Asian Regional Governance

Crisis and change

Edited by
Kanishka Jayasuriya

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Asian Regional Governance

In the wake of the Asian economic crisis, the APEC-led process of regional integration and trade liberalization has been found wanting. Increasingly, regional political leaders and domestic groups are searching for new forms of regional governance, from 'East Asian' regional groupings to the proliferation of new bilateral trade agreements.

This book looks at the changing global and domestic political economies shaping the new regional governance in Asia and examines the relationship between domestic, political and economic structures and forms of regional governance. Focusing on contemporary factors such as the impact of globalization on Asian regionalism, new security challenges, monetary cooperation, sovereignty, democratization, industrial policy and China's engagement with Southeast Asia, *Asian Regional Governance* suggests that both the theory and practice of regionalism need to be radically revised in order to make the process applicable to the twenty-first century.

With contributions from distinguished academics in the field who provide an overview of the conceptual foundations of regional governance, this book will be an indispensable resource for all who want to understand the emerging dynamics of regionalism in the Asia-Pacific.

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Edited by Kevin Hewison and Vivienne Wee

Southeast Asia Research Centre, City University of Hong Kong

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Crisis and change
Kanishka Jayasuriya (ed.)

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Series editors' preface

The Asian economic crisis that began in 1997 struck down some of the major economies of the region and had global economic and political consequences. In Hong Kong, the economic downturn also caused economic instability and coincided with the end of colonialism as Hong Kong became a Special Administrative Region of China. The conjunction of these events meant that the launch of the Southeast Asia Research Centre at the City University of Hong Kong in late 2000 was propitious.

This new book series reflects the centre's research agenda, which seeks to advance research and understanding of the political, economic and social forces that are shaping contemporary Southeast Asia. This series reflects the centre's emphasis on multi-disciplinary, comparative and holistic research. It also recognizes that the Asian crisis marked a further watershed in the often turbulent development of the constituent nation-states of Southeast Asia.

Through the turmoil of the Second World War, decolonization, independence and the Cold War, great power rivalry and nationalist aspirations shaped the development of post-colonial Southeast Asia in significant ways. The long struggle for national unification in Vietnam exemplifies the significance of the local in global contestation.

As the region emerged from these turbulent times, rapid economic development reconfigured the societies of Southeast Asia. From the mid-1970s, a number of Southeast Asian economies entered extended periods of significant economic growth. The economies of Singapore, Malaysia, Thailand, and Indonesia benefited from a more generalized development in East Asia and made rapid advances, becoming some of the most dynamic economies and societies in the world. Huge flows of foreign capital and the development of relatively powerful domestic capitalist classes transformed these societies in just two to three decades. The World Bank and other international financial institutions celebrated the region's economic success and urged a continued unfettering of markets.

But the 1997 economic crash and especially its negative social consequences posed new challenges for the development models of the region. This led to increased questioning of the processes of capitalist globalization. Further, the economic crash confronted the region's political regimes with significant challenges. The most notable of these was the collapse of the New Order in Indonesia. This confluence of economic and political turmoil stimulated a reassessment of the multiple impacts of globalization and associated ideas about regionalization. Nowhere has this reassessment been more vividly revealed than in the rise of China as an economic power. The regional reconfigurations that are in process indicate that multiple globalizing and regionalizing processes must be conceptualized to encompass economic, political, social and cultural processes.

Understanding how Southeast Asians are negotiating the broad and multiple challenges posed by globalising forces, and how they are reinventing their societies, are elements of the Southeast Asia Research Centre's research agenda. Another focus is the divisions of class, ethnicity, gender, culture, and religion that appear as fault lines underlying Southeast Asia's post-colonial nations. Such rifts shape diverse patterns of conflict and fragmentation in the region. While much recent attention has been directed to Islamic 'fundamentalism', this is but one type of conflict in the region. A third area of interest involves regional interactions, including those between states, civil society, business, labour and migration. Finally, attention is given to the ways in which Southeast Asian political economies are being reinvented following the Asian crisis, examining new patterns of accumulation and allocation, and how these are shaped by political struggles in the region.

This collection, edited by Dr Kanishka Jayasuriya, demonstrates that an understanding of the changing nature of Southeast Asian regionalism is essential in a region that is still recovering from the economic crisis. It is not that the economies have not recovered but rather that the crisis unleashed clashes and conflicts that are reshaping both the international and domestic political economies. In the era before the crash, when commentators regularly chanted the mantra that the world's economic centre was moving to Asia, an alphabet soup of regional organization developed. At the time, APEC was seen as a model of regionalism. This model is now seriously challenged. Indeed, the workshop where most of the papers in this collection were originally presented had 'running on empty' in its title; this seems an accurate depiction of the crisis facing this approach to regionalism.

As the papers in this collection indicate, the post-crisis regional political economy also provides opportunities for new or revised forms of regional governance. However, as they caution, this will remain a highly contested arena. The collection gives considerable attention to the role of China. In the post-crisis period, where the Chinese economy has achieved the stellar growth rates previously associated with Southeast Asia, this focus is important. China is increasingly courted in the region, and it is likely that China will continue to respond enthusiastically, both economically and politically.

A striking feature of this anthology is that many of the papers take an approach that is different from the dominant institutionalism of the international relations literature on the Asia-Pacific. They point out that domestic structures, coalitions and struggles over political and economic power are critical in shaping regional governance. In making this observation, this collection suggests the potential for innovative and productive cooperation between country specialists and those interested in the developing regionalism in East and Southeast Asia.

Kevin Hewison
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Preface

This volume first stirred into life over a latte with Kevin Hewison, Director of the Southeast Asia Research Centre (SEARC) of the City University, Hong Kong. Over subsequent discussions, we decided that it would be useful to have a roundtable of reputed scholars to examine the problems and prospects for APEC for the then forthcoming APEC Heads of State Summit in Shanghai in October 2001. Considering that much of what passes for conventional theory and practice of the APEC process was no longer sufficient or sustainable, it was agreed that it was an opportune moment to look at APEC, which as an institution had to confront the crisis and challenges of a new regional political economy that was taking shape in the aftermath of the Asian economic crisis. In the end, although the roundtable idea was abandoned in favour of a workshop, held in January 2002, entitled 'Running on Empty? Markets, Politics and Southeast Asian Regionalism', the rationale remained much the same. This project forms part of an ongoing series of research studies on regionalism to be carried out by the SEARC.

The greater part of the essays in this book form significantly revised versions of the workshop presentations. The essays seek to move the policy and theoretical debate beyond the forms and strategies of regional governance that shaped the development of APEC for most of the 1990s. Much of the trade liberalization agenda established under the auspices of APEC has been thrown into disarray after the Asian crisis.

Emblematic of these changes in the region is that East Asia, which has always been the jewel in the crown of the 'Washington consensus' of market and trade liberalization, was looking tarnished for international financial organizations – which suddenly discovered corruption – as well as political elites around the region. The latter began to defect from the 'consensus' when it threatened their financial and political interests. What is now evident in the East Asian context is an ongoing political struggle over programmes and projects of economic reform. While new forms of regulatory state are being established to manage the process of globalization, it is clear that for many states the emphasis is on management rather than simple integration into the global economy. Again, this marks a significant departure from the new regionalism that dominated the Asia-Pacific regional governance in the 1990s. Part I of this volume provides a conceptual framework for the analysis of the rise and fall of the regional project of open regionalism and locates these developments in a comparative framework.

A distinctive feature of this book is that, unlike the US-based international relations literature, which focuses mainly on institutions, it is concerned with the forms and strategies of regional governance. The notion of governance enables us to see regionalism not as some functionalist panacea imagined by trade economists but as a political project. Hence the several contributors in Part II focus on, and succinctly examine, the domestic roots of these regional governance strategies. In so doing, these authors highlight some of the insights from the literature on comparative political economy that help to shed light on the process of regional governance in the Asia Pacific.

The challenges facing regional governance, in particular, have drawn attention to the importance of monetary and financial coordination in the wake of the Asian crisis. Yet it is precisely these kinds of regulatory arrangement for policy coordination that the region lacked. In one sense, the Asian crisis brought home to regional policy makers the idea that a globalized economy needs to develop regulatory structures for a range of financial and monetary issues, all of which encompass areas thought to be within the domain of domestic governance. However, the emergence of these forms of regulatory regionalism signifies the need to move beyond the forms of governance that new regionalism has taken in East Asia.

Symptomatic of these changes has been a proliferation, most noticeably in the last few years, of a variety of regional governance arrangements, ranging from the so-called ASEAN+3 to the recent promotion of a string of bilateral trade arrangements. Some of these governance arrangements are likely to clash. For example, the idea of an East Asia regional grouping sits uncomfortably with a region rushing in to sign preferential trade deals with the United States. But the very proliferation of these governance strategies is in itself indicative of the crisis of ‘new regionalism’ in the Asia-Pacific. This proliferation of new regional governance arrangements across the region is comprehensively explored in Part III.

Without doubt, the election of the Bush administration and the events of 11 September 2001 have dramatically altered the dynamics of the region. As the USA becomes much more inclined to be a coercive rather than a benevolent hegemon within the region, it is to be expected that regional institutions such as APEC will feel the damaging fall-out from this new tilt in US policy. Given that the regional governance strategies of the 1990s were framed within the context of a different US economic and military posture, the question of how regional institutions and countries respond to these challenges will be of great significance to the future of regionalism in the Asia-Pacific.

Adding to the complexity of this picture is the emergence of China as an economic and political powerhouse within the region. The importance of China in the region has been abundantly clear in the impact of the Asian economic crisis on the region. More recently, the diversion of FDI into China is rapidly transforming the regional division of labour. Clearly, much of the new regionalism, previously based on a set of economic and political arrangements between the USA, Japan and Southeast Asia, has been considerably transformed by an economically and politically resurgent China.

These two important dimensions, (1) recent changes in US policy in the region, and the ramifications of this coercive bent of US policy for Southeast Asian regional politics, and (2) the implications of Chinese economic and political power for regional governance in East Asia, are critically examined in the concluding Part IV.

There are a number of individuals and institutions without whose support this project would not have been completed. First, I wish to acknowledge the vital contribution of the SEARC to this project. This includes funding and other support while I was attached to the Centre as Senior Research Fellow. A special word of thanks to Professor Kevin Hewison, the Director, and Dr Vivienne Wee, the Associate Director, for their encouragement and support. Equally, I wish to acknowledge various current and past members of the administrative staff – Ms Jill Chung, Ms Angel Ho, Ms Joy Lam, and Ms Amy Sim – who have provided valuable support not only with great efficiency and willingness, but also with good humour.

The chapters by Nicola Phillips, John Ravenhill, Andrew Rosser, Natasha Hamilton-Hart, Greg Felker and Kanishka Jayasuriya represent revised versions of articles published in Volume 24: (2) of *Third World Quarterly*.

Last, but by no means least, let me thank the contributors for their patience and forbearance with the tedious work of the editorial process. It has been a privilege and a pleasure to have been associated with a distinguished cast of both 'old hands' and younger scholars. Hopefully, this is but a first cut at setting a new research agenda for the study of Asian-Pacific regionalism, and one that may point the way towards further research on these issues.

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May 2003

1 Introduction

The vicissitudes of Asian regional governance

Kanishka Jayasuriya

The roots of the new regionalism in the Asia-Pacific

By focusing on the dynamics and nuances of regional governance within the context of the Asia-Pacific, a motivating theme that underlies the essays in this volume is the need to move beyond the 'new regionalism' characteristic of trade liberalization in the 1990s. The theory and practice of regional cooperation in the Asia-Pacific is moving through a period of crisis and change. Symptomatic of this regional transformation is the proliferating variety of regional governance projects. In a nutshell, these new forms of regional governance, which emerged in the period after the Asian economic crisis, need to be firmly located within the broader context of social and political changes that occurred across the region.

'New regionalism' is the term given to the infectious waves of regionalism that marked most attempts at regional cooperation across the globe in the last two decades of the twentieth century (Milner and Mansfield 1997). This new regionalism, as opposed to the older forms of regionalism, was directed at the integration of regional economies within the global economy through a variety of programmes, but chiefly through trade liberalization. In the Asia-Pacific region, this new regionalism was driven largely by the Asia-Pacific Economic Cooperation (APEC) strategy of open regionalism. However, in the aftermath of the Asian economic crisis, the core ideas and institutions of open regionalism have come to be seen as inappropriate in the circumstances of the global economy in the first decades of the twenty-first century. Regional governance is going through a period of crisis and change. The essays in this volume are designed to fill a much neglected gap in the literature on Asia-Pacific regionalism by exploring this ongoing period of crisis and change in regionalism.

Unlike earlier accounts of regionalism, mainly preoccupied with providing a descriptive accounting of institutional trends and features, a guiding motivation of the studies in this volume is to understand the new regional and political (dis)order that has been bequeathed by the Asian crisis – a disorder that stands in sharp counterpoint to the ringing triumphalism that was often characteristic of studies that examined the prospects for regional institutions and the economy during the period of the 'Asian miracle'.[1]

The approach adopted here relies on a fundamental analytical 'retooling' to sharpen the analysis of the dynamics of this new regional order. One reason for the analytical hubris in several earlier studies of regionalism in Asia was the overemphasis on formal regional institutions, which proved detrimental to an understanding of the domestic political mainsprings of regional governance.[2] This problem is not unique to the study of East Asian regionalism and only serves to draw pointed attention to a major shortcoming of the broad literature on international relations, which is replete with set-piece debates between *realists*, *institutionalists* and *constructivists*.[3]

For instance, realists tend to suggest that national interests drive regional cooperation and are often persuasively sceptical of the viability of regionalism. This scepticism flows from a view of the state as a black box with a clearly identifiable set of interests. In the final analysis, this thesis is hard to test empirically because of its inherent circularity: the view that both the breakdown and the persistence of institutions are a result of the play of interests.

Institutionalists, on the other hand, are likely to be more optimistic in that they, unlike realists, assume that institutions themselves have a degree of power to influence and shape national interests. Here, institutions are seen as abstract entities with an indefinable set of interests and effects that are independent of state interests. Besides confronting questions of how these interests are to be identified, where this mode of theorizing appears to falter is in its explanation of how and why institutions and the strategies embody change over time. Finally, constructivist approaches to regionalism highlight the importance of social norms and ideational forces in serving to constitute the very notion of a region. These normative influences are regarded as the binding agents of the broad goals of regional institutions. No doubt there is much to heed in these constructivist approaches to regionalism, but where they fail is in identifying the dynamics of change in regional institutions.[4]

The problem – and this is the red thread that runs through these conventional accounts of regionalism – is that regional institutions are seen as driven by external imperatives. In the main – with the notable exception of historically inclined accounts of institutions such as Beeson (2002a) – regional economic institutions are seen as being led by the imperatives of regional economic cooperation. In short, there is an assumption that as the demand for regional cooperation increases because of deepening economic integration or the opening of markets, it will be matched by a 'supply' of appropriate regional institutions. Market models of regional integration assume that institutional development is driven by a rational and functional response of governments. This remains problematic, because it undervalues the importance of different types of regional political project and the different national consequences that follow from pursuing certain types of regional integration strategy. Moreover, we need to deal with:

> a regionalism that in practice is much more multifaceted and multidimensional than in the past. States now engage in any number of overlapping

> regional endeavours without feeling that there may be contradictions in such a process.
>
> (Breslin and Higgott 2000: 339)

In sum, then, much of the literature drawn from studies of international relations fails to take proper cognizance of the fact that institutions are embedded in a deeper structural context that includes factors such as domestic coalitions, a particular set of growth strategies and a set of permissive international conditions. No wonder that after the Asian crisis, theories of regional economic and political cooperation performed rather poorly as explanations of regional (dis)order. This lacklustre performance can be largely attributed to the inability of prevailing accounts of regional cooperation to conceptualize adequately the relationship between the crisis in the domestic political economy and its capacity to pursue certain kinds of regional project such as the APEC strategy of open regionalism – the Asian variant of the new regionalism of the 1990s. Therefore, adopting a political project or governance perspective on regionalism allows us to look at institutions not as abstract entities but more or less as coherent projects of regional governance. Hence, regional governance projects, in turn, are seen as embodying particular constellations of power and interests. From this vantage, a framework can be developed that has the virtue of locating the dynamics of regional governance within the broader context of domestic political projects, which themselves are rooted in particular structures of the global political economy.

Regional governance and the global political economy

The distinct advantage in conceiving regional institutions as political projects is that it provides a way of linking these regional governance projects to periods of economic crisis and transformation. Economic crises unsettle prevailing entrenched interests and regional projects while providing opportunities for new reform coalitions to form around new kinds of political project. Accordingly, the crisis:

> is critical to the degree that it makes it possible for entrenched elites to be weakened as a result of threat to the existing institutional arrangements that previously benefited those elites. It is also important to the extent that it creates opportunities for reformist coalitions to exert greater influence.
>
> (Rodan *et al.* 2001: 26)

However, any consideration of the impact of the crisis on regional governance needs to be prefaced by a brief overview of how regional economic strategies had become entrenched in Southeast Asia. This has been described as one of ‘embedded mercantilism’ – borrowing an analytical category used by Pempel (1998) – in the context of the export-oriented industrialization strategies pursued by Southeast Asian economies (see Chapter 2, this volume). An illustrative example is the manner in which during the 1980s Malaysia developed a whole gamut of heavy industries, ranging from steel to a nascent automobile industry. In varying degrees, other countries pursued similar strategies (see the various country chapters in Rodan *et al.* 2001). Herein lies the nub of the argument, namely that these regional economic growth strategies were sustained by a set of permissive international financial and production structures abroad, and by a set of distinctive developmentalist state forms and coalitions at home. In short, domestic and foreign economic strategies are intertwined, and more importantly, cannot be divorced from the broader political and ideological projects of dominant coalitions in East Asia.

Southeast Asian economic development, unlike in the then newly industrializing countries of East Asia, relied on rapid inflows of foreign direct investment (FDI), especially from Japan. Furthermore, much of the industrial transformation in Southeast Asia[5] was spurred by the international agreement to allow the yen to appreciate – the Plaza Accord. As Beeson (2002b: 553) succinctly points out:

> Japan has been a crucial source of investment for the rest of the region, especially in the wake of the so-called Plaza Accord, which saw a fundamental restructuring of Japanese industry as a consequence of the yen's appreciation. The massive outflows of Japanese capital that intensified at the end of the 1980s had an important global impact, but were especially influential among the smaller Southeast Asian economies.

Significantly, this Japan-driven investment order was complemented by what Sum (2001), in a theoretically sophisticated paper, refers to as an 'American-led financial order'. Sum perceptively argues that one of the components of this is the fact that Southeast Asian currencies were pegged to the US dollar and that:

> this money-currency form suited the export-oriented region in two ways. On the one hand, since most of East Asian imports and exports are/were invoiced in dollars, it reduced currency risks involved in trading with major markets in the US or elsewhere. And, on the other hand, the dollar pegs anchored their domestic monetary policies.
>
> (*ibid.*: 149)

Although this explanation of how this financial order underpinned the embedded mercantilism of Southeast Asia – which Sum calls 'exportism' – is persuasive, it needs to be added that what sustained the currency pegs, even when they started to impact on export competitiveness, was the benefit provided to the non-tradable sector by an overvalued currency. At the same time, it also facilitated the flows of short-term capital that sustained the politically connected cartels.

Most importantly, the changes in the global political economy and the developmentalist regimes that it spawned underpinned a distinctive set of social and political coalitions. The strategy of embedded mercantilism depended on a set of trade-offs between economic sectors that were composed of distinct capitalist groupings with differing links to the state (for more details, see Chapter 2). Foreign investors drove the tradable sector, while the non-tradable sector was largely under the control of enterprises or corporate groups closely linked to the apparatus of political power. But this was not in some sense a coalition outside the state, because these alliances and contests were enmeshed within the state (Jayasuriya 1994a). Indeed, much of the increasing policy conflict in the period immediately prior to and after the crisis – over exchange rate or fiscal policy – reflected brimming tensions within the dominant coalitions. Nevertheless, during the boom period of Southeast Asian economies, enough growth was generated by the tradable sector for these tensions to be adequately managed.

The point that several authors in this book make is that the APEC-led process of regional integration – new regionalism – was a crucial ingredient of the domestic political economy of East Asia. This new regionalism, which went under the rubric of 'open regionalism', was only possible within the context of a set of permissive structures of the international political economy. These included the high rates of short-term financial flows, the dollar peg to which most Southeast Asian currencies were fixed and the inflow of Japanese FDI into Southeast Asia. These aspects are more fully elaborated in Chapter 2, but what needs to be underlined here is the importance of conceptualizing regionalism not as some inexorable process of regional economic integration but as a dynamic process whose governance is shaped by particular constellations of domestic and international forces. In other words, the argument here is that changes in the international political economy have led to the crisis of the new regionalism of the Asia-Pacific.

With the end of the Asian miracle, regional governance has been forced to adapt to the disciplines of the global political economy. Indeed, if the new regionalism is more appropriate to growing international interdependence (as reflected in the role of regional governance as a facilitator of global economic integration), it is clear that strengthening a more *global* (as against an international) economy demands increasing regularization and harmonization of domestic governance, ranging from finance to the environment.[6] If globalization is conceived not so much as an externally driven process – that is, through increasing flows of trade and capital – but more as an *internal* process that fundamentally transforms the internal and external aspects of sovereignty, then it is possible to conceptualize the emergence of a regulatory regionalism that is distinct from the new regionalism that dominated Asia-Pacific political economy up to the Asian crisis. In essence, regulatory regionalism, which underscores the importance of harmonizing regulatory standards across a range of areas, is more appropriate to a global, or perhaps more importantly, a regional economy (see Chapters 3, 5 and 8), where the notion of a national economic unit becomes problematic. These issues are discussed in more detail in Part I, but let me emphasize here that the real advantage of adopting this governance or political project perspective on regionalism is that regional arrangements come to be understood as strategies of economic and political governance that are causally associated with the intermingled structure of the global political economy and domestic state forms.

From 'new regionalism' to 'regulatory regionalism'

Hence, from this standpoint, the development of this regulatory regionalism must be seen in the context of the emergence of a new regulatory state, which is crucial to this market governance in the global economy. Just as the developmentalist regimes and state forms in East Asia were meshed in with the specific regional governance of open regionalism, the emergent regulatory regionalism develops and forms part of the (albeit contested) emergent new regulatory state in East Asia. Clearly, this perspective requires us to explore the reciprocal casual links between transformations of the global political economy, state forms and regional governance.

This new form of state organization, identified as a 'regulatory state', is at the heart of attempts by multilateral organizations such as the World Bank to promote 'good' governance. These attempts signal the emergence of regulatory state forms markedly distinct from the interventionist state forms so clearly associated with the Asian economic miracle. For this reason alone, the new regulatory state reflects a more general transformation of the state from one that performed numerous allocative and interventionist functions to one that has acquired a more regulatory role as a guardian of the market order. In brief, the main features of this regulatory state provide for:

- a separation of policy from operation through, for example, contracting out of services;
- a creation of new and autonomous regulatory institutions such as independent central banks;
- an increase in the role of the state as the regulator of regulation – it acts like a *meta-regulator*. Hence, it does not attempt to regulate directly but acts to shape the institutional context of regulatory institutions; and
- a shift from a discretionary to a rule-based mode of governance in a range of economic and social policy areas. At its broadest, the regulatory state implies a transition from government (direct intervention) to governance (facilitating intervention).

What needs to be recognized here is that the governance strategies identified with the regulatory state provide the basis for new ways of organizing state power. In this context, Ferguson (1990: 21), in developing a thesis on the depoliticizing effects of development projects, notes that:

> outcomes that first appear as mere 'side effects' of an unsuccessful attempt to engineer an economic transformation become legible in another perspective as the unintended, yet instrumental elements in a resultant constellation that has the effect of expanding the exercise of a particular sort of state

> power while simultaneously exerting a powerful depoliticising effect.

In fact, an analysis of the governance programmes promoted by multilateral agencies such as the World Bank clearly indicate the significance of these programmes in nurturing new forms of political rule. Indeed, one of the most important features of these programmes is their influence in depoliticizing key areas of economic and social life (Jayasuriya 2000, 2001a). This process of depoliticization is revealed in three important dimensions: first, by placing economic institutions, such as central banks and other regulatory agencies, beyond the reach of democratically elected office holders; second, through a shift in economic policy making from discretion to rule-based forms of governance in areas like monetary and fiscal policy; and, third, through the decontexualization of 'agency' from relations of economic and social power and its consequent embedding in frameworks such as responsibility and community. In short, depoliticization – or, even better, a strategy of anti-politics – provides the underlying rationale for many governance programmes. It is this process of depoliticization, rather than success or failure of governance programmes, that should be the primary concern of those wishing to understand the process of exporting institutional templates. And it is important to locate this depoliticization in the collapse of developmentalist state projects and their associated governance paradigms and strategies.

At the same time, these regulatory state structures are enmeshed with various forms of regional governance, which in turn are distinguished by an emphasis on the development of policy coordination and harmonization. This is a form of regulatory regionalism that should not be viewed as a departure from the disciplines of the global economy but as an attempt to instantiate the disciplines of neoliberalism within a regional framework. In this context, Phillips makes the strong case that, in effect, the relaunching of Mercosur in June 2000 provided the basis for a new programme of regional integration based on a system of policy harmonization in areas such as monetary policy and surveillance programmes. She makes the highly significant point that:

> subregionalism in the Mercosur has come to rest on a principle of policy coordination which implies, *in the long term*, the articulation of a new form of market governance. This form of market governance rests in the first instance on a significant regionalisation of governance mechanisms. While this process does not imply the wholesale elimination of more 'national' forms of economic governance, progressively the trend is towards convergence upon regionally coordinated policy norms and objectives and the location of market governance at the subregional level.
>
> (Phillips 2001: 580)

A similar dynamic, discernible in the process of regionalization in East Asia, is the knitting together of emerging regulatory states and new patterns of regional governance. The emerging fabric of governance is best understood in the sense that there is a simultaneous recognition that region-wide regulatory frameworks, such as monetary coordination and macro-economic policies, can be implemented and policed at a local level. From this perspective, the regulatory state is not a state form confined to the territorial boundaries of the national state. Rather, it should be seen as a system of multilevel governance that connects international organizations such as the IMF with regional entities such as the Asian Development Bank (ADB) and various national agencies, and even subnational or local entities. One nascent example of the emergence of this system of multilevel regional regulation is the Association of South East Asian Nations (ASEAN) regional surveillance process (ASP), which was endorsed by ASEAN financial ministers in December 1998. Manupipatpong (2002: 114–15) argues that:

> Another gap that the ASP can potentially fill has to do with current efforts to encourage countries to adopt internationally agreed standards and codes in order to enhance the effective operation of market forces and the resilience of financial systems. These standards and codes include the IMF code of good practices on transparency in monetary and financial policies, the IMF code of good practices on fiscal transparency, and the OECD principles of corporate governance.

What is clearly evident with this ASP process is that it links both national and international regulatory governance through the internationalization of various state agencies and actors. The latter became part of a regional system of surveillance and regulation that transmits the disciplines of a globalized economy. This underlines the critical point that the reproduction of the global economy requires the increasing harmonization of standards and codes such as corporate governance, transparency standards, and broad macro- and micro-economic policies. While the broad parameters of these standards are spelled out by supranational organizations, it is increasingly through regional governance structures that these standards are fleshed out.

To this end, close collaboration with national and other levels of governance is established to implement these standards and mechanisms of policy coordination. The regulatory system – or significant parts of it – is both internationalized and regionalized in the sense that the standards and mechanisms of policy coordination are instantiated within the local governing apparatus. The regional governance of this regulatory infrastructure goes beyond a mere focus on trade liberalization and constitutes the *raison d'être* of the new regionalism. In other words, the development of a global market economy and the increasing vulnerability of economies to financial crisis require the development of a type of regulatory regionalism that is able to provide some degree of regional policy harmonization. In short, we need to move beyond the new regionalism of the 1990s.

In this context, Dieter (2000) offers a provocative and highly stimulating argument which suggests that in an increasingly global economy regional integration projects driven by trade liberalization have only a limited viability for the newly industrializing countries of East Asia and Latin America. Instead, he proposes a shift towards what he terms 'monetary regionalism', which will offer a degree of protection to increasingly vulnerable national economies. He argues that:

> [countries] participating in a conventional integration project do not enjoy additional protection against financial crises. Neither with regard to the stabilization of the exchange rate of their currencies nor with regard to the stabilization of capital flows do conventional integration schemes strengthen the economies of their member countries.
>
> (*ibid*.: 2)

In a proposal for an Asian Monetary Fund, Dieter plausibly sees the development of a putative East Asian monetary regionalism. Some movement in this direction was made with the establishment of the Chiang Mai Initiative (CMI), which provided for emergency funds for currency stabilization (Manupipatpong 2002). Natasha Hamilton-Hart (Chapter 8) refers to this question of monetary regionalism and observes that monetary cooperation remains at a very early stage. She provides a detailed analysis of the benefits for East Asia from monetary cooperation, especially with regard to the process of crisis prevention and management. However, during the Asian crisis, the Japanese proposal for an Asian Monetary Fund was quickly taken off the diplomatic agenda. Yet the CMI provides some evidence that a nascent monetary regionalism of the sort that Dieter advocates may be developing in East Asia.

Nevertheless, the Asian crisis has, above all, demonstrated to East Asian governments that globalization of capital markets requires some degree of regional monetary cooperation if future crises are to be managed. In this regard, it is worth recalling, as Milward (1994) has argued, that European cooperation was designed to rescue domestic autonomy in certain key policy areas by conceding the loss of sovereignty in other areas of domestic governance. It may well be that East Asian policy makers would come around to viewing the loss of financial autonomy through monetary cooperation as a similar kind of rescue effort.

It is clear that this emergent regulatory regionalism has a number of implications for the way we conceptualize the relationship between regional governance and globalization. The recent spate of financial crises, not just in East Asia but also in Latin America, has effectively underlined the importance of developing a regulatory framework for the global economy and the development of a new regulatory state that is enmeshed in regional, national, and sub-national governance. Furthermore, this regulatory regionalism differs from the new regionalism of the 1990s in the emphasis placed on integration through regulation rather than simply through trade liberalization. Consequently, it may be the case that strategies such as that pursued by APEC, which focused on trade liberalization, may have run their course (Bowles 2002). Whatever the merits of these arguments, the important methodological point here is the need to conceptualize regional governance not in terms of the growth and consolidation of region-wide institutions but as strategies of economic and social governance inextricably tied to the broader patterns of the global political economy.

Structure and organization of this book

The essays in this volume are organized into four parts. Part I provides a conceptual overview of the key issues. In Chapter 2, I develop the framework of regionalism as ‘governance projects’ by focusing on ‘open regionalism’ as a regional governance project. The argument advanced here is that moves towards regional integration need to be understood as ‘regional governance projects’ undertaken by domestic actors and coalitions. Regional political projects – such as open regionalism – have roots in domestic structures, and it is this that defines the broad configuration of the regional political economy. On the basis of this framework, it suggests that:

- The strategy of open regionalism was contingent upon a particular configuration of power and interests in the domestic and external economy (embedded mercantilism).
- This system of embedded mercantilism depended on a set of domestic coalitions between the tradable and non-tradable sectors of the economy. The non-tradable sector in Southeast Asia was entrenched within a particular system of political patronage.
- The Asian crisis and other structural changes in the international economy have made these domestic coalitions less sustainable, thereby creating opportunities for new forms of regional governance.

The other chapter in Part I, by Nicola Phillips, examines the rise and fall of the governance strategy of open regionalism within a comparative context. Phillips argues that, as in the Asia-Pacific, the regional governance project of open regionalism that underpinned the development of Mercosur in the southern cone of Latin America is undergoing a process of transformation. Her central thesis is that in order to understand this process of transformation, we need to move beyond the static study of regionalism and instead focus on the way in which changes in the global political economy are driving deep-seated changes in the way regional space is configured. At the same time, she argues that this process is reinforced by the restructuring of capital along regional lines. This regionalization of business demands that regionalism be conceptualized in terms of the way it constitutes a regional economic space that is more than the sum of discrete national economic spaces. Both chapters serve to highlight the importance of understanding regional governance projects of the new regionalism in the broader context of changes in the global and domestic political economy.

In Part II, some of these themes are pursued further by situating regional governance strategies in the Asia-Pacific, in particular the ensuing political contestation over the direction of foreign economic policies within the broad ambit of the domestic political economy. John Ravenhill (Chapter 4) looks at the rapid growth of bilateral (or even minilateral) regional trade agreements. In fact, the rapid growth of this new bilateralism is symptomatic of the increasing crisis of the multilateral APEC approach to trade liberalization. In addition – reinforcing a key feature of the theme of this volume – Ravenhill argues that the push for bilateral agreements can also be located in sources that originate in the domestic political economy. In this context, he notes that business groups have pushed for bilateral agreements because they have strong interests in not being disadvantaged in markets where other competitors enjoy preferential access because of bilateral trade agreements. Equally, bilateralism does offer advantages to more domestically inclined protectionist interests in that such agreements have wide latitude to incorporate exclusion clauses that enable, as he succinctly observes, domestic interests to take the political pain out of trade liberalization.

In Chapter 5, Greg Felker explores the increasing diversion of FDI flows into China from Southeast Asia. The rapid inflow of FDI into China has raised doubts about the continuing viability of industrialization projects in Southeast Asia. This is important, given that these industrialization programmes provided the critical underlay for the regional governance project of open regionalism. Felker suggests that to view this in terms of a zero-sum game between China and Southeast Asia is to overlook how the Southeast Asian economies have been integrated into international production networks, which comprise internal linkages between multinational corporations (MNCs) and their subsidiaries and subcontractors. From this perspective, the economic emergence of China needs to be viewed in terms of a regionalization of production networks across the regional economy. In this sense, Felker's idea of a fundamental restructuring of MNCs along regional lines is consistent with Phillip's argument in Chapter 3 about the regionalization of business. More fundamentally, this restructuring of capital along regional lines implies the emergence of regional economic space, which is, as Phillips notes, more than the sum of national economic units. In this regard, Felker's contribution serves to highlight the way in which the newly emergent regulatory regionalism is a response to this more complex regional economy.

But the development of regulatory regionalism is fraught with its own problems. Andrew Rosser in Chapter 6 suggests that the new regulatory state in Southeast Asia is likely to be highly contested by those forces associated with earlier developmentalist regimes. Looking at a case study of corporate governance in Indonesia, he argues that the corporate governance regime in Indonesia is unlikely to converge on the Anglo-Saxon 'outsider model' of governance. While numerous attempts have been made to implement such an outsider model, these have been ineffective in the Indonesian context. According to Rosser, the reasons for this failure lie in the fact that old interests in the old regimes have been able to block effective reform of the corporate governance system. It is clear from Rosser's chapter that these battles over regulatory reform will form much of the backdrop to domestic and regional economic governance in the next decade.

In the final chapter of Part II, Amitav Acharya examines the way in which the admittedly tentative steps towards democratization have significantly affected the shape of regional governance in East Asia. The so-called 'Asian way' of regionalism – predicated on the development of informal, and often elite-led, channels of discussion within regional forums – is a product of the strong centralized, authoritarian regimes that prevailed at the height of the Asian crisis. In this chapter, Acharya explores the impact of increased openness and democratization on the traditional routines and techniques of Asia-Pacific regional governance. Regional governance will need to deal with new transnational issues such as a more active and assertive civil society and evolve strategies of govern ance that depart from the doctrines of non-interference. But, as he notes, this shift towards what he calls 'participatory regionalism' faces a number of challenges, one of which in my view is the fact that authoritarian state traditions still act as a powerful influence in otherwise democratic polities such as Thailand and the Philippines. In fact, the recent US 'war on terror' has only exacerbated these authoritarian tendencies. Nevertheless, Acharya's chapter clearly shows that the emergence of regulatory regionalism in the Asia-Pacific requires a move away from the informal and closed systems of regional governance that held sway at the height of the era of open regionalism.

Part III explores new and emerging regional governance projects in the Asia-Pacific region. Helen Nesadurai, in Chapter 8, argues that there has been a proliferation of regional governance projects, and these arrangements differ in terms of the substantive issues they address, especially with regard to the modalities or procedural approaches to cooperation. Her fundamental thesis is that Southeast Asian governments have adopted these governance arrangements in an effort to give them some measure of control over the effects of global economic integration. Again, the argument here suggests the critical role of the restructuring of capital along regional lines (see also Chapters 3 and 5) in driving new forms of regional governance. For Nesadurai, these new governance arrangements signify a shift from the new regionalism to what she calls 'developmental regionalism', which differs from the new regionalism in that it seeks to balance domestic stability and external integration. The broader point here is that we need to view the crisis in new regionalism as a shift away from strategies of governance suited to an international economy composed of national economic units to a regulatory regionalism more attuned to the growth of a regional economy in which there is regionalization of business.

Natasha Hamilton-Hart in Chapter 9 explores one of the critical elements of regulatory regionalism: financial and monetary coordination. Hamilton-Hart provides a detailed analysis of the benefits for East Asia from monetary cooperation, especially with regard to the process of crisis prevention and management. However, during the Asian crisis, the Japanese proposal for an Asian Monetary Fund was quickly taken off the diplomatic agenda. But as in the case of Indonesian corporate governance (see Chapter 6), Hamilton-Hart notes that the obstacles to the development of a comprehensive system of monetary coordination are considerable. These include political differences between countries such as China and Japan as well as the resistance of powerful domestic interests.

Nevertheless, initiatives such as the establishment of the CMI, providing emergency funds for currency stabilization (see also Chapter 10), suggest that a nascent form of monetary coordination may be taking root in East Asia. There can be no doubt that contests over financial and monetary coordination will provide a key touchstone for the emergent regulatory regionalism in the Asia-Pacific.

In Chapter 10, Nick Thomas examines the putative East Asian community – the so-called ASEAN+3 (i.e., South Korea, China and Japan). One of the most interesting developments in recent times (see also Chapters 11, 12 and 13) is the emergence of forms of regional governance that exclude Western countries, notably the United States and Australia. The so-called ASEAN+3 process is in essence the core of this putative East Asian grouping. Thomas examines these issues through the lens of a report presented by the East Asia Vision Group for promoting regional cooperation. He notes that the implementation of any such regional grouping will involve substantial constraints on the policy autonomy of ASEAN members. Hence the kind of regulatory regionalism that the ASEAN+3 process may usher in depends on a significant move away from the traditional patterns and routines of new regionalism in the Asia-Pacific. Thomas perceptively suggests that the way ASEAN+3 members respond to these challenges (i.e., regulatory regionalism) will determine to what extent this new East Asian regional governance is likely to be a permanent and durable feature of the regional landscape.

In the concluding section (Part IV), detailed consideration is given to the way in which major powers are shaping the contours of regional cooperation in the particular context of Southeast Asia. Mark Beeson, in his analysis of the role of the USA in the region from the beginning of the Cold War, observes that the USA has played a critical role in shaping the economic and political development of Southeast Asia. He also notes that the events surrounding 9/11 will have a significant bearing not only on regional governance but also on the broad shape of regional politics. Crucially, Beeson underscores the troubling tilt from a 'benevolent' to a more coercive US hegemony both globally and in the Asia-Pacific region. Consequently, what we have described as the emergent regulatory regionalism will need to mesh in with US-based policy networks, be it in money laundering or terrorism. According to Beeson, the way in which the USA manages these problems, especially within the more coercive strategic posture of the Bush administration, will have a decisive bearing on the future course of regional politics.

The remaining chapters in Part IV, by Daojiong Zha (Chapter 12) and Joseph Cheng (Chapter 13), explore with great clarity one of the critical and significant changes in regional political economy: the emergence of China as an economic powerhouse and major political player in the region's international relations. In addition to providing a detailed analytical overview and background to China–Southeast Asia relations, Cheng notes that Southeast Asia will be increasingly embroiled in the matrix of China–USA strategic competition. It is within this strategic matrix that China has come to be an enthusiastic supporter of the

ASEAN+3 regional process. However, Southeast Asian states need to balance this with the growing coercive character of US policy in the region (see also Chapter 11). Despite this, he observes that the desire of both China and the USA to keep a stable bilateral relationship will serve to constrain their competition in Southeast Asia. Nonetheless, he indicates the way in which the emerging regulatory regionalism in the Asia-Pacific will constantly need to accommodate US–Chinese strategic competition.

Zha examines the strategic and diplomatic aspects of China's decision to form a free trade area (FTA) with ASEAN in November 2001. This FTA is a singular landmark in the evolution of China–Southeast relations. Zha's careful and succinct analysis of the policy rationale contained in the Joint ASEAN–China Expert Study Group's report shows that the FTA decision was driven by broadly diplomatic and political considerations. He suggests that two factors were critical in shaping the Chinese decision: first, to seek to develop its southwestern provinces, and second, the competition with Japan for economic leadership in East Asia. Thus, he regards the FTA – and echoing some of Cheng's conclusions – as a part of a broader embrace of ASEAN by China. But again, this emerging framework of China–ASEAN relations needs to be placed within the framework of the developing regulatory state in China.

Conclusion

In shaping the new research agenda on Asia-Pacific regionalism, the contributors to this volume draw pointed attention to the need to wrest this agenda from academics and practitioners who view the process of regional integration as one of institution building. Institution building is clearly an important part of this process, but to view it as somehow an independent external process remains problematic. The standpoint adopted in these essays suggests the need to locate the development of regionalism within the framework of broader political or governance projects of market making in individual countries. These, in turn, are underpinned by a distinctive set of domestic coalitions, state forms and permissive international strategies. A broad convergence of these political projects would facilitate a parallel process of regional governance.

The strength of this approach lies in locating the dynamic of regional govern ance within the broader structures and processes associated with the restructuring of domestic and foreign capital as well as the state forms that underpin such restructuring strategies. In other words, regional processes are embedded within domestic structures. Accordingly, it would appear that the impact of the deep-seated structural changes in the global economy have unsettled previously dominant coalitions and growth strategies and concurrently established govern ance projects centred on the APEC-driven process of economic integration. These established governance projects have given rise to a wide array of new proposals for regional governance. While the final shape of the new regional order is far from clear, it is evident that these new regional governance projects will be shaped by the new forms of regulatory states and associated structures of regulatory regionalism. However, like all other regional governance projects, this new regulatory regionalism is likely to be heavily contested at both the national and regional levels.

However, what is clear is that the emergence of this regulatory regional governance will depend on significant changes to the way in which the new regionalism has being configured in the Asia-Pacific. As Acharya notes in Chapter 7, it requires a move away from the doctrine of non-interference, which has been at the core of regional institutions such as ASEAN; greater and more formal regulatory standards in a range of new areas; the enrolment of new actors, both state and non-state, in forms of regulatory governance (see Chapter 10); and an increase in multilevel forms of governance that are permeable across both national and international boundaries. Most important of all, it demands a set of governance strategies appropriate to a new global economy that makes increasingly problematic the notion of regionalism as the governance of national economic units.

It also needs to be emphasized that new regional projects are not simply about the creation of new forms of governance strategy but also entail the production of new forms of spatial organization. One important insight into the analysis of space and power by social theorists such as Lefebvre (1991) and Harvey (1999) is that spatial structures are not just given; they are constantly produced and reproduced. The production of space demonstrates how spatial configurations are inextricably linked to the particular manner by which certain forms of growth strategy are aligned with a particular configuration of space. In fact, even though proponents of the new regionalism embrace regional integration, they still think of regionalism as an agglomeration of national spaces. In the final analysis, 'new regionalism' as a project of integration is driven by trade liberalization between various national economies.

The key contention here is that globalization makes the very idea of national economic space problematic, and in this context regionalism denotes a much more broad-based restructuring – as Phillips points out – of both national and regional space. For example, one of the most important features of recent trends in Southeast Asian political economy has been the weakening of the centralized organization of space. To this end, a number of observers have pointed to the localization of power within the state through state-sponsored decentralization schemes or through pressure from the local regions. In turn, this localization is associated with the growth of a new assertiveness of provincial business and political elites. Clearly, these trends have important ramifications for regionalization and need to be comprehensively explored: for example, the development of sub-national linkages between and within states. Indeed, as Zha points out so well, a large part of the new regional dynamics of China and Southeast Asia relations is to be found in the specific local dynamics of those provinces bordering Southeast Asia. It is clear that the future research agenda on Asia-Pacific regionalism will need to examine much more closely the processes involved in the production of new regional spaces.

Regional space is not just produced; as Lefebvre (1991) perceptively notes, it is also a *system of representation*. One area for future research is not just to explore the way in which a region is imagined but to go beyond current constructivist notions by specifically relating these systems of representation to projects of regional and domestic governance. In this respect, it is interesting to note one of the major differences between the EU project for a single market and the APEC model of open regionalism. Whereas the EU representation of the region is as an independent economic space to be governed through a range of regulatory mechanisms, APEC's representation of the region is in a predominantly cultural sense, which made a liberal project of regional market making difficult (Beeson and Jayasuriya 1998). In the post-crisis period, these cultural conceptions of space have not disappeared, although they are now less tied to economic programmes of developmentalism, suggesting that a project of regional market making is fraught with difficulties. The continuity and change in these forms of regional representation is an important item to be added to the future research agenda. Whatever the future course of this research, it is clear that we need to articulate a new research agenda for regionalism more appropriate to the changed circumstances that we find in the first decades of the twenty-first century. This volume is but a 'first cut' at this new research agenda.

Notes

1 For an analysis of how the crisis shattered some of the prevailing orthodoxies of trade liberalization that had dominated the region, see Higgott (2000) and Higgott and Phillips (2000).

2 There are a number of exceptions that have managed to avoid some of the pitfalls of the international relations literature. Stubbs (1999) on the relation between war and export-oriented industrialization is an exemplar of the complex interweaving of domestic and international politics. Ravenhill (2001) on APEC provides an illustration of such an approach with respect to a pivotal institution of regional economic cooperation in the Asia-Pacific. Recent papers that have highlighted the way in which the crisis challenged dominant policy ideas and coalition would include (this is not by any means an exhaustive list) the essays in Robison *et al.* (2000), Katzenstein *et al.* (2000) and Higgott and Phillips (2000), and also Bowles (2002), Beeson (2002a) and Dent (2002).

3 For a comprehensive overview of the implication of the Asian crisis for these theories of regional cooperation, see Acharya (1999).

4 A point that has been made forcefully by Gamble and Payne (1996). See also Breslin and Higgott (2000).

5 Beeson (2002b) provides a good account of the rise and fall of the Southeast Asian economic miracle. Stubbs (1994), writing before the onset of the Asian crisis, provides an essential overview of the broad contours of Southeast Asian political economy. Bernard and Ravenhill (1995) provide a broader East Asian perspective on industrialization and regionalization in East Asia.

6 For an extended elaboration of the argument that globalization is an internally rather than an externally driven process, see Reinicke (1998).

7 For an initial approach to this issue in an East Asian context, see Jayasuriya (1994b).

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Part I
Conceptual framework

The politics of regional governance

2 Embedded mercantilism and open regionalism

The crisis of a regional political project[1]

Kanishka Jayasuriya

Strategies of regional integration as political projects

Open regionalism, in terms of the conceptual framework advanced in this chapter, is not so much a strategy of economic liberalization as a regional regime of political economy that encompasses a set of institutions, domestic coalitional structures and international strategies. The nature of regional integration in East Asia, it will be argued, needs to be understood in the context of the manner in which domestic structures have underpinned a particular project of regional integration that goes under the rubric of open regionalism. The coherent moves towards regional integration need to be seen as political projects undertaken by domestic actors and coalitions. In other words, regional political projects have roots in domestic structures, and these domestic structures in turn have come under increasing pressure in an era of globalization.

The neglect of the domestic foundations of foreign economic and security policies warrants critical analysis, as there is an important lacuna in the literature on multilateralism in East Asian policies. Much of the literature[2] – whether realist, liberal or constructivist – uses an 'outside in' methodology to understand foreign economic and security policies. In contrast, this chapter seeks to develop an 'inside out' framework to understand the dynamics of regional economic order (see Chapter 1). More specifically, it attempts to explore the role of domestic coalitions in underpinning a range of outward-oriented policies; it is argued that a particular set of arrangements between the tradable and non-tradable sectors – which, borrowing from Pempel (1998), we term 'embedded mercantilism' – drove the domestic engine of regionalism.[3]

Adopting this different perspective, regional strategies such as 'open regionalism' need to be analysed and understood within the broader framework of what may be termed 'regional governance projects'. Such governance projects should be seen as being composed of four central elements:

1 a stable set of international economic strategies;
2 a distinctive set of governance structures that enable regional economic governance;

3 a set of normative or ideational constructs that not only make possible a given set of regional governance structures but also make possible the very definition of the region; and
4 a convergence of domestic coalitions and political economy structures across the region, which facilitates the coherent construction of regional political projects.

On the basis of the above framework, it is suggested that the governance project that characterized the East Asian region prior to the crisis was underpinned by the following features:

- the dominance of open regionalism as a strategy of international liberalization;
- the presence of an informal rather than a rule-based set of governance structures;
- an ideational framework that places emphasis on a cultural definition of the region, which depends on what Beeson and Jayasuriya (1998) term a 'cameralist political rationality'; and
- the emergence of a form of embedded mercantilism and domestic political economy divided between the tradable and the non-tradable sectors.

Applying this regional governance framework to strategies of regional integration in East Asia, the nub of the argument advanced here is that the domestic configuration, identified as 'embedded mercantilism', created the distinctive forms of multilateralism exemplified by APEC in the Asia-Pacific. This embedded mercantilism rested on a specific set of trade-offs between the tradable and the non-tradable sectors. However, in the wake of the Asian crisis, these domestic foundations appear to be more brittle and more diverse. As a consequence, there are important fissures between those states dominated by reform-oriented coalitions and others where nationalist coalitions still remain deeply entrenched.

Open regionalism: economic technique or political project?

Open regionalism is basically a strategy of unilateral trade liberalization with the extension of its benefits to non-APEC member countries on the basis of the General Agreement on Tariffs and Trade (GATT) principle of most favoured nation (MFN) status (namely, that concessions offered by one country to any other GATT member should be offered to all). The rationale behind open regionalism is that a greater access to free trade within a designated area will increasingly produce positive trade-liberalizing effects on other trade blocs and countries through the GATT's MFN principle. It is argued that this has the virtual effect of avoiding trade diversion – a standard effect of a customs union (a trade area with common external restrictions). Open regionalism, therefore, extends the benefits of free trade to a greater proportion of the international economic system than just the member countries of APEC. In short, it is a trade-liberalizing strategy, the aim of which is to create lower trade barriers across the international economic system.

The competing notion of 'bloc regionalism' is based on the assumption that unilateral trade liberalization is not likely to be effective. Non-APEC members, it is suggested, would be able to gain a free ride on trade liberalization while holding back on their own domestic trade liberalization agendas. From this perspective, for APEC to be an organization of effective economic cooperation it is necessary that there should be reciprocal trade concessions from non-APEC members. APEC's huge and rapidly developing market would provide a further carrot for non-members. This vision for APEC is premised on the more political GATT principle of reciprocity. An even stronger version of bloc regionalism would suggest that APEC develop a well-regulated customs union along the lines of the European Community. However, this strong form of bloc regionalism is economically and politically untenable: economically, because of the vast differences in levels of economic development and the fact that most East Asian trade (if the USA is excluded) is more inter-regional than intra-regional; politically, because in the light of the political problems faced by the establishment of the North American Free Trade Area (NAFTA), it would be difficult to gain political acceptance for such a position in the USA.

Politically, however, the critical issue relating to open regionalism is not just its technical rationale as a set of economic strategies but also that these technical rationalities reflect an underlying set of politically constituted relationships between market sectors. Open regionalism is not about regional market making but is about maintaining export markets; and also that this helps to cement the dominant coalition between the domestic cartels in the non-tradable sector and the tradable sector. For these reasons, open regionalism may be seen as denoting a particular political project of regional integration undertaken by powerful domestic actors.

One of the attractions of open regionalism for powerful domestic coalitions lies in its informal and flexible nature of regional economic governance, which eschews formal rule-based regional integration. In East Asia, where the position of ruling elites is closely bound up with the existing economic structure, the possible formation of markets beyond the state's influence as a self-regulating and autonomous sphere strikes at the heart of the kinds of segmented political economy characteristic of East Asia. Indeed, such a transformation represents a direct threat to dominant patterns of political and economic power.

More generally, these points underscore the fact that multilateral strategies are deeply intertwined with domestic economic and political projects. During the boom years, the APEC strategy of trade liberalization within the ambit of open regionalism fitted well with the political projects of state-driven capitalism. Open regionalism is the preferred international strategy of the embedded mercantilism that defined Southeast Asian political economy. Nevertheless, during the Asian economic crisis domestic structures and coalitions that underpinned open regionalism were under severe pressure; hence, the APEC response to East Asia's economic problems has been a conspicuous failure.

Embedded mercantilism, segmented political economies and domestic coalitions

An understanding of regional governance strategies as a political project, driven for the most part by entrenched domestic actors, renders rather problematic a view of economic strategies – both domestic and international – as a rational response to the imperatives of market forces. However, in terms of the argument offered here, these strategies are intrinsically political because any given set of economic strategies needs to be underpinned by a coherent dominant coalition, the members of which benefit from the pursuit of a given economic policy regime. We discuss these elements in more detail below, but what needs to be underlined here is the fact that economic reform implies a dramatic change in previously dominant or influential configurations of interests, institutions and ideas and, therefore, any shift in economic strategies will bring forth serious resistance from political and social forces that have benefited from previously dominant economic strategies. For this reason, while the crisis has unsettled previously dominant coalitions, this was necessary but not sufficient to challenge the prevailing structures of interests (Beeson and Robison 2000: 19–24).

Central to our analysis is a consideration of the role of domestic coalitions in shaping economic policy trajectories. Coalition analysis of this sort has a long tradition in political science. There are a number of important studies that have used a coalitional framework to explain and account for a range of political outcomes and events (Gourevitch 1978, 1986). Moore (1966), in a path-finding study of the sources of democratic change, used a coalition analysis to explore the varying social foundations of dictatorship and democracy. Indeed, this study follows the classic work of Gerschenkron (1962) on the marriage of iron and rye in laying the foundations of German authoritarianism.

More recently, Solingen (1998), in an innovative work, has sought to extend these coalitional frameworks to encompass international as well as domestic economic and security strategies. She has suggested that there is a basic and underlying cleavage between international and nationalist-oriented coalitions, and she argues that while international coalitions favour economic strategies, nationalist coalitions will seek to protect and insulate the economy from global influences. These coalitional cleavages pivot around preferences towards economic liberalization. As she points out:

> external liberalization affects individuals and groups in different sectors through changes in employment status, labor incomes, and returns on assets, through changes in prices of goods and services consumed, and through the provision of public services.
>
> (Solingen 1998: 22)

However, a clear-cut distinction between nationalist and internationalist coalitions is much more problematic in Southeast Asia during the boom years. Indeed, what is striking in Southeast Asia is the presence of a strong internationalist orientation that is conjoined with a politically protected domestic economic sector. In fact, rather than cleavages, producing antagonistic Southeast Asian political economies seem to accommodate both nationalist and internationalist coalitions. And this is the critical point of our thesis: domestic coalitions in Southeast Asia were structured around a series of trade-offs between the domestic and international economies, which in turn were nested within a certain type of international strategy. In a nutshell, the international strategies of East Asian states were based on a political economy of embedded mercantilism.

We borrow the term 'embedded mercantilism' from Pempel (1997, 1998),[4] who uses a coalitional framework to understand the dynamics of regime shifts in Japan. In an insightful analysis of institutional and coalition transition in advanced industrial societies, he defines a regime as consisting of three key elements:

> a regime is composed of three essential elements: socio-economic alliances, political economic institutions and public policy strategies. These three overlap and reinforce one another; they resemble the three legs of a tripod that collapses when any one is removed. They interact in complex ways, developing and responding to a discrete internal logic.
>
> (Pempel 1998: 20)

He goes on to suggest that shifts in regimes are prolonged and may involve, as in the case of Japan, a period of long-term transition where the old regime is dying but a new regime struggles to find its coalitional and institutional anchors.

For Pempel, one of the defining characteristics of the postwar Japanese regime was a system of embedded mercantilism. In other words, embedded mercantilism captures the way in which a set of coalitional and institutional structures entrenched a form of political capitalism at home while pursuing a relentlessly internationalist strategy abroad:

> equally integral to the conservative regime's economic policy profile were policies that had a political rather than economic rationale. These involved side payments to the country's less economically advanced sectors: rice farmers, the small business sector, geographical regions lacking high-growth industries, and increasingly industries in decline.
>
> (*ibid.*: 60)

In essence, embedded mercantilism relied on a series of trade-offs and compensation for the domestic sector, thereby creating a kind of dual economy.

While much of this analysis of an embedded mercantilist regime in Japan is dictated by the nature of Japanese institutions as well as the key strategic role of the Liberal Democratic Party (LDP), it is nevertheless a model that can be very useful in understanding the role of domestic alliances and coalitions in Southeast Asia. Abstracted from its Japanese distinctiveness, the embedded mercantilist model has the following characteristics:

- a segmentation between the export-oriented and domestic economic sectors, creating a dual political economy;
- an overlapping of these divisions with distinct sections of capital; and
- a set of public policies to ensure that side payments from the more efficient export sectors facilitate a broad set of alliances between the two segments of the dual economy.

In essence, embedded mercantilism enabled the developing East Asian states to put together policies that compensated non-export sectors of the political economy, and compensatory policies were critical in securing the political coalitions required for the pursuit of export-oriented industrialization strategies. These issues will be examined in more detail in the next section, but it is important to mention here that one of the principal features of the political economy of the developmental state has been the constitution of a segmented political economy. On the one hand, there are internationally competitive export industries, and on the other hand, key elements of the domestic economy are inefficient and politically entrenched through close relationships with political and bureaucratic elites. In the Japanese context, Pempel (1998) and Calder (1988) have argued that compensatory public policies for farmers, small businesses and domestic industries such as construction have coexisted and, indeed, provided the political wherewithal for efficient competitive export industries. Woodall (1996) has pointed out that two distinct forms of state exist in Japan: developmental and *clientalist*. In this context, political clientalism is:

> an interaction characterized by the selective allocation of distributive benefits by public sector elites in exchange for the promise of solidarity and mutually beneficial inputs from private sector interests. This exchange may involve governmental subsidies, official price supports and import quotas, targeted tax breaks, regulatory favours in the allocation of trucking routes, and other policy benefits.
>
> (Woodall 1996: 9–10)

Similar examples of compensatory policies may be found in other developing East Asian states. For example, South Korea, like Japan, grants extensive subsidies to its farm sectors.

However, these rent-seeking[5] or clientalist structures are widespread in much of Southeast Asia. In Malaysia, for example, a relatively efficient export sector exists alongside industries characterized by widespread patronage and rent seeking. For instance, the heavily protected national car industry provides direct benefits to Malay elites closely associated with the ruling party (Bowie 1991, 1994). In this instance, industrial policy is a means of ensuring the political survival of the Malay-dominated UMNO coalition, so the rent-seeking structures have been central to the political consolidation of the Mahathirist political project in Malaysia. Herein is the nub of the argument: these domestic developmentalist projects were accommodated by the regional governance project of open regionalism. This project and the embedded mercantilism that it promoted enabled the consolidation of a segmented political economy composed of an open tradable sector and a protected non-tradable sector. In short, open regionalism went hand in hand with the domestic developmentalist political projects of East Asian governments.

The international political economy of open regionalism

Over and above these elements, but equally important for the operation of the system of embedded mercantilism, was a permissive set of regional and international economic structures. Cumings (1987) has drawn attention to the role of the Cold War structures in creating the kind of developing states that emerged in East Asia. However, it needs to be added that a more specific set of international forces was entrenched in embedded mercantilism in Southeast Asia. In particular, the expansion of Japanese foreign direct investment (FDI) and the distinctive open regionalism favoured by the APEC process helped to consolidate the politically protected domestic economic sector. In fact, the whole gamut of economic reform policies pursued in the late 1980s and 1990s served to consolidate the political economy of embedded mercantilism. From this perspective, domestic and international strategies are mutually constitutive of domestic coalitions and alliances around a system of embedded mercantilism.

In fact, the system of embedded mercantilism in East Asia may well be the counterpart of Ruggie's notion of 'embedded liberalism'. Ruggie (1983), in a highly influential article, introduced the notion of embedded liberalism as a way of understanding the emergence and development of internationalization of political authority in the postwar period. He starts off with two key assumptions: (1) that international political authority requires the fusion of power and authority; and (2) that the explanation of the nature, emergence and functioning of international regimes[6] requires that equal attention be given to the role of power[7] and social purpose. For Ruggie, the essence of the postwar economic order lay in the fundamental reconciliation of two distinct objectives: the need to provide a framework for a liberal international trading order and the conditions for domestic social stability. For example, the restrictions, exceptions and safeguards of the GATT were designed in such a manner to allow for the protection of domestic stability while benefiting from the advantages of liberal free trade. At the global level, embedded liberalism reflected the dominance of a kind of social liberalism. The essence of this embedded liberal compromise was twofold: 'unlike the economic nationalism of the thirties, it would be multilateral in character; [and] unlike the liberalism of the gold standard and free trade, its multilateralism would be predicated upon domestic interventionism' (*ibid.*: 209).

In part, Ruggie argues that this reconciliation of domestic stability and liberal free trade was at the cost of inflation, because the reduction in domestic adjustment that it permitted 'had inflationary consequences by sacrificing economic efficiency to stability' (*ibid.*: 231). Another crucial factor that has been essential to sustaining the regime of embedded liberalism is that it was able to combine a liberal trade system with the regulation of capital markets (Bell 1997). In retrospect, it appears that the regulation of capital structures played a major role in protecting domestic, social and economic programmes. It is the removal of these capital controls that has unleashed a fundamental restructuring of all forms of welfare and the developmental state itself.

More crucially, however, the regional production and financial structure that emerged in Southeast Asia in the mid-1980s served to buttress the dualistic and segmented political economies of Southeast Asia. As we have suggested, a critical feature of the Southeast Asian political economies during the boom period was the presence of two distinct economic segments: one, an international segment that was export-oriented and driven predominantly by FDI; and the other, a highly cartellized domestic segment. These economic sectors were also composed of distinct capitalist groupings with differing links to the state. Whereas foreign investors predominantly drove the tradable sector, the non-tradable sector was largely in the hands of enterprises or corporate groups closely linked to the apparatus of political power. The growth generated by the tradable sector was effectively compensated for through an implicit and explicit set of bargains between the capital in the tradable sector and the non-tradable sector. How this was achieved depended on the particular institutional configuration of each state. An elaboration of this is beyond the brief of this chapter, but for the purposes of the present argument it suffices to underscore the fact that these domestic coalitions were structured through a set of bargains that in the final analysis rested on the economic growth generated by the tradable sector of the economy. This, in essence, laid the domestic foundations for the system of embedded mercantilism that defined the basic contours of the regional political economy in the period prior to the Asian crisis of 1997–98.

In this context, there can be no doubt that the formation of the segmented political economies of Southeast Asia was accelerated by the rapid growth in Japanese FDI. From 1987, Japanese investment in Asia increased dramatically, particularly after the Plaza Accord (Stubbs 1994), which raised the value of the yen, thereby prompting Japanese manufacturers to seek overseas factories. Singapore and Thailand were the initial beneficiaries of these investments, but Japanese FDI shifted to Malaysia and Indonesia over the next few years (Jomo *et al.* 1997). As Table 2.1 indicates, Malaysia and Singapore remained heavily dependent on the inflow of FDI.

Japan was not the only major source of FDI. Newly industrializing countries in East Asia were also important investors in Southeast Asia. Just as an appreciating currency forced Japanese manufacturers to relocate, a similar set of pressures was being felt in South Korea and Taiwan. Taiwan, for example, is a

Table 2.1 **Asia: ratio of FDI inflows to gross domestic capital formation, 1971–93 (annual averages) and selected countries for 1997**

Country	*1971–75*	*1976–80*	*1981–85*	*1986–90*	*1991–93*	*1997**
China	0.0	0.1	0.9	2.1	10.4	
Hong Kong	5.9	4.2	6.9	12.9	5.7	
India	0.3	0.1	0.1	0.3	0.4	
Thailand	3.0	1.5	3.0	6.5	4.7	7.6
South Korea	1.9	0.4	0.5	1.2	0.6	1.7
Malaysia	15.2	11.9	10.8	11.7	24.6	29.0
Philippines	1.0	0.9	0.8	6.7	4.6	6.1
Singapore	15.0	16.6	17.4	35.0	37.4	
Taiwan	1.4	1.2	1.5	3.7	2.6	
Indonesia	4.6	2.4	0.9	2.1	4.5	7.7

Source: **Jomo *et al.* (1997) and various sources.**

*** Figures for the future 'crisis countries.**

significant investor in Malaysia, and South Korea made substantial investments in Indonesia (Stubbs 1994). In addition, the emergence of the growth triangle linking Singapore with the Malaysian state of Johor and the Indonesian province of Riau underlined significant Singaporean investment in the neighbouring region. In short, from the late 1980s Southeast Asia was the beneficiary of significant FDI from Japan and other East Asian countries.

However, this was not simply a question of market forces creating a 'flying geese' model of investment. This investment was driven by a set of forces that served to entrench the dominant coalitions in East Asia: first, it was driven by domestic pressures to move offshore in order to internationalize production; second, these strategies were underpinned by export markets in the USA, which in turn were dependent on a broader, political, relationship between the USA and Japan; finally, Japanese FDI was enmeshed in the political strategies of local dominant coalitions through equity investment or joint ventures. For example, significant Japanese investment in Proton, the Malaysian car company, helped to cement an enterprise that was both economically and ideologically pivotal to dominant sectors of the Malaysian political economy. The growth of FDI in Southeast Asia was driven not just by market forces but also by a complex array of political pressures, foremost among which were the economic and political interests of the domestic coalitions.

The domestic foundations of open regionalism

The inflow of FDI was paralleled by the political and economic power of the non-tradable sector in Southeast Asia. As will be argued, much of the enhanced power of this domestic sector was fuelled by the policies of deregulation and liberalization introduced in the late 1980s – the so-called 'Washington consensus'. Far from helping to curtail the growth of powerful politically linked domestic cartels, Washington consensus policies helped to consolidate the considerable shift of power to politically linked cartels. In fact, in Southeast Asia, outward-oriented economic policies helped to entrench a dual economy and its mainsprings, the constellations of power and interests in the domestic economy.

This economic and political consolidation of what could be termed '*nomenklatura* capitalism' was reflected, for example, in the rapid growth of infrastructural development in countries like Malaysia, which was fuelled by the export-oriented sector (Jomo 1998). Moreover, the high short-term capital inflows generated by the rapid growth of Southeast Asian economies fed directly into the politically connected non-tradable sector (Khoo 2000: 218–20). In fact, much of the recent discussion of capital inflows overlook the fact that most of the debt incurred has been with politically connected domestic cartels. In addition, the increased assertiveness of domestic cartels in the non-tradable sector has been clearly illustrated in the pegging of local currencies to the US dollar prior to the crisis – an action that effectively overvalued most local currencies. For instance, one of the main triggers of the Thai crisis was the failure of the Thai monetary authorities to make effective downward adjustments to the Thai baht (Jomo 1998). However, these policies cannot be simply dismissed as policy failures just because the benefits of an overvalued currency accrue to the non-tradable sector; they must be seen as a reflection of the relative political dominance of the non-tradable over the tradable sector (Friedan 1991).

More significantly, however, the distinctive character of embedded mercantilism in Southeast Asia is reflected in the growth of a type of *nomenklatura* capitalism in Southeast Asia. The term '*nomenklatura* capitalism' is used to highlight the close connection between political elites and insulated domestic cartels. In the Southeast Asian context, the connections are welded deeper than the clientalism of East Asian developmental states because the management and control of business groups are closely intertwined with the state and party apparatus. *Nomenklatura* capitalism here points to an important shift in Southeast Asian economies as agents or enterprises within the state, or indeed in dominant parties, become key players in the domestic economy and gatekeepers to the global economy.

Indonesia provides a neat illustration of the development of this type of capitalism. During Indonesia's oil boom (1973–82), state intervention in the economy was widespread. It was reflected in the rapid growth of state enterprises in areas such as steel, fertilizer, cement and paper. The rapid increase in state intervention was accompanied by a range of highly interventionist policies in areas such as trade and banking. For example, the new foreign investment laws introduced after 1974 required all foreign investors to take on local equity partners. In the trade area, a system of import monopolies for private and public firms was introduced, thereby providing a lucrative system of rents for well-connected state enterprises (Robison and Rosser 1998).

However, by the mid-1980s these systems had become much more tenuous. Internationally, there was great pressure to deregulate the economy, particularly in the wake of the collapse in oil prices, but there were also significant domestic pressures because beneficiaries of the previously regulated economy began to chafe at state restrictions. Many of the cartels, which were dependent on political connections, were locked out of lucrative state monopolies and were now intent on getting a slice of the action. In the light of these twin pressures, the Indonesian government in the mid-1980s began to pursue a more market-oriented approach to the economy.

While these reforms were much lauded by the international community, it is important to note that these reforms occurred within the context of the emergence of a powerful group of *nomenklatura* capitalists. In this context, the economic reforms shifted power away from state enterprises towards this group of capitalists. As Robison and Rosser (*ibid.*: 1998) point out:

> deregulation created the opportunity for sudden and extensive growth in the private sector and for the economic dominance of large predominantly Chinese-owned conglomerates as well as business groups owned by powerful political families, notably the Suharto family.

In short, far from the emergence of liberal markets, deregulation served to entrench domestic cartels (in the non-tradable sector) whose defining attribute remained their connections to the dominant apparatus of political power. In the Indonesian situation, this meant the political and social coalitions surrounding the Suharto family. In essence, the market reforms that were at the heart of the kind of open economic strategies pursued by Indonesia served to entrench a segmented political economy composed of a foreign-owned tradable sector and a domestic-owned non-tradable sector consisting of politically connected cartels.

In Malaysia, as in Indonesia, a dual economy is clearly apparent: a tradable sector largely owned by foreign capital and a domestic sector composed of enterprises with strong links to the ruling UMNO party. Central to an understanding of the Malaysian political economy is the adoption of the New Economic Policy (NEP), designed to promote greater Malay entrepreneurship in the domestic economy, which was largely in the hands of local Chinese capital. It is beyond the scope of this paper to document the working of the NEP (Jomo 1986), but two significant effects need to be noted. First, the NEP created strong incentives for powerful Chinese capitalists to enter into alliances and relationships with Malay politicians. This nexus, which has become increasingly important over the last decade, has blurred the distinction between Chinese and Malay capital and formed the basis for a broad-based dominant coalition (Gomez and Jomo 1997). Second, the NEP initially rested on an ambitious state-driven industrialization policy led by large state enterprises. These enterprises were controlled by powerful bureaucrats with close ties to the dominant political apparatus.

However, after the economic recession of the late 1980s, Malaysia embarked on a programme of extensive privatization and deregulation. This resulted in a shift of ownership from the public to the private sector, but control over the newly privatized assets was still dependent on links to the dominant political party, the UMNO. Therefore, in Malaysia, ownership of key strategic enterprises shifted from state to party. As Bowie points out, these developments have led to the 'erection of a corporate empire blessed with unrestricted access to state-issued licences and Malay preferences that is under the direct control of the governing party, UMNO, and is used to raise funds for constituent and electoral purposes' (Bowie 1994: 182). In other words, Malaysia created its own brand of *nomenklatura* capitalists, who are a key component of the dominant coalition.

While the crisis has severely undermined the viability of these enterprises, it is clear that the links between UMNO and key sectors of the domestic economy are so strong that any attempt to introduce market-oriented reform will be strongly resisted. The development of *nomenklatura* capitalism allows very little political space for the emergence of an alternative reform-oriented coalition. Nonetheless, it needs to be pointed out that there are significant pockets of domestic capital that may well form the basis of a future reform coalition. The recent electoral setbacks for the ruling party suggest that this may well be a plausible scenario.

More strikingly, Malaysian economic policies have a strongly nationalist orientation. However, 'it aspires to find its fulfilment in an equally committed Malaysian nationalist goal of competing equally with the advanced nations of the world. Mahathir himself has alluded to all this before' (Khoo 1995: 329).

Elements of this pervasive dual economy – although with a much higher degree of economic efficiency – are also evident in Singapore's political economy, which like Malaysia has two distinct elements: one, a tradable sector largely controlled by foreign capital; and the other, a powerful domestic sector composed of government-led companies, which have a strong presence in the domestic economy. The effective political and policy segmentation of the economy between the external and the domestic sector reduces (although it does not eliminate) potential conflicts between the two sectors. However, the powerful government-led corporations and domestic enterprises are the core components of Singapore's dominant coalition. Therefore, any analysis of policy reform in Singapore over the last decade or so needs to take into account the critical economic and political role of government-led companies in Singapore. Indeed, even as privatization and deregulation has proceeded apace, the government has used key holding companies (e.g., Tamesek, Singapore Technology, Health Corporation Holdings) to retain control over some of the biggest corporate entities in Singapore (Rodan 1997; see also Vennewald 1994). In fact, as Rodan (1997) points out, one of the distinctive features of the Singaporean political economy over the last decade and a half has been the gradual movement of state enterprises into the private sector without a concomitant shift in control of these enterprises.

These examples illustrate that contrary to much of the prevailing economic orthodoxy, trade liberalization or open economic policies served to consolidate a particular economic and political bargain between a politically connected non-tradable sector and an open export-oriented sector. From the late 1980s, state-led development projects gave way to a system of *nomenklatura* capitalism: powerful domestic cartels connected to the ruling apparatus of political power. To be sure, the precise nature of these connections, as well as the degree of economic efficiency, was dependent on the distinctive institutional configuration in each country, for example the 'presidential cronyism' in Indonesia or party-led companies in Malaysia. Relevant to our argument here is the manner in which this model of *nomenklatura* capitalism, and the domestic coalitions that sustained it, were enmeshed within a particular set of internationalist strategies.

Globalization and the crisis of the regional political economy

International competitiveness and open regionalism

There was increased competitiveness in the international economy, and it is clear that the segmented political economies of the politically connected non-tradable sector and the dynamic, efficient tradable sector required high levels of exports to feed the voracious rent-seeking appetites of the domestic cartels. Moreover, the high capital inflows that fed this non-tradable sector were dependent on the continued high growth rates and profitability of the tradable sector. Over time, these inflows have been unable to provide the resource transfers to sustain the political capitalism in the non-tradable sector because East Asian export and economic growth are becoming increasingly sluggish due in no small part to the competitive export pressure of the Chinese economy in addition to overvalued exchange rates.[8]

Moreover, this reliance on exports and the tightening competitive situation contributed to significant overcapacity in East Asia. In addition, the availability of cheap money and unrealistic expectations of future profitability contributed considerably to overinvestment in the region. Although overinvestment in the tradable sector was due, in part, to systemic factors in the global economy, the very significant overcapacity in non-tradables was due to its magnetism for mobile capital. Once again, this alerts us to the role played by the curious marriage of 'hot money' and 'crony capitalism' in the operation of East Asia's embedded mercantilism. Consequently, no amount of tinkering with trade policy is likely to alter these structural constraints on the region's political economy. It is clear that the presence of overcapacity in the region is in no small measure an attribute of the political economy of open regionalism.

Open regionalism and the balance between the tradable and non-tradable sectors

The balance between the tradable and the non-tradable sectors was dependent on the existence of agencies such as central banks, finance ministries and the like, which were able to monitor and effectively regulate the flow of rents from the export to the non-tradable sector. The effective maintenance of this regulatory autonomy was especially important in the context of the financial liberalization policies that were being implemented across the region. In some respects, this bears comparison with Wade and Veneroso's (1998) analysis of the financial crisis. However, what they regard as a series of policy errors by technocrats should be seen as a more deep-seated transformation of the state in East Asia where policy makers effectively lost their autonomy in key areas within the state. In short, there has been a diffusion of power within the state as key domestic cartels managed to influence and even capture sections of the policy-making apparatus of the state.

In this context, economic liberalization within a system of *nomenklatura* capitalism inevitably weakened the capacity of policy makers to respond to crises. Indonesia provides a clear illustration of this argument. First, deregulation in Indonesia led to the consolidation of powerful politically connected conglomerates (Robison and Rosser 1998; Pincus and Ramali 1998). Second, successive rounds of liberalization left technocrats with very few instruments through which to control the economy. As Pincus and Ramali point out:

> Paradoxically, although successive rounds of liberalization failed to achieve their stated objective of reducing the level of rents in the system, they had the unintended effect of limiting the technocrats' capacity to intervene in a meaningful way to adjust to external shocks.
>
> (Pincus and Ramali 1998: 724)

Globalization, or more particularly financial liberalization, served over the short term to reduce the capacity of the technocrats to regulate the economy. However, the potentially incendiary element was the fact that regulatory institutions (such as the Indonesian central bank) were captured by domestic cartels, and this, combined with strategies of liberalization, further entrenched the power of the politically connected domestic cartels.

In Thailand, long the 'teacher's pet' of the World Bank for its conservative macro-economic and monetary policies, there has been a continual shift in political power away from central state agencies to business groups and politicians (see Laothamatas 1992; see also Hewison 2000). Here, the close relationship between politicians and business groups was at the expense of central economic agencies such as the Ministry for Finance. Laothamatas (1994: 209) maintains that:

> with electoral politics in full gear in the later 1980s and early 1990s corrupt dealings between government and business have again picked up. In a country where vote-buying is often needed to win an election and funding for party activities and election campaigning comes mostly from covert donations (rather than legitimate government sources or publicly acknowledged donations), corruption becomes a crucial means for politicians to draw money from businesses.

The important point that needs to be recognized here is that the deregulation of the financial sector in the context of segmented political economies provided the circumstances for the inevitable collision between global economic forces and the dominant coalitions solidly entrenched in the *nomenklatura* capitalism arrangements of Southeast Asia. From this perspective, while the depth of the economic crisis was no doubt a contributing factor, the mainsprings of the crisis lay in the structure of Southeast Asian political economies. Economic liberalization within a system of *nomenklatura* capitalism inevitably weakened the capacity of policy makers to respond to a crisis. Hence, over the long term, an economic crisis of the magnitude of the economic shock of 1997–98 was inevitable, because the hitherto carefully regulated institutional balance between the tradable and the non-tradable sectors was now firmly tilted in favor of the non-tradable sector.

International trade policy and open regionalism

On top of these pressures, the system of embedded mercantilism came under increasing strain from US trade policy, which began to place a premium on issues of market access and fairness as well as liberalization. Consequently, insulation of domestic cartels from global pressure, which formed the nexus of the national–international bargain so pivotal to the stability of the system of embedded mercantilism, was increasingly being undermined by US trade policy. Furthermore, the advent of the WTO and the strongly juridical cast of trade law and regulation were deleterious to the pursuit of the embedded mercantilist policies that had provided significant political and economic dividends for dominant coalitions in East Asia. In essence, the bargain between domestic autonomy and international openness, which took the particular form of open regionalism, was being eroded by a combination of US and global trade policies.

Conclusion: the new regional disorder

Clearly, the crisis has unsettled the dominant coalitions in the region, and it has been very difficult to sustain the embedded mercantilism of the boom years. Yet this does not necessarily mean the dismantling of the systems of *nomenklatura* capitalism in Southeast Asia. Indeed, the clear evidence of the post-crisis period suggests that the most arresting feature of post-crisis developments in Southeast Asia has been the diversity of responses to the crisis. While in the pre-crisis boom period a fundamental commonality underpinned both economic strategies and the domestic coalitions, this was no longer the case in post-crisis Southeast Asia. What is most evident is the extent to which some states have embarked on reform, others resisting, and yet others remaining stuck in a kind of stalemate. It is this diversity that will significantly alter the shape and form of multilateralism in Southeast Asia.

The overriding point to emerge from this analysis is the extent to which regional integration is a deeply political process. Regional integration strategies such as open regionalism are not mere technical procedures aimed at enhancing economic liberalism but economic strategies deeply embedded in the configuration of power and interest in the domestic political economy. From this perspective, regional integration needs to be explained in terms of the political projects undertaken by domestic coalitions rather than deriving from the kind of external pressures identified by the 'market model' of regional integration.

Moreover, this 'inside out' model of regional integration is more adequately able to explain the mutation of foreign economic policy. In other words, changes in foreign economic policy or broad shifts from multilateralism to bilateralism need to be located in the context of the operation of broader structural forces. The 'market model' of regional integration assumes that policies of regional integration can be assessed on the basis of some preferred technical efficiency of one course of policy. The analysis here has demonstrated that these policy options are not mere technical choices but are the product of the evolution of a complex regional political economy. In short, regional integration cannot be divorced from wider contests over the distribution of economic power.

In the East Asian context, our analysis suggests that there has been a significant unravelling of the regional political economy. This emerging disorder is manifest in the fact that the post-crisis period is marked by a significant diversity of reform trajectories. In the boom years of growth in the 1990s, there was a remarkable similarity of economic strategies and policies. But it is this very convergence of domestic coalitions around domestic political projects of statist developmentalism that enabled the kind of strategy of open regionalism associated with APEC to remain the dominant regional governance project. From this vantage point, open regionalism was a strategy of internationalization that meshed with the internal configuration of power and interests embedded in Southeast Asia's domestic political economies. The economic crisis has undermined the domestic foundations of open regionalism, ushering in new political projects centred on the emergence of new regulatory states, which have important implications for regional organizations like APEC. As I have suggested in Chapter 1, if globalization leads to the formation of new regulatory states (Jayasuriya 2000, 2001), it is clear that these states will become enmeshed in new forms of regulatory regionalism. It is this new regulatory state and its entry into the fabric of regional governance that will form an emerging regional order in East Asia.

Notes

1 This is a revised version of a paper that was published in *Third World Quarterly* 24 (2), 2003.
2 For a good overview of these theories, see Higgott (1993).
3 Clearly, this does not exhaust all the different modalities of domestic influences on foreign economic policy; indeed, this essay complements and follows on from the work of Beeson and Jayasuriya (1998) on the role of political rationality – if you like, the contribution of the East Asian normative order – in shaping the distinctive configuration of regionalism in East Asia.
4 See Stubbs (1999) on the relationship between war and export-oriented industrialization in East and Southeast Asia, which probes the foundation of this embedded mercantilism.
5 'Rent-seeking' refers to the process through which economic enterprises use political connections to create higher than normal profits.
6 For an introduction to the concept of international regime, see Krasner (1983).

7 Ruggie argues that hegemonic stability theorists (such as Gilpin 1987) focus on the stability of international regimes but are unable to account for the content of these regimes.
8 For an account of these general trends in a more global context, see Brenner (2002).

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3 The rise and fall of open regionalism?

Comparative reflections on regional governance in the Southern Cone of Latin America[1]

Nicola Phillips

If the sceptics and doomsayers are to be believed, the prognosis for Latin American regionalist projects is not encouraging. The limited achievements to date of most subregional blocs, the increasing vitality of bilateralism, the threat from the wider hemispheric integration project in the Americas, enduring political instability in various countries across the region, the impact of global financial volatility and recurrent economic crises are not, at least according to dominant understandings, conditions conducive to the survival and health of regional integration initiatives. The Mercosur[2] is frequently seen as likely either to disintegrate under its own weight or to be swallowed up by whatever sort of free trade area of the Americas (FTAA) might come into being in the next few years; likewise, the Andean, Central American and Caribbean blocs are commonly depicted as being in a state of stagnation and equally likely to lose their rationale should hemispheric free trade be negotiated successfully. Observation of the splintering of the Mercosur, particularly, has meant that much of the early 1990s hubris surrounding 'new' or 'open' regionalism has given way to a scepticism about its viability and future prospects. At least at this level, the parallels with contemporary discussions about APEC and ASEAN, reflected in the present collection of papers, are striking.

What I wish to do here is not only to take issue with the idea that the Mercosur is at death's door but also to suggest that the endless arguments about whether this is true are not the most fruitful way of understanding contemporary regional governance in the Southern Cone. On an empirical level, I argue that rather than being in a process of obsolescence, the Mercosur project is undergoing an important redefinition and that this is producing, with some parallels to the process underway in Asia, a rather different *kind* of regionalism from the 'open regionalism' model that prevailed in the 1990s. On a conceptual level, moreover, I suggest that understanding the nature of this redefinition demands a reorientation of some of the prevalent ways in which the study of regionalism is approached. Most especially, domestic political economy is usually taken as constitutive of regional political economy, and consequently regional political economy is depicted simply as an extension, or magnification, of domestic processes. The result is the reinforcement of a rather narrow focus on formal state-led regionalist projects, which obscures the social processes of regionalisation that surround and overlap with them,[3] and indeed which has been pivotal in producing what I consider to be rather misleading accounts of the imminent demise of the Mercosur. What is needed, I suggest, is an understanding of regional political economy as involving a set of dynamics that reach beyond formal regionalist, state-led processes, through which lens we can understand better the reconfiguration of regional governance in the Southern Cone.

Open regionalism in the Southern Cone

As in Asia, the new regionalism in Latin America has conformed broadly with a model of 'open regionalism' predicated on a perception of the merits of unilateral trade liberalization for increased and more effective participation in the global economy. However, the label 'open regionalism' does not tell us much else about the *sorts* of regionalism that have emerged on the basis of this broad ratio nale. Here, as Kanishka Jayasuriya in his contributions to this book have already argued, a 'regional governance' framework offers significantly more value, particularly to a comparative exercise. Let us remind ourselves quickly of the four central elements he outlines as comprising a regional governance project:

1 a stable set of international economic strategies;
2 a distinctive set of governance structures that enable regional economic governance;
3 a set of normative or ideational constructs that makes possible not only a given set of regional governance structures but also the very definition of the region; and
4 a convergence of domestic coalitions and political economy structures across the region, which would facilitate the coherent construction of regional political projects.

When taken to the Southern Cone, these four components not only offer useful comparisons with Asian regionalism but also constitute a useful starting point for looking at the pressures under which the Mercosur project laboured during the 1990s. The first, as already suggested, offers a direct similarity with the East Asian region in the adoption of an 'open regionalism' model of trade liberalization. Despite some significant sectoral variation, this model filled its brief relatively well, especially in the early years of the Mercosur, as a mechanism for reinforcing domestic trade liberalization as well as spurring a significant growth in intra- and extra-Mercosur trade. Between 1990 and 1995, for example, exports increased by an annual average of 28.4 percent and imports by 27.8 percent. Between 1990 and 1996, Mercosur's share of total regional exports increased from 8.9 to 22.6 percent (INTAL 1997: ii). Nevertheless, one of the most notable features of the Mercosur is that it remains significantly inward-looking, as measured in terms of trade relative to GDP. While the percentages increased consistently through the 1990s, the figures in Table 3.1 still demonstrate that the impact of the 'open regionalism' strategy was not to make the

Table 3.1 **Selected trade openness measures, 1990–99 (%)**

	'90	*'91*	*'92*	*'93*	*'94*	*'95*	*'96*	*'97*	*'98*	*'99*
Imports/GDP										
W. Hemisphere	9.9	9.5	10.2	10.5	11.2	11.7	11.9	12.4	12.5	13.3
NAFTA	10.2	9.8	9.3	9.7	9.9	11.0	11.2	11.3	11.9	11.9
LAC	10.1	8.2	10.2	11.3	10.8	12.0	12.3	12.5	14.9	19.7
LAC excl. Mexico	8.0	7.4	10.2	10.7	10.4	11.0	10.8	11.9	11.7	13.8
Mercosur	4.7	4.2	6.3	6.9	7.5	7.6	7.7	8.7	8.6	9.6
Andean Community	12.5	13.7	16.4	16.9	15.3	15.8	15.2	15.8	15.4	12.8
CARICOM	36.3	40.2	41.3	35.9	40.5	45.3	39.5	45.5	n.a.	n.a.
CACM	24.2	24.6	23.6	26.6	25.8	24.6	27.6	25.4	27.7	33.9
Exports/GDP										
W. Hemisphere	8.5	8.3	8.5	8.5	9.4	10.3	10.5	10.8	10.2	10.6
NAFTA	8.1	8.2	8.3	8.2	9.2	10.3	10.5	10.9	10.3	10.3
LAC	12.3	9.9	11.3	11.2	11.6	13.2	13.8	14.0	13.4	19.7
LAC excl. Mexico	11.3	8.8	10.8	10.5	10.5	10.2	10.4	10.6	9.5	13.3
Mercosur	7.5	5.7	7.8	7.8	7.5	7.1	7.0	7.3	7.3	8.9
Andean Community	23.0	18.9	17.1	16.9	17.1	15.8	18.8	17.2	13.5	15.7
CARICOM	30.5	28.0	27.4	21.9	32.6	32.0	27.9	28.5	16.9	n.a.
CACM	15.9	16.1	15.5	14.7	15.0	16.5	17.7	17.0	19.8	20.9

Source:: IDB Integration and Regional Programs Dept, *Integration and Trade in the Americas*, December 2000.

Notes: LAC: Latin America & the Caribbean , CARICOM: Caribbean Community, CACM: Central American Common Market

region appreciably more 'open' than in its pre-Mercosur days. In Brazil and Argentina especially, the internal market remains considerably more important than the external sector.

The second element of the framework also suggests some similarities between Southern Cone and Asian regionalism in that the governance structures in both have remained largely informal rather than rule-based. The Mercosur, as has often been noted, is wholly intergovernmental rather than supranational and does not rest an extensive legal framework similar to that of the NAFTA. Rather, while a number of treaties and agreements underpin the regional economic strategies of the Mercosur, the latter have been marked by an important degree of *ad hoc* decision making, particularly in the increasingly frequent instances of violations by member countries of core agreements in times of crisis. In part, this highly politicized and unstable set of governance structures is engendered by the customs union model on which the Mercosur project rests and which, in contrast to a 'free trade area' model, requires the development of policy harmonization beyond a commitment to the removal of barriers to market access (Bernier and Roy 1999: 73). Associated governance projects are thus in theory defined largely by the political negotiation of policy harmonization and the construction of the institutions necessary to sustain such an arrangement. In good part also, the intergovernmentalism of the Mercosur reflects an ingrained Brazilian reticence on the matter of institutionalization, as well as the anti-statist thrust of the manner in which neoliberalism was pursued in Argentina under the Menem governments of the 1990s. The point, at any rate, is that the Mercosur project lacks any form of robust institutionalization that might facilitate a more rule-based governance structure.

The third and fourth elements of Jayasuriya's framework – relating to ideational constructs and domestic political economy structures – are the most important for our purposes here and can be taken in conjunction with each other. In contrast with the East Asian region, the definition of the Southern Cone 'region' has not been approached in cultural terms; indeed, one of the notable features of Southern Cone regionalism has been the absence of the sort of underlying regional 'identity' that is found, to a greater or lesser extent, in a number of other regional governance projects in the Americas.[4] The ideational constructs that have underpinned Southern Cone regionalism have been of the sort that do not lend themselves obviously to the task of defining a region: namely, the ideological constructs that derive from the broadest of commitments to democracy and neoliberalism. Moreover, particularly in respect of the neoliberal ideational framework, the divergences between Southern Cone countries have been central to the fragmentation of the incipient project of regional governance and indeed have been inimical to a convergence of domestic political economy structures and domestic coalitions of the sort envisaged in Jayasuriya's fourth point. Notwithstanding important points of diversity within the Asian region, the emergence of a model of 'embedded mercantilism' represented a relatively robust uniformity between domestic political economies. While the same might be said of the Latin American region in the widespread adoption of a roughly Anglo-American neoliberalism, a suggestion of uniformity is highly misleading, particularly so in the context of the Southern Cone, reflecting both historical-institutional specificities and the highly variegated relationships of the national economies with the world economy and globalization processes. A full account of these divergences between domestic political economy structures is beyond the scope of this paper, but the relevant point is that they have been constitutive of sharply contrasting visions of regionalism between the member countries of the Mercosur, to the extent that there has not been a solid underlying ideational or normative foundation for the regional governance project.

One of the principal cleavages relates to the nature of the Brazilian political economy. On the one hand, the relationship of the state with foreign capital has been significantly at variance with that of neighbouring countries in that external financing over the course of the 1990s was more abundantly and readily available to Brazil than to most other Latin American economies. While most countries were obliged to exercise fiscal responsibility in order to attract capital, investment flowed into Brazil irrespective of conditions in which bankrupt state banks continued to issue credit and the central bank remained one of the least independent in the region (Kingstone 1999: 136). Given that the rationale for regionalism rested on the twin pillars of commercial expansion and the attraction of foreign investment funds, the impulsion towards the Mercosur was thus notably less strong for Brazil than it was for its partners. On the other hand, Brazil is distinguished in the subregion by its diversified trade structure and the volume of its extra-regional trade, to the extent that even its commercial interests are much less linked with the regional marketplace than those of neighbouring countries. For these reasons, multilateral trade negotiations have been considerably more concern to Brazil than regional integration, and indeed the reticence of the Brazilian government in the early days of the Mercosur – and more recently to the hemispheric integration project – can be explained in large part by the potential trade-off it represents with multilaterally agreed liberalization provisions in the WTO (de Paiva Abreu 2003). Its engagement with regional integration, in this sense, needs to be understood as motivated by strategic and political goals, most of which relate to the construction of subregional leadership as a means of mediating the hegemony of the United States in the hemispheric and multilateral arenas. Certainly, this strategic vision of the Mercosur became considerably more robust as the hemispheric integration project picked up speed in the late 1990s, along with negotiations for economic cooperation with the European Union (EU), and the Brazilian indifference to regionalism of the mid-1990s has been progressively replaced by an activism oriented towards strengthening the Mercosur as a strategic and political platform (see Phillips 2000: 393–4).

In Argentina and the smaller member countries, as suggested, the much greater dependence on the regional marketplace, together with the more pronounced dependence on and vulnerability to external capital flows, have meant that participation in the Mercosur has been dictated far more by economic necessity than was the case for Brazil. The Argentine vision of regionalism consequently has been expounded by governmental actors as resting on the expansion of the membership of the regional bloc and the widening of the open regionalism project. While sharing the goal of 'deepening' regionalism, Argentine positions have consistently been oriented towards an extension of the Mercosur market, or conversely towards opening extra-regional markets by means, primarily, of inter-bloc negotiations. The Uruguayan and Paraguayan focus has fallen somewhere between the 'deepening' and 'expansion' options, but their principal concern, not surprisingly, has been with the need for institution building to ensure adequate representation of their interests in a process dominated by the interaction of Argentina and Brazil. In addition, the dominance of primary and agricultural exports in the three smaller member countries shapes a different set of structural and negotiating imperatives in the regional project from those of the Brazilian government and sections of the Brazilian business community. In a nutshell, Brazilian interests are tied principally to trade concerns, conforming closely with the 'open regionalism' rationale of using unilateral bloc-driven liberalization to propel reciprocal liberalization in other markets and at other levels. The interests of the Argentine, Uruguayan and Paraguayan governments are dictated by a broader set of developmental imperatives, foremost among which are the attraction of capital and the promotion of industrialization.

The upshot, in sum, is that there has been little convergence of domestic political economy structures in the Mercosur, and certainly no underlying 'model' such as that of embedded mercantilism from which a coherent and stable set of associated international strategies might have arisen. Indeed, the acceleration of political conflict and dispute over the course of the 1990s suggests that, if anything, the underlying divergences between domestic coalitions and political economy structures have become more rather than less pronounced, to the extent that the associated strategies of open regionalism have become less rather than more viable. Certainly, the progress made towards a stable regional governance project during the 1990s was not impressive. By the start of the 2000s, the Mercosur still constituted a very imperfect customs union that had made significant strides in the removal of tariff barriers to trade and the attraction of foreign direct investment (FDI) but precious little progress in basic areas such as the harmonization of customs procedures and in important areas such as trade in services, exchange rate coordination, intellectual property, government procurement, the free movement of workers and institution building (Phillips 2001: 568). For a time in the latter part of the 1990s, the movement by the Brazilian government towards a greater privileging of the Mercosur in its foreign and foreign economic strategies suggested a convergence, at least, on a commitment to the regional governance project, yet given that this commitment was premised on significantly divergent motives and interests, it did little to paper over the evident fissures in the bloc and certainly did not approximate to a convergence of the disparate visions of regionalism. To this extent, in some similarity to the manner in which responses to the financial crisis in Asia pulled apart the domestic commonalities underpinning APEC and the East Asian region, the lack of any such robust commonalities in the Southern Cone region has meant that the regionalist project has remained distinctly shallow and fragile.

Two more conjunctural factors come into play at this point. The first relates to the financial and economic crises that have dominated the landscape of the Southern Cone since the late 1990s, first with the Brazilian devaluation of 1999, and then more profoundly with Argentina's default and devaluation of 2001 and its knock-on effects in Uruguay and Brazil in mid-2002. The effect has been to undermine further the prospects for a convergence of domestic coalitions and also to fracture further the consensus surrounding the Mercosur itself. The Uruguayan government, particularly, appears to have started down a 'Mercosur-sceptic' path, opening a rift with the rather more optimistic Brazilian vision of the future of regionalism. Uruguayan President Batlle was reported to have branded ideas of a common currency for the Mercosur as 'absolutely impossible' (*La Nación*, 27 March 2002), and the government showed little hesitation in 2002 in implementing countermeasures against the impact of the Argentine devaluation. Moreover, the Uruguayan government at the start of 2002 became more strident in its preference for an FTAA over the subregional bloc and, in the interim for bilateral relations with the USA.

The second conjunctural pressure on subregionalism stems from the hemispheric integration project. If existing subregional arrangements are based on the extension of trade preferences to member countries, the construction of an FTAA will necessarily and logically remove the rationale for the smaller trade blocs it encompasses. The upshot, according to this argument, is that the loss of their economic rationale will generate a process by which the structures of tariffs and preferences that define these blocs are gradually or suddenly erased by the provisions of hemispheric free trade. Such is certainly the vision that the USA brings to the negotiating table: especially for business and members of Congress, subregional blocs are perceived to be simply the forerunners and facilitators of the levelling of the hemispheric playing field implied by an FTAA, and this vision of 'hemispheric globalization' thus brings with it the redundancy of subregional blocs (SELA 1999: 36–7). While this latter argument should be challenged (see Phillips 2003), nevertheless an FTAA does necessarily augur a reconfiguration of the nature of subregionalism in order to accommodate the rules agreed at the hemispheric level; consequently, the function of blocs such as the Mercosur becomes open to considerable question. In a situation in which the Mercosur is already beset by myriad internal tensions, including preferences for bilateralism and an ambivalent leadership, the threat to subregionalism from an FTAA has been seen by many to augur its demise. As Paul Cammack (2001: 214, 226) argues, for instance:

> Mercosur … is an ineffective regional association with little remaining capacity to contribute to regional or global integration, and little capacity to promote other goals. … It is likely to be marginalised by profound differences of perspective between its major partners, and overtaken by broader processes such as the move towards a Free Trade Area of the Americas.

However, I suggest that such a vision issues from a particular way of thinking about regionalism, specifically from a focus on the formal, regionalist processes associated with the regional governance project. It would seem that much of the problem emerges from the tendency to view regions as simply 'nations writ large'[5] in the sense that regionalism is portrayed simply as the magnification of domestic economic activity or sets of policy priorities. In other words, such a perspective assumes that the regional arena is a *modus operandi* for domestic modes of capitalist organization. The 'nation writ large' understanding of regionalism may identify ways in which domestic policy strategies might be influenced by the existence of a regional bloc, but it allows limited room for the notion that strategies might be informed, shaped and determined by the processes associated with the regional project. For this, we need an understanding of processes of regionalization parallel to our analysis of formal regionalist processes. In the context of the Southern Cone, these processes of regionalization are significantly stronger than the processes of state-led regionalism, but they serve to buttress the regionalist governance project in ways that cast doubt on its envisaged obsolescence.

The contours of market-led regionalization

Regionalization, like globalization, is not a state-led project but rather represents 'combinations of historical and emergent structures (a complex articulation of established institutions and rules and distinctive new patterns of social interaction between non-state actors' (Gamble and Payne 1996: 250). The relevant processes of regionalization are thus manifold and cannot all be covered in a single article.[6] Our concern here, in the first instance, will be with processes of market-led regionalization, which are grounded specifically in the gradual regionalization of the strategies and structures of firms. This reorganization of capital has propelled the construction of a genuinely regional market, which crystallizes around the Mercosur although it does not correspond exactly with the borders of its membership, and which rests, on the one hand, on the transnationalization strategies of domestic firms and, on the other, on the strategies of foreign investors and corporations aiming to erase the limitations to their activity posed by national boundaries within the Mercosur.

Corporate strategies linked to the Mercosur can be divided into two groups, the first relating to purely commercial strategies, found particularly in the capital goods sector, the second to more direct productive strategies. The latter strategies have been most characteristic of transnational corporations (TNCs) with operations in Argentina and Brazil, while complementation between local firms in these two countries has been concentrated in production activities linked with consumer and intermediate goods (López and Porta 1995: 255–6). In many respects, it is the market strategies of TNCs that have been most pivotal in carving out regionally defined modes of business organization in the wider Mercosur arena, and in turn the investment strategies of these corporations have largely been shaped by the existence of a subregional bloc. While foreign investment in Mexico, Central America and the Caribbean during the 1990s was directed predominantly towards generating international competitiveness (particularly in firms and sectors exporting to the USA), across the Southern Cone the target of capital inflows was consistently local and subregional markets constructed – and comparatively protected – by regional integration projects (ECLAC 2001: 55). In this sense, the focus of transnational capital in the Southern Cone has been the possibilities afforded by investment in local markets to make inroads into the Mercosur itself, along with the advantages offered by the subregional economy of scale. In some cases, in addition, TNCs have sought to take advantage of the special provisions afforded to certain sectors – most notably the automotive sector – in the Treaty of Asunción, which founded the Mercosur in 1991.

The strategies of foreign-owned TNCs, as a result, have moved consistently away from a national focus to a regional one. Recent survey data gathered by Oliveira Holzhacker and Guilhon Albuquerque (2002), for instance, suggests that about 85 per cent of EU TNCs (and 63 per cent of the largest Brazilian firms) have elaborated strategies aimed at the Mercosur market. The clearest dimension of this shift is reflected in the rationalization of operations in the Southern Cone, in terms both of activity and of management structures. The aim and result of rationalization have been that the subsidiaries of TNCs in various parts of the region have become significantly more specialized and production activities have been progressively defined in regional rather than national terms. Examples include firms such as Nestlé, Unilever, General Motors, Coca Cola and Procter and Gamble (ECLAC 2001: 96). Similar processes are visible in the restructuring of the pharmaceuticals industry, for instance, and especially in the automobile sector. Along with such rationalization strategies, investment strategies over the 1990s also became more conditioned by the notion of regional expansion, and in national markets they thus became styled as stepping stones to the rest of the Southern Cone and indeed Latin America. The example of services markets in Chile stands out in this regard (ECLAC 2001: 100). Conversely, the appeal of a Mercosur market has bolstered the appeal to TNCs of maintaining a presence in various national economies. This is most especially the case for Argentina, and here especially in the automobile, capital goods and household appliances sectors (López and Porta 1995: 258).

Likewise, the transnationalization strategies of Souther n Cone firms have focused preponderantly on the regional marketplace and have only exceptionally been genuinely ‘global’ in character. These regionalization strategies are particularly pronounced in Argentina, where Mercosur countries (including Chile and Bolivia) constitute the primary destination for firms’ FDI strategies. Take the example of the firm SOCMA.[7] While its activities are still concentrated in Argentina, its presence in Brazil (where it is probably the strongest of Argentinian firms) has steadily and significantly increased since about 1994 and its organizational and management structures are gradually being reconfigured to take account of this ‘bi-national’ profile.[8] Its operations in Uruguay have similarly gained in prominence in a number of sectors,[9] but crucially the automotive sector has been dominant in both SOCMA’s own regional expansion and in the broader processes of corporate regionalization that have crystallized in the Mercosur area since the mid-1990s. The importance of other Latin American markets should not be overlooked, but here there is a clear distinction between Argentine firms’ commercial strategies, on the one hand, and investment strategies involving the physical establishment of industrial operations on the other.

Destinations for the former are more regionally diverse than for the latter, for which Southern Cone economies are overwhelmingly preponderant. Companies such as Bagó, IMPSAT and the oil company YPF have industrial operations in North America (mainly in Mexico), and indeed the latter two might qualify as operational on a global stage, but an altogether much greater number (including Arcor, IMPSA, Pérez Companc, Sancor and SOCMA) have an almost exclusively 'South American' profile in terms of physical operations, in which Mercosur countries are again overwhelmingly preponderant (see Chudnovsky *et al.* 1999: 123–4).

While in Argentina the focus has fallen emphatically on Mercosur markets, the strategies of Chilean firms have been dominated rather more by the wider Latin American market, even though within this more diversified structure Southern Cone economies still stand out. The Latin American market has been especially pivotal in the turn towards non-natural resource-based exports, encompassing both manufactured products and non-financial services (*ibid.*: 266), and the Mercosur market has been particularly important given the lack of competitiveness of such export products in both wider regional and global arenas. Moreover, with regard to Chilean investment, Southern Cone economies overshadow destinations in both Latin America and in the rest of the world. Argentina constitutes the most important destination, accounting in 1997 for 43.6 percent of total Chilean investment, followed by Peru and then Brazil, the latter accounting for 10.8 per cent in the same year (*ibid.*: 281).

Such strategies have been less common in Brazil, where TNCs remain more dominant and the majority of domestic firms have been absorbed by transnational interests (*ibid.*: 9). It is notable that the activities of a good number of these TNCs in Brazil are oriented towards the domestic market rather than towards external trade. One side-effect of this comparatively low level of internationalization is that the onslaught of competitive pressure for Argentine, Uruguayan and Paraguayan firms was considerably greater than for Brazilian firms (as demonstrated by Oliveira Holzhacker and Guilhon Albuquerque's 2002 data), given both the relatively protected nature of the Brazilian market and the fact that Brazilian industrial products were already competitive in Southern Cone markets. As we have seen, it is also the case that the attraction to Brazil of Mercosur economies as trading partners is significantly less than vice versa. Nevertheless, leaving aside questions of volume, over the course of the 1990s the Mercosur market was the most dynamic destination for Brazilian exports, growing at an annual average rate of 26.9 per cent against an annual average growth rate of only 6.3 per cent for total exports. Exports to Mercosur countries were also concentrated in manufactured goods, which accounted for about 70 per cent of exports to Mercosur countries in 1998. Southern Cone economies are also important as sources of imports, among which Argentine agricultural products stand out, along with cars, footwear and food products (see da Motta Veiga 1999: 315, 325). Furthermore, Brazilian foreign investment in services is concentrated overwhelmingly in Mercosur markets, and conversely Brazilian investment in Mercosur economies is dominated by investment in the services sector, accounting for two-thirds of total Brazilian investment in Uruguay and almost 100 per cent of the total directed from Brazil to Paraguay. Argentina is the predominant destination for Brazilian investment in financial services (Page 2001: 56). Crucially, taking us back to earlier points in this section, this expansion of both commercial and investment engagement with the Mercosur arena has been notable for the growth of participation in it by TNCs, which increased by an annual average of 56 per cent over the period 1990–97 (da Motta Veiga 1999: 329).

For their part, the attitude of small- and medium-sized enterprises (PYMEs in Spanish) across the region to the Mercosur has, inevitably, been mixed. On the one hand, the threat from imported goods has produced a caution and in some cases a hostility towards the liberalization of regional trade and the construction of a regional marketplace. This has been particularly the case where mechanisms of compensation or active state promotion strategies are lacking, and also in situations in which the liberalization of regional trade entails the likely or actual retraction of state promotion mechanisms. Antipathy to the Mercosur during the 1990s was found predominantly in those national firms that were not regionally competitive in their particular sector, and this wariness found special expression, not surprisingly, in those firms and sectors faced with significant competition from their Brazilian counterparts. For many – perhaps most – PYMEs, the extraction of meaningful value from the Mercosur was thus at best difficult. On the other hand, many PYMEs in the 1990s saw the Mercosur as offering important opportunities for the expansion of their commercial activity and, consequently, their competitiveness. Given that participation in the wider global economy was not a feasible option for the vast majority of PYMEs, the Mercosur was thus both a logical strategic focus and a springboard for the future development of more active internationalization strategies. Francisco Gatto's (1995) surveys of Argentine PYMEs in the mid-1990s, for example, revealed that over half were committed to precisely such an expansion of their exchange with Mercosur countries, above all with Brazil, although proactive strategies of this sort remained in rather short supply. Moreover, he also detected a generalized perception of the potential benefits to be derived from cooperation between PYMEs in the region, particularly in the interests of enhancing production specialization. However, such perceptions notwithstanding, it should be emphasized that corporate strategies aimed at the Mercosur market remain predominantly the preserve of larger regional and transnational firms, and similarly the process of market integration, while still in its early stages, remains driven by big business, often to the exclusion of smaller firms.

We should take care not to exaggerate the extent of inter-firm cooperation, whether we are talking about PYMEs, domestic firms or TNCs. Certainly, the sorts of regional production network that had emerged by the end of the 1990s in the NAFTA were not mirrored in corporate development in the Mercosur (UNCTAD, cited in Klein 2000: 141). The point is two-fold: first, the attraction of FDI is vital for the emerging internationalization strategies of local firms, and the regional market constitutes a central incentive to inflows of FDI; and second, evidence suggests that the Mercosur arena is utilized increasingly as a stepping stone to more global production strategies and styled as an 'incubator' of industrial competitiveness for this purpose. With the launching of the FTAA project, this notion of the comparatively protected regional market as an 'incubator' has become particularly important. This is so primarily because of the lack of competitiveness of the bulk of Southern Cone products in both global and wider hemispheric marketplaces. Particularly in an FTAA in which minimal liberalization is envisaged in agricultural trade and other key sectors, the lack of industrial competitiveness brings with it very considerable adjustment costs for almost all economies. In Brazil, the emerging form of hemispheric free trade is seen by some (particularly smaller and domestic-oriented) business sectors and the state to represent a sizeable threat. In Argentina as well, the emphasis has fallen on the costs of adjustment implied by hemispheric free trade for domestic and subregional economic interests. A survey by the Unión Industrial Argentina (UIA, Argentine Industrial Union) in 1998, for instance, suggested that 70 per cent of Argentinian firms did not feel prepared for an FTAA, and one assumes that the impact of the current crisis will have increased that proportion. It goes without saying that the subregional market remains crucial for the smaller economies. Towards the end of the 1990s, the emphasis thus fell on the subregional arena (protected putatively by a common external tariff) as a site for the adjustment necessitated by a wider regionalist project.

States and the reconfiguration of the regionalist project

The result of these processes of market-led regionalization – in conjunction with the various other social processes of regionalization at work – has been not only the emergence of a new form of regional political economy in the Southern Cone but also the reconfiguration of the regionalist governance project. Its significance thus lies, both empirically and conceptually, in the relationship it signifies between the regionalist project and broader regionalizing processes: in other words, between the increasingly beleaguered and ponderous formal intergovernmental dimensions of the Mercosur, on the one hand, and the processes of market regionalization, on the other. Rather than advancing in tandem with the regionalist project, these regionalizing trends have developed a marked momentum. The construction of a 'region', in this sense, is proceeding on a number of fronts, of which the formal intergovernmental front became perhaps the least robust over the course of the 1990s. It is in good part for this reason that the Mercosur project retains its rationale and utility, despite the profuse political obstacles to its further consolidation and indeed the challenges issuing from an eventual FTAA. Crucially also, the regionalist dimensions of the regional governance project are increasingly oriented towards underpinning these processes of market-led regionalization, as a result of which they feature an important shift away from a dominant preoccupation with 'open regionalism' as a strategy of trade liberalization towards a set of regionalist strategies more attuned to the attraction of investment flows and industrial strategies oriented towards fostering the competitiveness of indigenous firms on. Recent efforts to so redefine the Mercosur – such as in its relaunching in 2000 and the flurry of talks in the early months of the Argentine crisis – can thus be seen as pointing towards the consolidation of an environment conducive to the entrenchment of the rules that undergird this form of regional governance structure.

However, the reconfiguration of the regionalist project has at its root a reorganization of the dominant form of state, given that regionalism is intrinsically a state-led project. In this regard, our argument above has a good deal in common with recent currents in the broad study of states and state strategies, in which the 'regulatory state' model has become one of the most favoured frameworks. This model has been applied most frequently to European states (McGowan and Wallace 1996; Wilks 1996) and the UK (Burnham 1999), increasingly to a number of Asian states (Jayasuriya 2001), and further to the Chilean case (Muñoz Gomá 1996). In its broadest sense, it refers to a process by which economic management becomes 'depoliticized' or 'proceduralized': it is characterized by an increasingly rule-based and technocratic approach to economic governance in which there is a greater emphasis on the operational independence of key institutions such as central banks. The functions of such a state are seen to be two-fold: first, to underpin markets; and, second, to address market failures through the provision of various rights and goods (McGowan and Wallace 1996: 562). As such, the notion of the regulatory state has been developed in order to understand a situation characterized not by complete deregulation but rather by key areas of re-regulation, particularly of financial markets (Burnham 1999: 46; Gamble 2000: 114). The regulatory state in this sense is fundamentally an enabling - rather than a planning or interventionist-one.

At first glance, the regulatory state model seems problematic as a descriptor of the changing nature of states in the Southern Cone region. The implementation of neoliberal strategies both preceded and outstripped the development of regulatory regimes and capacities, reflecting enduring and pervasive institutional weakness. Privatization took place without previous preparation of the state to assume the role of regulator of competition, and, except in Chile, central banks have not been accorded significant independence. The institutional realignments and operational independence associated with the depoliticization of policy management and moves towards regulatory governance elsewhere thus find minimal expression in the Southern Cone. Nevertheless, the model is useful in identifying a particular mode of economic governance, notwithstanding the lag in the emergence of the appropriate state structures at the domestic level. Emerging elements of a depoliticized or regulatory style of economic management are especially visible in the elements of the model that emphasize external mechanisms of policy validation and the acceptance of binding rules for limiting government room for manoeuvre (see Burnham 1999: 49). In the Southern Cone cases, such mechanisms most obviously include agreements with multilateral and financial institutions. While these are important to establishing credibility as well as necessary financing, it should be noted that these mechanisms of external validation are still perceived more as signs of weakness than as signs of economic health or as manifestations of an overall 'depoliticization' of economic governance, and that their record of effectiveness has been a rather unhappy one. Mechanisms of external validation that have found rather firmer ground relate to the implantation of a rule-based policy-making environment. So-called codes of fiscal responsibility were agreed in Argentina and Brazil in the late 1990s; the regulatory characteristics of the Chilean state, which in any case approximates the model most closely, to similarly rest on the principle of fiscal responsibility, along with a structure of financial regulation. Apart from being politically charged, especially in times of crisis, the implementation of such laws of fiscal responsibility is complicated by the aforementioned levels of institutional weakness, but nevertheless the drift at the domestic level has been towards the elaboration of such mechanisms of such mechanisms, which aim to lay the foundations of a rule-based model of economic governance.

Moreover, a central avenue by which such institutional and political obstacles are progressively addressed relates to strategies of regional coordination. On the one hand, such strategies are designed to reinforce rule-based economic governance by removing discretionary policy-making authority from individual national governments and to compensate the institutional weaknesses at the domestic level which hamper the development of states' regulatory capacities. Of course, regional-level coordination is in itself a 'mechanism of external validation' and is a key feature of regulatory styles of economic management. On the other hand, the process of market regionalization of the sort we have described – resting heavily on the appeal of a regional economy of scale to TNCs and transnationalizing domestic firms – requires both the maintenance of the rules governing such an arrangement between constituent countries and the further harmonization of domestic policies in order to increase the stability and attractiveness of this marketplace for private sector activity. The bulk of relevant regional initiatives in the late 1990s and early 2000s were tied up with the nascent process of policy harmonization, a first step towards which was statistical harmonization in order to increase the accountability and transparency integral to conceptions of regulatory styles of economic governance, and then progress towards the negotiation and agreement of common fiscal targets among Mercosur member countries. The issues of taxation and other economic policies that are necessary accompaniments to fiscal reform are also part and parcel of the emerging process of macro-economic convergence. Most importantly, the negotiation of common investment rules and competition policy has been identified as central to the process of deepening and redefining integration in the Mercosur, and these are pivotal in constituting the emerging regional governance structure. Early movements in the area of competition policy turned out to be largely illusory – the 1996 Protocol for the Defence of Competition is still awaiting congressional approval to make it legally enforceable – but there has been a handful of subsequent initiatives that indicate some (slow) progress towards the agreement of some regional norms. Examples include the establishment in 2000 of a working group on investment incentives and Argentina's 1999 Defence of Competition Law, which aligned the country's competition policy more closely with Brazil's and is likely to facilitate the advance of harmonization (Chudnovsky and López 2003: 151). The consequence is that a movement towards a rule-based style of economic governance is reinforced by the imperative of maintaining for investors the coherence of the regional market and transparency in the policy rules that govern it.

However, the key point in all of this relates not only to the ways in which regional coordination facilitates the elaboration of various state strategies, or to the ways in which the reorganization of the state propels and underpins the reconfiguration of the regionalist project, but also to the ways in which the shape of domestic political economy is moulded by processes of regionalization. As suggested earlier, this dimension of the relationship between domestic and regional processes is neglected as a consequence of the 'nation writ large' framework that pervades much of the study of regionalism. In other words, alongside our understanding of the ways in which regionalist projects emerge from and reinforce domestic processes, we need an understanding of the impact of regionalizing forces on the shape of domestic political economies and processes of change within them. Our attention here to the reorganization of the dominant form of state in the Southern Cone, propelled by processes of market-led regionalization and manifested in the form of the regionalist project, thus suggests the need to dispense with the 'nation writ large' assumption and to seek, instead, to understand a much more complex relationship between regional and domestic political economy. It also underlines our earlier argument that a focus merely on formal regionalist processes is inadequate to understanding the regional governance project underpinning the Mercosur, or indeed its viability.

Conclusions

As in Asia, the original project of open regionalism in the Southern Cone appears effectively to have petered out. This is not, like in Asia, the immediate consequence of financial crisis; rather, it reflects a more protracted process of internal fragmentation that has stunted the evolution of the regionalist project beyond its early successes in the area of trade liberalization, and issues predominantly from the entrenched divergence of domestic political economy structures – and consequently what we have called 'visions of regionalism' – among member countries. Although for different reasons, then regionalism in both Asia and the Southern Cone is in a state of flux, and I have argued that a 'new' regional governance project is crystallizing in the latter that represents quite a significant departure from the regionalism of the early 1990s. Pulling together the strands of the above arguments, I suggest that the 'new' regional governance project in the Southern Cone has three essential characteristics:

1 the constitution of the region primarily through market-led and other regionalization processes, which lend rationale and impetus to the maintenance of the regionalist project of the Mercosur;
2 the reorganization of the regionalist project to privilege investment attraction and industrial competitiveness and construct a rule-based governance foundation for the emerging regional marketplace; and
3 the dominance of strategic and political objectives in visions of the Mercosur project, reflected particularly in the articulation of Brazil's subregional leadership role.

This reorganization of the regionalist project has taken place against the backdrop of an increasingly complex wider regional context, of which the negotiations for an eventual FTAA are the most salient dimension. The hemispheric project augurs a more messy and overlapping pattern of regionalist arrangements that in many ways resembles patterns in the Asian region and not, as the 'hemispheric globalization' rhetoric suggests, an absorption of the existing patchwork of regionalist projects into a single FTAA. Accommodation between these contending projects is consequently the primary challenge for regionalism and indeed the contours of the Southern Cone project that have been sketched above reflect this context. There is a sense in which an FTAA represents an alternative regionalist project that will compensate for the numerous deficiencies of the Mercosur. Certainly, a good number of the most obvious sticking points, such as services and investment, will be negotiated at the hemispheric level. This might well be used as part of an argument that the Mercosur will lose its validity as much of the policy framework becomes standardized outside its borders. Yet it is important to recognize that the Mercosur and FTAA processes are completely separate from one another and treated as such within the Mercosur. The central aims are similar – namely, to eliminate export subsidies and to restrict the use of measures such as anti-dumping in trade relationships – but it is precisely these issues that might best be treated in the Mercosur, especially given the reluctance of the USA to open them for negotiation at the hemispheric level or in the WTO. Furthermore, there is no necessary correspondence between internal Mercosur policy and negotiating positions in an FTAA, and the activities of the national working groups and institutions that are involved in FTAA negotiations are aimed exclusively in this direction. Consequently, in areas such as industrial policy, treatment of smaller and poorer economies, anti-dumping and restrictive trade practices, perhaps social policy, and perhaps even dispute resolution, the Mercosur presents an arena in which regionally appropriate policies (or those that fill the gaps left at the hemispheric level) might be designed. The contours of the new regional governance project, in this sense, are both compatible with, and shaped by, its emerging relationship with the wider regionalist process in the Americas.

In conceptual terms, I have argued that an understanding of contemporary regional governance in the Southern Cone, and indeed elsewhere, requires much closer attention to processes of regionalization and their relationship with the formal regionalist project. Regionalization cannot be understood in the absence of a conception of regionalism: on the one hand, the latter seeks to accelerate, modify or perhaps reverse these processes of social change and, on the other, it is pivotal in the continual reproduction of these structures (Gamble and Payne 1996: 250). What regionalism means, in essence, is that strategies of national economic management and the processes by which accumulation occurs (as well as the type of accumulation that is privileged) can be expected to undergo a redefinition. This redefinition involves a reconfiguration of social relations occurring over a regional, rather than a peculiarly domestic, terrain and the emergence of common forms of market organization and economic strategy. However, regionalization also needs to be conceptualized as constitutive of regionalism, and indeed the case of the Southern Cone suggests that, increasingly, it is the emerging dynamics and architecture of regionalization that have lent a rationale to the ailing regionalist project and have shaped the domestic and international strategies it represents. While the dynamism of regionalization thus clearly depends on the articulation of a viable regionalist project that underpins the associated processes; progressively, the regionalist Mercosur project progressively derives its primary meaning and impetus from these non-state and market-driven dynamics.

Notes

1 This is a revised version of a paper that was published in *Third World Quarterly* 24 (2), 2003.

2 *Mercado Común del Sur*, or Southern Common Market, comprising Argentina, Brazil, Paraguay and Uruguay, with Chile and Bolivia currently as associate members.

3 I draw here on Anthony Payne and Andrew Gamble's (1996: 2) definitions of regionalism and regionalization, the former referring to 'a state-led or states-led project designed to reorganise a particular regional space along defined economic and political lines' and the latter to 'a social process manifest at the regional level'. Following their lead, I use the adjective 'regionalist' specifically to refer to regionalism and the adjective 'regional' to denote the much broader context of both region and the conjunction of processes associated with regionalism and regionalization.

4 It is interesting, in this regard, that one of the principal pillars of the Brazil-driven push towards closer integration in the region was the creation of a South American – as opposed to Latin American or indeed hemispheric – identity, which would facilitate the construction of a South American Free Trade Area (SAFTA).

5 This phrase is borrowed from Hugo Radice (2000: 8), who uses it in the different context of the treatment of regions in the globalization literature, referring to the tendency to treat a region as a nation in order to assert that globalization can be condensed into a notion of regionalization, and thereby to question the existence of the former.

6 These myriad processes of regionalization, and their constitution of a new regional political economy, are elaborated in my forthcoming *The Southern Cone Model: The Political Economy of Regional Capitalist Development.*, London: Routledge, 2004. The material in this section draws on this source.

7 Sociedad Macri. SOCMA classifies its activities principally in the fields of public services and infrastructure, automobiles, construction, food and information technology. See http://www.socma.com.ar for a profile of its interests, assets and activities.

8 'SOCMA: taking Mercosur seriously', *Argentina Monthly*, August 1999, http://www.invertir.com
9 See interview with Francisco Macri (president of SOCMA) for the Uruguayan radio station Radio El Espectador, 6 October 1999, from http://www.espectador.com/text/especial/macri.htm

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Part II

The domestic sources of regional governance

4 The new bilateralism in the Asia-Pacific[1]

John Ravenhill

> Regionalism in Asia (by itself or with the Pacific nations) would certainly be an important event but has yet to happen. Nor is it likely to happen soon … discrimin atory integration has not caught on there and is unlikely to do so.
>
> (Baldwin 1997: 867, 884)

For most of the last half century, western Pacific countries largely eschewed preferential trade agreements (PTAs).[2] As countries that had been the principal victims of discriminatory regional arrangements elsewhere, most notably in Europe, and whose economies had unusually diversified export markets, their preferred form of trade liberalization was unilateral action on a nondiscriminatory basis, an approach adopted by the region's most comprehensive grouping, APEC, as its original *modus operandi*.[3] At the end of 2001, only China, Hong Kong, Japan, Korea, Mongolia and Taiwan among the WTO's 144 member economies were not parties to discriminatory trade agreements. By this date, however, all the East Asian countries were included in one or more proposals for bilateral or multilateral PTAs. In the previous three years, more than twenty such schemes involving western Pacific countries had been put forward.[4] Contrary to Baldwin's prediction at the head of this article, western Pacific countries appeared poised to jump on the bandwagon of discriminatory trading. Why have these countries apparently changed their approach to trade liberalization? What are the likely effects of the proposed agreements? These are the principal questions that this chapter seeks to address.

The move to bilateralism

The pursuit of discriminatory trading agreements is arguably the most dramatic development in intergovernmental relations in the western Pacific since the financial crises of 1997–98. Three sets of reasons explain the new interest in bilateralism: an increasing awareness of the weakness of existing regional institutions and initiatives; perceptions of positive demonstration effects from regional agreements in other parts of the world; and changing economic interests.

The weakness of existing regional arrangements and slow progress in the WTO

The financial crises exposed the weaknesses of the major existing regional arrangements, APEC and ASEAN (Ravenhill 2002, Webber 2001). But why did governments not attempt to strengthen these existing institutions rather than adopt an approach to trade liberalization that had previously been disparaged?

APEC's weaknesses stemmed from ongoing fundamental disagreements among members over both its principal objective (trade liberalization versus trade facilitation/economic cooperation) and its *modus operandi* (unilateral non-discriminatory liberalization versus negotiated preferential liberalization). For some governments, especially its Western industrialized economies (and to some extent Singapore and Hong Kong), APEC had achieved too little and was moving too slowly towards realizing its goal of free trade. For others, APEC was attempting too much, too quickly. In particular, its efforts to expedite the process of liberalization by negotiating sectoral agreements, and thereby to move beyond the agreements reached as part of the Uruguay Round of the GATT had alienated some of its previously strongest supporters in East Asia, notably Japan and Korea, by posing a threat to sensitive domestic sectors. While APEC could hardly be blamed for the financial crises, its failure to go beyond endorsing the Manila Framework and IMF programmes for the region was seen by even its most enthusiastic supporters as a lost opportunity (Garnaut 2000). None of its key members were satisfied with APEC's performance or saw much prospect for significant improvement in the short to medium term. Consequently, they were unwilling to invest political or bureaucratic resources in attempting to revitalize the institution. That the most significant contribution that APEC has made in recent years to trade liberalization has been to serve as a venue for members to announce bilateral preferential deals contains more than a little irony.[5]

In contrast to APEC's stagnation, member states did respond to the perceived ineffectiveness of ASEAN by attempting to strengthen the institution. They brought forward the deadline for the implementation of the ASEAN Free Trade Area, issued new comprehensive blueprints for the institution's future (the 1997 'ASEAN Vision 2020' and, more significantly, the 1998 Hanoi 'Plan of Action') and attempted to increase its attractiveness to potential foreign investors.[6] However, the crisis coincided with the extension of ASEAN's membership, which eventually realized the founders' dream of an organization that encompassed all the states of Southeast Asia. Such widening, especially given the low levels of development of the three new members, Cambodia, Laos and Myanmar, inevitably came at the expense of deepening the institution in the sense of promoting closer economic integration. ASEAN chose once again to give priority to the political over the economic. Meanwhile, the recalcitrance of some member states on implementing their tariff-cutting obligations under AFTA further stimulated the interest of pro-liberalization governments (most notably Singapore but also Thailand) in reaching trade agreements with partners outside ASEAN, an interest already kindled by the relatively low share of their trade that was conducted within ASEAN.

Some observers have suggested that the new bilateralism was also encouraged by the failure of the Seattle ministerial meeting of the WTO and consequent pessimism about the prospects for a new round of multilateral trade liberalization. However, the timing lends little support to such arguments. The Seattle meeting was held at the beginning of December 1999. By then, numerous proposals for bilateral agreements, including those between Japan and Korea, Japan and Mexico, Japan and Singapore, Korea and Chile and Singapore and New Zealand, had already been made and, in some instances, negotiations had begun. Several states continued their bilateral talks at the Auckland meeting of APEC in September 1999. The trend towards bilateralism was well under way before the 'fiasco' in Seattle.

The strongest case that can be made for the argument that a breakdown in multilateral trade negotiations (MTN) prompted the new bilateralism in the western Pacific is that some governments were anticipating that the next round of WTO negotiations would not soon produce positive results. APEC was clearly divided over some of the key issues on the WTO agenda, including liberalization of agricultural trade and the linking of environmental and labour standards and human rights issues to international rules on trade. Old issues, such as agriculture, as well as new issues such as labour standards, tended to unite most East Asian governments against their American and European counterparts. And the more complex nature of contemporary trade negotiations was seen as dealing less developed countries a stronger negotiating hand than they had enjoyed in the past. Moreover, the tariffs of industrialized countries were now so low that they had little to offer by way of reciprocity for concessions on new areas of trade demanded of the less developed.[7] Such concerns may have contributed to perceptions that minilateral agreements would be easier to negotiate than a new global trade deal.

One other failed regional initiative was important in changing the attitude towards bilateralism of one of the GATT purists: the rejection at a ministerial meeting in October 2000 by the Indonesian and Malaysian governments of a proposed link between AFTA and the Australia–New Zealand CER. This link had been the Australian government's preferred means of pursuing closer economic integration with Southeast Asia. The failure of the talks convinced Australian officials that a multilateral agreement with ASEAN would not be possible in the foreseeable future and opened the way for bilateral negotiations to begin with Singapore and Thailand (the two ASEAN governments most dismayed by the failure of the proposed link).[8]

Demonstration effects

The interest of governments in negotiating bilateral agreements was also stimulated by the perceived success of arrangements elsewhere (and by perceptions that the worst fears of GATT purists regarding the potentially deleterious effects of discriminatory arrangements on the global trading system had not been realized).

Japan's Ministry of Economy, Trade and Industry has provided the most comprehensive official assessment of the benefits of regionalism in other parts of the global economy. Drawing on economic modelling, the ministry concluded that regionalism had brought a number of positive effects to participating countries, while any welfare loss caused to the rest of the world was minor. Preferential trade agreements had led to increased trade among their members, a positive competition impact on domestic economies and faster economic growth; these effects had often been accompanied by a spurt in direct investment flows. Preferential trade arrangements had also sometimes led to widening participation and to deeper integration, the most obvious example being the EU, but such positive effects, the study noted, also applied to Mercosur and NAFTA. Moreover, the regional groupings had enhanced the role that their members were able to play in global trade negotiations, and the increasing share of intra-regional trade and investment in the total flows of East Asian economies reduced any likely negative welfare effects from trade diversion should preferential agreements be negotiated in the region.[9]

For governments previously reluctant to jump on the PTA bandwagon, the experience of other regionalisms in the 1990s had provided some reassurance. Contrary to the alarmist scenarios popular at the beginning of the decade, the global economy had not fractured into warring trading blocs. Fortress Europe had not materialized. Overall, the trend towards liberalization of trade throughout the global economy had been maintained.[10] The 'defection' of the USA from multilateralism through its free trade agreements with Israel and Canada and then through NAFTA made it unlikely that Washington could mount any credible opposition to East Asian countries that sought to negotiate similar preferential arrangements. Pro-liberalization forces saw bilateral agreements as a means of sustaining the momentum towards freer trade and as foundations on which global agreements might subsequently be built. They could act as a stepping stone by gradually exposing protected sectors to international competition. And once the PTA bandwagon gathered pace, as it did in the 1990s, it created a dynamic of its own: governments jumped on board from concerns that they might miss out on something that could be advantageous to their competitors. WTO purists had the consolation that they were merely following the lead of others rather than themselves initiating a trend of defection from multilateralism. Moreover, once the bandwagon was rolling, potential partners whose advances had been rejected might interpret abstention on 'theological' grounds by WTO purists as an unfriendly act (Access Economics 2001: 45).

Critics of the new bilateralism suggested other, more cynical, reasons why governments might rush to get on the preferential trade bandwagon. Bhagwati *et al.* (1998) proposed a 'CNN theory' of preferential agreements, their argument being that whereas all the attention in global trade talks is focused on the major players, bilateral agreements afford leaders of smaller states their fifteen minutes of fame. And they reiterated the argument that others had previously developed (Hughes 1991), which pointed to the interests that bureaucrats might have in enhancing their careers through participating in meetings of regional trade forums.

Changing configurations of domestic interests

So far, this discussion has followed the convention of much of the literature on international relations in general and on regionalism in particular in referring to states as if they are unitary actors. Until recently, such an approach appeared reasonable in studying Asia-Pacific regionalism. As in other parts of the world, the origins of regional cooperation often lay primarily in the security concerns of states rather than in the economic interests of private sector actors. Moreover, states frequently appeared to be little constrained by domestic interests in their pursuit of regional agreements. Indeed, governments have often found it difficult to generate private sector involvement in the regional arrangements they negotiated.[11] The supply of regionalism often exceeded the demand for it.

Yet much of the best work on the political economy of Southeast Asia in the last decade highlighted the increased importance of business interests in policy making and focused on divisions within domestic business communities on key foreign economic policy issues such as levels of protection (Robison 1986; Doner 1991; Doner and Ramsay 1993; Hewison 1989; MacIntyre 1991). Not only were business communities divided on many issues pertinent to regionalism but so too were bureaucracies. The focus of some of the literature on the financial crises on the resentment of Asian governments at Western responses in general and IMF conditionality in particular frequently obscured the welcome that some agencies of governments in crisis economies gave to this external intervention, which was seen as a significant boost for their pro-liberalization agendas. In many countries in East Asia, the struggle between pro-liberalization and anti-liberalization forces within the state continues.

The increased interest of business groups in preferential trade agreements was stimulated by the growth of such arrangements elsewhere and the start of schedules for their implementation.[12] Domestic business interests found themselves disadvantaged in markets where their competitors enjoyed preferential access. The clearest example of new expressions of business interest in the negotiation of PTAs again comes from Japan, where Keidanren, the Federation of Economic Organizations, became increasingly outspoken in support of such agreements in the late 1990s (Keidanren 1999, 2000). It particularly voiced concern over access to the Mexican market, where US businesses enjoyed preferential treatment through NAFTA, as did EU businesses through the EU–Mexico Free Trade Agreement, whereas Japanese exporters faced average tariffs in excess of 16 per cent. Moreover, tariff concessions enjoyed by some Japanese companies had been diminished by modifications to the Maquiladora system that were demanded by the USA when the NAFTA was negotiated. Japanese companies in Mexico were also disadvantaged in that they faced high import duties on components imported from subsidiaries in Southeast Asia. In a similar vein, Korean auto and tyre exporters complained that they were having difficulties competing in the Chilean market because of its free trade agreements with Mexico and Canada.

The overall value of trade affected in all cases may have been relatively small, but it was concentrated in particular sectors and was of sufficient consequence to those affected to prompt political action in support of government negotiation of a preferential trade agreement.[13] And elements of panic appear to have affected some business communities, leading to expressions of concern disproportionate to any likely negative repercussions of exclusion from regional arrangements.

Uneven participation: identity and interests

The large number of PTAs proposed by western Pacific countries in the last four years is spread very unevenly across the region. The distribution across states provides clues as to which factors have been important in determining the interest of governments in these arrangements. The partners chosen for these arrangements cast doubt on arguments that emphasize the importance of a new sense of collective identity in explaining the development of post-crisis regionalism in East Asia, for as many agreements have been proposed with states outside East Asia as with East Asian (excluding Oceania) partners. The one instance in which identity issues arguably were important was Malaysia's abstention until the end of 2002 from the new bilateralism, Prime Minister Mahathir's views that such ventures will inevitably weaken ASEAN being well known. But even here the bandwagon has rolled on, affected perhaps by ASEAN's participation in the negotiation of a PTA with China: Malaysia in late 2002 expressed a desire to negotiate a preferential agreement with Japan.

As Table 4.1 illustrates, it is the advanced industrialized economies of the region plus the newly industrializing countries that have led the way in promoting these arrangements. Thailand, discussed below, is the only participating country that does not fall into either of these categories. None of the ten member states of ASEAN other than Singapore and Thailand has yet entered into official negotiation of a preferential trade agreement outside the ambitious proposal for a free trade agreement between ASEAN as a whole and China.

Why this particular distribution? That these arrangements are concentrated among the region's more developed economies is no accident. Countries must have something to offer potential partners to be attractive in preferential trade arrangements. Generally, the requirement is for a sizeable domestic market for goods and/or services, but political capacity is also required, so that potential partners are convinced of a state's capability to make credible commitments. Moreover, the technical complexity of trade negotiations for preferential arrangements, which involve, for instance, detailed rules of origin, necessitates a minimum level of bureaucratic capacity. Such considerations rule out many of ASEAN's less developed economies as viable candidates for these arrangements.

Some of the most active participants have been countries where a commitment to trade liberalization has been relatively long established and is now largely uncontested within the state bureaucracy. The principal examples are Australia, New Zealand and Singapore. The latter has been the most energetic proponent of preferential agreements of all western Pacific economies. The reasons are not hard to decipher. Singapore has negligible tariff or non-tariff barriers on most imports of merchandise.

Table 4.1: Participation of East Asian countries in negotiations on Preferential Trade Agreements

Country / Grouping	***Partners***	***Status of Agreement April 2003***
ASEAN	China EU Japan	Under Negotiation Proposed Proposed
China	ASEAN Hong Kong Macau	Under Negotiation Proposed Proposed
Hong Kong	China Macau New Zealand	Proposed Proposed Under Negotiation
Japan	ASEAN Canada Chile Korea Malaysia Mexico Singapore Thailand	Proposed Proposed Under Study Under Study Proposed Study Group Reported Agreement Signed Proposed
Korea	Australia Chile Japan Mexico New Zealand Singapore Thailand USA	Under Study Agreement Signed Under Study Under Negotiation Under Study Proposed Under Study Under Study
Philippines	Japan USA	Proposed Proposed
Singapore	Australia Canada EFTA EU India Japan Korea Mexico New Zealand Taiwan USA	Agreement Signed Under Negotiation Agreement Signed Proposed (rejected by EU) Under Negotiation Agreement Signed Proposed Under Negotiation Agreement Signed Under Negotiation Agreement Signed
Taiwan	New Zealand Panama Singapore USA	NZ withdrew from negotiations Under Negotiation Proposed Proposed
Thailand	Australia Japan Korea New Zealand	Under Negotiation Proposed Under Study Under Study

Source: Government websites and various newspapers.

Note: 'Proposed' refers to agreements that have been officially proposed with varying degrees of formality by one government to another (numerous other proposals have been made, primarily by business groups). Most proposals are then referred for study to either national think-tanks or to consultants and/or to joint working parties from the partners. Negotiations usually do not begin until governments have received these studies.

Providing duty-free access to its market imposes few costs on domestic interests, whereas preferential access to other's markets holds out the potential for substantial gain for manufacturing and services alike. Governments of Singapore, one of the most trade-dependent economies in the world, have always been preoccupied with security of access to export markets (Dent 2001; Rajan and Sen 2002). Yet the very fact that its trade barriers are so low and its economy relatively small make Singapore a not obvious partner for preferential trade arrangements. Two factors have offset this. First, the Singaporean government has been willing to enter into agreements that involve some degree of 'deeper' integration, i.e., that are WTO plus. In particular, it has been willing to negotiate improved access to its services sector, some parts of which still enjoy significant protection. Second, because Singapore produces few 'sensitive' products (either agricultural or labour-intensive), a PTA with the island state is relatively unthreatening to domestic interests in potential partners. Moreover, the Singaporean government has shown a willingness to accept 'unequal' agreements, as in the case of the treaty with Japan, the Japan–Singapore Economic Partnership Agreement (JSEPA), in which the few products it exports that caused domestic political sensitivities for its partner were excluded.

Under programmes of unilateral trade liberalization, Australia and New Zealand significantly reduced their tariff levels from the mid-1980s onwards. Both countries are somewhat reluctant converts to PTAs, having abandoned their WTO purist stance when it became clear that APEC was not going to advance trade liberalization as rapidly as they had hoped. Both face domestic pressures, particularly from agricultural interests, to attempt to use preferential agreements to enhance access for exports that typically have not fared well under WTO negotiations.

Thailand, like Singapore, has aspirations to establish itself as a regional hub (in this instance for auto manufacturing; cf. Singapore's emphasis on services). Its interest in preferential trade agreements can be attributed in large part to its desire to send a signal to potential investors of its commitment to ongoing liberalization. With Indonesia's continuing economic difficulties, Thailand has become ASEAN's single largest economy, with obvious attractions to potential partners. Hong Kong's situation is very similar to that of Singapore as a low-tariff economy, albeit one whose residual manufacturing sector and very close integration with the mainland economy pose greater problems for potential partners. Taiwan, meanwhile, is pleased to find any country that is willing to contemplate an international trade agreement with it in the light of Beijing's expressions of hostility to such arrangements.

From a political economy perspective, the proposals involving Japan and Korea are arguably the most interesting, because in both countries protectionist forces remain entrenched in the domestically oriented sectors. Opposition to liberalization in the forestry and fisheries sectors had wrecked APEC's early voluntary sectoral liberalization programme, for which the Japanese government received the blame, although the Korean government was happy to shelter behind Japan's veto of the proposals. Both governments had indicated that they were unwilling in regional agreements to go beyond the liberalization commitments for sensitive sectors they had made in the Uruguay Round of GATT negotiations. Governments faced conflicting pressures from outward-oriented pro-liberalization ministries and their domestically oriented protectionist counterparts. Preferential trade agreements offered an opportunity to reconcile the apparently irreconcilable.

Liberalization without political Pain: a new political economy of PTAs

For pro-liberalization forces, negotiation of bilateral free-trade agreements offered the potential of establishing a wedge, a foot in the door, against domestic protectionist interests. The Japanese Ministry of International Trade and Industry, which in the 1980s had become a significant advocate within the bureaucracy of trade liberalization, first made the case in its 1999 White Paper on International Trade for the potentially positive impact that regional trade agreements could have on domestic competitiveness. It elaborated this argument in the following year in its call for the Japanese government to adopt a new, 'multi-layered' approach to trade policy: 'regional integration and economic structural reform', it argued, 'must be pursued as mutually complementary elements'.[14] Regional trade agreements could help not only to sustain the momentum of trade liberalization at a time when the WTO was floundering but also to contribute to a revitalization of the stagnant Japanese economy.

Bilateral trade agreements, on the other hand, offered protectionist interests an opportunity to maximize their political leverage to avoid painful domestic adjustment. In bilateral agreements, the external pressures to which the domestic government is subjected come only from one other party and thus are substantially weaker than those to which it would be exposed in multilateral trade negotiations.[15] And Japan would be by far the larger of the two economies in any bilateral agreement, affording an opportunity for it to impose an unequal agreement on its partners (a consideration that also held some relevance for Korea, as the world's thirteenth-largest market for imports).

To reconcile the pro-liberalization and protectionist forces, governments have exploited the lack of a definitive interpretation of the requirement that 'substantially all trade' should be included in preferential trade agreements if they are to be recognized as compatible with members' obligations in the WTO. The conditions under which preferential trade areas will be regarded as legitimate are laid down in GATT Article XXIV.8, which defines the meaning of 'customs union' and 'free-trade area'. One requirement is that the parties 'eliminate duties and other restrictive regulations of commerce with respect to substantially all the trade between the constituent territories in products originating in such territories'. Neither the GATT nor its successor, the WTO, has been able to agree on what is meant by 'substantially all trade'. Some parties have interpreted it as a requirement that a specific percentage of total trade be covered. The Japanese government, for instance, suggests that it implies both a quantitative and a qualitative element – the elimination of tariffs in respect of more than 90 per cent of trade volume and that no specific sector be excluded from the agreement (Ministry of Economy, Trade and Industry 2002a). However, others have pointed out that the 90 per cent interpretation must also take account of the dynamic effects of any agreement and of potential as well as actual trade, and note that existing restrictions may have had a negative impact on the development of trade in some sectors.[16] The issue remains unresolved and is on the agenda of the current round of WTO negotiations. In large part because of members' inability to reach agreement on interpretation of Article XXIV.8, the WTO's Committee on Regional Trade Agreements has been unable to reach a conclusion on whether any of the multitude of agreements sent to it for evaluation conforms with the treaty requirements.[17]

The European Union set a precedent for excluding sensitive sectors from bilateral agreements by excluding most agricultural products from its PTAs with Mexico and South Africa (claiming that the agreements were, nonetheless, compatible with WTO requirements because they covered more than 90 per cent of current trade, and no sector was completely excluded from the preferential arrangements). These precedents were seized upon by Keidanren in its lobbying in favour of Japanese participation in PTAs. Whereas, Keidanren argued, it was desirable 'to liberalize as much trade as possible', the WTO requirement that such agreements cover 'substantially all trade' between the participants provided an opening to omit 'sensitive' items from the liberalization schedule, thereby minimizing the domestic political costs of the new regionalism (Keidanren 2000). And this is precisely what the Japanese government did in its negotiation of the JSEPA: the few products in the ultra-sensitive agricultural sector that Singapore exported to Japan, primarily cut flowers and goldfish, were excluded from the liberalization provisions. Because no new liberalization occurred in agricultural products, the JSEPA removed tariffs on only half of the Singaporean exports that were subject to Japanese duties at the time of the agreement. Korea has subsequently signalled that it will not expose its agricultural sector to additional competition from Mexico and Chile by lowering barriers as part of a preferential agreement. And the Taiwanese government is reported to have sought to exclude 800 products, mainly textiles and clothing, from its proposed free-trade agreement with Singapore to protect its domestic textiles industry.[18]

Article XXIV.8 provides a means by which the circle can be squared: a pro-liberalization agreement that avoids imposing adjustment on the least efficient domestic sectors, a liberalization without political pain. Such an approach essentially returns to the logic underlying APEC's original *modus operandi*: that governments voluntarily and unilaterally should choose which sectors they wish to expose to international competition and not be forced by their partners to undertake liberalization that imposes domestic political costs.

Another element of domestic protection afforded by the new bilateralism comes from the need for free-trade agreements to include rules of origin to ensure that a partner's exports are locally generated products. The protective effect of rules of origin is well known to students of the EU's partnership agreements, having been used for many years to afford European industry an advantage over third parties (Ravenhill 1985). Special provisions in rules of origin for outward processing of inputs can increase the advantages they confer on domestic industries. In recent years, economists have demonstrated the very substantial distorting impact of rules of origin in free-trade agreements and their role in increasing trade diversion effects (Krishna and Krueger 1995; Krueger 1997). As an illustration of the protective potential afforded by rules of origin, consider the Japan–Singapore Economic Partnership Agreement. The text of the JSEPA has a total of 360 pages, the first eighty of which are the clauses of the agreement; the second eighty identify products for which Japan either will or will not eliminate tariffs, and the remaining 200 pages constitute product-specific rules of origin, whose inclusion was insisted upon by the Japanese government.

The effects of the new bilateralism

This section reviews five dimensions of the possible effects of the new preferential trade agreements:

1 on the economies of the participants;
2 on the economies of non-participants;
3 on the political economies of the participants;
4 on regional institutions; and
5 on the global trading system.

Economic effects on participant economies

A striking characteristic of the new preferential arrangements is that they involve countries that are relatively insignificant trading partners with one another (with the exception of the proposed arrangements between Japan and the United States, none of which has yet come to fruition). Table 4.2 lists the share of proposed partners in the total exports of various western Pacific countries.

Many of the arrangements involve countries that account for less than 5 percent of each other's exports: close to one-third contribute less than 1 per cent of total exports. Moreover, they are being negotiated in an environment where tariffs are already low for most manufactured products. Consequently, the likely welfare effects on the participants are in most instances very small and inevitably smaller than those that would result from global or APEC-wide liberalization.[19] The estimation of such effects is an inexact science and often relies on 'guesstimates' of the elasticity of demand for various products; it is subject to difficulties in adjusting models to allow for imperfect competition and trade in differentiated products, and it relies on faith that implementation of the agreements will be 'clean', that is, that tariffs will not be replaced by other forms of administered protection. However, all economic modelling of the proposed arrangements has pointed to at best very small gains for participants, even where they involve a substantially larger trading partner. Scollay and Gilbert (2001) estimate that the welfare effects of a Japan–Korea free-trade agreement will actually be mildly negative for Korea. Other studies have found that an agreement would provide only a minor stimulus for Korean exports: Korea's trade balance would deteriorate, and output from its heavy and chemical industries would decline. Japan would gain more from a bilateral agreement because of the barriers that its exports currently face in Korea, but the growth of overall Japanese exports would be very small.[20] In the case of Korea's most significant economic partnership, that with the United States, a study by the US International Trade Commission (2001) concluded that the effect of a free-trade agreement would be to raise Korea's GDP by 0.7 percent, not a dramatic increase in the context of the overall growth rates of the Korean economy over the last three decades; US GDP would increase by only 0.2 per cent.

The estimated effects of other agreements are even smaller. A study of the likely effects of a free-trade agreement between Australia and Singapore predicted that it would increase Australian exports by a mere A$70 million (US$37 million) (Access Economics 2001). The agreement between Singapore and the European Free Trade Association is projected to reduce the tariff revenue from Singaporean exports by a mere $1 million per year.[21] Even allowing for the likelihood that the economic models may not fully capture the dynamic effects of liberalization, the results of the new PTAs are likely to be paltry.

Economic effects on non-participants

The comforting counterpart for non-participants from projections that the proposed PTAs will generate few significant gains for signatories is that they themselves will suffer at worst only small losses from these agreements. The various economic modelling suggest that the aggregate welfare losses that the PTAs would impose on the rest of the world will be minimal.[22]

However, such complacent conclusions may hide more significant losses for individual countries and/or industrial sectors. In MTNs, less developed economies have been able to free ride to some extent on the agreements between the big players, the 'principal suppliers' in GATT/WTO terminology. Their exports have benefited from these agreements courtesy of the 'most favoured nation' provision. To be sure, less developed countries have consistently complained that many exports of most interest to them have not benefited in MTNs to the extent of those produced primarily by industrialized economies simply because of the latter's lack of interest in promoting liberalization of trade in these products. In the rush to bilateralism, however, the weaker economies may miss out altogether, for the reasons discussed above. While tariffs worldwide have come down in the last fifteen years, islands of significant protectionism remain. A study undertaken by the economist William James for the US Agency for International Development (2001) notes, for instance, that if Korea were to sign preferential trade agreements with partners such as Mexico, Japan or Thailand, textile exporters in Indonesia would be placed at a competitive disadvantage because they would face tariffs of 15 to 18 per cent.

Table 4.2: Percentage share of PTA partners in countries' total exports (2000)

Country	*Partner*	*Percentage of Total*
Australia	Korea	7.9
	Singapore	5.6
	Thailand	1.9
	USA	10.3
Japan	Canada	1.7
	Chile	0.2
	Korea	6.9
	Mexico	1.2
	Singapore	**4.7**
	Thailand	1.2
Korea	Australia	1.6
	Chile	0.4
	Japan	12.5
	Mexico	1.5
	New Zealand	0.2
	Thailand	0.03
	USA	23.0
New Zealand	Chile	0.3
	Hong Kong	2.8
	Korea	4.5
	Singapore	**1.8**
	Thailand	1.2
	USA	15.1
Singapore	Australia	2.5
	Canada	0.4
	EFTA	**0.5**
	EU	14.1
	India	2.2
	Japan	**8.0**
	Mexico	0.6
	New Zealand	**0.3**
	Taiwan	n.a.
	USA	18.4
Thailand	Australia	2.5
	Japan	15.6
	Korea	1.9
	New Zealand	0.3

Source: Calculated from IMF, Direction of Trade statistics.
Figures in bold for agreements already signed.

For weaker countries, the great advantage of multilateralism is that it reduces the significance of power in international economic relations. And the most favoured nation principle largely removes political considerations from the granting of tariff concessions between WTO members. However, bilateralism potentially brings power asymmetries back to centre stage. Weaker parties may perceive themselves as being obliged to accept an unequal agreement, as appears to have happened to Singapore in the JSEPA. Political factors can also enter the equation in the choice of partners. Some countries face the risk of exclusion because of such considerations. In the western Pacific, Taiwan is the most obvious example. Not only has Taiwan been excluded from the ASEAN+3 dialogue, but Beijing has warned other governments against negotiating bilateral trade agreements with Taipei.[23]

Effects on domestic political economies

For trade liberalization, a principal advantage of multi-sector multilateral trade negotiations where reciprocity is required is that they tend to maximize the external pressure on governments to open up protected sectors. Moreover, given the potential access that they may afford to new markets, they are the most effective means of energizing exporters in a pro-liberalization coalition to counter protectionist interests. Rather than boosting pro-liberalization forces in the domestic political economy, bilateral preferential trade agreements may have the opposite effect.

First, they reduce the weight of external pressures on governments to engage in reciprocal liberalization. Second, selective liberalization, taking advantage of the lack of specificity in GATT Article XXIV.8 to achieve 'liberalization without political pain' can give exporters the desired access to markets while enabling protection for sensitive domestic sectors to continue. The possible result will be that exporting industries will lose the incentive to push for further trade liberalization.[24] Given the relatively small markets that are involved in many of the PTAs currently under study or negotiation, such a scenario might seem unrealistic, but any significant extension of bilateral arrangements will make it substantially less so. Consider Mexico, for example, which provides the current extreme outlier. A pioneer in negotiating preferential trade agreements, Mexico is now party to thirty-two such agreements with partners that collectively account for more than 60 per cent of global GDP and more than 97 per cent of its current exports (most, of course, being directed to its NAFTA partners). The incentive for Mexican exporters to expend resources in lobbying for multilateral liberalization has been substantially reduced.[25]

Effects on existing regional institutions and the global trading system

In principle, 'subregional' agreements can be made compatible with existing regional arrangements. Various suggestions have been put forward whereby, for instance, preferential trade arrangements might be reconciled with APEC's principles of open regionalism.[26] In reality, the record to date in the western Pacific is that the new bilateralism (excluding the long-established Australia–New Zealand Closer Economic Relations agreement) has not been compatible with APEC's non-discriminatory approach. This reflects not just the terms of the agreements themselves but also the diversion of leadership and bureaucratic resources that has occurred in their negotiation and implementation. With most foreign affairs bureaucracies severely stretched, allocation of resources inevitably is a zero-sum game. The correlation between the lack of supply of leadership to APEC since 1998 and the growth of bilateralism is surely no coincidence.

The incompatibility of different rules of origin across various bilateral and regional agreements can cause difficulties for other countries within a regional arrangement that are not party to the bilateral preferential arrangements. But it is the political signal that negotiation of a bilateral agreement with extra-regional partners can send to other members of regional institutions that holds the most potential for friction. For instance, Singapore's pursuit of bilateral preferential arrangements outside ASEAN has caused considerable resentment among some of its regional partners, the most outspoken of which has been the Malaysian government, which demanded that ASEAN states should seek approval from other members before pursuing bilateral agreements with extra-regional states (for further discussion, see Dent 2002).

The impact of preferential arrangements on the global system remains the most hotly contested topic in the economics literature on regionalism. As noted above, the failure of worst case scenarios of global fragmentation to be realized in the 1990s, coupled with the small magnitude of the welfare losses that regional arrangements were calculated to have generated, produced upbeat evaluations of the issue. Optimists point to the fact that many of the new preferential agreements are 'WTO+', extending external discipline into new areas of economic policy and thereby providing a model for new multilateral agreements. However, the new bilateralism provides additional reasons for concern. The problem of diversion of leadership and bureaucratic resources with the proliferation of negotiations has intensified. However, potentially far more serious is the 'liberalization without political pain' that the new bilateralism offers. Not only does this development have an adverse impact on the domestic political economy equation but it also provides governments with a more politically attractive path to partial trade liberalization.

Conclusion

How does the new bilateralism in the western Pacific relate to prevalent explanations for the growth of regionalism, and what is the future of such arrangements?

In recent years, two explanations for the growth of preferential trade agreements have become popular. Baldwin (1997), focusing on the proliferation of arrangements between the EU and its neighbours, has proposed a domino theory of regionalism, suggesting that the principal motivation for less developed countries in entering these agreements is a search for inclusion in regional arrangements to ensure parity in terms of access to markets and to foreign investment. Existing regional arrangements cause diversion of trade and investment, which outsiders seek to overcome by reaching their own agreements with the regional partnership. Because the existing regional agreements lower the profits of exporters, they have an incentive to invest in political activity in favour of their own governments joining the arrangement. Enlargement of the regional agreement in turn increases the cost of non-membership and encourages other countries to apply. Within countries, membership of the agreement increases exports, enhancing the influence of pro-liberalization elements, and reduces the economic and political significance of inefficient domestically oriented sectors. The new regionalism therefore has a benign effect on the trend towards liberalization in the global trading system.

Ethier (1998) proposes an alternative explanation: that the new regionalism 'typically involves reform-minded small countries "purchasing", with moderate trade concessions, links with a large, neighboring country that involve "deep" integration but confer minor trade advantages'. The principal motivation of the reforming countries is to increase their attractiveness in the competition for foreign investment. Regional agreements are important in enhancing the credibility of domestic reforms by 'locking them in', because regional partners are more likely to punish deviations than is the WTO. Again, the conclusion is that the overall effects of the new regionalism on the global trade system will be benign because PTAs help to lock in pro-liberalization reforms.

To what extent does the new bilateralism in the western Pacific correspond to these explanations? Proposals for free-trade agreements with the United States, so far unconsummated in large part because of the denial by Congress of fast-track trade authority to the president before mid-2002, fit one or both explanations: an attempt by countries excluded from the North American market to gain access on equal terms to NAFTA members; and on the part of smaller, reform-oriented economies like Thailand, an attempt to be perceived as an attractive host by potential foreign investors.

Some other arrangements, notably those involving Japan and Korea, appear to have different motivations and have domestic and international repercussions that are far less benign. Rather than signalling that they are locking in reforms, agreements that cordon off inefficient domestically oriented sectors from liberalization signal that these governments are determined that they will not go beyond the provisions negotiated for such sectors in the Uruguay Round. Gains may be achieved for export-oriented sectors, and the agreements may be WTO+ in extending into new areas of services or intellectual property protection, but the overall effect on the domestic political economy balance may be to strengthen anti-liberalization forces. And by offering an alternative to the political pain caused by MTNs, their impact on the global trading system may be far from benign.

How much of a danger do such distorting agreements pose? The answer is that it is too early to tell. Several factors that will inhibit the spread of such agreements can be identified. Those Japanese government ministries that favour trade liberalization appear increasingly concerned at how far the lack of specificity of Article XXIV.8 can or should be exploited for fear of weakening domestic reform efforts and of damaging the WTO's credibility. Exclusion of agricultural products from its agreement with Singapore was relatively inconsequential in a context where only a tiny fraction of overall trade was concerned. It may have breached the qualitative dimension of the WTO's 'substantially all trade provision', i.e., that no sector be excluded, but fell far short of contravening the quantitative, i.e., 90 per cent of total trade, dimension. However, exclusion of agricultural products from agreements with other Southeast Asian or Oceanic countries would be far more problematic. Agricultural goods constituted a quarter of Australia's total exports to Japan in 1999, more than a half of New Zealand's and a third of Thailand's.[27] Although some of these products do not compete with domestic agriculture in Japan, enough do to cause severe problems with Article XXIV.8 compliance. A realization of these difficulties, coupled with an unwillingness to confront domestic protectionist interests, caused Prime Minister Koizumi, on his tour of Southeast Asia in January 2002, to declare that while his government was interested in an enhanced economic partnership with the region, free-trade agreements would not be possible until these economies had 'matured'.

Moreover, the conclusion of partial agreements requires a partner country to be willing to acquiesce in an arrangement that excludes items of interest to its exporters. Mexico and Chile have been insistent on the inclusion of some agricultural products in their agreements with Japan and Korea, a reason why these proposals, launched at the same time as that for a Japan–Singapore agreement, remain stalled at the study group level.[28] While bilateral power asymmetries will inevitably come into play as in the Japan–Singapore and EU–Mexico cases, significant potential exists for domestic political conflict in partner countries between sectors that will benefit from a partial agreement and those that will be excluded.

Again, however, from the perspective of those who fear the consequences for the global trade system of further exploitation of the 'liberalization without political pain' path, some worrying signs have emerged. The Australian government, which ruled out the idea of entering a free-trade agreement with Japan during Prime Minister Koizumi's visit in May 2002 because of the inability of the Japanese government to liberalize agricultural trade, subsequently signalled that it was interested in pursuing an economic partnership agreement with Japan to negotiate improved trade access for those sectors on which agreement was feasible. The danger again is that such an agreement could remove the manufacturing and services sectors from domestic lobbying in Australia for the government to ensure comprehensive liberalization in an agreement with Japan, weakening the external pressure for liberalization of the most politically sensitive economic sectors. The potential dangers for the multilateral system that the new bilateral agreements pose come less from the new preferences that they create than from their adverse effect on the balance between pro- and anti-liberalization forces, domestically and internationally.

Notes

1 This is a revised version of a paper that was published in *Third World Quarterly* 24 (2), 2003.
2 The significant exceptions were the Australia–New Zealand Closer Economic Relations Trade Agreement, concluded in 1983, and ASEAN's Preferential Trade Arrangements, initiated in 1977, which have been superseded by the ASEAN Free Trade Area (AFTA).
3 In Aggarwal's (1995) terminology, these countries were 'GATT purists'.
4 Dent (2003) provides a comprehensive mapping of the proposed arrangements.
5 For further discussion of APEC's problems, see Ravenhill (2001) and Aggarwal (2002).
6 See Chapter 8 in this book.
7 See, for instance, the comments from Japan's Ministry of Economy, Trade and Industry (2000), which also pointed to the growing role of anti-globalization NGOs as an obstacle to successful MTNs.
8 The New Zealand government, another trade liberalization advocate, had already entered into negotiations for a bilateral agreement with Singapore.
9 Ministry of Economy, Trade and Industry (2000) and Ministry of International Trade and Industry (1999).
10 As concluded by a major World Bank study (World Bank 2000).
11 For a discussion of the lack of interest by private sector actors in APEC, see Ravenhill (2001).
12 Democratization in some countries (see Chapter 7 in this book) may have provided business with increased opportunities to influence foreign economic policies – not least where business became the primary source of funding for what were often very expensive election campaigns.
13 Wall (2001) estimates that the value of Japan's exports to Mexico was 19 per cent lower than they would have been in the absence of NAFTA and Mexico's preferential agreement with the EU.
14 As part of departmental restructuring in 2000, the Ministry of International Trade and Industry was renamed the Ministry of Economy, Trade and Industry. The most significant documents are Ministry of International Trade and Industry (1999) and Ministry of Economy, Trade and Industry (2000). Pages in the on-line English-language version of the latter report are unnumbered: the quote appears in chapter 2.
15 Direct pressures, that is. In the case of the JSEPA, the US government and others had lobbied the government of Singapore not to accept Japan's demand that sensitive sectors be excluded from the agreement.
16 For instance, Commission of the European Unions (n.d.).
17 More than 100 regional trade agreements were notified to the WTO between 1995 and the end of 2001.
18 'Some 800 items on Taiwan protected list in FTA with Singapore', AFP report, 21 April 2002, http://asia.news.yahoo.com/020421/afp/020421050556singapore.html
19 Such effects go beyond the stimulation of exports to include the benefits of efficiencies flowing from increased competition in domestic economies. But if overall trade volumes are small, such beneficial competitive effects will be limited and may be further restricted by incomplete product coverage.
20 These negative results for Korea were also projected by the 'official' joint study conducted by the Korea Institute of International Economic Policy and Japan's Institute of Developing Economies (Sohn and Yoon 2001). Studies reported in Castellano (1999) suggest that the overall growth in trade resulting from a Japan–Korea free trade area would be less than 2 per cent.
See also 'FTA with Japan seen battering key industries', *Korea Herald*, 28 February 2002, http://www.koreaherald.co.kr/SITE/data/html_dir/2002/02/28/200202280038 .asp
The results are heavily dependent on the assumptions underlying the models. For a review of various studies on the proposed Japan–Korea FTA and a more positive assessment of likely outcomes, see Cheong (2002).

21 'Singapore signs trade pact with EFTA', *Business Times Online* 27 June 2002, http://business-times.asia1.com.sg/news/story/0,2276,49533,00.html

22 A comprehensive study of existing regional arrangements reaches similar conclusions about their effects on non-participants (Soloaga and Winters 1999).

23 'FTA with Taiwan Means Political Trouble: Official', *People's Daily*, 21 June 2002, http://english.peopledaily.com.cn/200206/21/eng20020621_98285.shtml

24 The danger to pro-liberalization coalitions is equivalent to that when sectoral liberalization agreements are negotiated. See Aggarwal and Ravenhill (2001).

25 The intuitive argument that preferential agreements may cause some actors to lose interest in multilateral agreements finds theoretical support in Grossman and Helpman (1995) and Levy (1997).

26 The APEC Eminent Persons Group, in its third report (APEC 1995), suggested the following principles whereby subregional arrangements could be reconciled with APEC:

- the maximum possible extent of unilateral liberalization;
- a firm commitment to reduce barriers to APEC economies that are non-members of the SRTA as well as within the SRTA itself;
- an offer by each SRTA to extend the benefits of its SRTA liberalization to all other APEC members on a reciprocal basis; and
- recognition that any individual SRTA member can unilaterally and unconditionally extend its SRTA liberalization to all other APEC economies (and, under the rules of the WTO, to all other members of the WTO as well), or conditionally to one or several other APEC economies. See also Elek (2000).

27 Calculated from UN Standard International Trade Classification data.

28 The report of the study group on the proposed Japan–Mexico agreement. The Ministry of Economy, Trade and Industry (2002b) reports that 'the Mexican side expressed its view that certain agricultural liberalization is indispensable in the final package of a possible FTA, explaining that Mexican agriculture is also sensitive, and that Mexican agricultural products will not constitute a threat to the Japanese agricultural sector'.

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5 Global production and Southeast Asia's industrialization[1]

Greg B. Felker

Introduction

The same historical forces that propelled Southeast Asia's development 'miracle' now cast a shadow across the region. The globalization of manufacturing by multinational corporations (MNCs) transformed the region's resource-based economies into export dynamos in a mere two decades. Since the crisis, political instability and partial economic reforms, recurrent slumps in global electronics markets and China's emergence as the premier offshore manufacturing platform have curtailed the flow of new foreign direct investment (FDI) into Singapore, Malaysia, Thailand, the Philippines and Indonesia. Has Southeast Asian industrialization run out of steam? Has the region's FDI-reliant strategy led to a high-level dependency trap, leaving its economies without the capabilities required to chart a new development course as MNCs shift their attention to new and greener pastures?

These questions evoke longstanding major debates about the nature of Asia's regional political economy. The distinctive characteristic of Southeast Asia's industrialization is not reliance on FDI *per se* but rather the region's embeddedness in a particular mode of the international division of labour that was consolidated in the 1980s and 1990s. Over the last quarter century, a growing share of transnational economic activity has been *internalized* in MNCs' international production networks (IPNs), which link and coordinate the production activities of subsidiaries, affiliates, subcontractors and service providers across multiple national jurisdictions. Such networks have integrated Asia's economies despite the absence of strong formal regional institutions (Doner 1993, 1997; Ernst 1994; Lim 1995; Ravenhill 1998; Borrus *et al.* 2000). During the boom era of the late 1980s and early 1990s, IPNs were often credited with fostering a coherent regional growth process based on complementary industrial specialization, technology transfer and dynamic structural change across a multi-tiered Asian political economy (Ozawa 1999). More recently, the 'flying geese' pattern of coordinated regional development has come apart in the face of Japan's languishing leadership and China's drive to overtake Asia's newly industrialized economies. The current gloom stems from a belief that Southeast Asia's FDI-led boom failed to impart durable advantages or to localize capabilities for industrial change, and it thus left the region vulnerable to marginalization in post-crisis Asia's shifting international division of labour.

Drawing on an analysis of international production networks and local policy responses to them, this paper advances a more nuanced argument about the dynamics of Southeast Asian industrialization in the rapidly changing global political economy. In fact, the architecture of global production is not driven by an immutable economic logic of intensifying cost competition but rather is shaped by the interaction of multinational corporate strategies with host-country policies and institutions. Dynamism within the Southeast Asian operations of MNCs suggest that the region's embeddedness in corporate IPNs has not precluded localized processes of technological upgrading *per se*. Nor were the region's governments entirely ineffective in harnessing the FDI boom to enhance local capabilities and locational advantages, as several governments followed Singapore's lead in adjusting their investment policy regimes to bid for more lucrative niches within the international networks of MNCs. However, such 'post-nationalist' industrial strategies demand a broader and more sophisticated set of policy capabilities on the part of state actors than traditional industrial policies. These trends, uneven as they are, seek to build upon Southeast Asia's first-mover advantages as a platform for global production and thereby anchor multinational activity against the tidal pull of competition from the expanding global roster of low-cost production sites. The likely outcome of the reconfiguration of IPNs in Asia, then, is an even more fine-grained division of labour integrating Southeast Asia with China and East Asia.

Southeast Asia's strategic conundrum: reconsidering FDI-led industrialization

Early in his term in office, Prime Minister Thaksin Shinawatra announced his intention to alter Thailand's FDI-based industrialization policies, which he declared had made the kingdom a 'slave to the world' (*FEER*, 19 April 2001). 'The system must be changed, because it puts Thailand at a disadvantage. We're ready to see lower export revenues as long as we increase the value of these exports domestically. From now on, when considering privileges for foreign manufacturers, we must also consider what we will get back in return' (*The Nation*, 29 March 2001). A year earlier, Malaysian Prime Minister Mahathir Mohamed had declaimed:

> We had thought of globalization in terms of foreign direct investment, of inflows of capital technology and market access. But our recent traumatic experience has shown that globalization can also mean massive outflows of

capital in order to impoverish and weaken us and to prepare us for foreign takeovers of our businesses, and possibly our countries too.

(New Straits Times 12 April 2000)

Even Singaporean leaders publicly fretted that the city-state's successful FDI-led growth policy had run out of steam. In his 2001 National Day address, Prime Minister Goh Chok Tong warned of the 'hollowing out of the Singapore economy as China opened up and MNCs rushed to invest there. … Our biggest challenge is … to secure a niche for ourselves as China swamps the world with her high-quality but cheaper products … How does Singapore compete against 10 post-war Japans, all industrializing and exporting at the same time?' (*Asiaweek*, 31 August 2001).

The sense of crisis in Southeast Asian capitals was understandable in light of several alarming trends. An unexpectedly swift recovery in growth in 2000 was not matched by a significant revival of FDI inflows to the region, and growth faltered again in 2002. ASEAN's share of FDI inflows to developing Asia shrank from an average of 40 per cent between 1989 and 1994 to 10 per cent in 2000.

The collapse in the world electronics market that began in late 2000 dealt a further blow to the largest export industry in Southeast Asia's rapidly industrializing economies, and major electronics MNCs announced a raft of downsizing initiatives as the downturn gathered momentum. Meanwhile, China's FDI

Table 5.1 **FDI inflows (US$ million), developing Asia**

Country	*1989–94 (average)*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*
Brunei	102	n.a.	654	702	573	596	600	244
Cambodia	52	151	586	15	230	214	179	113
Indonesia	1,542	4,346	6,194	4,677	356	2745	4550	3277
Laos	19	95	128	86	45	52	34	24
Malaysia	3,964	5,816	7,296	6,324	2,714	3,895	3,788	554
Myanmar	135	277	310	387	314	253	255	123
Philippines	879	1,459	1,520	1,249	1,752	578	1,241	1,792
Singapore	4,798	8,788	8,608	10,746	6,389	11,803	5,407	8,609
Thailand	1,927	2,004	2,271	3,626	5,143	3,561	2,813	3,759
Vietnam	651	2,336	1,803	2,587	1,700	1,484	1,289	1,300
ASEAN	14,069	25,272	29,370	30,369	18,504	19,691	11,056	13,241
China	13,951	35,849	40,180	44,237	43,751	40,319	40,772	46,846
Hong Kong	4,164	6,213	10,460	11,368	14,770	24,596	61,938	22,834
China HK	18,115	42,062	50,640	55,605	58,521	64,915	102,710	69,680
Developing world	59,578	113,338	152,685	191,022	187,611	225,140	237,894	204,801
South, East and Southeast Asia	35,078	73,639	87,843	96,338	86,252	99,990	131,123	94,365

Source: UNCTAD *World Investment Report* 2001, 2002.

Table 5.2 Export performance among Asia's electronics producers

Country	*Exports as % of GDP*[1]	*Electronics as % of exports*	*Year-on-year change in exports*[2]
South Korea	42.0	38.2	20.0
Taiwan	54.0	47.3	28.4
China	22.0	24.9	6.6
Thailand	57.0	33.3	8.0
Malaysia	122.0	58.8	13.5
Singapore	180.0	64.2	24.0
Philippines	51.0	59.2	25.0
Indonesia	35.0	14.6	0.2
USA	11.0	–	–

Source: *Asiaweek*, 8 March 2001.

Note: [1] 1999 data. [2] July 2000 data, except Malaysia and Philippines (June), Thailand and Indonesia (May).

inflows (excluding Hong Kong) averaged just under US$14 billion per year between 1989 and 1994 but rose to over US$40 billion per year beginning in the mid-1990s. Its share of FDI flows to developing Asia reached 50 per cent in 1998, and in conjunction with Hong Kong accounted for more than two-thirds by the end of the decade.

Sluggish FDI and export trends suggest that Southeast Asia's ailing tiger economies are caught in a 'structural squeeze' between an ascendant China and the more advanced industrial economies in the regions. Despite tremendous export growth during the decade before the crisis, Southeast Asia's second tier of industrial economies failed to develop the design and innovation capabilities necessary to move towards the more sophisticated production profiles of Taiwan and South Korea. Meanwhile, China's export mix has come to include not only labour-intensive products like textiles, toys, plastic items and electrical items but also a growing share of own-design (ODM) and even own-brand (OBM) manufacturing in white goods and consumer electronics, along with aggressive thrusts into high-technology sectors such as wafer fabrication. According to the UN classification, Chinese exports of high- and new-technology products rose from US$7.7 billion in 1996 to over $37 billion in 2000, with foreign-invested enterprises accounting for 81 per cent of the total (UNCTAD 2001: 26). In this view, China's recent success represents not the take-off of the latest member of East Asia's 'flying geese' but the crosswind of an entirely new flock.

How is it that Southeast Asia's once-vaunted newly industrialized countries find themselves groping for an entirely new growth model, seemingly too pessimistic to build upon their prior success as platforms for exporting manufactured goods by shifting into higher-technology production? Their present strategic dilemma lends considerable weight to critical analyses of international production networks that emerged in the 1990s in response to liberal and product-cycle-based theories of regional integration in Asia. Liberal theorists maintain that FDI smoothes the operation of the international product cycle, transferring technology to developing host countries and enabling them to achieve dynamic structural change (Yamazawa 1990, 1995; Petri 1993). In so far as they acknowledge industrial organization theories of FDI, they maintain that diffusion processes and host-country learning eventually erode the monopoly rents of the firm-specific assets of MNCs. By contrast, neo-structuralist literature emphasizes that IPNs reflect multinationals' efforts to both control and exploit firm-specific assets, as well as to regulate and limit technology diffusion.[2] IPN architecture reflects the global competitive strategies of MNCs, and in transposing internal corporate organization to the transnational domain, reinforces international hierarchies (Borrus 1993; Zysman and Borrus 1994; Machado 1999). While shifting manufacturing and testing to offshore affiliates in developing countries during the 1980s and 1990s, even in high-technology sectors, they retained control over design, R&D and brand management in their home-country headquarters, resulting in a stark 'international division of knowledge' in the Asia-Pacific region (Morris-Suzuki 1992).[3]

The industrial take-off of South Korea and Taiwan in the 1960s and 1970s was also embedded in regional dynamics shaped by the production strategies of major Japanese and US corporations (Cumings 1987). These countries entered technology-intensive sectors like electronics through joint ventures and assembly subcontracting roles, and they were long dependent on components, technology and capital goods from foreign principals. But their developmental states intervened in the governance of IPNs to regulate FDI to preserve a minimum of strategic autonomy for national industries. Local firms could invest in localized technological learning and linkage formation, and expand from simple manufacturing into more engineering, design and ultimately innovation-intensive activities (Gereffi 1996; Hobday 1995). Southeast Asia's manufacturing boom gathered speed in the 1980s in a different phase of the globalization of manufacturing. As MNCs had begun to exploit new technologies and organizational techniques (such as TQM and JIT) to control and integrate their international operations more closely, they began to view internalization as a source of strategic competitive advantage. Rather than upgrading their joint-venture affiliates in Southeast Asia, established in earlier decades to serve local markets, the big five Japanese electronics makers insisted on launching greenfield operations through wholly owned subsidiaries in order to serve global production roles. The US semiconductor assembly facilities set up in the 1970s had always been wholly foreign-owned, but they and other FTZ-based operations grew swiftly as the boom progressed, instead of gradually divesting the manufacture of maturing or medium-technology product lines to nationally owned subcontractors, as they had in Korea and Taiwan.

During the decade of the post-Plaza FDI boom, MNCs expanded their operations in Southeast Asia and introduced more advanced products and sophisticated processes. Yet hoped-for linkage effects (Wong 1991) remained limited, although Singapore was a partial exception in this regard. Very few Southeast Asian firms progressed along the value-added chain to full turnkey OEM and then into ODM or OBM production based on proprietary engineering, design or innovation capabilities. As Bernard and Ravenhill (1995) convincingly argued, these trends highlighted the strategic, control-oriented nature of the IPN system into which Southeast Asia had become deeply integrated. Indeed, Southeast Asia's present-day competitiveness dilemma might well be understood as confirming the most critical assessments offered during the boom period.

Intra-MNC dynamism in Southeast Asia's boom: internalization and upgrading

As the neo-structuralist analysis of Asia's regional political economy suggested, the proprietary networks of MNCs reflected strategic, control-oriented motivations rather than the workings of the international product cycle, and structural change within host Southeast Asian economies remained overwhelmingly dependent upon a transnational logic of production. However, recent work in the economic geography of globalization shows that the ostensibly borderless nature of MNCs' trade and investment operations has not diminished the economic importance of territory in the organization of economic activity. Manufacturing has become more internationally dispersed and coordinated, but it has also become more spatially concentrated at the local or micro level (McKendrick *et al.* 2000).[4] In contrast to the general thrust of neo-structuralist critiques, Southeast Asia's foreign manufacturing sector during the boom period displayed clustering properties with important dynamic effects. To this extent, the global logic animating the strategies of MNCs converged, in part, with the desires of their Southeast Asian hosts for progressive industrial change, even as they frustrated hopes for technology diffusion to local industries.

With regard to the internal dynamism of the multinational production base in Southeast Asia, three boom-era clustering trends made the image of a region confined to simple end-stage assembly increasingly outmoded. First was a significant deepening of MNC-dominated export industries, as foreign firms moved from simple assembly into the production of parts and components. Since the 1970s, foreign manufacturing was typified by simple assembly operations in free trade zones or under import duty exemption and rebate schemes. As the FDI boom progressed, however, most Southeast Asian economies saw a new wave of FDI by small and medium-sized firms from East Asia, which took advantage of liberalized policies on foreign equity ownership to follow their principal assembly customers to the region. The migration of foreign suppliers allowed flagship MNCs to resurrect a partial facsimile of their home-country *keiretsu* (subcontracting systems) on Southeast Asian soil (Guyton 1996).[5] From the standpoint of Southeast Asia's industrial trajectory, production deepening via the relocation of foreign supplier industries reflected both the degree to which IPNs enshrined foreign control and an important expansion of value-added in the region as a whole.

A second aspect of intra-foreign cluster dynamics was a marked pattern of spatial co-location among MNCs in particular industry segments. Moving a generation ahead of its neighbours, Singapore cycled through several vintages of clustered FDI, notably including the assembly of PCs with Apple and IBM in the early 1980s, followed by the relocation of a large share of global hard disk drive production late in the decade (McKendrick *et al.* 2000), and finally a wave of wafer-fabrication investments in the early and mid-1990s. By the early 1980s, Malaysia's Penang hosted key assembly facilities of most of the world's leading semiconductor companies, including National Semiconductor and Intel, while Motorola and Texas Instruments sited their operations near Kuala Lumpur. In the mid-1980s, Malaysia's Klang Valley, as well as several zones in Thailand, became favoured locations for Japanese and Taiwanese production bases in electrical and electronic home appliances, including air conditioners, televisions and VCRs. Thailand attracted overflow investments in disk drive assembly from Singapore, and in the 1990s it lured the lion's share of new investment in automobile assembly and parts production. In the late 1990s, the Philippines developed clusters of computer assembly in the Subic Bay zone and disk drive assembly in Laguna province, south of Manila. FDI clustering in Southeast Asia did not correspond to Porter's (1990) competitive 'diamond', with a full set of vertical links to supplier and user industries, or to the collections of complementary assemblers, designers and component makers that define innovative SME clusters in the literature on Europe. Rather, they were horizontal groupings of foreign manufacturers performing similar production functions, lured by suitable cost and infrastructure factors and, significantly, by the externalities (skills, knowledge, logistics infrastructure) generated by each other's presence.

The third important trend stemmed from the functional co-location pressures operating within individual foreign firms. Over time, the advantages of locating engineering, design and even R&D close to manufacturing, driven by the need to shrink product-cycle times, led many MNCs to transfer a greater share of those responsibilities to their Southeast Asian subsidiaries. Local assembly operations were called upon to introduce automation technology in the late 1980s to achieve productivity and quality improvement targets. Later, MNCs' Southeast Asian operations moved from making mature product lines towards sophisticated products and even assumed global product launch roles. These shifts required local subsidiaries to expand local engineering capabilities and invest in upgrading workforce skills. In the case of Singapore, process-engineering capabilities in several branches of electronics soon became world-class, and subsidiaries there began to conduct R&D into the development of process technology (Wong 2001). Malaysian expertise became crucial to the global operations of several companies, notably Intel and Motorola, which began sending teams of local engineers abroad to assist in establishing new factories. These internal co-location dynamics eventually extended to product design and R&D. Singapore began to attract FDI into R&D operations in the late 1980s. Among the less advanced Southeast Asian countries, however, the growth of design functions and even adaptive engineering and development was also evident.

Several points about this trend are important in light of the earlier discussion of structural mobility within MNC-controlled networks. First, except in certain sectors in Singapore, the localization of design and R&D naturally did not involve basic or strategic innovation at the core of the technology development efforts of MNCs. Rather, most local innovation involved incremental adaptations of product designs and process technology to suit local market and production conditions. Yet the region's role as an offshore assembly site had not been the technological dead end that many anticipated, and in some cases it had given rise to a dynamic accumulation of innovative capabilities in MNC operations. Second, this progress represented an intersection of transnational and local forces. The decision to upgrade in-house technical capabilities of local subsidiaries was largely an outgrowth of MNCs' global strategies for cost reduction and production flexibility. Yet the reverse was also important – the accumulated technical expertise of the MNC subsidiaries based in Southeast Asia allowed them to compete against other subsidiaries to win sophisticated production tasks and advance within their parent companies' internal division of labour. Third, by implication the localization of modest innovation capabilities had very little to do with the product life cycle. In fact, pressure to co-locate engineering and design with manufacturing, which arose out of shrinking design-to-market cycle times, was higher in more technologically dynamic or immature sectors, such as semiconductors and industrial electronics (e.g., PCs and disk drives) than more technologically mature sectors.

Creating locational advantage: government policies and 'contingent clustering'

Another misleading implication in much of the neo-structuralist literature is the notion that foreign dominance of Southeast Asia's export industries meant, almost by definition, that host-country industrial policies were irrelevant. In the long-running state versus market debate about the origins of East Asia's industrialization, the promotion of national enterprise and the pursuit of national economic autonomy were seen as the keystones of statist-nationalist development projects. Singapore always fitted uncomfortably into this mould and hence was often treated as something of an anomaly. In fact, however, Singapore's FDI-led yet highly interventionist growth pattern furnished an influential template for emulation by its less proficient neighbours. With available roles in IPNs no longer confined to simple labour-intensive assembly, Southeast Asian governments exchanged (gradually and to varying degrees) their ambitions to build nationally controlled industries for efforts to secure more advantageous positions *within* MNC-orchestrated international divisions of labour. These 'post-nationalist' industrial policies sought to build locational assets that would complement the evolving global production strategies of MNCs and thereby encourage them to upgrade their local activities.

The post-Plaza FDI boom coincided with moves by Southeast Asian governments to liberalize their FDI policy regimes and attract their share of the investment bonanza. Restrictions on foreign ownership for export projects were lifted in the mid-1980s, largely as a desperate response to a region-wide recession.

Soon, however, governments' investment promotion agencies began to hone their investment 'pitch', and ministries of trade and industry invested in specialized infrastructure and skills in a bid to complement the MNCs' regional production strategies. Singapore's Economic Development Board (EDB) spearheaded a renovation of the city-state's investment promotion, targeting incentives to encourage multinationals to invest in design and R&D activity (Schein 1996). The EDB also partnered foreign governments and individual MNCs to set up sector-specific skills training centres to facilitate the integration of higher-end manufacturing with innovation tasks, like design and R&D. Meanwhile, Singapore continued its efforts to develop a world-class infrastructure suited to globally linked production. The Port of Singapore Authority became a world leader in the application of electronic customs clearance technology, while the telephone monopoly implemented value-added network services, ISDN and eventually island-wide broadband infrastructure. A science park opened in 1989 to host foreign research units; it was equipped with specialized prototyping equipment, a patent database and services, and links to the national university. Finally, the EDB established capital investment funds to partner foreign companies in wafer fabrication and other strategic projects.

Malaysia followed suit, with a lag of a few years, in similar ways. In 1986, the Malaysian Industrial Development Authority (MIDA) was turned into a one-stop shop for investment approvals and reorganized along sectoral lines. Tax incentives for R&D investments were promulgated around the same time. Five years later, incentives were curtailed for most ordinary investments, while high-technology or strategic investments continued to receive full pioneer status tax holidays. In 1993, the Human Resources Development Fund, patterned on Singapore's Skills Development Fund, levied 1 per cent on all corporate payrolls with the amount redeemable for firms' investments in worker skills in approved training programmes. Malaysia built a science park outside Kuala Lumpur and a specialized infrastructure industrial park in Kedah state to house investments in wafer fabrication and other designated high-technology projects. Mahathir's high-technology brainchild, the Multimedia Super Corridor (MSC), took the logic of MNC-complementing policies even further. In addition to generous fiscal incentives and unlimited expatriate work permits, willing multinationals were invited to participate in the governance of the zone by serving on its advisory panel and providing input into the development of national 'cyber-legislation'.

Thailand's investment policy regime was likewise adapted, albeit less adroitly, to encourage upgrading within multinational operations. The Board of Investment pursued sector-specific investment promotion and launched an R&D tax incentive in 1989. The BOI has been the key point of contact for export manufacturers bedevilled by an inefficient Commerce Ministry and Customs Bureau. In 1995, it established a non-profit Investor Club Association to serve as an organizational interface for providing post-investment services which has since enrolled 800 BOI-promoted companies. The association's staff of sixty operates an electronic raw materials tracking system, linked to the Customs

Department through electronic data interchange, that manages the documentation necessary to avail of import-duty rebates. In 1997, the BOI also coordinated the establishment of a one-stop office with the Immigration Department to process applications for work permits.

The Philippines, as a latecomer to the regional boom in FDI-driven export growth, only belatedly adjusted its investment-promotion policies to encourage clustering and upgrading trends. A new agency, the Philippines Economic Zone Authority (PEZA), was set up in 1995 to coordinate the inflow of new export-oriented FDI, together with separate authorities in the Subic Bay and Clark free trade zones. Zone growth itself has been striking, as private developers were encouraged to upgrade the country's industrial infrastructure. From sixteen in 1994, the number of zones reached forty in 1998, with twenty more under construction, and industrial parks with specialized infrastructure (pure water, industrial gases, abundant power supplies) facilitated the clustering of Japanese semiconductor and disk drive assemblers in Laguna province. Indonesia is largely an exception to the regional trend towards more proactive FDI policies. Liberalization measures in the early 1990s created the basic conditions (import duty rebate schemes, etc.) required to induce export-oriented FDI, but Indonesia's ambitions for technological development remained vested in the strategic heavy industries push led by Suharto's protégé (and successor as president), B.J. Habibie. Most FDI remained concentrated in light, labour-intensive assembly. The only partial exception was Indonesia's participation in Singapore's bid to foster trans-border clustering in the form of a 'growth triangle' that embraced Indonesia's Batam island along with Malaysia's Johor state.

The actual efficacy of host-country FDI policies in shaping regional IPNs is difficult to assess definitively. Compared with Singapore's disciplined and highly detailed efforts to foster specific FDI clusters, most of the region's policies suffered from haphazard implementation and poor bureaucratic coordination. On the other hand, the administration of industrial zones, investment incentives and skills-development policies displayed a genuine learning curve, and their cumulative effects made Southeast Asia a highly conducive environment for globally linked production. Indeed, the expansion and technological complexity of foreign production during the 1990s, particularly in electronics, would have been difficult to predict based on fundamentals like the levels of skilled human capital, supplier industries or technological endowments. Investment promotion efforts succeeded in encouraging parallel foreign investments in a series of product and technology categories, and both deliberate coordination and unintended spill-overs (of skills, information, infrastructural development) further enhanced Southeast Asia's locational advantages.

What is distinct about this pattern is that it is geographically specific without being local in a traditional sense. Locally generated skills, technologies and national firms (which are presumed to be more committed than foreign firms to reinvesting locally) cannot explain the dynamism of Southeast Asia's manufacturing sector. The key dynamic in Southeast Asia's FDI-based industrialization, by contrast, might better be termed 'contingent clustering' in that coordination economies operating through MNCs' investment decisions gave rise to localized externalities. The key distinction here is articulated by the eminent theorist of regional economies, Michael Storper (2000: 43), who notes:

> the strategic, financial, and technological capacities of large firms have developed to the point that what goes on inside these firms or, alternatively, in networks of key firms and their principal partners and dependent contractors, has become at least as important as the classical relations between firms and territories … 'Localization' or 'territorialization' refers to economic activity dependent upon territorially-specific resources. These resources can range from asset specificities available only from a certain locale *or, more importantly, assets that are available only in the context of certain interorganizational or firm-to-market relationships that necessarily require geographical proximity* [my emphasis].

Generic trends in international production networks

However, at issue in post-crisis Southeast Asia is whether contingent FDI clustering will prove to be a durable advantage in the face of intensifying competition from other offshore production locations. Several trends during the 1990s have transformed the governance of IPNs, particularly in electronics and to varying degrees in other international manufacturing systems. First, leading multinationals have progressively adopted what Dieter Ernst (1997) calls 'systemic globalization', defined as the international dispersal and integration of potentially all elements of the value-added chain. Not only manufacturing but also marketing, financing, logistics, design, training, procurement and even R&D functions may be located abroad and coordinated with home-country operations. R&D activities remain strongly concentrated in MNCs' home-country laboratories (Patel 1997), yet this is more a symptom than a cause of the global distribution of underlying technological capabilities. Keen observers of multinational business (Dunning 2000) discern that 'asset-seeking' motivations are increasingly important in the locational decisions of major MNC investments as they seek to tap into localized concentrations of knowledge and skills around the world.

Systemic globalization makes possible a more complex variety of IPN configurations. At one extreme is the pursuit of a horizontal intra-corporate global division of labour, in which overseas units are given global product mandates. Subsidiaries perform global exports allowed to create fully vertically integrated supply chains for specific products (or product groups), and vested with R&D, design, engineering, procurement, logistics and marketing responsibilities. This IPN configuration results in relatively horizontal patterns of trade and information exchange between MNCs' overseas establishments. At the other end of the strategic spectrum lie efforts to integrate all overseas operations into a single intra-firm functional hierarchy. MNCs have their offshore subsidiaries become increasingly specialized in specific components, or a single stage of the production process, which serve the parent company's entire product range on a global basis through vertical, intra-firm trade. In reality, a mix of strategies has been observed, varying by sector and by individual corporation. During the last fifteen years, however, MNCs' globalization strategies took on a distinctly regional cast, as functions such as design, procurement and customer relations were simultaneously internationalized and concentrated in regional headquarters. In Asia, regional HQs were most often located in Singapore or Hong Kong.

The second broad trend affecting IPNs in Asia is systematic outsourcing. Many critiques of IPNs draw on industrial organization theories of FDI, in which corporations secure quasi-monopoly rents by leveraging their firm-specific assets, including technology, to internalize a growing range of transactions. In the past five years, however, MNCs' competitive strategies have led them in the opposite direction, towards a strategy that Borrus (1999) calls 'Wintelism'. Leading firms in electronics (and other sectors to a lesser extent) have increasingly specialized in specific stages of the value chain, such as design and marketing, that allow them to set the 'architectural standards' for an entire industry. They then outsource a growing range of functions, including ancillary services, administrative functions, design and engineering, and various stages of production up to and including the entire manufacturing process. In contrast to internalization strategies based on proprietary standards, Wintelist competitors disseminate their 'private but open' technical standards to a wide range of complementary network collaborators, including manufacturing and design subcontractors, distributors and strategic development alliance partners (*ibid*).

A third shift, related to the others but even more momentous, is the advent of electronic commerce as a generic technology for coordinating IPNs. Business-to-business (B2B) e-commerce technology enables the real-time exchange of production-related data over a global scale and makes the entire value-added chain transparent to all network participants. In contrast to its predecessor, electronic data interchange systems, web-based B2B technologies radically reduce the fixed-cost entry barriers to participating in electronic networks. Moreover, their open standards permit more flexible, horizontal information exchange. One result of this trend, and its associated advances in data management and distributed processing, has been to commodify international logistics, once a prime source of MNCs' proprietary competitive advantage. Increasingly, then, flagship MNCs are choosing to outsource a great part of their supply networks to specialized logistics providers. In a major sign of this trend, a rapidly growing proportion of global production of consumer, telecommunications and PC-related electronics is carried out by specialized contract electronics manufacturers (CEMs) like Celestica, Solectron, SCI Systems and Flextronics. CEMs work with brand-holding principals, which remain the flagship corporations of IPNs, to produce to precise design and quality specifications, but they have nearly complete autonomy to manage procurement, assembly, logistics and, sometimes, final distribution on a worldwide basis.

These trends hold enormous implications for the geography of production in Asia, yet their major impacts are only now beginning to emerge. An optimistic analysis is that as IPNs become more open and less hierarchical, developing countries may seize new opportunities for upward mobility in global value chains. As MNCs shift more technically complex functions offshore, Southeast Asia may hope to lure some of these functions, including design and training headquarters, IT support centres, back-office and other specialized business service centres, and even R&D operations. Likewise, the outsourcing trend ostensibly affords Asian producers more autonomy to expand from simple manufacturing towards more integrated, innovation-based production. Smaller players, such as the handful of indigenous subcontractors in Southeast Asia, may hope to compete with China's enormous scale advantages by accessing a more open system of global supply networks. They may align themselves with MNCs' bids to make their technologies industry standards through accelerated diffusion to OEMs and other subcontractors. Finally, the e-commerce revolution, by diminishing the importance of geographical proximity to final markets, holds out the prospect that economies with smaller industrial bases and domestic markets, such as those in Southeast Asia, may nonetheless maintain a presence in global supply networks despite their geographical remoteness.

There is a far more pessimistic analysis, in which changes in global manufacturing systems herald intensified and increasingly de-localized competition. Simply put, open IPN architecture may signal greater willingness by MNCs to tap into pre-existing clusters of manufacturing and technological expertise while simultaneously reducing their incentive to develop new capabilities and supply links in any given location, or even to maintain longstanding offshore establishments and supplier networks. Even as systemic globalization makes IPNs more horizontal at a global level, with MNCs transferring design, procurement and R&D responsibilities to their East and Southeast Asian subsidiaries, they simultaneously become more hierarchical and vertically specialized *within* the region, with more complex functions re-centralized in regional HQs. Thus the ongoing rationalization of IPNs may enhance Singapore's efforts to shift its economy into innovation-driven producer services and R&D while diminishing the chances for lower-tier economies like Thailand and the Philippines to augment their manufacturing roles with co-located design and development capabilities.

The outsourcing trend also has ambiguous implications for latecomer technological learning. For those economies already equipped with the capacity for large-scale production, specialized design expertise or international logistics and coordination abilities, outsourcing may allow rapid expansion along the value chain towards turnkey OEM and ODM. Yet, compared with flagship MNCs with proprietary networks, the new breed of contract electronics manufacturers may have even less interest in their local environments, especially with regard to vendor development, i.e. identifying geographically proximate suppliers and nurturing them with technical and financial assistance. In fact, CEMs' core competitive advantage, as integrators of new and truly global supply networks, is their capacity to arbitrage the cost and productivity advantages of manufacturing in different locations. They continuously reshuffle production volume globally in response to short-term cost and logistical advantages.

E-commerce may likewise greatly sharpen locational competition, to Southeast Asia's potential disadvantage. A key aspect of greater openness of e-commerce networks is the diminished importance of geographical proximity in the configuration of IPNs. While electronic networks enable the rapid diffusion of common standards and codified technical knowledge, they filter out the social interactions that transmit tacit, experience-based knowledge, which lies at the heart of the localized technological learning observed in industry clusters. B2B exchanges and electronic marketplaces, with their radically diminished entry barriers and delocalized structures, are contributing to a consolidation of regional and global markets for components and other intermediate goods. This may favour established subcontractors who possess autonomous technological capabilities, massive production scales and a regional or global production presence. But they are likely also to shift bargaining power to major buyers, or IPN flagship corporations, who can use electronic market systems to squeeze supplier firms into more direct, transparent price competition over ever wider domains. In short, the same qualities that make web-based networks more effective at integrating existing capabilities from diverse localities may lessen their role in developing them in new locations.

These contrasting scenarios point to the dual role of IPNs, as mechanisms for integrating and mobilizing existing assets and as communities in which knowledge can be shared and interactive learning can occur. Southeast Asia's industrial future depends upon the balance struck between these two roles. In general terms, the region's governments have become increasingly aware of the need to upgrade their local capability-building mechanisms and invest in the diffusion of technical standards and e-commerce capabilities among a broader range of domestic enterprises. Changes in IPN governance and geography may offer new opportunities for upward mobility along value chains into more complex and lucrative value-added roles. Yet Southeast Asian host economies can rely less than before on the internal technological dynamism of foreign-dominated sectors to bring structural change. Instead, cluster-building efforts depend more than ever on local factors, including the policy capacities of state investment and industrial extension agencies.

Southeast Asian policy responses

In response to the tectonic shifts in global production systems, Southeast Asian governments have amplified their search for policies that will secure their positions in the global supply and manufacturing architectures of MNCs. Their policies do not amount to a fully formed strategic response to new competitive challenges; with the perennial exception of Singapore, the shift in direction typically remains muddled and incremental. Yet the sum effects may complement MNCs' own interests in maintaining and developing Southeast Asian production bases, to a degree that the region's industrialization trajectory survives, in modified form, the sudden ascendancy of China and other newly favoured sites for global production.

The first policy thrust builds on ASEAN's prior success in promoting FDI in manufacturing, but it extends the scope of investment policy regimes to capitalize on systemic globalization. Investment policies in the late 1990s began to shift from targeting individual sectors, and they now seek to foster clusters of complementary assembly, component production, producer services, skills development, and technology support infrastructure. Beyond attracting new types of FDI, this goal draws attention to the importance of encouraging established producers to reinvest in deepening their local operations, upgrading skills, forming local linkages and undertaking a higher profile in the global operations of their parent companies. Southeast Asian investment agencies and industry ministries have likewise widened their promotional incentives to capitalize on new types of FDI associated with the outsourcing trend, including producer services, logistics, venture-capital and back-office functions. A salient aspect of this effort is the granting of special incentives to investments in regional or operational headquarters (RHQs, OHQs), multinational corporate offices established to provide managerial and technical support to affiliates across Asia, as well as international procurement offices (IPOs), which manage supply chains and logistics.

Singapore's Economic Development Board (EDB) has pioneered these 'third-generation' investment policies (UNCTAD 2001), from which other Southeast Asian investment promotion agencies have sought to learn and emulate. In the early 1990s, the EDB began to target business clusters in electronics, petrochemicals, engineering services, logistics, biotechnology, IT and other areas. Singapore launched its RHQ scheme in 1986, as its labour-intensive manufacturing base began to relocate to other Southeast Asian countries. By early 2002, Singapore had granted 220 certificates to investments worth more than US$543 million and employing 2,000 executives, and the EDB mandarins had set a target of 1,000 global and regional headquarters. These figures reflect Singapore's drive to exploit the systemic globalization strategies of MNCs. Hitachi, for example, vested one of its Singapore subsidiaries with a global product mandate in disk drive and other storage media products. A dramatic illustration of the intersection of IPN changes and Singapore's response is the case of Caltex Corporation, which decided in 2000 to relocate its global headquarters from the USA to Singapore in order to be closer to its key production, refining and distribution networks.

Malaysia followed suit in 1990, and by mid-1999 had awarded incentives to forty-five OHQs. Its cluster-based Second Industrial Master Plan, announced in 1996, offered incentives for MNC investments in design, engineering and logistics projects. Thailand began in 1996 with an RHQ scheme whose criteria were liberally defined to include consulting, exporting, wholesaling and equipment maintenance, and by 1999, its BOI had approved 102 trade and investment support offices, with cumulative investment of more than 3.2 billion baht. Perceptions that it was falling behind in the race for headquarters and related investments in business services led Thailand to seek to revamp its RHQ programme in late 2001. The Philippines investment code also offers incentives to foreign investors establishing RHQs to provide managerial support to affiliated companies abroad. The scheme met little response, so in 1997 eligibility was extended to a wider range of managerial activities and relaxed to permit RHQs to generate sales revenue in the local market.[6] Similar incentive programmes target procurement and supply-chain management functions as MNCs have localized these within the region. Again, Singapore holds a tremendous advantage in this locational competition by virtue of its superior infrastructure and longstanding status as a trading and trans shipment centre. By early 2003, however, Malaysia had approved sixty OHQs with paid-up capital of US$90 million and 111 international procurement centres with a combined operating expenditure of US$370 million.[7]

Concern about their over-reliance on electronics manufacturing has also led authorities to seek to use investment policies to promote FDI into manufacturing-related and non-manufacturing activities, including high value-added services, which are increasingly internationalized or outsourced by leading multinationals. Following its decision to accelerate the liberalization of Singapore's telecommunications markets in 1999, for example, the EDB began to grant pioneer status to telecommunications service providers, network integrators and content developers. In recognition of the blending of its traditional manufacturing base with information-intensive functions, the EDB began to grant 'manufacturing headquarters' promotional status to these and other cluster-augmenting investments. The EDB has also been quick to identify new niches in the regional division of labour opened up by e-commerce. Dell Computer, the poster-child for build-to-order supply-chain management, set up its on-line data centre in Singapore, designated its Asia-Pacific 'Web Farm'. In 2000, IBM partnered Singapore ISP Pacific Internet to develop new e-commerce tools. Cisco Systems opened a US$6 million 'proof of concept' laboratory in the same year, while in 1999 Ericsson had opened a $7 million cyber-laboratory to develop wireless e-commerce applications. An EDB strategy to promote Singapore as a hub for intellectual property management began in 2002 with a web-based search portal and a matching grant scheme for global patent applications, which soon attracted projects like Japanese corporation NEC's new Asian regional intellectual asset management operation.

Malaysia's MSC was conceived as a grand strategy to leapfrog the country into innovation-based software and IT systems development, in direct competition with Singapore and other IT clusters among the first-generation of new industrial economies. The broad consensus is that this bid has been an expensive failure. Yet, while the MSC has not produced an innovation cluster of the calibre of Silicon Valley, Malaysia has seen a more modest trend of foreign investment in IT, especially including manufacturing-linked services and back-office operations. In 2000, for example, IBM located its ASEAN/South Asia customer support operations centre in the MSC, a move followed by 3-COM in setting up a web-based call centre and retail-chain management operation, and Ericsson's US$40 million regional training and support service centre and a separate design centre. Even more than Malaysia, the Philippines has come to view outsourcing of back- and front-office business operations by MNCs as one of the most promising opportunities to develop new niche clusters within IPNs. This strategic focus began with Federal Express's choice of the Subic Bay Free Trade Zone for its regional logistics and flight operations headquarters in 1994, with arch-rival UPS following seven years later. In 1998, AOL set up one of its global customer call centres in the Clark Development Zone, citing low costs and high workforce English-language proficiency. The zone authorities and the Department of Trade and Industry (DTI) reacted by formulating a new promotional drive to consolidate the Philippines' status as a primary regional centre for operations like customer services, accounting, and computer coding and data processing. In April 2000, Amazon.com announced that it would locate distribution, accounting and data-coding operations in the Philippines. By early 2003, twenty-two call centre service companies were operating in the country.

A third and potentially more significant policy trend is a renewed focus across Southeast Asia on the development of small and medium-sized enterprises (SMEs). SME support programmes have perennial political appeal as populist economic measures, but recent initiatives reflect a multifaceted effort to nurture populations of competitive supplier firms to support dynamic industrial clusters. In the late 1990s, the region's governments jump-started the dissemination of the ISO 9000 quality systems standards by setting up public training and certification authorities. In the past few years, the focus has shifted towards diffusing e-commerce tools, as supply chains have increasingly migrated onto web-based systems. Again, Singapore's example set the paradigm for regional policy learning. The EDB's Local Industry Upgrading Program (LIUP), begun in the early 1980s, subsidized MNCs' vendor-development activities, including providing technical assistance and training to local subcontractors. Beginning in 1996, the city-state's National Computer Board worked with major multinationals like Oracle Corp. to set up a parallel programme for the diffusion of e-commerce technology to local supplier industries. The goal of the LIUP was to ensure that local suppliers would retain their position in supply chains as MNCs migrated their regional procurement onto web-based systems, or outsourced them to specialized CEMs and logistics providers.

From 1999 onwards, Singapore's supplier development programmes were consolidated under a new 'technopreneurship' strategy, which packaged technical assistance with new financial incentives incentives to encourage the formation of new, technology-based start-ups (Wong 2001). The US$1 billion Technopreneurship Fund (later expanded) was set up to operate with foreign venture-capital companies on a matching-fund basis. Although the bursting of the dot-com bubble dealt a severe blow to Singapore's bid to emulate Silicon Valley, the establishment of a venture-capital industry, backed by the government's patient capital, created a new institutional infrastructure for SME support that has survived the downturn; by 2003, 130 international venture-capital firms were managing funds worth US$8 billion from Singapore (*Far Eastern Economic Review*, 31 October 2003). In late 2000, the Infocomm Development Authority established a new e-business industry development scheme to assist SMEs to adopt e-commerce technology, while the Agency for Science, Technology and Research launched a 'borrow a scientist' scheme in which public sector researchers are seconded to smaller firms to assist R&D efforts. An investment arm of the Singapore government helped to establish Sesame.com, which quickly became a leading B2B e-commerce portal with an Asian regional spread.

Rosetta-net, a non-profit association dedicated to creating and diffusing an open-source e-commerce standard, had enlisted over 100 members by mid-2001 and had set up an e-learning centre to offer sector-specific training courses. Singapore's linkage-development programmes have spawned a comparatively broad and deep base of local supply firms in precision engineering, components manufacturing and OEM subcontracting. Indeed, a government-invested company named Natsteel Electronics quickly rose in the late 1990s to become one of the world's top five CEMs, with plants around the Asia-Pacific, before being acquired by Solectron (the world's leading contract manufacturer).

SME programmes in the rest of Southeast Asia, despite their ubiquity, are generally less ambitious and successful as instruments of industrial strategy. Yet in an effort to remediate the meagre linkage effects of boom-era FDI, several countries launched special linkage-support programmes during the 1990s along the lines of Singapore's LIUP. Most of these begin with government investment promotion agencies, which are the key contact points with foreign investors and which seek to play a match-making role between MNCs and potential local suppliers. However, the large gap in skills and technology between foreign and local firms has caused governments to revamp their industrial extension systems to upgrade local supplier industries, often packaging technical support with dedicated financing programmes. Malaysia initiated a vendor development programme in 1993, under which multinational and local 'anchor companies' would provide guaranteed purchasing contracts and technical assistance to local vendors, who would also receive subsidized finance from local banks and technical support from government institutes. Under the cluster-based Second Industrial Master Plan (1996–2005), this was expanded into a broader linkage-development programme under the auspices of the new Small and Medium-sized Industry Development Corporation (SMIDEC). A global supplier program launched in 1999 aimed to help established MNC subcontractors to move beyond dependence on local links to a single principal buyer and to enter international supply networks. SMIDEC also administers the Industrial Technology Assistance Fund (ITAF), which since the early 1990s has provided matching grants to SMEs for technology acquisition and productivity improvement. SMIDEC's programmes had assisted 832 SMEs by April 2001. A separate grant scheme for the adoption of e-commerce technology was launched in July 2000, and 674 applications had been approved by April 2001 for the adoption of ERP and e-commerce applications. The MSC's development corporation also launched several venture-capital funds, totalling US$300 million, to nurture technology-based start-ups, although their performance has not matched Singapore's similar funds, which operate closely with private foreign venture-capital partners.

Linkage development has been most notable in Penang state, where a proactive local development authority has long fostered networking among MNC managers, including locally recruited executives of US companies and local suppliers of engineering parts and services. The Penang Skills Development Centre (PSDC) has become the focal point of cluster-enhancing initiatives, most notably in engineering training courses jointly managed by MNCs and in supplier development efforts subsidized by SMIDEC's global supplier programme and a new initiative, TiGER, to equip local suppliers with e-commerce capabilities. A small handful of subcontractors in Penang have grown to become key players in the regional supply networks of their chief MNC customers and have now established facilities in the Philippines, China and elsewhere.

Thailand's supplier base was initially nurtured through traditional local content programmes in the automotive and electrical appliance sectors, which gave rise to a relatively large base of supporting industries in metal working, tool and die, plastic products, PCB assembly, and electrical components. While local-content policies often result in the creation of uncompetitive industries, Thailand's automotive localization programme ultimately laid the foundation for success, not as a nationally owned export industry but as a 'contingent cluster' of international production by MNCs. In the wake of a US$1 billion investment committed by General Motors in 1995, new Japanese and European investments transformed the sector from an import-substituting industry to a base for regional exports.

As for specific linkage programmes, Thailand's BOI launched a scheme called BUILD (Board of Industry Unit for Linkage Development) in 1992, but its efforts produced meagre results before 1997 when the programme was revamped. A more proactive match-making effort, named the 'buyers meet vendors' programme, worked to arrange site visits to leading MNCs, 'reverse investment fairs' of the potential procurement needs of foreign buyers, and sector-specific informational workshops. By 1999, the BOI had arranged visits to eighteen large companies involving a total of 491 potential suppliers, and it claimed that fifty-eight contracts worth nearly 1 billion baht had resulted from the meetings, rising to 2.64 billion baht in 2000, although the actual importance of the government's intervention is unclear. In 2000, the BOI also established an ASEAN-wide supporting industries database, which included 20,000 firms by the end of 2001.

In 1999, the Ministry of Industry corporatized several of its sectoral divisions to create quasi-public extension and training institutes under an Industrial Promotion Foundation. The new organizational framework boded well for an enhanced extension effort, yet funding limitations have prevented this potential being fulfilled. The adoption of e-commerce has also lagged in Thailand, although the BOI works with local ISPs to subsidize the adoption of simple e-commerce tools among suppliers registered on its database. A comparatively small 106 software projects received promotional status after the introduction of incentives in mid-1997 through to mid-2001. Despite Thailand's slow progress in developing a relevant policy and institutional infrastructure, the BOI in early 2001 announced new plans for cluster-based policy making involving an expanded BUILD programme covering light manufacturing and agriculture-based industries as well as electronics and automobiles. The automotive sector has gone on to new strength in the post-crisis period as leading MNCs expanded exports rapidly. Toyota granted its Thai affiliate a global product mandate (including exports into the Japanese domestic market) from Toyota for the production of one-ton pick-ups.

Conclusion: Southeast Asia's prospects in the global production system

The collapse of global electronics markets in 2001 hit Southeast Asia tremendously hard. At the same time, China has offered prospective investors a potent combination of competitive advantages: the world's only rapidly growing economy, the biggest potential domestic market in a range of products, and the promise of easier access with the country's accession to the WTO. In the light of these factors, China's sudden rise to regional economic dominance is easily understood, at least with hindsight. Whether the current perception of a 'China threat' to Southeast Asia's industrial prospects is overdrawn remains to be seen. Ben Anderson (1998) reminds us that the industrialization of Southeast Asia was an unlikely by-product of the Cold War in Asia, which cut off the Chinese industrial heartland from the global economy. In his pessimistic analysis, Southeast Asia has failed to convert its FDI windfall into durable local advantages, based on human resources and technological development, and it may yet revert to its historical status as a resource-rich tropical hinterland to an industrialized East Asia. Similar expressions of alarm are often heard around the region, and governments have mooted new development models that focus on either demand-led domestic growth or agricultural and resource-based exports. However, despite the weak indigenous foundations of Southeast Asia's industrial ascent, its serendipitous boom has in fact created durable legacies. The region's advantages as a node within a networked global production economy have not evaporated in the face of the Chinese challenge but are evolving towards particular niches and horizontal clusters of multinational activity.

While MNCs are currently pouring money into China to create the production base required to serve booming markets and to achieve cost reductions in mass production for global export markets, China presents a thorny bouquet from the standpoint of IPN governance. The key long-term strategic consideration in IPN evolution is the ability of MNCs to appropriate and deploy intangible core assets – knowledge, skills and business alliances – globally while regulating their far-flung networks for maximum competitive advantage. China's policy making with regard to foreign-invested operations may yet see significant shifts, and the administrative complexities of dealing with national, provincial and local officials will continue to be an important stumbling block to MNCs' efforts to optimize their production networks there. Informal barriers to efficient management and supply logistics will remain significant for years to come, despite WTO accession. China's low-wage advantages are deceptively large; social insurance fund contributions and local payroll levies often impinge on MNCs' cost structures. The security of intellectual property will be a perpetual concern, not merely in terms of software and media products but also in terms of high-technology product designs and process technologies. By contrast, Southeast Asia offers leading MNCs an environment in which they can articulate their global production strategies with maximum flexibility and security. These countries' post-crisis struggles reveal more policy continuity than much of the political rhetoric and external commentary would suggest. Despite some second guessing, the region's governments have enhanced their efforts to upgrade their policy and institutional infrastructures, and they remain well positioned for the revival of electronics and other manufactured export industries.

As MNCs continue to build and reshape their IPNs, they will inevitably seek to integrate East Asian operations, including China, with their established Southeast Asian bases. It is significant that Indonesia accounts for 60 per cent of the decline in FDI in Southeast Asia from 1996 to 2001. Indeed, when Indonesia is excluded, FDI flows into Southeast Asia in 2001 registered a net increase over the average annual totals for 1990–95. Despite the fall-off in exports during the US recession, FDI totals have remained fairly stable across most of the rest of industrializing Southeast Asia, albeit at lower levels than their peaks in the late boom era.

A new regional division of labour is emerging, in which Southeast Asia's industrializing economies have the opportunity to build upon their existing advantages, locate new niches in the international production system and foster complementary local dynamism. In addition to maintaining political stability and investing in human resources, they will need to continue to develop their capacity for implementing cluster-building policies. In contrast to the general tenor of much commentary on the region's reform process, the crucial task is not to shrink the state's economic role decisively but to enhance its efficacy in investing in and diffusing the institutional, infrastructural, technical and skills bases appropriate to globally linked production.

Notes

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2 Hatch and Yamamura (1996: 10) put it starkly:

> By building keiretsu-like production networks that embrace and even smother local entrepreneurs, technicians, and workers in Asia, Japanese MNCs carefully control the pace of technology transfer. In effect, they lock it up in the vertical, quasi-integrated networks they control. In doing so, they are able to extract an unusually large share of the rent on the use of their know-how.

3 Much of this critique has been elaborated with particular reference to Japanese IPNs, and there is a large literature focusing on the differences in network structures and localization behaviour among MNCs from different home countries (Borrus *et al.* 2000). American electronics companies have practised a more open approach to network governance at the local, regional and global scales than have Japanese and other East Asian multinationals. Yet the syndromes of MNC network-based control, limited host-country autonomy and constrained structural dynamism are much broader questions than the variation by national origin of MNCs.

4 Recognition of this pattern has contributed to a new interest in the role of industrial clusters in both advanced and developing countries. See Schmitz and Nadvi (1999).

5 The extent of production deepening in Southeast Asia was often obscured by the parallel trend towards greater regional integration. Local procurement ratios, measuring the sourcing of components within a given national territory, rose only slowly and typically stagnated at around 30–35 per cent by value, even after a decade or more of production. At the same time, however, the regional procurement of components increased markedly over the boom period, a trend that has continued in the wake of the crisis. In 2000, Japan experienced a deficit with Asia in the trade of intermediate goods – parts and components – for the first time.

6 As in other countries, the original exclusion of in-country revenue generation was designed to distinguish genuine RHQs, with their skills-intensive managerial control and coordination functions, from mere representative offices, which simply arrange local sales.

7 The economic value added by RHQs/OHQs/IPOs is difficult to measure. Their reported sales turnover is greater by orders of magnitude than their true added value. Moreover, their transactions reflect internal corporate accounting rather than market-based pricing.

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6 Coalitions, convergence and corporate governance reform in Indonesia[1]

Andrew Rosser

Introduction

In recent years, many scholars have claimed that globalization is leading to increasing convergence in the nature of corporate governance systems across the globe. In a number of cases, they have argued that these systems are converging on the Anglo-American or 'outsider' model of corporate governance, the defining features of which are a high reliance on equity finance; dispersed ownership; strong legal protection of shareholders, including minority shareholders; strong bankruptcy regulations and courts; little role for creditors, employees and other stakeholders in company management; strong requirements for disclosure; and considerable freedom to merge or acquire. Hansmann and Kraakman (2000) have even gone so far as to argue that a global consensus has now emerged 'that corporate managers should act exclusively in the economic interests of shareholders' and that, as a result, all jurisdictions will inevitably move towards the outsider model of corporate governance. Borrowing Fukuyama's (1992) notion of the 'end of history', they suggest that we have reached the 'end of history for corporate law'.

Other scholars have argued that corporate governance systems are converging on a hybrid model of corporate governance – one that combines the outsider model with the 'insider' model characteristic of Germany and Japan (Rubach and Sebora 1998; Prowse 1999; Nestor and Thompson 2001). In contrast to the outsider model, the insider model is characterized by a high reliance on bank finance; concentrated ownership; weak legal protection of minority shareholders; a central role for stakeholders (e.g. creditors and employees) in the ownership and management of companies; weak disclosure; and limited freedom to merge or acquire. Yet scholars who argue that corporate governance systems are converging on a hybrid model generally suggest that far more change is involved for countries currently employing the insider model than for countries employing the outsider model. As such, their argument is very similar to that of the first group of scholars.

Claims that corporate governance systems are undergoing convergence have intensified in the wake of the Asian crisis. Weaknesses in Asian corporate governance systems were widely seen as a primary cause of the Asian crisis and its after effects (Summers 1998; Greenspan 1999; Capulong *et al.* 2000; Gregory 2000; Johnson *et al.* 2000; Dickinson and Mullineux 2001). In the wake of the crisis, the Organisation for Economic Co-operation and Development (OECD), the World Bank and the Asian Development Bank (ADB) have launched a range of initiatives to promote corporate governance reform in developing and transition economies.[2] At the same time, the International Monetary Fund (IMF) has made the adoption of corporate governance reforms a condition of its assistance programmes for Thailand, South Korea and Indonesia. Some commentators have seen these developments as further evidence of a trend towards convergence (Hansen 2001).

This paper examines Indonesia's experience with corporate governance reform. Contrary to the convergence thesis, it argues that Indonesia's corporate governance system, which has been a variant of the insider model, is unlikely to converge on the outsider model of corporate governance, at least in so far as this means an exact replication of this model in the country. While the Indonesian government has introduced a range of corporate governance reforms aimed at bringing in key elements of the outsider model since the mid-1980s, and especially since the onset of the Asian crisis, there have been serious problems with the implementation and enforcement of these reforms. In short, what appears to be emerging in Indonesia is a corporate governance system that resembles the outsider model of corporate governance in form but not in substance. Just as some scholars have suggested that at the macro level different forms of neoliberalism can exist simultaneously (Jomo 2001: 44–5), so the Indonesian case suggests that different forms of the outsider model of corporate governance can exist simultaneously at the micro level.

Underlying this outcome, it is argued, has been the structure of power and interest in Indonesia. The pattern of corporate governance reform in Indonesia over the past two decades has been a function of shifts in the balance of power between two coalitions of interest: the first consists of the controllers of financial capital and their allies in Western governments and international financial institutions (IFIs) such as the World Bank, the IMF and the ADB; and the second consists of the stratum of politico-bureaucrats that has occupied the state apparatus and the owners of the major domestic conglomerates. Whereas the first coalition has been supportive of reforming corporate governance, the second has sought to block or subvert reform. While the economic crisis has shifted the balance of power away from the second coalition and towards the first, these shifts have not been sufficient to make thoroughgoing corporate governance reform possible. In short, the political preconditions for convergence have not yet been established.

Understanding corporate governance reform

Underlying convergence arguments is a belief that convergence of corporate governance systems is both desirable and inevitable. As O'Sullivan (1999: 3–4) has pointed out, convergence arguments are underpinned by the neoclassical idea that the creation of liberal markets, which corporate governance reform is seen as facilitating, leads to optimal economic outcomes and, in particular, maximum efficiency in terms of the allocation of scarce economic resources. At the same time, these arguments suggest that growth and efficiency concerns are the driving force behind reform of corporate governance. Hansmann and Kraakman (2000), for instance, argue that the victory of the outsider model of corporate governance has stemmed from the failure of alternative models to produce the same levels of efficiency and growth, the persuasiveness of arguments that the outsider model provides greater efficiency and the tendency for mobile capital to locate itself in countries that have efficient corporate governance systems.

The view taken here, by contrast, is that corporate governance reform needs to be understood, not in terms of the extent to which it promotes growth and efficiency but in terms of the extent to which it serves or harms particular political and social interests. Corporate governance systems are an 'institution' in the sense that Douglass North has used the term (North 1981; 1990): that is, a particular configuration of rules, regulations and enforcement mechanisms that govern economic behaviour. More specifically, they are an institution that governs 'who makes investment decisions in corporations, what types of investments they make, and how returns from investments are distributed' (O'Sullivan 1999: 2). As such, they embody particular political and social interests; they reflect the balance of power in society between the various elements that have an interest in corporate performance and behaviour. This in turn means that corporate governance reform requires a prior shift in the balance of power away from coalitions that are opposed to such reform and towards coalitions that support reform.

In this view, there is no reason to assume that, just because a particular corporate governance system may result in greater economic efficiency than alternative models, it will eventually be adopted and implemented, even in the long run. The nature of corporate governance systems in particular countries will ultimately depend on the balance of power between competing coalitions of interest in those countries at particular times. As such, to understand the nature of corporate governance systems and reform processes in particular countries properly, it is important to identify which actors have an interest in the nature of a country's corporate governance system, what that interest is and how they seek to influence corporate governance policy and implementation.

At the global level, two sets of actors have played a key role in promoting reform of corporate governance in recent years. The first of these has been the controllers of financial capital.[3] As financial capital has become increasingly mobile, controllers of this capital have sought harmonization of financial sector regulations and practices to facilitate access to and exit from foreign markets and thereby reduce the risk and increase the profits associated with foreign investments. This has included harmonization of corporate governance regulations and practices, because these have determined whether controllers of financial capital have access to good-quality information on which to base their investment decisions and how well their interests are protected once they invest. One way in which they have sought to promote harmonization of corporate governance regulations and practices has been through funding of international standard-setting bodies such as the International Accounting Standards Board. This body produces international accounting standards, which individual countries can adopt instead of developing their own national standards. At the same time, controllers of financial capital have also made use of their structural power[4] to promote harmonization. With enhanced mobility, controllers of financial capital have been able to threaten states that they will relocate their capital to alternative jurisdictions if those states do not put in place corporate governance arrangements that suit their interests. This has placed significant structural pressure on states to pursue harmonization, especially in developing countries: if they do not, they risk reduced access to international financial markets and the economic benefits that go with this.

Western governments and the IFIs have been the other set of actors that have played a key role in promoting global corporate governance reform in recent years. As already mentioned, the OECD and the IFIs have introduced a range of programmes to promote corporate governance reform in developing countries in the wake of the Asian crisis. In part, this reflects widespread concern in industrialized countries that corporate governance systems in developing countries constitute a threat to the stability of the international financial system.[5] But it also reflects the close relationship that exists between the US government and the IFIs. With the USA having by far the dominant voice in the IMF and the World Bank, the US Treasury's line on economic policy matters has often had a strong influence on the policies of the IFIs (Bhagwati 1998; Wade 2001).

Beyond controllers of financial capital, Western governments and the IFIs, the actors that have been involved in corporate governance policy making and implementation have varied from country to country depending on the structure of power and interest that has existed in these countries. For instance, in Germany, where labour has been a relatively powerful political force, company employees have been the principal opponents of corporate governance reform. As Ziegler (2000: 198) has pointed out, a century of political struggle between workers and employers in Germany has produced a corporate governance system in which employees in many companies are represented on supervisory boards and are consequently able to play a role in company management. They have thus opposed adoption of the outsider model of corporate governance, because this would shift influence over companies away from employees (and other stakeholders) towards outside shareholders. Yet company employees have not been key actors in corporate governance policy making in Indonesia, where labour has been much weaker politically (Hadiz 1997) and employees have not generally had representation on company boards.

Actors and interests in Indonesia

In Indonesia, the main actors in corporate governance policy making since the New Order came to power in 1965 – in addition to the controllers of financial capital, Western governments and the IFIs – have been the stratum of politico-bureaucrats who have occupied the state apparatus; the owners of the major domestic conglomerates; and the small group of liberal technocrats based in the Ministry of Finance and other key economic ministries and agencies.[6] The first two of these elements have constituted the dominant coalition for much of the New Order period (i.e., 1965–99; Rosser 2002: 33–47). The politico-bureaucrats have been able 'to appropriate the offices of the state apparatus and in their own right exercise authority over the allocation of resources and access', effectively fusing political and bureaucratic power (Robison 1996: 82). At the same time, the owners of the major domestic conglomerates have exploited their strong connections with individual politico-bureaucrats to secure privileged access to state bank loans, trade and investment licenses, forestry concessions and other forms of state largesse and protection (Robison 1986; Schwarz 1994). Among the most successful business people under the New Order were several of President Suharto's children, his half-brother, his step-brother and some of his close associates. In short, the politico-bureaucrats and the owners of the conglomerates have exercised a form of instrumental control over the state: it has been their occupancy of senior political and bureaucratic positions, or their connections with individuals in these positions, that has given them influence over state policy.

Both the politico-bureaucrats and the owners of domestic conglomerates have been strong opponents of reforming corporate governance in so far as this has meant the full implementation of the outsider model of corporate governance or a hybrid variant of this model. The owners of major domestic conglomerates have had an interest in maintaining an insider system of corporate governance because that has made it possible for them to avoid disclosure of sensitive information, to retain control over the companies they founded in terms of both ownership and management, to abuse minority shareholders with impunity, and to avoid bankruptcy. In a booming capital market, they have thus been able to reap the benefits of listing on the stock market (e.g., raising cheap capital) without incurring any of the costs. Similarly, the politico-bureaucrats have had an interest in maintaining this system because it has made it easier for them to hide the precise nature of their connections to leading business groups and exploit state-owned enterprises for their own benefit. In the absence of adequate corporate governance systems, senior government officials have been able to secure lucrative positions in these enterprises, to ensure that supply contracts for these enterprises are awarded to private sector companies with which they have close connections, and to use these enterprises to raise extra-budgetary revenue for sections of the military and government departments (Crouch 1978: 273–303; Robison 1986: 211–49).

The technocrats, by contrast, have been strong advocates of corporate governance reform. Prior to the Asian crisis, they saw such reform as necessary to ensure that the country continued to mobilize investment capital from non-oil sources through the capital market successfully (Prawiro 1991; Muhammad 1995, 1996). Since the Asian crisis, they have seen it as a precondition for the revitalization of the private sector and economic recovery more generally (Herwidayatmo 2000; World Bank 2002). Their support for corporate governance reform has reflected their general commitment to liberal market reform: they have seen the development of a stronger framework for corporate governance as crucial to the development of a more market-based economy in Indonesia.[7]

However, in contrast to the politico-bureaucrats and the owners of the major conglomerates, their influence over policy has stemmed from the apparent ability of their policies to attract financial and other forms of mobile capital and foreign aid into Indonesia. At a number of key points in Indonesia's recent history, most notably during the mid-1960s and the mid-1980s, the technocrats were able to devise economic policy programs that brought financial and other forms of mobile capital as well as increased foreign aid into the country (Robison 1986; Winters 1996; Rosser 2002). The technocrats' primary concern has always been to ensure the continued health of the Indonesian economy, but there has always been a strong correspondence between their policy preferences and the interests and agendas of mobile capital controllers, the IFIs and Western governments.

In summary, the nature of Indonesia's system of corporate governance since the beginning of the New Order period has reflected the balance of power between two competing coalitions of interest. The first of these has consisted of the controllers of financial capital and their allies in Western governments and the IFIs and has been represented in the Indonesian government by the technocrats. The second has consisted of the politico-bureaucrats and the owners of the major domestic conglomerates.

Corporate governance in Indonesia prior to the mid-1980s

Prior to the mid-1980s, Indonesia's corporate governance system was characterized by a high reliance on bank finance, low levels of transparency and disclosure, concentrated ownership, owner management, weak protection of creditors and minority shareholders, and limited ability to merge or acquire.

Corporate finance

Prior to the mid-1980s, private sector conglomerates and state-owned enterprises relied primarily on the banking system to finance their investments. When the New Order came to power in 1965, it made revitalization and growth of the then unhealthy banking system one of its main priorities. During the oil boom years of 1973–82, the banking system became one of the primary conduits through which the country's new-found wealth was invested, resulting in further expansion of the banking system. Annual credit growth for the banking system averaged 53 per cent between 1968 and 1974, 35 per cent between 1974 and 1978, and almost 17 per cent between 1978 and 1982 (Rosser 2002: 52–60). But while the banking system grew strongly, the stock market developed little. Sukarno's Guided Democracy government had nationalized all Dutch companies in 1958 and suspended trading in shares of Dutch firms in 1960, making it impossible for the country's stock market to survive. It was eventually closed in 1968. When the New Order government re-established the Jakarta Stock Exchange in the late 1970s, it did so primarily to provide a mechanism by which wealth could be redistributed – or at least be seen to be redistributed – to indigenous Indonesians in order to placate those sections of Indonesian society that were concerned about what they perceived to be foreign economic domination (*ibid.*: 87). Reflecting its redistributive purpose, the stock market was highly regulated: restrictions were imposed on the extent to which share prices could fluctuate; foreign investors were prevented from owning shares; and PT Danareksa, the state investment trust, was required to purchase up to 50 per cent of all new share issues. This discouraged both financial capital controllers from investing in Indonesian stocks and Indonesian conglomerates from going public (Suseno and Tarihoran 1989: 81–3). Between 1977 and 1988, only twenty-four companies listed their shares on the Jakarta Stock Exchange, and market capitalization only rose to 449 billion rupiah.

Transparency and disclosure

Prior to the mid-1980s, the regulatory framework governing financial reporting was poorly developed. In 1973, the central bank in conjunction with the professional accounting institute – the Indonesian Accountants' Association (IAI) – had produced Indonesia's first set of accounting standards, known as Indonesian accounting principles (*prinsip akuntansi Indonesia* or PAI) (Sumantoro 1990). However, these standards were flimsy by international standards. They were a compilation of basic accounting principles, practices, methods and techniques and were intended to address general accounting issues rather than provide detailed prescriptions for accounting practice (Prawit 1988). At the same time, they were not given legislative backing. At that time, Indonesia's company law, which had been inherited from the Dutch colonial period, simply required that 'adequate accounts' be kept (World Bank 1993). It did not contain a specific requirement that financial reporting be done in accordance with the PAI or any other prescribed set of standards. For this reason, and because the PAI permitted companies to refer to other countries' accounting regulations where the PAI did not deal with a particular accounting issue, companies had enormous latitude in the way in which they accounted for their financial affairs.

Ownership concentration and management

Prior to the mid-1980s, ownership of private Indonesian companies was concentrated in the hands of founding families. Even though many private Indonesian conglomerates had achieved considerable size and become involved in a diverse range of businesses by the mid-1980s, most were run as family businesses. Positions on boards of directors and commissioners were generally given to family members or close relatives rather than professional managers (Robison 1986; Sato 1993). Because the stock exchange was so underdeveloped, very few private Indonesian companies had sold shares to the public. Most of the private companies listed on the Jakarta Stock Exchange in 1985 were foreign joint-venture firms that had gone public solely to fulfil minimum local ownership requirements (Drake 1986: 103). At the same time, ownership of many enterprises remained concentrated in the hands of the state. With state-owned enterprises providing a key source of rents for the politico-bureaucrats and the owners of the major conglomerates, there was strong political resistance to their privatization. Hence, by the mid-1980s, only one state-owned enterprise had been privatized through the Jakarta Stock Exchange: PT Semen Cibinong, a cement manufacturer, which went public in 1977 (Rosser 2002: 87).

Protection of creditors and minority shareholders

Creditors received little protection under Indonesian law prior to the mid-1980s. The country's bankruptcy system was based on a 1904 Dutch colonial regulation that, as one commentator put it, 'was biased in favour of debtors and made it almost impossible for creditors to seek court resolution when debtors defaulted' (Husnan 2001: 17). Minority shareholders fared little better. They were granted some very basic rights under the Commercial Code, another piece of legislation from the colonial era that remained in force following independence. This code guaranteed minority shareholders the right to vote in general meetings of shareholders and provided them with certain voting rights. It also granted them the right to object to a decision by the general meetings of shareholders, but it did not grant them protection in cases where majority shareholders had a potential conflict of interest or guarantee them representation on company boards (Gautama 1995: 298–9). The 1952 Capital Market Law and the government regulations issued in the 1970s to re-establish the Jakarta Stock Exchange, which between them provided the legal basis for the stock market during this period, provided no further protection for minority shareholders (Sumantoro 1990: 132–51).

Mergers and acquisitions

There were no regulations restricting mergers and acquisitions during this period. As Gautama (1995: 330) has pointed out, the Commercial Code was completely silent in relation to mergers and acquisitions. But the ability of firms to merge with or acquire other firms was restricted by the fact that few companies had listed their shares on the stock exchange, which made hostile takeovers through stock market purchases impossible; and the lack of competition in many domestic industries meant that there was little incentive for firms to merge or acquire in order to make themselves more competitive.

This system of corporate governance reflected the structure of power and interest in Indonesia prior to the mid-1980s. The economic crisis of the mid-1960s strengthened the position of the controllers of financial capital, Western governments and the IFIs. With the country desperately needing to renegotiate its debts, secure foreign aid, promote private investment and stimulate economic growth, the state was under enormous pressure to shift away from the radical populist and nationalist interventionism of the previous regime and towards the sort of market-oriented economic policies advocated by the technocrats. But before the technocrats could make much progress in re-establishing the capital market and reforming the country's system of corporate governance – their main achievements in the late 1960s and early 1970s were the creation of teams in the central bank to provide advice to the government on capital and money market policy and the formulation of the PAI (Sumantoro 1990: 36–41) – their influence over policy began to wane. The main reason for this was the dramatic increase in oil prices during the 1970s. With the country awash with petrodollars, the Indonesian state had little need to adopt policies designed to attract financial capital or foreign aid. As Jeffrey Winters (1996: 95–6) has explained: 'although the *ability* of mobile capital controllers to withhold or relocate their investment resources was not affected [by the oil boom], the state's direct access to substantial replacement resources meant that investors' threats and actions were not nearly as constraining on policy makers' (emphasis in the original). The state now had the resources to fund much of the country's industrial and infrastructural development without substantial private investment or foreign assistance. This, in turn, meant that the politico-bureaucrats and the conglomerates were free to shape the country's economic policies to suit their own narrow interests. For reasons outlined above, this meant a halt to corporate governance reform.

The political economy of corporate governance reform in Indonesia

From the mid-1980s to mid-1997

The collapse of international oil prices in the mid-1980s was to shift the balance of power back in favour of financial capital controllers, Western governments and the IFIs and see greater progress made in reforming corporate governance. The collapse of oil prices led to a fall in Indonesia's oil and gas exports from US$18.4 billion in 1982 to $8.3 billion in 1986 and a drop in government oil and gas revenues from 8.6 trillion rupiah in 1981/82 to 6.3 trillion rupiah in 1986/87. This in turn dramatically increased the country's need to attract financial capital and foreign aid to help to promote the development of non-oil export industries and to improve the government's fiscal position. For this reason, it also increased pressure on the government to meet the demands of financial capital controllers and their allies in Western governments and IFIs for a range of market-oriented policy changes, including stock market deregulation and regulatory reform (Rosser 2002: 90–120). In this context, the technocrats were able to exercise much greater influence over economic policy than they had previously. Significantly, however, the politico-bureaucrats and conglomerate owners were able to maintain their control over the state apparatus through the late 1980s and most of the 1990s. The government's electoral vehicle, Golkar – which embodied their interests – continued to win elections and, despite evidence of growing opposition to Suharto's rule in sections of the military, his position as president was never seriously threatened. As a result, the politico-bureaucrats and the conglomerates were able to ensure that the technocrats' market-oriented economic reforms did not go so far as to seriously threaten their interests. In terms of corporate governance, this was to mean a partial process of reform.

The technocrats were able to make significant progress in promoting the development of the stock exchange and, in doing so, increasing the role of equity capital in corporate financing. Through a series of policy packages in the late 1980s, they completely deregulated the capital market, suddenly making capital market investments and stock exchange listings much more attractive for investors and conglomerate owners, respectively. In response to deregulation, financial capital controllers injected trillions of rupiah into Indonesian stocks.[8] At the same time, most of Indonesia's major domestic conglomerates and a small number of state-owned enterprises lined up to go public: over 200 companies listed their shares on the Jakarta Stock Exchange between 1988 and 1996. Importantly, however, most of the conglomerates and state-owned enterprises that went public during this period sold only a fraction of their shares to investors, usually between 20 and 35 per cent. So, while this period saw a dramatic increase in the role of equity capital in corporate financing in Indonesia, Indonesian companies still remained heavily dependent on banks for finance (Rosser 2002: 90–7).

The technocrats were also able to push through a series of financial accounting reforms. In late 1994, the government introduced a new set of financial accounting standards known as financial accounting standards (PSAKs) to replace the PAI. Based on international accounting standards and issued formally by the IAI, the PSAKs were a much more comprehensive set of accounting regulations. In March 1995, the government provided legal backing for these standards and introduced a series of other regulatory reforms related to accounting in its new Companies Code. This code made it mandatory for all companies to prepare their annual financial accounts in accordance with PSAKs; required publicly listed companies to have their accounts audited by public accountants; and made company directors and commissioners personally liable for any losses incurred by any persons as a result of untrue or misleading information contained in financial reports (Cole and Slade 1996). Later in 1995, the government introduced further accounting-related reforms in its new Capital

Markets Law. This law specified the format of financial reports; forbade the providing of untrue or misleading information to the public by public companies; and required public accountants to report companies that have breached of the law or are experiencing financial problems to Bapepam (*Info Finansial*, October 1995; *Jakarta Post*, 18 January 1996).

At the same time, however, the government did little to ensure that these new accounting regulations were properly enforced. The quality of auditing in Indonesia was widely believed to be poor, even that done by the domestic affiliates of the large international auditing firms.[9] Yet few Indonesian auditors were prosecuted or suspended for negligence, incompetence or corruption during this period. Nor was the auditing market opened up to foreign entrants – in the mid-1980s, the government had officially prohibited foreign accountants from practising in the country, forcing international auditing firms to operate through domestic affiliates rather than set up their own offices – something that, it was widely thought, would improve auditor independence. In early 1997, following World Bank calls for Indonesian auditors to be more independent, the government decided to permit foreign accountants to practise within the country on an individual basis. But it continued to prohibit them from establishing their own auditing firms. The government also did little during this period to reform the country's notoriously corrupt judiciary. In the absence of an independent judiciary, the Companies Code provision concerning the personal liability of company directors and commissioners for losses incurred as a result of misleading information was effectively unenforceable (Rosser, forthcoming).

The technocrats were to make similar progress in the area of minority shareholder protection and participation. The years following deregulation were to see a large number of 'internal acquisitions' (i.e., acquisitions of other companies in the same group) involving companies listed on the Jakarta Stock Exchange that were structured in such a way as to transfer wealth from minority to majority shareholders. Public criticism of these acquisitions generated concern in the government that the confidence of financial capital controllers would be seriously undermined unless it provided better protection for minority shareholders. Hence, in January 1993, Bapepam issued a new regulation requiring companies to get the approval of at least 50 per cent of minority shareholders for transactions where company directors, commissioners or majority shareholders had a conflict of interest. The 1995 Companies Code gave minority shareholders further protection by granting them the right to call shareholders' meetings, demand court investigations into illegal activities at companies and have their shares in companies repurchased at a fair price if they disagreed with these companies' actions. The hostile takeover of PT Bank Papan Sejahtera in 1995, which also generated claims of minority shareholder abuse, led to a similar response by the government. This time Bapepam introduced a regulation requiring investors who were planning to take over a company through the stock exchange to make a tender offer and to publicize this through the Indonesian media (Rosser 2002: 111–16).

At the same time, however, the government did not seek to give minority shareholders a greater role in corporate decision making. For instance, it did not introduce any requirements for companies to have independent directors or commissioners. In 1996, Bapepam made it compulsory for companies to have corporate secretaries to provide information to investors, but it did not require them to be independent. Furthermore, it soon became apparent that there were serious obstacles to enforcing many of the new rights that minority shareholders had acquired. Majority shareholders were able to circumvent the 50 per cent approval requirement for internal acquisitions by buying public shares through proxies and having these proxies vote on acquisition plans (*Kompas*, 26 June 2000). In addition, the nature of Indonesia's judicial system meant that minority shareholders had little chance of securing a fair price for share repurchases or a court's agreement to launch an investigation into corporate corruption if they wished to pursue these options.

In the area of mergers and acquisitions, the government introduced little real reform. It included a series of new legal provisions relating to mergers and acquisitions in its new Companies Code in 1995, but these essentially provided a legal basis for existing practice (Gautama 1995: 330–1). More significant in facilitating mergers and acquisitions during this period was the fact that deregulation of the capital market and the boom it generated created the possibility for hostile takeovers, as the Bank Papan Sejahtera case demonstrated. In the area of creditor protection, the government made no significant changes to the existing regulatory framework. The 1904 bankruptcy regulation remained in force.

This pattern of corporate governance reform reflected the balance of power in Indonesia in the post-oil years. With the politico-bureaucrats and the conglomerates maintaining their control over the state apparatus, they were able to ensure that corporate governance reform was selective, notwithstanding the greater structural power of financial capital controllers and their allies in Western governments and the IFIs in the wake of the oil price collapse. The technocrats' success in deregulating the capital market reflected the fact that capital market deregulation did not pose a serious threat to the interests of the politico-bureaucrats and the conglomerate owners and, in fact, promised significant benefits to the latter. While deregulation of the capital market meant that the politico-bureaucrats in the state investment fund, Danareksa, lost their monopolies in underwriting and the mutual funds business, it allowed the conglomerates to gain access to cheap equity capital, opened up new opportunities for them in share broking and underwriting, and reduced their political vulnerability by diversifying their ownership structures (Rosser 2002: 86). The technocrats' relatively limited success in other areas of corporate governance reform, by contrast, reflected the fact that reform in these areas posed a more significant threat to conglomerate owners. Stricter financial reporting requirements and auditing, a stronger bankruptcy system, better protection of minority shareholders and increased participation by minority shareholders in corporate decision making all required the conglomerates to be more transparent and accountable. Hence, although some significant changes were introduced, on the whole reform in these areas was to be much less extensive.

The political economy of corporate governance reform in Indonesia since mid-1997

The onset of the Asian economic crisis in mid-1997 was to place enormous pressure on the Indonesian government to move ahead with the process of corporate governance reform, particularly in those areas where there had been strong resistance prior to the crisis. The crisis produced a further shift in the balance of power away from the politico-bureaucrats and the owners of the conglomerates and towards the controllers of financial capital and their allies in Western governments and the IFIs. The impact of the crisis was severe: the value of the rupiah fell by more than 80 per cent against the US dollar in the space of a few months; major conglomerates defaulted on their foreign and domestic debt repayments; inflation, unemployment and interest rates soared; and political stability began to crumble. With the country desperately needing to regain the confidence of financial capital controllers, the government decided to call in the IMF in late 1997 and begin negotiations on a rescue package, effectively surrendering control over economic policy to that organization. The IMF was to use its structural power to force the government to adopt reforms. At a number of key points, it withheld financial assistance from the government when the latter appeared to be baulking or delaying on reform. As noted earlier, the IMF was to include corporate governance reform in its list of required reforms.[10]

At the same time, the crisis seriously undermined the position of the politico-bureaucrats and the owners of the major conglomerates. Many conglomerate owners were forced to surrender assets to the Indonesian Bank Reconstruction Agency (IBRA) because their banks could not repay liquidity credits borrowed from the central bank in the early stages of the crisis. Some owners agreed to debt-for-equity swaps with foreign and domestic creditors, dramatically reducing their ownership stakes.[11] Most large conglomerates were demoted to a secondary board on the Jakarta Stock Exchange, limiting their ability to raise new equity capital (*Jakarta Post*, 4 July 2000). Others were delisted (*Jakarta Post*, 29 July 2000). Most importantly, the politico-bureaucrats and the owners of the conglomerates lost their absolute control over the state apparatus. In May 1998, President Suharto was forced to step down after widespread violence in Jakarta and the capture of parliament by student groups. At the national election in July 1999, Golkar was beaten into second place by Megawati Sukarnoputri's Indonesian Democratic Party of Struggle (PDI-P), dramatically reducing its representation in parliament and damaging its chances in the forthcoming presidential election. In October 1999, B.J. Habibie, a close confidant of Suharto who had succeeded him as president, failed to have his accountability speech accepted by the People's Consultative Assembly (MPR), the body that appointed the president and vice-president. This paved the way for the election a few days later of two former opposition figures, Abdurrahman Wahid and Megawati Sukarnoputri, as president and vice-president, respectively.

In this context, the technocrats were able to introduce a range of new corporate governance reforms. One of the most significant of these was the preparation of a Code for Good Corporate Governance by the National

Committee on Corporate Governance, a body established by the coordinating minister for the economy, finance and industry in 1999 to promote reform of corporate governance. Funded by the ADB, the code outlines a series of corporate governance principles and practices for the country that are broadly in line with the outsider model of corporate governance. These include equitable treatment of shareholders, the appointment of independent directors and commissioners, timely and accurate disclosure, the appointment of a corporate secretary, and the establishment of an independent audit committee.[12] The primary weakness of the code is that it has no legal backing: it is simply a point of reference for Indonesian businesses trying to improve their systems of corporate governance. But the government has suggested that the code will be incorporated into Indonesian law over time.[13] Already, the JSX Company, the private firm responsible for managing the Jakarta Stock Exchange, has included a number of corporate governance requirements similar to those in the code in its listing regulations.[14] Bapepam has also stated that it will include a requirement for companies to have independent directors and commissioners in the Capital Market Law as part of forthcoming revisions to this law (Bapepam, n.d.).

The government also strengthened the regulatory frameworks for mergers and acquisitions, minority shareholder protection, financial reporting, and bankruptcy. In February 1998, it issued a regulation on mergers, consolidations and acquisitions, facilitating implementation of the provisions in the Companies Code on these matters (Eddymurthy and Rasmin 2000). In 2000, Bapepam amended its regulation on conflicts of interest to make it more difficult for majority shareholders to circumvent the requirement for at least 50 per cent of minority shareholders to approve transactions in which there is a conflict of interest (*Kompas*, 25 August 2000).[15] In February 1998, the government announced that all limited liability firms with assets of 50 billion rupiah or more would be required to publish financial statements and have them audited by external auditors (*Jakarta Post*, 23 February 1998).[16] From 1998 onwards, the IAI issued a series of new PSAKs and revised several earlier ones, dramatically increasing the total number of Indonesia's accounting standards.[17] During 1998, the government introduced a new bankruptcy law and created a new commercial court, thus establishing a framework for foreign and domestic creditors to sue Indonesian conglomerates that had failed to repay their debts.

However, corporate governance policy making and implementation was not to be completely one-sided. The crisis did not eliminate the politico-bureaucrats and the owners of the major conglomerates as a political force. Although Golkar's representation in parliament and the MPR fell dramatically as a result of the July 1999 election result, it held the second largest block of votes in both institutions and, as such, continued to have significant influence on law making and the election of the president and vice-president. Indeed, Golkar's support was crucial in delivering the presidency to Abdurrahman Wahid in October 1999. Likewise, the military continued to be a player in Indonesian politics by virtue of its continued representation in parliament and the MPR,[18] its extensive business network, and its role in maintaining security in three provinces: Ambon, ownership base of many Indonesian firms. The debt-for-equity swaps that have been arranged since the onset of the crisis in mid-1997 have led to a further broadening of the ownership base of Indonesia's conglomerates. The regulatory framework for corporate governance has been substantially revised and strengthened, especially in areas such as financial reporting, protection of minority shareholders and creditors, and mergers and acquisitions. If the Code for Good Corporate Governance is translated into law over the next few years, Indonesia's corporate governance regulations will be broadly similar to those that exist in the USA, the UK and other countries where the outsider model of corporate gover nance prevails.

Notwithstanding this change, however, Indonesia's system of corporate govern ance has remained distinct from the outsider model of corporate governance. Indonesian conglomerates remain heavily dependent on banks for finance. Indeed, the big problem for Indonesia's conglomerates at present is how to get themselves out of debt. In addition, with financial capital controllers avoiding the Indonesian stock exchange and with many founding families apparently determined to retain majority control of their businesses, it is unlikely that there will be a significant shift towards increased equity financing in the near future. At the same time, while the country's corporate governance regulations have become increasingly similar to those in countries that apply the outsider model of corporate governance, as we have seen, there have been serious problems with implementation in areas such as auditing and the bankruptcy system. In this sense, in so far as convergence has occurred, it has been convergence in form rather than in substance.

As such, this paper suggests that we should not expect the universal adoption of the outsider model of corporate governance at any point in the near future, at least not in so far as this means an exact replication of this model in countries not currently applying it. Just as some scholars have suggested that globalization has led to different reform outcomes depending on the nature of domestic political systems (Jayasuriya and Rosser 2001; Deeg and Perez 2000), so this paper suggests that domestic politics will mediate the impact of globalization on national corporate governance systems. Where coalitions that favour the adoption of the outsider model of corporate governance are dominant, one can expect corporate governance reform to be relatively extensive. Where coalitions that oppose the adoption of the outsider model of corporate governance are dominant, one can expect either substantial resistance to such reform or the pursuit of reform in a selective manner that serves the interests of these coalitions. Where pro-reform and anti-reform coalitions of interest are of roughly equal strength, one can expect intermediate outcomes.

Furthermore, the paper suggests that even where political conditions facilitate reform in accordance with the outsider model of corporate governance, outcomes may still vary to a certain degree. In the Indonesian case, as we have seen, increased conformity with the outsider model at the level of regulation has not been matched by conformity in terms of corporate financial structures or in terms of the implementation of corporate governance regulations. Some

Aceh and West Papua. At the same time, as Golkar's fortunes waned, a number of politico-bureaucrats and conglomerate owners shifted their loyalties to Megawati and the PDI-P.[19] Conglomerate owners were also able to wield influence through bribery and intimidation, the best example of the latter being the assassination in 2000 of a supreme court judge who had sentenced Tommy Suharto, one of the former president's sons and the head of the Humpuss conglomerate, to eighteen months in prison for corruption. In short, the politico-bureaucrats and the conglomerate owners were to retain sufficient power to frustrate key reform initiatives.

One area in which they were able to do this was auditing. In contrast to the US government's response to recent accounting scandals involving Enron, WorldCom and Xerox, the Indonesian government has not launched any major court cases against Indonesian auditors[20] or introduced any major regulatory changes to force Indonesian auditors to be more independent since mid-1997. During 2000, the Agency for Financial and Development Supervision (BPKP) launched an investigation into auditors that had given clean bills of health to Indonesian banks that had subsequently had their operations frozen following the onset of the crisis. But while this investigation found that several auditors had failed to adhere to Indonesian accounting standards in conducting their audits, the government took little action against them. The auditors concerned were sent 'warning letters' rather than fined or prosecuted, and the auditing firms for which they worked were not penalized in any way (*Gatra*, 19 April 2001; *Koran Tempo*, 28 April 2001). In this case, it appears that the connections between Indonesian auditing firms and key parts of the Indonesian bureaucracy[21] were strong enough to get the former off the hook.

The other area in which the politico-bureaucrats and the conglomerates have been able to frustrate reform has been the protection of creditors. Within weeks of the establishment of the new commercial court, questions were already being raised about its effectiveness as a means for creditors to recover unpaid debts (*Far Eastern Economic Review*, 22 October 1999). Roughly thirty bankruptcy cases were filed with the court in 1998 and another 100 in 1999, but very few of these cases were successful. According to George Fane (2000: 35), creditors won only about 20 per cent of all cases they brought against Indonesian companies, far fewer than they should have according to a number of commentators (see, for instance, *Asiaweek*, 31 March 2000). At the heart of the problem for creditors appears to have been a combination of judicial favouritism towards debtors and judicial corruption. While a new bankruptcy law and court had been introduced, the nature of the Indonesian judiciary, and its relationship with powerful business people, had not changed at all.

Conclusion

Over the past two decades, Indonesia's system of corporate governance has undergone significant change. Deregulation of the capital market has increased the role of equity capital in corporate finance and, in doing so, broadened the scholars have argued that, rather than producing absolute conformity in the nature of economic systems across the globe, globalization is leading to the simultaneous existence of different forms of neoliberalism. Jomo (2001: 44), for instance, has argued that 'just as the acceptance of Islam has resulted in a great variety of Muslim cultural expression and behavioural norms, a twenty-first century Anglo-American global capitalism may still be quite diverse'. This paper suggests that part of this diversity may be the development of the different forms of the outsider model of corporate governance.

Notes

1 This is a revised version of a paper that was published in *Third World Quarterly* 24 (2), 2003. I wish to thank Peter Newell and Mick Moore for their comments.

2 In May 1999, for instance, the OECD adopted a set of non-binding corporate governance principles intended to act as a reference point for countries trying to evaluate and improve their corporate governance systems. In conjunction with the World Bank, the OECD has also established a Global Corporate Governance Forum to encourage discussion about corporate governance issues and coordinate assistance; has arranged several regional roundtables aimed at disseminating what it considers to be 'best practice' in corporate governance; and has organized a series of investor surveys on the success of corporate governance reform efforts. The World Bank and the ADB have carried out self-assessment exercises to measure the quality of corporate governance in selected countries and assess these countries' progress in reforming their corporate governance systems. A number of bilateral donors have also contributed to the global corporate governance reform effort, in many cases by supporting the work of international and regional organizations in individual count ries.

3 'Financial capital' should be taken here to refer to *private* financial capital.

4 'Structural power' refers to the power that derives from control over investment resources.

5 See *The Economist*, 24 April 1999.

6 It should be noted that 'technocrats' as used here includes not only senior economists in the Ministry of Finance and other parts of the government – the group usually identified by the label – but also officials in the Capital Market Supervisory Agency (Bapepam) who have postgraduate business qualifications such as MBAs. Because corporate governance matters have fallen within Bapepam's area of responsibility, the latter group has played a particularly important role in the formulation and implementation of corporate governance policy.

7 However, it is important to note that the technocrats' commitment to market-oriented economic policies has varied somewhat over time. For instance, during the 1960s and 1970s, many technocrats were strong supporters of import-substitution industrialization and the restrictive trade and investment regimes that that strategy involved. It was not until the mid-1980s that, as Robison and Hadiz (1993: 17) have pointed out, 'neo-classical, free market theories began to dominate the liberal element in Indonesian economic thinking'.

8 This investment came from a variety of sources: foreign financial institutions established special Indonesia country funds, local banks lent money for share purchases, middle-class Indonesians used their personal savings for the same purpose, and the large government pension funds – PT Astek and PT Taspen – were instructed to support a number of struggling initial public offerings. While it was foreign investment that drove trading on the JSX, most of the investment during this period came from domestic sources.

9 Interviews with informed parties. See also Backman (1999: 42–51).

10 See the Indonesian government's Letter of Intent to the IMF in January 2000.
11 According to the World Bank (2001: 2.5), sixteen debt-for-equity swaps have been agreed through the Jakarta Initiative Task Force. It also points out that IBRA has converted some of the debt owed to it into equity.
12 The code also draws on elements of the insider model in recognizing that stakeholders should be protected. But while the Code is very specific about what rights shareholders have and how they can exercise those rights, it is vague in relation to stakeholders' rights and the mechanisms through which these can be exercised.
13 See the preamble to the code. See also Mulyadi (2001).
14 See JSX Company regulation, Peraturan Pencatatan Efek Nomor IA/05/31/01/3:49PM: Tentang Ketentuan Umum Pencatatan Efek Bersifat Ekuitas di Bursa.
15 The amendment broadened the definition of 'conflict of interest' to cover not only transactions involving company directors, commissioners and majority shareholders but also transactions involving parties affiliated to these individuals; and the definition of 'independent shareholders' to specifically exclude parties affiliated with company directors, commissioners and majority shareholders.
16 Previously only publicly listed companies and certain financial institutions were required to provide public audited financial statements.
17 See http://www.akuntanpublik.org/standard/standard_ak.html
18 At the end of Suharto's rule, the military was guaranteed seventy-five seats in parliament, and because parliamentary representatives were automatically members of the MPR, in the latter institution as well. Following the fall of Suharto, this was reduced to thirty-eight.
19 Key examples in this respect are Bambang Kesowo, a senior bureaucrat in the State Secretariat under the New Order, and Arifin Panigoro, a tycoon who made his fortune under the New Order.
20 Interestingly, legal action has been taken against Indonesian auditing firms for corruption or collusion in the USA. In one case, the Indonesian affiliate of KPMG has been prosecuted for allegedly paying a bribe to an Indonesian tax official on behalf of Baker Hughes Inc., an American oilfield services company (*International Accounting Bulletin*, 28 September 2001). In another, US shareholders in Asia Pacific Pulp and Paper Company have launched a legal action against Arthur Andersen's Indonesian affiliate for its part in allegedly covering up around US$230 million in APP's losses made as a result of two derivatives contracts (*International Accounting Bulletin*, 28 September 2001; Backman 2002).
21 According to one former employee of Arthur Andersen's Indonesian affiliate, that firm has very strong connections to the Ministry of Finance and, in particular, the BPKP. In part, this stems from the friendship between Utomo Josodirdjo, one of the founders of the affiliate, and Radius Prawiro, a former minister of finance and coordinating minister for the economy, finance, industry and development supervision. In part, it is because a number of partners of Andersen's affiliates were formerly BPKP officials (interview, Perth, mid-1998).

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7 Democratization and the prospects for participatory regionalism in Southeast Asia[1]

Amitav Acharya

Introduction

This chapter explores how traditional modes of regional interaction in Southeast Asia are being transformed as a result of rapid changes in domestic political structures. The key force for change identified here is democratization. Unlike in Europe, regional institution building in Southeast Asia was not founded upon a shared commitment to liberal democracy. The founding of the Association of Southeast Asian Nations (ASEAN) was helped by a common desire of its members to ensure the survival of regimes that had by then retreated significantly from their post-colonial experiments in liberal democracy. This orientation was further institutionalized by ASEAN's doctrine of non-interference, which helped to shield its members from outside pressures towards democratization.

Since the people power revolution in the Philippines in 1986, Southeast Asia has experienced an incremental process of democratization. The Philippines was followed by Thailand, then Cambodia, and more recently Indonesia. Only Myanmar has clearly gone in the opposite direction, although pro-democracy forces opposing the military junta in Myanmar have become increasingly active in Thailand. And the democratic transition in Indonesia has had an effect in encouraging pro-democratic sentiments in neighbouring states, especially Malaysia.

The process of democratization during the late 1980s and 1990s (Acharya 1999) has called into question the ASEAN model of elite-centred regional socialization. Political change in Thailand, the Philippines and Indonesia has engendered efforts to democratize the regionalism. Civil society in the region demands greater openness in Southeast Asian regionalism.

The chapter begins by proposing a conceptual framework for analysing the relationship between democratization and regionalism. Such a framework is currently unavailable in the existing literature on regionalism in the Third World.[2] This is followed by an examination of the consequences of democratization for the traditional structures and dynamics of Southeast Asian regionalism. The key argument here is that while these consequences are mixed, the displacement of traditional patterns of regional elite socialization has been offset by advances in regional conflict management, transparency and rule-based interactions. Moreover, they pave the way for a more 'participatory regionalism' in Southeast Asia. The final section of the chapter examines the key aspects of this participatory regionalism.

Democratization and regionalism: a conceptual framework

The consequences of democratization for regionalism can be examined in terms of a number of hypotheses. First, democratization may alter the domestic political climate on which regional interactions are based. Preoccupation with democratization diverts the attention and resources of leaders from regional cooperation. The advent of a new and legitimate regime may revive tensions over issues 'settled' by an unpopular ousted regime. Resurgent nationalism, which is often a feature of newly democratic states, could fuel such tensions. Civil society groups remain hostile towards regional institutions that had backed the ousted regime. If the new regime happens to be led by people who, as opposition leaders, were severely persecuted by the ousted authoritarian but pro-regionalist regime, then the former's commitment to the regional institution could be weak. In any regional institution, change in the top leadership of member states can disrupt socialization with fellow members. But this is especially true of regional institutions founded upon close interpersonal ties and informal contacts between leaders and elites. In other words, regional institutions established and maintained by authoritarian states could lose legitimacy and support from within the populations of their member states that have experienced greater domestic political openness.

Second, democratization may call into question the sanctity of existing regional norms and the relevance of existing institutional mechanisms. The instability that accompanies democratization has a spill-over effect, which may strain the norms of regional institutions committed to the principle of non-interference in the internal affairs of states. Democratic rulers, pandering to nationalist sentiments, could become less inclined to resort to collective procedures and practices for conflict management. Institutions and procedures favoured by an ousted dictator, especially if he happens to be from a leading member state, may be discredited in the changed political climate. Added to this are the consequences of democratization for self-determination in ethnically divided autocracies. Leaders of separatist movements who become leaders of new states created by the collapse of an authoritarian polity are likely to be hostile towards a regional grouping that had previously not supported their cause or even acquiesced in their suppression out of deference to regional norms. Finally, uneven democratization within a regional grouping could polarize members over key political issues, including promotion of human rights and democracy through regional means. Non-democratic members are likely to resist strongly any proposals for pro-democracy changes coming from the democratic camp.

Democratization may also have a number of positive consequences for regionalism. A transition to democracy may create unanticipated moments of boldness in foreign policy, which could break longstanding stalemates in regional conflicts. This is partly because of the impulse by newly democratic states to distance themselves from the policies of their authoritarian predecessors. Moreover, by seeking a broader range of views on foreign policy and permitting greater domestic discussion and debate over foreign policy goals, democracies may be able to offer alternative solutions to existing regional conflicts. In fact, contrary to a popular belief that newly installed democracies destabilize their neighbourhoods by seeking to 'export' their revolution, one finds evidence that democracies often deal creatively and responsibly with their neighbours, including those with whom they might have been embroiled in conflict. As will be discussed later, the case of Thailand in the late 1980s supports this argument.

Democratization creates more domestic transparency in ways beneficial to regional understanding and trust. The transition to democratic rule brings in its wake availability of greater information about a state's national security and financial policies and assets. This could reduce suspicions among neighbours and expand regional security and economic cooperation. Democratization may lead to more open and regular interactions between states, reducing the importance of interpersonal contact. Democratization produces greater openness and the rule of law, not just within states but also between them. The rule of law in a domestic context often leads to demands for rule-based interactions in the regional arena. This can be more conducive to collective regional problem solving.

Democratization creates a deeper basis for regional socialization by according space to civil society and accommodating its concerns. Most forms of regionalism in the developing world (indeed anywhere for that matter) have been highly state-centred, which in turn invites opposition to their agenda from domestic and international civic action groups. A grouping of more participatory polities could change that and thereby increase their chances for more effective responses to transnational issues.

Next, democratization broadens the scope of the agenda of regional institutions, permitting a more relaxed view of sovereignty and allowing them to address issues that might have been considered too sensitive by authoritarian states (such as promotion of human rights). Newly empowered civil society elements apply pressure on their own governments to find regional approaches to transnational issues such as the environment, refugees and migration. This increases the overall relevance of regional institutions in promoting regional peace and stability.

Last but not least, democratization may secure better support for regional integration and cooperative projects from outside powers. In the changing international climate, where democracy and human rights have become ever more influential international norms, regional groupings of authoritarian states, or groupings that reluctantly tolerate authoritarianism out of deference to the principle of non-interference, are unlikely to find sympathy and support from international donors. Increasingly, the aid policies of bilateral and, to some extent, multilateral donors are specifically tied to the human rights policies and democratic practices of recipient states. Domestic pressure in donor countries makes it difficult for them to support regional groupings perceived to be anti-human rights and democracy. On the other hand, more aid is now available to regional groupings that promote democracy and human rights.

Authoritarianism, democracy and Southeast Asian regionalism

Assessing the impact of democratization on regionalism in Southeast Asia requires an understanding of the nexus between authoritarianism and the origins of ASEAN. A collective retreat from post-colonial experiments in liberal democracy was a key factor contributing to ASEAN's formation and consolidation. Liberal democracy had a considerable appeal among Southeast Asian nationalists (with the exception of Vietnam), but their acceptance of democracy proved to be qualified and short-lived. The late 1950s marked the beginning of the end of the flirtation with democratic systems modelled after their former colonial masters by nationalist elites in Southeast Asia. A major shift occurred in Indonesia, where President Sukarno dismissed the legally elected parliament and established 'guided democracy' to replace the liberal '50 per cent plus one' democracy in Indonesia (Yong 1992: 433). A similar complaint against liberal democracy was lodged by President Marcos of the Philippines, who near the end of his second elected term in office imposed martial law in September 1972, citing the threat of communist insurgency. Marcos' idea of 'new society' was centred on the principle of 'constitutional authoritarianism', stressing the prior importance of stability over participatory politics (*ibid*.: 426). In Malaysia and Singapore, democratic institutions based on the British model fared better without any military takeovers. But In Malaysia as well as in Myanmar, domestic ethnic and communal discord contributed to the retreat of democracy. Malaysia's ethnic politics, including tensions between the three principal groups, Malays, Chinese and Indians, imposed limits on the functioning of liberal democracy. Race riots in 1969 led to a major restructuring of the country's political and economic system, including a temporary suspension of parliament, and an attempt by the Malay leadership to develop a more corporatist structure by co-opting many opposition parties to the ruling coalition, the National Alliance, proclaiming a national ideology, the *Rukunegara*, which put a premium on loyalty to the king, country and constitution, banned debate on sensitive issues such as the status of Malays, and a new economic policy that moved from a *laissez-faire* system to redistributing wealth in favour of Malays to redress a perceived economic imbalance. Singapore too developed into a dominant party system.

Early academic explanations of democratic breakdowns in Southeast Asia emphasized cultural variables, especially the tension between traditional and modern concepts of power and authority. Lucian Pye (1985) contrasted two conceptions of authority in Southeast Asia: one influenced by colonial rule, bureaucratic, legal and rational; the other rooted in traditional culture and religion and producing a patrimonial political framework. The two were in constant conflict. Initially, the former prevailed because Western liberal notions of power were popular in nationalist movements dominated by Westernized elites. Subsequently, however, a revival of traditional concepts of power produced a rejection of liberal democracy. Indonesia, in the shift from Sukarno to Suharto, provided the clearest example of this trend. Indonesia started its post-colonial polity by emulating European-style democracy, and its political system espoused a rational, legal and constitutional type of authority. But Sukarno abandoned this in favour of 'guided democracy' based on traditional patrimonial rule. He denounced Western political and social values and urged a return to governance based on the traditional principles of consensus, *gotong-rotong* and *musjawarah*, or community mutual assistance and discussion leading to consensus.

A return to more indigenous conceptions of authority had implications not only for the domestic politics of the concerned states, which assumed an increasingly patrimonial character, but also shaped the conduct of foreign policy and regional cooperation, where it led to the emergence of the 'ASEAN way'. ASEAN was established in 1967 with an initial membership of Thailand, Indonesia, the Philippines, Malaysia and Singapore, which had, to varying degrees, experienced a retreat from liberal democracy. While the outward objective of ASEAN was to promote the socio-economic development of its members, its core basis was members' common concern with regime survival in the face of domestic and external threats, especially communist subversion (Acharya 1992). At the same time, ASEAN states, still nationalist-minded and zealous about their hard-earned sovereignty, rejected Western models of regionalism, such as the supranational and highly institutionalized European Community framework. In this context, the traditional principles of *gotong-rotong* and *musjawarah* seemed an ideal way to develop regional cooperation.

The 'ASEAN way' was defined in terms of informality, consultation and consensus, organizational minimalism and flexibility (Acharya 2000a). On the surface, the process of consultation and consensus in ASEAN, with its basis in traditional culture, is supposed to be a democratic approach to decision-making,[3] but the ASEAN process was managed through close interpersonal contacts between the top leaders, who shared a reluctance to institutionalize and legalize cooperation, which could undermine their regimes' control over the conduct of regional cooperation. Negotiations within ASEAN had no input from civil society and no feedback mechanism to take account of public opinion. The issues of human rights, democracy and the environment were kept strictly off ASEAN's agenda. Non-interference in the internal affairs of member states was the core ASEAN norm, except that ASEAN governments developed an extensive network of bilateral security ties aimed at denying sanctuary to insurgent groups and suppressing them. Overall, the ASEAN way supported a narrow elite-centred and sovereignty-bound framework of regionalism confined to intergovernmental contacts, providing little scope to address emerging transnational issues such as the environment, migration and refugees collectively and securing the involvement of social forces in the regional identity-building project. These main features of the ASEAN way, including its emphasis on regional cultural patterns and identity, avoidance of legalistic institutions and norms, dependence on very high-level leaders, the tendency to 'sweep conflicts under the carpet' so as not to create Western-style adversarial negotiating and bargaining postures, and state-centredness, qualified it as the core basis of Southeast Asia's 'patrimonial regionalism'.[4]

Southeast Asia's collective descent into authoritarian rule had paradoxical effects on regional order. It introduced an element of political convergence to what had been a strikingly diverse membership in terms of ethnicity, religion, language, colonial legacy and post-colonial polity (Acharya 2000b). ASEAN members, with a common fear of Vietnamese communism, embraced the 'free market' while keeping their political systems closed or semi-closed. This combination proved acceptable, indeed, highly convenient, to the Western powers in the Cold War geopolitical climate. As a result, Western economic and political support for ASEAN, including access to markets, foreign investment and aid, and diplomatic support for ASEAN's international campaign to punish Vietnam, contributed to ASEAN's reputation and image as an effective manager of regional problems. This, along with the common internal threat perceived from communist subversion and ethnic separatism, led to the amelioration of intramural disputes within ASEAN, thereby paving the way for its emergence as a viable regional grouping. Authoritarianism and regionalism proved to be mutually complementary.

Democratic transitions in three out of the four cases in Southeast Asia (the Philippines 1986, Thailand 1991–92, Cambodia 1993, Indonesia 1998) during the past fifteen years have not produced a regime that has willingly undermined its state-centred regionalism. There was no downgrading or change in the commitments of the Philippines and Thailand to ASEAN in the wake of democratic transitions. Instead, the solidarity shown by ASEAN leaders to President Corazon Aquino might have enhanced the regime's dependence on ASEAN support and strengthened regionalism. The democratization of Cambodia under the UN's auspices made it more suitable for membership in ASEAN, although it is debatable whether this move strengthened or weakened ASEAN. Hun Sen's tirade against ASEAN for postponing Cambodia's accession to ASEAN in 1997 in response to his *coup d'état* disappeared when Cambodia was finally admitted in 1999 after undertaking necessary democratic changes.

However, democratization has certainly altered the political climate of regional interactions in Southeast Asia. The domestic preoccupation of the newly democratic regime in Indonesia has led it to neglect regional cooperation (Acharya 2000c). Indonesia has not reneged on any of the commitments of its predecessor to ASEAN. But there remains a possibility that the new Indonesian nationalism could translate into animosity towards specific ASEAN neighbours. Indonesia's recent problems with Malaysia and Singapore (for different reasons) attest to this possibility. Both Singapore and Malaysia have made firm commitments to Indonesian territorial integrity in the wake of the secession of East Timor. But this did not prevent bilateral ties from being damaged over political issues. The new Indonesian government's support for pro-reform forces in Malaysia led by Anwar Ibrahim angered Malaysia. Singapore, despite having courted Abdurrahman Wahid before his election as president, was not spared his wrath over its perceived failure to offer economic support. And the Megawati government has responded to Singapore's demand for stronger action against terrorist suspects taking shelter in Indonesia by citing its democratic political system, which does not permit arbitrary arrests of the kind that internal security acts in Malaysia and Singapore facilitate.

Democratization has disrupted the traditional pattern of elite socialization within ASEAN. The departure of Suharto, 'the father of ASEAN', compounded the impact of generational shifts in the old ASEAN. Another change induced by democratization is the growing criticism and rejection of the ASEAN way. Although much of this criticism was initially inspired by ASEAN's perceived inability to respond effectively to the Asian crisis, there is certainly a link with the democratization process in the region, especially Thailand. The Thai government's call for 'flexible engagement' and a more open ASEAN during 1998–99 was partly inspired by a desire to project its own democratic credentials.

The climate of regional interactions is also affected by the growing voice of regional social movements. Civil society in Indonesia and elsewhere in the region has felt resentful towards ASEAN for its reluctance to support its cause or involve them in its decision making. This has led to a call for ASEAN to become more open by the NGO community in Indonesia, Thailand, the Philippines, Cambodia and Malaysia. Democratization has thus undermined the legitimacy of ASEAN's elite-centred regionalism.

While democratization has altered the climate of regionalism in Southeast Asia, this does not imply a threat to regional order. Three benefits of democratization to regional order may be cited. First, democratization in Thailand offered a breakthrough in regional conflicts in the late 1980s. Then, under a new government elected through a legitimate democratic process, Thailand adopted a foreign policy that had as its objective the transformation of the 'Indochinese battlefields into marketplaces'. This dramatic turn was in direct violation of existing ASEAN policy, which disallowed regular economic contacts with Indochina in the absence of a Vietnamese military withdrawal from Cambodia.[5] The new Thai government might have acted out of economic expediency (the actual lure of Indochinese resources and markets) or out of sheer geopolitical ambition (to develop a Thai-dominated Southeast Asian heartland as implicit under the government's revival of the traditional Thai Golden Peninsula concept). However, the outcome was a relaxation of regional tensions. It helped to reduce Vietnamese suspicions of ASEAN, engendered greater moderation on the part of Hanoi, leading to its decision to withdraw its forces from Cambodia, a key step towards the eventual settlement.

Second, by engendering greater transparency in the domestic arena, democratization could help to mitigate intra-regional suspicions. Democratic reforms in Thailand and Indonesia have allowed greater information on Thai defence spending and exposed corruption in arms procurement, which drove defence expenditure in Indonesia under Suharto. Democratization in the Philippines has led to a defence procurement and spending system that is subject to legislative scrutiny. Third, as will be discussed in the next section, democratization in Southeast Asia has also produced demands for more open and rule-based regional institutions. The economic crisis in 1997 was partly blamed on the elite-centred regionalism that prevented members from sharing vital economic information about their national economies as an early-warning mechanism. This has led to demands for more transparency and peer review in the regional political economy.

Towards participatory regionalism

Against this backdrop, we examine the relevance of new concepts and approaches towards a more participatory regionalism in Southeast Asia. The term 'participatory regionalism' as used here is distinguished by two key features. The first, at the level of official regionalism, is the acceptance by governments of a more relaxed view of state sovereignty and the attendant norm of non-interference in the internal affairs of states. This allows for more open discussion of, and action on, problems facing a region and creates more space for non-governmental actors in the decision-making process. A second feature of participatory regionalism is the development of a close nexus between governments and civil society in managing regional and transnational issues. This means not just greater cooperation between the social movements, leading to the emergence of a regional civil society, but also closer and positive interaction between the latter and the official regionalism of states.

In post-crisis Southeast Asia, both elements of participatory regionalism are evident. This is found in the idea of flexible engagement advanced the Thai foreign minister of the period, Surin Pitsuwan. This approach, like the idea of 'constructive intervention' advanced by the now-deposed Anwar Ibrahim (Acharya 1997), was not an outright rejection of state sovereignty. In the economic arena, it called for greater openness in regional consultations, information sharing and peer review of domestic economic policies. In the political arena, it sought the right of a member to criticize what it considered to be unacceptable internal conduct of fellow ASEAN regimes; for example, Thailand claimed a right to criticize the human rights abuses and anti-democracy policies of the regime in Myanmar. Flexible engagement thus implied a dilution of ASEAN's principle of non-interference in the internal affairs of states.

Intended to correct what he perceived to be a primary reason behind ASEAN's ineffectual response to the regional economic panic, flexible engagement was also a response to the growing seriousness of transnational challenges such as forest fires in Indonesia and the resulting haze, which affected neighbouring states, causing serious economic and health concerns; and the problem of drug trafficking and refugee flows out of Myanmar, which has had a lot to do with Thailand's more interventionist attitude towards Myanmar's domestic affairs. Surin also invoked the need for such a policy in the wake of ASEAN's failure to provide a timely response to the bloodshed in East Timor during the course of its secession from Indonesia out of deference to strict non-interference. As a policy, flexible engagement had strong roots in changing Thai domestic politics.[6] The Chuan Leekpai government disliked its country's past support for the constructive engagement policy and wanted Thailand not be seen as part of a 'club of dictators' (a reference to ASEAN, which accepted Myanmar as a member despite international protests). The desire to pursue a new course was also inspired by the Chuan government's own democratic impulse, as its predecessor, although nominally democratic and legitimate, was widely seen to be under greater military influence (its prime minister, Chavalit Yongchaiyudh, played a key role in the origins of the constructive engagement policy towards Myanmar), and the Thai military had been implicated for cultivating the Myanmar junta.

Resistance from Singapore, Malaysia and the Suharto and Habibie governments in Indonesia to flexible engagement succeeded in reducing it to a much more sovereignty-conforming 'enhanced interaction' concept. One of the striking features of the debate over non-interference in ASEAN has been to expose a clear division between the democratic and authoritarian members over the issue (for details, see Acharya 2000a, 2000b; Kraft 2000). The most severe critics of flexible engagement have been Vietnam and Myanmar. The Philippines has been a supporter, and Indonesia since the advent of a democratic government has signalled a more open attitude towards the issue of outside roles in its domestic affairs. To quote Adian Silalahi, director-general for ASEAN in the Indonesian Foreign Ministry:

> We still adhere to those principles [of ASEAN], but I believe that on this issue [non-intervention] we are more open now. It is no longer a principle which cannot be discussed. Indonesia is more open, more flexible because of the democratization process.
>
> (cited in Suryodiningrat 2000: 1)

Until now, the engagement of civil society in ASEAN has been minimal. Traditionally, there has been far greater cooperation between ASEAN intelligence agencies than ASEAN social movements. The Track-II processes, which are sometimes cited as examples of the participation of civil society in regional institution building, are in reality dominated by government-sponsored and supported think-tanks. Moreover, a key principle of Track-II, the participation of government officials 'in their private capacity', has rarely been upheld in practice; seldom have these officials been able to rise above national interests and concerns.

For their part, Southeast Asian NGOs have developed their own separate identities, networks and approaches (Lizee 2000), adopting mainly confrontational tactics that condemn ASEAN's pursuit of economic globalization and its neglect, of and tolerance, of human rights abuses and anti-democratic practices in the region. Several such regional coalitions of NGOs, some of them linked to wider Asian networks, have emerged. One clear example of NGO networking was the parallel meeting of Asian and Western NGOs in Bangkok in 1993, when a group of Asian governments was meeting to decide on a common strategy for the impending Vienna World Conference on Human Rights. Subsequently, Asian NGOs have participated in protests against APEC's free-trade agenda, most clearly visible during its Vancouver summit in 1997, and in parallel summits organized during the sessions of ASEAN, APEC and ARF. The high-profile campaigns of groups such as the Asia-Pacific Conference on East Timor (APCET) and Alternative ASEAN (ALTSEAN), a group mobilizing international opinion against the regime in Myanmar, as well as anti-logging protests by Thai NGOs, exemplify this type of civil society regionalism.

NGO campaigns in the area of human rights and sustainable development have increasingly been pursued at a regional level. Forum-Asia, the largest and most prominent transnational NGO in Southeast Asia seeks to 'facilitate collaboration among human rights organizations in the region so as to develop a regional response on issues of common concern in the region' (Forum-Asia official brochure, n.d.). The Manila People's Forum on APEC, created as a parallel grouping to challenge the Manila APEC summit in 1996, described itself as a 'dynamic consultative process aimed at … formulating a people's response to APEC and coming up with a regional strategy of equitable and sustainable development' (Manila People's Forum on APEC 1996).

Forum-Asia's activities include monitoring and reporting on human rights violations, conducting human rights educational activities and organizing fact-finding missions and trial observations (Forum-Asia 2000, 2001). Bangkok-based Focus on the Global South, along with the Malaysia-based Third World Network, has been at the forefront of campaigns to create greater awareness of the dangers of globalization and have organized protests against the exploitation of labour and the environment by multinationals. The environment has also become another key issue for mobilizing social movements, especially in the wake of massive forest fires in Indonesia in 1997, which led to widespread ecological and economic damage. Southeast Asian NGOs have also called for alternative approaches to national security that stress the security of people over those of states and regimes (Forum Asia 1997).

Several developments have helped to promote a more cooperative relationship between official and civil society regionalism in Southeast Asia. New transnational challenges, such as the environment and refugees, have led to a greater appreciation of the role of NGOs, which have traditionally been key players in terms of both their possession of knowledge and their pursuit of causes and campaigns to highlight the demands of civil society, which may run counter to state policy. Regional and international cooperation between NGOs is a way of overcoming the constraints imposed by limited domestic resources and support, especially in cases where their home governments remain intolerant of NGO activism (personal interview, Forum Asia, 21 June 2002). Political openness in Thailand and now Indonesia has involved the empowerment of NGOs with a regional and transnational agenda. Greater external support for Asian NGOs, induced by post-Cold War policy initiatives towards the promotion of human

Table 7.1 Selected Southeast Asian NGOs with a regional focus

Name of NGO	*Head office*	*Main issue areas*
Focus on the Global South	Bangkok	Campaign against neo-liberal globalisation
Asian Forum for Human Rights and Development (Forum-Asia).	Thailand	Promote democracy, human rights and a regional response
ALTSEAN (Alternative ASEAN)	Bangkok	Human rights and democracy in Myanmar
APCET (Asia-Pacific Conference in East Timor)	Sittings vary	Human rights and self-determination in East Timor
Third World Network	Penang (Malaysia)	Campaign against neo-liberal globalisation; human rights (social and economic rights)
Towards Ecological Recovery and Regional Alliance (TERRA)	Thailand	Environmental protection issues in Myanmar, Cambodia, Laos, Thailand and Vietnam
Committee for Asian Women	Bangkok	Women's issues, especially labour
Via Campesina (Southeast Asia)	Bangkok (?) c/o Assembly of Poor	Peasants, farmers
Coalition Against Trafficking in women in Asia-Pacific (CATW Asia-Pacific)	Philippines	Women rights (anti-prostitution/trafficking)
Asian Cultural Forum on Development (ACFOD)	Thailand	Human rights (take culture into account)
Child Workers in Asia (CWA)	Thailand	Children's rights (especially in work)
End Child Prostitution, Child Pornography, Trafficking of Children for Sexual Purposes (ECPAT International)	Thailand	Children's rights (Anti-child pornography)
Global Alliance Against Traffic in Women (GAATW)	Thailand	Women's rights (especially trafficking in women)
Asian Indigenous People's Pact (AIPP)	Thailand	Indigenous people's rights
Asia Pacific Forum on Women, Law and Development (APWLD)	Thailand	Women's rights
Asian Coalition for Housing Rights (ACHR)	Thailand	Housing rights
Asian Regional Resource Center for Human Rights Education (ARRC)	Thailand	Human rights education
Coalition Against Trafficking in Women in Asia-Pacific (CATW Asia-Pacific)	Philippines	Women's rights (anti-prostitution/trafficking)
International Young Christian Students (IYCS)	Philippines	Human rights education

Sources: Personal interviews with NGO officials, Bangkok, January 2001 and June 2002; *Directory of Asia and the Pacific Organizations Related to Human Rights Education Work* (1999).

rights and sustainable development, has helped the regional NGO movement. This is now supplemented by the call for 'human security', espoused by both Western countries and Japan. At the root of the human security concept is the recognition of threats to the safety and dignity of the individual (Acharya and Acharya 2000). The attendant shift from state or regime security provides a conceptual justification for a closer involvement of civil society and social movements in regional cooperation, which had traditionally been the exclusive preserve of governments.

Despite their continuing suspicion of governments, some NGOs have been amenable to working with them. Such cooperation is often issue-specific, conditional and context-dependent; for example, Forum-Asia has been willing to work with governments on women's rights but not on Myanmar (personal interview, Forum-Asia, 21 June 2002). Some NGOs resort to direct action and protest only if access to the state is unavailable. They are more willing to work with democratic governments that offer them such access, such as the Thai government under Chuan Leekpai during 1997–2001 (personal interview, Forum-Asia, 25 June 2001). For their part, some ASEAN government leaders have increasingly acknowledged the need to engage domestic and regional civil society. Initial efforts at mutual accommodation led to the holding of the first 'ASEAN People's Assembly' in November 2000 in Indonesia, immediately following an ASEAN summit in Singapore. Organized by a group of Southeast Asian think-tanks, the People's Assembly is designated as a Track-III mechanism because it brings together government officials (both serving and retired), Track-II groups (mainly government-supported think-tanks) and NGOs. If the assembly is any indication, a Track-III mechanism in Southeast Asia could become a useful vehicle for a more participatory form of regionalism by providing an arena for debates and discussions between states and citizens over subjects over which governments have thus far exercised strict control. These issues range from reducing poverty to the relevance of ASEAN in dealing with East Timor and Myanmar.[7] The principle of 'open economies, open societies' debated at the inaugural People's Assembly, for example, illustrates one approach to finding possible common ground between NGO communities that oppose economic globalization while demanding political openness on the one hand, and regional governments, which have thus far advocated open economies but not open societies, on the other hand. Track-III processes also have the potential to engender domestic and regional support for softer concepts of sovereignty and allowing more space for dissent and criticism in the conduct of regional interactions. It is significant that both the official and NGO participants at the inaugural People's Assembly seemed to accept more universal standards of human rights and sovereignty, thereby diluting the strong 'cultural relativist' opposition to these ideas displayed by the region's elite in the not too distant past.

The emergence of participatory regionalism in Southeast Asia reflects several factors at work, with democratization being a key force. Indeed, the holding of the ASEAN People's Assembly reflects the work of pro-democracy elements within the ASEAN Track-II elite, despite opposition from the governments of

Myanmar, Laos and Vietnam. The Track-II grouping is seeking to make its process more effective by developing a wider social base that includes a moderate section of the NGO community. There is also the suggestion that the Track-III process reflects a desire on the part of the Track-II to co-opt elements of regional civil society. For the latter, the incentives to participate in a regional Track-III process include the possibility of securing greater contacts and possibly influence with regional governments, with Track-II, with its own close rapport with governments, serving as a bridge. As one NGO representative put it, initiatives such as the ASEAN People's Assembly 'create space' for regional civil society (personal interview, Forum-Asia, 21 June 2002). In addition, working with Track-II can mean better access to the latter's research and other resources, which they themselves lack. By working with Track-II within a Track-III framework, regional NGOs can improve their research capacity and policy prescriptions.[8]

International pressures and incentives have also been at work in the development of a more participatory regionalism in Southeast Asia. For one thing, NGOs have targeted the annual summit meetings of Asia-Pacific Economic Cooperation (APEC) to organize vocal parallel NGO summits (Manila People's Forum on APEC 1996).[9] Western donors, especially Canada, provided financial support for hosting of the ASEAN People's Assembly. Some ASEAN member governments, for their part, have come to the realization that giving some accommodation to the NGOs will improve the political climate for their own interactions with Western countries. This is especially relevant to ASEAN's relations with the EU, which had been severely strained by the issue of Myanmar's membership in ASEAN. In this sense at least, democratization, and the resulting reshaping of regional institutions, can yield the benefit of creating a more conducive climate for interactions between ASEAN and the international community.

The constraints of participatory regionalism

The previous section has identified a number of factors that promote the development of a participatory and non-official regionalism in Southeast Asia, but it is important to recognize the limits of this development, especially in the post-September 11 regional and global political climate. Three main obstacles to the further development of participatory regionalism can be identified.

First, ASEAN itself has shown a strong resistance to post-sovereign regional norms. It shows no explicit commitment to democracy and human rights adopted by European and Latin American regional institutions. Thailand's commitment to human rights and democracy in its regional foreign policy agenda has declined since the ouster of the Chuan Leekpai government in 2001. Second, the democratization process in Southeast Asia remains incomplete and uneven, with several states, such as Myanmar and Vietnam, remaining firmly under authoritarian rule. Democratic consolidation in Indonesia faces a number of serious challenges and constraints. So the prospects for ASEAN as a democratic community remain a far-off possibility. Third, the terrorist attacks on the USA on 11 September 2001 and in Bali on 12 October 2002 have diminished the space for civil society in the region. Measures undertaken by regional governments to counter the threat of terrorism have cast a shadow over civil liberties. Indonesia has enacted new security laws, and the internal security acts in Singapore and Malaysia now enjoy the backing of Western countries, including the United States. Homeland security has assumed priority over human security. Muslim civil society groups have come under government scrutiny for their alleged links with terrorist networks. ASEAN governments are developing new forms of internal security cooperation to counter transborder terrorism. This could lead to a reassertion of Southeast Asia's official regionalism at the expense of civil society networks (Acharya 2002a, 2002b).

Conclusion

The foregoing shows that democratization in Southeast Asia is reshaping Southeast Asian regionalism by redefining official attitudes towards state sovereignty and opening space for the involvement of civil society. Both these developments are limited; if pushed further, they would pave the way for deeper regional interaction and problem solving. Newly democratic states have been more willing to depart from a strict adherence to sovereignty norms than authoritarian states. This finding from Southeast Asia should be of interest to students of Third World politics and security. Juridical sovereignty has been a key factor behind regime security and regional order in the Third World. Few scholars have seriously considered, let alone investigated, the conditions under which weak states in the Third World might deliberately seek a dilution of their juridical sovereignty as a way of enhancing the prospects for regional order. The case of Thailand and the Philippines suggests the importance of democratization as one such condition.

The emergence and role of regional institutions are often the product of domestic political institutions and structures. ASEAN's creation was facilitated by the common shift of its members towards greater authoritarianism and reflected non-democratic values. But the vulnerability of a closed, highly informal and patrimonial ASEAN has been clearly demonstrated by recent events. The pressure is now for ASEAN to move towards a more participatory form of regionalism, one that takes a less rigid view of non-interference, one that addresses a wider range of transnational issues, and one that becomes more responsive to the demands of civil society. Democratization can make an important contribution to the quest for durable and effective regional institutions. Democratization enhances the legitimacy of the regional project by opening the regional public space to civil society elements and makes it less vulnerable to the personal preferences and idiosyncratic habits of leaders. It can induce greater respect for the rule of law in regional governance.

Regionalism in Southeast Asia is confronting new challenges as a result of the enlargement of ASEAN, the continuing economic and social fall-out of the Asian financial crisis and the domestic instability of its largest actor, Indonesia.

Moreover, thanks to the entry of new non-democratic members (Myanmar, Vietnam and Laos) and the progressive democratization in three key founder members – the Philippines, Thailand and Indonesia – the political diversity within ASEAN has never been greater. This has undermined its unity in responding to the economic and political challenges facing the region. As ASEAN confronts greater intra-mural division, adjusting to the pressures of democratization presents new opportunities for ASEAN to broaden the social basis and political agenda of ASEAN regionalism and make it more relevant to the challenges of globalization. However, the shift to 'participatory regionalism' faces a number of challenges which, if overcome, can have decisive and long-term implications for regional order in Southeast Asia.

Notes

1 This paper revisits an earlier work (Acharya 1992) in which I examined the link between regionalism and regime security in Southeast Asia. The present paper is an attempt to ascertain how this link has evolved and changed in the wake of trends towards democratization in the region.

2 Etel Solingen's (1999) analysis of regional orders examines how domestic economic liberalization can lead to more stable and peaceful regional order, with economic liberalization linked to the democratization process. For a more general treatment of the relationship between democratization and regionalism, see the special issue of *Journal of Democracy* of July 1993 and Farer (1996). On the relationship between democracy and the emergence of a regional security community in Europe, see Adler (1998). The absence of such a link in the making of a security community in Southeast Asia is explored in Acharya (1998). There have been some studies of this relationship with respect to Latin America, including Muñoz (1993), Patomaki (2000) and Petrash (2000).

3 The traditional Javanese rural practices of *musyawarah* and *mufakat*, on which the ASEAN way is based, conformed to the patron–client model of leadership as it required the decisive guiding hand of a village elder who managed the consultation process and defined the consensus. See Pye (1985).

4 The term 'patrimonial regionalism' is extrapolated here from the Weberian concept of patrimonial authority or paternalistic authority used by scholars of domestic and comparative politics. Lucian Pye, for example, lists a number of features of the latter: 'an overriding concern for unity'; the regime's demand for 'conformity' for the sake of 'collective good'; domestic institutions that are 'adjuncts' of governments or are a 'product of government prodding'; rejection of 'adversary relations' in domestic bargaining ('The reason why strong … institutions have not emerged under Asian paternalistic authority is clear: with paternalism, adversary relations are an abomination'); preference for institutions that are not 'rigorously codified' but which are 'pliable … [and] can be bent to the convenience of the power holders'; and the overall 'weakness of institutional constraints' on political authority (*ibid.*: 329–31). Many of these features can be applied to the regional level to examine the nature of ASEAN and the ASEAN way. However, it should be stressed that, initially, these features were credited for making ASEAN flexible and relatively effective in reducing and managing interstate conflicts. Peter Katzenstein (1997) has drawn a link between the non-Weberian (non legal-rational) nature of domestic political structures in Asia and the informal and under-institutionalized form of its regional institutions, especially ASEAN. For other discussions of 'patrimonial authority' in domestic politics, see Rudolph and Rudolph (1979) and Theobald (1982).

5 This included S. Rajaratnam, Singapore's retired foreign minister and a founder of ASEAN. See Acharya (1993).

6 The link between Thai democratization and its concept of flexible engagement was drawn explicitly by Surin in the following words:

> Our commitment to freedom and democracy underlies Thailand's '*flexible engagement*' initiative… In proposing this free, open and intensified interaction among the ASEAN member countries, Thailand hopes to prepare ASEAN to meet the challenges of globalization that is transforming the international environment into a 'world without borders'.
>
> (Pitsuwan 1998)

7 The ASEAN People's Assembly included the following plenary sessions: Setting ASEAN's Agenda; The Role of the People; Towards Open Societies in ASEAN; The Issues; ASEAN and Regional Community Building; and Reflections on ASEAN. Panel discussions were held on Critical Assessment of the ASEAN 2020 Vision; Globalization and Human Security; The Power of Women and Their Empowerment; The Media: Informer, Educator and Reformer?; Towards a Regional Human Rights Mechanism; The Role of Civil Society in Good Governance; Poverty in ASEAN: What More to be Done?; Limits and Opportunities of Resources and Environmental management; Enhanced Interaction: Case Studies of Myanmar and East Timor; and Towards a Revolution in ASEAN's Education Systems.

8 For these and other insights into the ASEAN People's Assembly, I am grateful to Paul Evans and Pierre Lizee, two Canadian scholars who participated in the meeting.

9 The Manila People's Forum on APEC, attended by 400–500 delegates, was a direct successor to the Kyoto NGO Forum in November 1995 (120 delegates) and the Jakarta NGO Conference in November 1994 (a handful of delegates).

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Part III
New forms of regional governance

8 Asia-Pacific approaches to regional governance

The globalization–domestic politics nexus

Helen E.S. Nesadurai

Introduction

Until 1989, the Asia-Pacific region lacked any formal or intergovernmental arrangement for regional economic cooperation. Fourteen years on, the situation has altered dramatically. Today, the Asia-Pacific is a region where a bewildering array of regional agreements is in place, with more anticipated over the next few years. While the Asia-Pacific Economic Cooperation (APEC) forum established in 1989 and the ASEAN Free Trade Area (AFTA) initiated in 1992 were the sole economic cooperation arrangements in the Asia-Pacific region until about 2000, a number of new regional economic arrangements have emerged since then, among them the ASEAN–China Free Trade Area and a variety of bilateral free trade areas (FTAs). New proposals for more bilateral and multilateral FTAs have also been announced.

These trends raise at least two questions with regard to the different regional governance arrangements in the Asia-Pacific. First, why has there been such a proliferation and variety of regional projects in this part of the world, particularly since most if not all regional governments have explicitly expressed their interest in remaining engaged with the global economy and in the multilateral process centred on the WTO? Second, why do these arrangements differ in terms of the substantive issues they address and especially in their modalities or procedural approaches to cooperation? Although the focus of the discussion is on Asia-Pacific regional agreements, this chapter approaches these questions from the point of view of the Southeast Asian or ASEAN states given their centrality in the key regional arrangements in the Asia-Pacific to date and in those planned for the future. Their governments have played a significant role in shaping the regional economic architecture of the Asia-Pacific, although they are not the only actors.

Following this brief introduction, the second section outlines the chapter's central argument, that it is the *interplay* between external pressures associated with economic globalization and the dynamics of the domestic political economy that is key to explaining the emergence and evolution of regional arrangements in the Asia-Pacific. Regional agreements, in short, cannot be understood in isolation from their domestic foundations. The next three sections apply this general argument to the specific cases of APEC, AFTA and the newer regional arrangements. More specifically, the discussion in these sections shows that economic concerns in countries of the Asia-Pacific with maintaining access to export markets and global capital prompted the turn to regionalism since 1989. However, attention to domestic politics is necessary to account for the precise forms taken by these regional agreements. They reflect domestic pressures arising from the need to secure broad domestic social agendas as well as to protect the particular interests of politically important domestic coalitions formed between political and business elites. The concluding section discusses the implications of current trends in the Asia-Pacific.[1]

The globalization–domestic politics nexus

Contemporary regionalism is generally conceived of as a response to economic globalization (Gamble and Payne 1996). One approach to understanding this relationship is to focus on how regional projects address the issue of sovereignty or, more precisely, national policy autonomy in a context given by economic globalization. Scholars of the globalization–regionalism relationship have suggested three possible ways in which regionalism may be related to globalization.

First, regionalism potentially offers national governments a means to retain, if only partially, control over policy choices in the face of pressures to adopt increasingly neoliberal policies. Thus Kurzer (1993) suggests that the future of the European welfare state may only be secured through a Europe-wide regional project that emphasizes governance in the interests of social welfare goals. An extreme version of this argument would see regionalism aimed at resisting globalization (Hveem 2000). Second, regionalism is potentially a means through which governments gain some control over national policy choices by providing individual states with a collective capacity over the forces of globalization that they may not have had individually. Third, regionalism may well represent a renunciation of domestic policy autonomy, with governments fully committed to globalization and to its associated policies of liberalization, deregulation and privatization. In this liberal political-economic interpretation of the globalization–regionalism relationship, governments fully accept outcomes associated with global market forces and subscribe to the ideal of market competition within the regional project.

By emphasizing concern with domestic policy autonomy as central to explaining regional forms, this approach at once directs attention to the domestic level. Which of these three approaches to regionalism prevails depends not only on the specific kinds of pressure arising from economic globalization but more importantly, on the nature of domestic politics, which will influence the degree of importance that national governments place on maintaining control over domestic policy choices.

Globalization is often associated with three kinds of pressure deriving from its material, institutional and cognitive dimensions (Higgott 2000: 70). The worldwide shift to export-centred growth policies from the 1980s has not only led to growing interdependence in the world economy but has also made securing export markets a central concern of governments. On the investment front, there is now growing pressure on governments, and competition between them, to attract transnational corporations (TNCs) to their home territories (Stopford and Strange 1991: 1) because TNCs are increasingly the source of the assets required for wealth creation in the 'new' world economy, namely information, technological innovation, and management and organizational competence (Dunning 1993: 6).

Institutional pressures generally operate through the neoliberal economic rules that institutional agents of globalization like the WTO increasingly adopt. This effectively narrows governments' economic policy options to the standard neoliberal policy package of liberalization, deregulation and privatization. It also places them at a disadvantage if they are unable to employ traditional policy instruments to meet domestic social and political objectives (George 2001). Moreover, there is also a shared consciousness among governments, particularly in the developing world, of heightened global market competition *vis-à-vis* the TNCs and a sense of their growing dominance in markets everywhere. As a result, governments are not only reacting to the actual external pressures associated with globalization but are also increasingly responding in anticipatory fashion to perceived challenges to the competitiveness of the home economy and of home country firms (Palan and Abbott 1996: 32).

Regionalism can emerge as one such response to these multiple pressures. However, how policy makers respond to the external pressures associated with globalization depends on the location of these actors within distinct domestic social and political contexts. Political/state elites that make policy decisions on external matters generally do so on the basis of domestically derived interests and priorities, which helps to shape how they interpret external events, including globalization, and their responses to these events and pressures. This is not the same as saying that their choices are solely dictated by the demands of powerful domestic constituencies. Nevertheless, the degree of domestic political support and legitimacy enjoyed by political elites depends on how they meet the needs of a variety of domestic groups, including social and ethnic groups, business actors and citizens more broadly. International forces acquire political significance through domestic politics (Jacobsen 1996: 94).

Political actors everywhere are usually confronted by the choice of adopting policies that maximize wealth in society as a whole or that benefit particular interests: in other words, between concern over growth and over domestic distributive priorities. To the extent that growth for policy makers is achieved through participation in global market activities and the adoption of neoliberal policies, then they would be more willing to concede control over domestic policy to regional arrangements that are adopted as a means of engaging with globalization. When domestic distributive imperatives operate, departures from this posture are likely. Distribution involves the conscious allocation by governments of income, rents and other economic benefits to particular individuals, groups or firms who would otherwise not have received these gains through the workings of the free market. In such instances, policy makers are likely to want to retain as much policy autonomy as is possible under conditions of globalization, and their approach to regionalism will reflect that imperative. A closer examination of the Southeast Asian case shows more clearly the tensions between growth and domestic distribution that policy makers were confronted with, which since the 1990s has also influenced their response to both globalization and regionalism.

The Southeast Asian political setting

The political elites in Southeast Asia where elite governance political systems operate[2] generally need to respond to two sets of pressures arising from domestic society in order to maintain elite rule and its legitimacy, which remains fragile to date. On the one hand, political elites need the support of citizens to maintain their right to rule and to ensure political order, and this is largely achieved through creating material wealth for citizens – the notion of performance legitimacy, which remains salient in Southeast Asia (Alagappa 1995: 330; Stubbs 2001). This explains the preoccupation of political leaders with securing and maintaining key sources of growth in the economy, of which FDI is pre-eminent, while access to export markets is equally vital given the export-centred growth policies of these governments.

On the other hand, elite rule is also sustained by unity and accommodation between members of the elite/governing coalition (Haggard and Kaufman 1997). By the 1990s, it was the accommodation between the political elite and an emerging domestic business class that was crucial in many parts of Southeast Asia. In these countries, political elites often used regulatory/tariff policies to ensure that economic benefits were directed to their elite partners as a primary means of achieving elite unity, and through that to sustain elite rule. The material and other forms of political support provided by domestic businesses helped incumbent political elites to maintain their power bases, while the former in turn received economic privileges through preferential policies instituted by the latter. In addition, domestic businesses were often privileged because they helped political actors to fulfil broader social equity goals in society. In Malaysia and Indonesia, for instance, political legitimacy continues to rest on the capacity of the state to develop an ethnic Malay and indigenous Indonesian domestic capital class, respectively, particularly to offset the dominance of ethnic Chinese capital. There is also a wider distributive agenda in parts of Southeast Asia that leads policy makers to privilege non-elite or broad social groups in policy choices, ethnic groups for instance in Malaysia, provided that these represent key constituencies for ruling elites and are regarded as vital to sustaining elite rule and regime stability (Figure 8.1).

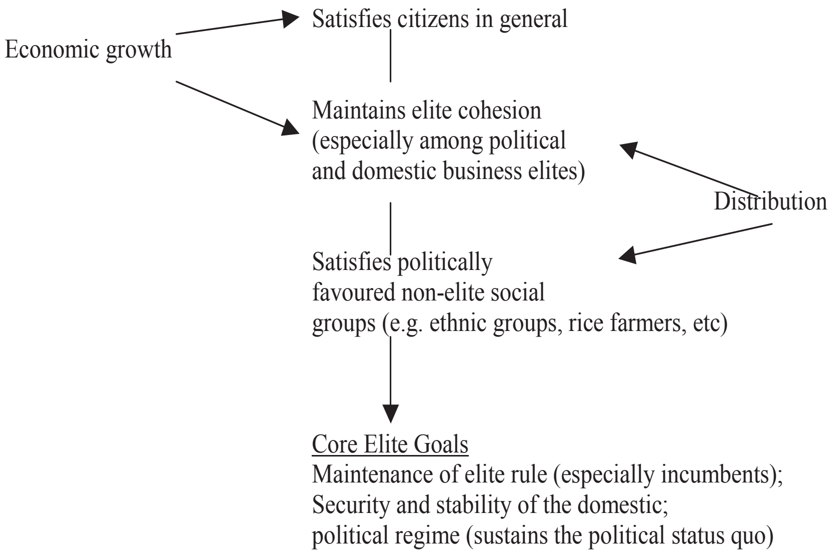

Figure 8.1: Growth and distribution in Southeast Asian political economies

The importance of the distributive agenda in maintaining elite unity does not imply that economic growth is unimportant. In fact, politically important domestic distributional coalitions are sustained by a set of bargains between political and business elites that ultimately depends on economic growth generated through export industries (Jayasuriya 2000: 34). During much of the 1990s, the competitive export-oriented sectors in parts of Southeast Asia, often driven by FDI, helped to maintain the viability of sectors, usually in the service-related or non-tradable sectors, in which politically connected domestic business actors were dominant. The precise nature of these domestic distributional coalitions and their economic efficiency in the areas in which they operate differ across ASEAN countries. However, the crucial point is that political elites often have to engage in difficult balancing acts in their policy choices, particularly when these involve significant trade-offs between the growth and distribution imperatives, or between maximizing wealth and efficiency in society as a whole and maximizing the wealth of a segment of society. This model of domestic politics in Southeast Asia is equally applicable to other regional states such as Japan and South Korea, for instance, which have been described as incorporating a distributive or clientalist element within their broadly developmental political orientations (*ibid.*: 32).

These insights help to explain the emergence and evolution of regional arrangements in the Asia-Pacific region. As the rest of the discussion shows, how much policy autonomy governments were willing to transfer to regional arrangements was influenced by the interaction between external pressures and domestic political-economic priorities. Regional arrangements are essentially political projects that cannot be understood apart from the approaches and priorities central to domestic economic governance.

The Asia-Pacific Economic Cooperation forum

Currently grouping twenty-one members, APEC was formed in 1989 as a ministerial-level meeting of twelve member countries.[3] Not only does this regional grouping include the three largest economies in the world – the USA, Japan and China – it also includes both advanced and developing countries. In addition, there is considerable diversity among the twenty-one members in terms of their systems of both political and economic governance. The latter in particular has had a significant influence on the institutional evolution of APEC.

The reasons behind APEC's establishment have been extensively discussed elsewhere and will not be repeated here.[4] Suffice it to say that despite initial reservations about the domestic implications of APEC from the Southeast Asian side, particularly Malaysia, these governments came on board the project in 1989. One of the most important considerations behind the Southeast Asian embrace of APEC was to ensure continued access to the US market by embedding the USA in a regional framework. There had been concerns that the USA would turn away from East Asia, given its growing trade friction with regional states and its embrace of North American economic regionalism. Despite their keen interest in engaging the USA, the Asian states were nevertheless prepared to impose an approach to regional cooperation that Washington was not in favour of. It is here that we see the influence of the Southeast Asian domestic political economy at work in shaping the form taken by APEC and its substantive content.

Modalities of cooperation: open regionalism and the salience of domestic politics

APEC is defined by 'open regionalism', a procedural approach to trade liberalization that is based on unilateral liberalization offers by APEC members, which may be extended to non-APEC members on a most favoured nation (MFN) basis without the need for reciprocity from the other party.[5] APEC has also rejected legally binding trade agreements, opting for a voluntary process of liberalization, which allows each member government substantial discretion in determining the substantive concessions it is willing to make and its schedule of liberalization, particularly since reciprocity is eschewed.

The adoption of the principle of open regionalism in APEC reflected the preferences of its Asian members, especially the Southeast Asian states (Plummer 1998: 309). Their aim was to ensure that APEC remained true to its initial goal of being a mechanism for regional dialogue to build confidence among its diverse members. Although APEC had adopted the goal of regional trade and investment liberalization in 1994, much to the disquiet of a number of its Asian members, the open regionalist mode of cooperation in APEC allowed these governments considerable discretion in the specific tariff concessions they would offer and in their liberalization schedules (*ibid.*: 308). The modality of open regionalism effectively institutionalized complete domestic latitude in regional liberalization within APEC. This mode of cooperation has therefore helped to sustain prevailing domestic distributional coalitions by allowing national governments almost full flexibility in deciding which sectors would be subject to trade liberalization (Jayasuriya 2000: 39). In fact, open regionalism was a means of ensuring that governments did not face pressure from their APEC counterparts to liberalize politically sensitive domestic sectors.

It is therefore unsurprising that these same members have not sought a change to the modality of cooperation in APEC, although a growing degree of bargaining and negotiations over members' respective liberalization concessions has become the norm, driven largely by the USA (Ravenhill 2001: 189). In fact, the widening of APEC's scope from being a purely consultative forum to include a more substantive agenda for trade and investment liberalization makes open regionalism even more important. Many Asian governments did not want trade and investment liberalization to form the central agenda item in APEC for fear that the regional organization would become another instrument through which the USA would attempt to open their markets and push for domestic economic liberalization before they were ready to do so. Instead of rejecting the trade liberalization agenda outright, which could have jeopardized continued US participation in APEC, these governments sought to retain their domestic political autonomy within the grouping by stressing adherence to APEC's *modus operandi* – open regionalism.

Investment liberalization followed a similar dynamic. Although FDI was crucial to growth in the Southeast Asian economies, these governments, with the exception of Singapore, were hesitant about adopting a set of binding investment principles in an association that also included the advanced countries, particularly the USA. In the end, a set of non-binding investment principles was adopted (APEC 1994). Despite FDI regimes being substantially liberalized in Southeast Asia since the mid-1980s, investment restrictions on market access (the right to establishment) and national treatment in certain sectors were maintained in many of these countries (Nesadurai 2003). Investment policy was employed extensively to attain domestic social and political objectives more broadly, as well as in a more particular way to distribute economic gains to politically important businesses and individuals. Thus these governments were not prepared to liberalize their investment regimes further, which a binding set of strong investment principles would have compelled them to do.

Thus, all of APEC's key programmes, on trade and investment liberalization as well as competition policy, operate along the lines of open regionalism, involving non-binding commitments, unilateral non-negotiated commitments and flexible implementation (Ravenhill 2001; Urata 1998). This procedural approach to regional cooperation implicitly constrains the USA and other like-minded members from using APEC to prise open and reform domestic economies in Southeast Asia.

The future of APEC

APEC's members that have endorsed open regionalism have clearly sought to introduce a high degree of domestic policy autonomy within the organization, which allows them substantial latitude to address domestic imperatives. Although APEC's Asian members had initially seen the project as a way to maintain continued access to markets, especially in the USA, permissive international conditions since APEC's initial days have reduced external pressures on the Southeast Asian members, which might have led them to be more forthcoming with regard to APEC's liberalization agenda. Not only were the USA and other global markets still open to Asia-Pacific exports, but the GATT negotiations of the Uruguay Round were also successfully completed by 1994 and the WTO formed, heralding a plus for multilateral processes and the maintenance of a liberal trading order. In other words, the original external pressures that had triggered the establishment of APEC had become marginal by the mid-1990s. Moreover, the Southeast Asian countries also had their own regional project, AFTA, through which they attempted to gain some control over globalization. This has made it possible for APEC's Southeast Asian members to live with the ambiguity that is now built into the organization. However, APEC as a vehicle for regional economic liberalization is compromised as a result.

APEC stands in marked contrast to AFTA. Unlike their position in APEC, Southeast Asian governments not only endorsed an extensive agenda for AFTA but also adopted an approach to AFTA that departed from their preferred modality in APEC. Instead, a more typical trade negotiation approach was adopted that involved bargaining and diffuse reciprocity, binding commitments, firm timetables, legal agreements that needed ratification, and increasing resort to rule-based institutionalization. Moreover, ASEAN governments have made considerable progress in implementing the first phase of AFTA – reduction of regional tariffs in manufactured goods to the targeted 0–5 per cent level. Why did the Southeast Asian governments privilege AFTA over APEC as a vehicle for trade liberalization while inscribing a modality of cooperation in AFTA that was distinct from the approach they endorsed for APEC?

The ASEAN free trade area[6]

ASEAN[7] formally adopted the AFTA project in 1992. The project was originally designed to lower tariffs on manufactured goods and processed agricultural products to between 0 and 5 per cent over a fifteen-year period beginning in January 1993. Despite considerable setbacks to the project during its early years, the six original or core members of AFTA[8] agreed in 1995 to accelerate the project's pace and extend its agenda substantially from what had been planned initially. They agreed to bring forward the date of AFTA's completion to 2003, when tariffs on all manufactured products and processed agricultural products are to be at the 0–5 per cent level. In addition, they also added new issue areas to the AFTA agenda, namely the liberalization of trade in unprocessed agricultural products and services and in investment flows, all potentially contentious issue areas that member governments had initially excluded from AFTA. Later, in 1998–99, member governments agreed to bring forward to 2002 if possible the deadline when tariffs would reach the 0–5 per cent target, although the formal deadline remained 2003. They also decided at this time to reduce tariffs to zero per cent for the six original signatories by 2010.

Thus AFTA has now become a composite project of ASEAN economic regionalism comprising three component programmes: the Common Effective Preferential Tariff (CEPT) scheme governs liberalization of goods trade; the ASEAN Framework Agreement on Services governs liberalization of trade in services; and the ASEAN Investment Area scheme governs investment liberalization. While the services agreement commits members to make offers that go beyond their WTO commitments, the investment agreement incorporates the principles of national treatment and market access to govern investment liberalization. A range of commitments in these different component programmes was subsequently negotiated, timetables and rules governing liberalization were firmed up, and additional programmes in trade facilitation[9] to support these primary liberalization agreements were adopted. All agreements governing liberalization programmes in AFTA are legally binding, requiring domestic ratification.

AFTA has registered significant progress on the tariff front. The CEPT scheme was virtually in place at the start of 2003, on schedule. Average tariffs fell to 2.89 per cent in 2002, down from 12.8 per cent in 1993. Moreover, there is a significant difference of 5–15 percentage points between average MFN tariff rates applicable to all parties and the AFTA preferential tariff rates applicable to ASEAN members. This point challenges the charge often levied against AFTA that it is a redundant exercise, merely replicating tariff reductions already offered unilaterally or negotiated at the global level.

However, other developments qualify this picture of progress in AFTA. Despite an otherwise excellent track record in lowering tariffs under AFTA, Malaysia chose to exclude automobiles from the AFTA schedule of tariff liberalization until 2005. The Philippines government announced in September 2002 that it might consider submitting a request to withdraw petrochemicals from the CEPT schedule temporarily, using the special protocol available that allows for the modification of CEPT concessions under certain conditions. Moreover, the deadline for trade liberalization in key unprocessed agricultural products was pushed back to 2010 from the original 2003, while a number of exceptions to the end tariff rate of 0–5 per cent were allowed for so-called ‘highly sensitive’ agricultural items, essentially rice. Negotiations in services liberalization have been slow, especially in the financial services and telecommunications sectors. Although a substantial portion of non-tariff barriers that had been prevalent in ASEAN have been removed, notably customs surcharges and barriers arising from domestic monopoly arrangements in agriculture, new forms of NTB are now prominent. Anti-dumping duties especially are on the increase, mirroring their widespread use in the multilateral trading system. Apart from these, the other curious development in AFTA was the distinction initially made in the investment liberalization programme between ASEAN and non-ASEAN or foreign investors. The ASEAN member governments pledged to remove all exemptions to national treatment and market access for ASEAN investors in the manufacturing sector by 2003 and in other sectors by 2010 while offering these concessions to foreign (non-ASEAN) investors only in 2020 (ASEAN 1998).

Three questions emerge from this survey of AFTA:

1 How do we explain the significant advances made in the regional project since its initial days, both in terms of commitments made and in implementing tariff liberalization as well as in the more formal modalities adopted, particularly given the opposite sentiments of these same governments in APEC?
2 Why, despite considerable success in implementing tariff reduction in manufactures, were setbacks experienced in sectors like agriculture, automobiles and services?
3 Why was a distinction between ASEAN and foreign investors made in the investment programme?

As in the case of APEC, these puzzles are best explained in terms of the interaction between external pressures associated with globalization and domestic political-economic dynamics.

Globalization and global capital: explaining the ambitious AFTA agenda

Officials preparing for the 1992 Singapore summit at which the decision to establish AFTA was formally adopted admitted that one of the most compelling arguments advanced for AFTA, and which convinced the leaders of its necessity, was its purported capacity to attract FDI to the region (Akrasanee and Stifel 1992: 36). Although a range of factors stimulated the ASEAN decision, including the need to keep ASEAN relevant as a regional organization in a post-Cold War world and in the face of competition from APEC, these strategic motivations behind the decision to establish AFTA were initial goals that were soon overtaken by the FDI imperative. The idea to establish a single regional market found support in all the ASEAN capitals when it became apparent that economic growth in ASEAN countries was under threat due to declining FDI inflows in the early 1990s. By this time, the ASEAN countries had grown highly dependent on FDI to fuel economic growth, which made these governments vulnerable to any slowdown in FDI.

However, the concerns over declining FDI inflows in the early 1990s do not explain what prompted the regional response, since ASEAN governments could well have adopted further unilateral reforms or used incentives at the national level to make individual economies more attractive to FDI without engaging in regionalism. In fact, it was the awareness, or at least perceptions, on the part of ASEAN leaders and policy makers that FDI was attracted to large and/or regional markets – NAFTA, the Single European Market (SEM) and especially

China – that demonstrated to ASEAN leaders the potential utility of a similar project in ASEAN. It was, in short, the contagion effect at work.

By 1993, China had become far more threatening as a competing investment location to ASEAN despite initial fears centred on NAFTA and the SEM. The call in January 1992 by Chinese leader Deng Xiaoping for faster and deeper economic reforms in China sparked off an investment boom in that country. The sharp rise in FDI flows into China since then was seen as being increasingly at the expense of ASEAN countries. Since 1992, the surge of FDI from the Asian newly industrializing economies to ASEAN moderated, with an increasing proportion of Japanese, Taiwanese and Hong Kong investment flowing to China instead (Parker 1993: 61). Investments from OECD sources, including North America and Europe, to ASEAN similarly weakened (Thomsen 1999: 16). Thus, by the end of 1992, the FDI situation in the core ASEAN countries had become extremely worrying to policy makers and political leaders.

ASEAN member governments believed that the large market potential of AFTA would act as a carrot to attract FDI flows to the region, given the keen interest shown by investors flocking to large markets elsewhere, or at least expressing an interest in doing so. In this, the ASEAN governments were aided by the changing 'regional' logic of global capital. By the early 1990s, foreign investors had begun to show increasing interest in regional divisions of labour (Oman 1994; Dicken 1998). While the aim of TNCs was to operate business globally, that goal was being increasingly achieved through the development of 'complete and integrated production and management systems within definable regions' (Rodan 1993: 234). China by itself offered investors a potentially competing investment site in the Asia-Pacific region, particularly in view of its (potential) market size (Baldwin 1997: 3). What the ASEAN governments attempted to offer to foreign investors through AFTA, specifically through its CEPT tariff liberalization component programme, was an alternative single regional space of investment and production, in effect exploiting the regional logic of global capital.

The FDI imperative also explains why the AFTA project has been sustained since its initial adoption, its pace accelerated and its agenda expanded despite growing domestic business opposition to it. Political leaders found the potential threat to economic growth from slowing FDI inflows sufficiently overwhelming to decide in 1995 to accelerate the completion of AFTA, to introduce new rules to govern tariff reductions through annual packages, and to adopt programmes in trade facilitation. They also placed agriculture, services and investment on the AFTA agenda in 1995 to keep AFTA relevant to foreign investors, especially since the GATT, NAFTA and even APEC had addressed, or were planning to address, one or more of these issues (Hay 1996: 266–8).

The further acceleration of AFTA during 1998–99 and the decision to aim for a zero-tariff AFTA by 2010 were also aimed at convincing foreign investors that despite the turmoil of the Asian financial crisis, AFTA remained on track (Bowles 2000: 444). The core ASEAN governments had to make sure that their respective economies remained attractive to FDI amid the economic turmoil of the regional financial crisis, and they attempted to accomplish this partly through regionalism. As huge amounts of portfolio capital began flowing out of these economies, the imperative of maintaining direct investment became paramount, especially since domestic investments had also suffered a sharp contraction in the region (OECD 1999: 120). AFTA became one tool in the process of maintaining foreign investor interest in the region, particularly as China still loomed as an alternative investment site. Although tariff barriers were employed to shield domestic industries during the financial crisis, many of these import restrictions were temporary, for a one- to two-year period, and were generally part of a set of short-term fiscal measures designed to reduce immediate pressure on countries' external accounts through restricting big-ticket and luxury items (Shimizu 2000: 83).

While the global capital/FDI explanation provides a plausible account for the driving force behind AFTA, it remains a partial explanation. As in the case of APEC, the domestic level offers additional insights into the questions raised earlier in this discussion. Most importantly, it explains the modality of cooperation adopted in AFTA, which may be characterized as 'negotiated flexibility', as well as the distinction made between ASEAN and foreign investors in regional investment liberalization.

Negotiated flexibility and domestic political economic considerations

Negotiated flexibility combines rigidity of project targets and schedules with a degree of flexibility that allows member governments to address both their domestic political economic imperatives and their FDI concerns. Although flexibility is a key feature of the *modus operandi* of AFTA, this is not the same as 'open regionalism', which effectively institutionalized complete domestic autonomy in APEC. APEC, as Ravenhill (2001: 165) so trenchantly puts it, is 'all flexibility with no rigidity'.

There were two approaches to negotiated flexibility in AFTA. The first saw flexibility institutionalized at the outset, or very early in the project, as an approach to implementing AFTA commitments. The second saw flexibility as the outcome of a political bargaining process that was set in motion when implementation problems arose.

Flexible implementation procedures

To ensure flexibility for member governments in implementing their AFTA commitments, particularly in the CEPT tariff liberalization programme, two key mechanisms were adopted: the normal and fast-track schedules, and the temporary exclusion list. The normal and fast-track programmes offered governments a choice of speed at which tariffs on different categories of products would be liberalized. Thus, under the fast-track schedule, the final 0–5 per cent tariff target would be reached in 1998 at the earliest for those goods with tariffs already under 20 per cent at the start of the CEPT programme, while the final deadline was set at 2003 under the normal schedule. The temporary exclusion list allowed further flexibility in that governments could opt to exclude certain products from the AFTA/CEPT tariff liberalization schedules for a limited period of time. Although initially there had been no rules to govern the treatment of temporary exclusions, by 1995 new procedures had been instituted that stipulated a firm five-year schedule for subjecting excluded items to AFTA disciplines, with the deadline for complete elimination of the exclusion list, therefore, set at 2000.

Problematic implementation and renegotiating commitments

The second approach to flexibility was in effect triggered by implementation problems, and it was most evident in the case of agriculture and automobiles. Problems over implementation in these two sectors had emerged as Indonesia and Malaysia, respectively, refused to comply with their original commitments. Intergovernmental bargaining was set in motion as a result of these disputes, which, although protracted, eventually allowed the problem to be resolved through a compromise. This involved both a downward renegotiation of original commitments from those previously agreed and institutional strengthening whereby additional procedures and rules to govern the revised programme were adopted.

Downward revisions to the original commitments were absolutely necessary, as otherwise Indonesia and Malaysia had threatened to withdraw from AFTA. For Indonesia, adhering to its AFTA commitments in agriculture would have hurt domestic coalition arrangements, particularly the domestic monopoly arrangements of politically well-connected individuals and firms prevalent in sectors like sugar, wheat flour milling and cloves. For Malaysia, implementing its AFTA obligations in automobiles would have jeopardized the country's national car project and thus the political and economic objectives that the project was designed to meet. Aside from helping to stimulate an indigenous capability in technological development, engineering design and industrial production, the national car project, the favoured project of the Malaysian prime minister, was also aimed at meeting ethnic development goals in Malaysia. The project formed the nucleus for nurturing an ethnic Malay business class in the automotive components industry through guaranteed purchase by the national car firm from an emerging group of ethnic Malay auto-part vendors.

However, to offset the fall-out from renegotiating the original commitments, ASEAN governments adopted new rules and procedures to govern implement ation of the revised targets. This was important not only to convince other governments in the project to continue cooperation and to raise the costs of future non-compliance but also as signalling devices aimed at convincing investors that the regional project remained viable despite the renegotiation of commitments (Nesadurai 2001). In the two cases outlined above, these rules took the form of two protocols. The Protocol on Sensitive and Highly Sensitive Agricultural Products (ASEAN 1999), adopted in September 1999, focused on procedural matters and outlined revised policy targets for liberalization of agricultural trade. Likewise, members adopted a Protocol Regarding the Implementation of the CEPT Scheme Temporary Exclusion List (ASEAN 2000) in November 2000 to govern the temporary withdrawal of concessions in AFTA. This protocol was based on Article XXVIII (Modification of Schedule) of the GATT.

Those parties for whom the original commitments had been superior in effect lost out in the short run as a result of the downward revisions to AFTA targets. Nevertheless, they were prepared to compromise to preserve the regional arrangement, which had become important to them as an instrument through which collectively to gain some control over the outcomes of globalization, namely where FDI locates. In fact, such processes are common in international agreements and are termed post-agreement or compliance bargaining (Jonsson and Tallberg 1998).

The 'negotiated flexibility' approach to AFTA clearly allowed member governments the leeway to maintain domestic arrangements in the two sectors concerned for a longer period than would have been the case if the original commitments had been implemented. Whether the governments concerned would respect their revised commitments is difficult to assess. In any case, this point is moot in the Indonesian case, since IMF restructuring programmes adopted during the financial crisis have dismantled virtually all the monopoly arrangements in agriculture (with the exception of rice), facilitating Indonesian compliance with its AFTA commitments in this sector. It is also apparent that the Malaysian government is preparing for eventual regional liberalization of the automobile industry despite delaying its AFTA commitments in this sector. Additional steps are being taken to improve the efficiency of the national car firms through global sourcing of components, departing from the previous policy of obtaining high-cost supplies from domestic vendors. Moreover, the decision to sell an equity stake in the company to foreign automobile firms, a departure from the prime minister's previous position, which reflected a sober recognition that foreign engineering expertise and technology, was invaluable for post-liberalization viability of the national car project.

Flexibility is also built into services liberalization, a sector where domestic priorities are responsible for the slow progress to date in obtaining commitments, particularly in the financial and telecommunications sectors. When meaningful commitments were not forthcoming in the first two rounds of negotiations conducted between 1995 and 2001, member governments decided to adopt the 'ASEAN minus X' formula for the third round of talks (2002–04), which does not require commitments from all ten members. This is a pragmatic move, given the different levels of economic development in ASEAN and the fact that member governments have ambitiously targeted negotiations in all four modes of service supply, namely cross-border supply (Mode 1), consumption abroad (Mode 2), commercial presence (Mode 3) and the presence of natural persons (Mode 4).

Domestic investment priorities and 'developmental' regionalism

The importance of domestic political economy priorities is also evident in the way investment liberalization was designed. While many of the ASEAN countries were highly dependent on FDI, and thus keenly interested in ensuring continued access to global capital, a few governments were also troubled by the impact of global competition on the future of domestic capital. More specifically, they were worried by the prospect that new multilateral rules on investment that emphasized national treatment and market access for all investors would soon become incorporated into the WTO, which would effectively allow TNCs maximum freedom of operation worldwide. This was a dimension to globalization about which governments of developing countries were concerned, as noted above. ASEAN members like Malaysia and Indonesia regarded the move by the OECD to negotiate a multilateral agreement on investment, the push by APEC's more advanced members to negotiate an investment code and the EU's keen interest in incorporating investment into the WTO as indications of the preference of governments of industrial countries and their TNCs for a global investment regime. This, they feared, would especially jeopardize emerging domestic capital, especially if national treatment and market access principles were adopted.

Although domestic capital was important in all the core ASEAN countries, it was especially important in Malaysia and Indonesia, often enjoying close political relationships with incumbent political elites and thereby helping to sustain elite coalitions and the stability of the prevailing regime. Domestically owned firms were also important in fulfilling wider socio-economic and ultimately political goals in these two countries, particularly in relation to ethnic development. Malaysia, therefore, spearheaded the idea of using regionalism as a developmental tool to secure the future of domestic firms amid impending global market competition, to which idea Indonesia gave its support. The idea of developmental regionalism was especially salient in sectors outside manufacturing, particularly in the category termed 'services incidental to manufacturing'. It is in these sectors that governments in ASEAN maintained significant restrictions on foreign investors, making the offer of national treatment and market access privileges to ASEAN investors ahead of foreign investors a significant policy move.

When ASEAN member governments endorsed the privileging of ASEAN investors over foreign investors in the investment programme, they intended these temporary investment preferences to stimulate the growth through regional expansion of domestic firms into larger enterprises able to compete with TNCs, including through forming ASEAN multinationals. All the core ASEAN governments were broadly united on the importance of domestic firms becoming large and/or multinational as a means for them to survive global competition. While the idea of developmental regionalism is theoretically plausible, underpinned by insights from strategic trade theory, whether the idea was workable in practice is a separate issue and beyond the focus of this chapter.[10] The point to note is that proponents of developmental regionalism did not fully accept the hegemonic position of foreign/global firms associated with globalization, and they attempted to nurture domestic firms in an environment that was considered to be harshly competitive to developing country capital. There was clearly a need to accommodate domestic distributive priorities centred on elements of domestic capital that were considered to be politically important.

Despite these concerns over domestic capital, the growth and FDI imperative became overwhelming by the middle of 2001 in the face of an expected slowdown in the global economy and the decline in FDI flows to regional economies. Consequently, member governments gave up their attempt at developmental regionalism and extended the offer of national treatment and market access privileges in non-manufacturing sectors to foreign investors at the same time as ASEAN investors, that is, by 2010. Although the differential treatment of FDI was not the main reason for the slowdown in FDI inflows to regional economies, ASEAN governments were nevertheless concerned that the ASEAN–foreign distinction could send the wrong signals to foreign investors at a time when ASEAN was under severe scrutiny by foreign investors and was facing a rather precarious FDI/growth situation.

The future of AFTA

For AFTA, the first and perhaps easier phase of liberalization – in manufactured goods – has essentially been concluded, while it enters a more difficult phase of implementing commitments in services, investment and agricultural trade. Nevertheless, AFTA has not become irrelevant for ASEAN member governments, and indeed key foreign and domestic business groups continue to push for its full implementation (amid pressures from other domestic sources to delay particular aspects of AFTA). Although ASEAN will continue to work towards full implementation of AFTA, the implementation of commitments in the remaining areas at issue is likely to be protracted, because this will affect entrenched domestic interests. While AFTA will remain a key feature of the regional economic architecture, it will increasingly be in competition with some of the newly emerging regional arrangements.

New regional arrangements in the Asia-Pacific

Since 1999, at least twenty proposals for new trading arrangements have been put forward in the Asia-Pacific, ranging from bilateral FTAs to multilateral arrangements.[11] Among the latter include proposals for an East Asian FTA grouping China, Japan and South Korea; an ASEAN–China FTA involving eleven countries; and an FTA grouping the thirteen countries of East and Southeast Asia. Their prospects remain uncertain, given that many of these remain at the proposal stage. Nevertheless, they may well add to pre-existing regional trading arrangements, namely APEC and AFTA. A closer examination of the two most concrete forms of new regional agreement already in place –

the ASEAN–China FTA and Singapore's bilateral FTAs – reveals that the same dynamics at work in APEC and AFTA are also at work in these new regional arrangements.

The ASEAN–China FTA

The cautious response of all ASEAN leaders and policy makers to China's proposal, made in late 2000, to form an FTA between China and ASEAN is completely understandable. The domestic distributional effects of market displacement and investment competition are key concerns of virtually all ASEAN governments. China by itself potentially offers foreign capital a regional site of production by virtue of its size and internal industrial complementarities. China's attraction is magnified when its overall lower cost of production is factored into the equation. Moreover, China's regional market potential is strengthened through the 'Greater China' configuration, which includes Hong Kong. In short, China offers a range of complementarities that producers can take advantage of, that smaller countries as in ASEAN are only able to do through pooling their complementarities via regional cooperation. This means that the market displacement effect in ASEAN from cheaper imports from China is likely to extend over the value-added chain rather than be confined to labour-intensive industries only, especially since China offers lower labour costs across a range of skill types.[12]

An ASEAN–China FTA could also tend to blur the distinction between the two regional sites, because the FTA would allow producers locating in China to sell at preferential rates in both China and ASEAN, and vice versa for those locating in ASEAN. At another level, this could well enhance the attraction of China relative to ASEAN as a site for investment as it means that an investor preferring to locate in China would be assured of preferential market access to ASEAN, assuming that selling in ASEAN is considered to be important. The converse also holds, with investors preferring to locate in ASEAN, which would still allow them to sell to China at preferential rates. Given the current uncertainties and political-economic risks in the ASEAN region stemming from Indonesia's protracted economic and political reconstruction and the spectre of transnational terrorism in Southeast Asia, the cards appear stacked in China's favour for the present. In short, if AFTA had previously been salient precisely because it offered investors searching for investment locations in the Asia-Pacific a distinct regional site for locating production, then an ASEAN–China FTA has the potential to weaken the salience of the AFTA region as a distinct regional space for investment.

These concerns explain the hesitant ASEAN response to the Chinese proposal in November 2000, when its members sidestepped the issue by suggesting a one-year feasibility study on the proposal. In the end, the project was formally endorsed by ASEAN in November 2001 and a framework agreement signed in November 2002. However, ASEAN is proceeding cautiously on implementation of the proposal, with a fully operational FTA with China scheduled for 2010 at the earliest. This is not to suggest that ASEAN policy makers and leaders are against the idea of closer economic integration with China. On the contrary, all ASEAN leaders, including those hesitant about the project, recognize the gains to their respective economies from investment opportunities for local firms in China, from preferential access to the China market and from access to lower-priced final products and intermediate inputs from China.

In fact, a China–ASEAN FTA may well provide the ASEAN side with a 'regional space of consumption' to supplement AFTA as a 'regional space of production' given the enormous potential of the China market. AFTA, at present, is most significant as a region of investment/production, while its capacity as a significant consuming region is limited until such time that economic growth and development raise regional consumption demand for a wider range of goods and services produced within ASEAN. AFTA is therefore best seen as a 'partial economic space', with its main markets remaining outside ASEAN, notably in the USA, notwithstanding the rise in absolute levels of intra-regional trade since the mid-1990s.[13] As such, global market developments and the prospects for the US economy would have considerable bearing on how ASEAN members calculate the costs and benefits of an FTA with China. The uncertainties surrounding the global economy in the closing months of 2002, particularly with economists fearing that the USA could linger for a few years in a post-bubble recession,[14] may well render the ASEAN–China FTA more attractive to those ASEAN members currently most hesitant about this project.

For the present, however, there is considerable ambivalence about this project in the region as leaders recognize the competitive and cooperative nature of an ASEAN–China FTA. The ten-year delay is therefore seen to be necessary to allow ASEAN to consolidate itself as a regional site for production and for domestic industries to make the transition to competing first in ASEAN.[15] In fact, Malaysia, the Philippines and Indonesia are said to prefer the project to become fully operational by 2012 or 2014 rather than in 2010 for precisely this reason.[16] Although this is not to suggest that a wider FTA with China will never materialize in the future, the argument put forward is that ASEAN governments will probably proceed cautiously for as long as they regard China as a major rival for FDI and as a competing producer of goods now being manufactured in ASEAN. ASEAN member governments may not concur with liberal economic expectations that wider regionalism with China would necessarily be a good thing. Thus the Framework Agreement on ASEAN–China Comprehensive Economic Cooperation, signed at the ASEAN–China summit in November 2002, will only flag off negotiations on the FTA, which are scheduled to begin in 2003. It is clearly with much caution that ASEAN countries are approaching the ASEAN–China FTA. These sentiments, driven by domestic concerns, could change if there is expectation of a prolonged global economic downturn, a point already alluded to above.

Bilateral free trade areas

Bilateral FTAs are increasingly the norm in the region, with Singapore the most active proponent of this instrument. At least seven bilateral FTAs involving Singapore have been considered, with the Japan–Singapore FTA[17] agreement signed in January 2002 and the USA–Singapore FTA signed in 2003. Singapore has also concluded agreements with New Zealand, the European Free Trade Area (EFTA) and Australia. Singapore, New Zealand and Chile have also signalled their intentions to begin negotiations on a trilateral FTA, due to be concluded in 2004, while Singapore and India are reportedly considering a bilateral free trade deal. The rush to bilateral arrangements is clearly an instance of governments aiming to secure market access for domestic exporters and investors in an increasingly uncertain global trading environment. This is a particular concern for Singapore, a highly trade- and FDI-dependent city-state economy.

Apart from its concerns over the future of multilateral trade liberalization (Desker 2002), Singapore's frustration over the slow pace of liberalization of services in AFTA also explains its new preference for bilateralism. The services sector is a critical component of the Singapore economy and is also the sector in which much domestic capital, especially domestic private capital, operates. Market expansion for these firms is crucial to their survival in a competitive global market. Thus the services component of all the major bilateral FTAs negotiated between Singapore on the one hand and Japan, the USA and Australia on the other is expected to generate the most gains for both parties in the respective agreements. In particular, Singapore's bilateral deal with Japan enables the country to gain access to Japan's notoriously closed but large services market.

Singapore's bilateralism in trade policy, which has generated some tensions within ASEAN over its potential to dilute AFTA, clearly reflects the kind of economic realism that paradoxically prompted the ASEAN countries to form AFTA in the face of an external threat from China to continued FDI inflows to the region. Singapore's foreign economic policy is based on the search for economic security and is achieved at various levels: bilateral, regional and multilateral (Dent 2001). That the bilateral instrument was pursued given the slow pace of regional services liberalization and the uncertainties in the multilateral process is unsurprising.

The bilateral instrument is clearly attractive to other countries as well as Singapore, as seen in the rush by APEC member countries such as New Zealand, Mexico, Vietnam, Chile, Canada, Australia and South Korea to pursue their own bilateral deals with selected partners. Their ambivalence about the prospects of early success in negotiating a new WTO round, given the very extensive agenda adopted in 2001 at Doha, may well be driving these governments to hedge their bets and opt for a surer approach to lock in market access. Moreover, their ability to include services, investment and government procurement in the bilateral agreements is extremely significant for those governments and firms wishing to move more quickly than both the WTO and existing regional arrangements. The bilateral framework clearly offers greater flexibility than global or even regional processes and is potentially a building block for global free trade.

Moreover, bilateral arrangements are likely to catalyse the expansion of existing arrangements through the inclusion of new members or by those excluded opting to negotiate their own FTAs, leading to what economist Richard Baldwin (1999) calls the 'domino effect' in regionalism and consequently a push for global free trade. In fact, economic simulations reveal that those excluded from the bilateral arrangement would suffer losses, particularly if these arrangements involve a major economic power such as the USA or Japan (Scollay and Gilbert 2001: 115–16). The domino effect is clearly evident in the Asia-Pacific, as seen in Washington's latest offer, made in October 2002, to negotiate bilateral FTAs with any ASEAN country, the trilateral FTA proposed by Singapore, Chile and New Zealand, and the ongoing negotiations between the USA and Australia on a bilateral FTA. Malaysia, long an opponent of bilateral trade deals, is now seeking to seal its first bilateral FTA with Japan.[18] Clearly, the fear of being left out of these market access deals was a major factor prompting the Malaysian *volte-face*.

Despite its apparent potential to build up global free trade, bilateralism offers an institutional framework through which to secure market access as well as to accommodate domestic political-economic sensitivities. There may be better prospects for negotiating bilateral FTAs on an *à la carte* basis or incorporating carve-outs than in global or even regional processes, with the cooperating parties opting to exclude particular sectors that are sensitive for one or both. Deals that address the core sensitivities of governments are much easier to achieve in a setting where only two parties are negotiating. This was evident in the Japan–Singapore FTA, in which goldfish and cut flowers were excluded due to domestic sensitivities in Japan. The significance of this move becomes clear given the impasse in APEC over Japanese intransigence in liberalizing agricultural tariffs. Any new bilateral/regional arrangement involving Japan and the ASEAN countries could well go down this *à la carte* path, given existing domestic political sensitivities in agriculture, particularly in Japan.

A closer examination suggests that the bilateral trend in the region may also be problematic for two other reasons. One source of concern stems from any mushrooming of bilateral arrangements that will lead to what Jagdish Bhagwati and his colleagues call a 'spaghetti bowl' phenomenon, and to the fragmentation of the regional economy (Bhagwati *et al.* 1998). Fragmentation could arise if overlapping arrangements involved mutually inconsistent rules of origin and different liberalization schedules. In such instances, firms are likely to suffer directly from the increased costs of complying with distinct trading arrangements, with firms having to comply with a range of requirements depending on which FTA partner they are trying to do business with. Such effects will be especially pronounced for overlapping FTAs, even if these are designed to be WTO-consistent. A mere difference in tariff-phasing schedules, in rules of origin and in other regulations could mean that the same product would be subject to different treatment depending on its origin and its destination (Scollay and Gilbert 2001: 17). For these reasons, the bilateral route, while offering a way out of the difficulties in obtaining further progress at the multilateral level or even at the regional level, might itself introduce economic inefficiencies and add to the cost of doing business in the region.

A second concern stems from the incongruence between the bilateral framework for organizing economic activity and the logic of capital, which is increasingly seeking *regional* spaces for organizing production. To the extent that firms are interested in regional divisions of labour and are increasingly engaging in regional production networks, then a 'spaghetti bowl' framework of market access arrangements may not be in their best interests. This is why in the USA–Singapore FTA a provision has been included to extend the juridical reach of the FTA to include two Indonesian islands, Batam and Bintan, for the categories of electronics and information technology items through an integrated sourcing initiative. Because production of final goods in Singapore involves extensive use of components produced in other parts of the region, like on Bintan and Batam, strict rules of origin under the bilateral FTA would effectively exclude Singapore-made final products from the US market unless crucial portions of Singapore's production space are included within the ambit of the FTA. This is rather an ironic situation, since Singapore-produced electronics/IT products already enjoy free access to the US market under the Information Technology Agreement signed under the auspices of the WTO in 1996 without the need for any rules on integrated sourcing. Indonesian-made products in this category also enjoy duty-free access to the US market.

This episode illustrates the tension or incongruence between the institutional framework for organizing economic activity that appears to be increasingly dominating the regional landscape – the bilateral framework – and the logic of capital, which is organizing transnational regional production networks across more than two states. While the US–Singapore approach of a formal integrated sourcing initiative is one way to address this structural issue, the exercise repeated over a number of bilateral FTAs will only raise the costs of negotiating, monitoring and enforcing agreements while increasing fragmentation in the regional economy. It will also be a problem for other ASEAN countries, since regional production networks already operate in sectors like automotive components, electrical and electronics products, and the food industry.

Conclusion

This chapter's central argument is that regional economic governance arrangements in the Asia-Pacific are best explained in terms of the interaction between concerns stemming from globalization at the systemic level and domestic political-economic priorities. Although the regional arrangements examined here – APEC, AFTA and the bilateral FTAs – are about ensuring continued integration of member economies into global markets, they are not all about governments renouncing national policy autonomy. There are significant domestic political priorities centred on emerging domestic capital, politically important domestic distributional coalitions and wider domestic social agendas that make it imperative for governments to retain domestic policy autonomy. Thus open regionalism in APEC, negotiated flexibility in AFTA and the possible adoption of either the *à la carte* principle and a WTO-plus agenda in bilateral FTAs are all attempts to secure domestic priorities through procedural approaches. The discussion has shown that regional agreements are embedded in a context shaped by the nature of dominant domestic coalitions, national growth strategies that take domestic socio-political agendas into account, and prevailing international conditions (Jayasuriya 2003).

There are clear commonalities in all three major regional forms studied. All three are about gaining some measure of control over the outcomes of globalization, notably access to export markets and to global capital. The manner in which both AFTA and APEC were structured, notably their modalities for cooperation, also reflected their members' keen interest in retaining national policy autonomy. The degree of regional policy autonomy transferred to these projects differed, however. APEC was allowed the least degree of regional autonomy, since members maximized their domestic policy autonomy through the procedural principle of 'open regionalism', which was the only way for many of APEC's Asian governments to retain policy autonomy in the presence of the more powerful governments of industrial countries, which might have employed APEC to accomplish market opening and economic reform in their economies before they were prepared to. AFTA, given its clear role as a regional instrument for ASEAN governments to gain some control over globalization, was clearly endowed with more regional autonomy than APEC, but it continued to permit domestic policy latitude through 'negotiated flexibility'. The bilateral arrangements concluded to date, notably involving Singapore, have retained the least domestic policy autonomy.

The implications of these different governance arrangements in the Asia-Pacific for global governance, particularly the WTO, are mixed. Certainly, these projects are not a direct threat to a liberal trading order, since they are all about engaging with the global market. However, governments may pursue the regional and especially the bilateral option with greater enthusiasm if they see the WTO process as likely to be a long drawn-out affair. In fact, the bilateral route might become extremely attractive for some states as APEC becomes increasingly marginalized as a vehicle for economic liberalization and AFTA enters a more difficult phase of economic cooperation. Bilateralism offers greater flexibility to its negotiating parties, whether it is to retain greater domestic policy autonomy in some areas through carve-outs or to advance beyond the present WTO agenda. The different bilateral agreements already negotiated have managed to accommodate both these distinct needs. It is precisely for this reason that bilateral arrangements will come to dominate the regional economic architecture.

While bilateralism may act as a building block to global free trade and an adjunct to global economic governance, it could nevertheless result in the fragmentation of the regional economic space, thereby creating a disjuncture between the 'regional' logic to global capital and the institutional framework governing economic cooperation. Bilateralism could also divert attention and resources from the multilateral process. Governments may turn to bilateralism due to impatience with what looks like an overloaded WTO agenda, especially in view of the attempts by developing countries to introduce developmental concerns into the multilateral trading system. On the other hand, the growing bilateralism in the region could well prod ASEAN governments into hastening the full completion of AFTA to mitigate the latter's possible marginalization in the regional economic architecture. Perhaps, in the end, it is this very threat to ASEAN/AFTA as a region of investment/production that will spur members to complete the next phase of AFTA if its members continue to regard the project to be crucial to their economic prosperity.

Notes

1 An earlier version of this chapter was presented at the Conference on Regional Integration and Global Economic Governance: Regulating Integrating Markets, organized by the London School of Economics and Political Science and the United Nations University/Comparative Regional Integration Studies, Brugge, Belgium, 22–23 November 2002.
2 See McCargo (1998).
3 The founding members of APEC in 1989 were the then six member states of ASEAN (Brunei, Indonesia, Malaysia, the Philippines, Singapore and Thailand), Australia, Canada, Japan, New Zealand, South Korea and the United States. In 1991, the 'three Chinas' were admitted to the grouping – the People's Republic of China, Hong Kong and Taiwan. Papua New Guinea became a member in 1993 and Chile in 1994, while Peru, Russia and Vietnam formally joined APEC in 1998. Since then, a moratorium has been placed on APEC membership.
4 Ravenhill (2001) provides an insightful and theoretically informed analysis of the formation and evolution of APEC.
5 This is the original definition of open regionalism, articulated most clearly by Drysdale and Garnaut (1993: 187–8). The term is now used in a more general sense to characterize regionalist schemes that are fundamentally about engaging with globalization and global markets, usually specified to mean projects where the exchange of preferences between regional partners is not accompanied by the imposition of new barriers to non-partners (Gamble and Payne 1996: 251). For this chapter, the term is employed in its original sense to mean unilateralism and non-reciprocity in trade liberalization.
6 Unless otherwise indicated, the material presented in this section is drawn from Nesadurai (2003).
7 The Association of Southeast Asian Nations was formed in 1967 by Indonesia, Malaysia, the Philippines, Singapore and Thailand. Brunei joined the grouping in 1984 on its independence from Britain. Vietnam joined in 1995, Laos and Myanmar in 1997 and Cambodia in 1999, bringing total membership to ten.
8 The core or founding members of AFTA are Brunei, Indonesia, Malaysia, the Philippines, Singapore and Thailand. The new members of ASEAN (Vietnam, Laos, Myanmar and Cambodia) acceded to AFTA on joining the association.
9 The latter include customs initiatives, standards harmonization and mutual recognition programmes.
10 The theoretical basis of developmental regionalism is discussed in Nesadurai (2003).

11 Scollay and Gilbert (2001: 1–2) provide a list of negotiated and proposed bilateral and multilateral FTAs in the Asia-Pacific region.
12 Computer simulations confirm the competitive nature of the ASEAN–China relationship. See Scollay and Gilbert (2001).
13 Intra-ASEAN trade accounts for 20–25 per cent of ASEAN's global trade.
14 See Paul Krugman, 'The US economy needs leadership', in *The New York Times*, reproduced in the *International Herald–Tribune*, 2 October 2002.
15 Interview with a Malaysian trade official, December 2001.
16 'ASEAN wants trade bloc with Japan before China', *Philippine Daily Inquirer*, 18 September 2002.
17 The Japan–Singapore Economic Agreement for a New Age Partnership was signed in January 2002.
18 'Malaysia aims for first free-trade deal with Japan', *Straits Times*, 13 December 2002.

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9 Cooperation on money and finance

How important? How likely?[1]

Natasha Hamilton-Hart

Introduction

Proposals for regional cooperation on money and finance took on a new level of prominence as a result of the Asian financial crisis that began in 1997. While national and global institutions for managing finance were also the subject of critical scrutiny, many ideas for reform were centred on the regional level. The crisis made it very clear that Asia lacked effective mechanisms for crisis prevention and management. However, the significance of this cooperative deficit is not obvious. Would financial and monetary cooperation on an intra-Asian basis benefit participating countries? Is such cooperation politically feasible? This paper examines both questions.

The first section outlines what cooperation on money and finance entails, the general reasons why it might be desirable and the trade-offs associated with different types of cooperation. The second section summarizes initiatives that involve Southeast Asian countries in schemes for regional cooperation in the area of money and finance. The most significant of these are for cooperation on an East Asian, not Southeast Asian, basis. the third section argues that there are incentives for cooperation on both monetary and financial issues, although some goals, particularly a region-wide common currency, are premature given the economic diversity of East Asia. The final section assesses the prospects for regional financial and monetary cooperation. It concludes that while political obstacles could impede potentially beneficial cooperation, such difficulties are not insurmountable.

Why cooperate? Benefits and trade-offs

Cooperation on money and finance can include a range of activities that are often interrelated. Cooperative crisis management, for example, often calls forth a concern with crisis prevention; currency cooperation is likely to entail a degree of monetary policy coordination as well as mechanisms to support national currency values in times of crisis; and financial regulation may well be linked to more general regulatory and economic policy agendas. Nonetheless, the different types of cooperative goal are worth distinguishing, because they are conceptually distinct and may involve different mechanisms, trade-offs and prerequisites.

Monetary cooperation

Monetary cooperation involves agreement between two or more countries to coordinate the external values of their currencies to some degree.[2] The degree of coordination can be total, involving the adoption of a common currency, but there are many goals that cooperation may aim at that fall short of this objective. In the case of the postwar Bretton Woods system, which lasted until the early 1970s, for example, countries agreed to fix their currencies at specified values, which would only be changed in accordance with agreed-upon rules. Outside Europe, a much looser type of monetary cooperation prevailed between the major players in the 1970s and 1980s, when the United States and Japan in particular made periodic *ad hoc* attempts to redress trade and other imbalances between them by deliberately managing their currencies (Henning 1994). Another type of monetary cooperation would involve agreement to limit currency fluctuation to within a certain band (say plus or minus 5 per cent) around an agreed currency peg – with its value determined in relation to another currency or basket of currencies. In the European case, such an exchange rate agreement preceded the decision to adopt a common currency.[3]

The benefits of monetary cooperation are mainly those that currency stability brings: a degree of predictability that reduces the costs and risks of international trade, investment and bank lending; the avoidance of competitive currency depreciation spirals; and (in the case of a shared currency) the total elimination of the exchange rate costs of doing business across national boundaries. Because monetary cooperation is often supported by crisis management facilities – commitments to provide emergency financial support to defend currencies at their agreed values – it may help to avoid the costs of sudden and steep devaluations caused by shifts in investor sentiment. Backed up by the pooled resources of a set of collaborating countries, each national currency may be more resilient to speculative attacks.

This type of cooperation comes at a certain cost. This cost is the loss (or reduction) in monetary policy autonomy that is a direct consequence of fixing the external value of a currency in a world of capital mobility. Following from the formalization by two economists in the 1960s, the impossibility of maintaining currency stability and monetary policy autonomy under conditions of capital mobility is often referred to as the Mundell–Fleming thesis (Kenen 2000: 346–61). This incompatibility arises because when capital can move easily from one country to another, monetary policy that is tighter than that prevailing elsewhere will trigger capital inflows, which will exert upward pressure on the currency. Conversely, a comparatively loose monetary policy will tend to be associated with capital outflows, which exert downward pressure on the currency. Even if in reality capital flows are considerably stickier and less predictable than the basic model assumes (because of market imperfections and risk perceptions), the empirical record suggests that as the technical and regulatory barriers to capital mobility are reduced, it becomes harder to avoid a trade-off between currency stability and monetary policy autonomy (Goodman and Pauly 1993).

Relatedly, a commitment to a fixed currency removes the option of using the exchange rate as a tool of monetary policy. Singapore, for example, has targeted the exchange rate as its primary monetary policy instrument since 1980. The relative stickiness of domestic prices means that many countries find it less painful, economically and politically, to bring about necessary price adjustments through the exchange rate rather than domestic deflation. Overall, therefore, whether the advantages of currency stability outweigh the costs of having a relatively inflexible currency depends very much on specific national and international contexts: the volatility and dynamics of international financial markets; the intensity and structure of trade and investment flows among a group of countries; and domestic economic factors, including the flexibility of domestic wages and prices.[4]

Financial cooperation

Financial cooperation can support monetary cooperation goals by making it easier for countries to stick to their commitments in the face of market pressure on their currencies.[5] Even when monetary cooperation is not an objective, joint management of currency and financial crises can yield overall gains as access to international lending provides some of the benefits of a domestic lender of last resort: a source of funds that prevents illiquid but otherwise sound firms from failing. While such funds are sometimes made available on a bilateral government-to-government basis, the International Monetary Fund (IMF) is the organization tasked with providing cooperative liquidity support at the global level.

The benefits of this kind of support are clear in theory, but the costs and risks are also fairly apparent. How is an international lender of last resort to distinguish between temporary liquidity crises deserving of support and crises brought on by more structural imbalances than the country needs to address? Will the expectation of a bail-out reduce incentives for lenders and borrowing countries to act prudently? Critics of the IMF have accused it of combining the moral-hazard consequences of a lender of last resort without the benefits: an institution that has failed to provide sufficient funds to avert genuine liquidity crises yet has also bailed out imprudent investors and improvident governments. Proposals to retain but reform the IMF aim to balance the requirements for surveillance and appropriate conditionality with the need for access to adequate emergency liquidity support (Eichengreen 2000). Effective cooperative crisis management therefore requires more than the availability of a pool of funds: the precise mechanisms and rules under which support is made available are critical. These are likely to lead to a second type of financial cooperation in the form of measures to make crises less likely. Such measures include cooperative monitoring of financial markets, surveillance and information exchange, and the development and implementation of common prudential standards. At the global level, this kind of function is performed largely by the Bank for International Settlements (BIS), but the IMF and other bodies are increasingly playing a standard-setting role (Kapstein 1994; Kahler 2000).

A third type of financial cooperation aims to develop and integrate financial markets through financial liberalization or more proactive efforts to develop certain types of financial market or promote investment flows. The benefits of this kind of integration are very much contested. Even if it yields gains, capital account liberalization also exposes countries to greater risks and can magnify the repercussions of financial instability, particularly in certain national contexts (Gruen and Gower 1999; Ishii and Habermeier 2002). For this reason, a fourth potential goal of financial cooperation would be to restrict capital mobility. Cooperative capital controls were part of the initial postwar Bretton Woods system, and serious analyses have begun to present the case for some restrictions on international capital movements (Helleiner 1994; Eichengreen *et al.* 1995). While there is a growing consensus on the benefits of selective controls on capital inflows in certain conditions, controls on outflows are more controversial (Cohen 2000).[6]

Initiatives: from SEANZA to APT

There is a longer history to financial and monetary cooperation involving at least some Southeast Asian countries than is generally acknowledged. The first formal organization for financial cooperation was established in 1957, and other initiatives were taken before regional cooperation became a much more ambitious and visible agenda item in the years after 1997. Most of the earlier institutions and schemes were not very significant in practical terms, but an awareness of their existence is useful for understanding the prospects of more recent proposals.

The first decades: limited, low-profile cooperation

The first organization tasked with cooperation in the area of finance involving Southeast Asian countries was SEANZA (Southeast Asia, New Zealand and Australia), a central bank group established in 1957. It has included Japan and South Korea since the 1960s. At the time, this group was mainly involved in low-profile training and advisory functions for Southeast Asian central banks, many of which were newly established or still in the process of handing over management to officers. This role was largely taken over by SEACEN (Southeast Asian Central Banks), established in 1966. This group actually has several members that are outside Southeast Asia (when it was established, it included then ASEAN members and Nepal and Sri Lanka) but has a strong Southeast Asian orientation. It has held regular meetings of central bank governors and officials and, through its training centre in Kuala Lumpur, it has organized numerous courses and seminars for officials since 1972.

The first ASEAN initiative in the financial area was the establishment of the Central Banks and Monetary Authorities Committee in 1972. The Committee on Banking and Finance held its first meeting in 1977, after which it met quite frequently: eleven times by April 1983.[7] Private sector cooperation in ASEAN has revolved around the ASEAN Banking Council, established in 1976. This council is made up of representatives from ASEAN private and state sector banks. It met twice a year until 1982, thereafter yearly. The reduction in the number of meetings was due to an increase in the council's permanent committees on issues such as banking education, an ASEAN bankers' acceptance market and publication of financial directories. Like the other ASEAN bodies, it was considered 'much more productive in new ideas or recommendations to other groups than in tangible results from their own efforts' (Skully 1985: 43).

The council's most tangible product was the ASEAN Finance Corporation (AFC), incorporated in 1981 in Singapore.[8] The AFC grew out of schemes proposed at an ASEAN Bankers' Council meeting in Jakarta by both Indonesian state banks and Chinese bankers from the Malaysia and Singapore Chinese Chambers of Commerce. The draft proposal by the Chinese Chambers of Commerce and Industry of Malaysia and Singapore (*Far Eastern Economic Review*, 1 February 1980) appears to be the one that, with a few modifications, was taken up. The AFC was to function as a guarantor of bond issues and a channel for equity and loans from outside the region (*Far Eastern Economic Review*, 15 February 1980). Its achievements were very limited, due to diffuse ownership, the limited number of eligible ASEAN projects and potential competition from the shareholding banks (Shulze 1988).

For most of the time until the 1990s, Japanese schemes related to foreign aid were the most significant type of financial cooperation in the region. Some aid and investment schemes did have a formal organizational basis. The largest of these is the Asian Development Bank (ADB), opened in 1966 following low-profile but substantial Japanese efforts (Yasutomo 1983: 3–7, 23–65). Another initiative started taking shape in 1980 with a Japanese business association mission to Jakarta (*Far Eastern Economic Review*, 15 February 1980). The result was the establishment of the Japan ASEAN Investment Company (JAIC) by members of the Japanese Business Association in July 1981.[9] The JAIC was also to be used as a channel for investment in the region in conjunction with the ASEAN–Japan Development Fund, which was announced in 1987 as part of Japan's capital export programme. Partly because of opposition from the IMF and World Bank, however, some of the operations originally intended for the fund were not pursued (Shiraishi 1997: 191).

Although sometimes referred to as financial cooperation, the much greater amounts of Japanese aid and investment channelled bilaterally do not really fall within the rubric of financial and monetary cooperation discussed in this paper. However, these financial flows are worth noting, because the economic linkages within both Southeast Asia and the broader East Asian region owe a lot to Japanese aid and investment strategies. Together with the integrating force of 'overseas' ethnic Chinese business people operating in Southeast Asia and, increasingly, China, these ties have created the regional interdependence that underlies recent calls for financial and monetary cooperation.[10] A further potentially significant aspect of Japanese involvement with ASEAN is that, more than any other country, it has taken care to develop its diplomatic relationship with

Southeast Asian countries as a group since the 1970s (Sudo 1992; Terada 2001). This degree of political and economic engagement with the region creates further grounds for later collective action among these countries.

Monetary cooperation was not considered seriously in the region until the 1990s. The idea of an Asian clearing house and Asian reserve bank did circulate in the late 1960s but for various reasons, including opposition by Japan, it never amounted to anything (Vorachattarn 1977: 34). Actual cooperation on monetary issues involving an Asian country was confined to periodic US–Japan efforts to manage the relative levels of their two currencies (Henning 1994). Other than this, monetary cooperation did not go beyond vague discussion of macroeconomic policy at meetings of regional central bankers.

Before the crisis of 1997–98, interest and exchange rates in most Southeast Asian countries were influenced primarily by the US dollar and US interest rates, with a more moderate influence exercised by the yen (Frankel 1993: 69–79). Although the Thai government encouraged the use of the baht in transactions in the Indochina area (Tantramongkol 1995), the yen was the only regional currency with any potential to challenge the US dollar. Japan gave the idea more attention from the late 1980s and, in 1994 and 1995, the country's Ministry of Finance, MITI and Economic Planning Agency all released reports mentioning the desirability of greater international and regional use of the yen (Kwan 1996: 3). In the mid-1990s, one of the main intellectual proponents of some kind of yen bloc, C.H. Kwan, argued that the idea was 'no longer ahead of its time' (*ibid.*: 15). However, significant changes in Japanese financial markets would be needed to provide attractive yen-denominated assets.

A Japanese proposal for a new central bank forum led to the establishment of the Executives' Meeting of East Asia–Pacific Central Banks (EMEAP) in 1991. It has held biannual meetings at the senior official level since then, and the first meeting of EMEAP governors was held in July 1996.[11] In September 1995, the governor of the Reserve Bank of Australia raised the idea of increased central bank cooperation in Asia, perhaps along the lines followed by the Europe-domin ated BIS. Later he said that the essential rationale was to provide a more focused forum than presently exists in the region to help central banks cope with the emergence of deregulated, global financial markets and their consequences (Fraser 1996: 23).

Currency cooperation in the region had been limited to a (never used) ASEAN swap arrangement, established in 1977 (Skully 1985). However, in February 1996, the Singapore and Hong Kong monetary authorities agreed to intervene to support the Bank of Japan to help to maintain stable yen–US dollar cross rates and prevent further appreciation of the yen. Malaysia, on the other hand, rejected the idea on the grounds that 'poor developing countries' should not be compelled to help to manage the Japanese currency (*Far Eastern Economic Review*, 29 February 1996; *Straits Times*, 18 March 1996). A series of bilateral repurchase agreements, which could be activated to provide currency support, were concluded in 1995 and 1996 by members of ASEAN, Hong Kong, Japan and Australia (Yam 1997).

After the crisis: increased visibility and momentum

The currency and financial crises that hit Asia and other emerging markets in 1997 provided the conditions for further interest in regional cooperation. Even before the crisis, Japanese officials had been considering the merits of some kind of regional crisis management facility. In the early stages of the crisis, they raised the idea privately with Asian governments (Amyx 2002). However, strong opposition from the USA and a lack of Chinese support meant that the proposal was shelved.[12] In the absence of a viable alternative, the crisis economies were forced to comply with much-criticized IMF rescue schemes (Higgott 1998). Nonetheless, regional countries were prepared to offer mutual support during the crisis. Some limited coordination to support currencies under pressure occurred in 1997 (*Straits Times*, 10 July 1997, 31 July 1997; Bank Negara Malaysia 1997: 68). Western Pacific countries were major contributors to the IMF-coordinated rescue funds; and Japan launched a large aid plan for crisis-affected Asia under which $48 billion had been committed by early 1999 (Masuyama 2000: 243–6).

Proposals for various types of regional monetary and financial cooperation were put forward over the next three years. ASEAN finance ministers (as opposed to 'economic ministers') met for the first time in 1997, and the organization has supported a feasibility study of an ASEAN currency (initiated in its December 1998 Action Plan) as well as a financial monitoring project. Members also began some coordination in multilateral negotiations on financial services liberalization in 2000.[13] Regular Asia–Europe meetings have also been a forum for regional dialogue on financial cooperation.[14] However, the main institutional locus for cooperation among Asian countries is the series of meetings being held on an 'ASEAN+3' basis, in which Japan, China and South Korea have joined the ASEAN countries at the summit level (the first informal meeting occurred in 1997) as well at the officials' and ministerial levels (Stubbs 2001).

Regular meetings of ASEAN+3 finance and central bank deputies have taken place since 1999, and ASEAN+3 finance ministers began to meet officially in 2000 (Thomas 2002: 16). The most visible outcome associated with ASEAN+3 meetings is a set of regional currency swap agreements. The plan to establish such support facilities, known as the Chiang Mai Initiative, was announced by ASEAN+3 finance ministers in May 2000. A year later, it resulted in three bilateral swap deals between Japan and Korea, Thailand and Malaysia (Amyx 2002). Total support committed under these swaps came to $6 billion ($1 billion to Malaysia, $2 billion to South Korea, $3 billion to Thailand).[15] Similar pacts were later negotiated with the Philippines and China. The intra-ASEAN swap facility was also increased by $1 billion in November 2000.

Moves towards cooperation on financial monitoring, regulatory capacity and standard setting have also begun to be made loosely under ASEAN+3 auspices. China has arranged training courses on economic reforms and development, Korea has hosted a working visit by senior officials and organized a training programme on financial restructuring, and Japan has offered funds and technical assistance for monitoring capital flows (*ibid.*: 17). In addition, new initiatives for information gathering and analysis have been located within the ADB, which may lead to the development of some regional standard-setting capacity.

Monetary cooperation in Asia remains far more embryonic. In early 1999, Miyazawa Kiichi, then Japanese finance minister, suggested that Asia adopt a currency basket based on the yen, the dollar and the euro (*Asian Wall Street Journal*, 18 January 1999), an idea that Japanese Ministry of Finance officials have since promoted in public speeches on regional cooperation in Asia. Building on ideas among many Japanese (and other) policy makers that overreliance on the US dollar had been a factor behind the crisis, calls to increase the use of the yen as an international currency have gained at least verbal support. Some of the obstacles to internationalizing the yen have begun to be addressed in Japan (CFEOT 1999). A number of ongoing research projects investigating the viability of monetary cooperation in the region have also received official support and funding. For example, the Japanese Ministry of Finance has co-sponsored a three-year research project on future financial arrangements in East Asia, which includes studies of cooperative currency arrangements in the region.[16]

The idea that Asia might benefit from various forms of currency cooperation in the future, including a common currency, has been raised by the secretary-general of ASEAN, policy makers in Japan and Taiwan, the financial secretary of Hong Kong, the governor of the Hong Kong Monetary Authority, the governor of the Philippines central bank and then Philippines President Joseph Estrada (Castellano 2000: 3). There is no serious support for a common Asian currency in the near term, but the idea of reducing the region's reliance on the US dollar appears to have taken hold.

Incentives: does regional cooperation make sense?

Making a case for regional cooperation need not involve dismissing the benefits of cooperation among broader groups of countries. In the case of money and finance, some rules and institutions that are virtually global in scope already exist and have an important role to play, given that financial markets are in many ways globally interlinked. However, as summarized in this section, there are several potential advantages of specifically regional cooperation on money and finance. While some cooperative goals probably do not make sense for all countries in the region, particularly in the immediate future, other avenues of cooperation do promise overall gains.

One incentive that has been raised frequently by policy makers in Asia since 1997 is a desire to improve the functioning of global institutions by presenting the region's interests more forcefully at the global level (Grenville 1998; Hayami 2001). Coordination could secure a greater say in global negotiations and organizations where Asia still lacks influence proportionate to its economic weight

(Morrison 2001). While ASEAN countries have acted collectively to increase their international voice, greater influence is likely to be achieved if Southeast Asia joins forces with the larger players, particularly Japan and China.

Some sense of common interest must underlie this and other types of regional cooperation. While many differences in policy preferences are apparent across the region, some common attitudes regarding economic policy also exist (Stubbs 2001). On the issue of managing international financial flows and crises, many policy makers and commentators in the region share a perception that arrangements at the global level are inadequate. There is no consensus on whether they are technically correct or not – the judgement depends on which analytical model of international capital flows and crises is adopted. On this score, opinions among influential economists and policy makers in the western Pacific tend to place more emphasis on the inherent instability of international capital flows than is reflected in the current direction of attempts at the global level to develop international rules and crisis management systems (see, for example, Rankin 1999; Sakakibara 1999; Yam 1999; Grenville 2000).[17]

The development of some type of crisis management capacity at the regional level holds out the possibility for embedding local preferences regarding financial and economic policy in regional standards and rescue packages. There is some doubt over whether the Chiang Mai Initiative swaps, which might be the first step towards creating a regional liquidity fund, will provide for this. China and Japan succeeded in linking all but 10 per cent of these facilities to IMF conditionality, a stipulation that Malaysia in particular had opposed *(Business Times*, 7 March 2001, 21 April 2001; Amyx 2002). According to Dieter and Higgott (2002), this undermines the potential for greater regional autonomy, which would be one of the benefits of a regional facility. However, the figleaf of IMF conditionality is useful to donor countries as a way of deflecting criticism of bail-out exercises that are likely to involve unpopular or intrusive measures. Once a regional facility is established, it would be politically difficult for the IMF to block disbursements that donor countries wish to make. Financial independence means that remaining an adjunct to the IMF would be unlikely (Narine 2001: 240).

Even if there are no distinct shared preferences on financial management in Asia, and even if regional countries are very dissimilar in terms of economic structure, there are nonetheless advantages to regional crisis management and prevention. Proximity on its own can create shared risks from contagion and, in the case of East Asia, substantial interdependence reinforces this incentive to respond to crises in neighbouring countries (Rajan 2000a). While there are also significant economic links with the USA, the asymmetry in these ties and America's global political and economic engagement dilutes its interest in Southeast Asia. Regional actors are also less likely to be distracted by experiences and activities elsewhere than the IMF, which has a global mandate. In addition, local actors may be better informed and thus better able to devise appropriate crisis management and prevention schemes. As noted by the governor of the Philippines central bank, the desire for 'a uniquely Asian institution that will have a focused mandate and will be responsive to the region's needs' lies behind recent cooperation initiatives (Buenaventura 2000).

Other moves that could provide countries in the region with some protection from the vulnerability associated with capital mobility include cooperation in capital account monitoring and technical assistance with financial regulation (Chalongphob 2000; Rajan 2001). Improving the region's self-sufficiency in long-term finance could reduce its vulnerability to currency destabilization and speculative pressures. By improving regional financial markets, Asia would be able to avoid channelling a large part of its savings to developed countries: at the time of the 1997 crisis, 80 per cent of total Asian foreign exchange reserves of about $600 billion were invested in North America and Europe. This meant that 'Asia is financing much of the budget deficits of developed economies, particularly the United States, but has to try hard to attract money back into the region through foreign investments … Some have even gone as far as to say that the Asian economies are providing the funding to hedge funds in non-Asian centres to play havoc with their currencies and financial markets' (Yam 1997). Recent moves to develop regional bond markets and close the gap between ratings on Asian bonds and the needs of local institutional investors have been explicitly related to these concerns (Chan 2001).

Some forms of monetary cooperation also appear viable in the near term. Reducing the overwhelming reliance on the US dollar in currency baskets, international transactions and reserve holdings could yield benefits given the level of regional trade, and also as a way of reducing the potential for the USA to abuse its position as the issuer of the world's most widely used currency (Kwan 2001). While further reform is needed in Japanese markets, this is becoming more feasible as markets for yen- and euro-denominated financial assets become more liquid and attractive. This shift in currency use also appears more feasible if private decisions regarding which currency to use in international transactions are seen as being significantly influenced by government choices regarding exchange rate baskets, official reserves and intervention currencies.[18]

There is a debate among economists over whether economic preconditions for a common currency basket peg or a shared regional currency exist (Khairul and Mollers 2000). Even if some flexibility is built into the arrangement, to the extent that currency values are fixed, individual countries lose autonomy in monetary policy. Is this loss of autonomy likely to be worth it? The more economies are similar in terms of trade structure and inflation rates, the fewer trade-offs they face in adopting similar monetary policies. In this regard, Japan, Taiwan, Singapore, South Korea and Hong Kong are better candidates for monetary cooperation than the whole of East Asia, which is much more diverse (Kwan 2001: 162–9).[19] The gains from a common currency basket might not be evenly distributed (de Brouwer 2000), but even an otherwise negative assessment of the prospects for currency cooperation concludes that 'On standard optimum currency area grounds, then, the economies of East Asia would seem to be more or less plausible candidates for internationally harmonized monetary policies as the members of the European Union' (Eichengreen and Bayoumi 1999: 360).

Prospects: is regional cooperation feasible?

Some forms of financial and monetary cooperation may be economically worthwhile for the majority of countries in the region, but it does not necessarily follow that such cooperation will be easy to achieve. Domestic and international political obstacles could make cooperation difficult or even impossible. This section argues that while such obstacles exist they are often exaggerated in analyses of Asia. At least some avenues of cooperation are not unrealistic for the region as it is now.

National policies are rarely made purely on the basis of objective cost–benefit calculations for a country as a whole. Different economic groups in a country are likely to have different preferences regarding the trade-off between capital mobility, exchange rate stability and autonomy of monetary policy, reflecting their different sectoral or asset-specific interests (Frieden 1991). Potentially mobile investors and bankers are typically advocates of unrestricted capital mobility, whereas exporters, for example, have less reason to oppose controls as long as they do not restrict trade-related transactions. National preferences regarding cooperation are unlikely to be determined completely by the relative economic importance of such domestic groups. The political weight of domestic groups that stand to lose or gain from specific measures, as well as the ideological predispositions of policy makers, will also shape cooperation preferences.

As initiatives for regional cooperation become more tangible, affected domestic interests are likely to become more politically active and influential. Work on regional cooperation that has taken national-level interests and political coalitions seriously in the Southeast Asian context has so far concentrated on trade (see, for example, Solingen 1999). We know very little about the domestic political economy of cooperation on money and finance in the region. At this stage, therefore, it is impossible to make firm predictions. Cooperation that promises overall national-level benefits could be thwarted by disproportionately influential domestic interests. However, such interests have not always dominated trade policy in Southeast Asia, and we have few reasons to believe that the structure of domestic policy making is systematically more perverse when it comes to financial and monetary issues.

International-level political obstacles to cooperation are more frequently cited in the case of East Asia. Cooperation among formally sovereign states is rarely easy to achieve, even when all parties have the same degree of interest in the same cooperative goals. In the absence of an undisputed regional hegemon to monitor the costs of compliance, do countries in the region have enough confidence in each other to allow them to overcome the collective action problems inherent in some forms of cooperation?[20] Asia is sometimes portrayed as a region in which interstate political rivalries and mistrust make cooperation all but impossible, but this picture is misleading because it ignores the many ways in which countries in the region have engaged each other in dialogues and ventures to increase levels of interdependence (Acharya 1997; Terada 2001). Political suspicion and resentments do intrude into some relationships, particularly between Japan and China, but all major countries in the region have already accepted some significant limits on their autonomy in order to reap the benefits of economic integration. In this context, it is unrealistic to maintain that international political obstacles impede all forms of cooperation.

Conclusion

Regional monetary and financial cooperation is moderately important for East Asia. While obviously no panacea, the benefits of stronger regional mechanisms for preventing and managing financial crises probably outweigh the costs involved, assuming appropriate institutional design. Similarly, some forms of currency cooperation seem likely to hold out the prospect for overall gains, compared with policies of total currency flexibility or *de facto* pegging to the US dollar. However, official initiatives to date remain limited in scope, and differences between countries in terms of domestic economic structures and institutions mean that negotiating specific agreements is unlikely to be a smooth process. Negotiations on the ASEAN+3 swap mechanisms, for example, have already seen such differences arise. These difficulties are real, but they do not preclude all forms of cooperation, particularly since levels of economic and political interdependence are high enough for most countries to have an interest in the stability and prosperity of their neighbours.

Overall, while further cooperation on money and finance will require fairly high levels of political will, many of the items on the current agenda are viable objectives. Some are inherently long-term projects, but it is significant that a cooperative infrastructure has already begun to develop in the region. National interests and priorities are not fixed, but the current demand for regional cooperation is probably more than a passing fad. Many countries have a material interest in cooperation, because they face problems that cannot be dealt with adequately at the national level or by institutions that are global in scope. Regional cooperation serves both as a complement to the development of global rules and institutions governing finance and as a way of influencing the evolution of these global institutions.

Notes

1 This is a revised version of a paper that was published in *Third World Quarterly* 24 (2), 2003.
2 Cooperation requires some reciprocity and is thus different from cases where a country unilaterally gives up control over its own currency (or gives up the currency itself) by fixing it against an external standard of value.
3 Eichengreen (1997) discusses the steps towards the creation of the European single currency.
4 Hence these factors determine whether a group of countries constitute an optimum currency area in economic terms. The economic theory of optimum currency areas and related issues was pioneered by Robert Mundell. See Calvo *et al.* (2001) on Mundell's work and more recent scholarship in this area.
5 For this reason, financial cooperation in the form of a regional liquidity support fund could be the first step towards monetary regionalism. See Dieter and Higgott (2002).

6 As demonstrated by the furore over Malaysia's implementation of capital controls in 1998, much of the controversy is politically or ideologically generated. Sober assessments of the controls have found that they did not have significant costs (Meesook *et al.* 2001), and several studies argue that they yielded overall benefits (see, for example, Athukorala 2000; Kaplan and Rodrik 2001).

7 Unless otherwise stated, the source for information on ASEAN schemes is Skully (1985).

8 Ideas for an ASEAN financial institution date back to a UN study team proposal in the early 1970s. See Skully (1985: 43).

9 At the end of 1984, the OECF became a shareholder in the company until it sold its share back to Japanese private companies in October 1989. In 1991, the firm's name was changed to the Japan Asia Investment Company. As of 1995, total assets of the company were 75 billion yen ($842 million). See JAIC's 1995 annual report.

10 On these integrative forces, see, for example, Katzenstein *et al.* (2000).

11 The group comprises Singapore, Malaysia, Indonesia, Thailand, the Philippines, China, Hong Kong, South Korea, Japan, Australia and New Zealand. A review of EMEAP and other regional central bank meetings is given in the 1997 annual report of Bank Negara Malaysia.

12 Despite Chinese opposition at this time, the head of the Hong Kong Monetary Authority, the territory's *de facto* central bank, made a strong but not unqualified argument in favour of regional cooperation (Yam 1997). Taiwan also offered to anchor an Asia-only fund of $50 billion, but this idea too was vetoed by the USA and China (*Australian Financial Review*, 29–30 November 1997).

13 An overview of these initiatives is provided in chapter 6 of the 2000 annual report of Bank Negara Malaysia.

14 See, for example, speeches at the 2001 finance ministers meeting, available at http://www.mof.jo.jp/english/asem

15 Malaysia already had a $2.5 billion agreement with Japan in place under its crisis-related aid package for Asia.

16 The project is located at the Australia–Japan Research Centre of the Australian National University.

17 After initially backtracking, the IMF returned to its pre-crisis move to add capital account liberalization to its list of official goals. See the managing director's statement to the executive board of the IMF, reported in *IMF Survey* 28, 143–4, 10 May 1999.

18 Kwan (2001: 146–7) sees private decisions as likely to follow government choices. McKinnon (2001) implicitly reverses the relationship in his argument that Asia would gain from a common monetary standard based on the US dollar.

19 Several other studies have estimated that there are potential gains from currency cooperation in the region. See Kusukawa (1999), Williamson (1999), Rajan (2000b) and Kawai and Akiyama (2001).

20 Expectations are critical, because decisions to cooperate are often made only if an actor is confident that potential partners are reliable but will not tolerate free-riding. See Oye (1986) for a set of influential essays on the problems of international collective action.

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10 Towards an East Asian community

Implications of the EAVG report[1]

Nick Thomas

> ASEAN countries, China, Japan and Korea share a common destiny. East Asia is our natural constituency, and Northeast Asia and Southeast Asia are inextricably intertwined economically, politically, and socially.
>
> (East Asia Study Group 2002: 58)

Introduction

1997 was a bad year for ASEAN and its member states. Not only did the organization have to contend with a capacity shortfall that made it impossible to assist in addressing problems of economic governance in member economies, but the attendant social problems threatening to spill over and worsen the crisis required the assistance of international donor organizations. Furthermore, a widespread environmental problem developed (the so-called 'haze problem') that only exacerbated existing social, economic and political misery. At the time (and afterwards), there was fierce condemnation of ASEAN, claiming that in its members' hour of need the regional organization had failed to develop an effective response. The defenders of ASEAN replied that the organization was never established to address sudden multiple crises. Both arguments were correct. It was not ASEAN's role to ensure good economic and environmental governance in its member states, yet ASEAN remained the only regional-level organization with the scope to address all the problems that emerged.

The need to create a regional organization able to meet a similar set of challenges to the ones faced in 1997 was behind a push, almost immediately following the crisis, towards increasing the level and scope of cooperation between ASEAN member states. The subsequent five years have seen an explosion of new regional meetings between officials and ministers from every sector. With these meetings have come new regional policies and practices whose cumulative effect, unintended or otherwise, has been to create a stronger sense of communality between the ten Southeast Asian states, and between these ten states and the three major states of East Asia (China, Japan and South Korea, making up ASEAN+3).

At the 2001 ASEAN informal summit, leaders from the thirteen countries that comprise ASEAN+3 examined a report presented by the East Asian Vision

Group (EAVG) for advancing cooperation and integration, not only within Southeast Asia but also across the whole East Asian region. A year later, the same leaders met to review the work of the East Asian Study Group (EASG) – a policy group whose work was intended to set the EAVG recommendations in motion. In essence, the two reports endorsed the ASEAN strategy of widening and deepening regional integration. However, continuing this strategy will involve a degree of policy constraint on the ASEAN states, something that is already occurring in the economic and financial sectors. A commitment to such a policy may signify the construction of a new regional order, one based on more mainstream regionalist structures of diminished sovereignty in return for greater regional benefits.

To assess the potential of this new order, this chapter is divided into five sections:

1 The ASEAN+ model of regional integration, the model by which ASEAN is expanding its norms and association into East Asia.
2 The crisis of 1997 and ASEAN's responses. This section also introduces the EAVG and EASG reports.
3 Three key areas of cooperation identified in the EAVG report.
4 The limits of an East Asian regional organization and the key obstacles facing its development.
5 The shape that such an organization may take when these limits and obstacles are compared and contrasted with the developments.

This chapter concludes with a preliminary evaluation of the ASEAN+3 process to date and its potential to develop and institutionalize a new regional organization in East Asia.

The ASEAN+ model of regionalization

ASEAN began its life as a security group intent on protecting itself (and its allies) against the spread of communism in Southeast Asia. Until the end of the Cold War in the late 1980s, ASEAN was centred on the original five states of Indonesia, Malaysia, the Philippines, Singapore and Thailand, which had formed the core security community. Twenty-two years of working together had helped these states (despite their inherent differences) to develop a common set of values (encapsulated in the notion of an 'ASEAN way') based on their participation in a shared regional identity. The end of the Cold War allowed the ASEAN states to reach out to the other Southeast Asian states in an attempt to realize the vision of a united region. Unlike the earlier period, the 1989–96 era was based primarily on economic security and interdependence rather than strategic concerns.[2] This era also saw the beginning of tentative steps towards greater socio-political interdependence characteristic of the 'new regionalism' process.[3]

Mattli (1999: 42) presents two core reasons why states move into regional arrangements: (1) the potential for gain within a region must be significant and states therefore 'have an incentive to lobby for regional institutional arrangements that render the realization of these gains possible'; and (2) 'there must also be a fulfilment of supply conditions. These are the conditions under which political leaders are willing and able to accommodate demands for regional institutions at each step of the regional integration process … they may be more willing to deepen integration if such a move is expected to improve their chances at retaining power'. Overarching these conditions must be institutions to which states can commit themselves to realize their objectives,[4] following the guidance of a leader state. Webber (2001: 345) modifies Mattli's single leadership state to postulate that 'a coalition of leading states may provide the requisite leadership for successful integration'.

When applying this framework to ASEAN, it can be said that prior to 1989 states gained security and stability, which allowed for socio-economic development. This was despite pre-existing frictions over land and sovereignty between the five founding members (for example, the competing claims by Malaysia and the Philippines to Sabah).[5] For the newer members, gaining regime legitimacy, access to foreign direct investment (FDI) and expanding their international presence (as members of a regional bloc) all served to satisfy their demand and supply needs.[6] The goal of all ten Southeast Asian states was a mutually reinforcing arrangement, in so far as the newer states would gain regime legitimacy and international presence at the same time as ASEAN did likewise – by representing all countries as a bloc – which would in turn encourage external and intra-regional investment.

However, ASEAN has its own unique aspects to regional formation, in particular, the ideology of the 'ASEAN way'. The 'ASEAN way' is, essentially, an equalizing formula where states as big as Indonesia or as wealthy as Singapore can coexist with states such as Laos and Cambodia. It entrenches the absolute sovereignty of the state, which is able to act internally as it sees fit free from other states' interference. Underpinning this is a consensus approach to regional issues, where diplomatic concerns are resolved in private rather than public spaces. Moreover, these concerns are backed by veto powers to prevent member states being forced into an unwanted course of action. In a regional context, this institutional philosophy has meant that ASEAN has remained a much looser arrangement than, for example, the EU or the Andean Community. It has also meant that, even given Webber's modification of Mattli's model, gathering sufficient consensus on institutional reforms has traditionally been difficult.

Even before the Asian financial crisis, the ASEAN way was under strain. Domestic problems in Myanmar and Cambodia (Munthit 1997) as well as transnational threats such as the haze had already forced attempted collective responses from ASEAN that impinged on the sovereignty of individual states.[7] ASEAN's actions in these matters were the episodic precursors to the limited beginnings of a policy of 'intrusive regionalism' (Acharya 1999) based on deeper forms of regional integration and indicated by a willingness to depart from the non-interference principle as required by circumstance and self-interest.[8]

However, the Asian financial crisis required a far more sustainable and far-reaching solution than other challenges that had emerged. This article posits that the Asian financial crisis placed in serious jeopardy the gains that had been made to date. In order to reclaim these gains and protect state legitimacy, regional members moved to deepen pre-existing processes of integration and to develop new opportunities for regional integration (Stubbs 2002). In doing so, member states have begun to move away from the ASEAN way to encompass a more flexible form of integration, albeit one where the state is still the primary actor.

The reason for this shift was twofold. First, the incapacity of regional governments to meet the needs of their populations by themselves forced them to look for external solutions. The existence of a regional grouping, ASEAN, with well-understood and acceptable norms and modes of behaviour, in conjunction with a perception that the crisis was an Asian crisis, helped regional governments to view ASEAN as an appropriate body through which solutions could be reached. This view was reinforced by popular anti-Western sentiment relating to both the causes of the crisis and the restoration programmes pushed by international donor agencies (such as the International Monetary Fund (IMF) and other groups (such as the Paris Club) (Higgott 1998).

Second, the spread of the crisis to the major East Asian economies highlighted interdependence between those economies and their Southeast Asian counterparts. This recognized interdependence increased the desirability of coordinating financial and economic activities more closely between the two hemispheres to assist regional economic recovery and future development. It also highlighted the growing role that China was playing in regional affairs at the expense of *de facto* Japanese leadership.

The failure of ASEAN to take an active role in alleviating the distress that cascaded through the region in the wake of these events was seen as a direct failure of the organization to meet the needs of its constituents. In addressing these problems, it was perceived by regional policy makers that a regional rather than domestic focus had a greater potential to both alleviate the then current crisis and to prevent the emergence of a new one. It was also recognized that this regional approach needed to include the major East Asian states if it was to be viable.

These actions needed a greater level of policy coordination between states, which required a partial relinquishment of sovereignty in order to succeed. As the Asian financial crisis was the catalyst for these changes, the economic and financial sectors were the first targeted for deeper coordination. Integration in these sectors also required more substantial political ties. The accelerated integration of these three sectors under the ASEAN umbrella has provided a motivating force for other sectors (such as energy and education) to integrate and, simultaneously, provided an acceptable methodology for incorporating new states (such as China, Japan and South Korea) into the expansion process.[9]

It is argued that across all areas of cooperation, but in particular the economic, financial and political sectors, there is an identifiable push towards deeper integration within ASEAN and its subregions – complemented by wider integration efforts with the three major countries of East Asia. It is also argued that there is a clear trend towards enacting common policies that are binding on member states. These changes constitute the beginning of a 'pooling of sovereignty' between the ASEAN+3 states (Hund 2002: 100). In this respect, while the real and perceived degree of interdependence that ASEAN had achieved so far served as a 'transmission belt' for spreading problems throughout the region, it also acted as the mechanism for its integrated recovery.[10]

The 1997 crises: dangers and opportunities

The first half of the 1990s witnessed unprecedented growth in ASEAN countries. In 1993, the World Bank released a report that reviewed eight high-performing Asian economies[11] and concluded that the high growth witnessed in these countries was due to 'a combination of fundamentally sound development policies, tailored interventions, and an unusually rapid accumulation of physical and human capital' (World Bank 1993). All countries in the region, even those not yet in ASEAN, appeared to be developing in accordance with established economic orthodoxy: FDI was flowing into the region, albeit towards the more developed economies; living standards across the region were improving; and ASEAN was, by the mid-1990s, starting to realize its dream of becoming a truly regional organization. Less than four years later, the 'miracle' more closely resembled a curse.

In 1997, this growth period came to an abrupt halt. The effects of the devaluation of the Thai baht, precipitating the currency crisis in July 1997, quickly spread to other economies in the region, Malaysia, the Philippines and Indonesia being the three most immediately affected. Although initially a financial problem created by unhedged borrowing by Asian investors, the crisis spread to other economic systems in the region, quickly overwhelming the monetary authorities (Garnaut 1998: 14). This spill-over into the public sector sharply reduced the capacity of governments in the region to meet their administrative and social responsibilities.

Importantly for the development of ASEAN+3, East Asian states were also exposed to the fall-out from the crisis. In Hong Kong, Peregrine Holdings quickly went bankrupt, and speculative forays by overseas brokerages forced the new SAR government to intervene directly in the marketplace to prevent a systemic collapse.[12] South Korea also came under speculative attack and was forced to call on the IMF for assistance (Choe 1997; Veale 1997). The behaviour of the two largest economies, China and Japan, is instructive. At that time, China was partially removed from the international financial system by a number of regulatory barriers. That said, China's resistance to devaluing its currency in the face of speculative pressure was an important step in the recovery process and gained it the appreciation of all countries in the region.[13] Japan was partly preoccupied with its own domestic economic situation and was not able to provide the level of ongoing assistance asked for by the afflicted economies.[14]

Thus, by the end of 1997, the ASEAN states had been challenged by a number of transborder issues that exceeded their individual capacities to address. Furthermore, criticisms were levelled against the continued effectiveness of ASEAN as a regional organization. Its lack of a timely response to the various crises, its inability to enforce agreements with member states and its reliance on extra-regional states and organizations were put forward as reasons why ASEAN was no longer viable.[15] These criticisms were not without foundation, although they usually presented a static analysis, where ASEAN was condemned never to grow beyond its limitations because of its past practices. This paper will demonstrate that, contrary to these criticisms, ASEAN used these failures as windows of opportunity to renew its relevance for its members and in the process has moved beyond a loose amalgamation of ten states (Shannon 2003).

To fulfil its goal of providing prosperity for Southeast Asia, ASEAN has looked to engage the three major states of East Asia. The push for an ASEAN+3 dialogue actually started in 1997, but it was only in 1998, at the ASEAN+3 informal summit in Hanoi, that the process began to be institutionalized.[16] The expansion of the ASEAN summit dialogue is recognition that the future stability and prosperity of Southeast Asia was intimately tied to the political economies to the north (Shihab 2000). It is this recognition that provides this new regional grouping with its geopolitical boundaries.

At successive ASEAN+3 summits, the process of integrating the region has developed rapidly. Beyond the leadership level, the ASEAN+3 process has steadily expanded to include agriculture and forestry ministers, economic ministers, energy ministers, environment ministers, finance ministers, foreign ministers, labour ministers, and tourism ministers. In addition, combined meetings have begun to be held just between the +3 ministers. Below the ministerial level, there are now also senior officials' meetings of the ASEAN+3 group. These act as policy coordinators for the respective state-based bureaux.[17] Implementing the decisions by ministerial and officials' meetings are the ASEAN+3 directors-general.

Since 1997, there has been a growing number of other meetings outside the explicit +3 framework, which has brought the East Asian states into a closer cooperative arrangement with their Southeast Asian counterparts. These meetings usually involve a subset of the thirteen members and focus on a specific issue. An example of this type of meeting was the anti-drugs meeting that took place in Denpasar in November 2001. Although called by Southeast Asian states and focused on the use of and trade in illegal narcotics in Southeast Asia, the meeting also included Chinese and Japanese (but not South Korean) delegations (*Jakarta Post*, 7 November 2001). As a result, an agreement was signed to combat drugs in Southeast Asia but utilizing the resources of both the Chinese and Japanese governments. In addition, a number of bilateral and multilateral cooperative arrangements between various regional governments were signed.[18]

Hence, what began over thirty years ago as a meeting largely confined to the leadership level has, since 1997, expanded to incorporate a wide range of linkages. In ASEAN and ASEAN+3, these links are primarily forged within the policy communities of individual countries. However, beyond the realm of the policy elites, there is a broad range of commercial and social bodies that seek contact with similar entities in either the ASEAN or ASEAN+3 areas (Thomas 2001). These bodies are creating epistemic communities that reach across state boundaries to bind sets of policy, market and social actors into a regional framework. As will be shown below, to sustain these communities and gain greater benefits for themselves, the ASEAN+3 states are choosing to relinquish a gradually increasing level of autonomy in their quest for greater stability and prosperity.

The EAVG was tasked with identifying ways by which the expansion of ASEAN to involve the three major states of East Asia could be taken forward. The group's report and its implications are the subject of the next section.

The EAVG report: ASEAN's next step

At the ASEAN+3 informal leaders' summit in Brunei in 2001, the leaders of the thirteen countries met to receive the final report of the EAVG,[19] which was formed after the ASEAN+3 summit in 1999 following a suggestion by South Korean President Kim Dae-jung that the region needed a blueprint to map out measurable ways by which East and Southeast Asia could unify into a single grouping more concretely.[20]

The report submitted to the leaders emphasized the need to institutionalize the initiatives then being undertaken. In particular, the report focused on five key areas for increased cooperation, namely (1) economic, (2) financial, (3) political and strategic, (4) energy and the environment, and (5) socio-cultural and education. The report also reviewed measures towards institutional development and reform, calling for ways to institutionalize the ASEAN+3 process, with some members seeking to take regional discussions to the next level by creating an East Asian Community with a formal secretariat and summit. For the purposes of this paper, only the three most developed areas – economic, financial and political cooperation – of the EAVG report will be examined.

Economic cooperation

Given that the Asian financial crisis was the primary catalyst for the enhanced regionalism that led to the creation of the EAVG, it is natural that deeper forms of economic and financial cooperation are the main focus of the report. Not only are these the key areas in which all East Asian countries need to address capacity shortfalls, but directing policy resources to these areas also allows for progress to be made without falling foul of cultural or nationalistic entrapments.[21] Cooperation in these areas among the thirteen countries of the region has accelerated since 1997. This is evidenced by the growth of regional meetings of economic ministers, senior officials and related policy makers as well as the scope of topics that these meetings now cover.

The first ASEAN+3 Economic Ministers Meeting (AEMM+3) was convened in Yangon in May 2000. From the start, AEMM+3 was charged with fostering economic growth and industrial development across the region. It immediately began to act as an umbrella group under which different issues could be coordinated to achieve common outcomes. Some of the areas identified in the first meeting included promoting regional trade, investment and technology transfers, technical cooperation in information technology and e-commerce, and support for small and medium-sized enterprises (SMEs) and supporting industries.

These three themes were taken up by senior economic officials in a series of meetings between the inaugural meeting of the economic ministers and the second in October 2000.[22] At that meeting, economic ministers began to identify a structure for ASEAN+3 economic programmes. In particular, the ministers agreed that for a project to come under the jurisdiction of AEMM+3, it would have to be regional in nature and benefits, and it would have to involve a minimum of two ASEAN and two East Asian countries. This criterion provides a useful benchmark for analysing whether or not a project has a subregional, ASEAN or ASEAN+3 focus.

With these core criteria revolving around the three agreed themes, the third AEMM+3 in May 2001 agreed to expedite six projects. These ranged from strengthening the competitiveness of ASEAN SMEs to software and related information and communication technology (ICT) projects, to environmental training programmes and studies. Four months later, the fourth meeting expanded this list of projects to include a range of e-learning projects under the rubric of the 'Asia e-Learning Initiative'.

The economic importance of regional information and communication strategies also led to senior economic officials and the e-ASEAN Working Group working together under the direction of the meeting of economic ministers to develop a series of e-policies.[23] This is an example of another key aspect of the ASEAN+3 process – the coordination of region-wide policies by umbrella groups, in this case e-policies being formulated under the aegis of the ASEAN+3 economic ministers' meeting. This policy 'creep' serves to widen the scope of regional integration by interlocking different policy bodies to provide tangible benefits to ASEAN+3 membership in an area of recognized importance. This also makes it increasingly difficult for member states to opt out of one particular area as the issues become tied to a widening range of policies.

Supporting economic integration at the pan-Asian level are a number of subregional efforts designed to accelerate economic ties between like-minded members. These can be seen at the subregional, ASEAN and ASEAN+3 levels.

The ASEAN Free Trade Area (AFTA) is the most developed and inclusive of the free trade initiatives in East Asia. The process of creating an area to promote intra-ASEAN trade began in 1992 and will finally become operational in 2003.[24] Indeed, it was only following the establishment of AFTA that there was an ASEAN policy of promoting free movement of capital to enhance economic cooperation. Following the crisis, AFTA was used to develop mechanisms to help to restore stability by encouraging the use of ASEAN currencies for payment of traded goods and services.[25] When examining the trade patterns of AFTA members, it can be seen that intra-ASEAN trade has steadily increased since AFTA's inception.[26]

The Greater Mekong Subregion (GMS), comprising Myanmar, Thailand, Cambodia, Laos, Vietnam and China's Yunnan province, is one such example. The potential of this grouping has long been recognized, but it has only been in the last decade that socio-political conditions have enabled the integration process to proceed.[27] Although there is no secretariat, the number of ministerial summits, senior official meetings and related forums encourages a high degree of policy cooperation between participating states. Hence, the integration between GMS members represents a compressed form of what is occurring in the wider ASEAN+ area. GMS countries have also recently signed memoranda of understanding and agreements addressing the subregional spread of HIV/AIDS and transnational security threats such as people smuggling, drug trafficking and arms trading (*Asia Pulse*, 26 February 2001).

Subregional cooperative efforts form strong bases for wider regional integration, because they encourage small-scale transnational development to take place that would not otherwise occur.[28] In many respects, the challenges faced by these initiatives mirror issues raised in wider regional forums. First, given wide social, economic and political disparities, the benefits may be distributed unequally between participating countries. Second, states have to provide long-term commitment to the project's objectives (Tan *et al.* 1995). This means that participating states have to willingly accept constraints on their ability to allocate resources – a key aspect of state sovereignty – for a greater regional good. It also means that the self-interest of states will not only ensure that they remain involved, to gain a return on their investment, but will also seek other related projects to maximize the return, thereby advancing regional integration.

In Southeast Asia, there are a number of new and proposed bilateral free trade agreements and studies linking East and Southeast Asian countries. In January 2002, Japan and Singapore signed the Japan–Singapore Economic Agreement for a New Age Partnership (JSEPA), the first such bilateral agreement that Japan has ever successfully negotiated. The JSEPA goes well beyond the standard format of other free trade agreements, covering cooperation in such areas as science and technology, tourism, financial services, human capital, and ICT.[29] The broad coverage of the JSEPA goes substantially further than the proposed Japan–ASEAN Free Trade Agreement (JAFTA), the parameters of which are currently the subject of a bilateral expert panel.[30]

The bilateral agreement that is likely to generate the most two-way regional trade in the medium term is the proposed China–ASEAN Free Trade Area.[31] At the 2001 ASEAN leaders' summit in Brunei, the ASEAN leaders endorsed the proposal for a framework on economic cooperation and the establishment of an ASEAN–China Free Trade Area as soon as possible. The implementation of this area will take ten years, due to ASEAN concerns that the implications of China's WTO accession will need to be fully understood by the ten Southeast Asian economies.[32] By the time the free trade market is established, it will cover two billion consumers and have a combined GDP of US$2 trillion and internal trade of US$1.23 trillion (Vanzi 2001).

These additional economic and trade agreements help to catalyse broader regional integration efforts by creating bilateral building blocks within a multilateral environment,[33] which can be implemented in a shorter time than region-wide agreements. Further enmeshing ASEAN with East Asia are cooperative financial efforts, which also necessitate a high degree of policy interdependence by participating countries and institutions.

Financial cooperation

Financial cooperation in East Asia has been developing in tandem with economic cooperation endeavours. As was seen in the previous section, although some cooperative efforts existed prior to 1997, new economic initiatives have been begun and existing projects deepened since the financial crisis. The same is true for regional financial cooperation. Some forms of cooperation existed prior to 1997, notably the Executives' Meeting of East Asia–Pacific Central Banks (EMEAP), but the majority of the cooperative forums, such as the Manila Framework Group (MFG), ASEAN+3 Finance Ministers Meeting (AFMM+3) and ASEAN+3 Finance and Central Bank Deputies (ADFM+3), were created after the crisis.

A key difference between financial and broader economic cooperation is that the former is more likely to involve non-East Asian members. In other words, whereas ASEAN+3 has developed economic groups that involve non-East Asian members, in areas of financial cooperation there are a growing number of instances where the ASEAN+3 group has created financial networks or organizations that mirror wider financial processes but exclude non-East Asian members, for example the ADFM+3 process. However, although some forums may include non-Asian members, it can be said that the core membership of each of these groups is drawn from the ASEAN+3 countries, and the primary targets of their policies are the East Asian financial markets and institutions.

With the development of ASEAN+3, there has been a marked strengthening of ties between the East and Southeast Asian members of these organizations. In 1999, Vietnam hosted the first of what has become an annual ADFM+3; in other words, the MFG members plus the missing East Asian members minus the Western participants.[34] Furthermore, in July 2002, the heads of the +3 central banks met and agreed to institute an irregular meeting of +3 central bank governors. This followed closely after the first meeting of the ASEAN central bank governors, also in July 2002. Together, these two sets of meetings mirror the work of EMEAP but leave out the Western members. Regardless of the merits of such groups, their creation under a broad ASEAN+3 umbrella is indicative of a strong trend towards financial regionalism under an established pan-Asian political structure. This has tied the East Asian region into a distinct economic-financial bloc that also allows for the maintenance of extra-regional ties.

Supporting these financial institutions are a number of ministerial meetings, deputies' meetings and working groups, which ground the financial dialogues in a regional context while advancing the process of regionalism in East Asia. In 2000, ASEAN finance ministers expanded their dialogue to include their East

Asian counterparts.[35] This expansion provided the context for implementation of the Chiang Mai Initiative (CMI), a currency swap arrangement between all ASEAN countries bolstered by 'network of bilateral swap and repurchase agreement facilities among ASEAN countries, China, Japan and the Republic of Korea'.[36] In the two years since the CMI was signed, bilateral swap arrangements have been signed between Japan and South Korea, Malaysia, the Philippines and Thailand, and between China and Thailand (see Agence France-Presse, 10 May 2001; AFX News Ltd, 30 October 2001). Other swaps being discussed include Japan–China, South Korea–China and South Korea–Thailand arrangements (Agence France-Presse, 28 June 2001; *China Business*, 11 September 2001).

The ASEAN+3 framework for financial cooperation has also led to regional human resources development in this area. China has arranged training courses on economic reforms and development for ASEAN+3 finance and central bank officials. South Korea has hosted a working visit by senior ASEAN officials and organized a training programme on financial and corporate restructuring for the ASEAN finance and central bank officials. Japan has offered financial assistance to member countries, through the ASEAN Secretariat, in the monitoring of capital flows in the region and the study of other appropriate mechanisms to promote financial stability.[37]

Both the economic and financial forms of cooperation have developed deeply integrated policy communities that operate at the ASEAN and ASEAN+3 levels. This is largely due to these issues being of immediate and uncontested concern to the regional leaderships. However, they are critically underpinned by political forms of cooperation, without which there is little hope of institutionalizing a regional East Asian organization.

Political and social cooperation

Although the economic and financial forms of cooperation at the ASEAN+3 level have reached a greater level of integration than either political or strategic cooperation, at its heart the EAVG's report is a political undertaking. Without political credibility and infrastructure, ASEAN+3 cannot successfully address the needs of its constituent members. However, developing new political institutions or expanding the capacity of current institutions remains a task fraught with difficulties, not only in terms of direction and commitment but also, more importantly, in terms of capacity. ASEAN has already been forced to confront this problem with its four newer and smaller members. Once the three developed states of East Asia and ASEAN are considered as a grouping, individual state capacities become even more disparate. Despite these shortcomings, the fact remains that ASEAN has reached out to the three largest states of East Asia. It has done this in a gradual manner that should allow the new institutions to evolve in a sustainable fashion.

The most significant development in regional politics is the expansion of ASEAN dialogue to include the three key states of East Asia in the ASEAN+3 process. This expansion process started slowly. The first two ASEAN+ summits (Malaysia in 1997 and Hanoi in 1998) were not attended by all regional leaders. However, the Hanoi summit did lead to the creation of the EAVG, the aim of which was to 'offer a common vision for East Asia that reflect[ed] the rapidly changing regional and global environment, as well as to provide direction for future cooperation among East Asian nations (EAVG 2001: 1).

The purpose of the EAVG report was to develop a platform 'towards a higher level of region-wide cooperation and integration', and the EAVG's work was then taken up by the EASG, which was tasked with developing explicit policy recommendations for implementing the EAVG's recommendations. The EAVG and EASG assisted the process of regional integration but ensured that the process remained in accordance with the consensual manner of ASEAN decision making.

At the third ASEAN+3 informal summit (Manila in 1999), all thirteen heads of government from ASEAN+3 zone were present, the first time that they had all met. Furthermore, at this summit, the leaders of the three +3 countries held their first trilateral summit, which has since become an annual event and spawned other meetings framed explicitly within the +3 milieu.[38] Although the main focus of the 1999 summit was the further development of economic and trade links, culture and information cooperation and politico-security and social issues were also discussed. This broad agenda allowed regional collaboration to move away from a narrow monetary focus to include a wide range of interrelated issues affecting the region.[39]

The fourth ASEAN+3 informal summit in Singapore in 2000 advanced regional efforts at integration. Although it focused on cooperation within the ASEAN+3 group (particularly on e-issues), this summit generated the Initiative for ASEAN Integration to promote faster regionalization efforts. The 2000 summit was also important for regional building efforts, as all members agreed to push for representation of all East Asian countries in the APEC and ASEM processes. Specifically, the summit identified the inclusion of Cambodia, Laos and Myanmar in the APEC working groups as priorities for the near term.[40] This type of agreement is an example of different levels of East Asian regional groupings mutually developing and reinforcing a unified East Asian perception of political regionalism.

The fifth ASEAN+3 informal summit in Brunei in 2001 began the process of advancing East Asian regionalism in a more systematic manner, because this was the meeting when the EAVG report was tabled. At its heart, this report viewed the long-term goal of an East Asian community in a positive light. However, the final shape that any formal regional community would eventually take was not detailed. It would be incorrect to assume that any such strategy will follow exactly the same path as the European Union, given the fundamental historical and cultural differences between the two regions. However, given the supporting examples from other regional groupings, it is difficult to envisage ASEAN deviating in a functional sense too much from the operating norm established by other regional organizations.

In July 2002, a fundamental policy shift took place with ASEAN that could allow the group to deepen integration efforts. Although signed off at an economics ministers' retreat, this policy is likely to be universalized within ASEAN. The policy, known as '10 minus X', allows ASEAN programmes to move forward without full consensus but also without compromising the group's organizational integrity. In conjunction with this new policy, ministers also agreed to prevent 'free-riding' by 'minus X' countries. In other words, when a subgroup of ASEAN states agree to deepen cooperation and integration in a particular area, the remaining states cannot benefit from this agreement until they have acceded to it (Agence France-Presse, 6 July 2002).

The sixth ASEAN+3 informal summit in Phnom Penh in 2002 marked a high point in China–ASEAN political relations. Four pacts were signed between the two sides covering agricultural, economic and security issues. Agreements such as the Memorandum of Understanding on Agricultural Cooperation and the Joint Declaration of ASEAN and China on Cooperation in the Field of Non-traditional Security Issues were of a concise functional nature, while others, such as the Framework Agreement on Comprehensive Economic Cooperation and the Declaration on the Conduct of Parties in the South China Sea, attempted to direct the future growth of the relationship.[41] ASEAN–Japan meetings were accorded noticeably less importance. Although the two sides agreed to study a possible regional economic partnership agreement, Japan's main focus remained on developing bilateral agreements. This summit also saw an expansion of the ASEAN+ process with the first summit held between ASEAN and Indian leaders.

At the 2002 summit, the EASG handed down its recommendations, based on the earlier work of the EAVG. The short-term measures decided on by the EASG include the formation of an East Asia Business Council and an East Asian Investment Information Network, the establishment of East Asian think-tanks and an East Asian forum with both governmental and non-governmental representatives, and the promotion of East Asian studies programmes. In the medium to long term, the EASG recommended the formation of an East Asian trade area and an East Asian investment area, the creation of a regional financial facility, and the evolution of the ASEAN+3 summit into an East Asian summit.[42]

The formation of a regional society with an ASEAN or an ASEAN+ identity is not as developed a community as those that exist in the regional policy communities. However, there are indications that a regional civil society is beginning to form. Although overwhelmingly centred on Southeast Asia, in some cases this society includes representatives from across East Asia.

There are four primary manifestations of this regional society: regime-affiliated, regime shadows, umbrellas and regional social organizations. The most structured is that of ASEAN-affiliated civil society organizations. As of 2002, there were fifty-seven such organizations affiliated to ASEAN. These include both professional and social groups, ranging from fisheries federations to land surveyors to regional chess clubs.[43]

There are also regional organizations whose activities shadow regional policy processes, examples of which can be seen in the cases of both ASEM and ASEAN. In the case of ASEM, networks of civil society organizations from Europe and East Asia shadow the main ASEM dialogue, in a similar manner to those groups that shadow APEC and WTO meetings. The development of ASEM has been seen as a precursor to the ASEAN+ process, as it created a space where East and Southeast Asian countries were grouped together against an external 'other'. Should regional social formation follow regional policy formation, then these groups and their meetings may (on the East/Southeast Asian side) be a catalyst for the emergence of a regional civil society. At the ASEAN level, a similar network, the ASEAN People's Forum, has emerged recently. This is a coalition of Southeast Asian civil society organizations with essentially liberal ideologies, whose three meetings have shadowed the three recent ASEAN leaders' and senior ministers' meetings.[44]

There are also examples of regional umbrella organizations, whose activities are directed more at building the capacity of civil society organizations with regional activities or interests. A good example, in Southeast Asia, is the ASEAN People's Assembly. This grouping, which held its second meeting in 2002, draws together representatives from regional organizations as well as regional parliaments and scholars in a 'Track-III' process with the stated aim of creating a regional 'community across borders' (Nurbaiti and Widiadana 2002).

The final manifestation of regional civil society can be seen in the development of transborder organizations that have a discrete or primarily regional focus. In this fourth category, these groups are grassroots-legitimized and have local/regional policies and programmes. Although such groups may join with other groups in any of the first three categories, their primary purpose is to serve the immediate needs of their constituents.

The economic, financial and political policy dialogues that have emerged since the financial crisis seem committed to stabilizing the region through the coordination of members' policy processes. This has not yet extended to the realm of civil society. Beyond this lack of a community-based ASEAN 'awareness' or 'identity', there remain serious challenges to institutionalizing ASEAN+3. The following section examines some of the challenges confronting East Asian policy makers as they move towards building a new community.

Institutionalizing ASEAN+3

Weaving the diverse areas identified in the EAVG report into a single East Asian organization will take time. The final shape will depend not only on how well member states can realize the integration of the areas identified in the EAVG and EASG reports but also on how well they can overcome a range of issues and challenges – some old some new – that could slow or derail East Asian regionalization. How these issues are addressed have fundamental implications for ASEAN and ASEAN+3 and the creation of an East Asian bloc.

Limits and challenges

Exactly what shape a regional East Asian organization might finally take was not explicitly detailed in either the EAVG or EASG report. However, by examining previous comments made by regional leaders or governments, it is possible to identify key proposals. One proposal supported by Malaysia envisaged a community defined largely by the combined geographical boundaries of Southeast and East Asia. This vision was first articulated in Prime Minister Mahathir's East Asian Economic Caucus and remains the lens through which Malaysia views the development of East Asian links. Thailand would appear less constrained by geography and has in recent times made an active effort to expand the ASEAN+3 process to include India (Press Trust of India, 28 January 2002). Some of the other ASEAN states, notably Indonesia and Laos, remain wary of rapid expansion of the ASEAN group, concerned that such expansion might affect the group's cohesion (Antara News Agency, 8 January 2001).

Of the East Asian states, Japan has recently proposed a regional community initially based on the ASEAN+3 model but with the possibility of expansion to include Australia and New Zealand.[45] Neither China nor South Korea has released a definitive policy statement on this issue. However, in the case of China, what statements have been made indicate a clear delineation between East Asia as an area of immediate concern and the broader Asia-Pacific region (Tang 2000).

The key problem that ASEAN and ASEAN+3 must address in increasing the zones of cooperation as well as implementing the two reports are the two principles of sovereignty and non-intervention. Since ASEAN's inception, its members have adhered to these principles, and all new members have agreed to follow them. Furthermore, these principles have guided discussions in ASEAN's dealings with the three East Asian states. However, there are two problems with the continued sanctification of sovereignty and non-intervention, one external, the other internal.

Externally ASEAN must recognize that the global norms that upheld the non-intervention principle have changed dramatically in the last ten years. Two important shifts have taken place in international society that will challenge the 'ASEAN way'. First, there is a recognition that states have an obligation to ensure that international standards are adhered to by all states. This has seen the rise of humanitarian intervention operations in all parts of the globe. Second, this recognition has not been restricted to areas of actual crisis but has a preventive aspect to encompass a broad interplay of issues (Thomas and Tow 2002; see also Chapter 7).

For ASEAN, this means that there will be greater pressure on regional governments to operate in accordance with the constraints imparted by these recent developments. Using the past ten years as a guide, it can be seen that ASEAN's response to these new norms is likely to vary depending on the sector involved. ASEAN's resistance to international pressure on such issues as responses to the Cambodian coup and Myanmar's accession is well documented. Individual countries (such as Malaysia and Singapore) regularly clash with their

Western counterparts regarding domestic social and political issues. However, in other areas (such as economic management and corporate governance), the exigencies of the financial crisis have seen many countries in the region follow externally imposed policy programmes, which have, once again, generated substantial resistance.

In addition to these clashes with Western states and international agencies, bilateral tensions between states remain in the ASEAN+3 area. Tensions over territorial claims in the South China Sea, between Malaysia and the Philippines over Sabah, and between Singapore and Malaysia and between Thailand and Myanmar over border issues, crop up regularly. More recently, Indonesia's unwillingness to deal with militant Islamic groups and Malaysia's treatment of illegal migrant workers has caused frictions with the regional grouping. Looking north, ASEAN states are very wary of a resurgent China, while Japan's wartime activities are still the subject of much bitterness in the region. Moreover, Sino-Japanese relations are easily strained, with South Korean–Japanese ties also fractious. Overriding all these issues are three potential war zones in the region: the Korean peninsula, the Taiwan Straits and the South China Sea. If conflict erupted in any one of these areas, it would pit state against state in the region, derailing the community-building process.

Economic disparities and disagreements may also mar the smooth development of a regional community. At present, the ASEAN+3 zone has a greater range of economic disparities than any other region.[46] Within ASEAN, the initiation of the 10 minus X policy is recognition of this fact. The four newer states of ASEAN simply do not have the economic resources to commit to all the regional programmes. Between ASEAN and the three East Asian states, China represents the biggest potential challenge, with regional leaders calling for AFTA integration to be accelerated so that ASEAN markets can cope with a rising level of Chinese exports. Extra-regionally, the pursuit by some states in the regional (particularly Singapore) of bilateral free trade agreements (FTAs) has generated criticism from other states (especially Malaysia), which claim that extra-regional FTAs dilute the integration of regional economic ties.

The existence of these serious challenges, as well as the as yet ill-defined limits of an East Asian organization, demonstrates the comparative rawness of the processes and institutions currently being formed. Other regional communities (such as the European Union and Caricom) have already addressed many of the issues that the ASEAN+3 grouping is only now confronting. Although some lessons may be drawn from these other communities, the ability to resolve the challenges and delineate the group's boundaries remains East Asia's alone.

Scenarios

Balancing these limits and challenges with the earlier analysis provides a partial road map for the future development of ASEAN and ASEAN+. Thus, although it is not possible to state with certainty that in *x* years *y* events will have occurred, it is possible to outline potential scenarios for regional development. These scenarios can be presented under three broad headings: an Asian version of the EU, an East Asian community, or an 'open' coalition.

The 'Asian EU' model takes the current convergence of policy communities and suggests that the self-interested nature of the regional states will bind them into ever more restrictive alliances so as to maximize their gains. They will undertake this action to strengthen their sovereignty, but the fact is that more advantage can be garnered from regional resources than domestic ones. The push for such an arrangement may come from the medium-sized powers in the region such as Thailand, the Philippines or South Korea out of a perceived need to protect themselves against encroachment by the larger states as well as from the smaller states (Laos, Vietnam or Myanmar) in an effort to protect their limited gains from comparative deterioration. An alternative term for this model is an 'East Asian community'.

Whether or not the current efforts towards regionalization will lead to a community with a formal structure and defined powers and a concession of state sovereignty to the region, or to a community where national interests come together to meet specific needs on an issue-by-issue basis, was one of the most contested aspects of the EAVG and EASG discussions.[47] In the end, the EASG report referred to the future arrangements as a 'community'. In this context, although a widening and deepening of current regional processes was seen as desirable, a more limited vision has been put forward. The rationale for this vision was to 'gradually build up' the 'comfort levels' of the thirteen countries (EASG 2002: 5). This middle path is based on the belief that the current growth trajectory is sustainable in the medium to long term and that the challenges facing the group will not prove an impediment to this growth continuing.

However, if the challenges do prove insurmountable, then the operationalization of the ASEAN and ASEAN+ regional processes would be jeopardized. In one sense, the 'ASEAN−X' concept is recognition that some states do not have the resources to undertake a faster form of integration, even at the sectoral level. An increase in the gap between the six developed and four less developed states in the region could make ASEAN a permanent two-tier organization, ending the objective of being a regionally equal organization. The inclusion of the three East Asian states presents a new set of stresses for ASEAN to deal with. For example, the organization has yet to develop a common negotiating position on ASEAN+ FTAs, creating tensions between member countries. This has led one Chinese official to state that the China–ASEAN FTA is a bilateral rather than multilateral process.[48] Moreover, the capacity differences (human and institutional) across the thirteen countries are substantially greater than between the ASEAN states alone. This scenario could lead to a situation where, while ASEAN and ASEAN+3 would continue in name and event, member states would put more resources into extra-regional or subregional relationships.

Conclusion

This paper has argued that, since 1997, ASEAN has embarked on a programme of institutional reformation that is moving towards the creation of a regional East Asian organization. In response to the challenges posed by the 1997 crises and the attendant criticisms of the institution, ASEAN has sought to become a more suitable vehicle for meeting the region's diverse needs. To achieve this goal, ASEAN has begun to promote various forms of deeper cooperation. This was already under way before 1997 but has since accelerated. The result of this enhanced policy direction is that ASEAN's members are beginning to be more integrated into a regional bloc than was previously the case.

At the same time that ASEAN began to deepen its regional networks, it reached out to the three major countries of East Asia. This was a recognition that the two regions were interlinked, as was shown when East Asian economies and corporations were affected by the financial crisis. It was also a way for ASEAN to attempt to manage, in a regional sense, the rise of China in its own right as well as in counterpoint to Japan. The success of this strategy was shown in late 2001 and early 2002, when both China and Japan announced plans to create FTAs with ASEAN.[49] It has also been shown in the development of political, strategic and other links with ASEAN members, as well as with subsets of the ASEAN countries and on a bilateral basis. The inclusion of South Korea in this 'look north' policy has also yielded benefits to ASEAN through the sponsorship of the East Asian Vision Group and subsequent the East Asian Study Group as well as the desire by the South Korean government to enter into an FTA with ASEAN.

As ASEAN was organizationally reaching north, subsets of its members were accelerating development in their immediate areas. Although cooperation zones such as the Greater Mekong Subregion have localized development programmes, such strategies cannot be, and indeed are not, divorced from broader ASEAN development and integration efforts. The GMS zone is an example of how a subset of ASEAN countries can also include a +3 partner, in this case China, in their activities.

In terms of developing an East Asian organization, an important development has been the creation of policy hierarchies, where more senior ministers meet to discuss and provide guidance for policies being generated by more junior ministers and working groups. The ASEAN+3 foreign ministerial meetings and the ASEAN+3 economic ministerial meetings exemplify ministerial forums that have taken on a review capacity of other policy sectors. These hierarchies are important in terms of developing East Asian policy mechanisms because they review a range of issues not strictly under their immediate purview. This policy 'creep' boosts the development of ASEAN+3 by bringing an expanding list of issues into a vertical pan-Asian ministerial policy review process. Supporting this vertical policy review mechanism has been the cross-integration of ministerial meetings. These joint ministerial meetings enhance regional integration by providing a space for state-to-state policy formulation, allowing for more coordinated interaction across bureaucracies at the sub-state level. Although both of these developments are in their infancy and are not yet institutionalized, they do offer a glimpse of how a regional East Asian organization may operate.

Despite the potential for development, the region, while currently peaceful and stable, contains a wide range of unresolved issues that could stall or derail the integration process. Issues such as evolving understandings of sovereignty and non-intervention, or challenges such as resolving territorial disputes, tackling regional crime networks, or addressing economic inequalities must be sustainably addressed before the regional situation is truly conducive to fuller integration. How ASEAN and its +3 neighbours deal with these situations will provide some indications as to how the region may develop in the future.

Historically, ASEAN has developed its policies largely as a reaction to events external to the organization. With the framework of the EAVG and EASG reports, these cooperative efforts offer East Asian states the opportunity to develop in a more systematic manner, based on internal priorities. In particular, the EAVG and EASG reports hold the prospect of the creation of a regional East Asian organization. The vehicle for this new organization is ASEAN+3, which is assisted by efforts at integration at the ASEAN, subregional and bilateral levels. How ASEAN and its three East Asian partners implement the EASG report is the next challenge facing the grouping. The past five years have shown a willingness by the states of East Asia to promote deeper integration as the way of enhancing regional stability and prosperity. How successful they are destined to be will depend on their capacity to forge a communal vision – an endeavour where much more still needs to be done.

Notes

1 I would like to thank Dr Melissa Curley, Dr Kanishka Jayasuriya, Professor William Tow and Dr Geoff Wade for their comments on earlier drafts of this chapter. Any remaining mistakes are solely the fault of the author. Aspects of this chapter have been earlier published in Thomas. (2002)

2 The evolution of ASEAN from security community to economic community has been covered extensively. One example that exclusively focuses on this is Yuen Foong Khong (1997).

3 For summaries of this process, see Hettne (2000), Hettne and Söderbaum (2000), and Breslin and Higgott (2000).

4 For examples of these 'commitment institutions', see *ibid*.: 73–7.

5 It has been noted that although there are conflicts between ASEAN members, the ASEAN process allows such conflicts to be compartmentalized 'so that it does not interfere with other areas of cooperation, and quiet diplomacy' (Narine 1997: 964).

6 A good list of the needs of ASEAN states, although not contextualized as such, is contained in Solingen (1999).

7 A good summary of the impact of these issues on the ASEAN way is contained in Ramcharan (2000). An alternative position is put forward by Hund (2002).

8 For the implications for Cambodia of the 'ASEAN way', see Narine (1998).

9 This argument has been advanced earlier in Thomas (2001).

10 The 'transmission belt' analogy is used by Ball (1998) as cited in Acharya (1999).

11 The eight were Hong Kong, Indonesia, Japan, Malaysia, Singapore, South Korea, Taiwan and Thailand.

12 For reports of the former issue, see Reyes and Shameen (1998), Sito (1999) and Moir (2001). On the latter, see Brown (1998), Callick (1998) and Lloyd-Smith (1998).
13 An alternative economic argument, which also indicates a high degree of regional interdependence between China and Southeast Asia, was articulated by Woo *et al.* (2000: 120), who cited the 1990–94 devaluation of the yuan as a key factor in depreciating the competitiveness of the Indonesian, Malaysian, Philippine and Thai economies, which helped to destabilize these four economies three years later.
14 This is not to say that Japan was not engaged in the recovery efforts. In addition to its contributions to the three main IMF rescue packages, the Japanese government also proposed the Miyazawa Plan and has subsequently brought regional financial officials to Japan for training. However, although the Miyazawa Plan was a substantial aid programme, totalling US$30 billion, it was a one-off initiative and carried an implicit – and controversial – call for the creation of an Asian Monetary Fund, whereas the affected Southeast Asian economies were asking for a long-term strategy of economic engagement with the region as a way of overcoming the crisis. For an analysis of the plan, see, for example, Ito Tatsuo (1999: 16).
15 See, for example, *Far Eastern Economic Review*, 'Out of its depth' (19 February 1998), 'ASEAN. In the bunker' (6 August 1998) and 'Divided they fall. ASEAN is losing its unity and its clout' (17 December 1998); *The Economist*, 'ASEAN's failure' (28 February 1998) and 'ASEAN. the game goes on' (1 August 1998); and *Asiaweek* 'Divided we stand' (31 July 1998) and 'ASEAN. Waiting to move ahead' (7 August 1998).
16 It was also during this meeting that ASEAN accelerated its own internal cohesion with the adoption of the Hanoi Plan of Action, which took forward the ideas contained in the 1997 Vision 20/20 Plan. The operationalization of these plans has been a critical component of post-crisis regional integration.
17 Meetings of senior officials can also act as policy initiators for the ASEAN+3 grouping. In May 2001, the ASEAN Committee on Science and Technology convened its first +3 meeting in Phnom Penh. This new arrangement is yet to be replicated at the +3 ministerial level.
18 In the case of China this was particularly important, as the flow of drugs through the Mekong region is known to cross into Chinese territory. Coordination of anti-drugs campaigns with the PRC government was therefore essential. Japan is a longstanding supporter of anti-drugs efforts in the region, providing both financial and human resources to less developed countries, which is why Japan was an important player at the Denpasar meeting. Source: press release, first meeting of the Accord Plan of Action Task Forces, Bali, Indonesia, 12–14 November 2001.
19 Long-term watchers of ASEAN would be familiar with ASEAN development reports that did not live up to their stated potential. The 1976 Bali conference, as one example, produced a set of broad development aims. For a good summary of the conference outcomes, see Irvine (1982).
What differentiates the EAVG report from earlier efforts is that (1) it builds on and codifies existing interregional development trends rather than attempting to create an effectively new development agenda, and (2) it goes beyond the traditional ASEAN group.
20 In its vision for a united East Asia, the EAVG report mirrors earlier efforts by regional leaders and governments (for example, the East Asian Economic Caucus proposed by Malaysian Prime Minister Dr Mahathir Mohamed). However, the EAVG's focus on functional cooperation distinguishes it from earlier, more ideological and exclusive efforts.
21 Although in some states, notably Laos, Vietnam, Myanmar and Cambodia, these entrapments do still arise on an issue-by-issue basis.
22 The second AEMM+3 was held in Chiang Mai, Thailand, on 7 October 2000.

23 For additional information on these policies, see the annex to the joint press statement of the Thirty-third ASEAN Economic Ministers' Meeting, 15 September 2001, Hanoi, Vietnam.

24 In 2003, Singapore, Malaysia, Thailand, Indonesia and the Philippines will remove the majority of their tariffs for goods produced in ASEAN countries. The less developed ASEAN countries will join the area in 2010.

25 As the Hanoi Declaration stated in part: 'We encourage wider use of ASEAN currencies in intra-ASEAN trade settlements'. See Paragraph 13 of the Hanoi Declaration, Sixth ASEAN Summit, Hanoi, Vietnam, 16 December 1998.

26 This is not to say that intra-ASEAN trade is dominant. Extra-AFTA trade (particularly with Europe and North America) far outweighs regional trading patterns. However, intra-regional trade is increasing. As a recent report noted: 'Between 1993 and 2000, intra-ASEAN exports grew to US$87.7 billion from US$43.26 billion, while the bloc's total exports to all markets increased to US$696 billion from US$374 billion' (Xinhua 2001).

27 As early as 1957, a report was issued by the Committee for the Coordination of Investigations of the Lower Mekong Basin. This report focused on the economic complementarity between Cambodia, Laos, Thailand and Vietnam.

28 This theme, with respect to BIMP-EAGA, is taken up in Haryati (2001).

29 For a good summary of the JSEPA, see the *Straits Times*, 14 January 2002.

30 Although the expert panel was established in September 2001, it was not until January 2002 that the panel members met for the first time in Bangkok. See Xinhua, 19 January 2002.

31 South Korea is also interested in creating a free trade regime with Southeast Asia, but it is well behind China and Japan in ASEAN's economic priorities.

32 China had been pressing for an FTA in as short a period as five years.

33 An alternative view to this one is contained in Soesastro (2002).

34 Cambodia was not yet a full member of ASEAN, so there was no Cambodian representative at the Hanoi meeting. See chairman's statement, First ASEAN + China, Japan, Korea (ASEAN+3) Deputy Finance and Deputy Central Bank Governors Meeting, 18 March 1999.

35 The first AFMM+3 was held in Chiang Mai, Thailand, on 6 May 2000.

36 See the joint ministerial statement of the AFMM+3, 2000.

37 See the joint ministerial statement of the AFMM+3, 9 May 2001.

38 This summit led to the creation of the Northeast Asia Business Forum in 2002. The inauguration of this forum, agreed by South Korean President Kim Dae-jung, Chinese Prime Minister Zhu Rongji and Japanese Prime Minister Junichiro Koizumi during the 2001 ASEAN+3 group summit, is aimed at reinforcing business cooperation between the three countries. (See *Asia Pulse*, 26 February 2001.)

39 Surin Pitsuwan, keynote address at the Global Leadership Forum, John F. Kennedy School of Government, Harvard University, Massachusetts, 12 June 2000. See also the Joint Statement on East Asia Cooperation released at the end of the summit, 28 November 1999.

40 See press statement by chairman. Fourth ASEAN informal summit, Singapore, 25 November 2000.

41 However, given the economic disparities within the ASEAN region as well as the lack of a formal regional negotiating position, it is unlikely that the economic cooperation agreement will be realized within its ten-year time frame. While the South China Sea document was watered down from a formal agreement to a declaration at China's insistence, that was more restrictive on the behaviour of regional claimant states. (These observations come from my talks with delegates in Phnom Penh during the Eighth ASEAN Leaders' Summit, November 2002.)

42 Although on the development of an East Asian Summit it is worth noting that the EASG concluded that ASEAN might be marginalized if an EAS was implemented

'too quickly' and that the ASEAN+3 process remains the 'only credible and realistic vehicle to advance the form and substance of regional cooperation in East Asia' (EASG 2002: 5). On balance, this assessment can be seen as reflective of broader ASEAN concerns that its needs might be swamped if its member countries were reduced to equal status with the +3 states in a new regional bloc.

43 A full list of the groups and their aims is available at http://www.aseansec.org/6070.html

44 At the third meeting of the forum, the following regional groups were present: ADHOC (Cambodia), Asian Human Rights Commission (Hong Kong), Initiatives for International Dialogue (Philippines), Asian Forum for Human Rights and Development (Forum-Asia), Asia Pacific Forum on Women, Law and Development (APWLD), Altsean-Myanmar, LICADHO (Cambodia), Southeast Asian Committee for Advocacy (SEACA), Committee for Asian Women (CAW), Nonviolence International Southeast Asia and Southeast Asian Press Alliance (SEAPA).

45 For analysis on this expanded model, see 'A "Koizumi doctrine" for Asia', *Japan Times*, 16 January 2002; and 'Koizumi eyes stronger ASEAN ties', *Asahi Shimbun*, 15 January 2002. The actual speech that outlined this idea was by Prime Minister Junichiro Koizumi: *Japan–ASEAN in East Asia – A sincere and open partnership*, Singapore, 14 January 2002.

46 Once the Free Trade Agreement of the Americas is concluded, (around 2005) this may no longer be the case.

47 From talks with a number of EAVG and EASG participants.

48 Comment by a senior Chinese Foreign Ministry official to the author, 18 October 2002.

49 However, the fact that both countries approached ASEAN independently of each other (and with a sense of competition against the other) suggests that ASEAN's management of Chinese and Japanese relations is still underdeveloped.

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Part IV

The USA and China, and the dynamics of regional governance

11 The United States and Southeast Asia

Change and continuity in American hegemony

Mark Beeson

The United States has been the most powerful country in the world since the Second World War, in the wake of the events of 11 September 2001 and at a time when the USA has an unrivalled ability to project power in any part of the globe, this may seem a remarkably anodyne observation. Yet it is important to remember that for much of the postwar period the Soviet Union was a formidable adversary that constrained American influence and provided an alternative vision of the way the world might be ordered. We now know that the Soviet system was incapable of supporting either its military pretensions or the aspirations of much of its citizenry, but this should not blind us to the fact that for many years ideological rivalry and superpower confrontation were the seemingly immutable realities of the postwar order. In the wake of the Soviet Union's disintegration, and despite periodic concerns about the performance of the USA's own economy, America has emerged as the sole superpower and the cornerstone of what is routinely depicted as a unipolar interstate system (Wohlforth 1999).

Over the last fifty years or so, therefore, American power has waxed, waned and waxed again. This is interesting enough in itself, but from the perspective of Southeast Asia it is especially important because the changing nature of America's global ambitions and its capacity to achieve them has coincided with a critical phase of nation building and economic development across Southeast Asia. The intention of this chapter is to examine the impact that the USA has had on Southeast Asia's historical development, both during the Cold War, when the emergent states of the region attempted to consolidate and assert their independence, and more recently, when the combined effects of economic fragility and the emergence of new strategic challenges have provided a painful reminder of just how susceptible the region remains to powerful external forces over which it has limited influence (Beeson 2002).

To understand why Southeast Asia continues to be profoundly affected by a variety of influences that emanate from outside the region, and by the actions of the USA in particular, it is important to say something about the postwar order that American power helped to create. As we shall see, 'American hegemony' has changed in ways that reflect the USA's own shifting foreign policy priorities, which were themselves products of long-term geopolitical change in the internat ional system. The first section of this chapter consequently describes this emergent order and provides a theoretical understanding of the changes and continuities that characterize it. Following this, I consider the distinct – although fundamentally interconnected – strategic and economic elements of American power and analyse their impact on Southeast Asia. Finally, I consider the prospects for America's relations with Southeast Asia both in the light of the USA's 'war on terror' and as a consequence of the wider East Asian region's attempts to develop a more formally constituted regional identity and organizational presence.

American hegemony

'Hegemony' used to be a term primarily associated with scholars working within a broadly Marxist or radical tradition. These days, it is used across a broad political and scholarly spectrum to describe the unparalleled dominance of the USA (see Beeson and Berger 2003). Although there are continuing grounds for concern about the health of both the US and global economies (see Brenner 2002), there is no doubt that the US economy experienced something of a renaissance in the second half of the 1990s, a recovery that not only seemed to refute some of the more pessimistic claims about American decline that were widespread a decade earlier[1] but also effectively underpinned America's growing military dominance. One of the most striking aspects of America's contemporary strategic primacy is that it is achieved with remarkably little economic effort or cost (Brooks and Wohlforth 2002). Consequently, no other country – certainly not the former Soviet Union, or even a rapidly emerging China – can rival America's overwhelming strategic dominance. Crucial as this military might is to America's pre-eminent position, it is not the whole story: part of what makes America hegemonic is its capacity to shape the rules and regulations that constitute the contemporary international system. In short, although recent events remind us that the USA has the ability to compel compliance with its wishes, it is the willingness of other nations to accede to, and even support, American power and the distinctive ideas and values associated with it that is such a telling aspect of its hegemonic dominance. To understand how America came to occupy this unique and privileged position, it is useful to make a few brief theoretical and historical observations.

One of the most influential and sophisticated attempts to explain the emergence and decline of particular countries and their dominance of the international system has been developed by Immanuel Wallerstein in particular and by 'world system theorists' more generally (see Chase-Dunn and Grimes 1995). In essence, this formulation claims that the rise to prominence of a particular power reflects long-term cyclical change in an increasingly global capitalist economy. This model suggests that powers rise and fall partly as a consequence of their economic position: technological innovation in 'leading sectors' of the economy underpins the rise of new hegemonic powers and undercuts existing ones (Schwartz 2000). The other key point to note about this depiction of global capitalism and the role of hegemonic power is that the world is characterized by 'structured inequality', in which a distinct *core* of politically and economically powerful, industrialized, wealthy countries systematically exploits and renders dependent a *periphery* of developing economies (see Chase-Dunn 1998). Although economic development in parts of East and Southeast Asia has tended to undermine such a sweeping and static depiction of international economic relations, much of the developed world plainly does enjoy the advantages that flow from industrializing early. One of the increasingly loudly heard complaints in parts of Southeast Asia in particular is that the contemporary international political economy perpetuates such inequalities by discriminating against 'late' developing states (see Hewison 2001). In such circumstances, one of the key challenges for the hegemonic power of the era is to win support for, or minimize opposition to, its preferred vision of international order.

Unfortunately, there have been a limited number of historical examples with which to examine either the rise and fall of hegemonic powers or the strategies that they have employed to maintain their ascendancy. In any case, we now inhabit a world in which 'global' forces and transnational institutions have assumed an unparalleled importance, raising questions about how relevant earlier historical experiences actually are, leading some scholars to claim that in the contemporary period power is far more 'de-centred' and diffuse than before (Hardt and Negri 2000). Nevertheless, the examples of British hegemony in the nineteenth century and American hegemony today do strongly suggest that if the leading power of the day is both economically and strategically paramount it will have the capacity, or at least the desire, to establish 'universal norms, institutions and mechanisms that lay down general rules of behaviour for states and for those forces of civil society that act across national boundaries – rules that support the dominant mode of production' (Cox 1983: 172).

While there may be debate about how universal and uncontested some of these norms and values are, there is no doubt that America has played a crucial role in establishing and maintaining a particular sort of world order, one associated with liberal values and the promotion of an 'open', capitalist economic order (Latham 1997). The creation, primarily under US auspices, of the so-called Bretton Woods institutions – the World Bank, the International Monetary Fund, and the General Agreement on Tariffs and Trade – in the aftermath of the Second World War confirmed America's status as the dominant power of the era. Although the roles of these institutions have changed in important ways, the USA retains considerable influence over their activities – a circumstance that has had major implications for Southeast Asia, as we shall see when we consider the recent economic crisis that gripped the region. Consequently, even if there is less than complete enthusiasm on the part of Southeast Asian elites about the precise nature of the neoliberal or market-centred order that US hegemony has assiduously tried to promote,[2] there may be little alternative other than to comply with its overall direction.

The possibilities for either effective resistance or the promotion of indigenous alternatives to the dominant paradigm appear to have been further foreclosed by recent strategic developments and the 'war on terrorism'. Interestingly enough, however, the prospect of conflict and warfare have, for some Southeast Asian countries at least, provided opportunities for economic development and limited autonomy: evolving American priorities and shifting geopolitical imperatives have profoundly shaped Southeast Asia's political and economic possibilities. To see why, we need to examine America's strategic engagement with the broader East Asian region and with Southeast Asia in particular.

America, the Cold War and Southeast Asia

America's involvement in Southeast during the Cold War provides an illuminating counterpoint to the contemporary period, in which the 'war on terror' has seen the region assume a renewed prominence in US strategic thinking. Despite the importance of strategic concerns in both periods, however, there are significant differences that help to explain the quite different dynamics that have shaped political and economic outcomes. Somewhat paradoxically, the Cold War period provided – for some Southeast Asian countries, at least – both a spur to economic and political development and a surprising degree of autonomy. As we shall see in the final section, a very different set of dynamics obtains in the region now.

The first point to make about America's immediate postwar involvement in Southeast Asia is that the region was initially a relatively minor part of the wider struggle against the perceived threat of communist expansion (Zhao 1998). Although America had emerged from the Second World War as the most powerful country on the planet, it was confronted by what looked to be a formidable and implacably opposed ideological opponent – the Soviet Union – which had already expanded its own empire throughout Eastern Europe. Unsurprisingly, therefore, Europe was the main game as far as containment of possible communist expansion was concerned. It took the outbreak of the Korean War in 1950 to push East Asia to the forefront of American security concerns and place the Manichean struggle between capitalism and communism on a global footing – a contest in which the region would play a pivotal and bloody part (see Yahuda 1996).

As far as Southeast Asia was concerned, the Americans had to rapidly expand the extent of their engagement with the region, which had hitherto been principally confined to administering its colony in the Philippines. For some Southeast Asian nations, America's preoccupation with the wider Cold War confrontation and its capacity to lean on the region's former colonial powers meant that their independence aspirations received an important fillip. The independence movement in Indonesia, for example, received crucial American support when the USA pressed the Dutch to withdraw in the hope that an independent, pro-Western capitalist democracy would ultimately emerge (Tarling 1998). In the changed intellectual environment in which colonialism became harder to defend strategically or morally, the Philippines, Myanmar and Malay either gained independence or made important moves toward it (Stockwell 1999). Other countries, were not so fortunate: in Vietnam, despite independence leader Ho Chi Minh's personal affinity with American political ideals, the independence movement's association with communism placed Vietnam on a collision course with the USA that would, following France's expulsion, ultimately culminate in the Vietnam War (see Kolko 1997).

However, for those countries outside Indochina that were fortunate enough to find themselves allied to America, the Cold War brought a number of direct benefits beyond accelerating the decolonization process. America's overarching strategic vision, which was predicated on establishing successful, pro-Western capitalist economies to stand as bulwarks against communist expansion, led it to pour aid and investment into East Asia. Two aspects of the unexpectedly beneficial impact that war had on some Southeast Asian countries are worth highlighting. First, American support for Japan in particular meant that Japan played a key role as a successful industrialized Asian economy, something that meant it would in turn become a source of further investment in Southeast Asia.[3] The second point to make is that, without American economic support for the region, both in the form of aid and investment and, crucially, in the form of a huge North American consumer goods market, development would have been a good deal slower, and the export-oriented strategies that characterized economic expansion across the region would have been much more difficult to sustain (see Stubbs 1999).

The other general point to make briefly about the effect of America's Cold War activities is about its impact on Southeast Asia as a region and the development of regional institutions as a consequence. At one level, it is plain that the USA's preference for bilateral as opposed to multilateral strategic ties, and the consequent establishment of a 'hub-and-spokes' security architecture across East Asia, did little to promote contact, either political or economic, within the wider region (Cumings 1997). The Cold War had the effect of fundamentally dividing both East and Southeast Asia along ideological lines, making the development of the sort of regionally oriented initiatives that have characterized other parts of the world inherently problematic. However, the Cold War generally, and America's influence in particular, have had the not always intentional effect of actually promoting greater regional institutionalization among the non-communist powers. The establishment of ASEAN is perhaps the most important example of this possibility. Although there were compelling reasons to develop an institution with the capacity to manage intra-mural tensions within Southeast Asia, such considerations were overlaid and given critical impetus by evolving superpower rivalries across the region. Acharya (2001: 202) argues that the mutual desire to protect sovereignty and create an entity capable of playing a larger role in a region dominated by the geopolitical rivalries of the external powers[4] had the effect of creating a sense of regional identity where none existed previously.

Systematic attempts are being made to cultivate this sense of regional identity across the wider East Asian region; it could conceivably present a significant buffer to American power if it achieves the hopes of its supporters. Before considering this in any detail, however, it is important to highlight how and why

America might wish to assert its influence, and why much of the region might wish to resist it.

America and Southeast Asian political economy

American priorities have been central determinants of, and constraints on, political and economic development in the region. Consciously or unconsciously, American power during the Cold War in particular structured the environment within which the less powerful Southeast Asian countries attempted to come to terms with the multiple challenges of decolonization, nation building and economic development. Significantly, however, America's preoccupation with grand strategy and the struggle with communism meant that US foreign policy elites were prepared to either actively support or at least tolerate regimes that may not have even paid lip service to the principles, much less practised, the sort of values that were central to the declaratory agenda of American-inspired liberalism. This contradiction was most evident during the Marcos era in the Philippines, where a repressive, illiberal and hopelessly corrupt regime was sustained for many years with the aid of America itself and through multilateral agencies like the World Bank, over which the USA wielded enormous influence (Hutchcroft 1998). Not only was America prepared to tolerate the flagrant abuse of its political principles in the Philippines, it also adopted a similarly benign view of the sort of strategies and policies that were adopted to boost economic development in Southeast Asia.

There is no intention here of attempting to describe the Southeast Asian development experience in any detail, as other contributions to this collection address such issues in some detail (see Chapter 5). However, it is important to highlight a few issues as they help to explain the dynamics that drive the occasionally fractious relationship that the USA has with a number of Southeast Asian countries. In this regard, a number of historical factors are crucial. The impact of the Cold War generally, and the way American policies helped to foster economic take-off in East Asia in particular, have already been noted. But what should also be stressed is that, with the noteworthy exception of Singapore,[5] the Southeast Asian economies had to cope with the challenges of 'late' development, made more problematic by the very success of the earlier economic expansion in Japan and its East Asian acolytes, Korea and Taiwan. In such circumstances, the sort of 'interventionist', state-led development strategies that were pioneered by Japan but that have come in for sustained criticism from the USA and other champions of neoliberal policies (Schoppa 1997) – offered a way for the governments of some Southeast Asian countries to accelerate the industrialization process and move up the regional economic pecking order. Although the picture across the region is mixed, with Indochina and the Philippines being noteworthy laggards, in Malaysia, Indonesia and Thailand, at least, 'there is little doubt that the structural transformation and industrialization of these economies have gone well beyond what would have been achieved by relying exclusively on market forces and private sector initiatives' (Jomo 2001a:

481).

Importantly, however, it was not just the fact that state-led industrialization strategies were attractive to Southeast Asian political elites and technocrats that put them on a potential collision course with America and the increasingly influential, pro-market intergovernmental organizations over which it exercised such influence. Resistance to the ideational aspects of American hegemony was almost inevitable given that the sort of reforms championed by the USA and its institutional handmaidens were directly threatening to existing patterns of power, interest and social accommodation across the region. As Jomo (2001b) reminds us, 'much state intervention in Southeast Asia has mainly been for redistributive ends, mainly at the behest of politically influential business interests and interethnic redistribution'. Malaysia is the most complete example of a society in which economic development strategies have been used to underpin a complex array of policies designed to achieve specific economic and social outcomes. Malaysia also highlights the way in which disparate developmental goals can lead to a fusion of political and economic power and the entrenchment of existing elites (Gomez and Jomo 1997). Whatever we may think of such regimes, from the perspective of many observers in the region, US policy, and the policies of associated institutions like the WTO, were intended to foreclose potentially critical developmental mechanisms and entrench the position of the rich industrialized economies (Khor 2000; Mahathir 1999).

It is also important to recognize, as Kanishka Jayasuriya (Chapter 3 of this volume) has persuasively argued, that during the Cold War period, and even up to the economic crisis of 1997, the distinctive combination of economic and security polices that characterized US policy in Southeast Asia was predicated on and actually facilitated a specific pattern of political and economic relationships across the region. What Jayasuriya describes as 'embedded mercantilism' refers to the development of domestic political coalitions that managed the relationship between the tradable and non-tradable sectors of the economy, allowing trade-offs to be made between those sectors of the economy that could compete in world markets and those that could not and needed protection. Crucially, this essentially political response to the challenge of international structural adjustment also established the preconditions for the sort of patronage-based political structures that are so characteristic of Southeast Asia. As Jayasuriya observes, there are parallels here with Ruggie's (1983) celebrated concept of 'embedded liberalism'. The difference is that in the postwar period, the governments of Western Europe retained domestic autonomy within a broadly liberal international order. Embedded liberalism, in other words, was compatible with the overall goals of American hegemony. Embedded mercantilism, by contrast, is not.

Another important comparative point that helps to explain why postwar American hegemony was tolerated, if not embraced, by Europe was that it was accompanied by a comprehensive and highly interventionist plan for the rebuilding of Europe, in which massive injections of American capital played a critical role (see Lundestad 1986; Hogan 1987). In contemporary Southeast Asia, by contrast, which is arguably facing a similar nexus of developmental and security threats, similar largesse has not been forthcoming. On the contrary, American hegemony has been primarily associated with the continuing promotion of neoliberalism in general and of American financial-sector interests in particular: long-term changes in the structure of the increasingly interconnected international economy – especially the rise to prominence of international financial capital – have fundamentally reconfigured the environment within which individual governments must operate. Financial-sector interests associated with Wall Street now exert a powerful influence over American domestic and foreign policy, a fact that explains the continuing promotion of financial-sector liberalization across the world despite compelling evidence about its dangers (Beeson 2003). The sort of policy paradigm that underpinned postwar reconstruction in Europe and the 'golden age' of social welfare capitalism are consequently incompatible with the dominant interests that shape current American policy and values (Phillips 2002).

It is within this context of potentially incommensurate normative and policy paradigms that the USA's relationships with Southeast Asian nations need to be seen. Although there have always been disjunctures between the rhetoric and reality of American foreign and domestic policy (see, for example, Blum 2000), the telling point is that there is a clear desire in much of the American policy-making establishment to encourage particular sorts of behaviour in other parts of the world. Thus it is also revealing, especially about the nature of contemporary American hegemony, that the preferred vehicle for achieving such outcomes is either direct bilateral pressure in the security sphere or through the auspices of powerful agencies like the IMF in the economic sphere. The high-profile role that America played in the aftermath of the Asian financial crisis demonstrated both its willingness to assume a much larger part in achieving its preferred outcomes in the region and its preference for direct institutional intervention through agencies like the IMF to achieve such outcomes, rather than operating through multilateral agencies like the increasingly discredited Asia-Pacific Economic Cooperation (APEC) forum (Beeson 1999). Crucially, it was the absence of the strategic imperatives associated with the Cold War that gave America the chance to pursue narrower economic interests.

At the very least, therefore, the USA's somewhat opportunistic behaviour in the aftermath of the Asian crisis raised serious doubts about scholarship, mainly North American, suggesting that the role of American hegemony was fundamentally benign and was centred on the provision of crucial collective goods (see, for example, Kindleberger 1973). For others, recent American policy has either been the entirely predictable behaviour of powerful states or a desirable expression of American power and a central component of international order (Mearsheimer 2001). Recent events have reinforced this latter view among some scholars and, more importantly, within the American foreign policy-making elite itself (Lieven 2002). However, before considering the implications of this development in any detail, it is important to say something about the regional context within which American power will be manifest, because at this level there have been significant developments that may blunt the impact, or at least complicate the application, of American policy.

America and East Asian regionalism

Despite the consolidation of the hub-and-spokes network of bilateral relations across East Asia noted above, American political elites have long thought of East Asia and its place in the world in regional terms. American strategy under Bill Clinton, for example, was predicated on the notion of incorporating East Asia into a wider 'Pacific community' (Tow 2001: 170). Whether such goals were ever realizable given the inherently artificial nature of the 'Asia-Pacific' is open to question (see Dirlik 1992), but the key point to stress here is that, until recently at least, in East Asia itself there has been very little interest in this sort of grand community building. What is noteworthy of late, especially in the wake of the Asian financial crisis, is that there is growing enthusiasm for precisely such an endeavour, albeit with a limited East Asian membership. If this trend consolidates, it could represent a significant check to American influence in the region.

The possibility that the development of more effective regionally based institutions might undermine American influence in the region has long been recognized by the USA and demonstrated in its opposition to Malaysian Prime Minister Mahathir Mohamed's proposed East Asian Economic Caucus (Hook 1999). This caucus was envisaged initially as an 'Asians only' grouping within the wider APEC forum, but US hostility to the concept meant that it was effectively stillborn; Japan's continuing deference to the USA and its consequent unwillingness to assume policy positions of which the latter disapproved assured the non-viability of the caucus. In the wake of the Asian economic crisis, however, the idea of an East Asian grouping has been revived. Although the USA was able to scupper the idea of an Asian Monetary Fund, which Japan proposed in the immediate aftermath of the crisis, such ideas have not disappeared and continue to provide the basis for regionally based strategies to counter future economic crises (Narine 2001). Indeed, it is significant that the formal expression of these regional initiatives – ASEAN+3, which comprises the ASEAN nations plus China, Japan and South Korea – has developed increased momentum since the late 1990s (Stubbs 2002).

Given ASEAN's modest track record of achievement as far as encouraging significant regional cooperation is concerned, there is a good deal of scepticism about how effective a larger organization might be in driving initiatives like an Asian Monetary Fund or an East Asian preferential free trade agreement (Ravenhill 2002). The sceptics have a point: not only are there enduring tensions within the smaller ASEAN grouping (Tan 2000), but the two regional giants, Japan and China, have a history of animosity made worse by their inherently antagonistic regional leadership ambitions. Nevertheless, there is evidence that Japan and China are making progress on some of the more mundane but symbolically important aspects of regional economic cooperation (Sevastopulo 2002), which could lay the groundwork for more extensive political cooperation.[6]

The emergence of greater regional cooperation in other parts of the world is likely to act as a spur to such developments and suggests that regionalism remains an important contemporary trend across the globe (Fawcett 1995). Yet whatever the long-term fate of these initiatives may be, the point of greatest significance here is that, in the case of East Asia at least, they are 'aimed at restoring to Asia a greater degree of political power and autonomy *vis-à-vis* the rest of the world, and the USA and the international financial institutions in particular' (Bowles 2002: 245). In other words, as Webber (2001: 364) argues, 'the new East Asian regionalism is taking place in effect *in opposition to the West in general and the US in particular*' (emphasis added).

What is most striking about recent American policy towards East Asia is that US economic goals, and by extension political goals, have been encouraging the development of greater regionalism, or the self-conscious pursuit of greater political and institutional integration at the regional level. The *unintended* outcome of the application of American power has been to encourage a sort of 'defensive regionalism' in response to the common challenge of US assertiveness and unilateralism.

A number of scholars have rightly emphasized the primacy of regionalization – or the underlying, predominantly private sector or market-led forms of regional activity – in encouraging greater regional integration (Phillips 2003); this has certainly been the principal engine driving economic interconnectedness in East Asia (Ravenhill 1995). However, we also need to recognize that regionalism can be encouraged by political forces that emanate from outside the regions themselves, even when such forces were intended to achieve very different goals. Therefore, far from resulting in the inevitable consolidation of the sort of 'open' regionalism associated with the USA's market-centred trade-liberalization agenda, externally generated reformist pressure may actually be encouraging the development of discriminatory, *regionally* based preferential trade agreements (*New Straits Times*, 'The road to and from preferential trade agreements', 5 August 2001).

Consequently in the area of economic reform and the consolidation of a neoliberal agenda in East Asia, the picture is mixed. In the financial sector, efforts to develop defensive currency swap mechanisms and doubts about the benefits of liberalization notwithstanding, there is continuing momentum towards further liberalization. In the trade sector, on the other hand, the push for universal liberalization is giving way to bilateral trade deals. In the economic sphere, therefore, especially where there are powerful, entrenched economic interests associated with embedded mercantilism, there have been significant limits to American influence and a capacity to resist reformist pressure. However, the events of 11 September 2001 provided a powerful reminder that economic development does not occur in isolation. The key question now is whether the renewed importance of strategic issues and the pivotal role that Southeast Asia has played in the evolving 'war on terror' will actually enhance American power and its overall capacity to achieve its goals.

Back to the future: Southeast Asia after 11 September

The primacy attached to strategic issues in the aftermath of 11 September 2001 and the Bali bombings in 2002 can be seen as a case of 'back to the future'. As the earlier consideration of the Cold War period demonstrated, American engagement with the wider East Asian region has always been driven primarily by security considerations. True, when the East Asian economies were booming and threatening to undermine America's own domestic economy as a consequence, and when the declining significance of military threats led to a widespread privileging of economic rather than strategic issues, it looked as if a permanent recalibration of America's foreign policy goals had occurred (Luttwak 1990). As the 'war on terror' continues to unfold, however, and as Southeast Asia in particular is pressed to play a suitably supportive part, such assumptions look increasingly untenable. This is not to argue that there was only one possible reaction to the attacks on America itself, but to suggest that the general strategic orientation of the Bush administration in particular made a mainly military response all too predictable (Lieven 2002).

The re-emergence of security as a key issue has highlighted some of the tensions and contradictions in the pursuit of greater East Asian regionalism, the position of Southeast Asia in particular and the ambiguous impact of American power. Although the actions of the USA in the aftermath of Asia's *economic* crisis were an inadvertent spur to greater regionalism, the 'war on terror' has provided a powerful reminder of the strategic fault lines that have helped to shape the region in the postwar period. For all the resentment that America's heavy-handed intervention in the economic sphere generated, it is important to recognize that for most East Asian nations – China is the obvious exception – America's strategic engagement is seen as a vital and irreplaceable component of regional stability (Christensen 1999). Consequently, despite the moves towards greater regional cooperation noted above, and the development of specific multilateral security organizations like the ASEAN Regional Forum (ARF), the USA's continuing strategic dominance of the region means that there are major constraints on the possible development of regionally based initiatives (Hara 1999). This was true even before 11 September 2001; recent events have had the effect of entrenching this reality.

As far as the countries of Southeast Asia are concerned, therefore, recent developments have highlighted their continuing susceptibility to external pressures. This was also the case during the Cold War, but the overarching struggle between formidable capitalist and communist powers created a space within which the nations of Southeast Asia could at least attempt to shore up their sovereignty and concentrate on domestic security. In the post-Cold War environment, the capacity of ASEAN countries to influence regional security outcomes has diminished along with their strategic significance (Narine 1998). Moreover, in the longer term the perception of regional instability that emerged in the aftermath of the economic crisis has been given further weight by Southeast Asia's association with Islamic separatism (Chalk 2001). In such circumstances, the USA has moved rapidly to consolidate or re-establish close bilateral security relations with Indonesia, the Philippines and even Malaysia (Lyall 2002). ASEAN, as was the case during the Asian economic crisis, has found it difficult to assert itself and play a significant role in responding to a security challenge that threatens to further undermine the region's fragile political and economic position (Callick 2002).

Despite cooperation with the USA in its self-proclaimed 'war on terror' being fraught with domestic difficulties for all of the major Southeast Asian nations (M. Richardson 2001), it is revealing that they all feel compelled to evince some degree of cooperation, if not enthusiasm for the project. While for some countries, notably Malaysia, recent events presented an opportunity to engineer a welcome *rapprochement* with America, in the longer term Southeast Asia's situation dramatically highlights a more general feature of contemporary American hegemony: the USA's insistence that other nations declare themselves 'for or against' terrorism – and by implication US foreign policy goals – combined with the USA's new doctrine of 'pre-emption' (Harding and Wolffe 2002),[7] means that all nations must come to terms with an ever more powerful and unilateralist America. Given that the so-called 'axis of evil' runs right through East Asia, this is a situation with fundamentally destabilizing implications for the entire East Asian region (Schorrock 2002).

September 11 may have been traumatic for the USA, but it threatens to inflict longer-term collateral damage on Southeast Asia. The presence of substantial Muslim populations across the region, especially when combined with credible evidence about terrorist activities in parts of Southeast Asia (Abuza 2002), served to further dent the region's battered post-crisis reputation. Indonesia is the most dramatic example of how perceptions of governmental ineptitude and incapacity can exacerbate existing economic problems and cause a further decline in desperately needed foreign investment (McBeth 2002). Any illusions that ASEAN or even the ARF might play a pivotal role in managing the security crisis have been rapidly squashed by the USA's decisive and largely unilateral response, and the concomitant need for Asian nations to fall into line or risk incurring the wrath of the USA or its institutional allies. In other words, American hegemony is once again proving to be a decisive determinant, if not *the* decisive determinant, of Southeast Asia's geopolitical future.

Concluding remarks

America's political influence, economic weight and – especially of late – military might have meant that there has always been a fundamental disparity in its power compared with Southeast Asia's. Even in the most favourable of circumstances, paradoxically at the height of the Cold War, the combined efforts of ASEAN nations were unable to influence American policy significantly. At best, the nations of ASEAN have been able to exploit moments of strategic preoccupation on the part of the USA, but it has become increasingly apparent that, freed from its Cold War constraints, the USA is prepared to use its overwhelming power to pursue what American foreign policy-making elites judge to be in their national interests. In such circumstances, Southeast Asia can do little other than comply.

Many Americans regard the USA's growing ascendancy as a good thing and see US power and influence as sources of stability. Yet, despite the fact that its primacy is currently underpinned by conscious attempts to promote American norms and values (de Grazia 2002), across much of East Asia – and Latin America too, for that matter (Higgott and Phillips 2000) – there is a substantial undercurrent of resentment about the impact of what are taken to be American-inspired initiatives and ideas. It is in such a context that recent attempts to develop a more authentically East Asian regional grouping need to be seen. Whether ASEAN+3 can overcome significant internal tensions and formidable technical obstacles to provide an effective mechanisms for the development and promulgation of Asian models of social, political and economic organization remains to be seen. Even if it is successful, it will be something of a mixed blessing for the countries of Southeast Asia, as they will risk being overshadowed by the regional heavyweights. The stark reality for Southeast Asian nations is that they have a limited capacity, alone or collectively, to control the external economic and strategic environment in which they must operate. In this regard, America is but the most compelling example of the constraints and challenges that face what are in many cases still developing economies and brittle political systems.

Given that Southeast Asians have a limited capacity to shape the international system or influence the behaviour of its most powerful members, the outlook might seem rather bleak. In many ways it is: the regional security crisis that emerged in the aftermath of the terrorist attacks in America and Bali has added to instability and undermined economic development. However, if – and this is a very big 'if' – American foreign policy makers can be encouraged to take the sort of longer-term, visionary position that characterized US policy in postwar Europe at the dawn of the Cold War, then there may yet be grounds for cautious optimism. True, little that the current regime has done augurs well in this regard, but if American hegemony is to be more securely grounded, then it plainly needs to gain the support of those who are drawn into its orbit. The big lesson to emerge from 11 September 2001 was that even the USA, with all its military might and political power, is not immune to the weapons of the weak when wielded by zealots. If Southeast Asia is not to become a breeding ground for such people, it is crucial that American hegemony becomes more consensual and less coercive.

Notes

1 See, for example, Keohane (1984).

2 On neoliberalism, see J.L. Richardson (2001).

3 Although there is some debate about the precise nature of Japan's relationship with the region, the overall impact of Japan as a source of investment and as a role model for successful development has been positive and has accelerated wider regional development. See Beeson (2001).

4 It should be noted that although ASEAN has displayed remarkable longevity and has played an important role in helping to resolve regional crises, even when it played a prominent role in the resolution of the Cambodia crisis, this was largely because it coincided with the interests of the major powers. See Jones and Smith (2001).
5 Singapore industrialized earlier and more successfully than the rest of Southeast Asia and is integrated into the global economy in ways that make it an exceptional case in the region.
6 It is worth emphasizing that should the East Asian nations develop the requisite political will, they already have the economic capacity to underpin these sorts of economic initiative and provide a degree of independence. See Dieter (2000).
7 This policy is predicated upon the idea that the USA reserves the right to unilaterally attack perceived enemies before they can threaten it.

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12 The politics of China–ASEAN economic relations

Assessing the move towards a free trade area

Daojiong Zha

Introduction

In November 2000, Chinese Prime Minister Zhu Rongji surprised his hosts in Singapore with a proposal to establish a free trade area (FTA) with all ten ASEAN economies by 2010. Eighteen months later, in May 2002, senior economic officials from the Chinese and ASEAN governments progressed to establishing a trade negotiating committee. This committee expected to produce a Framework Agreement on ASEAN–China Economic Cooperation for adoption during the November 2002 ASEAN–China summit in Phnom Penh. And as expected, ASEAN and Chinese leaders accepted the framework agreement, which includes a preliminary trade liberalization programME of selected products by 2004.

These are indeed significant developments. Notwithstanding China's sustained involvement in global economic activity since the late 1970s, until the FTA initiative with ASEAN, China had been more of a follower than a leader when it came to dealing with rule-based multilateral economic arrangements. Although China did not participate in the ASEAN process of regionalism until 1991, it has moved ahead of Japan in the area of formal integration. This is despite Japan having a much longer history of interaction with the ASEAN economies at the market, bilateral governmental and regional institutional levels.

Since its re-entry into the world economy in the late 1970s, China has been a beneficiary of the international economic system. In the 1990s, more and more states pursued the strategy of entering into FTAs that offered preferential terms of trade among its members while discriminating against non-members. The establishment of the World Trade Organization (WTO) in 1995, whose explicit intent was to strengthen application of the principle of non-discrimination in its member economies, saw the growth in the number of FTAs. By mid-2000, 114 FTAs were in effect. As a recent WTO World Trade Report notes, in 2001 virtually all WTO members were partners in at least one FTA, and many were partners in two or more (World Trade Organization 2001: 37). Notably, China was one of the few economies outside FTA arrangements when it joined the WTO.

Globally, the logic behind forming regional economic groupings usually falls into one of two categories. One is the so-called 'natural integration' grouping, which is largely based on economic merits (as is the case with extending the FTA from Canada and the USA to Mexico). The other is the so-called 'strategic integration' grouping, which is based on an imperative to form a strategic alliance against a third party (as is the case in the process of European economic integration) (Langhammer 1992: 3–4). In both cases, together with calculations of policy-induced changes in economic dynamics, geography, history and political-strategic considerations do matter in the choice of FTA membership.

This article addresses two main questions. Why did China choose to pursue formal integration with the ASEAN economies? What does China hope to achieve through the FTA arrangement? To answer these questions, the first section of the paper recounts key aspects of economic diplomacy between China and ASEAN as a group to provide an understanding of the background of China's FTA initiative. Based on an analysis of the final report produced by the Joint China–ASEAN Expert Group on Economic Integration, the article then examines the structure of the proposed China–ASEAN FTA (hereafter 'CAFTA') as envisioned in the report. The third section reviews major developments in China's pursuit of political-economic relations with ASEAN in the 1990s, illustrating China's efforts to convince ASEAN that its rise in economic power does not pose a threat to the latter. However, ASEAN is a diverse group of states in terms of levels of economic development and bilateral political ties with China. This fact complicates both the negotiation and operation of the CAFTA. As such, the fourth part of the article sheds light on China's consideration of the utility of the CAFTA for its own domestic development: to facilitate export growth in China's southwestern provinces. The final section then examines the apparent competition between China and Japan for influence in Southeast Asia, using FTA formation as a tool.

My basic arguments are as follows: although China had engaged ASEAN as an economic group in various existing venues, the formation of the CAFTA represents a significant step forward in China's regional economic diplomacy. Movement towards the CAFTA represents progress in China's efforts to win over ASEAN's trust in the past decade. The article argues that the CAFTA will bind China to work with ASEAN under a set of negotiated rules and thus ought to help remove fears of an economically rising China operating in disregard of the interests of the ASEAN economies. China has also, temporarily at least, gained the upper hand in competing with Japan for influence in Southeast Asia. On the other hand, the CAFTA scheme has the potential to complicate domestic govern ance in China's southwestern region, as well as China's political relations with Southeast Asian states in the future.

Channels of economic diplomacy prior to the CAFTA proposal

Why did China and ASEAN find it necessary to enter into an additional trade and investment arrangement in the CAFTA? In studies of modern international political economy, we find that states are 'political and economic agents at one and the same time' (Underhill 2000: 824). In other words, state policies both *respond* to market movements and attempt to *direct* changes in the global market. An FTA is one of a variety of instruments available to a state. At this level of understanding, there is little that is new in a CAFTA. At another level, as mentioned above, the choice of membership in an FTA has a particular historical and political context. In this regard, several aspects of economic diplomacy between China and ASEAN, prior to their agreement to negotiate a CAFTA, are worth noting.

- The Asia-Pacific Economic Cooperation (APEC) forum already incorporates all members of ASEAN and China. The 'open regionalism' principle and 'decision by consensus' approach that guides APEC also suits ASEAN's twin goals of rendering equal treatment in diplomatic status while requiring different schedules of commitment to trade liberalization. APEC's large membership and lack of binding power raise serious questions about its effectiveness as a regional economic institution (Aggarwal and Morrison 1998). The existence of APEC also allows China an opportunity to demonstrate its role in managing economic affairs in the Asia-Pacific. The fact that the Chinese government portrayed the 2001 APEC meeting in Shanghai as a diplomatic success, comparable with winning the right to host the 2008 Olympic Games, stands as ready testimony to the significance that China attaches to APEC. Nevertheless, APEC includes the United States and Japan, which are far more powerful than China and thereby pose limits on Chinese influence in the organization. Likewise for ASEAN, APEC has evolved into an institution over which, as a group, it does not have much influence. In other words, APEC membership cannot generate the kind of directive power that its member states may want over the market.
- China is an active member of the ASEAN+3 (China, Japan and South Korea) forum, which was created in December 1997 on ASEAN's initiative. ASEAN uses the forum to solicit assistance and advice from the outside world without having to deal with the pressure of managing domestic political affairs that comes with the APEC forum, particularly from the United States. The International Monetary Fund's (IMF) controversial handling of the 1997 currency crisis in Southeast Asia serves as a painful reminder of the incompatibility between the structural reform conditions attached to IMF lending and a borrowing government's habits in, and/or preferences for, conducting its domestic economic policies. One of the most significant achievements of the ASEAN+3 forum has been the establishment of mechanisms for intra-group monetary cooperation such as the Chiang Mai Initiative, signed on the sidelines of the annual meeting of the board of

governors of the Asian Development Bank in May 2000. This initiative makes it possible for China, Japan and South Korea to respond to signs of currency duress in an ASEAN economy on bilaterally agreed terms (Rana 2002). As part of the Chiang Mai Initiative, China, Japan and South Korea have signed bilateral currency swap agreements with each other. This ought to provide some assurance to ASEAN states. Under the initiative, bilateral negotiations between China, Japan and South Korea on the one hand, and ASEAN member states on the other, are still proceeding. For its part, China has signed a bilateral currency swap agreement with Thailand and is in active discussion with Malaysia and the Philippines. In short, China is well on its way to institutionalizing its role as a lender to other ASEAN+3 member economies.

- The inflow of international investment capital has contributed greatly to China's sustained high levels of growth in the past two decades. Among ASEAN countries, China's capacity to absorb foreign direct investment (FDI) is viewed as a direct loss. Even Malaysian Prime Minister Mahathir Mohamed (2002), who persistently maintains that China does not pose a military threat to Southeast Asia, argues that 'China is an economic threat for Southeast Asia. It is already a threat in terms of attracting foreign direct investment, and it is going to be a threat to Southeast Asia's world trade'. Indeed, there is empirical evidence to support such rhetoric of 'threat' that in academic terms reflects little more than a market-induced movement of factors of production in the age of economic globalization. According to one empirical comparative study of Japanese FDI flows into major manufacturing sectors in China and the ASEAN-4 (Indonesia, Malaysia, Thailand and the Philippines) over the period 1989 to 2000, China has 'replaced the NICs (South Korea, Hong Kong, Taiwan and Singapore) and ASEAN-4 as the largest Japanese FDI recipient in some sectors, such as machinery and textiles' (Xing 2002). China's membership of the WTO, then, promises to align further the international division of labour in China's favour. This is because WTO membership can have the effect of assisting the streamlining of China's domestic economic governance, thereby making it possible for the Chinese market to fully realize its potential. China still holds a comparative advantage over most ASEAN countries in labour, particularly in the low-technology sectors. Having just weathered the worst period of the financial crisis, ASEAN economies needed more than just verbal assurance from China that the latter's WTO membership poses no threat to Southeast Asia (*People's Daily*, 24 November 2000).
- With or without WTO membership, the governments of China and ASEAN states have to deal with the political-diplomatic ramifications of their economic ties due to the existence of 'ethnic Chinese business networks' that connect the ethnic Chinese communities in Southeast Asia with the Chinese mainland (Lewis and Rowley 1996). Such networks have existed for hundreds of years, but the past two decades of high-level economic growth in China have contributed to renewed questions about the

> impact that such networks have on the governing capacities of governments in Southeast Asia (Goodman 1997/98: 140–55). Precisely because in Southeast Asia, with a few exceptions, government capacity to effect economic and societal changes within their own boundaries is in question, the linkage role that ethnic Chinese businesses play in China–ASEAN economic relations continues to be an issue in overall relations between Southeast Asian states and China.

In short, on the one hand, China and members of ASEAN are linked through webs of economic diplomacy through APEC and ASEAN+3. These economic-diplomatic webs do provide a basis for policy coordination in addressing market dynamics. On the other hand, there are factors (the impact of China's accession to the WTO and the ethnic Chinese business networks) that ASEAN can address effectively only by working jointly with China. China, too, can benefit from entering another layer of economic-diplomatic arrangement with ASEAN states, for no other reason than that it addresses the latter grouping's fear of being under threat, thereby having to solicit assistance from other powers to jointly face China. Therefore, both China and ASEAN members can make use of an FTA arrangement in the hope of addressing the market developments that they face. The following section examines the rationale leading to their search for an instrument to achieve those purposes.

The Joint CAFTA Experts Group report

Until the outbreak of the Asian financial crisis in 1997, ASEAN was the leader in East Asian regional economic integration (Munakata 2002: 6–15). The first FTA in East Asia was the ASEAN Free Trade Area (AFTA), which came into being in 1992. AFTA set itself the goal of reaching a common effective preferential tariff (CEPT) of 0–5 per cent before 2008. The CEPT agreement covers most manufactured and agricultural products in four categories. Products in the Inclusion List have to undergo immediate liberalization, while products in the Temporary Exclusion List are protected from trade liberalization for a period of time. The Sensitive List contains unprocessed agricultural products, which have longer time frames to integrate with the FTA. Finally, products in the General Exception List are permanently exempted from the FTA due to national security, public morals, human, animal or plant life, or health concerns.[1]

The target year for implementation of AFTA – binding for the original six member economies (Singapore, Indonesia, Malaysia, Thailand, the Philippines and Brunei) – was moved forward to 2003 in the wake of the Asian financial crisis. The tariff-reduction mechanism was implemented on 1 January 2002. However, this quickened progress allowed for a series of compromises for more exceptions of products from the Inclusion List, most notably the Malaysian request to delay the opening up of its auto industry by another three years beyond 2003 (Tran 2001).

A significant part of the intent of AFTA has been to attract more investment capital from outside the region, which is understood to have gone to China instead of ASEAN. In fact, ASEAN's share of FDI attracted to Asian developing countries dropped from a pre-1997 figure of 30 per cent to 15 per cent in 2000 (Barry 2001: 6). How, then, would an FTA with China benefit ASEAN states and economies?

The drive towards establishing a regional economic mechanism linking ASEAN and China officially began in November 2000, during the ASEAN+3 meeting in Singapore. Subsequently, a Joint China–ASEAN Expert Group on Economic Cooperation was formed to assess the feasibility of a CAFTA. The group's final report, submitted to the China–ASEAN summit meeting in Brunei in November 2001, makes a positive recommendation on the political initiative articulated a year earlier.

The 37-page report offers a number of insights into why a CAFTA is thought to be desirable. First, there is a record of growth in trade and great potential for further trade between the two economic entities. ASEAN's share of China's foreign merchandise trade increased from 5.8 per cent in 1991 to 8.3 per cent in 2000, making ASEAN China's fifth biggest trading partner. China's share in ASEAN's merchandise trade grew from 2.1 per cent in 1994 to 3.9 per cent in 2000, making China the sixth largest trading partner of ASEAN (Joint China–ASEAN Expert Group on Economic Cooperation 2001: 1).[2]

Second, China's investment in ASEAN has been small – US$135.8 million in 1999, or less than 1 per cent of all FDI flows to ASEAN. While no figure for ASEAN investment in China is given, the report notes that 'until now ASEAN is a net investor in China' (*ibid.*:12). Lack of reference to data on this particular aspect should be seen as a reflection of the unspoken unease about the flow of investment capital from ASEAN to China. That unease stems in part from the role that ethnic Chinese businesses play in capital movement from Southeast Asia to China. In addition, Hong Kong as an *entrepôt* continues to function as a bridge between the mainland Chinese market and the rest of the world. This makes it difficult to track investment in the mainland by way of establishing front offices in Hong Kong, a common practice by ethnic Chinese for the past several decades. Thus it is possible that ASEAN governments simply do not have reliable data on the actual flow of investment capital into mainland China.

Third, the impact of China's WTO membership on ASEAN receives significant treatment in the report (ten out of the thirty-seven pages). WTO membership is seen as having the following possible impacts: opportunities for some sectors of ASEAN exports to China; increased competition in exports to third country markets; and an inevitable continuation of the China market attracting more FDI than ASEAN. However, the report speculates that as China's economy grows, more Chinese investment capital will be directed to the original six ASEAN economies rather than the present concentration in its four new members (Cambodia, Laos, Myanmar and Vietnam). Here again, the expert study group did not include a table of statistics to support its observation. This can be read as a reflection of the political imperative – that is, producing a recommendation in time for the ASEAN–China summit – that drove the production of the report.[3] At the same time, reliable data about the extent of

Chinese investment in the four Indochinese states are difficult to come by in the first place. Most research on ASEAN as an economic group simply bypasses this challenge by dealing with either ASEAN-4 or ASEAN-6 (plus Brunei and the Philippines).

Fourth, the report (*ibid.*: 17) cites significant policy barriers on trade (tariff and non-tariff barriers, different technical standards, restrictions on services), investment (absence of investment guarantee agreements) and the lack of suitable long-term visas for business people who regularly travel between ASEAN and China. Indeed, these are the policy areas over which the various states have direct control. Viewed against this background, the CAFTA mechanism can facilitate the movement of goods, capital and business personnel under a unified system. The challenge, as is true with all FTA arrangements, is how to prevent the mechanism from bureaucratizing (and thereby slowing down) such movements.

Overall, the report presents a candid assessment of the economic policies that China and ASEAN are currently adopting towards each other. The report's framework for action also provides a clear road map for the areas that need government action in the coming decade. In line with the need to practise 'saving face', the report omits reference to specific ASEAN country names and refrains from being specific about the areas in which China needs to reform. However, the report also reveals two key issues that will require persistent political will if formal integration of the ASEAN and Chinese economies is to be pushed forward.

The first issue is under what modality will the envisioned CAFTA operate? The report (*ibid.*: 32) sees 'the simplest modality' to be 'ASEAN countries extending their CEPT commitments, with perhaps some modifications, to China and the latter drawing up product lists similar to that in the CEPT scheme of AFTA' to establish the tariff reduction programme. In other words, China is supposed to adopt ASEAN's zigzag approach to achieving economic regionalism. If, as mentioned above, ASEAN countries have experienced difficulties in agreeing on product lists within the AFTA arrangement, will including China in the negotiating process assist or further complicate the process of liberalization as envisioned in an FTA regime? It should be noted in this respect that China is economically more powerful than its ASEAN negotiating partners and has stronger economic ties with partners outside ASEAN.

The second issue is the obvious reservations on the part of some ASEAN member states to even beginning negotiating an FTA with China. Although the main report unanimously recommends moving forward with negotiations, the ASEAN member countries' national reports annexed to the main report tell a different story. They provide proof that in order to move in the direction of a CAFTA, the very basic element of negotiations – standards employed to assess the state of affairs in trade and investment between an ASEAN member economy and China – must be agreed on first. The main report achieves this goal by relying on two sources of information: WTO reports and Chinese research material. In the individual national reports, however, there is a much greater reliance on statistics compiled by the various ASEAN governments involved. Such a state of affairs was probably the main cause for vast differences over the specific categories of product list to be included in the so-called 'early harvest' package agreed in Phnom Penh (ASEAN 2002). As was indicated in the national report from Laos, 'the right steps [towards] liberalization must be taken as the serious matter, otherwise we could step on the area of land mines'.

Many changes will occur during the ten years that the political leaders of ASEAN and China have agreed it will take to realize a CAFTA. A government's foreign economic policy, with or without an FTA arrangement, is inevitably conditioned by assessments of market changes that take place rapidly under conditions of economic globalization. Therefore, it is premature to begin making definitive predictions about the prospect of a CAFTA moving from a vision to a reality, or to speculate on the market impact of such a policy mechanism. However, one point is very clear. The fact that China and ASEAN have formally pledged to integrate their economies is already a very significant achievement. The next section recounts the trajectory of change in China–ASEAN economic relations in the 1990s, which provided an important base for the FTA initiative.

China–ASEAN economic relations in the 1990s

The evolution of China's political and economic relations with ASEAN, both as a group and at the bilateral level, has received extensive scholarly attention, and there is little need to restate here their asymmetric nature for the entire period of the Cold War (Kallgren *et al.* 1988; Chia and Cheng 1992; Wang 1999). The political and diplomatic isolation that China faced in the wake of the Tiananmen Square crackdown in 1989 provided the impetus for China to treat its relations with the ASEAN states in a global strategic context. This was part of the Chinese foreign policy goal of seeing that a multi-polar world would take shape (Cheng 1999: 176–204). At the diplomatic level, China's main strategy was to demonstrate to Southeast Asian states that a rising China would not pose a threat to its small neighbours. Chinese officials argued that the notion of a 'China threat' was nothing more than a political tactic employed by governments and intellectuals in the West (Xie 1996: 500–3; Collins 2000: 133–72).[4] Indeed, China spared no effort in attempting to foster a public image of cooperation, friendliness and common interests with ASEAN. This overall strategic goal has led the Chinese government to intensify high-level consultations with ASEAN governments and to subscribe to the rules and norms of diplomatic engagement that ASEAN has established. The general atmosphere of political relations between China and ASEAN has improved, although it is clearly not without problems (Ho 2001: 684).

A second part of China's post-Cold War strategy was to strengthen its economic ties with Southeast Asian states, beginning at the bilateral level. This is by and large a continuation of what China had been doing since the 1970s. For China, trade with a Southeast Asian state could and should take place before diplomatic ties. A case in point was that by 1989, China had made direct trade possible, including the signing of formal trade agreements, with all the original six ASEAN member states before it was able to establish formal diplomatic ties with half of them (Brunei, Singapore and Indonesia). Such pragmatism made it possible for total trade between China and ASEAN in 1989 to increase to more than twenty times the 1970 total (Stoltenberg 1990: 33; Chia and Cheng 1987). Prior to 1989, China signed bilateral investment treaties with three ASEAN member states (Thailand in 1985, Singapore in 1986, Malaysia in 1988). By 2000, China had signed such treaties with all ASEAN countries except Myanmar.

In the realm of economic diplomacy, after 1989 China began to involve itself more actively in regional economic groups. In 1991, China joined APEC, in which it shares equal representation with Hong Kong and Taiwan. While ASEAN is important in moving forward with the APEC process, China entered into a consultative relationship with ASEAN as a group in 1993. Since then, five parallel frameworks for dialogue between China and ASEAN have emerged: the China–ASEAN political consultation at senior official level; the China–ASEAN Joint Committee on Economic and Trade Cooperation; the China–ASEAN Joint Committee on Scientific and Technological Cooperation; the China–ASEAN Joint Committee on Cooperation; and the ASEAN Beijing Committee (Foreign Ministry of China, n.d.). Such joint committees make it possible for senior officials of ASEAN and China to enhance mutual understanding and exchange ideas. China-based scholarly assessments of these committees' activities echo complaints by scholars based outside China – that they are 'broad' or 'unfocused' (*wu xu* in Chinese) (Zhang 1999: 217; Ho 2001: 684–7). It should be remembered that the so-called 'ASEAN way' of diplomacy places value on the process rather than on time-driven policy outcomes, much less legalized ones. Above and beyond this, the original intent of ASEAN engaging its powerful neighbours was to cash in on group power to offset disparities in negotiating power in a bilateral forum.

China made by far the most significant overtures towards Southeast Asia in the economic realm in the summer of 1997. Three policy decisions are worth mentioning. First, by making a monetary contribution to the IMF currency stability loans to Thailand and Indonesia, China arguably demonstrated that its reputation as 'a self-serving Group of One both within and outside the multilateral economic institutions' was now unwarranted (Feeney 1994: 247). Meanwhile, China's crisis-related diplomacy was a balancing act. The country refrained from taking part in either of the extremes in the debate about a proper IMF way of handling the crisis. On the one hand, by participating in IMF-sponsored macro-economic policy packages, China demonstrated its acquiescence in the IMF's role and philosophy. On the other hand, it did not endorse the IMF's demands for policy reforms by affected Southeast Asian governments or calls for rejecting the IMF as a lender of last resort. Instead, the Chinese leadership concentrated on taking a lesson from the crisis and pushing through further structural reform in its own economy (Lautard 1999).[5]

Second, after the outbreak of the crisis, whether or not the Chinese government would choose to devalue its currency, the renminbi, to protect its own trade interests became a subject of daily scrutiny in the media in the region and beyond. To date, China has kept its pledge not to devalue the renminbi, thus removing an important external variable that might have caused another round of competitive devaluation of Southeast Asian currencies due to the overlap in Chinese and Southeast Asian exports in major international markets (Voon 1998: 273–91; Yu 2000: 163–74). Against this background, the Chinese leadership refrained from engaging in public debates about whether or not its decision to devalue the renminbi in 1994 had been a direct cause of the Southeast Asian crisis. In January 1998, an article published in the *People's Daily* did take on the criticism directly. In its view, when China unified its foreign exchange market and the official exchange rates of the renminbi in 1994, the exchange rate of the renminbi against the US dollar did depreciate to 8.7 to 1. However, since the nominal exchange rate was 8.09 renminbi to the dollar in 1993, the actual drop in 1994 was only 7 per cent after the integration, instead of 33 or 50 per cent, as had been calculated (Hui 1998: 1).

Independent and academic inquiry into a possible causal relationship between China's 1994 devaluation of its renminbi and the competitiveness of products made in China against Southeast Asian exports in third markets has yet to emerge. One study does cite evidence that 'points unequivocally to some rivalry effects from China on the ASEAN-4's exports to the United States from 1980 to 1994' (Voon 1998: 273). However, it is unscientific to argue that the 1994 change in Chinese fiscal policies amounted to a direct cause of the region-wide crisis in 1997. For the purpose of inquiry in this article, it is significant to note that the Chinese government did not choose high-profile, finger-pointing tactics that argued against its responsibility in this regard during the crisis.

Third, China again played a balancing role in the international debate about the launching of a regional monetary mechanism for dealing with future currency shocks in Southeast Asia. This debate involved three proposals: a Japanese proposal for an Asian monetary fund; the US insistence on no change to the IMF mechanism and its philosophy; and a warm reception for the Asian Monetary Fund proposal from ASEAN quarters. China did not endorse the latter proposal when it was made public in October 1997. However, in December 1998, at the ASEAN summit meeting in Hanoi, China announced a proposal for regular discussions between deputy finance ministers of the ASEAN+3 members, thereby indicating its interest in being an active participant in efforts to build a new regional financial institution. As noted earlier in this paper, China has demonstrated its willingness to be a full partner under the Chiang Mai Initiative. At the operational level, this initiative still recognizes the relevance of IMF conditions to be linked to lending by participating central banks in the region. It thus represents a compromise of the three positions articulated when the idea of an Asian Monetary Fund was floated (*Business Times*, 5 November 2001). China's demonstrated willingness to accept IMF monitoring of its policies towards managing regional macro-economic stability marks an important departure from its usual insistence on independence in Chinese foreign policy making. For ASEAN states, then, this represents a welcome change. A rising and unilateral China is certainly not in the interest of ASEAN nations.

Fourth, for ASEAN countries, a serious test of whether China would return to a 1950s nationalistic path when dealing with the treatment of ethnic Chinese in Southeast Asia came in May 1998, when large-scale riots broke out in Indonesia. Indonesian Chinese came under attack, and their plight drew significant international media coverage. Indeed, the riots led to calls in Hong Kong for Beijing to impose economic sanctions on Jakarta. The Chinese government initially monitored the situation unfolding in Indonesia and then allowed the mainland-based media to conduct a brief but controlled publicity campaign to express sympathy for fellow Chinese. In the end, Beijing chose to prioritize the stability of the Indonesian regime over either siding with the Indonesian Chinese or treating the Habibie government's handling of the riots as insufficient protection of human rights (Zha 2000: 557–75). In other words, the Chinese government had sent the message that it valued its bilateral relationship with Southeast Asia over political ties with their ethnic Chinese populations.

I have thus far focused on those aspects of China's handling of its political-economic relations with Southeast Asia that impacted on the macro-economic situation in the regional economy, and that demonstrate China's intention to be a good neighbour to Southeast Asian states. A detailed review of developments in bilateral economic ties between China and all ten ASEAN economies is beyond the scope of this article and indeed unnecessary for our purposes. However, it is important to note that ASEAN is a body for intra-regional consultation, and China's bilateral political-economic relations with ASEAN member states vary. Among the ASEAN member states, Myanmar comes closest to trusting China, whereas the Philippines is perhaps the most distrustful of China's intentions. The South China Sea territorial dispute remains the key issue that makes the Philippines and other direct parties to the dispute wary of China's strategic intentions. ASEAN as a group has endorsed the 'code of conduct' proposed by the Philippines and sought to bind China to its stipulation of no change in the status quo, among other confidence-building measures. Despite China's positive expressions of interest in the code, thus far a final agreement is still beyond reach (Valencia 2002). Nevertheless, there seems to have been sufficient momentum for those members in ASEAN most wary of China's intentions to have found it difficult to resist the process of formal engagement with China.[6]

The contrast between the progress that China has made in its economic diplomacy towards ASEAN as a group and continuing disparities in bilateral political-economic ties between China and individual ASEAN member states is important, because successful negotiation of the CAFTA demands harmonization of interests out of the complexities in bilateral ties between ASEAN member states and China. For China the negotiating process promises to be protracted, and the prospect that attempted harmonization of divergent interests makes agreement on common ground too minimal to be meaningful cannot be ruled out. What impact, then, does the Chinese state hope to have on the market it governs through the CAFTA? The next section addresses this question by looking into the Chinese government's stated goal: using the CAFTA to promote cross-border trade.

China–Southeast Asian economic ties: cross-border trade

As is true in any state's pursuit of economic diplomacy, China has its own domestic development agenda in mind in negotiating the CAFTA with ASEAN. For China, the CAFTA is an effective means of helping to find overseas markets for products made in its southwestern provinces. Indeed, Long Yongtu, China's vice minister of foreign trade and a key high-ranking official in the China–ASEAN discussions, has pointedly emphasized that:

> ASEAN economies are important export markets for provinces in China's southwestern region. Formation of the CAFTA will be a significant boost to these provinces' exports, which in turn is conducive to China's national strategy to develop the entire western region.
>
> (Long 2002)

To achieve this goal, when China initially proposed the FTA with ASEAN, it offered an 'early harvest package'. This package includes two essential elements:

1. Items such as tropical resources, agricultural products, food, textiles and electronics – goods in the production of which some ASEAN member economies enjoy a labour advantage over China – are to be included in the initial round of tariff-reduction negotiations.
2. The second element allows 'special and preferential treatment' to be extended to Cambodia, Laos, Myanmar and Vietnam. This implies a unilateral tariff reduction over selected items on the part of China and a delay for those four economies to reciprocate by five to eight years after a unified trade and investment-liberalization scheme is in place. The concession granted to these economies has already led to complaints from other ASEAN members. For example, in May 2002 the Malaysian minister of international trade stated that Malaysia should be 'practical' and emphasized the importance of pursuing bilateral economic ties in participating in CAFTA negotiations (Bernama Newswire, 22 May 2002).

Long's positive vision for the CAFTA to assist China in promoting its western regional development stems from the fact that Laos, Myanmar and Vietnam share land borders with China. Through those countries, goods made in China can also reach Cambodia. In China's southwest, Yunnan and Guanxi are located along the border with Laos, Myanmar and Vietnam. Closely behind them are Sichuan, China's most populous province, rich in low-cost labour, and Guizhou, one of China's poorest provinces. All four provinces are land-locked, making it commonsensical to seek overland transportation routes for the movement of exports and imports. Historically, Guanxi and Vietnam, and Yunnan and Myanmar, have had close cross-border trade ties. Normalization of diplomatic ties between Vietnam and China in 1991 resulted in a boost in cross-border trade between Guanxi and Vietnam (Womack 1994).[7] As China and Vietnam have now reached an agreement on demarcation of their border, promoting cross-border trade is one mechanism to assist these Chinese provinces to expand their export markets. Indeed, China's offer to finance the construction and upgrading of the Pan-Asian Railway connecting Yunnan with the four states of Indochina and eventually reaching Singapore is the clearest indication of its pursuit of self-interest in this regard (*People's Daily*, 2 April 2002). In anticipation of the CAFTA, China is now speeding up construction of expressways between western Yunnan and Myanmar, southwestern Yunnan and Thailand, and southern Yunnan and Vietnam (*People's Daily*, 7 September 2002).

When one looks only at the trade and investment aspect, increased cross-border trade and investment is indeed conducive to economic growth in the four Indochinese states, as well as in the adjoining Chinese provinces. China's western region in general, and southwestern provinces in particular, lags far behind the level of development of provinces located along the Pacific coast. Hence, since the early 1990s, China has persistently promoted cross-border trade with all its neighbours (Yu 1996). Cross-border trade is a key component of the Chinese strategy known as 'Greater Southwest' development. Then, for China's southwestern provinces, promotion of cross-border trade is directly related to increased Chinese activities in the development of the Mekong River basin (Li 2001). In view of domestic governance in China, faster development in its southwest is conducive to the goal of equitable development within. At a strategic level, a more evenly developed China is also conducive to providing a positive external environment for the development of ASEAN as a whole.

However, history has shown that the impact of cross-border trade between China and the Indochinese states goes far beyond the growth or decline in trade and investment levels. In the past, cross-border trade has had implications for issues of ethnic-national identity and, indeed, the capacity of the states of Indochina to govern their own territories effectively (Hutton *et al.* 2000). The proliferation of smuggling and other illegal activities across both the land and maritime borders between China and ASEAN also poses new challenges for domestic control in affected states (Hendrischke 2000: 23–36).

Taking these factors into consideration, the 'special and preferential treatment' that China has promised to Cambodia, Laos, Myanmar and Vietnam may turn out to be a mixed blessing. How these states perceive and manage their expanding economic relationships with China will impact on their performance in the negotiations towards the CAFTA. It is conceivable that the Indochinese states are unwilling to commit themselves to a binding trade agreement that may push them into economic domination by China. For China too, intensified economic activity along its southwestern border is likely to have political and strategic implications. The central government of China would not want to see its border provinces drawing closer to 'undesirable' political and societal forces beyond its long, shared border with the Indochinese states.

In short, movement towards the CAFTA is likely to be complicated by Indochinese sensitivities about cross-border trade with China, although it is perhaps not always loudly expressed. This may become a factor in China's relations with those states in particular and with ASEAN as an organization in general, beginning with the process of CAFTA negotiations. Whether or not special consideration of the stages of development of the four new ASEAN members is sufficient remains to be seen. Before concluding, I now turn to another significant factor that may affect the CAFTA negotiation process: Japan's pursuit of formal economic integration with ASEAN.

Sino-Japanese competition for regional leadership

Through ongoing aid, trade and investment, postwar Japan has solidified its unchallenged role as the leader of economic development in Southeast Asia. However, the historical trend of Japan leading Southeast Asian economies into the future in a 'flying geese' pattern was called into question during Japan's so-called 'lost decade' of the 1990s. The perception of a gap between an economically growing China and a stagnant Japan results in concerns about loss of Japanese leadership in Southeast Asia to China. In reality, however, it was not until August 2002 that China became a larger export market for the five largest ASEAN economies (Singapore, Thailand, the Philippines, Indonesia and Malaysia) than Japan (*Nihon Keizai Shimbun*, 1 August 2002). In addition, in terms of development aid and research, as well as responding to Singapore's policy initiative of trade and investment liberalization ahead of other ASEAN states, Japan has been ahead of China.

China has also used aid as an instrument to exercise economic influence in the Southeast Asian region. One noticeable example is the grant of US$400 million in aid to Indonesia in March 2002 (BBC News 2002). Being a developing country with large areas of poverty, China is not in a position to match Japan in extending development aid to Southeast Asia. An FTA therefore becomes a useful diplomatic instrument because it promises to increase trade and investment flows between member states. The CAFTA announcement has been widely interpreted as a symbol of an economically rising China exercising leadership in Southeast Asia.

One Japanese account holds that 'China, having closely watched Japan's trade policy shift [to embrace preferential trading arrangements], decided to join the regional trend of exploring FTAs' (Munakata 2002: 15). Zhang Yunlin, chairman of the China–ASEAN Expert Group that compiled the FTA feasibility report for Chinese and ASEAN leaders, saw the sequence differently. Noting that in the ASEAN+3 forum, discussions about an FTA with ASEAN had not made much progress since 1999, 'progress in CAFTA negotiations will propel Japan and Korea to engage the entire ASEAN region' (Feng 2002: 62).

In any case, the November 2001 announcement of China–ASEAN negotiations towards an FTA received wide attention in Japan. The *Asahi Shimbun* observed, ‘in contrast to the Japanese, shackled by farm interests, Chinese political leaders have convinced ASEAN members that a free trade area would benefit everyone’ (Yamada 2001: 1). The pro-business paper *Nikkei Shimbun* called on the Koizumi government to conduct a ‘policy review’ that is ‘based on a broad new regional strategy, rather than narrow domestic concerns’ (*Nikkei Weekly*, 12 November 2001, p. 1).

The apparent Chinese strategy of seeking a greater leadership role in regional economic affairs centred on offering to have agricultural products included in the trade-liberalization package to be negotiated. Japan’s choice of Singapore as its FTA partner in ASEAN implies an unwillingness to open Japanese markets to agricultural exports from ASEAN, since Singapore has no agricultural base to speak of. The timing of China’s decision to form an FTA with ASEAN may also have to do with the ongoing difficulty in resolving a bilateral trade dispute that began with Japan’s imposition of temporary safeguard measures on imports of three agricultural items from China in June 2001. The projected contrast between Japan, which is protective of its domestic agricultural interests, and China, which is open to agricultural imports, is only too obvious.

At this juncture, it is important to note that treatment of agricultural products in an FTA scheme between all ASEAN states and Japan may not be as much of a barrier as it is commonly perceived to be. That perception stems from two indisputable facts. First, ASEAN states enjoy a competitive advantage in agricultural production over Japan, particularly in the area of labour costs. Therefore, it makes economic sense for ASEAN states to want to give priority to agriculture and for Japan to open its market wider to imports from ASEAN through tariff reductions. Second, the Japanese government has a long history of campaigning internationally to protect its domestic farm interests to the fullest extent possible. The government has to behave according to the wishes of entrenched agricultural interests in the domestic Japanese political system and society (Mulgan 2000). However, if ASEAN applies the modality of CEPT under AFTA in its FTA arrangement with Japan, as it has done with China, then Japan is at least technically in a position to leave agricultural products on its Sensitive List (permanently off the liberalization agenda).

In addition, there are indications that agriculture may not be the most important issue for ASEAN in its FTA scheme either. A case in point is that by mid-August 2002, it was reported that Chinese negotiators were ‘having second thoughts’ about having such agricultural items as rice, sugar, tapioca and rubber included in the ‘first batch’ of the package being negotiated with ASEAN (*Kyodo News*, 15 August 2002). Still, ASEAN and China are forging ahead with CAFTA negotiations. It remains to be seen if such developments can be interpreted as ASEAN agreeing to allow China to exclude some agricultural products from tariff reduction, as the AFTA CEPT scheme allows. If so, there is little reason for ASEAN to insist that Japan must include agriculture under the scenario of formal negotiations towards a Japan–ASEAN FTA.

At the end of 2001, the Japanese government, ‘apparently in response to the China–ASEAN agreement’, proposed negotiating a ‘comprehensive economic cooperation accord' with ASEAN. Such an accord, to be completed within five to ten years, would include promotion of cooperation in the areas of investment, energy and intellectual property rights (*Daily Yomiuri* 23 December 2001, p. 1). Thus far, Japan has made little progress in this direction. However, as more salient Japanese assessment shows, it is in Japan's interests to pursue FTA arrangements in East Asia by exploring South Korea, Taiwan and Hong Kong as partners. Across the Pacific, it is certainly in Japan's interest to explore formation of an FTA with the United States, in addition to the Japan–Mexico and Japan–Chile FTA negotiations already under way (Urata 2002).

Japan also responded to another Chinese project aimed at building up its influence in Southeast Asia – the launching and hosting of the Bo'ao Forum for Asia, symbolically based in Bo'ao, Hainan Island. The forum, modelled on the World Economic Forum based in Davos, Switzerland, provides a venue for informal exchanges of opinion between East Asian leaders. In April 2001, when the forum was formally launched, Japanese Prime Minister Koizumi (2002a) travelled to Hainan to deliver a speech that outlined Japan's commitment to engagement in Asian affairs, including those in Southeast Asia and as far as Central Asia.

In January 2002, again against the background of Japanese media challenging the government not to lose regional leadership to China, Koizumi visited five Southeast Asian countries. On his last stop in Singapore, he signed the Japan–Singapore Economic Agreement for a New Age Partnership and delivered a speech outlining his vision for future relations between Japan and ASEAN. Koizumi's Initiative for Japan–ASEAN Comprehensive Economic Partnership, of which he said that the Japan–Singapore agreement served as an example, would include ASEAN members as well as Australia and New Zealand. Judging from his statement that 'the role of the United States is indispensable' in such a joint effort, Koizumi's (2002b) vision may have a pan-Pacific structure in mind.

There can be different interpretations of the policy implications stemming from the vision that Koizumi enunciated. One possibility is that it amounts to a carefully crafted presentation of Japan's policy towards ASEAN: Japan would not approach ASEAN at the expense of the interests of its major strategic partners in the entire Asia-Pacific. If this were true, then inclusion of more members would certainly increase difficulties in a negotiating process. Indeed, the experience of large membership under APEC serves as a warning sign. Under APEC, even a non-binding approach to trade and investment liberalization is problematic. In this sense, it would indeed be a miracle if Japan were to attempt to take on itself the task of harmonizing the interests of all fourteen members to which Koizumi made specific reference.

Another possibility is that trade liberalization through FTA arrangements with other ASEAN members, let alone one that included members beyond the ASEAN region, was not what Koizumi had in mind in the first place. Under this scenario, the purpose in making such statements was to raise awareness for governments throughout the Asia-Pacific region to jointly manage the challenges of a rising China.

At present, Japan's pursuit of economic diplomacy with ASEAN through the FTA scheme is hampered not only by considerations of the agricultural sector. As discussed earlier in this paper, this is important but may not be decisive. The Japanese government's current inability to be more forceful is also related to its difficulties in dealing with structural reforms of the Japanese economy.[8] On the one hand, the Japanese government faces the need to rid its economy of uncompetitive industries, with agriculture being a visible target but one impossible to tackle according to textbook economic prescriptions. On the other hand, amid the domestic political difficulties, the Japanese government has also demonstrated that it can act in the interests of the globally competitive sectors of its economy and at the same time against the uncompetitive ones. An excellent case in point is the Koizumi government's decision in late 2001 to end the temporary safeguard measures imposed on selected items of Chinese agricultural exports to Japan. China's retaliation directly targeted Japanese products that are competitive globally and in the Chinese market (automobiles, cellular telephones and air conditioners).

Indeed, increasing market competition from China contributes to the Japanese government's difficulties in realizing structural reforms to its economy (Ohmae 2002). At the same time, Japan has shown that it can find the political capital required to keep alive exploration towards forming its own FTA with ASEAN. As of mid-October 2002, Japan plans to prioritize its FTA negotiations beginning with South Korea, to be followed by ASEAN and China (*Nikkei Shimbun*, 13 October 2002). Indeed, should the Japan–ASEAN FTA negotiations proceed as proposed (to begin in 2003), such a development can serve as an external factor to make China and ASEAN states take each other more seriously than they would without it.

In short, through diplomatic activities Japan has indicated that it is determined not to fall behind China in the competition for political goodwill in the Southeast Asian region, although it does appear that Japan is behind China in conducting economic diplomacy to demonstrate engagement with all ASEAN economies. It is clear from the above analysis that FTA formation has become one instrument in the competition between China and Japan to win ASEAN's favour on the economic diplomacy front.

Conclusion

There is little doubt that economic relations between China and ASEAN have developed very rapidly in the past decade. When AFTA was launched in 1992, China was viewed as a potential participant at best (Imada and Naya 1992). The change in China's treatment of ASEAN as a regional actor in the final years of the Cold War and, more fundamentally, China's reaction to the Asian financial crisis, brought about the necessary change in the regional geo-strategic matrix to make the move towards forming a CAFTA possible.

As the Joint China–ASEAN Expert Group's report admits, the level of existing integration between China and the ASEAN economies is low, despite the impressive records of growth in the past decade. In other words, the CAFTA is not yet one of natural integration; nor does it appear to be a strategic one. For both China and ASEAN, there is no viable 'third party' market to target. As a result, 'open regionalism', an idea that informs the APEC process, becomes the guide for formal integration. 'Since seven of the ASEAN members and China are also APEC members, the year 2020 sets an absolute deadline' for liberalization (Imada and Naya 1992). It is in this sense that formal integration of the ASEAN and Chinese economies appears to be tactical in nature. For lack of better vocabulary, the term 'tactical' in this context refers to a policy commitment that has more to do with setting in motion a momentum, rather than cashing in on past achievements or hedging against a formidable adversary or rivalry in trade. A tactical economic integration may help to harmonize economic dynamism within the FTA; at the same time, a CAFTA could also turn out to be little more than an exercise in economic diplomacy. Then, what we have begun to witness seems to be yet another case of selective legalization in the international trade, investment and monetary affairs of the Asia-Pacific (Kahler 2000: 549–71).

In the event that a formal CAFTA turns out to be ineffective, having the mixed record of AFTA in mind, in what ways will China matter to economic development in Southeast Asia in the future? In relation to issues including regional security, territorial disputes and bilateral economic relations, developments in China and its foreign policy matter to Southeast Asia, as they have for the past millennia (Grant 1993). However China's approach to economic development may not have much to offer ASEAN states. Since the late 1970s, China's economic development has been driven not through conforming with any particular internationally promoted development paradigm or ideology. Instead, the primacy of growth and stability (*fazhan, wending*) inform economic, societal and political policy making at all levels of the Chinese governing apparatus. For instance, China rejected so-called 'Washington consensus' policies for the transformation of less developed economies, or the 'shock therapy' prescribed for the 'transition' (centrally planned to market) economies following the formal end of the Cold War (Nolan and Wang 1999: 169–200). Against this background, China's pursuit of economic ties with ASEAN, as Chinese Vice Premier Li Lanqing (1995/96: 9) stated in 1994, is part of a development strategy through 'strengthen[ing] South–South cooperation and pushing for North–South cooperation simultaneously'. In this sense, the movement towards a CAFTA is significant, but we should not overestimate its value to ASEAN in considering the overall development of the region.

A final aspect of China's importance to economic development in Southeast Asia in the future relates to the transformation of Hong Kong's role as a gateway to the mainland Chinese market. In the immediate wake of announcing the move towards a CAFTA came public discussions about forming a 'free trade zone' linking mainland China and Hong Kong (Ng 2001: 8). Consultations based on the 'one country, two systems' formula and WTO rules formally started in January 2002. The goal of such discussions is to eliminate tariff and non-tariff barriers to trade between the mainland and Hong Kong (Shi 2002: 7). The mainland–Hong Kong scheme of closer economic ties may or may not result in a formal agreement, given Beijing's insistence on Hong Kong affairs being domestic. Nevertheless, new mechanisms for promoting cross-border economic activities between Hong Kong and mainland China will almost certainly mean that Southeast Asian economies must learn to adjust to new dynamics in the transformation of Hong Kong's role as a gateway to the vast mainland market.

In short, through analysing developments in China's economic relations with Southeast Asia since the 1990s, and particularly the movement towards the CAFTA, this article has argued that there has been a change from China riding the bandwagon of ASEAN-style economic integration without structural reciprocation, to China working with ASEAN to reach a common set of policy instruments in its trade and investment relations. That change has been possible in part due to the overall change in Beijing's foreign policy orientation towards the Southeast Asian region dating back to the early 1990s. However, the implications of the CAFTA for future developments in wider ASEAN–China relations are less clear. By taking issues such as cross-border trade and Japan's future relations with ASEAN in the region into consideration, research efforts ought to pay attention not only to the process of economic diplomacy itself but also to the CAFTA's future impact on domestic governance and regional politics.

Notes

1 Updated information about AFTA's CEPT scheme can be found on the ASEAN Secretariat's home page at www.aseansec.org

2 Joint China–ASEAN Expert Group on Economic Cooperation, *Forging Closer ASEAN–China Economic Relations in the Twenty-first Century*, report presented to the ASEAN+China Senior Officials' Meeting, 3 November 2001, p. 1.

3 Author's interview with a Chinese academic familiar with the proceedings of China–ASEAN FTA discussions, Beijing, 16 July 2002.

4 For a contrasting view, see Collins (2000).

5 The research literature on China and the Asian financial crisis is very extensive. A good representation of how the official Chinese propaganda and policy establishments treated the crisis can be found in Lautard (1999).

6 I am grateful to Professor Brian Bridges of Lingnan University, Hong Kong, for these pointers.

7 See also a collection of articles on border trade in Sino-Vietnamese relations in the November/December 2000 issue of *Asian Survey*.

8 I am thankful to Dr Melissa Curley for providing a summary of discussions during the Fifth China–ASEAN roundtable held by the Centre for Asian Studies at the University of Hong Kong in October 2002.

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13 China–ASEAN relations in the early twenty-first century[1]

Joseph Y.S. Cheng

Introduction

At the end of the Cold War, major changes took place in Southeast Asia. With the break-up of the Soviet Union, confrontation between alliances disappeared in the region, and this was accompanied by the settlement of the Cambodian issue. The Association of Southeast Asian (ASEAN) states were then able to concentrate on economic development and regional economic integration. Attempts have also been made to establish regional security institutions to allow these states to play a significant role in the Asia-Pacific region. However, the Asian financial crisis was a major setback to the ASEAN states. It not only exposed their economic structural problems but also led to political instability in some of them. As a result, ASEAN has been weakened, and many of its member states are now tending to look inwards.

In the previous decade, China should be satisfied with its achievements in its relations with ASEAN. In August 1990, it restored diplomatic ties with Indonesia. This was followed by the establishment of diplomatic relations with Singapore in October 1990 and with Brunei in September 1991. Two months afterwards, China normalized party-to-party relations as well as state-to-state relations with Vietnam.

In July 1991, Chinese Foreign Minister Qian Qichen first attended an ASEAN ministerial meeting as China established a dialogue with the regional organization; subsequently, it became a full dialogue partner of ASEAN in July 1996. Despite the Chinese leadership's initial hesitation, China joined the ASEAN Regional Forum in 1994; and in the following year it initiated regular senior officials' meetings with the ASEAN states at the deputy foreign minister level. Finally, in December 1997, a summit meeting was held between the then nine ASEAN members and China, Japan and South Korea, as well as between the ASEAN states and China. In the joint statement released after the latter summit, it was announced that the two sides had established a partnership of good neighbourliness and mutual trust facing the twenty-first century. Both parties pledged to resolve their differences and disputes through peaceful means and not to allow existing differences to obstruct the development of friendly and cooperative relations between them (*Guangming Ribao*, Beijing, 17 December 1997).

China's ASEAN policy has to be placed in the context of its independent foreign policy of peace launched in 1982/83. The latter has been in pursuit of long-term objectives: (1) to secure a peaceful international environment for China's economic development to maintain the legitimacy of the Chinese communist regime; (2) to promote economic exchange, i.e., modernization diplomacy, to enhance China's comprehensive national power; (3) to eliminate the perception of the 'China threat' and to reassure its Asian neighbours how China will use its rising power; and (4) to strengthen China's status and influence as a regional and international power (Cheng 1989; Sutter 2002). However, adjustments are constantly being made in view of changes in the international situation.

This chapter intends to examine China–ASEAN relations at the beginning of the early twenty-first century through a study of the foreign policies of China and the ASEAN states, as well as the role of ASEAN and China in their respective foreign policy frameworks. The interests of other major powers in the Asia-Pacific region and how they have influenced regional cooperation and conflicts will be analysed. China's territorial disputes with the ASEAN states, the Taiwan issue, economic cooperation between the two parties and the evolution of regional international organizations are among the major issues discussed in detail.

ASEAN's role in the Chinese foreign policy framework

In the era of economic reforms and opening up to the external world, China wants to secure a peaceful international environment to concentrate on economic development. Chinese leaders accept that regional cooperation is an irreversible trend in global economic development and in the evolution of the contemporary international power configuration. As the largest developing country in the Asia-Pacific region, China has to participate in and promote regional economic cooperation enthusiastically in order to strengthen its influence in the region. This activism since the 1990s has been in sharp contrast to the aloofness and the lack of a regional policy in the 1970s. The Chinese authorities understand that only through active participation will China be able to benefit from the regional economic cooperation process and direct the flows of capital, technology and commodities in directions favourable to China's development. They certainly hope to influence the orientations and development of the organizations of regional cooperation while enhancing China's position in opposition to hostile blocs and organizations. It has been with such intentions that China participates in the Asia-Pacific Economic Cooperation (APEC) forum, the Pacific Economic Cooperation Council, the ASEAN Regional Forum and other bodies.

For the past two decades and more, China and the countries of Southeast Asia have been concentrating on strengthening their economic base. In their pursuit of economic development and prosperity, economic links between them in the areas of trade, investment, finance and technology have been strengthening. At the same time, China and ASEAN share very similar stands on issues such as Asian values. The discourse on Asian values emerged in the early 1990s, articulated most conspicuously by the then Prime Minister of Singapore, Lee Kuan Yew, and Prime Minister Mahathir Mohamed of Malaysia (Mahathir 1999; Zakaria 1994). The consensus on Asian values between China and ASEAN was best symbolized by the Bangkok Declaration, which embodied their agreement on the common human rights position to be articulated at the World Conference on Human Rights, held in June 1993 in Vienna. The Bangkok Declaration emphasized economic growth, community interests, non-interference in other countries' domestic affairs and respect for each other's different socio-economic, historical and cultural backgrounds (Sebastian 2000: 174).

In the early 1990s, when China was attempting to improve relations with its neighbours to ensure that it would enjoy a peaceful international environment, ASEAN countries were also considering how to meet the challenge of integrating China into the Asia-Pacific community by offering China a reasonable stake and a constructive role in the region in the post-Cold War era. In this mutual engagement process, both parties broadened their respective concepts of security to include not only the military but also the political and economic aspects as well. Chinese leaders also appreciated that they had to demonstrate an awareness of the needs of the ASEAN states and endorse their idea of security equilibrium and the promotion of regional economic integration. The strengthening of China–ASEAN relations in the early 1990s was partly a result of China's active responses to the ASEAN proposals on confidence-building measures and preventive diplomacy in the region. Both parties were eager to establish multilayered channels of consultation on a bilateral and multilateral basis as they realized that security cooperation would be in their mutual interests.

The peaceful resolution of the Cambodian issue through the Paris Peace Conference of 1989–91 reinforced China–ASEAN trust at the end of the Cold War era. China's push for multi-polarity therefore coincided with ASEAN's promotion of a regional security equilibrium. ASEAN states were proud of their diplomatic achievements in the Cambodian settlement, and they appreciated that such achievements would have been impossible without China's cooperation. Indonesia, especially, realized that it could not act as co-chairman of the Paris Peace Conference without at least a working relationship with China. The latter also exercised considerable self-restraint in facilitating the peaceful settlement. Improvements in China–ASEAN relations in the early 1990s were perhaps reflected in the following: in 1993, some mass media in ASEAN capitals called the year the 'ASEAN year' in Chinese diplomacy because of the frequent visits of ASEAN leaders to Beijing (Chen 1999: 228–9).

The strengthening of dialogue and mutual trust between China and the ASEAN states established a good foundation for the parties concerned to prevent the subsequent territorial disputes over the Spratly Islands from seriously damaging their relations (Cheng 1999). Chinese leaders quickly attempted to defuse the Mischief Reef incident in 1995. In March 1996, China and the Philippines held their first annual vice-ministerial talks to resolve problems caused by their conflicting claims to the Spratlys (*South China Morning Post*, 5 and 16 March 1996). Earlier, at the ASEAN Regional Forum meeting in August 1995 in Brunei, the Chinese government indicated for the first time that it would abide by international law in sovereignty negotiations with claimants to the Spratlys. This was a significant concession on the part of Beijing, which had hitherto simply insisted that the Spratlys were Chinese territory. The fact that the Chinese government allowed the issue to be brought up in a multilateral forum, albeit only in an informal consultative session, was another notable concession, because previously it had insisted on tackling the territorial dispute on a bilateral basis (*South China Morning Post*, 3 August 1995).

Both China and the concerned ASEAN states do not expect their territorial disputes over the Spratly Islands to be resolved in the foreseeable future. However, they believe that they share a common interest in maintaining a peaceful, stable environment in the region so that they can all concentrate on economic development. From the US point of view, the likelihood of armed clashes over the Spratly Islands on a scale that might prompt American involvement is low, and as long as peace and stability prevail and freedom of the seas is respected, it has no reason to be involved in the complex negotiations (Goldstein 2001).

However, the Chinese government's limited concessions have not been able to put the ASEAN states entirely at ease. There is still a serious concern with what is perceived as China's policy of gradual expansion in the South China Sea. This policy has been depicted as 'creeping assertiveness', and recently as 'talk and take' by the Philippine defence secretary (*Philippine Daily Inquirer*, 11 November 1998). 'Creeping assertiveness' is a policy of gradually establishing a greater physical presence in the South China Sea without recourse to military confrontation (Storey 2001:150–3). The perception of 'creeping assertiveness' is related to that of the China threat. Subscribers to the view of 'creeping assertiveness' believe that the Chinese military does not yet have the capability to dominate the South China Sea, and that China at this stage does not want to provoke the USA into adopting a more assertive stand in Southeast Asia and push ASEAN closer to the USA. Those who are worried about the China threat also consider that at present China is not yet a serious threat to ASEAN because of its limited military projection capabilities, but the threat will become significant in two to three decades when China becomes much stronger economically and militarily, and when China's economic development generates a huge demand for resources, especially energy resources, pushing China on to the road of expansionism. Those in ASEAN who are concerned by China's 'creeping assertiveness' and the China threat naturally welcome the renewed American efforts to revitalize bilateral security ties with Japan, South Korea, Australia, Thailand and the Philippines, as well as a more conspicuous forward deployment of US forces in the Asia-Pacific region.

Before the Asian financial crisis of 1997–98, ASEAN elites had been much encouraged by the spectacular economic development in the region and the relative economic decline of the West. They considered that the next century would be the Asia-Pacific century. Today, they have become more sober and have a more realistic assessment of the region. Catching up with the West is a more strenuous endeavour; and regional economic cooperation has become all the more important in view of the negative aspects of global capitalism. China's financial support for ASEAN in the latter's economic crisis have enhanced mutual trust between them. China's relative economic health has also won considerable admiration in ASEAN. In August 1997, China offered US$1 billion to help Thailand to overcome its financial difficulties. Similarly, it provided assistance to Indonesia. In December 1997, at the summit between ASEAN, China, Japan and South Korea in Kuala Lumpur, President Jiang Zemin pledged US$4–6 billion for the International Monetary Fund's (IMF) programme to support Southeast Asia, and to take part in other assistance programmes. Chinese leaders also promised not to devalue the renminbi so as to avoid another round of competitive devaluations among Asian currencies. Chinese leaders considered this an important contribution to stabilizing financial markets in Asia and a sacrifice on China's part, a view shared in ASEAN (*Ming Pao*, 18 April 1998).

In the wake of the Asian financial crisis, Chinese foreign policy researchers maintain their optimism regarding ASEAN's significant international status, although this optimism may have been unduly influenced by the official line. They believe that ASEAN governments will be more concerned by domestic problems, with economic recovery accorded the top priority. They will handle domestic contradictions carefully too. The established mechanisms in ASEAN and ASEAN members' respect for the principle of non-interference in each other's domestic affairs will be able to prevent frictions among them from getting out of hand. Major powers in the region also share a common interest in maintaining regional stability. Since ASEAN states are acutely aware that their solidarity has been weakened by the Asian financial crisis, and their influence in the international arena has thus been adversely affected, they will appreciate the importance of strengthening their unity and consensus. The Hanoi Declaration and the Hanoi Action Plan produced by the ASEAN summit in 1998 were seen as a reflection of this awareness. Nevertheless, Southeast Asian experts in China are closely monitoring the factors for instability in the region, especially the exacerbation of the ethnic, religious and social contradictions (Zhu 2000: 1–7).

China is obviously concerned by the military modernization plans of ASEAN states, which reached a peak before the Asian financial crisis but which have been much handicapped by their financial difficulties in recent years. The Chinese view tended not to regard this as an arms race. In the post-Cold War era, ASEAN states had to strengthen their defence capabilities in response to the reduction in security commitments to the region on the part of the USA and Russia. To varying extents, there was also concerns about the rising influence of the regional major powers, China, Japan and India. China therefore recognized that ASEAN states were worried about the uncertainty of their security in the future, as well as the emergence of potential threats.

At the same time, the strategic focus of many ASEAN states had shifted from domestic political stability to external defence, and the emphasis on military structure had correspondingly shifted from armies to navies and air forces. Economic development among ASEAN states also prompted them to strengthen national defence to safeguard their maritime resources. China's Southeast Asian experts were quick to point out that the ASEAN members that had spent more on military modernization before the Asian financial crisis were those less concerned by the China threat; Singapore, Malaysia and Thailand spent more simply because they were more prosperous and had the financial resources to do so. These experts liked to point out that territorial disputes also existed between the Philippines and Malaysia (over Sabah in earlier decades), between Malaysia and Indonesia (over the islands of Sipadan and Ligitan), between the Philippines and Indonesia (over the delimitation of the territorial seas between Mindanao and Sulawesi), and between Vietnam, Cambodia and Thailand (over the delimitation of the territorial seas in the Gulf of Siam) (Wang 1999: 10–15). In summary, China and the ASEAN states have been closely monitoring each other's military modernization programmes. They do not see such programmes as immediate threats, but they are concerned by the potential danger of getting into the vicious circle of an arms race.

Challenges to the security equilibrium in Southeast Asia

In the 1990s, the ASEAN states were able to maintain a security equilibrium in Southeast Asia and promote security cooperation in the region because all the major powers involved had neither the intention nor the capability to dominate the region. They were willing to allow ASEAN to take the initiative in the ASEAN Regional Forum and other regional organizations. ASEAN's significant role was therefore premised on the common interest among the major powers in maintaining the regional security equilibrium. Tension between the major powers will limit the role of ASEAN; and confrontation between the major powers will disrupt the equilibrium and force ASEAN states to take sides, a scenario that the latter will try their best to avoid.

In this connection, the difficulties and tensions in Sino-American relations during the first months of the Bush administration have caused considerable concern among ASEAN states. Since the break-up of the Soviet Union, ASEAN states have been applying a policy of linkage to ensure continued American military involvement in regional security affairs. They offer access to US forces to facilitate the latter's maintenance of a strong military presence in East and Southeast Asia to balance against China, and to prevent possible rivalry developing among the region's middle powers (de Castro 2000: 60–80). The Asian financial crisis has further enhanced the USA's role as the indispensable guarantor of regional political and economic stability. Singapore, for example, now sees a need to strongly encourage continued US involvement in Southeast Asia as a protection against any political unrest spilling over from its neighbours.

If China and the USA perceived each other as strategic partners, the American military presence in Southeast Asia would not be seen as a threat to China. If both countries treat each other as competitors, then Beijing's tolerance would be much reduced. When the two countries engage in confrontation, the forward deployment of the US forces in the region will become a source of friction involving the ASEAN states. An early indicator emerged on 17 April 2001, when a People's Liberation Army (PLA) naval patrol vessel intercepted three Australian warships sailing through the Taiwan Straits. The key allies of the USA in East and Southeast Asia generally interpreted this as a disturbing signal that they are likely to come under pressure from the Chinese leadership as the two countries move towards strategic competition. Despite expanding Sino-American economic ties, Beijing and Washington apparently have less and less motive for strategic cooperation (Lague and Saywell 2001: 16–21).

The spy plane incident, substantial arms sales to Taiwan and the progress in development of the National Missile Defence programme escalated tension in Sino-American relations in the early months of the Bush administration. American allies that have been strengthening their security ties with the USA in the past decade will begin to feel the squeeze if the region's two major powers step up their rivalry. The regional security situation has been further complicated by the deterioration in Sino-Japanese relations and the Bush administration's attempt to drive a wedge between Moscow and Beijing, especially regarding the National Missile Defence programme. Sino-Japanese relations have also entered a period of difficult adjustments in recent years. Mutual distrust has been increasing, and it has been exacerbated by the Taiwan issue and the failure to resolve the historical legacy relating to the Second World War. The Chinese leadership's eagerness to achieve breakthroughs in relations across the Taiwan Straits led to the exertion of greater pressure on Taiwan, as in the crisis in 1995/96. Direct outcomes of the tension in the Taiwan Straits have been the strengthening of US–Japan defence cooperation, Japan's rapid growth in military capability, and the likely incorporation of Taiwan into Japan's area of security vigilance under the pretext of 'situation in areas surrounding Japan that have an influence on Japanese peace and stability' (Wang Yunlang 1995: 7–10). In the eyes of Beijing, the USA's system of security alliances, including the US–Japan security alliance, is aimed not only at a common enemy but also against a specific ideology or civilization, especially when a Sino-American 'strategic partnership' becomes impossible. Furthermore, in the case of Japan, South Korea and Taiwan, military alliance and defence cooperation are more than a common defence arrangement; they also serve as mechanisms for Western values and ideas to penetrate into regional societies (Ji 2000: 140).

Competition between China and Japan may well deteriorate in the years to come. Japan is already a political power with formidable military strength. China's economy and military capabilities will continue to develop. How a powerful China lives with a powerful Japan poses a question never experienced by the two countries in their modern history. This adjustment process will be made all the more difficult in the event of a serious setback in Sino-American relations; Japan will then be forced into the awkward position of having to choose between the USA and China. The rising nationalism in both China and Japan is also a negative factor to reckon with. How Japan responds to such an awkward position will certainly have a significant and demonstrable effect on ASEAN states.

The Chinese leadership has been seriously concerned by the Bush administration's efforts to win over the Putin government regarding the National Missile Defence programme. It observes that Vladimir Putin's pragmatism means that he will be keen to maintain good relations with the USA and other Western countries; and unlike his predecessor, Boris Yeltsin, he will be prudent enough to avoid proposing an alliance between Russia, China and India to curb American domination in international affairs. The Sino-Russian Good Neighbourly Treaty of Friendship and Cooperation concluded in July 2001 reflects this common interest (*South China Morning Post*, 15–19 July 2001; *International Herald–Tribune* 17 July 2001; *Ming Pao*, 18 July 2001). It also reveals that both Beijing and Moscow were eager to demonstrate to the world that they shared a special relationship, although both parties wanted to avoid provoking the USA and declared clearly that the treaty did not amount to an alliance and was not directed against the USA. To some extent, the treaty was also a response to the Bush administration's scheme to isolate China by winning over Russia. While the re-emergence of the 'strategic triangle' in the post-Cold War era initially may not have serious effects on the foreign policy positions of ASEAN states, Chinese leaders will probably have a more negative view concerning security cooperation between the USA and its Asian allies, and they will be more eager to forge closer ties with ASEAN states. Regarding the former, it is interesting to note that an American strategic research report recently indicated that the USA had been supporting Singapore's military modernization to safeguard its expanding regional economic interests. The USA further hoped that in ten years, Singapore would become an important regional military power, and instead of remaining neutral, it would assume the role of a significant link in the US security chain around China.

In April 1999, ASEAN formally admitted Cambodia and completed its objective of involving all ten Southeast Asian countries under its umbrella. However, ASEAN's enlargement has generated problems within the organization (Kraft 2000: 453–72). The spectacular economic gaps between its members, for example, between Singapore and Laos, have certainly made consensus building much more difficult. Such gaps present serious obstacles to ASEAN's ability to adopt a common stand within a reasonable period in response to the new security and economic challenges. With the fall of Suharto, and Mahathir Mohamed severely weakened by domestic problems, ASEAN now suffers from a lack of leadership. The regional organization did not set clear criteria on the entry of Cambodia, Laos, Myanmar and Vietnam, and there are serious questions on their preparedness to participate in ASEAN effectively. Moreover, Myanmar has caused considerable strain in ASEAN's relations with its dialogue partners. All these have cast doubt on ASEAN's ability to minimize problems stemming from the potential competition between China and the USA. So far, both countries have been courting ASEAN, especially China; but the real challenges may emerge only gradually.

The ASEAN+3 approach

On the basis of the author's interviews, the Chinese authorities, in view of the difficulties in Sino-American relations, now attach top priority to East Asian cooperation following the formula of 'ASEAN-10 plus China, Japan and South Korea' (Zhang 2001: 1–4). This was in fact the East Asian Economic Group (EAEG) proposal from the Malaysian Prime Minister, Mahathir Mohamed, in the early 1990s based on his desire to create a new Asian political bloc excluding the 'white' nations in the Asia-Pacific (Tan 1995: 208; Fukuyama 1998: 23).

The summit meeting between the then nine ASEAN members plus China, Japan and South Korea in Kuala Lumpur in December 1997 was thus an important breakthrough in the eyes of Malaysia, Singapore and China, because the earlier opposition from the USA had finally been overcome. According to China's Asian experts, the real driving force was derived from the Asian financial crisis in 1997–98. The lukewarm support from the USA, the faulty and harsh rescue packages offered by the IMF and the inaction on the part of APEC all made East Asian leaders appreciate the significance of regional cooperation. Furthermore, the difficulties in ASEAN states in the wake of the financial crisis prompted ASEAN leaders to turn to East Asia; at the same time, East Asian countries were seeking ways to exploit the evolution of the ASEAN Free Trade Area (AFTA). By then, about half of the foreign trade of East Asian countries was intra-regional, and roughly two-thirds of their foreign investment also came from within the region.

At the third ASEAN+3 summit in November 1999, a joint statement on East Asian cooperation was released. On the basis of the previous agreements reached, the fourth summit held in 2000 in Singapore was considered a significant step in regional cooperation. It confirmed the earlier Chiang Mai agreement on regional monetary cooperation, the human resources action plan and the Greater Mekong River development project; and it also agreed to consider an East Asian free trade and investment area. Subsequently, an East Asian Vision Group was established with the responsibility of reporting to further summits on long-term regional cooperation. It would study (1) an East Asian free trade and investment area; (2) a regional monetary fund and exchange regime; and (3) regional institutional building on economic and financial cooperation, as well as political, security, social and cultural exchanges and cooperation to strengthen regional identity. Chinese leaders seem to have adopted the stance that political and security cooperation is one of the important areas for further development. According to Zhang Yunling, besides annual summits and ministerial meetings, the Chinese authorities have the following ambitious objectives for ASEAN+3: (1) a concerted voice in international affairs; (2) a regional parliamentary committee; (3) a defence ministers' meeting and East Asian security cooperation council; and (4) joint action on cross-border issues (Zhang 2001: 1–3).

At the eighth ASEAN summit in Phnom Penh in November 2002, two important agreements were reached between China and ASEAN, creating the world's largest free trade zone and establishing an accord on the disputed Spratly Islands in the South China Sea. The Framework Agreement on Comprehensive Economic Cooperation provides for the setting up of a free trade area between China and the six original ASEAN states in 2010, and the whole of ASEAN in 2015. Chinese leaders hope that the agreement will persuade ASEAN to perceive China as an economic partner rather than a competitor. The Declaration of Good Conduct in the South China Sea, on the other hand, serves as a code for avoiding armed conflict. Although non-binding, it obliges the ten ASEAN members and China to shun any activity that would damage or complicate the relations between them (*South China Morning Post*, 5 November 2002).

Chinese leaders' worries about the deterioration in Sino-American relations and the potential danger of the 'containment' of China by Western countries has been an important motivation for their promotion of East Asian regionalism through the 'ASEAN plus China' and the 'ASEAN+3' routes. On the part of ASEAN states, they hope that this regionalism may enable them to deal with Western countries from a position of strength on issues such as protectionism, in contrast to their impotence during the Asian financial crisis. They share Beijing's resentment against Washington's arrogance and unilateralism, as well as its promotion of a more multi-polar world. They are disappointed with APEC's failure to serve as an engine to push the World Trade Organization (WTO) to launch a new round of global trade negotiations; they have become more cautious about globalization too (Singh 2001: 10–13).

Japan and South Korea will obviously be very concerned by the Bush administration's position on the ASEAN+3 process; and they would not like to see the process weaken the American presence in Asia or their relations with the USA. At the same time, even the most enthusiastic proponents of East Asian regionalism in ASEAN, Singapore and Malaysia, have been trying to tone down its significance. As long as the Chinese leadership is aware of the limitations of the ASEAN+3 process and does not overplay its desire to exclude the USA, it should be satisfied with the breakthrough. ASEAN states, especially those sharing borders with China, want to maintain friendly relations with the emerging major power through constructive engagement. China, too, has been restrained by the strategic competition with the USA and is therefore eager to build goodwill and avoid contentious issues. Chinese Vice-President Hu Jintao, in his visit to Indonesia in July 2000, condemned 'Cold War mentality, hegemony and power politics' and pledged that China would be guided by the spirit of 'genuine mutual respect, mutual co-operation, consensus through consultation … rather than bullying, confrontation and imposition of one's will upon others in its relationship with ASEAN' (Mitchell 2000: 20–2). ASEAN leaders certainly hope that such a promise will be fulfilled, and they in turn will respect China's vital interests while maintaining a regional balance of power.

Economic relations between China and ASEAN

Trade between China and ASEAN states had been expanding at a respectable rate in the decade before the Asian financial crisis. In the wake of the economic setback, however, such trade stagnated when both parties turned to increase their exports to the USA and Western Europe. In 2000, such trade began to show respectable growth rates again (see Table 13.1). In May 2001, when the global economic slowdown threatened to stall the regional economic recovery, ASEAN labour ministers appealed to senior officials from China, Japan and South Korea in their first joint annual meeting for funding and technical assistance for programmes aimed at easing regional unemployment stemming from the global downturn. The ASEAN ministers especially urged China to continue to open its market to help to enhance the slackening demand for ASEAN exports. With Beijing's successful bid for the 2008 Olympic Games, healthy economic growth (7.9 per cent in the first half of 2001) and China's impending entry into the WTO, ASEAN states have considerable expectations of China to contribute to their economic recovery (*South China Morning Post*, 15 May and 20 July 2001).

In principle, ASEAN states welcome the proposal from Chinese Prime Minister Zhu Rongji for the establishment of a free trade area between China and ASEAN. However, both parties appreciate that this is only a long-term objective. They see considerable complementarity between their economies and significant potential in economic cooperation and trade development. China's Southeast Asian experts indicated that China–ASEAN trade amounted to only 6 per cent of China's total trade; and that the achievement of free trade between the two sides would require arduous, lengthy negotiations. Certain sensitive product categories would also be controversial (*Ming Pao*, 28 November 2000).

On the other hand, ASEAN states are very concerned that they have been left behind in the race with China for foreign investment. From 1994 to 1999, foreign direct investment (FDI) flows into ASEAN dropped from US$20.37 billion to US$16.19 billion. As a share of the world total, it declined from 8 to 1.9 per cent in the same period. On the other hand, FDI flows into China increased from US$33.78 billion in 1994 to US$40.4 billion in 1999 (Freeman 2000: 27–43; UNCTAD 2000). Singapore Trade Minister George Yeo Yong Boon observed that in 1999, China absorbed 40 per cent of FDI into East Asia; while actual FDI to China was little changed in 2000, approved investments jumped 50 percent in anticipation of China's entry into the WTO. Overall, ASEAN's share of investment in East/Southeast Asia (excluding Japan) dropped from 35 per cent in 1996 to only 17 per cent in 1999. Yeo further noted that a survey had shown that China was the second most attractive destination for global FDI after the USA (China actually overtook the USA and became the most attractive destination in 2002), while another study by the Japan External Trade Organization revealed that ASEAN had borne the brunt of the decline in Japan's FDI to East Asia in the past three years. Japanese investments in Indonesia, Malaysia, the Philippines and Thailand declined by more than half between 1997 and 1999. In the first half of 2000, while FDI from Japan increased in South Korea, Taiwan and China, Japanese investments in the original five ASEAN states plunged by between 27 and 70 per cent (*Sunday Morning Post*, 4 March 2001).

At the same time, China has also been attracting FDI from ASEAN states, especially from their ethnic Chinese communities (see Table 13.2). In 2001 alone, US$2.987 billion was invested in China by the Southeast Asian business community, although 71.8 per cent of this came from Singapore alone. Among China's coastal provinces, there will be increasingly keen competition for investment from ASEAN states. Guangdong Party Secretary Li Changchun, made a strong pitch for Singapore's business community to increase its trade and investment links with southern China during his visit to the island state in May 2001 (*South China Morning Post*, 14 May 2001). Apart from the competition from China, the main reason for the serious decline in FDI flows into ASEAN had been foreign investors' perception of increased political risk and economic instability in many countries in the region. The absence of clear direction and coherence in political decision making in some ASEAN states also turned foreign investors away. Awareness of such problems finally prompted ASEAN leaders to cross a previously forbidden line and discuss each other's domestic problems at the informal Singapore summit in November 2000 (*Sunday Morning Post*, 26 November 2000). Singapore in particular has been highlighting the strong competition from China to persuade its ASEAN partners to promote trade and investment liberalization within the regional organization.

An important area of achievement in East Asian regionalism was the Chiang Mai Initiative, agreed in May 2000 during the ASEAN+3 finance ministers' meeting. It involves an expanded ASEAN swap arrangement that would include all ASEAN countries and a network of bilateral swap arrangements between ASEAN states, China, Japan and South Korea. The arrangement aims at offering support for member countries encountering short-term foreign exchange difficulties. It is intended to discourage a repeat of the 1997 crisis by linking the foreign exchange reserves of the thirteen countries concerned, which amount to almost US$1 trillion. Some analysts think that the currency safety net foreshadows the creation of an Asian Monetary Fund (Singh 2000: 10; *Sunday Morning Post*, 13 May 2001). In May 2001, Japan indicated that it had agreed to set up a US$3 billion currency swap arrangement with Thailand, a US$2 billion agreement with South Korea and a US$ 1 billion facility with Malaysia. All parties concerned planned to complete all the main currency swap deals by May 2003 so as to finish the work in time for the annual conference of the Asian Development Bank (ADB) in Istanbul (*South China Morning Post*, 28 November 2002).

East Asian regionalism will also be strongly supported by road, rail and water transport links between China and ASEAN states. At the informal ASEAN+3 summit in Singapore in November 2000, Chinese Prime Minister Zhu Rongji indicated that Beijing was ready to fund construction of a Lancang–Mekong development project in Myanmar and Laos, paving the way for commercial navigation on the Mekong from Thailand to China.

Development of the Mekong basin will help to promote economic growth in the area and reduce the development gap between Southeast Asian countries. China, along with Thailand and the ADB, is also ready to build the Laos section of the proposed Kunming–Bangkok highway. A rough road already connects Kunming and Bangkok, but it is of poor quality. Finally, ASEAN leaders have endorsed the US$2.5 billion Trans-Asian railway project joining Kunming and Singapore. Most of the 5,513-kilometre railway is already in place, and the project can be completed by 2006. Japan is expected to be a major source of soft loans for the project, while China intends to participate in the construction through bidding (*Sunday Morning Post*, 26 November 2000).

Tourism is also expected to be an important growth point in China's economic links with ASEAN. In 2000, Thailand received 707,456 tourists from China, Singapore 262,776, Malaysia 86,696, the Philippines 33,647 and Indonesia 19,936; Vietnam attracted 605,167 Chinese tourists in 1999 (Murphy 2002: 22–4). The Tourism Secretary of the Philippines, Dick Gordon, expressed disappointment concerning the Philippines' share of the China market and in March 2001 announced that his department would target China in its overseas marketing efforts (Lim 2001). In view of China's economic growth, its segment of population who can afford to take holidays in Southeast Asia will expand rapidly. In terms of numbers at least, tourists from China will be just as important as those from Japan in the eyes of Southeast Asia's tourism industry.

Territorial disputes and the Taiwan question

During the visit of Vietnamese President Tran Duc Luong to China in December 2000, the two countries reached agreements settling a longstanding border dispute in the Gulf of Tonkin. They had reached an agreement settling their land border in March 1999. The Spratly and Paracel Islands were not discussed during the visit, although in the joint statement released, both sides 'agree to maintain the existing negotiation mechanism on the marine issue' (*Ming Pao*, 26 December 2000; *South China Morning Post*, 27 December 2000). Since the Paracel Islands are in China's hands, and it is a bilateral dispute between China and Vietnam, the Spratly Islands remain the most significant territorial dispute between China and the concerned ASEAN states, i.e., Brunei, Malaysia, the Philippines and Vietnam. Taiwan also claims sovereignty over the Spratlys, but it has largely been ignored in the negotiating process.

As previously mentioned, China and the concerned ASEAN states do not expect their territorial disputes over the Spratly Islands to be resolved in the foreseeable future. At the same time, they believe that they share a common interest in maintaining a peaceful, stable environment in the region so that they can all concentrate on economic development. However, frequent diplomatic confrontations and occasional military tensions over the islands occur, and they have been managed in a piecemeal and *ad hoc* way by the states involved. While the danger of a regional military crisis remains low, allowing the above situation to continue indefinitely is certainly risky and unsatisfactory (Furtado 1999: 386–404). The Declaration of

Good Conduct in the South China Sea is obviously an important step in the right direction, although difficulties remain.

Despite settlement of the disputes over the land border and the Gulf of Tonkin, Hanoi seemed to maintain an uncompromising position concerning the Spratly Islands. When Chinese Vice-President Hu Jintao visited Vietnam during the Ninth National Congress of the Vietnam Communist Party in April 2001, Vietnamese Foreign Minister Nguyen Dy Nien announced that the Ten-Year Economic Plan endorsed by the congress indicated that the government would establish settlements in 'islands related to national security', i.e., the Spratlys, build strategic logistical bases there and strengthen coastal defence (*Ming Pao*, 21 April 2001). The Ninth Party Congress was an important meeting to announce the new leadership. Party General Secretary Le Kha Phieu stepped down to make way for National Assembly Chairman Nong Duc Manh. Party elder Do Muoi indicated that 70-year-old Le had to retire not only because of his age but also because of 'mistakes in his work'. Many observers believe that such 'mistakes' included concessions made to China in settling the land border and Gulf of Tonkin disputes (*Ming Pao*, 21 April 2001). It has often been noted that a pro-China faction and a pro-Russia faction exist in the Vietnamese leadership; the former is a minority, while the majority is still suspicious of China's strategic designs. It is likely that relations with China will continue to be a divisive issue in the Vietnamese leadership.

The Philippines has also been very critical of China's assertive behaviour in the South China Sea. The Philippines has a defence treaty with the USA, but the latter does not consider areas of the Spratlys claimed by the Philippines as covered by the treaty and has called for a peaceful resolution of the territorial dispute (*South China Morning Post*, 24 July 1995; *Ming Pao*, 22 May 1995). In June 1995, Assistant Secretary of Defense for International Security, Joseph Nye, announced that if military conflict in the South China Sea interfered 'with the freedom of the seas, then the U.S. would be prepared to uphold freedom of navigation' (Dobson and Fravel 1997: 262). Hence, Beijing's acceptance of a commonly agreed code of conduct will help to forestall further US involvement in the South China Sea dispute.

Although Indonesia is not a claimant to the Spratlys, it was concerned by the potential conflict between some ASEAN states and China over oil and gas resources in the South China Sea. It was significant that President Suharto endorsed the Agreement on Maintaining Security with Australia in June 1995, only a few months after the Mischief Reef incident. Before Suharto's resignation in May 1998, the Clinton administration had seemed to be interested in establishing some kind of strategic partnership with Indonesia. At the APEC summit in Vancouver at the end of 1997, it was reported that Clinton had planned an 'extremely important' meeting with Suharto. The speculation was that the leaders wanted to discuss the possibility of bilateral military cooperation (*Ming Pao*, 22 November 1997). The Asian financial crisis had forced Indonesia to turn inwards. Former President Abdurrahman Wahid was perceived to be friendly towards China, and whether the rising nationalism under the administration of

Megawati Sukarnoputri will exacerbate Indonesian suspicions of China deserves attention.

Malaysia, on the other hand, has been playing down the China threat theory. Since the mid-1990s, Malaysian Prime Minister Mahathir Mohamed has often stated that his government accepts Chinese pledges of peaceful coexistence with its neighbours and non-interference in other countries' domestic affairs (*Business Times*, 12 November 1994). He argues that it is important to accept Beijing's promises without reservation, otherwise a China threat may become a self-fulfilling prophecy if countries begin to perceive China as a potential threat.[2] Naturally, the Chinese side is grateful for Malaysia's denunciation of the China threat theory (Wang Daohan 1995).

The Chinese leadership understands that its handling of the Spratlys territorial dispute is seen as a litmus test by ASEAN in many ways. It still faces an arduous task in reducing or eliminating fears of a China threat among ASEAN states. The PLA's emphasis on improving its capabilities to win regional wars by employing advanced technology will only exacerbate ASEAN's worries. There is a view among many ASEAN leaders that China promises to resolve the territorial dispute peacefully through negotiations and explore ways of jointly developing the maritime resources while it quietly expands its physical presence in and around the archipelago. More self-restraint is certainly called for in enhancing mutual trust.

In comparison with the territorial disputes, Taiwan is less of a problem in China–ASEAN relations. After the USA and Japan, ASEAN states are probably the most important targets of Taiwan's pragmatic diplomacy. Taipei has been trying to exploit economic engagement as a means of securing varying degrees of quasi-diplomatic recognition and status in an attempt to expand its room for manoeuvre in the international community. In the five original members of ASEAN, substantial trade and investment ties have paved the way for quasi-diplomatic establishments in their capitals as well as diplomatic privileges and immunities for the Taiwanese staff. The extent of these privileges depends on the significance of the trade with Taiwan, that of investment from Taiwan, and the political orientation of the government concerned (Leifer 2001: 173–85). The Philippines, for example, has offered Taipei most favourable treatment; and Singapore, largely through Senior Minister Lee Kuan Yew, has been in the unique position of enjoying the trust of both Beijing and Taipei. It has a special relationship with both, and Lee has been able to advise both sides publicly and privately on the handling of their relations.

ASEAN states understand that the focus of the present Sino-American strategic competition is Taiwan, which the Chinese leadership has threatened to retake by force if it indefinitely delays negotiations on reunification. As discussed above, ASEAN states do not want to see a Sino-American confrontation, which will force them to choose between the two and which will disrupt their plan of involving all major powers in the region and maintaining a security equilibrium. Under present circumstances, ASEAN states will probably quietly try to persuade Washington and Beijing to exercise self-restraint and maintain their 'one China' policy more cautiously. They had, for example, refused to support Taiwan's initiative to seek a place at the United Nations from 1993 onwards, with its bid being made on behalf of the Republic of China on Taiwan. Similarly, they declined to endorse the proposal from August 1999 onwards when it was presented by twelve states with diplomatic relations with Taiwan to the United Nations Secretariat seeking the admission of Taiwan to the world body. But they certainly would not accept that their economic ties with Taiwan be adversely affected.

The Taiwan issue will continue to be a source of friction in China's relations with some ASEAN states. However, the Chinese leadership respects the economic ties between ASEAN states and Taiwan, while ASEAN states have no intention of violating their recognition of the government of the People's Republic of China as the sole legal government of China. Lee Teng-hui and Chen Shui-bian's definitions of the state of relations between the two sides of the Taiwan Straits in recent years have basically not affected ASEAN states' ties with Beijing and Taipei; it is not expected that Taiwan's pragmatic diplomacy will achieve any significant breakthroughs in its relations with ASEAN states in the foreseeable future, despite the significance of Taiwan's trade with and investment in the region. Beijing's serious suspicions of the Chen Shui-bian administration will probably make ASEAN states more cautious in dealing with Taipei.

Conclusion

The Asian financial crisis and the domestic political problems in some ASEAN states have obviously weakened the regional organization's influence. However, Sino-American strategic competition has increased ASEAN's weight in Chinese foreign policy. The Chinese leadership is worried about the emergence of a new US-led Asian security alliance composed of Japan, South Korea and Australia; and it appreciates the reluctance of ASEAN states to get involved, despite their eagerness to retain a substantial American military presence in the region (*South China Morning Post*, 1 August 2001). Hence, the bargaining power of ASEAN states has been increased in their dealings with China. The Bush administration's determined development of the National Missile Defence programme and the Chinese leadership's promotion of ASEAN+3 at the expense of APEC will continue to exacerbate Sino-American strategic competition. Since both China and the USA still want to avoid a sharp deterioration in their bilateral relationship, ASEAN states probably will not encounter a situation in which they will have to choose between the two in the foreseeable future. However, the regional organization has yet to regain its vigour and initiative to be in a position to persuade Beijing and Washington to exercise restraint.

The interest of ASEAN states in East Asian regionalism and the ASEAN+3 model has to be balanced against the need to strengthen ASEAN and to avoid neglecting the promotion of an open regionalism through the ASEAN Regional Forum and APEC. The Chinese leadership has to appreciate the limitations of the ASEAN+3 approach, because its other members have no intention of excluding the USA in their attempts to develop regional ties.

China's uninterrupted economic growth in the wake of the Asian financial crisis and its anticipated entry into the WTO have enhanced its attraction as a market for ASEAN states. In view of Japan's economic stagnation, it is now considered a more important locomotive in generating regional economic growth. There is a genuine concern that investment flows into China may reduce those into ASEAN states. However, the international financial community tends to see differently. Many investment bankers believe that FDI flows to China and to the rest of Asia have been complementary, not competitive. In the first half of the 1990s, when there was a significant upsurge in FDI going into China, FDI flows to the rest of Asia also increased. Similarly, during the slowdown of investment flows into the large resource-based Southeast Asian economies in recent years, FDI flows into China dropped too (Saywell 2001: 40–3). According to Cliff Tan, since Asian countries are at different development stages, FDI may be attracted by the comparative advantages within the region: some to abundant labour, some to technological know-how, etc. Moreover, capital movement is motivated by the desire of multinational firms to be close to their ultimate customers and other partners in the production processes. Hence there are considerable incentives to diversify investment if the market in Asia is also dispersed (*ibid.*: 41).

The extent to which China provides demand for ASEAN exports is increasingly important. Asia excluding Japan provided 36 per cent of China's imports in 2000, compared with 10 percent by the USA and 14 per cent by Europe. Taiwan secured a market share of 11 per cent, South Korea 10 per cent, Hong Kong 4 per cent and ASEAN states more than 9 per cent (*ibid.*: 42).

It seems that ASEAN will benefit disproportionately from China's entry into the WTO. It has also been observed that servicing China's expanding middle class is likely to become an increasingly important source of revenue for ASEAN states, especially Thailand and Singapore. Chinese tourists in ASEAN states have already been mentioned; Asian companies that can capitalize on exporting agricultural goods to China's more discerning middle class will also do well.

It is to be hoped that economic contacts will enhance mutual understanding between China and ASEAN, especially at the people-to-people level. The strengthening of common economic interests will provide a better foundation for confidence-building measures, preventive diplomacy and eventually conflict resolution. China has been active in multilateral diplomacy, especially at the regional level. For example, a forum conceived in September 1998 by regional statesmen including former Australian Prime Minister Bob Hawke and former Philippine President Fidel Ramos received strong support from the Chinese government. The Bo'ao Forum for Asia, which was held in Hainan in China in February 2002, was intended to give regional states an opportunity to discuss their problems on their own terms (*South China Morning Post*, 27 February 2001).

The Chinese government's enthusiastic support for a non-governmental and non-political organization driven by the private sector is a sign of the times.

Chinese leaders are now ready to play a more active part in the Track-II process. All these constitute positive factors in the gradual erosion of the distrust by ASEAN states of China and their fear of the 'China threat'.

Notes

1 In June 2001 and December 2002, I visited the Chinese Academy of Social Sciences, Beijing University, the Central Party School, the China Institute for International Strategic Studies and the Shanghai Institute of International Studies. I held extensive discussions with over fifty academics and researchers on Chinese foreign policy, with special reference to China's ASEAN policy. In May/June 2001 and September/October 2002, I also interviewed staff members of the ASEAN consulates-general in Hong Kong, concentrating on their respective countries' relationships with China and on ASEAN–China relations in general. This is a substantially revised version of a paper published in *Contemporary Southeast Asia* 23 (3): 420–51.

2 See, for example, the speech delivered by Malaysian Prime Minister Mahathir Mohamed at the Nihon Keizai Shimbun Conference on 'The Future of Asia', 17 May 1996, Tokyo, Japan.

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