



Edited by
Ross P. Buckley,
Richard Weixing Hu
and **Douglas W. Arner**

East Asian Economic Integration

Law, Trade and Finance



Asian Commercial, Financial and Economic Law and Policy

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ASIAN COMMERCIAL, FINANCIAL AND ECONOMIC LAW
AND POLICY

Edward Elgar

Cheltenham, UK • Northampton, MA, USA

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Published by
Edward Elgar Publishing Limited
The Lypiatts
15 Lansdown Road
Cheltenham
Glos GL50 2JA
UK

Edward Elgar Publishing, Inc.
William Pratt House
9 Dewey Court
Northampton
Massachusetts 01060
USA

A catalogue record for this book
is available from the British Library

Library of Congress Control Number: 2010939363



ISBN 978 1 84980 868 2

Typeset by Servis Filmsetting Ltd, Stockport, Cheshire
Printed and bound by MPG Books Group, UK

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Introduction

**Ross P. Buckley, Richard Weixing Hu and
Douglas W. Arner**

The economic integration of East Asia is a remarkably uneven phenomenon.

Production of goods is highly integrated. Many products labeled 'Made in China' would be more accurately identified as 'Made in East Asia', as over 40 per cent of the content of manufactured exports from China typically consists of components or other inputs imported from the region. This system of production is replicated in other nations of the region – the nation that finally assembles a product may well contribute less than one-half of the actual value of the final product. Indeed, manufacturing in East Asia today can often more accurately be viewed as a regional, rather than national, endeavour.

This production integration is supported by a high degree of formal trade integration achieved by way of a noodle bowl of regional and bilateral trade agreements. It is also supported by a high degree of direct investment integration, with nations in the region investing in production facilities in other nations. This investment integration in support of production activities is in turn supported by a network of multilateral and bilateral investment treaties. Regional portfolio investment, however, is less well developed.

In stark contrast, financial integration in the region is underdeveloped. Most East Asian nations are more closely integrated financially with nations outside the region, typically in Europe or North America, than they are with other nations in the region. This would make sense if the region were capital poor and the principal sources of capital were external. Yet the region enjoys the largest foreign exchange reserves, and the highest personal savings rates, in the world. So this lack of financial integration is a product of historical factors and underdeveloped financial sectors – particularly underdeveloped equity and capital markets – not supply-side factors.

This volume explores these fascinating inconsistencies in regional integration. It is a volume in three parts. Part I explores the changing regional

institutional order and the dynamics of the rapidly evolving regional cooperation. Part II explores the functional and formal integration in trade and investment within the region. Part III analyses the anomalous case of financial integration and explores ways forward this integration may take.

Part I commences with a chapter by Richard Hu that provides an overview of the state of regional institution building and an analysis of the influences in this regard of China and the United States. This is followed by Chin Leng Lim's contribution, exploring who is afraid of East Asian regionalism and why. This chapter puts the increasing integration of this region in a broader context and explores which countries beyond the region might oppose these developments and why they might do so.

In the final chapter in Part I, Roda and Miron Mushkat use the case of transboundary pollution in Hong Kong to analyse the institutional fragility of the region particularly when it comes to balancing the tension between economic and ecological imperatives.

Part II – trade integration – begins with chapters by Junji Nakagawa and Henry Gao which explore the regional free trade agreement (FTA) strategies of Japan and China respectively. Nakagawa concludes that competitive dynamics best explain Japan's policy shift, in the past decade, towards preferential trade arrangements and away from its traditionally staunch support of multilateral initiatives. Gao on the other hand concludes that the principal drivers of China's use of preferential trade arrangements have been geo-political factors rather than economic ones.

Bryan Mercurio then takes a sceptical look at the dramatic expansion in intra-regional trade in the past three decades and concludes that while this growth occurred at the same time as the growth in regional trade agreements, there is no causal link between the two; that is, trade grew despite, rather than because of, the proliferation of formal trade agreements. Mercurio then goes on to explore the changes in regional trade agreements which would serve to promote intra-regional trade.

The next chapter in this part is by Lisa Toohey. She analyses ASEAN trade dispute resolution and explores the cultural, political and other factors which explain why ASEAN's members have consistently avoided resolving trade disputes by using the region's own dispute resolution protocols and instead, when it is unavoidable, taken their trade disputes to the Dispute Settlement Understanding of the World Trade Organization (WTO).

In the final chapter of Part II, Trinh Yen examines the role of investment treaties in regional investment integration and analyses preferable ways forward towards a more coherent and consistent regional investment regulatory structure.

Part III deals with financial integration. It commences with an analysis

by Douglas Arner and Cyn-Young Park of the implications for Asia of the recent global financial regulatory reforms and of the regional and sub-regional mechanisms and institutions that would serve to advance the region's financial growth and integration. It then proceeds with Injoo Sohn's analysis of the political dynamics of East Asia's financial regionalism. The following chapter by Paul Lejot analyses the multilateralized Chiang Mai Initiative (CMIM), the series of bilateral credit arrangements among regional central banks designed to enhance the financial autonomy and stability of the region in times of crisis. Lejot explores the incompleteness of the initiative at its current stage of evolution.

From this basis, Ross Buckley explores one direction in which the CMIM might lead, if developed extensively, which is to an Asian Monetary Fund. Buckley explores what a regional monetary fund has to offer and concludes that while such a fund has an important role in enhancing regional financial autonomy and stability, it may have even more to offer the region, and the world, by developing an Asian Consensus on development and becoming an authoritative voice to enunciate and promote those policies that have worked in Asia to the benefit of the region's further development and that of other developing nations in other parts of the world.

In the final chapter of Part III Nhu Vu explores one of the potential future paths open for regional financial integration: the establishment of an Asian currency unit and, in particular, the potential role of the Asian Development Bank in its creation.

The work concludes with a chapter by the editors in which we summarize some of the themes of the volume and examine the future prospects of regional institution building.

This volume grew out of two workshops held in the region in the second half of 2009. In October, the University of New South Wales and the Asian Institute of International Financial Law of the University of Hong Kong jointly hosted a workshop in Hong Kong on regional economic integration. The following month the University of New South Wales hosted a workshop on the same subject in Hanoi, Vietnam. Most of the chapters in this volume were presented and discussed at these workshops. Discussions have continued since then among authors working in similar areas with a view to producing a cohesive volume.

This book seeks to do more than describe what is, although we trust it does this competently. More importantly, it seeks to explore alternative pathways down which the region could progress, for the region today truly does stand at a cross-roads. In the past regional institution building and cooperation have been stymied by China's distrust of regional institutions, the long-standing tensions between China and Japan as they have

competed for influence, and the strong preference of the United States to continue to exert its influence in the region through its series of bilateral relationships – a preference that has resulted in US opposition to most regional initiatives.

In the past decade this landscape has changed. China has come to understand and appreciate the need for, and potential of, regional institutions and has grown comfortable with being a member of such institutions. China and Japan, while certainly still competing for influence, have seemingly come to some rapprochement, an understanding that influence shared might be influence enhanced. And, finally, for most of the first decade of the new century the United States was obsessed with terrorism and the Middle East. By the time the Obama administration came to power and started to give Asia a focus appropriate to the region's economic importance, the region generally, and China in particular, had grown remarkably in confidence and economic power, and the United States has found a return to its old approaches simply untenable.

So East Asia's economic destiny lies today in its own hands more than it has for the past century. It will be Asians who decide on paths of regional cooperation or competition. And it will be the region that decides whether it is sufficiently committed and serious to lift its financial integration to the levels of its integration in production and trade.

The past two decades in East Asia have witnessed economic growth without peer in human history (except perhaps for the two decades of Japan's growth in the 1950s and 1960s, which is in many ways the starting point for the East Asian growth story). The potential for the next two decades is no less exciting. It has been our pleasure to assemble this volume which explores the directions the region might most usefully take in the future.

PART I

The changing regional order and dynamics
for cooperation

1. China, the US and regional institution building in East Asia

Richard Weixing Hu

INTRODUCTION

China and the United States are two key players in shaping future East Asian regional order and institutions. For a long time after World War II, East Asia was perceived as being institutionally underdeveloped with no region-wide political and economic institutional structure, except an American-centered network of bilateral security treaties. Yet, after the Cold War and especially after the Asian Financial Crisis of 1997–98, a rising tide of regionalism and institution-building projects appeared. There is a proliferation of regional groupings and dialogues, ranging from the Association of Southeast Asian Nations (ASEAN), the ASEAN Regional Forum (ARF), ASEAN+3 and the East Asia Summit (EAS) to Asia-Pacific Economic Cooperation (APEC). East Asian nations are organizing themselves into an ‘alphabet soup’ of multilateral groupings and organizations with overlapping membership and different mandates. This makes people wonder what kind of regional order East Asia is building and what role China and the US will play in regional institution building.

China is a rising power on the global and regional stage. China’s ascent and its growing influence in East Asia have important bearings on regional order and regional institutional building. Yet, how China comes to terms with regional institutions is still an issue under debate. In order to rise peacefully, China needs a stable and prosperous regional environment for concentrating on its growth. Meanwhile, Beijing also wants to engage in regional institution building to reassure its neighbors as well as to gain normative and institutional power in shaping the future regional order. On the other hand, the United States is a ‘non-territorial’ but leading power in East Asian affairs. The US has built and maintained a regional security order based on a system of ‘hub-and-spokes’ bilateral alliances and an open trading system in the post-war era. This regional structure has provided a remarkably comfortable basis for Washington to pursue its

economic and security interests in the region. But since the end of the Cold War, the strategic and institutional landscape in East Asia has undergone fundamental changes in the context of the rise of China and East Asian regionalism. The rise of the Chinese influence is viewed as being at the expense of American power in the region.

There are two contending perspectives on the US–China struggle for power in East Asia. One perspective views the growth of Chinese power as being at the expense of American influence. Although China's power at the present time is no match for that of the US and it does not seem quite obvious that Beijing is explicitly driving Washington out of regional institutions, the Chinese influence is quickly picking up while the American influence in the region has been on the decline. On the other hand, the opposing view argues that things cannot be viewed through a zero-sum lens. The rise of Chinese clout in East Asia does not necessarily mean the loss of American influence. The increase in Chinese influence around its periphery and in different realms is not even, and there are still strong barriers to Beijing advancing its influence in East Asian institutions. As one leading US China scholar argues, American and Chinese influence in East Asia is in an interlocking pattern. Even if it is the case that China's influence has increased, 'the overall direction in which China's regional policy has moved is consistent with fundamental US interests.'¹

The East Asian region and the world are trying to make sense of the US–China relationship in regional institution building. How does the emerging China–US struggle for influence affect future East Asian institution building? Does emerging regional institution building in East Asia benefit or impede Washington's and Beijing's influence in the region? Does the proliferation of Asian institution-building projects benefit the rising China? Does it help or impede China's efforts to advance its regional influence? How should Washington respond to the growing regionalism in East Asia? How should the US engage China in the development of regional political and economic institution building?

This chapter focuses on two questions of this debate. The first question is about what role China and the US play in regional institution building. Both China and the US have their own strengths and weaknesses in the regional institutional competition. As Peter Katzenstein argues, Asia is a 'porous' region.² It is an 'open region,' letting through all sorts of

¹ David M. Lampton, 'China's Rise in Asia Need Not Be at America's Expense', in David Shambaugh (ed.), *Power Shift: China and Asia's New Dynamics* (Berkeley, CA: University of California Press, 2006), 322–3.

² Peter J. Katzenstein, *A World of Regions: Asia and Europe in the American Imperium* (Ithaca and London: Cornell University Press, 2005), 21.

inputs and influence, internal and external. China is an 'insider,' with geographic advantage, economic attractiveness, local neighborhood, rising soft power, and sharing compatible regional governance interests with regional nations. Beijing is also well plugged into many on-going region-building projects. The US, on the other hand, is a 'non-territorial' power. It still has enormous material and normative power and a strong bilateral security structure in East Asia, enjoying the critical position of 'honest broker' and 'balancer' in regional affairs. Being two leading powers in the region, both the US and China have opportunities and capacities to shape or reshape regional institution building. They also have plenty of room to cooperate in regional institution building and governance. East Asia being a 'porous' region, its regional structure takes different institutional forms and has already witnessed an array of region-building programs flourishing. Thus I would argue that it is in both countries' interests to handle regional institution building in an accommodating way, not in a competitive and mutually exclusive way.

The second question concerns how the rise of China affects the US power position in the region. I would argue that China's ascent so far has fared well with the existing power position held by the US. It is true that China's regional influence is on the rise, and the rising China is challenging America's primary role in the region. Yet, we should recognize that the rise of Chinese influence and the decline of American influence are two separate matters, not negatively related. We should not use zero-sum logic to see the two matters; rather, we should study them separately on their own merits. Yet I believe, although they are not causally related, the two major powers and their relations are closely linked to the play of regional institution building and regional order shaping. What really matters here is not the realist type of power balancing (such as containment, alliance, arms race, or hedging) for future US-China competition but rather, a 'soft' type of power balancing. The underlying logic of competition is not 'balance of power'; rather, it is 'balance of influence'. The soft competition is not about coercive power; instead, it is about remunerative and normative power, ideas, intellectual might, and moral appeals.³ Among them, regional institutions are an important realm for power competition. Both Beijing and Washington have to try to increase 'institutional power' through initiating, transforming and dominating regional institutions in their favor to counterbalance the other's influence in the region.

³ See David M. Lampton, *The Three Faces of Chinese Power: Might, Money, and Minds* (Berkeley, CA: University of California Press, 2008).

RISING EAST ASIAN REGIONALISM AND INSTITUTION BUILDING

Compared with Europe, East Asia is much less institutionalized. East Asian nations do not have a comparable integrationist tradition, and the region is too vast and diverse to form a coherent regional organization. East Asian cultural and political traditions have also helped to cultivate a greater reluctance to pool sovereign authority together under a regional institutional framework, as the Europeans did through the European Economic Community by the Treaty of Rome in 1957 and eventually the European Union by the Treaty of Maastricht in 1993. For East Asian nations, economic integration is largely driven by market forces, and the benefits of economic cooperation have nurtured an appetite for regional institution building. Growing economic interdependence and the desire for further economic integration have become the sustained driving force for regional institution building in East Asia.

Yet, East Asian regional institutions are 'soft', shallow, and weak. The process of institution building is largely driven and sustained by the Association of Southeast Asian Nations in the so-called 'ASEAN way'. The ASEAN way emphasizes informality, consultation, consensus building, conflict management and confidence building, and progressing institution building at a pace and to a level comfortable to everyone. The pace of East Asian institution building is slow and the level of institutionalization is low. Everyone involved seems more interested in the 'process' and 'form' than the final result of institution building. In the process, ASEAN has been in the driver seat and other players, including regional major powers, in the passenger seats.

ASEAN has built a series of concentric regional institutions with itself at the center. Now there are at least four layers of regional institution-building projects around ASEAN. At the center, ASEAN itself is moving gradually toward an EU-type of regional community, with three pillars in the security, economic, and social-cultural realms. The next layer is what is called ASEAN+3 (APT), ASEAN's engagement with China, Japan and South Korea in functional cooperation. APT has developed some regional cooperative arrangements, such as the Chiang Mai Initiative (CMI) and the Greater Mekong Subregion (GMS).⁴ Under the APT process there is also a collateral Northeast Asian dialogues program among China, Japan

⁴ For background information about APT, the CMI and the GMS, see <http://www.aseansec.org/16580.htm> and <http://www.aseansec.org/11600.htm>, accessed 10 June 2010.