism can be seen as a pathway to globalisation. This is a key distinction between current and old explanations for regional projects. Rather than building (or joining) regional arrangements to enhance independence from the global economy, many developing states now see regionalism as a measure to ensure continued participation in it but with emerging regionalism as a meso-level comfort zone.

Thus, regionalism can be simultaneously a response to, and a dynamic behind, globalisation. We are dealing, in short, with mutually reinforcing and co-constitutive rather than contending processes. Regional regimes are not barriers to globalisation, but rather 'in-betweens'. The regional project is both part of and a facilitator of globalisation and a regional counter-governance layer in the world political economy. This relationship between regions and neo-liberal paradigms and economic policies stands at the heart of the new assessments of regionalism and regionalisation at the beginning of the 21st century.

‘Lateralisms’: Trends in East Asian Regionalism

Since the turn of the century, several broad trends have emerged in East Asia:

- The growing malaise of APEC as the foremost regional construct has continued unabated.
- The growth of bilateral Free Trade or Preferential Trade Areas (PTA or FTA) in the region was already strong and has strengthened further.
- The development of an East Asian understanding of regionalism (embodied in the development of the ASEAN + 3) gathers momentum in the wake of the first East Asian Summit
- Closely linked to the above point, the development of an East Asian interest in mitigating the prospects of further financial volatility at a regional level via the gradual development of policies promoting monetary regionalism.

The defining issue in the development of these regional trends is not 9/11. Rather, it is the Asian financial crisis of 1997/8. For most Asian states this crisis, its aftermath, and Asian responses to US policy in the period since then provide the most salient component of an explanation of current trends and policies in the region.

Bilateral Trade Policy and Regional Theory: While the rhetorical support for markets remains strong, the impact of politics on markets is never far away. Moreover, the growing interest in bilateral trade arrangements is determined by a number of factors other than US policy. The WTO had not fared well since its inception and the unbalanced diet that is the Doha MTN Round has proved particularly indigestible in many parts of the world. However, there can be little doubt about the influence of the growth of interest in bilateral preferential trading relationships (PTAs). This interest was (is) not simply a US phenomenon. But, if the Europeans started it, and other, smaller and weaker states also began to explore it, it has been the role of the US, as the strongest partner in any bilateral relationship, which has been disproportionately influential.

On few things are economists and political scientists so agreed than that bilateral trade deals are sub-optimal and pose major threats to the multilateral trading system (Bhagwati 2002). This is especially so when trade agreements are used to advance non-trade specific issues, such as security policy. Actions, rather than rhetoric, suggest that the USA since 9/11 has attached as much importance to its bilateral deals with a range of countries, including Chile, Australia, Singapore and Morocco as it has to the conclusion of an acceptable MTN round (see Higgott 2004).

The Asian interest in bilateral agreements reflects a general appreciation of the success of GATT/WTO in reducing tariffs and, albeit to a lesser extent, non-tariff barriers in the second half of the 20th century. Thus, the benefits of regional free trade agreements are much less significant than they were thought to be. Industry leaders in the region (de facto agents of market-led economic integration) are acutely aware of the degree to which manufacturing is now more global than regional. Building large, multi-member, regional trade blocs in an era of globalisation is deemed less relevant.

More specifically, bilateral trade arrangements—in many ways a defining feature of the regional political economy in the early 21st century—are felt to give regional policy elites greater control over national trade policies. This reflects the fear of Asian states that their influence over deliberations, within the context of the WTO, is not always as great as they would wish. As such, bilateral free trade agreements are statements of sovereignty. While the US may see bilateral agreements as a way of bolstering or rewarding good partners in the fight against terrorism, East Asian leaders also see them as a useful policy tool with both extra-regional and inter-regional payoffs for the states concerned. The effects of this trend can be, at one and the same time, to enhance regional convergence in one area of activity on the one hand yet exacerbate regional divergence in another area of economic activity on the other. At the end of 2003, East Asian states were involved in 41 state-to-state bilateral FTA projects (actual and putative) with Singapore and Thailand the most active and 23 states were involved in region-to-state agreements such as the ASEAN-China FTA (Dent 2004).

If bilateral economic cooperation in the trade domain is a fact of life in East Asia in the early years of the 21st century, the key issue for this paper is the degree to which it might enhance the regional project overall or detract from greater regional economic policy coordination and integration. This is clearly not an either/or situation. Elements of both enhanced cooperation and increased competition are present in the contemporary regional policy process. In a 'structural argument', bilateralism can bolster the economic foundations of the region with the prospect of enhanced cooperation at the regional level. It can provide a regional 'lattice' of technical and institutional arrangements to reinforce the regional project. This is an argument frequently advanced by states active in the FTA game (Desker 2004).

By contrast, a 'process-led argument' in favour of the recourse to bilateralism would suggest that it has the effect of enhancing the broader discourse on regional economic cooperation and integration. No state, it is argued, pursues just a bilateral or multilateral trade policy. The two arms can surely be reinforcing. Bilateral activity should be seen as a complement to other initiatives such as the development of an ASEAN Economic Community and the APT, both of which have different, but complementary agendas and functions. This is a position advanced, for example, by Singapore and Thailand as part of their trade strategies.

In sum, support for enhanced economic cooperation and integration at the regional level is a possible outcome of the trend towards bilateralism in East Asia, but it is not inevitable and strong counter-veiling tendencies and outcomes are equally possible. We have little or nothing in the historical or scholarly armoury to make a strong prediction one way or the other at this stage. The risks may outweigh the opportunities. The degree to which the positive outcome might prevail will in part be determined by the success or failure of activities in other areas of the policy domain and with other putative economic initiatives, such as monetary cooperation, where the collective regional urge in East Asia is currently stronger. Nevertheless, the jury will remain out on the strength of these arguments for the foreseeable future.

Opponents argue that in fact, the increasing recourse to bilateral initiatives has the effect of undermining the wider regional projects in East Asia. Intellectual and technical capability and political will are finite resources that cannot be indefinitely sub-divided without diminishing their utility and effectiveness. At the ASEAN level, bilateral activities must inevitably be in competition for attention with attempts to upgrade the ASEAN FTA (AFTA) to the ASEAN Economic Community (AEC) by 2020 (see Hew and Soesastro, 2003). A longer-term outcome of this competition in the trade domain could be increased consolidation of existing asymmetries, enhanced inter-state rivalry amongst regional neighbours at a more general level, and a diminution of the region's ability to present a united front to other global actors in a range of other policy domains.

Monetary Regionalism and Cooperation: This is discussed elsewhere in the report, but with empirical detail, several general points about regional monetary policy as an example of substantial cooperation can be drawn out. The nascent nature of regional cooperation, when accompanied by the fear of being on the receiving end of asymmetrical agreements in times of low trust in the multilateral trading system, has seen governments developing bilateral strategies. More generally, East Asian co-operation, in the economic (and indeed, the security domain) and the search for a new voice of Asian regionalism, remains problematic. The dialogue at the Asia Pacific level has faltered. APEC's identity crisis persists, unable to decide if it is an economic or a security body. However, the regional dialogue has moved on dramatically since the time of the financial crisis of 1997/8. The key issue here is how one defines region.

The debate about enhanced cooperation at the level of East Asia, writ small to mean ASEAN, continues with discussions about the development of an AEC as a hosting body to integrate the activities of AFTA, the ASEAN Framework Agreement on Services, and the ASEAN Investment Agreement. However, it is at the level of East Asia—writ large to include ASEAN, China, Japan and South Korea—that the regional dialogue on how best to mitigate the kind of volatility experienced during the financial crisis of 1997/8 has developed most rapidly.

Notwithstanding the failed attempt to establish an Asian Monetary Fund in 1998, the principle behind the proposal did not die. Evidence of an emergence of monetary regionalism is indeed to be found. By the end of 1999, the worst of the Asian crisis was over and East Asian policy circles once again addressed the topic of regional co-operation. The regular ASEAN summits were expanded by the participation of Japan, China and South Korea, the new body being called ASEAN+3 (or APT). Since the late 1990s, steps in the search for a new monetary regionalism have been frequent and numerous. They represent a contribution to the regional institutional economic architecture that departs from previous models of regional cooperation in Asia.

Efforts to secure monetary cooperation are very much part of the wider exercise of soul searching that has been taking place both within ASEAN, and between ASEAN and its other East Asian partners, since the turn of the century. The crucial point of these exploratory exercises is not their immediate significance. Nor is the point to under-estimate the difficulties of such policy coordination in the region. Rather, I suggest we would be naive to think that

Asians will not continue to develop greater regional institutional mechanisms for the common management of financial questions. To see ASEAN + 3 as but an exercise in extended conference diplomacy, reflecting weakness rather than strength, would be misleading. True, in the opening years of the 21st century, it is too early to see what kinds of institutional structures will inevitably be embedded in the region, but the range of interactions developing is unprecedented. ASEAN+3 has moved on from initial leadership meetings. Considerable deepening has taken place with regular ministerial meetings across most policy domains (economics and finance, agriculture, forestry, tourism etc) (see Stubbs 2002; Suzuki 2004 and Thomas 2004). In T.J Pempel's perceptive view,

> … a strikingly contradictory view of the East Asian region emerges. … [D]espite the overwhelming structural impediments to integration, East Asia has in recent years become considerably more interdependent, connected and cohesive. [It is] … a region that has developed an increasingly dense network of cross border cooperation, collaboration, interdependence and even formalized institutional integration (Pempel 2004: 2).

In keeping with earlier analysis (Higgott and Stubbs 1995), what we are seeing is a trend picked up by others (Bergsten 2000; Webber 2001; Rapkin 2001); namely, the emergence of a voice of region beyond that of the sub-regions—Southeast and Northeast Asia—but more restricted than that of the Pacific as a mega region. The Asian voice of region that is emerging in the global political economy is a new, 'East Asian' one. When looked at collectively, the processes in train actually represent a more systematic package of activities than would at first sight appear to be the case. The whole will be greater than the mere sum of its parts provided the momentum can be maintained. The degree to which this is likely to be the case will be conditioned by the structures of regional leadership that emerge over the coming years.

1.4 The Leadership Issue

Leadership is one of the most difficult analytical concepts in the lexicon of the modern day policy sciences. It is one of those popular and populist concepts that everyone thinks they understand. Few do. The key distinction drawn in this section is between what we might call structural/institutional leadership and agency oriented/political leadership. The two are of course not distinct but they do provide a useful way of identifying the problems and prospects for leadership in the enhancement of Asian regional cooperation over the short to medium term period. Specifically, the twofold classification allows us to distinguish between hegemony and leadership.

Leadership is not the same as hegemony (that is economic and military preponderance). Leadership can be intellectual and inspirational. If we look at the development of the EU, for example then we can see both kinds of leadership over the life of the organisation, pace the intellectual leadership of figures such as Schuman and Monnet in the crucial agenda setting period of the 1950s and the quasi co-operative hegemony of France and Germany in the following era. From such a judgement, it is easy to suggest that part of the problems that Europe faces is the absence of either kind of leadership in the current era. From this position, we can ask a series of questions about leadership in Asia in the early 21st century. Two broad and several specific questions come to the fore in this context:

- From where will the necessary leadership come to take the cooperative dialogue in East Asia forward at this time? That is, where are the necessary actors to be found?
- What are the structural constraints on actor based leadership emerging and can they be overcome?
- The specific questions pertain to the roles of the principal actors in the region over the short (1-5 years) to medium (15-20 years) period.

The USA and the Question of Hegemony**:** To talk of regionalism in East Asia without addressing the specific question of the role of the USA is rather like a performance of Hamlet without the Prince. To do so is to miss the historical context of the US role in East Asia since the Second World War, especially when viewed in comparison with its historical role in the reconstruction of Western Europe. More importantly for this report, it is to miss the global context of contemporary regionalism. This is especially, but not solely, the case since the advent of the Bush administration and the policy changes emanating from the events of 9/11/2001. There is a stronger degree of continuity rather than change in attitudes towards regionalism since 9/11, but these trends have consolidated since that date.

Quite clearly, US policy towards the regional agenda is more significantly shaped by its own agenda, which since 9/11 has become increasingly a security driven agenda at the expense of what was called the neo-liberal economic agenda that underwrote its bilateral and multilateral policies towards the region prior to then.

In historical terms, the US role, as an exogenous actor, in the development of a European community was pivotal (see Latham 1997). Within a Cold War context US foreign policy pro-actively supported the European project. In East Asia, while American hegemony and the geo-political setting are:

> … still crucial influences on regional processes, they are having an inadvertent rather than intentional impact. Whereas the EU sprang from a highly successful attempt to reconstruct Western Europe on a new integrated basis, in East Asia American foreign policy is having a more ambivalent impact on the region that is gradually moving to assume greater autonomy despite, rather than because of, American policy (Beeson 2005: 970).

Enhanced regional cooperation in Europe may have taken place without US support. We will never know one way or the other. But we do know that the US, via a range of initiatives, gave considerable impetus and assistance to the early collaborative efforts of the European project. This is not the contemporary case in East Asia. Indeed, Beeson (2005: 978-81) would argue that one of the key reasons for the slowness of enhanced economic cooperation in East Asia has been precisely because of the constraining role played by the USA in the Cold War context.

The Cold War in Europe was centripetal whereas in East Asia it was centrifugal. For fifty years, US policy split the region along ideological grounds and built a structure of bilateral hub and spoke relationships between it and its major East Asian partners on the one hand and Cold War divisions on the other that rendered impossible any leadership pretensions of the region's two major powers. Japan for the second half of the 20th century subordinated any leadership ambitions to its asymmetrical bilateral relationship with the USA. Japan's rise to become the world's second largest economic power in the 1980s and 1990s was achieved at the expense of its own regional leadership ambitions. Similarly, China (for Cold War and obvious ideological reasons) was not in a position to contribute to East Asian wide regional cooperation. For most of the second half of the 20th century, both states, one for ideological reasons, the other for its own particular debilitating historical reasons, were effectively denied any regional leadership ambitions. Only in the 21st century is the bilateral strategic architecture of the region undergoing a process of gradual dismantlement.

The historical balance sheet on US economic leadership in the post World War II era is mixed, or perhaps more precisely divided into two eras. In the first era, it provided massive reconstruction funding, especially for Korea and Taiwan. It also provided relatively open market access for the rapidly growing Japanese economy and other newly industrialising countries in the first three decades after World War II without receiving a reciprocal openness from these trading partners. This is explained, of course as part of a wider grand strategy in the Cold War context. From the early 1970s, however, this benign (Kindleberger-esque) reading of US hegemony needs to be revised. Straightened economic circumstances in the US from that time have seen a well documented recourse to aggressive economic policy to restrict access to the US economy for East Asian exports and open East Asian markets to US exporters. This has taken place through a range of strategies variously described as 'aggressive unilateralism' (Bhagwati and Patrick); strategic trade policy (Krugman 1986) and the recourse to sectoral protectionist activities with euphemistic names such as Voluntary Export Restraints, Orderly Marketing Arrangements, Structural Impediments Initiatives and the like and, since the 1980s, a more or less permanent pressure on the major countries of the region to progressively de-regulate their financial markets.[3]

In contemporary terms, it is perhaps inevitable in the wake of 9/11 that we should see the robust reassertion by the US of the geo-security agenda over the geo-economic agenda that prevailed in the 1990s. With specific relevance for this report, US attitudes towards regional projects are now ambiguous, to say the least. This is not only the case with regard to Europe in the wake of the war in Iraq but also in its attitudes towards enhanced regional cooperation in an East Asian context. While keeping a sense of perspective, we should note that the principal contemporary trends are not substantially different to those that were developing prior to 9/11. The US since the time of the Asian financial crisis, and the attempts to establish an AMF, opposes (or at best feigns indifference) to regional initiatives that run counter to its perceived interests in the region. In part, this is clearly to do with a recognised change in the nature of the relationship with East Asia. Specifically, there is now an emerging body of empirical evidence of a quantitative nature that suggests that changes in the relationship between the USA and East Asia are becoming less economically asymmetrical and, as a consequence, the ability of the US to set the regional agenda is becoming less convincing than at anytime in the last two decades.

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[3] There is a vast body of literature on these topics. For a review see Ravenhill 2005.

Resulting from a secular trend over the last 30 years, US GDP is now only 80 percent of that of East Asia. East Asia's share of total world trade is, at approximately 25%, almost double that of the US at 13%. Perhaps more importantly, as of 2003, East Asian exports are double those of the US; inter-regional trade in East Asia is strengthening rapidly and the US share of East Asian export trade has declined to 25%. Holdings of foreign currency reserves in East Asia are now more than 20 times those of the United States. It would also seem, obvious US technological superiority notwithstanding, that East Asia, judged by the increase in its share of patent registrations, is making some inroads here too (see Ravenhill 2005: 12-13).

Of course, quantitative indicators alone are not definitive, especially when dealing with a concept as illusive as hegemony. East Asian aggregate performance does not axiomatically find its way into enhanced political leverage over the US given that East Asia does not formulate policy towards the US based on an 'East Asian' interest or via policy-making machinery capable of reflecting any such aggregate interest. Decision-making resides firmly at the level of the constituent states not at the level of the wider regional collective. In this context, the agenda setting abilities of the US far outweigh those of any single East Asian state individually or, given the slight probability of rapidly enhanced cooperative decision-making in the region, collectively. For East Asia to bring about a closure of the asymmetry in the decision making process with the USA to accompany the declining gap in material capability, East Asia needs to enhance its collective decision making capabilities. For this to occur, leadership endogenous to the region needs to strengthen. How this might be achieved is, of course, the single most important regional policy issue for the future.

2– Monetary Regionalism and Financial Markets

At the beginning of the 21st century, the international financial architecture is characterised by continuing change. Perhaps the most profound difference with the preceding decade is that the dollar's hegemony can no longer be taken for granted. The introduction of the euro results in increasing competition for the dollar, and consequently the world is moving to a bipolar monetary arrangement (Bergsten 2005: 4). These changes are a challenge for East Asian and Southeast Asian countries:[4] First, they demonstrate that monetary regionalism and the creation of a single currency is possible in practice, not just in theory. Second, Asia's traditional reliance on the dollar – as an external anchor for exchange rates, a reserve currency as well as the main invoicing currency – has to be evaluated from a new perspective. Is it sensible to tie one's currency to the dollar? Is the accumulation of dollar reserves a wise strategy? In addition, it is useful to continue emphasizing the ties to the dollar when the United States is confronted with an unsustainable balance of payments, the result of which will probably be a severe reduction of imports within the coming decade.

As analysed in this report, regional economic co-operation has several dimensions, but monetary and financial regionalism probably receives most attention in East Asia. The reasons for the emphasis on this element of economic integration of a region are obvious: after decades of rapid trade-driven growth, virtually the entire region experienced a traumatic shock when the Asian financial crisis hit in 1997. This event continues to be the most important factor for the advancement of regionalism in East Asia. The experience of being both put-up and let-down by Western countries drives the desire to develop regional safety nets as well as greater independence, from Western money markets in particular.

So what are the characteristics of monetary and financial cooperation in a region? The process tries to achieve four goals in particular: the facilitation of trade in goods and services by providing stable monetary conditions, the provision of efficient, well-functioning financial markets, the prevention of financial crises and finally the regional management of credit and currency crises.

Although these four goals are primarily economic, there is nevertheless much to be said against purely economic evaluations of monetary regionalism.[5] The process is essentially driven by political motives, and one-dimensional economic evaluations – for instance debating whether Asia satisfies the criteria to be an optimum currency area – do not fully grasp the

[4] Throughout this part of the report, the term Asia will refer to East and Southeast Asia i.e. the countries that constitute ASEAN+3.

[5] Monetary regionalism aims to contribute to the stability of currencies and financial markets in a region without the need for formalizing trade links. The terms regional financial cooperation and monetary regionalism can virtually be used synonymously – although there is a difference: monetary regionalism is a broader approach with a more ambitious agenda.

contexts in which it evolves. As in Europe, a combination of political and economic motives can be observed in Asia. Monetary integration always had and still has a strong political connotation – both in Asia and in Europe. However, the key point driving the search for monetary regionalism is a perceived communality of interests (Grenville 2000: 1).

Up to today, steps toward monetary integration in Asia have been rather limited in scope. After the experience of the Asian crisis, governments have pursued a two-track strategy. The first and most obvious is the build-up of enormous currency reserves. Countries have significantly strengthened their first lines of defence. The second development has been a novel concerted effort to strengthen monetary co-operation in the region. For the time being, the agreed measures are not significant. There is the so-called Chiang Mai process, established in 2000 and aiming at creating a regional liquidity reserve. Although this appears to be useful – and mirrors a similar proposal by Giscard d'Estaing and Helmut Schmidt in the late 1970s – the goals of this process remain largely undefined. Is it aiming at providing liquidity in the event of an unexpected credit crunch, i.e. the simultaneous retreat of the majority of international lenders? Or is the stabilisation of exchange rates the goal? The latter remains the more ambitious project and the report will need to explore which preconditions will have to be addressed if the process is to be a success. Again, political issues are at least as important as economic considerations, and leadership issues have to be resolved *before* further substantial steps can be taken.

However, even in the absence of a consensus on the further evolution of economic integration in general and monetary regionalism in particular, a surprising number of activities have emerged in the region in recent years. Similar to the co-operation of central bankers under the gold standard, which flourished despite recurring political tensions, today central bankers in Asia do work together. Again, there was very little if any co-operation of that kind prior to the Asian crisis. If central bankers exchanged views, it was in multilateral organisations, such as the BIS, not in regional ones. The shift to regional dialogue on monetary affairs – resulting in some rather concrete steps – can be observed at four levels: the networking of currency swaps under the Chiang Mai agreement, the monitoring of short-term capital flows and other surveillance measures, initiatives to strengthen the regional bond markets and cooperation on exchange rates.

This part of the report will evaluate the debate on monetary regionalism since about 2000. Of course, the debate by now is so comprehensive that a selection has to be made with regard to the issues addressed. The topics have been selected in order to cover those dimensions of monetary regionalism that are of relevance to policy makers in Asia or differ from the European experience. In the next section, emphasis will be on the rationale for monetary and financial co-operation. Why do Asian policy makers consider enhanced co-operation? What are the potential benefits? In addition, the sequencing of integration processes will be discussed. There is considerable debate on the merits of a swift shift to monetary stability. The following section will analyse the Chiang Mai process, one of the more tangible results of Asian monetary cooperation to date. Subsequently, monitoring and surveillance as well as the evolution of regional bond markets are discussed. The choice of exchange rate regimes that is available for a region, including the debate on optimum currency areas, is analysed next, followed by an analysis of the regional scope of monetary regionalism. If there were no progress in economic co-operation in Asia, this would open possibilities for sub-regional initiatives. One of them is a Greater Chinese Currency Union, comprising China, Hong Kong, Taiwan and perhaps Singapore. Finally, the institutional dimension will be addressed and proposals for the anchoring of integration by way of establishing regional monetary organisations will be made.

2.1 The Rationale for Monetary Regionalism and Sequencing

There is virtual unanimity amongst academic and political observers that the Asian crisis of 1997 is the single biggest reason for pursuing more intensified monetary and financial cooperation in Asia.[6] As countries in Southeast and East Asia were receiving identical treatment by international financial markets – regardless of their individual merits or problems – this experience has laid the foundation for intensive monetary and financial cooperation.

Nevertheless, the Asian crisis alone would not have generated sufficient momentum for the current drive towards monetary regionalism. The frustration of Asian policy makers with the slow reform of the international financial architecture is probably as important (Wang 2004: 940). It is becoming increasingly obvious that Asian elites resent the dominance of Washington in regional and global affairs. Eisuke Sakakibara, an important Japanese government official and former Deputy Finance Minister, sees a parallel between the decline of Britain after 1918 and America's decline today. Whereas World War I symbolised the end of the British Empire, today's so-called War on Terror indicates the end of Pax Americana. The watershed was the Asian crisis, a position that Sakakibara spells out clearly:

> After the Asian crisis of 1997-98, Asian countries strongly perceived the vulnerability of their region, which does not have any viable regional cooperative scheme. They recognised that there is no global lender of last resort, that international organisations like the IMF and the World Bank were not of much use in preventing or addressing the crisis, and that the United States did not infuse much in the way of resources into Asian countries when the crisis broke (Sakakibara 2003: 232f).

The Asian crisis therefore was not simply an unexpected and badly managed financial affair. Rather, it altered the relationship of Asia with the USA. Governments and elites were reminded that America had a domestic agenda to deal with, and the interests of the American financial sector prevailed over the interests of America's allies in Asia.

However, there is more to monetary regionalism than resentment over past developments. Open capital markets, i.e. the absence of capital controls, have resulted in the need to improve governance structures, either on a national, regional or global level. The lack of effective Global Governance, including the development of a lender of last resort and the regulation of capital flows, will not disappear quickly. National regulation can no longer provide sufficient regulation, but the region – from a theoretical perspective – is much more apt in providing these structures (Sakakibara 2003: 234). Although regional financial governance could be

[6] See for example Milner 2003, Stevenson 2004, Kohsaka 2004, Wang 2004, Dieter 2000b, de Brouwer 2002, Ryou/Wang 2003.

inferior to global financial governance, provided by the IMF in particular, this is not inherently so. It all depends on how the instruments of cooperation and the institutions created are structured in practice (de Brouwer 2002: 19). Considering the experience of the last decade, there is little evidence for the assumption that regions are less prepared for financial governance than the IMF.

Eric Giradin has stressed the potentially positive contribution of monetary regionalism, considering it to be a public good:

> The gains from regional financial cooperation essentially stem from reducing regional systemic risk. Regional financial stability has the nature of a public good, in that no country would have an incentive to work toward it if others do not do it, while all benefit from it. Disruptions caused by financial crises, at a regional level, are a major incentive for cooperation. The public good nature of regional financial coordination is due to the fact that financial instability is a potential public bad that spreads across countries (Giradin 2004: 334).

There are, however, also strong divisions within Asia. The motives in Asia outside Japan for enhanced monetary cooperation are partly driven by the inability of Japan to speakup for the region as loudly as it could have, in particular in the IMF. Whereas the United States and Europe have long been robust supporters of their respective regions in the Fund, Japan has failed to do so for Asia. Gordon de Brouwer argues that this has damaged Japan's position in the region:

> Whatever the reasons – the legacy of colonialism and war, Japan's dependence on US security, a preference for consensus, the division of policymakers' focus on domestic economic problems – the result is that East Asia's champion has let itself be squeezed out (de Brouwer 2002: 8).

The failure of Japan to provide leadership to the region became obvious in 1997. Japan was the one country that could have beaten the panic, but it failed and missed this 'golden opportunity' (Walden Bello). The failure of Japan could be witnessed at two levels. First, Japan reduced its imports from the region rather than expanding them. Imports from the countries in crisis dropped significantly after 1997, in some cases by over a third (Dieter 2005a: 129). Rather than being a regional consumer of last resort, Japan left that role to America. Second, and probably more important, Japan failed to implement its own proposal of an Asian Monetary Fund.

Japan had suggested an Asian Monetary Fund (AMF) in September 1997. The AMF was a brainchild of Eisuke Sakakibara, then Deputy Minister of Finance, and was put forward to G-7 Ministers of Finance. The AMF should have been endowed with a capital of $ 100 billion and should have applied fewer conditions than the IMF. In practice, the countries of the region would have strongly preferred the AMF to the IMF, first and foremost because of the preferable conditionality. Nevertheless, Japan's proposal was not well prepared, and within weeks, the idea of creating an AMF was abandoned. In October 1997, during the annual meeting of the IMF and the World Bank in Hong Kong, Japan withdrew its plan.

A number of reasons caused that failure. First, the Clinton Administration, particularly Finance Minister Robert Rubin and his deputy Larry Summers, strictly opposed the Japanese initiative. They correctly assumed that there would be no need for the IMF if the AMF were to be successful (Stiglitz 2002: 134). For the US government, which in the past had successfully used the IMF to further its own agenda, this was not an appealing prospect. A regional competitor for the Fund would have undermined its monopoly over the management of financial crises, bringing a weakening of American influence with it.

Second, accepting the creation of an AMF would have diminished the opportunity of liberalising the Asian economies affected by the crisis. Opening those countries was an aim of the Clinton administration, and the Asian crisis provided an opportunity to pursue that goal.

Third, and probably most important, the Japanese government was quickly intimidated by the resistance it faced. Although Tokyo clearly saw the opportunity to position itself as the leading power in Asia, it was ill-prepared to implement its own initiative. Waldon Bello identifies an 'occupation psychology' as the reason for that timidity (Bello 1998b: 19). However, the inability of Japan to lead Asia in the event of a severe crisis might reflect a serious dilemma. Japanese policy makers see their country as part of the West, and not necessarily as a part of an Asian community. The willingness to fight with Washington over an issue that did not directly affect Japan was limited, even though the failure to utilise the opportunity the Asian crisis provided has done crucial harm to Japan's leadership aspirations (Dieter and Higgott 1998).

Sequencing - monetary regionalism before trade integration?

When analysing the rationale for monetary regionalism the issue of sequencing must be given a prominent position. The conventional sequence for regional economic integration starts with trade, to be followed by monetary integration at a much later stage (see also Higgott's contribution in this report). This is the path Europe successfully took, but today the reverse strategy might be sensible. Since barriers to trade are much lower than they used to be in the 1960s and 1970s, the benefits from regional free trade are more limited. Furthermore, financial instability can cause severe damage to economies, and this potentially is an incentive for a different sequencing: finance first, the integration of markets for goods and services at a later stage (Dieter 2000b; Shin/Wang 2002; Pomfret 2005).

In Europe, trade integration preceded monetary integration. The customs union was accomplished in 1968, years before monetary integration saw a fresh impetus. In the late 1970s, monetary integration was put back at the top of the agenda. It was proposed that monetary integration should be accompanied by the pooling of reserves. The concept that was suggested by Valéry Giscard d'Estaing and Helmut Schmidt in 1978 envisaged a three tier monetary integration:

- First, the creation of a parallel currency, the European Currency Unit (ECU). The ECU was a new unit of account based on an internal currency basket.
- Second, the European Monetary Cooperation Fund (EMCF), a liquidity pool that was supposed to multilateralize national foreign reserves.
- Third, the Exchange Rate Mechanism (ERM), the purpose of which was to stabilise exchange rates (Ing 2003: 384).

The joint liquidity fund, which today is the most tangible achievement of monetary regionalism in Asia, was never implemented in Europe. The German Bundesbank vigorously opposed the concept that would have reduced its own influence and that would have given the other participating central banks the option of drawing on the joint pool without the Bundesbank's consent (Dieter 2005a: 367). If Asia intends to follow the European model, sequencing would have to be different from today's CMI.

So what would be the advantages of monetary integration ahead of trade integration? Shin and Wang suggest that a monetary union may speed up intra-regional trade without requiring a free trade agreement or other measures (Shin/Wang 2002: 11). Reducing the costs of hedging against currency volatility – zero in a monetary union but high in the event of substantial exchange rate movements – is an advantage that can be quantified for individual companies as well as for countries. The cost of insuring against volatility can reach five percent of the value of an export item, and this is substantial by any standard. Furthermore, today's most frequent type of preferential trade agreement, a free trade area, is also not without substantial costs: in order to qualify for duty-free treatment, goods have to have certificates of origin, and the administrative cost for the issuance of these certificates is estimated to be around five percent of turnover (Dieter 2004a: 281). Considering that a monetary union immediately reduces cost whilst free trade areas increase them, inverting sequencing appears to be a concept worth exploring.

An empirical study by Andrew Rose supports the expectation that a common currency has a dramatic positive effect on bilateral trade. Rose analysed bilateral trade over a twenty-year time span in 186 countries. The results are surprisingly positive: other things being equal a common currency more than triples bilateral trade. However, the samples that support his argument are somewhat atypical: they involved a very small economy that formed a currency union with a much larger neighbour, and that choice of sample distorts the findings (Pomfret 2005: 117). There is, however, no need to argue about the quantitative results. The main finding is that the absence of monetary instability in space, i.e. a monetary union or a single currency between countries, is facilitating trade.

However, the lack of connection between trade and monetary integration literature makes this endeavour complicated. There are very distinct theoretical approaches: in trade the basic concepts go back to Jacob Viner's seminal book on customs unions, whilst the theory of monetary integration was first developed by Robert Mundell in the early 1960s (see Viner 1950; Mundell 1961). Nevertheless, this artificial separation does not make sense: trade flows are influenced by the prevailing monetary conditions, and capital flows are, to a degree, a function of trade.

A sequencing pattern that differed from the traditional trade-based model of integration has been suggested by Dieter (2000b). Rather than starting with a free-trade area, followed by a customs union, a common market, an economic and monetary union and finally a political union, Dieter has proposed to start with the pooling of foreign reserves, followed by the creation of a regional exchange-rate regime, an economic and monetary union and a political union. Instead of postponing the benefits of monetary integration, this four-stage approach would begin with a monetary measure. A formal trade agreement would not be necessary in that scheme, although a differentiation has to be made: regional trade would be facilitated, but there would not be a formal agreement, which would have severe negative side-effects in any case.[7]

Yunjong Wang has suggested that regional monetary cooperation does not have to evolve into a regime that could be characterised as deep integration. The three pillars Wang identified – liquidity assistance, monitoring and surveillance and exchange rate stabilisation – might not be fully implemented in a region. Some type of shallow financial co-operation, e.g. the pooling of foreign reserves without any exchange rate coordination, might be the maximum level of co-operation that a given group of countries is willing to engage in (Wang 2004: 940). Needless to say, such an approach to monetary regionalism is a low-risk and low-profit strategy. Not much is gained, not much sovereignty is lost.

2.2 The Chiang Mai Initiative and the pooling of reserves

As already mentioned, during the Asian crisis the Japanese proposal for an Asian Monetary Fund was confronted with opposition from the US, the IMF and China and was not implemented. Only two years after that experience, the leaders of ASEAN responded and invited China, Japan and South Korea to join in efforts to deepen economic and monetary cooperation. The ASEAN +3 Summit in November 1999 released a joint statement that covered a wide range of potential areas for co-operation (Wang 2004: 941). The first major result was presented by the ASEAN+3 finance ministers less than a year later.

In May 2000, the ASEAN swap agreement of August 1977 was reconsidered and strengthened. It was widened to cover all ASEAN members and the amount available was raised from $ 200 million to $ 1 billion in May 2001. The second development, also under the umbrella of the Chiang Mai Initiative (CMI), is the development of a full series of bilateral swap and repurchase agreements between the ASEAN+3 countries. Countries can swap their local currency for major international currencies for up to six months and for up to twice their committed amount (Pomfret 2005: 114). By mid-2002, the sum of the bilateral deals agreed had already reached $ 30 billion (de Brouwer 2002: 25). Since then, the CMI has been further expanded.

[7] The negative effects of bilateral trade agreements are by now well documented. See, inter alia, Dieter 2004a and the report by the Consultative Board on the Future of the WTO (2004).

Table 1: Progress on the Chiang Mai Initiative (as of 31 August 2004)

Bilateral Swap Arrangement	Currencies	Conclusion dates	Amount (in billions of US dollars)
Japan-Korea	USD/Won	4 July 2001	7.0[a]
Japan-Thailand	USD/Baht	30 July 2001	3.0
Japan-Philippines	USD/Peso	27 August 2001	3.0
Japan-Malaysia	USD/Ringgit	5 October 2001	3.5[a]
China-Thailand	USD/Baht	6 December 2001	2.0
Japan-China	Yen/Rmb	28 March 2002	3.0 equivalent
China-Korea	Won/Rmb	24 June 2002	2.0 equivalent
Korea/Thailand	USD/Baht	25 June 2002	1.0
Korea/Malaysia	USD/Ringgit	26 July 2002	1.0
Korea-Philippines	USD/Peso	9 August 2002	1.0
China-Malaysia	USD/Ringgit	9 October 2002	2.0
Japan-Indonesia	USD/Rupiah	17 February 2003	3.0
China- Philippines	Rmb/Peso	29 August 2003	1.0
Japan-Singapore	USD/S $	10 November 2003	1.0
China-Indonesia	USD/Rupiah	30 December 2003	1.0
			Sum: 34.5

a) Amounts include credits agreed under the New Miyazawa initiative.
Source: Park/Wang 2005: 95.

The Chiang Mai Initiative was started as a very cautious endeavour. The amounts agreed are modest compared to the enormous national reserves that central banks in Asia have accumulated.[8] Furthermore, the decision to limit the amounts available under the swap at the discretion of the two countries involved to 10 percent of the total and to require IMF consent for the remaining 90 percent surprised observers (e.g. Dieter 2001). The explanation for this decision has to be found not in economic rationality, but in diplomatic considerations. The ASEAN+3 countries had no desire to give the US government and the IMF an opportunity for renewed criticism. Functionally, the need for IMF consent does not make sense. It is not plausible to expect the IMF to be any faster or generous with the Chiang Mai funds than with its own loans. Taking the experience of 1997 into consideration, there is much to be said for the exclusion of the IMF. Therefore, the requirement of IMF approval from the beginning could have been considered a temporary measure, primarily for diplomatic reasons.

However, the CMI has additional shortcomings. Despite the fact that the CMI has now been operational for five years, the project remains vague and ambiguous. It does not yet have an operational structure, in particular a monitoring and surveillance mechanism. But more important is that it is still unclear what its ultimate purpose is (Wang 2004: 948). Is the CMI the nucleus of an emerging process of monetary regionalism in Asia? Alternatively, is the goal much more limited, i.e. do the participating countries envisage a joint liquidity program? Cynics could argue that the ASEAN+3 countries have followed the European model: in 2005, almost 50 years after the signing of the Treaty of Rome, Europeans are not sure what the

[8] It should be noted that accumulating high reserves has the drawback of high fiscal costs because the country effectively swaps high-yielding domestic assets for lower yielding foreign ones (Rajan/Siregar 2004: 293).

ultimate goal of their own integration process is. Nor do they know where the borders of the European Union should eventually be.

Similar to other issues discussed in this section of the report, there is a considerable conflict between Japan and China that hampers the further deepening of the CMI. Japanese authorities expect some sort of assurance that their loans will be repaid, and unless they receive such guarantees, there will be continuing reluctance to expand the credit volume substantially. Consequently, for a meaningful expansion of the lending volumes, Japan expects the development of monitoring mechanisms that are both efficient and provide Japan with the opportunity to exercise influence on other countries. At the same time, China almost certainly feels no desire to play second fiddle to Japan in any regional organization in Asia, and these concerns probably constitute the most important roadblock to further development of regional integration in Asia in general and the CMI in particular (Wang 2004: 949; see also Higgott's contribution in this report).

However, in 2005 there has been some progress. During the annual meeting of the ADB in May 2005, the finance ministers decided to transform the bilateral swap arrangements into a multilateral fund. Instead of individual decisions to activate bilateral swaps, in the event of a crisis the decisions would be taken jointly (E&Z, Vol. 46, No. 6: 227). This is a significant step forward and adds a new spirit of community to the process. In addition, the part of the entire fund that does not require IMF consent was doubled to 20 percent of the total. During the meeting, the doubling of the sums available was considered as well (Frankfurter Allgemeine Zeitung, 9 May 2005: 145).

However, the sums that are available under the CMI – even if doubled – are still insignificant compared to the combined national reserves of Asian countries, which in 2005 exceed 2,000 billion dollars. Rajan and Siregar have emphasised that the pooling of reserves – accompanied by the reduction of national reserves – would result in a substantial reduction of fiscal costs (Rajan/Siregar 2004: 320). They have suggested a three-tier system of liquidity provision in the event of a financial crisis: first, the country will draw on its own national reserves, which can be used quickly and without consideration of conditionality. The second tier would be the regional liquidity arrangement, which would be subdivided into the country's resources placed with the pool and the other members' reserves. The third tier would be conventional IMF lending (Rajan/Siregar 2004: 320f).[9]

Today, many countries in Asia apparently have not fully embraced the concept of monetary regionalism, despite showing a keen interest in exploring its possibilities. If the countries participating in the CMI were to decide to go ahead and deepen integration, then the CMI could

[9] Jean Tirole has expressed doubts as to whether the concepts on which the regional liquidity pool is based make sense. The implicit assumption is that there are phases of illiquidity which can be distinguished from insolvency, the latter category not being a temporary shortage of liquidity, but a permanent one. Tirole argues that there is never illiquidity without the suspicion that insolvency may follow (Tirole 2002: 111). Although this is true, Tirole ignores the possibility that herd-behaviour and the pro-cyclical tendencies of financial markets may turn illiquidity into insolvency without any fundamental economic problem.

serve as a starting point and be expanded into a regional liquidity pool, perhaps the first step of monetary regionalism (see Dieter 2000b; Dieter/Higgott 2003).

2.3 Monitoring and Surveillance

The rationale for regional surveillance – as opposed to national or global approaches – is not only based on the desire to integrate further, but also on the assumption that there is a risk of contagion. If there is a risk that a financial crisis in neighbouring countries will spread beyond the borders without the fundamentals providing an explanation, then regional surveillance makes sense. The Asian crisis was a powerful catalyst for increasing the understanding of the need for regional monitoring.

> The spread of a financial crisis to many countries can be due to externalities such as the transmission of domestic shocks to foreign countries through trade and financial flows; exposure to common shocks, such as a common external lender withdrawing liquidity, or informational imperfections on regional and international markets (pure contagion) (Giradin 2004: 345).

Monitoring and surveillance is part of the regional policy dialogue, without which policy formation in a region cannot function properly. Whilst it is true that regional surveillance is no substitute for efficient national banking supervision, the exchange of information nevertheless is essential for the development of regional responses to challenges that affect a number of countries.

Nowhere was this more obvious than in Asia. Prior to the crisis of 1997, there was very little – if any – dialogue between finance ministers, central bankers and regulators. Paul Blustein has provided anecdotal evidence that shows the level of co-operation in the middle of the crisis: on 17 October 1997 Lee Kyung Shik, governor of the Korean central bank, was playing golf with his Taiwanese counterpart, Hsu Yuan Dong. Both central bankers kept talking to each other during the game, which was frequently interrupted by incoming phone calls for Hsu. That very day Taiwan devalued its currency, and the fact that this issue was not debated between the two central bankers sheds a light on the lack of trust that prevailed in regional economic co-operation (Blustein 2002: 123).

There is an emerging consensus in Asia that an independent monitoring and surveillance process is an important element of any deepening of monetary and financial co-operation in the region (Wang 2004: 944). A distinction has to be made: there can be monitoring with agreed sanctions or there can be monitoring without any ex-ante agreed rules. In Asia, the former type is difficult to implement in the short-term. In Europe, by contrast, there is a well developed set of institutions for supranational governance. The European Commission, the European Parliament, the European Court of Justice and not to forget the European Central Bank provide the institutional environment for governance above the level of the nation state. Although the European institutions are in continuing competition with the nation states, they nevertheless guarantee that the supranational perspective is not overlooked in any decision. There is no equivalent in Asia, and the lack of powerful supranational institutions has negative consequences for surveillance.

Monitoring and surveillance is of great importance in Asia because financial markets are not yet as developed as they ought to be for successful monetary integration. After the crisis of 1997, Eichengreen and Bayoumi pointed out that underdeveloped financial markets are major obstacles for the further integration of the region.

> The strongest argument against even a limited sacrifice of monetary autonomy is that domestic financial systems are less well developed than in Western Europe. The legacy of financial repression and capital controls continues to limit financial depth … Currency pegs, whether unilateral or collective, are risky where governments are required to intervene in support of their banking systems (Eichengreen/Bayoumi 1999: 364).

This assessment is less convincing in 2005 than it was immediately after the Asian crisis. There has been considerable effort to make national financial markets – and for the time being the regulation of these markets is a matter of national policy – more efficient. Nevertheless, the regional monitoring and surveillance processes that have been emerging since the Asian crisis are useful stepping stones for monetary integration because they may create the functional basis for further integration.

Surveillance, however, should not be overestimated. Some institutions, e.g. the IMF, have been expressing the expectation that surveillance can be a powerful tool in the prevention of future financial crises. On closer inspection, it cannot. In financial history, there are few examples of successful crisis prevention by efficient surveillance (Dieter 2005a: 396). To take two prominent examples: there was no lack of data both in the Asian boom prior to 1997 or in the dotcom bubble before 2000. There simply is no formula that is not predicting too many crises but does not miss the main ones. Up to now, there is no forecasting model that would have predicted the Asian crisis (Frenkel/Menkhoff 2000: 29).

2.4 Initiatives for the deepening of regional bond markets

Before the Asian crisis, many companies in the region borrowed funds from Western financial institutions, usually denominated in foreign currency. The absence of an Asian bond market left enterprises in Asia with little choice. After 1997, the concept of an Asian bond market to keep the region's savings in Asia and to enable financing without currency risk enjoys renewed attention (Tourk 2004: 859). Financial systems, which rely entirely on bank financing or foreign financial markets, unduly concentrate risk (Stevens 2004: 68).

The development of regional bond markets has important advantages. Sophisticated bond markets contribute to the deepening of regional financial markets, which gives borrowers more choice, but simultaneously stabilises the markets. Rather than having to borrow in London or New York, being able to use the region's savings without either facing exchange rate risk or having to hedge against that risk would represent a major improvement of the region's financial architecture. It should be remembered that the combination of declining exchange rates and the unwillingness of international lenders to roll-over existing debt were the two most important factors in the financial meltdown of 1997.

The initiatives to create regional bond markets as well as strengthen national markets have taken various forms: the Asian Bond Market Initiative (ABMI), proposed by the Japanese

Ministry of Finance in 2002, the Asian Bond Fund (ABF) and the initiatives of the Executives' Meeting of East Asia and Pacific Central Banks (EMEAP), which will be discussed in turn.

The ASEAN+3 finance ministers endorsed the creation of an Asian Bond Market Initiative (ABMI) in Manila in August 2003. The ABMI aims at the creation of a suitable environment for the emission of bonds in regional financial markets (Tourk 2004: 862). The ministers not only agreed on the principle, but went on to establish six working groups, e.g. on standardized debt instruments, the creation of credit rating agencies and the setting-up of guarantee mechanisms (de Brouwer 2005: 7). For the development of improved bond markets, other problematic factors are weak financial institutions, a lack of financial intermediaries such as insurance companies and pension funds as well as the unwillingness of international ratings agencies to provide credit ratings for Asian companies, many of which are family-owned and unable to provide the data required for financial analysis by independent evaluators. Without an improvement of the conditions for bond emissions, companies in Asia will continue to be reluctant to use these instruments because unsecured corporation bonds will simply be significantly more expensive than bank loans.[10] The Asian Development Bank supports ABMI by issuing bonds denominated in Thai baht and Philippine pesos (Financial Times, 15.4.2005: 9).

The Japanese initiative, however, has not been limited to improving the infrastructure. Takatoshi Ito has proposed an Asian Basket Currency (ABC) Bond Corporation, whereby Asian governments issue bonds denominated in local currency and contribute them to the ABC entity. These bonds would back the emissions of the ABC Bond Corporation, which itself would issue bonds to match the value of the original assets, but denominated in the Asian Basket Currency. In the second phase, the private sector would be enabled to establish a corporate bond market, again using the Asian Basket Currency for the denomination of the bonds (Tourk 2004: 863).

Taken together, these two initiatives could represent important steps forward, both for the deepening of regional financial markets *and* for the emergence of an Asian currency. However, it remains to be seen whether this Japanese initiative will gain momentum in the coming years.

The Asian Bond Fund was established in 2003. Nine Asian governments have agreed to contribute to this fund, which will invest in Asian debt securities. Each country will contribute one percent of its foreign reserves to the fund. The participating countries are China, Japan, Hong Kong, Malaysia, Indonesia, the Philippines, Singapore, South Korea and Thailand (Tourk 2004: 865). Since foreign reserves are very high in the participating countries, the ABF will probably be a very liquid instrument attracting national and international investors. The ABF initiative underlines the willingness of Asian governments to promote actively the deepening of their financial markets. Rather than waiting for the private sectors alone to develop these

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[10] Tourk suggests that unsecured bonds would require interest coupons of more than 18 percent p.a. (Tourk 2004: 862).

structures, governments in the region seek to speed-up that process by creating the necessary market environment.

In contrast to the other projects, EMEAP is not a purely Asian venture. Membership is similar to the ABF, with the significant addition of Australia and New Zealand. There can be little doubt that these two economies have well-developed financial markets and that their central banks possess expertise which is very useful in the development of deeper financial markets. In fact, Bowman has argued that the Australian dollar today is as important in Asia as the yen, a development that could be observed after the Asian crisis (Bowman 2005: 84). In the post-crisis period, linkages between the Asian currencies and the Australian dollar have been significantly intensified. Whilst the yen was much more important for Asia prior to 1997, the Australian currency has caught up in all categories that were analysed by Bowman (2005: 96). The inclusion of Australia in the cooperation scheme of central bankers in the region is therefore not only justified by the expertise in financial markets the Australians possess, but also by the importance of the Australian dollar in the region.

EMEAP is one of the older dialogue institutions in the region, having been set up in 1991 at the behest of the Bank of Japan (Castellano 2000: 1f). Whereas during its first years of existence few concrete steps were taken, since the turn of the century it has become an important – if underrated – venue for central bank cooperation in the region. The importance of EMEAP has not escaped the attention of Washington, but to date the USA is excluded from this scheme.[11]

The first EMEAP Asian bond fund was launched in June 2003 with a capital of $ 1 billion, to be invested in a basket of *dollar denominated* bonds, which were issued by governments in all EMEAP countries except Japan, Australia and New Zealand, since these three had already well-developed bond markets. The fund was managed by the BIS in Basle (Battellino 2004: 13; Tourk 2004: 860; de Brouwer 2005: 8).

The next phase is the Asian bond fund 2, which comprises a Pan-Asia Bond Index Fund (PAIF) and a Fund of Bond Funds (FoBF), which consists of investments in eight separate country sub-funds (Battellino 2004: 13). The implementation phase has been announced on 12 May 2005. PAIF is a single bond fund investing in sovereign and quasi-sovereign *local-currency denominated* bonds issued in the eight EMEAP markets, excluding again Australia, Japan and New Zealand. The single-market funds are also investing in local-currency denominated bonds. The EMEAP group has allocated 2 billion dollars for the entire phase 2. PAIF will be managed by State Street Global Advisors, domiciled in Singapore and initially listed in Hong Kong. The single-market funds will each be managed by a financial institution from the relevant country and all nine funds will have the Hong Kong and Shanghai Banking Corporation as their master custodian (EMEAP Press Statement, 12 May 2005).

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[11] According to well-informed circles in Canberra, in recent years the Federal Reserve Bank knocked at the door and wanted to participate in EMEAP, but that request was turned down by the Asian central bankers.

The importance of the EMEAP initiatives is significant.[12] Central bankers from the larger economies of the region have taken active steps to broaden and deepen financial markets in the region. The aim of the initiatives is to reduce dependence on non-Asian financial markets and enable borrowing in domestic currency – both dimensions reducing the vulnerability of the region. If successful, in the long run these efforts will result in reduced risk and better management in Asian financial markets. At the same time, the willingness to exclude the American Federal Reserve underlines the willingness of central bankers to emancipate themselves from the mighty authority of the USA, and this dimension of the EMEAP process is as important as the bond market initiative itself.

However, despite the enthusiasm that has characterised the above named processes, a note of caution is appropriate. Regional bond markets are not a substitute for the reform of national financial markets. Furthermore, even if the initiatives for the creation of regional bond markets are successful, their deepening will take time and further investment in the infrastructure of financial markets (Wang 2004: 947). Although the will to achieve can be observed today, there is no guarantee that this wave of enthusiasm will persist.

The scenarios for the CMI mirror those for the entire process of regional integration in Asia. Consider three scenarios: the first is a Chinese/Japanese alliance in which Japan dominates the CMI process and China the process of trade integration. There would be distinct spheres of influence, and the entente would serve both countries' leadership aspirations. The second scenario assumes a continuing rise of China, which over time could try to pursue its own liquidity scheme and attempt to bypass Japan. Considering that successful trade integration is facilitated by monetary stability, and taking into account the leadership aspirations of China, this might indeed be a realistic preposition (Wang 2004: 953). Third, the CMI could muddle through, searching for direction, but not achieving substantial progress.

2.5 Exchange rate cooperation and an Asian currency

We have to ask whether the Asian region would benefit from the introduction of new exchange rate regimes at the regional level. Before discussing the potential paths that could be explored, it has to be asked whether the region is a good candidate for such an endeavour. The question to be asked is whether Asia is an optimum-currency-area (OCA), an issue first addressed by Robert Mundell in 1961. According to OCA, the choice of currency area is a cost-benefit analysis with a trade-off between microeconomic efficiency and macroeconomic flexibility (Pomfret 2005: 111). The former would be improved if there were only one global currency, but this would put all economies in a monetary straitjacket that is undesirable. One global currency would result in a single uniform interest rate policy and the inability to gain flexibility by changing the exchange rate of a currency.

[12] EMEAP itself claims that the launch of the Asian bond fund 2 represents a milestone in central banking cooperation in the region, which is a rather unusual expression of excitement for central bankers (EMEAP press statement, 16 December 2004).

The four most important points that have to be considered when analysing an OCA are the level of interdependence through trade, the symmetry of shocks, the mobility of factors of production and the convergence of macroeconomic policies (Ryou/Wang 2003: 16). The first criterion is easy to understand: the higher the trade density within a region, the greater the utility of forming a single currency (or a monetary union with stable exchange rates). However, the argument can also be turned around as discussed in the part on sequencing: providing monetary stability can potentially result in greater trade intensity.

The second factor reflects the consequences of different economic structures. If two regions adopt a single currency and have very different industrial structures, this constitutes an obstacle to a successful currency area. One region might be specialising in a highly cyclical commodity whilst the other has specialised in products that are barely affected by cyclical downturns. A common monetary policy for these two countries would frequently be suboptimal. Consequently, two countries with similar economic structures are more likely to benefit from a single currency.

The third factor is as obvious as the first. Without the mobility of factors of production, adjustment to shocks would be difficult. For Mundell himself the mobility of labour was of utmost importance (Mundell 1961: 661). Nevertheless, on close inspection, this is not really a necessary precondition. There is no need for both free movement of labour and free trade. Paul Samuelson showed in 1947, an argument he rehearsed in 2004, that free trade has the same effect (over time) as the free movement of labour. There will be an equalisation of factor costs if there is free trade even without unrestricted movement of labour (Samuelson 2004). This point is important for Asia, where great differences in wages result in the reluctance of governments to permit the free mobility of workers, in particular from China. Consequently, in order to raise the potential benefits of a single currency there ought to be at least unrestricted mobility of labour *or* free trade.

The importance of convergence of macroeconomic policies, perhaps the most prominent area of debate before the creation of the single European currency, should probably not be overstated. Convergence is probably more important in the field of interest rates than in that of fiscal policy. If the introduction of a single currency gives rise to a big drop or a big rise in interest rates in some of the participating countries, this could result in adjustment problems that could discredit the integration process. However, whether fiscal policy really requires convergence as well as continuing limits of public borrowing is a contested issue. There was no scientific justification for the levels that were chosen in Europe: the 60 percent ceiling on stocks of public debt was roughly the average of the candidates (with the exception of Italy and Belgium), and the three percent deficit limit was chosen for the same reason. If there is no explanation why a certain *uniform* limit to new debt has to be observed, then it is hard to explain the need for any limit. As debt remains national and not regional, repayment will have to be made based on national tax revenue, and there is perhaps no need to fix deficit limits. In addition, as we have seen in Europe, once those levels are rigidly fixed, the difficulties of standing by them in a prolonged slump can result in a dilemma: should fiscal policy be pro-cyclical and reduce expenditure as well as raise taxes in a lasting downturn?

Barry Eichengreen and Tamin Bayoumi have analysed the suitability of a currency area for Asia (Eichengreen/Bayoumi 1999). They argue that Asia is as suitable for monetary union or a single currency as Europe.

> We find that the region satisfies the standard optimum currency area criteria for the adoption of a common monetary policy as well as Western Europe. Its small, open economies would benefit from the reduction in uncertainty that would result from the creation of a durable common peg. Intra-Asian trade and investment have reached relatively high levels. Adjustment to shocks is fast, and supply and demand disturbances are small and symmetric by European standards (Eichengreen/Bayoumi 1999: 364).[13]

OCA theory – although still widely used when the prospects for a regional monetary union are evaluated – has nevertheless lost some of its usefulness. The main point is that economic evaluations are less important than political will. Without the latter, there will never be a process of monetary integration. Peter Kenen has criticised the limited usefulness of OCA:

> In its original form, OCA theory does not tell us much about the macroeconomic costs of entering into a monetary union. That is because it dealt chiefly with the effects of entering into a simple currency union under the conditions of low capital mobility ... It paid no attention whatsoever to the most prominent feature of a full-fledged monetary union – the introduction of a single monetary policy (Kenen 2002c: 155).

Although the political will for improved monetary arrangements in Asia can be identified, there is uncertainty about the potential shape of such a cooperation scheme. Any political agreement in a region on the need for joint exchange rate arrangements is only a starting point. It is necessary to identify the precise nature of such a regime. Tommaso Padoa-Schioppa from the European Central Bank has identified four categories: floating for all economies, a regime with exchange rates tied to a basket of currencies, an intra-regional exchange rate mechanism, and a single currency (Padoa-Schioppa 2004: 321). It is important to note that these four concepts do not address the same issues: there is no attempt to stabilise exchange rates in the free float, whilst tying the individual exchange rates to a basket is aiming at the stabilisation of exchange rates with the rest of the world. By contrast, the main aim of an intra-regional exchange rate mechanism is to stabilise exchange rates within a region, and the same applies to a monetary union and to a single currency.

Floating: Immediately after the Asian crisis, the so-called bipolar view enjoyed widespread support. The idea was that intermediate exchange rate regimes, e.g. crawling pegs or managed floats, were unsustainable over time. Only the two corner solutions, a free float or a hard-peg, i.e. a currency board, were supposed to be manageable. Needless to say a free float is manageable, since the affected central bank takes a very passive position and does not try to intervene in foreign exchange markets. The trouble with free floats is that they do not produce convincing results. Although appealing in theory, in practice a free float – whether for an individual economy or for an entire region – can produce lasting imbalances. Serious misalignments even occur for today's two major currencies. Free floating is even less desirable for small and medium-sized economies (Padoa-Schioppa 2004: 321).

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[13] Ryou and Wang as well as Ing have supported the assessment; East Asia is not inferior to Europe in satisfying OCA conditions (Ryou/Wang 2003: 22; Ing 2003: 399).

Anchors, baskets and numeraires: An individual country as well as a group of countries can tie their own currency to a basket of other currencies. There is a prominent example for such an approach: China changed its peg from a single-currency peg to a basket of currencies in July 2005. However, pegging to a basket is not as beneficial as it may sound. Although in theory a basket will avoid the disadvantages of a single-currency peg, new problems arise. Baskets require a liquid foreign exchange market for all currencies, which is a condition that does not always exist (Padoa-Schioppa 2004: 321).

A region would have to agree on a basket of currencies and their relative weight, which might be complicated: some countries will suggest a greater weight for, say, the euro, because a high percentage of trade is done with the eurozone. However, pegging to a basket has additional disadvantages, as Ronald McKinnon pointed out after China changed its peg from a single-currency to a basket of currencies. Instead of a clear regime with a well-defined monetary anchor, China has entered a nebulous no-man's land, with the consequence of reduced predictability of monetary policy (McKinnon 2005). Part of the specific problem with the Chinese basket is that it is composed of a relatively high number of currencies, the result of which is reduced transparency and clarity.[14]

John Williamson does not share McKinnon's position. He argues that shifting from a single-currency peg to a basket (which he calls a basket numeraire) is beneficial and can be constructed in a manner that is neither complicated nor results in a lack of transparency. Williamson emphasises that switching to a basket numeraire does not imply that any intervention in foreign exchange markets would have to be conducted in the currencies represented in the basket. Even the composition of reserves could differ from the composition of the basket without causing problems (Williamson 2005: 2). Williamson emphasises that a basket numeraire differs from a basket peg: the former is the more general concept and permits both the fixing of exchange rates and a managed float (Williamson 2005: 3).

For many years Williamson has been advocating the use of a currency basket to stabilise exchange rates (Williamson 1999: 327), a concept which he has somewhat refined in a paper in August 2005. He suggests a basket numeraire for the entire East Asia region.[15] He explicitly mentions Indonesia, Malaysia, the Philippines, Singapore, Thailand as well as China, Japan and South Korea. Hong Kong and Taiwan could perhaps join as well. The existing intra-regional trade is an indicator of the level of interdependence that has been achieved by a particular region, and Asia shows quite a high level of intra-regional trade. In 2004, the share of intra-regional trade (exports and imports combined for Japan was 46.1 percent of total trade, and

[14] Taking these difficulties into consideration, the negative consequences of a basket could be mitigated by limiting the number of currencies in the basket to two or three. If China would have changed its dollar-peg to a basket in which both dollar and euro would have had a 50 percent weighting, this regime would have been both an improvement over the dollar peg and would have maintained clarity and transparency.

[15] Sung Kwack has proposed a similar pegging to a basket (Kwack 2004: 66). He suggested a composition that would include the dollar, the yen and the euro with weights of 40 percent (dollar) and 30 percent for the two other currencies.

for the other countries in the sample the average is even higher -55.5 %, see table 2 in the annex).

There is little gain in a very complex composition of the basket. Large baskets add complexity without providing much additional benefit (Williamson 2005: 6). Taking the rationale for switching to a basket into consideration, this is obvious. The main purpose of a basket numeraire is to reduce the volatility of one exchange rate vis-à-vis the rest of the world. Nevertheless, the most prominent as well as most important swings of exchange rates are between the major currencies, i.e. the dollar, the euro and the yen.

This leads to the question as to whether – if a region has made the decision to switch its exchange rate regimes to basket numeraires – individually designed basket numeraires are superior to a joint basket. Williamson supports a joint basket, because only this approach guarantees that changes in external exchange rates do not disturb the intra-regional rates (Williamson 2005: 8). Apart from this economic point, a more political aspect has to be added: individual baskets would not contribute to the perception of monetary regionalism as a joint project, and perception matters in regional integration. The basket composition proposed by Williamson is quite straight-forward: the dollar should have a weighting of 40.2 percent, the euro of 31.6 percent, and the yen of 28.2 percent. Although one could debate whether the precise figures should not be somewhat adjusted, the bottom line is clear: roughly the same weight for the dollar, the euro and the yen.

There is one aspect that makes this particular basket problematic: Japan would exclude itself. It is impossible to tie one's own currency to a basket in which that very currency is featured. But for the non-Japanese Asian countries, the exclusion of the yen from a joint basket would make it much less useful because the fluctuations of the yen would result in substantial variations of their effective exchange rate.

Robert Mundell has suggested that East Asia would have to use an anchor – whether internal or external – in order to move quickly towards a monetary union. Although he admits that the European approach was different – the EMS was a basket of currencies without an explicit internal or external anchor – Mundell suggests that this would not be a good idea for Asia. Europe, he argues, could have reached monetary union three decades earlier had it used the dollar as an external anchor in the 1960s (Mundell 2003: 5). Furthermore, Mundell argues that even with an internal anchor, i.e. the German mark, the creation of a monetary union would have been faster. After the end of fixed exchange rates vis-à-vis the dollar, the European countries could have floated together if they had been able to choose one currency as the anchor for the joint float. In the 1970s, however, European countries were unable to agree on the German mark as an anchor for a joint float against the dollar. Although the mark was the key currency in Europe, neither France nor the UK wanted to give that prestigious position to the German currency. The consequence was that a joint float was not implemented: individual floats were chosen. It took another decade before the mark became the internal anchor of the European Monetary System (Mundell 2003: 5).

Ronald McKinnon and Gunther Schnabl have been supporting a dollar-peg for East Asia for some time (McKinnon/Schnabl 2003; McKinnon 2004). They argue that it is entirely rational for Asian countries to peg their currencies to the dollar. This enables traders and banks to hedge against volatile exchange rates, and at the same time central banks can anchor their domestic price levels to an external anchor. They identify two motives:

> The *microeconomic* rationale for stabilizing dollar exchange rates in East Asia stems from the need to limit foreign exchange risk in intra-regional trade and capital flows that are mainly invoiced in dollars. … The *macroeconomic* rationale stems from the monetary need for a nominal anchor for domestic price levels – more against the threat of inflation before 1997, and now against threatened deflation in the new millennium (McKinnon/Schnabl 2003: 4; see McKinnon 2004: 204f).

McKinnon and Schnabl point out that many East Asian economies are no longer confronted with the problem of being unable to borrow in their own currency, a situation that has been termed by Barry Eichengreen as ‘original sin’. They have the opposite problem: they cannot lend in their own currency and accumulate large dollar holdings, which results in a currency mismatch (McKinnon/Schnabl 2003: 6). It is, however, a virtuous situation, since there is only a risk of reduced returns on the claims of those countries, but there is no risk that an unmanageable situation emerges.

The criticism of the McKinnon proposal has an economic as well as a political dimension. First, the US economy is of decreasing importance to Asian economies. Since growth rates in Asia continue to be higher than in the US, the relative importance of the US economy is declining. With the American economy set for a period of adjustment and significantly lower imports than in the past, America will no longer be the consumer-of-last-resort for Asian-made manufactures (Dieter 2005b). Second, using the dollar as an anchor implies that the region will not explore the possibility of setting up its own, regional currency area (Ryou/Wang 2003: 25). Third, using the dollar as an anchor currency for the whole of Asia is becoming increasingly difficult because the Americans themselves have been critical of such a move. The campaign against the fixed exchange rate of the yuan in 2004 and 2005 clearly demonstrates that there is a tendency in Washington to interpret fixed exchanges rates as an unfair exploitation of the US. Even though this explanation does not make much sense, it is a fact that has to be considered.

Intra-regional exchange rate mechanism à la EMS

In the literature on monetary regionalism, the terms monetary union and single currency are sometimes used as if they refer to the same arrangement. This is not the case. Monetary union differs from a single currency, as adopted in Europe. A monetary union requires the permanent fixing of exchange rates between participating countries, but there is no single currency (Castellano 2000: 5). The plan proposed by Pierre Werner in 1970 envisaged this type of monetary integration for the then European Community. Up to 1980 parities should have been fixed permanently, but national currencies would have continued to exist (James 1996: 202f; Wyplosz 2002a: 26).[16]

The Werner Plan was never implemented, nevertheless an intra-EC exchange rate mechanism dubbed "Snake in the Tunnel" was implemented from 1972-1979. Its purpose was to provide stable exchange rates between the participating economies (Ing 2003: 383).

Whilst the economic consequences of a monetary union and a single currency do not differ sharply, differences remain. Only a single currency symbolises integration both for the citizens of the integration project and for financial markets. The individual currencies of a monetary union will have difficulties in becoming accepted as reserve currencies, which is easier for a single currency. However, for Asia a monetary union – for the time being – might be sufficient. A monetary union would provide stable exchange rates without requiring the abandonment of national currencies.

This point has been emphasised by Robert Mundell in 2003. He has supported the plea for a common currency, but not for a single currency, referring to the lack of political accord between China and Japan (Mundell 2003: 4; see also Richard Higgott's contribution in this report). Mundell argues that the Delors report of 1989 – which favoured a single currency over a common currency for international transactions – was a big gamble for Europe, but the proposal was based on the greater irrevocability of the single currency. When national currencies are abolished, the cost of abandoning the single currency is significantly greater.[17]

Barry Eichengreen has been advocating an approach for East Asia that uses a parallel currency, similar to the early phase of monetary integration in Europe. The value of the parallel currency would be defined as a basket of East Asian currencies, and it would be used in the region (Eichengreen 2005). John Williamson has proposed that East Asian countries use a basket of currencies as an anchor for their exchange rates (Williamson 1999 and 2005). It is necessary to make the differences between the various types of baskets very clear: Eichengreen suggests a fixing of exchange rates within the region and a float vis-à-vis the rest of the world, whereas Williamson proposes a stabilisation of the individual exchange rates vis-à-vis the rest of the world. These are two distinct and different concepts.

Ryou and Wang have been suggesting the use of an internal basket. They propose the introduction of a parallel currency, the Asian Currency Unit (ACU). This currency would be a basket comprising all the regional currencies, weighted according to economic size. The exchange rate of each national currency vis-à-vis the ACU would – like in the European Monetary System – be limited. The main advantages would be a limited volatility between the regional currencies – including the yen – and the harmonisation of monetary policies in the

[16] The Werner Plan was endorsed by the Council of Ministers in 1971, just before the Bretton Woods System collapsed (Ryou/Wang 2003: 8).

[17] In 2005, there has been some debate on this issue in Italy. The introduction of the euro has deprived Italy of the ability to regularly devalue its currency and thereby regain international competitiveness. The much harder process of improving productivity is causing great strains in the Italian economy.

region (Ryou/Wang 2003: 28). The replication of the EMS indeed has a number of attractive features. Volatility between the yen and the other currencies would be reduced and intra-regional trade further facilitated. Traders and financial intermediaries would have reduced – if any – expenses for hedging intra-regional flows. It has to be pointed out that such a scheme would not be aimed at stabilising exchange rates vis-à-vis the rest of the world.

However, both approaches could be combined: a group of countries could both stabilise their regional exchange rates as Eichengreen has suggested and stabilise the exchange rate of that basket vis-à-vis a basket of non-regional currencies (Williamson 2005: 1). It should be made clear that the two approaches serve different purposes: Eichengreen's proposal would enhance regional exchange of goods, investment and services, while Williamson's primary goal is to facilitate economic exchange with the rest of the world. In Williamson's words:

> One possibility is that they (East Asian currencies, H.D.) would in due course be candidates for a monetary union, on the European model. In that event, they might wish to create a parallel currency at an early date, as suggested by Eichengreen (2005), and the value of that parallel currency probably ought to be defined as a basket exclusively of East Asian currencies. There is absolutely no contradiction between creating such a basket to determine the value of a parallel currency and using currency baskets that contain – perhaps exclusively – extraregional currencies in order to peg or otherwise manage the exchange rate of regional currencies. These are two quite independent decisions, and either could be taken with or without the other (Williamson 2005: 11).

Williamson's proposal is complex, but manageable. He himself defends it by arguing that the calculations might be messy, but that there is no need for the entire population to understand these details. It is more important to understand that using a basket numeraire provides enhanced monetary stability, a goal many people would support (Williamson 2005: 12).[18]

Robert Mundell has argued along similar lines. He suggests that a monetary union would be best for East Asia and he suggests that this requires the choice of an anchor currency. But which currency would be a suitable anchor? The first-best solution would be an internal anchor. This is not just a question of numbers, but also of Asian pride. At the same time, it can be the source of distrust between countries competing for leadership in East Asia. For economic and political reasons the choice is limited in Asia: either the yen or the yuan could in principle be used as anchors (Mundell 2003: 6). The currencies of smaller economies are far too vulnerable to externally induced fluctuations to be viable.

But would any of these two currencies be a good choice? The answer is easier in the case of the yuan: as China continues to use restrictions on capital flows and since the Chinese financial system is in a rather fragile condition, the yuan could not serve as an internal anchor for a monetary union.

However, the yen is also not as convincing as it could be. True, Japan continues to be the economic heavyweight in the region and produces a GDP that is several times larger than the

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[18] A point that is of secondary importance for the purpose of this report was considered by Stefan Collignon. He has argued that the goal of reduced exchange rate volatility of some countries that tie their exchange rates to an anchor currency has had the unintended side-effect of increasing volatility between the floating key currencies. In other words: there is a trade-off between intra-bloc stability and inter-bloc volatility (Collignon 1999: 317).

Chinese GDP. Japan is the world's largest creditor nation and inflation rates have been very low for many decades. Although the Japanese currency possesses some qualities an anchor currency should have, a lot leaves to be desired. The Japanese economy is by and large still crippled by the 15-year-long recession that started in 1990. The macro economy still is in a mess. Gross government liabilities will reach about 170 percent of GDP in 2005 – far above any other OECD-country. The financial sector – despite some signs of improvement – still suffers from the aftermath of the simultaneous bubbles in the stock and real estate markets in the 1980s. In addition, perhaps the biggest problem is the volatility the yen has shown vis-à-vis the dollar. No country would choose an anchor that would provide increased external volatility, instead of stability. Needless to underline, the period of Japan's most rapid growth – 12 percent per annum between 1955 and 1970 – correlates with fixed exchange rates. The same is true for Germany. If Japan wants to achieve the position of financial hub of Asia, it has to stabilise its exchange rate as well as sort out its macroeconomic mess. There are very few indications of such a policy change.

From today's point of view, the only option for an internal anchor is the yuan – if current trends continue. By 2010, China might have solved the problems of its financial system *and* have demonstrated its ability to provide a relatively stable exchange rate vis-à-vis the rest of the world (Mundell 2003: 8).

Barry Eichengreen has argued that Asia possesses none of the institutions that characterise integration in Europe. There is no administration implementing integration, no parliament and no regional court of justice. Consequently, Eichengreen takes a sceptical position with regard to the ability and plausibility of creating a monetary union in Asia (Eichengreen 2004 a: 2). Whilst he certainly has a valid point, Eichengreen's assessment is both underestimating the (potentially) dynamic process of integration and is simplistic in his analysis of the paths available. As monetary regionalism is not a recipe cast in stone, it can be adopted to region-specific conditions. In Asia, it is true that there is limited willingness to create an integration process that imposes substantial limitations on national sovereignty. However, this does not imply that Asian governments are unable to agree on substantial monetary cooperation and a monetary union with fixed exchange rates, but no common currency could be a suitable solution. Consequently, Eichengreen's list of preconditions for monetary union in Asia is questionable. He states:

> The essence of monetary unification is therefore agreement to establish an international institution to which the participating national governments are prepared to delegate the relevant policy prerogatives (Eichengreen 2004a: 5).

Whilst the creation of a regional central bank is a precondition for the establishment of a common currency, it is not necessary for a monetary union. One can envisage an integration process that seeks to establish stable exchange rates as the final goal of the process, without aiming for a common currency. Of course, a monetary union is second-best in a number of areas, e.g. the establishment of a new global reserve currency, but that second-best evaluation stems from economic, not political analysis. Asia, which includes a number of countries that were colonies of England, the Netherlands or Japan, might be better advised not to aim for goals that are too demanding. Recent European experience warrants such caution.

Whereas European policy elites have advocated further deepening and widening of integration, the negative referendums on the proposed European constitution in France and the Netherlands have shown that it is risky to assume everlasting support for a good purpose.

It is, however, also true that fixing exchange rates without a common institution requires additional harmonisation of economic and fiscal policy. In the Werner Plan of 1970, exchange rates should have remained stable, but economic and fiscal policy should have been guided by a regional body. Rather than fixing certain targets for fiscal policy, the Werner Plan envisaged supranational control of national finance ministers. Furthermore, markets for capital and labour should have been integrated quickly (Eichengreen 2000: 204). The plan eventually implemented set a different emphasis: the treaty of Maastricht required the participating economies to observe set targets for fiscal policy.

Whatever the eventual path chosen, the options available to policy makers are determined by a fundamental policy choice. The underlying dilemma is described in the impossible trinity of international finance, analysed by Robert Mundell and Marcus Flemming in the early 1960s (see Mundell 1962; Flemming 1962). Mundell and Flemming have pointed out that monetary policy tries to reach three goals at the same time: independence of monetary policy, unrestricted flows of capital and stable exchange rates. However, it is impossible to reach more than two goals at the same time (see Frenkel/Menkhoff 2000: 11ff; Fischer 2001: 8). Monetary policy can only choose between the following three options:

- Either a stable exchange rate and an independent monetary policy. This option requires capital controls and is that of the Bretton Woods system. Capital controls were a central element of that monetary regime. These controls are necessary to enable the implementation of an independent monetary policy. For instance, in the absence of capital controls the lowering of domestic interest rates would lead to an outflow of capital with subsequent pressure on the exchange rate. Bretton Woods was a stable financial system for more than 20 years. Moreover, Bretton Woods was a period of rapid economic growth of the global economy. Another example is China, which also generated exceptional growth over a long period of time. During the Asian crisis, China could maintain its fixed exchange rate vis-à-vis the dollar primarily because of the tight capital controls it implemented.
- Or unrestricted capital flows and an independent monetary policy. In this case, the exchange rate will have to be flexible. The second case describes the current system in the OECD outside the Eurozone. Exchange rates fluctuate and capital flows are more or less unrestricted and national monetary policy enjoys a certain, but limited, autonomy, at least in the larger OECD-countries.
- Or unrestricted capital flows and a stable exchange rate. The central bank gives up an independent monetary policy and concentrates its activities on the stabilisation of exchange rates. The third case is plausible from an economic point of view, but not politically. The reason is that in such a scenario, monetary policy has to give absolute priority to the stabilisation of the exchange rate. The consequence is that the central bank may have to raise interest rates even if that is counterproductive for the

domestic economy. In democratic societies, very few interest groups support such a monetary policy. Both trade unions and employers' associations are not willing to accept a stable exchange rate as the primary target of monetary policy. In addition, many sectors of an economy are not affected by changes in the exchange rate and would therefore not support a policy that ignores the consequences for the domestic economy.[19] The bottom line is that stable exchange rates and an independent monetary policy are only achievable with capital controls.[20]

There is a trade-off between autonomy and stability. If capital controls are excluded, there is a choice between independent monetary policy and flexible exchange rates. The goal being stable exchange rates, there is no alternative to the partial surrendering of monetary autonomy. This applies to a global currency as much as it does to a regional currency, and this issue should not be taken lightly. Surrendering monetary autonomy is not easy, in particular for countries that were governed by colonial forces for long periods,. Indonesia, Malaysia and South Korea are the most prominent examples in Asia.

However, conditions in Asia may be somewhat different. Whilst the support for a monetary policy that makes stable exchange rates its priority is not plausible for European and North American countries, things might be different in Asia. The reason for that might, again, be the Asian crisis. The traumatic experience of 1997 probably has left the region with lasting legacies, and the willingness to accept limits on the options available for national monetary policy might be one of them.

At this stage, a differentiation has to be introduced. Fiscal and interest rate policy both are frequently considered to be in need of harmonisation in a monetary union (and for a common currency). While there is little doubt that interest rate policy has to be harmonised in both a monetary union and a common currency, because failure to do so would create strong capital flows endangering exchange-rate stability, there is probably less need for harmonisation of fiscal policy. Eichengreen doubts that excessive fiscal deficits in one part of a monetary union will drive up interest rates union-wide. Further, he suggests that the costs of debt servicing will continue to be borne by national governments and their taxpayers, with no monetary free riding involved (Eichengreen 2004: 17).

The choice of exchange rate regime is evidently the most complex part of monetary regionalism. From a theoretical point of view, the most convincing proposals at this stage are the introduction of an internal parallel currency, the ACU, combined with an external basket

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[19] Before the First World War, such policies were implemented under the Gold standard. The participating countries made the stability of the exchange rate an absolute priority of their economic policy. In the three core countries of the Gold standard, i.e. France, Germany and the United Kingdom, the gold reserves and the convertibility at a given exchange rate were defended regardless of the short-term cost for the domestic economy (see Eichengreen 2000: 51). The political opposition against these policies was limited, mainly because trade unions were too weak to argue their case: full employment was not yet on the political agenda.

[20] Stanley Fischer, for many years the most important figure in the IMF, accepts this conclusion and asserts that the implementation of capital controls permits a stable exchange rate. In Fischer's opinion , the problem is the declining efficiency of capital controls. Over time, the evasion of capital controls rises (see Fischer 2001: 10).

numeraire as proposed by John Williamson. These two regimes combined would provide external and internal stability, and thus make a significant contribution to the creation of growth-enhancing conditions in the region. There is, however, one important caveat. In Europe, the EMS was sustainable because the larger countries in Europe provided ample financial support, whilst the weaker players continued to use capital controls to protect their currencies. The country that would have to stabilise the Asian Monetary System (AMS) is Japan, and Japan appears to be less willing to play the role Germany played in the EMS. In that vacuum, China might try to push its own project.

2.6 Greater Chinese Currency Union and other alternative projects

The rivalry between China and Japan also overshadows monetary cooperation in the region. Although one could argue that both countries have had a constructive relationship in recent years – and the various initiatives outlined above prove just that – the unresolved nature of the two countries' relationship is the decisive issue for all types of integration in Asia. In addition, some of today's issues go way back indeed. The Chinese-Japanese war of 1894/95 resulted in a humiliating defeat for China and – more important today – the loss of Taiwan, which was a Japanese colony until 1945. In the second decade of the 20th century, Japan presented the '21 requests' and sought to integrate China in a Pan-Asian union under Japanese leadership (Hilpert/Wacker 2004: 7). .The occupation of Manchuria in 1931 and further invasions of Chinese territory in 1937 by Japanese forces are only the most prominent issues overshadowing Asian cooperation (for detailed discussion see Richard Higgott's contribution in this report).[21]

At the beginning of the 1990s, China's position in Asia was much worse than today. At that time, it did not enjoy full diplomatic relations with Indonesia, South Korea and even Singapore whilst the relations with Russia, India and Vietnam were hostile (Shambough 2004: 66). In the first decade of the 21st century, this has changed dramatically. David Shambough has emphasised that China is the fundamental cause of change in Asia, altering the traditional underpinnings of international relations in the region. In contrast to the past, China is today seen as an opportunity and no longer predominantly as a threat.

> …most nations in the region now see China as a good neighbour, a constructive partner, a careful listener, and a nonthreatening regional power. This regional perspective is striking, given that just a few years ago, many of China's neighbours voiced growing concerns about the possibility of China becoming a domineering regional hegemon and powerful regional threat (Shambough 2004: 64).

In the last two decades, China has become an economic hub in Asia. Both in trade and production, the countries in the region and elsewhere are increasingly benefiting from intense links with China. Today, nearly 50 percent of China's trade is intra-regional, and there is no

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[21] Polls both in China and Japan demonstrate that the citizens of both countries have limited sympathy for their neighbour. In 2002, 49.1 % of surveyed Japanese considered China to be hostile to Japan. In the same year, only 7 % of Chinese citizens asked agreed to the proposal that China should have friendly relations with Japan (Hilpert/Wacker 2002: 9).

large trade surplus or deficit with any country in the region (Shambough 2004: 83). By opening itself to foreign investment and trade, China has not only become an indispensable trading partner, but has turned into a strategic interest for many foreign companies (Zakaria 2005).

Chinese diplomacy has accompanied this company-level development by portraying the country as the benign emerging giant in East Asia.[22] Today, as David Shambough has put it, China is an exporter of goodwill and consumer durables instead of revolution and weapons (Shambough 2004: 65). China is investing in soft power: the efforts to popularize Chinese culture in the region and the attempts to lure future elites into Chinese universities are just two examples of that process. The rise of China's influence has been most significant where America's influence simultaneously declined: in South Korea and in Southeast Asia (Shambough 2004: 90). This is no coincidence. America's position has deteriorated in those countries that were affected by the Asian crisis and had to deal with IMF programmes, and in those countries, China appears to be a more benign partner.

Leading by example surely is an appealing characteristic of the Chinese model, but the rigorous defence of the concept of national sovereignty is probably as important for the governments of smaller countries in the region. However, there is one area where China has not yet attempted to advance its position in the region and that is finance and monetary co-operation.

This, of course, is no coincidence. The financial sector in China requires comprehensive reform. At the end of 2001, the four largest state-owned banks were struggling with non-performing loans worth about $ 200 billion (Schröder 2003: 8). The presence of capital controls enables the Chinese authorities to postpone reform because Chinese savers cannot export their savings, i.e. capital stays in China. However, if the Chinese government were successfully to reform the financial sector, there would be room for a greater role for China in financial affairs, too. Considering the large foreign exchange reserves of Beijing, which can partly be used for consolidating the state-owned banks, within a decade China could attempt to establish itself as the monetary and financial heart of the region.

In 2005, there has been a somewhat unexpected development in the Chinese financial sector. Foreign investors have started to make major investments in Chinese banks. The two largest ones, Bank of China and Industrial & Commercial Bank of China, have secured foreign investment of about € 5,000 million in August 2005. The Industrial & Commercial Bank has sold a 10 percent stake to a consortium of Goldman Sachs, American Express and Allianz, whilst the Bank of China has received a similar investment from Singapore's state-owned investment company Temasek (The Wall Street Journal, 31 August 2005, p. 1 and 8). Including these two latest deals, foreign banks and other financial intermediaries have invested around € 12,000 million in the Chinese financial sector. The other foreign investors are equally

[22] For example, China has offered an asymmetrical opening of its markets five years ahead of the opening required from its ASEAN trading partners (Cai 2003: 396).

well-known: Bank of America, Royal Bank of Scotland, Merill Lynch as well as HSBC (The Wall Street Journal, 31 August 2005, p. 1). Deutsche Bank is negotiating with the (relatively small) Huxia Bank (Handelsblatt, 1.9.2005, p. 19). These are fundamental changes. Foreign banks are betting that the profit potential in China outweighs the legacy of bad loans and a state-controlled financial sector. By making substantial investments in China, foreign investors can be expected to intervene in the management of these banks – at least over time. With foreign capital and foreign management skills, the Chinese financial sector might be commercially run and becoming competitive faster than many observers are expecting today. If this were to happen – and there cannot be any doubt that the risks for this process are formidable – the prospect of China becoming the financial hub in Asia suddenly looks much less futuristic and becomes much more plausible.

With hindsight, the Asian crisis has been a good opportunity for China, and it has exploited it. The decision not to devalue its currency in 1998 was wise and probably stopped the further spread of panic (Dieter/Higgott 1998). China offered aid packages to several Southeast Asian states, whilst the USA initially refused to participate in the bail-out of Thailand. The Chinese approach was appreciated in the region, and it stood in stark contrast to the authoritarian way the IMF and other international creditors imposed their programs (Shambough 2004: 68).

The opportunity for taking a leading role has opened up largely because of the unwillingness of the obvious candidate for that role, Japan, to provide stability and leadership in financial affairs. During the entire post-war period, monetary policy in Japan was geared toward national economic goals (Hilpert 1992: 185). With the long-lasting recession of the 1990s, this path has not been altered. The Japanese central bank tried to reduce the negative consequences of the economic slump, a policy that was counterproductive for developing a leading role in international monetary affairs (Herr 1997: 135f). In recent years, the interventions of the Japanese central bank aimed at stopping an appreciation of the yen vis-à-vis the dollar have further strengthened the perception that the yen is not a suitable anchor currency for Asia (Hilpert/Wacker 2004: 40).

This assessment contrasts sharply with that of the German Bundesbank, which for many years enjoyed a remarkable reputation in Western Europe. Although the Bundesbank more than once temporarily hurt European integration by stubbornly implementing its stability-oriented monetary policy – the prime example being the tight policy implemented after German unification in the early 1990s, which resulted in the EMS crisis of 1992 – this very orientation enabled it to acquire respect and leadership in its region.

Castellano has emphasised that the yen's limited role in the global (and regional) economy can partly be explained by the relatively underdeveloped status of Japan's financial sector (Castellano 2000: 8). Although the Japanese government has addressed this problem with the Big Bang initiative of April 1998, to date there has not been much improvement. As a store of value and means of transaction, the dollar continues to dominate, with the euro slowly catching up, in particular as a store of value.

Cheung and Yuen have analysed the potential for a Greater Chinese Currency Union, comprising China, Hong Kong and Taiwan. They argue that these three economies have considerable complementary assets. China has low-cost resources and developed production facilities, Taiwan has advanced technological know-how and capital, and Hong Kong offers sophisticated financial services, modern management skills, and a well-developed legal system (Cheung/Yuen 2004: 1). The two authors argue that Greater China is suitable for a currency union – from an *economic* point of view. The three economies already have extensive trade and investment links. Furthermore, business-cycles are relatively synchronised, which would greatly reduce the negative impact of a common monetary policy (Cheung/Yuen 2004: 27).

Of course, suggesting a Chinese push for a prominent role in financial affairs remains highly speculative and can attract criticism for being unrealistic both with regard to economic *and* to political conditions. Nevertheless, excluding such a possibility appears to be premature for a number of reasons. Greater China has all the necessary features: Hong Kong (and possibly Singapore) has the expertise in financial markets, Taiwan has the investment links to mainland China and China proper has the political will to establish the country as the main regional power. An additional factor to be considered when evaluating the prospects of a Greater Chinese monetary union is that overseas Chinese represent the majority of dynamic entrepreneurs in Southeast Asia (Tourk 2004: 856).

As political friction continues to dominate the relationship between China and Taiwan, for the time being there is only a limited likelihood that such a project would be started in the near future. Nevertheless, in the recent past, a softening of policies towards mainland China could be observed in parts of the Taiwanese political elites, and if such rapprochement continues, the likelihood of a Greater China Currency Union would change quickly. If that were to happen, it would represent a worst-case scenario for Japan, because Asia's largest economy would become dispensable for monetary integration in Asia – a worrying prospect.

2.7 The Institutional Dimension and Political Obstacles

The previous discussion on monetary and financial integration in Asia has shown a number of merits as well as the substantial technical problems that would have to be overcome. However, the most problematic obstacles continue to exist at the political level. As discussed in the preceding section, China's policies are one dimension to be considered, and the other doubtless is the Japanese approach to regionalism.

Observers from the region continue to express doubts with regard to the motives of the Japanese government. First, there is the problem of ambiguity. Japan has been promoting integration among the ASEAN+5, but are the two additional members Australia and New Zealand, or Taiwan and Hong Kong? (Wang 2004: 951). More serious are the suspicions raised in the region concerning the motives of Japan, as Wang has expressed them.

> There is also the suspicion that Japan is not interested in free trade and financial arrangements per se in East Asia for purely economic reasons. Instead, Japan is engaged in the discussion of those regional arrangements with other East Asian countries to maintain its leadership role as the region's largest economy by checking and balancing China's expansion. On top of this suspicion, Japan is perceived to be a country insensitive to and unwilling to resolve wartime legacies and disputes on historical and territorial claims. … These developments combined with its lack of a strategy for East Asian development seem to undermine Japan's ability to pull East Asian countries together for regional cooperation and integration (Wang 2004: 951f).

Wang raises a number of serious points, but fails to consider other issues. As much as Japan has failed to present a convincing strategy for the economic integration of the region, other players, notably China, have not permitted such a development. The Chinese opposition to the AMF in 1997 is a case in point. Furthermore, using anti-Japanese sentiment within some Asian countries distracts attention from their own atrocities, and provides legitimacy to existing regimes.

Despite these obvious flaws in Wang's analysis, his basic point is convincing. If Japan is serious about its regional policies, it has to top-up its offers. There is a risk that Japan is drifting towards some kind of isolation – closely allied with the US, not considering itself as an integral part of its own region, trying to participate in regional processes without making serious, substantial commitments. Although this picture is a gross oversimplification of the Japanese position, what matters is that the regional policies of Japan may be perceived that way. In some ways, the position of Japan is similar to that of the UK in Europe. There is a strong tendency – in England in particular – to have a very critical perception of European integration.[23] There are explanations for that hostility towards continental Europe, one of which is that the relative decline of the UK coincided with the deepening of European integration.[24] Whilst the centre of gravity in the European Union may over time shift further to the East, in Asia the rise of China will be the decisive factor – unless Japan is able to turn the tide in its favour.

Beyond that, there are some institutional questions to answer which may appear to be of secondary importance. However, the European experience has demonstrated that this is not the case. Institutions matter in any regional integration process, and without them, it can be difficult to sustain the necessary momentum. In the absence of powerful institutions that can provide dynamic input into an integration process, these processes are too dependent on the leadership provided by individual member countries.

In Asia, one issue that has to be solved in that context is the location of an ASEAN+3 secretariat. This is an issue of national pride as much as a functional issue. An ASEAN+3 secretariat will have a prominent function in the integration process, and consequently there is considerable rivalry over this issue. De Brouwer has made some insightful proposals in this context (de Brouwer 2005: 20).

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[23] For instance, there is no other EU country in which the main opposition party has suggested to leave the EU and to join NAFTA, as the Tories have in the UK. Britain has declined to participate in two major integration steps, the Schengen agreement and the Eurozone.

[24] The reservations substantial parts of the British population have towards monetary integration in Europe can be partly explained by looking at two events in financial history. The first incident happened in 1931. British commercial banks had substantial claims on Central European banks. When the largest Austrian bank, the Vienna Creditanstalt, failed in May, a bank run started in Central Europe. In that process, British banks suffered freezes on their assets, which in turn led to the departure of Britain from the gold standard on 21 September, 1931 (James 1996: 22). The second traumatic experience took place on 16 September, 1992, when a combination of high interest rates in Germany and vitriolic attacks by hedge funds pushed Britain out of the EMS.

The first criterion is that the institution should not be in a large country (the Brussels solution). This excludes any city in China, Japan and Indonesia.[25] The second criterion is that the decision for a certain location should take into consideration the interests of the entire region and also try to balance rivalries in sub-regions. The third issue is a more practical one: the institution should be located in a country with a well-developed economy and a good infrastructure. This doesn't leave many choices: Bangkok and Seoul, with some preference for Seoul because of its greater economic dynamism and better infrastructure.

Another issue which has to be addressed is the name of the endeavour. ASEAN+3 is a temporary name, which does not properly reflect the regional dimension, i.e. there is too much emphasis on Southeast Asia. Considering that the region is holding the first East Asian Summit in 2005, it appears to be appropriate to change the name of the group to East Asian Community. Again, one might argue that this is a minor issue. Drawing lessons from the European experience, it clearly is not irrelevant. The European Economic Community first dropped the "Economic" and then changed to "Union", and both changes symbolised a new phase in integration.

2.8 Conclusion and Policy Recommendations

In this section of the report, the options for monetary regionalism were analysed and, where appropriate, the European model was considered. Studying the European experience might not be useful when looking at the details. There is one important lesson nevertheless. Technical detail is far less important than the political will to jump the hurdles that inevitably emerge in any integration process. Furthermore, the broad political will cannot be tied to precisely planned schedules. Too much rigidity in the drawing of schedules and plans can backfire and harm the integration process.

The evaluation of monetary integration has to be based on the analysis of its positive and negative consequences. There is no win-win model in monetary integration. Inevitably, countries that participate in monetary integration will lose some options when pursuing others. Creating a single currency has – as some countries in Europe are currently realising – a substantial cost. The analysis has to carefully consider gains and losses of such a process.

The financial crises of the 1990s may have been a sufficiently traumatic learning experience, especially for some of the weaker state policy making elites, to recognise a need to shed a little sovereignty, in order to preserve wider state building capacity and regional stability. Vulnerability to financial market volatility is now the major challenge to policy autonomy. It may be this sense of vulnerability that is the key to the further development of regional collective action in the monetary sphere.

[25] The European Central Bank has its seat in Germany, which appears to be a contradiction. However, the choice for the ECB's seat was made decades after the integration process in Europe started. The situation in Asia today is similar to the one in the early days of the European integration process.

However, the analysis in this part of the report confirms the assumption that monetary regionalism in Asia will be both a complex endeavour and – if at all – will only be achieved in the long run. From today's point of view, it appears unlikely that Asian governments will give up sovereignty over macroeconomic affairs, let alone push the creation of an Asian supranational fiscal and monetary authority. At the same time, expecting Asian countries to bet solely on their own, national capabilities and the international financial institutions to support them in the event of crises is most probably a delusion. Asian countries will strengthen their ties, the main question being which shape that cooperation will take.

3- Commercial Integration

In the last ten years, an acceleration in the number of Regional Trade Agreements (RTAs) reached across the globe could be observed (Crawford 2005: 7). The economies of the Asia-Pacific Region have played an active role in this process with the creation of 40 RTAs involving at least one East Asian economy. Paradoxically, the latest RTAs involving Asia-Pacific countries are neither an extension nor a deepening of the old RTAs, but consist mainly of bilateral initiatives. Existing regional institutions such as ASEAN and APEC do not seem to be the appropriate institutional frameworks for further liberalising intraregional trade and deepening regional integration. Founding members of ASEAN or APEC have signed or are currently involved in bilateral negotiations with non-Member economies aiming at more comprehensive agreements than those existing within the framework of these two regional entities.

This flurry of RTAs has created an opaque institutional environment for intraregional trade. Enterprises trading in the region are facing overlapping agreements with conflicting liberalisation timetables, a phenomenon referred to as the “spaghetti bowl” (Nesadurai 2003: 183). Many of these RTAs are far from being effective. Even the ASEAN Free Trade Area (AFTA), which is supposed to have created a common effective preferential tariff for its Members, is still being considered, according to a McKinsey report, by most business leaders as “a disparate mix of 10 largely distinct markets” (FT 2003: 03/X). During the Bali ASEAN summit in October 2003, the Singapore Prime Minister Goh Chok Tong claimed that most businesses still do not use ASEAN preferential trading rules because applying them costs too much in terms of delays and red tape (FT 2003: 08/X). According to a survey made by JETRO, most Japanese firms operating in the ASEAN find the standard of ASEAN content of 40% easy to meet but claim that the administrative procedure regarding rules of origin are too costly in time and resources (JETRO 2005: 6). Furthermore, the lack of clarity on rules of origin and the absence of third party enforcement have created some disputes between member states. For example, in 2001 Malaysia, which has traditionally been protecting its car industry, argued over the fact that Thailand and Indonesia should provide the proof that they met the 40% criteria for the automobile industry (Soesastro 2001: 6). Many analysts still warn that AFTA rules of origin need further simplification and harmonisation (Lloyd 2004:6). With the proliferation of bilateral FTAs involving ASEAN economies, Japan, China and non-Asian economies, the “spaghetti bowl” problem is likely to increase the existing constraints on business activities so as to significantly reduce the impact of these FTAs (JETRO 2005: 19).

This fairly confused situation is not sustainable and raises numerous questions. Why has this spaghetti bowl problem been particularly important in East Asia? What will be the emerging institutional framework that will regulate commercial integration in East Asia? What will be its authority, if any, vis-à-vis national states? Which countries are most likely to be included in this process and in what order? What are the obstacles facing further commercial integration in East Asia?

To answer these questions, one will need to go beyond mainstream international trade theory to adopt a dynamic approach linking economic integration with the development of regional institutions. The following analysis will show that for regional integration processes to be successful, they have to meet specific conditions.

The first of these conditions is the existence of underlying microeconomic dynamics behind regional integration. There are two main microeconomic dynamics behind regional integration. The first is the necessity to create a large regional market to reap the full benefits of economies of scale. The second is the regional division of labour pursued by Multinational Enterprises (MNEs) to minimise their costs. The second condition is the existence of a clear regional leader that can act as a regional paymaster to make some of the integration costs more easily bearable to the economies involved in the regional process of integration. The third condition is the existence of a third party (supranational institutions or a foreign power acting as a benevolent referee for geopolitical reasons) that can monitor and enforce the problematic aspects of the RTA. In the case where the geopolitical situation will not allow for a foreign power to act as this third party, the question of building regional supranational institutions is crucial. In that case, another factor will be decisive: the level of homogeneity and economic cohesion between the economies involved in the regional integration process as it facilitates the emergence of lasting supranational institutions.

The following sections will examine to what extent these conditions are met in the case of the East Asian Integration Process (EAIP). Section 4.2 will analyse the long term dynamics of the EAIP. Sections 4.3 and 4.4 will highlight the differences with the European Integration Process (EIP) in order to see to what extent knowledge of the European experience could be useful to the East Asian economies. This analysis should then enable us to determine in section 4.5 which economies are the most likely to be involved in the deepening of the EAIP and what obstacles they will be facing considering the integration paths that they will choose.

3.1 The microeconomic dynamic of the EAIP

The recent interest in developing RTAs reflects a profound change of attitude of East Asian governments compared to the five decades that followed WWII. In the 1950s, apart from Japan, most East Asian economies started from a very low economic level in terms of wealth and technological capabilities. Like many other developing economies, East Asian economies with a large population adopted development strategies based on Import Substitution Industrialisation (ISI) (Yoshihara 1988: 20). They tried to create their own national industries by importing turnkey factories and by setting up joint ventures or licensing agreements with MNEs. China and Vietnam dissociated themselves from the capitalist world economy in the geopolitical context of the Cold War, the result being a drastic reduction of trade with the rest of East Asia. Only city-states like Hong Kong and Singapore preferred to open up their economies to foreign investors.

The capitalist East Asian economies nurtured “national champions”, both in key industries and services, and sheltered them from foreign competition, often inspired by the Japanese model of industrial policy. They imposed on foreign investors what Oman called “new forms of investment", which notably included restrictions on foreign ownership, local content requirements and negative lists (Oman 1989: 91). These strategies seriously hampered the growth of intraregional trade in manufactures, services and FDI flows. The two city-states' more favourable attitudes towards inward FDI and trade liberalisation did not particularly foster intra-Asian trade but global trade as the local authorities did not discriminate against Western investors (Hobday 1995: 139). In this context, it is difficult to see how RTAs could have emerged in East Asia. This deadlock was only gradually broken after the mid 1980s with the profound changes which took place in the global and regional contexts.

3.1.1 The two main global factors behind the acceleration of the EAIP

As oil prices began to soar in 1974, soon followed by other raw material prices, those East Asian economies which were net importers realised the need to shift towards export oriented industrial policies, even if this meant attracting foreign Multinational Enterprises (MNEs) with a view towards making their country an export platform. The other remaining East Asian economies began to limit the scope of their Import Substitution Industrialisation (ISI) strategy after the debt crisis of the 1980s (Kolko 1987: 258; Vanderwee 1990: 496).

From the late 1970s to the 1990s, MNEs shifted from fordist methods of production based on large-scale standardized production to flexible specialisation or "post-fordist" methods based on intensive product differentiation and just-in-time deliveries (Piore 1984; Boyer 1998: 78). Post-fordist methods of production fostered intraregional trade as MNEs divided their global production capacity into more autonomous regionalised production networks (Oman 1994: 18). This result was produced by the two opposing forces that were shaping the way of wording of the largest MNEs. On the one hand, these firms had to operate at a high volume of production to cover the accelerating fixed-costs in advertising, robotics and R&D (Boyer 1998: 38; Dicken 2003: 107). This meant that most national economies did not have a domestic market large enough for the firms to operate at the minimum efficient scale. On the other hand, most MNEs did not opt for a unique globalised production process as it proved too rigid and too standardized to adapt quickly to the heterogeneous demands across the globe. Indeed, the increased product differentiation, the adoption of just-in-time methods and the necessity to react swiftly to changes in consumer tastes (more volatile in a more differentiated market) all meant that the firm had to locate its production units relatively close to the market it wanted to serve (Hurrell 1999: 55). Therefore, the region most often became the optimal area for the MNEs to geographically position the different segments of their production process. This new microeconomic dynamic favoured the increase in RTAs worldwide.

By the early 1990s, many technocrats and officials across developing industrialising countries understood that belonging to a large regional integrated market was an important factor in attracting MNEs for operating in their region, for regionalising their production processes and for transforming the region into an export platform targeting the OECD markets. Europe was about to launch its Single Market and the NAFTA project was made public in 1991. Most of the leaders of emerging economies knew that they were facing serious competition in attracting FDI and East Asian nations were no exception in that respect (Yue 2003: 286).

3.1.2 The main regional factors behind the acceleration of the EAIP

Japan was the first economy to experience strong push factors. During the 1970s, the appreciation of the yen, the rising wages and trade frictions with the US forced some Japanese firms to shift their labour-intensive activities abroad. After being stable from 1978 to 1985, Japanese FDI flows to East Asia began to accelerate as a second wave of relocations took place after the 1985 Plaza Accord, which resulted in the so-called *endaka*. Petri claims that after this wave, efficiency-seeking FDI dominated market-seeking and resource-seeking FDI, as the Regionalisation of their Production Processes (RPP) became a priority for Japanese MNEs (Frankel 1993: 41). Fukasaku notices the concomitance of this wave with the acceleration of intraregional trade after 1985 (Fukasaku 1992: 16) and gravity model analysis has confirmed the role of FDI flows in fostering intraregional trade since the 1980s (Otsubo 2003: 144). The geographical reorganization of the production processes of Japanese firms implied various types of FDI flows.

The first type of flow was generated by the extension of the relocation of labour-intensive activities to low-wage neighbouring economies. However, contrary to the wave of the late 1960s and early 1970s, these investments were not directed mainly to the Asian newly industrialised countries (NICs) (South Korea, Taiwan, Hong-Kong and Singapore), but to other East Asian economies, that is the four largest countries of ASEAN (Thailand, Indonesia, Philippines and Malaysia). These less-developed East Asian economies had previously been chosen as recipients for resource-seeking or market-seeking FDI.

By the late 1980s, the four NICs met similar problems to those encountered by the Japanese economy in the 1970s. Industrial labour costs rose rapidly in Taiwan and in South Korea because of full employment, rising union militancy and new social legislation (Yamamura 1997: 90; Gee 1992: 17). Like Japan, these countries had a trade surplus that caused their currency to appreciate. Ultimately, trade frictions with the United States and Europe became more frequent. Hence, these countries lost their comparative advantage in labour-intensive sectors with low profit-margins to their less developed Asian neighbours. Japanese FDI expanded dramatically in Thailand and Malaysia and then in Indonesia and the Philippines (Terry 2004: 106).

At the same time, the four Asian NICs had some mature sectors. They had gained technological and managerial expertise. By the mid 1980s, South Korea and Taiwan had managed to develop some strong competitors in specific industrial sectors. The Japanese firms adapted to this situation and continued to extend their regional strategy. Many *keiretsu* continued to invest or to license technology to the four Asian NICs but they focused more on technology-intensive sectors and on services (Frankel 1993: 170). By 1990, Japan was the first investor in the four Asian NICs with 38% of the total FDI flows hosted by these economies.

This new wave of Japanese FDI coincided with another wave originating from the four Asian NICs and directed to the “ASEAN-4” (Indonesia, Malaysia, Philippines and Thailand) (Hobday 1995: 29). Having assimilated technological and managerial know-how, these firms from the

NICs gained intangible assets that made them confident enough to open subsidiaries in less developed neighbouring economies when their domestic macroeconomic environment became less attractive for the location of new labour-intensive activities (see below). This parallel wave of FDI from the four NICs to the ASEAN-4 was of a comparable size to that generated by Japanese MNEs (Hobday 1995: 29).

These waves that occurred in the late 1980s created a complex regional division of labour. From the late 1960s to the mid 1980s, Japanese MNEs moved from establishing “hubs” (simple relocations of screwdriver operations) to “clusters” (which implied more local content by local affiliates). After the *endaka*, Yamamura and Hatch consider that the production process of the Japanese MNEs experienced a qualitative change with the building of regional intrafirm webs (Yamamura 1997: 24). This process was made possible by the abandonment of ISI schemes in the ASEAN economies mentioned earlier which enabled some Japanese subsidiaries to move from producing with assembly kits a limited volume of final goods aimed at serving the domestic market to producing a higher volume of components within their RPP for the whole East Asian region.

The decade of financial crisis that followed the burst of the speculative bubble in January 1990 accelerated and deepened the RPP of the *keiretsu*. Indeed, the slowing down of the Japanese economy was jeopardizing the traditional Japanese-specific industrial structure and industrial relations systems. Features such as the relations between *keiretsu* and their SME subcontractors, lifetime employment, *amakaduri* were already growing problems with the maturing of the Japanese economy in the 1980s but the crisis in 1990 forced a restructuring of these institutions. Breaking up those institutions would have been hazardous for the Liberal Democratic Party that had been the main architect of that system and remained one its main benefactors. Most of the Japanese business and political elites were determined not to eradicate the traditional system though they needed to increase productivity and the profit margins of the *keiretsu*. Considering the low level of Japanese interest rates, the easiest short-term solution was to invest abroad and deepen the Asian division of labour introduced by Japanese firms and to extend Japanese specific institutions to the rest of the Asian economies (Hatch 2000: 384; Dieter 2002: 82). The *keiretsu* began to increase the pressure on their subcontractors. Second-tier, third-tier and fourth-tier suppliers were squeezed out and many went bankrupt (Hatch 2000: 389). The first-tier suppliers however possessed sufficient capital and technological capabilities to relocate to other parts of Asia. By the end of the decade, Hatch estimates that a third of Japanese MNEs had reinstated at the Asian level the traditional subcontracting links that they enjoyed in Japan before the relocation of their assembly in Asia (Hatch 2000: 387). This trend is likely to continue as other Japanese MNEs like Canon have shown a readiness to relocate more activities from Japan to East Asia (FT 2003: 10/X).

Although the waves of Japanese FDI were driven by the private sector, the Japanese governmental agencies provided substantial support to this process (Terry 2004: 129). Since the late 1960s, Japan has developed aid programs aimed at facilitating the establishment of Japanese subsidiaries in East Asia. The strong links between the private sector and the Japanese development aid agencies are seen as a normal and desirable feature of the

Japanese Official Development Aid (ODA) system by both the government and the business elites (Lincoln 1992: 28). As a result, Japanese ODA has been targeting its East Asian neighbours and particularly the zones where Japanese firms would develop their regional hubs rather than the least developed regions (Frankel 1993: 233; Yamamura 1997: 131; Cook 1996: 18). This "utilitarianist" aid policy was strengthened in the late 1980s to accompany the wave of FDI generated by the *endaka* (Donner 1993: 178; Terry 2004: 113). ODA is also used by the Japanese government as a green light for Japanese firms to invest in countries still not penetrated by Japanese FDI (like former non capitalist Asian countries) (Lincoln 1992: 34). Apart from the effects of the ODA programs, Japanese enterprises could also benefit from the "regional guidance" and loans provided by the Japanese government, notably through the MITI local offices across Asia (Terry 2004: 19; Hatch 2000: 387).

After two decades of isolation, China's reinsertion in the capitalist economy gives it new opportunities to upgrade its technological capabilities through the means of attracting FDI with a view to reaping its potential spin-offs. In order to reach that goal, it has been essential for China to guarantee a stable investment environment. At the domestic level, MNEs benefited from a favourable legal framework that guaranteed their private investments. Furthermore, the steadiness shown by the Chinese authorities in their resolve to join the GATT throughout the 1990s was a clear signal to foreign investors that the transition economic reforms were being locked-in. At the regional level, China was very diligent in easing tensions with its capitalist neighbours and adapted its foreign policy rhetoric accordingly.

The transition of the Chinese economy towards capitalism fostered intraregional trade and investment flows in different ways. Firstly, there was a direct effect due to the sheer size and growth of the Chinese market. China became the largest importer of the region for raw materials and machine-tools. This was reinforced, as China became an attractive place for market-seeking FDI and for export processing. It offered a cheap and semi-qualified labour force in a relatively stable political environment.

East Asia was the first source of FDI flows to China, accounting for two thirds of total inward FDI stocks in China (MOFTEC 2002: 25). This dominance of East Asian flows is due to geographical proximity, cultural and historical links. This obviously accounts for the importance of Hong-Kong and Taiwan FDI flows (see graph 1), but also for some of the locations in China chosen by other East Asian firms. For example, Dalien resumed the traditional links with Japanese MNEs it enjoyed before WWII. In the 1920s, Dalien had been the first destination of Japanese FDI in China as it represented the Japanese entrance to the Chinese market. South Korea used the ethnic Korean minority in China to increase their knowledge of the Chinese economic and political system. Zeijiang, which has been one of the major hosting provinces of Taiwan FDI, is also the birthplace of Kuo-Min-Tang Jiang Jeishi. During the 1990s, thanks to these factors, China became inserted inside the regional division of labour of most East Asian MNEs and even of SMEs.

A more indirect effect of China's reinsertion in the East Asian regional economy was to foster subregional integration among Southeast Asian economies themselves. ASEAN countries began to consider China as a major threat for their own development as it took an increasing share in

East Asian inward FDI flows at the expense of the ASEAN economies (Yue 2003: 286; Nesadurai 2003: 80). Given the new post-fordist functioning of global MNEs, the ASEAN economies were convinced that they had to achieve a higher degree of economic integration to regain the comparative advantages as an investment location that they had partly lost to China. Until the early 1990s, the ASEAN integration process had been blocked by the numerous protectionist resistances from its four largest Member states (Nesadurai 2003: 57). However, after the confirmation of China's economic reforms in 1992, the threat of FDI diversion became more concrete. In 1993, Japanese FDI in China was almost as important as in the ASEAN. China's share of the total FDI flows to developing countries rose from 10.5% to 34.9% between 1991 and 1993 while the share hosted by the ASEAN plummeted from 32.1% to 20.3% (Nesadurai 2002: 81). Chinese competition became even fiercer after the devaluation of the RMB in 1994 (Yoshihara 1999: 6). The Chinese threat pushed the ASEAN governments to decide to accelerate the pace of regional integration, especially after 1995.

3.1.3 A REGIONAL DIVISION OF LABOUR

To fully understand the microeconomic dynamics underlying the EAIP, the edge of Japanese MNEs in the process cannot be underestimated. Despite real progress in industrialisation and technological capabilities by the other East Asian economies over the last three decades, the EAIP continued to be characterized by a pyramidal structure with Japan at the top.

Thanks to the spin-offs generated by hosting Japanese and Western MNEs, South Korea, Taiwan, Hong Kong and Singapore managed to industrialise and started to catch up with the most advanced economies. Their domestic firms acquired new technological knowledge and management experience that provided them with the intangible assets necessary for transforming them into global competitors like Samsung or ACER. Nevertheless, most of these firms can only offer a limited scope of products and they depend on Japanese technology for high-tech inputs and machinery (Yamamura 1997: 88; Hobday 1995: 90; Dicken 2003: 432).

Korea is number two in the region with respect to the level of technology but is far from overtaking Japan despite the fact that South Korea is the most important R&D spender among the Asian NICs. The bilateral Korean-Japanese trade during the 1990s was showing an important trade deficit in high-tech products on the Korean side, highlighting how vain the strenuous efforts engaged by Korea since the 1980s for reducing its dependence on Japanese technology had been (Liu 1996: 157). Attempts by the *chaebol* to acquire technology through joint-ventures or takeovers overseas have only led to disappointing results (Sun Pai 2003: 224). Many South Korean economists and businessmen believed that the technological gap between South Korea and Japan was actually widening in 1997 (Yamamura 1997: 90). The Asian crisis of 1997 certainly did not improve this situation with the restructuring of the *chaebol* and the numerous takeovers by foreign firms. In the first decade of the 21st century, Korea's higher education system has still not reached the level of developed economies and lacks basic foundations in sciences (Sun Pai 2003: 224; Kwon 2003: 43).

The situation of Taiwan is no different even for its most advanced firms. Taiwanese leaders like ACER have acquired companies in the USA in order to improve their innovative capacities but have met with little success because of the different management styles, the lack of motivation of American staff or because the best US researchers moved to other US companies (Gee 1992: 37). Like their South Korean competitors, Taiwanese firms still have to rely heavily on Japanese high-tech equipment and key inputs (Hobday 1995: 108).

In the other Asian economies, almost no domestic firms have yet managed to reach that technological level or to open as many subsidiaries outside the East Asian region. Apart from Taiwan and South Korea, Singapore is the only economy of the region that had an ambitious education program to improve the skills of technicians and engineers (Yamamura 1997: 83). However, for three decades, this policy aimed mainly at providing foreign MNEs with skilled local personnel rather than at supporting the creation of indigenous manufacturing firms (Hobday 1995: 141). The recent change of government policy during the late 1980s has modified this situation, but the new Singapore-based MNEs are developing mainly in regional services (Nesadurai 2003: 87). In order to pursue this strategy, they do not need the highest levels of management and scientific skills. This implies that Singapore is still very much dependent upon Japanese and Western technology. The other Asian economies have not invested sufficiently to build a technological and scientific base comparable to Japan or even South Korea. The share of skilled workers among the domestic workforce of most ASEAN economies (except Singapore) was still very low in the late 1990s. In Malaysia (which is considered more advanced than Indonesia or the Philippines), this figure only reached 2.4%, far below the take-off stage that advanced economies like Japan experienced decades before (Yamamura 1997: 83).

Most of the indigenous firms in ASEAN economies are completely dependent on their Japanese partners, even those which are strongly protected and subsidised by their governments. Within the ASEAN economies, indigenous high-tech industries able to compete on the global markets have not yet emerged despite decades of intensive industrial policies. Mahathir himself conceded the failure of this type of policy in Malaysia (FT 2002, 7/X). As for Indonesia, the 1997 crisis exposed the weaknesses of the high-tech national champions.

Therefore, Japan remains the undisputed technological leader in Asia. The webs that the Japanese MNEs have built up through the regionalisation of their production processes have generated technological spin-offs but these were far from providing the other Asian economies with a sufficient scientific and technological base to develop indigenous innovation capacities in most high-tech sectors. The dependency of Asian economies on Japanese technology is much higher than what FDI figures suggest. Technology licensing accounts for a substantial part of the Japanese firms' activities in East Asia (Yamamura 1997: 100). The pattern of trade clearly indicates this dependence. Japan maintains a trade surplus with all its East Asian partners. Among the East Asian economies, Japan has got by far the highest share of high-tech products in its total exports (Terry 2004: 108). Japan exports machinery and high-tech inputs to the East Asian economies that process manufactured goods and export them to the global markets. The East Asian economies finance their trade deficit with Japan thanks to their trade surplus with the Western economies (see graph 2).

This technological gap will not be easily closed in the next decade by the East Asian latecomers. Firstly, one should not forget that an important part of the post-war technological base in Japan, South Korea and Taiwan was developed with the financial aid and the technological cooperation of the United States (Frankel 1993: 275; Lanzarotti 1992: 36; Jones 1997: 81). Free transfers of technology and markets for the new high-tech products were available to these three economies because of the context of the Cold War. The less developed ASEAN economies and China cannot expect anymore to benefit from this exogenous factor.

Secondly, most of the successful Korean and Taiwan high-tech firms started to develop in the 1960s and 1970s in partnership with MNEs. However, once they had acquired a technological base, the local governments put very strict rules on FDI and in the case of South Korea went as far as to discourage MNEs from staying in some high-tech sectors. Japan, Korea and Taiwan adopted very protectionist tariffs and also pursued active industrial policies, which today would be opposed by multilateral institutions such as the WTO or the IMF. The fact that almost all East Asian countries have joined the WTO means that they cannot apply such protectionist industrial policies because of the agreements on Trade Related Intellectual Property Rights (TRIPs) and on th Trade Related Investment Measures (TRIMs) (Nolan 2002: 61).

Thirdly, the global economic environment has changed compared to the 1960s and 1970s. Those two decades were characterized by high growth rates in the OECD countries. Most of the FDI flows were directed towards Europe and the US, then considered as the main markets. East Asia was not a priority for Western MNEs, some of which were actually divesting out of the region (Yamamura 1997: 37). Since the 1990s, Western MNEs have focused much more on East Asia and the US government has adopted a tougher stance on more open rules for trade and investment in the region (Liu 1996: 139; Beeson 2000: 354). It means that the infant industries of the East Asian economies will face much tougher competition on their regional markets than their Japanese or Korean counterparts did.

Fourthly, there is abundant evidence that in most sectors, the minimum efficient scale has been rising drastically in the last two decades. The shift to “post-fordist” methods of production (see above) has generated an advantage for the very large global MNEs (Hurrell 1999: 53). Furthermore, these new methods of organisation required more skills in international management as well as a very developed infrastructure in transport and information in order to coordinate these different regional production units globally (Hurrel 1999: 54). For the East Asian indigenous firms to transform themselves into global MNEs in the 21st century, they will have to overcome much higher barriers to entry than those met by the Japanese or even Korean firms two decades ago.

All these elements indicate that Japan is likely to keep its comparative advantages in innovation, management expertise and in technology intensive sectors. Japanese MNEs will continue to play a leading role in the East Asian regional division of labour. Even the business and political elites of South Korea, the most advanced East Asian economy after Japan, only seem to aim for an intermediary position in this regional division of labour rather than a leading role as suggested by the adoption of the so-called “Open Neo-Trading Nation strategy” consisting of opening up entirely to MNE’s in order to create a world business hub (Cho 2004:

18). Other East Asian economies are trying to move up the value chain but very few analysts believe that they could catch up with Japan in the foreseeable future and continue to develop without maintaining strong trade and investment links with Japan.

3.1.4 Can China leapfrog its East Asian partners and challenge Japan's regional leadership?

Some analysts claim that China could experience a more favourable situation than its ASEAN counterparts because of the sheer size of its economy. Thanks to its potentially huge domestic market, the bargaining position of the Chinese government is stronger in imposing technological transfers from MNEs investing in China (Shenkar 2005: 3). Even disregarding this argument, many MNEs simply prefer to invest in R&D facilities in China to improve "time to market" and to be able to react more quickly to a volatile demand keen on new differentiated products (Kim & Lee 2003: 16). Some MNEs have recently established R&D centres for product development aimed at the Chinese market (Chen 2003: 13). MNEs are attracted by the cheap price and availability of high-quality Chinese engineers (Chen 2003: 13). No other developing Asian economies can offer such a large pool of trained scientists. This enabled world class firms like IBM, Microsoft and Intel to engage in basic technology research in China in collaboration with Chinese universities and state-funded research institutes (Chen 2003: 14).

This has generated many fears from neighbouring economies such as Taiwan and Korea that are afraid of being technologically leapfrogged by China (Chen 2003: 15; Nam 2003: 22). Some Korean economists believe that China's technological gap with respect to Korea is shrinking. They estimate this gap to be around three to five years for many products (Nam 2003: 22). The most pessimistic view was probably expressed by South Korea's national science and technology committee. It claimed in December 2003 that the country had a technological advance of only 1.7 years over China and that this gap would be closed within five years (FT 2003: 21/XII).

However impressive, one should not overstate the technological advantages enjoyed by Chinese firms. Most of the R&D facilities are being built by MNEs and target product development research. Product innovation and fundamental research are still lagging far behind OECD economies. There is still no Chinese company in the top 300 firms in R&D expenditures (Nolan 2002: 47), which is not true for some *chaebol* such as Samsung. China's largest firms are still lagging far behind the world class competitors in technological innovation and their spending on research is less than 1% of the largest MNEs' in many key industrial sectors (Nolan 2002: 51). Macroeconomic statistics show that most of the Chinese growth is extensive (based upon the use of additional factors of production) rather than intensive (based upon the better combined use of all factors). Wolf estimates that total factor productivity (which reflects intensive growth and technological improvement) only accounts for a small share of Chinese growth during the 1990s and that this share is actually decreasing (FT 2003: 8/XII). According to some IMF analysts, most of the efficiency gains are due to FDI and not to domestic investors (FT 2003: 8/XII). There is still no evidence of major Chinese technological leaders in their sectors that could compare with the *chaebol* in terms of indigenous technological innovation capabilities.

The largest Chinese firms which are attempting to transform themselves into MNEs endure many liabilities compared to their largest global competitors. They are much more overstaffed and achieve a far lower return on investment than the average largest global firms in their fields of activities (Defraigne 2005: 12). Even when compared to the situation enjoyed by the Japanese and Korean largest firms at the time they began their overseas expansion- respectively in the 1960s and in the 1980s- , the Chinese largest firms are not performing as well in terms of profitability and capital-intensity (Defraigne 2005: 20).

These liabilities are clearly reflected in the patterns of the Chinese MNEs' overseas expansion. Since the beginning of the new millennium, the emerging Chinese MNEs have been engaged in widely publicized take over operations such as Thomson by TCL, Sannyong by the Blue Star group, some IBM subsidiaries by Lenovo or the recent attempt by Haier to take control of Maytag. However, far from reflecting strength, these takeovers reveal inherent weaknesses. Firstly, in these operations, the Chinese firms are not acting alone. They are supported by the Chinese state banking system and by a special tax regime. Some of these deals are more geopolitical than based on enterprise profit maximization. For example, some acquisitions of US firms are supported by the Chinese government with a view to creating a constituency for China in Washington so as to contain bilateral tensions (FT 2005, 20/VII) Secondly, most of these takeovers were targeted at ailing companies (Maytag, Sannyong or Rover) or production units aimed at serving the lower-end of the market (Thomson television) (Kroeber 2005: 1). This reflects a lack of know-how in innovation, distribution and marketing from the Chinese firms. They need to acquire the brand or the experience of firms from more advanced economies in order to pursue their expansion. As has been mentioned in the previous section, this takeover strategy to gain know-how has not proven very successful in East Asia. Chinese MNEs are also involved in takeovers and joint ventures in the energy sector. Here again, government intervention is decisive and geopolitical considerations outweigh the market criteria. Most of the overseas markets that Chinese firms have managed to capture in capital and technology intensive sectors have been located in developing economies – e.g. building telecom networks in Indonesia or an Algerian airport – and not in the most demanding markets of the developed economies (The Economist 2005: 6/I).

Overall, Chinese firms willing to develop world-class indigenous innovative capabilities are still facing, like other developing Asian economies, the four challenges outlined above. They show no middle-term capacity to challenge the most advanced Japanese MNEs in their role as Asia's technological leaders.

3.1.5 Conclusion: a bottom-up process led by private firms

As these sections have shown, East Asian integration has been mainly a bottom-up process driven by the Japanese MNEs and to a lesser extent by the MNEs of East Asian NICs. The Japanese state played an important role in this process by accompanying private FDI flows through its ODA programs but it was never an institutionalised process.

Through the regionalisation of their RPP, Japanese – and some East Asian – MNEs have built up a complex regional division of labour involving economies at very different levels of development and fostering intra-industrial vertical regional trade. Although this process has generated substantial spin-offs, Japan continues to be the uncontested technological leader of this heterogeneous group of East Asian economies.

Some scholars have claimed that the Japanese government and MNEs have been reluctant to institutionalise the EAIP in order to keep their edge on Western competitors in the East Asian market (Nesadurai 2003: 79; Rapkin 2001: 382). The argument goes that *keiretsu* helped by the regional guidance of Japanese government agencies and by Japanese aid flows, have developed privileged informal networks with local politicians, civil servants and business communities across East Asia. During the 1980s and 1990s, these networks were sufficient for the Japanese MNEs to let them complete their RPP across East Asia and keep a strong position in many of these local markets.

Clear common regional rules on the so-called "Singapore issues" could have facilitated the intra-firm trade of the Japanese MNEs operating in East Asia but they could also have fostered the penetration of East Asian markets by Western MNEs. This potentially tougher competition in the region was not welcome by Japan at a time when the East Asian affiliates of Japanese corporations brought a much higher return on investment than those in the rest of the world (Terry 2004). Until the 1997 crisis, most East Asian business and political elites were satisfied with the fact that the EAIP was not institutionalised and was functioning the "Asian" way. The various attempts by the US to set more formal and binding rules within the APEC framework failed as it faced a very effective passive resistance from both Japan and the ASEAN Members (Rapkin 2001: 385).

Nevertheless, this has completely changed at the turn of the millennium. The way the IMF dealt with the 1997 financial crisis was very negatively perceived by all East Asian governments. The "Wall Street-Treasury-IMF complex", as it was nicknamed in East Asian countries, rejected the Mitsuzuka proposal for an Asian Monetary Fund and imposed a very comprehensive and harsh liberalisation package on the bailed out economies. The adjustment policies imposed by the IMF were considered by many economists as unnecessarily painful. Some saw it as a device that reduced national sovereignty (Rapkin 2001: 395) and favoured cheap takeovers of local firms by Western firms (Chang 2003: 106). The US intentions were clear: US Secretary of Commerce Jeffrey Garten, was declaring that the "worsening financial flu will lower the Asian immunity to US business" (Higgott 2000: 259). The bluntness of America's rejection of an Asian solution to the crisis generated a return of populist nationalism in Asia, criticizing the "robbery" by "a new imperialism", rhetoric almost unheard of since 1945 in non-communist Asia. This reaction not only affected traditionally nationalist leaders like Mahathir, but also prominent politicians in Thailand, Indonesia, the Philippines and South Korea (Higgott 2000: 259). In the face of rising blunt US unilateralism and of the successive failures of Seattle and Cancun WTO ministerial conferences, building a clear regional institutional framework was seen by the East Asian elites as a means to strengthen the bargaining power of East Asian nations vis-à-vis the US as well as multilateral institutions in which Western economies had a dominant position. It could enable East Asian firms to keep a privileged access to the regional markets when their European and US competitors each had a trade bloc of their own.

3.2 The relevance of EU experience in commercial integration for the EAIP.

Since this change occurred, many East Asian political and business elites have specifically used the term "Community" as a goal for regional integration in East Asia. The Bali Summit of 2003 set the objective of building up an ASEAN Community for 2020. Other references to the EU's past experience in deepening integration are being made by various East Asian commentators. Nevertheless, it is necessary to address in depth whether and to what extent the European Integration Process (EIP) could constitute a benchmark for the deepening of East Asian integration.

The EU has indeed experienced a top-down integration process quite different from the bottom-up integration that can be observed in East Asia these last decades. The first milestones of the EIP were set up by European governments and supranational institutions and not by private firms. In some instances, especially at the beginning of European construction, European business leaders were not even consulted or informed (Brugmans 1970: 165). Nevertheless, despite the dominant role of the states versus the enterprises in the setting up of the European integration agenda, the latter responded to an underlying microeconomic necessity for the survival of European big business.

3.2.1 Large scale standardised production

During the last quarter of the 19th century, a wave of technological innovations caused a dramatic rise in the minimum efficient scale. From then on, the existence of a large integrated domestic market became crucial for firms to be able to operate at a volume sufficient to fully capture economies of scale. Unsurprisingly, US firms were the first to achieve this and to adopt mass standardised production (or "fordist") methods thanks to the incomparable size of their integrated and relatively homogeneous domestic market (Chandler 1990: 20). The next natural step of the large US firms was to transform themselves into MNEs and to begin opening subsidiaries overseas (Dunning 1993: 69).

From that time on, European firms suffered from a heavy handicap because of the narrowness of their domestic markets. Protectionism was on the rise throughout Europe and America from the 1880s to WWI. In that context, the fragmented European market did not enable European firms to benefit from the same economies of scale as their American competitors. The pursuit of colonial and commercial expansion was the main European response to that challenge. With the benefit of hindsight, one can argue that the fragmentation of the European market and the rising competition from US multinational companies were among the main structural factors behind the two wars that shattered Europe in the first half of the 20th century. Indeed, the need to rationalise the industry at a continental level in order to reach the minimum efficient scale enjoyed by their American competitors was the driving force behind the German leader motivation to build up an integrated European economic space, if necessary by resorting to military force (Defraigne 2004: 147).

During the first half of the 20th century, the gap between the largest American and European firms continued to widen because of the larger economies of scale offered by the American domestic market. This trend was only reversed in the late 1950s with the beginning of the long process towards European supranational integration that led to the creation of a single market of “American” size. Paradoxically, this process, which enabled Europe’s largest firms to begin to reduce the size and productivity gaps with their American competitors, was initiated by the US administration. The latter played the role of a benevolent referee who managed to put down the nationalist pressures in each European state.

3.2.2 The US as the benevolent referee

The determination of the American administration to foster integration in Western Europe was driven by the fear of rising Soviet influence in Europe (Kindleberger 1986: 507; Ellwood 1992: 68). The rebuilding of strong manufacturing capacities in Western Europe and Asia became their priority in order to stabilise domestic political situations and to intimidate the Soviet Union with a strong arsenal. As the rebuilding of Europe was a preliminary step for ensuring the sustainability of the new world economic order, the American administration launched the European Recovery Program (ERP – sometimes known as the European Reconstruction Program and more widely known as the Marshall Plan 1947-1952).

The Marshall Plan was not simply a scheme aimed at delivering reconstruction aid: it incorporated a new economic and social model for Europe. It was seen as a means to propose a political and social alternative to the Soviet system to Western European workers. European Recovery Program officials outlined explicitly the links between a large integrated European market, economies of scale, productivity gains, rising living standards of workers and reducing communist influence in Western Europe (Hogan 1989: 39). The American administration therefore favoured a European customs union within which industries would be rationalised at the European level in order to increase the scale of production of the firms.

Despite a few attempts by the French to build up a continental customs union without Germany, the American administration considered it essential that Germany be put back in its pivotal role in the continental European economy. This meant quickly imposing the normalisation of political and economic relationships between Germany and Western Europe.

However, this project faced potential opposition from other Western European nations, as German firms still possessed a greater experience of large-scale standardised production and managerial know-how thanks to the war economy and a to larger pool of qualified scientists than their European competitors (Harrison 2000: 163; Overy 1994: 337). Furthermore, the immediate post-war period in Europe was characterised by serious shortages of foreign exchange reserves because of the trade imbalance between Europe and the United States. As a result, the various European economies adopted protectionist policies in order to keep sufficient hard currency reserves. This rise of "neo-mercantilism" was incompatible with the project of normalising economic relations between Germany and France (Milward 1992: 131).

The US administration managed to put down nationalist rivalries in Western Europe and to force Western European states into accepting some kind of economic integration regulated by supranational institutions. The Marshall Plan's officials used the massive aid funds and know-how transfers as leverage to carry out this strategy. Firstly, the American administration favoured the development of the European Payments Union (Milward 1992: 390). Secondly, the Marshall Plan enabled the French to modernise their heavy industry, in particular the steel industry, so that the fear of German competition would be a lesser obstacle for France to join a European customs union (Kipping 2002: 187). Thirdly, they actively supported groups of individuals in favour of supranational integration through open and covert operations. Individuals like Jean Monnet, a high level French official, had personal and financial links with Secretary of State Dulles (Milward 1992: 334; Djelic 1998: 96) and the CIA was financially involved in sponsoring pro-European think tanks and political clubs (le Monde 2003). Fourthly, the Marshall Plan made European business familiar with large-scale American production methods (Lynch 1997: 58, Djelic 1998: 206; Wonoroff 1994: 503).

The American impetus was decisive in launching European integration. Two supranational institutions – the European Payments Union and the European Coal and Steel Community – both essential for the development of intra EU trade and for the foundation of the Franco-German axis, could not have been created without Washington's support.

3.2.3 The emergence of a strong euro-federalist current

US pressure to set up strong supranational institutions found important support among the governments and senior civil servants of the six founding member states of the European Coal and Steel Community (ECSC) and the European Economic Community (EEC). Projects for European political integration had been put forward by European politicians and thinkers like France's head of government Aristide Briand or count Coudenhove-Kalergy during the interwar period but found no echoes amid the rise of protectionism in the 1930s (Mattli 1999: 69). What differed after WWII was the even weaker position in which Western Europe found itself compared to the two emerging superpowers.

For German elites, the spectrum of options was rather limited. After the Nazis had been defeated, the Red Army occupied the Eastern *landers* while some Western powers were considering the dismantling of German industrial plants (Ellwood 1992: 51; Grosser 1986: 15). In such a context, the priority of German business leaders and non-communist politicians was to normalise relations with their Western partners, avoid another Versailles treaty and openly show that Germany had forever renounced to impose its hegemony over Europe by violent means (Buhrer 1995: 94). German leaders felt that they had to make the necessary economic concessions in order to gain equal treatment from the members of the Western community (Buhrer 1995: 88; Lister 1960: 8). To overcome the fears and hostility of French businessmen and of the French government, Germany's Chancellor Adenauer pursued an earnest policy of appeasement with France (Buhrer 1995: 88). On the home front, rejecting the Soviet system that he considered a "barbaric Asiatic system" and the brutal Nazi ideology of world hegemony, Adenauer was convinced of the need for the German people to embrace a European federalist project: "one has to give the people an ideology and that can be only a European one (…) Therein lies the salvation of Germany" (Milward 1992: 330). As for France (and later Britain), decolonisation and the Suez affair soon exposed the fragile strategic position of Europe. In France, Italy and the Benelux, many European technocrats of the new generation were impressed by the efficiency of the American economic and political model that constituted in their view a third way between Stalinism and fascism.

These reasons explain the emergence of a strong Euro-federalist current in continental Western Europe. Even those who remained sceptical about the feasibility of a federal Europe were convinced that some form of supranational institutions was needed as a way to solve the fragmentation of European markets between national states and as a way to strengthen Europe's bargaining position on trade and strategic issues (Mattli 1999: 71). Given this context, the strong wording of the Treaty of Rome, which refers to the goal of merging the European economies into an "ever closer union", is not surprising. It reflected the will of the EC's founding fathers to build up a politically united Europe in the long term.

3.2.4 The homogeneity of the national economies involved in the EIP

When the EIP was launched, the countries involved were experiencing quite similar levels of economic development. Although German firms held more intangible assets, their European competitors involved in the early phase of the EIP were not too far behind. The Benelux and French economies had a sound technological base and some strong competitors for German firms. GDP per capita was quite similar (see table 3 in the annex). Only Italy was clearly behind, especially its southern regions.

This relatively high degree of homogeneity among member countries facilitated the emergence of supranational institutions. The relative symmetry between the first member states of the EC enabled them to reach agreements going beyond a free trade area. Policies that were not guided by pure short term economic rationality but that aimed at reinforcing the political cohesion of the EC could emerge. The Common Agricultural Policy (CAP) and the regional policy with its structural funds would have been much more difficult to finance if the level of homogeneity would have been much higher among Member states. In the European case, the risk of having less developed economies take control of the supranational institutions simply did not exist because of their limited demographic and economic weight. The largest nations continued to dominate the process and made sure that excessive net transfers towards supranational institutions did not take place.

3.2.5 The slowing down of the process (1958–1978)

The creation of an effective European Single Market was a long process that lasted four decades because many EC Member states pursued a protectionist strategy of nurturing national champions during the 1960s and 1970s. As the Western economies resumed high growth and as the Soviet Union adopted the doctrine of “peaceful coexistence”, the leverage of the benevolent referee weakened: the US could not impose its agenda the way it had done during the late 1940s and 1950s. European technocrats who favoured a rationalisation of production capacities at the European level in order to enable European champions to reach the size of their American competitors found themselves in a weaker position vis-à-vis the lobbying power of national industries with their short term agendas and protectionist demands. The EIP became less of a top-down process imposed by technocrats and some Euro-enthusiast politicians who aimed at improving the long term efficiency of European economies and at strengthening the strategic bargaining position of Europe in world affairs. It became a mixture of top-down and bottom-up processes in which the European enterprises did not constitute a monolithic group with regard to their views about the European integration process.

3.2.6 The cause behind the acceleration of EIP (1978–1985)

The global crisis that erupted in 1973 gave a new impetus to the EIP by exposing the non-sustainability of the national champion strategy in the context of an economic slowdown and of acute international competition. Three different factors, which all appeared in the late 1970s and through the 1980s, were decisive in this respect. The first was the strengthening of international competition, especially from the US, Japan and some emerging economies, which forced a reaction upon European firms and governments. The second was the change that has been described in the industry from fordist mass production methods to post-fordist methods of production that induced a rapid increase in the minimum efficient scale, reinforcing the disadvantage caused by the relatively small size of the national champions of each European economy. The third was the deterioration of state finances in all European economies and the shift of orthodox economic thought from the neo-classical Keynesian paradigm to a more Hayekian or monetarist paradigm that meant that subsidising national champions was perceived as being too costly and inefficient. At the same time, economic analysts began to criticise the excessive degree of national concentration while showing that the degree of concentration at the continental level was still lagging far behind the level of the American economy (Geroski 1985: 175; Pelkmans 1984: 62; De Jong 1977: 52).

In the early 1980s, the strongest European firms were fully conscious of these developments and became more pro-active in defending the building of an effective European single market, which was seen as the only way of adopting the new production methods of their American and Japanese competitors. They organized into strong lobbying groups. Among them, the most famous was probably the European Round Table of Industrialists (ERT), which included MNEs such as Philips, Siemens, Olivetti, GEC, Daimler Benz, Volvo, Fiat, Bosch, ASEA, Ciba-Geigy. The ERT complained openly about the fact that “in reality, despite (…) the measures taken by the EEC, Europe remains a group of separate national markets with separate national policies and separate industrial structures. This prevents many firms from reaching the scale necessary to resist pressure from non-European competitors” (Mattli 1999: 78). Their agenda recommended notably the harmonisation of economic and monetary policies, the end of subsidies to obsolete industries, the harmonisation of technical standards, the adoption of legislation apt at facilitating the emergence of transnational industrial structures and at easing the free circulation of people and information (Mattli 1999: 78). European business leaders managed to influence the French government so that it did not oppose the idea of building up a European Single Market in a short time span. This removed the last important obstacle to the acceleration of the EIP as the British, German and Benelux governments were all strong supporters of lifting internal barriers within the EC.

By the mid 1980s, all European governments agreed to accelerate the EIP. They became ready to give up many of their national champions, to lower the internal barriers of the European economic space in order to let European MNEs grow in size either by merger or by selection and to transfer more effective powers to European supranational institutions so as to enforce these changes. This was made easier by the fact that the Treaty of Rome already contained all the necessary provisions to ensure that transfer of powers: they simply had not been effectively implemented during the 1960s and 1970s.

The first important lifting of EC internal barriers came with a swift move towards mutual recognition of national regulations. In its “Cassis de Dijon” ruling in 1979, the European Court imposed the principle that a commodity the production and commercialisation of which comply with the security regulations of the producer country must be admitted on the markets of other Member states as long as the legislation of the producer country meets essential security and quality requirements (Olivi 1998: 329). Basing itself on this ruling, the European Commission advanced quickly in the harmonisation of technical regulations and norms. Organisations like the CEN or the CENELEC were created to implement common European technical standards (Pigott 1993: 212). With the issuing of directive 83/189, the making of national technical regulations was submitted to the approval of the European Commission, which could intervene in the national legislative process in order to prevent the creation of new technical barriers inside the European Common Market (Pelkmans 2000: 85). This principle was seldom applied in the 1980s, but was more rigorously enforced after 1989 (Piggott 1993: 190) and became completely accepted by the end of the 1990s (Pelkmans 2000: 54).

The second important step was obviously Jacques Delors’s White Paper for the creation of a Single European Market without borders. The Commission was strongly influenced by the ERT and UNICE (the main European employers’ association) in the design of its white paper which recommended the adoption of 300 different pieces of legislation to do away with all obstacles to the four freedoms of movement inside the European common market (commodities, services, the labour force and capital). It finally led to the suppression of physical borders on the 1st of January 1993, which meant significant time gains for intra-European trade as half of it was crossing at least two borders (Aujean 1992: 37).

The third step towards giving up national champion strategies and towards the creation of a European market with free competition was for Member states to accept to reduce their capacity to pursue autonomous national industrial policies and to adopt a European competition policy. This was favoured by the fact that a majority of national European governments were willing to reduce state intervention in the economy and to start privatising state-owned companies. Throughout the 1980s, the European Commission gained more control over state aids to domestic firms. Articles 90, 92 and 93 of the Treaty of Rome were applied more vigorously. This new determination to enforce legislation on state aids was clearly designed to accelerate the selection of the most efficient firms at the European level as the Commission saw state aids as having a deterrent effect on the potential entrants to the European markets. Many European MNEs feared that gaining an important market share in a European Member state would mean retaliation from the local government *via* subsidies given to its national champion (Cherot 1993: 229). The European Commission gradually imposed a strict procedure for settlements between itself and the national Member states (Cherot 1993: 227). The number of controls over national subsidies, and the number of rulings by the European Commission refusing state aids, increased tremendously during the 1980s (Pelkmans 1984: 263). From 1988 to 1998, the percentage of national subsidies in the added value of the industrial sectors was halved (Pelkmans 2000: 242). In order to ensure effective competition in the European Single Market, the European Commission was given new powers on concentration control thanks to a new merger regulation adopted in 1989 (Whish 1993: 703). It became compulsory to notify the European Commission of any merger or acquisition project with a “Community dimension”, that is where the total turnover of the merged companies was above 250 million ECU (after 1997, this threshold was lowered to 100 million) (European Economy 11/97: 12). It was thus far more powerful than articles 85 and 86 of the Treaty of Rome, where only the abuse of a dominant position was restricted (Yvars 1997: 200).

Finally, the fourth step was to foster monetary and financial integration by adopting a common currency for the Eurozone and removing obstacles that prevented free competition in the financial services sector. Again, this was strongly pushed forward by the largest European enterprises (Mattli 1999: 78).

3.2.7 Merger wave reduces the gap between Europe and America (1986-2001)

The removal of these internal barriers generated the largest merger wave in European history in the years 1986 to 2001. M&A made by EU firms in the EU were more important in numbers and in value than M&A made in the EU by non-EU firms (Commissariat Général du Plan 2004: 102). Because it was convinced of the need to catch up with the largest US firms, the European Commission showed great leniency towards the rising market shares of newly merged European MNEs. Between 1990 and 2001, the European Commission received only 1908 notifications relating to the 27.000 mergers that occurred during the period and only opposed 18 of them (European Economy 2001: 9 & 16).

This merger wave led to an industrial specialisation at the European level. Inefficient national champions were eliminated, especially in the small countries. In the small European Member states, only the most competitive MNEs, often focused on niche markets, survived (Davies 1996: 132). This created larger MNEs but almost all of them were still *national* champions. They were controlled by a national group of shareholders and had a special relationship with only one national government. However, since the end of the 1990s a few *supranational* European MNEs have emerged. That is, enterprises of comparable size from different EU Member states began to merge to create new entities. These newly merged European groups had a core of European rather than purely national shareholders and held a privileged relationship with more than one European Member state. Examples of these European champions are ARCELOR (created by the merger of the Spanish ACERALIA, the French Usinor and the Luxemburg ARBED) and EADS (created by the merger of the French, German and Spanish aerospace champions with headquarters in the Netherlands). If these European supranational groups were to multiply, it would hasten the EIP and not only at the economic level. These new supranational groups are certainly hostile to the pursuit of national champion strategies. They have a dominant position within the integrated European market. Their competitors almost all originate from outside the EU. They do not fear intra-European competition and want to increase the leverage of state institutions in order to increase their protection against non-EU competitors. This implies that if they are to use "state" institutions to defend their interest, they will do it at a *supranational* rather than at a *national* level. They will push forward integration in the fields of higher education and research, foreign policy and transport in order to benefit from the same strong state structure enjoyed by US MNEs.

The acceleration of EIP gave birth to large European groups, which were able to reorganise their production processes at the continental level and to reap larger economies of scale and integration. The reduction in the difference in size between EU and US MNEs has been impressive in the aeronautics, automobile, chemistry, non-defence electronics, rubber, oil and steel sectors. In all of these sectors, the top European MNEs have reached the size of their American competitors and sometimes more (Defraigne 2004: 261).

Despite these achievements, US MNEs continue to dominate in the technology-intensive sectors such as computers, defence electronics, pharmaceuticals and also in financial services.

However, one must consider that these specific sectors are also those where the European market is far from having achieved a high degree of integration (Pelkmans 2000: 115). The Commission has been trying to lift internal barriers in these sectors and there are some important advances, especially in the field of financial services. The launching of the euro has naturally accelerated the integration of Europe's financial markets and the European Commission has accompanied that trend by pushing forward the harmonisation of accountancy standards and mutual recognition of share issuing procedures. Since January 2005, the 7000 largest European enterprises listed on European stock markets will have to adopt International Accounting Standard (IAS) norms recommended by the Commission. The harmonisation of European national interest rates in the Eurozone has generated a "Europeanisation" of institutional investors' portfolios (Pelkmans 2000: 186). This also provoked a wave of mergers inside this sector just before the launching of the euro. Stock exchanges have been anticipating these developments and there have been pressures to merge the different European stock exchanges. The French, Belgian, Dutch and Portuguese stock exchanges have joined to form EURONEXT. Deutsche Börse, the Swedish stock exchange and EURONEXT have shown their willingness to take over the London Stock Exchange. This trend towards more concentration of the European financial services industry is likely to continue as it will facilitate capital access to fuel the external growth operations of European MNEs.

Overall, the underlying microeconomic problem of the fragmentation of the European market, which prevented European firms from benefiting from economies of scale comparable to their US competitors, has been solved in most industries and services thanks to the acceleration of the European integration process in the 1980s and the mergers wave that followed.

3.2.8 The new emerging microeconomic dynamics and the 2004 enlargement

However, since the 1980s, new microeconomic dynamics were at hand shaping the EIP. Like their Japanese and American competitors, the shift to post-fordist methods of production implied the RPP of EU firms and the relocation of labour-intensive activities in less developed neighbouring economies. In Europe, the RPP was also a means to increase the bargaining power of firms against national governments on corporate tax issues and against unions on wage and flexibility issues. In 2000, the 500 biggest European firms had an average return on investment that was almost half the one enjoyed by US firms (The Economist 2000: 5). Among the factors put forward to explain the superior performance of American firms were the more flexible labour market and the business friendly tax system of the USA.

> As a result, intra-industrial vertical trade developed quickly in the textile industry with Mediterranean and Eastern Europe as early as the 1980s (Boillot 2003: 56). The enlargement to the Iberian Peninsula provided another pool of relatively cheap labour. Nevertheless, the generalisation of this process across various industries and some services came when the Eastern European countries broke away from the Soviet Union and the COMECON in the 1990s.

Although geopolitical factors (taking them away from Russia's sphere of influence) and a common cultural identity certainly hastened the enlargement process towards Eastern Europe, economic motivations were at the top of the agenda. Increasing the size of the European Single Market and facilitating the EU MNEs' RPP were the two main economic motives behind the 2004 enlargement.

As the United States was pushing forward NAFTA and FTAA, there was a feeling among the European political and business elites that the EU should include Eastern Europe and some Mediterranean economies in the economic hinterland of the EU. The ten new Member states that joined in 2005 plus Croatia, Bulgaria and Romania constitute a modest but significant increase in the size of the European Single Market. In 2002, their total GDP amounted to 5% of the total GDP of the 15 EU Member states (Eurostat 2002).

However, among the economic motives behind the enlargement, the market access motive was probably not the strongest one. Most of these economies were already open to Western European firms before the agenda of their entry into the EU was set. Thanks to free trade agreements signed in the early 1990s between the EU and Eastern European economies, 80%

of EU exports towards Eastern Europe faced no tariffs during the decade (Boillot 2003). Furthermore, Western European firms penetrated the local markets through the establishment of local subsidiaries. Many European MNEs gained control of entire sectors of Eastern European economies through the takeover of former state monopolies during the privatisation programmes. Between 1993 and 1996, FDI accounted for 10% of gross investment in the Czech Republic, for 15% in Poland, for 25% in Estonia and for more than 30% in Hungary (UNCTAD 1998: 396).

Facilitating the RPP of EU MNEs was an even more decisive factor than market access. Eastern European economies offered a vast pool of very cheap and semi-qualified labour, a significantly better opportunity than that offered by Spain or Portugal in 1986. Even in the richest applicant economies, wages were more than 80% below the EU average (Eurostat 2004). Interviews of business leaders showed that the Eastern European labour force is also very attractive to European MNEs because of its high flexibility and the absence of long-standing strong autonomous unions (Financial Times 2002: 22/VII). The high level of unemployment, 13% on average in Eastern Europe compared with 7% for the EU (Eurostat 2004) has slowed down the reduction of the wage gap between Eastern and Western Europe. The European Commission estimates that the reform of the agricultural sector of the applicant countries will cost four millions jobs (Alternatives Economiques 2002: XII 11) and will thus contribute to keeping wages relatively low in the medium term.

There is ample evidence of the magnitude of RPP by EU MNEs across Eastern and Western Europe (UNCTAD 1998: 286). The geographic dispersion of FDI in Eastern Europe shows a pattern of concentration around the borders of the EU and around capital cities or other industrial sites with a developed transport infrastructure (UNCTAD 1998: 273). Strong FDI flows occur between EU Member states which share a common border with an Eastern European country (UNCTAD 1998: 273; Bafoil 1997: 19). This pattern of FDI localisation reflects the fact that Western MNEs re-export a share of the production made by their subsidiaries in Eastern Europe towards Western Europe. European MNEs are much more active than their American or Japanese counterparts in the area. In 1997, the stock of FDI originating from the EU was three times higher than the American one while the Japanese presence was negligible (UNCTAD 1998: 273). Western European supremacy in the region has been strengthened during the following years (UNCTAD 2004). Breton and Di Mauro have shown that the Eastern European countries bordering the EU host an FDI stock far greater than would be expected if those investments were exclusively market-seeking (i.e. were exclusively made to serve the local market) (Pelkmans 2000: 382). Furthermore, Pelkmans estimates that 80-90% of the intra-industrial trade between the EU and Eastern Europe is vertical rather than horizontal, which reflects an East-West geographical dispersion of the production process of manufactured goods (Pelkmans 2000: 382).

RPP was made easier and more effective after the inclusion of Eastern Europe in the EU, as it removed administrative non-tariff barriers that still constrained trans-European intra-firm trade. Furthermore, European MNEs have also benefited from leads and lags thanks to the more lenient tax systems of the new Member states tailored to attract FDI.

The inclusion of Eastern European countries will accelerate the pace at which the European labour market is becoming more flexible. As in the case of NAFTA, the fear of relocation of labour-intensive activities in the poor new applicant economies is already weakening the bargaining power of unions. The case of Volkswagen is particularly significant. Unions have been traditionally strong in the different European plants controlled by the German carmaker. However, between 1997 and 2001, despite record profits and a good economic climate, the unions settled for more flexibility in working hours arguing that is was the only way to avoid further relocation and local job losses.

The accession of the new Member states also hastened the reduction of corporate tax rates that started in the early 1980s. Many MNEs will now have a greater opportunity to play on their intra-firm trade so as to report the highest level of profits in those subsidiaries based in the countries where fiscal pressure is lowest. This will most probably increase tax competition between EU Member states to attract FDI.

3.2.9 The changing nature of the EIP

During the last two decades, two phenomena had a profound influence on the EIP. Firstly, with stagflation and the rise of public deficits, state interventionism, which had dominated the design of economy policy since the Depression years in the 1930s, was significantly reduced. Consequently, private firms recovered the influence that they had enjoyed on economic policy up to the 1930s. At the European level, it meant that the lobbying power exercised by the private sector grew in importance in the shaping of the plans of the Commission, particularly through the influence of English and American think tanks. The EIP was becoming more of a mixture between a bottom-up and a top-down process, especially with the emergence of supranational European enterprises.

Secondly, the problem of the fragmentation of the European market was in the process of being solved in most sectors during the 1990s. This enabled many European firms to operate at a size comparable to that of their US and Japanese competitors. From then on, the main microeconomic dynamics that drove the enterprises' strategies became the improvement of the RPP within Europe but also within the other major trade blocs such as NAFTA, Mercosur and East Asia. European MNEs could influence the institutions to facilitate their RPP much more easily in Europe than elsewhere, thanks to their privileged access to European national and supranational institutions.

The evolution of the EIP, particularly the enlargement towards Central and Eastern Europe clearly bears the mark of the European MNEs' agenda. Over this last decade, this process seems to have been driven by almost pure short term economic objectives rather than by a vision of political cohesion fostering an "ever closer union". Reaching economic convergence among all the EU economies did not seem as important as in the early phase of European construction.

There were substantial aid programmes such as PHARE, SAPARD and ISPA designed to ease the transition policies pursued by the new applicants throughout the 1990s. However, over a ten year period these programmes ensured, in terms of amount of aid per capita, 30% less than the level enjoyed by Spain and Portugal in the ten years following their accession (Economie Européenne 1995; Chavance 2003). This is despite the fact that the development gap to catch up was much wider in the case of the Eastern European applicants than in that of their Iberian counterparts (Chavance 2003; Eurostat 2004). Furthermore, aid programmes were mainly designed to improve the institutional and business environment of the old EU Member States' MNEs (improving infrastructure, adopting EU competition and copyright laws as part of the *acquis communautaire*). Even in the field of the environment, ISPA programme appropriations went to Western European MNEs. In this respect, EU aid programmes followed the same logic as Japanese ODA in East Asia. Finally, the agricultural question was dealt with in a rougher way than during the previous enlargements. While most Eastern agricultural production units were too small to operate at the minimum efficient scale and were not sufficiently mechanized, the farmers of the new Member states will only receive a fraction of the CAP subsidies given to the old EU Member states during a long transition period that only ends in 2013. This will lead to a massive and harsh restructuring of the agricultural sector and to a strong increase in the already high level of unemployment. Adding to this, one must not forget the 7 years' restriction on East to West labour mobility, towards Germany and Austria, at their request (Chavance 2003).

Heavily in debt, highly dependent on the EU that was by far the main outlet for their exports and the largest foreign investor, the new applicants were in a difficult bargaining position when they decided to join the EU. They were imposed harsh conditions. There are simply no large MNEs in these 10 new Member states. Most local firms are SMEs lacking the technological and managerial know-how and condemned to offer low value-added local services and subcontracting activities. The new applicants are likely to play a similar role in the European regional division of labour to that which the ASEAN countries play in the context of the East Asian regional division of labour.

3.2.10 The risk of political backlash

The change in the nature of the EIP, which seems more and more market driven and less and less politically driven, is bound to create political problems for the European political elites. Influenced by the lobbies of European employers, the EU has accepted an enlargement that has strongly increased the heterogeneity of its Member states (see tables 2 & 3). Before the enlargement, EU Member states were ranked 2nd to 16th on the UN human development index, but now the variance is considerably greater, with Latvia ranking 50th. The EU Sapir report that outlined the guidelines for the new enlarged EU, insisted on the fact that the percentage of EU GDP going to the EU budget would remain unchanged. The dearth of financial means to fund the common policies will prevent the emergence of any ambitious scheme dealing with the agricultural and unemployment issues, and with closing the social gap between Eastern and Western Europe for the next twenty years. The level of heterogeneity between Member states is not a major concern for European MNEs that are completing their RPP, but the risk of political backlash should not be underestimated.

In Eastern Europe, the new Member states and applicants have little room for manoeuvre; they pursue the objectives set by the Accession Treaties, whatever the political coalition in power. Meanwhile, the unemployment level is still very high and social protection is much weaker than at the time of the non-market economy. This has generated a sort of political apathy on European and domestic issues for the majority of the Eastern European electorate. Abstention rates in recent elections have reached more than 75% of the population in countries like Slovakia and Poland. Populist nationalist (often agrarian) parties are growing and use strong anti-European rhetoric. At the same time, Western Europe is facing similar problems. The new competition from Eastern labour has generated fears over the sustainability of the Western European social system and fears owing to the rising flexibility of the labour market and to falling real wages. This has reinforced populist nationalist, extreme left and other currents that strongly oppose the Commission agenda and certainly account for a large part of the results of the referenda in France and the Netherlands. The political deadlock caused by the rising heterogeneity of the EU could jeopardize further progress in developing supranational institutions and, in the worst case scenario, weaken the existing ones.

3.3 The difference between the two processes of regional integration

3.3.1 The different sequence of microeconomic dynamics

The first important element to note is the difference in the sequence of the microeconomic dynamics that have been underlying the two integration processes. In Europe, the dominant logic of integration from the first stage of European construction in the 1950s until the mid 1980s was the reaping of economies of scale through the formation of a single market. During this period, the EAIP had not really taken off. The largest Asian (i.e. Japanese) MNEs had to rely on Western demand, especially from the US, to try to produce at the minimum efficient scale. Ever since the 1960s, the fast growing Japanese market was a sound base for the *keiretsu* but it was not sufficient in this respect. Evidently, building an RTA in East Asia could not have provided an alternative to Western markets for the *keiretsu*. Notwithstanding the geopolitical instability that characterised this region until the 1980s and the US strategic objectives for this part of the world, the total size of their GDP added up to less than one fifth of the one of the EC since large economies like China and Vietnam could not have been included.

As a result, the EAIP only started with the RPP of East Asian – mostly Japanese – MNEs. It has so far been a bottom-up process led by the private sector without supranational institutions. It also meant that the heterogeneity of the economies affected by the process was substantial. On the contrary, the EIP was first driven by the problem of economies of scale and the RPP dynamics only emerged in the late 1980s.

The RPP dynamics is continuing to be a driving force of the EAIP as Japanese business leaders want to deepen the division of labour in East Asia and make it smoother by removing various administrative barriers (Keizai Doyukai 2003: 8). Nevertheless, since the end of the 1990s, another dynamic has also been at work. As a response to the strengthening of trade blocs on the European and American continents, East Asian leaders began to consider creating an integrated East Asian market.

The first motive behind the building of an integrated East Asian market is to reduce the dependency of the East Asian “workshop” on its Western outlets. By providing a large domestic market, East Asian MNEs could operate at the minimum efficient scale without depending upon the US and Europe at a time when trade frictions are on the increase. This is hardly surprising considering that throughout the 1980s and 1990s, the spin-offs generated by FDI waves have created markets for durable consumer goods in the less advanced developing East Asian countries. There is a natural development in which the share of market-seeking FDI flows of the East Asian MNEs increases relatively to the efficiency-seeking investment made as part of their RPP. This means that a larger share of the final products of the East Asian division of labour will be directed to East Asian markets. This is consistent with the analysis of regional trade flows and various empirical studies, which have shown that the pattern of East Asia’s trade flows is characterised by a more inward-looking trend (IMF 2002). The Asian crisis of 1997 has slowed down this process but without reversing the trend (Nagano 2003: 124). Contrary to the situation prevailing in the 1950s, an integrated East Asian market would today enable domestic firms to operate at the minimum efficient scale.

The second motive is to strengthen the negotiating position of East Asian nations with regard to American unilateralism. The latter is partly driven by private sector lobbies and by domestic politicians grabbing short term opportunities. Nevertheless, world trade analysts are well aware that unilateralism is also a tool used to achieve the long-run objectives of US trade policy within the multilateral framework (Pantz 1998). In this respect, East Asian leaders are in part inspired by the strengthening of Europe’s bargaining position vis-à-vis the USA in trade and monetary issues after the adoption of the European Single Market and later of the euro.

The third motive is to create an East Asian market for services as the region is far behind NAFTA or the European Union on this issue. The bottom-up integration process driven by the RPP of East Asian MNEs in the region has mostly affected the secondary sector. Throughout East Asia, indigenous service enterprises have been highly protected by severe restrictions on FDI and heavily subsidised by their national states, even in advanced economies like South Korea and Taiwan. Singapore itself, which had not pursued active industrial policies during the 1960s and 1970s, adopted a more interventionist policy to diminish its reliance on foreign MNEs by actively promoting domestic entrepreneurs in regional service activities (Nesadurai 2003: 177; Dicken 2003: 187). The state protection of indigenous service companies was particularly visible in the ASEAN countries when a specific timetable was designed to give a ten-year extension throughout the 1990s to service activities before Member states would have to apply the AFTA rules on goods.

The emergence from the crisis of 1997 and the lopsided negotiations over China’s accession to the WTO improved East Asia’s market access for Western MNEs specialised in services, especially in banking, insurance and finance. At the same time, many Asian firms in key services have been undergoing heavy restructuring, slowly recovering from the 1997 crisis and have not yet been able to take full advantage of the liberalisation process in China, South

Korea and the ASEAN. However, the post-1997 liberalisation remains limited and could be stalled as the East Asian economies improve their trade balances. Some countries like Thailand and the Philippines even seem to be moving back towards more active industrial policies, defying the IMF neoliberal model, as shown by the regional popularity of the "thaksinomics" concept, named after the Thai Prime Minister and referring to an attempt to pragmatically give priority to national economic development without giving much consideration to text book recipes (Phongpaichit 2004: 100). In various service industries, the creation of a deep East Asian RTA including services and FDI issues could give East Asian enterprises an edge vis-à-vis their Western competitors. As in the European case, the arguments advanced by Krugman, Jacquemin and Oman apply. Removing internal East Asian barriers would foster intra-regional competition, eliminate inefficient protected industries and enable the service provider from the most advanced East Asian economies to benefit from economies of scale and learning by doing before totally opening the region to Western MNEs (Krugman 1991: 161-175, Aujean 1992; Hurrell 1999: 56).

Were the East Asian governments now to engage on the path of a top-down process to build an "East Asian Single Market" including the "Singapore issues", the EAIP would be driven by a sequence of underlying microeconomic dynamics that would be the reverse of the one experienced throughout the European process. As will be shown further on, this could have strong repercussions on the building up of East Asian supranational institutions.

3.3.2 A potential leader and the absence of a benevolent referee

In his analysis of the successes and failures of regional integration processes throughout history, Mattli considers that one of the necessary conditions for a successful regional integration is the existence of an undisputed regional leader who can act as an institutional focal point and as a regional paymaster to compensate the losers in the process. Mattli claims that Germany played this role in the EIP especially in the 1970s (Mattli 1999: 101). Nevertheless, by that time, the process was already well under way and was benefiting from strong and stable supranational institutions, which had gained the acceptance of all Member states. What Mattli's analysis underestimates is the vital role played by the Franco-German axis throughout the 50 years of European construction. Chancellor Adenauer was well aware that Germany could not act alone as regional leader in the aftermath of WWII (West Germany was not even officially a state until 1955) and needed the acceptance of the French to participate in any European integration scheme. This axis was decisive in providing some strong supranational institutions and policies that ensured a degree of political cohesion within the European Community (notably the CAP).

As far as economic matters were concerned, there is no doubt that Germany could act alone. All its small neighbours were highly dependent on the German economy and they were not technological rivals across the whole industrial spectrum, although Switzerland and the Benelux were home to some high-tech MNEs. Germany could have been the institutional focal point of the region, particularly in defining technical standards. Germany also had the financial means to act as regional paymaster considering the relative homogeneity of the EC Member states in the early phase of European integration. Nevertheless, politically and strategically, Germany could not act without France and only a Franco-German alliance offered the undisputed leadership both economically and politically to push forward the ECSC and the Treaty of Rome.

As analysed by Webber, one of the problems of East Asia is the absence of undisputed leadership because of the “enormous mutual suspicions” between Japan and China (Webber 2001: 362). Japan faces a similar situation to that of Germany at the beginning of the EIP. Japanese MNEs are the regional leaders in high tech industries and represent the main driving force behind the EAIP. Through its ODA programmes in infrastructure, its FDI flows, its licensing agreements, the Japanese economy is well placed to set up regional technical standards. However, Japan will have more difficulty in playing the role of regional paymaster alone as the economies involved in the EAIP are much more heterogeneous today than their European counterparts were at any time of the EIP.

Furthermore, China has inserted itself in this EAIP so deeply that it now plays a pivotal role in the regional economy and in the RPP of Japanese MNEs. This makes it impossible to ignore China in the building of a deep RTA. The sheer size of its population and its important military capacities give China a role as important as that of France in the early phase of European integration, even more so if one considers China’s economic weight in the region. These reasons show how crucial the capacity to build a strong Sino-Japanese axis to fulfil Mattli’s necessary condition of undisputed regional leadership will be.

The geopolitical context is much more difficult in East Asia. The analysis of the European experience has highlighted how vital the benevolent referee role played by the US was in the context of the cold war. The US acted as regional paymaster to prevent the adoption of protectionist measures. They were the institutional focal point as many European states adopted their standards, their methods of production and their antitrust laws. Finally, US arbitration created a climate of reciprocal trust between Germany and France. As capitalism is no longer threatened by an alternative economic and political system, the hegemonic position of the US is bound to be contested. The US administration, unwilling as it is to accept a multi-polar world, finds itself in a defensive position. US interference in East Asian affairs cannot be considered as benevolent refereeing but appears more like a case of divide and rule with a view to justifying its military and economic presence in the region.

3.4 The challenge of enforcing a "deep" RTA in East Asia

3.4.1 The conditions for a successful RTA

The observation of regional integration processes in Europe and elsewhere in market economies has shown that they cannot be purely top-down processes imposed by governments on economic agents but that they need to respond to existing underlying microeconomic dynamics. Ambitious integration projects in Latin America, Africa or Europe (EFTA) never became effective or successful because they were not driven by strong microeconomic dynamics. These microeconomic dynamics have been either the pursuit of economies of scale or the RPP of MNEs.

The second condition is the existence of an undisputed leader fulfilling the tasks defined by Mattli. This implies indirectly a limited level of heterogeneity among the economies involved in the process of integration so that the paymaster can carry out his financial duty. One sub-condition should be added to the set of Mattli criteria: the MNEs of this leading nation must be one of the main driving forces of the microeconomic dynamics underlying the integration process.

The third condition, which plays a decisive role in the process, is the existence of an important common economic or geopolitical threat. In the case of the EU, it was the Soviet bloc during the first phase of European integration. In the second phase it was the strengthening of international competition brought about by the emergence of Japanese and East Asian MNEs in the 1970s and 1980s. As for other integration processes such as NAFTA, the ASEAN+3 and MERCOSUR, they have been a response to the threat of a so-called "fortress" Europe and/or to the rise of US unilateralism.

If the East Asian nations want to go beyond a loose FTA solely driven by East Asian MNEs RPP and achieve deeper integration, they have to address the problem of setting up some kind of supranational institutions. Adopting a common system for certification of origin that incorporates changes in tariff classification and added-value standards as proposed by some scholars (Fukanari 2004: 8) will not be sufficient to reach a level of market integration comparable to the EU. An RTA, which would include "WTO+" commitments including the "Singapore issues", is more likely to function if a third-party monitors their enforcement. Mattli considers that third-party enforcement is one of the conditions (although a weak one) of successful integration (Mattli 1999: 65).

3.4.2 ASEAN4+3: THE COHERENT GROUP TO START DEEPENING THE EAIP

The process now taking place in East Asia meets all of these conditions except the last one. The problem is the flurry of competing and overlapping RTAs. Which institutional framework should emerge in order to monitor the deepening of the EAIP?

The first condition (namely for an institutional framework to respond to the existing underlying microeconomic dynamics) clearly eliminates APEC as the ideal framework for deepening the EAIP. The RPPs operated by MNEs do not cover both sides of the Pacific because of the requirements of post-fordist production. Furthermore, the East Asian MNEs have not considered Russia as a suitable location for their RPP because of its high transaction costs and its infrastructure problems. It also eliminates India as an active participant in the EAIP except maybe in the long run. Although it is growing fast, India is not among the top 10 trading partners of East Asia (IMF 2004) and there is no evidence of large MNEs pursuing a RPP in East Asia including India. APEC also does not satisfy the second condition: there is no clear leadership and no nation seems to be ready to pay the very high cost of maintaining political and economic cohesion if APEC was to pursue deeper integration considering the very high heterogeneity of its Member economies including many poor developing economies.

ASEAN appears to be better suited than APEC because most ASEAN Member economies meet the condition of being affected by the same microeconomic dynamics (East Asian MNEs RPP). Nevertheless, these dynamics were mainly driven by MNEs originating from outside ASEAN, namely from Northeast Asia. This is consistent with empirical studies which show that South-South RTAs in East Asia generate less trade than RTAs involving South Korea and Japan with other economies from North Asia or Southeast Asia (Otsubo 2003: 125; Scollay & Gilbert 2001). Furthermore, the accession of new members like Cambodia, Laos, Myanmar and Vietnam the economies of which are far less affected by East Asian MNEs' RPP, have desynchronized ASEAN and the main microeconomic dynamics of regional integration. This desynchronizing phenomenon is supported by empirical evidence. Soloaga and Winters have estimated that AFTA had a significant negative effect on intra-bloc trade contrary to what previous studies made before ASEAN's extension had shown (Clarete 2002: 25).

A much more decisive reason for rejecting ASEAN as a potential framework for deepening the EAIP is the fact that none of its economies can play the role of paymaster. Singapore is the most advanced but is too small to afford the cohesion costs. The repetitive failures of Singapore to speed up the enforcement of AFTA and the fact that, as a result, it had to turn to Japan shows that Singapore does not have the weight to play the role of an institutional focal point.

For these reasons, it is not surprising that neither ASEAN nor APEC were suitable starting points to deepen the EAIP. At best ASEAN could play a role similar to that of the Benelux during the early days of European integration. ASEAN+3 seems to be considered by most East Asian governments as the group of economies having the necessary coherence to go beyond a *de facto* integration process. In fact, the brief analysis of the dynamics of the EAIP clearly shows that ASEAN+3 is endowed with the underlying microeconomic dynamics if one excludes the latecomers to ASEAN (certainly Myanmar, Laos, Cambodia and maybe Vietnam). This is consistent with various General Computable Equilibrium model assessments that show that among the possible combinations of FTAs involving the East Asian economies, ASEAN+3 would generate the most important regional welfare gains but also substantial global welfare gains (Scollay & Gilbert 2001).

3.4.3 The different paths towards East Asian integration

Purely economic regional integration: the American model

At first glance, the Free Trade Area of the Americas (FTAA) could constitute an attractive RTA model for Japan. The integration process taking place in the Americas has been pushed forward by the US MNEs. RPP has certainly triggered the underlying dynamics behind NAFTA and CAFTA (Dicken 2003). The FTAA project is not entirely based on RPP. It is also pushed forward by the US administration to provide preferential market access to US MNEs across the continent. It has partly been a response to the acceleration of the EIP, to the penetration of EU firms in Latin America since the 1980s in various key local industries (automobile, food processing) and services (telecoms, air transport, banking, energy) and to the emergence of Brazilian competitors in the region.

Most Latin American countries, having been hit by the debt crisis, the macroeconomic consequences of harsh adjustment programmes and finally by the increased volatility of capital flows in the 1990s, had no other choice but to give up ISI policies, opening up their economies and competing to attract MNEs with a view towards generating capital flows, exports and employment. Even large economies like Mexico found themselves in a very weak bargaining position. It was President Salinas who proposed the severe concessions to the US for the future of Mexican indigenous industry and agriculture in order to launch NAFTA and attract the needed FDI flows to restore its trade balance and resume economic growth.

NAFTA has shown the strength of the US vis-à-vis its neighbouring partners. The US conceded no real transfer of power to supranational institutions. NAFTA's twin main bodies, in charge of labour and environmental standards, are short of financing and have no coercion powers against Member states. Their total budget accounts for less than 0.01% of NAFTA GDP (Tennier 2003). The US therefore cannot be compelled to act as a regional paymaster in the absence of supranational institutions. The one-shot $50 billion bailing out of the Mexican economy after the Tequila Crisis in 1994 was not mainly made to ensure long term cohesion of NAFTA but to guarantee US MNEs that they could pursue their RPP across the region (Krugman 1999). Furthermore, NAFTA provisions offer US MNEs the option to attack NAFTA Member states if they don't comply with their FTA commitments. Some US MNEs have been successfully challenging legislation in Member countries, showing how NAFTA provisions give private US firms a right to impinge upon the national sovereignty of Canada or Mexico.

NAFTA remains the benchmark for the FTAA. The US administration is pushing for a deep and extensive RTA, more ambitious than the existing East Asian FTAs. It would include services and TRIMs and exclude as few products as possible (Zoellick 2003: 2). Most Latin American economies are not left with much choice given the state of their economies' fundamentals and the lack of indigenous entrepreneurship able and willing to build global MNEs. Only Brazil, thanks to the size of its domestic market and to the relative success of MERCOSUR, enjoys a better bargaining position against the US in the FTAA negotiations. This was illustrated by their arm-wrestling at the FTAA meeting in Miami in late 2003. However, Brazil's position has been weakened by the numerous bilateral FTAs with Latin American economies launched by the US and by the acceptance of CAFTA by the US Congress (de Joncquieres 2003). These FTAs with the US clearly limit the possible geographical extension of MERCOSUR and the number of economies that Brazil could hope to attract into a coalition against the US in future Summits of the Americas.

The winners of the process are mainly the US MNEs. In the case of NAFTA the welfare effects that many economic studies anticipated for the Mexican economy failed to materialise. Taking purchasing power and the deterioration of public goods (including security) into account, the Mexican population enjoyed better standards of living in the late 1970s than during the last 25 years (Lustig 1992; Tennier 2003). National sovereignty has been reduced to its strict minimum.

FTAA and other US-Latin American RTAs represent a strongly asymmetrical model of integration without any delegation of national sovereignty by the US. As there are few indigenous Latin American MNEs and since most of the indigenous exporting firms are in the primary sector, the US is unlikely to be challenged for not complying with future FTAA rules in key industries and services. In practice, the US will not be bound by any supranational constraint in the FTAA and in other American RTAs as none of these agreements contain provisions for setting a supranational third party with monitoring and coercion powers. The other Member economies will have to accept US unilateralism as they are constrained by their structural dependence upon US financial flows and US market access.

Although Latin American countries have been trying to reduce this dependence by developing RTA with other OECD partners (Chile with South Korea and the EU, Mexico with Japan and the EU, and MERCOSUR with the EU), the trend in FDI and trade flows over the last decade indicates the strengthening of the interdependence between these economies and the US.

It is difficult to predict whether or not the FTAA project will prove sustainable in the long run. The lack of political and social cohesion, the absence of any economic convergence objective to reduce the heterogeneity of the economies involved in the integration process, weakens the FTAA. Risks of political backlash with the emergence of populist currents hostile to US supremacy cannot be excluded.

Some Japanese business leaders are clearly in favour of an integration model in which state intervention in the building of a RTA is restricted to "minimise as far as possible frictions related to the flow of resources". They believe that "East Asian economic solidarity can be propelled in practical terms only by private enterprises within the countries concerned" (Keizai Doyukai 2003: 4). Should Japan follow this model, it would face serious obstacles. Firstly, the most advanced East Asian economies have better economic fundamentals and some effective MNEs. For example, the best performing Korean *chaebol* are technologically more advanced than Brazilian firms and have more substantial overseas operations. The degree of structural dependence between the East Asian economies and Japan is less important than for those involved in the American integration process.

Secondly, in imposing this asymmetrical integration process, the US only had to face Brazil, prevented from contesting the regional hegemony of the US by its smaller population and limited defence capabilities. Brazil does not have a central pivotal role for the economy of the whole American continent but only in the Eastern part of a subcontinent (that is less than ten economies over the more than 40 involved in the process). The US could even achieve a FTAA without MERCOSUR in a first stage. Japan will have to face China, a more populated country which is also a nuclear power and which has become an essential pivot in the East Asian division of labour operated by Japanese and other East Asian MNEs. The loss of national sovereignty accepted by some Latin American economies in their FTA with the US is unlikely to be conceded to Japanese MNEs by China or even by smaller countries like South Korea or Malaysia.

An original East Asian path to deep integration with supranational institutions

The European experience cannot be applied to the Asian context. As has been pointed out before, various factors mean that Asia is on a different dependence path. Firstly, the countries involved in the EAIP cannot count on the US to act as a benevolent referee for geopolitical reasons, on the contrary. Furthermore, because the EAIP first started as a bottom-up process led by private MNEs pursuing RPP, it involved a very heterogeneous group of national economies.

If supranational institutions to monitor a deep RTA involving the ASEAN+3 economies are to function effectively as in the European case, they will have to gain acceptance by the majority of the different interest groups in each Member state. Considering the high level of heterogeneity, the Japanese economy could not ensure in East Asia the same level of cohesion as Germany did: the policies would be financially unbearable considering the number of poor countries involved in the process. Transferring powers to East Asian supranational institutions in the European manner could prove just too costly for Japan.

Nevertheless, there is a growing feeling among the economies involved in the EAIP that a free trade area will not be sufficient to counter US unilateralism and tackle the financial instability created by global financial deregulation. Furthermore, Japanese and Korean business leaders favour a deepening of their RPP and the regional division of labour, which will need to go beyond a simple free trade area, towards some kind of East Asian harmonisation of technical standards, of administrative procedures regarding business operations, of transport policies as well as toward greater mobility for some types of skilled labour (Keizai Doyukai 2003: 13). This means at least the creation of a supranational or “third-party” enforcer of the different agreements that can be reached by the firms or persons concerned.

So far the method adopted by the Japanese government to launch an East Asian comprehensive RTA seems quite similar to the US model. Reacting to China’s proposition to create a FTA for 2010 with ASEAN, Japan has developed a series of bilateral initiatives with ASEAN economies and with South Korea. The Economic Partnership Agreement reached with Singapore in 2002, which includes “WTO+” commitments (i.e. the so-called Singapore issues), is used as a benchmark for the ongoing negotiations with the other ASEAN4 economies and South Korea. If successful, this could create a Japanese-led web of relatively harmonized bilateral RTAs in the region.

China would find itself isolated despite its RTA projects in Southeast and Northeast Asia. Japan could then play the role of institutional focal point. Chinese officials are openly worried by the efficiency and speed at which the Japanese negotiators managed to reach bilateral agreements (Cho 2004: 15). The chances of a Japanese success in this first stage are high. Firstly because Japanese MNEs have been the driving force behind the EAIP. Secondly because various economists, officials and business leaders are now determined to restructure the agricultural sector in depth and to give up many of the traditional protectionist measures as demonstrated by the successful RTA with Mexico.

A major problem is what the Japanese government can do next to prevent China from feeling cornered by this Japanese web. When the negotiations aimed at reaching a comprehensive RTA start, China will probably have to follow a roadmap based upon the harmonised model provided by the various existing bilateral Economic Partnership Agreements. However, what use will it be if the provisions of the final ASEAN+3 cannot be enforced in China. The size of China gives her more room for manoeuvre than the Latin American economies in the FTAA negotiations. Although the economic interdependence between China and Japan has been rising, China has FDI sources, a large expanding market and substantial overseas markets other than East Asia. A General Computable Equilibrium analysis (although based on the restrictive assumptions of constant returns to scale) has shown that China could actually suffer welfare loss were it to join an ASEAN+3 FTA (Lee, Roland & Van der Mensbrugghe 2002). If China were to gain more in terms of economic welfare through multilateral liberalisation than through regional liberalisation, there would be a real problem in keeping China to the deepening of the ASEAN+3 integration.

To overcome this difficulty, Japan could propose some kind of supranational bodies in which China and other East Asian partners would be given a greater weight than the one they presently have in the region. These supranational institutions would enforce the RTA commitments and continue to work on the regional harmonisation of technical standards. As in Europe, East Asian supranational institutions should quickly harmonise financial services regulations so as to integrate capital markets. They should lift the internal obstacles to transnational M&A in order to enable the creation of East Asian *supranational* enterprises, an objective already supported by some Japanese business leaders. If these emerging groups of East Asian capitalists with a common interest see the light of day, they would become a strong lobby in favour of the EIAP and of locking-in transfers of powers at the supranational level.

In exchange for this lowering of internal barriers that will highly benefit Japanese MNEs, Japan could act as regional paymaster to ease the phasing-out of non competitive protected “national champions” in East Asia and to develop public goods in the region. This would require a change in the present organisation of Japanese ODA: from launching unilaterally utilitarianist projects aimed at assisting Japanese MNEs in their regional expansion to moving towards financing a sort of supranational East Asian cohesion fund. Although these financial transfers will be substantial, the Japanese economy is sufficiently strong to afford them. The economic weight of Japan in East Asia is much more important that that of the Franco-German axis at any time of the EIP and its national debt is mainly held by nationals. The real challenge for the Japanese authorities is to determine which economic agents within the Japanese economy should finance these funds given the situation of the state's finances. In any scenario, the Japanese MNEs will have to carry some of the financial burden linked to Japan's role of regional paymaster. It is unclear whether the government has the bargaining power and the will to impose this on the *keiretsu*. The latter are likely to oppose such transfers as they traditionally claim that the EAIP is mainly an affair of the private sector and seem reluctant to transform the EAIP into a more and more top-down process.

Supranational institutions should also be able to address the problem of labour mobility in some sectors where there is a high degree of complementarity between the ASEAN+3 economies (e.g. in medical services).

Finally, it will be essential for the region to have some supranational body to deal with the energy issue. Because of the competing national strategies on energy supply (mostly between Japan, China and South Korea), this sector has been driven by geopolitical considerations and is far less integrated than others. Tremendous economic gains could be achieved. A supranational body would reduce intraregional tensions, strengthen regional bargaining power and avoid the kind of Sino-Japanese competition seen in the recent Siberian dispute. Supranational powers in energy matters would also involve dealing with pollution and diffusing energy-saving technology (intensifying the existing efforts already made by Japanese aid programs in the region on this specific issue).

Obviously, given the state of its public finances, Japan cannot by itself reduce the high heterogeneity of the region to a point that would ensure some political cohesion. Firstly, some countries should be temporarily excluded from participating in the deepening of an ASEAN+3 RTA (including representation in the possible supranational institutions), leaving "opting out" possibilities. The excluded countries would be those that are not directly affected by the dynamics of RPP and those where the implementation of a comprehensive RTA would be very difficult due to weak infrastructure and administrative capacities. These two categories of countries clearly overlap. They are mainly the ASEAN latecomers (see table 6 in the annex). As for China, although it is a very sensitive issue, it would be worth considering the possibility of exemptions for some of its least developed provinces.

Whatever the options taken, it is clear that any deepening of the EAIP beyond a FTA will imply informing and consulting the population. As long as the process remained a bottom-up form of integration requiring only limited intervention by the states involved, it could remain largely elite-driven. However, if the EAIP is to move towards a more top-down approach involving transfers of powers towards a supranational body, it will not be possible to avoid some public debate on the goals of EAIP and to depart from nationalistic rhetoric. The challenge will be more difficult given the higher degree of heterogeneity within the ASEAN+3 group. Various analysts have highlighted the tremendous efforts that remain to be undertaken to prepare public opinion in the two regional powers and in the other East Asian countries in this respect (Serra 2003: 77; Webber 2001: 362; Kim Chulsu 2004: 12). A feeling of sharing common "Asian values" has been slowly emerging throughout the 1990s but continues to be far vaguer than the Euro-federalist ideology of the early 1950s. If these issues are not addressed, a risk of disaffection like the one experienced recently in Europe could create a real obstacle for the deepening of the EAIP.

If successful, an original East Asian path towards regional integration will have tremendous consequences on the evolution of the future global economic and political order. A pessimistic scenario would see trading blocs that could become dangerously less interdependent. The US could consider an East Asian bloc as an intolerable threat to their hegemonic position and react in a similar way that the British Empire reacted against the economic rise of Germany in the early 20th century. In the optimistic scenario, the achievements of the three largest integration processes (Europe, FTAA, ASEAN+3) would be the starting point of another era of multilateral liberalisation, the US being forced to accept the existence of a multipolar capitalist world because of a coalition in favour of multilateralism formed by East Asia and Europe.

4–Geo-Politics, Leadership and East Asian Cooperation

This section will explore the issue of regional 'leadership'. In the context of the East Asian regional dialogue, this is identified as the key issue for the 21st century. At its core, the degree and the nature of regional leadership in the emerging Asian integration process that can be provided by China *and/or* Japan will prove crucial to the success of the current endeavours to secure enhanced regional economic (and political) cooperation in the region. The ability, or otherwise for the emergence of some kind of collective leadership, or at least consensual cooperation, is the major instrument for, or obstacle to, any advancement of regionalism in Asia. Without an 'historic compromise' between China and Japan economic integration will be severely delayed, if not made impossible. This section will explore a range of scenarios.

East Asian responses to US economic policy are not insignificant. Significant strides have been made by East Asian states in using existing institutional opportunities to defend sectoral interests, via the WTO Dispute Settlement Mechanism (see for example Pekkanen 2004), although the region remains basically under-represented in the Bretton Woods institutions that still reflect the configuration of global power at the end of the Second World War. However, Japanese and Chinese leadership aspirations continue to grow and the discursive practices of regionalisation continue to evolve in a non-trivial manner. For example, the APT process is being institutionalised through the evolution of an over lapping multi-dimensional process of regional conference diplomacy strengthening, and indeed creating, links between the states of Northeast Asia and Southeast Asia.

Whether the Asians will be successful or not in their endeavours, there can be little doubt that the continued exploration of cooperation as a way to combat vulnerability is an established item on the regional policy agenda in the early 21st century and it demonstrates a marked contrast with the late 20th century. If we consider APEC as the dominant regional initiative of that era, then during this period we saw the US strongly pro-active; Japan as a passive, reactive actor in the organisation; and China giving its support to the EAEC initiative of the Malaysians rather than APEC. The AMF initiative of the late 1990s was initiated by the Japanese and met with resistance (albeit low key) from the Chinese and outright hostile rejection by the USA.

In the early 21st century the major regional agenda item is the attempt to develop enhanced monetary cooperation, especially since the Chiang Mai initiative, as the major exercise in regional cooperation in the 21st century. In this initiative we have, for the first time, a position where both the Japanese and the Chinese are strongly supportive of this regional project. While the USA is opposed, it is not minded to develop strong countermeasures. China and Japan are not, it should be stressed, engaged in a concerted coordination of their foreign policies. Rather, we see a happy coincidence where it is recognised by both major powers that the regional agenda for enhanced monetary policy coordination can be supported and advanced comfortable in the knowledge that it is a positive sum, not a zero sum, game.

In such an emerging context, APEC's potential to fulfil anything more than a vehicle for general and imprecise dialogue, notwithstanding some quite detailed technical work in its sub-groups and committees and by some of its members (especially Australia), has always been over-hyped. Without accepting Mahathir style rhetoric, East Asian regional support for APEC has always been constrained by national interest concerns that eschew any serious commitment to its core analytical and policy concepts of 'open regionalism' and 'concerted unilateral liberalisation'. The Asian financial crisis exposed the limitations of the progressively excessive expectations that were heaped on APEC from the time of the first summit in 1993 until the crisis of 1996-7. From that time on rose tinted lenses and soft rhetoric were replaced by harder realist lenses as APEC lost is appeal for Asian policy makers in particular. No significant economic initiatives have emerged from APEC since that time. Other factors diminished its attraction as an 'institution' for East Asian leaders; especially the American 'securitisation' of APEC following 9/11 (Higgott 2004).

It is against this backdrop that the tentative, but nevertheless secular trend towards the consolidation of an East Asian discussion needs to be seen. However the December 2005 summit turns out, it is part of a wider context of changing thinking amongst pivotal policy elites in Asia throughout the early years of the 21st century. We can see this if we contrast support for the initiation of APEC with moves to secure enhanced monetary cooperation

Monetary regionalism is not the kind of regional cooperation that has its antecedents in a necessarily European intellectual pedigree. Rather it is what we might call the rise of a regulatory regionalism that links national and global understandings of regulation via the intermediary regional level. Effectively, regionalism is a transmission belt for global disciplines to the national level through the de-politicising and softening process of the region in which regional policy coordination—evolving regional governance—has become the 'meso' link between the national and the global. It is emerging as a genuinely multi-level exercise. It reflects several trends where:

1. Regional policy coordination to mitigate risk is delegated to the state. It is sovereignty enhancing. Indeed, there is a strong relationship between state form, the global economic and political orders and the nature of regional governance emerging. This compromise is inevitable if the continuing tension between nationalism and regionalism in East Asia is not to jeopardise the cooperative endeavour. It is instrumental regionalism.

2. The meshing of multilevel processes of regulation reinforce the connections between the international institutions (especially the IMF and World Bank) and regional institutions such as the ADB and the emerging instruments of regulation developing in the context of monetary regionalism at the level of ASEAN plus Three, such as the ASEAN regional surveillance process (ASP).

3. The transmission of internationally agreed codes, emanating from the perceived best practice of international institutions such as the IMF, help enforce market standards, and do so much more than sceptics concede.

It is in the area of monetary regionalism, not trade regional liberalisation, where cooperation is advancing most rapidly. It is not *de facto* trade led regionalism driving the agenda—this is taken care of now much more at the global multilateral level and at the bilateral level. The key to monetary regionalism is closer integration through common national 'regulation' rather than regional institution building. Nor is it *de jure* institutional cooperation driving the agenda. Rather, the discourse of regulatory regionalism carries fewer negative connotations for sovereignty and regime autonomy than 'regional institution building'. Institution building throughout the pre-crisis days in East Asia carried with it the implications of sovereignty pooling of the European Cartesian legal formalist variety that alarmed Asian regional elites. Regulatory regionalism does not have the same echoes. It is instrumental regionalism. While it reflects a different understanding of regionalism to that which prevails in Europe, it nevertheless demonstrates perhaps a greater interest in the development of regional institutions and inter-regional relationships to enhance collective action problem-solving under conditions of globalisation than is to be found in the United States in the contemporary era as the brief comparison set out below suggests.

Americans and Europeans project sharp differences in their approaches towards world politics in general and global and regional institutional cooperation in particular. The US and the EU, for example, differ on questions of 'partnership', 'burden sharing', and 'exceptionalism' as approaches to global economic management. For the Bush Administration, what drives the contemporary world order is 'primacy', 'Realpolitik' and freedom to manoeuvre. For Europeans, it is 'globalisation' and 'interdependence'.

The EU disposition for multi-level-governance and 'sovereignty pooling' is incomprehensible to US foreign policy makers. The *'acquis communautaire'* (the body of common standards and regulations that have developed over the life of the European project) are, notwithstanding perpetual complaints about excessive bureaucracy and even in the context of the current constitutional crisis, generally accepted in Europe. Europe, in theory if not always in practice, exhibits a stronger positive normative attitude towards multilateral governance structures developing constitutional and regulatory frameworks that transcend the nation state.

For all its problems, those states of greater Europe that are not yet members of the EU are still keen to join it. With the benefit of the longer term historical perspective, what looks like weakness through the traditional state-centric realist power politics lenses actually looks like strength through the newer lenses of the increasingly diffused and networked nature of power in the contemporary global era.

Again, without over-stating the case, similar differences with the US towards regionalism and multilateralism may also be found in East Asia in the early 21st century. This part of the world also places a greater stress on multilateral and regional cooperation than the US, although, as in Europe, there may be a marked disconnect between theory and rhetoric on the one hand and application and practice on the other. However, we live in an era of the 'new regionalism' in East Asia that has progressed apace since the financial crisis of the latter part of the 1990s. The key elements of this new regionalism are enhanced regional economic dialogue and interaction both *amongst* the states of Northeast Asia (China, Japan and South Korea) and *between* these states and the states of Southeast Asia through the development of the ASEAN Plus Three process.

These East Asian endeavours represent alternative voices to APEC, spurred by the perceived limitations of the multilateral system and the changing relationships of the major regional actors to the USA—especially Japan and, recently China. This tendency is not, of course, unproblematic and the behaviour of China in East Asia over the medium to longer term is crucial. The current war of words between China and Japan has not stopped China replacing the USA as Japan's major trading partner. Neighbours attracted by China's market potential and willingness to enter into regional partnerships in the economic domain are much more sanguine about China's growing regional military might. It is possible to identify potential pitfalls standing in the way of the longer term consolidation of the relationship, if we privilege the security relationship at the expense of the economic one.

How this relationship between China and the rest of the region will play out in the long run is the key to security and cooperation in East Asia. This issue is best approached by posing a question rather than offering unsustainable propositions regarding future behaviour: *Does increased wealth and power lead to greater cooperation or greater competition?* This is a perennial question of international relations. It is central to the relationship between China and Japan. The evolution of their respective economies, over the last two decades at least, has been complementary, rather than competitive. There has been a fortunate complementarity in terms of what they produce for the global market and what they take bilaterally from each other.

Longer-term, however, it is likely that the relationship will become increasingly competitive as they will compete for inputs into their respective economies—especially in their search for sources of energy and other resources. 2004 saw China overtake Japan as the world's second largest oil importer. It is also now, depending on statistical interpretation, the world's second largest economic power in PPP terms and the world's third largest trading power. It can also be argued that US policy fuels rather than cools the competition between the two Asian superpowers as it grapples to adjust to changes in the global power structure brought about by China's rising role. To-date all the signs are that it is not doing this well, or even responsibly (see Johnson 2005).

In addition, of course there are still strong, residual nationalistic antagonisms between the two countries that cannot be assigned to the historical past. Aaron Friedberg's (1993) suggestion that the region is 'ripe for rivalry' could be countered by T. J. Pempel's (2005) recent assertion that the region could just as easily be 'ripe for cooperation'. How it turns out will depend on how the regional conversation is managed in the coming decades. To say that the discussion could and should be rationalist and instrumental is not to say that the regional dialogue cannot be derailed. In essence there are thus two scenarios for consideration.

In the worst case scenario, contemporary strains in the relationships between the regional great powers are seen as fundamentally irresolvable. There are several factors that we might anticipate in this scenario:

- The unwillingness of Japanese policy makers to distance themselves and their country from the atrocities of World War II continues, and remains unacceptable to the rest of the region.
- Japan sides with the US in attempting to block China's greater participation in the regional economic and political orders and this is seen as a fundamental act of hostility by the Chinese government. Note here certain signalling activities by Japan such as its support for the US approach towards Taiwan and other factors such as Japan blocking Chinese participation in the Inter-American Development Bank.
- A conflictual rather than peaceful outcome to the increasing contest for energy supplies amongst the US, China (and Japan).

The worst case scenario also assumes a certain course of action by the USA towards greater regional economic cooperation in East Asia. In grand strategic terms, Asian economic co-operation is not nearly as useful for the US as European integration was in the second half of the 20th century. There is no longer the need to demonstrate the superiority of market economies – the alternative vanished. Successful economic integration in Asia today (more so from China than Japan notwithstanding parallels with the 1980s) is a challenge to US competitiveness (and for some its security). If Asia were to emancipate itself from American guidance, Washington's hold on the region would deteriorate sharply. How the US takes this forward is yet to be determined.

Thinking more positively, there is an alternative scenario that can be developed around the rise of regulatory regionalism. The key elements of this would be enhanced regional economic dialogue and interaction both *amongst* the states of Northeast Asia (China, Japan and South Korea) and *between* these states and the states of Southeast Asia through the development of the ASEAN Plus Three process leading to an East Asian (Economic) Community.

In this scenario, while the USA remains the dominant presence in the region, defined as the Asia Pacific (in both economic and military terms), it does so as a more passive, exogenous catalyst in the 'East Asianisation' of the Western Pacific seaboard. Processes in train in East Asia may actually represent a more systematic package of regional governance activities in which the whole will be greater than the mere sum of its parts. The APT process is being institutionalised through the evolution of an over lapping multi-dimensional process of regional conference diplomacy strengthening, and indeed creating, links between the states of Northeast Asia and Southeast Asia. Of course, the future of successful regional discourse seems dependent not only on Japanese economic reform, but also on a willingness of the PRC to continue the new found regional cooperative economic role that it has developed since 1997. If this continues in a positive way, then regionalism will grow as an important activity and as a meso-level instrumental expression of the desire to optimise sovereign decision-making by states confronting the rigours of global competition. If Japanese and Chinese instrumental interests can be privileged over cognitive differences this could be a massively powerful force for regional cooperation in East Asia. In contexts where they are at odds, it will be very counter-productive.

These scenarios are not merely determined at the local level. They need to be located in the wider context of the overall discussion about globalisation and regionalisation in the early 21st century. There is a general principle that we can draw about power and regionalism from a comparative discussion of Europe and Asia. Again, it is better put as a question than offered as an assertion: *Is it likely that we are entering an era where large sections of the global community look less to the major multilateral institutions—so much the playthings of the major powers—as vehicles for collective action problem solving and more towards the development of regional activities and communities*? If so, then the growing salience of the regional dialogue is a positive trend in international relations.

Regionalism is an effort to transcend a uni-polar world in which the hegemonic power shows an increasing reluctance, in contrast to times past, to engage. To this extent, although this is not the intended outcome, contemporary US foreign policy can act as a catalyst to regional consolidation in Asia. Growing discontent with US policy in, and towards, the East Asian region (especially since the Asian financial crisis) has been a significant factor in the enhanced regional dialogue of the 21st century.

Taken to extremes, it is not impossible to envisage a situation in which the world does become more multi-polar. Not necessarily multi-polar in the traditional realist sense of other regions combining to 'balance' against the US, but multi-polar in the sense that the US becomes less salient as an actor in the development and activities of other regions. That we even raise these questions in the early 21st century is testament to the magnitude of change that has taken place in thinking about the strength of the glue holding the contemporary global order together.

The US – having won the Cold War through a combination of hard power and soft power – nowadays seems to hope that raw material power will be sufficient to intimidate other great powers. This assumes that China, Japan (and East Asia in general) as well as Europe, Russia, India, Brazil and Latin America are not capable of developing policies and strategies to mitigate the influence of US economic and military power. US hegemony, or primacy in the military sphere, is not preventing the development of multi-polar initiatives in geo-political and economic domains, as the nature of regional institution building without US participation attests.

None of this should allow us to under-estimate the continuing power and influence of the USA in the region. A growing Asian rhetorical resistance to US policy in the region (agency driven sources of power and leadership) should not cause us to neglect the residual and continuingly strong structural influences from the US, what Joseph Nye (2002) would call 'soft power', especially in the context of a continuingly strong support for the broad neo-liberal economic agenda.

In the continued absence of global structures of economic governance (not a real prospect) we must expect policy makers to explore more manageable alternatives. Traditional state-centric, power politics approaches to the management of the world order under conditions of globalisation are becoming less salient. More diffuse networked understandings of power, with loosely institutionalised regulatory actions providing a *modus operandi* for co-operation are becoming increasingly attractive. It is here that regionalism and multi-level governance, for all its faults and all its detractors, offers the bones of an alternative model. It is also the level that is proving of interest in parts of the world such as East Asia. The European experience is not, of course, simply an 'off the shelf' export model. It will be adjusted and developed, and while some elements will be adopted in other parts of the world, some key elements will also be resisted.

Conclusion: Towards the Regulatory Regionalism in the 21st Century

Both the practice and theory of regionalism are undergoing a period of significant change. The key element of this is a shift from a Cold War to a post Cold War/globalisation era. During the Cold War, regionalism was primarily statist, largely European-influenced, and stressed inter-governmental bargains. Regionalism in the era of globalisation is more complex, multidimensional and, notwithstanding the increased salience of security issues post 9/11, still primarily political economy focussed. In the first era, the 'economic' and the 'political' were largely treated as separate issue areas for investigation and action. In the second era, politics and the economics are more clearly linked and the state is joined by a series of other significant, non-state actors in the practice of regionalism. The relationship between state authority and market power is much fuzzier.

In addition, the early Balassian model, based on a reading of the evolution of the EU, no longer stands scrutiny in the context of globalisation, where guarding against the volatility of the erratic mobility of capital is in many ways now a factor of as great, if not greater, regional concern than guaranteeing the openness of the trade regime. Balassian theory pays insufficient attention to the possibility of different routes to, or different agendas for, regional cooperation. It is also too silent on the significance of socio-cultural factors—especially the role of identity in region building—to be relevant in an era of globalisation. In this sense, the contemporary discussion in East Asia illustrates the differences between the two eras and offers us an alternative reading of regionalism in a wider global context. The glue of regionalism at the level of the Asia Pacific—embodied in APEC—has come unstuck since the time of the Asian financial crisis. Events post-9/11 have merely exacerbated this trend.

The discussion of PTAs with the USA by many states of the region suggests an interest in positioning themselves on a firmer bilateral basis in their relations with the USA. For most states of the region, notwithstanding the increasingly important role of China, the relationship with the US remains the major bilateral relationship. For the smaller partners it is not an easy one. The Bush administration has been the most self-regarding US administration any post-colonial Asian leaders have known. Its regional posture has not been noted for nuance. Often failing to differentiate between individual states, it sees the East Asian region as a problematic partner. This is especially the case with Southeast Asia, to the intense irritation of the Singaporeans, Malaysians and Thais, all of whom have clamped down strongly on prospective terrorists.

East Asia is a region of economic experimentation. Asian policy communities have learned that globalisation and regionalisation are not mutually exclusive activities but rather exist in a dialectical relationship. Regionalism is not an alternative to globalisation. Following this logic allows us to explain the emergence of a multiplicity of policy responses to recent economic issues in the Asia-Pacific. These responses reflect, in part at least, Asian resistance to western driven models. Specifically, the financial crisis of the late 1990s forced regional scholars and policy makers alike to examine not only their national economic policies, but also their very understanding of regionalism.

The regionalism we see emerging in the early 20th century is not the kind of regional cooperation that has a necessarily European intellectual pedigree. Rather it is what we call in this report 'regulatory regionalism' that links national and global understandings of regulation via the intermediary regional level. Effectively, regionalism is a transmission belt for global disciplines to the national level through the de-politicising and softening process of the region in which regional policy coordination—evolving regional governance—becomes the 'meso' link between the national and the global. As a multi-level exercise it reflects three trends:

- A significant point about contemporary regionalism in Asia is that the growing regulatory urge is not simply restricted to trade. Indeed, it is in the area of monetary regionalism that it is advancing most rapidly. The key to monetary regionalism is closer integration through common national 'regulation' rather than regional institution building.
- In discursive terms, 'regional regulation' carries fewer negative connotations for sovereignty and regime autonomy than 'regional institution building'. Institution building throughout the pre-crisis days in East Asia carried with it the unwanted implication of European style 'sovereignty-pooling'.
- Europe's immediate past is not Asia's immediate, or indeed long-term, future. The development of a corpus of regulatory governance at the regional level in East Asia, rhetorically at least, carries none of the sovereignty-shedding baggage we associate with the European integration process.

Conclusions

The picture of regional integration that emerges from Europe and Asia is one of two very different processes, a top-down approach in the case of Europe and a bottom-up one in the case of Asia. For Europe's founding fathers, there was an institutional prerequisite for European integration. Asians by and large do not share Europeans' reverence for institutions. Before the 1997 crisis "European legal formal cartesianism" was a derogatory term in Asia. The top-down nature of the European integration process has not stopped it growing strong roots in the general public, however much one may be tempted to say today, in the wake of the referenda in France and the Netherlands, that they are not strong enough. It has been driven in part by a strong political commitment, on both sides of the Rhine, to bury the legacy of three disastrous wars over a period of just seventy years: in such circumstances, Germany and France quite naturally assumed the role of leaders. They became the engines of the process. Asian integration has so far appeared to be much more of a trial and error exercise, pushed forward by a very small group of high ranking officials and central bank governors aware of the rewards to be reaped; the general public has not been a party to the process. There is no blueprint or overall design showing the way forward. There is no meaningful competition policy, nor is there any regulatory cooperation in the field of services the way there is in Europe. Grievances going back to the Second World War and beyond have not really been laid to rest and the process has not been seen and promoted as a way of laying them down to rest. Another major difference has to do with the role played by America, the role of a sponsor and of a benevolent godfather of integration, at least until the most recent period, in the case of Europe, while no such role appears in the case of Asia. And given that the two main regional players in East Asia are far from agreeing on what an appropriate agenda for regional integration should look like, and on what their respective roles in driving such an agenda forward should be, one can only conclude that the foundations for regional integration are not as strong in Asia today as they were in Europe. Japan is sometimes cast in the role of Britain, closely tied to America for political and security reasons and yet having a vital and growing interest in regional economic developments.

Where do we stand and what could we be looking forward to? The East Asia integration process, if indeed it does turn out to be a process, is still at a very early stage. A number of factors, which brought the European process to fruition, are missing. To-date, with the exception of early visionaries such as Kiyoski Komima, there are few far-sighted individuals offering a vision of where it should be heading, building on a contrast between a terrible past and a future of peace, reconciliation and prosperity, together with a grand design purporting to show how best to get from here to there. For the moment, there is no outside challenge or threat to concentrate minds on the need for unity. There is no real feeling that the region is sliding down a slope leading sooner or later to global irrelevance or even to oblivion, and that the slide needs to be arrested. There is no outside benevolent sponsor urging the different parties to repress their nationalistic instincts in the name of strength through unity. There are some large discrepancies between the different members of the group: the world's second largest economy is there together with a number of other developed economies, with a number of fast growing middle income economies and with a number of very poor developing economies. The cultural heritages of East Asian countries are far more varied than those encountered in Europe, and, leaving aside the Mekong Delta, there is no tradition in the field of "beyond the nation" governance, there are no over-arching regional institutions exerting real authority. If regional integration is to proceed, convergence will not be an easy exercise. For a number of countries that experienced colonialism in the recent past, there remains a kind of mystique surrounding the idea of national sovereignty: the colonial legacy certainly does not work in favour of regional integration programmes based on the pooling of sovereignty. East Asia does not seem to be taking the Balassa*[26] road to regional integration; it will probably not be developing along the lines and the stages he described in his seminal work on the subject.

China, supposing it has the will, will have some strong cards to play for the future of regional integration. If it wants to put together a regional integration plan to suit its interests, China will probably be taking into consideration, to a greater or lesser extent, the different comparative advantages of Hong Kong, Taiwan and Singapore, given the special relationships that exist with the three. It could be looking even further, to the overseas Chinese, who in a way form a natural constituency and who make up a majority of South East Asia's dynamic entrepreneurs.

The conclusion of this survey is that the future of regional integration in East Asia can be thought of in three different ways.

- The first scenario is basically a continuation of present trends. It would be a slow process, and it may well turn out to be only an exercise in managing the interests of the countries of the region as well as possible, in the wider framework of economic globalisation. In this case, it would remain essentially a bottom-up process, expressing *de facto* economic solidarities; there would be no transmutation, and it would be a case of soft, and, in many ways, superficial, integration. Moving towards a form of deeper integration would call for strong convergence in a number of areas, and that would in turn be predicated on the existence of a political will, of a political energy, that are not part of the premises of this scenario. The soft scenario, in other words, is constrained, and will not develop into anything different: it does not have a future. One can see it as the Chinese scenario in that it will play into the hands of the biggest players. China would be signing free trade agreements with its regional partners. Its position in the regional balance of power could be enhanced in much the same way the position of the United States was enhanced by NAFTA in North America. A variation on this base scenario, developed in the last section of the report by Professor Higgott, would see further advances of monetary integration as insurance against a repeat performance of the 1997 crisis. Regulatory regionalism, as opposed to regionalism based on new institutions, would be brought into play as the most appropriate means

[26] See the first section of the first chapter of Part I

to stabilise financial markets, notably by way of improving the poor state of the Chinese banking system. Too many Chinese and even some Japanese banks remain saddled with the burden of huge accumulated non-performing loans. In a more general way, regulatory cooperation is indispensable for services. It happened in Europe, but it is still not happening in Asia.

- The second scenario is a form of considered and well-designed interdependence of the willing. It implies a degree of political will and the resort to institutions to safeguard present regional equilibria which would otherwise be threatened. New institutions will need to be created and developed so that the necessary convergences are elaborated and decided, and so that integrated structures can live through economic and political downturns, and such institutions will need to be strong in order to provide the right balance, given the large asymmetries that are a feature of the region. The scenario would need to be grounded on a strong political initiative, and such an initiative could only conceivably come from Japan. There is currently no sign, no indication, that such an initiative is in the making. And there are few reasons to believe that it will be forthcoming, given Asian cultural values and the institutional approach that would be called for, an approach that appears to be alien to the Asian way of conceptualising international relations, as has been pointed out earlier.

- The third scenario sees regional integration as a consequence of an external shock, be it a financial and monetary shock similar to the one of 1997-1998, or a trade shock, such as the collapse of a major external market, i.e. a turn towards protectionism on the part of the United States or Europe. Such a shock could spur a move to counter the resultant vulnerability by embracing stronger economic integration. The end of the Bretton Woods fixed exchange rate regime in the early seventies laid the groundwork for the emergence of the euro in Europe, that is for the emergence of the monetary dimension of European integration.

For whatever reason, if the process does accelerate, then a number of political issues will come to the fore, and will have to be addressed. One such issue is the relationship between China and Japan. A kind of catharsis is called for: it has yet to take place. The Chinese and the Japanese are still too ready, sixty years after the end of the Second World War, to pour scorn on each other and that is a cause for concern.

Whatever the scenario, regional integration in East Asia will be hampered to a degree even greater than in Europe by a lack of popular support. European experience has shown how important the *demos* dimension, or rather the lack of it, can be. Strong institutions, however necessary for a deep-seated integration process, have shown themselves not to be sufficient. The people must have a stronger say in a development that will have major repercussions on their daily lives. In the final analysis, support has to come from the people and for that reason alone they must be brought into the game. An elite-driven process is not sustainable over the long run.

Annex: Data and Graphs

Table 2: Direction of trade of East Asian economies in 2004 (in percent)

Country	United States	Japan	European Union	Non-US Western Hemisphere	Rest of non-Japan East Asia	Rest of world
China						
Exports	22.8	12.4	18.1	4.6	30.1	12.1
Imports	7.7	16.1	12.4	4.8	39.4	19.5
Total	15.2	14.3	15.3	4.7	34.8	15.8
Hong Kong						
Exports	17.0	5.3	14.0	2.7	55.3	5.8
Imports	5.3	12.1	8.0	2.0	67.6	4.9
Total	11.1	8.7	11.0	2.3	61.5	5.3
Indonesia						
Exports	13.5	21.8	14.3	2.1	35.6	12.7
Imports	5.7	19.3	12.1	2.5	43.3	17.1
Total	9.6	20.5	13.2	2.3	39.4	14.9
South Korea						
Exports	17.8	8.3	13.8	6.3	41.4	12.5
Imports	12.7	21.6	10.8	3.4	28.8	22.7
Total	15.3	14.9	12.3	4.8	35.1	17.6
Malaysia						
Exports	18.8	10.1	12.6	1.8	44.6	12.2
Imports	14.6	16.1	12.1	1.6	47.4	8.1
Total	16.7	13.1	12.3	1.7	46.0	10.2
Philippines						
Exports	17.5	15.8	15.5	1.9	46.6	2.8
Imports	16.0	20.6	8.8	1.8	42.1	10.8
Total	16.7	18.2	12.1	1.8	44.3	6.8
Singapore						
Exports	13.0	6.4	14.5	2.1	51.9	12.1
Imports	12.7	11.7	13.5	1.4	45.2	15.5
Total	12.9	9.1	14.0	1.7	48.5	13.8
Taiwan						
Exports	18.0	8.3	11.3	n.a.	48.2	n.a.
Imports	13.2	25.6	9.9	n.a.	30.1	n.a.
Total	15.6	17.0	10.6	n.a.	39.2	n.a.
Thailand						
Exports	15.9	13.9	14.7	2.6	38.8	14.1
Imports	7.6	23.6	9.9	2.3	34.4	22.2
Total	11.8	18.7	12.3	2.5	36.6	18.2
Weighted average						
Exports	18.3	11.3	14.9	4.1	40.3	11.1
Imports	9.5	15.9	10.6	3.5	43.5	16.9
Total	13.9	13.6	12.7	3.8	41.9	14.0
Japan						
Exports	22.7	n.a.	15.8	5.4	47.6	8.5
Imports	14.0	n.a.	12.7	4.6	44.6	24.1
Total	18.4	n.a.	14.3	5.0	46.1	16.3
India						
Exports	18.4	3.5	22.6	3.4	22.9	29.3
Imports	7.0	3.5	23.1	5.2	24.2	37.0
Total	12.7	3.5	22.9	4.3	23.5	33.1

Source: Policy Briefs in International Economics, Number PB05-1, Institute for International Economics, August 2005, p. 4.

Table 3: GDP of the 6 founding Members States of the European Community (in 1990 dollars)

1958	GDP per capita	GDP
Belgium	6,306	57,085
France	6,922	310,008
Germany	7,377	400,533
Italy	5,244	259,449
Luxemburg	9,500	3,120
Netherlands	7,300	81,668

Source: Maddison 1995; European Economy 1999

Table 4: Degree of heterogeneity of the national economies involved in the regional integration processes

2004	**EU 15**	**EU 25**	**ASEAN 10 + 3**	**ASEAN 5 +3*** **
Human Development Gap*	22	49	126	112
GDP gap I (largest/smallest economy)	94,5	508,7	2348,8	51,2
GDP gap II (largest economy/region's average)	3,4	5,5	8,2	5,1
GDP per capita gap I (highest/lowest economy)	3,3	6,6	26,2	8,3
GDP per capita gap II (highest/region's average)	2,1	2,7	2,9	2,2
R&D gap I (biggest/smallest spending economy)**	6,6	11,5	31	31
R&D gap I (biggest/ region's average)**	2,4	3,2	4	2,6
Regional paymaster economic weight (%)	France-Germany 39,6	France-Germany 37,8	Japan 62,9	Japan 63,4
Regional paymaster demographic weight (%)	France-Germany 37,5	France-Germany 31,3	Japan 6,4	Japan 6,9
Total regional GDP ($billion)	8628	9040,7	6353,2	6295,4
Total regional population (millions)	379,1	453,5	2004,7	1855,9

* difference between the highest and the lowest ranking within this group of states
** % of GDP spent in R&D
*** ASEAN 5 = Indonesia,Malaysia, Philippines, Singapore, Thailand
Sources (UNDP 2004; IMF 2004)

Table 5: Comparison between the EAIP and the EIP

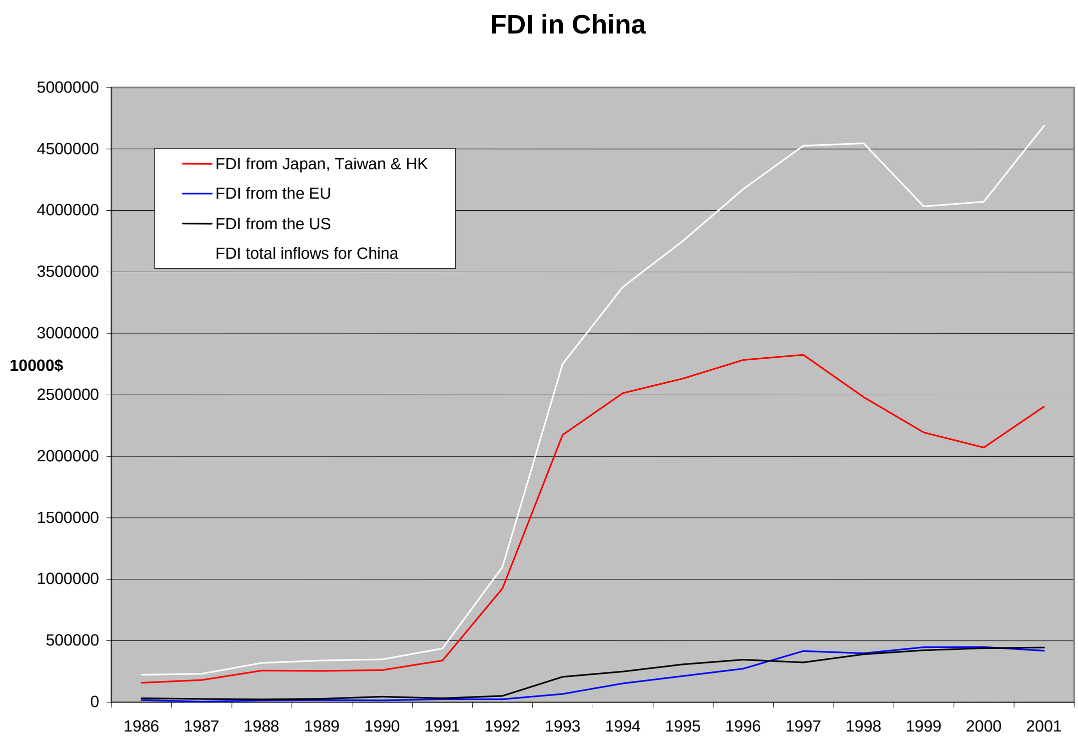
	Microeconomic Dynamics underlying the Integration Process		**Geopolitical Environment**		**Regional Heterogeneity**	
	East Asia	**Europe**	**East Asia**	**Europe**	**East Asia**	**Europe**
phase 1	none	reaping economies of scale (1947-1993)	Cold war	Cold war & benevolent referee (US Marshall Plan) 1948-1952 Franco-German axis	high	low
phase 2	post-fordist RPP (1985-2005) reaping economies of scale (1998-?)	post-fordist RPP (1985-2005)	End of Cold war no benevolent referee Strong US reservations Sino-Japanese mistrust	End of cold war enlargement Franco-German axis	very high	high

Table 6: Human Development Index Ranking and GDP : ASEAN+3 and EU 25

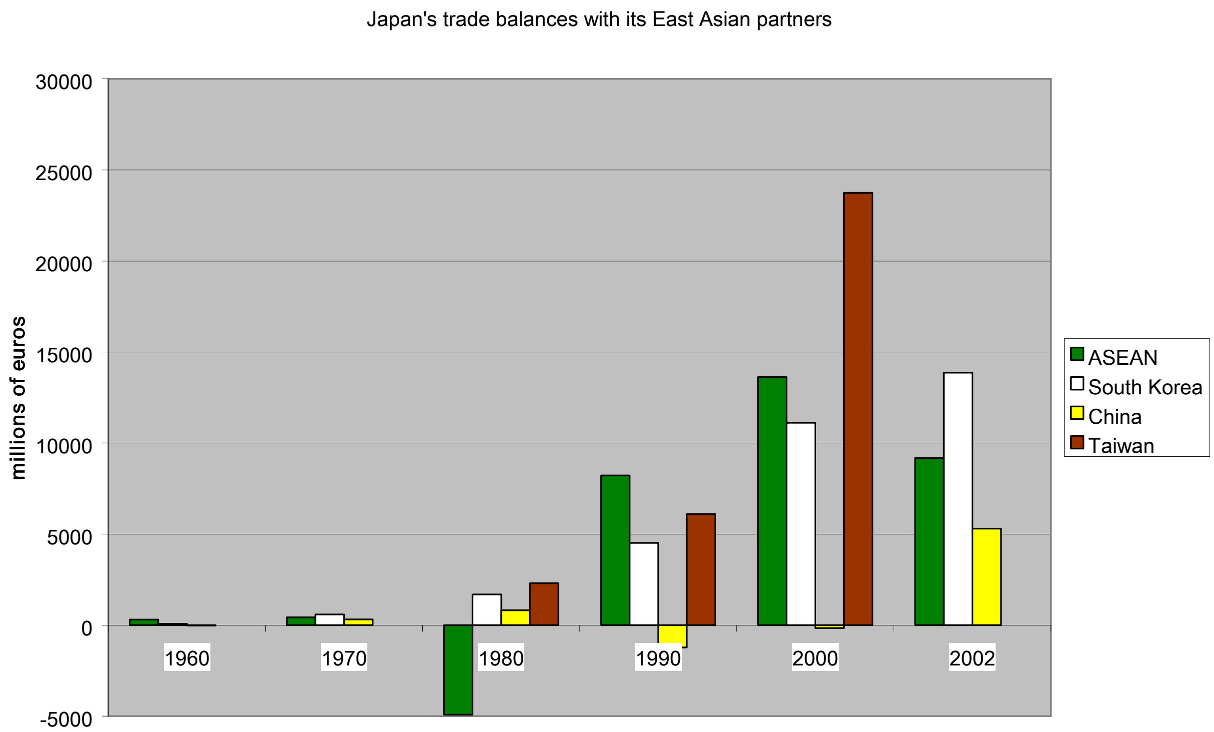
2004	HDI ranking	Nominal GDP (billion $)	GDP per capita PPP
Japan	9	3993	26940
China	94	1266	4580
ROK	28	476,7	16950
Singapore	25	87	24040
Philippines	83	78	4170
Malaysia	59	94,9	9120
Indonesia	111	172,9	3230
Thailand	76	126,9	7010
Brunei	33	4	19210
Vietnam	112	35,1	2300
Laos	135	1,7	1720
Cambodia	130	3	2060
Myanmar	132	14	1027
Sweden	2	240,3	26050
Netherlands	5	417,9	29100
Belgium	6	245,4	27570
Ireland	10	121,4	36660
UK	12	1566,3	26150
Finland	13	131,5	26190
Austria	14	204,1	29220
Luxemburg	15	21	61190
France	16	1431,3	26920
Denmark	17	172,9	30940
Germany	19	1984,1	27100
Spain	20	653,1	21460
Italy	21	1184,3	26430
Grece	24	132,8	18720
Portugal	26	121,6	18280
Slovenia	27	22	18540
Cyprus	30	10,1	18360
Malta	31	3,9	17640
Czech Republic	32	69,5	15780
Estonia	36	6,5	12260
Poland	37	189	10560
Hungary	38	65,8	13400
Lithuania	41	13,8	10320
Slovakia	42	23,7	12840
Latvia	51	8,4	9210

GRAPHS ON FDI & TRADE FLOWS

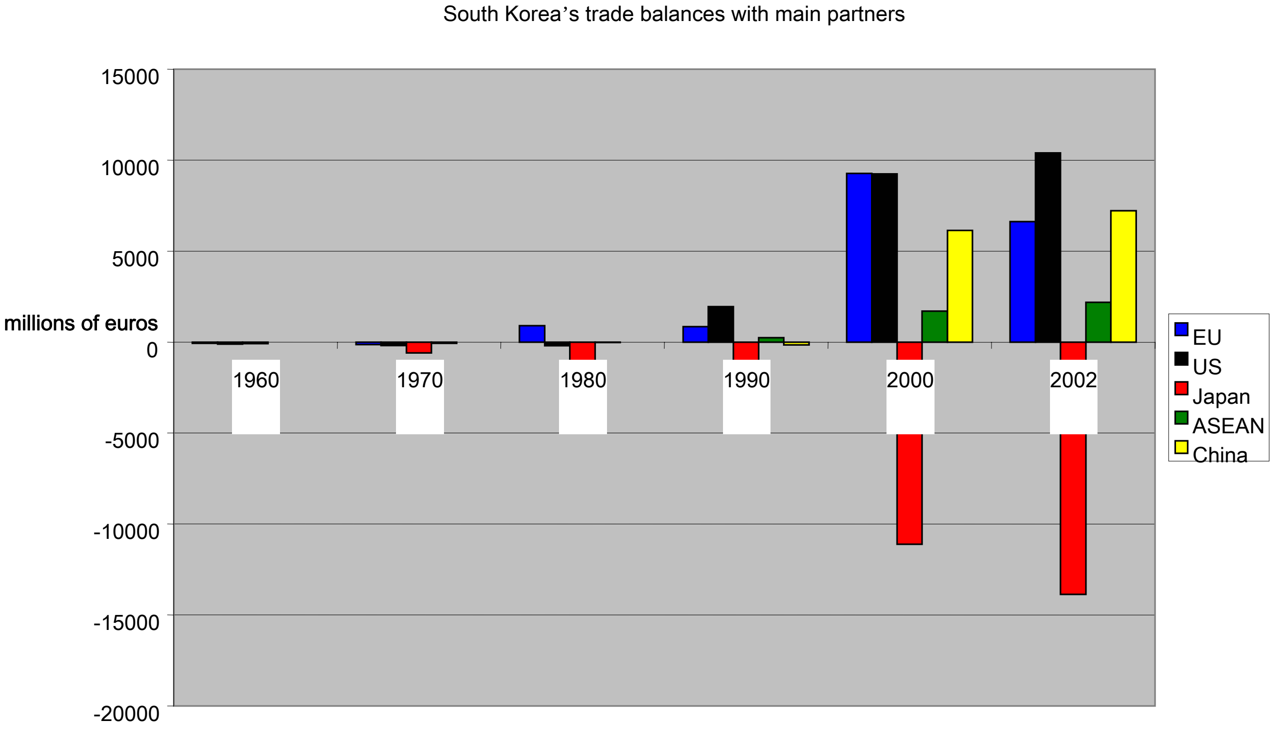
Graph 1.



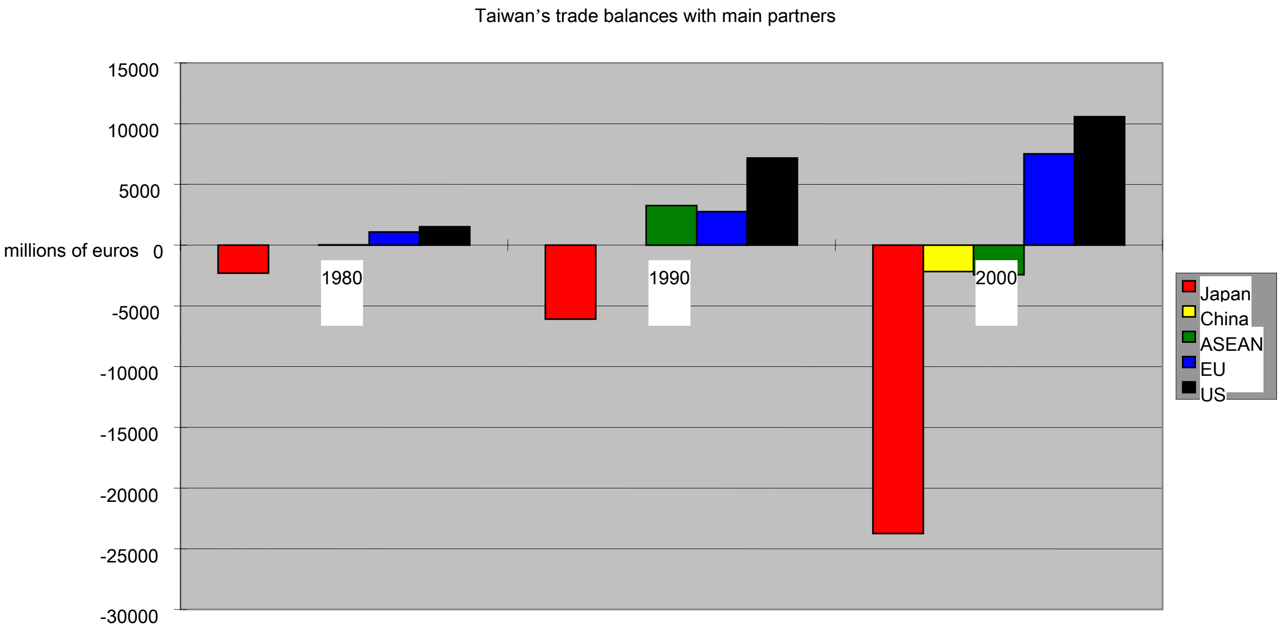
GRAPH 2.



GRAPH 2BIS.

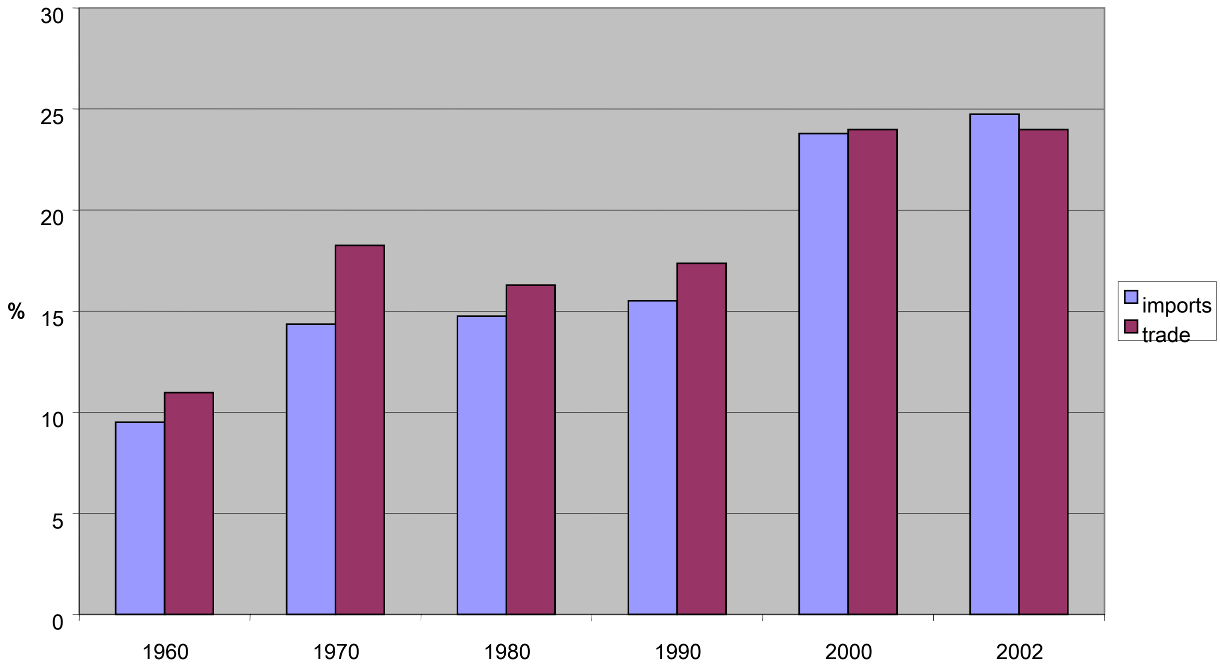


GRAPH 2TER.



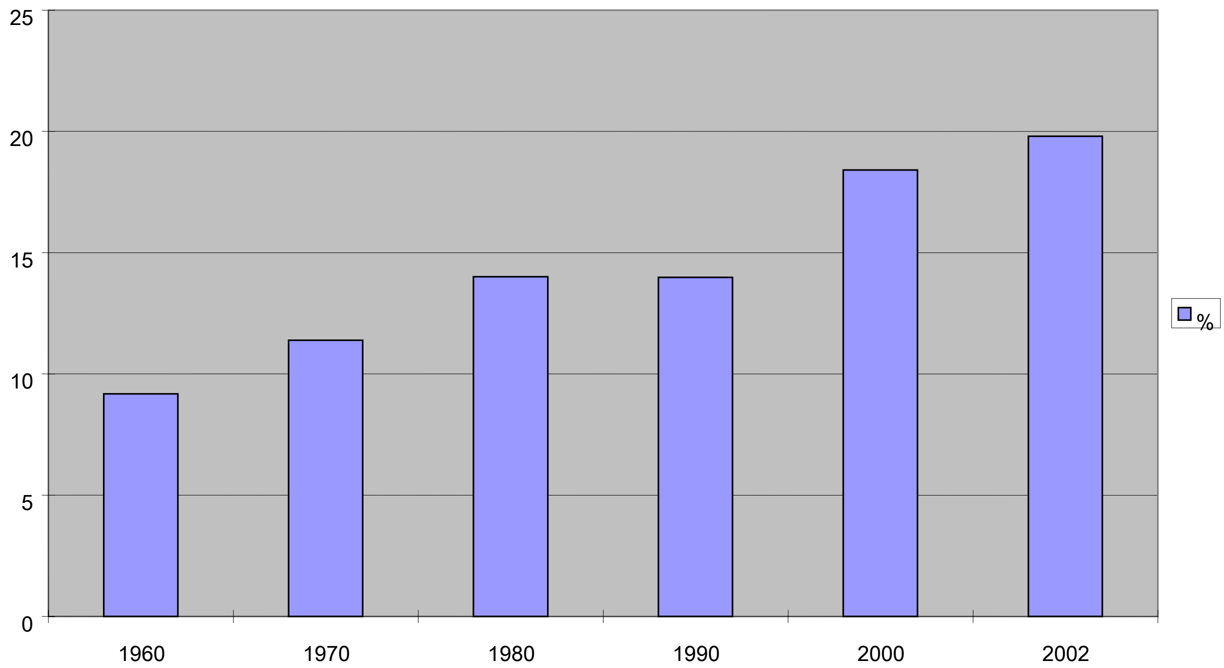
GRAPH 3.

Share of intra-ASEAN trade in foreign trade of all ASEAN economies



GRAPH 4.

Share of intra ASEAN+3 trade in foreign trade of ASEAN+3 countries



Sources : IMF 2004, CEPII 2004, MOFTEC 2003

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