CHAPTER 2

EAST ASIAN FREE TRADE AGREEMENT: STRATEGIC ASPECTS FOR JAPAN

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1. INTRODUCTION

Although the globalization of economic activities is the main trend, regionalism in the form of regional economic integration also began to develop around the end of the 20th century and has grown more rapidly in the 21st century. The scale and scope of activities of an economic unit has been changed by developments in telecommunication and transportation technologies, as well as in production and distribution technologies. Information technology has improved the network-system of mutual exchanges of those technologies. An optimum economic border is different from a national border, and the integration of national borders will become necessary when an economic space of one nation is not sufficiently large. Economic effects of regional economic integration depend on the level of technologies and the size of markets, above all.

Traditional textbooks of international economics have explained international trade and investment and international financial payments based on existing national borders. However recent developments in the globalization of economic activities have increased the number of issues that can be explained more appropriately in the context of regions or multiple nations than in the context of existing national borders. Multinational firms or international financial firms make decisions about the extent of their activities regardless of existing national borders. They draw their optimal maps. Overlapping those many maps, the world will have a de facto new border map. However existing national borders are determined by a long history and are still effective in many aspects—political, social and cultural. Therefore, it is important to discuss the issue of regional economic integration from the viewpoint of the optimum map of regional integration. This point of view is the foundation of this paper.

Regional economic integration includes both financial and real aspects. The financial aspects are discussed in the context of optimum currency area arguments pioneered by R. A. Mundell (1961), while the real aspects are discussed in

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arguments on free trade agreements (FTAs) or customs unions. Of course those two aspects cannot be separated and both real and financial investigations are necessary for practical arguments on regional economic integration. Both an optimum currency area and an optimum FTA area (map) could be investigated with comparisons between scale merits of integration and costs of adjustments for integration. However the two optimum areas (maps) may not coincide with each other. In this paper, we focus on East Asian (ASEAN, China, Korea, and Japan) FTA arguments only. We have discussed the idea of an East Asian currency area in a different paper (B. Kim and K. Igawa (2001)), which pointed out that the macroeconomic indices of East Asian countries show a high potential for the development of a single currency area in the region.

FTA arguments often discuss the problem of the distribution of costs and benefits. Countries excluded from an FTA might suffer from trade diversion effects and some groups within an FTA member country might have to bear losses. Therefore, there always exist game strategies among players (countries and interest groups). We will make clear the strategic aspects of an East Asian FTA, especially the aspects of Japan, which we assume. The strategic FTA policy of the Ministry of Foreign Affairs of Japan was revealed in major Japanese newspapers on October 13, 2002. Although the strategy is more comprehensive and general, it does not seem to differ greatly from the strategy we assume here.[1]

In the following sections, we discuss the optimum FTA map of the world (section 2), and FTA players in East Asia (section 3). Section 4 examines the strategies of Japan for an East Asia FTA.

2. FTA MAP

Traditional theories of customs unions and FTAs depend on the pioneering works of J. Viner (1950), which provide a clear view of the trade creation effects of benefits and trade diversion effects of losses. There, costs and benefits comparisons are made between the economic situations before and after integration. The effects of integration of countries with given borders are analyzed, and an optimum size of integration is not taken into consideration. However recent arguments are more conscious of the size of integration and of whether the direction of FTA movements is towards global trade liberalization or fortress construction. P. Krugman (1991) showed by simulation that world welfare is minimal with a three-bloc division map of the world, and J. Bhagwati (1993) promoted investigations about the global versus regional liberalization aspects of FTAs. More than 100 FTAs exist and the number will increase rapidly, with these FTAs overlapping each other. A substantial economic border map will be changed by the development of these overlapping FTAs, or FTA networks. We are now in the position to investigate an optimum free trade area in the world.

[1] Summarizing the reports: the priority of Japanese government is on economic cooperation with East Asian countries, and thus Japan will advance the schedule of FTA between Korea, and between ASEAN, and then will negotiate with China. Japan's FTA with NAFTA and with EU will be long-run subjects.

Arguments of costs and benefits in economic integration have changed the emphasis from static trade creation and diversion effects to dynamic effects of accumulation or concentration of economic activities. The traditional trade theories of D. Ricardo, E. Heckscher and B. Ohlin focus on gains from trade and how such gains are distributed; but the analysis is static. With opening international trade (or trade creation by FTAs), a larger share of gains from trade are distributed to smaller countries, whose terms of trade change by a larger scale, compared to larger countries whose terms of trade change by a smaller scale. However, relative adjustment costs will be larger in a small country facing large changes in terms of trade than in a large country facing small changes in terms of trade. In an increasing return economy, gains from trade come from cost decreasing effects, through mass production and consumption, and from increasing consumption menu effects, through product diversification. This new trade theory was developed by Helpman-Krugman (1985), using a monopolistic competition model by Dexit-Stiglits (1977). With increasing return to scale, the increase in market size and thus production size make possible diversified final and intermediate products. These effects increase the economic welfare of participants in the larger market. These increasing return benefits will be found in capital (technology) intensive industries of manufacturing products, and communication and distribution network services. Advanced countries are more aggressive in FTA formation because they have more increasing return industries. The economies of scale and scope usually have dynamic effects of endogenous development.

If a regional economic integration has accumulation effects or concentration effects of endogenous development, member countries will get enough net benefits by forming an FTA. This idea is not new and can be found in Adam Smith's *The Wealth of Nations* (1776). How and why nations become wealthy depends on the division of labor, which determines a nation's productivity, and the division of labor is determined by the extent of the market. The nation can open its markets to exploit the advantages of labor specialization. This implies that knowledge and technologies, which support works of market mechanisms, and the division of labor in production and distribution determine appropriate productivities and market sizes. This idea is applicable to the problem of an optimum integration of markets and concentration (and accumulation) of economic activities in the world. One of the interesting recent applications is in M. Fujita, P. Krugman and A. J. Venables (2001). A concentration and accumulation of economic activities produces core and periphery relations in the world, where core areas develop faster than peripheral areas. The size of concentration (or accumulation) and relations between the core and periphery, both depend on the level of available knowledge and technology. The technologies of telecommunications, transportation, production and distribution, and also knowledge (know-how) of management are important determinants of scale economies, economies of scope, and network economies.

An optimum FTA map asks how many and what size of economic concentration areas should exist in the world to maximize an economic welfare. The objective function could be the welfare level, world production or consumption, or those of a specific region or country. There are more than 100 FTAs in the world, but NAFTA and the EU are exceptionally large and powerful. Of course there are many effective

FTAs but they are rather restricted to a specific local area or have no strong external effects. There also exist large regional cooperation areas, but they are not effective as free trade areas. APEC, for example, covers a large area but the member's are not strongly concentrated enough to form one FTA. APEC has no unique core and no explicit organizational ability. The two large FTAs are dominant in the present situation of the FTA map of the world. Then the optimum FTA map asks whether the recent situation of "NAFTA and the EU plus small FTA network" is optimal or not. In our opinion, the present map is not efficient enough and there should be one more large FTA concentration in East Asia.

It is easily found that NAFTA and the EU are not absorbing all their peripheral areas and are not fully using up the capacity of those areas. NAFTA is planning to extend its membership to include Central and South America. However, Central and South American countries are not yet prepared to join NAFTA in terms of their economic systems and political environment. The problems of geographical environment and distance are also not yet completely resolved by the present level of technologies and knowledge (know-how). Similarly, the EU is planning to include East Europe and the former Soviet Russia into its union, but the level of technological-knowledge is not yet high enough to make this possible. The system for putting forth a collective view (opinion) is not fully advanced enough to expand the EU. NAFTA. The EU should develop and concentrate within present members, and gradually utilize the potential capacities of their peripheries. In the following sections, we discuss the possibility of the formation of a third large FTA in the East Asian region.

3. FTA PLAYERS IN EAST ASIA

Two concentration cores of FTAs, NAFTA and the EU, do not cover the entire world, and East Asia does not understand the incentive to form one more economic concentration in East Asia region. If East Asia does not have FTAs, East Asian countries must act as players in the NAFTA-EU FTA system. Geographically East Asian countries are located far away from the center core of NAFTA or the EU; thus, East Asian countries face the risk of being treated as a periphery of NAFTA and/or the EU. In this case, East Asian countries will not gain enough benefits from economic concentration in spite of their large potential. On the other hand, when East Asian countries have their own concentration of FTAs, they will be able to form a large enough market and to make full use of their potential, with the existing technology and knowledge. It is well known that the stream of economic development in the region started with Japanese development, and next moved to the Asian NIES, then to ASEAN, and has now moved on to China. This development stream was driven by the technology transfers and foreign direct investment (FDI) first of Japanese firms and then the firms of the Asian NIES. Now ASEAN has started to become more active in regional FDI and FDI into China. Technologies and knowledge are transferred along with FDI in East Asia. After the Asian currency crisis, most East Asian countries have recovered. Their potentials for economic developments, inherited from the era of the East Asian miracle are not lost.

East Asian countries are engines of economic growth of the world, again.

There is a story that a natural concentration is advancing among East Asian countries without an effective FTA, and an East Asian FTA might prompt offensive strategies from NAFTA and EU members. East Asian countries have largely depended on the US and EU as export markets, and these markets are still important. It was true in the past, that an economic strategy of East Asian countries, which might be called as an equidistant foreign policy or a multilateral trade policy, provided advantages to access global export markets. Many FDI inflows of capital-intensive industries and export-oriented products have become feasible with the support of multinational (global or trans-national) firms that based their main business activities in NAFTA or the EU. Loose connections in APEC and in ASEM, have increased opportunities for international trade and investment and have widened policy strategies for East Asian countries.

However economic situations have changed. Increased dependency on intra-regional trade and investment among East Asian countries has given greater importance to East Asian regional markets (see Table 1 and 2).[2] In competing with NAFTA (or EU)-based firms, East Asian firms are seeking to form a larger domestic market, where main business activities can enjoy economies of scale and scope. The change has been strengthened by the Asian currency crisis. The natural concentration story of East Asian countries is being reexamined in the context of uncertainties and risks like currency crises. To ensure the concentration formation, it is better to adopt policy strategies to facilitate an FTA in East Asia.

Table 1. Intra-regional, Extra-regional trade in East Asian countries

(Unit: Millions of US$, %)

			Value		Share		Growth rate	
			1999	2000	1999	2000	1999	2000
Total	Export	Intra-regional	349,606	437,626	35.8	37.2	8.0	25.2
		Extra-regional	626,496	739,802	64.2	62.8	5.6	18.1
		Total	976,102	1,177,428	100.0	100.0	6.4	20.6
	Import	Intra-regional	337,565	433,070	39.3	40.0	8.8	28.3
		Extra-regional	521,288	650,689	60.7	60.0	9.8	24.8
		Total	858,853	1,083,759	100.0	100.0	9.4	26.2
IT Products	Export	Intra-regional	131,085	177,998	39.0	41.2	23.3	35.8
		Extra-regional	205,397	254,199	61.0	58.8	13.3	23.8
		Total	336,482	432,197	100.0	100.0	17.0	28.4
	Import	Intra-regional	122,086	171,595	46.4	49.1	18.4	40.6
		Extra-regional	140,811	177,932	53.6	50.9	13.1	26.4
		Total	262,897	349,527	100.0	100.0	15.5	33.0

Source: JETRO, *JETRO White Paper on International Trade*, 2001.

[2] Intra-regional export and import shares of East Asian countries are about 40%, and their growth rate is high. The figure is not much less than the one of EU (50%). Intra-regional shares of FDI into East Asia are very high (more than 60% for China and about 50% for ASEAN 4).

The US, which has opposed an East Asian FTA in the past, has now adopted a more moderate stance. ASEAN is making an effort to accomplish an ASEAN FTA, including the new ASEAN 4 members. China has called for an FTA with ASEAN and this has led to a call for strengthening cooperation among the ASEAN+3 countries. The recent world trend of FTA formation has pushed East Asian countries to establish a larger FTA in Asia.

Table 2. FDI Inflows in East Asian Countries

(Unit: Millions of US$, %)

		Asian (Japan)	Total	Shares (Japan)
Korea	1990	257 (236)	803	32.0 (29.4)
	1996	1202 (255)	3203	37.5 (7.6)
China	1990	4,440 (457)	6,596	67.3 (6.9)
	1996	44,111(5,131)	73,276	60.2 (7.0)
Thailand	1990	4,827(2,757)	8,182	59.0 (33.7)
	1996	9,122(6,156)	13,050	69.9(47.2)
Malaysia	1990	973 (657)	2,303	42.3(28.5)
	1996	4,006(1,831)	6,780	59.1(27.0)
Indonesia	1990	4,221(2,241)	8,750	48.2(25.6)
	1996	16,147(7,655)	29,931	53.9(25.6)
Philippines	1990	494 (271)	851	58.1(31.8)
	1996	384 (58)	967	39.7 (6.0)

Note: 1) Asian members include Japan, Korea, China, Hong Kong, Indonesia, Malaysia, Philippines, Singapore, and Thailand.
2) Contract Base
Source: JETRO, *White Paper on Foreign Direct Investment*, 1999.

There is another reason to call for a larger FTA in East Asia. East Asia has many countries with similar economic structures that compete with each other in a common export market. Although bilateral FTAs might be a necessary step for forming a larger FTA, bilateral FTAs will have beggar-thy-neighbor effects on third countries in East Asia. A large FTA, alongside NAFTA and the EU, will be accepted as an intermediate situation toward a global free trade system. East Asian countries are now in the position of having to make a big push for the formation of an East Asian FTA.

However, forming an East Asian FTA is not an easy task, and is accompanied by many hurdles to clear. Although East Asian countries are diverse in economic, political, and cultural aspects, we can divide them into three types (or subgroups) of players. One type includes Japan and Korea. These countries are at a higher level of economic development and the products in which they have the greatest comparative advantage are capital-intensive manufacturing products and technology-based products. It is possible to include Taiwan in this group, but this involves complexities in the strategic game of an East Asia FTA because of the political relations between Taiwan and China. This is not to ignore the importance of Taiwan, but excluding Taiwan simplifies the East Asian FTA strategies, without changing the main story of the East Asia FTA. Japan was the first Asian country to join the group of advanced countries. Japan succeeded in catching up with the U.S. in its textile industry, then in the electrical appliances and automobile industries. Korea underwent similar catching up processes following Japan, and has become an OECD member. The similarities between Japan and Korea might stem from the pre-war history of unification of the two and from their political relations with the US after World War II. Geographical location in the Asia-Pacific is also a reason for their similarities. Protecting their domestic market from foreign competitors and promoting the export of manufacturing products have been their main foreign trade policies. Both for Japan and Korea, recent competition with large foreign companies calls for a large domestic market and the recent threat of China catching up calls for FDI into China. Both Japan and Korea are players with advanced technology in the manufacturing industries and who want to have a large domestic market. An FTA including ASEAN and China will provide both countries with a strong strategic advantage against the larger US and/or EU companies.

Although encompassing many different member countries, ASEAN is another type of player for an East Asian FTA. The diversity of East Asian countries is condensed into the diversity of ASEAN. Singapore is one of the financial centers of the world and per-capita income is high, despite the country's small population and land area. Malaysia and Thailand are developed in the labor-intensive manufacturing industries and are aiming an industrial reform with more capital-intensive industries. Indonesia and the Philippines have some difficulties in terms of political stability, but are aiming to gain a comparative advantage in labor-intensive manufacturing industries. Indonesia has a large population and is rich in natural resources. The quality of labor in the Philippines is high. Brunei is exceptionally rich because of its oil production but it should find other industries in which it can be competitive in the future. The new ASEAN 4 countries are transitional economies and have different development levels from the other ASEAN countries; for them, learning the system of the market economy is a priority matter. For Vietnam, Cambodia, Laos and Myanmar, it is necessary to change their latecomer disadvantages into latecomer advantages. It is very difficult to find a typical ASEAN player. However for an East Asian FTA, ASEAN members will have a united strategy as an ASEAN FTA unit. Therefore we treat ASEAN as one player here, assuming Thailand, Malaysia, Indonesia, and the Philippines (ASEAN 4) are the dominant decision-makers of the ASEAN 10. The ASEAN 4 countries are in a position in which they must graduate from the labor-intensive industries at an early stage and must catch up in the capital-intensive industries without enough accumulated experience. This is necessary for the new ASEAN 4 as China catches up in the labor-intensive industries. The situation is harsh for ASEAN because FDI inflows are shifting from ASEAN into China (see Table 3),[3] and this means a decrease in the transfers of technology from the developed countries to ASEAN. It is important for ASEAN to have policy strategies for an East Asian FTA, in the face of the large potential of China's development.

The third player is China. China also has its own complicated problems of

[3] China is the biggest FDI absorber, and ratio of ASEAN4 to China has reduced from 42.5% in 1996 to 16.7% in 2000.

Taiwan and Hong Kong, and there are disparities between China's coastal areas and inland provinces in terms of development levels. China is also a transitional economy with government-owned firms, which are not efficient in many cases. Despite the political difficulties and uncertainties in its transitional economy, the central government retains a firm grip on the Chinese economy. The policies of the government are key for the economic environment not only of East Asia but also of the world. The development of China has large effects on other countries, especially on neighboring countries. Its potential ability has produced rumors of the menace of Chinese power in the future. China has an economic potential comparable to the US economy, which started its development in the 19th century and became the world's top economy in the 20th century. The development stage of China is an important factor in determining the international division of labor. Neighboring countries must take into account China's stage of development in forming their development strategies. In the past, there was a time when China was strong as a unified nation, but it was too big to be one economic unit and there were many sub-regions with many concentration cores. However, recent developments in technology and information knowledge and transportation have made it possible for China to form one economic core.

Table 3. FDI inflow in East Asian Countries

(Unit: Balance of payments base: Millions of US$)

	1996	1997	1998	1999	2000
Japan	200	3,200	3,268	12,308	8,227
China	40,180	44,237	43,751	38,753	38,399
ANIES	25,.22	29,428	26,726	44,043	85,035
Korea	2,326	2,844	5,412	9,333	9,283
Taiwan	1,864	2,248	222	2,926	4,928
Hong	10,460	11,368	14,776	24,587	64,433
Kong	10,372	12,967	6,316	7,197	6,390
Singapore					
ASEAN4	17,343	16,307	11,946	7,573	6,387
Thailand	2,336	3,895	7,315	6,213	3,366
Malaysia	7,296	6,513	2,700	3,532	5,542
Indonesia	6,194	4,677	-356	-2,745	-4,550
Philippines	1,517	1,222	2,287	573	2,029
Total	82,745	93,171	85,691	102,677	138,048

Source: UNCTAD, *World Investment Report 2001*.

It might be easy to understand the development of China by comparing and overlapping the history of its development with that of the United States. The U.S. was a land-rich country and immigrant workers from Europe, starting on the east coast, and capital fund investments, also from European countries, supported its economic development. Agricultural products in the southern area and mining products in the eastern area drove the early stage of U.S. development. The wave of development moved from the Midwest area and then to the west area. In the meantime the north became a developed industrial region. The U.S. depended on

European funds and technologies for its development and also on European markets, but gradually increased its dependency on its own domestic market. After two World Wars, during which European countries suffered severe blows, the U.S. became the supreme ruler of the world.

China is a labor-abundant country whose economic development has been stimulated by FDI of funds and technologies in its southeastern coastal areas. The development wave is now being directed to the inland areas in the north and west. The coastal area has become a development center with manufacturing products, many of which are exported to the U.S. and EU, and also to Japan. The recent economic stagnation of Japan, the U.S. and EU after 2001 has changed the situation of China's development from depending on foreign markets into more dependence on its own domestic market. It is not possible for a large country to continue an export-oriented development strategy and the large potential of the domestic market should be developed. The very recent development of China depends on domestic investment and this is financed by FDI inflows (see Table 4).[4] If FDI inflow into China with advanced technologies continues and if China constructs an efficient domestic economic system and market, it will be one of the largest economies in the world. The problems of how to make those government-owned firms efficient or how to privatize those firms might be critical for this change. Economic growth without productivity growth will impose limits on China's growth and economic development. In the near future, China will be in an important position to change its growth policy of input quantity growth to one of productivity growth. An East Asia FTA will give China a greater chance of maintaining high growth rates with higher productivity growth.

Table 4. FDI into China

(Unit: Millions of US$)

	1999		2000		2001.1~6	
	Contract value	Realized value	Contract value	Realized value	Contract value	Realized value
Hong Kong	13,329	16,363	16,961	15,499	9,667	7,469
U. S.	6,016	2,659	8,000	4,383	3,711	2,050
Japan	2,591	2,973	3,681	2,915	2,937	1,879
Taiwan	3,374	2,599	4,041	2,296	3,339	1,299
Singapore	2,258	2,642	2,030	2,172	802	945
Korea	1,484	1,275	2,385	1,489	1,555	973
United Kingdom	1,085	1,044	834	1,164	641	489
Germany	939	1,373	2,900	1,041	509	684
France	470	884	634	853	268	351
Others	9,677	8,507	20,913	8,902	10,030	4,569
Total	41,223	40,319	62,379	40,714	33,459	20,708

Source: JETRO, *JETRO White Paper on Foreign Direct Investment,* 2002.

[4] China is accepting large FDI from East Asia (Japan, Taiwan, Singapore, and Korea), US, and Europe (UK, Germany, and France).

From the above arguments in this section, it will be understood that each player has its own problems. Depending on the economic environment, the three types of players will move with their own strategies in forming an East Asia FTA. In the following section, we discuss a possible process of FTA negotiations among the three types of players. The focus will be on the strategic aspects from the perspective of Japan, in the sense that possible scenarios in which Japan leads in the formation of an East Asia FTA are considered.

4. THE PROCESS FOR AN EAST ASIA FTA: THE STRATEGY OF JAPAN

Our arguments for an East Asia FTA in this section start by investigating the possibilities of a bilateral FTA between the three types of players if there is no Japan-Korea FTA. It will be shown that a bilateral FTA with practical effects will be difficult to form, although a superficial FTA might be concluded. Then we discuss the necessity and possibility of a Japan-Korea FTA as a strategy for both Japan and Korea. The final arguments show a possible process for an East Asia FTA when a Japan-Korea FTA exists.

4.1. The Case when There is No Japan-Korea FTA

Let us examine the costs and benefits of forming a bilateral FTA between the three types of players. First, China proposed forming an FTA with ASEAN. This comes from political reasons rather than economic reasons because gains from an FTA between China and ASEAN are not large for China. China is relatively larger than ASEAN and static gains of trade creation will go to the smaller members of ASEAN. Dynamic gains of concentration and scale/space economies will not be large with the unification of the two markets, although potential gains in the future will be large. The FDI that flows into China might be diverted into ASEAN. ASEAN might get larger benefits by specializing in relatively more capital-intensive products and inviting FDI, which might have gone to China without an ASEAN-China FTA. These expected gains for ASEAN should be discounted with the risks of China, which is still in transition and has large economic disparities among its various regions. On the other hand, ASEAN might have to pay greater costs in adjusting from labor-intensive products into more capital-intensive products. The costs will be high for new ASEAN members who must compete with China in labor-intensive products. Both China and ASEAN have internal problems to clear, and thus while an FTA between the two parties may be possible, it may not be an effective FTA.

The benefits of a bilateral FTA between ASEAN and Japan, or ASEAN and Korea, will also be limited. The size of the ASEAN market is not large enough, and Japan and Korea are also unable to provide a large export market for ASEAN. Japan and Korea seek a division of labor in which they specialize in more capital-intensive products while ASEAN countries specialize in labor-intensive products. However ASEAN will be interested in specializing in more capital-intensive products, considering the competition from China and from the development of the new

ASEAN 4. For Japan and Korea, both ASEAN and China are important partners of international trade and investment. ASEAN is interested in attracting FDI and in obtaining technology from Japan and Korea. However Japan and Korea, in the economic environment of global competition, are more interested in directing FDI into China. Therefore, Japan and Korea may not be so enthusiastic about forming an FTA with ASEAN, unless it is a step towards a larger FTA including China. ASEAN has received many proposals for an FTA (most recently from the U.S. at an APEC meeting in Mexico). It is not easy to make a strategic choice among the various FTA scenarios, including an ASEAN-Japan FTA or ASEAN-Korea FTA. Of course a bilateral FTA between one of the ASEAN member countries and Japan or Korea could be formed, but it will take time to have a substantial FTA including ASEAN as a whole.

Currently, the situation is not right for a bilateral FTA between China and Japan, or between China and Korea. The capital funds and technology levels of Japan or Korea are not sufficiently large to make the best use of China's potential. Therefore, it is still necessary for the U.S. and EU to participate. As FTA partners, Japan and Korea do not have large enough markets to absorb larger shares of exports from China. Both countries also have a limited capacity to provide China with a large number of machines for manufacturing products. The limitations also come from risks, stemming from China's economic development and transition into a market economy. Japan or Korea alone do not have enough negotiating power against China and will hesitate to conclude a treaty voluntarily in the near future.

A gradual progress of bilateral FTAs among the three player countries will cover the East Asian region but it will take time for an FTA net to cover all of East Asia without a big push and large incentive policy cooperation among East Asian countries. The priority, at this stage, should be put on preparations for an East Asian FTA for each type of player. ASEAN must make efforts to complete an ASEAN FTA, appropriately treating the four new members. Without an efficient ASEAN FTA, it will be difficult for ASEAN as a whole to engage in FTAs with other countries. China should reduce the uncertainties produced by domestic regional disparities and other problems including its transition into a market economy and problems with Hong Kong and Taiwan. It is not easy for a partner to conclude an FTA treaty with China when there are so many uncertain factors. The other players Japan and Korea should form an FTA between themselves. The benefits and strategic aspects of a Japan-Korea FTA (J-K FTA) will be discussed in the following section.

4.2. An FTA between Japan and Korea

As already mentioned, both Japan and Korea have similar experiences of government-led development and manufacturing sector export-led growth. In both countries, household sector savings are high and investments of big manufacturing firms are financed through the domestic banking systems. The government distributes funds for basic or key producers, and there are not many benefits for consumers. After, the explosion of the recent Japanese bubble in the early 1990s, the Japanese economy is at a lower equilibrium (deflation) level of GDP. For Korean firms, after the Asian currency crisis, Korea's small domestic market has become more disadvantaged in terms of international competition. Both Japan and Korea are interested in a Japan-Korea FTA as there is momentum for economic reform in light of the recession from the bursting of the bubble and the damage from the Asian currency crisis. It has become evident that a traditional system of KEIRETSU (organizational system of grouping in enterprises) or ZAIBATSU (combine, a giant family concern) is not efficient. Competition in a global market is the best way for firms to gain competitiveness. Competition in a free and large market with a J-K FTA might help both countries in their economic restructuring. The changes in the economic environment have caused Japan and Korea to transform their negative views on FTAs into the recent positive actions towards concluding an FTA.

There are arguments against the J-K FTA because of the similarity in the economic structures of the two countries and the large adjustment costs. However, most of the arguments depend on the traditional economic assumption of non-increasing returns. As already mentioned, new international trade theory, of monopolistic competition with increasing returns, has pointed out many gains in the case of trade between similar partners. The new theory of the special economy stresses the concentration effects and a J-K FTA will provide a large enough market to yield concentration effects. Firms that manufacture similar products compete with each other and extend their production capacities to obtain economies of scale and scope. With severe competition, only efficient firms will survive. Firms might survive by product differentiation, by concentration in a final or intermediate product, or by outsourcing their parts. The industrial structure after a J-K FTA will be more complex with a horizontal and vertical network relation of firms and with a diversified division of labor in production processes. The protection of agricultural products and marine products is a politically important issue both for Japan and Korea. However, specialization depending on comparative advantages will be accepted if appropriate compensation mechanisms are provided. The weight of the total value of those products in GDP is small so it should not be too difficult to find a political solution with the international pressure to form FTAs.

It is easy to understand that economic competitiveness scenarios with a J-K FTA are better than scenarios without an FTA for both Japanese and Korean firms. One of the factors which determine the international competitiveness of firms is the size of the domestic market, and thus without an FTA, firms in Japan or Korea cannot gain the advantage of scale relative to firms in NAFTA or the EU. The process of structural reforms in the financial and manufacturing sectors with an FTA will result in the survival of a few competitive firms (banks and companies). With a J-K FTA, the joint domestic market is relatively larger. Mutual investments, cooperation between firms or M&As, and a competitive economic environment will produce firms with more competitiveness in the global market. From this point of view, it should be pointed out that a J-K FTA, which entails investment liberalization, deregulation of M&As, and competitive cooperation among firms, will bring more benefits than mere trade liberalization or tariff reduction.

A J-K FTA is also important as a step towards strategic policy cooperation. Joint strategies of Japanese and Korean firms against firms of the EU and U.S. will be more effective than individual strategies. While Japanese and Korean firms now compete with each other in the export markets of the EU or NAFTA, cooperative strategies between those firms will generate more profitable opportunities. By forming an export coalition, Japanese and Korean firms will find it easier to change the protective policies of the EU and NAFTA countries. Japan and Korea now worry about increasing imports from China; a coalition of Japan and Korea will have greater power in negotiations on import protections. A more important strategy might be in negotiating for FDI into China. Competition between Japanese and Korean firms with regards to FDI into China will reduce the benefits for firms of both countries and give China an advantageous position. However, the benefits will increase if Japan and Korea cooperate to devise negotiating strategies against China. Through a J-K FTA, Japan and Korea can strengthen their bargaining power against outsiders.

4.3. East Asia FTA with J-K FTA

If an FTA between Japan and Korea is concluded, the process for an East Asia FTA will be more promising. The market size of a J-K FTA is not as large as the markets of the EU and NAFTA, but is attractive enough for other East Asian members to join.

With a J-K FTA, ASEAN member countries will have more incentive to conclude a bilateral FTA with Japan or Korea because of a larger export market and FDI by firms with more competitiveness in Japan or Korea. Singapore concluded a bilateral FTA with Japan, and the ASEAN 4 of Thailand, Malaysia, Indonesia, and the Philippines will follow this in the future. The new ASEAN 4 should wait for the accomplishment of an ASEAN FTA to have an effective FTA with Japan or Korea. These bilateral FTA networks will cover ASEAN, Japan, and Korea, and will bring about an environment suitable for an FTA between ASEAN as a whole and Japan or Korea, and then for an FTA between the three parties.

An FTA with China holds risks of uncertainty for the partner country, but the risks could be mitigated and shared if the partner is a group of countries. The partner should be large enough to be comparable to China's potential. Together, Japan and Korea through the J-K FTA could be a good candidate. Under a J-K FTA, the market size is not small and the possible international division of labor between China and Japan-Korea could be diverse. Japan-Korea could provide larger capital funds and appropriate technologies; together, the two countries can also share the risks associated with China and ensure greater negotiating power against China. For China, the benefits of forming an FTA with Japan-Korea will not be small, with a larger J-K FTA export market and inflows of efficient FDI firms from Japan-Korea

China has proposed an FTA to ASEAN, which it will advance in steps. However, as already mentioned, gains from the FTA might not be large for China while costs might be large for ASEAN. Now if ASEAN joins a J-K FTA, China will have a strong incentive to join the J-K FTA to avoid losses from not joining. The same is true for ASEAN so it will have a strong incentive to join a J-K FTA if China joins in. Therefore, an East Asia FTA will be realized through a consensus of the three main players in East Asia.

As a strategy for promoting an East Asian FTA, the first important step is an FTA between Japan and Korea. Then, the next step is to extend the FTA network with bilateral negotiations. With a larger network including a J-K FTA, the possibility of an East Asia FTA will be higher. This scenario is urgent for Japan and Korea, where domestic space for economic concentration is limited and there is an urgent need to extend the space for further concentration. Without an East Asia FTA, Korean and Japanese firms might not be competitive in the global market and then might face the problem of international M&As. Recent international M&As show the strong power of firms in the US and EU (see Tables 5 and 6).[5] East Asian firms might be absorbed by U.S. or EU firms.

Table 5. Cross-border M&As (Sale by countries)

(Unit: Millions of US$)

	1997	1998	1999	2000	2001.1~6
World	340,546	616,602	841,677	1,220,854	361,060
U. S.	87,634	221,221	251,791	335,119	111,772
EU	126,203	237,463	400,525	607,635	147,898
Japan	699	5,108	17,156	16,815	14,446
China	2,143	1,273	2,613	4,550	943
ANIES	14,059	9,212	23,880	17,217	11,527
Korea	900	4,810	11,839	7,383	2,155
Taiwan	894	66	1,867	937	1,448
Hong Kong	10,839	3,735	5,047	6,847	4,471
Singapore	1,426	601	5,127	2,051	3,453
ASEAN4	6,645	8,065	7,826	5,126	2,751

Source: JETRO , *JETRO White Paper on Foreign Direct Investment,* 2002.

Table 6. Cross-border M&As (Purchase by countries)

(Unit: Millions of US$)

	1997	1998	1999	2000	2001.1~6
World	340,546	616,602	841,677	1,220,854	361,060
U. S.	87,842	124,813	161,156	142,697	50,028
EU	154,363	332,400	562,708	881,935	234,254
Japan	5,463	9,630	15,107	21,186	14,716
China	7,810	2,866	437	776	755
ANIES	11,257	10,910	8,188	20,949	2,259
Korea	2,336	118	39	1,421	35
Taiwan	551	645	669	1,286	311
Hong Kong	3,954	8,948	3,652	8,309	1,311
Singapore	4,416	1,199	3,828	9,930	603
ASEAN4	3,265	1,147	1,167	3,443	847

Source: JETRO, *JETRO White Paper on Foreign Direct Investment,* 2002.

China and ASEAN do not fully utilize their economic potentials and it could take

[5] It should be noted that sales of Korea and ASEAN4 are larger than purchase, and this is true for China after 1999. Japan is not a big player of M&A.

time for them to promote an East Asia FTA. China and ASEAN need to establish a cooperative economic relationship, not only with Japan and Korea, but also with the US and EU. For now, it might be a better strategy for China and ASEAN, to get the benefit of competitive assistance from Japan, Korea, the US, and EU. Although, as already mentioned, it will be better for all East Asian players to have a large economic concentration in East Asia. An East Asia FTA will enable the region to realize its large economic potential.

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