



**ADB Working Paper Series**

**Political Economy of East Asian  
Regional Integration and Cooperation**

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No. 170  
November 2009

**Asian Development Bank Institute**

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I would like to thank Masahiro Kawai, Chalongphob Sussangkarn, Mario Lamberte, and Peter Morgan for inviting me to the conference. I would also like to thank Rodolfo Severino and Carolina G. Hernandez, as well as the conference participants, for their insightful comments and suggestions on my earlier paper.

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Suggested citation:

Katada, S. N. 2009. Political Economy of East Asian Regional Integration and Cooperation. ADBI Working Paper 170. Tokyo: Asian Development Bank Institute. Available: <http://www.adbi.org/working-paper/2009/12/01/3390.political.economy.east.asia/>

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**Abstract**

In the last decade, East Asia has engaged in constructing numerous mechanisms to enhance regional cooperation in the areas of trade and finance. However, the region's economic architecture exhibits certain idiosyncrasies such as an eclectic institutional structure and a limited level of commitment shown by its members. These idiosyncrasies seem to prevent regional cooperation from becoming deeper and more coherent. This paper focuses on the political factors that have thus far shaped the institutional form of East Asian regional trade and financial cooperation, particularly in the three essential aspects of regionalism derived from the theories of regional institution building. The first aspect is the level at which governments are willing to compromise sovereignty and political autonomy for the sake of regional cooperation. The second is the progress in creating mechanisms through which the "losers" and the "weak" within a country or region can be compensated. The third is the clear definition of which members can benefit from such mechanisms. These three elements are useful in furthering regional cooperation and institution building by removing resistance and obstacles that work against functional spillovers.

The paper argues that East Asia's economic institutions established through the cooperation efforts of the last ten years exhibit different qualities from those that have emerged in Europe, and thus fall far short of overcoming unexpected political tensions in the region. These deficiencies, however, contrast in two important fields of regional integration. In finance, the clearly defined member governments have difficulty compromising their respective national macroeconomic policy autonomy, while in the field of regional trade cooperation, the challenge is in redistributing the economic gains to those who stand to lose during the process of integration, or to the countries that have a long distance to catch up within a relatively well-defined group.

**JEL Classification: F55, F59**

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## 1. INTRODUCTION

In the last decade, East Asia has engaged in constructing numerous mechanisms to enhance regional cooperation, especially in the areas of trade and finance.<sup>1</sup> Given the usually path-dependent nature of institution building, it is striking that after almost fifty years of very limited regional cooperation from the end of World War II to the mid-1990s, the regional efforts have started to bloom all at once in the last ten years or so. East Asia's regional economic architecture as it currently stands, however, exhibits idiosyncrasies such as an eclectic institutional structure and a limited level of commitment by the member states. These idiosyncrasies, according to the established view on the evolution of regionalism, seem to prevent regional cooperation from becoming deeper and more coherent. This paper focuses on the political factors at various levels that have thus far shaped the institutional form of East Asian regional economic cooperation in trade and finance, in particular examining the three essential aspects of regionalism derived from analysis of the European Union (EU), which is arguably the most advanced and successful example thus far of regional institution building.<sup>2</sup> By examining the nascent regional institutional evolution in East Asia from the perspective established by Europe, not only is it possible to understand the political challenges involved in regional cooperation but it is also possible to outline alternative or supplementary paths toward regional cooperation and institution building for Asia.

Some discussion on the definition of often-used terms is in order at this point. In this paper, a conscious distinction is made first between "regionalism" and "regionalization," where regionalism represents a policy-guided process of conscious regional integration, while regionalization is a bottom-up process of regional integration led by private sector business activities and subnational communication through people's activities such as migration. Second, and in relation to the first distinction, the term "regional economic integration" is used to mean that there is some level of sovereignty pooling taking place in the area of cross-border movements of people, goods, and services. In that sense, regional integration is part of a stronger commitment by the participating governments. On the other hand, the term "regional cooperation" constitutes a part of regionalism, where conscious policies are adopted in favor of cooperation within the region to consciously facilitate regional arrangements. Third, "regional architecture" or "regional institution building" is a form of regional cooperation with the specific goal to form formal or informal regional institutions. Formal institutions tend to include a higher level of commitment, while informal institutions tend to constitute a large part of regional cooperation. Thus, in my view, regional institutions do not necessarily have to be formal, with headquarters and dedicated staff, but instead can be arrangements consisting of firm commitments made by the participating governments. Finally, the terms "political" and "politics" in the paper are used to mean the pursuit of power and influence either domestically or among governments, which encompasses elements broader than the narrow definition of national security or strategic interaction among states. Therefore, it is not only examples such as the Sino-Japanese rivalry, but also the politics behind tactics such as lobbying that shape government's choices in engaging in regional cooperation. In short, this study focuses on the decisions and actions taken by the leaders and governments in East Asia (i.e., regionalism/regional cooperation) in pursuit of regional institution building, both formal and informal, and the politics involved in such decisions and actions are understood to be much broader than the inter-national pursuit of power.

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<sup>1</sup> In this paper, East Asia is considered to be the Association of Southeast Asian Nations (ASEAN) Plus Three (People's Republic of China, Republic of Korea, and Japan).

<sup>2</sup> The purpose of this analysis is not to compare East Asia with Europe. Nonetheless, since Europe has the most developed regional cooperation scheme, and the literature on the political economy of regional cooperation is most advanced in examining the European case, the study takes those theories as its benchmark.

This study first summarizes various interpretations of the actions taken post-World War II that prevented East Asian regionalism from taking a clear shape until well into the 1990s. Second, the study discusses the sources of the sudden rise of East Asia's regionalism in the late 1990s, when regional economic integration began to take an institutional form. This study also identifies, from a theoretical perspective derived from the European experience, which political elements are essential in making regional cooperation more self-sustaining. After analyzing the institutional form of regional cooperation in East Asia that has developed in the last ten years in the third section, the study assesses how these elements of the political factors work to constrain or promote the strengthening and growth of regional cooperation. Instead of identifying the one most plausible political factor in shaping the regional institutional arrangement, the study errs on the side of being comprehensive and identifies the possibilities of how those key political factors operate at domestic, regional, and international level.

In sum, the study argues that the regional economic institutions established through the cooperation efforts of the last ten years in East Asia exhibit different qualities from those that have emerged in Europe, and thus fall far short of overcoming unexpected political tensions in the region. These deficiencies, however, contrast in two important fields of regional integration—finance and trade. In finance, the clearly defined member governments have difficulty compromising the autonomy of their respective national macroeconomic policies; while in the field of regional trade cooperation, the challenge is in the redistribution of economic gains to those who stand to lose in the process of integration or to the countries that are less developed economically.

## **2. EAST ASIA WITHOUT A REGIONAL FRAMEWORK: PATH-DEPENDENCE AND POWER CONFIGURATION**

Post-independence East Asia does not have a tradition of cooperation within a regional framework.<sup>3</sup> The European experience, with its developed regional institutions, can often be more of an exception than a rule,<sup>4</sup> and the level of regional cooperation efforts in East Asia until very recently has been low. The comparative and theoretical understanding of the relative absence of a regional framework in East Asia can be largely derived from two sources. The first source is the historical institutionalism of path-dependent evolution, while the second source is a power-based realist explanation.

Institutions are path-dependent. That is “once a country or region has started down a [particular] track, the costs of reversal are very high” (Levi 1997: 28). The cost of reversal increases because “the relative benefits of the current activities compared with [the] once-possible options [have] increased over time” (Pierson 2004: 21). This is a source of positive feedback for a particular path or institution and it is only at “critical junctures” that those paths and institutions are put in a distinctive direction.<sup>5</sup>

In Europe and Asia, the end of World War II set in motion regional configuration that has had lasting effects. The politico-economic arrangements that emerged in the aftermath of the

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<sup>3</sup> The only exception, of course, is ASEAN, which was established in 1967 as a political association in the face of the Viet Nam War. After the end of the Cold War, the focal point of ASEAN turned to free trade and industrial cooperation. This paper, however, does not focus on ASEAN because regional cooperation in East Asia is defined with at least the three Northeast Asian countries (People's Republic of China, Republic of Korea, and Japan) included. ASEAN as well as regional integration efforts such as Mercado Común del Sur (Mercosur) and Caribbean Community (CARICOM) are considered subregional cooperation in this paper.

<sup>4</sup> Baldwin (2008: 29) recently discussed that the world has relatively little to learn from the European integration experiences because “[the] EU started its life in circumstances...almost unimaginable in today's world.”

<sup>5</sup> “Critical juncture” is defined by Collier and Collier (1991) as a period of fundamental political reorientation in which countries are set on distinct trajectories of change.

war's devastation in both regions could not, however, have been any more contrasting. In Western Europe, regional integration, particularly between the major enemies of (West) Germany and France, became the focal point of the war recovery. On the regional level, European leaders were actively involved in region-building from the very beginning of the recovery, as seen in the process of establishing the European Coal and Steel Community in 1951. On the global level, Western Europe was integrated as an important unit into the US-led global politico-security regime. The North Atlantic Treaty Organization (NATO since 1949) and Organisation of European Economic Cooperation (since 1948) were both created at quite an early stage of Europe's recovery from the war and at the onset of the Cold War, and both those institutions are multi-member institutions that incorporated major European countries.<sup>6</sup> Even the American continent semi-succeeded in "inward-looking" integration efforts, which established Latin American Free Trade Association (LAFTA) in 1960 replaced by Latin American Integration Association (LAIA) in 1980. Also the Andean Pact (which was renamed Andean Community) was established in 1969. On the East Asian side, however, not only did the colonizers of Europe, from the British to French to Dutch, come back to reclaim their former territories after Japan's total defeat, but also the security and economic arrangements that emerged post-independence took mainly bilateral form (often called "San Francisco System") including the hub-and-spoke alliance and preferential trading (and foreign aid) arrangements with the United States, and bilateral reparation arrangements with Japan.<sup>7</sup>

Different institutional formation in Europe (regional and multilateral) and in East Asia (bilateral and eclectic) emerged from distinct US policies with regards to those two regions. Comparing the US security arrangements of the two regions, Hemmer and Katzenstein (2002) argue that the combination of the high threat perception in Europe and better understanding and stronger identification with the Europeans by the US policymakers led the United States to allow multilateral arrangements in Europe but not in Asia. East Asia also missed an early opportunity post-World War II to create multilateral arrangements in the region. Analyzing the critical junctures that led to the organization gap of East Asia, Calder and Ye (2004) conclude that the sudden intensification of the Korean War with the entry of the People's Republic of China (PRC) into the conflict helped establish the San Francisco system without any regional organization in East Asia.<sup>8</sup>

Power configuration, on the other hand, can determine whether or not integration and cooperation in a certain region is possible and whether it will proceed smoothly. Realists, who believe in the fundamental influence of the states' power in a world devoid of a supra-national governing authority, have seen East Asia as a place of instability and conflict due to its rapidly changing power configuration and inherent multi-power system, especially in comparison to Europe (Friedberg 2000). East Asia is also seen as an environment where institutions, which tend to lock-in a certain power balance, are less likely to emerge. In fact, Grieco (1997) compares three regions of the world—Europe, Latin America, and East Asia—and concludes that the rapid pace of the "relative power shift" among the major powers in East Asia makes the region the least likely place for regional institutions to emerge or stick.

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<sup>6</sup> NATO is a military alliance between Western European states and the US with a system of collective defense. The Organisation of European Economic Cooperation was an international organization that preceded the Organisation for Economic Cooperation and Development (since 1961), which was originally established to administer the US foreign aid channeled to Western Europe through the Marshall Plan.

<sup>7</sup> The only possible multilateral security efforts parallel to Europe is Southeast Asian Treaty Organization that was established in 1954. Not only did it include very few East Asian countries (Thailand and the Philippines), but it also included many outside members such as Pakistan, France, Suriname, and United Kingdom. The organization dissolved in 1977.

<sup>8</sup> The Korean War quickly triggered the formation of the San Francisco system because of the need to rapidly conclude peace with Japan, preempting local nationalism, and to allay the financial fears of the US congress. The pace did not allow for any focal point to emerge in the construction of regional politico-economic architecture in the Pacific (Calder and Ye 2004).

Furthermore, given the complexity of the Cold War dynamics in East Asia, the global hegemon, the US, long preferred to deal with the region through bilateral channels. It was only after the waning of the US hegemonic power that East Asia started to see nascent regional institutions (Crone 1993).

History and power configuration have never provided East Asia with a suitable environment in which to launch regional cooperation within an institutional framework. Thus, it is quite striking to see the recent developments in regional institution building. The underlying factors from the late 1980s that have contributed to this change include (a) the end of the Cold War, which minimized the Cold War divide in the region, (b) the rapid economic growth of many of the countries in the region and the associated economic liberalization, and (c) the democratization of many countries in the region and the associated social maturity and increased flow of information. In addition, the growth of informal economic regionalization through the regional production network led by Japanese firms (Hatch and Yamamura 1996) and the ethnic Chinese business network (Peng 2000) has established a critical foundation for regional cooperation efforts. Nonetheless, it is worth summarizing the concrete analyses of the sudden interest in and emergence of a regional cooperation framework in the form of formal institutions before analyzing the shape that East Asian regionalism currently takes.

### 3. NEW REGIONALISM IN EAST ASIA

#### 3.1 The Origin of Regional Institution Building in East Asia

How can we begin to understand the sudden emergence of regional economic institutions in East Asia since the late 1990s? This topic has fascinated international relations scholars for the last ten years.<sup>9</sup> Starting from the challenges resulting from the Asian financial crisis, the visible rise of regional institutional building efforts has been attributed to various sources and the arguments can be divided into four categories: New Institutional Economics, geopolitics, Asian identity, and domestic politics.<sup>10</sup>

The first category variously attributes the rise of new regionalism in East Asia to the region's economic statecraft, the region's insulation under globalization, and/or the rise of *Factory Asia*. Following North's (1981) footsteps, some scholars argue that institutions adapt to a changing economic environment and transform to reduce transaction costs. Economic maturity among the East Asian countries, along with the global trade and financial challenges that would disrupt the region's economic growth and stability, is fundamental in motivating the governments to establish regional arrangements. Regionalism strategies are born of both proactive incentives and defensive incentives. On the one hand, emerging Factory Asia triggered strong interest in the free trade area in East Asia as production and business networks expanded throughout Southeast Asia (Baldwin 2006). As Munakata (2006b) discusses in her book, governments have slowly begun to respond to business-led regional economic integration that has preceded policy actions. Meanwhile, defensive instincts have also been at play. Obviously, the Asian financial crisis has made Asian leaders realize the inadequacy of the region's financial cooperation (Wesley 1999). The lack of regional provisions and weakening global trade regime under the World Trade Organization (WTO) are important in the emergence of the strong bilateral free trade agreement (FTA) push in East Asia since the late 1990s (Dent 2003; Ravenhill 2003). East

<sup>9</sup> Many books and articles have been published in this area in the field of political science and international relations. The books include Pempel (2005), Lincoln (2004), Rozman (2004), Munakata (2006a), Aggarwal et al. (2008), and Katzenstein and Shiraishi (2006).

<sup>10</sup> Solingen (2008) has neatly synthesized contrasting views—neorealism accounts, neoliberal institutionalism, domestic politics arguments, and constructivist approach—regarding regionalism, and she emphasizes the need for discerning the genesis, design, and effects of those institutions. In her empirical studies, domestic politics weigh heavily on both the genesis and design of regional institutions.



Asia can be considered variously as the object of a positive demonstration effect, the successful emulation of FTAs implemented in other regions (Ravenhill 2003), or the object of the defensive “domino effect” (Baldwin 1995).

The second category of arguments focuses on the changing geopolitics after the end of the Cold War, specifically in the context of the rapid rise of the PRC. Closely analyzing the regionalism debates among the major powers in the region as the Cold War ended, Rozman (2004: 3) puts forth a rather pessimistic prognosis on the success of regionalism across Northeast Asia due to what he calls “insufficient globalization (i.e., resistance to openness and a lack of trust of the outside).” Many observers of East Asian regionalism reach a similar conclusion, emphasizing the limits of regional cooperation, that because of the historical mistrust between the two regional hegemony, the PRC and Japan, exclusive East Asian regional cooperation is doomed (Lincoln 2004). More optimistically however, the contributors to Pempel’s (2005) edited volume note that East Asia is now driven to cooperate and to redraw a rather more coherent regional map for itself. Aggarwal et al. (2008) note that the end of the Cold War, the end of the Asian financial crisis, and the September 11 attacks were three shocks that created space in which a new regional policy equilibrium could be created.<sup>11</sup> On the regional financial front, Grimes (2009) focuses on the distinctive interests of the three big powers (the US, the PRC, and Japan) in shaping the contours of financial regionalism in East Asia.

The third category concentrates the discussion on the changing and emerging Asian identity through socialization. One of the influential theories on international cooperation focuses on the emergence of an epistemic community (Haas 1992), and the even more encompassing, emerging security community (Deutsch et al. 1957) is known to influence the way states interact with each other. Many scholars focus on East Asia’s leaders and policymakers who are forging strong relationships and networks in various issue areas. There seems to be a variety of views regarding the source of such a regional identity; some argue that it comes from the nostalgia for the withering “developmental state” model of development (Hatch 2002; Bowles 2000), others argue in support of the emerging “Asian way” of communication and business (Acharya 2004), and still others would attribute it to the creation of “the other” particularly in the aftermath of the Asian financial crisis (Lee 2006). Of course, the contagion effects experienced during the Asian financial crisis have also made East Asian leaders realize the common fate that they would face in an economically integrated region.<sup>12</sup> Going beyond the elite level, Shiraishi (2006) emphasizes the importance of the emerging middle class in East Asia, thanks to rapid economic development and democratization, as the source of new Asia. This social transformation has led to increasing cross-border communication among East Asian countries through media, internet, and tourism, which has resulted in expansion of the subnational regional network of exchanges, creating a support base for liberalization and regional cooperation.

Domestic politics, the final category, remain relevant for how regional institutional architectures are set up. Pekkenen, Solis, and Katada (2007) argue that a state shifted from privileging multilateral trade forums to privileging bilateral FTAs because of domestic politics, were, at the expense of the large trade gains of a multilateral forum, gaining government control of the agenda, as well as control over partner selection. As domestic pressure against liberalization mounts on a democratic government, the government starts to turn to bilateral forums to control negotiation dynamics. On the financial side, Hiwatari (2003) argues that the lack of regional coherence in the financial arrangement in East Asia emerges from differences in preferences of the member countries stemming from the individual features of their respective financial systems (prominence of direct versus indirect finance) and capital account positions (capital dependent versus capital supplier). MacIntyre, Pempel,

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<sup>11</sup> Ravenhill (2008) discusses how the turning points in regional cooperation were defined and influenced by those three shocks.

<sup>12</sup> I would like to thank Rodolfo Severino for pointing this out during the ADBI conference.

and Ravenhill (2008) introduced in their recent edited volume that the Asian financial crisis has had a catalytic impact on the economic governance of many governments in East Asia and has triggered a desire towards insulation from global forces.

Scholars have, from various perspectives, paid attention to the emergence of East Asian regionalism over the last ten years as they attempt to explain the origin and limits of the phenomenon in East Asia. As the institutions evolve, it becomes increasingly important to analyze closely the nature of the institutions as they stand now and examine the political underpinning of the shape they are taking.

### 3.2 Politics of Regional Institutions

It is not easy to define what constitutes the elements that allow effective regional cooperation in search of regional prosperity and stability, and the analysis surrounding the effectiveness of regional institutions is vastly underdeveloped in comparison to the theories of nation-state or the international system.<sup>13</sup> Furthermore, direct comparison of regional institutions tends to become superficial because of the particularity of the regional contexts in which those institutions have emerged. Nonetheless, because Europe spearheaded regional institution building after the end of World War II, much of the analysis on regional institution building has come from the European experience.<sup>14</sup> Within this body of work, Balassa's (1961) influential book has long provided a stylized view (the "logical roadmap") regarding the sequence of regional integration from free trade agreements (no trade barriers across borders), to customs union (a free trade area protected by a common external tariff), to common market (free cross-boarder movement of not only goods but also factors of production, namely capital and labor), to economic and monetary union (including macroeconomic policy coordination and single currency), and finally to political union. Balassa's prediction has nicely resonated with the way in which the European Economic Community progressed into the Single Market and then transformed into the European Union in the 1990s, introducing its single currency in 1999. Neofunctionalists have incorporated the dynamic evolution of regional integration by conceptualizing "spillovers" (Haas 1958). One of the spillover channels, functional spillover, triggers an expanding coverage of issues in regional integration efforts, as the lowering of trade barriers across boarders and increased trade creates externalities in the form of heightened demands for lower transaction costs (for example, exchange rate risks, unstandardized measurement and legal standards, health and other standards) and of expanded common challenges (environmental challenges, public health consideration, etc.).

However, de-emphasized in such functional logic are the heavy political factors both at the international and domestic level, which have sometimes promoted and other times delayed institutional development in Europe.<sup>15</sup> This paper focuses on three political elements, extracted from the European experience, that have been crucial in establishing a stable regional arrangement. Of course, these three elements do not constitute an exhaustive list of

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<sup>13</sup> For example, Tilly (1990) gives a functional explanation of the formation of nation-state, while Anderson (1991) argues the "imagined community" to be the foundation of such a construct. In terms of the international system, there has been a continued debate between neorealists (Waltz 1979) and neoliberalists (Keohane and Nye 1977).

<sup>14</sup> Scholars have explained the phenomena from competing perspectives—from neofunctionalism (Haas 1958) to intergovernmentalism (Moravcsik 1991). For a brief overview, see Mattli (1999). Comparative regionalism theories are summarized nicely in Choi and Caporaso (2001). Mansfield and Milner (1999) also have a comprehensive summary regarding the theory and practice of regionalism. Numerous scholars discussed the characteristics of this "new" regionalism in the 1990s, for example, Hurrell (1995), and Ethier (1998).

<sup>15</sup> The European Union has multiple layers of institutions, some of which house sovereign influence such as the European Council, which has a qualified majority voting system. Much of the policies are made through the Council, whose implementation is passed down to the European bureaucracy, the European Commission. In addition, the European Parliament (whose members are elected directly by the European people) has been strengthened in recent years to counter the criticism of there being a democratic deficit in the EU's policymaking.

essential elements for successful regional institution building, but at least they are logical and fundamental elements that resonate with rational institutional design (Koremenos, Lipson, and Snidal 2001).

The first element is the levels and ways in which each government is willing to give up national sovereignty and policy autonomy for the sake of smoother cooperation and integration at the regional level.<sup>16</sup> The more formal regional cooperation becomes, as the number of legally-binding agreements increases, the more a government has to compromise its sovereignty and policy autonomy in favor of the regional effort. From the Treaty of Rome (in 1957) to the Single European Act (in 1986) to the Maastricht Treaty (in 1994), Europe has widened and strengthened the legal agreements to unite the region through movements in goods, to movements of services, people and business, to uniting the macroeconomic and monetary policies. Meanwhile, the European Court of Justice, set up in 1952, has served to make sure that the EU laws are interpreted and applied in the same way in all the EU member countries. Although all those institutional arrangements allow the European integration efforts to move forward, there is no doubt that the integration proceeds at the expense of policy autonomy on the part of the member states.<sup>17</sup>

The second element that clearly has a high cost but also a large pay-off is for the regional institution to set up a redistributive mechanism to help those who stand to lose through integration and those countries that lag behind, particularly economically, during the process. As noted by economists and political economists, economic liberalization tends to create social cleavages between those who stand to gain and those who stand to lose. At the domestic level, the winner-versus-loser dynamic influences each government's stance on liberalization. In the area of trade, the negative and positive impact of trade liberalization can be demarcated clearly on the basis of factors of production owner and class (Rogowski 1989), or on the types of industry (Schattschneider 1935).<sup>18</sup> Hence, the trade policy of a country produces winner and loser groups, both of which are motivated to engage in collective action to influence government policy in pursuit of either protection or further liberalization. In the context of regional preferential trade liberalization, Milner (1997) argues that the preferences of increasing returns to scale industries such as aircraft manufacturers push strongly in favor of expanding their production and market scope as long as they do not have to face foreign competitors. Thus, argues Milner, the increasing returns to scale industries tend to prefer regional free trade where the industry can capture economies of scale without having to face stiff foreign competition (for example, Boeing would rather capture the regional market in the Western Hemisphere than compete globally where Airbus from Europe would compete against it). Policymakers and politicians balance industry demands with the levels of tariff revenues and consumer surplus to produce a preference towards regionalism. In the realm of finance and monetary affairs, however, such domestic cleavage is less clear or direct. Frieden (1991) takes up this ambitious challenge and examines the winners and losers of increased cross-border capital mobility. As capital market integration proceeds, mobile and non-sector-specific capital is able to move. This benefits the owners of mobile (financial) capital in a capital abundant country and present

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<sup>16</sup> In legal terms, sovereignty is defined as "the supreme, absolute, and uncontrollable power by which an independent state is governed and from which all specific political powers are derived; the intentional independence of a state, combined with the right and power of regulating its internal affairs without foreign interference" (West's Encyclopedia of American Law). Meanwhile, policy autonomy refers to a government's freedom to determine its own actions and behavior.

<sup>17</sup> Legalization is not necessarily an indispensable tool of regional cooperation. Kahler (2000) argues that East Asian governments tend to resort to legalism as needed.

<sup>18</sup> Hiscox (2001) synthesizes those two views and argues that this difference between class cleavage and industry cleavage comes from the level (speed) of factor mobility. When cross-industry factor mobility is high, industries adjust to open trade utilizing abundant factors, thus winner-versus-loser cleavage emerges based on the owners of factors of production (i.e., labor and capital) and, therefore, class. Meanwhile, when the factor mobility is low, each industry becomes a winner or loser depending on its own competitiveness in the open economy.

challenges for the owners of sector-specific capital in a capital scarce country. In most advanced economies, financial capital would be managed by financial institutions such as transnational banks and institutional investors, while sector-specific capital would be in the hands of the individual sectors such as manufacturing, farming or real estate. On the stability and level of exchange rates, Frieden (1991) produced a two-by-two matrix where a less flexible exchange rate regime (that one would expect to see under regional monetary cooperation) would benefit export-oriented producers when the currency is weak, and international traders and investors when the currency is strong.<sup>19</sup>

At the regional level, it is critical to create as “leveled playing field” as possible among the members by compensating the less developed. Even though the Common Agricultural Policy in Europe, which currently uses slightly less than half of the EU budget, is often cited as a major vice associated with the region’s integration efforts (by buying off the French farmers), this type of measure allows governments to sign on to the integration project despite strong domestic opposition. Furthermore, regional institutions should house a mechanism through which the income level of less affluent or less developed countries can be pulled up in order to minimize the income discrepancy in the region, a discrepancy that could encourage both a race to the bottom and a capacity gap in the region. The Europeans have long tackled this challenge through the Cohesion and Regional Policy, based on which the Regional Structure Fund and Cohesion Fund are distributed to less-developed members of the EU. These policy instruments allow regional integration and its associated institution to develop through functional logic with less political opposition.

The third element is the willingness on the part of the governments in the region to clearly define the membership. That is, who is in and who is out. This element is also closely related to the second element, where it helps to define the membership for the purpose of redistribution in order to reduce both domestic and regional resistance to further integration. Meanwhile, if the constructivist perspective (the third perspective regarding regional identity giving rise to regionalism in East Asia) has something to contribute to our understanding of regional cooperation in East Asia, it is important for the leadership pushing the regional integration forward to define with whom they are cooperating, and from whom they are distancing themselves. Of course, for the Western Europeans, in the context of the Cold War since the late 1940s, it was very easy to define who they were with and who they were against. As the challenge of defining themselves has become more intense with the end of the Cold War and with aggressive enlargement from 12 members in 1987 to 27 by 2007, the institutional arrangement of the EU accession criteria and accession procedures help define who can join and who cannot.<sup>20</sup>

These three elements serve to provide the political basis for increasing the functional expansion of and commitment to regional integration. In the next section, the study turns to the two aspects of a region’s economic cooperation efforts, one in finance and one in trade, to examine how these arrangements fare in supporting functional progress in East Asia.

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<sup>19</sup> Meanwhile, a more flexible exchange rate (which would increase monetary policy autonomy for the country according to the Mundell-Fleming condition or the Unholy trinity of exchange rate stability and macroeconomic policy autonomy under the world of full capital mobility) would benefit import-competing producers of tradable goods when the exchange rate is low, and would benefit producers of non-tradable goods when the exchange rate is high.

<sup>20</sup> All the EU accession candidates have to agree to and implement all the EU laws. The (EU) *acquis* consists of 35 chapters that cover a variety of subjects ranging from the movement of goods to foreign and security policies.

## 4. REGIONAL ECONOMIC INSTITUTION BUILDING IN EAST ASIA

### 4.1 Regional Financial Cooperation and Institutions

In the aftermath of the Asian financial crisis, efforts to provide an institutional base for regional financial cooperation developed very quickly in East Asia. The experience of the crisis prompted these efforts, which aim to make sure that such a financial disaster will never happen again. Despite all three aspects of regional financial and monetary architecture being essential for securing maximum financial and monetary stability in the region, the emergency liquidity funding arrangement of currency swaps under the Chiang Mai Initiative (CMI) has become the most institutionalized, while the Asian Bond Market Initiative (ABMI) and Asian Bond Fund (ABF) are moving forward slowly and informally. There is currently very little movement in the area of monetary and currency cooperation in the form of an Asian Monetary Union or an Asian Currency Unit (ACU).

Both in terms of chronology and level of institutionalization, the CMI is the most well-established financial initiative in East Asia at the moment. As early as November 1997, the East Asian governments launched a regional framework in the context of Association of Southeast Asian Nations (ASEAN) Plus Three (Japan, PRC, and South Korea (hereafter Korea)) with the hope of dealing with financial emergencies. This framework became the core of the region's emergency liquidity mechanism consisting of a network of mostly bilateral currency swap arrangements. The ASEAN Plus Three governments arrived at the basic agreement regarding this regional mechanism by May 2002.<sup>21</sup> One component of the CMI is the expanded ASEAN Swap Agreement, a small regional currency swap facility that has existed among ASEAN members since 1977. The other, more recent components are the Bilateral Swap Arrangements and the repurchase arrangements between each member of the ASEAN Plus Three.<sup>22</sup> The CMI has two basic objectives: the first is to provide emergency liquidity at a time of financial crisis, such as the Asian financial crisis. The second and longer-term goal is to enhance regional cooperation both in terms of currency stabilization and financial monitoring. As of June 2009, US\$90 billion worth of swap lines have been committed by the participating monetary authorities.

In May 2009, the decision to multilateralize (i.e., regionalize) the CMI was finalized, and in the near future the funds already committed to bilateral swap lines will be pooled to create a potential for a much larger swap volume per use.<sup>23</sup> The newly established CMIM (Chiang Mai Initiative Multilateralized) will consist of a multilateral *private* swap agreement among the member central banks with a pooled fund of US\$120 billion. Through the multilateralization process, not only did the amount available for each swap expand, but it also allowed the ASEAN countries that were not incorporated into either the Bilateral Swap Arrangements or

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<sup>21</sup> The Chiang Mai Initiative (CMI) takes its name from a town in Northern Thailand where an ASEAN Plus Three meeting was held in 2000, during which the CMI proposal was made. It took two more years for most of the bilateral swap arrangements to be negotiated and agreed.

<sup>22</sup> Note, though, that the less advanced and newer ASEAN members (Viet Nam, Cambodia, Lao People's Democratic Republic, and Myanmar) are only covered by the ASEAN Swap Agreement, and do not have bilateral lines of currency swap with the Plus Three countries.

<sup>23</sup> The multilateralization process started in May 2007 when the monetary authorities of the member countries agreed at the ASEAN Plus Three Finance Ministers' meeting in Kyoto to gradually establish "a self-managed reserve pooling arrangement governed by a single contractual agreement." (Point 6 of the Joint Ministerial Statement of the 10<sup>th</sup> ASEAN+3 Finance Ministers' Meeting, available: [http://www.mof.go.jp/english/if/as3\\_070505.htm](http://www.mof.go.jp/english/if/as3_070505.htm) [accessed 15 November 2007]). At the 11<sup>th</sup> ASEAN Plus Three Finance Ministers' Meeting in Madrid in May 2008, the 13 members agreed then to move forward with the multilateralization as they committed to discuss specific conditions on "economic surveillance, borrowing accessibility, activation mechanism, decision making rules and lending covenants." (Point 6 of the Joint Ministerial Statement of the 11<sup>th</sup> ASEAN+3 Finance Ministers' Meeting, available: [http://www.mof.go.jp/english/if/as3\\_080504.htm](http://www.mof.go.jp/english/if/as3_080504.htm) [accessed 1 February 2009]).

ASEAN Swap Agreement to become full members of the CMI process (namely Brunei Darussalam, Cambodia, Lao People's Democratic Republic, and Viet Nam). Despite the large amount of available funds and the image of the "revival" of the Asian Monetary Fund (AMF) proposed by the Japanese authority at the onset of the Asian financial crisis in the summer of 1997, there are two features that clearly distinguish the CMIM from the (relatively vaguely defined) AMF.

The first is the fact that the CMI so far has been a virtual institution. The recent agreement will lead the CMIM to establish a more formal institution to engage in the monitoring and surveillance of member countries in preparation for the activation of currency swaps, but it is unlikely that this will turn into a large standing institution, and nor does it consist of an actual pool of funds in the same way that the International Monetary Fund does. The currency swap arrangements are based on a contractual agreement among the central banks to activate those swaps based on their respective foreign exchange reserves as the CMIM receives requests.<sup>24</sup> The other feature of the CMIM is the IMF-link as a condition to activate the currency swaps. This 90% link (i.e., 90% of the swap can only be activated when the IMF agreement is either negotiated or in place) was put in place at the establishment of the CMI due to the lack of a monitoring function under the ASEAN Plus Three framework. Without this link, deciding to activate a swap line and guaranteeing repayment becomes difficult.<sup>25</sup> The explicit definition of the CMIM as a complementary liquidity funding mechanism within the international framework led by the IMF did not emerge solely from the lessons of the failed AMF,<sup>26</sup> it was established to make sure that repayment on the part of borrowers is secured through international pressure. A regional monitoring and surveillance mechanism has also been developed through the search for a way to prevent a financial crisis from occurring, and if it does, the borrowers can be monitored closely. The financial ministries of the member governments have, since the start of the CMI process, worked on those functions in the form of a biannual meeting of the Economic Review and Policy Dialogue, but the CMIM has already promised to develop a more specific surveillance function to allow the advisory panel to activate the swaps.<sup>27</sup>

The current global financial crisis after the collapse of Lehman Brothers of September 2008 helped the multilateralization of the CMI by making the leading countries compromise on and commit to a common regional goal.<sup>28</sup> Despite such regional success, however, the monetary authorities of the countries with large foreign exchange reserves, namely the PRC and Japan, have established their own respective bilateral swap arrangements using their own currency (yuan and yen) besides the CMIM.<sup>29</sup>

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<sup>24</sup> An interview with a Ministry of Finance (Japan) official in June 2009.

<sup>25</sup> The IMF-link was later reduced to 80% at the 8<sup>th</sup> ASEAN Plus Three Finance Ministers' meeting in Istanbul in 2005. The PRC government is said to have insisted on the IMF-link not only for the two purposes discussed, but also to curtail the power of the Japanese government in influencing the CMI's development.

<sup>26</sup> The AMF alleged to have failed partly due to the view that it would be challenging the IMF authority.

<sup>27</sup> Point 9 of the summary of the statement of the 12<sup>th</sup> ASEAN+3 Finance Ministers' Meeting, available: <http://www.aseansec.org/22536.htm> [accessed 20 June 2009].

<sup>28</sup> The agreement of the amount of contribution between the People's Republic of China (32% including the contribution from Hong Kong, China) and Japan (32%) was the key to settling the multilateralization process. Furthermore, the strong need for financial monitoring was felt as the Korean government refused to acknowledge that it was facing a balance of payment crisis (and thus did not request to activate the CMI) in the fall of 2008. Interview with a Ministry of Finance (Japan) official, June 2009.

<sup>29</sup> The first of such bilateral swap arrangements was between Japan and the Republic of Korea on 12 December 2008 that added \$17 billion worth of yen/won swap lines besides the existing \$87 billion in the CMI. The Republic of Korea also added \$10 billion to its swap with the PRC. Beyond that, the Japanese government has committed \$60 billion (worth in yen) of swap lines within Asia, while the PRC is reported to have committed \$95 billion (in yuan) worldwide.

The ABMI, in the context of the ASEAN Plus Three, also directly addresses the regional need for financial stability, a lesson that unmistakably came from the Asian financial crisis. The Asian financial crisis revealed the financial vulnerability of the East Asian economies ranging from domestic financial weakness to an inefficient investment climate. The challenge of the double mismatch problem, which came about as East Asia borrowed short-term in dollars and invested long-term in assets denominated in their local currency, has imposed more costs and risks on the borrowers in East Asia. As a region with relatively high savings, there was an emerging sense that “surplus savings from East Asia [flowing] out of the region to Western financial markets and then return[ing] by way of loans to Asian borrowers...makes little economic sense” (Rowley 2003).

The idea of the Asian bond market emerged first from Thailand in the summer of 2002. The creation of a bond market requires both issuers of bonds and investors in those bonds. The Thai initiative focused mainly on the investor side as then-Prime Minister, Thaksin Shinawatra, proposed that the members of ASEAN Plus Three contribute 1% of each country’s respective foreign exchange reserves to launch a regional fund to purchase Asian bonds. The idea, which was discussed at the East Asia Economic Summit in Kuala Lumpur in October 2002, was developed and adopted by the Executives’ Meeting of East Asia Pacific Central Banks as they set up the ABF, which was formally announced in June of 2003. As the central banks of eleven Asia-Pacific countries (including Australia and New Zealand) pledged US\$1 billion for the purchase of semi-sovereign and sovereign bonds from less advanced countries (i.e., not Japan, Australia, or New Zealand) in the region. At this stage, the bonds that this fund had purchased were all US dollar-denominated. In June 2005, however, as the second phase of the Asian Bond Fund (ABF2) was launched, the fund used US\$2 billion to invest in bonds denominated in Asian currencies.<sup>30</sup>

On the other hand, the Japanese government from the early stage of the Asian bond discussion was interested in developing a regional and local bond market in East Asia with the focus on the issuers. As early as the time of the New Miyazawa Initiative (October 1998), the Ministry of Finance (MOF) was interested in supporting local bond market development to tap into local savings and avoid a heavy reliance on foreign capital. In December 2002, Japan officially proposed the idea of the ABMI at an ASEAN Plus Three meeting in Thailand. The aims of the ABMI are two-fold: to facilitate access to the market through a wider variety of issuers, and to enhance market infrastructure to foster bond markets in Asia (Ministry of Finance).<sup>31</sup> Under this initiative, the Japan Bank for International Cooperation extends bond guarantees to local-currency denominated bonds. Six working groups under the ABMI umbrella are working to establish a market infrastructure including a regional bond-rating system.<sup>32</sup> The Japanese government also extends technical assistance in the development of a local bond market in some ASEAN countries utilizing Japanese foreign aid. Furthermore, the new ABMI Roadmap, which includes an insurance mechanism, the facility to increase the demand of local currency-denominated bonds, an improved regulatory framework, and a related infrastructure for the bond markets, was endorsed at the 2008 Madrid meeting.

The currency and exchange rate arrangement (the other element of the double mismatch) constitutes the last necessary component of East Asia’s regional financial cooperation.

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<sup>30</sup> Currently, ABF3 is being discussed. The third phase of ABF aims at providing credit enhancement to sovereign and private Asian bonds. (Rowley 2005).

<sup>31</sup> Ministry of Finance, “Regional Financial Cooperation among ASEAN+3” ([http://www.mof.go.jp/english/if/regional\\_financial\\_cooperation.htm#ABMI](http://www.mof.go.jp/english/if/regional_financial_cooperation.htm#ABMI), accessed 6 May 2009).

<sup>32</sup> The six working groups are: New securitized debt instruments (WG1); Credit guarantee and investment mechanisms (WG2); Foreign exchange transactions and settlement issues (WG3); Issuance of bonds denominated in local currencies by multilateral development banks, foreign government agencies, and Asian multinational corporations (WG4); Rating systems and information dissemination on Asian bond markets (WG5); and Technical assistance coordination (WG6).

Because of high and increasing regional economic interdependence in the mid-1980s, the dollar–yen exchange rate volatility (e.g., the depreciation of the yen to the US dollar after the spring of 1995) also put pressure on many Asian economies in the 1990s. After the de-pegging of the baht in the summer of 1997, some East Asian countries, most of whose currencies used to be pegged one way or another to the US dollar, floated their currencies. Being highly dependent on their investment and trade, the East Asian governments were eager to see their exchange rates stabilize (Kuroda and Kawai 2004). As Japan's first efforts to increase the use of the yen in the region did not bear much fruit, East Asia has gradually started to entertain the possibility of regional monetary cooperation, even of a monetary union.

As the first step towards the Asian Monetary Union, economists and policymakers in East Asia conducted a joint study with the European Union (the Kobe Research Group) that published its report in July of 2002 and recommended a monetary integration process for phase one (to be completed by 2010); preparation for a single currency for phase two (to be completed by 2030); and the launching of a single currency in phase three that would start in 2030 (Institute for International Monetary Affairs 2004). The second and most current initiative is related to the idea of the ACU, initially discussed in late 2005 by the newly expanded Office of Regional Economic Integration at the Asian Development Bank under the leadership of its then-director Masahiro Kawai, and the new Asian Development Bank president Haruhiko Kuroda. The proposed ACU models itself after the European Currency Unit that existed as the region's currency unit before the introduction of the euro. The European Currency Unit constituted a unit of exchange based on the weighted average of values of a basket of currencies. The ACU idea was picked up by the ASEAN Plus Three at the finance ministers' meeting in May 2006, where all thirteen participating governments agreed to conduct in-depth research on its feasibility.<sup>33</sup> One thing to note here, however, is that monetary cooperation at this stage has not given rise to discussion on convergence criteria or explicit macroeconomic policy coordination, which would be necessary in managing the stable exchange rates among the countries whose capital movement is relatively free (i.e., Mundell-Fleming Condition or Unholy Trinity).<sup>34</sup> Moreover, despite the concerns over global imbalance and the high dollar-dependence of East Asia, the currency discussion in the region has not yet converged into concrete actions.

Regional financial and monetary cooperation in the last ten years has established a relatively clear membership. Given the experience of the Asian financial crisis, the question of who is in and who is out is easily answered. In this context, regional cooperation includes a mechanism to protect vulnerable countries with relatively low foreign currency reserves and financial capacity to acquire access to emergency liquidity funding and technical assistance in developing their financial markets. Meanwhile, as seen in the progress within the three areas of financial and monetary cooperation, there is still strong resistance against a country compromising its policy autonomy. The regional currency discussion, though fundamental in addressing the dollar dependence and ultimate stability in regional financial affairs, is progressing very slowly and, at this point, quite superficially without much commitment from the monetary authorities of the region. Furthermore, the protection of sovereignty over monetary affairs is strikingly clear even in how the CMIM is set up differently from the envisioned AMF.<sup>35</sup>

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<sup>33</sup> Nihon Keizai Shimbun, 5 May 2006.

<sup>34</sup> The idea that has been most widely floated in Japan in terms of this current unit arrangement is to use the unit for financial and macroeconomic policy monitoring purposes.

<sup>35</sup> Cooper (2007) also notes that the main reason why we see more trade cooperation in regions than monetary cooperation is that governments are most protective of their macroeconomic policy autonomy and monetary sovereignty.



## 4.2 Regional Trade Cooperation and FTAs

Despite increasing the amount of intra-regional trade in East Asia, it was only after the Asian financial crisis that East Asian governments began to actively seek preferential trade agreements. East Asia's major economic powers, which have prospered continuously from their successful exports to the rest of the world, have been staunch supporters of the multilateral General Agreement on Tariffs and Trade (GATT)/World Trade Organization (WTO) regime. Even as many parts of the world began to aggressively negotiate preferential trade agreements in the 1990s, and as the US shocked the world by establishing FTAs with Canada (1989) and Mexico (1994), East Asian countries faithfully kept their loyalty to trade multilateralism by supporting the GATT/WTO process. With the exception of ASEAN, which began its first steps towards a free trade area in 1992, the only other visible free trade negotiations that many East Asian governments engaged in was through the Asia Pacific Economic Cooperation (APEC), a loosely organized forum that in the mid-1990s established its goals to facilitate and liberalize regional trade by 2010 for advanced countries and by 2020 for its developing members.<sup>36</sup> Nonetheless, towards the late 1990s as the FTA frenzy expanded throughout the world and East Asian economic powers became the only remaining few without any FTAs, pressure was mounted vis-à-vis those governments by industries demanding government action to avoid a total FTA exclusion.<sup>37</sup>

The shift in these governments' trade policy was also motivated by both regional and global challenges. The regional challenge was not directly linked to the Asian financial crisis, but first emerged as APEC's trade liberalization through the Early Voluntary Sectoral Liberalization miserably fell apart in 1997 (Krauss 2004). Moreover, it did not help when APEC failed to effectively address the Asian financial crisis (Wesley 1999). In the late 1990s, the multilateral trade regime under the WTO also began to face challenges from its own weight of success as its membership expanded rapidly including many developing countries around the Pacific Rim, and the issues left to be discussed such as agricultural liberalization became more contentious and political. Nineteen ninety-nine was the year when the trade liberalization forces of the WTO were confronted directly and visibly with counterforces at its Ministerial meeting in Seattle. Since then, despite the launching of the Doha Development Round and the admission of the PRC into the WTO in 2001, trade liberalization negotiation at the WTO level has stagnated.

Under those global and regional circumstances, East Asia started to rush into FTA negotiations in the early 2000s. Many of the first steps towards FTAs were taken as feasibility studies of those FTAs among sets of countries. One of the earliest cases for Japan was the proposal by the then-Korean President Kim Dae-Jung during his visit to Japan in October 1998 to conduct studies with the hope of negotiating Japan–Korea bilateral FTAs. A proposal from Mexico towards a Japan–Mexico FTA emerged at around the same time. From Southeast Asia, Singapore spearheaded the region's FTA boom first by engaging in FTA negotiations with New Zealand in 1999, and soon after the Singaporean government began exploring FTA possibilities with Mexico, Chile, and Korea. The FTA negotiations in East Asia picked up pace in the fall of 2000. Japan's FTA overture to Singapore, which had already started in late 1999 as joint FTA studies between the two countries, upgraded itself to an official negotiation in October 2000. After one year of negotiations, the Japan–

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<sup>36</sup> APEC is an arrangement that is very difficult to categorize as a "regional" institution. Not only does it encompass 21 countries from Australia, to Malaysia, to the PRC, to Russia, to the US, to Peru and Chile, it does not operate under the same binding obligations as typical FTAs do. In addition, under its "open regionalism" principle, the APEC members make their agreement consistent with the GATT/WTO, and extend the preferential trade access not only to the members but also to non-members.

<sup>37</sup> Baldwin (1995) discusses the domino theory of preferential trade agreements, where industries of countries that are excluded from the FTA network will lobby hard to get their government to launch FTAs so as not to suffer from trade diversion. Solis, Stallings, and Katada (2009) find that competitive pressure both economic and political triggered many East Asian governments to rush into FTAs, thus leading to FTA proliferation.

Singapore New Age Economic Partnership Agreement was signed in January 2002, and after ratification in both countries, it came into effect in November 2002. During this time, the US proposed an FTA with Singapore. More importantly for the region, the then-Chinese Premier Zhu Rongji proposed in November 2000 to start exploring the possibility of an FTA between the PRC and ASEAN. The framework agreement on this Comprehensive Economic Cooperation between the two entities was signed within two years, leading the PRC to offer early harvest measures to individual ASEAN members as it opens its market up for certain products before schedule. For Korea, Chile became its FTA partner, with the negotiations starting in September of 1999, and the agreement came into effect in 2004.<sup>38</sup>

Since this initial stage, the FTA proliferation in East Asia is striking. As of December 2008, the ASEAN Plus Three members have signed or put into effect a total of 39 bilateral and plurilateral FTAs with partners within and beyond the region, and many more are currently being negotiated or are under study (see table).

### East Asian FTAs as of December 2008

	Immediate Neighbor	Within the "Region"	Cross Region
<b>Republic of Korea</b>	Japan (under negotiation) People's Republic of China (under study)	Singapore (in force 2006)  ASEAN (in force 2007)	Chile (in force 2004)  EFTA (in force 2006) United States (signed 2007) Canada (negotiation) EU (negotiation) Mexico (negotiation) India (negotiation) Australia (negotiation) Russia (study) Mercosur (study) Republic of South Africa (study)
<b>Japan</b>	ASEAN Plus Six (initiative) Republic of Korea (negotiation suspended)	Singapore (in force 2002)  Malaysia (in force 2006) Philippines (signed 2006) Thailand (in force 2007) Indonesia (in force 2008) ASEAN (signed 2008) Brunei Darussalam (in force 2008) Viet Nam (signed 2008)	Mexico (in force 2005)  Chile (in force 2007) GCC (negotiation) Switzerland (negotiation) Australia (negotiation) India (negotiation)  Peru (negotiation)
<b>People's Republic of China</b>	The Macau Special Administrative Region (in force 2004) Hong Kong, China (in force 2004) Japan–Korea (study) Japan (study) Republic of Korea (study)	ASEAN (2005)  Singapore (negotiation)	Chile (in force 2006)  Pakistan (in force 2007) New Zealand (in force 2008) GCC (negotiation) Iceland (negotiation) SACU (negotiation announced) Australia (negotiation) Peru (negotiation) India (study)

<sup>38</sup> For a good summary of the FTA boom in East Asia, see Munakata (2006a, chapters 6 and 7).

	<b>Immediate Neighbor</b>	<b>Within the "Region"</b>	<b>Cross Region</b>
<b>Singapore</b>		Japan (in force 2002) Republic of Korea (in force 2006)	New Zealand (in force 2001)  Australia (in force 2003) EFTA (in force 2003) US (in force 2004) Jordan (in force 2005) India (in force 2005) Panama (in force 2006) Peru (signed 2008)
<b>Thailand</b>	Lao People's Democratic Republic (in force 1991)	People's Republic of China (in force 2003)  Japan (in force 2007) Bangladesh, India, Myanmar, Sri Lanka, Nepal, Bhutan (negotiation 2004)	Australia (in force 2005) Bahrain (framework agreed 2002) Croatia (proposal 2001)  Czech Republic (proposal 2001) Peru (signed 2005) India (signed 2003) US (negotiation 2004) New Zealand (in force 2005)
<b>Malaysia</b>		Japan (in force 2006) People's Republic of China (in force 2000) Republic of Korea (negotiation)	Pakistan (in force 2008)  India (negotiation)  US (negotiation) Chile (negotiation) Australia (negotiation) New Zealand (negotiation)
<b>Indonesia</b>		Japan (in force 2008) People's Republic of China (in force 2004)	
<b>Philippines</b>	State of Brunei Darussalam (in force 2008)	Japan (in force 2008) People's Republic of China (negotiation)	US (proposal 2002)
<b>Viet Nam</b>		Japan (signed 2008)	
<b>Lao People's Democratic Republic</b>	Thailand (in force 1991)		
<b>Brunei Darussalam</b>	Philippines (in force 2008)	Japan (in force 2008)	

Although the timing of the post-Asian financial crisis rise of trade regionalism has coincided with that from the financial/monetary side, regional trade cooperation exhibits strikingly different features from the regional financial cooperation discussed above. The first is the specificity of regional membership, which is very clear in the context of ASEAN Plus Three in finance, but is not so clear in the context of trade. The FTAs thus far have been dominated by bilateral agreements, and many of the early FTA partners for those East Asian governments are from beyond the immediate region (Solis and Katada 2007). The reasons for this eclectic partner selection come from various sources, but for countries like Japan and Korea, strong agricultural opposition to any kind of forced market opening has a strong bearing on the choice of countries with which they can engage in FTA negotiations. It is particularly so for the Japanese government which is categorized as a developed country in

the context of the WTO, and is thus obliged to comply with GATT article 24. Though loosely interpreted, the article demands that any preferential trade arrangements cover “substantially all trade” among the signatories. Japanese government officials are very conscious of the obligation, which generally requires the FTAs that Japan signs to liberalize at least 90% of import value. Pekkanen, Solis, and Katada (2007) argue that, in complying with the WTO rules, a democratic government such as Japan’s faces a “gains and control tradeoff” as the government chooses a forum to liberalize trade. If it seeks to maximize gains from trade, it cannot expect to have much control over partner selection or trade protection agendas (sectoral exclusions or delayed liberalization), while if the government sacrifices gains from trade that it can expect from a multilateral or large regional trade liberalization forum (such as through the WTO or APEC) and opts to engage in an FTA with a smaller partner, it will obtain a high level of control over the agendas. The latter choice can minimize domestic opposition. In that context, as expanded below, an East Asia-wide FTA is yet to emerge.

East Asian governments have used cross-regional bilateral FTAs as their political leverage to negotiate FTAs intra-regionally (Solis and Katada 2007). The governments of Japan and Korea among others have gained political leverage through the on-the-job training that the government officials experienced by engaging in FTA negotiations with their more experienced Latin American and European counterparts, and by creating domestic precedents to negotiate regional FTAs more aggressively without being constrained by domestic politics (Katada and Solis 2008). Particularly for relatively small countries like Singapore or Korea, in establishing an FTA with the US, these Asian countries can not only acquire preferential access to the largest and most important market in the world, but they can also increase their prestige and leverage by becoming regional trade hubs (Koo 2009; Terada 2009).

The contents of the FTAs are quite eclectic, partly due to their bilateral (or hub-and-spokes) nature, but also due to the different positions (especially developed versus developing countries) and approaches to FTAs among the countries in East Asia. For example, the FTAs signed between Japan and its partners have a significant portion of WTO-plus agreements. From its first FTA with Singapore, the Japanese government preferred to call its arrangement an Economic Partnership Agreement (EPA) because it covers issues that go beyond liberalization of trade in goods and services, and includes agreements on investment, government procurements, and the movement of business and professional people, as well as technical cooperation in various areas such as improvements in the business climate. Although many of these new issues included in the EPAs are non-binding, the Japanese government is quite keen on highlighting that those issues are an integral part of Japan’s FTA relationship (Katada and Solis 2008). This feature of Japan’s EPAs clearly reflects the demand for FTAs between developed and developing countries, where issues such as investment protection and improved business environment are crucial for the Japanese businesses operating in these countries. Furthermore, the limited opening of Japan’s agricultural market to those FTA partners that are developing countries makes it imperative for Japan to provide more “carrots” in its FTAs with countries whose main competitive exports to Japan are agricultural products. The PRC, on the other hand, extends the measure of early harvest to ASEAN countries.

The clash over the appropriate membership of the region-wide FTA in East Asia is an intriguing feature of regional trade cooperation. Contrary to the conventional argument carried out by international relations scholars (Mansfield and Milner 1999), the collection of FTAs thus far has not translated into regionalism in East Asia. The “spaghetti bowl” of FTAs that crisscross within and outside East Asia has become a challenge to East Asian integration due to complex and conflicting rules of origin, cumbersome transactions throughout the region, and the lack of a top-level management function (Dent 2006; Baldwin 2006). Despite calls from regional academics, think tanks (Kawai and Wignaraja 2008), and some government officials (such as those in the Ministry of Economy, Trade, and Industry in Japan) to create a broad Asian FTA, no convergence of vision and approach has emerged.

So far, the closest arrangements to a region-wide FTA in East Asia are the multiple ASEAN Plus One FTAs where ASEAN has FTAs with PRC (framework agreed in 2002), Korea (2005), India (2008), and Japan (2008).<sup>39</sup>

There are, nonetheless, some efforts to establish a region-wide FTA. Currently, there are three competing region-wide FTA proposals indicating the difficulty in defining the regional membership. The PRC has consistently been in support of an FTA in the context of ASEAN Plus Three (the so-called East Asian Free Trade Area), and it tried to push the scheme as a supporting report presenting it at the ASEAN Plus Three Economic Ministers' meeting in August of 2006. During the same month and at the East Asian Economic Ministers' Meeting, the Japanese government revealed its proposal to create a free trade area among the ASEAN Plus Six (Japan, PRC, Korea, India, Australia, and New Zealand). The idea of constructing a Comprehensive Economic Partnership in East Asia is still at the feasibility study stage, but a series of discussions and presentations are lined up for the East Asian Summit.<sup>40</sup> Finally, the old "competing logic of regionalism" (Ravenhill 1995) raised its head again as the then-US President George W. Bush proposed the Free Trade Area of the Asia Pacific (FTAAP) at the annual APEC meeting in Viet Nam in November 2006. Both a section of the US policy makers as well as the APEC itself were looking for ways to re-energize APEC as a way for the US to "move back to Asia."<sup>41</sup> According to Bergsten (2007), a vocal supporter of the FTAAP, not only would this arrangement provide the largest free trade area in the world, but it would also impose huge pressure on the WTO to move its Doha Round forward. The FTAAP would also solve the spaghetti bowl phenomena of numerous, disjointed bilateral FTAs that emerged in the Pacific Rim as it ties all the APEC member countries into one free trade area (Bergsten 2007).<sup>42</sup>

The rapid increase in the number of FTAs in East Asia in the first decade of the 21<sup>st</sup> century has demonstrated that those governments are now willing to commit themselves to the legal obligation of an FTA, which of course forces them to liberalize a large part of their trade. FTAs often cover a wide ground including not only trade liberalization measures but also trade facilitation. Despite the willingness on the part of the regional governments to expand their FTA networks, their respective partner selection is highly eclectic. The choice itself is often driven by domestic political constraints and by the way in which the FTA package gets assembled to balance the give-and-take elements of each partnership. Given the particularity of the trade relationship between each partner, and therefore, the different configurations of domestic winners and losers, it is easier to tailor FTAs bilaterally than regionally. The catch here is that unless a regional solution to domestic political constraints is found (such as in the case of the common agricultural policy in Europe), the spaghetti bowl of tailored arrangements is an easier option; while the lack of a clearly defined membership in regional trade cooperation makes it impossible for the regional mechanism to address the domestic political conflict.

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<sup>39</sup> ASEAN also signed a close economic partnership agreement with Australia and New Zealand in 2002.

<sup>40</sup> Information on the Comprehensive Economic Partnership in East Asia is available from the Ministry of Economy, Trade, and Industry ([http://www.meti.go.jp/policy/trade\\_policy/epa/index.html](http://www.meti.go.jp/policy/trade_policy/epa/index.html)).

<sup>41</sup> Since September 2008, the US has shown a strong interest in joining the Trans-Pacific Strategic Economic Partnership Agreement based on the P-4 (New Zealand, Chile, Singapore, and Brunei Darussalam) agreement that entered into force in 2006. US trade representatives consider the Trans-Pacific Strategic Economic Partnership Agreement to be a way to reinforce transpacific trade cooperation and an important component in the way of defining the APEC-wide trade liberalization efforts.

<sup>42</sup> Aggarwal consistently criticizes the FTAAP as the US's misguided trade policy to subvert East Asian integration efforts, and that it would have a detrimental effect on the global trade liberalization efforts at the WTO (Aggarwal 2007).

## 5. CONCLUSION: THE POLITICS OF REGIONAL COOPERATION

This study has examined the characteristics of developing East Asian regional cooperation in the areas of trade and finance from the viewpoint of the three facilitating political elements toward regional institution building derived from the European experience. The first political element was the level at which governments are willing to compromise sovereignty and political autonomy for the sake of regional cooperation. The second is the progress in creating mechanisms through which the “losers” and the “weak” within a country or region can be compensated. The third element was the clear definition of which members can benefit from such mechanisms. These three elements are useful in propelling progress in furthering regional cooperation and institution building because they remove resistance and obstacles against functional spillovers.

The last ten years demonstrated that regional financial and monetary cooperation has been quite successful in addressing the financial vulnerability of the region by establishing a clearly defined regional emergency liquidity mechanism to prevent and counter possible financial crises. The ASEAN Plus Three has, however, yet to consolidate its strategy to tackle arguably the most important component of monetary cooperation, the dollar dependence. Despite active discussion and political gestures, the actual progress on this currency issue is quite limited. The reluctance comes as monetary cooperation will inevitably impose limits on the macroeconomic autonomy of each member. As discussed repeatedly by the euro-skeptics (who were proven wrong), national currency is one of the most important symbols of national unity (let alone the pragmatic benefit of seignorage), a quality that those East Asian countries that had struggled for independence cherish. Despite (or because of) the weak domestic cleavage (thus politics) that financial cooperation produces, the monetary authorities are quite unwilling to give up their autonomy on this front.

Regional trade cooperation, on the other hand, suffers from too much social involvement and complex need to compensate the losers. A bilateral FTA is a way to make a government commit to trade liberalization and facilitation goals despite domestic resistance, but such resistance and politics inevitably makes East Asian FTAs quite tailor-made and eclectic. Without a clearly defined membership, the region-wide efforts to balance gains and losses will be difficult to implement. Thus, the patchwork of FTAs has so far been the second best solution to potentially much larger gains from region-wide cooperation.

Given the idiosyncrasies of every regional integration project in the world, it is entirely possible that the case of regional institution building in East Asia can benefit more from regionally unique elements other than the three that this paper has concentrated on. These candidates have already emerged in existing literature focused on topics such as regional identity and policy network, as well as subregional and transnational relationships, and track-two processes. Nevertheless, this study has examined the importance of those three elements in facilitating or hindering the progression of the region. It will be essential in the future to expand this analysis into regional cooperation and integration in areas other than trade and finance (such as regional environment, public health and transnational crimes of drug or human trafficking) to make the assertion more robust in the face of empirical analysis.

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