

The Prospects for Economic Cooperation in Northeast Asia

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1. Introduction

Over the past decade, the environment for socioeconomic development in Northeast Asia has changed significantly. China acceded to the WTO in 2001 and has subsequently reformed its trade policies and institutions in line with its new commitments. China and ASEAN concluded the Framework Agreement on Comprehensive Economic Cooperation in 2002, under which both sides agreed to liberalize trade in goods and services progressively and to facilitate investment. The negotiations on the ASEAN-Japan and ASEAN-ROK Comprehensive Economic Partnerships were concluded in 2007 and the process to eliminate tariffs will begin soon. In the meantime, the WTO Doha Round is at a standstill, which casts doubt on the prospects for the multilateral trade system. The soaring prices of energy and food arouse worldwide concern about energy and food security. The Northeast Asian economies (NEAEs) are now facing both new opportunities and challenges in their socioeconomic development.

This paper does not aim to assess quantitatively the benefits and costs of FTA options involving NEAEs. Instead, it presents the background information to economic integration in the Northeast Asian region (NEAR) and addresses key issues from China's point of view regarding the future prospects for this process. The paper is organized as follows: After this introduction, progress in the economic integration of the Northeast Asian region is described. The third section discusses the core interests for China becoming involved in the process of Northeast Asian regional economic integration and the likely approaches toward such engagement. The concluding remarks make up the last section.

For simplicity in the discussion below, NEAEs refers to mainland China, Japan, the Republic of Korea, the Democratic People's Republic of Korea, the Russian Federation, and Mongolia; while East Asian Economies (EAEs) additionally include Hong Kong, Macao, Taiwan and ASEAN.

2. Progress in Economic Integration in the Northeast Asian Region

The countries in the Northeast Asian region are quite dissimilar in terms of natural resources, level of economic development and sociopolitical institutions. While Japan and the ROK are well developed market economies, China, Mongolia and Russia are still in a transitional process, through socioeconomic reform, from the previous central-planning regimes toward market economies. The DPRK remains to a large extent in isolation. In the Northeast Asian region, China, Japan and the ROK have strong economic and trade links and constitute the core group in regional economic integration. Therefore the discussions below

focus predominantly on those three countries.

Formal Economic Integration Arrangements

The process to establish formal economic integration arrangements (EIAs) by countries in the Northeast Asian region has accelerated significantly since the beginning of the 21st century. In recent years, the governments of China, Japan and the ROK have devoted great efforts to negotiating FTAs or EIAs with their preferred partners, against a backdrop of such economic integration arrangements proliferating worldwide with the stagnation of the WTO Doha Round negotiations.

The governments of Japan and the ROK worked out their FTA strategies in 2002 and 2003, respectively, emphasizing the promotion of economic development and the securing of political and economic stability through EIAs (Ministry of Foreign Affairs of Japan, 2002; Ministry of Foreign Affairs and Trade of the Republic of Korea, 2003). Both countries place high priority on the negotiations with EAEs, where the potential benefits from removing trade barriers are high.

In recent years, the Chinese government also began to take regional and bilateral FTAs as an integral component of its trade strategy. Although the Chinese government has not issued official documents on the FTA strategy so far, a steady promotion of bilateral and regional free trade zones was specifically addressed by the top leaders in their speeches to the National People's Congress and the National Congress of the Communist Party (Wen 2007; Hu 2007). Many internal studies have been carried out to assess various FTA options from either the national or sectoral angles (e.g., Tian and Wang, 2003; Hu and Chang, 2006; Liu and Liu, 2007).

China began to negotiate an FTA with ASEAN almost at the same time as its WTO accession in 2001. The negotiations on the China-ASEAN Free Trade Area (CAFTA) were concluded in 2003, which set a schedule for the full removal of trade barriers by 2010 for China and the six oldest ASEAN members and by 2015 for the four newer ASEAN members. Since then, China has initiated negotiations on FTAs with several potential partners. Table 2.1 lists the status of China's activity on FTAs. It can be seen that the partners include both developed and developing countries, as well as countries on different continents.

Apart from the FTA activity listed above, China, Russia and four Central Asian countries established the Shanghai Cooperation Organization (SCO) in 2001. Mongolia, Pakistan, Iran and India have recently been participating as observers. While the SCO initially focused on issues related to regional security, it has begun to address strengthening economic and trade relations under a Framework Agreement on economic and trade cooperation

Table 2.1 China's progress in negotiation of FTAs

Region	Partner	Status of progress
Northeast Asia	Japan	Feasibility studies on bilateral FTAs and regional FTA conducted
	ROK	
East Asia	Hong Kong	Closer Economic Partnership Arrangement implemented in 2004
	Macao	Closer Economic Partnership Arrangement implemented in 2004
	ASEAN	Regional FTA on goods and services implemented in 2005 and 2007 respectively
	Singapore	Bilateral FTA under negotiation since 2006
Other Asia	Pakistan	FTA on goods under negotiation; an "Early Harvest" program implemented in 2006.
	Gulf Cooperation Council	Bilateral FTA under negotiation since 2004
	India	Bilateral FTA proposed and feasibility study conducted
Other regions	Chile	Bilateral FTA on goods implemented in 2006 and an FTA on services under negotiation since 2007
	New Zealand	Bilateral FTA nearly concluded
	Australia	Bilateral FTA under negotiation since 2004
	Southern African Customs Union	Regional FTA under negotiation since 2004
	Iceland	Bilateral FTA under negotiation since 2007
	Peru	Bilateral FTA under negotiation since 2007
	Norway	Feasibility study on bilateral FTA completed in 2007

Source: Compiled by author based on information released by the Chinese government.

signed in 2003. Cooperation on energy-security strategy was discussed specifically at the SCO summit meeting in 2007. While the SCO is unlikely to evolve into a FTA in the near future, economic and trade relations are certain to gradually strengthen.

The above development illustrates that the Chinese government has made great efforts in enhancing political and economic cooperation with its neighbors on all sides, although China is negotiating FTAs with some far-off countries also. This reflects the thinking that China must ensure a favorable external environment for its socioeconomic development in the future and the FTA strategy should serve that end. In this regard, an EIA/FTA in the Northeast Asian region has strategic importance to China.

In recent years, Japan and the ROK have also made significant progress with regard to FTA and EIA negotiations. According to the WTO (2007a), by October 2007 the number of trade arrangements notified to the WTO was four for Japan and six for the ROK. This may not include the latest development in which Japan and ASEAN concluded negotiations for the ASEAN-Japan Comprehensive Economic Partnership agreement in November 2007. While bilateral and trilateral FTAs among China, Japan and the ROK were proposed several years ago and some feasibility studies were conducted, none, however, has proceeded to the negotiation stage. On the other hand, the three countries have competed in negotiating FTAs with potential partners outside the Northeast Asian region.

Russia's center of gravity in economics and trade does not lie in its Asian part. While Russia's bilateral trade with China, Japan and the ROK have increased very rapidly in recent years, it maintains preferential economic and trade arrangements with members of the Commonwealth of

Independent States only. So far Mongolia has had no FTA engagement with any country. China and Russia are the two major trading partners of Mongolia. In 2006, Mongolia exported 68 percent of its goods to China, and imported 27 percent and 37 percent of its goods from China and Russia, respectively. In terms of its trade pattern the DPRK is similar to Mongolia.

It is apparent that the development of economic integration in the Northeast Asian region is not well coordinated and there exist many economic, political and cultural obstacles to the negotiations. Therefore, a formal economic integration arrangement for the region as a whole seems unattainable in the near future.

Development of Economic and Trade Relations

While the establishment of a Northeast Asian FTA (NEAFTA) is still far from being realized, regional economic integration is continuing to move forward, driven mainly by market forces. In the past decade, several important factors have demonstrated an impact on the regional integration of the Northeast Asian region.

The first factor was the Asian financial crisis in 1997, which led to a collective effort to establish a mechanism for stabilizing the Asian monetary system. Soon after the crisis, a network of Bilateral Swap Arrangements was agreed by major EAAs, to allow them to cope with similar crises by themselves. The idea to establish an Asian Monetary Fund has been proposed recently, in which China, Japan and the ROK would play a major part. As a result, the initial moves on economic integration in East Asia started in the monetary area rather than in trade.

The second factor was China's accession to the WTO in November 2001. Apart from opening the domestic market, China has further deepened the ongoing policy and institutional reforms begun 30 years ago in order

Table 2.2 Changes in the trade intensity indices of NEAEs and ASEAN

Economy	Year	Export					
		China	Japan	ROK	Mongolia	Russia	ASEAN
China	1995		3.01	1.76	5.38	0.97	1.05
	2000		2.96	1.90	4.85	1.35	1.23
	2006		2.03	1.84	3.74	1.24	1.33
Japan	1995	1.98		2.75	1.23	0.23	2.61
	2000	1.89		2.68	0.65	0.18	2.52
	2006	2.25		3.12	1.37	0.83	2.14
ROK	1995	2.92	2.14		2.84	0.98	2.14
	2000	3.20	2.11		3.47	0.69	2.06
	2006	3.35	1.75		2.83	1.21	1.79
Mongolia	2000	17.12	0.31	0.24		14.59	0.00
	2006	10.64	0.10	0.56		2.22	0.03
Russia	2000	1.52	0.48	0.40	19.35		0.19
	2006	0.82	0.33	0.35	13.58		0.12
ASEAN	1995	1.03	2.11	1.15	0.75	0.42	
	2000	1.12	2.29	1.48	0.45	0.16	
	2006	1.28	2.16	1.43	0.39	0.16	

Source: Calculated by author using data from the UN Comtrade database.
The DPRK is excluded due to incompleteness of data.

to comply with WTO rules and disciplines. In essence, the accession to the WTO has locked China firmly on the path of establishing a market economy, which in turn helps to enhance the confidence of China's trading partners regarding strengthening economic and trade relations with China. In the years following the accession, China was able to attract more foreign direct investment (FDI) inflow and expand trade at an amazing speed. All the countries in the Northeast Asian region have benefited from China's economic growth.

The third factor is the emergence of the ASEAN Free Trade Area (AFTA). ASEAN is a major trading partner of China, Japan and the ROK. Japan and the ROK are important sources of FDI and advanced technology for China and ASEAN, as well as major exporting markets for a wide range of products, particularly labor-intensive ones. In this regard, China has a competitive relationship with many ASEAN countries. Meanwhile, Japan and the ROK are also in competition in their economic and trade relations with China and ASEAN. As a result, any initiative on economic integration by one party will result in a response by the others concerned. This leads to competition among China, Japan and the ROK to enhance economic and trade relations with ASEAN in order to avoid the effects of trade-diversion. Such a development would make little contribution to a formal FTA/EIA in the Northeast Asian region.

The fourth factor is the fight against transnational terrorism led by the United States. The War on Terrorism has resulted in profound changes in geopolitics. While Japan and the ROK are aligned with the United States, China and Russia are beginning to keep their focus

closely on combating terrorism in Central Asia within the framework of the SCO. The recent nuclear crisis on the Korean Peninsula required cooperation on regional security issues, which led to the six-party talks in which China, Japan, the ROK, the DPRK and Russia are all involved. The War on Terrorism has led to significant disturbance of world markets. China, Japan and the ROK are countries that are heavily dependent on access to overseas markets for obtaining their supplies of essential inputs of production and for selling their goods. Within such a context, the enhancement of economic and trade relations with their desired partners is a rational approach to coping with the potential risks. For instance, Russia is approached by China and Japan in competition for securing energy supplies; meanwhile, conflicts between China and Japan on exploiting oil resources on the continental shelf intensify. Such factors have an impact on governmental FTA/EIA policies.

Progress in regional economic integration can be measured through the development of trade and FDI. Table 2.2 shows trade intensity indices¹ among EAAs. An index number greater than 1 indicates that the bilateral trade relation of the two parties is stronger than what would normally be expected. It can be observed that bilateral trade relations are consistently strong among China, Japan and the ROK, and between the three countries and ASEAN. China and Russia have very strong two-way trade with Mongolia. Japan and the ROK have strong exports to Mongolia, but imports are insignificant. While the bilateral trade relations between China and Russia are stronger than those between Japan and Russia and between the ROK and Russia, the intensities are relatively low. In brief, within

¹ The trade intensity index (TII) between country *i* and *j* is defined as the share of country *i*'s exports going to country *j* divided by the share of total world exports to country *j*; namely $TII_{ij} = (X_{ij}/X_i)/(X_{wj}/X_w)$, where X_{ij} is the value of exports of country *i* to country *j*, X_i is the total export of country *i*, X_{wj} is total world exports to country *j*, and X_w is total world exports.

Table 2.3 FDI flows and stocks in the Northeast Asian region (US\$ billion)

Country	FDI flow					FDI stock			
	1990-2000 (Annual average)	2003	2004	2005	2006	1990	2000	2005	2006
China									
Inward	30.1	53.5	60.6	72.4	69.5	20.7	193.3	272.1	292.6
Outward	2.2	2.9	5.5	12.3	16.1	4.5	27.8	57.2	73.3
Japan									
Inward	3.1	6.3	7.8	2.8	-6.5	9.9	50.3	100.9	107.6
Outward	25.4	28.8	31.0	45.8	50.3	201.4	278.4	386.6	449.6
ROK									
Inward	3.1	4.4	9.0	7.1	5.0	5.2	38.1	66.0	71.0
Outward	3.1	3.4	4.7	4.3	7.1	2.3	26.8	38.7	46.8
Mongolia									
Inward	0.0	0.1	0.1	0.2	0.2	-	0.2	0.7	0.9
Outward	..	-	-	-	-	-	-	-	-
Russia									
Inward	2.4	8.0	15.4	12.8	28.7	-	32.2	169.0	197.7
Outward	1.6	9.7	13.8	12.8	18.0	-	20.1	138.8	156.8

Source: UNCTAD (2007).

the Northeast Asian region China, Japan and the ROK constitute a trade block, which is also closely integrated with ASEAN. On the other hand, China, Mongolia and Russia (and the DPRK also) constitute another trade block which is less integrated with ASEAN. From this angle, China plays a role as the pivotal point linking the two relatively separate trade blocks.

It can be observed that the trade intensities change over time without any uniform pattern. For China, export intensities with Japan and Mongolia show a decreasing trend, and an increasing one with Russia; the import intensities with Japan and the ROK show an increasing trend, and a decreasing one with Mongolia and Russia. The two-way trade relations between China and ASEAN are strengthening, which can be attributed partially to the establishment of CAFTA. In general, China has begun diversifying its export markets in recent years, which leads to a relative decline in the share of the traditional markets.

FDI is another key aspect driving regional economic integration. FDI plays roles not only in improving the productivity of less developed countries, but also in shaping regional production chains in response to global market demand, taking into account the different comparative advantages. The countries in the Northeast Asian region are at different stages of development and faced with different bottlenecks hindering economic growth. FDI and an associated technology transfer are essential to economic growth and development for the less developed countries in the Northeast Asian region. The inflow of FDI is a major factor in China becoming a world-leading manufacturer.

According to the data reported by UNCTAD (2007), Japan is the only country in the Northeast Asian region that has a net FDI outward flow, while the ROK is approaching

the transition point from net inward flow to net outward flow. So far China is the largest host country for FDI in the region. In recent years, however, it has begun to increase its outward FDI (See Table 2.3). The inward FDI to Mongolia has been very small compared with other countries, but the amount has shown a significant increase in recent years. Similarly, both inward and outward FDI has increased in Russia, reflecting improvement in the economic power of Russia. It can be noted from Table 2.3 that Japan's outward FDI flows have grown at a slower rate in recent years than previously. In contrast, outward FDI from China and the ROK has been rising rapidly since 2000. If this trend continues, Japan's leverage in pushing forward regional economic integration will definitely weaken in the future.

Table 2.4 shows the FDI intensities² of China, Japan and the ROK with their top ten host economies. When the intensity ratio is greater than 1, the FDI relationship is stronger than would be expected based on the relative importance of the two economies as source and host. Given its technological superiority, Japan's FDI is distributed more diversely around the world, including in developed countries like the US and Australia. In contrast, the FDI from China and the ROK goes mainly to less developed economies. Not counting Hong Kong, China in the main invests in its neighboring countries to all sides. Nevertheless, all of the three countries have high FDI intensities with EAAs.

The Changing Position of China in the East Asian Economy

Thanks to its policies of opening-up, China's economic relations with NEAAs have strengthened gradually, and its WTO accession has further boosted that momentum. China's trade volumes with NEAAs have been rising

² FDI intensity is defined as the ratio of the proportion of FDI stock from country *i* to country *j* to the proportion of country *i*'s outward FDI stock within the world total.

Table 2.4 FDI intensities of China, Japan and the ROK with their top ten host economies

China			Japan			ROK		
Economy	1995	2005	Economy	1995	2005	Economy	1995	2005
Hong Kong	62.5	55.3	Thailand	3.5	7.7	Laos	23.5	46.9
Mongolia	18.8	39.6	Philippines	2.4	6.1	China	15.9	23.3
Cambodia	2.1	27.3	Taiwan	3.2	5.3	Sri Lanka	46.7	21.2
Laos	1.1	12.5	ROK	4.7	4.4	Bangladesh	34.8	16.7
Sri Lanka	1.8	9.6	China	2.2	4.0	Vietnam	28.5	15.4
Myanmar	0.3	7.2	Malaysia	2.6	3.4	Cambodia	1.0	15.3
Indonesia	0.5	5.9	Singapore	2.3	3.2	Mongolia	20.0	12.8
Kazakhstan	0.7	4.3	United States	2.4	3.2	Indonesia	16.2	11.3
Peru	3.6	1.7	Australia	1.4	1.8	Philippines	3.8	4.9
Vietnam	0.6	1.1	Hong Kong	2.4	1.0	Panama	3.8	4.3

Source: UNCTAD (2007, pp. 223-224)

Table 2.5 Structural changes in China's exports to the EAEs

Year	Total Exports US\$ billion	Shares of East Asian economies and Russia (percentage)									Sub-Total
		Hong Kong	Macao	Taiwan	Japan	ROK	DPRK	Russia	Mongolia	ASEAN	
1995	148.78	24.2	0.5	2.1	19.1	4.5	0.3	1.1	0.0	7.0	59.0
1996	151.05	21.8	0.4	1.9	20.4	5.0	0.3	1.1	0.0	6.8	57.8
1997	182.79	24.0	0.4	1.9	17.4	5.0	0.3	1.1	0.0	7.0	57.0
1998	183.81	21.1	0.4	2.1	16.1	3.4	0.2	1.0	0.0	6.1	50.4
1999	194.93	18.9	0.3	2.0	16.6	4.0	0.2	0.8	0.0	6.3	49.2
2000	249.20	17.9	0.3	2.0	16.7	4.5	0.2	0.9	0.0	7.0	49.5
2001	266.10	17.5	0.3	1.9	16.9	4.7	0.2	1.0	0.0	6.9	49.4
2002	325.60	18.0	0.3	2.0	14.9	4.8	0.1	1.1	0.0	7.2	48.4
2003	438.23	17.4	0.3	2.1	13.6	4.6	0.1	1.4	0.0	7.1	46.5
2004	593.33	17.0	0.3	2.3	12.4	4.7	0.1	1.5	0.0	7.2	45.6
2005	761.95	16.3	0.2	2.2	11.0	4.6	0.1	1.7	0.0	7.3	43.5
2006	968.94	16.0	0.2	2.1	9.5	4.6	0.1	1.6	0.0	7.4	41.6

Source: Calculated by author using data from UN Comtrade database.

steadily and uniformly over time. The rates of growth, however, vary depending on the partner. According to China's official statistics, Japan, Hong Kong, ASEAN, the ROK, Taiwan and Russia are ranked respectively as the third to eighth largest trading partners of China in 2006 (NSB, 2007). China's trade is heavily concentrated in East Asia.

Table 2.5 shows China's exports to EAEs over the period 1995-2006. During that period, the total export value grew at an average rate of 18.6 percent annually. The growth accelerated significantly after WTO accession, to 29.5 percent. While the EAEs remain as important markets for China, their aggregate share, however, declined gradually from 59.0 percent in 1995 to 41.6 percent in 2006. It can be seen from the figures in Table 2.5 that China's share of exports to Japan and Hong Kong show the largest declines, although the value of exports rose during the period. The stagnation of the Japanese economy is a factor leading to slow growth in domestic demand, which becomes a limiting factor for China's exports. As China has become increasingly more open, more and more Chinese enterprises have established direct trade relations with foreign enterprises. This development reduces Hong

Kong's role as the export gateway of mainland China. China's exports to the ROK and Taiwan held their share. In contrast, China's exports to ASEAN and Russia have risen modestly in recent years. While establishment of CAFTA is doubtless a factor leading to the fast growth in exports to ASEAN, improvement of the Russian economy and the strengthening of bilateral cooperation have contributed to the growth in China's exports to Russia.

The structural change in China's imports from EAEs is shown in Table 2.6. During the period 1995-2006, China's import values grew at 17.7 percent annually due to both an opening market and sustained economic growth. Similar to exports, the growth in imports also accelerated after WTO accession, rising to 26.6 percent during 2001-2006. It can be found from the figures in Table 2.6 that, among the EAEs, the shares of the ROK and ASEAN increased, the shares of Hong Kong and Japan declined, and the shares of all other economies had no significant changes. The sub-total of the import share of EAEs also declined, but to a smaller extent than it did for export share.

The trade statistics show that, in recent years, China has incurred large deficits in intra-regional trade while it has gained surpluses in inter-regional trade (see Table 2.7). This

Table 2.6 Structural changes in China's imports by origin

Year	Total Imports US\$ billion	Shares of East Asian economies and Russia (percentage)									Sub-total
		Hong Kong	Macao	Taiwan	Japan	ROK	DPRK	Russia	Mongolia	ASEAN	
1995	132.08	6.5	0.1	11.2	22.0	7.8	0.0	2.9	0.1	7.5	58.0
1996	138.83	5.6	0.1	11.7	21.0	9.0	0.0	3.7	0.1	7.8	59.1
1997	142.37	4.9	0.1	11.5	20.4	10.5	0.1	2.9	0.1	8.7	59.2
1998	140.24	4.7	0.1	11.9	20.2	10.7	0.0	2.6	0.1	9.0	59.3
1999	165.70	4.2	0.1	11.8	20.4	10.4	0.0	2.5	0.1	9.0	58.5
2000	225.09	4.2	0.0	11.3	18.4	10.3	0.0	2.6	0.1	9.9	56.8
2001	243.55	3.9	0.0	11.2	17.6	9.6	0.1	3.3	0.1	9.5	55.3
2002	295.17	3.6	0.0	12.9	18.1	9.7	0.1	2.8	0.1	10.6	58.0
2003	412.76	2.7	0.0	12.0	18.0	10.4	0.1	2.4	0.1	11.5	57.1
2004	561.23	2.1	0.0	11.5	16.8	11.1	0.1	2.2	0.1	11.2	55.1
2005	659.95	1.9	0.0	11.3	15.2	11.6	0.1	2.4	0.1	11.4	54.0
2006	791.46	1.4	0.0	11.0	14.6	11.3	0.1	2.2	0.1	11.3	52.1

Source: Calculated by author using data from UN Comtrade database.

Table 2.7 China's intra-regional and inter-regional trade balance in 2006 (US\$ billion)

	Exports	Imports	Balance
World total	969.1	791.6	177.5
NEAR intra-regional trade	153.7	224.7	-71.0
EAR intra-regional trade	403.3	412.3	-11.0
excluding Hong Kong	247.9	401.6	-155.6
Inter-regional trade	721.2	390.1	333.0

Source: Calculated by author using data from NSB (2007).

situation reflects the fact that assisted by growing FDI and technology transfer from developed countries China has become one of the manufacturing centers within global production chains. Within such a context, China imports primary resources and intermediate inputs in large volume from EAEs and then exports final products worldwide. Consequently, China has large trade deficits with many EAEs, including Japan, the ROK, Taiwan and ASEAN, while maintaining large trade surpluses with the EU and the United States, the two largest consumer markets in the world. Such a pattern is consistent with the competitive positions of EAEs in the world economic system. It indicates that vertical integration is emerging among the EAEs, within which different economies are beginning to specialize in certain stages of production. The formulation of a production network provides EAEs with the benefits of economies of scale, specialization, and agglomeration. Such a development helps to consolidate the foundations for regional economic integration in the long term.

With rapid economic growth during the past three decades, China has become one of the leading economies in the world. In 2006, China was the third largest trader after the United States and Germany (WTO, 2007). China's foreign exchange reserves jumped to US\$ 1.59 trillion by the end of 2007. Since China ended its exchange rate pegged to the US dollar, the renminbi (RMB) appreciated approximately 18 percent by end of March 2008. All these factors in combination strengthen China's leverage for

pushing forward economic integration in an all-round manner, in terms of expanded purchasing power in the world market, improved capacity for outward FDI, and its growing influence on a wide range of international issues. Therefore, China's role in regional economic integration is certain to grow in the future.

Future Challenges

While the NEAEs in general perform well in the global economy, they face many challenges in their future development. Some challenges are cross-border by nature and require the cooperation of all the countries in the region. Below are some critical issues warranting attention.

The first is the sustained threat to global and regional peace by terrorism. The socioeconomic development of the NEAEs depends very much on trade. As a result, the NEAEs are generally vulnerable to external conflicts. This situation may reinforce the interest of all NEAEs to strengthen regional political cooperation and economic integration, so as to ensure regional stability and prosperity. Institutional arrangements for coping with major risks within a regional framework are badly needed.

The second issue is the growing insecurity in the world energy market. In the past two years, the energy prices have risen sharply to record levels. Such a situation has a marked impact on all NEAEs. In the Northeast Asian region, China, Japan and the ROK are large energy-importing countries, while Russia is a major energy supplier. For China, Japan

and the ROK, securing their energy supply has become an essential condition for supporting economic growth. There exist conflicts among NEAEs in regard to energy security. The interlinked interests, however, can be turned into the basis for regional cooperation in energy strategy provided all parties make an effort to create a favorable political environment. In this respect, the trading of energy, FDI in energy production and distribution, and innovation in and transfer of energy-saving technologies are the likely fields for regional cooperation on energy strategy.

The third issue is instability in food supply and prices. While China has been able to expand food exports continuously following its WTO accession, it has significantly increased imports of raw agricultural commodities, leading to a turn from net export to net import in agricultural trade. It is expected that China's comparative advantage in agricultural production will gradually be eroded in the process of economic development and China may become a large net-importer of food products in the long term. Food self-sufficiency ratios in Japan and the ROK are already very low. Mechanisms for a stable and secure supply of food products of suitable quality are also appropriate for the regional cooperation agenda.

The fourth issue is the growing pressure on natural resources and the environment. In this regard, global warming is of course the most important issue requiring the collective effort of all the NEAEs. On the other hand, there are regional problems as well. For instance, in the process of China's transformation into a world manufacturing center, polluting industries also are being relocated to China, sometimes in the form of foreign ventures. Although industrial pollution is often site-specific, there exists cross-border pollution, such as the release of sewage into rivers and the ocean, and acid rain, etc. Problems like these could also be solved through collective effort.

These challenges may have a marked impact on the socioeconomic development of the Northeast Asian region. While effort by individual countries is needed, collective action could be more effective in coping with the situation. However, whether such a need would become a stimulus for enhancing regional economic integration is uncertain.

3. China's Core Interests in Regional Economic Integration

The Chinese economy has been performing very well after the country's WTO accession. This fact is conducive to building the confidence of policymakers and the public regarding further opening of the domestic market with bilateral and multilateral relationships. However, China is still learning how to deal with this new situation, which leads to frequent reconsideration of the policies concerned.

FTA Strategy

Starting from the beginning of the 21st century, the Chinese government began to revise its socioeconomic development strategy. The new strategy places a high priority on improving people's lives on a stable and sustainable basis, rather than purely from economic growth. Under the new policies, the realization of harmonious development between the urban and rural sectors and among the different regions is strongly emphasized. Meanwhile, the government also proposes to change

the current paradigm of economic growth characterized by excessive dependence on capital investment and exports. Measures are being taken to stimulate domestic consumption.

It is recognized by policymakers that a favorable external environment is crucial for achieving these domestic socioeconomic development objectives. At the 16th National Congress of the Communist Party, Jiang Zemin, the former Secretary General of the Chinese Communist Party (CCP), declared that China would implement an "eight-character" guideline of *yu lin wei shan, yi lin wei ban* (与邻为善、以邻为伴), which could be translated as "to cement friendly ties with our neighbors and persist in building a good-neighborly relationship and partnership with them" (Jiang, 2002). In such a context, the Chinese government is beginning to place a high emphasis on promoting economic cooperation with the surrounding regions through the establishment of FTAs.

In the FTA initiatives, the Chinese government is focusing on several objectives: 1) to expand the potential for economic development; 2) to secure the supply of resources needed for economic development; 3) to remove barriers to trade and FDI; 4) to clear itself of the alleged "China threat" through opening China's markets to other countries and participating in world economic development; and 5) to contain effectively the drive for "Taiwan's independence" (Yi, 2005). Some scholars emphasize the issues of the impact on domestic policy reforms and of the promotion of the integration of domestic markets (Liu and Liu, 2007). FTAs with neighboring countries are also thought to be an instrument for eliminating regional disparities in development (Jiang, 2006).

While China's policy reforms have stimulated national economic growth, the performance varies markedly by region. The northern and western border provinces lag far behind the coastal provinces. The growing regional disparities in socioeconomic development have become a major policy concern in recent years. To cope with the problem, the Chinese government has implemented a series of regional development programs, such as the large-scale development of China's western region, and supporting the northeastern region in accelerating the revitalization of its old industrial base, etc. In this regard, the role of FTAs in enhancing economic cooperation with adjoining countries is receiving attention. For instance, the CAFTA may serve the purpose of improving economic development in southwestern China. Cooperation with Russia and Central Asian countries is taken up in the development of northwestern China. The potential benefits of establishing an NEAFTA are emphasized in the revitalization of the old industrial base in the Northeast.

Seen from this perspective, the establishment of an NEAFTA is of strategic importance to China. In the Northeast Asian region, Japan and the ROK are economically and technically advanced countries, Russia is rich in natural resources, and China has the largest labor force. The complementarities in economic and trade structures also stem from different levels of development. Within such a context, the establishment of an NEAFTA is economically sound. Many studies give supporting evidence to the idea of an EAFTA; for example, Tian and Wang

(2003), Zhai (2006), Kawai and Wignaraja (2007), and Abe (2007). It is also recognized that different FTAs may generate differing trade diversion effects, and there exist sectors sensitive to trade liberalization in each economy. Therefore, such FTAs will inevitably face resistance from both special interest groups within, and traditional trading partners without.

The Chinese leadership shows a positive attitude to the idea of establishing FTAs with Japan and the ROK. It is clear, however, that great effort should be made by all parties for the consolidation of the political and economic foundations for such cooperation. It is expected that China is not in a hurry to enter negotiations with either Japan or the ROK on FTAs. Instead, China may enhance its role within the framework of "ASEAN Plus Three," which could be a vehicle for economic integration in East Asia.

While the FTA initiatives of the NEAs are very important, China is in the broader position of developing political and economic cooperation with countries in other parts of the world, such as South Asia, Africa and South America. It is expected that China will take a multi-track approach in FTA negotiations based on the criteria of economic and political feasibility and desirability.

Important Issues in Negotiating an NEAFTA

Status of the market economy

In China's FTA negotiations, the recognition of China as a market economy becomes an important issue. In the negotiations for WTO accession, China accepted the clause that other members can treat China as a non-market economy in taking anti-dumping measures. This arrangement is regarded as discriminatory to China, which creates uncertainty for exporting enterprises. To some extent, granting China the status of market economy will be a recognition of China's socioeconomic reforms in the past three decades. This will doubtless be an issue in the negotiations of an NEAFTA.

Agricultural trade liberalization

The opening of the agricultural market is an important issue in China's FTA negotiations. Given its limited cultivated land and water resources, China is not very competitive in the global agricultural market. However, within the Northeast Asian region, China is a low-cost producer for a wide range of agricultural produce. In 2006, Japan and the ROK ranked as the first- and third-largest export markets for China's agricultural produce (Ministry of Agriculture, 2007). Improved access to Japanese and ROK agricultural markets is of great importance for the Chinese government to achieve "harmonized urban-rural development." In the long term, China's interest in exporting to Japan and the ROK may diminish over time as China turns into a large net-importer of agricultural produce. Even if this were to happen, however, China would have the potential to import raw agricultural produce from external sources such as North and South America, and Oceania, etc. and then export processed food products to Japan and the ROK on a continuous basis. On the other hand, China's weakness in enforcing food safety regulations could be a major obstacle to export expansion.

At present, the barriers to agricultural trade are very high in Japan and the ROK in terms of both tariffs and non-tariff measures. Although the governments of Japan and the ROK have declared their intentions to pursue FTAs that are high-level in terms of their degree of liberalization and comprehensive in terms of their coverage and scope, they face strong pressure for not making large concessions in liberalizing their agricultural markets, particularly concerning sensitive products. This tendency is well demonstrated in the FTA negotiations with parties that have strong agricultural sectors, such as ASEAN and Australia. Given the fact that China is the largest producer of agricultural produce in the world and the second-largest supplier to Japan and the ROK, liberalization of agricultural markets under an NEAFTA would be politically sensitive for the governments of the two countries.

In pursuing an NEAFTA, the various parties must search for cooperative methods in dealing with the liberalization of agricultural markets. While special arrangements are needed to make the idea viable, it may be rendered meaningless if too many agricultural products are treated as sensitive products and excluded from opening markets.

Market access for manufactured products

China's trade barriers to manufactured products are relatively low. According to the WTO (2007b), China's trade-weighted average tariff for non-agricultural products in 2005 was 4.2 percent, which was markedly higher than Japan's (1.9 percent), but quite similar to the ROK's (4.0 percent). China has an interest in improved access to textile and clothing markets, for which protection is relatively high in both Japan and the ROK. This situation applies to other labor-intensive products as well. Apart from tariffs, other non-tariff barriers, such as technical-barrier-to-trade (TBT) measures, may also be a concern. China has great potential to increase imports of machinery and equipment from Japan and the ROK. Demand, however, will shift gradually toward high-tech products. In this respect, the removal of export restrictions by Japan and the ROK is equally as important as the removal of protection by China.

FDI

FDI has been one of the key driving forces for China's rapid economic growth during the past three decades. As a result of this economic growth, however, China has been able to eliminate the impasses of insufficient domestic savings and of the shortage of foreign exchange. At present, China has the largest foreign-currency reserves in the world, and the Chinese government now has the problem of how to use those foreign reserves efficiently, rather than of how to attract more FDI. With such a profound change, the Chinese government has revised its FDI strategy and given priority to FDI which includes the transfer of advanced technology and managerial skills. FDI for ecological improvement, environmental protection, energy-saving and the comprehensive use of resources are strongly encouraged (NDRC, 2006). It is expected that the Chinese government will remove the traditional preferential taxation arrangements for foreign joint ventures and bolster environmental and labor protection standards. As a result,

those joint ventures that are largely dependent on low-cost labor and lax environmental standards may suffer rising production costs. The main FDI-related issues in an NEAFTA may be whether all parties allow FDI in certain sensitive industries and whether Japan and the ROK are willing to make high-tech investments in China.

Trade in services

How to deal with the liberalization of the service sector could be a sensitive issue as well. This is related not only to trade in services, but also to facilitating the movement of factors of production, including labor and capital.

Compared with Japan and the ROK, China's service sector is still underdeveloped and relatively uncompetitive. Besides, China lacks an appropriate institutional system for regulating the trade in services, such as the protection of intellectual property. Some parts of the service sector are still controlled by state enterprises with the help of restrictions on foreign competition. China must deal with the pressure from other trade partners to open up the services market. On the other hand, China may require that Japan and the ROK remove restrictions on the transfer of advanced technology, investment in sensitive industries and the migration of labor.

4. Concluding Remarks

Over the past decade, the trade environment has changed significantly in the Northeast Asian region, leading to the emergence of the NEAFTA concept. It is fairly certain that establishment of an NEAFTA will offer great benefits to all participants, but some sensitive sectors will be affected negatively to varying degrees. Although an NEAFTA is economically attractive, however, the idea can be made a reality only after the removal of numerous existing political and cultural barriers. On the other hand, even without any formal arrangements, regional economic integration is continually moving forward, driven in the main by market forces.

By reason of the size of their economies and population, China, Japan and the ROK will be the core members of an NEAFTA. In the near future, economic integration in the Northeast Asian region will be a matter for China, Japan and the ROK. The prospective NEAFTA depends very much on whether the three countries can overcome the major obstacles between them. Although the leaders of the three countries agreed to advance cooperation in 2003, the progress toward a tripartite FTA has been insignificant so far. Instead, the three countries have made independent efforts to develop close economic partnerships with their desired partners. In this regard, three "ASEAN Plus One" FTAs have emerged along with several bilateral FTAs involving NEAEs. Within such a context, future economic integration in the Northeast Asian region is more likely to take the form of consolidating these already-established FTAs into an East Asian FTA.

It can be observed from past experience that China's FTA strategy is based very much on diplomatic and domestic policy considerations. The former focus on improving the external environment for China's socioeconomic development. The latter are concerned with the positive or negative effects on sensitive industries and

regions. To these ends, the Chinese government is taking active steps to bolster political and economic cooperation with neighboring countries in a flexible form. It is expected that, with a growing purchasing power in the global marketplace and improved capacity for FDI that includes the transfer of appropriate technology, China will be able to play a more active role in pushing forward economic integration in Northeast Asia and East Asia than ever before.

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