

# Thinking about an East Asian Community

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## 1. Why an East Asian Community?

The Japanese government has proposed the concept of an East Asian Community. Unfortunately however, up to this point no concrete policy has been established indicating how to proceed with efforts towards the establishment of such a community.

The question of what types of economic relationships to establish with the other nations of East Asia<sup>1</sup> has been a major issue for Japan. What types of relationships should Japan form in East Asia, what types of specific policy issues will it be necessary to take up in order to form these relationships, and what impact will establishing closer relationships with the other nations of East Asia have on Japan: these are all issues which demand consideration.

The Asian financial crisis which afflicted the region in the latter half of the 1990s had the effect of making many people aware of the importance of deepening relationships between Japan and the other nations of East Asia. Not merely Japan itself, but the other East Asian nations began to discuss the best direction for cooperation in the region. The concept of an East Asian Community represents an extension of such discussions. Different people hold different images of such a community. A variety of names have also been applied to the concept, with, for example, “East Asian Cooperation” being used in addition to “East Asian Community.”

As economic ties between East Asian nations grow stronger, those nations are recognizing the importance of engaging in closer cooperation. However, because this cooperation is not restricted to the economic field but is also deeply related to politics and diplomacy, a diverse range of concrete images of its nature exist. Arguments running the gamut from those that envision a concrete process in Asia of the type employed in

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<sup>1</sup> Here, “East Asia” refers to the region encompassing Japan, China, South Korea and the ASEAN nations. This region includes North Korea, and also takes in the politically sensitive region of Taiwan. Some commentators consider that the nations of Oceania such as Australia and New Zealand, and also India, should be considered part of the region. However, given that the present report focuses on economic issues, the reader may assume that in the majority of cases East Asia here refers to ASEAN plus Japan, China and South Korea.

creating the European Union by the nations of Europe, to vaguer notions that suggest we deepen cooperation on a variety of fronts in East Asia, are collected under the common rubric of “East Asian Community.” Precisely because of this, it will be essential to develop a shared awareness regarding an East Asian Community.

The nature of the relationships that should be developed with the other nations of East Asia is a significant policy issue for Japan. Given this, in the past attempts have been made in various forms to consider Japan’s relationship with Asia at the national level. The Global Strategy Team established under the aegis of the Koizumi Cabinet’s Council on Economic and Fiscal Policy discussed the possibility of opening Japan towards Asia from a variety of perspectives. This trend was further developed under the Abe Cabinet, with the establishment of the Asia Gateway Strategy Council (chaired by the Prime Minister), which discussed a comprehensive economic and diplomatic strategy for Japan with consideration of the rest of Asia.

The stance of the present administration concerning an East Asian Community should probably be understood as part of this trend. In this case, rather than the question “How can Japan open itself towards East Asia,” the focus has shifted to the question “What direction for the development of the East Asian region is desirable for Japan.” This is because the form that East Asia should take is an issue that transcends Japan, and must be looked at from the perspective of the region as a whole.

In a certain sense the fact that Japan’s East Asia strategy, and the desirable form of East Asian cooperation from Japan’s perspective, have emerged as important policy issues is only natural. The nations of East Asia are displaying rapid economic development, and the value of Japan’s trade with these nations is rapidly increasing. Given the speed of growth of the East Asian nations, it is safe to say that this trend will continue into the future.

Consideration of a number of points will be essential: What areas should cooperation be deepened in, what will Japan be required to do to this end, and will it be possible for an entity that can be termed an East Asian Community to emerge from these efforts? This consideration should not stop at economics, but should take in a diverse range of areas, including politics, security, and social cooperation. In addition, thinking about an East Asian Community also means thinking about relationships with the U.S. and the EU, and about the relationship between Japan and China.

This is not to imply, however, that the present report seeks to provide a comprehensive vision in relation to these significant and complex problems. The main purpose of this report is to consider, from the economic perspective, the types of problems and the potential that may be inherent in cooperation between Japan and East Asia, while maintaining an awareness of the significant issues discussed above. The subject of these considerations will not only be concrete policies which can be realized in the short term, but also a long-term vision which provides an orientation for Japan’s economic strategy in East Asia.

## 2. Keeping Pace with the Speed of Change in Asia – Time Doesn't Wait

East Asia is changing at a rapid pace. Unfortunately, Japan is not keeping pace with the speed of this change on either the political or the economic fronts. Japan must be more proactive and proceed more quickly in formulating economic partnership agreements with the other nations of East Asia, and must also rapidly establish frameworks for cooperation in areas such as currency and macroeconomic policy. What is demanded is the creation of frameworks by means of which the region as a whole could deal with the important issues faced by each of the nations making it up – issues such as environmental problems and the fostering of human resources.

Europe does not represent a point of comparison in terms of the speed with which initiatives in these areas should be effected. There is no essential reason that East Asia should simply follow in Europe's wake. The movement towards regional economic unification across national borders is proceeding in a variety of regions throughout the world – the phenomenon is by no means restricted to Europe. The need to deepen economic cooperation is not limited to Europe and East Asia, but represents an issue for regions across the globe. It will be necessary to consider the pace of initiatives towards regional cooperation in East Asia in the context of this global trend.

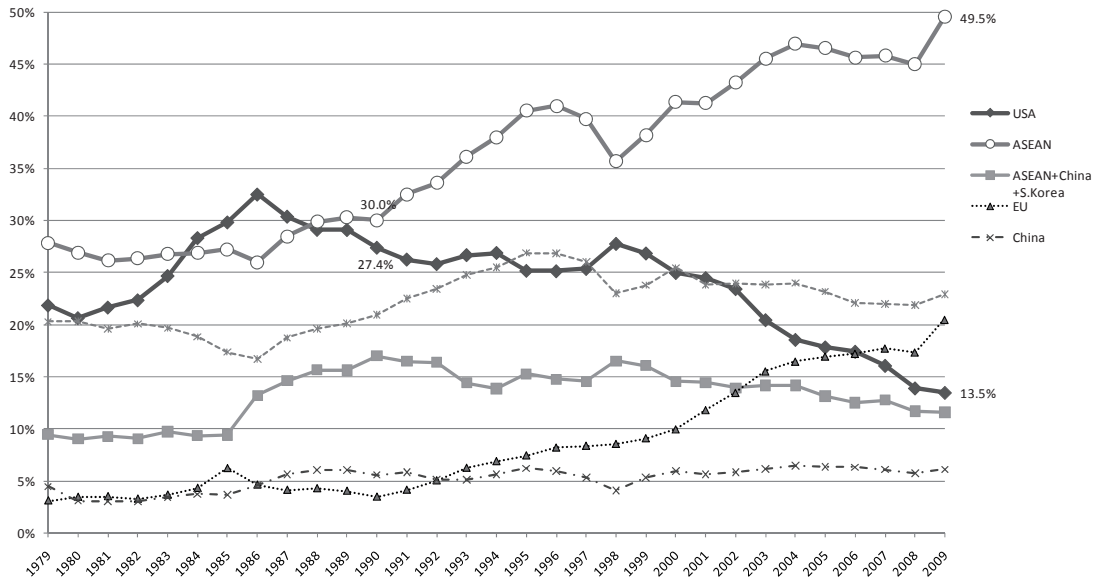
Figure I shows trends in the value of trade and share of trade between Japan and major nations and regional entities. In 1990, immediately following the collapse of Japan's bubble economy, trade with the U.S. represented approximately 27.4% of Japan's total trade volume, while trade with East Asian nations represented 30.0%. The gap had widened by 2009, however, with trade with the U.S. representing 13.5% and trade with East Asia 49.5% of the nation's total trade. In the 20 years since the collapse of the bubble economy, a period in which the Japanese economy has stagnated and its numerous structural problems have remained unresolved, East Asia has rapidly increased in importance for Japan<sup>2</sup>.

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<sup>2</sup> In order to prevent misunderstanding, I must indicate at this point that this is not to say that the importance of the U.S. to Japan has declined. Considered solely from the economic perspective, a large part of the regional trade which is expanding in East Asia is trade in intermediate goods and capital goods; the products manufactured as a result of this process are exported in large quantities to Europe and the U.S. Representing a significant share of world demand, the European and U.S. markets remain important, and it is not being suggested here that the economic chain can be completed in East Asia alone.

Figure I Trends in Japan's trade ratio with major nations and regions

A significant gap has opened between Japan's trade ratio with East Asia and its trade ratio with the U.S.



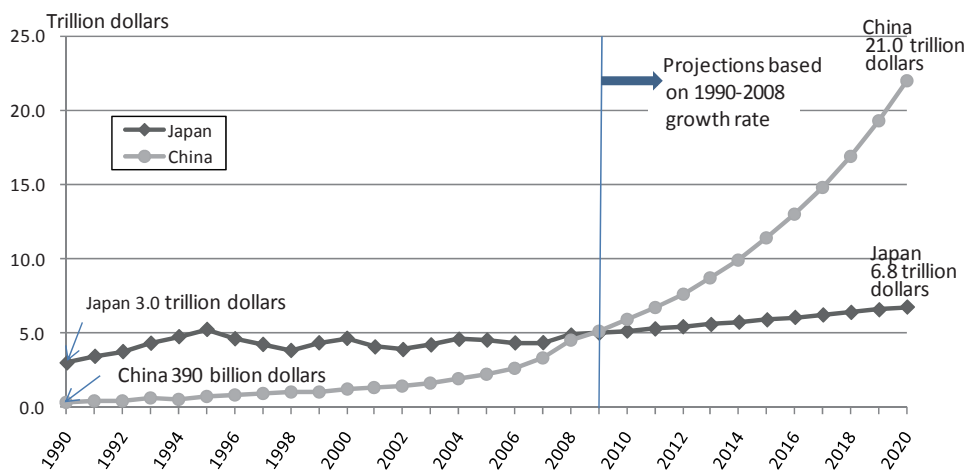
(Source) Compiled from Ministry of Finance trade statistics (<http://www.customs.go.jp/toukei/suii/html/time.htm>)

The expansion of the Chinese economy was the most important of the economic changes occurring in East Asia in this period. Attention has been focused on the projection that China's GDP will overtake Japan's this year (2010), making it the world's second-largest economy. However, what is more important than this current trend is the speed of China's growth over the past 10 or 20 years. Figure II compares GDP figures, expressed in U.S. dollars, for China and Japan since 1990. From a mere one-eighth of Japan's GDP in 1990, China's GDP has risen to match Japan's in 2010. During that 20-year period, Japan's GDP increased only 1.6-fold, while China's increased 12-fold<sup>3</sup>. 10 years ago, in 2000, China's GDP was still less than one-third of Japan's. In these 10- and 20-year periods, the economic balance of East Asia has rapidly shifted, and China's presence is looming larger.

<sup>3</sup> Figure II shows GDP converted into U.S. dollars to enable comparison between China and Japan. In the past 20 years, price indices (for example, the consumer price index) have risen by approximately 40% in the U.S. (This figure is the change between 1995 and 2008; the rate of change becomes even higher, at approximately 72%, when calculated for 1989 to 2009). If this amount is subtracted, Japan's GDP has grown only 1.2-fold.

Figure II Trends in nominal GDP for China and Japan

In 2020, China's GDP will far exceed Japan's



(Source) Compiled from IMF, World Economic Outlook Database (<http://www.imf.org/external/pubs/ft/weo/2010/01/weodata/index.aspx>), "International Financial Statistics." Figures from 2009 onwards are projected by NIRA based on the average annual growth rate in nominal GDP, expressed in U.S. dollars, for the period 1990-2008.

If this trend continues, it is not impossible that China's GDP could reach a level more than three times Japan's in 2020. Assuming that Japan's GDP continues to grow at a low rate of around 1% and that China's continues to grow at 8% or more, in 10 years China's GDP will be more than twice Japan's. If the possibility of the yuan being significantly revalued in this period is also taken into consideration, it is by no means a fanciful suggestion that China's GDP could reach a level more than three times Japan's in 2020 (Figure II).

The presence of an economy more than three times the scale of Japan's neighboring the nation in 10 years time would generate significant changes in Japan's political and economic relationships with other East Asian nations. Based on the assumption of further development of the economic relationships between South Korea and the ASEAN nations and China, it will be essential for Japan to build an East Asia strategy predicated upon significant changes in the region. The economic expansion of its neighbor will also represent a major security threat for Japan. Not all factors will tend in a direction favorable to Japan. For precisely this reason, it will be necessary for Japan to throw off the past and effect responses in anticipation of change.

As an example of a direct line of action in response to anticipated changes in East Asia, I would like to consider certain trends in South Korea. Major South Korean companies have actively entered the Chinese market, and are achieving results that outshine those of Japanese companies in both the automotive and electronics fields<sup>4</sup>.

<sup>4</sup> It is well known that Samsung has surpassed the majority of Japanese electronics manufacturers and holds a large share of the market. In the automotive field also, South Korea's Hyundai Group holds a higher share of units sold in the Chinese market than Toyota, Honda

South Korea's domestic market is comparatively small, and these companies could therefore be seen as actively furthering their development in China. However, what is being rather unexpectedly forgotten here is the fact that 20 years ago China and South Korea did not have diplomatic relations<sup>5</sup>. As will be discussed below, during this 20-year period, amid its domestic economic deadlock, Japan has been overly inward-looking, both politically and economically. During this same 20-year period, Japan's neighbor South Korea has deepened its political and economic ties with China, a nation with which it did not previously have diplomatic relations.

Significant changes are occurring for ASEAN also. Facing political and economic turmoil during the Asian financial crisis in the 1990s, the ASEAN nations have played an important role as a hub for East Asian cooperation. Having established FTAs with Japan, China, South Korea, India, Australia, New Zealand and others, ASEAN also functions as a hub for the liberalization of trade in East Asia as a whole. Discussions concerning currency stabilization and financial cooperation are proceeding within the framework of ASEAN+3, where the enhancement of systems based on lessons learned from the Asian financial crisis is also on the agenda.

Taiwan also, while previously excluded for an extended period from regional cooperative frameworks due to its relationship with China, is now considering the establishment of relationships of economic cooperation with Japan and the ASEAN nations, having established the Economic Cooperation Framework Agreement (ECFA) with China under the presidency of Ma Ying-jeou.

It can be assumed that this trend towards major changes in East Asia will continue for some time. The possibility that Japan might be excluded from this trend must be avoided at all costs.

### 3. Learning the Lessons of the EU

The trend towards regional cooperation that is taking shape in East Asia differs in numerous respects from the trend towards regional cooperation that developed in Europe. It is not necessarily the case that it will be possible to rapidly form a community of a similar type to the EU in East Asia. However, the experience of the nations making up the EU does provide a number of valuable lessons to consider in thinking about regional cooperation in East Asia. These are both lessons to emulate, and lessons by negative example.

The problems in the EU that have emerged from the financial crisis in Greece demonstrate the difficulty of currency unification. Simply bringing nations with different economic structures under the umbrella of a common currency produces desta-

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and Nissan.

<sup>5</sup> South Korea established diplomatic relations for the first time with China in 1992.

bilizing factors in the region. Elements such as flexible exchange rate coordination and the implementation of independent macroeconomic policy by each nation concerned can play a significant role in enabling the region to respond appropriately to severe changes taking place in the international economy.

It can be assumed that in future the present financial crisis in the EU will be examined from a variety of perspectives. At present, it is difficult to predict how the situation will develop. It goes without saying, of course, that the unification and cooperation instituted in the EU will not be rejected in its entirety. The abolition of borders for people, goods and capital and the subsequent invigoration of regional trade and investment are not directly related to the present financial crisis. With regard also to initiatives in the area of currency, the view exists that rather than the introduction of a single currency itself, the problem lay in the lack of more intensive cooperation and the institution of governance mechanisms in the area of fiscal policy, necessary conditions for the introduction of a single currency. Whether the present crisis will cause some of the EU nations to move away from the euro, or whether it will provide the occasion for more intensive fiscal cooperation, cannot be predicted at present.

What can be indicated is that, despite the current difficulties, the nations of Europe achieved tremendous successes in moving ahead with regional unification. European unification was initially based on the concept of preventing a repetition of the wars that had occurred between France and Germany. From this perspective, the European Community has achieved a great success, and there is no possibility of a major conflict erupting in Europe in the near future. The European Community also played an important role in assimilating the Eastern European countries wishing to make the transition from socialism to market economies following the collapse of the Berlin Wall. From this perspective alone, the unification of Europe has been of great significance.

In the East Asian region also, it is necessary to increase the level of economic cooperation in order to prevent political confrontations and discord. ASEAN members include countries with different religions, democratic countries, socialist countries and military dictatorships. The various economic cooperation initiatives undertaken by these nations within the ASEAN framework are an important factor in ASEAN's ability to maintain political stability and continue steady economic development<sup>6</sup>.

The most important factor in the future political stability of the East Asian region is the existence of a rapidly developing China. As indicated above, if China is able to maintain this rate of growth for another ten years, the nation's GDP will be approximately three times Japan's. An expanding China will provide the region with eco-

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<sup>6</sup> One European researcher drew a comparison between the Indochina Peninsula and the Balkan Peninsula, and made the following comment: "Both peninsulas are home to different religions and ethnic groups. However, the Balkan Peninsula experienced a vicious civil war, while the Indochina Peninsula has been peaceful in recent years. I believe that the consultations and cooperative programs conducted within the ASEAN framework play a significant role in ultimately maintaining the peace of the Indochina Peninsula."

conomic opportunities, but may also pose a military threat. China is already involved in various disputes with neighboring countries over marine areas.

The most important factor in terms of the security of the East Asian region is the U.S.-China relationship. The absence of conflict in this relationship is the most important condition for political stability in the region. This report will not give specific consideration to this issue. It will simply indicate that cooperation between the nations of the region, including China and Japan, in dealing with various economic and social issues, in addition to the provision of opportunities for mutual discussion, will have an important meaning for East Asia's political stability.

One other important goal in European unification was to provide Europe with the ability to oppose the power of the U.S. as an entire region. The European nations have in fact joined as one in negotiating with the U.S. on an equal footing in venues ranging from trade negotiations conducted by the World Trade Organization to debates concerning environmental problems at the UN. In addition, the European nations are acting in concert to advance the global spread of the unified standards (regulations, norms, etc.) developed in the region<sup>7</sup>.

It will also be necessary for the nations of East Asia to cooperate as a region in order to formulate systems and frameworks. In the area of various norms and standards also, it will be essential for East Asian nations to take the initiative and create regional systems. In the areas of the environment and trade, taking action as a region will not merely affect the region itself, but could be expected to have a significant effect on global frameworks. From this perspective, the creation of regional frameworks for the stabilization of currencies and finance is also a significant issue. The experience of the Asian financial crisis has made the nations of the region aware of its importance. The existence of frameworks in the region for dialogue concerning fiscal and monetary policy could also ultimately be expected to exert a considerable effect on frameworks for the harmonization of macroeconomic policy at the global level.

#### 4. Is it Possible to Double Trade Dependency?

We can discover a major difference between Europe and East Asia by considering Japan's trade structure. Figure III shows trade (total of exports and imports) for major nations and the share of trade in GDP for those nations. Comparing Japan and Germany in this figure, we find that Japan's level of trade dependency (ratio of trade to GDP) is less than half Germany's.

There are a number of reasons for the difference in these figures. A nation's level of trade dependency tends to be lower the larger the scale of that nation's economy. Ja-

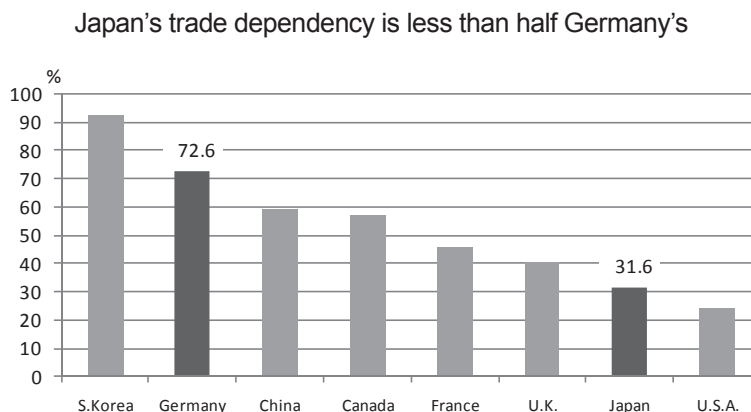
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<sup>7</sup> The NIRA report "Asia as a Single "Domestic Market" – The Harmonization of Rules and Systems" pointed out that these initiatives on the part of Europe were having a significant impact on standards and norms in the Asian region.



pan's GDP is larger than Germany's, and the difference in the nations' level of trade dependency presumably reflects the abovementioned tendency. Again, Germany has numerous close neighbors, and numerous cities from which a neighboring nation can be reached in less than an hour. This fact tends to increase trade across its borders. By contrast, because Japan is surrounded by water, Japan tends to have a lower level of foreign trade.

Figure III Trade dependency of major nations



(Source) World statistics, Statistics Bureau, Ministry of Internal Affairs and Communications (<http://www.stat.go.jp/data/sekai/09.htm#h9-03>)

Nevertheless, despite the involvement of these factors, Japan's level of trade dependency is too low. It must be increased.

However, we must also keep in mind the possibility that Japan's trade dependency may increase rapidly in future.

One major reason that Germany's trade dependency is so high is the fact that France, Italy, the UK, the countries of Northern Europe and other high-consuming countries are its close neighbors. These neighboring countries import a great deal of goods, raw materials, and equipment from Germany. These neighbors are also major exporting nations, and a variety of goods and services flow from these countries to Germany. This high-value two-way trade is reflected in Germany's high import- and export-dependency.

Let us compare this to the case of Japan. 10 or 20 years ago, the economic scale of China and other East Asian nations was not particularly large. Naturally, their volume of exports from and imports to Japan was restricted by their economic scale<sup>8</sup>. However,

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<sup>8</sup> The "gravity model" is often used in international trade research. According to this model, there is a strong tendency for the volume of trade between two countries to be greater the closer those two countries are, and the larger their economies are. This concept resembles the fact that the force of gravity between two planets is inversely proportional to their distance, and directly proportional to their mass – hence the name "gravity model." Based on this concept, the volume of trade will tend to be high between geographically close neighbors. This seems intuitively

as has already been stressed a number of times, in the past 10 years the East Asian economies, and the Chinese economy in particular, have displayed remarkable growth, and the possibility that the economic expansion of its neighbors could contribute to the expansion of Japan's trade volume is increasing. A trend of this type is already visible, with Japan's trade volume with the nations of East Asia, and with China, exceeding its trade volume with the U.S. The important point here is that, assuming the continuation of this trend into the future, working to promote such an expansion of Japan's trade volume is a significant agenda for the nation's economic policy<sup>9</sup>.

An increase in Japan's level of trade dependency implies an increase in imports in addition to an increase in exports. If it is possible for Japan's trade dependency to dramatically increase in this form, the nation's industrial structure and corporate strategy will also change significantly. Goods and services produced in Japan are those in which the nation has a comparative advantage in the true sense of the term, and Japanese companies will be rigorous in terms of which to select for export to other countries. On the other hand, the production of goods and services that it is desirable to produce in East Asian countries with lower wages will be rapidly reduced in Japan, and the nation will supplement these through imports. When these major changes in the trade structure occur, there will also be large-scale changes in the domestic industrial structure, and realizing these changes smoothly will also be a significant policy issue.

A representative example of this type of change can be indicated in the field of agriculture. Rising wages in East Asian nations should present Japan with excellent opportunities for the export of agricultural products and foodstuffs. Experts have pointed out that it is even possible that exports of previously highly protected foodstuffs such as rice from Japan to China could increase if wages rise and Chinese labor costs spiral upwards.

However, it is likely that Japanese imports of agricultural products and foodstuffs from East Asian nations will also increase. Processed foods that incur labor costs are already imported from China in large quantities by Japan. If Japan proceeds with the liberalization of agricultural products, imports from the rest of Asia can also be expected to increase. Numerous Japanese foodstuffs manufacturers and trading companies are already involved in food production, processing and distribution in East Asian nations, adding value to regional agricultural products.

If these trends increase in scope, an expansion of both imports and exports of agri-

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correct. The problem in the case of Japan is that until recently, the economies of the nation's neighbors were not sufficiently large to significantly increase the volume of trade based on the "economic scale" factor in the theory.

<sup>9</sup> To repeat, this is not to imply that trade with the U.S. is declining in importance. This is because the majority of trade within East Asia will not be confined within the region. The most important regional trade pattern will be one in which industrial machinery exported from Japan is used to produce components in South Korea or Taiwan for assembly in China, with the majority of the finished goods exported to Europe and the U.S.

cultural products can easily be imagined. The important thing in that event will be for Japan's agricultural industry to concentrate farmland and other agricultural resources in the hands of agricultural producers that achieve high levels of productivity, and to shift towards the production of high-added value agricultural products that will appeal throughout East Asia. In order to accelerate these processes, fundamental changes to Japan's agricultural policy will be essential.

What will be necessary is a transition from a protectionist policy that isolates Japan's agricultural market from the outside world through tariffs to a subsidy policy that achieves the necessary boost in the productivity of Japan's agricultural producers, even as they are exposed to overseas competition through increasing liberalization. Rice is one example. If the liberalization of rice proceeds, the cost of producing rice as a sideline business will no longer be supportable, but it will be possible to significantly increase production efficiency by concentrating farm land in the hands of specialist (professional) producers who focus exclusively on the production of rice.

To return to the beginning: Structures of trade and investment are undergoing major changes not merely in East Asia, but on a global scale. These changes are becoming an important area of research for international economics. Oversimplifying somewhat, the tendency of these changes is towards a shift in weight from inter-industry trade to intra-industry trade, an expansion in trade within companies, a shift in weight in terms of trade from finished goods to intermediate goods, and an increase in the complementary relationship between direct investment and trade. I will provide a brief explanation of these trends.

Inter-industry trade is a trade pattern in which a country's main import goods and main export goods are products of different industries. This was previously Japan's trade pattern. Primary products such as oil, iron ore, etc. represented the greater part of the nation's imports, while the majority of its exports were made up of products created from these raw materials. Today, however, manufactured goods make up more than half of Japan's imports. The nation imports large quantities of manufactured goods such as home electronic equipment and automobiles at the same time as it exports large quantities of the same products. This is intra-industry trade, and this trade pattern is becoming conspicuous even in Japan.

The main reason for the expansion in intra-industry trade is that as national borders become increasingly porous and various transportation costs (information costs, cost of human movement, cost of carrying goods, etc.) become lower, goods that were previously only traded within borders come to be traded across borders<sup>10</sup>. The diversification of consumer tastes and the consequent consumption of a more diverse range of

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<sup>10</sup> For example, the skewers of fried chicken eaten at bars in Japan are processed in Thailand or China and sent to Japan. Many of the jeans sold by Uniqlo are made in China from denim produced in Japan, and are then shipped to Japan. This pattern of processes and division of labor operates across national borders, and ultimately appears as an expansion of intra-industry trade.

goods is also driving the expansion in intra-industry trade. An increase in intra-industry trade increases the thickness of trade, and ultimately increases trade dependency in the majority of countries. Germany's level of trade dependency is high because the nation has been blessed with opportunities to expand intra-industry trade in a variety of industries with its neighbors.

One of the characteristics of an increasing thickness of trade is an expansion of trade in intermediate goods and capital goods. The division of labor in production and processes crosses borders, and there is an increasing involvement of multiple countries in the completion of a single product. As a result, a variety of intermediate goods are traded across national borders.

The East Asian region possesses an exemplary characteristic in enabling such a division of labor to proceed. This is the fact that the borders of many nations in the region are connected by oceans. We tend to regard the fact of separation by oceans as an impediment to trade, but maritime transport offers the lowest transportation costs for shipping large amounts of goods. There is little difference in the distance between California on the west coast of the U.S. and New York on the east and the distance between Singapore and Japan. However, the cost of transporting goods from Singapore to Japan is considerably lower than the cost of transporting goods within the U.S. by land or via the Panama Canal. This condition enables numerous countries in East Asia to participate in the division of labor, with a resultant increase in trade in intermediate goods.

Another reason that a regional division of labor is proceeding in East Asia is the fact that countries of varying income levels coexist within the region, and their differing characteristics are convenient in promoting a division of labor. If high technology is demanded, Japan or South Korea can be relied upon, but if labor at the lowest possible cost is necessary, then China or Vietnam are available. Thailand and Malaysia are intermediate between these categories. Making use of countries in this way makes possible a more sophisticated division of labor.

A consideration of this characteristic of the Asian region leads one to understand the great significance of promoting EPAs and FTAs within East Asia. As indicated in the detailed discussions concerning individual fields to be found in the separate research report, in addition to accelerating the pace of its EPA negotiations, it will be essential for Japan to proceed towards forms of liberalization that will be effective in forming free trade areas that encompass the entire East Asian region, such as a Japan-China-Korea EPA. These initiatives would not only provide a driving force for the expansion of trade in East Asia, but could also be expected to assist in the modification of Japan's industrial structure into a form more open to East Asia.

## 5. Changing Japan's Inward Focus – Greater Openness will Provide a Spark for the Japanese Economy

A variety of goals come together in the quest to increase cooperation in East Asia. The stable and peaceful development of the region represents a significant benefit to all of the region's nations, including Japan. This is, perhaps, the most important reason for initiatives in this area. But in addition to this, Japan's opening itself to East Asia would be extremely effective in providing a powerful motive force for the achievement of positive change in the Japanese economy and in Japanese society.

Unfortunately, in the 20 years since the collapse of the bubble economy, Japanese society has become extremely inward-looking. Government policies are chiefly focused on domestic issues, and consideration of the policies that the nation should be implementing as an actor in the global community has become a secondary issue. The Japanese people have also become extremely inward-focused. The fact that the number of Japanese students studying overseas is declining is representative of this tendency among Japan's young people. Japanese companies are also swayed by domestic trends, and lag behind their South Korean counterparts in expanding their businesses into East Asia.

When speaking with Asian friends, I am quite often asked "What's happened to Japan?" The world is moving at a rapid pace, but Japan appears to have turned its back. The fact that in the past 10 or 20 years Japan's position has dropped significantly in terms of a number of internationally recognized indicators is surely not unrelated to the nation's inward-directedness.

In order to revivify Japanese society and the Japanese economy, it will be necessary to conduct a thorough rethink from the perspective of opening all of the nation's systems to East Asia. Industry and finance, naturally, but also other issues which have previously been discussed mainly from a domestic perspective, including education, medical care, food, taxation, regional revitalization, and environmental resources, will need to be reexamined from the perspective of opening Japanese society to the outside.

Issues of education and environmental resources are also taken up in this report, and it can be expected that by reexamining these areas with a view to opening them to the outside, we will be able to find paths to new possibilities. The urgent requirement of education is that it should produce human resources meeting the shared standards of the international community, and cooperation between Japan and its East Asian neighbors in the field of education would therefore be of considerable significance. As they continue their high rates of growth, the need for the provision of infrastructure is increasing in East Asian nations. There is considerable margin to make use of Japanese technologies and experience in these areas, and promoting East Asian development in such areas is also necessary from the perspective of increasing Japan's potential for growth. The government itself has indicated the importance of infrastructure fields in its growth strategy.

It will also be essential to formulate stronger policies predicated on market openness in the area of agriculture and food. Japan cannot indefinitely maintain protectionist agricultural policies based on tariff barriers that result in prices that diverge widely from international prices. Japan's protectionism in the field of agriculture is not only a major stumbling-block to its EPA strategy, but also represents a considerable impediment to building strong agricultural and foodstuffs industries. Experts have indicated that the competitiveness of Japanese agriculture would be significantly boosted by a transition in agricultural policy from protecting part-time rice growers to focusing assistance on professional growers. In addition, potential demand for Japanese foodstuffs is increasing with rising wage levels in East Asian nations. A major turning point is looming for Japan's agriculture and foodstuffs industries. The goal should be to expand bidirectional trade, importing a greater number of agricultural products at the same time as increasing agricultural exports. To this end also, it will be necessary to increase Japan's domestic productivity.

The importance of greater cooperation with East Asia is also increasing from the perspective of regional revitalization. The postwar Japanese economy has been entirely Tokyo-centered, and regional economies have looked to Tokyo in their development. However, this Tokyo-focused economic management has produced weaknesses in these regional economies. Efforts to boost tourism are being made here and there in order to revitalize regional economies. Interest in attracting East Asian companies is also increasing. Deepening economic cooperation with East Asia would no doubt indicate more clearly where the specific competitiveness of different regional areas lies.

The rapid pace of growth of East Asian nations is strongly related to the fact that these nations have strengthened their posture of openness to the outside. South Korea numbers the U.S. and the EU among its FTA partners. China's growth would be inconceivable without openness to the outside. 60% of China's exports are conducted by foreign-affiliated companies, and young Chinese students are studying at foreign universities in large numbers. The nations of Southeast Asia are also actively strengthening regional cooperation through the ASEAN framework, but when viewed from the perspective of individual nations, this is nothing other than openness to the outside. The goal of the ASEAN nations is to remove regional barriers to trade, investment, and the movement of capital. This strengthening of the trend towards openness throughout the region represents a significant opportunity for Japan. This is not the time for Japan to be alone in the region in focusing inwards.

## 6. The Importance of Multi-tracking

What would the precise nature of an East Asian Community be? What type of region would it encompass? Would a community be merely an abstract cooperative entity, or would it proceed further to regional unification of the type realized in Europe?

Would it be limited to economic cooperation, or would it encompass security cooperation? A variety of questions cluster around the issue of a regional community. It is not easy to give clear answers to these questions. It is not a simple matter to define the nature of an East Asian Community in a precisely delineated form.

Attempting at this point in time to precisely define an East Asian Community is both unrealistic and undesirable. If we engage in shortsighted discussions, we run the risk of making mistakes. The desirable course is to strengthen regional cooperation step by step through the channels that are available to us, without too precisely defining the ultimate form of an East Asian Community. This is the perspective adopted in this report.

A variety of Asian regional alliances and cooperative frameworks presently coexist. These include APEC, ASEAN, ASEAN+3, ASEAN+6, the Asia-Europe Meeting (ASEM), and the Six-Party Talks convened to discuss the issue of North Korea. Each of these frameworks has a different character and different functions.

It will be necessary to move ahead with cooperation in East Asia by a process of trial and error. It will also be essential to proceed with consideration of relations with the U.S., the nations of the EU, and other nations outside the region. From this perspective, frameworks which are extra-regional but in which regional nations participate, such as APEC and ASEM, will play an important role. ASEAN+3, in which East Asian nations themselves discuss trade policy and economic issues, will be another important framework. The Six-Party Talks also, while existing for the specific purpose of discussing issues such as the provision of aid to North Korea and the security of the Korean Peninsula, have the potential to be extended in future to function as a forum for the discussion of a broader range of issues related to the security of Northeast Asia.

In seeking to realize an East Asian Community, it will be essential to focus on open regionalism – i.e. regional cooperation that is open to the outside – as an important basic concept. We must rigorously avoid allowing regional cooperation to act as an impediment to the functioning of multilateral frameworks. This point can be easily grasped through a consideration of EPAs and FTAs. As indicated in the detailed discussions concerning specific fields in the separate research report, ASEAN+3 and ASEAN+6 are current EPA/FTA targets, and the conclusion of a Japan-China-Korea EPA/FTA will be important to their realization. However, it would also be desirable to consider an APEC-wide EPA/FTA in tandem with this process. It would also be desirable for Japan to consider its own separate EPA/FTA negotiations with the EU or with the U.S.

It goes without saying that maintaining favorable relations between the U.S. and the nations of the region is an important issue in considering an East Asian Community. Preventing the development of the conditions of possibility for serious confrontation between the U.S. and China is an absolute precondition for maintaining peace in the region. If friction were to develop between the U.S. and China, it would have a

significant impact on the region in a variety of forms<sup>11</sup>. This will make it of great importance to organize leaders' summits and foreign ministers' meetings in which three nations or more participate (Japan-U.S.-China, Japan-U.S.-Korea, etc.), and it will be necessary to encourage the active participation of the U.S. in such meetings.

The foundation for cooperation in the East Asian region at present is multi-tracking. It will be necessary to proceed with a range of frameworks working in parallel, and to use different frameworks depending on the issue being addressed. Proceeding with regional cooperation on multiple fronts, we can expect a clearer image of an East Asian Community to become visible.

## 7. How Should We Think about the Relationship with China?

Two major issues present themselves in considering an East Asian Community. The first of these is how to situate a China which is continuing to expand, and the second is how to consider the nation's relations with the U.S.

Less than one-third of Japan's figure ten years ago, China's GDP will this year exceed Japan's, and in ten years' time is expected to be approximately three times Japan's. Not only is it impossible to discuss cooperation in East Asia without the inclusion of China, but China's increasing economic scale must in fact be taken as a precondition in such considerations.

China's growth and development has been driven by the nation's opening of its markets and the deepening of its economic ties with other Asian nations. Prior to launching its policy of reform and openness at the end of the 1970s, China was a closed society and had been involved in a variety of conflicts with its neighbors. From the end of the Second World War to the Sino-Vietnamese War in 1979, China can be seen to have been either directly or indirectly involved in almost every conflict or war in the region. Given this history, it is particularly noteworthy that from 1980 onwards, China has not been involved in any conflicts with neighboring nations. The prevention of conflict with China is an important precondition for the continuation of peaceful and stable development in East Asia.

It goes without saying that the deeper China's economic relationships with its neighbors, and the greater the openness of China's internal markets, the stronger the forces preventing conflict in the region. In addition, the growth of China's middle income bracket promoted by openness and economic growth can be expected to control parochial nationalism.

How to treat cooperation with China is a major factor in building a variety of frameworks in the East Asian region. If China does not play an active role, cooperation

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<sup>11</sup> Regarding this point, see NIRA Dialogue Series No. 54, "Japan's Diplomatic Strategy for East Asia" (Dialogue with Professor Akihiko Tanaka).



in the region will not be functional, but the creation of frameworks in which China is clearly the leader is undesirable not only for Japan, but also for the ASEAN nations<sup>12</sup>. In order to improve relations between Japan and China, it will be important not to consider the issue merely as one of the relationship between the two nations, but to constantly focus on how the two nations can cooperate for the prosperity and stability of the East Asian region as a whole<sup>13</sup>.

The peaceful development of Chinese society is a precondition for the peaceful and stable development of the East Asian region. The thing that must be borne in mind is that China is unique among its neighboring democracies in being a single-party communist state. Given that China is developing rapidly, and given the nature of its political system, Chinese society faces significant destabilizing factors. The increasing income gaps arising from economic development are causing friction in the nation. In addition, the environmental destruction and difficulty in securing resources that China is experiencing as a result of economic growth are issues that are having a significant effect on the nation's neighbors, including Japan. The possibility cannot be ruled out that China's range of internal problems could result in acts of aggression against other nations.

It would be no exaggeration to say that supporting the peaceful and stable development of China is in itself the most important factor in enabling the peaceful development of East Asia. China is at present making efforts towards the provision of infrastructure and the promotion of economic development in its inland areas, in order to reduce income gaps and achieve a balanced growth trajectory. There must be numerous ways in which Japan could support such initiatives. Further, what is necessary is not only cooperation between China and Japan, but the establishment of frameworks

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<sup>12</sup> With regard to the political effect of deepening economic ties, the case of the Economic Cooperation Framework Agreement (ECFA) which has recently been signed between China and Taiwan is extremely interesting. Under the presidencies of Lee Tung-hui and Chen Shui-bian, Taiwan intensified its oppositional stance towards China. In part because of this, China blocked the formation of FTAs between Taiwan and its neighbors. As a result, Taiwan became the only nation in the region that was unable to establish an FTA. Under the presidency of Ma Ying-jeou, Taiwan's confrontational posture has diminished, a fact which is symbolized by the conclusion of the ECFA with China. This type of economic cooperation can be expected to increase the stability of the relationship between China and Taiwan, and represents a breakthrough that makes it realistic for Taiwan to seek frameworks for cooperation with other East Asian nations.

<sup>13</sup> This might be compared with the situation in the latter half of the 1980s, when APEC (Asia-Pacific Economic Cooperation) was established. At that time, Japan and the U.S. were experiencing severe economic friction. When the two nations attempted to respond to the situation via bilateral negotiations, confrontational attitudes came to the fore. One of the most significant aspects of multilateral frameworks for dialogue such as APEC is that the participation of Japan and the U.S. in dialogue within such frameworks promotes recognition of the nations' shared interests. This is because, as advanced nations in the region, Japan and the U.S. have shared interests in numerous respects in the process of framework creation in the Asia-Pacific region. In the case of Japan and China, the demonstration that they were able to cooperate within an East Asian regional framework would be of deep significance in terms of maintaining good diplomatic relations between the two nations.

for regional cooperation in fields including infrastructure, resources, energy, and the environment. This would also benefit Japanese industry.

However, China's economic development cannot be taken simply as a positive factor for the maintenance of peace in the East Asian region. Increased economic power equates to increased military power, and China's increased military expenditure is, in fact, becoming a significant threat to its neighbors. China's navy has recently been conspicuous in areas over which the nation has had historical conflicts with its neighbors, such as the Spratly and Senkaku Islands. It is difficult to expect enhanced economic cooperation alone to control China's military expansion.

The fact that the peaceful economic development of East Asia cannot be discussed without consideration of the U.S. is related to this point. The maintenance of a stable relationship between the U.S. and China is an absolute precondition for controlling China's military expansion. This is not to say that Japan should be involved in some way in U.S.-China relations, but at the least it should maintain a focus on diplomatic considerations that will ensure continuing good relations between the two nations. This is another major reason why the U.S. cannot be excluded in promoting regional cooperation.

## 8. The Lessons of the Asian Financial Crisis

Many of the current moves towards East Asian regional cooperation had their origins in the Asian financial crisis of the late 1990s. Prior to the Asian financial crisis, most of the nations of the region, including Japan, did not participate in any free trade agreements. We may say that there were no frameworks for exchange rate stabilization or forums for dialogue concerning macroeconomic policy that considered the region as a whole. From this perspective, the Asian financial crisis represented an important turning point for cooperation in the region.

The speed of the contagion was an important characteristic of the Asian financial crisis. The crisis that originated in Thailand spread rapidly to South Korea and to the nations of Southeast Asia. Despite the fact that the economic structures of individual countries are all different, the sudden movements of capital that trigger a financial crisis represent a herd behavior without a rational basis, and function to amplify the crisis. There is no reason why such an event should not reoccur in the near future. It is difficult for a single country to respond to such a situation. The functions of international organizations such as the IMF are also limited. What is required are frameworks enabling a cooperative response by the nations of the region. There must also be many ways in which the region's nations can cooperate to maintain a stable macroeconomic environment which is resistant to crises<sup>14</sup>.

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<sup>14</sup> The IMF is an international organization that was originally established in order to stabilize

The Asian Monetary Fund (AMF) proposed by Japan following the crisis did not materialize, but efforts have continued since the event, with the Chiang Mai Initiative creating a framework for exchange rate stabilization via bilateral currency swaps, the multilateralization of the Chiang Mai Initiative, and moves towards the creation of regional frameworks for dialogue and the coordination of macroeconomic policy. Beyond these efforts, the establishment of the AMF as a framework for regional currency stabilization is emerging as a distinct possibility.

If economic ties become closer in East Asia and trade, investment and financial transactions across borders increase in scale, then it is a natural consequence that relationships of macroeconomic interdependence will become deeper. If this does happen, then regional frameworks for currency stabilization and financial stabilization will become necessary. In addition, it will be essential to secure opportunities for dialogue on and coordination of fiscal and monetary policy.

The existence of international organizations such as the IMF at the global level is important. However, the lesson of the Asian financial crisis is that simply relying on these international organizations alone entails significant costs for countries which are experiencing financial or monetary crises. An early warning system for debt accumulation and excessive inflows and outflows of capital would be effective in heading off a crisis before it occurred. Forums for policy dialogue to prevent the implementation of macroeconomic policy by individual nations in the region from becoming a destabilizing factor will also be necessary.

One of the causes of the Asian financial crisis was the fact that many of the nations of the region pegged their currencies to the U.S. dollar. For emerging and developing nations, pegging their currencies to a stable currency like the U.S. dollar is an effective method of stabilizing their macroeconomic environments. Today, however, when the U.S. dollar itself is at risk of significant fluctuations, the nations of East Asia need a more stable anchor. More discussion of the use of a common currency basket system based on an Asian Currency Unit (ACU) or other unit of currency will also be necessary.

When currency cooperation in East Asia is discussed, interest tends to focus on the limited area of exchange rates. However, exchange rate trends reflect the fiscal and monetary policies implemented by individual nations and the macroeconomic trends in

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the exchange rates of the major nations. The organization used funds supplied by the major nations to maintain the stability of their currencies. This was the first incarnation of the IMF. The role of this first IMF was greatly reduced when the major nations made the transition to a floating exchange rate regime in 1973. However, following this the organization expanded its function of using the funds contributed by the major nations to provide aid to developing and emerging nations experiencing currency crises or debt crises. This may be termed the second incarnation of the IMF. The functions of the AMF, using funds supplied by the nations of the region to maintain currency and monetary stability in the region, can be seen to be similar to those of the first incarnation of the IMF. Because the present IMF is the organization's second incarnation, the existence of the AMF might also in a certain sense be said to supplement the IMF.

those nations, and currency policies have a significant impact on the macroeconomies of individual nations. As the current crisis in Greece has made clear, how far a region is prepared to proceed in coordinating fiscal management is the key to currency stabilization.

This is not to suggest that East Asia will rapidly introduce a European-style single currency, or that this would be desirable. The introduction of something resembling a fixed rate system between regional currencies is also unlikely to be possible<sup>15</sup>. However, it is clear that against the background of deepening macroeconomic interdependence between the region's economies, it is necessary to be aware of the interdependence between the macroeconomic policies of individual nations, and to establish forums for dialogue on macroeconomic policy. In particular, it will be essential to create systems that are capable of rapid response when the risk of monetary or currency crises increases. The 2008 Lehman Brothers shock did not occur in East Asia, but its effect was transmitted to the region instantaneously. We have not proceeded as far as actualizing a framework for currency stabilization, but it cannot be denied that the existence of such a framework has produced a certain sense of security in the region.

## 9. The Bicycle Theory – Both Process and Results are Important

The bicycle theory is a theory employed in the world of trade negotiations. It argues that while the results of trade negotiations, for example negotiations conducted through the WTO or negotiations for the formulation of FTAs, are important, the process of continuing the negotiations in itself is also of great significance. If these negotiations are not conducted, protectionist trends will become more powerful in a variety of forms, and the free trade system will recede. But when countries continue with negotiations, their details stimulate intense discussion within those countries, and as a result the trend towards free trade will be strengthened.

The concept that the process is important also applies to East Asia. As has already been sufficiently pointed out, while we may use the term East Asian Community, it remains difficult to draw a clear image of what form such a community should take. The East Asian region possesses regional frameworks in a variety of forms – APEC, ASEAN+3 and +6, and others. Against this background, the fact that the nations of the region continue discussions and negotiations at a variety of levels is in itself highly significant.

A variety of actors are also involved in negotiations and discussions. We must create forums for discussion and negotiation between individuals at various levels, including leaders' summits, working-level meetings, conferences involving researchers and cul-

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<sup>15</sup> From 1979 to the introduction of the euro in 1999, the major nations of Europe operated a system of mutually pegged exchange rates.

tural figures, and conferences at the local government and .civil society levels.

The subjects of these discussions would also cover a wide range, some examples of which are presented in this report. To those examples, trade, currency and financial issues, education, environmental resources, air transport networks, and personal exchanges, we can add competition policy (antitrust policy), system standardization, medical insurance, taxation, information and communications, and measures to combat crime as some of the areas in which the necessity for discussion between the nations of the region is increasing.

The nations of East Asia face numerous shared issues. The creation of frameworks in which to discuss those issues and engage in cooperation in relation to them will be of considerable value to the nations of the region. Efforts to deal with shared issues could also be expected to deepen regional cooperation.

The launching of the concept of an East Asian Community is to be celebrated, but as a concept without substance, it will lose momentum rapidly. It will be essential to set a timeline for the realization of a regional community. Specifically, an approach that encompasses at least the following three points will be necessary:

- (1) Formulation of policy issues that can be taken up with a view towards concrete realization in one or two years
- (2) Setting of policy targets for five to ten years in the future
- (3) Development of the concept of an East Asian Community from a longer-term perspective

Concerning point (1), there are numerous policy issues that could be voluntarily suggested by Japan. Concrete details are discussed in the main body of this report. This would involve activating efforts towards practical implementation in the case of issues on which the Japanese government had previously taken initiatives, or had attempted to take initiatives and failed, etc.

Concerning point (2), cooperation between the nations which will be members of an East Asian Community will be necessary. This would involve the creation of opportunities for discussion concerning an East Asian Community at forums such as the East Asia Summit, and proceeding with continuing discussion regarding what should be done towards the realization of a community. If discussions could be held under the common banner of an East Asian Community, this in itself would represent a great success. Such discussions could be expected to produce concrete medium- and long-term targets. To that end, perhaps it would be possible to launch an East Asian Community Forum participated in by specialists, government researchers, and representatives of the business communities of the nations of the region. The free discussions held at such a forum would generate proposals that could be made to national governments, the East Asia Leaders' Summit, etc.

The longer-term perspective on an East Asian Community mentioned in point (3) could be expected to emerge from the forum suggested in (2). Separately to this, we might also consider the creation of reports on themes such as the form that East Asia

should take in 30 years' time. These reports might be formulated by research groups bringing together specialists from all the region's nations, or could potentially be formulated in Japan alone. Reports might also be produced by organizations such as the Asian Development Bank. It would be desirable for these reports not to be produced in isolation, but to come from a variety of channels to ensure that a diverse range of perspectives is taken into consideration.

NIRA will also seek to contribute to the formation of a shared awareness concerning an East Asian Community by continuing research that takes into consideration such factors as trends towards regional cooperation in East Asia and the diversity of the region's nations.

\* The texts of this report may be accessed on NIRA's homepage.

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