Economic Integration in East Asia and Japan's Strategy towards an East Asian Community

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Abstract

The purpose of this article is to examine what strategies Japan should develop on the issue of East Asian community building. First, I introduce representative views in Japan on an East Asian community. The discussion given there is formulated mainly from a political and diplomatic perspective. Secondly, I provide an analysis of the actual progress of economic integration in East Asia. The ultimate objective is to articulate my own view after thus clearly presenting an overview of the current strategies in Japan on East Asian community

Representative views in Japan on an East Asian community

There are three views that can be cited as representative views in Japan on an East Asian community, which will be discussed below. The first mention must go to the one presented by the Council on East Asian Community ("CEAC") (founded in May 2004; operating with former Prime Minister Yasuhiro Nakasone serving as Chairman and Kenichi Ito serving as President), which professes itself as having been founded as an "all-Japan" intellectual platform on the subject of an "East Asian community" in the form of an industry-government-academia forum. The CEAC released a policy report entitled "The State of the Concept of East Asian Community and Japan's Strategic Response thereto" in August 2005. The report consists of three parts (Part One: Discourse, Part Two: Recommendations, Part III: List of the Members of the CEAC Who Signed the Report), of

which Part Two is composed of two sections, namely, "I. Principles Guiding Japan's International Strategies" and "II. Policy Recommendations."

The section "I. Principles Guiding Japan's International Strategies" contains a statement that Japan's national strategies on an East Asian community must ultimately serve to augment Japan's national interest, which is explained by the use of three keywords: 1) Security, 2) Prosperity and 3) Values important to the Japanese. An East Asian community as a "no war community" is envisioned in the light of keyword one, or security, and this policy report's basic stance is to "take as [an absolute] precondition the need to strongly maintain the Japan-U.S. Alliance". For keyword two, or prosperity, it is argued that "it is obviously important for [the economic growth of] Japan to create the environment in which people, goods, capital and information move freely and rapidly and to foster close relationships with this region of high growth potential," and the establishment of an East Asian Free Trade Area ("EAFTA") is called for. In addition, the "development of a regional contingency planning system to prevent another financial crisis," the "promotion of more stable capital markets" and the "establishment of frameworks promoting stable exchange rates" are also suggested, which takes into account the fact that the Asian economic crisis gave rise to regionalism in East Asia. In relation to keyword three, or values important to the Japanese, it is stated: "In general terms, the East Asian Community to be formed over the long term must be aligned with values held by the Japanese people. More concretely, these values – which include freedom, democracy, respect for basic human rights, and the rule of law – must be embraced by any East Asian Community." Implications of this argument will be left for later discussion in this paper.

In "II. Policy Recommendations" that follows, the report advocates promotion of cooperation in the respective areas of trade and investment, the financial sector, and political, social and cultural spheres; what is notable is an assumption

presented there that such promotion should be guided by the principles that the CEAC embraces. There are four principles that the CEAC says should be applied to an East Asian community: 1) emphasis on peace, prosperity and progress, 2) emphasis on openness, transparency and inclusion, 3) promotion of functional cooperation and 4) development of a soft identity. The report emphasizes "1) principles of peace, prosperity and progress" by stating: "the Community's ideals [that should guide efforts to form an East Asian Community] must envisage mutual security within a security community (no-war community), promote prosperity founded on a balance between economic competition and cooperation, and ensure a community of progress dedicated to such values as freedom, democracy and respect for human rights." These ideals are the same as those espoused in a report of the East Asia Vision Group ("EAVG") (2001), with which the CEAC shares another emphasis that the development of an East Asian community is an evolutionary process and is not the formation of a static club. In relation to "2) emphasis on openness, transparency and inclusion," the report stresses that the East Asian Community, once formed, must be predicated on friendly relations, and coexistence and cooperation with other regions of the world. For "3) promotion of functional cooperation," it argues that the cooperation in the economic sector (currency/financial cooperation and promotion of trade and investment) should be promoted as an engine of community building in East Asia and that promoting functional cooperation in the widely diverse fields of politics, security, environmental protection, social issues and culture can lead to the development of a lasting foundation for the formation of such a community. Lastly, on the subject of "4) development of a soft identity," it maintains that a soft regional identity should be promoted based on the recognition that the common characteristic of various cultures in East Asia is its hybrid composition of cultures.

In fact, the strategy principles and ideals presented in the CEAC's policy report that have been discussed above overlap the Japanese government's stance on an East Asian community for the most part. The following is the Japanese government's "basic standpoints" expressed in "Japan's Approach to East Asian Community Building," which it announced in October 2005:

1) Standpoint one: Based on the principle of "open regionalism." In East Asia, ASEAN, Japan, China and South Korea, as well as Australia, New Zealand, India and the U.S. etc. each fulfills a significant role in functional cooperation in various fields. Openness, transparency and inclusion should be ensured, and close cooperation should be firmly established with these widely varied partners.

2) Standpoint two: Centered around promotion of functional cooperation ("functional approach"). In the light of the region's diversity (in stage of economic development, culture, ethnicity, religion, political ideal, and security policies etc.), the introduction of an E.U.-type political system or framework is still within the realm of possible future objectives. The aim for the time being should be to achieve community formation mainly by promoting functional cooperation in a broad range of areas (FTA/EPA, financial sector, cross-border issues etc.).

3) Standpoint three: Respect for universal values and compliance with global rules. Universal values, such as democracy, freedom and human rights, and global rules, such as those of the WTO, should be weighed heavily.

Considering that the recommendations given in the CEAC's policy report thus effectively fulfill a role of supporting the Japanese government's stance on East Asian community building, one should pay attention to the fact that two broad strategic intents lay in the background. What forms the two important matters in Japan's strategy on East Asian community building? The answer is, among all else, Japan's relations with the U.S. and relations with China; Kenichi Ito (President) and Akihiko Tanaka (University of Tokyo), two key persons of the

CEAC, have outspokenly talked about this issue.

Ito and Tanaka (2005) present the following argument: "The kind of East Asian community to be envisioned by Japan must be formulated so that it will encourage the U.S. to be further involved with East Asia and will develop Japan-U.S. relations to an even greater extent. A perpetually prosperous and peaceful East Asia, existing as an open framework, would promote trade and investment relations of the U.S. in the region. Designing an East Asian community as a community that exercises such values as freedom, democracy and the rule of law also fits various objectives of East Asian policy measures of the U.S. In formulating such a vision, accordingly, it is of critical importance to realize "values" that Japan embraces, ones that were previously discussed, from a perspective of keeping a good balance between its relations with the U.S. and relations with Asia as well." As is evident in this quote, what they really mean by designing an East Asian community as an "open framework" and a "community that exercises such values as freedom, democracy and the rule of law" is, as they quite frankly suggest, taking into consideration the position of the U.S.. This is exactly where we can find the implications of the idea that has previously been discussed in brief: "values – which include freedom, democracy, respect for basic human rights, and the rule of law – must be embraced by any East Asian Community."

Having thus made their point on Japan's relations with the U.S., they go on to talk about its relations with China, maintaining that "with China continuing to achieve dynamic growth, it will contribute to Japan's mid- to long-term national interest to help pave a path for China to grow as a superpower that is peaceful and economically developed and respects freedom, democracy and the rule of law, as Japan joins hands with countries within the region, including China," and also stating that "what is important for Japan is, whilst having a clear look at East Asia in its current as well as future form, to exert the policy design capacity to

shape an order. There is no option for Japan to sit on the sidelines when it comes to any initiative on an East Asian community. Japan must create an order for East Asia as an active architect." The second or alternative view, which will be discussed next, takes a very different position on this issue (Japan's relations with China), while they are similar in basing their arguments on the Japan-U.S. alliance.

Let us first examine the view of Toshio Watanabe, as one of the champions of the second view. On the following three grounds, he argues that the idea of an East Asian community cannot, and should not, be realized:

1) Countries in East Asia are at different stages of economic development. The difference in their respective political systems can also become a hindrance to the community formation.

2) There are frictions lurking in the political relations between Japan, China and South Korea, which cannot be solved easily.

3) The latent mastermind of the plan for an East Asian community is China. The greatest factor behind actions towards the development of an East Asian community is China's regional hegemonism. The bilateral relation that is vitally important for Japan is the Japan-U.S. alliance, in the context of its efforts to ensure a free hand in its actions and make its presence clearly felt in East Asia in standing against China, which is on track to become a superpower. The reason why China proactively champions the idea of an East Asian community is because it calculates that, by inviting Japan into an East Asian community, it can create a chasm between Japan and the U.S.

This argument by Toshio Watanabe is boiled down in his own words as follows: "The final goal for any integrated body of East Asian nations should be to develop a functional system under FTA and EPA arrangements, and should not go beyond that. The region just lacks the political conditions required for the living

under a "common roof" that is characteristic of any community, and one must recognize that China's regional hegemonism lies behind the community formation; hence, an East Asian community is indeed a very dangerous choice not only for Japan, but also for East Asia as a whole" (Watanabe 2005).

Toshio Watanabe is not alone in considering Japan's relations with China to be the greatest hindrance and denying the idea of East Asian community building. Takakazu Kuriyama (2006) also says that East Asian community building is unrealistic. He points to the apparent lack of common values as the reason. Although, argues Kuriyama, the concept called an East Asian community initiative recently popped up as a hot topic and is talked about in the manner of a buzzword in Japan and other Asian countries alike, no basic values critical for any community formation that would bring coherence to society are found in the region. According to him, there are no common values because, given the fact that post-war Japan has been moving forward steadily as a democratic country while China has been a totalitarian state under a one-party dictatorship, Japan and China have totally different sets of basic values that govern their respective political systems; as long as this difference exists, there is not a chance that any community in which the two countries share the future will be created in Asia.

While the two views discussed above are centered around the Japan-U.S. alliance, there is another or the third view, though a minority, that favors revisions of the Japan-U.S. alliance and maintains that an East Asian community should be built by strengthening cooperative relations with East Asia, especially China. Let us examine the view of Makoto Taniguchi (2004) as the representative figure of this school of thought.

Taniguchi points out, "It is not an exaggeration to say that the Japan-U.S. Security Arrangements have been at the root of everything in the minds of the post-war Japanese people and all their political, economic and social activities

have been set on the foundation of the Japan-U.S. Security Arrangements, as if they were incapable of thinking beyond that." His argument is really a suggestion that now is the time to examine if the Japan-U.S. alliance will remain unchanged forever. What supports his argument is an awareness that there is currently a sea change in the international environment that surrounds Japan in the 21st century; he pays particular attention to the progress of obvious polarization of the world economy into the three centers of Europe (E.U.), North America (NAFTA) and East Asia, as a result of growing regionalism. In the case of East Asia, the region has ample potential to form an economic bloc and might grow to be a regional community that, in the light of its economic scale and growth capacity, rivals and may eventually even outgrow the E.U. or NAFTA. In the meantime, the economic relations between Japan and East Asia are becoming increasingly close and deep and, in the wake of the Asian economic crisis, there is also a growing enthusiasm in East Asia for the prospect of regional integration. Given the need for Japan to accurately grasp those signs of the times to move towards East Asian community building and contribute to the growth and stability of East Asia, argues Taniguchi, what will make or break such an attempt is whether relations of mutual trust can be established between Japan and East Asia, particularly Japan's cooperative relations with China.

As has been discussed, we now understand that there are three distinctive views among representative views in Japan: 1) one that is centered around the Japan-U.S. alliance but argues that East Asian community building is possible through efforts to develop Japan's relations with China; 2) one that is also based on an ideology centered on the Japan-U.S. alliance but finds East Asian community building to be difficult or unrealistic due to a specific opinion of China (difference in values or system); and 3) one that favors revisions of the alliance-centered approach and advocates East Asian community building through strength-

ened cooperative relations with East Asia, especially China. Before moving on to evaluate those views, we would like to analyze the actual progress in regional economic integration that shapes the foundation for an East Asian community. This is done with the intention of later presenting our view with such an analysis and objective fact situations taken into account.

Analysis of the actual progress towards regional economic integration in East Asia

In analyzing the actual progress towards regional economic integration in East Asia, an analysis presented in "International Trade White Paper (2005 Edition)" (Ministry of Economy, Trade and Industry, 2005) serves as a useful reference. To begin with, let us review the basic stance of this White Paper on the issue of an East Asian community. The White Paper has a section entitled "Japan's growth strategy in a society of low birthrates, population aging and falling population-Bringing in East Asia's vitality," in which it is stated: the economic vitality of East Asia, where economic interdependency is further deepening, should be actively brought in for the purpose of revitalizing the Japanese economy and, in such an attempt, FTA (free trade agreement) arrangements can work as quite an effective means; a structural reform of the Japanese economy is essential, however, in efforts to push forward economic integration with East Asia and bring in its vitality; in other words, productivity needs to be improved through transfer of production resources from low-productivity sectors to high-productivity sectors. By rationalizing that "the importance of such actions looms even larger when considering that constraints on the [production] resources will become greater in the future due to low birthrates, population aging and falling population," the White Paper has a salient feature of linking the society of low birthrates, population aging and falling population with economic integration in East Asia. This is best

symbolized in the comparison of “Rising Asia” and “Aging Japan” presented in the section’s “Conclusion.”

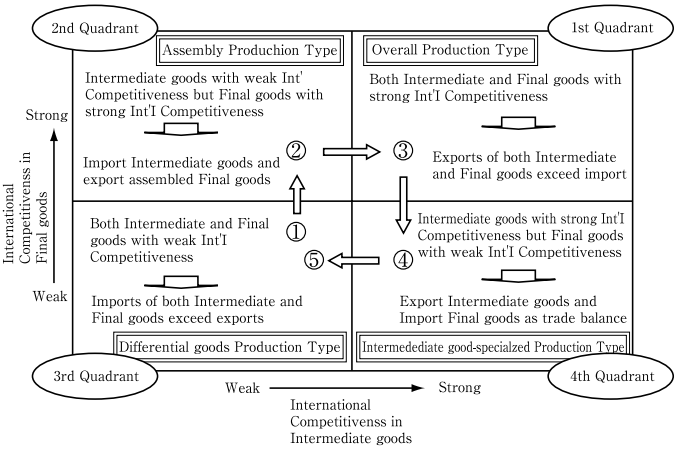
Let us next examine the work of analysis of the actual progress regarding regional economic integration, our main topic. While other studies, including a report of the World Bank, “East Asia Integrates: A Trade Policy Agenda for Shared Growth” (World Bank, 2003) and a report of the Asian Development Bank, “Asian Economic Cooperation and Integration: Progress, Prospects, and Challenges” (Asian Development Bank, 2005), also point to a trend in trade in East Asia, where intra-regional trade growth outpaces extra-regional trade and growth is particularly marked in parts and partially-finished products for assembling, and attribute such a trend to the ongoing formation of an international production network in East Asia, the White Paper gives a more detailed account of this progress.

To reveal the real state of the production network development in East Asia, the White Paper classifies all tradable goods (as in the data from 2003) into (i) “Raw materials and ingredients,” (ii) “Intermediate goods (processed goods and parts),” and (iii) “Final goods (capital goods and consumer goods)” and then articulates country-specific characteristics by production process. Namely: (i) Japan imports raw materials and ingredients as well as intermediate goods, and exports domestically-produced intermediate goods and final goods, especially parts and capital goods; (ii) Consumer goods occupy an overwhelming share of China’s exports, with final goods including capital goods taking up over 60%, while the percentage of parts and processed goods is high in imports, occupying more than 70% if raw materials and ingredients are also included; in other words, a pattern of assembling production, where intermediate goods are imported and final goods are exported, is evidently reflected there; (iii) South Korea shows characteristics somewhat in the middle of Japan and China, with intermediate

goods taking up almost 60% of imports while final goods are diminishing and intermediate goods are growing in exports; in other words, South Korea can be found to be in the process of shifting from a China-type assembling production pattern to a Japan-type production pattern specializing in intermediate goods; and (iv) the percentage of intermediate goods is high in both imports and exports in ASEAN but there is a variety in country-specific characteristics, with figures particularly high in Indonesia (processed goods trade), the Philippines and Malaysia (parts trade) and Thailand (intermediate goods trade and consumer goods exports). The conclusion that the White Paper drew from the above analysis is that East Asia presumably represents a complementary economic bloc where there are economies with an assembling production pattern and economies with a pattern of production specializing in intermediate goods.

The White Paper criticizes the "flying-geese model of industrialization," which has thus far served as a theoretical pillar in the studies of industrial development patterns in East Asia, by pointing to the model's focus on the international competitiveness of an industry per se as a target of analysis, asserting that "an analysis of an industry that does not take into consideration the cross-border sharing of production processes is likely no longer capable of providing means by which to adequately evaluate development patterns in the region, or its coherency or complementarity as an economic bloc," and presents "International Competitiveness Chart" (Figure 1) and "Spiral-Patterned Development Hypothesis" (Table 1 and Figure 2), which were developed on its own. While the "International Competitiveness Chart" represents a two-dimensional analysis, the "Spiral-Patterned Development Hypothesis" is a three-dimensional analysis in which an axis indicating the level of labor cost, technology and added values is added in a spatial fashion.

These figures show that industrial development takes a gradual, clockwise



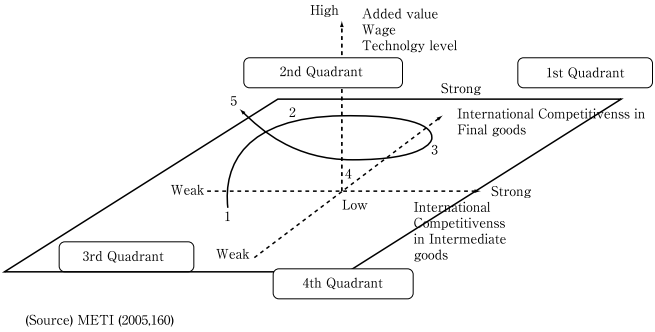
Note: International Competitiveness Index (ICI) =(Export − Import)/(Export + Import)
(Source) METI(2005,159)

〈Figure 1〉 How to read the Chart of International Competitiveness Index

〈Table 1〉 Hypothesis of Spiral Pattern Development Model

	Industrial Pattern	Location in Chart of Int'I Competitiveness Index	Added value Wage/Iocome Tech level	Development stage in the in Industry
①	Domestic market Production Type	Third Qnadrant	LOW ↓ HIGH	Domestic demands for both intermediate and Final goods exceed domestic productions.The industry has week Int'I Competitiveness.
②	Assembly Production Type	Second Quadrant		Development of capital accumulation and introduction of foreign technology makes the assembly process in the industry stronger in Int'I Competitiveness. The industry imports Intermediate goods because it dose not have production technology for key Parts & Components, Industrial structure of so-called assembly production type is established.
③	Overall Production Type	First Quadrant		In the course of the assembly production, the industry advances technology and then starts to produce key Parts&Components. The industry, acquiring Int'I Competitiveness in both Intermediate and Final goods, comes to the ripening period.
④	Intermediate goods-specialized Production Type	Fourth Quadrant		Due to the constraints like rising labor cost, the industry loses comparative advantage in the assembry process which weakens Int'I Competitiveness in Final goods, Focusing on key Parts & Components with advanced technologies, the industry retains Int'I Competitiveness in Intermediate goods
⑤	Differential goods Production Type	Third Quadrant		The industey loses Int'I Competitiveness in Indtermediate goods, It does not, however, mean the industry loses competitiveness completely, In general the industry competes in both domestic snd world markets by specializing the differential product with high quality and high function, utilizing the advanced technologies as well as the established brand names.

Note: The number from ① to ⑤ corresponds to the same number respectively shown in Figure2.
(Source) METI (2005,160)



(Source) METI (2005,160)

〈Figure 2〉 Diagram of Spiral Pattern Development

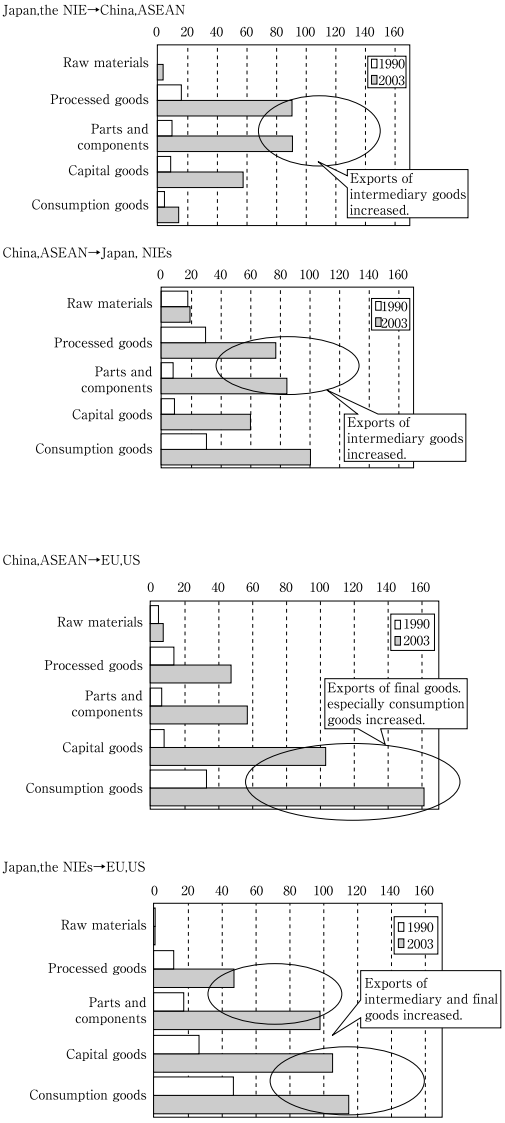
course as it advances. The features of the respective quadrants are as follows: (i) In the third quadrant (domestic supply pattern), domestic industry lacks international competitiveness; intermediate goods and final goods are both not internationally competitive; (ii) In the second quadrant (assembling production pattern), intermediate goods are imported and assembled final goods are exported; while intermediate goods are internationally competitive, final goods are not; (iii) In the first quadrant (integrated production pattern), intermediate goods and final goods are both internationally competitive; both intermediate goods and final goods are produced and exported; and (iv) In the fourth quadrant (pattern of production specializing in intermediate goods), intermediate goods are internationally competitive but final goods are not; intermediate goods are exported and final goods are imported. Applying this industrial development analysis to a country-specific analysis provides the following conclusions: (i) In Japan, most industries are situated in either the first quadrant or the fourth quadrant; machinery such as general machines, transport machines and precision machines are situated in the first quadrant and are internationally very competitive; while home appliances and electric machines are also situated in the first quadrant,

their international competitiveness is now showing a sign of decline; for textiles, steel, chemicals and general merchandise etc., final goods are becoming internationally less competitive but intermediate goods still remain internationally competitive, showing an industrial structure with a pattern of production specializing in intermediate goods; on the other hand, there is no industry that is situated in the second quadrant, which means that Japan has no industry of which advantage rests with its industrial structure with an assembling production pattern; (ii) China is characterized by an industrial structure with the advantage in the assembling process that is situated in the second quadrant; in contrast to Japan, China has no industry in the fourth quadrant and there is hence still no structure specializing in intermediate goods production; another point is that China shows an industrial structure with an assembling production pattern, i.e., one situated in the second quadrant, in the chemical, steel, textile and general merchandise industries etc., in which Japan is competitive in intermediate goods exports; this confirms a high degree of complementarity in industrial structure between Japan and China; (iii) South Korea shows industrial structure characteristics that are somewhat in the middle of Japan and China; while its textiles and home appliances are becoming internationally less competitive, international competitiveness in transport machines and electric machines is increasingly raised in both intermediate and final goods; its steel industry is situated as an assembling industry, and higher competitiveness of its final goods in precision machine production is now causing a structural shift to assembling production; and (iv) Thailand's international competitiveness is increasingly raised only in particular industries (car, textile and food etc.), rather than running after South Korea or China in all product areas.

Thus, two distinctive patterns that exist within the East Asian region have been detected, i.e., a pattern of production specializing in intermediate goods

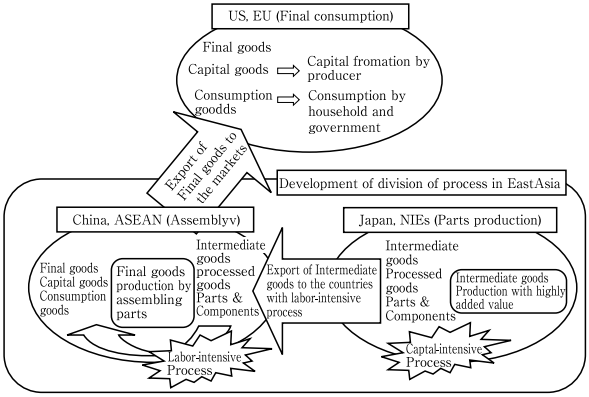
shown by Japan and now also by the NIEs, and an assembling production pattern shown by China and ASEAN, and it has been brought to light that the two are mutually complementary and are each internationally competitive as well. A concept that grasps such intra-regional and extra-regional relations in East Asia is the "triangular trade structure." Figure 3 shows shifts in trade value in the triangular trade structure. What can be understood from this is: (i) Intermediate goods trade has been growing both ways between Japan/NIEs and China/ASEAN; (ii) Growth in final goods exports from China and ASEAN to the U.S. and the E.U. is particularly marked, especially in consumer goods; and (iii) Intermediate goods and final goods exports from Japan and the NIEs to the U.S. and the E.U. have been growing steadily. In order for the kind of triangular trade as shown in Figure 4, one in which the locations of production, assembling and consumption are all different, to be established, the following conditions need to be met: (i) Japan and the NIEs should produce intermediate goods that are capital-intensive and are high value-added; (ii) China and ASEAN should have the advantage in the labor-intensive processes; (iii) The assembling process for final goods should be generally more labor-intensive than the production process for intermediate goods; and (iv) Production cost in China and ASEAN should still be sufficiently lower than that in Japan and the NIEs even if the trade-related cost is counted in. As Figure 5 shows, these conditions have indeed been met and the triangular trade has been developing dynamically. The value exchanged in trade within the triangular trade structure jumped from $85 billion in 1990 to $447 billion in 2003, a rapid growth of more than fivefold. Not only the trade value, but the percentage of the triangular trade to the whole trade also marked a more-than-double increase from 11.7% in 1990 to 23.1% in 2003. Obviously, the trilateral trade is growing rapidly in the manner of driving the entire trade.

Let us now provide an observation of the above analysis of the actual progress



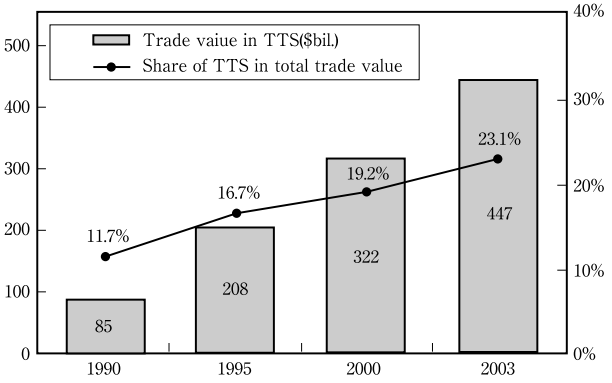
(Source) METI (2005,166)

〈Figure 3〉 Trends in Trade Value for Triangular Trade



(Source) METI (2005,167)

〈Figure 4〉 Model of Triangular Trade Structure



(Source) METI (2005,167)

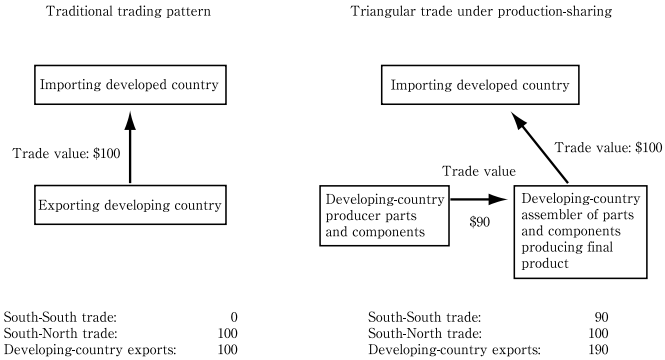
〈Figure 5〉 Change of Trade Value in Triangular Trade Structure

of regional economic integration in East Asia presented in the "White Paper (2005 Edition)," by focusing on the following three points.

The first point: the trade value in the triangular trade is indicated to be greater than it actually is. This has been noted by the UNCTAD (2005). As Figure 6

shows, the figures involve a double counting that causes the trade value to well exceed the amount of added values. This is related, on one hand, to the ongoing development of a production network in East Asia-what the UNCTAD (2005) refers to as the “intraregional production-sharing in East Asia”- and, on the other

〈Figure 6〉 Schematic Illustration of Impact of Production Sharing on the Statistically Recorded Value of Triangular Trade



(Source) UNCTAD (2005, 138)

hand, to the fact that Hong Kong and Singapore play a significant role as intermediary ports. It is indeed true that East Asia is experiencing a remarkable growth in its intra-regional trade, but the intra-regional trade value indicated is statistically inflated through double counting, resulting in the extra-regional trade being indicated in undervalued figures, especially the percentage of U.S. markets. Therefore, it would be wrong to draw from such statistics a conclusion that plays down the importance of U.S. markets for East Asia. Considering the structure unique to the triangular trade, one could only naturally conjecture that if the U.S. economy slows down, not only will final goods exports from China and ASEAN to the U.S. drop, but parts and intermediate goods exports from Japan and the NIEs to China will also be affected negatively to decline, resulting in a rapid reduction of the overall intra-regional trade value in East Asia. Such a turn of events was actually observed in 2000 when the burst of the IT bubble in the U.S. caused exports from East Asia to the U.S. to drop.

The second point: the issue of the economic relations within East Asia-particularly Japan and the Asian NIEs versus China. The White Paper depicted them as complementary economic relations, but that is not the case at all. A study conducted by G. Gaulier et. al. (Guilaume Gaulier, Francoise Lemoine, Deniz Unal-Kesenci, 2005) of the Centre d'etudes prospectives et d'informations internationales or "CEPII" of France closes in on the nature of the economic relations within East Asia through an analysis of China's economic rise and its trade.

The French researchers also first point to the development thus far of production-sharing in East Asia. This production-sharing consists of parts and intermediate goods production by Japan and the NIEs, and their exports to, processing and assembling in, and exports to extra-regional destinations, especially the U.S., from China. Such reorganization of production in East Asia gave rise to the triangular trade structure. It is, they argue, under this triangular trade structure that

China became an export base as well as an assembling country.

In Table 2, China's trade is classified by 1) trade partner country and by 2) traded goods, in an attempt to grasp its features. In reading this Table, it is necessary to know about the three trade categories used there. They classify the trade according to the tariff, namely: (i) Ordinary trade: In relation to imports, goods imported to domestic markets to which ordinary tariffs are applied; in relation to exports, those produced mainly from home-grown inputs and exported;

〈Table 2〉 Breakdown of China's Trade by Main Partners and Customs Regimes

Imports (% total)						
	World	Dragons＊	Japan	EU 15	USA	ROW
1993						
Imports by all custom regimes	100	28	22	15	10	25
Ordinarty imports	37	3	8	8	5	13
Imports for processing	35	18	8	2	2	6
Other custom regimes	28	7	7	6	3	6
2002						
Imports by all custom regimes	100	29	18	13	9	31
Ordinary imports	44	8	6	8	5	16
Imports for processing	41	17	8	2	2	11
Other custom regimes	15	3	3	3	2	4
Exports(% total)						
	World	Dragons＊	Japan	EU 15	USA	ROW
1993						
Exports by all custom regimes	100	29	17	13	18	22
Ordinary exports	47	12	10	7	6	13
Processed exports	48	16	7	7	13	6
Other custom regimes	5	0	0	0	0	4
2002						
Exports by all custom regimes	100	27	15	15	21	22
Ordinary exports	42	8	6	7	7	14
Processed exports	55	18	9	8	14	7
Ohter custom regimes	3	1	0	0	1	1
Trade Balance(billon of US$)						
	World	Dragons＊	Japan	EU 15	USA	ROW
1993						
All custom regimes	-12.2	-2.4	-7.5	-3.5	6.3	-5.1
Ordinary trade	5.2	8.0	0.7	-2.	-0.0	-1.5
Processing trade	7.9	-3.8	-1.3	4.2	9.7	-1.0
Other custom regimes	-25.2	-6.6	-6.9	-5.8	3.4	-2.6
2002						
All custom regimes	30.4	3.2	-5.0	9.7	42.7	20.1
Ordinary trade	7.1	3.2	1.1	-3.1	6.7	-0.8
Processing trade	57.7	7.2	3.1	19.6	39.9	-12.1
Other custom regimes	-34.4	-7.2	-9.3	-6.8	-4.0	-7.2

＊2002-4 Dragons: Hong Kong, Korea, Taiwan, Singapore.
1993-3 Dragons: Hong Kong,South Korea, Taiwan.
(Source) Gaulier, Lemoine, Unal-Kesenci (2005,18)

(ii) Processing trade: Goods imported for processing and assembling purposes and re-exported which are exempted from tariffs; and (iii) Other custom regimes: Any trade to which ordinary tariffs are not applied (compensatory trade, international relief, trade in bonded zones and intermediary trade).

From this Table, the following four points can be noted:

1) Assembly trade plays an overwhelming role in China's trade with East Asia.

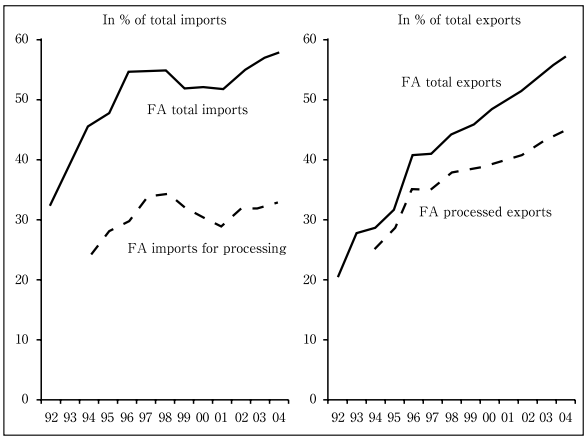
2) In terms of imports, approximately 60% of China's imports from the NIEs and 40% of its imports from Japan were occupied by processed and assembled goods (parts and intermediate goods) in 2002. The percentage taken up by the NIEs and Japan in China's entire processed and assembled goods imports was 40%. In contrast, parts and intermediate goods have only a minor share in China's imports from the E.U. and the U.S.

3) In terms of exports, on the other hand, the shares of Japan and the NIEs in China's processed and assembled goods exports are admittedly on the rise, but they should be regarded with a grain of salt. This is because exports from China to Hong Kong that are to be later re-exported to the U.S. and the E.U. are also included there. While, therefore, processed and assembled goods exports from China to Japan and the NIEs do not have as large a share as in the case of imports, the share of exports to the U.S. and the E.U. in China's processed and assembled goods exports (40% in 2002) is – if Hong Kong's re-exports are taken into account – actually greater.

4) In terms of trade balance, China's trade balance for 2002 was $30.4 billion in surplus. The greatest contributor to China's trade surplus was its trade in processed and assembled goods ($57.7 billion in surplus), which in turn owes to the surplus with the U.S. as well as with the E.U. ($39.9 billion and $19.6 billion). China's trade balance involves a skew between results with Japan and the NIEs versus results with the U.S. and the E.U.; considering that China's processed and

assembled goods exports to the U.S. and the E.U. include a high percentage of its parts and intermediate goods imports from Japan and the NIEs, it is wrong to view China's large trade surplus with the U.S. on a bilateral basis and it is accordingly necessary to pay attention to the fact that it was brought about in the context of production-sharing in East Asia as a whole.

On a related note, who has been leading China's trade? It is, in point of fact, mainly subsidiaries of multinational companies (foreign affiliates or FAs) of countries like Japan and the NIEs, of which role is becoming more and more important. As Figure 7 shows, more than 55% of China's entire exports and entire imports during 2004 were handled by FAs. That their role is becoming increasingly important is evident when considering that the equivalent figures in 1992 were 20% of its entire exports and 30% of its entire imports. In particular, nearly 80% of processed and assembled goods are the work of FAs (ibid., p. 21). An observation of the degree of their role in the trade – exports and imports – of Japan and the NIEs with China in 2002 reveals that FAs were engaged in 62% of



(Source) Gaulier, Lemoine, Unal-Kesenci (2005,22)

〈Figure 7〉 Share of Foreign Affiliates (FA) in Total China's Trade, 1992-2004

exports and 67% of imports in the case of Japan. With the equivalent figures being 49% and 63% in South Korea, 57% and 67% in Taiwan, 63% and 63% in Hong Kong and 65% and 61% in Singapore (ibid., p. 22), they clearly have high shares across the board.

Lastly, let us examine China's trade in high technology products. As Table 3 shows, the role of foreign companies in high-tech trade is becoming even greater. While the share of Chinese companies in high-tech product imports was 42% in 1997 but dropped to 33% in 2002, the share of foreign companies (joint-venture companies and wholly-owned subsidiaries) rose from 58% (33% and 25%) to 67% (22% and 45%). A similar trend is found in high-tech product exports as well. The share of Chinese companies in high-tech product exports was 42% in 1997 but dropped to 24% in 2002, in contrast to the increased share of foreign companies (joint-venture companies and wholly-owned subsidiaries) from 58% (28% and 30%) to 76% (29% and 47%). It is also multinationals that drive China's high-tech product trade, or exportation of high-tech products (mainly final goods) from China in which importation of high-tech products (mainly parts and intermediate goods) to China is embedded.

The following conclusions can be drawn from the analysis by the French researchers described above:

〈Table 3〉 Breakdown of China's High-Tech Trade by Category of Firms

	M %		X %		Trade Balance (% X+M)	
	1997	2002	1997	2002	1997	2002
Chinese firms	42	33	42	24	-13	-18
Joint Venture	33	22	28	29	-20	10
Fully foreign owned firms	25	45	30	47	-4	-1
All firms	100	100	100	100	-37	-9

(Source) Gaulier, Lemoine, Unal-Kesenci (2005,22)

1) Through the production-sharing in East Asia, China gained an opportunity to make an advance into a global trade structure in the form of triangular trade. It is true that China has achieved a remarkable economic growth by taking advantage of this historic trade opportunity, but the main players in China's trade have been multinationals of countries like Japan and the NIEs.

2) As is pointed out in the White Paper, there exists between Japan/NIEs and China a complementary economic zone that has in it economies with an assembling production structure and economies specializing in intermediate goods production. However, it is multinationals that have been dominating it, making the nature of this setup more aptly defined as a vertical international division of production on an intra-industry basis, rather than a complementary international division of production.

3) While a shift to high technology in China's trade, especially in export products, is indeed becoming more and more marked in recent years, this cannot simply be understood as reflecting the improved or upgraded level of China's own technology. It is because, given an even greater role that multinationals play in high-tech trade, the main factor in the high technology shift in China's trade is presumably technology transfers by multinationals.

4) The higher the degree of dominance of multinationals in China's trade—especially in high-tech trade, the more fully their pursuit for profits is accomplished. Hence, a growth in China's high value-added product exports means that multinationals end up taking the lion's share, which leaves China to handle lower value-added sectors of low-tech assembling and processing and which consequently causes the practice of unequal profit division to be locked in and widened.

Being of particular importance, the fourth conclusion will be topped up with a supplementary observation. In fact, this point has already been analyzed in detail

by the UNCTAD (2002). The UNCTAD has confirmed that statistics prove that exports in technology-intensive and high value-added products have been on the rise in developing countries as well since 1980. It argues that such statistics are misleading, however, due to the fact that in most cases, developing countries are simply assimilated in the low-tech processing and assembling process of production organized by today's multinationals. The share that developing countries take in added values is accordingly limited to those from low-tech, non-skilled labor while a majority of their added values end up being taken in the form of earnings etc. by multinationals which own the capital, management and know-how etc. Thus, profits gained from trade and direct investment are divided between developed nations and developing nations in a highly unbalanced fashion, leading to global inequality becoming wider. Admittedly, the opportunity for developing countries to take part in the processing and assembling process of production organized by multinationals did benefit the developing countries to a considerable extent when they had a workforce surplus at the initial stage of their industrialization. This alone, however, cannot enable them to make a big leap forward to a new pattern of fast-paced and sustainable industrial growth. This explains the essence of the analysis that the UNCTAD conducted: the UNCTAD believed that a strategy that developing countries should apply in the future was to achieve a higher domestic share in the added values included in their product exports.

Third point: the issue of sustainability of triangular trade, which is related to the twofold global imbalance that the current world is faced with – a massive amount of the U.S. current-account deficit and huge current-account surpluses of East Asia. As Taniuchi (2005) argues, the U.S. current-account deficit has been growing constantly since the mid 1990's up until now. The figure increased rapidly from $109.5 billion in 1995 (1.5% of GDP) to $665.9 billion in 2004 (5.7%

of GDP); the current count stands out as being much greater than the level of the late 1980's, or the last period of current-account deficit growth (the deficit for 1987, when its current-account deficit grew the most last time, was 3.4% of GDP). How, then, has this current-account deficit been financed? The U.S. current-account deficit for 1996 of $120.2 billion was covered mainly by capital imports from the E.U. ($101.4 billion) and Japan ($63.4 billion). The U.S. current-account deficit for 2003 jumped to $530.7 billion, which was financed by the E.U. ($36.6 billion), Japan ($80.8 billion) and East Asia (excluding Japan) ($139.1 billion) etc., with Japan and East Asia (excluding Japan) put together making up 41.4% with $219.9 billion. The reason behind such a large role that East Asia fulfills in financing the U.S. current-account deficit is the rapid increase of foreign reserves in East Asia in the wake of the Asian economic crisis, due to a combination of their growing current-account surpluses and capital account surpluses (rising capital imports). Of the world's total foreign reserves of $3.8537 trillion at the end of 2004, East Asia had $2.2878 trillion (59.4%), which was comprised of those of Japan ($833.9 billion or 21.6%), the Asian NIEs ($676.5 billion or 17.6%), ASEAN nations ($162.9 billion or 4.2%) and China ($614.5 billion or 15.9%). They manage their growing foreign reserves mainly in U.S.$ denominated assets (i.e., purchasing U.S. bonds), the other side of the coin of this fact being that the U.S. current-account deficit is financed by them.

This carries two problems. The first one is the issue of sustainability of the U.S. current-account deficit. As is noted by Taniuchi, there is no denying the possibility of a hard landing triggered by some form of unexpected economic or political event, taking the course of: reverse flows of capital → dollar crash → U.S. stock market collapse → skyrocketing interest rates → U.S. economy falling into depression. Even if such a hard landing scenario does not materialize, if the global imbalance gets unwound as a result of a sharp depreciation of the dollar,

the triangular trade, which is highly dependent on the global economy, particularly in relation to the U.S., will be affected to a considerable extent. The other problem is that this may nonetheless not necessarily make it appropriate for East Asia to continue financing the ever-increasing U.S. current-account deficit.

Facing this problem right on, Masaru Yoshitomi (2005) argues that while the U.S. current-account deficit is not sustainable and will have to be adjusted through a dollar depreciation, East Asia will be able to withstand its impact. According to him, the present U.S. current-account deficit (5.5% of GDP) is not sustainable. A sustainable level of current-account deficit is 2-something percent of GDP. Accordingly, the current figure of 5.5% has to be brought down by 3% to attain 2.5%. On the other hand, the U.S. dollar has to be depreciated by approximately 10% for the U.S. current-account deficit to come down by 1% of GDP. Therefore, the U.S. dollar needs to be depreciated by roughly 30%. The East Asian currencies then need to be adjusted to appreciate all in all by 30% against the dollar.

Yoshitomi nevertheless asks himself, "Would the East Asian economies be able to withstand such a large rise in exchange rates?" and answers "Yes." His rationalizations are: (i) If all currencies of East Asia appreciate at once by 30% against the dollar, the relative rates between East Asian currencies remain unchanged, which means that economic activities within East Asia will continue to be carried out smoothly; and (ii) The percentage of intra-regional trade in East Asia has already reached 52% (in 2003) and is showing signs of further increase. FTA arrangements will further spur this trend. Therefore, an appreciation of East Asian currencies by as much as 30% against the dollar will be mutually offset by more than half among and between them thanks to the intra-regional trade, making the effective appreciation a little more than 15%. He says that the East Asian economies, which are equipped with sound macroeconomic fundamentals,

should be able to well withstand a currency appreciation in that range.

We would like to note the following two points as insights into Yoshitomi's view described above. The first point is the cause of the constantly growing U.S. current-account deficit. It is impossible to give a prescription for rectifying the imbalance that the current-account deficit represents unless its cause can be clarified. As many researchers have already pointed out, its cause rests with an investment-savings (I-S) imbalance in the U.S., or its insufficient savings (a fiscal deficit and a household sector deficit), and not with a strong dollar (or weakened international competitiveness of the U.S. caused by that). Confessedly, Yoshitomi presents what he sees as the cause and solution by arguing that "the strongest key to solving the imbalance faced by today's world is actions by the U.S. itself to recover a good I-S balance, i.e., to solve its fiscal deficit and encourage savings in the household sector." In all likelihood, however, such an argument remains insufficient without pointing to the fact that the main cause of its fiscal deficit lies in the war in Iraq, as well as the massive war cost involved with it, stemming from the Bush administration's unilateralism, coupled with its tax cut policies favoring the rich. The reality is: the U.S. is having its insufficient savings covered by overseas savings by allowing to continue its fiscal deficit free-fall and its excessive consumption on the housing bubble bandwagon (a situation that is the cause of the household sector deficit), which may sound nice if called a robust consumer demand, as it takes advantage of the privileges that the U.S. enjoys due to the U.S. dollar's role as the key currency. The bottom line is that the Bush administration does not appear likely to change its policies on the war and pro-rich taxation and that, more to the point, the Japanese government is engaged itself in the Iraqi policies of the U.S. and is ever diligently maintaining the role of covering the U.S. fiscal deficit, which also does not appear likely to be changed. This implies that the U.S. current-account deficit may only be expanded with lit-

tle possibility of turning downward, which leaves Japan to continue being fearful of a possible dollar depreciation like a dangling sword of Damocles as long as it insists on an ideology centered around the Japan-U.S. alliance.

The second point is concerned with Yoshitomi's proposition about East Asia's currency adjustment that "East Asian currencies then need to be adjusted to appreciate all in all by 30% against the dollar." If, as Yoshitomi argues, all currencies of East Asia were to appreciate by 30% against the dollar at once, the relative rates between East Asian currencies should indeed remain unchanged. To that end, however, monetary cooperation in East Asia would be required. As is widely known, there are currently no actions in East Asia in the area of monetary cooperation, except for international financial cooperation such as the Chiang Mai Initiative. Therefore, it is only fair to conclude that Yoshitomi's view lacks any thoughts on such preconditions; in the absence of monetary cooperation, a volatile dollar would continue subjecting East Asian currencies to significant shocks and serious blows as has been the case, especially for the yen, the very currency of Japan. As Eiji Yamashita (2002) says, we can learn a lot from the European Monetary System ("EMS"). The so-called Nixon shock in 1971 caused currency systems of developed countries to be shifted from a previous fixed-rate system to a floating rate system, but stable movements of the German mark thereafter contrast with substantial fluctuations that the Japanese yen has undergone. After the Nixon shock up to the present, the dollar has fluctuated rather frequently and, being the key currency, has forced the international monetary system to take an extremely unstable course; Europe has, however, succeeded in protecting itself from adverse effects to a considerable degree, thanks to an intra-regional common monetary system represented by the EMS. Yamashita calls this an isolation effect of the EMS and has named his rationale the "EMS hard-shell capsule theory." At the opposite end of the spectrum is the

Japanese yen, which has been bearing the brunt of dollar fluctuations due to the non-existence of any monetary cooperation framework in East Asia thus far.

No matter what effect Yoshitomi's argument is designed to accomplish, looking into it from a perspective described above reveals the strong necessity to fulfill two requirements: (i) rethink the ideological persistence with the Japan-U.S. alliance and (ii) arrange monetary cooperation in East Asia.

In conclusion, we would like to touch on the issue of the appropriateness for East Asia to cover the U.S. current-account deficit. What is meant by the global imbalance is a situation where the U.S., a developed country, is a capital importer while East Asia, among which there are many developing countries, is a capital exporter. This implies that the capital that those developing countries would really need for economic development purposes is flowing out of their hands. As, in addition, they manage their foreign reserves mainly in dollar-denominated assets (i.e., by purchasing U.S. bonds), they are left with taking a risk of considerable capital losses that could materialize in the event of a dollar depreciation. Given the list of such significant disadvantages, there is a pressing need to solve the matter through regional cooperation in East Asia, such as by fostering an Asian bond market.

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