

A SEARCH FOR CLOSER ECONOMIC RELATIONS IN EAST ASIA

By CHOONG YONG AHN[†] and INKYO CHEONG[‡]

[†]Chung-Ang University [‡]Inha University

In recent years, growing interdependence in East Asia through trade and financial cooperation heightened the need for East Asian Economies to engage in closer regional economic relations. This paper attempts to discuss emerging economic integration efforts in East Asia with special reference to bilateral and regional free trade agreements. It discusses backgrounds for recent developments of East Asian regionalism in terms of deepening intraregional economic dependence and financial cooperation, and South Korea's position towards FTAs with major trading partners as well as East Asian economic integration. Important issues and challenges for an East Asian FTA are presented.

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1. Introduction

The 1990s witnessed a global wave of free trade agreements (FTAs), but East Asia largely ignored the proliferation of regional trading arrangements (RTAs) and the subsequent regional integration phenomenon.¹ Until recently, East Asian economies, especially those in North-east Asia, had not developed any meaningful economic cooperation schemes. However, intraregional interdependence in trade and investment has been deepening in North-east Asia due to geographical proximity and sheer market forces. If East Asia accepts the newly emerging international trade environment, closer regional economic cooperation such as FTAs must be in order.

In recent years, the growing interdependence in East Asia through trade and financial cooperation heightened the need for East Asian economies to engage in regional economic cooperation and integration. The Asian financial crisis triggered a rising sense of East Asian identity and, in November 1999, the ASEAN + 3 (China, Japan and South Korea) Summit released the Joint Statement on East Asian Cooperation that outlines a wide range of possible areas for regional cooperation.²

In addition to the existing ASEAN Free Trade Agreement (AFTA), the three major North-east Asian countries—China, Japan and South Korea (hereafter Korea)—recently joined the FTA bandwagon. Furthermore, the 1997 Asian financial crisis brought about consensus among East Asian countries for closer regional economic cooperation to avoid a recurrence of another regional financial crisis. In particular, the framework for financial cooperation was consolidated in May 2000 by the ASEAN + 3 Chiang Mai Initiative (CMI), which involves a regional currency swap to provide self-help and support mechanisms.

This paper attempts to discuss emerging economic integration efforts in East Asia with special reference to bilateral and regional FTAs. Section 2 describes the background of

¹ In this paper, East Asia implies ASEAN and North-east Asian economies of China, Japan and Korea (CJK).

² The areas for cooperation were diverse, including trade, investment, technology transfers, e-commerce, agriculture, small and medium-sized businesses, tourism and the development of the Mekong river basin.

recent developments of East Asian regionalism in terms of deepening intraregional economic dependence and financial cooperation. Section 3 presents recent FTA developments in East Asia and Korea's position and policy direction. Section 4 discusses some important issues and challenges for an East Asian FTA, especially viewed by Korea. Section 5 concludes with some broad policy implications for East Asian economic integration.

2. The rise of intra-regional economic dependence and financial cooperation in East Asia

As East Asian countries have experienced disadvantages from the effects of regionalism in other regions, they have lately begun to consider establishing a regional trade bloc, realizing that without their own FTAs, they would be positioned at a disadvantage compared with North America and Europe. The 1997 financial crisis led East Asian countries to realize the need to strengthen regional economic cooperation. The relationship between East Asia's financial crisis and regionalism can be seen in studies by Bergsten (2000), Cheong (2002), Eichengreen (2003) and Yamazawa (1995).

Yamazawa (2001) asserts that the turning point in East Asian regionalism was the financial crisis. "Through the experience of that awful time, policy makers in this region acknowledged that they were not equipped to prevent and manage such a crisis. They were irked by their helplessness and undue dependence on the international financial institutions in Washington, and they began to toy with the idea of resolving their problems for themselves within Asia." Bergsten (2000) suggests that "another motivation for Asian regional initiatives is the failure of the existing international economic institutions to provide East Asia with a role consistent with its economic progress."

2.1 Rising dependence in intra-regional trade and investment

Given the already institutionally integrated ASEAN FTA (AFTA), we focus on integration efforts in North-east Asia, which shares roughly 90% of East Asian GDP. As seen in Table 1, East Asia accounts for about one-third of the world's population and slightly greater than one-fifth of the world's GDP and trade volume (and about 14.3% of global FDI). In terms of population, GDP and trade volume, East Asia is expected to have a similar economic potential as the EU and NAFTA in the years to come, provided that the region is properly integrated.

Table 2 shows the economic importance of key North-east Asian countries in the world in 2002 and the relative importance of each country in terms of trade. It is evident that China, Japan and Korea are key players in any integration process for East Asian economies. North-east Asia occupied 17.8% of world GDP in 2002. Adding Hong Kong to these three countries, its share reached 18.3%.

Trade between North-east Asian countries shared 12.8% of the world trade total (exports 14.0%, imports 11.7%) in 2002. When adding Hong Kong to China, Japan and Korea, they comprised 15.9% (exports 17.1% and imports 14.8%, respectively). Intra-trilateral trade between Korea, China and Japan shared 22.4% of their total trade with the world in 2002. With Hong Kong included, intraregional trade reached 33.6%.³

³ Trade transactions with China are routed through Hong Kong; therefore, each country's interregional trade might be overestimated.

TABLE 1
Economic profile of East Asia in the World (2002) (%)

| | Population | GDP | Trade | FDI (inflow) |
|------------------|-------------|-------------|-------------|--------------|
| East Asia† | 32.6 | 21.0 | 23.6 | 14.3 |
| North-east Asia‡ | 23.6 | 17.8 | 12.8 | 9.8 |
| ASEAN | 8.6 | 1.9 | 5.8 | 2.1 |
| EU | 6.1 | 26.7 | 37.2 | 57.5 |
| NAFTA | 6.8 | 36.5 | 20.6 | 9.9 |
| Other | 54.5 | 15.8 | 18.6 | 18.3 |
| World | 100.0 | 100.0 | 100.0 | 100.0 |

‡East Asia is defined as ASEAN plus three (China, Japan And South Korea), Hong Kong and Taiwan.

†North-east Asia is defined to include China, Japan and South Korea.

Sources: IMF (2004) *Direction of Trade Statistics Yearbook*.

Global Insight (2004) *World Economic Service*.

UNCTAD (2002) *World Investment Report 2002*.

TABLE 2
North-east Asian countries' share of global GDP and trade (2002) (%)

| | GDP | Intra-trade | Trade | Exports | Imports |
|--------------------------------|------|-------------|-------|---------|---------|
| Korea | 1.7 | — | 2.4 | 2.5 | 2.3 |
| China | 3.8 | — | 4.7 | 5.1 | 4.4 |
| Japan | 12.3 | — | 5.7 | 6.5 | 5.0 |
| Korea, China, Japan | 17.8 | 22.4 | 12.8 | 14.0 | 11.7 |
| Korea, China, Japan, Hong Kong | 18.3 | 33.6 | 15.9 | 17.1 | 14.8 |

Sources: IMF (2004) *Direction of Trade Statistics Yearbook*.

Global Insight (2004) *World Overview*.

The deepening trade interdependency, even in the absence of an institutional frame of regional cooperation within North-east Asia, is more distinct when we look at the trade intensity index (Table 3). The latter is usually used to estimate the degree of trade linkage between two countries.

As shown in Table 3, the trade intensity index of Korea with China was 0.08 in 1980. After the diplomatic normalization between China and Korea in 1992, the figure increased rapidly from 0.78 in 1990 to 2.84 in 1996 and 3.22 in 2001, continuously intensifying the economic cohesion between the two countries.

However, the trade intensity index between Korea and Japan declined from 2.39 in 1980 to 1.98 in 2001, showing that the intensity between the two countries has weakened slightly over time. It eventually stagnated: starting from 3.59 in 1980, the index fell to 2.47 in 1985, stagnating at 2.79 in 1991 and 2.86 in 2001. The trade intensity index of Japan with China also shows a drastic decrease and stagnation: starting from 3.71 in 1980, the indices declined to 3.18 in 1985, 1.52 in 1991 and were stagnant at 1.88 in 1996 and 1.98 in 2001.

ASEAN's trade intensity with China, Japan and Korea remained nearly unaltered except for a substantial decrease between ASEAN and Japan. The intraregional trade intensities among the three countries were all greater than one, indeed very high in absolute magnitude. This high trade intensity among the three countries is due to the intensified interdependence in terms of intraregional trade.

TABLE 3
Dynamics of the intra-regional trade intensity index in East Asia

| | Year | China | Japan | Korea | ASEAN |
|-------|------|-------|-------|-------|-------|
| Korea | 1980 | 0.08 | 2.39 | — | 1.97 |
| | 1985 | 0.06 | 2.23 | — | 1.56 |
| | 1991 | 0.78 | 2.61 | — | 2.02 |
| | 1996 | 2.84 | 1.88 | — | 2.03 |
| | 2001 | 3.22 | 1.98 | — | 1.92 |
| China | 1980 | — | 2.90 | 0.12 | 2.00 |
| | 1985 | — | 3.30 | 1.01 | 3.20 |
| | 1991 | — | 2.17 | 0.32 | 1.16 |
| | 1996 | — | 3.17 | 0.79 | 0.88 |
| | 2001 | — | 3.21 | 2.02 | 1.19 |
| Japan | 1980 | 3.71 | — | 3.59 | 3.05 |
| | 1985 | 3.18 | — | 2.47 | 1.98 |
| | 1991 | 1.52 | — | 2.79 | 2.41 |
| | 1996 | 1.88 | — | 2.57 | 2.63 |
| | 2001 | 1.98 | — | 2.86 | 2.59 |
| ASEAN | 1980 | 1.02 | 3.64 | 1.42 | — |
| | 1985 | 1.63 | 3.61 | 1.90 | — |
| | 1991 | 1.12 | 2.71 | 1.54 | — |
| | 1996 | 1.12 | 2.18 | 1.28 | — |
| | 2001 | 1.40 | 2.45 | 1.71 | — |

Notes: 1. The trade intensity index of country i is defined as $TII_{ij} = (X_{ij}/X_i)/(M_j/M_w)$, where X_{ij} is export from country i to j , X_i is total export of country i , M_j is total import of country j , M_w is world total import. TII_{ij} compares export from country i to j divided by total export of country i to the ratio of import of country j divided by total world import. If TII_{ij} is greater than 1 then country i and j are related more closely than others. The index was computed using IMF, Direction of Trade Statistics Yearbook (various issues).

2. ASEAN data represent Indonesia, Malaysia, Philippines, Singapore and Thailand.

TABLE 4
Main economic blocs' share of intra-regional trade (%)

| | EU | | | NAFTA | | | North-east Asia | | | MERCOSUR | | |
|-------------------|------|------|------|-------|------|------|-----------------|------|------|----------|------|------|
| | 1980 | 1990 | 2002 | 1980 | 1990 | 2002 | 1980 | 1990 | 2002 | 1980 | 1990 | 2002 |
| Intra-regional | 57.3 | 64.5 | 61.7 | 33.2 | 37.2 | 45.8 | — | 12.7 | 22.4 | 9.7 | 11.0 | 13.8 |
| Rest of the world | 42.7 | 35.5 | 38.3 | 66.8 | 62.8 | 54.2 | — | 87.3 | 77.6 | 90.6 | 89.0 | 86.2 |

Notes: 1. EU: 15 Western European countries; 2. NAFTA: USA, Canada and Mexico; 3. North-east Asia: China, Japan and Korea; 4. Mercosur: Brazil, Argentina, Uruguay and Paraguay.

Source: IMF (2004) *Direction of Trade Statistics Yearbook*, historical and 2004.

Table 4 and Figure 1 compare the intraregional trade shares of the main economic blocs including North-east Asia. NAFTA increased its intraregional trade share from 37.2% (1990) to 45.8% (2002). MERCOSUR (a customs union in South America) recorded gradual growth of the intraregional trade share. At the same time, North-east Asia saw an increase of intraregional trade share from 12.7% to 22.4% during 1990–2002. The EU's intraregional trade had the highest ratio of the main regional economic blocs with around 60% over the last two decades (Table 4 and Fig. 1). However, the EU's intraregional trade decreased slightly in 1990–2002 due to economic stagnation within the region. As East

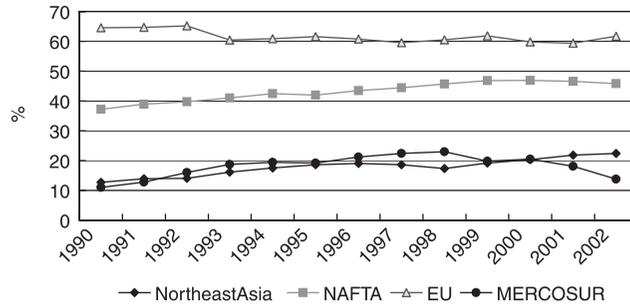


FIGURE 1. Intra-regional trade share of main economic blocs

Source: IMF (2004) *Direction of Trade Statistics Yearbook*.

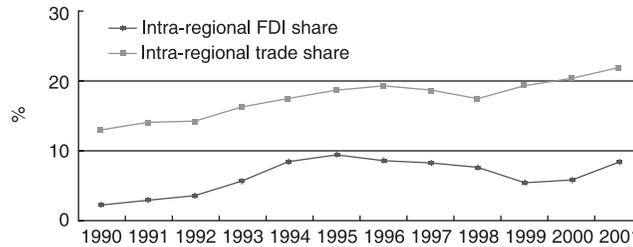


FIGURE 2. Intra-regional FDI and trade share between Korea, China and Japan

Source: Ministry of Commerce, Industry, and Energy, Korea (2002) Trends of FDI; Bank of Korea, FDI Statistics, various issues; Office of External Trade and Economic Cooperation, Yearbook of External Economy & Trade, various issues; China Statistics Press, China Statistical Yearbook, various years; UNCTAD, World Investment Report, various issues; IMF (2002) *Direction of Trade* (www.jetro.go.jp/ec/j/trade).

European countries became official members of the EU in May 2004, intraregional trade increased once again.

Figure 1 shows that the intraregional trade shares of North-east Asia and MERCOSUR increased rapidly in the 1990s. Compared with EU and NAFTA at 60% and almost 50%, respectively, which were nearly constant in the late 1990s, the intraregional trade shares in North-east Asia as well as MERCOSUR are still quite low. As Scalapino's (1991) natural economic territory states, when formal economic agreements such as FTAs are introduced in North-east Asia, intraregional trade and the subsequent economic gains are expected to increase due to trade creation effects and augmented investment on the basis of geographic proximity and an expected reduction of logistic costs.

As another indicator of increased economic interaction in North-east Asia, intraregional foreign direct investment (FDI) has also increased to take advantage of reduced production costs and to secure shares of the expanded market. Figure 2 shows that after 1990, FDI between China, Japan and Korea increased rapidly until the mid-1990s but declined during the Asian financial crisis. Since 1999, however, trilateral FDI has risen again. It is worth noting that the cross-border movement of trade and investment in North-east Asia seems to mutually reinforce each other. Therefore, the introduction of regional FTAs and follow-up market expansion will not only increase intraregional FDI, but will also attract foreign investment from outside East Asia.

2.2 Financial cooperation in East Asia

In addition to the rise of the functional integration process in trade and investment by sheer market forces, there has been a remarkable development in the area of financial cooperation in East Asia. The Asian financial crisis has provided East Asian economies with a new perspective on regional cooperation matters. As a self-help and support mechanism for regional financial cooperation, the CMI was a significant turning point. The search for a regional cooperation mechanism that could forestall future crises is now gathering momentum and opening the door to possible significant policy-led integration in East Asia (Henning, 2002).

Bergsten (2000) foresees that because of the financial crisis and the non-discriminatory nature of financial cooperation, East Asia's institutional economic cooperation or potential integration movement might come first in the financial area. As a follow-up to the ASEAN + 3 CMI, there is a critical need for East Asian countries to establish an institution that allows mutual consultation regarding exchange rates, interest rates and foreign exchange reserves.

As occurred during the Asian financial crisis, if the channels of contagion cannot be blocked off through multilateral cooperation at an early stage of a crisis, countries with insufficient foreign reserves might not be able to survive a financial crisis. Without sound financial institutions and adequate regulatory regimes, Asian financial markets will remain vulnerable to external shocks. Therefore, regional policy dialogue should contribute to strengthening the restructuring of financial markets and institutions in East Asia. In this regard, it is equally important that East Asian countries continue to undertake respective financial sector restructuring and development.

In this context, three pillars of liquidity assistance—monitoring, surveillance and exchange rate coordination—are essential elements for regional financial and monetary cooperation. However, the development of regional financial cooperation and its related institutions will be evolutionary, as evident in the case of European monetary integration. A shallow form of financial cooperation may comprise no more than a common foreign reserve pooling, or mutual credit arrangement such as bilateral swaps. In connection with regional trade facilitation, some kinds of shallow financial cooperation are conceivable without any commitment to exchange rate coordination under which the exchange rates of the participating countries are pegged to each other or vanish through the adoption of a common currency. East Asian countries presently appear to be pursuing this form of financial cooperation. Although a fully fledged form of monetary integration is not viable at this stage, East Asia may begin to examine the feasibility and desirability of cooperation and coordination in exchange rate policies.

After the Asian financial crisis, Fischer (1999) suggested that greater exchange rate flexibility would be desirable in the future, while others suggested more stable exchange rates against the yen might be preferable (Ohno, 2000). However, McKinnon (2001) suggested a modified East Asian dollar standard to curb hot money inflows while observing a resurrection of the East Asian dollar standard and continuing stability of the dollar exchange rate in the postcrisis period. In order to facilitate further ongoing intraregional trade in East Asia, a stable and coordinated exchange rate mechanism must be in order. However, at the same time, region-wide financial sector restructuring and coordination must again be a fundamental prerequisite.

In order to expedite the CMI process, Japan has been playing a leading role in terms of both the number of bilateral swap agreements (BSAs) and the amounts committed under

TABLE 5
Progress on the Chiang Mai initiative (as of 30 September 2003)

| BSA | Currencies | Conclusion dates | Amount (US\$) |
|-------------------|---------------------|-----------------------|------------------------|
| Japan-Korea | USD/Won | July 4, 2001 | \$7 billion (a) |
| Japan-Thailand | USD/Baht | July 30, 2001 | \$3 billion |
| Japan-Philippines | USD/Peso | August 27, 2001 | \$3 billion |
| Japan-Malaysia | USD/Ringgit | October 5, 2001 | \$3.5 billion (a) |
| PRC-Thailand | USD/Baht | December 6, 2001 | \$2 billion |
| Japan-PRC | Yen/Renminbi | March 28, 2002 | \$3 billion equivalent |
| PRC-Korea | Won/Renminbi | June 24, 2002 | \$2 billion |
| Korea-Thailand | USD/Baht | June 25, 2002 | \$1 billion |
| Korea-Malaysia | USD/Ringgit | July 26, 2002 | \$1 billion |
| Korea-Philippines | USD/Peso | August 9, 2002 | \$1 billion |
| PRC-Malaysia | USD/Ringgit | October 9, 2002 | \$2 billion |
| Japan-Indonesia | USD/Rupiah | February 17, 2003 | \$3 billion |
| PRC-Philippines | USD/Peso | Negotiation completed | \$1 billion |
| Japan-Singapore | Under negotiation | | |
| PRC-Indonesia | Under negotiation | | |
| Korea-Indonesia | Under consideration | | |

Note: (a) The US dollar amounts include the amounts committed under the New Miyazawa initiative—\$5 billion for Korea and \$2.5 billion for Malaysia.

the BSAs: Japan concluded six agreements (with Korea, China, Indonesia, Malaysia, the Philippines and Thailand) and is currently negotiating another agreement with Singapore. Korea, which concluded four agreements with China, Malaysia, the Philippines and Thailand in addition to the Japan-Korea BSA, is also expected to conclude BSA negotiations with Indonesia (see Table 5).

Most East Asian countries that are willing to participate in regional financial cooperation agree in principle that the CMI needs to be supported by an independent monitoring and surveillance system. The system should be able to: (i) monitor economic performances in the region; (ii) serve as an institutional framework for policy dialogue and coordination among the members; and (iii) impose structural and policy reform on the countries drawing from the BSAs.

As East Asian economies grow more open and interdependent, they are becoming vulnerable to international disturbances, given the high degree of capital mobility across the globe. The spread of capital mobility makes it difficult for a single small country to retain its pegged exchange rates. Forming a single currency region may be desirable. Currently, such a currency area is a very distant prospect. The lack of political commitment and experience with regional cooperation in East Asia are decisive factors against the formation of a common currency area in the near future.

Therefore, a transition process, to form a quasi-monetary bloc for example, remains a viable option for East Asia. Kwack *et al.* (2003) suggest that a new organization be formed to assess necessity and desirability and coordinate and implement the steps necessary for the formation of a quasi-monetary union. The coordinating institution should provide the framework for implementing unified systems for flexible exchange rates and a flexible inflation target to all member countries. At present, however, flexible exchange rate systems together with flexible inflation targets are suitable to attain the objectives of lowering the costs of external shocks and keeping inflation low. In addition, the coordinating institution should monitor the progress of financial reforms and

development. The financial system should be improved and good fiscal performance should be attained.

If the systematic implementation of financial coordination and the coordinating institution can establish a quasi-monetary bloc, it may lead to political and economic convergence in East Asia. This is a necessary process toward establishing common monetary standards. Increasing intraregional trade, a regional FTA and capital investment will work toward the formation for a common currency area, as discussed in Kwack *et al.* (2003).

China and Japan have been, and continue to be, important economic and political leaders in East Asia, and each has problems that will need to be resolved before asserting economic and political leadership in Asia. Both will play a leading role, with neither dominating the Asian transition process. An absence of single clear leadership or coordinated dual leadership might hamper East Asia from forming a common currency bloc, but there will still be room for the pursuit of regional monetary and financial cooperation.

3. Recent developments toward FTAs in East Asia

Recently, there has been both a growing interest in FTAs in East Asia and a rapid functional integration process. The newly emerging enthusiasm for FTAs in East Asia can be attributed to a set of factors: proliferation of regionalism worldwide; the intensified integration process of EU and NAFTA; the East Asian financial crisis; East Asia's awareness of the need to boost its economic cooperation; China's WTO accession; competitive FTA initiatives by China and Japan; and the expansion of East Asian policymakers' networks through various meetings.

There are approximately 162 cases of various regional trade agreements reported officially to the WTO at the end of 2005 (as shown in Table 6). Of the total existing arrangement, 135 cases were established after 1990, 102 of which were reported after the launch of the WTO (January 1995).

Until recently, East Asian countries, especially North-east Asian countries have pursued multilateral free trade regimes under the WTO. Japan's FTA with Singapore came into effect in February 2002. China offered tariff reductions to less-developed ASEAN members effective in 2004 on 500 agricultural products under the Early Harvest Package. In November 2004, China and ASEAN announced the conclusion of market access to manufacturing products in their bilateral FTA, leaving investment and market openings for the services sector to be negotiated. Korea began to implement an FTA with Chile in April 2004, and concluded the negotiation for an FTA with Singapore in April 2005. Currently, Korea is pursuing bilateral FTAs with Japan, the European Free Trade Area (EFTA) and ASEAN.

TABLE 6
Number of FTAs in the world

| | 1955–60 | 1961–70 | 1971–80 | 1981–90 | 1991–95 | 1996–2000 | 2001–2005 |
|------------|---------|---------|---------|---------|---------|-----------|-----------|
| NEW | 3 | 3 | 11 | 10 | 33 | 39 | 63 |
| CUMULATIVE | 3 | 6 | 17 | 27 | 60 | 99 | 162 |

Note: As notified to WTO and effective as of 5 May 2005.

Source: WTO Committee for Regional Trade Agreement.

The main regional trade agreement in East Asia is the AFTA. Initially composed of six member countries including Malaysia, Indonesia, Thailand, the Philippines, Singapore and Brunei, AFTA was formed as a result of the fourth ASEAN Summit meeting in 1992. With Vietnam joining in 1995, Myanmar and Laos in 1997 and Cambodia in 1999, AFTA developed into a regional trade agreement overseeing the entire South-east Asian region.

The possibility of an East Asian FTA has been actively discussed at ASEAN + 3 meetings. An East Asian FTA was proposed by the East Asian Vision Group (EAVG)⁴ in a report to the ASEAN + 3 Summit in 2001, and the issue has been an important agenda at the succeeding ASEAN + 3 Summit meetings. The East Asian Study Group (EASG), which was assigned to follow up the proposals by the EAVG, also proposed mid- to long-term cooperative measures and additional subjects for study in its final report at the ASEAN + 3 Summit at Phnom Penh in 2002. Some of the measures proposed in the report are the transformation of the ASEAN + 3 Summit into the East Asia Summit, the establishment of an East Asia Investment Area and an East Asian FTA. Through the official studies by EAVG and EASG, the members of ASEAN + 3 began to realize the need for an FTA as a means of promoting economic integration in the region in the long term in response to ever-deepening economic integration in North America and Europe and to introduce institutional measures for trade and investment liberalization in the region.

The most dramatic change in the FTA policies of North-east Asian countries took place at the Singapore ASEAN-China Summit in November 2000, when then Chinese Premier Zhu Rongji proposed the possibility of an FTA with ASEAN. China is also actively promoting a bilateral FTA with ASEAN. China proposed tariff reductions on 500 agricultural items for ASEAN countries and announced its desire to conclude an FTA with ASEAN by 2004 at the Phnom Penh ASEAN-China Summit. Meanwhile, Japan also made it clear that it plans to promote an FTA with ASEAN within the next 10 years. It seems that "Japan, playing catch up with China, seeks a piece of the Free Trade Area pie."⁵ In other words, instead of playing a leading role in promoting East Asian regionalism, Japan was reacting passively to China's FTA policy. Recently, in addition to ASEAN-China FTA, ASEAN members have been discussing bilateral FTAs with Japan, Korea, India and Australia and New Zealand (through their trans-Tasman FTA). Table 7 summarizes a web of FTAs in progress in East Asia.

One of most important developments towards an East Asian FTA is China's progressive approach to East Asian regionalism. The biggest advantage for China with regard to its FTA policy is that once China's leaders promote an FTA within a certain region, the government can make rapid progress under its socialist system of centralized decision-making. This contrasts with Japan and Korea, where FTA negotiations could be obstructed by vulnerable industries and diverse interest groups. When China realizes the economic necessity of an FTA and believes that the internal and external conditions are ready, it will promote FTAs with its neighbouring countries in addition to ASEAN. The on-going trilateral

⁴ The East Asian Vision Group was composed of 26 representatives from 13 member countries (two representatives per country) and was assigned to produce a report for East Asian economic cooperation. The Vision Report was reported to the ASEAN + 3 Summit held in Brunei in November 2001. The report recommends that East Asia should pursue economic integration through the liberalization of trade and investment, developmental and technological cooperation and information technology (IT) development.

⁵ Quoted from the editorial of the *New Straight Times* in Singapore on 6 November 2002.

TABLE 7
Regional economic cooperation in progress (as of August, 2005)

| FTAs | Progress | | | | |
|-------------------|------------|-------------|--------------|------------|----------------|
| | Discussion | Joint Study | Negotiations | Conclusion | Implementation |
| AFTA | | | | | V |
| AFTA-China | | | | V | |
| AFTA-Japan | | | V | | |
| AFTA-Korea | | | V | | |
| AFTA-India | | V | | | |
| AFTA-U.S. | V | | | | |
| China-Japan-Korea | V | | | | |
| East Asian FTA | V | | | | |
| Japan-Chile | | V | | | |
| Japan-Canada | | V | | | |
| Japan-Mexico | | | | V | |
| Japan-Taiwan | V | | | | |
| Japan-Singapore | | | | | V |
| Korea-Canada | | V | | | |
| Korea-Chile | | | | | V |
| Korea-EFTA | | | V | | |
| Korea-India | | V | | | |
| Korea-Japan | | | V | | |
| Korea-MERCOSUR | | | | | |
| Korea-Mexico | | V | | | |
| Korea-New Zealand | | V | | | |
| Korea-Singapore | | | | V | |
| Korea-Thailand | | V | | | |

Source: Cheong (2003) and updates.

study⁶ on an FTA between China, Japan and Korea will be an important momentum for Korea's FTA policy in addition to that of China.

Japan had not paid serious attention to the formation of preferential trading blocs until 1998, emphasizing its consistent efforts to maintain free trade under the multilateral trading system. Korea's Ministry of Foreign Affairs (MOFA) had also held to a negative position toward regionalism until 1998. MOFA (1998) emphasized the problems of regional trading blocs and underlined the importance of strengthening the multilateral trading system. However, as Korea and Chile announced their plan to proceed with an FTA and China and ASEAN suddenly agreed to launch FTA negotiations within a concrete timeframe, Japan began to show a strong interest in entering into an FTA with Korea. Japan established its first FTA with Singapore in January 2002 and completed an FTA negotiation with Mexico in late 2004.

The development of leaders' networks has been an important factor in accelerating recent talks on East Asian regionalism. The ASEAN + 3 Summit first took place in 1997 when former Malaysian Prime Minister Mahathir unofficially invited the political leaders of China, Japan and Korea to ASEAN's 30th anniversary. This event sparked the acceleration of discussions on intraregional economic cooperation and consolidation in East Asia.

⁶ The Korea Institute for International Economic Policy (KIEP), China's Development Research Center (DRC) and Japan's National Institute for Research Advancement (NIRA) have undertaken a three-year joint study on the economic impact of trilateral FTAs, beginning in 2003.

After the financial crisis, East Asian countries realized the limit of an export-oriented developmental policy, mainly targeting the US market (Ahn, 2001, 2003). Being heavily dependent on a major export market (such as the USA) made East Asia vulnerable to negative effects stemming from the depression of the US economy and the growing US trade deficit and a stagnating world economy. Regarding this aspect, Munakata (2001) points out that the East Asian regional market should be integrated to stimulate regional demand. While East Asian countries are concerned about the “hollowing out” of industries triggered by China’s industrialization, they hope to make the most of China’s economic growth. Moreover, as the stagnation of the world economy causes a substantial reduction of East Asia’s exports to other regions, the incentive for East Asian countries to expand exports to China is growing.

While promoting an East Asian FTA, East Asian economies are likely to face tricky issues, such as the economic gap between member countries and a regional leadership issue. The ASEAN + 3 Summit discussed the possibility of an East Asian FTA in future ASEAN + 3 meetings, while recognizing the continuous global expansion of regionalism. However, China and Japan, the two hegemonic powers in the region have different interests and hence different strategies for economic integration in East Asia. Ahn (1996) and Cheong (2002) state that differences in the economic and military status of the two countries suggest that even if they manage to reconcile their troubled memories of the past, China and Japan may find it difficult to work together as equal partners for regional integration in East Asia.

3. Building an East Asian FTA: a roadmap and challenges

Despite political and social barriers, there is much to be gained from an East Asian FTA. Factors such as geographic proximity, complementary endowments of production factors and growing economic ties after the crisis will help in achieve this goal. As East Asia becomes a free market with the elimination of tariffs and non-tariff barriers, businesses will be able to expand exports and enjoy economies of scale. Moreover, the creation of a huge free market will bring dynamic benefits to member countries, for example, increased inflows of foreign direct investment, which will subsequently create more jobs and facilitate the transfer of advanced technology.

Other forms of dynamic benefits also exist. First of all, common standards for production technology, product regulations, distribution and after-sales services can be expanded across countries in the region. Even if these standards are in conflict with the standards of North America or the EU, the Asian countries can gain leverage during international standardizing negotiations by presenting a unified front (Igawa, 2001).

A rapidly emerging China has already changed the regional economic landscape and is likely to influence whatever mechanism an East Asian economic cooperation might take, as East Asian countries need to strengthen cooperation with China. With China’s admission into the WTO, its hosting of the Beijing Olympics in 2008 and the Shanghai EXPO in 2010, its economic and political position will be greatly enhanced not only in East Asia, but also in a global context. Obviously, an East Asian FTA offers a way to effectively access the Chinese market and at the same time strengthen economic cooperation with China. Of course, such effects could be derived through a bilateral FTA with China. However, more economic benefits could be gained under an East Asian FTA rather than under a bilateral FTA.

Some economists have proposed the restructuring of East Asia's development model after the financial crisis.⁷ So far, countries in the region have achieved high economic growth through increased exports to the US market. However, since the US demand for imports could wane with fierce competition in its markets and its growing trade deficit, it is time for East Asia to create its own demand for sustainable growth. The establishment of an East Asian FTA presents an effective way to go about creating this demand. Considering the deepening processes of both the EU and NAFTA, an East Asian FTA is likely to improve regional economic and social stability and contribute to strengthening the region's presence in the international community.

There are several possible ways to promote an East Asian FTA. Under current conditions, it may be difficult to promote an FTA covering the whole region in the short term, although it is the most economically desirable approach. Therefore, as the second best alternative, a simultaneous and/or piecemeal East Asian FTA should be phased in, starting with those agreements currently under discussion. For example, each country in North-east Asia can form a bilateral FTA with ASEAN and gradually develop and expanding those bilateral FTAs into a wider East Asian FTA. Another scenario is to establish an East Asian FTA based on bilateral FTAs currently under active negotiation. Japan has already concluded an FTA with Singapore (EPA); Japan and Korea entered formal negotiations on 22 December 2003; and China, Japan and Korea are pursuing respective bilateral FTAs with ASEAN. Sooner or later, East Asia will observe a regional web of bilateral FTAs. These bilateral FTAs will contribute to subregional trade liberalization and increase the need for an East Asian FTA while fostering a foundation for it.

However, a consolidation of different FTAs could be tremendously difficult because the different trade regulations under various bilateral FTAs would have to be standardized into one agreement. Cheong (2002) states that it is highly unlikely that an East Asian FTA will evolve by itself as a result of the amalgamation of bilateral FTAs. In addition, there is a possibility that the competition between China and Japan, with both currently vying for regional leadership, may be intensified through bilateral FTAs with ASEAN, making an East Asian FTA more difficult.

As Baldwin⁸ suggests, there is a danger that a hub-and-spoke bilateralism led by China and Japan might develop, as demonstrated in his 1994 study of the European trade arrangement. If this happens, "this arrangement tends to marginalize the spoke economies both economically and politically." It also leads to a profusion of FTAs that can make the whole region less attractive to foreign direct investment—an effect that might be called, in an Asian context, the "noodle bowl problem", creating a bicycle pattern of East Asian FTAs as shown in Figure 3.

The third option is to have North-east Asia create a China-Japan-Korea (CJK) FTA rather than having multiple bilateral FTAs and then to move in the direction of consolidating with AFTA. Wanandi (2000) supports this approach by presenting East Asia as able to establish an FTA across the region in the mid- to long-term through bilateral negotiations and through activation of subregionalism. He emphasizes that AFTA and a Japan-Korea FTA will play the most important role in forming an East Asian FTA.

⁷ For details about discussions on new East Asian development models following the financial crisis in search for robust an East Asian development model through mutual learning from development and restructuring experiences, see Ahn (2001).

⁸ See Baldwin (2003) and Baldwin (1994).

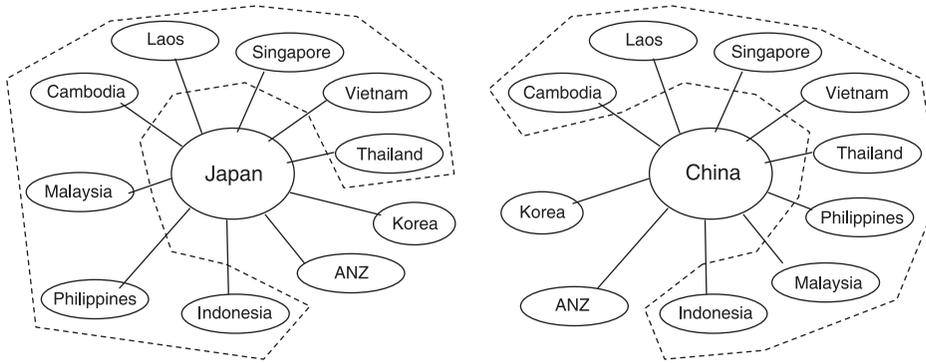


FIGURE 3. A possible FTA pattern: East Asian bicycle
 Source: Baldwin (2003).

Discussions on a CJK FTA and Japan-Korea FTA negotiations have been carried out simultaneously starting from 2003 but in the current environment the Korea-Japan FTA is likely to progress more quickly. This presumption is based on the fact that the two countries have discussed their bilateral FTA since 1999. Furthermore, in addition to negotiating their bilateral FTA, Japan and Korea should examine a scheme to invite China to participate in the two countries' FTA. In other words, Japan and Korea should develop their FTA as a benchmark framework for a CJK FTA in the medium term and an East Asian FTA in the long term. Thus, when Japan and Korea form an FTA, it should be designed with China in mind—as a potential partner in the not too distant future. If Japan is not ready to accept CJK FTA negotiations, Korea should accelerate its FTA negotiations with China along with the Korea-Japan FTA.

It would be ideal to have China as an initial member, but China is not ready to join the negotiation for an FTA between Japan and Korea. If Japan and Korea complete their FTA, then move to establish another FTA with ASEAN in order to gradually initiate an East Asian FTA, China will inevitably feel conflicted about whether to participate in the East Asian FTA discussions or to construct its own independent regionalism. From an economic perspective, it is desirable for China to participate in an East Asian FTA. Rather than participating in an FTA of Japan-Korea-AFTA led by Japan, China might pursue China-led East Asian regionalism by first concluding an FTA with ASEAN and extending it to Korea.

In addition to the technical difficulties involved in consolidating multiple FTAs, the sequencing of FTAs in East Asia can raise serious and often noneconomic issues such as the hub-and-spoke problem, regional leadership struggles and political instability. Moreover, without a clear understanding of the problems these issues could lead to, it will be difficult to construct a policy direction for East Asian economic cooperation. Countries tend to aspire to become a regional FTA hub country so that they can improve competitiveness by importing the most suitable raw materials from multiple spokes free of tariffs, further attracting FDI inflows. Moreover, in a new FTA discussion, a hub country has the advantage of settling existing agreements that can establish an agreement favourable to itself. In a specific region, a hub country could also display its political and economic leadership. This is one of the reasons why China is promoting an FTA with ASEAN and Japan is also promoting respective bilateral FTAs with Korea and ASEAN.

TABLE 8
Incremental growth impacts of FTAs in East Asia (%)

| FTAs in North-east Asia | | | | | | | | |
|-------------------------|-----------------|---------|-----------------|---------|-----------------|---------|---------|---------|
| | China-Japan FTA | | China-Korea FTA | | Japan-Korea FTA | | CJK FTA | |
| | TL | TL & CA | TL | TL & CA | TL | TL & CA | TL | TL & CA |
| China | 0.27 | 1.11 | 0.12 | 0.45 | -0.01 | -0.03 | 0.34 | 1.29 |
| Japan | 0.05 | 0.12 | -0.00 | -0.04 | 0.01 | 0.04 | 0.06 | 0.13 |
| Korea | -0.05 | -0.26 | 0.76 | 1.76 | 0.22 | 0.92 | 0.94 | 2.45 |
| ASEAN | -0.03 | -0.36 | -0.02 | -0.19 | -0.01 | -0.08 | -0.06 | -0.59 |
| ROW | -0.00 | -0.06 | -0.00 | -0.06 | -0.00 | -0.02 | -0.01 | -0.12 |

| FTAs in East Asia | | | | | | | | |
|-------------------|-----------------|---------|-----------------|---------|-----------------|---------|----------------|---------|
| | ASEAN-China FTA | | ASEAN-Japan FTA | | ASEAN-Korea FTA | | East Asian FTA | |
| | TL | TL & CA | TL | TL & CA | TL | TL & CA | TL | TL & CA |
| China | 0.076 | 0.441 | -0.02 | -0.12 | -0.01 | -0.07 | 0.36 | 1.39 |
| Japan | -0.007 | -0.076 | 0.04 | 0.09 | -0.01 | -0.05 | 0.10 | 0.17 |
| Korea | -0.025 | -0.177 | -0.04 | -0.20 | 0.13 | 0.65 | 1.01 | 2.84 |
| ASEAN | 0.229 | 2.077 | 0.43 | 3.19 | 0.41 | 2.17 | 0.73 | 4.00 |
| ROW | -0.004 | -0.075 | -0.01 | -0.05 | -0.00 | -0.04 | -0.02 | -0.22 |

Note: TL and CA refers to growth effects of trade liberalization and capital accumulation, respectively.

Source: Cheong (2002).

Cheong (2002) estimated the growth impacts of various FTA combinations using a computable general equilibrium model.⁹ His results show that the economic growth effects of trade liberalization (TL) alone are moderate, but introducing capital accumulation effects (CA) together with TL substantially increases the economic growth benefits (Table 8). For example, when the incremental growth effects are estimated under a China-Korea FTA scenario, China and Korea's GDP increase by 0.12% and 0.76%, respectively, taking into account the effects of trade liberalization only. However, if the effects of both trade liberalization and capital accumulation are considered together, Chinese and Korean GDP increase by 0.45% and 1.76, percent, respectively. The analysis shows that greater economic growth would be derived under a regional FTA like CJK or East Asia FTA.

Under North-east Asian FTAs, Korea is expected to gain relatively higher economic growth compared with China or Japan. Korea is forecasted to gain relatively more growth benefits from a CJK FTA than from a bilateral FTA with either China or Japan. As with other FTAs, it is estimated that Korea can realize greater growth due to capital accumulation effects rather than trade liberalization effects under an FTA with Japan. In addition, Korea can achieve higher growth gains under an East Asian FTA than under a CJK FTA. Based on this simulation result, it can be said that large-scale FTAs, such as an East Asian FTA, will be preferred to small-scale FTAs in the region.

⁹ Needless to say, an FTA model should be built in a dynamic context and needs to specify an investment equation in particular to take the expanded market into consideration. Any FTA modelling becomes difficult when reflecting plurilateral arrangements. Given a static CGE model, the expected rate of capital is considered in specifying investment equation to estimate capital accumulation effects due to increased investment for an expanded market. For the estimation of growth effects of various FTA combinations, see Cheong (2002).

For an East Asian FTA, competitive regionalism can be a problem. China and Japan are pursuing FTAs competitively for securing the leadership position in the region. Considering the rivalry between China and Japan, Japan's reluctant position towards an FTA with China, among others, East Asia may end up with two meaningful large-scale FTAs (the Japan-Korea FTA and the China-ASEAN FTA) in the near future. Japan and China may try to strengthen their respective leadership positions through their own FTAs with Korea and ASEAN, rather than make an effort to form an East Asian FTA by consolidating the two large FTAs. This may have unstable and destructive consequences for East Asian regionalism in the future. This situation should be avoided in East Asia. If neither Japan nor China can play an FTA hub function, the East Asian economy may suffer from Baldwin's (2003) spoke trap.

One of the ways to avoid the competitive leadership issue is to form a trilateral FTA between China, Japan and Korea. European experience shows that stronger economic cooperation substantially reduces political conflicts. The trilateral FTA can be an important stepping stone for an East Asian FTA and the follow-up integration process. Due to regional characteristics, an East Asian FTA may be realized only if it is promoted from a long-term perspective. On a purely economic point of view, constructing an East Asian FTA through amalgamating both CJK FTA and AFTA would be a more realistic approach than realizing it through a web of bilateral FTAs. In this regard, countries like China, Japan and Korea that have proposed FTAs with ASEAN should start examining the possibility of establishing an FTA among themselves first and then expanding it to ASEAN.

East Asian countries will face many economic and non-economic obstacles while pursuing region-wide economic integration. Among the economic challenges, there are the substantial differences in stages of economic development, trade barriers and market opening issues of agriculture. Non-economic factors might be more critical. Regardless of how important the CJK FTA is in terms of economic gains and strategic aspects, the three countries have different political, social and historical perspectives. Unfortunately, mutual distrust among the three North-east Asian countries is the most crucial factor impeding the conclusion of a political decision. Ohnishi (2002) points out that "building trust among the people of the three countries, rather than presenting empirical evidence of economic benefit, is the necessary step to realizing a Japan-Korea FTA or CJK FTA. The positions of non-Asian countries could significantly affect East Asia's economic integration. Above all, the USA has a high stake in East Asia's economic integration policy in terms of security. According to Cooper (2002), the USA does not expect an East Asian FTA to be possible in the near future, and neither the US Congress nor the US administration has yet clarified its position on the issue. Development of East Asian regionalism is anticipated to have both positive and negative economic effects on the USA. The latter could support the East Asian FTA as it may benefit from the improvements in the East Asian trade system accruing from a regional FTA. It has also been suggested that China's FTA could be advantageous for the USA. Munakata (2001) emphasizes that if China strengthens its relations with neighbouring countries through East Asian economic cooperation and integration, it would ease tensions in the region and lessen the US security burden. Thus, the USA would also support East Asian economic integration.

However, as Schott and Goodrich (2001) indicated, there is a chance that the USA might suffer losses from an East Asian FTA that excludes it. Because promoting a CJK FTA or establishing an East Asian FTA might induce conflicts with non-Asian countries such as the USA, East Asian countries might need to look into strategies to resolve possible conflicts with non-Asian countries.

Korea might need to consider its FTA policy together with regional security issues. In particular, North-east Asian economic integration is expected to have very positive effects on the security of the Korean peninsula. Measures to persuade North Korea to participate in the East Asian integration process should also be examined. In addition, it is necessary to establish FTAs with countries that have a great interest in a CJK FTA, including the USA. From Korea's point of view, an FTA with the USA is also one of the targets to be accomplished with a medium to long-term horizon. A Korea-USA FTA needs to be considered not only in terms of economic aspects, but also in terms of military and security aspects.

In order to carry forward an East Asian FTA on a pan-regional level, it is necessary to set up an institution such as the tentatively named Organization for East Asia Economic Cooperation (OEAEC) as a part of the ASEAN + 3 process. The OEAEC will be an organization through which a roadmap and step-by-step practical strategy can be sought to accomplish an East Asian FTA. The OEAEC would be able to find the most suitable FTA model by analysing the relationships between the economic structure of East Asia and the prospects for future development. It will also critically assess liberalization schedules under the East Asian FTA, trade rules, industrial cooperation and other cooperative measures. Moreover, the OEAEC can enhance the perception of the East Asian FTA among member countries to enhance the region's relations with the USA and other non-Asian countries. Of course, such tasks will be possible only after member countries reach a consensus on concluding the East Asian FTA along with political support.

4. Conclusion

Although it is regarded as one of the three major economic pillars in the world, East Asia has still the lowest level of economic cooperation and integration when compared to the EU and NAFTA. Economies in East Asia should therefore recognize the need for strengthening regional economic cooperation to utilize a "partnership from differences." Although there are difficulties in establishing intraregional free trade areas in North-east Asia due to a hegemonic leadership competition in the region and historical legacies, North-east Asian countries need to recognize the necessity of economic integration while observing FTAs being proliferated worldwide and experiencing great difficulty from such economic shocks as the Asian financial crisis in 1997.

East Asian countries have been remarkably successful in nurturing manufacturing sectors able to compete in international markets under export-led development regimes. Recent East Asian enthusiasm for regional FTAs is likely to enhance regional manufacturing efficiency. East Asian economies were less successful in developing their financial sectors; hence financial weakness persisted even during the high performance years. To make the current recovery more permanent and provided a buffer against external shocks in the future, East Asian countries have to strengthen their financial markets (Ito, 2001).

The Asian financial crisis in the late 1990s ushered in a new era for regional economic cooperation. The CMI has already set the tone for regional financial cooperation. Regional FTAs in East Asia that have been completed or in progress are likely to add renewed momentum to the ongoing integration process. The two forces will accelerate the "long march" toward an East Asian Community. Although East Asia embarked upon a regional economic integration process later than the EU and NAFTA processes, both the Asian financial crisis and subsequent restructuring and on-going regional FTA initiatives are

likely to reinforce each other. To make this happen, East Asia's quest for regional integration should proceed following the WTO regime.

East Asia has great potential to match the EU or NAFTA provided that East Asian countries with their hugely diverse economic and political backgrounds can reconcile whatever differences they may have to achieve dynamic region-wide growth within a sustainable framework. Indeed, FTAs are international agreements of like-minded countries. Any possible "spaghetti bowl" or "noodle bowl" effects due to the possible complexity of preferential rules of origin or excessive competition for regional hegemonic leadership need to be avoided. In particular, a China-led FTA and a Japan-led FTA in an uncooperative game is likely to generate a hub-spoke bilateralism in East Asia. The region should work out an ASEAN + CJK FTA that could set the tone for East Asian integration from a long-term perspective.

East Asian economies have undertaken restructuring efforts as evident in the cross-border investment and trade facilitation measure and behind the border structural reform agenda in APEC process. Japan has actively pursued development of a special economic zone for deregulation. China has also strengthened legal and institutional reform to comply with the level playing fields requirements after WTO accession. South Korea has also proposed a vision for a North-east Asian business hub by making serious commitment to becoming a transparent and "international best practice" economy (Ahn, 2003). Similar developments with varying degrees are also observable in ASEAN. Various structural reforms underway in East Asia in line with the WTO principles are likely to set a positive tone for closer economic cooperation towards an East Asian community in the years ahead.

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