

# **East Asian Integration and U.S.-Japan Relations**

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## **Executive Summary**

### ***Political and Economic Aspects of Trade Integration***

As the economies of East Asia continue to expand, the issue of economic integration is occupying an increasingly important role within the international agendas of regional forums and individual states. This concern is driven by the changing realities of trade in the region, particularly the growth of intra-regional trade ties. To a certain extent, economic integration between the ASEAN states and the north-east Asian states of China, Japan and South Korea is not merely a goal but a de facto reality. This evolving interdependency is grounded on two developments: the dis-aggregation of supply chains, with many intermediate goods passing from ASEAN states to China for final assembly, and the increasing role of China as a domestic market for finished East Asian products.

There are several formal processes in play that aim to further enhance these commercial links via trade liberalization and facilitation. Within ASEAN, efforts have been accelerated in the hopes of forming a comprehensive economic community from 2015. The aim is to broaden the scope of economic integration to goods, services and investment, unlocking scale effects and increasing competitiveness. Partially, this is motivated by increasing competition from China in high-end value-added products. A single cohesive ASEAN economy is also seen as a possible hub for approaches to wider regional integration.

Such trade negotiations also recognize the fact that there are significant political and geo-strategic gains that may be associated with forging such links. Panelists highlighted the opportunities open to both Japan and China to maintain their influence in South East Asia and to play a role in shaping regional norms between East Asian nations. Additionally, South Korea is also engaging with ASEAN, and is concerned not to be left behind in the context of evolving regional standards and deepening economic interconnections, at a time when the locus of the global economy is shifting towards East Asia.

### ***Issues of Scale, Scope and Pace***

Currently, wider economic integration is being pursued primarily along these three lines in the form of ASEAN + 1 Free Trade Agreements (FTAs), directed at China, South Korea and Japan respectively. However there is little consensus yet on the final scale of economic integration in East Asia. Several panelists argued that the ASEAN + 1 agreements, if mutually compatible, could pave the way for an ASEAN + 3, or East Asian, Free Trade Agreement (EAFTA). This 'building-block' approach would imply an incremental development of the regional

economic architecture. However there is still much debate as to whether this FTA could then be gradually expanded into an ASEAN +6, so as to include other nations such as India, Australia and New Zealand that also share strong economic links with the region. Aspirations towards any form of common market arrangement would suggest that the structure of this economic agreement should look to go beyond more basic trade deals. However, beyond ambition there is an overall lack of consensus on the overall scope of such an arrangement, particularly in trade related areas of intellectual property rights, labor and environmental concerns. Additionally, there are still differences between partners regarding the actual pace of the liberalization process, with China favoring 'early harvest' sequential implementation of changes, as opposed to a simultaneous process.

In terms of pursuing trade liberalization, there was a significant support from several members of the panel for continuation of the multilateral Doha round of World Trade Organization negotiations. This may represent the most effective means of facilitating further East Asian economic integration. The pursuit of regional measures should not be seen to detract from the commitment of East Asian states to the WTO process. However, with these negotiations apparently stalled for lack of consensus, attention has redoubled on the possible regional, sub-regional and bilateral alternatives.

As several panelists highlighted, such regional agreements both require significant torturous negotiation and are still some distance over the immediate horizon. In this context, bilateral FTAs were considered as a stop-gap tool for promoting East Asian regional integration. Such agreements, whilst providing much more limited economic gains, may play a role in developing capability in trade negotiation, inculcating a free trade consensus regionally. However there is the possibility that bilateral trade agreements lead to a misallocation of economic resources that harms third-party economies. The proliferation of bilateral FTAs in recent years has led to a 'spaghetti-bowl' effect in the region, which may impose complex transaction costs on multi-national corporations seeking to enter multiple markets.

### ***Implications for Japan***

The process of East Asian economic integration is not only the focus of sustained regional political initiatives, but a growing de facto reality in an area set to become the future heart of the global economy. Japanese firms are increasingly embedded within regional supply chains, utilizing the comparative advantages of a spectrum of East Asian economies to increase the efficiency of their production processes. At the same time, however, the growth of these economies has bred a new generation of competitors within the high-end technology markets. As the largest regional economy, Japan faces both new market opportunities but also new competitive challenges as this process of economic integration continues to intensify.

Panelists suggested that as economic integration continues in East Asia, Japan will increasingly focus on providing the advanced manufacturing, research and managerial capabilities needed to power the global expansion of the regional economy. However, there is recognition that to further develop these capabilities, the Japanese economy will have to boost its growth through increased efficiency. Individual panelists suggested some obstacles that Japan will have to overcome. Firstly, Japan's aging population is set to place a growing strain on the economy in the coming decades, with a shrinking population actually detracting from GDP growth. Secondly, the financial sector and tax code will require reform, in order to promote more innovative investment. Related to this, Japan should also seek measures to promote further Foreign Direct Investment. Finally, industries that are over-regulated and subsidized, such as agriculture, will need to be opened up in order to ease barriers to formal trade negotiations.

These reforms will certainly benefit Japan's prospects of concluding a Comprehensive Economic Partnership with East Asia. To complement this process, several members of the panel recommended that Japan also pursue a Comprehensive Economic Partnership Agreement with the United States. Such an agreement would not only lay the ground work for deepened US economic links to the region, but would also open new avenues for technology transfers and cooperation between the United States and Japan that would benefit both economies. Furthermore, these panelists contended that such engagement is not only in Japan's interest, but in the interest of East Asia in general.

### ***Implications for the United States***

As the setting for the overriding strategic and economic concerns of United States foreign relations over the long-term, this process of integration in East Asia has a variety of implications for the United States as well as for Japan. The US has strong links to the region, built around the keystone of the US-Japan alliance, and the United States continues to play a vital economic role as both a vast market for East Asian products and as a source of new technology flows. Former Deputy Secretary of State Richard Armitage stressed that the US-Japan alliance was of central importance in US global strategy, and that mutual reinforcement of the bilateral relationship was a vital priority in maintaining US relevance in East Asia. According to Mr. Armitage, this relationship remains so important because it is grounded in shared values and concerns, but needs to evolve to meet the current demands of the future, which will necessarily require Japan to assume a stronger 'co-pilot' role. Part of this should involve Japan expanding its links to ASEAN nations, a move which will aid Japan economically as well as further securing a place for the alliance within the process of regional integration.

However, there are challenges to the expansion and intensification of this core relationship. Prospects for a FTA between the United States and Japan still

remain limited, due to continued differences regarding agricultural liberalization. In terms of direct engagement with the economic integration of the region, several individual panelists strongly supported the US pursuit of an APEC-centered trade architecture, such as the Free Trade Area of the Asia Pacific (FTAAP) proposed at the Hanoi summit. Panelists noted that there had recently been increased US interest in the economic aspects of APEC, in contrast to the previous US focus on counter-terrorism coordination. In the absence of a resumption of the Doha round, it was suggested that this could provide an important avenue to ensure a US role in regional economic integration. Panelists also highlighted the possibility that movements towards US-ASEAN integration could also be facilitated off of the basis provided by existing bilateral and collective agreements between the US and several East Asian states. The importance of access to the US economy for East Asian states should continue to drive closer economic relations across the Pacific. Again, however, the extent to which these relations are broadened and deepened depends on the final consensus amongst East Asian nations regarding the desired size of the EAFTA area.

A major challenge to greater US participation in East Asian economic integration may, however, be domestic. As Rep. Adam Smith (D-WA) argued, the current domestic perception of a threatening global security environment combined with concerns over the effects of free trade on the make up of the US economy has the potential to significantly boost isolationist and protectionist sentiments at the expense of the trade agenda . In the wake of the recent Congressional elections, the shift away from the right towards more centrist positions may well lead to more uncertainty regarding the direction of trade policy, particularly in regards to the extension of the Presidential Trade Promotion Authority, as other concerns such as the environment, labor regulations and human rights are given greater emphasis within legislation. However, this new political environment certainly does not preclude the emergence of a robust US trade agenda during the 110<sup>th</sup> Congress.

## **Conclusion**

East Asian economic integration has progressed significantly as companies have diversified production to take the best advantage of the region's growth. This process continues to be paralleled by and extended upon through formal trade negotiations centered on the ASEAN sub-regional grouping. Though there appears to be strong support amongst states to form a free trade area within the region, there is a lack of consensus on both the scope of trade provision, and indeed on what constitutes a suitable boundary to the area. Additionally, there seem to be divergent approaches on how to go about institutionalizing such an architecture, particularly between Japan and China.

This process has major implications for both the United States and Japan. Japan is clearly already a deeply embedded actor within this rapidly integrating East

Asian economy, yet it faces major reform challenges that will be difficult to handle without support. For the United States, growing East Asian economic integration raises fears of being locked out of potential regional benefits. However, this possibility is as much driven by domestic unease with the free trade agenda as it is by difficulties of negotiating such an agreement with East Asia. The conclusion to be drawn is that in the 21<sup>st</sup> century Japan and the United States need each other more than ever. Their common interests are increasingly entwined, strategically, economically and ideologically, and for both states to remain successful stakeholders in the region, they must discover ways to strengthen their bilateral relationship.