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1 The East Asian Trading Bloc: An Analytical History

Peter A. Petri

1.1 Introduction

The phenomenal expansion of East Asia's[1] intraregional trade—from $116 billion to $265 billion between 1985 and 1990—has raised the prospect of an East Asian economic bloc that could more than match the scale of either the European or North American trading area. This bloc would inevitably be dominated by Japan, and thus trade frictions between Japan and the United States could be generalized into a massive confrontation among giant economies. Against the background of declining U.S. competitiveness and suspicions about the "fairness" of global markets, some observers see sinister motives behind growing East Asian interdependence. Some scholars even go so far as to argue that Japan's recent investment, aid, and trade patterns "cloak political and conquistadorial designs similar to those in the past" (Montgomery 1988, xiii).

These issues are examined here in a historical and analytical context. I will show that East Asia has been and continues to be a trading bloc in the sense that its trade is more regionally oriented than would be expected on the basis of random trade patterns. As Frankel shows in chapter 2 of this volume, this is true even while controlling for geographical proximity. Moreover, East Asian interdependence has intensified in the last five or so years. But I will also show that recent increases in interdependence are small in a historical context, and that the East Asian economy has steadily *dis*integrated during the previous three decades. East Asia is *less* interdependent today than it was for most of

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1. The regions referred to in this paper will be North America (Canada and the United States), East Asia (China, Hong Kong, Indonesia, Japan, Korea, Malaysia, Philippines, Taiwan, Thailand, and Singapore), and Pacific Rim (North America, East Asia, Australia, and New Zealand).

the twentieth century, save for short periods of time in the aftermath of World War II and during the mid-1980s. The key long-term story has been the shift of East Asian linkages from regional partners to a more diversified group of countries, including the United States.[2]

Nevertheless, there is reason to see 1985 as a turning point in these trends. East Asian interdependence has not greatly intensified so far, but the break with previous trends is clear. In addition, still larger changes have taken place in investment linkages, and these foreshadow future trade changes. These developments, combined with anecdotal evidence on how individual agents and governments are stepping up investments in regional linkages, suggest that from now on the East Asian trading bloc may be strengthening rather than continuing to dissolve.

The analytical base of this paper is a simple model of bloc formation. The model begins with the idea that a trading bloc's intrabloc bias—its preference for inside rather than outside partners—rests on low intrabloc transaction costs compared to outside-bloc transaction costs. Intrabloc transaction costs can be reduced by investments in intrabloc linkages—for example, in transport links, economic policies that facilitate integration, or information about regional business opportunities. These investments, in turn, depend on economic and/or political developments that draw the bloc's countries closer together. The process of bloc formation is dynamic, because a growing volume of intrabloc trade itself provides incentives for investing in linkages. Thus "historical accidents" that bring economies together may well be amplified and perpetuated by the linkage investments that they induce.

Three major historical developments are important for understanding East Asian interdependence. The first is the development of Asian treaty ports in the nineteenth century, which established a network of trade driven by major ports such as Singapore, Hong Kong, Manila, and Shanghai. A second is Japan's imperial expansion, which created a very high level of economic integration among the economies of northern East Asia. Finally, the spectacular growth of the region's economies is emerging as a new force for integration today: as East Asian countries are becoming increasingly important to each other, they are beginning to invest heavily in linkages that are very likely to increase their intraregional bias.

It is also possible to identify forces that have worked against regional integration in the postwar period. These include the central role of the United States in the postwar Pacific economy, the rapid economic development of the region, which enabled its economies to enter many new global markets, and the general integration of the world economy due to trade liberalization and improvements in transport and communications. This paper attempts to trace

2. The importance of the United States in the Pacific trade network is examined in some detail in Petri (1992). That study concludes that these transpacific connections make it unlikely that any exclusionist East Asian bloc could develop in the near future.

how the changing balance of these pro- and antiregional forces has led to the complex pattern of rises and declines that have characterized East Asian economic integration.

1.2 Measures of Interdependence

There is no single, widely accepted measure of interdependence. As we shall see, the reason for this is that the appropriateness of a particular measure depends on the uses to which it is put. Briefly, three different types of measures are frequently used. Let x_{ij} represent exports from country i to country j, and the subscript $_*$ (in place of i or j) represent the summation across all i or j. Thus x_{i*} represents the total exports of country i, x_{*j} the total imports of country j, and x_{**} total world trade. In this notation, the three commonly used concepts of interdependence are (1) *absolute* measures of trading intensity, which deflate a particular bilateral (or intraregional) trade flow with overall world trade:

$$A = x_{ij}/x_{**};$$

(2) *relative* measures of trading intensity, which deflate absolute intensity with *either* the worldwide export share of the exporting country, or the worldwide import share of the importing country:

$$B = A/(x_{i*}/x_{**}) = x_{ij}/x_{i*} \qquad \text{or} \qquad B' = x_{ij}/x_{*j};$$

and (3) *double-relative* measures of trading intensity, which deflate absolute intensity with *both* the worldwide export share of the exporting country and the worldwide import share of the importing country:

$$C = A/\{(x_{i*}/x_{**})\,(x_{*j}/x_{**})\} = x_{ij}x_{**}/x_{i*}x_{*j}.$$

In effect, measure A compares the scale of a particular bilateral (or intraregional) trading relationship to worldwide averages, measure B compares it to the trade shares of one or the other of the two partners participating in the relationship, and measure C compares it to the product of the trade shares of both partners. These indexes of trading intensity can evolve quite differently over time. For example, exports from X to Y could grow rapidly compared to world trade (rising A measure), but could still fail to keep pace with X's rapidly increasing share of world exports or Y's rapidly increasing share of world imports (declining C measure). The double-relative measures calculated as the C measure in this study are commonly described as "gravity coefficients" in the literature.[3]

Each of these measures of trading intensity is appropriate for answering a particular type of question. For example, if one is interested in the relative stakes or influence of different groups of countries in global trade negotiations,

3. Some of the early studies based on gravity coefficients include Linnemann (1966) and Leontief and Strout (1963).

it may make sense to compare their trade volumes to world levels by using an absolute intensity index. Alternatively, if one wants to know to what extent a country will respond to the interests of a particular partner (or group of partners), then the intensity of the bilateral (intrabloc) trading relationship is best judged using a relative measure (in effect, the share of the partner[s] in the country's trade). Finally, if one wants to assess the extent of trade biases toward particular partners (or groups of partners) relative to the neutral of assignment of trade across all partners, then double-relative indexes, or gravity coefficients, provide an appropriate answer.

The evolution of East Asian interdependence is summarized, using each of three measures defined above, in table 1.1 and figures 1.1–1.3. The data used represent the longest consistent time series available on international trade flows, and were assembled from the International Monetary Fund's *Direction of Trade* and its many precursor publications. The measures shown are all calculated for *two-way* trade, that is, with x_{ij} defined as the sum of both exports and imports between i and j (not just as exports from i to j as in the previous discussion).

In absolute terms (table 1.1 and fig. 1.1), East Asian intratrade is only slightly larger than North American intratrade, and considerably smaller than Western European intratrade. Indeed, East Asia's share of world trade is still smaller than it was during the height of the Japanese empire before World War

Table 1.1 **Measures of Regional Interdependence (exports plus imports)**

	1938	1955	1969	1979	1985	1990
Absolute measure: intratrade as share of world trade						
North America	0.030	0.067	0.069	0.042	0.064	0.053
Western Europe	0.182	0.196	0.287	0.293	0.271	0.338
East Asia	0.100	0.022	0.029	0.042	0.064	0.079
Pacific Rim	0.180	0.135	0.169	0.156	0.248	0.246
Relative measure: intratrade as share of regional trade						
North America	0.227	0.334	0.379	0.287	0.330	0.313
Western Europe	0.461	0.491	0.647	0.664	0.654	0.712
East Asia	0.671	0.313	0.293	0.332	0.363	0.407
Pacific Rim	0.583	0.450	0.566	0.545	0.643	0.649
Double-relative measure: gravity coefficients						
North America	1.73	1.65	2.09	1.95	1.71	1.84
Western Europe	1.16	1.23	1.46	1.51	1.58	1.50
East Asia	4.48	4.45	2.97	2.64	2.05	2.09
Pacific Rim	1.89	1.49	1.90	1.91	1.67	1.71

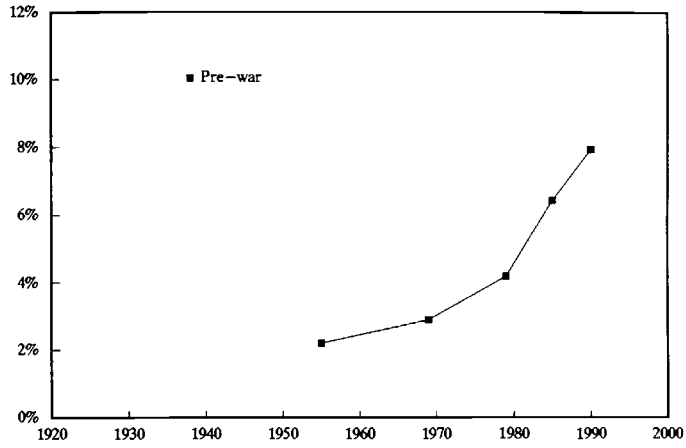

Fig. 1.1 East Asian interdependence: absolute

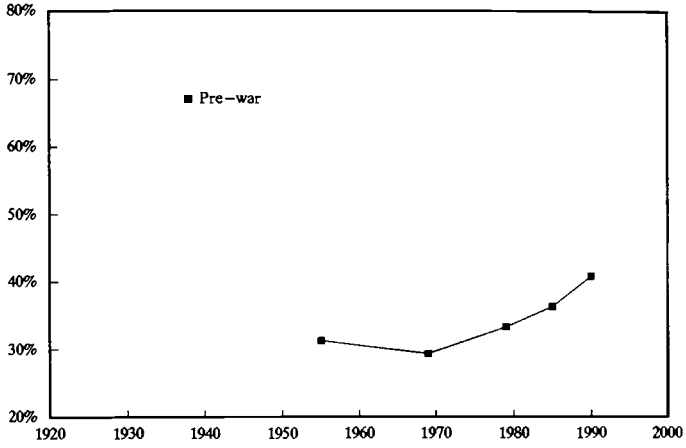

Fig. 1.2 East Asian interdependence: relative

II. Nevertheless, over the postwar period East Asian intratrade has grown very fast, nearly quadrupling its share of world trade.

In relative terms, East Asian intratrade shows a U-shaped pattern (fig. 1.2). By this measure, East Asian interdependence fell sharply as the Japanese empire was dismantled, and continued to decline well into the postwar period. During this period, despite the rapidly growing absolute volume of East Asian intratrade, the relative importance of regional trade fell, since the region's third-country trade developed even more rapidly. Eventually, the region's rapid growth caught up with the diversification of its trade patterns, and intratrade began to increase.

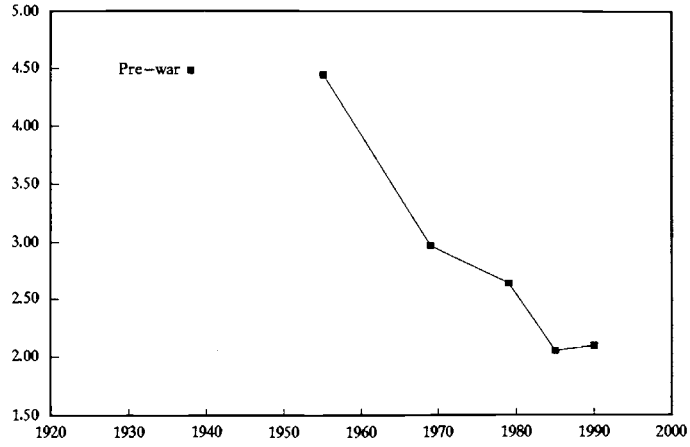

Fig. 1.3 East Asian interdependence: double-relative

Still a third story emerges from the double-relative measure (table 1.1 and fig. 1.3). This index shows a steady and sharp decline in the regional bias of East Asian trade in all but the last five years of data. It also shows that the level of interdependence was initially very high, and that it remained high even in the initial years after World War II. By this measure East Asia was more highly integrated than either North America or Western Europe both before and after the war, and remains so today. Moreover, even the Pacific Rim as a whole, with East Asia and North America combined, is more interdependent than Western Europe, although its trading bias has diminished somewhat in the 1980s.

1.3 Determinants of Interdependence

Bilateral trade patterns and their determinants usually receive little attention in the economic analysis of international trade flows. Economists usually chide noneconomists for concerning themselves with bilateral or regional trade flows when, at least according to some popular theoretical models, bilateral trade flows are analytically uninteresting and even indeterminate.[4] Yet the pattern of bilateral flows is far from random and exhibits remarkable stability over time. It would be difficult to understand this stability without reference to large differences in transaction costs across alternative bilateral linkages.

The most obvious candidate for explaining the differential intensity of bilateral linkages is transport cost. Studies of bilateral trade patterns typically show that bilateral trade is negatively related to the distance separating the partners.[5]

4. For example, the bilateral pattern of trade is indeterminate in a Heckscher-Ohlin model with more products than factors, assuming zero transport costs.

5. For example, Linnemann (1966) and Frankel (chap. 2 in this volume) provide clear evidence of distance effects.

Yet the strong empirical effect of distance is hard to reconcile with the facts of transport technology. Transport costs amount to only a few percentage points of the value of international trade, with much of the cost accounted for in arranging for shipment and the loading and unloading of products (Leontief 1973). Thus, while transport costs can vary greatly across products and modes of transport, they do not vary much with distance itself.[6] Nor is there evidence that bilateral flows were much affected by the large fluctuations in transport costs that took place, for example, during the oil price shocks of the 1970s.

So the empirical importance of distance is most likely due, not to distance itself, but to factors correlated with distance. Important among these may be human and physical assets that facilitate trade, on both sides of a trading relationship. Investments in such assets are more likely to be made among physically and culturally proximate trade partners.[7] These assets may include knowledge about the partner's language, culture, markets, and business practices. They may also include a network of personal or business relationships and business reputations abroad.

The importance of these factors is underscored by the pervasive role of institutions that economize on transactions costs in international trade. International trade is often intrafirm trade (Lawrence 1991); it is likely to be mediated by international banks (e.g., through letters of credit and other instruments that enable the firm to shift the risks and information requirements involved in international deals to banks); and in many countries it is dominated by large, specialized international trading companies.

The level of international transactions costs depends in part on past investments in physical infrastructure, information, and education. Often, the investments required to reduce transactions costs involve substantial scale economies, and so transactions costs across a bilateral link will be lower in proportion to the activity across the link. For example, it is generally cheaper (per unit of output) to establish and operate a transport or telecommunications link across a high-density linkage. This is even more true for investments in information, which generate an essentially public asset, whose services can be costlessly shared by all. Interestingly, the provision of trading information was an important early objective of Japanese policies in East Asia, and is among the first objectives of the Asia Pacific Economic Cooperation (APEC), the region's new forum for economic cooperation.

6. Linnemann (1966) concludes a survey of transport cost data by saying that "one cannot help feeling that these magnitudes [of transport costs] (for instance in comparison to prevailing profit margins) are in a sense too small to justify the emphasis on transportation costs as the major natural obstacle to international trade."

7. In an early empirical study of trade patterns Beckerman (1956) concluded that, "while transport costs paid (directly or indirectly) by an Italian entrepreneur on a raw material supplied by Turkey may be no greater (as the material may come by sea) than the same material supplied by Switzerland, he is more likely to have contacts with Swiss suppliers, since Switzerland will be 'nearer' to him in a psychic evaluation (fewer language difficulties and so on) as well as in the economic sense that air travel will absorb less of his time."

In still other cases, intrabloc transactions costs will be reduced through political mechanisms. For example, a free trade agreement will be easier to negotiate among partners who already have intense linkages. Similarly, the arguments for stabilizing an exchange rate will be much more compelling for countries with substantial bilateral trade than for those that are not highly interdependent. Such mechanisms presume, to be sure, that the trade linkage is valued highly by all of the bloc's countries; asymmetric trade, by contrast, may not lead to reinforcing agreements even if the (one-way) flow is very intense.[8]

The key point is that developments that increase bilateral contacts may trigger strong, positive feedback effects through their impact on trade-facilitating investments. A shock to a bilateral link may be significantly amplified as the initial increase in contacts leads to new investments in the bilateral linkage, which in turn reduce bilateral transaction costs. In some respects, these mechanisms are similar to those that generate irreversible changes ("hysteresis") in trade flows in reaction to exchange rate changes.[9]

The endogeneity of trade-facilitating investments, and thus transactions costs, suggests a simple model of bloc formation. Suppose that a relatively loosely connected group of economies becomes more interdependent due to an economic or noneconomic shock. The increased intensity of contacts will make it attractive to invest further in the bilateral relationship. Bilateral transactions costs will fall, leading to further increases in the intensity of the bilateral relationship. The cycle may repeat itself over time. This story is consistent with Europe's integration process in the 1950s and 1960s. After the war, European peace and economic recovery increased the importance of European partners to each other and provided incentives for reducing intra-European trade barriers. The Common Market undertook a massive effort to eliminate trade barriers and later to reduce the volatility of European Community exchange rates. These steps substantially raised the regional bias of European trade and, arguably, resulted in further efforts to reduce intra-European barriers.

If international transactions costs are endogenous, then history matters. The extent to which countries are "shocked" into close trading relationships, and the extent to which their periods of rapid growth are parallel, affects their investments in their bilateral trade and shapes their subsequent trading relationships.

This paper will examine how various historical events have shaped East Asian interdependence. A key piece of the argument is that various "accidents" of history—that is, close international contacts that cannot be traced to market

8. Petri (1992) argues that strong asymmetries in East Asian trade, including especially the fact that many East Asian countries run large trade deficits with Japan and large trade surpluses with the United States, explain why purely East Asian trading agreements are unlikely.

9. Baldwin (1990), for example, presents a model in which firms establish a "beachhead" (say, an export distribution system) in a foreign market after the appreciation of that country's currency and then continue to sell in the market even after the currency depreciates. The argument here subsumes such investments, but especially focuses on investments that affect transactions costs in the bilateral trading relationship.

forces alone—have changed the international pattern of transactions costs and have permanently affected East Asia's bilateral trading patterns. Three such accidents appear particularly important. First, the imperialist policies of the Western countries established an initial network of East Asian trade. Later, Japanese imperialism provided an impetus for the integration of East Asia's northern economies. As it was often observed at the time, "trade followed the flag." Finally, the rapid growth of various East Asian countries is now making them loom increasingly large to each other and is providing a new impetus for regional integration.

1.4 East Asian Interdependence before 1931

East Asia has a long history of trade, dating back to Arab and Chinese trade among East Asian countries and with Europe. The volume of East Asian trade in general, and of East Asian intratrade as well, appears to have gained momentum with the stepped-up involvement of European powers in the nineteenth century. Subsequently, the expansion of Japan's economic sphere of influence became the main force driving interdependence.

1.4.1 The Treaty Port System

Toward the middle of the nineteenth century, prompted by British leadership, a wave of liberalization spread through Europe. Britain sought similar objectives in East Asia: it abolished the monopoly of the East India Company and moved aggressively to obtain free access to Chinese markets. The Treaty of Nanking, which Britain concluded with China at the end of the Opium War of 1840–42, opened five ports where British subjects could carry on trade "without molestation or restraint" and ceded Hong Kong "in perpetuity" to Her Majesty. Export and import duties were fixed at an average of 5 percent, and consular courts were established to keep British subjects safe from local laws.

As in Europe, Britain also included most favored nation clauses in this and other treaties. Thus it paved the way for "cooperative" imperialism, with France and the United States, and eventually Russia, Prussia, Portugal, Denmark, the Netherlands, Spain, Belgium, and Italy all signing treaties guaranteeing access to Chinese and other ports (Beasley 1987).

A surge of trade ensued, both regionally within East Asia, and with Europe. The profitability of this trade led to a lively competition for new ports. The United States focused on Japan, and following Matthew C. Perry's landings eventually concluded a treaty in 1858. Russia, the Netherlands, Britain, and France followed with similar treaties of their own. Japan's early trade thus came to be oriented toward the West: silk, tea, and coal were exported to France, Italy, and the United States, while textiles, weapons, and machinery were imported from Britain and the United States.

Thus, by the turn of the twentieth century, when relatively comprehensive

regional trade data become available, the level of East Asian regional interdependence was already high. As table 1.2 shows, by 1913 about 42 percent of the region's trade was intraregional, compared to 46 percent in 1938 and 47 percent today. Most of this trade was mediated by the great ports developed by the European powers—Hong Kong, Manila, Shanghai, and Singapore. In addition to maintaining bilateral ties between the colonies and their home countries—between Malaysia and Singapore and England, Indonesia and the Netherlands, and the Philippines and the United States—the ports also played a key role in coordinating the trade of a vast region stretching from India to Japan. Roughly 70 percent of Thailand's trade, for example, was mediated by Singapore, which sent some of Thailand's rice on to China and Japan, in exchange for Indian and British textiles.

1.4.2 Japanese Expansion

A second impetus for the intensification of regional ties came from Japan's industrialization and expanding economic influence. By the end of the nineteenth century Japan had established a role parallel to or surpassing those of other powers in Korea and China. It continued to gain economic and military power in the early twentieth century, and began to displace the exports of European powers in their own colonies.

Japan's role in the treaty port system quickly changed from host to protagonist. By 1876 Japan had itself opened three Korean ports and began competing aggressively with China to reexport Western textiles to Korea. In 1895 Japan won a major military victory over China, gaining a large indemnity, further influence in Korea, commercial privileges in China, and two important territories: the Liaotung Peninsula (including Dalien, Manchuria's most important port) and Taiwan. Japan was eventually forced to back down on the Liaotung claims, but its victory had clearly established it as a rising imperial power.

Table 1.2 **East Asian Trade as Share of Total Trade for Different Countries (exports plus imports)**

	1913	1925	1938	1955	1990
China	0.53	0.46	0.70	0.43	0.59
Indonesia	0.32	0.38	0.26	0.32	0.60
Taiwan			0.99	0.50	0.42
Japan	0.41	0.47	0.70	0.22	0.29
Korea			1.00	0.35	0.40
Malaysia	0.44	0.39	0.35	0.30	0.37
Philippines	0.18	0.15	0.11	0.17	0.43
Thailand	0.62	0.71	0.65	0.52	0.51
Simple average	0.42	0.43	0.59	0.35	0.45
Excluding Korea, Taiwan	0.42	0.43	0.46	0.33	0.47
Excluding Korea, Taiwan, Japan	0.42	0.42	0.41	0.35	0.50

Sources: League of Nations, Long-Term Economic Statistics of Japan.

Scholars tend to agree that the conquest of Korea reflected primarily military, rather than economic, objectives—as the Japanese army's Prussian advisor put it, Korea was "a dagger thrust at the heart of Japan" (Myers and Peattie 1984, 15). But the economic potential of a broader sphere of influence was not lost on the Meiji leadership. Foreign Minister Komura Jutaro explicitly recognized the importance of economic objectives and their relationship to military power.

> Competition through commercial and industrial activity and through overseas enterprises is a phenomenon of grave importance in recent international relations. . . . [Western countries] have been zealous in expanding their rights in mining, or in railroads, or in internal waterways, and in various other directions on the Asian continents, especially in China. . . . However, when we look at the measures [taken by] our own empire, which has the most important ties of interest in the area, separated by only a thin stretch of water, there is not much to be seen yet. Both those in government and those outside it regard this as highly regrettable. (Duus 1984, 133)

In any case, Japan's military triumphs in Korea were quickly followed by investments in communications infrastructure related to bilateral trade, and eventually modifications in the Taiwanese and Korean economies that helped to make them more complementary to the Japanese economy. Meiji-style agricultural reforms, such as comprehensive land surveys, were introduced, establishing clear criteria for the ownership and taxation of land and facilitating the sale of land.[10] A combination of these administrative measures and new agricultural technologies imported from Japan resulted in a dramatic surge of agricultural production.[11] By the late 1920s Korea and Taiwan supplied 80 percent of Japan's rice imports,[12] two-thirds of its sugar, and substantial shares of other minerals and lumber (Peattie 1984, 32).

But it was China that was regarded as the great prize. In 1905 Japan defeated Russia in Manchuria and acquired control over the Liaotung Peninsula (known as the Kwantung Leased Territory), all of Korea, the southern half of Sakhalin Island (Karafuto), and the Chinese Eastern Railway. There followed a substantial wave of investments in communications, coordinated by the Southern Manchuria Railway Company (SMR), a quasi-public company that remained a key player also in later phases of Japanese expansion. A key objective of the company was to shape the transport infrastructure of Manchuria—that is, to ensure

10. According to some historians, the land surveys made it easier for Japanese investors to acquire land from Korean and Taiwanese owners.

11. Colonial farmers did not benefit, however; despite substantial growth in output, per capita rice consumption was essentially flat in both Korea and Taiwan in the 1920s and declined substantially in the 1930s (Ho 1984, 379).

12. In light of the considerable current emphasis on full self-sufficiency in rice, it is interesting to note that Japan depended extensively on rice imports during much of the prewar period, generally importing 20 percent of its requirements.

that the network fed into Dalien, the Japanese-controlled port (Beasley 1987, 90–92).

The Japanese government also moved aggressively to improve information on the Chinese economy. The Ministry of Finance proposed a wide-ranging study of Chinese demand, exhibitions in treaty ports, visits by Japanese entrepreneurs, and new ways of disseminating information, including a China Association in Japan that would encourage businessmen to take interest in China. The minister of agriculture and commerce (the precursor of the modern-day MITI) provided a particularly eloquent argument for investments in information.

> There was a time when Japan hoped to find her chief field of commercial enterprise in the west; but today the mind of Japan is all toward China as the commercial hope of our future, not to say anything of our geographical and racial advantages with that country. It is our ambition to be to the East what Great Britain is to the West. We have left no means untried in making a thorough investigation of the present conditions of China. . . . We think we know a good deal about commercial conditions in China because we know a little more than the merchants of the West; but we really know nothing as we ought to know; and I would advise all those who hope to share in trade with China, to make careful and constant investigation into the conditions prevailing there; for I am sure there is much yet to be learned, if our trade with China is to achieve its best. Instead of our business men staying at home and waiting for orders, let them go or send representatives into central China, and they will find a more remunerative field of demand and consumption than they ever dreamed of, reclining in their offices at home. (Whelpley 1913, 247–48).

But as Japan became good at imperialism, the Western powers began to change the rules of the game. The powers started to relax their control over their colonies by revising the treaties on foreign ports; soon after World War I, for example, China was granted substantial tariff autonomy. At the same time, powers moved to control Japan's growing regional influence. The Washington Conference in 1921 sharply limited the size of the Japanese navy, and a period of economic and political frictions ensued.

Despite the strained political circumstances, the sphere of influence established at the turn of the century resulted in a sharp increase in Japan's regional economic role. By the late 1920s Japan had essentially caught up with Western interests in China, and by 1931 the stock of Japanese investments in China equalled those of Great Britain and exceeded those of all other countries combined (Beasley 1987, 133). Japanese investments reached deep into Manchuria; for example, by the end of World War I, the Hanyehping Coal and Iron Company supplied 60 percent of Yawata Steel's iron ore requirements (Beasley 1987, 137). This period of the so-called Shidehara diplomacy was characterized by frequent Japanese-Western clashes, repeated concessions on both military and trade rights, yet considerable economic gains.

1.5 Interdependence between 1931 and 1945

The era of political compromise ended in 1931. This turn of events was hastened by Chinese resistance to Japan's economic advance and by world depression. Subsequently, Japan's economic strategy dramatically changed. The colonial-style exchange of manufactures for raw materials gave way to a concerted effort to develop independent bases of industrial strength in several parts of Japan's economic empire. The new strategy led to substantial industrial investments outside Japan proper, and eventually gave rise to increasingly sophisticated economic linkages among Japan, Korea, Taiwan, and eventually China.

1.5.1 Military Expansion

Three factors helped to replace the economic approaches of the 1920s with a strategy based on military power. The first was China's emerging nationalism. By the late 1920s Japan's influence in China came under increased threat from the Kuomintang. In 1927, for example, the northern Chinese warlord Chang Tso-lin, under Kuomintang influence, withdrew permission for the construction of five new Japanese railway lines into northern Manchuria. A year later, Chiang Kai-shek defeated his Beijing rivals and set his sights on the north Chinese provinces dominated by Japan. Japan's Kwantung Army responded with a complex series of intrigues that eventually led to the invasion of Manchuria in 1931 (Barnhart 1987).

A second factor involved trade frictions that increasingly limited Japan's conventional access to international markets. As the world economy began to decline starting in 1929, Japan's trade relations sharply deteriorated, since many trade partners blamed Japan for the particularly large gains that it had achieved during the previous decade. For example, by 1932 Japan had displaced the Netherlands as Indonesia's largest trade partner, and had made similar inroads in Malaysia. During the 1930s Japan became embroiled in one trade dispute after another; conflicts with India, the Dutch East Indies, and Canada each resulted in a trade war or reciprocal boycott. As one contemporary writer put it, it was

> the bad fortune of the Island Empire that it has come of age industrially at a time when economic theory and, still more, economic practice have drifted far away from the ideals of Bright and Cobden. . . . [Its] export trade has been considerably retarded by a multitude of economic barbed-wire entanglements in the shape of quota restrictions, high tariffs, and other measures designed to check the sweep of "Made in Japan" products. . . . More than sixty countries have imposed special restrictions on Japanese textiles; less than thirty have left the door open on equal terms. (Chamberlin 1937, 219)

The final factor that pushed Japan toward a military strategy was a severe agricultural recession. Policies designed to generate rice surpluses in Taiwan

and Korea coincided with worldwide commodity deflation. As rice prices fell, conditions in Japanese agriculture worsened, and the government rapidly shifted its colonial investments toward industry.

In any case, the 1931 invasion of Manchuria, like previous Japanese colonial moves, was followed by a large wave of public and private investments. But there was little room in this picture for non-Japanese companies; by the early 1930s Anglo-Dutch Petroleum, Standard Oil, Siemens, and Skoda had all liquidated major interests (Jones 1949). Manchuria, Korea, and to a lesser extent Taiwan became thoroughly transformed. In the meantime, the complementarity of the Manchurian, Korean, and Japanese economies came to be based on manufacturing; Nissan, for example, a manufacturer of armaments, airplanes, automobiles, and machinery, moved its headquarters to Changchun, and its president eventually went on to direct the Manchuria Industrial Development Company (MIDC; Jones 1949). Manchuria was to become a self-sufficient industrial base, supplying basic materials, including coal, iron and steel, electricity and synthetic oil, rolling stock, and ships to itself and Japan in exchange for machinery (Beasley 1987, 216).

Toward the end of the 1930s Japan's expansion into China became increasingly ominous and continued to accelerate. In 1937 a minor clash between Chinese and Japanese troops provided a pretext for capturing Nanking and much of the Yangtze valley. Soon afterward, Prime Minister Konoe announced a "new order" that called for close cooperation ("coprosperity") among China, Japan, and Manchuria.

A broad southern advance also began to emerge as part of Japan's increasingly expansionist strategy. In 1939 the Showa Research Institute developed an extensive plan for an East Asian Economic Bloc (Lebra 1975, 100–103), which would be self-sufficient by relying on tin, rubber, bauxite, tungsten, nickel, and chromium from Thailand, the Philippines, the Dutch East Indies, and Malaya (Beasley 1987, 225).

As World War II approached, the scope of Japan's sphere of influence was expanded to include Indochina in the so-called Greater East Asia Coprosperity Sphere (GEACS). In the event, not much economic integration took place during the GEACS period, aside from the diversion of some raw materials to Japan, because the sea-lanes were not safe enough to permit large-scale transport. Instead, the region suffered a deep economic decline as its trade with the West collapsed.

1.5.2 Legacies and Parallels

Japan's role in the prewar economy substantially increased East Asian interdependence, particularly among China, Korea, Taiwan, and Japan in the 1930s. Japan's activities in these countries focused on developing transport infrastructure and information, and in the end on developing complementarities with the Japanese economy. The result, naturally enough, was a surge in Japan's regional trade, as shown in figure 1.4. GEACS expanded Japan's influence into

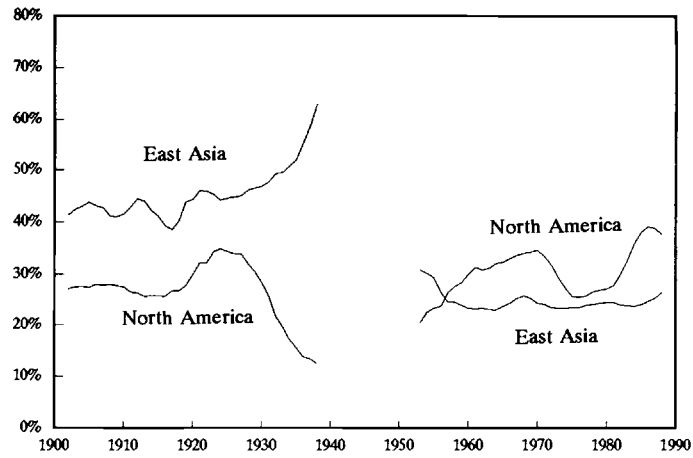

Fig. 1.4 Partner composition of Japanese exports (five-year moving averages)

Southeast Asia, but the economic connections between this region and Japan were brief and overshadowed by the imperatives of war. The Japanese occupation, however, did drive European colonial governments from Southeast Asia and laid the foundations for independence after the war. Thus the economic links that emerged after the war were more Asian than before.

Japan's intense style of imperialism has left long-lived legacies. Unlike the European imperialist powers, Japan was close to its colonies and, in Korea and Manchuria, had excellent communications with them through rail transport. Also, because it was concerned not only with the economic exploitation of the colonies but also with their role as buffers against Russian and Western forces, Japan developed dense political and military organizations to control its empire. Finally, given rice exports as a key early objective, Japan could not restrict its economic activities to an "enclave," but was forced to penetrate local economic structures (Ho 1984, 385).

By the early 1930s Japan's style of complementarity differed dramatically from that of other colonial powers; as Cumings (1984, 482) has observed, Japanese imperialism "involved the location of industry and an infrastructure of communications and transportation *in* the colonies, bringing industry to the labor and raw materials, rather than vice-versa." Although the linkage between the Japanese occupation and the subsequent spectacular development of Manchuria, Korea, and Taiwan is extremely controversial, there is no doubt that powerful industrial centers developed in each of these areas and that these centers evolved along the same technological lines as Japan's own industries.

The notion of a large regional bloc that would also include Southeast Asia does not appear to have been a part of Japan's strategy until 1939. Prime Minister Konoe's 1938 announcement made no mention of southern areas, and the inclusion of Southeast Asia did not arise until the fall of France. By that

time, GEACS was clearly designed to obtain raw materials needed for war. As Peattie has argued, GEACS is best seen as a response to a "sudden turn in international events . . . rather than the consequence of long-considered or widely-held interest in the co-prosperity of Asian peoples" (1991, 42).

1.6 Interdependence from World War II to 1985

As table 1.1 and figure 1.4 show, World War II thoroughly disrupted the trade patterns established in the prewar years. Trade flows shifted toward the United States, now the leading military power in the Pacific and the only country with its economy largely intact. Linkages between Japan and Taiwan and Korea were sharply curtailed. China's trade also collapsed as the country sank into civil war. Insurrections erupted also in Indonesia, Indochina, and Malaysia. As a result, trade flows declined sharply throughout the Pacific, especially among China, Japan, Korea, and Taiwan, the "core" countries of GEACS.

Postwar U.S. policy recognized that this sharp dislocation in trade patterns would undermine the prospects for economic recovery in all of the countries that once formed the Japanese empire. The influential Institute of Pacific Relations, for example, concluded at its 1947 conference on the reconstruction of East Asia that, for the sake of Japan and the rest of the region, "Japan must be actively helped to regain something of her old position as the mainspring of the Far Eastern economy as a whole" (Institute of Pacific Relations, 1949). The U.S. occupation authorities in turn began to use the leverage provided by their influence over aid and Japanese reparations to China, Korea, and Taiwan, as well as in Southeast Asia, to revive these countries' trade with Japan.

The data show the magnitude of this challenge. Japan's two-way trade with East Asia fell from 73 percent of her trade around 1940 to only about 31 percent in 1951. At the same time, the partner composition of this East Asian trade shifted from the "core" economies of GEACS to Southeast Asia. The decline in the importance of East Asian countries in general, and of the core partners in particular, can be traced almost entirely to the general decline of their economies, rather than to a decline in their special gravitational linkages with Japan. The analysis of gravity coefficients suggests that regional biases within East Asian trade remained at essentially the same high level in 1955 as they were in 1938. While East Asian linkages remained strong, they were now driven, not by Japanese policy, but by economic structures inherited form the prewar period and by U.S. policies designed to restart this group of highly interdependent economies.

The subsequent story of East Asian economic growth is well known and has been recently reviewed by Kuznets (1988), Noland (1990), Wade (1990), and others. What is of interest here is that the spectacular growth of the region's economies was accompanied by a substantial decline in their regional trade bias. As shown in table 1.3, the gravity coefficients of East Asian trade—coefficients that summarize each country's bias toward East Asian trade partners—

Table 1.3 **Intensity of the East Asian Trade Linkages of Different Countries and Regions (gravity coefficient measure)**

	1938	1955	1969	1979	1985	1990
Japan	4.66	3.13	2.07	2.02	1.46	1.50
North America	0.92	1.16	1.48	1.53	1.48	1.44
Australia, New Zealand	0.53	1.35	2.70	2.85	2.24	2.11
Taiwan	6.63	7.15	4.83	2.82	1.72	2.14
Korea	6.68	4.92	4.83	2.91	1.96	2.04
Hong Kong	3.96	7.55	3.72	3.22	3.09	2.96
Malaysia, Singapore	2.31	4.22	3.34	3.11	2.05	1.88
Thailand	4.34	7.36	5.38	3.64	2.69	2.61
Philippines	0.70	2.45	4.58	3.17	2.54	2.22
Indonesia	1.76	4.60	5.52	4.89	3.34	3.10
China	4.70	6.13	2.91	2.76	3.23	3.04
Western Europe	0.26	0.49	0.33	0.34	0.31	0.36
Middle East	0.46	1.05	1.39	1.84	1.36	1.33
Rest of world	0.30	0.67	0.81	0.62	0.70	0.76
Total imports	1.00	1.00	1.00	1.00	1.00	1.00
East Asia	4.48	4.45	2.97	2.64	2.05	2.09
Pacific Rim	2.61	1.95	2.05	2.08	1.77	1.80
Average	2.72	3.51	2.93	2.44	1.94	1.91

which survived World War II at relatively high levels, fell steadily in the following years. The pattern of decline is similar for most East Asian countries, and the few anomalies that do occur (an unusually rapid decline in the case of China, and an unusual increase in the case of the Philippines) can be understood in terms of major political changes in the countries involved.

Equally remarkable is a parallel decline in the *dispersion* of gravity coefficients (that is, in variations in the intensity of linkages across different trade partners) in the region. As shown in table 1.4, the standard deviations of the gravity coefficients of most East Asian countries fell steadily during the postwar period. In effect, each country's bilateral trade pattern came to look more and more like the world's trade pattern—the importance of any particular partner to a given country came to resemble the importance of that partner in world trade as a whole. (If each partner's share of a country's trade were equal to that partner's share in world trade, then all gravity coefficients would be one.) Country-specific biases became less and less important in explaining the distribution of East Asian trade, both between East Asia and other regions and across different East Asian partners.

Three types of factors help to explain the diversification and homogenization of the region's trade. The first was the general integration of the global economy during most of the postwar period, which was spurred by several successful rounds of trade negotiations, steady progress toward convertibility, and considerable improvements in international communications and transport. All of these factors worked to pull East Asia's trade (as well as the trade

Table 1.4 **Dispersion of Gravity Coefficients, by Country and over Time (standard deviations of gravity coefficients)**

	1938	1955	1969	1979	1985	1990
Japan	5.55	4.25	2.50	1.75	1.26	1.22
North America	1.41	0.85	0.62	0.50	0.55	0.47
Australia, New Zealand	0.65	0.66	0.94	1.19	0.97	1.23
Taiwan	4.08	4.51	2.60	1.53	1.07	1.13
Korea	4.18	5.45	2.01	1.19	0.91	0.97
Hong Kong	6.81	10.22	2.79	2.61	3.36	4.02
Malaysia, Singapore	9.25	4.21	3.78	2.74	1.95	1.24
Thailand	9.59	4.92	3.14	2.18	1.80	1.26
Philippines	1.52	1.42	1.96	1.19	1.23	0.86
Indonesia	3.11	3.53	3.45	2.58	1.49	1.30
China	6.15	9.51	2.77	2.57	3.47	4.09
Western Europe	0.56	0.43	0.33	0.32	0.36	0.33
Middle East	1.12	0.68	0.74	0.63	0.41	0.49
Rest of world	0.41	0.38	0.58	0.48	0.37	0.37
Total imports	0.00	0.00	0.00	0.00	0.00	0.00
East Asia	2.28	2.52	1.68	1.15	0.88	0.80
Pacific Rim	0.97	0.76	0.77	0.64	0.49	0.46
Average	3.39	3.19	1.80	1.37	1.21	1.19

of all other countries) away from its regional partners toward more global sources and destinations.

A second important factor was the rapid development of the region's economies. The expansion of each economy's overall trade provided the scale needed to justify investments in trading linkages with an increasingly large number of countries. More frequent shipping and air schedules could now be maintained; additional investments could be made in communications; and a greater stock of information could be developed to link firms and their foreign counterparts. All these trends undoubtedly contributed to the broadening of East Asian marketing efforts. These trends presumably operated in all countries, but it is likely that their effect was especially pronounced in the context of East Asia's "miracle" economies.

A third factor driving East Asia's diversification was the similarity of East Asian development patterns. Each country rapidly shifted its output from raw materials to manufactures, and within manufactures from labor-intensive to more capital- and technology-intensive sectors. These patterns have been described as the "flying geese pattern" of development by the Japanese economists (Akamatsu 1960) and are consistent with Heckscher-Ohlin explanations of how trade patterns are likely to change with the accumulation of human and physical capital.[13]

13. A case can be made that East Asian development trajectories are *more* similar than would be justified by Heckscher-Ohlin considerations because they "follow" a common East Asian de-

The similarity in development patterns is important for two reasons. First, it explains how each country acquired an increasingly sophisticated basket of exports and thus positioned itself to compete in a wider world market. Second, it explains why East Asian countries developed competitive rather than complementary economies, and thus why they had to look to outside markets, rather than regional markets, for new trading opportunities.

An important exception of this story involves linkages based on the importation of intermediate inputs and capital goods. The commonality of East Asian development trajectories has meant that each country would typically look to neighboring countries for appropriate technology. These supply-side linkages in turn gave rise to substantial imports of machinery and components. As a result, several East Asian economies acquired asymmetrical linkages. On the one hand, they relied heavily on the region's more advanced economies—Japan, Korea, Taiwan, Singapore—for imports of machinery and components, and on the other, they looked outside the region to sell their exports.

1.7 Interdependence Today

The intensity of East Asian interdependence appears to have reached a trough in 1985–86. The turning point came at the end of a period when the real value of the U.S. dollar was unusually high; in the preceding years, several East Asian countries had sharply shifted their trade toward the United States. In addition, the high value of the dollar permitted Japanese companies to maintain their exports despite sharply higher wages and declining competitiveness against other East Asian economies.

The large exchange rate adjustments of 1985 and 1986 affected interdependence in a complex way. Initially, the appreciation of the yen was not matched by other East Asian currencies; thus other countries became more competitive against Japan in both U.S. and Japanese markets. For a while, East Asian imports surged in both markets, and Korea, Taiwan, and other countries began to run substantial trade surpluses. These export surges also led to accelerating imports from Japan and Singapore. As a result, East Asian interdependence intensified; intraregional trade expanded very rapidly, and the long-run decline of the region's gravity coefficients ceased.

Many observers assumed at that time that the trade flow adjustments described above represented the beginning of a new historical trend toward the

velopment model, as pioneered by Japan. This case is most easily made for Korea, which systematically researched and adopted Japanese policies during its high-growth period. Petri (1988) has shown that the composition of Korean industry resembles the composition of Japanese industry more closely than would be expected on the basis of resource similarities alone. These similarities are in part due to the similarity of external opportunities; for example, the dynamics of foreign protection systematically "capped" import surges from Japan and thus created systematic incentives for Korean producers to move into the same industries in which Japan excelled.

greater integration of the East Asian economy. This may still be the case, but the events of 1985–88 were in large part driven by the staggered adjustment of exchange rates in different East Asian countries. By the late 1980s the second phase of the exchange rate adjustments took hold, as most of the region's currencies appreciated to close the gap that had opened between them and the yen in the mid-1980s. These corrections slowed the surge of Japanese imports from East Asia and stopped the increase in the region's gravity coefficients. To be sure, the absolute volume of East Asian trade continued to expand at a rapid pace due to the high growth of the region's economies.

The more significant impact of the appreciation of the yen was a sharp increase in regional investment flows (see table 1.5). Malaysia, Thailand, and Indonesia had two-thirds as much investment in 1988–89 alone as in all previous years until then. The cause of this wave is widely accepted; the exchange rate changes of the late 1980s reduced the competitiveness of Japanese firms and led firms to shift some production activities closer to markets and to countries with lower labor costs. While most of these investments went into the United States and other developed countries, a substantial amount also occurred in East Asia.

Table 1.5 **Foreign Direct Investment in East Asia (millions of U.S. dollars)**

Host/Source	Total	Japan	U.S.	Korea	Taiwan	Hong Kong	Singapore
Thailand							
Up to 1987	11,536	2,773	1,910	9	675	445	351
1988–89	7,868	4,431	570	66	530	278	408
Malaysia							
Up to 1987	4,200	1,741	202	0	34	262	594
1988–89	3,690	967	179	49	1,314	138	231
Indonesia							
Up to 1987	17,284	5,928	1,244	222	144	1,876	299
1988–89	11,159	1,304	783	728	1,126	867	489
Philippines							
Up to 1987	2,830	377	1,620				
1988–89	275	71	98				
Korea							
1984–88	3,648	1,857	876				
Taiwan							
1984–88	4,170	1,343	1,251				
Singapore							
1984–88	6,529	2,200	2,814				
Sum (Thailand, Malaysia, Indonesia only)							
Up to 1987	33,020	10,442	3,356	231	853	2,583	1,244
1988–89	22,717	6,702	1,532	843	2,970	1,283	1,128
Shares of sum							
1987	1.000	0.316	0.102	0.007	0.026	0.078	0.038
1988–89	1.000	0.295	0.067	0.037	0.131	0.056	0.050

Sources: Tho (1993); Holloway (1991).

By the late 1980s, as the newly industrializing countries (NICs) also adjusted their exchange rates and began to face competitive strains similar to Japan's, they too joined Japan as major investors in East Asia. Thus an entirely new channel of interdependence began to operate: cross-investments among a large number of East Asian countries. This is a natural result of the region's prosperity; it recalls patterns of integration that have evolved in Europe.

The investment wave of the late 1980s differed from earlier investments in developing country production facilities not just in magnitude and origin, but also in structure. Japan's investments in East Asia in the 1970s, for example, were primarily focused on local markets, often encouraged by policies that sought to increase local participation in industry, for example, through the importation of automobile kits instead of assembled automobiles. The recent wave of investments, by contrast, is the product of new, global strategies by regional firms. Nearly all firms have adopted such strategies, and some have gone to some length to plan a comprehensive distribution of their activities across different regional markets. Toyota, for example, has selected locations that will permit it to build a regional automobile, with components produced in different countries, depending on the advantages of the location in terms of supplier infrastructure and local resources (fig. 1.5).

Since the recent investment wave has been driven by production strategy rather than by market considerations, it has included a larger share of export-oriented industries. More so than in the past, the firms established in foreign

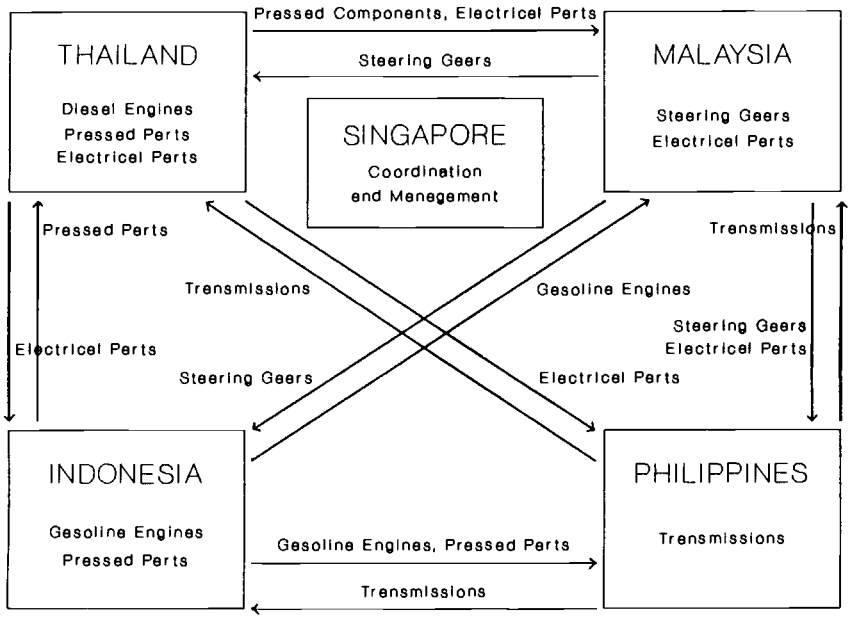

Fig. 1.5 Toyota's Asian regional production scheme

locations have also been intended to serve home (e.g., Japanese) markets. At the same time, since these investments were closely tied to Japanese technologies and suppliers that have remained at home, they have typically required a higher ratio of imported inputs than earlier investments. Because of these characteristics, the recent wave of intra–East Asian investment flows has helped to intensify regional linkages by facilitating exports into Japan and other regional markets and by spreading technologies that require regional inputs and capital goods.

The market forces that have helped to intensify regional linkages through trade and investment have been also supported by government aid policies. Japan's aid program has been always oriented toward Asia, but its growing scale has made it an important factor in recent economic linkages. Japanese aid flows to East Asia have been substantial compared to private investment flows. These flows have helped to finance the infrastructure that supports private investment.

The volume of intraregional investment has slackened somewhat recently but is likely to remain relatively high compared to historical levels. Some of the reasons for the current slowdown are permanent: the investment wave of late 1980s represented, in part, a onetime adjustment in corporate sourcing policies, triggered by the appreciation of the yen and the NICs' currencies. But other reasons are temporary. As a result of the rapid inflow of capital, infrastructure bottlenecks developed in several of the receiving economies, including especially Thailand, and labor and real estate costs rose sharply due to the overheated economy. At the same time, the accumulation of Japanese firms has contributed to the development of an economic infrastructure—consisting of suppliers and service companies—that will make it easier for other firms to invest in the future.

1.8 Policy Reactions

Postwar trends in East Asian interdependence have been driven by market rather than political forces. These forces initially worked to diversify the region's trade, as the growing scale of the region's economies permitted more diversified links, and as the region's competitive development strategies forced each country to look for markets outside the East Asian region. But even as the *intensity* of the region's trade declined, its volume dramatically increased. Over the past two decades, East Asia's share in world trade doubled, and even in the face of declining regional intensity, this meant that East Asia's internal trade increased from 30 to 41 percent of its total trade.

The importance of a particular partner in a country's transactions is likely to be closely related to the country's investments in linkages with that partner. It is thus not surprising that a wide array of regional initiatives have recently emerged to address the new issues generated by East Asian interdependence. From an analytical perspective, these initiatives can be seen as attempts to

reduce transactions costs in regional trade, manage intraregional trade frictions, and marshal regional economic forces against external economic challenges.

The institutions that are emerging from these initiatives are still very much in flux. But to the extent that they manage to accomplish the objectives cited, they will further encourage intraregional transactions. In the pattern of European and North American interdependence, private sector trends and policies designed to accommodate these trends may lead to reinforcing political mechanisms that encourage interdependence.

The development of regional institutions is complicated both by the great diversity of the region's countries and by the preference of many of the region's countries for informal, negotiated (as opposed to formal, legalistic) approaches to policy. Regional trade policies range widely from the virtual absence of trade barriers in Hong Kong and Singapore, to the relatively liberal regimes of Malaysia and Thailand, the intermediate and more opaque regimes of Korea, Indonesia, and the Philippines, and the still extensive protection in China. The picture is further complicated by the fact that some highly outward countries—for example, Korea and Thailand—still use protection to promote infant industries and exports. And even countries that have little formal protection, such as Japan, have policy and business structures that are difficult to penetrate.

Regional cooperation is also tempered by the "style" of East Asian policymaking. At the risk of excessive generalization, many East Asian countries pursue informal and relatively opaque approaches to policy. Relationships among businesses and between business and government are often characterized by long-term collaboration, reciprocal favors, and continuous negotiations, rather than market-mediated transactions and explicit contracts. Most East Asian governments, even in countries with modest trade barriers, actively participate in the management of the economy and administer complex arrays of incentives and barriers (Arndt 1987). Bureaucrats and influential industrialists have high stakes in maintaining this system of intervention and thus prefer to respond to new policy challenges with administrative instruments such as VERs, VEIs, and regulatory interventions.

In this context cooperation on a modest, practical level has proved more possible than the development of large-scale agreements and institutions. Small, local free trade areas (especially the Shenzhen Free Trade Zone and the Singapore growth triangle) are especially well suited to this policy setting and appear to be developing very fast. In what follows, each of the region's cooperative structures is reviewed in the context of its history and likely evolution, moving from the least to the most comprehensive.

Mini–Trading Areas (MTAs). Though not unique to East Asia, international trading schemes involving small geographical areas of two or more countries have multiplied. These areas feature special provisions to exempt international trade from national tariffs until the products leave the MTA, as well as trans-

portation and other infrastructure to support international trade and investment. The oldest and perhaps most successful such area is the Shenzhen Free Trade Zone, which forms a bridge between Guangdong Province and Hong Kong. A new initiative along these lines is the "growth triangle" formed by Singapore, Johore province of Malaysia, and Batam Island of Indonesia. Similar zones have been proposed to link (1) China, the Koreas, eastern Siberia, and western Japan (North-East Asia Economic Cooperation); (2) Japan, China up to Liaoning, and Korea (Yellow Sea Cooperation); (3) Hong Kong, Taiwan, and China south of Shanghai (Southern China Economic Cooperation); (4) Hong Kong, Guangdong, Guangxi, northern Thailand, Laos, and Vietnam (Tongking-Mekong Economic Cooperation); (5) Thailand, Cambodia, and southern Vietnam (Southern Indochina Economic Cooperation); (6) Myanmar, Thailand, and Indochina (Souvannaphoum); and (7) Thailand, northern Sumatra, and northern Malaysia (ITM Nexus).[14]

Not all of these MTAs will get off the ground, but the proliferation of the idea is interesting. MTAs fit the region's pragmatic approach to policy, and especially its reluctance to adopt more complex agreements than warranted by immediate economic needs. Such pragmatism is likely to be especially helpful in cooperations with the formerly socialist economies, which may not have the institutions to offer credible large-scale agreements for some time to come. So MTAs offer a potentially important model for linking China, Russia, Indochina, and North Korea with East Asia's market economies.

Association of Southeast Asian Nations (ASEAN). This association, comprising Brunei, Indonesia, Malaysia, the Philippines, Thailand, and Singapore, was initially focused on political and security issues. Due to competing industrial objectives, the organization made little progress toward integrating the region's economies until recently. A Preferential Trade Area Agreement was signed in 1977, but the proportion of trade covered by this agreement has remained small. As the association's economies came to pursue more liberal economic strategies, however, the possibilities for regional cooperation improved.

In February 1992 ASEAN adopted an ambitious program to establish a free trade area in fifteen years. Some tariffs have already been lowered with this objective in mind. But ASEAN's internal trade is modest, and the great similarity of ASEAN's economies (Brunei and Singapore aside) raises the possibility of substantial trade diversion within an ASEAN free trade area, particularly if external tariffs remain high. Against this, the opportunity to serve a larger regional market may improve prospects for attracting large-scale foreign investment. Overall, ASEAN's political divisions and the doubtful economic merits of the free trade area will tend to limit the influence of ASEAN in the region's institutional framework.

14. Some items on this list are drawn from Noordin Sopiee (1991).

East Asian Economic Caucus (EAEC). In late 1990, with the Uruguay Round negotiations heading for stalemate, President Mahathir of Malaysia called for the formation of an East Asian Economic Group (EAEG), consisting of Japan, the East Asian NICs, China, and the remaining ASEAN countries. Perhaps the plan emerged in President Mahathir's mind as a natural extension of his "Look East" program, which aimed to shift Malaysia's economic perspectives closer to the development models of Japan and Korea. Although the objectives of the EAEG were not spelled out, it appeared to create an alliance of East Asian states to counter emerging blocs in Europe and the Western Hemisphere. The plan was strongly opposed by Australia, New Zealand, and the United States, because it was viewed as undermining the Asia Pacific Economic Cooperation (APEC), the emerging OECD-like institution that includes countries from both sides of the Pacific (see below). Japan also publicly opposed the plan, but some Japanese government officials and senior business executives were more positive in private statements.

The opposition of the United States and the lack of a clear agenda for the EAEG(roup) eventually led President Mahathir to recast the idea as an EAEC(aucus). The concept now calls for periodic consultations among East Asian states—a mission no clearer than that of the EAEG. Three interpretations are possible. First, the EAEC may be a face-saving device for abandoning the EAEG idea. Second, the EAEC may be represent a threat against exclusionist U.S. and European policies. Third, the EAEC could be a step toward accelerating the integration of East Asian economies by promoting the coordination of their policies. Given the conflicting styles of East Asian and Anglo-Saxon policymaking, the EAEC may be better suited for this purpose than a broader group such as the APEC, which also includes Anglo-Saxon countries.

Asia Pacific Economic Cooperation (APEC). The idea of forming a Pacific region–wide organization has been pursued for several decades through informal, quasi-private organizations such as the Pacific Basin Economic Conference (PBEC), Pacific Economic Cooperation Council (PECC), and Pacific Association for Trade and Development (PAFTAD). Since 1989, however, the foreign ministers of twelve Pacific Rim countries—Australia, Brunei, Canada, Indonesia, Japan, Korea, Malaysia, New Zealand, the Philippines, Singapore, Thailand, and the United States—agreed to meet annually to review issues of mutual interest. APEC's initial work program consisted of a series of tasks, managed by member countries, on cooperation in areas such as the collection of trade and investment data, and the analysis of policies in sectors such as energy, tourism, transportation, and fisheries. At its 1991 meeting APEC also established a modest secretariat.

APEC's mission is still evolving. The organization has been most comfortable with tasks involving technical cooperation and information exchange. Its stiffest challenge has been the "China problem"—resolved by admitting

China, Taiwan, and Hong Kong to APEC membership. Beyond this, APEC meetings have dealt with noncontroversial issues such as support for international trade liberalization through the Uruguay Round. It remains to be seen whether APEC can assume functions beyond the technical, for example, whether it can facilitate movement toward regional liberalization, the harmonization of regulations, or the resolution of trade frictions. APEC's membership is very diverse, and few members seem willing to trust this new institution with significant responsibilities.

1.9 Conclusions

This paper has explored the hypothesis that blocs are, in part, the product of historical accidents. Reinforcing mechanisms of integration can be set into motion by military force or other developments that make countries important to each other. In East Asia important initial investments in regional linkages were triggered by imperial conquest—first by the Western powers under the treaty port system, and then by Japan during its imperialist period. By the advent of World War II these investments had transformed East Asia into perhaps the most interdependent region in the world.

After World War II the intensity of East Asian interdependence resumed its prewar level. Subsequently, however, the region diversified its trade patterns, due to the important role of the United States in postwar Pacific relations and to the growing sophistication of the region's industries. The trend toward diversification has been reversed in the last five or so years. Since 1985, spurred in part by investment and aid, trade flows within East Asia have grown sharply and have become more regionally biased.

An interesting question is how the recent flurry of regional policy initiatives will affect these trends. It is likely that the institutions created by these initiatives will not be strong enough to liberalize regional trade. Even if growing intraregional linkages create a demand for cooperation, the diversity of the region's policy approaches makes broad, formal agreements difficult and unlikely. So far, collaboration has focused on narrow, highly pragmatic objectives—trade cooperation in the context of MTAs and ASEAN, and technical cooperation in the context of APEC.

For the time being, then, much of the region's business will be conducted through bilateral rather than multilateral institutions. Japan is raising its profile in regional diplomacy as well as in economic cooperation and consultation. Intense series of Asian visits are scheduled for the emperor and the prime minister. Japanese ministries are also developing country-specific development plans and are encouraging their implementation with aid, expert advice, infrastructure lending, and support for private investment.

The East Asian trading bloc has a long and complex history. Investments in this bloc, some made more than a century ago, have proved surprisingly durable. Today's developments, likewise, may shape the pattern of East Asian

trade far into the future. If there are externalities associated with investments in bilateral trade, as the evidence here suggests, then the factors and policies that affect bilateral trade deserve more attention than they usually receive.

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Comment

Stephan Haggard

Peter Petri's paper provides an excellent introduction to the question of regionalism in the Pacific. It combines an interesting theoretical idea, centered on transactions costs, the collation of new data on the extent of regional interdependence, and a stylized history that is attentive to political as well as economic variables. I want to begin by placing Petri's paper, and others in the volume, in the context of the larger debate about the regionalization of the world economy, before turning to several specific comments.

Recent debates have employed *regionalism* and *regionalization* to mean two quite different things. Regionalization may be used to refer to an *economic* process in which trade and investment within a given region—however defined—grow more rapidly than the region's trade and investment with the rest of the world; this is the definition typically adopted by economists, including Petri. Regionalization has also been used to refer to the formation of political

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groupings, or "blocs," that aim to reduce intraregional barriers to trade and investment.

Any discussion of regionalism must begin by keeping these two meanings of the terms separate, since the relationship between the two phenomena is far from clear. In this regard, it is useful to make a further distinction between economic and political explanations for the two types of regionalism, yielding the typology of different analytic approaches outlined in table 1C.1.

The economic explanation for increased regional integration (cell I) rests on "natural" economic forces of proximity, income convergence, and intrafirm trade; in this view, regionalism may owe very little to policy-induced discrimination. Proximity implies lower transport costs, higher information flows, and increased investment aimed at reducing transactions costs, the factor emphasized by Petri.

According to this view, the tendency toward greater intra-Asian trade should reflect only marginal preferences. There is no necessary tendency for these patterns to continue or deepen; the opposite may be the case. At some point, the advantages of extraregional diversification outweigh the economies associated with regionalization, thus providing a mechanism checking the tendency toward continuing regional concentration.

The "economic" perspective explains the emergence of regional political cooperation in functional terms (cell II). Regional agreements and institutions provide governance structures for managing increased economic integration; cooperation follows, rather than leads, trade and investment flows. Petri states this position succinctly when he argues that "a wide array of regional initiatives have recently emerged to address the new issues generated by East Asian interdependence. From an analytical perspective, these initiatives can be seen as attempts to reduce transactions costs in regional trade, manage intraregional trade frictions, and marshal regional economic forces against external economic challenges."

The economic perspective suggests several structural and policy conditions

Table 1C.1 Alternative Approaches to Regionalism

	Causes of Regionalism	
	Economic	Political
	I	III
Regionalism defined as economic integration	Proximity, income convergence, intrafirm trade, policy convergence	Preferences favor intraregional over extraregional trade and investment
	II	IV
Regionalism defined as political cooperation	Governance structures established to manage increased economic interdependence	Hegemonic power exploited, response to rival blocs. Dependence on domestic coalitions in member countries

that are likely to be necessary for successful regional political groupings to form. First, some threshold of economic integration is necessary for there to be an interest in the formation of a regional political arrangement in the first place. Second, the expected gains from discrimination must apply universally, and not only to some members of the group. Cooperation can founder when gains are unequally distributed.

Finally, the initial trade, investment, and macroeconomic policy stances of the countries should be broadly similar. Wide divergence in policies will make it more difficult to reach regional consensus because of the asymmetric nature of the concessions required of the more closed members. Divergent macroeconomic policies will imply unstable exchange rates, inhibiting both trade and investment, and differences in tax or regulatory regimes will create conflicts between countries with high and low levels of taxation and between countries with more or less strict regulatory norms.

From a normative perspective, this economic view of integration emphasizes the welfare gains to be achieved through trade creation and political cooperation, and assumes that the adverse effects to the rest of the world are limited. Under two conditions, regional organizations can provide "building blocks" for deeper integration: the arrangements must be liberalizing; and they must be nonexclusive in their membership. Arguably, this is what happened in the North Atlantic "region" in the immediate postwar period, flowering gradually into what we now know as multilateralism.

The political view of regionalization tends to see the growth of intrabloc trade primarily as a consequence of policy decisions, either already taken or potential (cell III). The emphasis is on an "unnatural" regionalism constructed on the basis of intraregional preferences that discriminate against extraregional trade and investment. The main puzzle, therefore, is to explain these policy choices. In doing so, the political economy view draws attention to both the internal and domestic factors that the functional economic view ignores (cell IV).

Countries may be motivated to construct regional "fortresses" for a number of international political as well as economic reasons. First, and most obviously, the formation of blocs provides a means of countering competitive pressures from outside the region by providing more assured markets within it. Second, blocs might initially be formed to gain bargaining leverage vis-à-vis other regional blocs. Interbloc negotiations could eventually produce liberalizing outcomes, but it is also possible that bargaining dynamics could degenerate into competitive protectionism rather than a liberal equilibrium.

Finally, intraregional arrangements between larger and smaller countries may reflect hegemonic power relations. Regional hegemons can exploit bilateral asymmetries in interdependence to exercise monopoly and/or monopsony power over smaller and poorer trading partners and to extract policy changes that favor the regional hegemon. Under such a scenario, regionalism will not be multilateralism in miniature, but will rest on a network of bilateral deals.

Such power can ultimately be turned to political objectives, as is seen in extreme form in Japan's Greater East Asia Co-prosperity Sphere or Nazi trade policy in central Europe during the 1930s.

The economic view emphasizes the aggregate welfare gains from integration and thus implicitly assumes the easy reallocation of resources necessitated by increased trade. The political perspective, by contrast, places greater emphasis on the distributional effects of economic integration *within* countries. Integration will have adjustment costs, and thus the viability of regional agreements will hinge in part on domestic political coalitions and conflicts within potential members. This is the main theme of the Frieden and Froot and Yoffie contributions to this volume, though they stress different cleavages: Frieden's is rooted in a real exchange rate analysis, Froot and Yoffie's distinguishes between sectors with declining versus rising returns to scale.

Before situating Petri's arguments, it is important to tackle a prior question: whether there is in fact any evidence of increased economic regionalization in East Asia. There is no reason to repeat the findings that are neatly summarized in table 1.1, except to note that Petri pays particular attention to trends in the East Asian figures, when on both the absolute and relative measures, there is also evidence of a deepening of the Pacific Rim region as a whole; I will return to this point below.

Petri's explanation for East Asian regionalism has two steps. First, a shock increases interdependence; second, this shock increases returns to investments that further reduce transactions costs, creating a virtuous circle of further transactions. It is not theoretically clear why this virtuous cycle would continue. Why don't the advantages of diversification come to outweigh continued investment in regional linkages? Put differently, why does Petri believe there are increasing, rather than decreasing, marginal returns to such transactions costs–reducing investments?

My second broad comment concerns a kind of asymmetry in the historical argument of the paper. The first two phases of integration are attributed to imperialism, but the third is not. This suggests an alternative argument that is familiar to political scientists, namely, that patterns of economic integration are determined by hegemonic actors.

What Petri's account shows, however, is that hegemons operate in quite different ways. British imperialism was aimed primarily at overcoming Chinese resistance to free trade. But the British conception was essentially nondiscriminatory, in that other imperial powers were allowed to benefit from the opening of the treaty ports. From the perspective of the other imperial contenders in the region, including the United States, Britain's victory in the Opium War constituted a pure public good.

Petri's assertion about the effects of these arrangements on regional interdependence are somewhat misleading, however, because they include entrepôt trade via Hong Kong, Shanghai, and Singapore, most of which was directed to Europe and India. If this entrepôt trade is removed, the degree of intraregional

interdependence fostered by British penetration would be much less. Rather, as a theory of hegemony would predict, the region's trade was ultimately directed toward the European metropolitan powers or their colonies, particularly India.

The Japanese empire, of course, was organized on a fundamentally different basis, and suggests that the term "reducing transactions costs" can be somewhat euphemistic. Though Japan reduced transactions costs for Japanese exporters and investors, the government was clearly intent on raising them for everyone else through the imposition of formal and informal preferences. In developing the transactions costs approach, therefore, it is crucial to consider the extent to which the transactions cost–reducing investment is a private, club, or public good.

The U.S. strategy resembles to a greater extent the British one, though initially without the same emphasis on forcing liberalization on strategic allies. The result of this strategy was a steady increase in Pacific Rim interdependence on all three of Petri's measures between 1955 and 1979, and conversely, a decline in the intraregional share. The reason for this pattern was that first Japan, then the East Asian newly industrializing countries (NICs), and then the ASEAN countries adopted export-led growth strategies that were targeted on the United States. Moreover, the United States encouraged them to do so, both through its exchange rate policy and through bilateral influence on economic policy in Japan, Korea, and Taiwan.

Thus, while Petri emphasizes transactions costs in his model of regionalism, there is an implicit political explanation of regionalism lurking in the paper, in which the preferences of the hegemonic actor play a crucial role in the pattern of trade and investment. Petri's conclusion that "postwar trends in East Asian interdependence have been driven by market rather than political forces" ignores the role of the grand strategy of the United States in reconstructing the region as a component of its political-military effort to contain China and the Soviet Union.

This political argument also explains why the emergence of an exclusive East Asian bloc, or even the further deepening of intra-Asian trade and investment, is unlikely. First, Japan, the NICs, and ASEAN all remain heavily dependent on the U.S. market and thus ambivalent about political initiatives that would exclude the United States. Second, it is highly unlikely that Japan will be able economically to play the role of absorber of regional exports that the United States has played. And finally, even if Japan could play this role economically, the countries of the region may have valid political reasons to diversify their trade and investment relationships in order to guarantee that Japan would not be in a position to exercise undue influence.