

# China and Economic Integration in East Asia

## Implications for the United States

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East Asia is clearly, if gradually and unevenly, moving toward regional economic integration. Market forces are leading the process, as firms construct across the area production chains that exploit the comparative advantage of individual East Asian countries.<sup>1</sup> Governments are now moving to build on and consolidate those forces through a series of formal agreements to intensify their economic relationships and create an East Asian Community.

The current phase of intergovernmental economic cooperation was launched in the wake of the financial crises of the late 1990s. In part to avoid ever again being dependent on the Washington-based International Monetary Fund (IMF), World Bank, and U.S. Treasury, Asians have built a network of bilateral swap agreements to help insulate themselves from outside pressure in future crises.<sup>2</sup> Though the swaps, now called the Chiang Mai Initiative (CMI), have seen their modest \$70 billion overshadowed by the huge buildup of national foreign exchange reserves in most countries in the region, some Asians hope this evolution will eventually produce an Asian Monetary Fund that can be a viable alternative to the IMF.

Regional trade initiatives have been even more active in recent years. At least half of the East Asian countries are already linked through such agreements, and the linking of the remainder is well under way through ongoing negotiations or at least official studies. Such studies have been mandated to develop blueprints for

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<sup>1</sup> On China-ASEAN trade, for example; see Nicholas R. Lardy, *The Economic Architecture of China in Southeast and Central Asia* (Washington: Peterson Institute for International Economics, 2006). China has now become the leading trading partner of Korea, Taiwan, and many other economies in the region.

<sup>2</sup> For a review of the debate over the Asian Monetary Fund and the CMI, see Randall C. Henning, "East Asian Financial Cooperation" in *Policy Analyses in International Economics* 68 (2002).

both a Northeast Asia Free Trade Area (China, Korea, and Japan)<sup>3</sup> and a full East Asia Free Trade Area (those three plus the member countries of the Association of Southeast Asian Nations [ASEAN], also called the “10+3”). Japan has recently proposed broadening the group to a “10+6,” to include Australia, India, and New Zealand, but the countries of the region have declared the “10+3” to be “the main vehicle,” at least for now, for pursuing their “long-term goal” of an East Asian Community.<sup>4</sup>

Unlike the European experience after World War II, these Asian economic integration schemes are not driven by any top-down, overarching political decision to unify the region. Indeed, not even the monetary and trade initiatives have been coordinated. The different pieces might be joined at some point in the future, and an East Asian Vision Group has been proposed, to be created via an East Asian Community, but each economic integration initiative is currently proceeding on its own track, and this trend seems unlikely to change in the foreseeable future.<sup>5</sup>

China plays a central role in all these efforts. Like the United States, it vetoed the original proposal for an Asian Monetary Fund in 1997, largely because the fund was a Japanese initiative intended to preserve that country’s financial leadership of the region. At the same time, it has helped strengthen the Chiang Mai Initiative and has agreed to study its multilateralism. After its accession to the World Trade Organization (WTO), China moved quickly to begin developing a free-trade agreement (FTA) with the Association of Southeast Asian Nations (ASEAN), which has recently been extended to cover some services, while Japan and Korea are still trying to conclude their belated efforts to catch up with parallel compacts. Meanwhile, China has responded coolly to Japan’s effort to broaden the 10+3 to include three more major powers, India, New Zealand, and Australia, from the region’s perimeter, as China perceives the 10+6 as a ploy to dilute its own influence.<sup>6</sup>

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<sup>3</sup> The study of a China-Japan-Korea FTA commissioned by the three governments has been carried out by the Development Research Center of the State Council of China, the National Institute of Research Advancement (NIRA) of Japan, and the Korea Institute for International Economic Policy. The study recommended in 2005 the formation of such an FTA “as a midterm goal” and reaffirmed “an increasing need” for that proposal in 2006. See NIRA, “Joint Report and Policy Recommendations Concerning a Free Trade Agreement among China, Japan, and Korea” in *NIRA Newsletter*, no. 10 (January 2007).

<sup>4</sup> The countries specified their preference most recently at their latest summit in Cebu on January 15, 2007.

<sup>5</sup> One leading Japanese analyst of the process characterizes it as “regionalization without regionalism,” with the latter defined as “an articulated idea of creating a region with specific goals in mind.” See Akihiko Tanaka, “Prospects for East Asia Community” in *Challenges to Trilateral Cooperation: The Trilateral Commission, Tokyo Plenary Meeting 2006* (Tokyo: Trilateral Commission, 2006). Fukushima (2006) views the challenge as “how to transform a web into a network.”

<sup>6</sup> One Chinese observer argues, however, that “it is impossible for China to lead the regional integration process,” because it is a latecomer (far behind ASEAN) to that process, has too many domestic problems, and provokes too many suspicions from others both inside and outside the region. He believes that Japan is also unsuited for a leadership role and concludes that “ASEAN is the only qualified driver.” See Qin, “Prospects for East Asia Community” in *Challenges to Trilateral*

A key question for the United States and the rest of the world is how East Asia's evolving economic integration will affect China's role, and vice versa. Will it further enhance China's power by enabling it to count on support from this large and dynamic region on key global issues, including multilateral trade negotiations, rule-making, and responses to future financial crises?<sup>7</sup> Will it foster a set of increasingly close and extensive political-security relationships, thereby altering the regional security environment?<sup>8</sup>

Conversely, and despite China's growing regional dominance in both economic and security terms, will regional constraints limit China's ability to exercise its growing national power—much as the North Atlantic Treaty Organization (NATO) was once said to be intended “to keep the Soviet Union out, the United States in, and *Germany down*” [italics added]? Or, most likely, will the outcome be somewhere in the middle—presenting opportunities for the United States to exercise its influence as well as challenges?

## How Has East Asian Integration Affected U.S. Relations with the Region So Far?

The United States and Asian countries have already skirmished over the budding initiatives toward East Asian regionalism. Some tensions have been bilateral, others broad and systemic. And while they haven't yet been too disruptive, they could presage more serious conflict.

As already noted, Japan's initial proposal for an Asian Monetary Fund in 1997 elicited sharp opposition from the United States (and China). The proposal, offered in the midst of the financial crises of 1997–1998, was viewed by the United States as a potentially fatal blow to the IMF, on which it was relying to counter them. The United States has moderated its opposition to the subsequent and more modest CMI but still insists that any regional arrangement must be consistent with the global institutional order to be acceptable to it.<sup>9</sup> In particular, the United States wants CMI lending to be linked to IMF programs and conditionality—which is precisely what some Asians want to escape.

On the trade side, the United States has grown increasingly uneasy over the prospect of an East Asian bloc, which could discriminate significantly against U.S. exports. One U.S. response has been to counter the intra-Asian network of FTAs with bilateral FTAs of its own. After concluding an initial agreement with Singapore in 2002, it has undertaken negotiations with Thailand, Korea, and

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*Cooperation: The Trilateral Commission Tokyo Plenary Meeting 2006* (Tokyo: Trilateral Commission, 2006). A similar Japanese view can be found in Fukushima (2006). This is consistent with the series of “10+1” FTAs, centered on ASEAN, that have dominated the regional trade process so far. At a minimum, however, China must be an active participant if regional initiatives are to prosper.

<sup>7</sup> Antkiewicz and Whalley (2004) note that “in China, the argument is made that [its FTA with ASEAN] may be the first step for China in creating an economic counterforce to the United States and Europe....”

<sup>8</sup> As argued by Frost (forthcoming, 2007).

<sup>9</sup> How such consistency should be promoted is treated in Henning (2006).

Malaysia and has begun to talk about initiatives with Indonesia and Japan. The potential conflict here is over the terms of the agreements: Most of the intra-Asian FTAs to date, especially those including China, are of relatively low quality in terms of issue coverage and effective liberalization, while the United States consistently seeks “gold standard” FTAs with comprehensive coverage and extensive—even intrusive—reduction of impediments to trade and investment.<sup>10</sup>

In late 2006, at the Asia-Pacific Economic Cooperation (APEC) summit in Hanoi, President George W. Bush launched the second and more comprehensive U.S. response by proposing that the APEC forum “seriously consider” the creation of a Free Trade Area of the Asia Pacific (FTAAP), which would embed the Asia-only trade initiatives in a broader framework that included the United States and would thereby avoid, or at least sharply limit, any new discrimination against it. The APEC leaders agreed to do so, and APEC is studying the issue for further consideration at the September 2007 Sydney summit (Bergsten, 2007).

China approved the APEC declaration, and President Hu Jintao did not comment on President Bush’s strong support for the idea at the leaders’ meeting. At the preceding APEC ministerial meeting, however, China had reacted negatively to Secretary of State Condoleezza Rice’s equally strong advocacy for the idea, arguing that it would undercut the Doha Round of global trade negotiations in the WTO and delay implementation of APEC’s own commitment to achieve “free and open trade and investment” among the advanced countries in the region by 2010 (the Bogor Goals). At the meeting of APEC senior officials in mid-January 2007, China posed a long list of questions about the initiative. Hence, its position on the FTAAP is unclear at this time.

So far, China’s stated objections do not have much substance. Beijing is not pursuing the Doha Round issue itself with any great vigor, and the round may fail regardless. China also knows that there is no way APEC will achieve the 2010 goal. Most likely, China’s chief concerns about the FTAAP lie elsewhere—for example, in its opposition to including Taiwan in any trade initiative of this type, although it has been agreed since 1991 that Taiwan can participate fully in all APEC activities.<sup>11</sup> Another likely concern is China’s preference for trade agreements that are of low quality, do not require much new liberalization by China itself, and are largely motivated by political rather than economic considerations.<sup>12</sup> Yet another

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<sup>10</sup> A useful analysis of China’s early regional trade agreements can be found in Antkiewicz and Whalley (2004). They stress the very sharp differences both among China’s initial agreements themselves (i.e., the absence of any common template) and between them and the much more precise agreements of the United States and the European Union.

<sup>11</sup> This and other institutional objections to the FTAAP idea (e.g., that APEC is not a negotiating forum) could be met by pursuing the initiative outside of APEC. The United States’ and the APEC leaders’ statement itself has been careful to propose a Free Trade Area of the *Asia Pacific* [emphasis added] rather than an “APEC Free Trade Area.”

<sup>12</sup> Sheng (2006) concludes that China’s trade policy priority is clearly its regional FTAs, compared with the Doha Round or other possible options, including the FTAAP. He suggests that China’s doubts about the FTAAP also include old-fashioned protectionism (“protection of sensitive sectors”) and the implied institutionalization of APEC procedures. He also argues, however, that “China would undoubtedly benefit from joining [a high-quality] agreement and

likely concern is China's fear that the United States might use the FTAAP to hijack and dominate the Asian regionalism process (Wu 2006).

Other APEC members, including Japan, have tried to reconcile the contrasting views on the region's future architecture by suggesting the pursuit of both the Asia-only and Asia-Pacific ideas. Most have proposed doing so on a sequential basis, however, with the 10+3 or 10+6 to be accomplished first as a "building block" for the FTAAP. Such sequencing is unlikely to satisfy the United States, in light of the long gestation period any of the Asia-only configurations would require. Both the Taiwan issue and the conflicting views on the basic architecture of the region could produce clashes between China and the United States as the FTAAP process unfolds, though it is hard to make predictions until the Chinese view becomes clearer.<sup>13</sup>

A final Asia-U.S. skirmish, also minor to date but potentially of greater magnitude over time, has arisen over participation in the annual East Asia summits. Some Americans and Asians believe that the United States should be invited to such gatherings in view of its traditional deep involvement in Asia and its keen interest in the topics that Asian leaders are discussing. Many Asians (and some Americans, including this author) believe it would be inappropriate for the United States to attend, and note that Asians are not invited to the periodic Summits of the Americas and that neither Americans nor Asians are invited to the frequent summits of the European Union.

This disagreement obviously carries political as well as economic overtones and could become much more salient if the substance of the Asian summits—especially with respect to meaningful economic integration or important security questions—intensifies.

## **What Challenges Does an East Asian Economic Bloc Pose for the United States?**

The growing prospect of an East Asian economic bloc poses two fundamental issues, one bilateral and the other systemic, for the United States and the world. Because China will inevitably play a central role in the evolution of East Asia, the United States will need to devise a strategy to counter both dimensions in its increasingly complex relationship with China.<sup>14</sup>

The bilateral issue is "simply" the discriminatory impact of East Asian regionalism on the United States. Based on an earlier in-depth analysis of a wide

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therefore would be likely to join," although he opines at the same time that "achieving a high-quality agreement is highly unlikely" (p. 65).

<sup>13</sup> Japan's effort to counter China's rising dominance in the region by attempting to include Australia, New Zealand, and India via its 10+6 proposal is puzzling. It would seem more promising for Japan (and others fearing China's rise) to align with the United States in broadening the 10+3 to the Asia-Pacific context.

<sup>14</sup> A third, predominantly security, issue is that the creation of effective East Asian regional arrangements could undermine the U.S. security alliances and quasi-alliances in the region. This important topic will not be addressed here.

range of possible pan-Asian and Asia-Pacific trade configurations (Scollay and Gilbert 2001), I have estimated that the United States could immediately lose as much as \$25 billion of annual exports as a result of the initial static effects of the tariff discrimination that would result from true free trade in East Asia (based on the 10+3 model). These numbers could increase over time as dynamic economic effects are triggered, especially with respect to new investment patterns.

On the other hand, the impact could be reduced by the extent to which the East Asians exempted “sensitive products” and otherwise diluted their new trade arrangements, and the extent to which the United States negotiated East Asian FTAs of its own.

The systemic issue is the potential clash between a China-led Asia and a United States-led “West” for leadership of the global economy. China itself is already the second- or third-largest economy in the world and will shortly become the second-largest trading nation. Supported by a cohesive Asian bloc, it could ascend even more rapidly toward a high degree of influence, and indeed leadership, in global economic norms and institutions. At a minimum, it could undermine the functioning of the current institutions; indeed, its blatant manipulation of its exchange rate is already undermining the IMF norm against competitive currency undervaluation and producing huge current account surpluses that make it harder for other countries, including the United States and European countries, to maintain open trade policies and support the WTO system.

China and much of Asia are already offering an alternative to U.S. leadership of the global trading system with their emphasis on low-quality FTAs driven largely by political considerations. The Doha Round’s failure would discredit the existing WTO-based multilateral system and provide an opening for such new leadership. The Asians, led by China, are likewise posing to the principles of the monetary regime an alternative of flexible exchange rates through their active currency management to prevent the reduction of their external surpluses. The related, weakening reduction in political legitimacy of the IMF and its G-7 steering committee in recent years provides an equally opportune opening for China and, on the financial side, a possible Asian Monetary Fund.

This is of course not the first time that the United States has faced the creation of a megaregional economic bloc that has discriminated substantially against its trade and challenged its systemic leadership. The European Union has represented a similar case over the past 50 years, evolving from a simple customs union at its outset in 1957 into a comprehensive economic and monetary union. Despite some ambivalence throughout this period and sporadic sharp clashes over particular issues, notably agriculture and exchange rates but also several of the EU bursts of membership expansion, the United States has accepted and basically supported the enterprise.

There were three fundamental reasons for this benign outcome. One was the adherence of the European Union to the General Agreement on Tariffs and Trade (GATT) requirement to cover “substantially all trade” (and, indeed, to go far beyond it) and the plausible argument that its economic union created for outsiders more trade than it diverted. A second was Europe’s willingness,

sometimes reluctant but to date always eventually realized, to enter into global negotiations to subsequently reduce its discrimination toward outsiders through reciprocal negotiations in the GATT/WTO; in fact, the creation and subsequent broadening and deepening of the European Union contributed significantly to the globalization of the past half century by catalyzing the process of “competitive liberalization” (Bergsten 1998). Most important was the overriding U.S. security goal of supporting a unified Europe that would never again drag the world into war, the cardinal purpose of the European leaders themselves who initiated and carried through the continent’s integration.

A fourth factor should be mentioned as well in explaining U.S. attitudes toward European integration. That process began when the United States was still the world’s dominant economy and military power. The European Union was already well into its unification process by the time the United States began to worry about foreign competition, and even the early stages of that modification in the American mindset focused heavily on Asia rather than Europe. America’s current global economic position and the geographical locus of perceived threats to it may result in more anxiety about Asian integration than about Europe’s endeavor of half a century ago.

At the moment, the “Asian model” of trade agreements appears to be on a collision course with that of the United States. As figure 1 shows, there are two considerable differences. The substantive difference lies in the quality of the agreements, with the United States insisting on comprehensive coverage, including sensitive sectors like agriculture, while the Asian compacts are far from meeting such standards.<sup>15</sup> The geographical difference, now brought into sharp relief by the U.S. proposal and APEC decision to “seriously consider” an FTAAP, is that the United States wants to embed Asia-only trade arrangements in a broader Asia-Pacific construct to counter both the bilateral and systemic implications of Asian regionalism.

Figure 1. Competing Models of Trade Integration

	High quality	Low quality
Asia only	Japan’s economic partnership agreements and “10+6” →	China’s free-trade agreements and “10+3”
Asia Pacific	U.S. free-trade agreements	←Free Trade Area of the Asia Pacific?

<sup>15</sup> The Asians, including China, argue, correctly in legal terms in the case of most of their FTAs to date, that they are not bound by the higher standards, because they are (self-declared) developing countries covered by Part IV of the WTO rather than by the “substantially all trade” and other criteria that apply to advanced countries. Moreover, the United States itself does not always adhere precisely to those standards, as when it excludes sugar altogether from its FTA with Australia and insists on “yarn forward” rules of origin to maintain important protection for its textile industry. Still, there is a substantial qualitative gap between U.S. and Asian FTAs to date.

There are several possible compromises between the currently polar positions of the United States and China. Japan's proposals for "economic partnership agreements" (EPAs), which have already been implemented with Mexico as well as within Asia, include some of the same ambitious objectives as U.S. FTAs, for example regarding investment and some services, while excluding some others, particularly agriculture. An FTAAP could inspire constructive amalgamation among the competing models and the evolution of a new Asia-Pacific template for trade liberalization and, eventually, economic integration—one that might differ from the traditional GATT/WTO/U.S./EU approach.

The arrows in figure 1 indicate the direction of deviation of the Japan and FTAAP "models" from the columns in which they are listed: Japan's EPAs and its 10+6 proposals are not always of the *highest* quality, and an FTAAP would hopefully be of considerably higher standard than China's current compacts and 10+3 ideas. The matrix nonetheless displays the important differences across the two key variables in the policy debate.

The security aspect of the issue is necessarily even more conjectural, particularly because of the rivalry between China and Japan for leadership of Asia. On the one hand, as former secretary of state George Shultz has argued,<sup>16</sup> an Asian community that eliminated the risk of conflict between those two countries would benefit the United States in much the same way as the ruling out of future Franco-German conflict by the European community has benefited it. On the other hand, the Sino-Japanese rivalry—and the absence of any Monnet-type vision and regional consensus—raises profound questions about the prospects for meaningful integration. It also preserves a temptation for the United States to oppose regional cooperation in favor of maintaining and seeking to exploit its traditional bilateral relationships—especially with Japan but also with Korea, Taiwan, Australia, and even Singapore and Thailand—in order to balance China, as advocated by former secretary of state Henry Kissinger.<sup>17</sup>

At this point, it would be futile to speculate on either the timing or the substantive outcome of Asian economic integration. It is quite possible, however, that the results will be contrary to U.S. interests in several respects:

- n substantial discrimination against U.S. trade;
- n such discrimination without the mitigating benefits of either full economic integration or meaningful political union and perhaps even without much constraint on China's behavior from its Asian partners;<sup>18</sup>
- n such discrimination without, perhaps, a willingness to reduce its new economic preferences through subsequent negotiations with nonmembers (either globally via the WTO or regionally via an FTAAP or even bilaterally);

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<sup>16</sup> In conversations with the author.

<sup>17</sup> Ibid.

<sup>18</sup> For example, China's neighbors have a major current interest in the appreciation of China's currency, but aside from a few statements on the issue by Japan and Korea a couple of years ago and by Thailand recently, they have been unwilling to pursue it. It is unclear whether China's domination of its neighbors on such topics would be greater with or without more formal Asian economic links.

- n increasing acceptance, in Asia and beyond, of low-quality and highly politicized trade agreements that would undermine the traditional U.S. emphasis on high-standard trade deals along with global rules and institutional arrangements centered on the WTO;
- n a steady buildup of a network of Asia-only financial agreements, and perhaps eventually an Asian Monetary Fund, that will undermine the global stewardship of the IMF; and
- n China's increasing leadership and even domination of the process, with the resulting augmentation of its international economic (and perhaps political) clout.

## What Should a U.S. Strategy Look Like?

The United States needs a thoughtful, skillful strategy to try to tilt the Asian integration movement in directions more compatible with U.S. interests. Fortunately, some of the Asian countries themselves would prefer to strengthen rather than jeopardize transpacific ties. Moreover, other non-Asian countries presumably share the U.S. objectives and should be willing to cooperate with the United States in seeking to affect the course of the Asian process.

An effective U.S. strategy toward the East Asian integration movement would begin by accepting, clearly and unambiguously, the legitimacy and desirability of economic integration in East Asia. The rationale would largely mirror U.S. acceptance of European integration: The potentially substantial benefit that a united Asia would offer the United States—both by creating more trade than it would divert and by putting to rest traditional rivalries, especially between China and Japan, in a region that has drawn the United States into three major wars in the twentieth century.<sup>19</sup>

The Asian consensus in favor of regional integration has already progressed beyond the point where the United States could block the initiative. Indeed, such a U.S. effort at this time could create such a backlash in Asia that it would spur exactly what it aims to prevent—accelerating integration and encouraging the Asians to shut America out, as well as alienating even its best friends in the region.

In the past, it might have seemed appropriate for the United States to postpone any clear expression of policy while waiting to see how quickly, and in what direction, Asia evolves. But the region's growing commitment to unify, at least in some important areas, suggests that this cautious approach is feeding

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<sup>19</sup> A similar Chinese view can be found in Qin (2006), who argues that "East Asian regionalism is not a zero-sum game between China and the United States" and that "there is a huge amount of room for the United States to play several roles in these areas (of the East Asian integration process)." For a contrary view, see Bernard K. Gordon, "U.S. Perspectives on East Asian Economic Integration" in *Journal of Economic Development* 31, no. 2 (December 2006): 149–68, based on judgments that "any movement toward Asian economic integration" will intensify Sino-Japanese rivalry, have other adverse effects on U.S. security interests, and generate domestic political resistance in the United States.

Asian suspicions of U.S. hostility toward their efforts.<sup>20</sup> This in turn undermines the United States' ability to discuss those efforts candidly with the Asians and help steer them in constructive directions. The time has come to clearly articulate U.S. support for East Asian economic integration, to create a basically cooperative framework within which U.S. suggestions on the specific outcomes—and especially the external relationships—of that integration will be taken seriously and hopefully accepted.<sup>21</sup>

Second, the United States (and the other non-Asian members of APEC, especially Canada and Mexico) should seek to embed any new Pacific-Asia trade arrangements in a broader Asia-Pacific framework.<sup>22</sup> President Bush has already urged the APEC member economies to “seriously consider” an FTAAP, as noted above, and the APEC leaders agreed to do so at their 2006 summit in Hanoi. The United States should now try to move this process forward as quickly as possible, not least because the onset of Democratic control in the U.S. Congress will make it difficult to extend trade promotion authority beyond mid-2007 without a major new initiative of this type, especially if the Doha Round remains stalled; and also because the prospect of a Democratic president in 2009 means that it may be essential to commence such a negotiation in the near future if it is to get off the ground at all (Bergsten 2007). China and the other East Asian countries should support these goals, as they would be among the largest losers from the turn toward protectionism in the United States that would result from a cessation of U.S. participation in new liberalizing initiatives.

The case for nesting regional economic agreements in a broader context is well-known. Otherwise, the smaller grouping may become content with its own arrangements, including its discrimination against outsiders, and resist further external liberalization. The Southern Cone Common Market (Mercosur) is

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<sup>20</sup> See Wu (2006). He even reports “widespread suspicion in China that the United States, concerned with possible Chinese domination in (the East Asia summit process), was actually behind the idea” advanced by Japan to dilute the 10+3 by adding Australia, India, and New Zealand. He also indicates, however, that “the attitude that Washington adopts toward East Asian cooperation is perceived to have a crucial impact on the process.”

<sup>21</sup> There have already been several U.S. policy statements that move modestly in this direction. In June 2004, James A. Kelly, former assistant secretary of state for East Asian and Pacific affairs, testified briefly to the House International Relations Committee that “regional cooperation and integration in East Asia is part of an encouraging set of trends” in the region. More importantly, the joint statement from the White House in June 2005 of President Bush and President Susilo Bambang Yudhoyono of Indonesia “welcomed the development in the region of an open and inclusive institutional architecture that... contributes to economic development and prosperity.” Christopher Hill, assistant secretary of state for East Asian and Pacific affairs, added in a speech in Singapore in May 2006 that “it is understandable that Asia is looking to strengthen its own regional initiatives—and we welcome it.” He added, however, that “we need to think hard and clearly about how we can integrate pan-Asian and transpacific forces (including APEC)... to determine how the pieces can fit better together.”

<sup>22</sup> Non-Pacific countries that might support the U.S. effort to tilt the evolution of East Asia in the suggested directions might balk at this component of the proposed strategy or at least seek to augment it with new arrangements of their own. The European Union, for example, might insist on pursuing an Asia-EU Free Trade Area, based on their Asia-Europe Meetings, to parallel the FTAAP in APEC.

perhaps the best contemporary example of that reaction, as it has apparently become unwilling to make the concessions necessary to permit agreement on a broader Free Trade Area of the Americas or perhaps even a meaningful Doha Round in the WTO. The European Union, by contrast, was always embedded in an effective multilateral system via the GATT, along with an exceedingly thick network of transatlantic arrangements with the United States and Canada, which effectively countered its periodic proclivities to resist cooperation with nonmember countries.

At present, it would be risky to rely on the global system to provide such nesting, as both the IMF and the WTO, particularly in light of its stalemate over the Doha talks, are themselves increasingly shaky. Hence, the Bush administration has taken an important step by proposing an FTAAP, which could evolve in parallel with the Asia-only arrangements, avoiding the multiple economic and political risks of an Asia-only integration process. It would be essential for the Asia-Pacific and Pacific-Asia processes to proceed in tandem, however, as opposed to the idea currently being suggested by some Asians to build their 10+3 or 10+6 construct first, with a Pacific-Asia counterpart to follow at some undefined, probably quite distant, point in the future.<sup>23</sup> Reprising the NATO analogy, a key goal of an FTAAP would be “to keep the United States in”—this time, in the transpacific community.<sup>24</sup>

The global system can still provide a useful context for any new Asian bloc, however, and it would in fact be highly desirable to imbed an FTAAP in such a system to make sure that it, too, does not become inward-looking. Thus, the third part of the U.S. strategy should be to redouble its efforts to shore up the global economic institutions, notably the WTO and IMF. Both are under severe threat at present because of their inability to successfully address their substantive agendas.

The Doha Round is at risk of total collapse, or at least indefinite suspension, which would seriously undermine the entire WTO system and likely prompt its erosion. This in turn would reduce the prospect of using multilateral liberalizing negotiations to dilute future discrimination by a new East Asia Free Trade Area against outsiders.

The IMF has proven totally impotent—especially vis-à-vis the Asian surplus countries, most notably China with its substantially undervalued exchange rate and massive intervention to maintain that undervaluation—in addressing the

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<sup>23</sup> Wu (2006) in fact argues that “a vigorous APEC can contribute to the development of an East Asian Community” through the standard logic of competitive liberalization. APEC’s adoption of its initial trade liberalization goals in the early 1990s clearly energized ASEAN to attempt to accelerate its own integration process.

<sup>24</sup> The most authoritative Chinese statement to date on these issues concludes that “if the FTAAP unfortunately fails... China would continue to pursue its building of an RTA/FTA network [and would] launch more RTAs/FTAs with other countries such as Brazil, Mexico, and Russia. Particularly, it is highly likely that China will promote the establishment of an EAFTA.” The paper recognizes that “all these outcomes will exacerbate the U.S.-China confrontation in APEC,” though also acknowledging that China might “join the FTAAP at a later time” if it proceeded without China at the start. See Sheng (2006).

huge trade imbalances and currency misalignments that it acknowledges are a major threat to the world economy.

Even more fundamentally, the political legitimacy of both the WTO and IMF is under intense challenge. Both have traditionally been dominated by the United States and the European nations that created them in the immediate aftermath of World War II. Both have been slow to adapt to the radical shift in global economic power deriving from Asia's dramatic growth over the past few decades. The IMF has proved to be particularly rigid in light of its more highly articulated quota system and voting structure, as opposed to the consensus nature and one country-one vote approach of the WTO (Truman 2006). The fund is now seeking to realign its governance arrangements to provide a larger role for China and other Asian countries, but the Europeans, who would have to give up most of the representation that needs to shift to Asia, are resisting tenaciously. In the WTO, Japan continues to participate periodically in the de facto steering committee of six or seven key countries, but China, pleading its "new member" status, has declined that responsibility, and no other East Asians are centrally involved.

The United States has a major interest in maintaining the systemic primacy of these global institutions. It has been making modest efforts to address the problems cited here, but the importance of preventing the potentially adverse implications that could flow from the emergence of a new Asian bloc should add considerable urgency and emphasis to this U.S. policy effort over the period ahead. If the global institutions continue to weaken, East Asian integration will probably accelerate, and the risk of conflict with the United States will rise further.

## **What Lies Ahead?**

As with many of the other key issues on the U.S.-China agenda, the impact of China's regional participation and initiatives raises more questions than it answers. An Asian bloc could significantly augment Chinese economic power and perhaps its global political clout as well, but it could also constrain Chinese behavior through moderating pressures from its neighbors. An Asian bloc could have positive effects on the world economy, by accelerating trade liberalization and providing additional financial resources to counter international monetary disturbances, or it could divert substantial amounts of trade and dilute future efforts to stabilize the financial system—thus adding to the backlash against globalization in the United States and other non-Asian countries. China and Japan could use the Asian integration dynamic to limit or at least contain their rivalry, reducing the risk of future conflict for the United States as well as for the region, or that dynamic could fuel new Sino-Japanese tensions that heighten their mutual suspicion and even hostility.

Given these uncertainties, the United States should proceed by trying to tilt the outcomes in directions that would support its own interests and those of the broader global system. This does not mean, however, that China and the rest of Asia should be expected to uncritically accept existing U.S. and international norms. They may bring valuable ideas to the work of constructing a "new

international architecture”—one that reflects the rapid pace of change in the agenda and geographic composition of the world economy itself.

It is clear, however, that the time has come for the United States to take seriously the likely construction of new Asian economic arrangements, as these arrangements could well have important consequences for the United States itself and for global economic (and possibly political) patterns and institutions. The United States must therefore devise a coherent strategy to respond to this evolution, in terms of its relationship with China (which will inevitably dominate the Asian movement) as well as with the region as a whole. This topic needs to be added to the list of issues to be addressed in the Strategic Economic Dialogue and other ongoing efforts to deal constructively with the China–United States relationship and its impact on the world economy.

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