

THE POLITICAL ECONOMY OF THE ASIA PACIFIC

Vinod K. Aggarwal  
Min Gyo Koo  
*Editors*

# **Asia's New Institutional Architecture**

*Evolving Structures  
for Managing Trade,  
Financial, and  
Security Relations*

 Springer

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*Editor*

Vinod K. Aggarwal, University of California, Berkeley, CA, USA

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# Asia's New Institutional Architecture

Evolving Structures for Managing Trade,  
Financial, and Security Relations

 Springer

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## Preface

Can regional and interregional mechanisms better institutionalize the increasing complexity of economic and security ties among states in Northeast, Southeast, and South Asia? As the international state system undergoes dramatic changes in both security and trade relations in the wake of the Cold War's end, the Asian financial crisis, and the attacks of September 11, 2001, this question is now of critical importance to both academics and policymakers. Still, little research has been done to integrate the analysis of both regional security and economic dynamics within a broader context that will give us theoretically informed policy insights.

Indeed, when we began our background research on the origin and evolution of Asia's institutional architecture in trade and security, we found that many scholars had focused on individual subregions, whether Northeast, Southeast or South Asia. In some cases, scholars examined links between Northeast and Southeast Asia, and the literature often refers to these two subregions collectively as "Asia", artificially bracketing South Asia. Of course, we are aware that as products of culture, economics, history, and politics, the boundaries of geographic regions change over time. Yet the rapid rise of India and its increasing links to East Asia (especially those formed in the early 1990s) suggest that it would be fruitful to examine both developments *within* each subregion as well as links *across* subregions. The recent debates over whether an Asian-specific institution should include only the ASEAN states along with China, Japan and Korea (the so-called "ASEAN Plus Three") or also Australia, New Zealand, and India, illustrates the highly contested nature of what "properly" constitutes "Asia". Moreover, we found that the study of Asian institutions tends to separate the analysis of security matters from the analysis of economic matters, failing to address key linkages between the two.

In an effort to better understand how regional and interregional mechanisms are likely to evolve, we began with the oft-noted erosion of the "San Francisco System." This arrangement, codified largely through the 1951 San Francisco Peace Treaty between the U.S. and Japan, provided Asian nations with a bilateral-multilateral institutional mix. It offered many East Asian states access to the U.S. market in return for a bilateral security alliance with the U.S. It also encouraged America's Asian allies to participate in broad-based multilateral forums such as the United Nations, the General Agreement on Tariffs and Trade (GATT) and its successor organization,

the World Trade Organization (WTO). Yet countries in South Asia did not directly participate in these arrangements and countries within the Soviet sphere of influence (such as China) were clearly excluded. As we argue in our introductory chapter, we find it useful to examine how this traditional institutional equilibrium in Asia has come under heavy strain in what we term the post-“triple shocks” period following the Cold War, the 1997-98 financial crisis, and the attacks of 9/11. We then analyze the resulting implications of these shocks and longer-range trends such as the rise of China and India on the creation of a new institutional architecture using an institutional bargaining game approach. We are well aware that the construction of a new institutional architecture in Asia is a work in progress. Yet at the same time, we believe that it is timely from both a theoretical and policy perspective to examine the shifts we are seeing so as to shed light on the likely trends and implications of these dramatic changes for both Asia and the rest of the world.

This book has been generously supported by the Center for Global Partnership of the Japan Foundation (CGP). Its current director, Akihiko Murata, has been extremely supportive of our research effort. CGP Program Associate Carolyn Fleisher has been a steadfast supporter of this research. Her help and prompt attention to our endless requests have considerably lightened our burdens. The financial assistance we received from the CGP allowed us to host two major conferences at the University of California at Berkeley and at the East-West Center in Honolulu. These meetings and opportunities for interaction have greatly strengthened our work and also helped to build enduring ties among scholars that geographically span more than half the globe.

At our first meeting in Berkeley in December 2005, we benefited greatly from the insights and comments of Pradeep Chhibber, Jonathan Chow, Beverly Crawford, Ellen Frost, Mujeeb Khan, Jin-Young Kim, and Kenji Kushida. We would like to particularly single out the help we have received from Seung-Youn Oh, who not only provided logistical and organizational support for the conference, but also lent her expertise as a discussant.

Our second meeting, held in Honolulu in December 2006 at the East-West Center, benefited from discussants from both the University of Hawaii and the East-West Center. They included Muthiah Alagappa, Sumner La Croix, Chung Lee, Chris McNally, and Peter Petri. Jonathan Chow of the Berkeley APEC Study Center (BASC) not only served as a discussant and rapporteur, but also worked closely with the East-West Center staff to manage the conference. We are especially grateful to Nancy Lewis, Director of the East-West Center Research Program, Eugene Alexander’s logistical support, and Charles Morrison’s encouragement of this project.

We also benefited from comments and suggestions from the participants of the 2006 International Studies Association's annual meeting held in San Diego and the East Asian regionalism conference organized by the Center for International Studies at the University of Southern California in spring 2006, which was in part supported by the CGP. We especially thank Peter J. Katzenstein, Gilbert Rozman, T.J. Pempel, Peter Rosendorff, Saori Katada, Mireya Solis, Young-kwan Yoon, Akiko Fukushima, Chaibong Hahm, and Seungjoo Lee for their constructive feedback on our framework paper.

The work of BASC staff proved crucial. Without the help of Project Director Jonathan Chow, this book would never have seen the light of day. He has helped in providing comments to the paper writers and managed the publication process, greatly easing the editors' workload, and making what at times seemed impossible appear easy. In these tasks, a number of undergraduates also assisted in helping to organize the Berkeley conference, edit papers, and prepare the manuscript for publication. For their help, we are particularly grateful to Robert Chen, Sean Fahle, David Guarino, Michelle Haq, Annie Ho, Rohit Jain, Christine Kao, Patricia Kim, Nikhil Kumar, Vivek Narayandas, Michael Ricci, Renee Schneeberger, Akash Suri, Jessica Vu, and Linh Vuong—all of whom have worked or currently work at BASC as part of the Berkeley Undergraduate Research Apprenticeship Program. We have also been particularly fortunate to benefit from the administrative support of Amy Chi, Serene Lo, and Tami Driver who kept the project on track.

We are deeply grateful to Niels Peter Thomas of Springer Verlag for seeing the merit of this book. It is also a privilege to be the first book in the series entitled "The Political Economy of the Asia Pacific" that Vinod Aggarwal will edit for Springer.

We, of course, remain responsible for any errors or omissions.

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# Abbreviations

ABMI	Asian Bond Market Initiative
ACFTA	ASEAN-China Free Trade Area
AEC	ASEAN Economic Community
AFC	Asian Financial Crisis
AFTA	ASEAN Free Trade Area
AMF	Asian Monetary Fund
APEC	Asia-Pacific Economic Cooperation Forum
APT	ASEAN Plus Three
ARF	ASEAN Regional Forum
ASC	ASEAN Security Community
ASEAN	Association of Southeast Asian Nations
ASEAN-ISIS	ASEAN Institutes of Strategic and International Studies
ASEAN-PMC	ASEAN Post-Ministerial Conference
ASEM	Asia-Europe Meeting
BIMP-EAGA	Brunei Darussalam Indonesia Malaysia the Philippines-East ASEAN Growth Area
BIMSTEC	Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation
BIS	Bank for International Settlements
CBM	confidence-building measure
CMI	Chiang Mai Initiative
CSCAP	Council for Security Cooperation in the Asia-Pacific
EAEC	East Asia Economic Caucus
EAS	East Asia Summit
EAVG	East Asia Vision Group
EEZ	Exclusive Economic Zone
EFTA	European Free Trade Association
EVSL	Early Voluntary Sectoral Liberalization
FPDA	Five Power Defense Arrangements
FTA	free trade area/agreement
GATT	General Agreement on Tariffs and Trade

GMS	Greater Mekong Subregion
IAP	Individual Action Plan
KEDO	Korean Peninsula Energy Development Organization
METI	Ministry of Economy, Trade and Industry (Japan)
MITI	Ministry of International Trade and Industry (Japan)
NAFTA	North American Free Trade Agreement
NATO	North Atlantic Treaty Organization
NEACD	Northeast Asia Cooperation Dialogue
NPT	Nuclear Non-Proliferation Treaty
PAFTAD	Pacific Trade and Development Forum
PBEC	Pacific Basin Economic Council
PECC	Pacific Economic Cooperation Conference
PTA	preferential trade agreement
SAARC	South Asian Association for Regional Cooperation
SCO	Shanghai Cooperation Organization
SEATO	Southeast Asia Treaty Organization
SPT	Six-Party Talks
TAC	Treaty of Amity and Cooperation
UNCIP	UN Commission on India and Pakistan
USTR	United States Trade Representative
ZOPFAN	Zone of Peace, Freedom and Neutrality

# 1. Asia's New Institutional Architecture: Evolving Structures for Managing Trade, Financial, and Security Relations

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## 1.1 Introduction

During the Cold War, the Asian region consisted of three distinct sub-regions—Northeast, Southeast, and South Asia. Aside from the geographical constraints of the region itself, this subdivision of Asia was a product of culture, economics, history, and superpower rivalry. From one perspective, Asia remains too heterogeneous to permit the invocation of a distinct Asian identity. Southeast Asia is divided deeply along ethnic, linguistic, and religious lines. In Northeast Asia, the effects of Japanese colonialism and imperialism have left sharply diverging historical memories and interpretations. And conventional analysis has separated South Asia from its “East Asian” counterpart. Such divisions and heterogeneity have inhibited the emergence of a common Asian identity let alone broad-based, effective Asian institutions.<sup>2</sup>

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<sup>1</sup> We would like to thank Jin-Young Kim and Peter Petri for their valuable comments. We are deeply indebted to Jonathan Chow for his editorial assistance.

<sup>2</sup> International regimes have been defined broadly as “sets of implicit and explicit principles, norms, rules and decision-making procedures around which actors’ expectations converge” (Krasner 1983). To refine this definition, we can distinguish between the principles and norms—the “meta-regime” (Aggarwal 1985)—and the regime itself, defined as the rules and procedures to allow us to distinguish between two very different types of constraints on the behavior of states. We use the term institution to refer to the combination of a meta-regime and a regime—rather

Today, however, the acceleration of globalization and the rise of absolute power available within Asia have made superpower rivalry and geography matter less than underlying structural changes in regional economic and security orders. While *global* structural conditions have become less determinative of regional economic and security outcomes, *regional* structural conditions will likely become even more significant, particularly in light of the “triple shocks”, which we identify as the end of the Cold War, the 1997-98 Asian financial crisis, and the attacks of September 11, 2001.

The question now at the forefront of the minds of both academics and policymakers is whether or not regional and interregional institutions can better manage the increasing complexity of trade, financial, and security ties among the states in Asia. This chapter theorizes about the emerging institutional architecture by systematically taking into account the role of state and non-state actors across the Asian region. Falling communication costs due to globalization have increased the number of participating actors and increased the relevance of “complex interdependence.” In addition to the traditional actors at the sub-national and national levels, transnational actors are increasingly leaving their mark on the international system. Still, increased participation at a distance and a move toward complex interdependence do not necessarily imply the end of politics among “territorial” states. Globalization shrinks distances but does not make geography irrelevant; the filters provided by domestic politics and political institutions play a major role in determining the actual effects of globalization and how well various countries adapt to it. We thus analyze the roles of both national and transnational actors in forming regional institutions in Asia.

In investigating the origins and evolution of Asia’s new institutional architecture in trade, finance, and security, this book focuses on three sets of distinct but related issues. The first concerns the evolution of a new institutional equilibrium in trade and finance. The second examines the changing paths toward security cooperation. The final set of issues addresses the strategic interaction between trade, financial, and security arrangements. Each set of questions will be investigated along the three sub-regional lines with attention to linkages among Northeast, Southeast, and South Asia through interregional arrangements.

As we discuss below, the traditional institutional equilibrium in Asia has come under heavy strain in the post-“triple shocks” period. The new dynamics of rivalry and cooperation among states at both the intraregional

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than Krasner’s definition. Note that an institution is *not* the same thing as an international organization: one can find areas of international collaboration where there are well-defined principles, norms, rules, and procedures for actors’ behavior in the absence of an organization such as the International Monetary Fund (IMF).

and transregional levels are now shaping new institutional pathways. Political and business leaders from Northeast and Southeast Asia interact with each other more frequently. South Asia's engagement with East Asia in recent years has been truly impressive. The future institutional trajectory of Asia is still open, but we believe that it is now timely to examine the shift. An academically informed approach to the links between economic and security institutions and issues will give us a unique perspective on the types of institutional solutions that may be feasible in Asia.

The remainder of this chapter proceeds as follows. Section 1.2 presents an overview of the shifting institutional balance in Asia. Section 1.3 categorizes of different modes of trade, financial, and security governance. Section 1.4 develops an institutional bargaining game approach and analyzes the process through which various types of trade, financial, and security arrangements have been pursued in Asia. Section 1.5 lays out the structure of the book, highlighting the institutional developments in Northeast Asia, Southeast Asia, and South Asia. Finally, Section 1.6 summarizes the argument.

## **1.2 Traditional and Emerging Institutional Balances in Asia**

At the outset of the Cold War, hostile geo-strategic circumstances and historical animosities shaped unique institutional pathways for Asian countries to manage their economic and security ties. In the virtual absence of an alternative mechanism at the regional level, trade, financial, and security relations were governed through a combination of U.S.-centric bilateral and multilateral arrangements and informal networks based on corporate and ethnic connections in the economic arena.<sup>3</sup>

The so-called "San Francisco system," codified largely through the 1951 San Francisco Peace Treaty between the Allies and Japan, provided Asian countries with a unique institutional mix of bilateralism and multilateralism. It offered America's Asian allies access to the U.S. market in return for a bilateral security alliance with the U.S. It also encouraged Asian countries to participate in broad-based multilateral forums in both economics—e.g., the General Agreement on Tariffs and Trade (GATT), the World Trade Organization (WTO), and the IMF—and security—e.g.,

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<sup>3</sup> Cumings (1997); Grieco (1997); Katzenstein (1997)

the United Nations (UN).<sup>4</sup> This system, which proved relatively beneficial for most Asian countries, created few incentives for them to develop regional arrangements until the mid-1990s. At the same time, bitter memories of Japanese and Western colonialism, heterogeneous policy preferences and strategies, and cultural diversity also reinforced the preference against formalized regional organizations.<sup>5</sup>

For example, since its creation in 1967, the Association of Southeast Asian Nations (ASEAN) has shown a certain degree of institutional capacity in both security and trade matters. Yet ASEAN remains a remarkably modest organization with only scattered signs of institutional deepening and widening. The ASEAN Free Trade Area (AFTA) is a collective effort by ASEAN members to eliminate tariffs on intra-ASEAN trade on a voluntary basis, but relatively slow progress has impeded movement toward a true free trade area since the idea was first formulated in 1991. Asia-Pacific Economic Cooperation (APEC) remains an essentially consultative forum more than fifteen years after its birth, with most members continuing to prefer “loose family-type linkages” to more formal institutional structures.<sup>6</sup> Several proposals for a more exclusive Asian economic club failed throughout the 1990s.<sup>7</sup>

On the security front, Asia lacks an equivalent to the North Atlantic Treaty Organization (NATO) for Europe and the U.S. Alliances in Asia tend to be bilateral, leaving security coordination at the minilateral level under-institutionalized. Together with large U.S. military forces stationed in Japan, South Korea, the Philippines, South Vietnam, and Guam, these bilateral security treaties became the backbone of the U.S. “hub and spoke” strategy to contain communist forces in Asia.<sup>8</sup> The ASEAN Re-

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<sup>4</sup> Calder (2004: 138-140) outlines the key defining features of the San Francisco system: 1) a dense network of bilateral security alliances; 2) an absence of multilateral security structures; 3) strong asymmetry in alliance relations, both in security and economics; 4) special precedence to Japan; and 5) liberal trade access to American markets, coupled with relatively limited development assistance.

<sup>5</sup> Cumings (1997); Grieco (1997); Katzenstein (1997)

<sup>6</sup> Aggarwal and Morrison (1998); Ravenhill (2002); Tsunekawa (2005)

<sup>7</sup> The most oft-cited example is the fate of the East Asian Economic Group (EAEG), proposed by former Malaysian Prime Minister Mahathir bin Mohamad. Strong U.S. opposition, Japan’s hesitation, and lukewarm support from most East Asian neighbors led to a downgrading of his idea to the creation of an East Asian Economic Caucus (EAEC) in 1993.

<sup>8</sup> Tsunekawa (2005: 108)

gional Forum (ARF), which was launched in 1994, is virtually the only intergovernmental forum for security dialogue in Asia.

The U.S. was relatively passive and more concerned about how such a transregional security dialogue might constrain U.S. military forces and weaken bilateral alliances in the region. For its part, although an early proponent of multilateral security dialogues, Japan shied away from pushing hard for more substantive discussions and negotiations. China obstructed any moves in this direction for fear of international intervention and pressure on its domestic affairs such as human rights and civil justice. And the two South Asian giants, India and Pakistan, were left out of the regional scene. As a result, the conventional wisdom was that the development of cooperative security norms among Asian countries would likely have to rely on so-called “concerted bilateralism”—the structuring of a formal bilateral summit process in which major regional powers interact systematically with each other—rather than explicit multilateralism.<sup>9</sup>

Although one might argue that the San Francisco system served much—if not all—of East Asia well for the postwar era by obviating the need for any significant regional arrangements to manage economic and security relations, this mix of institutions now faces severe challenges. With respect to trade, many Asian countries’ commitment to a broad-based, multilateral trade regime is currently in question as the Doha Round of WTO negotiations have made little progress thus far since its inception in 2001. At the transregional level, APEC, as a formal mechanism to facilitate economic integration, has been unsuccessful.<sup>10</sup> With respect to informal market integration, the unprecedented economic shocks at the end of the 1990s have demonstrated that the seemingly dense networks of Japanese and overseas Chinese business are quite vulnerable.<sup>11</sup> As a result, a growing number of Asian countries are now actively pursuing greater institutionalization at the sub-multilateral level, actively weaving a web of preferential trade agreements (PTAs) with each other.<sup>12</sup>

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<sup>9</sup> Buzan (2003); Evans and Fukushima (1999); Mochizuki (1998)

<sup>10</sup> Aggarwal (2000)

<sup>11</sup> Aggarwal and Koo (2005)

<sup>12</sup> The conclusion of Japan’s first post-World War II free trade agreement (FTA), the Japan-Singapore Economic Partnership Agreement, came at this critical juncture in October 2001. The other economic giant in Asia, China, also signed a framework FTA with its neighbors in Southeast Asia in February 2003. In addition, other Asian countries have wasted no time in moving toward PTAs, departing from their traditional commitment to the WTO. See Aggarwal and Urata (2006)

With respect to financial cooperation, the current process of regional financial institution building in Asia revolves around three motives. First, it is a response to the Asian region's dissatisfaction with the global financial regime, as manifested during the Asian financial crisis. The perceived injustice or unfairness of the global financial architecture enshrined in the IMF has made it politically easier for the leaders of crisis-ridden countries to seek regional solutions.<sup>13</sup> Indeed, the Asian financial crisis had a profound affect on the way in which Asian countries perceive the global and regional financial institutions. The regional attempt to create an "Asian Monetary Fund (AMF)" during the early stages of the Asian financial crisis was immediately rejected by the U.S., owing to fears that an AMF could undermine the leadership role of the IMF and foster a split between East Asia and North America. Instead of directly confronting American opposition, the APT countries, therefore, set up a currency swap scheme in Chiang Mai, Thailand, in 2000 as a "firewall" against future financial crises.<sup>14</sup> Looking beyond the Chiang Mai Initiative (CMI), which only allows for country-to-country currency swaps, ASEAN Plus Three (APT) finance ministers met in Kyoto in May 2007 to discuss combining some of region's \$2.7 trillion in foreign reserves to help central banks shield their currencies from speculative attacks.<sup>15</sup> Although these arrangements are at a very early stage and details have yet to be worked out, this represents a serious move toward an Asian Currency Unit (ACU).

With respect to security, the San Francisco system has been gradually modified since the early 1970s by the inclusion of China and other communist countries, but until recently has hewed remarkably closely to its original Japan-centric, Washington-dominated form.<sup>16</sup> In the post-9/11 era, however, the fissure in the system has become increasingly visible, primarily due to changes in America's alliance policy. With its counterterrorism initiatives, the U.S. is now reconfiguring its traditional security policy in Asia for strategic and logistical reasons while soliciting multilateral cooperation against terrorism and scaling down its forward deployment. In order to maintain its strategic strength despite a smaller physical presence, Washington has begun to urge its Asian allies to expand their regional security missions, leading to a number of regional cooperation initiatives. APEC and the ARF, encouraged by the U.S., have adopted a series of counterterrorism measures. Although counterterrorism cooperation under-

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<sup>13</sup> Katada and Solis (2006:7-8); Higgott (1998)

<sup>14</sup> Amyx (2003)

<sup>15</sup> Kim and Li (2007)

<sup>16</sup> Calder and Ye (2003)

taken by regional organizations focuses on intelligence and information exchanges rather than substantive measures, there has increasingly been exploration of more rigorous efforts to institutionalize security affairs at the regional level.

What might these developments imply for Asia? How are they likely to affect U.S. relations with China, Japan, and India? Will new developments undermine or enhance the WTO and the IMF, and efforts to manage security concerns on a broader basis? To examine these questions, we first begin by outlining Asia's current institutional landscape.

### 1.3 Modes of Economic and Security Governance in Asia

Asian countries have utilized a host of measures to regulate trade and financial flows and assure security in an anarchic world, yet the literature on Asian regionalism fails to distinguish among various modes of governance of economic and security issues. While lacking well-institutionalized organizations like the European Union (EU) and NATO, Asian countries have relied on a *mélange* of institutional and semi-institutional measures to manage their economic and security relations.

Such measures can be characterized according to various criteria, but four main features are particularly important. First, in terms of the *number of participants*, Asian economic and security institutions include unilateral, bilateral, minilateral, and multilateral arrangements. Second, in terms of *geography*, their membership is either concentrated within Asia or includes other actors outside of the region. Third, agreements can be classified according to their *strength*—while some agreements are strictly binding, others lack strong enforcement and are weakly institutionalized. Finally, the *issue scope*—that is, the range of issues that an institution deals with—can run from narrow to broad.<sup>17</sup> One could also examine the *nature* of agreements,<sup>18</sup> but our primary focus here with respect to economics is on trade-liberalizing measures. Naturally, some agreements are more preferential in nature than others and may exclude sectors, making them protectionist in orientation. And in security, we can refer to agreements as security-enhancing or security-reducing, which can refer to their impact on countries not party to the agreement. To keep the analysis in our tables manageable, we do not include “nature” as a characteristic, but individual authors in their empirical chapters discuss this aspect in detail.

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<sup>17</sup> For details of these criteria, see Aggarwal (1985)

<sup>18</sup> *Ibid.*

### 1.3.1 The Membership and Geography of Arrangements

Of these four dimensions, we first focus on the two most salient features that characterize Asia's emerging institutional architecture, namely the *number of participants* and *geography*. This approach allows us to systematically classify the types of arrangements that have been pursued in Asia as a basis for further analysis. Table 1.1 illustrates different modes of trade, financial, and security arrangements. Note that although we include the possibility of unilateral actions, these are clearly not "arrangements".

1) The first column of the table consists of *unilateral actions*. Unilateral economic liberalization includes measures such as those by Singapore and Hong Kong, as well as APEC-led initiatives such as Individual Action Plans (IAPs). Outside of these few cases, however, unilateral economic liberalization efforts have been as relatively rare in Asia as in other regions. Unilateral security management often involves actions that are detrimental to overall regional security although a credible threat may also be stabilizing. For example, North Korea's unilateral show of force as seen in the missile and nuclear weapons tests in 2006 has frustrated its neighbors as well as the U.S., destabilizing relations in the region.

2) Along with the bilateral currency swap agreements between China, Japan, and South Korea, the prospective Japan-South Korea and South Korea-China FTAs fall into the category of *geographically concentrated bilateral subregionalism*. More often than not, such agreements indicate not only geographic, historic, and cultural affinity but also complementary industrial structures. Their counterpart in the security realm can be found in the "spider web" of bilateral military ties that links together the states of Southeast Asia, with the majority of joint military exercises taking place between Indonesia, Malaysia, and Singapore.<sup>19</sup>

3) The second category of bilateral arrangements consists of *geographically dispersed bilateral transregionalism*. Trade arrangements that fall under this category include the bilateral FTAs between Singapore and New Zealand (2000), Japan and Singapore (2002), South Korea and Chile (2002), Singapore and the U.S. (2003), Japan and Mexico (2004), and South Korea and the U.S. (2007), to name just a few. Various bilateral currency swap agreements between Japan/South Korea and individual ASEAN countries represent bilateral financial transregionalism. Meanwhile, the most significant transregional-bilateral defense ties exist between Asian countries and the U.S. As noted above, the postwar U.S. grand strategy has revolved around bilateral security and economic ties with its allies in the region.

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<sup>19</sup> Acharya (2003)

**Table 1.1: Modes of economic and security arrangements in Asia\***

	<b>Bilateral</b>		<b>Minilateral</b>		<b>Multilateral</b>	
	<i>Geographically Concentrated</i>	<i>Geographically Dispersed</i>	<i>Geographically Concentrated</i>	<i>Geographically Dispersed</i>		
<b>Trade and Financial Arrangements</b>	(1) Various trade liberalization measures taken by Singapore and Hong Kong APEC Individual Action Plans (IAPs)	(2) Japan-China, Japan-South Korea, and China-South Korea currency swap agreements Japan-South Korea FTA (under negotiation) China-South Korea FTA (under study)	(3) Singapore-New Zealand CEP (2000) Japan-Singapore EPA (2002) Korea-Chile FTA (2002) U.S.-Singapore FTA (2003) Taiwan-Panama FTA (2003) Japan-Mexico FTA (2004)	(4) AFTA (1991) BIMSTEC (1997) ASEAN-China FTA (2003) NEAFTA (proposed)	(5) PAFTAD (1968) PBEC (1980) APEC (1989) EAEC (1994) ASEM (1996) ASEAN Plus Three (1998) CMI (2000) ABMI (2003) South Korea-EFTA FTA (2005)	(6) IMF (1947) World Bank (1947) GATT/WTO (1947/1995) ITA (1997) BTA (1998) FSA (1999)

\* Adapted from Aggarwal (2001); Updated as of June 2007 with illustrative examples.

	Unilateral	Bilateral		Multilateral		
		<i>Geographically Concentrated</i>	<i>Geographically Dispersed</i>	<i>Geographically Concentrated</i>	<i>Geographically Dispersed</i>	
<b>Trade and Financial Arrangements (cont'd.)</b>			<p>Korea-Singapore FTA (2005)</p> <p>Japan-Malaysia FTA (2005)</p> <p>China-Chile FTA (2005)</p> <p>Korea-U.S. FTA (2007)</p>	<p>South Korea-ASEAN FTA (2006)</p> <p>ASEAN-Japan CEP (under negotiation)</p> <p>ACU (under study)</p>		
<b>Security Arrangements</b>	<p>Unilateral use or show of force</p> <p>Arms acquisition</p>	<p>Joint military exercises</p>	<p>U.S. military treaties with Japan, South Korea, and others in Asia</p>	<p>ASEAN (1967)</p> <p>ASEAN TAC (1976)</p> <p>SAARC (1985)</p> <p>ASEAN-ISIS (1988)</p> <p>South China Sea Code of Conduct (2002)</p>	<p>ARF (1994)</p> <p>CSCAP (1993)</p> <p>NEACD (1993)</p> <p>Six-Party Talks (2003)</p>	<p>UN operations (1945)</p> <p>NPT (1970)</p> <p>PSI (2003)</p>

4) Expanding the number of actors, the next category consists of *geographically concentrated minilateral agreements*. In the trade realm, such agreements include Southeast Asian initiatives at the minilateral level such as AFTA and the 2002 ASEAN-China Free Trade Area (ACFTA) framework agreement. In Northeast Asia, Japan, China, and South Korea are increasingly discussing the potential benefits of institutionalizing economic and (less enthusiastically) security relations at the subregional level. In 1997, Bangladesh, India, Myanmar, Sri Lanka, and Thailand formed a subregional grouping called the Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation (BIMSTEC). Nepal and Bhutan joined the organization in 2003. In the security area, ASEAN as a geographically focused body was originally created in 1967 to promote regional peace and stability in the wake of the Vietnam War. In 1976, ASEAN countries signed a Treaty of Amity and Cooperation (TAC). At their summit in Phnom Penh on November 4, 2002, the ten member states of ASEAN along with China signed a Declaration on the Conduct of Parties in the South China Sea with the aim of preventing conflict and promoting cooperation in the region. Another security arrangement is the ASEAN Institutes for Strategic and International Studies (ASEAN-ISIS), which networks various non-governmental organizations (NGOs) in developing strategies for regional security management. On the Indian subcontinent, the South Asian Association for Regional Cooperation (SAARC) aims to promote cooperation not only on security, but also on non-security issue areas like tourism and agriculture.

5) The next category refers to *geographically dispersed minilateral arrangements*. Transregional or interregional ties define these arrangements. These include arrangements such as the East Asian Economic Caucus (EAEC, 1994), APEC (1989), the Asia-Europe Meeting (ASEM, 1996), the APT (1998), the South Korea-ASEAN FTA (2006), and the ASEAN-Japan Closer Economic Partnership agreement (under negotiation). The creation of semi-institutionalized, non-governmental institutions as confidence-building instruments and icebreakers prior to the founding of official transregional/interregional institutions has become an established practice in the Asian region. For instance, the Pacific Trade and Development Forum (PAFTAD), Pacific Economic Cooperation Council (PECC), and Pacific Basin Economic Council (PBEC) preceded the establishment of APEC. In the financial issue area, various transregional, minilateral arrangements include the CMI (2000), an Asian Bond Market Initiative (ABMI, proposed), and an Asian Currency Unit (ACU, proposed).<sup>20</sup> The

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<sup>20</sup> The region's holdings of foreign reserves have dramatically increased since the early 2000s. China's foreign-currency holdings reached \$1 trillion in 2006, the

best example of a transregional security forum is ARF, consisting of twenty-four countries including the ASEAN member countries, China, Japan, South Korea, and the U.S. The ARF follows ASEAN's pattern of gradual institutionalization and provides a setting for preventive diplomacy, confidence-building measures, and conflict resolution.<sup>21</sup> Though an economic forum, APEC has also been used recently as a transnational forum in which to discuss security matters, particularly since the 9/11 terrorist attacks. Yet the weakness of both the ARF and APEC as security forums has led to regional efforts at launching unofficial "Track Two" dialogues such as the Council for Security Cooperation in the Asia-Pacific (CSCAP) and the Northeast Asia Cooperation Dialogue (NEACD), both of which are specifically designed to provide a non-governmental forum for experts from the academic and policy analysis communities as well as government officials.<sup>22</sup> For some observers, the Six-Party Talks process to resolve the second North Korean nuclear crisis serves as an early indication of a more permanent regional security forum in Northeast Asia.<sup>23</sup>

6) The final category includes *global arrangements*. Trade organizations in this realm include broad-based multilateral arrangements such as the GATT (1947) and its successor, the WTO (1995). Their financial counterpart has been the IMF (1945). East Asian countries have also been participants in multilateral sectoral market-opening agreements such as the Information Technology Agreement (ITA, 1997), the Basic Telecom Agreement (BTA, 1998), and the Financial Services Agreement (FSA, 1999). In pursuit of security assurances, all the South, Southeast, and Northeast Asian countries—with the exception of Taiwan—have become UN members in the postwar period. From one perspective, the UN has never been a prominent place for mediating, managing, or resolving some of the major conflicts that have wracked the Asian region. The continuing tension between North and South Korea and between China and Taiwan, the earlier wars between North and South Vietnam, China and India, and India and Pakistan—to name but a few of the most serious instances of violence—have been dealt with largely in the absence of major UN initia-

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most in the world. Japan's foreign reserves have doubled since 2000 to \$888 billion as of early 2007. South Korea's reserves are now the world's fifth largest, surging to \$244 billion. The three countries are cautiously working on the development of an Asian bond market to tap the region's \$1.5 trillion of savings and other financial resources to fund regional projects in lieu of investing the funds in the U.S. bond market (Kim and Li 2007).

<sup>21</sup> Buzan (2003)

<sup>22</sup> Job (2003)

<sup>23</sup> Aggarwal and Koo (2006)

tives. Nevertheless, the UN has often provided vital support, acting sometimes as a third-party facilitator or neutral mediator, and sometimes intervening in important ways behind the scenes.<sup>24</sup> In the meantime, the Nuclear Non-proliferation Treaty (NPT, 1968) and the Proliferation Security Initiative (2003) are good examples of issue-specific multilateral arrangements with broad membership.

### 1.3.2 The Strength and Scope of Arrangements<sup>25</sup>

It is also important to classify Asia's various institutional arrangements according to their strength and scope. As noted, strength refers to both the precision and obligation of rules. From this perspective, authors have often contrasted the so-called European and Asian models of regional economic integration. The first one is built upon a wide set of specific and binding rules (called the *acquis communautaire* in the jargon of European integration) whereas the second is built upon declarations, intentions and voluntary commitments. In the monetary area, for example, the lack of any precise and concise definition of a balance of payments problem in the IMF severely affected the constraining power of this institution on preventing its members from running imbalances.

Second, we consider the *scope* of agreements defined as issue coverage. The evolution of the GATT from its origins in 1947 to the creation of WTO in 1995 reveals an important increase in the scope of the agreements. Whereas the GATT initially focused on the liberalization of trade in goods, the WTO covers services, agriculture, as well as trade-related aspects of intellectual property rights and investment. And in the Asia-Pacific region, APEC scope has dramatically widened over time to include not only trade liberalization, but security, environmental issues, finance, and the like. At the other end of the spectrum, one finds sector-specific institutions such as the International Organization of Securities Commissions (IOSCO), the International Associations of Insurance Supervisors (IAIS), and International Accounting Standards Board (IASB) as well as product-specific organizations such as the International Coffee Organization (ICO), the International Cocoa Organization (ICCO), the International Copper Study Group (ICSG), and the International Sugar Organization (ISO).

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<sup>24</sup> Foot (2003)

<sup>25</sup> Portions of this discussion draw on Aggarwal and Dupont (forthcoming). That work also considers other characteristics such as institutional centralization and delegation.

The authors of the empirical chapters trace the evolution of strength and scope of the key accords in their region to examine how they have changed and the causal factors underlying this shift. In our conclusion, we also classify the key arrangements in Asia along these lines in view of the empirical findings. Here, we simply illustrate the idea of change in the number of countries in accords, their strength, and scope (see Table 1.2).

**Table 1.2: The evolving strength and scope of arrangements**

Arrangement	Number of members t=0	Current members	Issue Scope t=0	Issue scope now	Strength t=0	Strength now
ASEAN	5	10	Medium	Broad	Weak	Medium
APEC	12	21	Narrow	Broad	Weak	Weak

## 1.4 Analyzing Asia's Institutional Architecture

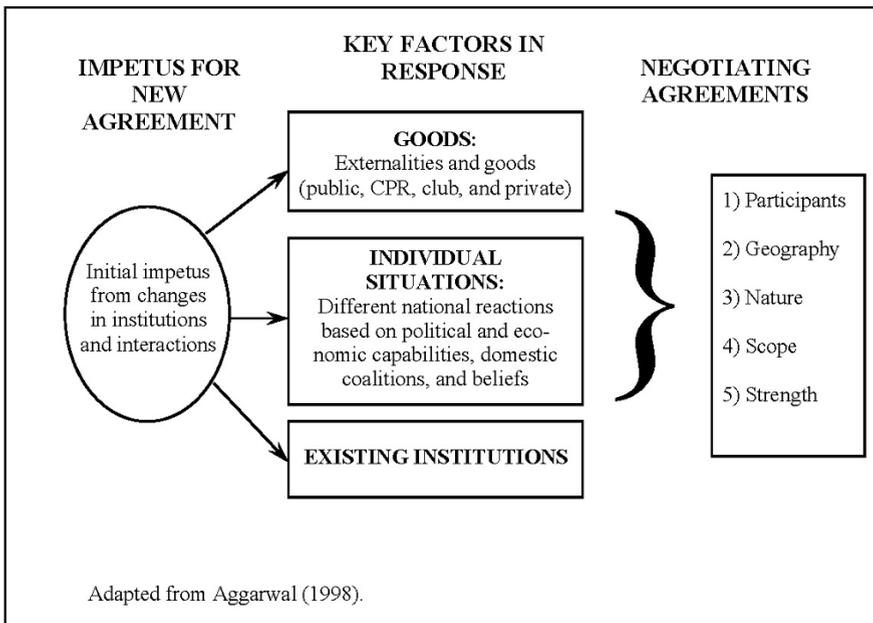
A number of factors have driven changes in the institutional equilibrium in Asia. Much ink has been spilled over the uniqueness of Asian regionalism that has formed during the postwar period, but little progress has been made in our understanding of the shifting dynamic between economic and security ties among Asian countries in the post-“triple shocks” period. To bridge this gap and more adequately analyze the process by which various types of trade, financial, and security arrangements have been pursued in Asia, we offer an institutional bargaining game approach.

An institutional bargaining game approach begins by identifying the initial impetus for a new economic and security strategy. The process of a shift from an initial institutional equilibrium to a new one generally comes about with some external shocks that create pressure for change. Countries respond to such external shocks in various ways based on their individual political-economic situation. To systematically analyze why different countries respond in different ways, we focus on the interplay of three interrelated elements, namely goods, individual bargaining situations, and the existing institutional context. As countries attempt to meet their economic and security needs in a new environment, they negotiate new arrangements or modify existing ones while interacting strategically within the context of broader institutional arrangements such as the WTO, the IMF, and the UN. Strategic considerations and institutional constraints are likely to lead countries to “nest” their arrangements, meaning that they bring lower-level arrangements into conformity with broader-level ones. Determining whether such nesting is actually possible for sub-multilateral arrangements is critical for understanding the interaction of different types

of economic and security accords. Figure 1.1 illustrates the key elements and processes of our institutional bargaining game approach.

### 1.4.1 Initial Impetus for New Economic and Security Strategies

We believe that the pressure for a shift from traditional institutional pathways to new ones in Asia has been partly driven by three major external shocks since the turn of the 1990s. As noted, we refer to these three shocks as the “triple shocks”, which include the end of the Cold War, Asian financial crisis of 1997-98, and the 9/11 attacks. Of course, an impetus for change can also come through more secular long-term trends. Examples of such shifts include the increasing importance of China as a global competitor, or rapid changes in technology that have affected the ease with which companies can create production networks across the region. In the empirical analysis, authors use these three shocks as an organizing device, but they also explore the extent to which other key shifts might be driving institutional change in their region (and assess if these three shocks are indeed relevant to their region of analysis).



**Fig. 1.1: The origins of security and trade arrangements**

Turning to the shocks themselves, the end of the Cold War has made it politically easier for Asian countries to consider regional institutionalization. The end of bipolarity has reduced the significance of Cold War perceptions and divisions, breaking down barriers that had previously precluded regional economic and security cooperation between capitalist, communist, and non-aligned countries. In addition, the U.S. has adopted a more receptive position toward regional organizations.<sup>26</sup>

The second turning point was the Asian financial crisis. This crisis revealed a number of institutional weaknesses that Asian countries shared. Most importantly, Asian economies continued to export to the U.S. and other developed country markets where they could sell the investment-fueled output that vastly exceeded the absorption capacity of domestic consumers. It was not until the financial crisis, which exacted heavy tolls, that many in Asia came to recognize that tighter institutionalization of intraregional commercial and financial ties might be a better commitment mechanism for providing economic security, and thus began to actively weave a web of PTAs and bilateral currency swap agreements.<sup>27</sup>

The third critical turning point is the 9/11 terrorist attacks. Among the more fundamental shifts produced by the 9/11 attacks, the American global war on terror has called into question the fate of the Asian balance of power system, which has been long credited by conventional strategic thinking for the maintenance of the region's peace and prosperity.<sup>28</sup> As will be discussed below in more detail, post-9/11 developments have placed unpredictable pressures on the balance of power politics among the principal powers in the region: the U.S., China, Japan, and India.

#### **1.4.2 Key Factors in Response: Goods, Individual Situations, and Institutional Context**

The three elements of the institutional bargaining game—goods, individual bargaining situations, and existing institutional context—determine how different countries respond in different ways to external shocks.

##### **Goods**

An external shock may create either positive or negative externalities on countries that are not immediate participants in the precipitating event,

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<sup>26</sup> Breslin and Higgott (2000); Buzan (2003)

<sup>27</sup> Aggarwal and Urata (2006)

<sup>28</sup> Acharya (2003)

thereby stimulating or impeding the supply of trade liberalization, financial stability, and/or national security as goods. Broadly speaking, there are four types of goods: public goods, common pool resources, club goods, and private goods. Differences among goods can be characterized along two dimensions: jointness, which refers to the extent to which goods are affected by consumption; and by the possibility of exclusion, which refers to whether non-contributors to the provision of the good can be kept from consuming it (see Table 1.3).

In the case of public goods, actors face a collective action dilemma because all can benefit from the joint nature of the good (e.g., national defense). However, because exclusion is not possible, beneficiaries need not contribute to its creation or maintenance. In such cases, analysts have focused on the incentives for differently situated states to provide public goods. The classic representation of the provision problems for public good is the *n*-person prisoners' dilemma (PD): in such cases, cooperation can potentially help all players, but actors have a dominant strategy to defect and the good may not be provided.

**Table 1.3: Types of goods**

Exclusion Possible?	Jointness		
		Yes	No
	No	Public Good	Common pool resource
Yes	Inclusive club good	Private good	

Common pool resource goods include global commons concerns such as fishery resources or goods where exclusion of noncontributors from consumption of the good is not feasible. In such cases, providers of goods risk being exploited since they will not only end up paying for the cost of the good, but will also suffer from free riding that will diminish the good due to its lack of jointness. Thus, at least in principle, the provision of such goods will be a more severe form of a PD.

Inclusive club goods refer to the case of goods that exhibit jointness (not diminished by use), but where exclusion is possible. Two examples of this type of good are the provision of satellite transmission of television and the use of scrambling technology to prevent noncontributors from accessing the good. Because of the benefits of having additional consumers of the good that one produces, we might expect that in the case of international institutions, actors will compete to have their institutional approach adopted as the standard by all participants to maximize their revenue possibilities.

Finally, private goods, which reflect the possibility of exclusion but not jointness, include the consumption of goods diminished by use. Individual actors will have an incentive to produce these goods and to charge according to their marginal cost of extending these goods.

Turning to how goods have shifted over time, Asia's new appetite for PTAs and regional security dialogues reflects a convergence of interests in securing inclusive club goods in the face of growing economic and security uncertainties. Put differently, the political initiatives and intrinsic interest in creating regional economic and security arrangements reflect the growing need for an insurance policy to realize free trade, financial stability, and collective security when traditional mechanisms under the San Francisco system stall or dismantle steadily in the post-"triple shocks" period. Table 1.4 summarizes the shifting pattern of the provision of trade liberalization and national security as goods in the postwar period.

**Table 1.4: The provision of goods in Asia (1951-2007)**

	<b>Period I (1951-1989)</b>	<b>Period II (1990-1996)</b>	<b>Period III (1997-2000)</b>	<b>Period IV (2001-2007)</b>
<b>Trade liberalization and financial stability</b>	Multilateral club goods with a strong public good characteristic	Multilateral club goods with a declining public good characteristic	Multilateral club goods in trouble; pursuit of bilateral club good	Proliferation of bilateral and minilateral club goods
<b>National security and regional stability</b>	Bilateral club goods with a strong public good characteristic	Bilateral club goods with a declining public good characteristic	Bilateral club goods with a declining public good characteristic	Pursuit of bilateral and minilateral club goods

During the Cold War period, the GATT and the IMF were Asian countries' primary providers of trade liberalization and financial stability, respectively. To the extent that these global multilateral institutions required membership, trade liberalization and financial stability were multilateral club goods, but they contained a strong public good characteristic since Asian countries were allowed to pay less to get more out of the system. In the security realm, the San Francisco system provided Asian countries with security as a bilateral club good, made available through their alliances with the U.S. or the Soviet Union, but the provision also contained a strong public good characteristic, since the costs and benefits from the alliances were skewed in favor of the two superpowers' respective Asian allies.

The shocks of the postwar period modified the nature of the goods being provided in significant ways. In the early years after the Cold War, trade liberalization, financial stability, and national security remained club goods, but their public good characteristics began to decline in significance. The stalemated Uruguay Round of WTO talks, the controversial role of the IMF during the Mexican peso crisis in the early 1990s, and

some early indications of U.S. disengagement from the region were the main causes.

In the aftermath of the Asian financial crisis, Asia's new appetite for PTAs and currency swap agreements reflects a convergence of interests in securing bilateral club goods. Except for China, Asian countries benefiting from the seemingly endless export boom of the 1980s and early 1990s began to face problems in the mid-1990s. At the end of 1995 the "trade triangle" that had linked Japanese (and overseas Chinese) capital, developing Asian manufacturing capacities, and Western markets appeared to be in trouble.<sup>29</sup> Among others, Indonesia, Thailand, and South Korea were severely hit. The unsuccessful defense of their plunging currencies promptly depleted their foreign reserves, forcing them to turn to the IMF's \$100 billion rescue loans to shore up their finances. Yet the IMF loan package developed into a region-wide resentment of the Washington-dominated agency.<sup>30</sup> One major option for the crisis-ridden countries and their affected neighbors was to secure preferential access and create a more diversified export market and financial resources. With traditional mechanisms in the WTO, APEC, and the IMF offering no salient solutions, these countries quickly turned toward preferential arrangements to assure a market for their products, on the one hand, and secure a financial firewall, on the other.

Finally, in the post-9/11 era, the multilateral mechanism for trade liberalization and financial stability has yet to regain the full confidence of participating countries, while the pursuit of alternative trade and financial mechanism through bilateral and minilateral channels has proliferated. In the meantime, the provision of security as a bilateral club good is in trouble since the U.S. began to reconfigure its alliance politics in Asia. These new developments do not necessarily mean that the hub-and-spoke system promoted under the San Francisco system will be terminated any time soon. Nevertheless, it has prompted Asian countries to recognize the need for the provision of collective security at the regional level. As such, regional solutions are now being considered, though they fall short of a col-

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<sup>29</sup> For example, Thailand experienced a drastic drop in its export market growth rate from 31.6 percent in 1995 to 4.1 percent in 1996. As a result, its current account deficit reached 8.1 percent of GDP and remained at that high level in 1996. Other Southeast Asian economies faced similar threats.

<sup>30</sup> The IMF, in a 1999 assessment of its handling of the crisis, said it "badly mis-gauged" the severity of the collapse and acknowledged its fiscal prescriptions for the three countries were too harsh (Kim and Li 2007).

lective security mechanism, mainly due to the unresolved antagonism and rivalry among the regional giants: China, Japan, and India.<sup>31</sup>

### ***Individual Situations***

While there are many factors that might affect state actors' individual preferences and situations, the most significant elements that determine national responses to an external shock include: (a) an actor's international position;<sup>32</sup> (b) the makeup of its domestic coalitions and regime types;<sup>33</sup> and (c) elite beliefs and ideologies.<sup>34</sup>

**International Positions.** Among others, two aspects of the international context have been the basis for theorizing about economic and security relationships. The first aspect concerns a country's relative position within the international continuum of economic development. For instance, a country with a large market—either actual or potential—is more likely to entice others to seek it out as a trading partner rather than the other way around. The way in which many Asian countries approach China as an FTA partner illustrates this point. In turn, this attractiveness may afford the country with the larger market greater political leverage.

The second aspect concerns the degree to which security concerns drive interest in new economic and security agreements as a means of linking one's fate to those of other countries. Countries may prefer trade with their (potential) allies, avoiding trade with enemies because the relative gains realized from free trade can cause changes in the relative distribution of power in politics and military affairs. For example, the ACFTA is clearly driven by security concerns as well as economic considerations held by

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<sup>31</sup> The tug of war in Kuala Lumpur in 2005 indicates the persistence of such antagonism and rivalry despite an emerging consensus on broader East Asian regionalism. In December 2005, Japan and China made dueling claims in Kuala Lumpur at the ninth APT summit followed by the first East Asia Summit (EAS). Japan succeeded with support from Indonesia and Singapore in getting ASEAN to invite India, Australia, and New Zealand to be members in the EAS as part of its push for universal values and open regionalism. Then, China with backing from Malaysia gained ASEAN's consent for entrusting APT with primary responsibility for building the East Asian Community (EAC), leaving the EAS with just a secondary agenda while raising the prospect for a narrow vision of community that would not try to bridge gaps in values (Rozman 2006).

<sup>32</sup> Aggarwal (1985); Gowa (1995)

<sup>33</sup> Grossman and Helpman (1995); Milner (1997)

<sup>34</sup> Haas (1992)

both Chinese and ASEAN political leaders.<sup>35</sup> Therefore, one might hypothesize that trade accords are more likely to overlap with alliance relationships. Alternatively, countries in alliance relationships are more likely to be successful in realizing trade expansion.<sup>36</sup>

In theory, rapid shifts in major powers' relative positions can complicate the task of balancing against threatening or rising countries. One danger is that the more advanced powers will not make the necessary adjustments fast enough to sustain a stable balance of power. This could then embolden the rising power to become more assertive, especially if it has a revisionist agenda of challenging the territorial status quo.<sup>37</sup> The other danger is that more advanced powers will overreact. Rather than being inhibited by this response, a rising power may then devote more of its resources to building up its military, thus fueling an arms race that increases the possibility of military miscalculation. What emerges is a security dilemma in which efforts by countries to maximize their own security provoke hostile responses by others that ultimately make all the countries in the system more insecure.<sup>38</sup>

For these reasons, many countries in the Asian region are increasingly concerned about China as a potential threat and have begun to reformulate their security policies in accordance with that perception. In this regard, the ARF usefully binds both China and its neighbors into a regional institutional framework, allowing China to address the fears of its neighbors and its neighbors to avoid conspicuous balancing behavior toward China. After initially being uncomfortable with multilateralism, China quickly adjusted to the ARF, seeing advantage in using its soft procedures to defuse conflicts.<sup>39</sup>

**Pressure Groups and Political Regime Type.** In Asia, individual bargaining situations in terms of pressure groups and regime type have changed significantly as a result of the "triple shocks". State structures vary significantly in the region—ranging from highly democratic regimes (e.g. Japan, South Korea, and India) to highly authoritarian ones (e.g., China, Vietnam, and Cambodia). To varying degrees, many governments in the region have experienced challenges to their political legitimacy and actual political turnover by groups and individuals who had previously tol-

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<sup>35</sup> Kwei (2006)

<sup>36</sup> Gowa (1995); Mansfield, Milner, and Bronson (1997)

<sup>37</sup> Organski (1968); Organski and Kugler (1980)

<sup>38</sup> Jervis (1978)

<sup>39</sup> Buzan (2003); Foot (1998)

erated cronyism and familism. Such developments in the regime structure as well as societal pressures have altered the economic and security pay-offs confronting individual countries. As countries move toward more liberal and democratic regimes, cooperative outcomes at the inter-governmental level become more likely and the requirements of institution-building less daunting.

For instance, the economic interests that Japan and the U.S. have in China might constrain these countries from standing up to China on security matters for fear of losing commercial opportunities. The democratic political systems of both countries will enable their respective business communities to persuade their governments to avoid antagonizing China.<sup>40</sup> But an authoritarian Chinese state would be less immune from domestic economic interests that might have a stake in good relations with Japan and the United States. One way to avoid the dangerous scenario that flows from this situation is to help China evolve into a democratic state in which international economic interests constrain security policy as much as they do in Japan and the U.S. This possibility is consistent with the insights of democratic peace theory that collaboration is more likely between stable democracies.<sup>41</sup>

By contrast, it can be argued that as Asian countries move from authoritarianism toward greater political pluralism, the political leeway with which to deal with complex economic and security interdependence may be constrained by domestic political pressures. Indeed, the twin challenges of responding to nationalist sentiments and maintaining political legitimacy are major constraining factors that have grown more significant as liberalization has taken a greater hold in the region.<sup>42</sup> Recent research suggests that countries with more veto players (such as a legislature, an independent judiciary, an independent central bank, or the military) are less likely to engage in international cooperation. Where leaders confront an array of domestic groups with diverse preferences and the ability to block policy initiatives, it is difficult to forge international agreements.<sup>43</sup>

At the same time, the advent of the Internet and information technology has not only made national political leaders less capable of censoring the dissemination of news that might provoke ultranationalist sentiments, but also made it easier for otherwise small, poorly financed activist groups to mobilize support for their nationalist agenda. The brief but intense spat be-

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<sup>40</sup> Papayoanou (1996)

<sup>41</sup> Doyle (1983); Maoz and Russett (1993); Oneal and Russett (1997)

<sup>42</sup> Snyder (1996)

<sup>43</sup> Mansfield, Milner, and Peevehouse (2004)

tween China and Japan in spring 2005 over the Japanese history textbooks as well as the disputes over the sovereignty of offshore islands in the East China Sea and the gas deposits in their vicinity highlighted how domestic nationalist groups can hijack the otherwise warming Sino-Japanese relations.<sup>44</sup>

**Elite Beliefs and Ideologies.** The third and last dimension of individual bargaining situations concerns elite beliefs and ideologies about the causal connections among issues and the need to handle problems on a multilateral, minilateral, bilateral, or unilateral basis. The setback in Seattle at the WTO ministerial meeting in 1999 has significantly eroded the traditional confidence in multilateral trade liberalization through the GATT/WTO. In the aftermath of the Asian financial crisis, Asia's political and business elites are increasingly engaged in regional financial institution building such as the Chiang Mai Initiative, the Asian Bond Market Initiative, and the Asian Currency Unit proposal. In the meantime, the eroding confidence of Asian countries in America's military commitment to the region in the post-9/11 period has made everyone scramble in search of alternative security mechanisms. These changes have led to the construction of new ideational formulas that support "Asian" alternatives for trade, finance, and security.

In the development of the trade, financial, and security architecture of an avowedly state-centric regional order, the growing influence of non-governmental institutions and unofficial processes is truly notable. Many experts in the region are now part of an "epistemic community" which shares the view that regional arrangements can enhance trade liberalization and financial stability, and that a regional security institution is the right course to take in the face of a loosening San Francisco system.<sup>45</sup> The informal security diplomacy through Track Two dialogues such as CSCAP and the NEACD represent good examples of the emerging epistemic community in Asia. As noted earlier, ARF's formation followed shortly after CSCAP's establishment and was greatly facilitated by the participation of ASEAN-ISIS, which played a key role not only in actively promoting ARF's establishment but also in seeking to ensure that ASEAN maintained a central role in its direction and management.<sup>46</sup> Advocates of Track Two dialogues do not exclude government officials but reject the notion that state officials should monopolize consideration of economic and security matters. They seek to engage participation of leaders from the academic,

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<sup>44</sup> Koo (2005:182-194)

<sup>45</sup> Tsunekawa (2005)

<sup>46</sup> Job (2003)

financial, social, and political sectors of society in order to bring expertise and new ideas to the table and, more importantly, to foster transnational understanding and confidence building.

### ***Institutional Context***

The political initiatives and intrinsic interests in creating regional economic and security arrangements reflect the growing need for an alternative way to provide trade liberalization, financial stability, and national security when traditional mechanisms stall or proceed slowly. On the economic front, many of the recent preferential arrangements in Asia attempt to cover broader areas and elements like trade in services, factor mobility, investment rules, intellectual property rights, government procurement, and other trade facilitation measures such as mutual recognition of product standards and harmonization of customs and quarantine procedures. Furthermore, most Asian countries, stricken by the financial crisis, have a keen interest in accessing the financial resources that might accompany a preferential accord, especially with the region's financial giant, Japan.<sup>47</sup>

In post-Cold War Asia, an emerging strategic triangle involving the U.S., China, and Japan has replaced the Cold War competition between the U.S. and the Soviet Union in the region. Furthermore, post-9/11 developments put additional pressure and strain on the new strategic triangle in Asia. In the post-9/11 era, the U.S. and Japan both recognize their bilateral security relationship as the linchpin of their defense postures in Asia. Nevertheless, their recovering security ties cannot fully overshadow the rise of China as a potentially unsettling development in regional security.

### **1.4.3 Negotiating New Economic and Security Arrangements**

If a country decides to create a new trade, financial, or security arrangement, it must decide on the participants, geography, nature, scope, and strength of the agreement. In Asia, the latest enthusiasm for PTAs seems to revolve around a bilateral FTA as a popular mode of participation, while there are also strong indications of minilateral participation such as the APT and the ACFTA. Asia's new appetite for FTAs is geographically open. On the one hand, these FTAs go beyond the traditional concept of a region defined by geographical proximity. On the other hand, other "trans-regional" initiatives have emerged that attempt to formalize the traditional concept of an "Asian economic community" with multiple cross-cutting

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<sup>47</sup> Amyx (2003); Katada and Solis (2006)

linkages of trade, investment, and finance, as exemplified by APT, ABM and EAS initiatives.

The strength of these PTAs and financial arrangements reflects not only the power of different actors, but also the willingness of governments to give up some autonomy to their economic partners. Moreover, the nature and scope of coverage of such agreements are also driven by economic concerns about trade competition, investment flow patterns, and the danger of rapid capital flows. Many of the recent PTAs and financial arrangements in Asia attempt to cover broader areas and elements, indicating their nature of WTO- and IMF-plus, or institutional division of labor. At the same time, however, these agreements are potentially incompatible with WTO provisions, since some sensitive sectors are deliberately excluded, and the IMF due to the possible diversion of financial resources.<sup>48</sup>

In theory, successful regional economic institutionalization can spill over into the security arena. National leaders who learn how to compromise and cooperate on economic issues have a greater chance of doing the same on traditional security problems or preventing security disputes from escalating to actual military conflict. Over time, regional economic institutions can even transform national attitudes, preferences, and the definition of interests so that regional accommodation and cooperation become more likely in the security realm.<sup>49</sup> Ultimately, a collective security order might emerge to keep the peace.

## 1.5 Overview of the Book

In the previous sections, we demonstrated that a substantial degree of autonomy in subregional dynamics has been further enhanced by the “triple shocks”. Most notably, Southeast and Northeast Asia have undergone both external and internal transformations, effectively merging their economic and security dynamics with each other and thus raising the prospect of a single “East Asian” economic and security community. Both economic and security linkages between South and East Asia are increasingly becoming visible (albeit subtly), raising the prospect of transforming the two distinct sub-regions into a fully-fledged “Asian” community.<sup>50</sup> In what follows, we summarize the empirical chapters of this volume and highlight that the conditions for institutionalization of economic and secu-

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<sup>48</sup> Koo (2006); Ravenhill (2006)

<sup>49</sup> Nye (1988)

<sup>50</sup> Alagappa (2003); Buzan (2003); Aggarwal and Koo (2006)

rity affairs in Asia are more favorable now than ever before in the postwar period.

### **1.5.1 Economic and Security Overviews**

In Chapter Two, John Ravenhill provides an overview of how the “triple shocks” have affected the development of regional economic institutions. The end of the Cold War removed strategic considerations from the calculus of economic cooperation, enabling new linkages between countries that had once been in opposing blocs. In the decade since the Asian financial crisis, economic institutions have proliferated at multiple levels, including the regional, trans-regional and minilateral levels. However, Ravenhill notes that an even more important trend has been the rise of bilateral FTAs, which have undermined broader arrangements. In addition, he discusses the implications of China’s rise and the growing importance of South Asia for regional economic institutions.

In Chapter Three, Keiichi Tsunekawa examines how the “triple shocks” have shaped the development of regional security institutions throughout Asia. Among the most important trends are the weakening of America’s bilateral alliances, the strengthening of the U.S.-Japan alliance, the growth of minilateral organizations to manage regional security (particularly ASEAN and its derivative organizations in Southeast Asia), and the increasing influence of China as illustrated by the establishment of the Shanghai Cooperation Organization (SCO) in 1996. Tsunekawa holds that a key question for regional security institutions is whether to expand their scope to include more extra-regional actors or to confine their membership to states located within Asia. How the question will be resolved depends largely on America’s China policy. If the U.S. perceives China as a competitor, it may eschew minilateral forums in favor of broader cross-regional ones where China’s influence can be diluted. If, on the other hand, bilateral relations between China and the U.S. grow warmer, Washington may play a larger role in creating and strengthening regional security organizations to share the burden with Beijing.

### **1.5.2 Northeast Asia**

In Northeast Asia, the interplay between economic and security relations has been driven by the balance of power politics. The Sino-Soviet-American “strategic triangle” during the Cold War has been superseded by a new triangular relationship involving the U.S, Japan, and China, while the influence of Russia on regional matters has significantly receded. The complex balance of power in the region does not allow for a single pace-

setter. For all the power of the U.S. and Japan, the past two decades have been most notable for the regional surge of China.

In Chapter Four, Mie Oba discusses the development of trade and financial institutions, focusing on the cooperation and rivalry between Japan and China. The emergence of China as an economic juggernaut has fostered a rivalry with Japan as they compete with one another for regional economic dominance, as illustrated by their attempts to conclude FTAs with ASEAN as well as with other countries on a bilateral basis. Moreover, China and Japan offer differing visions of a regionally integrated economic community, with Japan advocating the inclusion of external actors such as Australia, New Zealand and India, and China preferring a more exclusionary system. Oba argues that this rivalry is currently fostering greater regional economic integration as both countries race to establish FTAs and currency swap agreements. In the regional context of the growing Sino-Japanese rivalry, South Korea also pursues preferential arrangements in order to strengthen its bargaining position and diplomatic weight.

In Chapter Five, Min Ye examines security institutions in Northeast Asia, showing how the U.S.-dominated hub-and-spoke system of bilateral alliances during the Cold War period is giving way to increased multilateralism. She argues that collective security has been slow to develop and has been hampered in part by the growth of popular nationalism in regional domestic politics, particularly in China and Japan. More importantly, one of the main sources of uncertainties lies in whether China's strengthened military capability could present itself as a threat to regional stability and whether North Korea's nuclear adventurism would make everyone scramble in a region already characterized by the security dilemma. However, Ye notes that despite simmering tensions, there have been various minilateral dialogues to resolve regional security issues. The ARF, the Korean Peninsula Energy Development Organization (KEDO), the APT, the NEACD, and the Six-Party Talks exemplify this emerging minilateralism, rooted in increasingly dense economic, social, and strategic interactions among the major powers in Northeast Asia. Although their strength and effectiveness remains unclear, the variety of channels for security interactions in Northeast Asia indicate positive and dynamic processes in exchanging information and opinions, which should be promising signs for regional peace and stability.

### **1.5.3 Southeast Asia**

Southeast Asia is a unique region in that it features the widest variety of regional institutional arrangements in Asia. ASEAN has shown a certain degree of institutional capacity in economic matters. AFTA is a collective

effort by ASEAN members to eliminate tariffs on intra-ASEAN trade on a voluntary basis, although no concrete progress has been made since the idea was first formulated in 1991. More recently, a growing number of ASEAN countries are now turning to bilateral FTAs as an alternative mechanism to liberalize trade and investment relations.

In Chapter Six, Helen Nesadurai investigates economic institutions, demonstrating that the establishment of new institutions became possible and was frequently viewed as necessary when elites perceived external shocks to threaten Southeast Asian countries' economic growth. For instance, Singapore's search for sub-multilateral alternatives beyond ASEAN is motivated by dismal prospects for the progress of AFTA. Despite its early criticism of Singapore's shift toward FTAs as "worrisome" and "damaging to the unity of regional groupings such as ASEAN," Malaysia eventually turned to FTAs by initiating FTA talks with Japan in December 2002. Other Southeast Asian countries such as Thailand, Indonesia, and Vietnam have followed in the footsteps in the time of rising peer pressure.

In Chapter Seven, Ralf Emmers examines a variety of Southeast Asia's collective security measures. Traditionally, Southeast Asian countries have been very guarded about their sovereignty and the principle of non-interference. The picture in Southeast Asia has become complicated by the growing presence of China. Most significantly, the end of the Cold War created a strategic vacuum in the South China Sea. During the 1990s, incidents related to fisheries, oil exploration and military occupation of islands and reefs in the South China Sea were major irritants in Southeast Asian countries' relations with China. Nevertheless, despite (or perhaps because of) concerns about military competition, the disputes over offshore islands have prompted many multilateral dialogues and confidence-building measures to facilitate peaceful solutions in the South China Sea. Notable examples of more systemic efforts include the ARF, CSCAP, and a series of workshops on "Managing Potential Conflicts in the South China Sea." More positive progress was made at the ASEAN summit in Phnom Penh on November 4, 2002, when China and the ten ASEAN states signed a Declaration on the Conduct of Parties in the South China Sea with the aim of preventing conflict and promoting cooperation in the region. Although none of these new minilateral mechanisms amount to legally binding formal institutions, if their terms are respected and further incidents are avoided, these arrangements and forums will mark a significant institutional change in Southeast Asian security.

### 1.5.4 South Asia

South Asia has remained essentially inhospitable to dialogues intended to resolve regional security and trade issues, regardless of actor scope or level of formality. By and large, subregional conditions fail to meet the minimal levels of trust and incentives for official and unofficial interaction. Hostility between the key actors, India and Pakistan, is sustained by ongoing conflict and inflamed by domestic political actors. At minimum, the SAARC was established in December 1985 by the heads of Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka with a goal to accelerate the process of economic and social development among member states.

In Chapter Eight, Vinod K. Aggarwal and Rahul Mukherji argue that the characteristics of trade institutions in South Asia are determined primarily by two factors: the nature of the security relationship among South Asian countries and the particular development paradigm that those states have adopted (e.g. whether or not they value global economic interdependence). The end of the Cold War partly improved security relations and thus enabled reciprocity and the negotiation of FTAs between India and its neighbors including Sri Lanka, China, and the ASEAN countries. While SAARC has failed to facilitate free trade due to the fragile security situation between India and Pakistan, India has strengthened its economic ties to Southeast Asia as illustrated by its participation in a number of bilateral FTAs as well as in the nascent BIMSTEC, pointing to the possibility of further regional integration in the future.

In Chapter Nine, Eswaran Sridharan analyzes the evolution of regional security institutions in South Asia following the end of the Cold War, the Indian and Pakistani nuclear tests of 1998, and the 9/11 attacks. Security relations between India and Pakistan remain weakly institutionalized although the threat of nuclear war resulting from the 1998 nuclear tests generated an impetus for confidence-building measures to improve transparency. Furthermore, America's war on terrorism has driven both India and Pakistan toward a unique type of political brinkmanship. In the current international climate, both India and Pakistan want to curry favor with the United States and view peacemaking as a way to do this. Both parties try to outdo each other and make ever more generous offers in order to please external actors. On the other hand, cross-regional security relations between South Asian countries and countries in East and Southeast Asia have improved. The 9/11 attacks have created an impromptu triangular relationship among India, China, and the U.S., stabilizing the otherwise hostile Sino-India relationship. The improvement of South Asia's relationship with Southeast Asia has also been dramatic. Since India launched its 'Look East Policy' in the early 1990s, Indo-ASEAN ties have grown increasingly

solid, from mere sectoral dialogues in 1992 to the 2002 ASEAN-India summit where the two parties agreed to create a Regional Trade and Investment Area (RTIA). The relationship has also widened its scope to address security issues, with India joining the ARF in 1996 and the Treaty of Amity and Co-operation in 2003. The benefits of a prospective RTIA go beyond the economic realm. Along with its new place on the ARF, India has taken an increased interest in security issues in Southeast Asia (and vice-versa). Pakistan followed suit by signing a TAC with ASEAN and joining the ARF as its 24<sup>th</sup> member in 2004.

Finally, in the concluding chapter, Vinod K. Aggarwal and Min Gyo Koo evaluate the prospects for Asian regional integration in trade, finance, and security in a rapidly changing context. In particular, the authors highlight the key links between security and trade issues in the formation and evolution of new institutions. In a more speculative vein, the editors consider likely trends over the next decade and its implications for both Asia and other regions of the world.

## 1.6 Conclusion

We began our analysis with the observation that the postwar economic and security order in Asia remained multilayered under the San Francisco system, involving elements of bilateral alliance structures, global institutions for managing economic and security problems, and long-standing informal alternatives. In the wake of the three major external shocks in the past fifteen plus years, however, the traditional institutional equilibrium in Asia has come under heavy strain. As a result, principal actors are now pursuing greater institutionalization at the regional level, actively weaving a web of PTAs and security dialogues.

Explaining the emerging institutional architecture in Asia poses a challenge. In an effort to understand the shifting institutional dynamics, we examined external shocks, goods, countries' individual bargaining situations, and the fit with existing arrangements. We focused on the post-"triple shocks" period following the end of the Cold War, the Asian financial crisis of 1997-98, and the 9/11 attacks. With respect to goods, we noted that disturbances in the traditional mechanism to provide trade liberalization and regional security have motivated countries to seek club goods as a viable alternative to the diminishing supply of public goods. This observation undermines the myth that the combination of bilateral and multilateral arrangements under the San Francisco system and loosely structured production networks could be a viable alternative to tighter, formal institutionalization at the regional level.

In looking at countries' individual bargaining situations, we focused on their international strategic and economic interests, domestic power dynamics, and elite beliefs about the value of pursuing regional alternatives. We also showed how the changing nature of broader institutions interacted with country characteristics to alter institutional payoffs in the region.

With respect to trade liberalization, the weakness of the WTO and APEC opens up institutional space for an Asian economic community by affecting the provision of public goods and thus the incentives for club goods. In the financial issue area, Asian countries have made steady progress in financial institution building, as manifested by the launch of the Chiang Mai Initiative and the proposal of an Asian Bond Market and an Asian Currency Unit. Yet much depends on the possibility of a Sino-Japanese entente as well as an Indo-Pakistan rapprochement. In the meantime, the establishment of a permanent security forum in Asia to address security issues may appear premature. Yet we argued that the current Six-Party Talks as well as the ARF process have the potential to evolve into an Asian security dialogue, albeit through the unforeseen and unplanned spontaneous development of consultations among the countries involved. In the post-9/11 environment, the prospect of establishing a framework for multilateral cooperation is enticing in a region where no forum has previously existed.

We do not claim by any means that regional institutions are a magical formula for transforming power politics and economic competition into cooperative internationalism in Asia. Rather, we believe that they are becoming viable means for creating norms and rules of interstate behavior that are essential for establishing regional institutional architecture to manage collective economic and security issues, the process of which could possibly take at least a decade, if not decades.

In sum, Asia faces the uncertainty of a host of multiple institutional alternatives for regional economic and security cooperation. In view of the tremendous political and economic uncertainties in the contemporary period, the path to deeper and wider economic and security integration in Asia is likely to be complex.

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## 2. Asia's New Economic Institutions

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### 2.1 Introduction

The decade since the East Asian financial crises has seen a remarkable proliferation of intergovernmental economic institutions in the region. Whereas in 1997, the only minilateral preferential trading arrangement involving Asian states was the (far from robust) ASEAN Free Trade Agreement (AFTA),<sup>2</sup> a decade later the region had become the most active site in the global trading system for the negotiation of bilateral and minilateral preferential trade arrangements. And the definition of the “region” for the purposes of such negotiations increasingly was expanded to include economies in South Asia, particularly India.<sup>3</sup> East Asian states had also begun a program of unprecedented financial and monetary collaboration.

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<sup>2</sup> For further details of the history of economic collaboration in Southeast Asia see Helen Nesadurai's chapter in this volume, and Nesadurai (2003).

<sup>3</sup> The definition of “region” for the purposes of economic collaboration remains a matter of contestation. Since the establishment of APEC in November 1989, the principal dividing line has been between its trans-regional approach to economic collaboration and conceptions of the region as exclusively “East Asian”, an approach formulated originally by former Malaysian PM Mahathir in his proposal for an East Asian Economic Group. The definition of “East Asia” itself is not straightforward, however, given Beijing's determination to exclude Taiwan from regional intergovernmental institutions. More recently, exclusively East Asian conceptions of the region have been challenged by efforts to include South Asia and Oceania in collaborative arrangements, most notably in the East Asian Summits, and in Japan's proposals for a “Comprehensive Economic Partnership in

At the same time as Asian governments embarked on this new trade policy activism, they allowed the principal trans-regional economic institution, the Asia-Pacific Economic Cooperation (APEC) grouping, to languish to the extent that some observers suggested that it was in danger of becoming “terminally irrelevant”.<sup>4</sup> It seemed that governments’ new activism in the negotiation of discriminatory arrangements was coming at the expense of the two institutions that advocated non-discriminatory liberalization—at the trans-regional level, APEC, and at the global level, the WTO—although arguments about the diversion of resources away from these two institutions towards minilateral arrangements remain largely impressionistic and hotly contested by some governments.

## 2.2 Turning Points: Overcoming the Cold War Divide

The first of the turning points identified by the editors in their overview chapter to this volume—the ending of the Cold War—did indeed have a profound impact on the institutionalization of intergovernmental economic collaboration in Asia. Cold War divisions had long impeded economic collaboration among countries in Northeast Asia and in Southeast Asia, and across the Pacific. It was only with the waning of the Cold War, the cessation of hostilities in Vietnam and subsequently between Vietnam and its neighbors, and China’s opening to the global economy that the construction of an intergovernmental institution that embraced most of East Asia as well as Oceania and North America became possible (and even then, China’s participation in APEC was delayed by the Tiananmen Square incident of June 1989). APEC was constructed on more than two decades of patient efforts by academics, businesspeople and government officials who sought to facilitate economic collaboration in the Asia–Pacific region through the creation of an intergovernmental institution. These efforts had been institutionalized primarily through the Pacific Trade and Development (PAFTAD) Conferences and the tri-partite (business, government, academic) body, the Pacific Economic Cooperation Council (PECC).

It was only in the mid-1980s that the demand for a new intergovernmental institution to help manage economic tensions across the Pacific, which had been exacerbated by the trade imbalances between the United States on the one hand, and Japan and the Newly Industrializing Economies of

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East Asia”. For the purposes of this paper, when I refer to “region”, unless otherwise specified, I mean “East Asia” understood as the ten member states of ASEAN, China, Hong Kong, Macau, Japan, Korea and Taiwan.

<sup>4</sup> Gyngell and Cook (2005)

Northeast Asia on the other, was met by a new interest in official circles in supplying a significant trans-regional institution. Crucial to this development was the interest that Russia and China for the first time expressed in global and regional economic institutions. Even though Russia was not among APEC's founding members, Gorbachev's Vladivostok initiative of July 1986 was of enormous significance for APEC's foundation. In his speech, Gorbachev proclaimed that "the Soviet Union is also an Asian and a Pacific country", and expressed an interest in Soviet participation in regional economic institutions that had previously been vilified as tools of Western imperialism. PECC responded immediately by admitting a Soviet observer at its fifth conference, held in Vancouver in November of that year.<sup>5</sup> Gorbachev's Vladivostok speech in retrospect was an acknowledgement that the Cold War in the Pacific was for all practical purposes over and that the U.S. had won. Strategic considerations would no longer pose a major barrier to the realization of institutionalized interstate regional economic collaboration.

Of arguably equal importance was China's economic opening from 1978 on. Beginning in 1982, China obtained observer status in General Agreement on Tariffs and Trade (GATT) ministerial meetings and in 1986 it formally applied for readmission to the global trade body. In the same year, China accepted an invitation to join PECC. The Tiananmen Square incident prevented China's early admission to APEC but this eventually occurred in November 1991, just two years after APEC's inaugural meeting.

The Cold War had arguably played an initially positive role in sustaining collaboration among the countries of Southeast Asia in the Association of Southeast Asian Nations (ASEAN), although even here the effect was ambiguous because the dream of ASEAN's founders of creating an institution that would embrace all ten of the countries of Southeast Asia would not be realized until the legacies of the Vietnam conflict were finally buried in the 1990s.

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<sup>5</sup> The dispute with Japan over the Kurile Islands delayed the admission of the Soviet Union to full membership status in PECC. Eventually this membership was granted in September 1991, but with the breakup of the Soviet Union a few months later, Russia took over the membership. Russia joined APEC in November 1998.

## 2.3 Turning Points: The Financial Crises of 1997-98

The Asian financial crises coincided with the move to minilateral discriminatory trading arrangements in the region. Their importance lay primarily in accelerating a trend that was already under way, rather than precipitating a radical departure from the status quo. They did lead, however, to an important new dimension of collaboration among East Asian states—on financial and monetary matters.

One important consequence of the crises was to weaken existing regional and trans-regional institutions and to reinforce perceptions among state elites of the need to find alternative means of pursuing economic collaboration. The crises had a particularly negative effect on APEC—though it is difficult to determine the extent to which this was caused by 1) APEC's ineffective response to the impact of the crises on several of its members, as opposed to 2) the simultaneous collapse of its efforts to accelerate trade liberalization on a sector-by-sector basis through its early voluntary sectoral liberalization (EVSL) program. APEC's venture down this path had been sparked by the success in the WTO of the Information Technology Agreement, an initiative of the Quad Group (Canada, the EU, Japan and the United States), which most APEC countries had backed. But it was soon evident that APEC's own efforts at pursuing liberalization through a sectoral approach would serve only to exacerbate existing tensions—evident from the Osaka APEC meetings of 1995—over what APEC's priorities should be, and especially whether it should be a venue for negotiation of trade liberalization that went beyond countries' commitments at the WTO.<sup>6</sup> The collapse of the EVSL program at the Kuala Lumpur meetings in 1998 was significant both in that it effectively removed trade liberalization from APEC's agenda and because of its effect in alienating countries that had the resources to provide leadership to the institution. This was particularly the case for Japan, which together with Australia had been the most enthusiastic supporters of APEC from the time of the negotiations for its establishment.<sup>7</sup> But it also reinforced skepticism in the United States, especially in its business community, that APEC could ever be used as an effective instrument for the pursuit of U.S. foreign economic policy objectives.

The failure of APEC to take any action to address the financial crises, beyond endorsing the International Monetary Fund's (IMF) approach, was

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<sup>6</sup> For discussion of the failure of the EVSL program see Ravenhill (2001), Krauss (2004) and Wesley (2001).

<sup>7</sup> Aggarwal and Morrison (1998) and Ravenhill (2001)

important as much for its symbolism than for what it said about APEC's capabilities. After all, APEC was an institution whose primary focus was trade. Annual meetings of finance ministers from APEC economies had begun in 1994 but were confined to discussions about developments in finance at the regional and global levels. APEC itself had not taken any initiatives to promote financial coordination. That APEC would not itself be able to fashion an effective response to the huge re-direction of capital flows that afflicted many East Asian economies in 1997 thus should not have come as a surprise to any reasonably dispassionate observer. Nonetheless, the apparent indifference of APEC's Western members to the plight of crisis-stricken economies, exemplified by the failure of the U.S. government to participate in the rescue package put together for Thailand, was a significant stimulus to intergovernmental economic collaboration among East Asian governments. It prompted them (initially unsuccessfully) to search for a regional alternative to the IMF as a source of crisis financing, to promote a regional bond market as a means of reducing reliance on debt financing, and to pursue preferential trade agreements.

Perceptions of ASEAN's current and future potential as an effective institution for economic collaboration were similarly adversely affected by the financial crises. Again, it would have been unrealistic to assume that ASEAN itself could have provided an effective antidote to the financial panic that spread throughout Southeast Asia in 1997. But few expected that it would be so completely ineffective in addressing the crises. Its failure to take any decisive action further reinforced the skepticism of some of its members, most notably its highest income economy, Singapore, that the "region" as defined by ASEAN could provide an effective stimulus to their economic development.

Finally, at the global level, countries seeking further liberalization were increasingly skeptical of the prospects for rapid progress through the WTO. The first WTO ministerial meeting, held in Singapore in December 1996, was not the embarrassing disaster of the third meeting in Seattle three years later. Nonetheless, the negative reaction of developing economies to the new issues placed on the agenda in 1996—when the ministerial meeting mandated the establishment of working groups to review the so-called "Singapore issues" of investment, competition policy, transparency in government procurement, and trade facilitation—was an early indication that further liberalization at the global level was likely to encounter significant opposition.

### **2.3.1 Post-1997 Enthusiasm for Bilateral Trade Agreements**

The move to discriminatory trade did not come entirely out of the blue. Preferential trade agreements had been put forward in APEC's early years

as a possible strategy for realizing its goal of trade liberalization. During his re-election campaign in 1992, George H.W. Bush issued a manifesto, "Agenda for American Renewal", which proposed a global web of free trade agreements, building on the yet to be ratified North American Free Trade Agreement (NAFTA). This proposal, developed by Robert Zoellick, then aide to White House Chief of Staff James Baker, identified a number of Western Pacific Rim countries, including Australia, as possible candidates for agreements. It met with little enthusiasm, however, as Western Pacific Rim governments were concerned that it would lead to the development of a hub-and-spoke system, an economic counterpart to the San Francisco system, to their disadvantage. The proposal for negotiating free trade agreements with Western Pacific Rim countries was not resurrected until March 1997 when United States Trade Representative (USTR)-designate Charlene Barshefsky released "The President's Trade Policy Agenda" which included the commitment that

...the United States will continue to negotiate reciprocal free trade agreements with individual nations in the Asia-Pacific. Australia, New Zealand, and Singapore are a few of the possible partners in this respect.

Again, it is notable that this document preceded the financial crises that developed later in that year. The USTR followed up on this commitment in its November 1997 proposal for a "Pacific 5" free trade agreement with Australia, Chile, New Zealand and Singapore. But it failed to pursue this proposal. Significant factors here were the inability of the Clinton administration to secure "fast-track" negotiating authority and ongoing domestic opposition to free trade agreements, particularly over labor and environmental concerns, following the implementation of NAFTA. Australia and New Zealand, moreover, posed potential problems for agricultural interests in the U.S. (to compound, in the case of New Zealand, the political stand-off over that country's ban on port visits by U.S. nuclear vessels).

The inclusion of Singapore on the list of possible participants was particularly significant. Its government had frequently indicated its impatience with the slow pace of progress of ASEAN's Free Trade Area. Whatever emotional commitment it had to the idea of furthering Southeast Asian integration was tempered by recognition that this region would never provide a market for more than a small share of its overall exports. The financial crises and political instability that afflicted its neighbors in 1997-98 merely reinforced views in the island state about the need to widen the range of trade partners with which it sought preferential agreements.

Few governments are as well placed as that of Singapore to negotiate free trade agreements. It has very few tariffs on imported manufactures—automobiles, beer, gasoline and tobacco are the exceptions. Consequently, in any exchange of tariff concessions on manufactures in trade negotia-

tions, Singapore is likely to come out ahead. Moreover, because of the structure of its economy—with the bulk of activities in the hands of subsidiaries of foreign corporations or government-linked companies—the Singaporean state enjoys unrivaled autonomy (for any high-income economy) from domestic interests in formulating its foreign economic policies. Any political costs that Singapore would incur in trade agreements would be borne primarily by the service sector.

Singapore became the first East Asian economy to sign a bilateral free trade agreement. When the U.S. failed to pursue its proposal for a P5 grouping, Singapore approached the New Zealand government for a bilateral agreement.<sup>8</sup> Negotiations began in September 1999, with the ensuing agreement entering into force at the start of 2001. Singapore's calculations in choosing New Zealand for its first trade agreement outside of ASEAN reveal some of the multiple considerations that governments have in pursuing such agreements. Certainly it would be hard to argue that its choice of New Zealand owed anything to its significance as an economic partner—at the time of the negotiation of the agreement, New Zealand accounted for little more than 0.25 percent of Singapore's total exports. Indeed, the contrary case can be made: it was precisely New Zealand's lack of economic significance that made it an attractive proposition for Singapore's first bilateral PTA.<sup>9</sup> To this was added New Zealand's enthusiasm for pushing the pace of trade liberalization beyond what APEC was perceived as being capable of delivering.

Singapore was not the only government in the region actively reconsidering its approach to trade liberalization. Japan's Ministry of International Trade and Industry (MITI) had begun in the second half of the 1990s to conduct studies of regionalism and of the potential costs and benefits to Japan of pursuing preferential trade arrangements. The first public indication that the Japanese government was seriously reconsidering its stance on regional trade agreements came in the publication of MITI's *White Paper on International Trade 1999*.<sup>10</sup> Noting that whereas Japan had traditionally stressed the negative impact of regional arrangements on third parties and thereby had distanced itself from the majority of countries in the international community that were now participating in such arrangements, the *White Paper* asserted that evidence was now accu-

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<sup>8</sup> In addition, Singapore began to explore the possibility of a smaller-scale P-group: one initially based on Chile, New Zealand and Singapore (see below).

<sup>9</sup> As one Singaporean official put it, if anything went wrong because of the agreement, the consequences would be minimal. Interview, February 2006.

<sup>10</sup> Ministry of International Trade and Industry (1999)

mulating of the positive effects that regional arrangements were generating not just for participating states but for the global trading system as a whole. The *White Paper* concluded that Japan should reconsider its policy on regionalism and use it as a supplement to approaches taken at the level of the global trading system.

A report issued in the following year, *The Economic Foundations of Japanese Trade Policy—Promoting a Multi-Layered Trade Policy*, articulated the new approach in more detail.<sup>11</sup> This report suggested that a broadening and deepening of regional integration had occurred in response to the growth of economic interdependence, reflected in flows of trade and foreign direct investment. The new regionalism had generated positive effects for participating economies not just through conventional Vinerian trade creation and enhancing the competitiveness of domestic industries, but also because these arrangements had encouraged investment flows. MITI noted that the new regionalism moreover typically involved “deeper integration”, with provisions relating not just to border barriers but also to investment and services, etc. Conventional economic models that focused only on the static effects of integration therefore tended to underestimate the gains from such arrangements. MITI was particularly impressed with the benefits that NAFTA appeared to have delivered in the form of accelerated growth for its member economies. Moreover, various studies of the new regionalism seemed to suggest that it had relatively few negative consequences for non-participants.<sup>12</sup> MITI also noted that by entering into regional arrangements, participants had strengthened their negotiating position in their talks with members of other regional groupings. Furthermore, in a globalizing economy, it was beneficial for a country if the technical standards used by its industries were adopted throughout the wider geographical area that a regional trading agreement might encompass.

Calls for Japan to reconsider its policies towards preferential trade agreements also came from the private sector. Keidanren, the Japan Federation of Economic Organizations, in its statement on the agenda for the proposed “Millennium” round of WTO negotiations, asserted that Japan needed to give “concrete consideration” to pursuing WTO-consistent free trade agreements.<sup>13</sup> In July of the following year, Keidanren issued a more detailed call for the government to negotiate FTAs, noting that businesses

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<sup>11</sup> Ministry of Economy, Trade and Industry (2000)

<sup>12</sup> But contrast with Wall (2001) who suggests that Japan’s exports might be as much as 19 percent lower than they would otherwise have been because of the negative effects of NAFTA and the EU.

<sup>13</sup> Keidanren (1999a)

were concerned that government action on this issue, despite business pressure, had been “lamentably slow”.<sup>14</sup>

In pressing its case that the government should not confine its negotiation of FTAs to a specific region, Keidanren restated some of MITI's arguments about how such agreements might complement actions within the WTO and indeed facilitate multilateral negotiations. It also emphasized the beneficial effects such agreements might have on promoting Japan's own structural reform. However, Keidanren also added specific business concerns to the case for FTAs. Because the new regional agreements were typically “WTO Plus” in providing for investment protection and liberalization, harmonization and mutual recognition of standards, and liberalization of trade in services, they would offer expanded opportunities for Japanese business in the economies of partner states. Moreover, with North American and European countries aggressively expanding the number of preferential agreements to which they were party, Japanese companies would be at a disadvantage unless the government negotiated similar arrangements. Keidanren pointed to the case of Mexico, where American firms enjoyed preferential access to the market through the NAFTA arrangements, and European firms had similar access because the EU had signed a bilateral free trade agreement with Mexico. In contrast, Japanese companies faced Mexican tariffs of 10 to 20 percent on key exports such as automobiles and household electrical appliances, and were excluded from bidding for government contracts.<sup>15</sup> The intervention of Keidanren appeared to lend support to Richard Baldwin's “domino” theory of regionalism: the argument that once momentum on PTAs gathers pace, the process becomes self-sustaining because export-oriented companies in countries that are non-participants will lobby their governments to negotiate equivalent concessions.<sup>16</sup>

The pressure from Keidanren marked a significant development in the evolution of the regionalism debate not just in Japan but in the region more widely. Previously, regionalism in the Asia-Pacific had been largely a governmental affair. Although business had participated in the tripartite PECC, governments had enjoyed little success in interesting large corporations in the activities of the principal regional arrangement, APEC. Indeed, the capacity of business to operate successfully across national boundaries in East Asia and its consequent lack of interest in regionalism was often

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<sup>14</sup> Keidanren (2000)

<sup>15</sup> Keidanren (1999b)

<sup>16</sup> Baldwin (1997). For further discussion of Keidanren's role in the FTA debate in Japan see Yoshimatsu (2005).

held to be one of the most significant factors in the lack of institutionalization of intergovernmental collaboration in the Asia-Pacific.<sup>17</sup>

Japan's eventual entry into negotiations for preferential trade agreements, however, came in response to invitations from potential partners. The decisive political breakthrough in Tokyo's consideration of the role of regionalism in its foreign economic policies came with Korean President Kim Dae-jung's October 1998 visit to Japan. The visit produced a Joint Declaration on a New Japan-Republic of Korea Partnership Towards the 21<sup>st</sup> Century; the action plans appended to the Declaration included provisions for strengthening economic ties. Building on the spirit of reconciliation that the presidential visit had created, the Korean trade minister in the following month proposed to his Japanese counterpart at an APEC ministerial meeting that the two countries should establish a joint study group on the future of bilateral economic relations, including the possibility of negotiating a free trade agreement.<sup>18</sup> At the same time, Mexican President Ernesto Zedillo proposed that Japan should enter into a free trade agreement with his country to parallel that which Mexico was about to negotiate with the EU.

But Japan's first PTA was a response to an invitation from the Singaporean government. Japan's failure to reject the initiatives from Korea and Mexico was perceived as a signal that the government was undertaking a reconsideration of its policies on preferential agreements, providing the encouragement the Singapore government needed to begin informally to explore the interest that Tokyo might have in negotiating a bilateral accord. Munakata (2001) reports that the initial response of the Japanese government to the Singaporean initiative was one of skepticism, in part because of the relatively small size of the Singaporean economy, but also because of doubts about the wisdom of abandoning the previous policy of emphasizing multilateral approaches to trade liberalization. Tokyo remained concerned about the potential backlash of other countries—within and outside the region—to such a move. Nonetheless, negotiations, which built on the report of a joint study group launched in November 1999, pro-

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<sup>17</sup> For further elaboration see Ravenhill (2001).

<sup>18</sup> The results of a study conducted by government think tanks on the future of Japan-Korea economic relations were published in May 2000. Munakata (2001), a former Director of Policy Planning in MITI, provides a detailed discussion of the developments that led to Tokyo's decision to pursue bilateral trade agreements.

gressed relatively rapidly—not least because the Singaporean government was willing to accept an agreement markedly uneven in its obligations.<sup>19</sup>

No other Asian government has spelled out in as much detail as Japan the reasons behind its change in thinking on the desirability of adding preferential trade agreements to its armory of foreign economic policies. The discussion of the Japanese debate above suggests that while the financial crises of 1997-98 may have provided a stimulus to more actively consider alternatives to existing regional institutions, it was a matter of reinforcing a trend that was already under way rather than of prompting a radical departure from ongoing considerations. The Japanese case points in particular to several factors underlying the official rethink:

- 1) A positive assessment of the effects of preferential trade agreements in other parts of the world (in facilitating WTO Plus liberalization and in stimulating investment), and the conclusion that besides stimulating the economies of participating countries they had no significant deleterious impact on the global economy as a whole;
- 2) Notwithstanding the conclusion that the European and North American agreements did not substantially disadvantage non-participants, a concern that failure to go down the preferential route would potentially weaken economies in three principal ways:
  - a) it would deny them the perceived advantages that Europe and North America were gaining from promoting larger integrated markets
  - b) it would diminish their bargaining power in global trade negotiations;
  - c) it would directly disadvantage their domestic corporations in the markets of countries that had negotiated PTAs with the EU or with the United States.

### **2.3.2 Financial and Monetary Cooperation**

The most immediate move toward enhanced regional collaboration in the wake of the financial crises, however, came not in the trade sphere but in

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<sup>19</sup> In contrast, the proposals for agreements with Korea and Mexico, even though launched a year earlier, proceeded much more slowly (and nearly a decade later, no agreement has been reached with Korea).

that of finance—entirely appropriate, if not predictable, given the origins of the crises. This was the proposal by the Japanese Vice-Minister for Finance, Eisuke Sakakibara, to establish an Asian Monetary Fund (AMF). The history of this proposal is well-known and warrants little discussion here save to note that it was a direct response to a perceived anti-Asian bias in the response of the IMF to the financial crises, and to East Asia's under-representation within the Fund itself. Its significance lay also in its paving the way for later initiatives on financial collaboration.<sup>20</sup>

As Jennifer Amyx argues, however, while the financial crises may have been a catalyst for financial cooperation, the subsequent moves to establish new vehicles for interstate collaboration were driven by other forces. In particular, she points to changing attitudes on the part of the Chinese government, which had opposed Sakakibara's original AMF proposal. The key meeting in this regard was the third ASEAN Plus Three summit in Manila, which institutionalized this new regional grouping.<sup>21</sup> At this meeting, the Chinese government proposed an annual meeting of ASEAN Plus Three finance ministers. At their first meeting in Chiang Mai, Thailand, in May of the following year, the ministers endorsed a Japanese proposal, which came to be known as the Chiang Mai Initiative (CMI), for a network of bilateral currency swaps, which would enable a country whose currency was under speculative pressure to draw on the reserves of its partners. Building on a similar but very small facility that ASEAN had created in 1977 (which limited the total liability of any country under the arrangement to \$20 million),<sup>22</sup> the initial CMI established 16 bilateral agreements with total funds of \$36.5 billion.

The need for quick access to larger sums of foreign exchange than were available to East Asian states in 1997 was the first lesson drawn from the financial crises (although the principal means for addressing this problem has come through unilateral action—the very substantial increase in foreign exchange positions that most East Asian governments have built in the decade since the crises—against which the total funding available under the CMI pales in comparison). The second lesson was the desire to reduce dependence on bank loans for development financing. Again, the principal solutions for addressing this problem would most likely be found

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<sup>20</sup> For discussion of the motivations of the Japanese government and the reasons for the proposal's failure see Amyx (2004) and Lee (2006).

<sup>21</sup> The first informal meeting of leaders from ASEAN plus China, Japan and Korea had taken place during the second ASEAN informal summit in Malaysia in December 1997—a meeting that had been planned before the onset of the financial crises.

<sup>22</sup> ASEAN Secretariat (1977)

at the national level, but it also attracted interest at the regional level, initially through the previously obscure grouping of central banks, the Executives' Meeting of the East Asia and Pacific Central Banks (EMEAP).<sup>23</sup> Discussion of an initiative to launch a regional bond fund to promote the development of bond markets in Asia began in earnest in 2002. In 2003, EMEAP launched a modest \$1 billion fund in dollar-denominated securities issued by eight EMEAP economies. A further \$2 billion in bonds was launched in 2005. Meanwhile, the ASEAN Plus Three finance ministers sought to take up the running on this issue (causing some friction with EMEAP) by adopting the Asian Bond Markets Initiative in 2003, which encouraged the issuance of local currency-denominated bonds.

## 2.4 The 9/11 Attacks and Asian Economic Institutions

The third turning point the editors identify in their Introduction, the events of September 11<sup>th</sup> and the subsequent "War on Terror", has had relatively little impact on Asia's economic institutions.

The one exception to this argument is the role that the events played in shaping U.S. economic initiatives in the region. Even before September 11<sup>th</sup>, there was a tendency for Washington to use PTAs as a means of rewarding allies and to withhold offers to negotiate from countries regarded as unsupportive of the U.S. foreign policy agenda (New Zealand, for instance, because of its refusal to allow port visits by U.S. nuclear vessels). It was probably no accident that Singapore, a key supporter of the U.S. role in the region, was the first Asian state to succeed in negotiating an FTA with Washington. This success was not just a matter of supply, however, but also of demand—the Singaporean government deliberately choosing to use FTAs as a strategy for attempting to enmesh all of its key strategic partners.<sup>24</sup>

Yet while an argument regarding the securitization of U.S. foreign economic policy has a certain *prima facie* plausibility given the worldwide

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<sup>23</sup> EMEAP had been established in 1991 at the initiative of the Japanese government. It provides yet another definition of the region, alternative to that of ASEAN Plus Three: its membership comprises the Reserve Bank of Australia, the People's Bank of China, the Hong Kong Monetary Authority, Bank Indonesia, Bank of Japan, Bank of Korea, Bank Negara Malaysia, the Reserve Bank of New Zealand, Bangko Sentral ng Pilipinas, the Monetary Authority of Singapore, and the Bank of Thailand.

<sup>24</sup> Hence, subsequent bilateral negotiations with Japan (FTA implemented 2002), China (negotiations resumed in 2006), and India (FTA implemented 2005).

pattern of the preferential agreements that the Bush administration negotiated between 2001 and 2006,<sup>25</sup> it can easily be pushed too far with respect to U.S. policy toward the Asia-Pacific region. To be sure, the linkage between the Australia-U.S. FTA and the Howard government's support for the Bush administration's Iraq policy was explicit. Yet subsequent U.S. policy toward East Asia provides less compelling evidence. In 2006, the U.S. was negotiating PTAs with three East Asian countries: Thailand, Malaysia, and South Korea; the latter was concluded in 2007. An FTA with Thailand (before the 2006 coup, which led to a suspension of the negotiations) might arguably fit the "PTAs as reward for allies" proposition: negotiations with Malaysia, a longtime critic of U.S. foreign policy in general, and the Iraq War in particular, much less so. And the Bush Administration's October 2002 Enterprise for ASEAN Initiative, which promised support for Cambodia, Laos and Vietnam's accession to the WTO, and the possibility of eventual negotiation of FTAs with all ASEAN economies, made no distinction between longstanding friends in the region and, for instance, the three WTO aspirants whose relations with Washington had traditionally been little more than lukewarm.<sup>26</sup>

Similarly, while South Korea had long been a staunch ally of the United States, the administration of Roh Moo-hyun, with which it began negotiations for an FTA, was widely perceived in Washington as having done more than any of its predecessors to undermine U.S. influence in the region (one could save the securitization hypothesis by arguing that Washington was offering PTAs to wavering allies in an effort to cement faltering relationships, but this really seems to be stretching the credibility of the argument).

## 2.5 The Rise of China

Arguably of greater importance than the events of September 11<sup>th</sup> for reshaping regional economic institutions has been the rise of China. The impact has been twofold: first, through its effect on trade and investment patterns in the region; second, through the new competition for diplomatic and economic influence it has provoked, a significant stimulus to other Northeast Asian economies to offer FTAs to other economies in the region.

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<sup>25</sup> See, for instance, Feinberg (2006) and Higgott (2004)

<sup>26</sup> On the Enterprise for ASEAN Initiative see The White House (2002).

China's ongoing rapid economic growth has encouraged regional institutions through both "negative" and "positive" effects. The negative effect comes from the fear of China as rival: both as a host for foreign direct investment and as a source of exports for third country markets. As Helen Nesadurai's chapter demonstrates, a fear of China was an important stimulus to ASEAN's efforts to agree to and accelerate the implementation of its Free Trade Area.<sup>27</sup>

The "positive" effect comes from the attraction to other regional economies of gaining preferential access to China's burgeoning market. China's emergence as the world's assembly plant has dramatically changed patterns of trade within East Asia and across the Pacific. The trade triangles that developed following the Plaza Accord have been replaced by a new triangulation in which components from other Northeast Asian economies and from Southeast Asia are assembled in China for export to North American and European markets. As Chinese officials are quick to point out, most of the negotiations for PTAs currently involving China are the result of initiatives of trading partners anxious to improve their market access.

One significant exception to this is the China-ASEAN FTA framework agreement. The China-ASEAN FTA was proposed by former Chinese Premier Zhu Rongji at the 4<sup>th</sup> ASEAN Informal Summit in November 2000.<sup>28</sup> The proposal was significant as much for its political as its economic dimensions. It was a diplomatic masterstroke by Beijing in that it helped to assuage ASEAN concerns about the rivalry they faced from China (low-income ASEAN economies had been identified by various World Bank studies as the most likely losers from China's accession to the WTO) and simultaneously placed the other Northeast Asian countries—Korea but more importantly Japan—on the diplomatic back foot because of their reticence in offering PTAs to ASEAN states (a reticence driven primarily by governmental fears at upsetting powerful domestic agricultural lobbies). The agreement is also notable in that it is a rare instance in the recent wave of preferential trade agreements where the larger party to the treaty made more concessions than its weaker partners.

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<sup>27</sup> For further discussion of the "China threat" to Southeast Asia, see Ravenhill (2006a).

<sup>28</sup> Timing is significant here. China's new enthusiasm for preferential trade came only after it had locked into place the principal components of the provisions for its accession to the WTO.

**Table 2.1: Bilateral/minilateral PTAs involving East Asian countries**

<i>Country</i>	<i>Currently Implemented</i>	<i>Under Negotiation</i>	<i>Under Study</i>
ASEAN	AFTA China Korea	Australia-New Zealand India Japan	US
Brunei	AFTA Chile-New Zealand-Singapore*	Japan	
China	ASEAN Hong Kong Macau Pakistan Thailand	Australia Chile Gulf Cooperation Council New Zealand SACU Singapore	India Korea
Hong Kong	China	New Zealand	
Indonesia	AFTA	Japan	Pakistan
Japan	Malaysia Mexico Philippines Singapore Thailand	ASEAN Brunei Indonesia Korea	Australia Chile India South Africa Switzerland
Korea	ASEAN** Chile EFTA Singapore	Canada Japan US (awaiting ratification)	China India Malaysia MERCOSUR Mexico***
Malaysia	AFTA	Australia Japan New Zealand US	India Korea
Singapore	AFTA Australia EFTA India Japan Jordan Korea New Zealand US Brunei-Chile-New Zealand*	Bahrain Canada China Egypt Kuwait Mexico Panama Peru, Qatar	Pakistan Sri Lanka
Taiwan	Guatemala Nicaragua Panama	Dominican Republic El Salvador Honduras	
Thailand	AFTA Australia Bahrain China India BIMSTEC*****	EFTA New Zealand Peru US	

**Notes for Table 2.1**

\*After the Clinton administration's proposal for an FTA among the United States, Australia, Chile, New Zealand and Singapore lapsed, Chile, New Zealand and Singapore signed the "Pacific-Three FTA" in October 2002. On 3 June 2005, with Brunei's accession to the agreement, it was renamed the Trans-Pacific Strategic Economic Partnership.

\*\*Excludes Thailand, which refused to sign after Korea excluded rice and 200 other agricultural products from the agreement.

\*\*\*After failing to reach agreement on negotiation of an FTA, Korea and Mexico agreed in September 2005 to negotiate a more limited economic cooperation agreement.

\*\*\*\*Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation (Bangladesh, Bhutan, India, Myanmar, Nepal, Sri Lanka, Thailand).

The Chinese initiative, which led to the 2002 signature of a framework agreement in which China and ASEAN states agreed to introduce an FTA by 2010 (for the six original ASEAN members) sparked a flurry of negotiation of preferential agreements on the Western Pacific Rim—in which the desire not to be left out of a snowballing process, either for diplomatic and/or economic reasons, energized governments from Malaysia to Taiwan (see Table 2.1).

Another significant consequence of China's increasing economic and diplomatic influence has been an intensification of the competition between alternative definitions of the "region". In particular, the Japanese government became concerned that the ASEAN Plus Three grouping would be a vehicle for Beijing's domination of the region, a sentiment shared by some Southeast Asian countries. Although the report of the East Asian Vision Group (2001), established by the ASEAN Plus Three grouping at the suggestion of Korean President Kim Dae-jung, notably failed to specify the composition of "East Asia", the subsequent report of the East Asia Study Group (2002), whose mandate was to devise practical measures to implement the "East Asian Vision", made it clear that its conception of "East Asia" was identical to the ASEAN Plus Three grouping. When, however, preparations began for the first East Asia Summit, one of the nine mid- and long-term measures proposed by the East Asia Study Group, invitations were extended at the insistence of Japan to Australia, India and

New Zealand, provided that they first signed ASEAN's Treaty of Amity and Cooperation.<sup>29</sup>

The recent origins of the East Asia Summit make it impossible to judge what relationship it will have with either the ASEAN Plus Three grouping or with APEC. At the second East Asia Summit held in the Philippines in January 2007, leaders signed the Cebu Declaration on Energy Security, in which they pledged to strengthen regional cooperation on energy security to ensure stable and affordable supplies over the long term. This agenda directly overlaps with the work of APEC's Working Group on Energy, one of APEC's most active working groups, and with one of the nine medium- and long-term concrete measures proposed by the East Asia Study Group (to "build a framework for energy policies and strategies, and action plans"). Japan's proposal for a "Comprehensive Economic Partnership for East Asia" did not, however, gain sufficient support at the July 2006 meeting of the foreign ministers of the East Asia Summit countries to be placed on the agenda for the January 2007 meeting (with China, Korea and some ASEAN countries expressing opposition)—but the Summit did agree that the ASEAN Secretariat would coordinate a study into the proposal. The East Asia Summit at the moment may be primarily symbolic but this in itself is significant in that it signals the increasing interest in extending East Asia southwards.

## 2.6 Extending the Region to South Asia

Growing concerns about China's potential dominance of exclusively East Asian groupings have coincided with increasing awareness in the region of India's own "economic miracle" and the market opportunities that this presents. Diplomatic, strategic and economic interests have coincided in increasing efforts to enmesh India within a greater "Asian" region.

A framework agreement to "Enhance ASEAN-India Trade and Economic Co-operation", including provisions for an FTA, was signed at the ASEAN summit in Bali in October 2003. Progress in negotiating the agreement has been slow, noticeably much more so than ASEAN's agreement with China. The early harvest scheme which was to precede the FTA had to be dropped because of disagreement over the issue of rules of origin. Both sides have been unwilling to open their markets to one another—with ASEAN objecting to India's initial proposal to exclude 1500 items from liberalization. Negotiations on goods were supposed to have been completed by mid-2005 but were ongoing at the time of writing (early

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<sup>29</sup> Ministry of Foreign Affairs (2005)

2007). ASEAN had suspended negotiations in July 2006 because of India's continued determination to exclude a large number of products from the agreement; after negotiations resumed, ASEAN stunned the Indian government in December 2006 by proposing to double the number of products it had originally proposed to exclude from the agreement. Meanwhile, India sought to maintain protection in its textiles, machinery, autos, chemicals and plastics industries.

A similar lack of substantive progress has characterized India's economic negotiations with China. Although a bilateral investment agreement and two protocols facilitating Indian exports of iron ore and rice were signed during the visit of Chinese President Hu Jintao to New Delhi in November 2006, India resisted China's efforts to speed up negotiations of an FTA. The Indian government was reportedly reluctant to grant market economy status to China, something on which China had insisted before entering into FTA negotiations with Australia and New Zealand, and which it now insists is a pre-requisite for countries wishing to negotiate an FTA. A joint task force studying the feasibility of an FTA was scheduled to report in October 2007.

The only East Asian country that has succeeded in negotiating a bilateral PTA with India is Singapore. Negotiations for the India-Singapore Comprehensive Economic Cooperation Agreement (CECA) were launched on May 27, 2003 in New Delhi, following the report of a joint study group. After 13 rounds of negotiation, an agreement was signed in June 2005. The Agreement encompasses trade in goods, trade in services, investment protection and mutual recognition agreements. The Agreement's coverage of merchandise trade is decidedly less than comprehensive, however, far more so than in any of Singapore's other FTAs.

The other principal agreement currently linking parts of East and South Asia is the Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation (BIMSTEC), whose membership comprises Bangladesh, Myanmar, India, Sri Lanka, Thailand, Nepal and Bhutan. The foundation of the grouping coincided with the onset of the Thai financial crisis in mid-1997, and originally only included Bangladesh, India, Sri Lanka as well as the sole Southeast Asian representative, Thailand. Myanmar was admitted at the end of 1997; Bhutan and Nepal in 2004. Despite being of greater longevity than most East and South Asian regional groupings, BIMSTEC has made little headway on its aspirations to create a free trade area. A framework agreement was supposed to be in place by mid-2006 with trade liberalization to begin by July 1. By the end of 2006, its Trade Negotiating Committee had yet to reach agreement. BIMSTEC's lack of progress is typical of South Asian regional economic collaboration; intra-

regional trade in the South Asia Free Trade Area, established in 2004, for instance, accounts for less than 4 percent of the region's total trade.<sup>30</sup>

## 2.7 Making Sense of Asia's New Institutional Architecture

The decade since the East Asian financial crises has been characterized by a proliferation of economic institutions in Asia at the regional (e.g., ASEAN Plus Three), trans-regional (e.g., South Asia-East Asia), minilateral (e.g., Trans-Pacific Strategic Economic Partnership) and especially the bilateral level. So frequent are the proposals and negotiations for new agreements that even the most careful researcher has difficulty in accurately tracking them.

Accounting for the origins of the proliferating proposals is reasonably straightforward although a full account inevitably points to an array of factors that motivated governments. Of the three turning points identified by the editors in their Introduction to this volume, by far the most important were the ending of the Cold War and the Asian financial crises. Overcoming Cold War divisions was a pre-requisite for launching region-wide intergovernmental collaboration, initially through the APEC forum. The financial crises in turn were significant for encouraging trends that were already under way—reinforcing skepticism towards the principal existing economic institutions (especially APEC and ASEAN) and bolstering a desire both for collaboration on an “East Asian” basis, and for the pursuit of trade agreements through arrangements that had a much more “practical” scale (i.e. bilateral or minilateral in scope). The events of September 11, 2001 were arguably of less significance in their impact on economic collaboration than were developments within Asia—most notably, the rapid growth of the Chinese and Indian economies.

Ideas were important in some instances. The financial crises were significant both for prompting East Asian governments to look for sources of emergency finance that did not carry the strings imposed by the IMF, and for prompting a search for alternatives to debt-based development financing. It is easy, however, to overstate the role of the crises in fostering a new sense of regionalism. To the extent that it created a sense of unity it was based more on anti-Western sentiment rather than on a positive notion of “East Asian-ness”. Rivalries between East Asian countries soon re-emerged—nowhere more apparent than in China's refusal to support Japanese proposals for an Asian Monetary Fund. Even if the current political

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<sup>30</sup> For further discussion see Chapter Eight by Aggarwal and Mukherji in this volume.

tensions between Japan, China and Korea are reduced, the chances of a region-wide PTA are slim indeed.

Material factors provide a more satisfactory explanation for the new enthusiasm of Asian states for constructing collaborative arrangements. But these were by no means exclusively economic. Governments enter economic agreements for multiple reasons. Variance in motivations exists not only across different governments and across different agreements entered into by the same government, but also within governments in the negotiation of a single agreement. Foreign ministries, for instance, have often been more enthusiastic in their advocacy of bilateral trade agreements than have ministries of trade, a reflection of the former's perception of their desirability for diplomatic reasons, and of the latter's concern for their possible impact on the WTO or, more frequently, on clients in protected domestic sectors.

It would be unfair, therefore, to evaluate the new agreements solely on their potential contribution to the economic welfare of the participating states. The new agreements are serving a variety of diplomatic purposes from confidence-building among countries with little previous institutionalized contact with one another, to scoring diplomatic points over regional rivals, to attempting to confirm an international legal personality (in Taiwan's case), to attempting to lock extra-regional powers into the region. No assumption can be made, however, that the negotiation of the agreements will necessarily have a positive impact on diplomatic relations. It would be difficult to argue that a decade of negotiations for a PTA between Japan and Korea has improved relations between those countries. Likewise, relations between Korea and Thailand soured when Korea excluded rice from its PTA with ASEAN, a decision that prompted Thailand's refusal to sign the agreement. Conflicts are to be expected in all trade negotiations but unless resolved within a reasonable period of time can do lasting damage.

PTAs are "club" and "positional" goods: they benefit only members, and they confer maximum advantage when others do not have access to them. These characteristics are potential sources of conflict. Nowhere is this more obvious than in the agreement between Korea and the United States concluded in April 2007. Should this agreement be ratified by both parties, which was by no means certain at the time of writing, it has the potential to have profound economic and strategic implications for the region. One factor is the likely non-renewal by the U.S. Congress of Trade Promotion Authority (TPA): if the Korean agreement is ratified and TPA is not renewed, Korea is likely to enjoy better access to the U.S. market than do other East Asian economies (with the exception of Singapore, which already has a bilateral agreement with the U.S.) for perhaps as long as a decade. Moreover, Korea is also negotiating an FTA with China, and

plans to negotiate one with the EU. Should these negotiations prove successful, Japan will be increasingly isolated in the region, lacking preferential agreements with all its major trading partners (ASEAN, with which Japan has been negotiating collectively and individually, accounts for under 12 percent of Japan's exports compared with 23 percent each for the United States and China/Hong Kong).

Participation in the new PTAs across the region has been very uneven. Taiwan has effectively been excluded from negotiating arrangements with other Asian countries by Beijing insistence that the "one China" principle must extend to trade agreements (contrary to both the WTO and APEC). But, as Table 2.1 illustrates, so too have most of the lower income countries in the region, who simply are not attractive partners save as part of a larger (in this instance, ASEAN) coalition. Of the various PTAs, it is notable that only one—the Trans-Pacific Strategic Economic Partnership—has explicitly proclaimed its openness to new members.

To what extent have the new economic institutions had a significant economic impact? Here, it is difficult to go beyond the answer that to date they have made very little difference.<sup>31</sup> The ambitious attempts at financial cooperation have generated two schemes—the Chiang Mai Initiative and the Asian Bond Markets Initiatives—notable for their very limited funding. Their significance lies primarily in the learning experience that governments are going through over what is required to make bond markets operate effectively, with implications for domestic as well as regional markets. Many of the PTAs are between countries that are minor trading partners, are less than comprehensive in their product coverage for understandable political economic reasons, and frequently have a long lead time and an ambiguous definition of "free" trade. The real regional economy continues to be driven primarily by private sector actors rather than governments.

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<sup>31</sup> For reasons that I discuss in detail elsewhere: Ravenhill (2006b).

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# 3. Building Asian Security Institutions Under the Triple Shocks: Competitive, Complementary or Juxtaposed?

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## 3.1 Changing Threats and Changing Institutions

Asia presents scholars of international security institutions with a bewildering variety of arrangements to examine. This chapter provides a broad overview of the regional institutions that Asian countries are using to manage security, their characteristics and the driving forces that have shaped them over the past two decades. In so doing, I attempt to avoid being confined by any single theoretical commitment, whether it be neorealist, neoliberal or constructivist, and instead share Peter Katzenstein and Rudra Sil's view that regional phenomena in Asia are so complex that a variety of theoretical approaches is necessary to capture their multiple facets.<sup>2</sup> Having said that, I believe that we can derive a great deal of explanatory power from a constructivist approach that emphasizes how cognitive and perceptual shifts interact with material structures such as military power and existing institutions. These interactions, in turn, can mitigate material constraints and ultimately lead to structural transformations in regional politics. Given that there have been significant shifts in Asia's power dynamics and security institutions, a constructivist approach seems to be a good place to start.

The role of actors' perceptions is particularly salient when discussing security. For example, Stephen Walt notes that states engage in balancing

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<sup>1</sup> For their very helpful comments and suggestions on drafts of this chapter I would like to thank the editors and the other participants in the Berkeley and Honolulu workshops.

<sup>2</sup> Ravenhill (2002); Ikenberry and Mastanduno (2003); Alagappa (2003); Katzenstein and Sil (2004)

or bandwagoning behavior against those states that they perceive to be threatening, not simply those that are more powerful. Threat perceptions, in turn, can be influenced by a variety of factors, including the arming state's past and present behavior, military capability, geographical proximity, and the presence or absence of a shared ideology.<sup>3</sup> Expanding on the idea that material capabilities in themselves do not signal intent, Alexander Wendt argues that "anarchy is what states make of it" and that the defining characteristic of the international system needs not force states into conflict with each other. States interpret other states' actions as benign or threatening by using filters or beliefs that can be conditioned by a range of factors from current interactions among themselves and collective memories of the past to understandings about how the international environment operates.<sup>4</sup> For instance, a country may perceive a buildup of arms to be a threat if undertaken by a historical enemy, while it may perceive a similar buildup by a long-time ally to actually benefit its overall security.

Studying perceptions and understanding how they shape states' security behaviors is difficult because it requires some analysis at the individual level to explain how they aggregate and because so many different factors can shape actors' perceptions.<sup>5</sup> Therefore, it is crucial to examine actors' "individual situations", which, as Vinod Aggarwal and Min Gyo Koo have noted, include (a) their "international position" (not only in an objective materially defined sense but also how it and other states perceive that position), (b) the makeup of domestic coalitions and regime types (which can also include popular sentiment such as nationalism) and (c) elite beliefs and ideologies.<sup>6</sup>

Threat perceptions are key to understanding Asian security in the context of shifting structural conditions. The growth of China, the uncertain status of Taiwan, and the volatile situation on the Korean peninsula created a strategic situation highly conducive to a classic security dilemma. Any of these locations could serve as regional flashpoints and lead states to arm in response, generating further fears of attack and potentially leading to what Robert Jervis has described as a "spiral" dynamic of arming that raises the risks of war.<sup>7</sup> For example, Thomas Christensen has observed that the

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<sup>3</sup> Walt (1987:21-26, 33-40)

<sup>4</sup> Wendt (1992:403-407); Wendt (1999:163)

<sup>5</sup> In many cases, as Tan (2006) criticizes, constructivist accounts end up combining structural factors with final behavior, mentioning the processes only perfunctorily.

<sup>6</sup> See Chapter One of this volume by Aggarwal and Koo.

<sup>7</sup> Jervis (1976:62-76)

United States' military presence in the region and especially its alliance with Japan have been compared by Chinese analysts to a "bottle cap" that keeps Japan's militaristic ambitions in check or as an "eggshell" that nurtures Japan's military power until it one day hatches onto the regional scene.<sup>8</sup> With or without the American alliance, then, the enhancement of Japan's military capabilities could heighten China's sense of vulnerability and provoke a regional arms spiral.

Threat perceptions are not only driven by structural conditions, however, but are filtered through actors' biases and memories. The history of Japanese colonialism and the Second World War remains fresh in the collective memories of many Asian governments and has stoked fears that Japan may pursue a more assertive, even militarist, regional foreign policy in the future. When Japan sent an advanced destroyer equipped with the AEGIS system to the Indian Ocean in support of American operations in Iraq, the Chinese Foreign Ministry issued a statement saying, "Based on historical reasons, the dispatch of Japanese soldiers overseas has always been a rather sensitive problem that concerns Asian countries...We hope Japan will strictly abide by its exclusively defensive defense policy and continue to follow a path of peaceful development, and exercise prudence over these matters."<sup>9</sup> Normally, a single ship being dispatched to help an ally should not touch off such concerns. However, China's particular configuration of historical memory and its fears that any abrogation of Japan's "self-defense only" policy would pave the way for renewed militarism served to greatly increase the salience of that one incident.

Large-scale changes or shocks to the international system play a critical role in the development of international security institutions since they tend to make human perceptions particularly fluid and open to change. Shocks may weaken fixed prejudices and enhance opportunities for cooperation, but the uncertainty they create can also impede cooperation by making it difficult to calculate other players' intentions. The last two decades have seen three major shocks: the end of the Cold War, the Asian economic crisis, and the terrorist attacks of 9/11. In this chapter, we will use these shocks as springboards from which to trace the interactions, perceptual shifts, and structural changes affecting the development of Asian security institutions. Before we do, however, it is necessary to first place the shocks in historical perspective and examine the Cold War security environment.

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<sup>8</sup> Christensen (2003:33-34)

<sup>9</sup> "China says Japan's Aegis ship dispatch worries Asia," Kyodo News Service, 12/5/2002

### 3.2 Asian Security Institutions in the Cold War Era

The strategic environment in Asia during the Cold War was characterized by the U.S.-Soviet bipolar confrontation and the resulting alliances that formed on both sides. The Soviet Union concluded bilateral security agreements with North Korea, North Vietnam, and China, although the latter agreement grew increasingly ineffective as the Sino-Soviet rift widened during the 1960s. On the American side, the Philippines, Japan, South Korea, Taiwan, and Pakistan each concluded bilateral security treaties with the United States during the first half of the 1950s, while Australia and New Zealand concluded a trilateral security treaty with the United States (the so-called "ANZUS" treaty). As Sino-Soviet relations deteriorated, China developed a tacit alliance with the United States against the Soviet Union. Border disputes with India led China to seek an alliance with Pakistan, a relationship that resulted in China becoming Pakistan's largest arms supplier after 1966.<sup>10</sup> While India had professed a policy of non-alignment, its encirclement by China and Pakistan led it to conclude a Treaty of Friendship and Cooperation with the Soviet Union in 1971.

While there were attempts to implement minilateral security arrangements with links beyond the region during the Cold War, they generally failed either to materialize or to play any significant role in providing collective security. A Pacific Pact whose draft had been prepared in the State Department by the beginning of 1951 was to cover the island nations of the Pacific (Australia, Japan, New Zealand, the Philippines, the United States, and possibly Indonesia) but exclude continental Asia together with Hong Kong.<sup>11</sup> The exclusion of continental Asia was due to the strong insistence of the Joint Chiefs of Staff who, according to John Swenson-Wright, opposed tying American forces into any explicit security agreement in the volatile and unpredictable Asian region.<sup>12</sup> The proposed pact, now named the Pacific Ocean Pact, was abandoned after John Foster Dulles, Special Representative of the President, traveled to Tokyo, Manila and Canberra in January-February 1951. Reasons for the abandonment, as cited in the Draft Memorandum for the President, were the lack of Japan's preparedness to be a positive contributor, strong public opposition to an alliance with Japan in the Philippines, Australia and New Zealand, and British objections to an agreement that only included the island states, which they believed could jeopardize the security of the mainland, including Hong Kong and Ma-

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<sup>10</sup> Kang (2003:370)

<sup>11</sup> U.S. Department of State (1977:132-134)

<sup>12</sup> Swenson-Wright (2005:70)

laya.<sup>13</sup> The separate bilateral or trilateral agreements for the Philippines, Australia/New Zealand, and Japan emerged in the wake of the quick demise of the Pacific Pact proposal.

Two more attempts to establish regionally dispersed minilateral Asian security organizations have been the Southeast Asian Treaty Organization (SEATO) led by the United States and the Five Power Defense Arrangements led by Great Britain. The former was signed on September 4, 1954 to counter the Communist threat after the French defeat in Vietnam and incorporated both intra- and extra-regional actors.<sup>14</sup> Although its name suggested that it was modeled on the North Atlantic Treaty Organization (NATO), it was hobbled by a dispersed military command, the absence of dedicated military forces, and a nonexistent collective defense agreement. Unlike in NATO, an attack on a single power was not treated as an attack against all, which greatly undermined the organization's credibility. Moreover, the United States retained its bilateral alliances, allowing it to deal with security threats individually as it decided, thereby signaling weak commitment to SEATO.<sup>15</sup> Without a strong commitment to making SEATO a robust collective security organization, it quickly became defunct and was formally dissolved in 1977. The Five-Power Defense Arrangements brought together Britain, Australia, New Zealand, Malaysia and Singapore and was intended not to be a collective defense mechanism but rather a confidence-building measure to aid Singapore and Malaysia in developing their own defense capabilities following Britain's withdrawal from east of Suez in 1971.<sup>16</sup>

What accounts for the failure to establish a robust collective security arrangement in Asia, particularly in light of the fact that Western Europe established a powerful multilateral alliance in the form of NATO under U.S. leadership? Christopher Hemmer and Peter Katzenstein provide a cultural argument that the United States' unwillingness to commit to SEATO or a similar organization in Asia was shaped by American decision-makers' lack of cultural and political identification with Asian societies in sharp contrast to their strong identification with Europe.<sup>17</sup> Although the ideational factors raised by Hemmer and Katzenstein may have had some impact on U.S. policy, the timing of decision-making seems to have been

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<sup>13</sup> U.S. Department of State (1977:184-185)

<sup>14</sup> SEATO's membership consisted of the United States, the United Kingdom, France, Australia, New Zealand, Pakistan, the Philippines, and Thailand.

<sup>15</sup> Hemmer and Katzenstein (2002:578-579)

<sup>16</sup> Acharya (2003:220)

<sup>17</sup> Hemmer and Katzenstein (2002:593-594)

more important to explain the different nature of NATO and SEATO. Dulles, the principal architect of regional security frameworks during the first half of the 1950s, clearly stated that he wanted to avoid the same kind of fierce constitutional battle in the Congress that he had had to endure at the moment of the NATO debate.<sup>18</sup> As a result, the draft of the Pacific Ocean Pact, which Dulles was personally involved in preparing, stated only that

each Party recognizes that if there should be direct aggression in the form of armed attack in the Pacific Ocean upon any of the Parties, such attack would be dangerous to its own peace and safety and declares that it would act to meet the common danger in accordance with its Constitutional processes.<sup>19</sup>

This draft became a model for subsequent security agreements concluded by the United States. The U.S.-Philippine treaty, the ANZUS treaty, and the SEATO treaty all used the above expression to avoid obligating the U.S. to take military action in case of direct aggression. It should be noted that Australia and New Zealand, though being offspring of the West, were not granted the same privilege as had been European NATO members. The U.S. Joint Chiefs of Staff also strenuously opposed including a clause in the ANZUS treaty that would stipulate a joint body for military planning.<sup>20</sup> They wanted to minimize formal military commitments in Asia and the Pacific as much as possible after they had made heavy commitments in Europe. Dulles concurred by saying, “the U.S. should not assume formal commitments which overstrain its present capabilities and give rise to military expectations we could not fulfill, particularly in terms of land forces.”<sup>21</sup>

Two regionally concentrated minilateral security arrangements are worth noting here. The South Asian Association for Regional Cooperation (SAARC) was founded in 1985 by seven South Asian countries as a confidence-building mechanism, but its limited capacities and consensus-based decision-making process meant that it was—and continues to be—hobbled by the India-Pakistan conflict.<sup>22</sup> The second institution, the Association of Southeast Asian Nations (ASEAN), stands out as the most successful minilateral security arrangement by far. Established in 1967 by five Southeast

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<sup>18</sup> Dulles (1952:180)

<sup>19</sup> U.S. Department of State (1977:133)

<sup>20</sup> *Ibid.*, 201-211

<sup>21</sup> Dulles (1952:183)

<sup>22</sup> For a more detailed analysis of SAARC and security cooperation in South Asia, see Chapter Nine by Eswaran Sridharan in this volume.

Asian countries, ASEAN was not an alliance but rather a “security community” of relatively weak states who sought to ensure the inviolability of their own sovereignty by pledging to forgo the use of violence in disputes with each other. In addition, member states were to adhere to norms of consultation and consensual decision-making. While these norms helped to keep the peace among states, it also made it virtually impossible to deepen institutionalization. Although ASEAN did not play a decisive role in the outcome of the Cold War, it did succeed in socializing Southeast Asian states into a set of cooperative norms and laid the groundwork for future security and economic cooperation in the region.<sup>23</sup>

In sum, the Cold War Asian security environment was defined by bilateral arrangements with the United States at the center. The memory of Japanese militarism among both Japanese citizens and their former adversaries, together with the perception by the U.S. Joint Chiefs of Staff that American military capability was limited, made collective security a highly unlikely proposition in Asia. ASEAN stands as an exception to the bilateral rule, but its security role during the Cold War was quite limited. While the norms of consultation, non-intervention, and consensus-based decision-making helped keep the peace among member states, those same norms impeded any institutionalization of binding collective security arrangements.

### **3.3 Asian Security Institutions in the Post-“Triple Shocks” Period**

In Chapter One of this volume, Vinod Aggarwal and Min Gyo Koo articulate an institutional bargaining game model that links exogenous systemic shocks to changes in regional institutions. To briefly recap, exogenous shocks can alter the supply of national security or free trade as goods, thus creating a need for the provision of more and/or different security or trade goods. While broader secular trends certainly play a role in molding institutions, exogenous shocks can alter the course of those trends as well, leading to institutional change. The shape of a given institution—its participants, geographic coverage, strength, scope and nature—is determined by the nature of the goods it will provide, the individual situations of the bargaining states, and the existing institutional context. The end of the Cold War, the advent of the Asian financial crisis, and the terrorist attacks

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<sup>23</sup> For a more detailed discussion of ASEAN’s role in Southeast Asian security cooperation, see Chapter Seven by Ralf Emmers in this volume.

of 9/11 each placed significant pressure on existing regional security institutions in Asia.

The collapse of the Soviet Union in 1991 and the consequent end of the Cold War signaled a momentous shift in regional power relations in Asia. Countries that had previously relied on the Soviet Union for military and economic assistance now found their resources sharply curtailed. The ideological attraction of Communism also declined. On the other hand, the end of bipolar tensions also reduced the United States' incentives to maintain its hub-and-spoke system of multiple bilateral alliances, as attested to by the first Bush Administration's announcement of a major drawdown of troops located overseas.<sup>24</sup> Both American and Soviet allies scrambled to adjust to the power vacuum and the resultant sense of uncertainty and insecurity. As the balance of power shifted, so did actors' perceptions and beliefs about their key interests in the region. In addition, the end of the Cold War unleashed pent-up animosities originating in the imperialist past.

During the period immediately following the end of the Cold War, the United States was generally viewed as a relatively neutral arbiter whose presence could prevent regional tensions from mushrooming into security crises. With the end of bipolarity as an organizing principle, rivals and allies of the United States alike worried that American retrenchment in Asia could further destabilize the region and give rise to unfettered power competition. As a result, states began to establish or retool regional institutional mechanisms to navigate the increasingly complex security environment, including ASEAN, the ASEAN Regional Forum (ARF), the Council for Security Cooperation in the Asia-Pacific (CSCAP), and the ASEAN-Plus initiatives.

The 1997 Asian financial crisis played a significant role in the region's institutional development in two ways: first, it revealed the unexpected weaknesses of Northeast and Southeast Asia's Newly Industrializing Economies (NIEs) in the rapidly globalizing financial market and the inadequacy of regional institutions to handle major economic shocks. This served as an impetus for further regional strengthening. Second, the crisis created an opening for China to take a leadership role. With Japan still sunk into deep recession, China became widely regarded as the engine for regional economic growth and used its rapidly increasing economic resources to quicken its military modernization programs.

Finally, the attacks of September 11, 2001 placed new pressures on regional security institutions by creating tensions between the unilateralism of the Bush Doctrine and the loose, consensus-based decision-making style of organizations like ASEAN. The United States' actions in Afghanistan

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<sup>24</sup> Khong (2004:181)

and Iraq, as well as its designation of North Korea as a member of the so-called “Axis of Evil”, fostered cleavages both among and within Asian states as they weighed the pros and cons of cooperation or alliance with the United States and the potential impact that such cooperation could have on domestic legitimacy—particularly in the case of South and Southeast Asia’s large Muslim populations—and autonomy.

In this section, I examine how the “triple shocks” altered the shape of Asia’s regional security architecture in each of the sub-regions of Northeast, Southeast, and South Asia. Several major effects of the post-“triple shocks” period stand out: 1) changes in the strengths of the United States’ bilateral relationships in the region; 2) the rise of China as a major player in the region and the consequent anxieties that it has generated; 3) the growing importance of minilateral organizations such as ASEAN, the ASEAN Plus Three arrangement, and the Six-Party Talks; and 4) increasing concerns about “non-traditional” security issues such as terrorism, trafficking in drugs and humans, piracy and the threat of weapons of mass destruction. Utilizing the institutional bargaining game model introduced by Aggarwal and Koo in Chapter One of this volume, I will examine how these trends have developed over the past two decades and how the “triple shocks” have helped to reshape Asia’s security architecture.

### **3.3.1 Northeast Asia: The Elusive Search for Stability**

With the collapse of the Soviet Union, the balance of power in Northeast Asia entered a state of flux. The period following the Cold War was marked by the rapid growth of China’s economy, looming crises over North Korea’s nuclear weapons program and the status of Taiwan, and a reevaluation by the United States of its military role in the region. As China continued to grow and tensions with its neighbor Japan increased, the United States revised its strategy of retrenchment and continues to maintain a forward military presence in the region. Because of the lingering legacy of the Cold War and heightened mistrust among the major players in the region, Northeast Asia has been marked by the virtual non-existence of regional security institutions. When such institutions have existed, they have tended to be very weak and quickly pushed into irrelevance by power politics. Instead, the bilateral hub-and-spoke system of U.S.-led alliances has provided a substitute for regional security organizations since its presence is perceived by virtually all regional players to be a stabilizing force for Northeast Asia’s multiple flashpoints.

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***Changing Threat Perceptions and Rebalancing Alliance Structures in Northeast Asia***

In China, the previously close Sino-U.S. bilateral relationship was dramatically altered by the 1989 Tiananmen crackdown in which government troops reportedly killed or injured thousands of pro-democracy demonstrators in Beijing's Tiananmen Square. Widespread outrage in the United States prompted the Bush administration to suspend all military cooperation with China, impose economic sanctions and link the status of Most Favored Nation trading status to an annual review of its human rights record, a move that caused the Chinese leadership significant embarrassment. At the same time, the United States began to grow increasingly concerned about China's growing strength in the region and the potential threat to its neighbors, especially Taiwan.

Although the Chinese government under Deng Xiaoping took a highly conciliatory posture for border negotiation with its continental neighbors, it was stubborn in its claims of sovereignty over Taiwan. The Chinese leadership insisted that Taiwan had been snatched away from China by Japanese imperialists and repeated highly belligerent and intimidating statements against Taiwan thereafter.<sup>25</sup> As a result of these two events, the United States began to demonstrate greater support for the island. For example, it began to provide Taiwan with increasingly sophisticated arms, including 150 F-16 fighter jets in 1992 which constituted a major qualitative improvement in the kinds of arms that the U.S. was willing to make available to the island. The sale predictably irritated China and raised suspicions that the United States was seeking to contain it.

Throughout the remainder of the 1990s, the United States' professed "strategic ambiguity" toward Taiwan, which was predicated upon preventing both a Chinese invasion and a unilateral declaration of Taiwanese independence, came under increased strain. In 1995, the United States elicited strong protests from China when it granted Taiwan's President Lee Teng-hui a visa to speak at his alma mater, Cornell University. During the 1996 Taiwanese presidential elections, China's People's Liberation Army (PLA) held large-scale exercises in the Taiwan Strait to intimidate the electorate into voting against Lee, including launching missiles near the Taiwanese coast, a move which ultimately backfired when Lee was elected. The United States sent two aircraft carrier battle groups to the region in a show of force to deter any Chinese military action against Taiwan.

In addition to the Taiwan Strait issue, the Chinese government also enacted the Law of Territorial Waters in 1992 by which it declared China's

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<sup>25</sup> Medeiros and Fravel (2003:28)

ownership of nearly all islands in the South China Sea and the East China Sea, including the Senkaku/Diaoyu Islands which are currently controlled by Japan, the Paracels (claimed by Vietnam) and the Spratly Islands which are also claimed by Taiwan, the Philippines, Malaysia, Indonesia, Brunei, and Vietnam. These claims, driven by nationalist sentiment and by China's burgeoning demand for energy to fuel its rapidly expanding economy, have occasionally led to international incidents, such as the 1995 and 1996 skirmishes between Chinese and Philippine naval forces on Mischief Reef in the Spratlys.<sup>26</sup> China has also conducted frequent exploratory activities in East China Sea and, by 2004, started to build drilling rigs guarded by Chinese warships and submarines in several spots just outside the Japan-claimed EEZ line, ignoring repeated Japanese protests.<sup>27</sup> Finally, the Chinese government has not hesitated to make deals for oil with highly anti-American countries like Iran, Sudan, and Venezuela.<sup>28</sup> Taken together, all these incidents helped increase the "China threat" perception in Japan, the United States, and the ASEAN countries.<sup>29</sup>

In the United States, the election of George W. Bush and his declaration that China was a "strategic competitor" rather than a "strategic partner" contributed to China's view that the United States and its allies were intent on containing it. Soon after taking office, the Bush administration found itself in the midst of an international incident when an American reconnaissance plane collided with a Chinese fighter jet in April 2001. Combined with the administration's initial refusal to apologize for the death of the Chinese pilot, the incident sparked violent anti-American protests throughout China. Moreover, it came on the heels of the accidental bombing of the Chinese embassy by American aircraft in Belgrade in 1999, helping to fuel suspicion that the United States was out to prevent China's rise.<sup>30</sup> The

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<sup>26</sup> Zheng (2000:100)

<sup>27</sup> On one occasion (November 2004), a Chinese nuclear submarine "accidentally" intruded in Japan's territorial waters.

<sup>28</sup> Zweig and Jianhai (2005)

<sup>29</sup> The mid-term defense plan prepared in late 2004 by Japanese Self Defense Force (SDF) for 2004-2008 reportedly listed China as a "potentially threatening country" for the first time (Asahi Shimbun, 9/26/2005).

<sup>30</sup> As early as 2000, Congress obligated the Department of Defense to prepare and submit an annual report on China's military strategy and capabilities (U.S. Department of Defense 2000). The Pentagon's Quadrennial Defense Review Report of 2006 (U.S. Department of Defense 2006:29) wrote: "China has the greatest potential to compete militarily with the United States and field disruptive military technologies that could over time offset traditional U.S. military advantages absent

seeming improvement of Sino-U.S. relationship just after the September-11 attacks turned out to be short-lived. The Bush Administration's basic stance viewing China as the major competitor rather than a partner in Asia did not change.

The United States' bilateral alliance with South Korea also underwent significant transformations following the end of the Cold War. Without the common threat of the Soviet Union to bind both countries together, cracks and fissures began to appear in the U.S.-Korean alliance. The primary reason for this was a divergence of threat perceptions toward North Korea, particularly in the wake of President Kim Dae-jung's "Sunshine Policy." Following the collapse of the Soviet Union, the United States turned its attentions to North Korea, which it perceived to be a major threat given its pursuit of nuclear weapons. The loss of previously substantial Soviet aid increased the likelihood that it would attempt to trade fissile material for food and other aids and raised the alarming possibility that nuclear materials could end up in the hands of so-called "rogue states" or terrorists who could use it to craft a "dirty bomb". Of equal concern was the risk that a nuclear North Korea would spark a regional arms race that might lead Japan, South Korea, and Taiwan to develop nuclear weapons of their own. In 1994, the United States and North Korea signed the Agreed Framework and established the Korean Energy Development Organization (KEDO), which is described in greater detail in Min Ye's chapter in this volume. Under the terms of the agreement, North Korea agreed to halt the development of nuclear weapons in exchange for two light-water reactors for energy, which would be supervised by KEDO. However, the deal died in 1998 when the United States Congress voted to withhold all funding following North Korea's test-firing of a Taepodong-1 multistage missile over Japan in August as well as satellite evidence that it had restarted its highly enriched uranium program.

The election of President Kim Dae-jung in 1998 and his subsequent attempt at engagement with the North created new tensions between the United States and South Korea. Kim Dae-jung adopted the "Sunshine Policy," which involved diplomatic visits, efforts to unify families separated by the Korean War, attempts at establishing special economic zones where South Korean companies could establish facilities, and the opening of tourism in the North in exchange for large sums of aid. Yet as the Sunshine Policy continued throughout the Kim presidency and that of his successor, Roh Moo-hyun, it chafed against a growing consensus among conservatives in Washington, Seoul and Tokyo that North Korea ought not to be

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U.S. counter strategies." On the Chinese side, citizens who regarded the United States as the major military threat against their country jumped up from 40 percent to 70 percent between 1997 and 2001 (Asahi Shimbun, 6/9/1997; 12/25/2001).

aided until it had demonstrated that it was willing to give up its nuclear weapons development program, particularly after a number of embarrassing incidents that seemed to demonstrate North Korea's intent to exploit the good will of its neighbors. These included the 1998 missile test over Japan, the discovery of North Korean spy submarines in South Korean waters in 1996 and again in 1998, a June 1999 naval battle between North and South Korean forces in the Yellow Sea that sank one North Korean ship, the revelation of a series of abductions conducted in Japan by North Korean agents during the 1970s and 1980s, the reopening of the Yongbyon nuclear facilities and North Korea's withdrawal from the nuclear non-proliferation treaty (NPT) regime in 2002-2003, the withdrawal of 8,000 used fuel rods from the reactors in May 2005, the launch of seven missiles in July 2006, and a nuclear weapons test in October 2006.

Alarmed by the prospect of a North Korea armed with nuclear missiles and increasingly wary of China's future role in Asian security, Japan rapidly sought to re-strengthen its security ties with the U.S. when the latter reversed the predecessor's policy and proposed in the 1995 East Asia Strategic Report (the so-called Nye Report) to maintain a sufficient forward presence in the Asia-Pacific region and to set the U.S.-Japan alliance as the basis on which to plan U.S. security policy in Asia.<sup>31</sup> The Japanese government revised the guidelines for U.S.-Japan defense cooperation to stipulate the role of Japan not only in the case of a direct attack against Japan but also in the event of an incident that, if left unattended, could lead to a direct attack against Japan.<sup>32</sup> There was almost no objection in Japan to the interpretation that the new guideline covers the Korean Peninsula, but the question remained as to whether it would also cover the Taiwan Strait.<sup>33</sup> This ambiguity irritated the Chinese government and heightened its perception of a threat emanating from the U.S.-Japan alliance. The same kind of interaction occurred when Japan decided to cooperate with the U.S. in developing the Theater Missile Defense (TMD) system in September 1998 and the Ballistic Missile Defense (BMD) system in December 2003. Although the intended target of the defense systems for Japan was North Korea, China reacted negatively because once deployed, the same systems could be used to neutralize its own deterrent capability.<sup>34</sup>

On the other hand, the U.S. military and the Japanese SDF are strengthening cooperation and integration in response to the American policy of

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<sup>31</sup> Takita (2005:62)

<sup>32</sup> Soeya (1998:214-215); Kamiya (1998:125-136)

<sup>33</sup> Katzenstein and Okawara (2004:114, 118)

<sup>34</sup> Christensen (2003:34-35); JDA (2005:147, 156)

military transformation and redeployment.<sup>35</sup> One Defense Department official estimated that Japan's total burden for redeploying American forces on its soil amounted to \$26 billion (out of a combined total of \$30 billion).<sup>36</sup> The balance of the estimated burdens for the U.S. and for Japan clearly demonstrates the relationship of dependence between the two countries.

### ***Institutional Sterility in Northeast Asia?***

As discussed above, the institutional security environment in Northeast Asia during the post-"triple shocks" era was primarily characterized by bilateral relations and a growing perception of regional flux prompted by the rise of China, the changing role of the United States, and the nuclear ambitions of North Korea. The easing of rigid bipolar tension, the economic opportunities created by China's growth, and the common challenge of combating terrorism could have served as foundations on which to build security institutions of subregional or broader scope. Yet to establish such institutions, it would be necessary to overcome the impediments of mutual suspicion and hostility that had been built up throughout modern history and during the Cold War.

The problems in the Taiwan Strait and the Korean Peninsula became the initial stumbling blocks for Japan-China relations. China's attempts to intimidate Taiwan reinforced its image in Japan as an uncompromising military power. On the other hand, the refurbished U.S.-Japan security ties, though mainly aimed at containing North Korea, were perceived by China as a potential threat to its own security. Adding to the mistrust were the Japanese government's endorsement of history textbooks that omit or play down descriptions of Japan's atrocities before and during World War II and Prime Minister Junichiro Koizumi's regular visits to the Yasukuni Shrine, which includes several Class-A war criminals on its roll of honor. On the Chinese side, its unilateral oil exploration in East China Sea as well as the rapid expansion of the PLA's capabilities heightened the feeling of insecurity among Japanese leaders and citizens. The mutual suspicions and mistrust spiraled in action-reaction cycles aggravating bilateral relations. By 2005, the relationship between Japan on the one hand and China and South Korea on the other deteriorated to such an extent that the trilateral summit meeting, which had been routinely convened at the occasion of the ASEAN Plus Three (APT) summit meeting, was cancelled by the Chinese and South Korean governments. Although Japan's new premier, Shinzo

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<sup>35</sup> For the details of the redeployment plan, refer to Asahi Shimbun, 10/30/2005.

<sup>36</sup> Asahi Shimbun, evening ed., 4/26/2006

Abe, has tried to be more conciliatory to China and South Korea, the trilateral relations are still too fragile for the three countries to develop any substantial subregional institution in the near future.

While Northeast Asia has failed to build any subregional institutions, it has made somewhat more progress with broader institutions. The 1997 Asian financial crisis saw the advent of the APT mechanism (discussed later in this chapter) which brought China, Japan and South Korea together with the ASEAN states for regular consultations on a variety of issues. The North Korean crisis has also served to bring together key players—China, Japan, South Korea, the United States, and Russia—to collaborate in getting North Korea to relinquish its nuclear weapons via the Six-Party Talks (SPT). However, the SPT has thus far failed to get North Korea to cease its nuclear program due to a lack of basic trust between the United States and North Korea and divergent threat perceptions held by the U.S. and Japan on the one hand and by China and South Korea on the other. Thus, although the SPT has introduced a multilateral component into the regional strategic environment, they have remained extremely weak in terms of their functional strength while the issue scope remains narrowly focused on North Korea. For the SPT to become a true and robust security organization for Northeast Asia, it must overcome the obstacles of mutual mistrust and hostility that have hobbled other attempts.

### **3.3.2 South Asia: the Limits of Cooperation Under Conditions of Mutual Hostility**

As in Northeast Asia, the development of a robust regional security system in South Asia has been effectively forestalled by active conflicts and mutual suspicions—in this case, between India and Pakistan. SAARC, the primary regional security institution in South Asia, has been relegated to a backseat role. Security decisions are essentially made on a unilateral or bilateral basis with regard to the India-Pakistan rivalry or the two countries' relationships with external powers such as China and the United States.

In South Asia, as in the rest of Asia, the end of the Cold War loosened bilateral security ties. U.S.-Pakistan relations, which had been close throughout the 1980s as both countries sought to combat the Soviet presence in Afghanistan, cooled considerably over the issue of Pakistan's nuclear weapons program. In 1990, the United States imposed a ban on the exportation of weapons to Pakistan as punishment for its clandestine nuclear weapons program. Meanwhile, India became isolated without Soviet backing. To make the situation worse, the Kashmir conflict and radical Islamic groups left behind by the Cold War battles of the 1980s reinforced each other and deteriorated India-Pakistan relations. The rivalry between

the two countries culminated in the 1998 nuclear tests while activities of Islamic guerrilla groups almost provoked major wars in 1999 and 2002.<sup>37</sup>

Pakistan's international position, which had been weakened by its incursion into India-dominated Kashmir in 1999 and the disruption of the democratic process by Pervez Musharraf's coup d'état, became even more precarious after 9/11 as the Kashmir conflict came to be regarded as a terrorist-precipitated conflict of global implication. The Musharraf government supported the "war on terror," which the U.S. government reciprocated by revoking economic sanctions and granting generous amounts of aid and debt rescheduling.<sup>38</sup> It also granted Pakistan status as a major non-NATO ally in March 2004.<sup>39</sup> Nevertheless, Musharraf's efforts have been obstructed by strenuous activities of Islamic militants.

In contrast, India's economic achievement, as well as its internationally appreciated self-restraint during the 1999 Kargil conflict, contributed to improving its international status.<sup>40</sup> During the conflict, U.S. President Clinton put pressure on Pakistani Prime Minister Nawaz Sharif to withdraw the Pakistani regular forces and Islamic militants.<sup>41</sup> Clinton also visited India (but not Pakistan) in March 2000 as the first American president to do so since 1978. After 9/11, India made naval yards available to U.S. warships operating in the Arabian Sea against Taliban forces in Afghanistan. Indian policymakers also shared a deep concern about China's military buildup with the Bush Administration although China adopted a relatively conciliatory posture toward India by not challenging the status quo on the borders.<sup>42</sup> The U.S. and India announced the so-called Next Steps in Strategic Partnership in January 2004 and officially agreed in March

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<sup>37</sup> Smaller skirmishes were numerous. During the decade following 1989, 22,000 people reportedly died in Kashmir as a result of violence. See Kang (2003:367-368).

<sup>38</sup> Haider (2005:537)

<sup>39</sup> IISS (2005:147)

<sup>40</sup> For more details on the Kargil conflict, please see Eswaran Sridharan's contribution to this volume in Chapter Nine.

<sup>41</sup> IISS (2000:151)

<sup>42</sup> Although China did not reach a territorial agreement with India, it signed an agreement for the Maintenance of Peace and Tranquility along the Line of Actual Control in 1993 and another agreement to reduce troops in the border areas in 1996.

2006 that the U.S. would assist India for civilian nuclear-energy programs (although it could contradict the NPT regime).<sup>43</sup>

Being regionally and internationally in a disadvantageous position, President Musharraf agreed in 2004 to resume the “composite dialogue” with India. His government also placed increased pressure on militant groups.<sup>44</sup> Still, the progress of the dialogue is tortuously slow, interrupted from time to time by militant attacks such as the Mumbai bombings in July 2006.<sup>45</sup> Under these conditions, SAARC has made very little progress. Its activities have been almost exclusively directed to dialogues concerning economic and functional matters.<sup>46</sup> Its only merit in the security field has been that its annual summit meetings offer the opportunity for the Indian prime minister and the Pakistani president to talk directly. For example, Musharraf and Atal Bihari Vajpayee reached their decision to resume the composite dialogue at the SAARC meeting in Islamabad in January 2004.

### 3.3.3 Southeast Asia: ASEAN in the Driver’s Seat

In contrast to Northeast Asia and South Asia, Southeast Asia has proven to be far more fertile ground for the development of regional security institutions, largely spearheaded by ASEAN. Two factors account for this difference: first, the end of the Cold War was more clear-cut in Southeast Asia than in Northeast Asia, with no lingering interstate rivalries following the collapse of the Soviet Union. For example, Vietnam was weakened so much by the exhaustion it had suffered in Cambodia and by the drastic decline of Soviet assistance that it chose to coexist peacefully with its neighbors. Vietnam joined ASEAN as an observer in 1992 and became a

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<sup>43</sup> IISS (2005:146); Tellis (2006:146); Asahi Shimbun, 3/3/2006. In the face of India’s rising influence in the region and its increasingly close links the U.S., the Chinese government apparently felt it necessary to court India and thus counter what it perceived to be U.S. containment. President Hu Jintao visited India in November 2006, ten years after his predecessor had done so and reached an agreement with his Indian counterpart with regard to cooperation for nuclear-energy development (as well as for trade and investment), an apparent counter to the similar agreement reached between the U.S. and India eight months earlier (Asahi Shimbun, 11/22/2006).

<sup>44</sup> It arrested the top leader of Harakat al-Mujahedin, one of the most militant groups. Cross-border infiltration into India-controlled Kashmir reportedly declined throughout 2004 (IISS 2005, 143).

<sup>45</sup> Asahi Shimbun, 11/16/2006

<sup>46</sup> SAARC website: <http://www.saarc-sec.org>.

full member in 1995. Laos and Cambodia followed suit in 1997 and 1999 respectively. It is no doubt that the successful ASEAN economies served to attract the poorer former socialist countries.

Second, when the Cold War ended, ASEAN already existed as a mature regional institutional framework already existed in the form of ASEAN. Since its founding in 1967, ASEAN had developed a long-term habit of avoiding intramural military conflict as well as the experience of organizing broader forums for dialogue beyond Southeast Asia. Since the countries in institutionally barren Northeast Asia and South Asia had no other options to foment regular regional interaction, ASEAN emerged as the de facto leader of institution-building in Asia. As a result, almost all new multi-subregional institutions came to take the “ASEAN-Plus” format, in which participating states meet in regular forums chaired by an ASEAN member and held in tandem with equivalent ASEAN meetings.

The ASEAN framework, characterized by the “ASEAN Way” of decision-making by consensus, mutual consultation, quiet diplomacy and strict respect for sovereignty, greatly influences the shape of derivative institutions such as the “ASEAN-Plus” groups and the ASEAN Regional Forum. As such, we can describe these institutions as being relatively weak in functional strength, broad in geography and generally broad in issue scope (though the strict respect for sovereignty means that member states can veto discussion of sensitive topics, such as China refusing to allow open discussion of the Taiwan dispute). The ASEAN states have consistently demonstrated a preference for a broadening geographic scope over time even though it has resulted in relatively weak institutions. For the ASEAN states, which remain concerned about the potential for a single country like China or the United States to dominate such organizations, institutional weakness can be seen as a strength and the price to be paid for the opportunity to engage with and socialize otherwise reticent states into long-term habits of transparent discussion and cooperation.

### ***The ASEAN-Plus Model: A Framework for Multi-Subregional Security Cooperation?***

The first example of an “ASEAN-Plus” institution was the ARF. The original idea for a region-wide security institution that could fill the post-Cold War “power vacuum” was the brainchild of Australian foreign minister Gareth Evans who proposed in 1990 to form an organization modeled on the Conference on Security and Cooperation in Europe (CSCE). The Japanese government was skeptical about the inclusion of Communist countries in the scheme and proposed to use the ASEAN Post-Ministerial Conference as a forum for security-related dialogue. At the same time, the U.S. government did not like either idea as it feared that its network of bilateral security ties would lose influence in the region as a result. The

ASEAN governments, on the other hand, supported Evans' idea of broad engagement with Communist countries (particularly China) but did not want to see the new institution dominated by outside powers. As a compromise measure, ASEAN proposed to found an enlarged forum that it would lead. This ultimately took shape in July 1994 as the ARF with the participation of the twelve ASEAN Post-Ministerial Conference members along with China, Russia, Vietnam, Laos, and Papua New Guinea.<sup>47</sup>

In evaluating ARF's characteristics according to the institutional bargaining game model, we can see that like ASEAN itself it is weak in functional strength, broad in issue scope, and broad in geographic scope. The weakness of the ARF is a function of its attempts to include as many countries as possible, leading to a "lowest common denominator" approach to policy discussion. The loose, consensus-based organization that was modeled on ASEAN's norms of interaction helped persuade hesitant participants like the United States and China to join the ARF. Once initiated, the Clinton Administration became a positive participant.<sup>48</sup> In contrast, China remained suspicious of any measures beyond confidence-building, fearing multilateral intervention in the disputes over Taiwan and the South China Sea.<sup>49</sup> Nevertheless, easier measures for confidence building flourished, from voluntary publication of annual defense posture to human and information exchanges among defense institutions. CSCAP, founded earlier as a Track Two forum, served as another channel for confidence building in parallel with the ARF.<sup>50</sup>

The Asian financial crisis gave birth to the APT, another "ASEAN-Plus" forum.<sup>51</sup> In response, Malaysian Prime Minister Mahathir bin Mohamad proposed the formation of an "Asians only" organization to manage regional finance, the so-called East Asian Economic Group (EAEG), which failed to materialize in 1990. However, the 1997-98 crisis prompted Japan and other East Asian countries to reappraise the possibility

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<sup>47</sup> Yamamoto (2001:50)

<sup>48</sup> The Nye Report published in February 1995 stated that regional multilateral institutions could play important supplementary roles in increasing transparency and confidence building in East Asia. See Khong (2004:183).

<sup>49</sup> Wang (2000:79); Acharya (2001:177)

<sup>50</sup> Shigemasa (1998:73)

<sup>51</sup> The first summit meeting of ASEAN, Japan, China, and South Korea was convened in February 1996 to prepare for the Asia Europe Meeting (Yamakage 2001, 66), but the Kuala Lumpur meeting of late 1997 is officially counted as the first APT summit (Japan Ministry of Foreign Affairs webpage: <http://www.mofa.go.jp/mofaj/area/asean/asean+3/wakugumi.html>).

of “Asians only” cooperation. The Chiang Mai Initiative (CMI) and Asian Bond Markets Initiative (ABMI) emerged under the APT framework between 2000 and 2003.<sup>52</sup> In due course, the leaders of the APT countries saw the possibility that this framework could serve issue areas beyond monetary and financial matters and decided in 2003 to establish a Track Two forum called NEAT (Network of East Asian Think-tanks) to explore methods for deepening cooperation under the APT framework.<sup>53</sup> The progress of the NEAT process, however, is tortuously slow, and the group has not yet developed substantial measures.

### ***ASEAN and China: Engaging the Dragon***

Toward the end of the 1990s, China changed its posture toward regional institutions and, as a consequence, helped ASEAN’s efforts for institution-building. On the occasion of the 2000 APT summit meeting, Premier Zhu Rongji expressed his government’s intention to positively participate in the process of regional cooperation. In a separate meeting during the summit, he suggested the idea of free trade between China and ASEAN. This proposal led to a November 2002 framework agreement of ASEAN-China Free Trade Area (ACFTA), an Early Harvest Program in October 2003, and the Agreement on Trade in Goods signed in November 2004.<sup>54</sup>

China also demonstrated its conciliatory posture in the territorial disputes with ASEAN countries. In November 2002, China and the ASEAN countries signed a Declaration on the Conduct of Parties in the South China Sea.<sup>55</sup> China became the first non-ASEAN country to sign ASEAN’s Treaty of Amity and Cooperation (TAC) in October 2003.<sup>56</sup> As a further sign of good will, China proposed and signed a series of agree-

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<sup>52</sup> For details of the CMI and the ABMI, refer to the Japan Ministry of Finance website: <http://www.mof.go.jp/jouhou/kokkin/frame.html>. Also, see Helen Neadurai’s contribution to this volume in Chapter Six.

<sup>53</sup> See the webpage of the CEAC (Council on East Asian Community), a network of Think Tanks in Japan: [http://www.ceac.jp/e-e-exchange\\_neat.html](http://www.ceac.jp/e-e-exchange_neat.html).

<sup>54</sup> Texts of the agreements: <http://www.aseansec.org/13196.htm>; <http://www.aseansec.org/15157.htm>; <http://www.aseansec.org/16646.htm>.

<sup>55</sup> The parties also committed themselves to undertaking “to exercise self-restraint in the conduct of activities that would complicate or escalate disputes” including, among others, “refraining from action of inhabiting on the presently uninhabited island, reefs, shoals, cays, and other features” See <http://www.aseansec.org/13163.htm>.

<sup>56</sup> <http://www.aseansec.org/15268.htm>.

ments with the Philippines and Vietnam for joint oil prospecting in the South China Sea during between 2004 and 2005.<sup>57</sup>

China also changed its stance toward the ARF. At the ARF Ministerial Meeting in July 2002, China agreed to enhance defense officials' interactions within the ARF framework, proposed to establish an ARF Security Policy Conference (ASPC), and offered to host the first ASPC at the Eleventh ARF meeting in July 2004.<sup>58</sup> This conference was in fact convened in Beijing later that year. The ASPC was to be held back-to-back with the ARF SOM in order to give senior defense officials at the vice-ministerial or equivalent level opportunities for deepening security-related dialogue.<sup>59</sup> China, as the proponent of the conference, was expected to go beyond simple confidence-building dialogues. Thus far, though, it has remained a forum for general discussion about terrorism, maritime security, non-traditional security issues, peacekeeping operations, and natural disasters.<sup>60</sup> The problem of improving transparency in military expenditure and deployment, the main U.S. and Japanese concern in their security relationship with China, has never been tackled. At the same ARF ministerial meeting in 2002 China continued to demonstrate its adherence to the supremacy of national sovereignty by strongly opposing Japan's proposal to establish a permanent ARF secretariat for implementing confidence-building and preventive diplomacy measures more effectively.<sup>61</sup> A compromise measure was to set up a small pseudo-secretariat named "ARF Unit" within the ASEAN Secretariat in June 2004.<sup>62</sup>

Some authors interpret China's turn to positive regional policy as evidence that ASEAN's engagement policy to socialize China is bearing fruit.<sup>63</sup> Other authors, however, argue that China's commitment to multilateralism is still thin and instrumental. For one thing, in the negotiation leading to the Declaration on the Conduct of Parties in the South China

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<sup>57</sup> Asahi Shimbun, 11/3/2005

<sup>58</sup> ASEAN secretariat webpage: <http://www.aseansec.org/14846.htm>.

<sup>59</sup> The ASPC concept paper is available at [http://www.dfat.gov.arf/statements/annex\\_h.html](http://www.dfat.gov.arf/statements/annex_h.html)

<sup>60</sup> ARF webpage: <https://www.aseanregionalforum.org/Default.aspx?tabid=67>

<sup>61</sup> Yuzawa (2005:474-475)

<sup>62</sup> ARF webpage: <https://www.aseanregionalforum.org>. The same kind of "Unit" was also established in December 2003 for the APT (<http://www.aseansec.org/16580.htm>). This format was supported by ASEAN which fears that an independent secretariat could jeopardize state sovereignty and its leadership.

<sup>63</sup> Ba (2006).

Sea, China declined to accept a “code of conduct” which was regarded as legally more binding. Chinese survey vessels and warships were reportedly making frequent visits to the unoccupied shoals and reefs of the Spratlys even after the signing of the Declaration.<sup>64</sup>

Furthermore, different from the “multilateral” approach it took in Southeast Asia, China remained staunchly unilateral in its natural gas development in East China Sea. Nor did it relinquish military options vis-à-vis Taiwan. The Chinese government has also been conspicuously passive in the Asian Security Conference (ASC), an unofficial forum for security dialogue sponsored by the British International Institute for Strategic Studies, whose membership and agenda cannot be controlled either by ASEAN or China.<sup>65</sup>

China’s behavior in regional forums appears to support the assertion by Nan Li, Thomas Christensen and Christopher Hughes that the principal motive of its multilateralism is to hedge against U.S. policy of containment by nurturing friendship and mobilizing the ideology of multilateralism.<sup>66</sup> As mentioned above, the Bush Administration’s view of China as its largest strategic competitor in Asia did not change after 9/11. Moreover, America’s increasing unilateralism in the wake of 9/11 and its suspiciousness of Chinese influence in regional forums like ARF worried Chinese leaders.<sup>67</sup>

### ***Japanese and South Asian Engagement with ASEAN: the ASEAN Model Spreads***

Facing the tacit rivalry over regional forums between the U.S. and China, the Japanese government came to adopt an “APT-Plus” policy by involving non-APT countries while keeping ASEAN in the driver’s seat. By doing so, it hoped to dilute Chinese influence while appeasing ASEAN. This enlargement policy was best observed in the process leading to the first East Asia Summit (EAS) meeting in December 2005. The Japanese government insisted on inviting Australia, New Zealand, and India. Malaysia and China, in contrast, favored APT members only. Finally, the APT Min-

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<sup>64</sup> Li (2004:69)

<sup>65</sup> Asahi Simbun, 6/15/2005. Also see the IISS Singapore webpage: <http://www.iiss.org/conferences/the-shangri-la-dialogue>.

<sup>66</sup> Li (2004); Christensen (2006); Hughes (2005)

<sup>67</sup> Johnston (2004:74)

isterial Meeting decided in July 2005 to invite the three non-APT countries but keep the “ASEAN-Plus” format.<sup>68</sup>

The Japanese-led ReCAAP (Regional Cooperation Agreement on Combating Piracy and Armed Robbery against Ships in Asia) also covers India, Sri Lanka, and Bangladesh in addition to the APT countries although Malaysia and Indonesia refuse to join so far.<sup>69</sup> The East Asian Economic Partnership Agreement (EAPEA) is still another Japanese-led “APT-Plus” scheme. This East Asia-wide free trade agreement covers not only the APT countries but also Australia, New Zealand, and India.<sup>70</sup>

In short, the distrustful state-to-state relations in Northeast Asia and South Asia, the pre-existence of institutionally flexible ASEAN, China’s conciliatory posture in South China Sea and its newfound “multilateralist” tactics to counter U.S. containment policy, all explain why all “Asians only” multi-subregional forums as well as some of the “non-Asians included” forums are characterized by the “ASEAN-Plus” format. Although the Japanese government recently promotes “APT-Plus” forums, neither ASEAN nor China is enthusiastic about them since they share the belief that state sovereignty can be better protected by narrower ASEAN-led institutions. The lack of firm ASEAN and Chinese endorsement, together with the newness of their existence, makes “APT-Plus” forums functionally much weaker than older “ASEAN-Plus” forums like the ARF, the APT (in the economic field), and ASEAN Plus One.

ASEAN not only served to engage Japan and China but India as well. India’s “Look East” policy can be interpreted both as an expression of economic bandwagoning with prosperous ASEAN and also as an attempt to partially compensate for the vulnerability of its northern frontiers by cultivating good relationships in Southeast Asia. India was accepted as a sectoral dialogue partner of ASEAN in 1992 and was admitted to the ARF

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<sup>68</sup> Asahi Shimbun, 12/4/2005. Although the Japanese proposal of membership was adopted, the acceptance was made under the ambiguous understanding that EAS is a *part* of the process leading to an East Asian Community (EAC) but not necessarily identical to the EAC.

<sup>69</sup> The agreement went into effect in September 2006 (Monthly JICA, November 2006, 28-29).

<sup>70</sup> The EAPEA was originally formulated by Japan’s Ministry of Economy, Trade and Industry (METI) in April 2006 and was officially proposed by Japan at the APT Economic Ministers’ Meeting held in late August 2006 (METI 2006; *Asahi Shimbun*, 8/25/2006). The Bush Administration, however, strongly insisted at the APEC meeting of November 2006 that the APEC should be the basis on which a Free Trade Area of the Asia Pacific (FTAAP) is negotiated (*Asahi Shimbun*, 11/20/2006).

in 1996, a privilege not granted to Pakistan until 2004.<sup>71</sup> When the 9/11 attacks reignited concern about possible terrorist or pirate attacks in the sea lanes around Southeast Asia, India took advantage of its naval power to strengthen its presence in the area. After 2002, the Indian navy conducted coordinated patrols with its Indonesian and Malaysian counterparts.<sup>72</sup>

### 3.3.4 Regional Cooperation Chinese-Style: the Shanghai Cooperation Organization

One of the more successful regional security organizations in Asia is the Shanghai Cooperation Organization (SCO). Formerly known as the Shanghai Five, its membership now consists of China, Russia, Kazakhstan, Kyrgyzstan, Tajikistan, and, as of June 2001, Uzbekistan. According to its founding declaration, the SCO is intended to build mutual trust among its member states, foster cooperation among its member states in a wide variety of areas, including political, economic, environmental, cultural, and scientific and technological matters, safeguard regional peace, and finally, establish “a democratic, fair and rational new international political and economic order.”<sup>73</sup> Of note is the declaration’s assertion that “in the current international situation, it is of particular significance to preserve global strategic balance and stability,” which can be interpreted as an allusion to resisting United States hegemony.<sup>74</sup>

SCO owes its existence largely to the initiative of China, which sought to establish cordial relationships with its land-border neighbors by settling territorial disputes, maintain an economically stable environment after the Tiananmen incident, secure an oil supply for its rapidly growing economy, and contain separatist movements in the western province of Xinjiang.<sup>75</sup> The first annual summit meeting of the Shanghai Five was convened by China in 1996 and the group implemented a number of confidence-

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<sup>71</sup> Indian efforts paid off in July 2002 when the ARF Ministerial Meeting, in the face of the terrorist attacks against the Indian parliament compound (in December 2001) and an Indian army base near Jammu (in May 2002), announced that, while welcoming Pakistani government’s commitment to counter terrorism, “Ministers earnestly looked to Pakistan to take urgent further steps to implement it” (<http://www.aseansec.org/12003.htm>).

<sup>72</sup> Ho (2006:568)

<sup>73</sup> “Declaration on Establishment of Shanghai Cooperation Organization”, June 15, 2001. Found at: <http://www.sectsc.org/html/00088.html>

<sup>74</sup> Ibid.

<sup>75</sup> Lee (2005:270-271)

building measures regarding territorial borders over the following years. On the occasion of the sixth summit meeting of June 2001, the heads of government agreed to formally establish the SCO with the addition of Uzbekistan. After 9/11, SCO member states agreed to establish a regional counterterrorism center in Bishkek, Kyrgyzstan in 2002 and conducted joint training exercises thereafter.<sup>76</sup>

The structure of the SCO bears a number of similarities to ASEAN in certain respects. As in ASEAN, decisions are non-binding and all interactions are undergirded by a norm of strict respect for sovereignty. However, the issue scope for ASEAN is considerably wider, encompassing economic and cultural cooperation as well as security cooperation. For the moment, the SCO remains primarily preoccupied with combating terrorism, drug trafficking and religious extremism. Moreover, although the SCO provides a regional forum in which member states can discuss security matters, states have been reluctant to share a great deal of intelligence with one another, limiting the organization's effectiveness.<sup>77</sup> Tajikistan, Kyrgyzstan, Kazakhstan, and Uzbekistan have forged bilateral relations with the United States surrounding access to airspace and bases in support of its operations in Afghanistan. Such ties have helped to further sideline the SCO. From China's point of view, American troops deployed in Central Asia could be part of an encirclement strategy designed to contain China. In recent years, however, China has had some success in inducing the SCO to be a counter to the U.S. policy of containment. On the occasion of the 2005 summit meeting, China persuaded the heads of the SCO governments to pass a resolution demanding that "respective members of the antiterrorist coalition" (in practice, the United States) set a timetable for the withdrawal of their military forces from the Central Asian countries.<sup>78</sup>

### 3.4 The Future of Asia's Institutional Architecture for Security

Given the current characteristics of Asia's regional security architecture, which trends might we expect to play an important role in its future development? This chapter has demonstrated the role of changing threat percep-

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<sup>76</sup> In 2002, they also agreed to establish the secretariat at Beijing (Modern China Library webpage: <http://panda-mag.net/keyword/sa/kyouryoku.htm>). The counterterrorism center was moved to Tashkent, Uzbekistan in 2003 (Allison 2004:479)

<sup>77</sup> Ibid.

<sup>78</sup> The SCO webpage (<http://www/sectsco.org/html/00500.html>)

tions in shaping regional security institutions (or the lack thereof). Exogenous shocks frequently affected different countries and subregions in significantly different ways, a variation that can be attributed to differences in individual countries' threat perceptions. These perceptions can be influenced by beliefs about historical interactions—as demonstrated by China's attitudes toward Japan or the ASEAN countries' expectation of peaceful intramural relations—as well as material structures. The presence of active conflicts appears to inhibit the development of robust security institutions due to a lack of trust and an unwillingness to discuss security cooperation until the conflicts have been resolved. Conversely, a long-term habit of cooperation and trust-building such as in ASEAN has enabled that organization to develop a wide range of institutional structures with increasing credibility among regional actors as evidenced by its sponsorship of some of the most prominent regional security forums. Ultimately, the success or failure of Asia's nascent regional security institutions depends on the bilateral relations of their individual members. In particular, three bilateral relationships are critical: U.S.-China relations, China-Japan relations, and India-Pakistan relations.

Of these relationships, the one between the United States and China is arguably the most important. As China continues its military buildup and adopts an increasingly assertive stance on the regional stage, it will undoubtedly heighten perceptions of threat among policymakers in Washington. China has developed close economic relations with oil-rich countries such as Sudan, Iran, and Venezuela which are viewed with strong suspicion by the United States. These relationships raise the potential for China's geopolitical interests to clash with the United States'. Moreover, the issue of Taiwan remains a bone of contention between both countries. The United States' military presence in Southeast Asia and the Korean Peninsula are generally perceived by Asian states to be a stabilizing force that keeps both China and Japan in check. However, as China develops stronger military and deeper interests in the region, it may begin to see the United States as more of a meddler than a stabilizer, particularly if the United States is seen to be putting pressure on Japan to expand its military missions abroad. If relations between the United States and China deteriorate, regional security institutions may be sidelined in favor of bilateral alliance structures. The Six-Party Talks have provided China with a golden diplomatic opportunity that it has exploited to good effect, demonstrating to the region its commitment as a "good neighbor" by brokering negotiations with North Korea. However, whether China can take advantage of this opportunity to cement its reputation as a regional leader largely depends on its ability to induce North Korea to implement agreed-upon agreements.

The second critical bilateral relationship in the region is between Japan and China. Historical rivalries have helped to foster threat perceptions on both sides, inhibiting the formation of any robust security institution in Northeast Asia. Both Japanese and Chinese leaders have sparked diplomatic scuffles with each other by playing the nationalism card at home, but such brinksmanship merely reinforces both countries' perceptions of the other as a potential threat and promotes worst-case scenario thinking about each other's actions. Moreover, popular nationalism is a difficult force to control and can lead the government to adopt increasingly provocative actions to satiate a public eager for the humiliation of its rival. While defusing popular nationalism, altering threat perceptions and solving major existing conflicts are not sufficient for establishing a strong regional security institution, they are necessary.

Third, the relationship between India and Pakistan is the key to the subregional order in South Asia and also has implications for multi-subregional institution-building. If Indian and Pakistani leaders can come up with a solution for the Kashmir conflict and persuade their citizens to endorse it, SAARC will definitely enhance its functions as a subregional forum. If, on the contrary, the two countries continue to fear the outbreak of war between them, SAARC will continue to languish in irrelevance as the norm of consensus will essentially enable them to veto each other. This may lead SAARC members to seek accommodation in any "ASEAN-Plus" or "APT-Plus" forum ready to accept them. If India and Pakistan join the same forum, it may help to increase transparency between the two and aid in confidence-building. If, however, only India becomes an active participant in these forums and leaves Pakistan behind, it will probably alienate Pakistani leaders and make a solution of the India-Pakistani conflict more unlikely.

At present, ASEAN remains the most successful model of regional security cooperation in Asia. In order to alter threat perceptions, it is necessary for states to increase their transparency and develop a long-term habit of cooperation. Although ASEAN and its derivative institutions are limited by their consensus-based decision-making process which allows for states to exercise veto power, they are nevertheless important in allowing for the development of greater trust among decision-making elites and socialization into norms of peaceful dispute resolution. Because of this, the strict norm of non-interference in state sovereignty enables states to participate in the "ASEAN-Plus" forums when they might not otherwise do so. However, as long as the supremacy of state sovereignty persists, so does the temptation to act unilaterally, making it difficult to solve common challenges. Confidence-building does not necessarily translate into mutually satisfactory solutions to stubborn geopolitical disputes. If ASEAN can reduce constraints imposed by its strong state-sovereignty principle, it will

be able to serve as an exemplar and precipitator of effective dispute prevention and settlement in Asia.

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# 4. Regional Arrangements for Trade in Northeast Asia: Cooperation and Competition between China and Japan

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## 4.1 Introduction

Over the past decade, scholars have noted the development of a variety of Asian trade arrangements at the bilateral, minilateral and multilateral levels.<sup>2</sup> Such arrangements vary significantly in terms of the actors they involve, their issue scope, and their strength. Although some of these arrangements were established during the Cold War, most of them have come into existence only since the 1990s. What accounts for this diversity in institutional design? In this chapter, I adopt the institutional bargaining game approach articulated by Vinod Aggarwal and Min Gyo Koo in Chapter One of this volume and examine how three shocks—the end of the Cold War, the 1997-98 financial crisis, and the terrorist attacks of 9/11—generated new impetuses for regional trade cooperation in Northeast Asia.

While this chapter examines Northeast Asia, which for our purposes includes China, Japan, Taiwan, South Korea and North Korea, the primary focus is on China and Japan as their policies play a disproportionately large role in shaping the security and economic contexts not only in Northeast Asia but in the region more broadly. I begin with an overview of the Cold War institutional equilibrium in trade and discuss how strategic considerations and deep mistrust between Japan and China inhibited the development of trade institutions in Northeast Asia even as both countries experienced increasing economic growth and interdependence. I then

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<sup>1</sup> I wish to acknowledge the efforts of Jonathan Chow in organizing the workshops and in commenting on drafts of this chapter. I also want to thank the workshop participants for helpful comments.

<sup>2</sup> For example, see Katzenstein (1997), Aggarwal (1998), Kahler (2000), Katzenstein (2005), Katzenstein (2006), Munakata, (2006).

move to a discussion of the role that the 1997-98 Asian financial crisis played in fomenting the establishment of regional institutions to manage trade and finance. Finally, I examine the post-9/11 period and how it has affected Northeast Asia's finance and trade institutions, focusing on the failure of the Third World Trade Organization (WTO) Ministerial Conference to commence a new round of negotiations in 1999 and the recovery of Northeast Asian economies from the financial crisis as stimuli for the development of new institutions. In the conclusion, I provide some final thoughts on how China and Japan will continue to influence Northeast Asia's institutional architecture for trade and finance.

## **4.2 Northeast Asia's Cold War Institutional Equilibrium in Trade**

Unlike Southeast Asia or South Asia, where the Association of Southeast Asian Nations (ASEAN) and the South Asian Association for Regional Cooperation (SAARC) served as regional forums during the Cold War, Northeast Asia lacked any significant institutions of regional scope at that time. Multilateral arrangements such as the General Agreement on Tariffs and Trade (GATT) did not cover all Northeast Asian countries during the Cold War. Japan entered the GATT in 1955 and South Korea did so in 1967, but China was not a member (its 1986 application for membership having been turned down) and did not join its successor organization, the WTO, until 2001.

Political cleavages generated by the Cold War and bitter historical memories from the World War II era prevented Japan and China from constructing any effective regional arrangements. Indeed, even the establishment of diplomatic relations between the two countries took many years to unfold. Negotiations between Japan and South Korea to establish diplomatic relations were not completed until 1965 because of conflict over the evaluation of Japan's colonial domination of the Korean Peninsula. Because of strong pressure from the U.S. government, which was embroiled in conflict with China over the Korean War, Japan was forced to grant diplomatic recognition to the Republic of China (Taiwan) instead of the People's Republic of China (PRC) when it restored diplomatic relations in 1954. Only after the rapprochement between the United States and the PRC in the early 1970s could Japan establish diplomatic relations with the PRC. The normalization of diplomatic relations between China and South Korea was not realized until 1992, three years after the collapse of the Berlin Wall. Without a normal relationship, it was difficult for the two countries to construct any economic arrangements at the governmental level.

### 4.2.1 Informal Regional Integration in East Asia<sup>3</sup>

In the absence of formal trade agreements among Asian countries during the Cold War, there emerged a number of informal schemes for regional economic integration between Northeast and Southeast Asian countries by the end of the 1980s. These informal arrangements revolved around networks of large Japanese corporations that funneled FDI into the region.<sup>4</sup> Japan's economic success and subsequent investment, generated by its rapid economic growth in the 1960s and 1970s, stimulated the economic development of other East Asian economies such as Taiwan, Hong Kong, South Korea, and several of the ASEAN countries, leading them to develop their own industries and trade and deepening economic interdependence. Some scholars and the media have coined this phenomenon the "flying geese" model.<sup>5</sup> After the 1985 Plaza Agreement, which weakened the U.S. dollar, Japanese investment in its Asian neighbors increased, further driving regional development as evidenced by markedly high growth rates during the late 1980s.<sup>6</sup>

China occupied an ambivalent position in the market-oriented integration in East Asia during the Cold War. It began to adopt market-based economic and development policies at the end of the 1970s but retained numerous planned sectors as well as authoritarian rule by the Communist Party.

### 4.2.2 Track Two Economic Organizations in Northeast Asia during the Cold War

As was the case with more formal regional institutions, Northeast Asia had very few "Track Two" arrangements for discussing and promoting re-

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<sup>3</sup> For details about the development of various regionalisms in Asia, see Katzenstein (1997).

<sup>4</sup> Hatch and Yamamura (1996); Pempel (1997)

<sup>5</sup> For a more detailed description of the flying geese model, see Hatch and Yamamura (1996:27-36).

<sup>6</sup> The amount of Japanese FDI in Asia was about \$1.5 billion annually until the mid-1980s (with the exception of 1982, in which Japanese FDI jumped to \$3.3 billion). In 1985, Japanese FDI in Asia totaled \$1.4 billion but then jumped to \$2.3 billion in 1986, \$4.9 billion in 1987, \$5.6 billion in 1988 and \$8.2 billion in 1989. See MITI (1991), Chapter 3, Section 6, Chart 3-6-6.

gional cooperation in trade and development.<sup>7</sup> The Pacific Trade and Development Forum (PAFTAD), a series of conferences for discussing regional cooperation in the Asia Pacific, was launched in 1968 by economists and other intellectuals from Japan, Australia, New Zealand, United States and Canada (the so-called P5) as well as the United Kingdom. The founding members of Pacific Basin Economic Council (PBEC), which is a Track Two organization for promoting Pacific cooperation within the business community, all came from the P5 countries. In June 1980, the Pacific Community Seminar, organized by Japan and Australia, was held in Canberra, and developed another regional non-governmental arrangement for Pacific cooperation called the Pacific Economic Cooperation Council (PECC).

China remained hostile to Asia-Pacific regionalism until the end of the 1970s because it regarded such arrangements as a vehicle to promote American and Japanese dominance. However, this hostility gradually changed as China embarked on its own economic reforms in 1978. Beginning in 1979, Chinese intellectuals sometimes participated in PAFTAD conferences, and in 1986, China became a member of PECC, though the latter only occurred after several years of debate over Taiwan's desire to also join the organization (in the end, China was allowed to join first and Taiwan was allowed to join later as "Chinese Taipei").<sup>8</sup> In PAFTAD, PBEC and PECC, participants discussed liberalization, and the promotion and facilitation of trade and investment. However, various reports, recommendations and decisions made within these organizations did not directly affect the trade policies of member countries, so their role remained limited.<sup>9</sup>

### **4.3 Negotiating New Trade Arrangements in the Post-"Triple Shocks" Period**

Policymakers in the Asia-Pacific region perceived that the end of the Cold War mitigated great power rivalries. The effect of this historical event at the global level was twofold. First, it raised the profile of globalization in international society to prominence. Globalization itself was not a new phenomenon, but it began to be widely recognized as a vital international

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<sup>7</sup> For details about PAFTAD, PBEC and PECC, see Woods (1993) and Oba (2004a).

<sup>8</sup> Woods (1990:211-212)

<sup>9</sup> See Chapter 5 in Oba (2004a).

trend after the end of the Cold War. Second, the end of the Cold War deepened regionalism worldwide.<sup>10</sup> Regional organizations had already existed in Europe as early as the 1950s with the European Coal and Steel Community (ECSC) and the European Economic Community (EEC), and in Southeast Asia with ASEAN in the late 1960s, but their effectiveness was largely circumscribed by the strategic imperatives of the Cold War. The revival of regionalism in the international realm began at the end of the 1980s and proceeded apace during the 1990s with the establishment of the European Union as well as deepening cooperation among the ASEAN countries.

### 4.3.1 The Aftermath of the Cold War

The end of the Cold War itself, of course, significantly altered power relationships in Northeast Asia as former enemies sought to take advantage of new opportunities to boost security and trade. South Korea established normal diplomatic relations with the Soviet Union in September 1990 and with China in August 1992. The legitimacy and authority of Communism collapsed and former communist countries, including Russia, began to introduce market reforms into their economies.

In Aggarwal and Koo's analytical framework, the shock of the Cold War's termination generated new uncertainties among Asian countries regarding the provision of regional collective economic goods and also changed the individual situations in Japan and China. Economic "collective goods" in this case refers to economic development, interdependence, and the prospects for continued growth. The economic boom that began in the late 1980s continued into the first half of the 1990s as flows of trade and investment increased among Japan, the Northeast Asia's Newly Industrializing Economies (NIEs), and the ASEAN countries, accelerating regional growth and interdependence and increasing the value of economic collective goods in Asia. At the same time, however, three trends threatened to undermine that continual growth. First, the United States strongly pressured Japan and other East Asian countries to open their economies to foreign goods. Such pressure and demand had already escalated in 1980s but grew more intense following the Cold War because the common military and ideological threat of communism had waned. Second, Japan and other East Asian countries regarded the revival of regionalism in North America (with NAFTA, the North American Free Trade Area) and Europe (with the European Union) as a sign of growing protectionism and thus a

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<sup>10</sup> Faucett and Hurrell (1995:17-20)

threat to their own economies, which were dependent on a friendly U.S. market and an open trade regime sustained by the GATT rule. Moreover, they viewed the trend toward regionalism as destabilizing to the GATT-led multilateral free trade system. A third trend undermining Asian economic growth was the presence of domestic political and economic defects that would impede further economic development in Asia. Some reports pointed out Asian economies' vulnerabilities. For example, the study group on trade and development in the Asia-Pacific, established by Japan's Ministry of International Trade and Industry (MITI), submitted a mid-term report in July 1988 that pointed out the dangers of East Asian economies' heavy dependency on the American market.<sup>11</sup>

As for the "institutional context" in the early 1990s, GATT and Asia Pacific Economic Cooperation (APEC) had already existed in addition to informal Track Two regional institutions mentioned in the previous section. In 1986 GATT members launched the Uruguay Round of trade negotiations, which frequently deadlocked until the establishment of the World Trade Organization at the end of 1994. The recurrent slumps of the Uruguay Round led Asian countries to doubt the efficiency of GATT for maintaining and enforcing a liberal and open economic system. China did not affiliate with GATT because the United States did not deem the Chinese economy sufficiently mature to become a GATT member. On the other hand, APEC was established in November 1989 on the eve of the end of the Cold War. Under pressures from the strict U.S. trade policy, the revival of regionalism, the continual stagnation of Uruguay Round, and the necessity of reformation and improvement of internal economic systems, Japan and other Asian countries began to recognize that cooperation through a regional forum could be an effective tool to maintain and enlarge their economic collective goods.

### ***APEC and Northeast Asia***

New trends generated by the end of the Cold War encouraged the development of APEC as an economic forum for the Asia-Pacific. Specifically, it promotes the liberalization and facilitation of trade and investment as well as the advancement of economic and technical cooperation. Japan, along with Australia, took the initiative to build this regional framework, holding the first APEC ministerial meeting in November 1989.<sup>12</sup> China

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<sup>11</sup> Oba (2004a:319)

<sup>12</sup> Numerous previous studies have explored the process of APEC's establishment as well as Japan and Australia's contributions to it. See Higgott et al. (1990), Funabashi (1995), Ravenhill (2001), and Oba (2004a).

almost became one of the founding members of APEC but did not enter until 1991, partly because of the June 1989 Tiananmen incident. Taiwan and Hong Kong also joined the forum in 1991.

Japan and Australia's initiative for building APEC stemmed from the enthusiasm for constructing a regional forum in Asia among some government officials in MITI.<sup>13</sup> They regarded the trends of growing U.S. protectionism and regionalism as serious threats to the prosperity and development of the Asia-Pacific. Moreover, they recognized the necessity of regional cooperation for promoting economic reform in developing East Asian countries.<sup>14</sup> On the other hand, the Chinese government's reasons for joining APEC were decidedly defensive. The Chinese government feared that a world of regional trading blocs, North America, Europe, and Asia Pacific, would exclude China. In addition, it regarded APEC as a potential shield against U.S. unilateralism and expected that its participation would provide a stimulus for foreign investment in China.<sup>15</sup>

The Seoul Declaration in 1991 made it clear that APEC focused on discussion, collaboration and cooperation in the economic sphere, and that its objectives were to promote trade liberalization, trade facilitation and investment in a manner consistent with GATT principles, and to encourage economic and technical cooperation.<sup>16</sup> Because of U.S. President Clinton's positive policy toward APEC, after 1993 the United States and Australia sought to make APEC's primary focus the rapid reduction of tariffs rather than trade facilitation or economic and technical cooperation.<sup>17</sup>

The policy of rapid tariff reduction alarmed Japan and China for several different reasons. The Japanese government reacted to what it perceived to be an overemphasis on APEC's trade liberalization mission to the detriment of its trade facilitation and technical cooperation goals.<sup>18</sup> One of the main reasons for Japan's attitude was that it preferred to negotiate about trade liberalization through the GATT, which sustained a multilateral free trade system. Second, Japan harbored a number of sensitive yet politically powerful sectors (such as agriculture) that viewed tariff reductions as a major threat to their competitiveness against imports. These interest groups placed significant domestic pressure on Japanese policymakers to resist trade liberaliza-

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<sup>13</sup> See Oba (2004a:309-328).

<sup>14</sup> For example, MITI proposed the New Aid Plan in 1987.

<sup>15</sup> Ravenhill (2001:112)

<sup>16</sup> APEC, Seoul Declaration (1991)

<sup>17</sup> Yamakage (1997); Ravenhill (2001)

<sup>18</sup> Ravenhill (2001:100)

tion. Japan's reluctance to liberalize its markets was laid out in the "General Principle for Entire APEC Liberalization and Facilitation" in the Osaka Action Agenda, which was adopted at the 1995 Osaka APEC meeting. The principle, especially the principle of flexibility, essentially halted APEC's attempts at rapid trade liberalization. Moreover, when Early Voluntary Sectoral Liberalization (EVSL) was attempted at the Vancouver Leaders' meeting in 1997, Japan stopped the process by refusing to agree on liberalization in forestry and fisheries.<sup>19</sup>

The Chinese government has also been unsupportive of U.S. attempts to make APEC a negotiation forum for trade liberalization. While the Chinese government found some merit to being an APEC participant, its attitude was largely passive, stemming from its unstable position as a developing country, albeit a regionally powerful one.<sup>20</sup> The Chinese government preferred bilateral negotiations with its neighbors because its size could give it an advantage. On the other hand, multilateral arrangements were dominated by major powers such as Japan and the United States, making it more difficult for China to offset their power when it negotiated with them.

### ***EAEG/EAEC and Northeast Asia***

In December 1990, Malaysian Prime Minister Mahathir bin Mohamad proposed the formation of an East Asian Economic Group (EAEG) that he envisioned would serve as an indigenous counterweight to APEC, which he saw as overly influenced by Western powers. Mahathir envisioned that EAEG members would share common interests in specific areas of trade, including the GATT Uruguay Round. Moreover, the EAEG would help to formalize regional trade and economic links, boosting growth. Although Mahathir did not specify which members the EAEG would include, he indicated that the sphere of "East Asia" would cover a part of Asia that had experienced rapid economic growth and deepening economic interdependence. The EAEG was formally renamed the East Asian Economic Caucus (EAEC) at the ASEAN Economic Ministers Meeting in October 1991, in response to concerns that the original name sounded too much like an attempt to build a regional trading bloc. However, ASEAN leaders essentially shelved the EAEC proposal through the Singapore Declaration adopted at the Fourth ASEAN Summit of 1992.<sup>21</sup>

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<sup>19</sup> For more details about the EVSL negotiation process, see Ravenhill (2001:180-184) and Okamoto (2001)

<sup>20</sup> Takahara (2003:60-61)

<sup>21</sup> ASEAN, Singapore Declaration (1992); Yamakage (1997:141-142)

The EAEG/EAEC proposal elicited a variety of responses from both within and outside the region. In Japan, the initial response was cautiously receptive.<sup>22</sup> However, after the United States expressed its strong opposition to the EAEG, the Japanese government grew hesitant to participate. Despite this reluctance, though, some organizations such as the Keidanren as well as a number of Japanese government officials expressed open support for the EAEC.<sup>23</sup> This apparent split reflected the beliefs of some elites in Japan that an “Asians-only” framework for regional cooperation should be established in order to respond to U.S. protectionism and the accelerating trends of regionalism in North America and Europe. However, these sentiments were in the minority; most policymakers believed that Japan should avoid any coalition that would potentially hamper the U.S.-Japan alliance. In this sense, the end of the Cold War did not change elite beliefs about the direction of Japanese foreign policy.

China, which had a much more distant relationship with the United States, did not openly oppose the EAEG/EAEC. Indeed, Chinese foreign minister Qian Qichen expressed implicit support for the EAEC when the United States was eager to make APEC a forum for negotiation over trade liberalization at the Seattle APEC in 1993.<sup>24</sup> Like Malaysia, China’s positive attitude toward the EAEC stemmed from its desire to offset the influence of Western powers in APEC, though it continued to participate in APEC.<sup>25</sup>

Ultimately, strong American and Japanese opposition to the EAEG/EAEC proposal prevented the arrangement from materializing, but the idea of establishing an “Asians-only” forum remained and resurfaced during preparatory meetings of the Asia-Europe Meeting (ASEM).<sup>26</sup> Several meetings of senior officials, including economic and foreign ministers from Japan, China, South Korea, and the ASEAN countries, were held before the First ASEM Summit convened in March 1996. Some of the press reported that it was the “virtual realization of EAEC” though none of the governments formally admitted to it.<sup>27</sup>

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<sup>22</sup> Funabashi (1995)

<sup>23</sup> Higgott and Stubbs (1995:531)

<sup>24</sup> *Ibid.*, 529

<sup>25</sup> Ravenhill (2001:112)

<sup>26</sup> Oba (2004b), Oba (2001)

<sup>27</sup> “‘EAEC’ Shyno Seizoroi: Ajia 10 kakoku de kaigi (The premiers of ‘EAEC’ gather: the meeting of 10 Asian countries),” *Nihon Keizai Shinbun*, 2/26/1996.

### 4.3.2 The Asian Financial Crisis and Beyond

The Asian financial crisis that began in 1997 undermined the “East Asian miracle” and turned it into an “East Asian meltdown.” The crisis significantly altered the nature of economic collective goods in Asia by retarding growth and curtailing economic interdependence. In addition, the crisis changed elite beliefs about regionalism in Japan and China.

In Northeast Asia, South Korea was especially devastated by the economic crisis and was forced to undertake a painful restructuring of its internal economic and political institutions. China and Japan did not incur such severe damage, but the crisis changed elites’ beliefs regarding regional frameworks for cooperation. Elites in China and Japan grew more aware of the need to construct a regional mechanism that could prevent a second financial crisis from occurring and free Asia from American and European influence.<sup>28</sup> Japan was eager to deepen regional cooperation, especially in the financial field as exemplified by its promotion of the Chiang Mai Initiative. In 1997, Chinese Vice-Prime Minister and Foreign Minister Qian Qichen expressed his support for enhancing regional financial mechanisms in order to construct a stable economic environment that could protect Asia from future speculative attacks.<sup>29</sup> In order to grant Asia a greater say in regional economic affairs, political and business elites in both China and Japan viewed the establishment of a new Asians-only organization as an appropriate tool for achieving these goals. These ideas, stemming from the rupture caused by the financial crisis, ultimately led to the development of the ASEAN Plus Three (APT) framework.

#### ***ASEAN Plus Three and the East Asian Free Trade Area***

The establishment of an Asians-only framework for managing regional economic matters initially resulted in a relatively weak arrangement: a forum in which to discuss regional issues and which encouraged enhance financial cooperation; there was no formal regional trade agreement. The development of this regional architecture was also affected by China and Japan’s competition for regional leadership. But during these early stages, Japan occupied a more visible leadership role while China’s attitude to-

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<sup>28</sup> Takahara (2003); Oba (2004b)

<sup>29</sup> Takahara (2003:62)

ward linkage with Asian countries appeared to be more passive and wary.<sup>30</sup>

In the midst of the financial crisis, the First APT Summit was held in December 1997. Although the Asian financial crisis was not the direct reason for the summit, the APT advanced rapidly to enhance regional cooperation, remedy the damages caused by the financial crisis and demonstrate regional solidarity in overcoming it.<sup>31</sup> This transformed the notion of “East Asia” as a region defined by countries with shared economic prosperity and interdependence to a region comprising countries damaged by the financial crisis and other countries that were able to help.

Japan was eager to promote discussion and cooperation in the APT, especially financial cooperation. When some officials from the Japanese Ministry of Finance proposed the establishment of an Asian Monetary Fund (AMF), the U.S. government strongly opposed and pressured them to abandon this proposal, eventually leading them to call it off for fear of undermining the bilateral alliance.<sup>32</sup> However, the U.S. government did not openly oppose the development of APT. Chinese elites also recognized the necessity of an Asian framework after the crisis and began to view the APT as vital to their own economic stability, leading them to throw their support behind the APT.<sup>33</sup> The Joint Statement on East Asia Cooperation promulgated by the APT Summit in November 1999 in Manila showed that ASEAN and the three Northeast Asian countries took a step forward to build regional cooperation in East Asia beyond an ad hoc reaction to the crisis.<sup>34</sup> The list of issues to address includes economic, political and social matters such as accelerating trade and investment, monetary and financial cooperation, social and human resources development, and the continuation of dialogue, coordination and cooperation in political and security affairs. This statement was monumental for the advancement of East Asian cooperation,

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<sup>30</sup> Some government officials from Japan’s MOF attempted to take the initiative to construct an Asian Monetary Fund after the Asian financial crisis in 1997. For more details of the process, see Higgott (1998) and Amyx (2002).

<sup>31</sup> The APT Summit was convened not because of the financial crisis but rather in response to Japanese Prime Minister Hashimoto Ryutaro’s proposal of a summit between Japan and ASEAN in early 1997, prior to the crisis. The ASEAN countries offered a counterproposal to convene an informal summit which would include ASEAN, Japan, China and South Korea. This proposal led to the APT Summit.

<sup>32</sup> For further details, see Oba (2003).

<sup>33</sup> Mori (2005:238)

<sup>34</sup> ASEAN Plus Three Joint Statement on East Asia Cooperation (1999)

but did not propose any regional trade arrangements. It simply stated that East Asian countries' leaders "agreed to strengthen efforts in accelerating trade, investments, technology transfer."<sup>35</sup>

Proposals for a regional free trade area came from the East Asian Vision Group (EAVG) and the East Asia Study Group (EASG). The establishment of a study group was proposed in 1998 by South Korean President Kim Dae-jung in order to examine fields for future cooperation among East Asian countries. In response to his proposal, the establishment of the EAVG, comprising 26 experts from 13 countries, was agreed upon at the Second APT Summit in Hanoi in December 1998. Following the establishment of the EAVG came the creation of the EASG in March 2001 based on an agreement at the APT Summit in Singapore in November 2000. EASG consisted of 13 senior officials from APT countries and the Secretary-General of ASEAN and was intended to discuss measures to implement the recommendations of the EAVG. The final report of the EASG, which was submitted to the APT Summit in Phnom Penh in November 2002, provided more detailed and concrete measures for deepening regional cooperation.<sup>36</sup> It proposed the formation of an East Asian Free Trade Area and the evolution of the APT Summit into an East Asia Summit (EAS) as medium-term and long-term measures.<sup>37</sup>

However, even after the EAVG and EASG reports were submitted, China and Japan did not immediately promote the East Asian Free Trade Area (EAFTA). Rather, China and Japan began to compete to conclude ASEAN + n type FTAs and bilateral FTAs, both of which will be examined later.

### ***The Realization of the Trilateral Summit***

In response to the Asian financial crisis and accelerating globalization, Japanese Prime Minister Keizo Obuchi proposed an unprecedented breakfast meeting of the leaders of China, Japan, and South Korea. This historic trilateral summit was held in November 1999 when Korean President Kim Dae-jung and Chinese Prime Minister Zhu Rongji gathered in order to take part in the third APT Summit in Manila and was the first time that all three Northeast Asian leaders met together.

The most important impetus to hold this meeting was the active policies of the Obuchi cabinet toward Asia. For example, Obuchi sent the "Mission

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<sup>35</sup> Ibid.

<sup>36</sup> East Asian Study Group (2002). When this final report was submitted in November 2002, the press paid little attention to it.

<sup>37</sup> For details, see East Asian Study Group (2002:4, 43-44, 50, 56-60).

for the Regeneration of the Asian Economy” on August 1999 to South Korea, Vietnam, Thailand, Malaysia, Indonesia, and the Philippines showing that the Obuchi Cabinet was eager to tighten its relationship with its Asian neighbors. This mission stemmed from the viewpoint that Japan should revitalize its own economy and society by opening itself to developing Asian countries and supporting their economic revival.<sup>38</sup> In addition to Obuchi’s initiative for holding this meeting, the improving relationship between China and Japan during this period also encouraged the realization of this Summit. Chinese President Jiang Zemin made an official visit to Japan in November 1998, marking the first visit by a Chinese head of state to Japan. In July 1999, Obuchi conducted an official visit to China.

This historic trilateral summit represented enormous symbolic significance for these three countries that shared bitter historical memories. However, the agenda was not focused on these difficult political issues but rather on an economic agenda concerning the WTO, especially the negotiation process of China’s accession to the WTO and the future effects that the accession would have. At the same time, they agreed to commence joint research on economic cooperation among the three countries through their respective think tanks, following the initiative of President Kim Dae-jung. The following year in November 2000, the leaders met again and decided to regularize the Trilateral Summit. Furthermore, the talks began to be held not only at the summit level but also at the ministerial level, and the summit has promoted trilateral cooperation in various functional areas, including environmental concerns, intellectual property rights, and information technology development.

Following the agreement reached at the First Trilateral Summit meeting, a joint research project on economic cooperation among three countries was launched in 2001, coordinated by the Development Research Center of the State Council (DRC) of China, the National Institute for Research Advancement (NIRA) of Japan and the Korea Institute for International Economic Policy (KIEP). This mission was composed of eminent business leaders and intellectuals, including Okuda Hiroshi (Chairman of Keidanren and leader of the mission). It met with the prime minister, president, ministers and business leaders in each country, and submitted a final report to

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<sup>38</sup> This mission was composed of eminent business leaders and intellectuals, including Okuda Hiroshi (Chairman of Keidanren and leader of the mission). It met with the prime minister, president, ministers and business leaders in each country. Its final report was submitted to Prime Minister Obuchi on November 1999 and contained proposals for the regeneration of the Asian region and greater Japanese openness toward Asia the rest of the world.

Prime Minister Obuchi containing proposals for regenerating the region and increasing Japanese openness to the rest of the world.<sup>39</sup>

### ***Competition and Cooperation under Globalization***

The 9/11 attacks in 2001 strongly affected perceptions about security in a globalizing age and led to greater United States intervention in regional and local affairs worldwide in its efforts to tighten counterterrorism coalitions and boost counterterrorism efforts. However, the 9/11 attacks had less of an impact on the construction of trading arrangements in Northeast Asia than did the negotiation of various FTAs at the turn of the century and the secular trend of increased East Asian integration. The shock was that the Third WTO Ministerial meeting held in Seattle between November and December 1999 failed to start a new round of trade talks. This failure decreased the expectation of many countries that the WTO could function to promote trade liberalization. In tandem with this failure, East Asia witnessed a revival of regional interdependence as economies began to recover from the 1997-98 financial crisis.

Against this backdrop, China and Japan changed their policies toward regionalism and trade arrangements between the end of the 1990s and the early 2000s. Chinese elites have gained confidence in thinking of their own country as one of the great powers against the background of its rapid economic growth since 1992.<sup>40</sup> China's long negotiated accession to the WTO in 2001 also enforced such confidence that China is an important player in the international society. Furthermore, China garnered applause and enhanced regional confidence by refusing to devalue the Renminbi (RMB) in the midst of the financial crisis.<sup>41</sup> With growing confidence, China, which was formerly passive in engaging in regional arrangements, began to take a positive attitude in contributing to the development of regional frameworks and FTAs. The Chinese government began to conclude an ASEAN-China FTA (ACFTA) and a bilateral FTA with Asian countries after 2000. In addition, it actively began to engage with the Great Mekong Scheme, the Boao Forum and the Asian Cooperation Dialogue, and contributed to the effort to upgrade the Shanghai Five to the more formal Shanghai Cooperation Or-

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<sup>39</sup> Trilateral Joint Research by DRC, NIRA, and KIEP (2001)

<sup>40</sup> Takahara (2003:63). For more details on China's policy transformation toward Asia and reassessment of regional institutions, see Shambaugh (2005).

<sup>41</sup> Takahara (2003:63); Shambaugh (2005:68).

ganization (SCO), consisting of China and several of the former Soviet republics.<sup>42</sup>

China's energetic policies toward FTAs and regional arrangements have been sustained not only by its economic interest in development but its desire for leadership status as a great power. China's quick and positive FTA policies have generated the impression that it is rising as a great power not only in the region but also in the world. Ties through FTAs represent strengthening political relationships between China and each of its partners. Moreover, China's FTAs help to enlarge the market for Chinese goods and stabilize the supply of natural resources, especially natural gas, which is required to sustain China's rapid development. At the same time, this new assertiveness toward FTAs has raised both fears and expectations of China's expanding influence among neighbor countries. Furthermore, the rise of China's power, wealth, and prestige changed the power configuration in Asia and generated an increasingly acrimonious rivalry between China and Japan for political leadership in Asia.

Around 1999, Japan also dramatically changed its reluctant attitude toward FTAs, whereas previously it had only supported a multilateral free trade system based on the GATT/WTO.<sup>43</sup> The failure of the Seattle WTO conference helped to change elite beliefs regarding regional trade agreements and led Japan to adopt a more active policy to promote FTAs with various trading partners while it continued to support the WTO and a multilateral trade system.<sup>44</sup> The idea that FTAs complement a multilateral trade system sustained by the WTO has repeatedly appeared in various documents issued by Japanese government.<sup>45</sup>

The policy transformation on FTAs was also reflected by a change in the content of MITI annual reports. The 1999 MITI report mentioned the trends of regional and bilateral trade arrangements in the world, described the trials of trade liberalization on the bases of open regionalism and economic and technical cooperation in APEC and ASEM, and discussed eco-

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<sup>42</sup> The Shanghai Five was established in 1996 because of security concerns rather than economic ones. The transformation to the SCO was a direct result of the 9/11 attacks. However, it now also focused on promoting economic cooperation, particularly in the area of resource development. China's economic interest in the SCO was primarily to maintain a stable supply of natural gas, which was abundant in Central Asia. See Mori (2005:236).

<sup>43</sup> Ogita (2003:234-240); Munakata (2001)

<sup>44</sup> Bowles (2002:259)

<sup>45</sup> For example, each of the annual reports published by MITI (and its successor organization, METI) since 2000 makes mention of the complementarity of the WTO and regional FTAs.

conomic assistance toward ASEAN cooperation. However, it did not make clear whether Japan would engage in any bilateral or regional trade and investment arrangements.<sup>46</sup> On the other hand, MITI's 2000 report articulated that Japan was promoting some bilateral FTAs while continuing to support enhancing the rule of the WTO multilateral trade system.<sup>47</sup>

The "Basic Policy towards further promotion of Economic Partnership Agreements (EPAs)", approved by the council of Ministers on the Promotion of Economic Partnership on December 2004 makes clear the objectives of Japan's FTA policies. It articulated that EPAs "contribute to the development of Japan's foreign economic relations as well as the attainment of its economic interests as a mechanism to complement the multilateral free trade system," and "to the creation of [an] international environment further beneficial to our country from the politically and diplomatically strategic points through, among others, fostering the establishment of an East Asian community."<sup>48</sup> Japan's incentives for promoting FTAs are to revitalize its economy by way of concluding FTAs with counterparts in whom Japan has vital economic interests, enlarging the market for goods, increasing the flow of investment, and maintaining its political power in Asia.

China's eagerness to be at the helm of regional economic integration has motivated Japanese policymakers to promote FTAs and RTAs of their own in order to maintain Japan's influence among neighboring countries. In short, both China and Japan are competing with each other for the role of regional leader by concluding FTA and/or other agreements or declarations, and by contributing to the collaboration in regional arrangement.

### ***The Northeast Asian Free Trade Area (NEAFTA) Proposal***

At the First Trilateral Summit in 1999, Japan, China, and South Korea agreed to initiate a joint research project to study economic cooperation among the three countries in 2000. At first, the project examined "trilateral trade and investment after China's entry into WTO" and submitted the report to the Third Trilateral Summit in November 2001. This report recommended policy measures for trade facilitation such as the creation of a training system for customs, inspection and quarantine and the establish-

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<sup>46</sup> MITI (1999:III-3-3)

<sup>47</sup> MITI (2000:I-3-3-3)

<sup>48</sup> Basic Policy towards further promotion of Economic Partnership Agreements, approved by the Council of Minister on the Promotion of Economic Partnership on December 21, 2004, Paragraph 1 and 2.

<http://www.mofa.go.jp/policy/economy/fta/policy0412.html>.

ment of a trade and dispute early warning system. It also recommended convening an annual trilateral economic ministers meeting and establishing a tripartite forum including representatives of academia, business and the government in order to build a comprehensive dialogue mechanism on trade and other economic issues among the three countries.<sup>49</sup>

The next theme of the Trilateral Joint Research was trade facilitation among the three countries and was examined in a second report submitted in October 2002. This report suggested the launch of joint research on the “Economic Effects of a Possible Free Trade Area among China, Japan and South Korea.”<sup>50</sup> The third report of the Trilateral Joint Research in October 2003 emphasized the urgent need to establish a trilateral FTA. It showed the result of simulation and speculated that the FTA would bring about “massive macroeconomic benefits to the three countries in terms of production, trade and economic welfare,” and that its establishment would be a “win-win-win situation.”<sup>51</sup>

The Fifth Trilateral Summit meeting in November 2003 in Bali, shortly after the submission of the third report of Joint Research, declared the Joint Declaration on the Promotion of Tripartite Cooperation among Japan, China, and South Korea.<sup>52</sup> The Joint Declaration defined the specific areas for regional cooperation in Northeast Asia.<sup>53</sup> It did not recommend the establishment of a trilateral FTA but instead expressed its appreciation for the progress of the Trilateral Joint Research on the economic impact of a trilateral FTA and emphasized the importance of cooperation to facilitate and promote trade and investment. This showed that the three leaders did not agree on the formal negotiation for creating a trilateral FTA at this summit. However, Trilateral Joint Research has continued to examine the feasibility and possible effects of a trilateral FTA.

According to the decision stipulated by the Joint Declaration in 2003, two meetings of the Three-Party Committee, composed of foreign ministers of these three countries, were held in June 2004 in Qingdao and in

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<sup>49</sup> Trilateral Joint Research by DRC, NIRA, and KIEP (2001)

<sup>50</sup> Trilateral Joint Research by DRC, NIRA, and KIEP (2002)

<sup>51</sup> Trilateral Joint Research by DRC, NIRA, and KIEP (2003)

<sup>52</sup> Three-Party Committee (2003)

<sup>53</sup> Areas for cooperation included trade and investment, information and communication technology industry, environmental protection, disaster prevention and management, energy, financial cooperation, science and technology, tourism, fishery resource conservation, people-to-people exchange, cooperation in international affairs, Asian regional cooperation, security dialogue, and cooperation to prevent SARS, terrorism, drug trafficking and other transnational threats.

November 2004 in Vientiane. The aim of the Three Party Committee is to study, plan, coordinate and monitor the cooperative activities of specific areas listed in the Joint Declaration.<sup>54</sup> At the meeting in Vientiane, foreign ministers of three countries adopted “The Action Strategy on Trilateral Cooperation” and “The Progress Report of the Trilateral Cooperation.”<sup>55</sup> The former suggests the strategies on how to promote trilateral cooperation. The latter reported the progress of trilateral cooperation in each area.

The convening of a trilateral summit and the Three-Party Committee reflects an embryonic Northeast Asian regionalism. The proposal of a NEAFTA shows that some intellectuals who were close to the decision making process are interested in the economic benefits that may derive from a free trade area composed of three leading economies in East Asia. However, this project has faced serious obstacles stemming from political tension. The perception gap over Japanese colonialism and atrocities during the Second World War has generated great distrust and tension between Japan on the one hand and China and South Korea on the other. Between 2001 and 2006, former Prime Minister Junichiro Koizumi undertook annual visits to the controversial Yasukuni Shrine honoring Japanese war veterans, including several noted war criminals. These visits stirred up strong popular opposition and criticism in China and South Korea. Contributing to the tensions are the territorial dispute between Japan and China over the Senkaku/Diaoyu Islands confrontations over the development of natural gas in the disputed Exclusive Economic Zones in the East China Sea, and territorial disputes between Japan and South Korea over the Dokdo/Takeshima Islands.

These events provided the backdrop for anti-Japanese demonstrations that occurred in several Chinese cities in March and April of 2005 as Japan ramped up its efforts to become a permanent member of the United Nations Security Council. The political tensions have worsened the current relationship between Japan and other Northeast Asian countries and ultimately resulted in the cancellation of the anticipated 2005 Trilateral Summit.<sup>56</sup>

Within Northeast Asia, exploratory efforts toward bilateral FTAs have also progressed. The Japan-Korea FTA has been under negotiation, and the Japan-China and China-Korea FTAs have been under study at the non-

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<sup>54</sup> Three-Party Committee (2003), Section VI.

<sup>55</sup> Three-Party Committee (2004a); Three-Party Committee (2004b)

<sup>56</sup> “Chyu-goku ga Enki wo Happyo: Nichi-Chyu-Kan Syuno Kaidan (Chinese government announced the delay of Trilateral Summit), Asahi Shinbun, 12/5/2005.

governmental level. According to the Joint Study Group Report on the Japan-Korea FTA, the FTA aims not only to strengthen the economic relationship between the two countries by expanding trade and investment, but also to emphasize the Korea-Japan partnership as a neighborly pact between two mature advanced countries.<sup>57</sup> However, the negotiation on the Japan-Korea FTA has remained deadlocked since 2003, largely due to political disputes over Yasukuni and the Takeshima/Dokdo Islands.

New Prime Minister Shinzo Abe, who came to power in September 2006, appears to be more conciliatory than Koizumi in rebuilding relationships with Japan's neighbors and has yet to make clear whether he will visit the Yasukuni Shrine in the near future. Moreover, in March 2007 Abe infuriated Asian public opinion (especially in the Philippines, Korea, and Taiwan) when he openly denied that the Japanese military had coerced young women into becoming "comfort women" for Japanese soldiers during World War II. North Korea's nuclear test in October 2006 provided both China and Japan with a common threat and thus an opportunity to improve bilateral relations. However, it is still unclear if these changes will contribute to the enlargement of trilateral cooperation and the realization of a NEAFTA.

### ***The Rise of FTAs***

While China, Japan, and South Korea cooperate through Trilateral Cooperation, APT, and other frameworks, these three countries have also examined, negotiated and concluded various FTAs with partners both within and outside the region. Current situations are summarized in Table 4.1. As mentioned before, there are two incentives for why the three countries would promote FTAs. One is to gain the economic benefits from enlarging bilateral trade by reducing and/or removing tariff and other obstacles, and the other is to enhance the political ties with each counterpart. The other is to promote regional and (especially for China) worldwide political and economic leadership. The extent to which these two incentives apply for a given FTA varies. For example, the FTAs between Japan and Mexico, Japan and Chile, China and Chile, China and Gulf Cooperation Council (GCC) depend on economic incentives. However, FTAs with each ASEAN country have been driven by both economic and political incentives.

China and Japan's attempts for concluding ASEAN + n type FTAs demonstrated the eagerness of these two countries for leadership. China and Japan are currently rivals for predominance in East Asia. Both coun-

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<sup>57</sup> Joint Study Group on Japan-Korea FTA, Joint Study Group Report (2003)

tries are trying to tighten economic and political ties with the ASEAN countries. Japanese policymakers were shocked at the announcement in November 2001 that China and ASEAN had agreed on the establishment of an FTA by 2010, a year after Chinese Prime Minister Zhu Rongji had proposed such a development.<sup>58</sup> The anxiety that Japan was trailing behind China and its eagerness to catch up to China's bold approach to ASEAN countries led to the proposal of the "Initiative for Japan-ASEAN Comprehensive Economic Partnership," the "Initiative for Development in East Asia," and a "community that acts together and advances together," in what is called, an "Extended East Asia Community," by Prime Minister Koizumi in Singapore in January 2002.<sup>59</sup> On the other hand, Chinese policymakers tried to counter the Japanese movement by examining bilateral FTAs with some Asian countries such as Singapore and South Korea.<sup>60</sup> In short, policymakers in China and Japan have been very conscious of each other's movements and intentions. Additionally, both countries have been seeking to consolidate political and economic ties with ASEAN countries in order to gain more leverage over them.

China's attempts to tighten its political and economic ties with ASEAN by means of an FTA and other arrangements preceded Japan's attempts, although Japan-ASEAN cooperation has been developing since the 1970s.<sup>61</sup> During the China-ASEAN Summit in November 2002 in Phnom Penh, the parties signed a Framework Agreement on Comprehensive Economic Cooperation, which declared that China and ASEAN would agree on trade liberalization and facilitation in goods and services, liberalization and facilitation of investment, and five other areas of economic cooperation. The agreement had a list of some 600 products, mostly agricultural, targeted for "early harvest" in tariff reduction which started in January

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<sup>58</sup> "China 'open to FTA' with ASEAN", *Straits Times* (Singapore), 11/27/2000; "Why China speeded up plans for FTA with ASEAN" *Straits Times* (Singapore), 11/13/2001

<sup>59</sup> Koizumi (2002); "Analysis: Japan's New ASEAN policy comes as China rises," *Kyodo News Services*, 1/13/2002

<sup>60</sup> Takahara (2003:63)

<sup>61</sup> For details regarding the conversion of China's policy towards ASEAN, see Asano (2005).

2004.<sup>62</sup> Tariff reductions on the other goods began in July 2005 according to the Agreement on Trade in Goods in November 2004.<sup>63</sup>

At the 2002 summit, Chinese and ASEAN leaders also began to address cooperation in security matters. They signed an agreement aimed at preventing the escalation of tensions over the hotly contested Spratly Islands in the South China Sea.<sup>64</sup> Furthermore, China acceded to the Treaty of Amity and Cooperation (TAC) during a summit in Bali in October 2003.<sup>65</sup> At that same summit, China and ASEAN issued the Joint Declaration on Strategic Partnership for Peace and Prosperity, which included provisions for both economic and security cooperation.<sup>66</sup> Furthermore, they signed the Agreement on Trade in Goods and the Agreement on Dispute Settlement Mechanism in 2004, both of which implemented the 2002 ASEAN-China Framework Agreement of Comprehensive Economic Cooperation. China has actively constructed the framework to promote economic cooperation, including trade promotion, liberalization, and facilitation as well as the enhancement of political ties with ASEAN by means of various agreements and declarations.

Japan has also attempted to build a new framework with ASEAN by concluding several agreements and declarations. At the Japan-ASEAN Summit in November 2002 in Phnom Penh, Japan and ASEAN adopted a joint declaration stipulating that ASEAN countries and Japan should work on a framework of Comprehensive Economic Partnership by 2003 and

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<sup>62</sup> See ASEAN-China Summit, Framework Agreement on Comprehensive Economic Co-operation between the ASEAN and PRC (2002).

<sup>63</sup> ASEAN-China Summit, Agreement on Trade in Goods of the Framework Agreement on comprehensive Economic Cooperation between the ASEAN and PRC (2004). This agreement was concluded at the China-ASEAN summit in Vientiane.

<sup>64</sup> ASEAN-China Summit, Joint Declaration of ASEAN and China on Cooperation in the Field of Non-Traditional Security Issues (2002)

<sup>65</sup> ASEAN-China Summit, Instrument of Accession to the Treaty of Amity and Cooperation in Southeast Asia by China (2003); ASEAN-China Summit, Instrument of Extension of the Treaty of Amity and Cooperation in Southeast Asia to China (2003); "ASEAN inks key pacts with Asian giants," *Straits Times* (Singapore), 10/9/2003. India also acceded to the TAC at the India-ASEAN Summit in October 2003.

<sup>66</sup> ASEAN-China Summit, Joint Declaration of the Heads of State of the ASEAN and the PRC on Strategic Partnership for Peace and Prosperity (2003)

achieve such Partnership within 10 years.<sup>67</sup> It stated that Japan and ASEAN should seek broad-based economic partnership covering such issues as: 1) liberalization of trade and investment, 2) trade and investment promotion and facilitation measures including standards conformity and non-tariff measures, and 3) cooperation in other areas, including financial services, information and communications technology, science and technology, human resource development, small and medium enterprises, tourism, transport, energy and food security. Along these lines, the Framework for Comprehensive Economic Partnership between ASEAN and Japan was adopted at the following year's summit in Bali.<sup>68</sup> Japan was initially reluctant to accede to the TAC but did so at the ASEAN-Japan Commemorative Summit in December 2003. In this summit, the Tokyo Declaration for the Dynamic and Enduring ASEAN-Japan Partnership in New Age and the Action Plan was also adopted. It declared that Japan and ASEAN would cooperate with each other to build an "East Asian Community (EAC)."<sup>69</sup>

Compared with Japan, China has been quicker to conclude FTAs with ASEAN and its individual member states. There are several reasons for this disparity, all of which stem from the differences between the two countries' internal regimes and international positions. First, China's authoritarian regime insulates decision-makers from domestic interest groups, allowing them to avoid having to make compromises between their domestic and international interests. On the other hand, Japan has a mature democratic regime with diverse economic sectors that stand to lose from liberalization, such as agriculture. The Liberal Democratic Party (LDP) has strong links to such sectors. The negotiation surrounding bilateral FTAs with ASEAN countries sometimes made slow progress because of Japan's reluctance to promote freer trade in agricultural products and to open its labor market because of the strong pressures from interest groups in each sector. Second, China is categorized as a developing country, so its FTAs with ASEAN countries must fulfill conditions set by the Enabling Clause of the GATT, while Japan, as a developed country, must forge FTAs that fulfill the conditions of Article 24 of the GATT. Article 24 stipulates that members of customs unions and FTAs must not impose import regulations on non-members that are more restrictive than the ones that had existed prior

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<sup>67</sup> ASEAN-Japan Summit, Joint Declaration of the Leaders of Japan on the Comprehensive Economic Partnership (2002)

<sup>68</sup> ASEAN-Japan Summit, Framework for Comprehensive Economic Partnership between ASEAN and Japan (2003)

<sup>69</sup> ASEAN-Japan Summit, Tokyo Declaration for the Dynamic and Enduring ASEAN-Japan Partnership in the New Millennium (2003)

to the formation of the customs union or FTA.<sup>70</sup> The Enabling Clause virtually allows developing countries to construct FTAs without being subject to the strict conditions under Article 24.<sup>71</sup> Thus, China can readily proceed to contract FTAs with ASEAN while Japan must be more deliberate and careful.

### ***Toward What Kind of East Asian Community?***

The idea for constructing an East Asian Community has existed since EAVG examined how to promote regional cooperation in East Asia. The First EAS meeting and the Ninth APT Summit, both of which were held in Kuala Lumpur in December 2005, issued declarations that they would pursue the construction of an EAC. The discussions in the process of preparing the EAS and discussion in two meetings showed the conflict over what “community” would be held in East Asia especially between China and Japan.

When the EAVG and EASG submitted their final report, East Asia appeared to encompass the ASEAN countries, China, Japan and South Korea, even though they did not clearly identify their membership. However, Koizumi proposed an “extended” East Asian community that included not only the above countries but also Australia and New Zealand.<sup>72</sup> The Japanese government also suggested the inclusion of Australia, New Zealand and India in the East Asian Community in an issue paper submitted to the APT Senior Officials Meeting on May 2004, and reiterated their call for membership enlargement during the membership discussions in 2005.<sup>73</sup> The Japanese Ministry of Foreign Affairs (MOFA) has also insisted that the East Asian Community should be based on open regionalism, functional cooperation, universal values and global rules such as democracy, liberty, human rights, and WTO rules on trade, while avoiding any men-

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<sup>70</sup> General Agreement on Tariffs and Trade, Article XXIV 5(a) and 5(b)

<sup>71</sup> The formal title of the Enabling Clause is “differential and more favorable treatment reciprocity and fuller participation of developing countries”. The problem of how Article XXIV determines the Enabling Clause has been controversial for a long time but currently remains unsettled.

<sup>72</sup> Speech by Prime Minister of Japan Junichiro Koizumi, “Japan and ASEAN in East Asia: A Sincere and Open Partnership”, Singapore, 1/14/2002

<sup>73</sup> Issue Papers prepared by the Government of Japan, Yogyakarta, Indonesia, 5/11/2004

tion of “Asian values.”<sup>74</sup> In addition, in April 2006 the Japanese Ministry of Economy, Trade and Industry (METI) put forth the proposal for an East Asian Economic Partnership Agreement (EAIPA) so as to encourage trade liberalization, making rules of investment and intellectual property rights and economic cooperation on environmental protection and human resource development.<sup>75</sup> In this proposal, the EAIPA would be composed of APT members and Australia, New Zealand and India. The Japanese government formally proposed the idea at the APT Economic Ministers’ meeting in August 2006.

**Table 4.1: Bilateral FTAs involving China and Japan**<sup>76</sup>

	<b>Under study</b>	<b>Under negotiation</b>	<b>Signed</b>	<b>Currently in force</b>
<b>Japan</b>	Switzerland	Indonesia	Philippines (2006)	Singapore (2002)
	Australia	Brunei		Thailand (2007)
	Trilateral (w/ China and South Korea)	ASEAN	Malaysia (2006)	
		South Korea	Chile	
		Vietnam		
		India		
<b>China</b>	South Korea	Australia		ASEAN (2003)
	India	New Zealand		Hong Kong (2006)
	Trilateral (w/ Japan and South Korea)	GCC		Macao (2004)
		SACU		Chile (2006)
		Pakistan		

While Japan sought to enlarge East Asian membership, China tried to limit the participants of EAS to APT members. When the APT ministerial meeting in July 2005 decided that Australia, New Zealand and India would

<sup>74</sup> For example, see MOFA, “Wagakuni-no Higashiajia-Kyodoai Kochiku ni Kakawaru Kangaekata (Japan’s concept on constructing East Asian Community)”, October 2005.

<sup>75</sup> METI, “Nihon no Grobal Senryaku (Japan’s global strategy)”, 4/7/2006

<sup>76</sup> The Economic Bureau of the MOFA, Nihon no Keizai Renkei Kyotei Kosyo, October 2006, the MOFA homepage, the METI homepage.

participate in the EAS, Chinese Foreign Minister Li Zhaoxing primarily focused on the significance of “10+3 cooperation” (APT cooperation) for East Asia, saying that EAS “will serve as an important platform for dialogue between East Asia and countries in other regions,” implying that he regarded 10 + 3 as East Asia and the other three as not belonging to the region.<sup>77</sup> Additionally, at the APT ministerial meeting in 2006, he assured that China “supports the 10 + 3 as the main channel of building the East Asian Community, to be complemented by the East Asia Summit and other mechanism.”<sup>78</sup> In short, the Chinese government contends that the East Asian Community should be limited to “Asian countries.”

Why does the Japanese government prefer to extend the definition of East Asia while the Chinese government pursues the “10 + 3-type” of East Asia? The Japanese government seems to want to blur the character of “Asia” in the East Asian community and to build a new community based on universal values rather than more vaguely defined regional ones. From the Japanese government’s point of view, including Australia, New Zealand and India—all of which are democratic countries—in the East Asian region might contribute to constructing a community based on universal values like democracy, human rights. Such preferences seem to stem from MOFA’s concern that Japan should not engage in any group which might hamper its special relationship with the United States, rather than from “functional” or “pragmatic” concerns.<sup>79</sup>

On the other hand, the Chinese government seems to be eager to construct a community composed of only Asian countries. There are several reasons why. First, the Chinese government does not want Western countries like Australia and New Zealand to intervene in East Asian affairs, es-

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<sup>77</sup> Speech by Foreign Minister Li Zhaoxing at the 10+3 Ministerial Meeting, Vientiane, Laos, 7/27/2005

<sup>78</sup> Speech by Foreign Minister Li Zhaoxing at the 10+3 Ministerial Meeting, Kuala Lumpur, 7/26/2006

<sup>79</sup> In June 2002, METI proposed the idea of an “East Asian Business Area” whose membership would only comprise ASEAN+3 members. See Trade Policy Bureau of METI, Higashi-Ajia Bijinesu Ken ni Tsuite, 6/17/2002. Tusho-Hakusho in 2003 made clear on this point such as: “while considering geographical proximity, the intensity of interdependency through economies such as trade and investment, the sphere of East Asia basically should be ASEAN+3 members, then should add Taiwan and Hong Kong in it as the final goal. Australia and New Zealand should be categorized in the members of the other region because both the intensity of interdependency and identity of East Asian countries/regions are not so strong. So Japan should try to conclude economic partnership with two countries separately from East Asian Business Area.” METI (2003:185)

pecially on human rights issues. Second, it perceives that powers like Australia, New Zealand and India would restrict China's influence over East Asian countries. In other words, China's objective to construct an East Asian community is to build a China-centered sphere of influence. Third, the Chinese government regards the ASEAN Way based on "Asian values" as crucial to the East Asian community.<sup>80</sup> It prefers advancing and discussing various issues and agreements for cooperation rather than negotiating regional issues on the basis of universal values and global rules. It is obvious that China and Japan have shaped what sort of community will be established in East Asia, yet the vision for an East Asian Community remains vague.

#### 4.4 Conclusion

This chapter sheds light on why and how trade arrangements in Northeast Asia have been constructed and developed by using the institutional bargaining approach, while focusing on Japan and China. The external shocks of the end of the Cold War, the Asian financial crisis and the failure of the Third WTO ministerial meeting provided stimuli for the development of new regional integration schemes. These shocks interacted with changing domestic situations and an evolving institutional context such as that of the WTO. Under such complex conditions, China and Japan have engaged in proposing, forming and maintaining new trade arrangements in Asia.

As this chapter has demonstrated, China and Japan's policies towards regionalism and trade arrangements in Asia changed under the external shocks and regional trends. These policy transformations stemmed mainly from changes in elites beliefs and perceptions regarding which solutions would be "rational" and "pragmatic" responses to shocks and trends. The content of "rational" and "pragmatic" solutions has been redefined in each era. For example, for elites in Japan, any FTA was "irrational" when they had only supported to the multilateral free trade system centered by GATT/WTO. For elites in China, engagement in regional arrangements did not become practical until the mid-1990s because such arrangements would have constrained China's policy choices and potentially hindered its economic growth.

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<sup>80</sup> The report by the China Institute of Contemporary International Relations (CICIR) in 2002, which strongly affected the basic strategy toward East Asia, argued that China understood the significance of the ASEAN Way as being rooted in Asian values. See Mori (2005:240).

In addition, elites' perceptions of what their own countries should be or how they should act are very important. For example, images of being a "great power," a "global power," a "regional power" or even an "Asian country" can influence policy directions and filter perceptions of exogenous events. Self-perceptions and ideal images of each country defined by elites make up the identity of the country and can determine what is "rational" or "pragmatic".<sup>81</sup> Furthermore, all kinds of elite beliefs and perceptions mentioned here of course require material grounds, e.g. possession of sufficient military services, good economic performances, and so on, at least to some extent. In order to explore this argument more deeply, the internal conflicts among various "rational" and "pragmatic" choices, and the self-perceptions of national elites should be examined.

For a broader and more long-term point of view, it is apparent that the orientation for constructing and enhancing an "Asian" institutional architecture, in short, Asian regionalism, has been under development since the early 1990s. Yet at the same time, it is still unclear as to what constitutes "Asia," or "Asian identity." This paradox can be found in the progress of East Asian regionalism including the development of ASEAN+3 cooperation and the convening of the EAS. East Asian regionalism has been burgeoning since the Asian financial crisis, but the definition of what is "East Asia", and which norms, rules and values it should be based on remain vague. One answer to this question could be "the ASEAN Way", but the ASEAN Way itself might change in order to deal with human rights issues and cross-border issues e.g., environmental protection, piracy and transnational crimes.<sup>82</sup>

Finally, it is clear that economic interdependence alone is insufficient to promote regionalism and maintain various projects including trade liberalization in regional arrangements. A stable political climate is crucial. The political cleavages between China and Japan over territorial issues and his-

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<sup>81</sup> Regarding the concept of identity in international politics, see Katzenstein (1996) and Wendt (1999). However, most research on the topic seems to focus on the aspect of "self-portraits" or "ideal image" of the state, rather than how others view a given state or possible disconnects between one's self-portraits and the view from others. Wendt acknowledges the importance of "others" for one's identity formation, but he argues that the disconnect between one's identity and others will diminish in the long run through interaction between oneself and others. Yet, as I argue in Chapter One of Oba (2004a), this disconnect is not so easily resolved and its endurance can create significant international conflict.

<sup>82</sup> Regarding the influence of the "ASEAN Way" as a set of regional norms, see Acharya (2001). Regarding the possibility of the transformation of the ASEAN-Way through dealing with the human rights issue in Myanmar, see Ruukun (2006).

torical disputes present critical obstacles for the development of deeper regional institutionalization. However, we should also acknowledge that China, Japan and South Korea have dramatically improved their relationships with one another over the past few decades, as evidenced by the increasing frequency of their interaction in multiple venues and the high level of economic interdependence that they share. While such interactions will not settle all of the disputes and confrontations in Northeast Asia in the short run, they will nevertheless provide Northeast Asian countries with the basic conditions for improving their relationship in the long run and lay the groundwork for a potentially robust regional institutional architecture.

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# 5. Security Institutions in Northeast Asia: Multilateral Responses to Structural Changes

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## 5.1 Introduction

Northeast Asia, comprising China, Japan, North and South Korea, Taiwan and their adjoining waters, is arguably one of the world's most unstable and conflict-prone regions. Outstanding security risks in the region include the North Korean nuclear crisis, the Taiwan Straits, territorial disputes between China and Japan and between Korea and Japan, as well as frequent skirmishes between China and Korea. Furthermore, China's growing economic and military prowess continually challenges existing strategic frameworks in Northeast Asia.

Overall, Northeast Asian security arrangements are driven by forces at the global, regional, and domestic levels. Global contexts such as the Cold War, the fall of the Soviet Union, and the global war on terrorism following the attacks of September 11, 2001 have significantly influenced regional security structures. Regional developments such as dynamic economic growth, deepening interdependence, changes in the regional power balance, and the Asian financial crisis have also shaped the institutional environment. Finally, domestic politics in the United States in addition to the Northeast Asian states condition the process and products of institutional development in the region.

This chapter offers a systematic and historical review of strategic frameworks in Northeast Asia, analyzes the driving forces behind institution building in the region, and assesses plausible strategic scenarios in the future. Given complex changes at the global, regional and national levels,

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<sup>1</sup> I wish to thank Vinod Aggarwal and Min Gyo Koo for organizing the project and arranging the workshops, Jonathan Chow for his assistance in reading early drafts of this chapter, and Kent Calder for his guidance and mentorship.

this chapter discusses how the institutional architecture for security in Northeast Asia has evolved from the multiple bilateral ties of the Cold War era (exemplified by the “hub-and-spoke” San Francisco System) to a set of increasingly multilateral regional arrangements. The current state is in flux and there are various uncertainties with respect to the future, yet the nascent multilateralism can potentially solve one major Cold War legacy—the divided Korean peninsula—thus greatly alleviating the regional security dilemma.

In the following pages, I provide an overview of structural features and corresponding institutional frameworks in Northeast Asia, following the periodization identified in Chapter One—the Cold War era and the post-“triple shocks” period.<sup>2</sup> The institutional bargaining game model articulated by Vinod Aggarwal and Min Gyo Koo in Chapter One is adapted to discuss institutional development in the overview and subsequent individual sections. Since the 1980s, the security framework based on multiple bilateral relationships has faced increasing strain as the East Asian economies have grown rapidly and become increasingly interdependent. After each external shock, bilateral ties appeared insufficient to cope with structural changes and volatile security threats. Multilateral frameworks were thus proposed to respond to these challenges. In the meantime, domestic politics in individual countries have become more salient in this period and conditioned the process of multilateralism and scope of the resultant multilateral frameworks in the region.

## 5.2 An Overview of Northeast Asian Security

During the Cold War, Northeast Asian security was managed by the U.S.-dominated hub-and-spoke system known as the “San Francisco System.”<sup>3</sup> Under this system, the U.S. relied on its bilateral alliances with Japan and Korea. Beginning in 1972, the U.S. also adopted a similar bilateral approach to China. In contrast to strong ties between the U.S. and its allies, relations among regional actors were relatively weak. Regional security concerns were largely addressed through the Washington hub. Major structural changes in the region, however, made the hub-and-spoke system untenable. The three external shocks in particular served as catalysts in galvanizing regional actors into multilateral dialogues.

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<sup>2</sup> See Chapter One of this volume by Aggarwal and Koo.

<sup>3</sup> Calder (2004)

One major change in Northeast Asia has been rapid economic growth which has increasingly challenged American dominance in the region. In the decades after World War II, Japan, South Korea and Taiwan all experienced rapid economic development. GDP grew even faster beginning in the 1980s. China, for example, achieved a nearly sevenfold increase in GDP between 1978 and 2004, from roughly \$225 billion to \$1.9 trillion. In 1983, South Korea's domestic production was around \$85 billion; in 2003 that figure increased sevenfold to over \$605 billion. Japan's domestic production underwent a fivefold increase between 1980 and 2000 despite the "lost decade" of the 1990s when the economy experienced a prolonged slump.<sup>4</sup>

Second, intra-regional economic relations have become tighter and more interdependent since 1989. Trade among Japan, China, and South Korea constituted 6 percent of those countries' total trade in the mid-1980s and increased to more than 13 percent in 2004. Japan's trade with China and South Korea is five times larger than it was 15 years ago. South Korea's trade with China and Japan is eight times larger than it was in 1989, and China's trade with Japan and South Korea in 2004 was 14 times the size of its trade with those countries in 1989.<sup>5</sup>

Third, the distribution of power in Northeast Asia has evolved significantly. In 1983, for example, Korea's GDP was 7 percent of Japan's, while China's GDP was only 6 percent of Japan's. In 2003, by contrast, Korea's GDP was 14 percent of Japan's. More dramatically, China's GDP increased to 40 percent of Japan's GDP. If we use the purchasing power parity index, the transformation is even more dramatic. Northeast Asia is arguably becoming more equitable and interdependent than ever.<sup>6</sup> Power alignment has likewise become more dynamic. Since normalization in 1992, China-Korea relations have improved substantially. In bilateral and regional matters, the two countries seem to be cooperating more extensively and at a deeper level. On the other hand, the U.S.-Japan alliance relationship is becoming even stronger, in contrast to the troubled and deteriorating China-Japan relationship that has emerged in recent years. Anti-Americanism has also become increasingly visible in South Korea. Differences in the two-by-two alignment have surfaced repeatedly.

Making these structural changes at regional levels even more complicated is the fact that the United States, China, Japan and South Korea are

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<sup>4</sup> GDP data are from the World Bank, *World Development Indicators*, 1998-2006.

<sup>5</sup> The trade statistics are drawn from IMF, *Direction of Trade* (1980-2004)

<sup>6</sup> According to the PPP measurement, China has surpassed Japan in gross output since 2004. <http://www.worldbank.org>.

simultaneously undergoing major changes in their domestic politics. The U.S. is clearly more concerned with counterterrorism and homeland security. Japan tries to expand its international role and become a “normal state”. South Korea is arguably more populist—anti-U.S., anti-Japan, and anti-China sentiments often surface in public opinion polls. Finally, China is conspicuously more nationalist in its regional diplomacy, especially toward Japan. These developments have significantly affected regional politics in Northeast Asia. Domestic politics, on the other hand, facilitates multilateral development in Northeast Asia. Transnational economic actors and local governments in China, Japan, and South Korea have a considerable stake in regional stability and peace and have thus actively supported regional cooperation. Transnational think tanks and epistemic communities also become a salient integrating force in the region. More importantly, external shocks greatly enhanced regional collaborative trends and provide windows of opportunity for individual leaders to promote multilateral institutions in Northeast Asia.

### **5.3 The Cold War Legacy: The Korean War and the San Francisco System**

Northeast Asian security is rooted in a bilateral structure known as the San Francisco System, dominated by the U.S. in Asia-Pacific since the early 1950s.<sup>7</sup> This bilateral structure was so enduring that later efforts to create multilateral security and economic arrangements during the Cold War were unsuccessful. How did this come into being in the first place and why did Northeast Asia eschew multilateralism? Peter Katzenstein and Takashi Shiraishi argue that domestic institutions in Asian countries lacked a strong legal tradition and were thus not conducive to multilateral institutionalism.<sup>8</sup> Friedberg emphasized the asymmetric power distribution in the region and concluded that it made Northeast Asia unsuitable for multilateral institutions.<sup>9</sup> Christopher Hemmer and Peter Katzenstein also argue that there was an element of racism in U.S. decision-making that treated Asia differently from Europe.<sup>10</sup>

The first two explanations are incomplete and the third one is wrong. There is little evidence to conclusively support that a strong legal tradition

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<sup>7</sup> Calder (2004)

<sup>8</sup> Katzenstein and Shiraishi (1997)

<sup>9</sup> Friedberg (1993)

<sup>10</sup> Hemmer and Katzenstein (2000)

and power parity are necessary conditions for multilateral organizations. ASEAN apparently did not have legal tradition and NAFTA had no power parity in their conception and growth. In fact, most global and regional organizations were established without legalistic norms and power parity. Furthermore, if the first argument holds, we ought to observe no substantive changes in regional institutional frameworks in Northeast Asia as domestic legal traditions have remained almost constant over time. If the second argument holds, then we expect to observe developments in regional institutions as the power distribution in Northeast Asia has shifted. The historical evidence does not support either hypothesis. Tracing the regional strategic developments in 1949-1951 demonstrates that the race-based explanation is clearly wrong. The U.S. leaned toward a collective security for Northeast Asia known as the Pacific Pact, analogous to the NATO in Europe. It was the sudden eruption of the Korean War and the need to stabilize the region quickly to address domestic concerns in the U.S. that led to the quick birth of the San Francisco System in September 1951.<sup>11</sup>

From the “fall of China” in 1949 to the eruption of the Korean War, the idea of a Pacific Pact circulated among decision-makers in Asia and the U.S. In January 1949, Philippine Foreign Minister Carlos Romulo first advanced the idea of a league of Asian nations that he envisioned would promote mutual economic and security interests under U.S. auspices and with a small permanent secretariat.<sup>12</sup> Later in 1949, following the establishment of NATO, the United States expressed heightened interest in the Pacific Pact. Encouraged by American support, the Philippines hosted six key states to discuss regional cooperation at the Baguio Conference in April 1950.<sup>13</sup>

Two months later, however, the Korean War drastically altered the Asian security equation. From the beginning, President Harry Truman regarded the conflict as having serious effects at a global level and feared that it might broaden. This concern, combined with the deepening crisis on the ground, initially gave the Pacific Pact greater momentum. From the fall of 1950, John Foster Dulles, Special Advisor to Secretary of State Dean Acheson, began to entertain a special interest in the Pacific Pact concept.

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<sup>11</sup> This discussion draws on Calder and Ye (2004:14-17).

<sup>12</sup> Meyer (1965:142-143)

<sup>13</sup> The seven participants included the Philippines, Australia, Pakistan, India, Ceylon, Thailand, and Indonesia. As indicated earlier, South Korea and Taiwan were also highly supportive of regional cooperation, including security cooperation. See Meyer (1965:153).

Within the U.S. government, a complete Pacific Pact was drafted in early 1951 and seriously discussed.<sup>14</sup>

Despite the initial movement toward a multilateral agreement, however, regional events and U.S. domestic politics rendered the prospects of the Pacific Pact increasingly grim. Washington was shaken by the intervention of the People's Liberation Army "volunteers" in Korea, which trapped more than 150,000 UN troops, many of them Americans, on the frozen battlefields of North Korea just after Thanksgiving in 1950. U.S. public support for Truman was low<sup>15</sup> and the deeply divided Congress was not at all supportive of Truman's Asian policies.<sup>16</sup> The intensity of domestic political frustrations about the war clearly enhanced the time pressure that U.S. decision makers felt to make clear and rapid decisions.

Events also moved very rapidly the following month, intensifying the pressure for early and decisive measures. Japanese ambivalence toward the U.S. increased after the Korean War erupted. With its Peace Constitution and recent bitter memories of protracted land war in Asia, many Japanese feared the prospect of being dragged deeper into an escalating conflict on their nation's doorstep. Prime Minister Shigeru Yoshida came under intense criticism from the Socialist opposition from the very outset of the Korean conflict for allowing the United States to wage war from American bases in Japan.<sup>17</sup> When Chinese troops entered the fighting in the fall of 1950, there was even more intense domestic pressure for Japan to embrace neutralism and distance itself from the United States.<sup>18</sup> This situation made every escalation of the Korean War a more compelling reason for the United States to conclude an early peace treaty with Japan, which would in turn undermine the prospects for a multilateral security institution.

It was in this environment that Dulles embarked on his fateful January 1951 Pacific tour. He wanted above all a rapid resolution to the broad range of troubling geopolitical uncertainties across the region and a formal peace agreement with Japan. Both developments mandated the creation of a Pacific security framework. Time pressures were overwhelming and fundamentally influenced the institutional product that finally emerged in the wake of the Korean War. Under the urgency of the War and the imperative of shoring up ties with Japan through a peace treaty, the U.S. and its Pacific allies could not readily concur on a broad multilateral structure like

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<sup>14</sup> U.S. Department of State (1951)

<sup>15</sup> Christensen (1996)

<sup>16</sup> Paige (1968:45)

<sup>17</sup> Lee (2001:102)

<sup>18</sup> Lee (2001)

the Pacific Pact. The limited bilateral San Francisco System, involving less ambitious international cooperation, provided a “satisficing” solution for the United States and its allies to consolidate trans-Pacific international relations in general and U.S.-Japan relations in particular.

In September 1951, Japan signed the San Francisco Peace Treaty with forty-eight countries and returned to the international community as a member of the Western bloc. The Treaty largely determined the bilateral political order in the region. Japan was to become the linchpin of an anti-Communist coalition in Asia and the U.S.-Japan alliance was to be the center of gravity in the postwar Asian order. Dense bilateral alliance structures were also built linking the U.S. with South Korea, Australia, the Philippines, Taiwan, South Vietnam, and Thailand. By the mid-1950s, the U.S. had succeeded in creating in Asia a strong anti-Communist, cross-regional coalition to balance against the Soviet Union and China.

Using Aggarwal and Koo’s classificatory system for institutions, detailed in Chapter One, the San Francisco System featured the following five characteristics: 1) Participants: bilateral treaties between the U.S. and its Pacific allies; 2) Geography: dispersed across the Pacific region; 3) Nature: considerable asymmetry in alliance relations with U.S. domination; 4) Strength: strong alliance relationship with formal treaties; 5) Scope: broad coverage of military, diplomatic, economic and social issues. The San Francisco System committed the U.S. to the defense of many East Asian countries around the perimeter of China without explicitly obligating them to reciprocate with support of the U.S. The U.S. was also committed to opening its domestic market for Asian trade. In exchange, these Asian countries offered basing rights and diplomatic subservience to the U.S.

The San Francisco System provided extensive benefits to the United States’ allies. The American security umbrella enabled Asian states to concentrate their resources on economic reconstruction, resulting in phenomenal postwar regional growth. With socialism contained, capitalism boomed in the Asia-Pacific. However, the Treaty left several disputes intact. It absolved Japan of having to pay war reparations to American allies in Asia, indefinitely postponing the thorny issues of Japanese reconciliation with its erstwhile enemies and allowing national resentment and suspicion to simmer for years. The San Francisco Peace Treaty did not specify to which country Japan would renounce its former territories, nor did it define the precise limits of these territories, thereby creating various territorial disputes, including the “Northern Territories”/Southern Kuriles (Japan vs. Russia), Dokdo/Takeshima (Korea vs. Japan), Senkaku/Diaoyu (Japan vs. China), the Spratly Islands disputes, the treatment of Taiwan, and the divided Korean Peninsula.

The San Francisco System divided Northeast Asia into two confrontational Cold War blocs with China, North Korea, Mongolia and the Soviet

Union on one side, and Japan, South Korea, Taiwan and the U.S. on the other. It also increased antagonism within the bloc, notably between South Korea and Japan.<sup>19</sup> Since 1972, relations between China and the U.S. have improved substantially. In subsequent years, their military and political cooperation reached historic levels—being sometimes closer than that between allies.<sup>20</sup> Japan followed the U.S. initiative and established diplomatic relations with the People's Republic of China in 1972. Yet interaction among China, South Korea, and Japan was far less common than their bilateral interactions with the U.S. The hub-and-spoke system served as a disincentive for communication and cooperation among the “spokes” as Asian countries communicated their regional security concerns through the Washington hub. Indeed, the bilateral security structure has deeply impaired Asian countries' capabilities to cooperate in security issues by allowing them to avoid building up long-term habits of security interaction and cooperation or the incentives to institutionalize them.

The System was premised on two critical conditions: first, that the U.S. retain economic preeminence so that it could shoulder economic dependence from Asia, and second, that Asian countries honor bilateral ties with the U.S. and be willing to yield a certain amount of sovereignty for American military bases. The two conditions have come under increasing scrutiny since the 1970s. On the one hand, United States' economic decline relative to Asia made U.S. security aid and economic openness to Asian countries domestically unsustainable. On the other hand, rising confidence and growing nationalism in Asian nations challenged Asia's diplomatic dependence on the United States.

Despite these developments, though, the basic structure of the San Francisco System remained unchanged. Throughout the 1980s, Asian countries experienced difficulties in establishing intra-regional strategic linkages despite increasingly dense economic interactions. South Korea and Japan, for example, maintained a strained political relationship despite their strong economic ties, their level of bilateral cooperation varying inversely with their security relations with the U.S. The less confident Korean and Japanese leaders were of the U.S. security commitment, the more likely they were inclined toward autonomous policymaking and cooperation with one another.<sup>21</sup> Similarly, their security concerns regarding China were also

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<sup>19</sup> Cha (1999)

<sup>20</sup> In areas of joint military research and exercises, U.S.-China collaboration had surpassed the level of U.S.-Japan collaboration in the 1980s. Mann (1999)

<sup>21</sup> Cha (1999)

communicated through their bilateral relationship with the U.S. Situations would change significantly in the post-“triple shocks” period.

## **5.4 The Post-“Triple Shocks” Period: Regional Shocks and Northeast Asian Security Institutions**

After the end of the Cold War, Asia-Pacific actors intensified initiatives to establish regional multilateral institutions. Since the San Francisco System had inhibited multilateral cooperation, however, regional actors lacked experience in establishing such institutions and as a result, a number of initial frameworks were attempted and failed. Nevertheless, recurrent security crises precipitated collective security building in the region. The three shocks: the end of the Cold War, the Asian financial crisis, and the attacks of 9/11 demarcate the periods of institutional development in Northeast Asia. Each period began with new structural developments in the region that overwhelmed existing institutional instruments, leading to regional crises. Crises served as catalysts for collective actions in the region. Each period subsequently ended with a markedly improved institutional environment.

Following this spiraling institution building process, the current institutional structure in Northeast Asian security has progressed significantly from the Cold War legacy. In 1989, there were practically no multilateral security arrangements in the region. In 2007, by contrast, there is a dense web of multilateral institutions at different levels to cope with a wide range of security concerns in the region, as suggested in Table 5.1. Far from being conclusive and definitive, new institutional frameworks such as the Six-Party Talks, ASEAN Plus Three, and the Shanghai Cooperation Organization embody ingredients for successful institutional design and promise to play vital roles in securing future regional stability.<sup>22</sup> The remainder of this chapter examines the causes and processes of institutional development in Northeast Asian security, from an “organization gap” to the emergence of new institutions. It also attempts to assess how different regional institutions manage structural shifts in the region and how effective these organizations are in providing public security goods.

In order to fully examine institutional development in the post-“triple shocks” period, I analyze several major multilateral security frameworks in depth. These frameworks include the ASEAN Regional Forum (1994), the Korean Energy Development Organization (1995), ASEAN+3 (1999), and

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<sup>22</sup> Keohane (2006) elaborates eleven maxims for successful institutional design.

**Table 5.1: The institutional environment in Northeast Asia**

Strength*	Number of Actors				Multilateral	
	Unilateral	Bilateral	Mimilateral			
		<i>Geographically concentrated</i>	<i>Geo. dispersed</i>	<i>Geo. concentrated</i>	<i>Geo. dispersed</i>	
<b>Strong</b>	South Korea's "Sunshine Policy" (1998)	Sino-Japan Fishery Agreement (2000) Sino-South Korea Fishery Agreement (2001)	U.S.-Japan Alliance U.S.-Korea Alliance	Shanghai-5 (1996) APT (1999) SCO (2001)	ARF (1994) KEDO (1995) SPT (2002) EAS (2005)	NPT Security Council IAEA
<b>Weak</b>	China's "Peaceful Rise" (2003)	China-North Korea China-Russia Sino-Japan East China Sea Oil Exploration (2006)		NE-ASCD (1989) E.AEG (1991) EAVG (2002) Trilateral Meeting (1999)	APEC (1989) CSCAP (1993) NEAT (2000) Five Party Energy Ministerial (2006)	ASEU (1996)

\*Institutional strength is measured by one of the two conditions: 1) whether there is a formal treaty or policy to solidify the framework, and 2) whether political leaders regularly attend the meetings.

the Six-Party Talks (2002). These arrangements represent institutional responses to shifting structural environments in Northeast Asia after each individual external shock. Since their establishment, these institutions have evolved in membership, strength, and issue coverage. Table 5.2 offers a sketch of how these factors changed between the time of the arrangements' establishment and the present.

The strategic environment in Northeast Asia shifted dramatically in 1989 when the Cold War ended and consequently challenged the existing hub-and-spoke structure.<sup>23</sup> Several important trends deriving from the end of the Cold War greatly influenced the emergent regional institutional architecture.

**Table 5.2: Multilateral arrangements in Northeast Asia**

Arrangement	Orig. Mem- bers	Curr. Mem- bers	Orig. Issue Scope	Curr. Issue Scope	Orig. Strength	Curr. Strength
ARF	26	27	Medium	Medium	Medium	Weak
KEDO	3	10	Narrow	Narrower	Medium	Weak
APT	13	13	Medium	Broad	Strong	Strong
SPT	6	6	Narrow	Broad	Medium	Strong

### 5.4.1 ARF and KEDO in Post-Cold War Northeast Asia

#### *Declining Bilateralism*

Changes in the international environment and domestic politics in the aftermath of the Cold War rendered the dominant bilateral structure unsustainable. One change was a gradual deterioration of U.S.-China relations as new contentious issues began to eclipse the common interest generated by the threat of the Soviet Union. In particular, the June 1989 crackdown in Tiananmen Square placed new strains on U.S.-China ties. In China, anti-hegemonic rhetoric directed against the United States was widespread, while in the United States, public opinion turned against China for its violations of human rights. Further, bilateral relations between the United States and Korea came under renewed pressure. The normalization of China-Korea relations in 1992 reduced Korea's strategic dependence on

<sup>23</sup> Allison and Treverton (1992); Gaddis (1992)

the United States, while democratic movements in South Korea increasingly targeted U.S. military bases as a means to criticize the incumbent government.

The U.S. and Japan likewise disagreed as to the kind of international role Japan should play and the degree of burden-sharing it should undertake for its own security. The U.S. pushed Japan to take a more forceful international role, yet the Japanese political system approached the issue much more slowly and cautiously. By the end of the Cold War, Japan had expanded its regional and international role. Prime Minister Toshiki Kaifu's willingness to coordinate with the U.S. on global affairs gave birth to the notion of "global partnership" between the two countries.<sup>24</sup> Japan also at times took initiatives ahead of the U.S. For example, it resumed aid and investment in China soon after the Tiananmen crackdown, well before the U.S. or EU. In 1991, Japan's failure to send troops to the first Gulf War and subsequent criticism from the United States initiated a redefinition of Japan's global involvement among Japanese elite circles.<sup>25</sup>

Other American allies in the Asia-Pacific such as the ASEAN countries, Canada, and Australia urged the U.S. to move in the direction of collective security and to reevaluate the most probable threats to regional stability and the manner in which Washington and its Asian partners could best meet these challenges.<sup>26</sup> They argued that since the Cold War had ended, the region should develop a "comprehensive security" framework that would address a wide range of issues in the region.<sup>27</sup> Moreover, they argued that the region should also develop "cooperative security" to strengthen ties among regional actors.<sup>28</sup> The idea of an Asian equivalent to

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<sup>24</sup> Calder (1991)

<sup>25</sup> *Ibid.*; Vogel, Yuan, and Tanaka (2004)

<sup>26</sup> Tow (1993:75-77)

<sup>27</sup> Japan and ASEAN both supported comprehensive security, though each had a different understanding of it. For Japan, comprehensive security referred to a focus on non-traditional security concerns on top of traditional concerns. Southeast Asian countries, on the other hand, argued that comprehensive security included political stability, economic success, and social harmony. See Capie and Evans (2002:64-75)

<sup>28</sup> Cooperative security was mainly advocated by Australia and Canada, who argued for 1) the importance of inclusiveness in terms of participants and subject matter, 2) the importance of habitual dialogue, and 3) cooperation in contemporary security issues such as transnational crimes, environmental degradation, and disease. See Capie and Evans (2002:98-107)

the Conference on Security and Cooperation in Europe (CSCE) was circulating among regional political elites.

Economic developments further strained the San Francisco System. The United States experienced a recession in the late 1980s as Japan and other East Asian economies grew at a phenomenal rate. The two conditions that sustained the San Francisco System—U.S. economic primacy and an Asian willingness to be dependent—now came into question. Strategists in Washington began to discuss the reduction of the United States' global responsibility and the extrication of American power from its Cold War legacy. To this end, the United States began to reduce its defense spending and turn its attention to the wellbeing of its economy. At the same time, the United States sought to balance this trend toward retrenchment by remaining engaged in international fora. In particular, it emphasized the importance of universal human rights as a priority among its foreign policy goals.<sup>29</sup>

China energetically cultivated a “friendly neighborhood” policy, especially in the aftermath of the Tiananmen crackdown. Its economic “open door” policy considerably widened and deepened regional production and trade networks. China's continual economic growth also generated fears that it would become a strategic threat. Such apprehension worsened as the U.S. engaged in a policy of retrenchment and Japan experienced economic recession. Small countries such as the ASEAN states and South Korea were anxious to establish a sustainable multilateral framework to bind China's growing power. Chinese leaders, recognizing the imperative to alleviate the “China threat” apprehension in the region, were receptive to multilateral dialogues. In Northeast Asia, the U.S. was particularly concerned about potential security fallout on the Korean Peninsula. Japan and South Korea, in contrast, were actively meeting with their Northeast Asian neighbors—North Korea, China, and Russia—to discuss regional security problems, including emerging border trade disputes and traditional territorial disagreements.

A blueprint for security cooperation gradually emerged in the informal regional discussions among think tanks, NGOs, and officials. The establishment of the ASEAN Regional Forum (ARF) was situated in these collective actions. The ARF was not designed as a regional security organization with peacekeeping responsibilities. The designers emphasized its role as regional forums for discussions of various disputes and confidence-building measures. From 1993 onwards, the Northeast Asian Cooperation Dialogue (NEACD) has also progressed, involving Japan, China, Russia, South Korea, and the U.S. In 1995, the Korean Energy Development Or-

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<sup>29</sup> Simon (1996:1050)

ganization (KEDO) was established to resolve the North Korean nuclear issue. The establishment of ARF and KEDO, as well as the nature and strength of these organizations, is analyzed below.

### ***The ASEAN Regional Forum***

Initiated by ASEAN, Australia, and Canada in 1994, the ASEAN Regional Forum was intended to jointly address volatile strategic complexities in the post-Cold War Asia-Pacific, including a rising China, a stagnant Japan, and an increasingly withdrawn United States. While the U.S., Japan and South Korea supported ARF from the beginning, China was initially skeptical, as the ARF was partly designed to constrain its regional influence. At the same time, China did not want to antagonize other regional actors with whom it shared considerable economic interests. Ultimately, China's increasingly active participation in the ARF transformed its attitudes toward the organization as well as multilateralism in general.

In a region with little multilateral security cooperation, the ARF has become the principal venue for security dialogue in Asia. It complemented the various bilateral relationships underpinning regional security by borrowing from the ASEAN experience of "habitual dialogue." "Habitual dialogue" is premised on the notion that frequent and consistent interaction among states can produce qualitative improvements in political relationships. ARF facilitates these interactions by providing a setting in which members can informally discuss current regional security issues both bilaterally and multilaterally and therefore develop cooperative measures to enhance regional peace and security. Several key norms—collectively known as the "ASEAN Way"—serve as the foundation for interactions at the ARF. These include decision-making by consensus, incremental progress at a pace comfortable to all, a low level of institutionalization and strict adherence to a principle of non-interference in member states' domestic affairs. These norms help to explain why, in spite of membership diversity, the ARF has nevertheless been able to boast several significant achievements.

One important impact of ARF on Northeast Asian security is that it socialized China into norms of multilateral diplomacy. China's attitude toward multilateral regional organizations changed from antagonism to embrace. As ARF was established to cope with the "China threat," China was cautious at the start. Chinese diplomats customarily argued that the region was too diverse and the time unripe for a multilateral regional security arrangement. More immediately, Chinese leaders were concerned about its sovereignty claims over the Spratly Islands and the status of Taiwan. China's strategists believed that the United States, as the only superpower, would seek to dominate the proceedings, perhaps using the body as an-

other venue to marshal collective criticism of China's internal and external behavior.<sup>30</sup> The ARF helped to dilute such fears for a number of reasons.

First, the institutional features of the ARF—non-binding, voluntary, and incremental—dispelled China's worry of internal interference by an external organization. Second, the U.S. clearly was not dominant in the Forum. If anything, U.S. behavior was constrained by the ARF. Finally, China set up bureaucracies and trained personnel to manage multilateral regional organizations. These bureaucrats and scholars fostered networks with their counterparts in other Asian countries and later became strong supporters of China's regional policies. Participation at ARF helped Chinese leaders recognize the utility of multilateral regional forums. They found themselves capable of conveying their own security concerns while gaining clear understandings of others' positions. China also appeared to increase leverage over the Taiwan Strait by blocking Taiwan's involvement in regional organizations, especially as undivided sovereignty was one of the core values promoted at the Forum. The positive experience with the ARF is arguably important for China's regionalist shift in the Post-AFC period.

Prior to the financial crisis of 1997, the ARF was the main venue for leaders in the region to meet and discuss security and political concerns. It helped establish policy networks across different countries. Yet the ARF suffered from two fatal weaknesses from the start, eventually undermining its role as the region's preeminent security forum. First, it did not reflect the power distribution in the Asia-Pacific. Second, it did not have a substantive agenda or the capability to force one through. The three stages set out in the 1995 Concept Paper did not proceed.<sup>31</sup> ARF's strengths as a geographically dispersed and voluntary institution are also its limitations for further development. Although its members consist of all the actors in Asian Pacific, it does not have the capacity or mechanisms to manage potential security upheavals in Northeast Asia. It does not have authority to even discuss matters pertaining to Taiwan, North Korea, or territorial disputes in Northeast Asia. Its main attraction and vitality derived from being the first regional security dialogue to regularly bring major regional powers together. When alternative institutions emerged later, ARF's strength declined (see Table 5.2).

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<sup>30</sup> Foot (1998:426)

<sup>31</sup> The three stages are 1) confidence-building, 2) preventive diplomacy, and 3) a conflict resolution capability.

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**KEDO**

The end of the Cold War unleashed security risks previously contained by the Soviet and U.S. bipolar structure. When the Soviet Union collapsed in 1989, its former ally North Korea was soon engulfed in difficulties, chief among which was the supply of energy. An indigenous nuclear program appeared to be a solution that would enhance both energy and security simultaneously. The first nuclear crisis on the Korean peninsula erupted when evidence of North Korea's nuclear weapons program was uncovered in late 1993. This crisis presented both a security danger in the region and an opportunity for establishing a regional security framework.

The U.S. was deeply concerned about the potential for nuclear proliferation, whether through North Korea selling nuclear weapons technology to non-nuclear states or individuals, or through an arms race that might lead South Korea, Japan, and Taiwan to develop their own nuclear programs. Proactive moves were undertaken by South Korea, Japan, and the U.S. on one side and North Korea on the other to defuse the tense situation. In October 1994, North Korea and the United States signed the Agreed Framework establishing the Korean Energy Development Organization (KEDO) and calling for the immediate suspension of the North's nuclear projects in exchange for two light water nuclear reactors and other developmental assistance.

In contrast to ARF, KEDO was a multilateral governmental organization that dealt exclusively with Northeast Asian security. It was established through bilateral negotiations between the United States and North Korea and narrowly conceptualized as a means to provide incentives for North Korea to cease its nuclear program. Energy was KEDO's primary concern, not security. The narrow scope of KEDO reflected the United States' preference at the time for relatively low foreign involvement. The Clinton Administration clearly tried to influence the outcome of the immediate nuclear crisis with minimal resources and planning. Once the United States negotiated the Agreed Framework with North Korea, it passed the financial burdens of KEDO on to South Korea and Japan. South Korea shouldered the majority of the cost of providing light water reactors to North Korea. Due to subsequent financial difficulties, the EU was later brought into KEDO.

KEDO had the potential to become a permanent security institution in the region if the institution designers had had more strategic vision. The U.S. and its allies only half-heartedly tried to solve energy concerns in North Korea and demonstrated virtually no concern for North Korea's security dilemma. From the start, financing KEDO was a major challenge for the members. By 1997, the U.S. Congress had failed to approve the necessary budget for implementing the agreement. The South Korean government also encountered difficulties in convincing domestic constituencies

for financial support, especially when the U.S. failed to meet its financial commitment. The situation deteriorated further after the Asian financial crisis as South Korea could no longer afford the financial burden it pledged in the 1994 Agreed Framework. KEDO suffered another blow in 1998 when Japan announced that it would withdraw its funding.

The U.S. and its allies established KEDO to buy time, thinking that North Korea would either reform or collapse in due course. KEDO was narrowly conceived without addressing North Korea's security concerns. It did not attempt to normalize North Korea's relationships with the U.S., South Korea, and Japan. KEDO incorporated close allies of the United States but excluded China and Russia, two major strategic powers in the region. Considering that China and Russia were the only countries in the world that had direct ties with North Korean leadership, such exclusion was tragic. For one thing, any agreements reached between the U.S. and North Korea could not have effective monitoring mechanisms to ensure the DPRK's compliance. The U.S., distant from the Korean peninsula, was unable to monitor domestic politics in North Korea. Japan and South Korea, despite making substantial financial contributions to KEDO, lacked separate communication channels with the DPRK. The lack of knowledge and monitoring of the North Korean regime enabled Kim Jong-Il to secretly improve his nuclear weapons program over the next twelve years. The second nuclear crisis was in the making.

#### **5.4.2 The Asian Financial Crisis and ASEAN Plus Three**

Although the 1997-98 Asian financial crisis was by nature economic, it significantly influenced strategic frameworks in Northeast Asia as well. ARF, for example, was weakened as Southeast Asian economies were relentlessly undermined in the crisis. KEDO experienced severe problems as the economy of its main financier, South Korea, was devastated by the crisis. American authority in the region was compromised as the U.S. government and U.S.-led international financial institutions failed to assist Asian economies in a timely fashion. China emerged as a new leader in Asian regionalism. Northeast Asia and Southeast Asia jointly developed dynamic political cooperation in the ASEAN plus Three (APT) frameworks with far-reaching strategic implications. Thus, the Asian financial crisis arguably served as a turning point for collective security in Northeast Asia.

The Asian financial crisis created major shockwaves across the region. ASEAN, Hong Kong, and South Korea suffered economic turmoil and human disaster, but international financial institutions such as the IMF and World Bank appeared more interested in pursuing a liberalization agenda

than in rescuing the Asian economies from the crisis. The richest country in the world, the U.S., was quite miserly in providing assistance as well. To be sure, the Clinton Administration faced domestic constraints in using the Exchange Stabilization Fund, which had already been depleted by the Mexican crisis in 1995, and both Republican and Democrat legislators were critical of the Administration's costly intervention in Mexico. As the Asian financial crisis was in the making, the U.S. Congress remained deeply divided and unwilling to commit the U.S. for costly foreign assistance. Whatever the crosscurrents in American politics, the U.S. failure to support Thailand clearly had major shock effects in Asia, exacerbating the Asian financial crisis and fueling nascent preferences for regional institutions over international institutions.

China, on the other hand, was alarmed by the financial crisis in the region and particularly concerned with economic stability in Hong Kong, whose wellbeing following its return to mainland control on July 1, 1997 held great economic and political significance for China. China was hoping to showcase Hong Kong to the world as evidence of its ability to govern a capitalist and democratic region.<sup>32</sup> China thus actively applied stabilizing measures during the AFC. For example, at the height of crisis, it contributed \$1 billion to the Thai support package of August 1997. It also decided not to devalue its own currency, despite the negative impact on its exports, thereby stabilizing the regional financial system. Furthermore, China initiated several institutional dialogues in the region.

Irrespective of China's motives, its actions during the AFC met with appreciation from the ASEAN countries and South Korea. In contrast to the United States' reluctance to assist, China's proactive stance laid the groundwork for its new institutional leadership in East Asia. In December 1997, at the second informal ASEAN Summit in Malaysia, China, Japan, and South Korea were invited to attend sideline meetings. The APT became institutionalized in 1999, and a variety of institutions were advanced to address issues in both economy and security.

Prior to the AFC, Japan was an active supporter of regional institutions in Asia, going so far as to broach the idea of an Asian Monetary Fund in early 1997 as a potential regional solution to liquidity crises. The proposal was summarily rejected by the U.S., which was wary of being excluded from the AMF, and by China, which was concerned about Japan taking on a regional leadership role. The AFC provided new impetus for regional financial cooperation. Many of the ideas embodied in the AMF essentially were incorporated in the Chiang Mai Initiative in 2001.

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<sup>32</sup> Calder and Ye (2004)

### ***ASEAN Plus Three***

The establishment of ASEAN Plus Three was a direct result of the Asian financial crisis. In December 1997, when the ASEAN secretariat met in Malaysia, they invited leaders from Japan, South Korea, and China to sideline meetings to discuss collective means to cope with the financial crisis. Apart from the heads of state, finance ministers of the 13 countries also gathered to brainstorm collective mechanisms in the region. As the Asian economy recovered in late 1998, the APT framework was intensified and upgraded to a permanent and broad institution in the region. South Korean president Kim Dae-jung played a salient role. Together with Chinese and Japanese leaders, he sponsored the East Asian Study Group, which produced the East Asian Vision Report in 1999. The Report served as a practical charter of the formalized APT.

As Table 5.2 notes, APT has 13 members, with the ten ASEAN members and China, Japan, and South Korea. Since its formal establishment in 1999, APT has broad issue agenda, covering economic, social, diplomatic, and security areas. It has clear steps to complete in the near, medium, and long term. The strength of APT was unprecedented in Asia, with individual heads of the states attending the meetings and discussing substantive issues in the region. Seven years after its establishment, APT's issue areas have been further expanded, and its strength as a regional organization is stable. In 2005 when the envisioned East Asia Summit was inaugurated, the membership increased to incorporate India, Australia and New Zealand, although the APT frameworks preserved its core 10+3 arrangements.

APT has contributed significantly to cooperation in East and Northeast Asia. For the first time, China, Japan, and South Korea are involved in a regional organization that allows for regular trilateral meetings. Despite its non-security nature, the APT provides strategic common goods for Northeast Asia. First, it helped change China's stance in regional institutions from that of a reluctant participant to an active leader. Second, it enhanced multilateral cooperation in a variety of issue areas, making the region more connected as a whole. Third, it was a framework under which a variety of security-related regulations were passed. And finally, it presented a common strategic vision for the region. Despite subsequent internal disagreements, such strategic visions are continuously pursued by countries in Northeast Asia.

China's changes through the APT frameworks are most noteworthy in 1999-2002. At the Hanoi APT leaders' meeting in 1998, for example, with the region still deep in the shadow of the financial crisis, China proposed that central bank governors and deputy finance ministers throughout the region should meet regularly to explore possibilities for further multilateral cooperation. At the Manila leaders' meeting in 1999, Chinese Prime Minister Zhu Rongji played a leading role, together with Japanese Prime Min-

ister Keizo Obuchi, in finalizing the swap-quotas arrangement that led to the historic May 2000 Chiang Mai Agreement. As a rising power embedded in multilateral dialogues, China became more responsive to Southeast Asian security concerns. On July 27, 1999, China signed the Southeast Asia Nuclear Weapon Free Zone Treaty (SEANWFZ) and concluded a Treaty of Amity and Cooperation (TAC) in Southeast Asia. For several years, ASEAN had been trying to get nuclear powers to accede to the protocol, and thus the member states welcomed China's gesture.<sup>33</sup> In 2002, the Declaration on the Conduct of Parties in the South China Sea was also seen as another example of China's friendly gesture toward Southeast Asia. Meanwhile, China stepped up its multilateral efforts in central Asia. The unilateral diplomacies are overtures to China's grand strategy of "peaceful rise", which was formally announced in 2002.

Additionally, bilateral trading arrangements between ASEAN and China and between ASEAN and Japan have been established; those between ASEAN and South Korea have been underway since 2000. These arrangements are expected to serve as building blocks for the possible future establishment of an East Asian Free Trade Area (EAFTA).<sup>34</sup> In the area of financial cooperation, the "Chiang Mai Initiative" was put in place, consisting of a network of bilateral swap arrangements among ASEAN member countries, China, Japan and South Korea. In monetary cooperation, substantive progress has been made in developing the Asian Bond Market Initiative (ABMI). The AsianBondsOnline Website (ABW) was launched in May 2004. Each was designed to ensure regional financial stability independent of the United States.

Political and security cooperation among the APT countries is progressing as well. APT countries hold regular dialogue and consultations at the summit, ministerial, senior officials and working groups/expert levels to strengthen and deepen cooperation, addressing bilateral difficulties and regional security issues. APT countries have cooperated in addressing the threat posed by terrorism and other transnational crimes. The first ASEAN Senior Officials Meeting plus Three Consultation on Transnational Crime (SOMTC+3), for example, was held in June 2003 in Hanoi. The first ASEAN Ministerial Meeting on Transnational Crime Plus Three was held in Bangkok in January 2004, where the ministers adopted the Concept Plan to address transnational crimes in eight areas, namely terrorism, illicit drug trafficking, trafficking in persons, sea piracy, arms smuggling, money laundering, international economic crime, and cyber crime.

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<sup>33</sup> [http://www.mint.gov.my/policy/fora\\_asean/bernma990727.htm](http://www.mint.gov.my/policy/fora_asean/bernma990727.htm). Accessed on June 20, 2003.

<sup>34</sup> Cai (2001)

In addition to political and security forums, the APT framework has also established a number of other groups to promote its regionalist vision. The East Asian Vision Group (EAVG), formed by the APT in 2002, clarified short-, medium- and long-term measures and goals to achieve regional stability. At the time of this writing in mid-2007, Japan has been taking the lead in establishing a program to promote the exchange of people and human resources. The Network of East Asian Think Tanks (NEAT), under the general stewardship of China, serves as another Track Two mechanism to bridge regional academic and policy circles. The Korea-led East Asian Forum is also under development, while Malaysia leads the East Asian Business Council. Despite internal struggles for leadership slowed the progress of the goals specified in the EAVG, the inauguration of the East Asia Summit in 2005, which brings together the heads of state from sixteen regional countries for annual meetings, was another milestone in Asian regionalism.

#### **5.4.3 The Aftermath of 9/11 and the Six-Party Talks**

The attacks of September 11, 2001 marked a major shift in the United States' international strategy and subsequently influenced Northeast Asia's regional security environment. First, the United States re-prioritized its global strategic goals and elevated counterterrorism to paramount importance. As a result, its relationship with China and Russia improved considerably. Second, the Bush Administration's designation of North Korea as a member of the "axis of evil" intensified the DPRK's security dilemma. Kim Jong-Il's response was to step up the development of nuclear programs, reviving the threat of regional nuclear proliferation. These two factors provided the impetus for the development of a multilateral security framework—the Six-Party Talks—to address the North Korean crisis in the near term and sustainable regional security in the long run.

##### ***The Six-Party Talks***

In 2002, not long after President Bush's "axis of evil" speech, the U.S. confronted North Korea upon learning that it had resumed its nuclear weapons program. North Korea first denied and subsequently confirmed the allegation. The U.S. took an uncompromising position. It decided to impose economic sanctions on North Korea and refused to enter into bilateral negotiations with it. In response, North Korea withdrew from the Non Proliferation Treaty (NPT) and declared to continue developing nuclear weapons. Fearing a nuclear arms race in Northeast Asia and the proliferation of WMD to terrorist groups, the U.S., China, South Korea, Japan, and

Russia brought North Korea to the negotiation table in the form of the Six-Party Talks in August 2003.

The process of the Six-Party Talks was perceived as a victory for the United States because it was finally able to pressure North Korea into accepting multilateral dialogues, engaging all the important actors in the region: the two Koreas, Japan, China, the United States and Russia. Although each individual state has different strategic considerations, they agree on the imperative to manage the nuclear crisis on the Korean peninsula. Internal divisions remain, however. China and South Korea, on the one hand, seek to ensure a stable North Korean regime while inducing North Korea's economic reforms. The United States and Japan, on the other, are more interested in bringing about North Korean collapse.

The road to agreement in the Six-Party Talks has been tumultuous. North Korea appears highly reluctant and volatile. The U.S. holds only limited leverage over the DPRK. It does not have substantial economic ties with North Korea, but possesses various means to provoke North Korean leadership into reckless behavior. The financial sanctions imposed on North Korea in 2005, for example, partly motivated North Korea to renege on its commitment to the tentative proposal reached earlier. The United States' promise to unfreeze North Korean assets in Macau was important for major breakthroughs in February 2007.

China seems to have the most leverage in North Korea's domestic politics. Without China's supply of food, oil, and other resources, the North Korean regime cannot sustain itself. Yet China's influence is also limited, as Beijing is disinclined to induce regime change in North Korea. First, China is deeply concerned about the destabilizing forces that could be unleashed by North Korean collapse, such as an influx of refugees or North Korean weapons ending up in the hands of anti-Chinese insurgents. Second, China's economic interests in North Korea are bound to be damaged, especially as investment and trade flows between China and North Korea have been rising steadily since the 1990s. Third, China hopes to preserve a buffer state between the Chinese border and the U.S. military bases in South Korea. And finally, the core leadership of China's Communist Party still retains ideological commitment to the North Korean government's survival.

South Korea's position is similar to China's. South Korea's interest in a stable North Korea is at least as strong as China's. In contrast, Japan's preferences regarding the Korean peninsula are similar to the U.S. Solving North Korea's nuclear crisis is Japan's top priority, but the collapse of the North Korean regime would certainly be welcomed in Tokyo. Separated by the East China Sea, Japan is less vulnerable to the forces unleashed by North Korean collapse, yet it is more vulnerable to North Korea's nuclear threat. If China can maintain its friendship with the DPRK and South Ko-

rea can count on its “brotherhood” with the North, the possibility of North Korean nuclear weapons targeting Japan seems more imminent. Russia, as part of the Six-Party Talks, has strong and strategic ties with China, as having been fostered in the Shanghai-Five frameworks since 1996. Nevertheless, it does not welcome a Korean peninsula dominated by either Chinese or American interests.

Due to these complex strategic calculations, the progress of the Six-Party Talks has been slow. On Sept 13, 2005, almost three years after its inauguration, the Six-Party Talks concluded a tentative deal in which North Korea was to give up its nuclear program in exchange for energy assistance and other financial aid. The tentative agreement was hailed as a diplomatic victory, but shortly thereafter, North Korea refused to return to the negotiation table for almost nine months before it launched multiple missile tests in July 2006. Before debates on North Korea’s missile tests were settled, the DPRK carried out nuclear tests in October 2006, defying warnings from the U.S., China, and other regional actors in the region, thereby officially declaring itself a new nuclear power.

Then, in February 2007, another major twist occurred in Beijing. In the third phase of the fifth round of talks, the SPT produced a joint statement in which the DPRK agreed to shut down its main nuclear reactor at Yongbyon within 60 days, allow the return of International Atomic Energy Agency (IAEA) inspectors, list all its nuclear activities and freeze weapons development “for the purposes of eventual abandonment.” In return, the DPRK would receive 50,000 tons of heavy fuel oil to generate electricity. Following this breakthrough, the agenda of the SPT has expanded and the negotiation deepened. Steps to build a “permanent peace regime” in Northeast Asia are devised and gradually carried out.<sup>35</sup> On March 16, 2007, the SPT working group on peace and security in Northeast Asia held its first meeting in Beijing, with officials from all the six parties attending and the Russian delegation acting as the chair. Another working group meeting on economic and energy cooperation was held one day earlier in Beijing to discuss the need to assist the DPRK and various proposals for such assistance. The first meeting of the SPT working group on the denuclearization of the Korean Peninsula was held on March 17. The SPT frameworks focus on five major negotiations: 1) denuclearization on the Korean Peninsula; 2) DPRK-U.S. relations, 3) DPRK-Japan relations, 4)

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<sup>35</sup> “Korea Deal Could End Asia’s Cold War,” *Financial Times*, 3/16/2007; “Six-Party Talks Working Group on Peace, Security in NE Asia Meets in China,” *Financial Times*, 3/16/2007; “World Six Parties Discuss Northeast Asia Security,” *Financial Times*, 3/20/2007.

economic and energy resources cooperation, and 5) peace and security in Northeast Asia.

Apart from external shocks and regional crises, the post-9/11 multilateral development in Northeast Asia is also rooted in rising economic interdependence, social exchanges, and regional policy networks. Since the late 1990s, for example, China, Japan, and South Korea have traded more among themselves than with the U.S., reversing a decades-long dependence on the United States. Korean and Japanese investments have grown rapidly in China, creating a close-knit regional production network with China at the center.<sup>36</sup> Policy networks in support of closer regional integration are rapidly developing. Bureaucrats in China, Japan, and Korea are frequently engaged policy discussions about regionalism. Meanwhile, policy think tanks produce a significant number of proposals for regional cooperation. The business community also plays a supporting role through top-down and bottom-up institutional mechanisms now in place to engage the Asian region as a whole.

Furthermore, as the U.S. made counterterrorism and homeland security a top priority after 9/11, a window of opportunity emerged for multilateral cooperation in East Asia. China dramatically improved its relationship with Southeast Asia by becoming a signatory to the Treaty of Amity and Cooperation in 2003. At China's initiative, the Shanghai Cooperation Organization (SCO) was formalized in 2001, incorporating China, Russia, and the four central Asian states of Kazakhstan, Kyrgyzstan, Tajikistan, and Uzbekistan.<sup>37</sup> These institutional developments helped to shift the balance of influence between China and the U.S. in Northeast Asia. China has likewise augmented its networks with regional actors: North Korea, the former Soviet republics, Mongolia, as well as South Korea and Japan, in sharp contrast to the San Francisco System where the U.S. dominated the spokes. Security issues in the region, such as disputes in East China Sea or South China Sea, can be solved without direct U.S. participation, while solutions to major regional challenges increasingly require China's involvement.

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<sup>36</sup> Borrus, Ernst, and Haggard (2000).

<sup>37</sup> The Shanghai Cooperation Organization was originally established in 1996 by China, Russia, Kazakhstan, Kyrgyzstan, and Tajikistan to deal with border issues, and to counter the "three evil forces" of terrorism, separatism, and extremism.

## 5.5 Future Scenarios for Northeast Asian Security

Northeast Asia faces a number of security perils: the Taiwan issue, China's disputes with Japan in the East China Sea, the disputes over the Dokdo/Takeshima Islands between Korea and Japan, territorial disputes between Russia and Japan, and the North Korean nuclear crisis. Each has the potential to destabilize the region and generate military conflicts involving major world powers. In the near future, the likely scenarios will be determined by the North Korean nuclear crisis.

The Taiwan issue, despite the seemingly inflexible claims of indivisible sovereignty across the Straits, is managed by stable bilateral arrangements between China and the U.S. Moreover, the economic and social ties across the Straits are so vibrant that the outbreak of conflict is bound to threaten the wellbeing of Taiwan and China's prosperous coastal region. Territorial disputes among China, Japan, and Korea are also stable, as the intentions and capabilities over the disputed areas are clear. Furthermore, the three countries have strong diplomatic relations, relatively predictable domestic politics, and deeply interdependent economic relations, far outweighing the importance of the disputed areas. Disputes surely will continue for a long time, yet surprise conflicts or quick solutions are unlikely. For these relatively minor territorial disputes, multilateral frameworks may prove useful in the future.

The outcome of the North Korean nuclear crisis is still uncertain at this point. We can make a sensible prediction of its future based on the three factors specified in Aggarwal and Koo's model: goods, individual situations, and existing institutions.<sup>38</sup> First, what is at stake if stability on the Korean Peninsula breaks down? The consequences would be nothing short of disastrous. With North Korean refugees and weapons, major cities in Northeast Asia, including Seoul, Beijing, Shanghai, Tokyo, and Taipei, would all be paralyzed, especially Seoul and Beijing, two capitals in the vicinity of North Korea. As the Asia-Pacific economy is deeply interdependent, the eruption of crisis in Beijing or Seoul would surely spill over into the whole region, inhibiting Asia's rapid growth and dynamic market. This economic crisis would likely lead to political upheavals as well. The Chinese authoritarian regime's core legitimacy has been based on economic growth, and it is likely to be destabilized, if not collapse outright, in the face of a major economic crisis. The region, as well as the world, does not have the capacity to cope with major fallout from China. The stability of the Korean peninsula is thus not only critical to security, but also to the political and economic wellbeing of the entire Asia-Pacific.

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<sup>38</sup> See Chapter One of this volume.

Second, domestic coalitions behind multilateral cooperation are important in individual countries. In China, for example, corporations and local governments are anxious to preserve regional stability and expand regional cooperation in various social and economic projects. Software manufacturers in China, Japan, and South Korea have coordinated to develop a region-wide UNIX-based standard for operating systems so as to compete with the dominant Microsoft Windows standard. Regional economic zones surrounding the East China Sea are vibrant. Major economic actors seeking to avoid potential military disputes over contested maritime claims have pushed for projects to jointly exploit gas reserves in the East China Sea between China and Japan. Economic bureaucrats in China and South Korea are also active in forging agreements with regard to fishing in disputed waters to avoid potentially destabilizing conflicts. Such cooperative efforts typically involve both government officials as well as business representatives.

Third, the regional institutional environment has improved significantly since 1989. Skeptics in the U.S. have questioned the prospects of multilateral institutions in Northeast Asia. As Table 5.1 suggests, Northeast Asia has developed dense multilateral arrangements in the recent decade, consisting of minilateral and multilateral organizations and dialogues. Bilateral ties among countries in the region are also extensive. Furthermore, government-affiliated think tanks have played an important role in coordinating regional policies in different countries, as suggested by the activities of the Network of East Asian Think Tanks and other Track Two groups. These multilateral frameworks helped to bring North Korea back to the negotiating table by voicing regional public opinion against its nuclear program, facilitating coordination among individual actors, and presenting credible threats of sanctions toward the DPRK.

Shortly after North Korea carried out its nuclear test in October 2006, Southeast Asian countries used ASEAN and ARF meetings to criticize the DPRK and called for its return to the Six-Party Talks. China, Japan, and the U.S. not only publicly criticized the DPRK, but also jointly passed UN Security Council Resolution 1695 to condemn the DPRK and urge its immediate return to the SPT. In the meantime, the five other parties kept multilateral negotiations open. Japan declared that it would not test nuclear weapons in response to North Korea's. China maintained active diplomacy behind the scenes to coax North Korea back to the SPT. The United States became more flexible in releasing North Korea's frozen assets in Macau. These activities demonstrated a high degree of regional coordination and collaboration in solving the Korean peninsula crisis.

The SPT has also become more institutionalized and broadened. Three working groups are officially in place to cover North Korean denuclearization, peace and security in Northeast Asia, and economic and energy coop-

eration. Bilateral relationships between the U.S. and DPRK and between Japan and the DPRK are included in the SPT frameworks, aiming to normalize North Korea's relationships with other countries and fundamentally address both its economic and security concerns. Individual countries appear committed to multilateral diplomacy. China, as the host of the SPT, remains fully committed to making multilateralism work. The Bush Administration, challenged by the Iraq war and Democrats in Congress, is anxious to secure some diplomatic success in Northeast Asia. Japan's new Prime Minister Shinzo Abe is also eager to achieve diplomatic breakthroughs in Korean Peninsula to strengthen his domestic position. Russia, chairing the first working group on Northeast Asian Peace and Security, expects to increase its regional presence and potentially provide an enormous market and numerous opportunities for investment. North and South Korea have the most to gain in the SPT, as the talks promise not only to stabilize the Peninsula but also to facilitate a permanent settlement of their decades-long confrontation.

Domestic politics, however, are also likely to complicate the process of North Korean denuclearization. First, hardliners in the U.S. are clearly in favor of regime change (or collapse) in the DPRK and criticize any settlement that potentially contributes to the DPRK's survival. Within the U.S., we can expect policy debates that support stringent sanctions and tough conditions to bring down the DPRK.<sup>39</sup> U.S. policy debates are likely to be intensified by the 2008 presidential elections. Second, although Japan has agreed in principle to provide energy assistance to North Korea, Japanese Prime Minister Abe has taken a cautious position in actually committing Japan to such assistance. Japan's domestic politics remains complicated by North Korea's past abduction of Japanese citizens. South Korea's heavy financial commitment to the North also faces domestic criticism, creating political difficulties for an increasingly weak government. Thus, in the absence of imminent crisis, the negotiation for a "permanent peace regime" in Northeast Asia is likely to be difficult. Yet, as demonstrated by the increasing institutionalization of relations, the proactive multilateral diplomacy of the Six-Party Talks and signs of conciliation from both North Korea and its interlocutors, there is still reason to be cautiously optimistic about a peaceful settlement.

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<sup>39</sup> O'Hanlon and Mochizuki (2006); Lim (2006)

## 5.6 Conclusion

Since World War II, Northeast Asia has changed greatly in its aggregate power, distribution of power, and intra-regional interdependence. We can draw a few concluding observations. First, multilateral frameworks have grown rapidly in the region despite persistent disagreements among major actors. Second, the rising multilateralism is rooted in growing regional interactions in economic, social, and strategic spheres. Third, due to complex domestic politics in China, Japan, and South Korea, collective security is slow to develop, yet potentially significant to alleviate regional security perils.

As pointed out before, nationalism is growing in China, along with populism in Korea and internationalism in Japan. All these trends have the potential to upset regional stability. Multilateral cooperation clearly provides a more pragmatic and peaceful means to address bilateral issues in the region, considering complex domestic politics. China's nationalist domestic audience is more likely to disapprove of any bilateral compromises that China would make with Japan than a diplomatic bargain in a multilateral setting. Similarly, the South Korean government is less likely to be constrained in multilateral diplomacy in the region than bilateral interactions with either Japan or China. Finally, Japan's drive to become an international power is more likely to succeed without setting off regional alarm bells if such growth is managed within multilateral frameworks.

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## 6. Southeast Asia's New Institutional Architecture for Cooperation in Trade and Finance

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### 6.1 Introduction

For much of the 1990s, the Southeast Asian states were involved in only two regional economic cooperation projects, namely the ASEAN Free Trade Area (AFTA), first adopted in 1992, and the Asia Pacific Economic Cooperation Forum (APEC), initiated in 1989. It was only in the new millennium that the Southeast Asian countries expanded their regional cooperation efforts through new projects in regional economic integration as well as in financial cooperation. Thus, in addition to multilateral arrangements such as the World Trade Organization (WTO), the Bank for International Settlements (BIS) and the International Monetary Fund (IMF), the trade and financial relations of the Southeast Asian states are governed today by a variety of minilateral arrangements that are based on a Southeast Asian, East Asian or Asia-Pacific regional configuration. Aside from APEC, the other two regional configurations, AFTA and ASEAN Plus Three (APT) are centered on ASEAN, the Association of Southeast Asian Nations (Tables 6.1 and 6.2).<sup>2</sup>

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<sup>1</sup> For their comments, views and suggestions for revision, the author would like to thank Vinod Aggarwal, Min Gyo Koo, Jonathan Chow, Ellen Frost, Muthiah Alagappa, Chung Lee as well as participants at the two workshops organized by the Berkeley APEC Study Center, University of California, Berkeley. The insightful and lively debates at both these workshops pushed me to think a little more deeply about Southeast Asia's economic institutions and their relationship with other regional institutions beyond the immediate Southeast Asian region.

<sup>2</sup> The ten-member Association of Southeast Asian Nations was established in 1967 by Indonesia, Malaysia, the Philippines, Singapore, and Thailand, with Brunei joining in 1984, Vietnam in 1995, Laos and Myanmar in 1997 and Cambodia in 1999.

**Table 6.1: Regional arrangements governing Southeast Asia's trade and financial relations**<sup>3</sup> Note: Only arrangements already in force or with negotiations complete are included

Unilateral	Number of Actors				Multilateral
	Bilateral		Minilateral		
	<i>Geographically Concentrated</i>	<i>Geographically Dispersed</i>	<i>Geographically Concentrated</i>	<i>Geographically Dispersed</i>	
Trade and financial liberalization measures adopted by individual Southeast Asian countries APEC Individual Action Plans (IAPs)	Singapore-Thailand (2003)	Singapore-New Zealand (2000) Singapore-Japan (2002) Singapore-Australia (2003) Singapore-European Free Trade Area (2003) Singapore-U.S. (2004) Singapore-India (2005) Singapore-Jordan (2005) Singapore-Korea (2006) Malaysia-Japan (2005) Thailand-China (agricultural products only, 2003) Thailand-Australia (2005) Thailand-New Zealand (2005)	AFTA (1992) ASEAN Economic Community (AEC) (2003)	APEC (1989) ASEAN Plus Three (APT) Financial Cooperation (2000) ASEAN-China (2003) ASEAN+Korea (2006) East Asian Summit (EAS) (2005) Singapore-Brunei-New Zealand-Chile (2005)	WTO Bank for International Settlements (BIS) IMF

<sup>3</sup> Based on the categorization developed by Aggarwal and Koo in Chapter One of this volume.

**Table 6.2: Institutional features of Southeast Asia's minilateral arrangements**

Org. Name	# of members at establishment	# of members now	Issue scope at establishment	Issue scope now	Strength at establishment	Strength now
ASEAN	5	10	Medium	Broad	Weak	Medium
AFTA	6	10	Medium	Broad	Weak	Medium
AEC	10	10	Broad	Broad	Medium	Medium
APT	13	13	Broad	Broad	Weak	Medium*
EAS	16	16	Narrow	Narrow	Weak	Weak
APEC	12	21	Narrow	Broad	Weak	Weak

\* It is only in APT financial cooperation that a moderately strong institutional arrangement has evolved.

The 1992 adoption of AFTA by the member states of ASEAN is noteworthy as these same governments had previously rejected calls by the ASEAN business community and scholars to establish a Southeast Asian free trade area. AFTA's adoption followed the 1989 establishment of APEC.<sup>4</sup> These two institutional arrangements dominated the Southeast Asian regional economic landscape for much of the 1990s. Nevertheless, APEC and AFTA stand in marked contrast to each other. While APEC reflects a geographically dispersed trans-Pacific membership, AFTA reinforces a geographically concentrated Southeast Asian regional configuration defined by membership in ASEAN. Moreover, the Southeast Asian governments embraced a higher degree of institutionalization in AFTA through the adoption of binding rules. By contrast, these same governments rejected institutionalization in APEC in favor of non-binding agreements and voluntary commitments.<sup>5</sup> Following the completion of AFTA's first tariff-reduction phase in 2002, ASEAN initiated the ASEAN Economic Community project (AEC). The project was intended to create an integrated Southeast Asian market by 2020 through a program of deeper integration beyond the tariff reductions that were AFTA's main (though not sole) focus.

On the other hand, the ASEAN Plus Three forum reflects a broader East Asian regionalism (as opposed to a narrower Southeast Asian regionalism) by bringing the ten members of ASEAN together with three Northeast Asian countries—China, Japan, and South Korea. Although the APT aspires to be a comprehensive regional cooperation agenda covering both

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<sup>4</sup> Currently consisting of 21 members, APEC was formed in 1989 as a ministerial-level meeting of 12 member countries, its original aim to provide an informal regional dialogue mechanism on trade matters.

<sup>5</sup> Nesadurai (2004:154)

trade and non-traditional security, it is presently best known for its projects in regional *financial* cooperation, namely the Chiang Mai Initiative (CMI) and the Asian Bond Market Initiative (ABMI). The CMI is a regional liquidity facility that offers the Southeast Asian states emergency financing to respond to speculative attacks on their currencies; the ABMI contributes to the development of the necessary institutional and regulatory infrastructure in the APT member states to support the growth of national and regional bond markets. Another regional institution with a broader focus is the annual East Asia Summit (EAS) first held in Malaysia in December 2005. The EAS comprises a slightly different membership from APT, with India, Australia and New Zealand also invited as participants. How the EAS will unfold remains unclear for the moment.

In addition to these regional arrangements, a variety of other initiatives for economic cooperation have also taken root in this part of the world. These include free trade areas (FTAs) that ASEAN as a grouping has negotiated—such as the ASEAN-China Free Trade Area (ACFTA)—or is in the process of negotiating (such as with Japan, South Korea, India and the Australia-New Zealand grouping). There has also been a mushrooming of bilateral FTAs negotiated between individual ASEAN members and non-Southeast Asian countries, with Singapore as the most active proponent of bilateralism, and Thailand and Malaysia not far behind.

The wide variety of institutional arrangements involving the Southeast Asian countries, each with its own distinctive agenda, membership and modality of cooperation, raises a number of questions that constitute the focus of this chapter. First and most fundamentally, why have the Southeast Asian countries adopted such a wide variety of institutional arrangements to govern their economic relations? Other questions inevitably follow. Why have these governments privileged AFTA over APEC as a vehicle for regional trade liberalization? Similarly, why has financial cooperation become a key item on the APT agenda rather than at the ASEAN or APEC levels? Finally, what accounts for the growing interest in bilateral arrangements?

To answer these questions, I use the institutional bargaining perspective elaborated in Chapter One by Vinod Aggarwal and Min Gyo Koo to trace first how different types of external shocks stimulated the initial turn to regional institution building. The analysis also explores how the choice of institutional arrangement has been shaped by the distinct nature of the “goods” being sought by the Southeast Asian states, namely foreign investment, export markets and short-term liquidity to respond to currency crises. The discussion also considers the role of three other contextual factors central to the institutional bargaining approach: the international position of the Southeast Asian states, the nature of dominant domestic coalitions and elite beliefs.

In Section 6.2, the discussion turns to the Cold War period in which regional economic relations were only weakly institutionalized. In Section 6.3, I examine how the factors mentioned above have shaped Southeast Asia's new institutional architecture for cooperation in economics and finance in the post-Cold War period. Section 6.4 explores the implications of Southeast Asia's new institutional arrangements for the region itself and beyond. In particular, the discussion considers whether these different arrangements conflict with or reinforce each other, how they might evolve over the next five to ten years, and what their implications are for the global economic order. The chapter concludes in Section 6.5 by drawing out the key factors that have shaped the emergence and evolution of Southeast Asia's new institutional arrangements for economic and financial cooperation.

## **6.2 Southeast Asia and Regional Economic Cooperation in the 1970s and 1980s**

Economic cooperation in Southeast Asia was formally initiated in 1977 under the auspices of ASEAN. Although the 1967 Bangkok Declaration establishing ASEAN highlighted economic cooperation as a key goal and a United Nations report advocated ASEAN economic cooperation, no concrete projects in this area were developed.<sup>6</sup> Instead, ASEAN focused on building confidence amongst its members through regular consultations on a host of shared intra-regional and wider political and security issues.<sup>7</sup> The emphasis on regional rapprochement was not surprising given that ASEAN's formation in 1967 had been aimed at overcoming intra-regional tensions and rivalries that had been endemic throughout the 1960s.<sup>8</sup> Peace and security between former rivals were regarded as vital to enable member governments to devote their attention to national economic growth. Economic growth, in turn, was believed to be the primary route to social and political stability in the divided post-colonial societies and a means to secure these governments' own political legitimacy.<sup>9</sup>

The primary impetus for economic cooperation in 1977 was external. The fall of South Vietnam in 1975 prompted concerns about enhancing ASEAN's security and cohesion. It led the ASEAN members to initiate

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<sup>6</sup> ASEAN (1967); Ravenhill (1995:851)

<sup>7</sup> Antolik (1986:17-19)

<sup>8</sup> Acharya (1997)

<sup>9</sup> Leifer (1989:3-4)

four regional economic schemes to ensure the grouping's own internal cohesion through closer economic collaboration. The Preferential Trade Arrangement (PTA) and the ASEAN Industrial Projects were both launched in 1977; the ASEAN Industrial Complementation scheme was launched in 1981 and the ASEAN Industrial Joint Ventures scheme was initiated in 1983. Unfortunately, these four regional cooperation schemes were not successful because they were hampered by protectionist concerns and conflicts over the allocation of individual projects to the different ASEAN member states.<sup>10</sup> The main stumbling block was the absence of any *economic* need for a regional market during the 1970s and 1980s since all the ASEAN countries were trading far more with industrialized countries beyond Southeast Asia than with each other (see Table 6.3). Even without any form of formal economic cooperation, the ASEAN countries registered credible economic performances during the 1970s and 1980s (see Table 6.4).<sup>11</sup>

The regional cooperation initiatives adopted by ASEAN did not offer sufficient economic gains or fulfil any pressing economic needs for its member countries. Although these economic projects theoretically offered the small ASEAN countries a larger regional market to support domestic industries that were being cultivated through import-substitution industrialization, each government also wished to preserve its own domestic market for domestic firms, especially politically important ones, thereby making it difficult to move regional economic cooperation beyond identification of new projects or the early stages of their implementation.<sup>12</sup> As a result, governments had no incentive to overcome their different national interests and ensure the proper design and implementation of these schemes.

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<sup>10</sup> Ravenhill (1995:852-853), Bowles and MacLean (1996:321-322), ASEAN Secretariat (1997:54-62)

<sup>11</sup> The exception was the Philippines, which was mired in internal political turmoil during the Marcos era.

<sup>12</sup> Bowles and MacLean (1996:332)

**Table 6.3: ASEAN direction of trade, 1993 (%)**<sup>13</sup>

Country	USA	Japan	European Community	ASEAN (1993)	ASEAN (1970)
<b>Exports</b>					
Brunei	1.2	54.2	17.8	19.2	83.2
Indonesia	14.2	30.3	14.4	13.4	21.1
Malaysia	20.3	13.0	14.5	28.2	25.4
Philippines	38.3	16.3	16.8	7.1	1.2
Singapore	20.3	7.5	14.0	23.9	29.4
Thailand	21.6	17.0	17.0	16.3	14.9
ASEAN	19.9	15.7	15.0	20.2	21.4
<b>Imports</b>					
Brunei	20.2	5.4	27.1	38.3	49.4
Indonesia	11.5	22.0	19.9	9.3	7.6
Malaysia	16.9	27.5	11.6	20.0	22.5
Philippines	19.8	22.8	10.3	10.9	5.2
Singapore	16.3	21.8	11.5	21.8	26.7
Thailand	11.7	30.3	14.9	12.1	3.2
ASEAN	14.9	24.4	13.3	17.5	16.3

**Table 6.4: Growth performance of ASEAN countries, 1965-90 (%)**<sup>14</sup>

	Brunei	Indonesia	Malaysia	Philippines	Singapore	Thailand
Real GDP growth (1980-91)	N/A	5.6	5.5	0.8	6.4	7.6
Per capita GNP growth (1965-90)	N/A	4.5	4.0	1.3	6.5	4.4

In addition to the lack of economic incentives, government officials and leaders were not overly enthusiastic about regional free trade schemes during the 1970s and 1980s, believing that such projects constituted *alternatives* to participation in world markets and were aimed at reducing dependence on trade with extra-regional industrialized countries.<sup>15</sup> Virtually all the ASEAN member countries rejected regional free trade schemes on

<sup>13</sup> ASEAN Secretariat (1997:42)

<sup>14</sup> World Bank (1992)

<sup>15</sup> Bowles and MacLean (1996:332-333)

these grounds in the belief that these schemes would jeopardize their engagement with world markets. As the next section reveals, it was only when it became clear that regional free trade schemes could *enhance* countries' integration with world markets that an ASEAN-wide free trade area became possible.<sup>16</sup> The overall benefits theoretically promised by regional free trade prompted governments to overcome some, though not all, of the domestic vested interests lobbying against AFTA. Before discussing AFTA, I first turn to a brief discussion of APEC, the first inter-governmental regional economic organization established across the Pacific.

### **6.3 New Regional Cooperation Schemes in the 1990s: APEC, AFTA and APT**

The establishment of APEC in 1989 represented the realization of an idea for a trans-Pacific regional organization that had been proposed in the 1960s by Japanese economist Kiyoshi Kojima.<sup>17</sup> Although most governments had rejected the need for such an organization, it was kept alive by the region's non-governmental or Track Two bodies, namely the Pacific Trade and Development Forum (PAFTAD), the Pacific Basin Economic Council (PBEC) and the Pacific Economic Cooperation Council (PECC). These groups played a key role in articulating the need for a regional inter-governmental institution to manage the growing economic interdependence in the Asia-Pacific.<sup>18</sup> Yet this does not explain why APEC was successfully formed in 1989 despite serious misgivings on the part of most Southeast Asian governments that it would undermine their own regional organization.

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<sup>16</sup> Nesadurai (2003:78-82)

<sup>17</sup> APEC's founding membership included the (then) six ASEAN members (Brunei, Indonesia, Malaysia, the Philippines, Singapore and Thailand), two Northeast Asian countries (Japan, South Korea) and Canada, the U.S., Australia and New Zealand. In 1991, the 'three Chinas' (China, Hong Kong and Taiwan) were admitted, while Mexico and Papua New Guinea joined in 1993, and Chile in 1994. In 1998, APEC's membership expanded to 21 with the inclusion of Peru, Russia and Vietnam. There is currently a moratorium on further expansion.

<sup>18</sup> Morrison (2006:206-210)

### 6.3.1 APEC and the End of the Cold War

A major external driver for the successful establishment of APEC in November 1989 was the waning Cold War, which raised a new set of strategic concerns for the Southeast Asian states that in turn paved the way for trans-Pacific regionalism. By the late 1980s, there was rising concern among governments in Southeast Asia that the U.S. would withdraw militarily from the Pacific region. Compounding these fears were growing perceptions in the U.S. Congress that East Asian countries were discriminating against American goods, services and investment while not shouldering their share of responsibility for maintaining security in the Pacific, as well as U.S. trade imbalances with countries in the region. The waning Cold War made it less likely that Washington would continue to tolerate discriminatory economic practices in Japan, South Korea and Taiwan as it had since the 1950s when these countries became key allies in American Cold War strategy. The unfolding developments of the 1980s made U.S. economic and military retrenchment from the region a very real possibility.<sup>19</sup>

In these circumstances, the Southeast Asian and Northeast Asian countries saw APEC as a means to sustain U.S. interests in the region and manage trans-Pacific trade disputes. Given the slow progress of the Uruguay Round of trade negotiations during this period as well as the move to establish regional markets in Western Europe and North America, it was not surprising that the Southeast Asian governments, increasingly reliant on open world markets to support their export-dependent growth, became worried by the specter of fragmentation (and possibly even closure) of the world economy. The U.S. was a major export market for East Asia, absorbing about a fifth of ASEAN's total exports in 1989 and a third of Japanese and South Korean exports.<sup>20</sup> Despite their initial reservations, the ASEAN governments joined the project in 1989 as they recognized that APEC offered them the best chance of keeping the U.S. engaged in the region. Southeast Asia's concern that APEC would overshadow ASEAN was also overcome to some extent by extensive consultations between ASEAN and Australia, one of APEC's founders. ASEAN was assured that it would be granted a central role in the new organization.<sup>21</sup>

Nevertheless, this account of the formation of APEC still leaves one puzzle unanswered. If the ASEAN governments wished to ensure contin-

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<sup>19</sup> Ravenhill (2002:62)

<sup>20</sup> *Ibid.*, 77

<sup>21</sup> *Ibid.*, 84

ued U.S. economic and strategic engagement with the region, then they should at least have attempted to accommodate Washington's economic interests in the Pacific. Growing regional economic interdependence also suggests that the Southeast Asian countries would have attempted to ensure that APEC would be effective in reducing the problems generated by economic interdependence, including liberalizing existing barriers to regional trade.<sup>22</sup> The domestic liberalization drive in Southeast Asia from the mid-1980s should have made such an exercise possible. Yet, APEC was designed in a way that undermined its potential to promote more effective regional collaboration and regional liberalization, eventually leading to U.S. disinterest in the institution. To account for this, we need to turn to domestic factors and shifts in the broader institutional context.

Although most of APEC's Southeast Asian members had relatively open economies, especially since the new round of liberalization undertaken after the mid-1980s recession, these governments nevertheless were concerned that any hasty liberalization would undermine their own industrialization efforts as well as their ability to achieve domestic socio-political priorities that rested on redistributive agendas. Mindful that Washington might try to use APEC to force through liberalization of their economies in ways or at a pace unacceptable to them, APEC's Asian members had secured a commitment that APEC would function as a dialogue process rather than as a forum for negotiating regional liberalization. When APEC adopted a regional liberalization agenda in 1994, its Asian members insisted that unilateralism and consensus should guide this exercise, an approach termed "open regionalism".<sup>23</sup> Although APEC's Asian members were unable to prevent the new liberalization agenda, their insistence that liberalization should be based on non-binding, unilateral or non-negotiated commitments and flexible implementation effectively allowed each member government considerable discretion in determining the substantive concessions it was willing to make and its schedule of liberalization.<sup>24</sup>

As a result, APEC-wide liberalization progressed too slowly for members like the U.S., which lost interest in APEC after negotiations between Washington and Tokyo collapsed at the 1998 Kuala Lumpur summit when

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<sup>22</sup> Interdependence among APEC economies, measured in terms of intra-APEC trade as a share of total trade, grew from 56.9 percent in 1980 to 66.4 percent in 1985 and 68.5 percent by 1989. See Ravenhill (2002:73)

<sup>23</sup> Open regionalism has been defined as an approach to regional liberalization based on unilateral offers by members that could be extended to non-members on an MFN basis. See Drysdale and Garnaut (1993:187-188).

<sup>24</sup> Plummer (1998:308)

Tokyo insisted that its liberalization commitments in the forestry, fisheries and agriculture sector were non-binding.<sup>25</sup> With its liberalization agenda in tatters, APEC now focuses on trade facilitation and economic/technical cooperation, issues that are significantly less important to Washington. It was probably because such a vacuum existed in APEC in the first place that the United States' concerns regarding terrorism quite easily assumed center stage at the 2003 APEC Leaders' Summit in Bangkok. The adoption of a range of anti-terrorism measures under APEC's auspices was disquieting to a number of APEC members as well as the business community, however.<sup>26</sup> For many of its members, APEC has clearly taken a back seat as an exercise in regional economic liberalization.<sup>27</sup>

Although APEC's Asian members had initially seen the project as a way to maintain continued access to markets, especially in the U.S., changing international conditions since APEC's early years reduced the external pressure on the Southeast Asian members that might have led them to be more forthcoming with regard to APEC's liberalization agenda. Not only were the U.S. and other global markets still open to Asia-Pacific exports in the 1990s, but the WTO was also established in 1994, considerably advancing the liberalization agenda. In other words, the original external pressures for securing export markets that had prompted Southeast Asian participation in APEC had become rather marginal by the mid-1990s. Moreover, the Southeast Asian countries had their own regional project, AFTA, through which they attempted to collectively respond to what they perceived were potentially threatening structural shifts in the global economy.

### 6.3.2 ASEAN, AFTA and the FDI Imperative

When the six ASEAN leaders announced in 1991 that they had decided to form AFTA,<sup>28</sup> scholars and the business community remained unconvinced that the project would take off, even in its initial limited form.<sup>29</sup> AFTA was originally designed to lower tariffs on manufactured goods and

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<sup>25</sup> Ravenhill (2002:235)

<sup>26</sup> "APEC out of touch, say businessmen." *The Straits Times*. 10/22/2003

<sup>27</sup> Ravenhill (2002:241)

<sup>28</sup> The six founding members of AFTA are Brunei, Indonesia, Malaysia, the Philippines, Singapore and Thailand. The new members of ASEAN (Vietnam, Laos, Myanmar and Cambodia) acceded to AFTA upon joining ASEAN.

<sup>29</sup> "Delegate: Thai proposal not viable," *New Straits Times*. 7/25/1991

processed agricultural products to between 0-5 percent by 2008 over a fifteen-year period beginning in January 1992. Critics charged that the economic incentives necessary to sustain a free trade area in ASEAN were insufficient since member countries were not natural trading partners and were instead far more closely linked through trade and investment flows with non-ASEAN countries. In 1990, intra-ASEAN exports among the six members constituted about 20 percent of their total trade while their exports to non-ASEAN industrialized countries totaled 58 percent of total exports.<sup>30</sup> Surprisingly, in view of these economic realities, the AFTA project was sustained, its pace accelerated and its scope expanded from what was initially planned. Its six founding members agreed to reduce tariffs on all manufactured goods and processed agricultural products to 0-5 percent by 2002 and to zero by 2010. Regional liberalization was expanded to include unprocessed agricultural products, services and investment, all potentially contentious issue areas that member governments had initially excluded from the liberalization agenda.

Why were ASEAN governments more forthcoming with respect to regional liberalization in ASEAN than they were toward APEC? The answer lies in how ASEAN officials and leaders interpreted the shifts in global FDI flows that were taking place at that time and what role they saw for a project like AFTA in responding to these shifts. By the end of 1992, ASEAN leaders had become anxious that large-scale diversion of FDI from the region would disrupt economic growth, which was and remains the basis of social stability and political legitimacy in the ASEAN states. In the early 1990s, each of the five original ASEAN members faced falling applications for foreign investment approvals.<sup>31</sup> ASEAN's share of global FDI flows also declined from a high of 35 percent in 1990 to 24.3 percent by 1992. ASEAN officials and leaders were disturbed by these FDI trends, particularly because by now FDI had become a crucial source of growth for their economies. In reality, as Table 6.5 reveals, the FDI situation was not that dire. However, the interpretation of these trends by officials and leaders served as the crucial determinant of the decision to form AFTA. Decision-makers act not in response to an "objective situational structure" but to their interpretations of it.<sup>32</sup>

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<sup>30</sup> Calculated from the IMF (1996)

<sup>31</sup> For details, see Nesadurai (2003:82-87)

<sup>32</sup> Beckert (1999:14)

**Table 6.5: Flows of FDI to host region/economy, 1983-1998 (US\$ million)**<sup>33</sup>

	Total FDI flows	Industrial countries	All developing countries	ASEAN countries*	(%)	China	(%)
1983-88	91,554	71,779	19,757	3,708	5.2	1,823	2.5
1988	159,101	131,313	27,772	6,991	25.2	3,194	11.5
1989	200,612	171,722	28,622	7,591	26.5	3,393	11.9
1990	211,425	176,436	34,689	12,158	35.0	3,487	10.1
1991	158,936	114,792	41,696	13,400	32.1	4,366	10.5
1992	173,761	119,692	49,625	12,074	24.3	11,156	22.5
1993	219,421	133,850	78,813	15,994	20.3	27,515	34.9
1994	253,506	146,379	101,196	19,681	19.4	33,787	33.4
1995	328,862	208,372	106,224	21,643	20.4	35,849	33.7
1996	358,869	211,120	135,343	25,980	19.2	40,180	29.7
1997	464,341	273,276	172,533	27,813	16.1	44,236	25.6
1998	643,879	460,431	165,936	21,400	12.9	45,460	27.4

\* Includes all ten ASEAN member economies

Note: Percentage figures refer to investment flows as a proportion of total flows to developing countries.

ASEAN officials and leaders were deeply concerned by how foreign investors were eyeing the large regional markets being constructed in North America and Western Europe around this time. They had become familiar with a growing number of reports that identified diversion of FDI from ASEAN as the main outcome of regional free trade schemes in North America (NAFTA, the North American Free Trade Agreement) and Western Europe (the Single European Market).<sup>34</sup> They interpreted these new patterns of global FDI flows in terms of an FDI “crisis” that threatened their own economies. Additionally, these same studies helped persuade officials and leaders that *regional* collaboration was the most logical response to the “crisis” rather than relying solely on unilateral strategies by individual member states. The views of the ASEAN leaders can be summed up in the words of Thailand’s Prime Minister in 1993, Chuan Leekpai, who cautioned, “The possible diversion of direct foreign investment to emerging groupings such as the Single European Market and NAFTA is a perpetual reminder that smaller countries have to unite.”<sup>35</sup> As a result of its renewed economic reform effort in 1992, China too came to

<sup>33</sup> UNCTAD, World Investment Report, 1999; ASEAN Secretariat (1999a:131-132)

<sup>34</sup> Means (1995).

<sup>35</sup> “Stepped-up liberalization of trade can be expected: Chuan.” Business Times. 1/8/1993

be seen as a direct competitor with ASEAN for foreign investors seeking attractive investment and production sites in the Asia-Pacific region. For ASEAN officials and leaders, therefore, the most compelling argument advanced for adopting AFTA was its capacity to attract FDI to the region.<sup>36</sup>

By the late 1980s, multinational corporations (MNCs) were increasingly establishing “complete and integrated production and management systems within definable regions”.<sup>37</sup> Their new “global” strategy was to set up similar production networks in three different regions of the world economy – Europe, North America, and the Asia-Pacific.<sup>38</sup> ASEAN policy-makers were convinced that AFTA offered them a way to tap into this new regional logic of global capital. They hoped to provide global investors with a regional production space in the Asia-Pacific that could supplement or even supplant other locations, China in particular. It was not expansion of trade *per se* that officials and leaders were seeking. Rather, they hoped that an increase in foreign investment in the region would be catalyzed by the creation of a large geographical economic space to which investors would consider (re)locating their production processes.

Despite their readiness to establish AFTA as an instrument through which to attract FDI to the region, the ASEAN governments did not create binding rules and institutions to enforce their liberalization commitments. In line with long-held practice during the preceding 25 years of ASEAN, member governments opted for limited institutional mechanisms to support regional liberalization.<sup>39</sup> This approach also secured the interests of powerful domestic groups that could be hurt by regional liberalization. It was only later, in the mid-1990s when implementation of the first set of AFTA commitments was due and member governments began backtracking on offers, that ASEAN adopted new rules and binding protocols to govern regional liberalization. Setbacks in implementation set in motion a series of negotiations between member countries over the terms of liberalization, which eventually led to a compromise – the downward revision of original targets coupled with the elaboration of new rules to govern liberalization.<sup>40</sup> The former measure allowed affected member governments to assuage dominant domestic coalitions in their respective states that would have been adversely affected by AFTA-based liberalization. These domes-

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<sup>36</sup> Akrasanee and Stifel (1992)

<sup>37</sup> Rodan (1993:234)

<sup>38</sup> Ng and Sudo (1991) and Oman (1994)

<sup>39</sup> On the path dependence of institutional development in ASEAN, see Khong and Nesadurai (2007)

<sup>40</sup> See Nesadurai (2003:151-170) for details.

tic groups were mostly involved in the agricultural sector (specifically cloves, wheat, rice and sugar), petrochemical products and automobiles.<sup>41</sup> Revising the original liberalization targets downwards, therefore, helped to keep these ASEAN members on board the project. The adoption of a set of clearer rules and procedures, on the other hand, helped institutionalize the liberalization process. The new rules also signaled to investors ASEAN's continued commitment to the regional free trade area.

These compromises, far from being detrimental to AFTA, were important to its continuation despite being a 'second-best' outcome. Otherwise, officials conceded that the project would have been in danger of collapsing.<sup>42</sup> Instead, the end of 2002 saw the successful conclusion of the first phase of AFTA, with tariffs on 99 percent of all products traded within the region set below the targeted 5 percent, comprising US\$1.4 billion of tariffs.<sup>43</sup> Sensitive agricultural products followed a delayed schedule while Malaysian automobiles were exempted until 2005 when they became subject to AFTA tariff reduction schedules. Moreover, the extended deadlines have helped maintain the participation of ASEAN's newest members: Vietnam, Laos, Myanmar and Cambodia.

AFTA had a limited impact on intra-ASEAN trade, which rose to about 25 percent of ASEAN's total trade in 2002 from the pre-AFTA average level of 20 percent.<sup>44</sup> On the other hand, investor interest in the newly emerging single Southeast Asian market increased significantly.<sup>45</sup> The growth of regional production networks across Southeast Asia involving two or more member countries reflects growing business interest in the regional market, with these networks especially prominent in electronic and electrical products, telecommunications equipment, automobiles and food manufacturing.<sup>46</sup> The emerging regional division of labor is also reflected in the growing proportion of intra-industry trade within the region. Trade in intermediate inputs now accounts for a growing proportion of total intra-

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<sup>41</sup> See Nesadurai (2003:128-150) for a discussion of the different domestic lobbies resisting AFTA liberalization.

<sup>42</sup> Reported in Nesadurai (2003:154-158).

<sup>43</sup> From ASEAN Secretariat (2004:17) Also see the statement by ASEAN Secretary General, Ong Keng Yong in "Pacific nations rush to sign free trade pacts." *International Herald Tribune*. 3/12/2005.

<sup>44</sup> Intra-ASEAN trade has, however, grown slightly faster than ASEAN's trade with the rest of the world.

<sup>45</sup> See Baldwin (1997:126), ASEAN Secretariat (1999:16), and "Are Japanese businesses leaving for China?" *The Straits Times*. 9/15/2002.

<sup>46</sup> ASEAN Secretariat (1999:16), Felker (2004)

ASEAN trade, especially in the all-important electrical, electronics and telecommunications equipment sectors, which together account for 45 per cent of total intra-ASEAN trade.<sup>47</sup> Recent studies reveal a high degree of regional integration in these sectors with AFTA cited as one factor that explains this trend.<sup>48</sup>

Despite these trends, many regional businesses do not take advantage of AFTA tariff preferences due to the high administrative costs of doing so. In addition, market fragmentation persists due to differences in domestic business regulations, divergent product standards and weaknesses in customs clearance.<sup>49</sup> Consequently, ASEAN's aim to offer investors a single regional market as an alternative regional production site to China remains only partially realized. Unsurprisingly, business groups such as the U.S.-ASEAN Business Council and the ASEAN Business Advisory Council have been lobbying ASEAN members to hasten the process of deep integration.<sup>50</sup> This prompted the adoption of the AEC project in 2003, which is driven by the same FDI logic that drove regional market creation under AFTA. The AEC, however, aims to surpass AFTA by consolidating regional liberalization in services and investment, further reducing non-tariff barriers, harmonizing product standards, and allowing for the limited movement of skilled and professional workers within Southeast Asia.<sup>51</sup> Its ultimate goal is to achieve by 2020 a "seamless" and integrated Southeast Asian market and production base that can act as a magnet for investments through its combined population of 500 million people and its combined GDP of US\$685 billion.<sup>52</sup> Under the AEC, member states have formulated a fast-track integration program for eleven priority sectors and established new institutional mechanisms to hasten the resolution of complaints and enhance the dispute settlement process.<sup>53</sup>

There is clearly strong recognition among the ASEAN states that regional economic integration is necessary if they are to remain an attractive destination for investment.<sup>54</sup> Much, however, will depend on how national

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<sup>47</sup> Rajan (2004)

<sup>48</sup> Austria (2004:xxxiv)

<sup>49</sup> Tongzon (2005)

<sup>50</sup> U.S.-ASEAN Business Council (2004). Brunei: regional leaders laud ASEAN's BAC efforts. *Borneo Bulletin*. 10/13/2003

<sup>51</sup> ASEAN (2003)

<sup>52</sup> Hew (2005:4)

<sup>53</sup> For details, see ASEAN (2004)

<sup>54</sup> Ramos (2005), Tongzon (2005:145)

governments balance competing domestic interests and socioeconomic priorities when making and implementing their liberalization commitments, no easy task given that ASEAN includes countries representing vastly different levels of development. Governments are conscious of the potential domestic upheavals that are likely to result from an overly rapid pace of regional liberalization. There are also national aspirations to develop local entrepreneurs and firms, which leads governments to be wary of opening up too fast, lest foreign firms and multinationals wipe out fledgling domestic firms. Hence, ASEAN is now contemplating flexible modalities for the AEC to take account of these remaining domestic sensitivities. However, members keen for a faster pace of liberalization, notably Singapore, have expressed frustration with the regional liberalization process and embraced bilateral trade agreements as a way to ensure continued access to export markets and new sources of investment.

### 6.3.3 Bilateralism and Other Arrangements

Although Singapore's embrace of bilateral arrangements is partly due to the slow pace of ASEAN economic integration, it was initially prompted by expectations that the 1999 WTO Ministerial Conference in Seattle would fail.<sup>55</sup> Singapore is the most active proponent of the bilateral instrument, having concluded nine different FTAs<sup>56</sup> while negotiations with 11 states, mostly in the Middle East, are ongoing.<sup>57</sup> Singapore's signing of these trade deals, especially with major markets such as the U.S. and Japan, has prompted other ASEAN countries, initially critical of bilateral deals, to do the same to avoid being left out of key export markets, especially with the stalemate at the WTO.<sup>58</sup> Thailand has signed or is pursuing agreements with the U.S., New Zealand, Australia, China, and Japan. Malaysia has concluded talks with Japan and begun talks with the U.S.

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<sup>55</sup> Desker (2004:15)

<sup>56</sup> Singapore has agreements with Australia, New Zealand, Japan, South Korea, the U.S., the European Free Trade Association, India, Jordan and a Trans-Pacific agreement with Brunei, New Zealand and Chile.

<sup>57</sup> Ministry of Trade and Industry, Singapore. (<http://app.fta.gov.sg/asp/index.asp>, accessed 11/29/2005).

<sup>58</sup> Other political/strategic motivations are also behind the spurt in bilateral deals negotiated by Southeast Asian countries. See Dieter (2005). See also Aggarwal and Urata (2006).

Despite its embrace of bilateralism, even Singapore remains convinced that ASEAN economic integration is crucial for small economies.<sup>59</sup> In fact, Singapore was the first country to propose the AEC amidst strong concerns that China posed a threat to the ASEAN economies as an alternative location for investment and production. This is why China's November 2000 proposal for an FTA with ASEAN met with deep reservations on the part of many ASEAN members concerned with the implications for their economies of liberalizing trade with China, their main economic competitor.<sup>60</sup>

Despite their reservations, ASEAN formally endorsed the ASEAN-China FTA in November 2001. It would not only have been difficult for ASEAN to reject the Chinese proposal given its strategic interest in engaging China, but the ASEAN leaders also came to appreciate the economic advantages of closer integration with China. However, a fully operational FTA will not exist until 2010 at the earliest in order to help ASEAN consolidate itself as a fully integrated regional site for production, and for domestic industries to make the transition to competing first in ASEAN.<sup>61</sup> ASEAN and China are already increasingly integrated through intra-industry trade in certain sectors. For instance, the share of parts and components in ASEAN's exports of machinery and transport equipment to China is now at a high of around 62 percent while these items also constitute 50 percent of ASEAN's imports in this category, having risen from between 20-25 percent in 1990.<sup>62</sup> As with the Chinese case, ASEAN's pursuit of bilateral trade arrangements with India, Japan, South Korea and the Australia-New Zealand grouping has been prompted largely by the economic gains these links are expected to offer ASEAN (markets, investment, inputs) although strategic considerations are not unimportant.

### **6.3.4 The Asian Financial Crisis, APT and Regional Financial Cooperation**

Aside from cooperation in economics and trade, the Southeast Asian states have also embarked on a number of rather novel projects in regional financial cooperation. However, financial cooperation has been launched under

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<sup>59</sup> Speech by Singapore Prime Minister, Lee Hsien Loong delivered in Tokyo at the 11th International Conference on The Future of Asia. Reported in: "The way ahead in East Asian cooperation." *The Straits Times*. 5/26/2005

<sup>60</sup> "All eyes on China push for FTA." *Business Times* (Singapore). 11/24/2000

<sup>61</sup> Nesadurai (2003:180-181)

<sup>62</sup> Athukorala (2005)

the auspices of APT rather than ASEAN. APT cooperation emerged gradually out of a series of ad-hoc discussions held between the ASEAN governments and Japan, China and South Korea beginning in 1996 to prepare the Asian agenda for the Asia-Europe Meeting (ASEM).<sup>63</sup> By 1999 when leaders issued the *Joint Statement on East Asia Cooperation* at the Third APT Summit in Manila, ASEAN had already recognized that its prosperity was tied closely to Northeast Asia, thus making APT an increasingly important component of the regional economic architecture.<sup>64</sup> Although APT aspires to a fairly comprehensive agenda,<sup>65</sup> it is in the financial realm that APT has displayed its most concrete cooperative outcomes to date.

In May 2000, the APT Finance Ministers' Meeting initiated the Chiang Mai Initiative, a regional liquidity facility that is aimed at pooling participating members' foreign exchange reserves to provide emergency financing in the event of a speculative attack on a member's currency. The primary impetus for this project was the 1997-98 Asian financial crisis, which revealed to policymakers in both Southeast Asia and Northeast Asia the importance of having some form of *regional* capability in providing timely and adequate financing to support currencies in crises. The financial crisis also revealed to regional policymakers how the lack of effective regional emergency response mechanisms led to over-reliance on the IMF and external parties like the United States. Political motivations regarding the dismantling of the East Asian developmental state then influenced the way these parties designed crisis assistance policies, which exacerbated rather than directly addressed the crisis.<sup>66</sup> The hesitant approach adopted by the international community to East Asian demands to reform the international financial architecture also meant that the systemic vulnerabilities associated with minimally regulated global financial markets would persist. This encouraged the East Asian governments to consider regional solutions rather than rely on global ones that did not appear to be forthcoming. These governments were also aware that another contagion would need resources beyond the IMF's limited pool.<sup>67</sup> Consequently, they were very

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<sup>63</sup> Stubbs (2002:443)

<sup>64</sup> See the summary document: ASEAN Plus Three Cooperation. ASEAN Secretariat. <http://www.aseansec.org.16581.htm>. Accessed 9/7/2005

<sup>65</sup> These are detailed in: Final Report of the East Asia Study Group. Adopted at the November 2002 Summit of the ASEAN+3. <http://www.aseansec.org/viewpdf.asp?file=/pdf/easg.pdf>. Accessed 10/18/2005

<sup>66</sup> Hall (2003)

<sup>67</sup> Grenville (2001)

determined to develop a self-help capability to manage future currency and financial crises.<sup>68</sup>

These governments explicitly acknowledged the APT as the most effective site from which to launch such initiatives. The Southeast Asian countries realized that ASEAN did not have the necessary resources to provide members with the capacity to effectively respond to future currency attacks.<sup>69</sup> Although APEC possessed the resources and expertise to support such activities, it was unwilling to take on this task. The East Asian states were also skeptical that Washington would act in disinterested fashion, further undermining their trust in APEC.<sup>70</sup> It is not surprising that the APT rather than APEC or ASEAN emerged as the key site for the CMI.

The bulk of funds for the CMI come from the network of bilateral swap arrangements negotiated between different pairs of APT countries. Bilateral arrangements were needed due to the difficulties associated with negotiating a multilateral arrangement among countries holding vastly different amounts of foreign exchange reserves. Nevertheless, by December 2004, available funds totaled US\$36.5 billion, with individual countries able to draw on between US\$1-3 billion for up to 90 days, renewable for two years.<sup>71</sup> A year later, the total CMI funding pool had sharply increased to US\$54.5 billion, following a series of measures announced in May 2005 to improve the facility's effectiveness.<sup>72</sup> By May 2006, the total funding pool had reached US\$77 billion (see Table 6.6).

Japan's role has been critical to the CMI. The Japanese finance ministry had been responsible for proposing the arrangement and later for its design.<sup>73</sup> With the largest pool of foreign currency reserves at the time the CMI was launched, Tokyo was also able to get the CMI project off the ground quickly by concluding the first four bilateral swaps with Korea, Malaysia, the Philippines and Thailand within a year and a swap arrangement with China in March 2002. Although it was not a major proponent of the project, China has also used its large pool of foreign reserves to conclude a total of five bilateral swap arrangements by the end of 2003 com-

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<sup>68</sup> PECC (2002)

<sup>69</sup> Speech by the Malaysian foreign minister, Syed Hamid Albar at the opening of the 33rd ASEAN Ministerial Meeting, July 2000. <http://www.aseansec.org/4086.htm>. Accessed 10/13/2005

<sup>70</sup> Amyx (2004, 2005)

<sup>71</sup> See the 'Joint Ministerial Statement of the ASEAN+3 Finance Ministers Meeting', Jeju, Korea, May 15, 2004. <http://www.aseansec.org/16116.htm>

<sup>72</sup> For details of these measures, see Nesadurai (2006).

<sup>73</sup> Amyx (2005:3)

pared to Japan's seven. Only Japan and China had been in a position to

**Table 6.6: The Chiang Mai Initiative (as of May 2006)**<sup>74</sup>

Bilateral Swap Agreements (BSAs)	Swap Direction	Swap Size (US\$ billion)	Total Funds Available (US\$ billion)
Japan-Korea	2-way	3.0	6.0
Japan-Korea	1-way	10.0	10.0
Korea-Japan	1-way	5.0	5.0
Japan-China	2-way	3.0	6.0
Japan-Thailand	1-way	3.0	6.0
Japan-Philippines	1-way	6.0	6.0
Philippines-Japan	1-way	0.5	0.5
Japan-Malaysia	1-way	1.0	1.0
Japan-Indonesia	1-way	6.0	6.0
Japan-Singapore	1-way	3.0	3.0
Singapore-Japan	1-way	1.0	1.0
China-Korea	2-way	4.0	8.0
China-Indonesia	1-way	2.0	2.0
China-Philippines	1-way	1.0	1.0
China-Malaysia*	1-way	1.5	1.5
China-Thailand*	1-way	2.0	2.0
Korea-Thailand	2-way	1.0	2.0
Korea-Malaysia	2-way	1.5	3.0
Korea-Philippines	2-way	1.5	3.0
Korea-Indonesia	2-way	1.0	2.0
<b>TOTAL BSAs</b>			<b>75.0</b>
<b>ASEAN Swap Arrangement</b>	Among ASEAN-10		<b>2.0</b>
<b>TOTAL FUNDS</b>			<b>77.0</b>

\*These swaps have expired and will be extended

take on the role of lender in these bilateral swap arrangements given their vast foreign currency reserves relative to other APT members at the time the project was initiated. With its reserve position vastly improved by 2004, South Korea too has emerged as a key lending country in the CMI. The distribution of international reserves among the East Asian states ex-

<sup>74</sup> Table compiled from information from the Bank of Japan  
[http://www.boj.or.jp/en/type/release/zuji\\_news/data/un0605a.pdf](http://www.boj.or.jp/en/type/release/zuji_news/data/un0605a.pdf).  
 Accessed 11/23/2006

plains why the CMI could never have been adopted under the auspices of ASEAN alone (see Table 6.7).

**Table 6.7: Foreign exchange reserve holdings of East Asian countries (billions of US\$)<sup>75</sup>**

Country/Region	1995	2000	2002	2004
Japan	183.3	354.9	461.2	820.8
China	75.4	168.3	291.1	500.6
South Korea	32.7	96.1	121.3	174.4
Hong Kong	55.4	107.5	111.9	118.2
Singapore	68.7	80.1	82.0	101.1
Indonesia	13.7	28.5	31.0	35.0
Malaysia	23.8	29.5	34.2	54.2
Philippines	6.4	13.0	13.1	12.7
Thailand	36.0	32.0	38.0	43.7
<b>East Asian-9</b>	<b>495.4</b>	<b>909.9</b>	<b>1183.8</b>	<b>1860.7</b>
<b>World Total</b>	<b>932.5</b>	<b>2028.8</b>	<b>2525.1</b>	<b>3517.0</b>

Although China and Japan have historically been rivals, Sino-Japanese tensions have yet to derail cooperation on the CMI. Interestingly, the May 2005 decision to embark on a series of measures to advance the CMI was reached during a time when relations between the two countries were at their lowest in three decades. The perceived necessity of this project prompted Japanese finance minister Sadakazu Tanigaki to note, “Whatever happens, we need to promote financial cooperation even if there are [political] issues.”<sup>76</sup> The APT members, China included, also value the capacity-building activities linked to the CMI and the ABMI, the APT’s bond market initiative, both of which aid member states in developing the necessary infrastructure to support efficient financial systems and bond markets.<sup>77</sup> This kind of functional cooperation, moreover, takes place at the trans-governmental level among officials of central banks and finance ministries who have maintained good working relations over a period of

<sup>75</sup> Kawai and Motonishi (2004:223)

<sup>76</sup> “Three Asian giants join forces to fight currency attacks.” *The Straits Times*, 5/5/2005.

<sup>77</sup> Amyx (2004)

time and share common goals with respect to regional financial cooperation.<sup>78</sup> In such circumstances, political differences and historical rivalries are unlikely to disrupt APT cooperation in finance, especially since the economic benefits are quite clear to all parties. In contrast, differences between Japan and China over the membership of the EAS held in December 2005 in Kuala Lumpur could well impede attempts to put in place any institutional framework for an “East Asian community”, especially if its economic gains are poorly defined such that interstate rivalries and political differences are able to overwhelm the project.<sup>79</sup>

## 6.4 Implications of Southeast Asia's New Institutional Arrangements

What are the implications of this array of new institutional arrangements that the Southeast Asian countries have put together to govern their trade and financial relations since the 1990s? The emerging regional economic architecture is characterized by the following features:

1. Economic integration undertaken at the ASEAN level;
2. Financial cooperation undertaken at the APT level;
3. A slew of bilateral economic arrangements, ranging from those at the ASEAN +1 level, to those between individual ASEAN member countries with one or another of the Northeast Asian states or with outside third parties;
4. An emerging institution centered on a distinct *East Asian* rather than an APT configuration; and
5. A trans-Pacific institutional arrangement centered on APEC.

How do we interpret these trends, and what are their implications for both the regional and world political economies? One key point to note is that both the ASEAN and APT institutional levels remain important. They fulfill distinct economic functions and should not be seen in zero-sum terms as competing institutions. Both these institutions will remain key to meeting Southeast Asia's economic and financial needs. While ASEAN economic integration remains vital to its members as an instrument to ensure regional economies remain attractive to global investment capital, especially in competition with China, the APT is the most logical level at

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<sup>78</sup> Author's interview with a senior ADB official in Singapore. 11/11/2005

<sup>79</sup> “Japan, China clash over East Asian Summit.” The Daily Yomiuri, 11/25/2005

which to develop a regional liquidity mechanism given the vast financial resources available in the Northeast Asian countries and the unattractiveness of APEC as a setting for such a project. APT also supports efforts in regional bond market development, which, if successful, can help to channel the region's considerable savings for use within the region.<sup>80</sup>

In the case of ASEAN economic integration, the geographically concentrated nature of this arrangement is important because the aim is to create a regional market not only in terms of size (GDP, population) but also in terms of a geographically contiguous space. Geographic contiguity facilitates regionalized production networks and allows them to take advantage of the full range of economic complementarities existing within that geographic space. The setbacks encountered in trade liberalization notwithstanding, all the ASEAN governments accept that regional integration enables small economies to better position themselves to attract global investment. Progress thus far may be slow, but perceptions of China soaking up investment could well act as a fillip to the integration process.

The APT, on the other hand, will remain focused on financial cooperation for the foreseeable future. Apart from financial cooperation, the APT has yet to see concrete progress in other areas earmarked for cooperation. Negotiating an APT-wide free trade area, as some have suggested, will be a formidable task given different levels of development, diverse special interest groups, and other political sensitivities. The divisions that will hinder an APT-wide free trade area, in fact, reflect the same divisions in the WTO over agriculture, investment and services that have stalemated global trade talks since the Seattle debacle.<sup>81</sup> As already noted, stalemate at the WTO is one reason why bilateral FTAs have mushroomed in the region. Bilateral FTAs cannot, however, replace ASEAN-wide liberalization given the reality of transnational production networks spread out across ASEAN.

Prospects for the formation of an East Asian community remain somewhat dim, notwithstanding Malaysia's hosting of the first East Asia Summit in December 2005. Although the Summit itself went smoothly, it is likely that an East Asian Community will take some time to evolve into something more concrete, especially given the diversity of its membership (all the ASEAN-10, the three Northeast Asian states, India, Australia and New Zealand) and the deep rivalries between some of these members, reflected in the difficulties experienced in drafting a joint leaders' declaration for the 2005 Summit.<sup>82</sup> The major point of contention was the form of

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<sup>80</sup> Amyx (2005)

<sup>81</sup> Desker (2004:16)

<sup>82</sup> Japan, China clash over East Asian summit. *The Daily Yomiuri*. 11/25/2005

a future East Asian Community, with China and some ASEAN countries eager for East Asian regionalism to be built on the APT while Japan preferred the broader EAS as a foundation instead. For Japan, the presence of India and Australia would help balance China within the grouping. These difficulties suggest that even if held regularly, the EAS will likely end up as a dialogue mechanism for its current 16 participants for the foreseeable future while more substantive areas of cooperation, such as financial cooperation, will be continued under the APT framework.

APEC is highly unlikely to assume a significant place in the region's economic landscape, particularly with the U.S. taking APEC into counter-terrorism activities and trade security initiatives. Nevertheless, APEC will not become marginal to the region's economic needs, either. Its continued focus on regional capacity building through its various programs in trade facilitation and economic and technical cooperation contributes to ongoing regional efforts to build the regulatory and institutional infrastructure badly needed for effectively governing globalizing economies.

As for their implications for the world economy, both ASEAN economic integration and APT financial cooperation, the central planks in the emerging regional economic architecture, are supportive of rather than detrimental to the global economy. These institutional arrangements were instituted primarily to enhance the ability of member economies to participate in the global economy while minimizing the risks of doing so. Moreover, the rules that are being put in place in both these projects are essentially liberal rules that endorse the market mechanism and open markets.

It is the embrace of bilateral agreements between two countries that is more threatening to multilateralism as well as to regionalism. Bilateralism also undermines business efficiency, as it is institutionally incongruent with the regional production networks that are now emerging across the region. This raises transaction costs for firms operating in countries that have signed multiple bilateral agreements since each agreement imposes its own rules of origin and schedule for liberalization. A bilateral agreement can penalize firms for their existing production networks if these firms already source their inputs from countries outside the bilateral framework. It is for this reason that the U.S.-Singapore Free Trade Agreement incorporated a provision called the Integrated Sourcing Initiative, which extended the juridical reach of the free trade area to include two Indonesian islands, Batam and Bintan, for the category of electronics and information technology items. Because production of final goods in this crucial sector in Singapore involves extensive use of components produced on Bintan and Batam, strict rules of origin under the bilateral FTA would have excluded Singapore-made final products from the U.S. market unless crucial portions of Singapore's production space that extended outside the

country were included within the ambit of the bilateral agreement. However worrisome the bilateral trend is, it will remain attractive to regional states seeking to lock in access to major trading partners and new sources of markets and investment so long as global trade talks remain in limbo.

## 6.5 Conclusion

The institutional bargaining approach adopted in this chapter identifies an external shock as the primary impetus for the shift to a new institutional equilibrium, with three further factors shaping preferences towards regionalism. These include the international position of the state(s), the composition of domestic coalitions, as well as elite beliefs and ideologies. As the discussion in this chapter has shown, these factors were brought together in unique ways that determined the shape of Southeast Asia's new institutional architecture for cooperation in economics and finance. Although it would be unwise to attempt to disentangle the complex interplay of these factors and identify one or another that was important for encouraging economic and financial regionalism, it is possible to make the case that external shocks and the international position of these states were primarily responsible for promoting the search for new institutional mechanisms.

In particular, it was when external shocks were seen to threaten countries' economic growth that institutional change became possible. The analysis revealed how growing elite perceptions of a foreign investment "crisis" were responsible for the establishment of AFTA in 1992 and also accounts for subsequent moves to expand the AFTA agenda and enhance its implementation as well as adopt the ASEAN Economic Community project in 2003. AFTA and the AEC represent strategies by which member governments in Southeast Asia have sought to create a single integrated market out of individually small markets in order to counter the perceived threat of foreign investment diversion from their countries to other large markets, especially China. The need to secure access to markets and investment also accounts for the turn by a number of Southeast Asian countries to bilateral FTAs since the late 1990s as insurance policies given the ongoing stalemate at the WTO. A further external driver of new institutional arrangements in Southeast Asia was the 1997-98 Asian financial crisis, which prompted strong interest within ASEAN to build regional capabilities for preventing and responding to future crises that ASEAN policymakers believed to be inevitable if global financial markets remained weakly regulated. However, this required the help of ASEAN's richer Northeast Asian neighbors, especially Japan and China with their considerably larger financial reserves and explains why financial cooperation proceeded under the auspices of APT rather than ASEAN. The Sep-

tember 11 terrorist attacks had minimal effects on Southeast Asia's drive toward economic and financial cooperation but did provide a boost for APEC, renewing Washington's interest in the organization as the site for a variety of trade security initiatives, including counterterrorism.

Additional leverage in explaining institutional choice and design in these cases is provided by the prevailing context facing Southeast Asia's policymakers—namely their beliefs and cognitive frameworks as well as the nature of domestic distributional coalitions. To the extent that domestic interests posed a barrier to regional cooperation, these were usually accommodated through designing regional institutions in ways that allowed national governments a good deal of leeway in terms of their regional commitments. Although APEC is the classic example, even AFTA was initially designed to be highly flexible although the project later saw institutional strengthening through rule building. The AEC is also designed to balance countries' domestic priorities and interests with their regional commitments. Such measures suggest that ASEAN governments were willing to compromise, to some extent, the interests of protectionist domestic coalitions in order to ensure that economic growth is not disrupted. Unlike AFTA, domestic protectionist interests did not hamper APT financial cooperation.

This discussion also highlighted the central role played by elites' interpretations of external events. Because growth remains a central basis of political legitimacy in Southeast Asia and acts as a guarantor of domestic regime security, particularly in the semi-democratic or soft authoritarian political systems found in much of Southeast Asia, external shocks and events are always interpreted through the prism of what they mean for growth. How events are construed in terms of their potential to disrupt economic growth provides the political space for members to initiate new institutions as well as review the design of existing ones.

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# 7. Southeast Asia's New Security Institutions

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## 7.1 Introduction

Southeast Asian countries have traditionally relied on a variety of overlapping arrangements to guarantee their individual and common security. The security institutional equilibrium in Southeast Asia and beyond has consisted of formal and tacit bilateral alliances linking regional states to external players. These alliances are complemented by a series of multi-lateral arrangements adopting a more comprehensive and cooperative approach to security.<sup>2</sup> Bilateral defense ties, primarily with the United States, have remained central to the regional strategic architecture. Coexisting with and complementing such bilateral links, the Association of Southeast Asian Nations (ASEAN) and its region-wide initiatives have been at the core of the overlapping multilateral security structure. ASEAN has improved the climate of regional relations and contributed to conflict avoidance and management in Southeast Asia. Rejecting legal mechanisms, its model of security cooperation has traditionally relied on dialogue and consultation, the practices of self-restraint and consensus building, and the principles of national sovereignty and non-interference in the domestic affairs of other states.

This chapter examines the origins and evolution of the security institutional architecture both within and beyond Southeast Asia. Security and security relations in the region are at the core of the study, although attention is also given to the overlap and strategic interaction between security and trade issues in light of the 1997-98 financial crisis. This chapter offers

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<sup>1</sup> The author wishes to thank Beverley Loke for her research assistance, Jonathan Chow for organizing the workshops, and the editors and other contributors for their valuable comments on earlier drafts of this chapter.

<sup>2</sup> Emmers (2004)

typologies of security arrangements in Southeast and East Asia in the Cold War and post-Cold War eras. It then applies the institutional bargaining game approach developed in Chapter One by Aggarwal and Koo to both periods to examine the process by which some of the security arrangements have been created and developed. Particular attention is given to their origins in conjunction with specific regional and external shocks. Specifically, the analysis will focus on the policy of Confrontation and the New Order in Indonesia both during and after the Cold War, the 1997-98 Asian financial crisis, and the terror attacks in the United States and Bali in 2001 and 2002, respectively.

The chapter argues that the three external shocks faced by the region since 1989 have been pivotal in shaping the institutional security context of Southeast and East Asia today. It claims, however, that the institutional changes in the post-Cold War era have occurred with respect to geographical focus and issue scope rather than institutional strength. The institutional changes have primarily derived from a need to move beyond a subregional approach to security, as well as from a widening of the security agenda. In recent years, Southeast Asia's security environment has been characterized by a large number of institutions. Rather than surveying all the security institutions that have been attempted over the years, the chapter applies the institutional bargaining game to what are regarded as the three most important negotiated arrangements: ASEAN, including the ASEAN Security Community (ASC), the ASEAN Regional Forum (ARF), and the ASEAN Plus Three (APT). These three institutions are analyzed based on the number of actors involved, the degree to which such arrangements have been geographically concentrated or dispersed, and also their strength, nature, scope, and historical development. The final section of the chapter highlights key forces for change in the coming 10 to 15 years and explores possible outcomes in the development of security arrangements in Southeast Asia and beyond. The chapter considers the following variables and their effects on the institutional architecture: the U.S. presence in East Asia, China's role in the region, and regional dynamics in Southeast Asia. The conclusion offers a review of the general findings and reflects on the strengths and weaknesses of the current multilateral security structure in Southeast and East Asia.

## 7.2 The Cold War Institutional Equilibrium in Security

Table 7.1: Southeast Asian security arrangements during the Cold War

Strength	Number of Actors				
	Unilateral	Bilateral		Multilateral	
		<i>Geographically concentrated</i>	<i>Geographically dispersed</i>	<i>Geographically concentrated</i>	<i>Geographically dispersed</i>
<b>Strong</b>	Singapore's Poison-shrimp strategy	Vietnam-Laos Treaty of Friendship and Cooperation (1977)	US-Philippines Mutual Defense Treaty (1951)	ASEAN (1967)	UN (1945)
	Singapore's Total Defense Approach to National Security (1984)	Vietnam-Cambodia Treaty of Peace, Friendship and Cooperation (1978)	Soviet Union-Vietnamese Treaty of Friendship and Cooperation (1978)		
	Indonesia's Armed Forces and the Total People's Defense Doctrine				

**Table 7.1 (cont'd.): Southeast Asian security arrangements during the Cold War**

Strength	Number of Actors				
	Unilateral	Bilateral		Multilateral	
		<i>Geographically concentrated</i>	<i>Geographically dispersed</i>	<i>Geographically concentrated</i>	<i>Geographically dispersed</i>
<b>Weak</b>			Thai-US joint military exercise: Cobra Gold (1982)	Association of Southeast Asia (ASA) (1961)  Maphilindo (1963)	Southeast Asia Treaty Organization (SEATO) (1954)  Anglo-Malayan Defense Agreement (1965)  Five Power Defense Arrangements (1971)  ASEAN Post-Ministerial Conference (ASEAN-PMC) (1977)

### 7.2.1 Categories of Cold War Security Arrangements

Table 7.1 categorizes Southeast Asian security accords during the Cold War. Southeast Asian states sought to strengthen their individual armed forces to guarantee their security. Singapore, for example, built up its deterrence capabilities through the formation of a professional Singapore Armed Forces (SAF).<sup>3</sup> Yet most Southeast Asian states suffered from socioeconomic difficulties that reduced available means for ensuring their national security on a unilateral basis. Consequently, they often sought protection through bilateral agreements.

Although bilateral geographically concentrated arrangements were rare in Southeast Asia during this period, two are particularly relevant to note as they dominated the security relations of Laos and Cambodia. In July 1977 the Lao People's Democratic Republic signed a Treaty of Friendship and Cooperation with Hanoi, after which Vietnam stationed 40,000 troops in the country.<sup>4</sup> Following the Vietnamese invasion of Cambodia in December 1978, Phnom Penh signed a Treaty of Peace, Friendship, and Cooperation with Hanoi in February 1979.

Bilateral geographically dispersed arrangements played a key role in regional security. Singapore, the Philippines, Thailand, and to a lesser extent Brunei, Indonesia, and Malaysia saw the United States as a protector. The San Francisco System was applied to Southeast Asia through the U.S.-Philippine Mutual Defense Treaty of 1951. The U.S. had military bases in the Philippines and Thailand, both of which were indirectly involved in the Vietnam War. The Soviet Union also focused on bilateral agreements, including a Treaty of Friendship and Cooperation signed with Vietnam in November 1978.

The 1960s also witnessed attempts at creating minilateral geographically concentrated arrangements in Southeast Asia. The Association of Southeast Asia (ASA) was formed in Bangkok in July 1961 and included Malaya, the Philippines and Thailand. Its operations were interrupted in mid-1963. Maphilindo, a loose confederation involving Indonesia, Malaya, and the Philippines, was created in 1963 but collapsed due to the Indonesian Policy of Confrontation. ASEAN, established in 1967, was significantly more successful, as will be explained later in this chapter.<sup>5</sup>

Few minilateral geographically dispersed arrangements existed in Southeast Asia. The Southeast Asia Treaty Organization (SEATO) was

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<sup>3</sup> Huxley (2000)

<sup>4</sup> Ross (1988)

<sup>5</sup> See Acharya (2000, 2001); Broinowski (1990); Jorgensen-Dahl (1982); Leifer (1989); Simon (1982)

created in February 1955 as a result of the Southeast Asia Collective Defense Treaty (the Manila Pact) of September 1954. SEATO included Australia, Britain, France, New Zealand, Pakistan, the Philippines, Thailand, and the U.S., but never played an active military role. The Anglo-Malayan Defense Agreement was formed in 1957 and rested on a commitment by Britain to guarantee the external defense of Malaya. By 1965, it included Australia, Britain, Malaysia, New Zealand, and Singapore. It was replaced in 1971 by a consultative Five Power Defense Arrangements (FPDA) which was limited to a consultative role in the case of an external attack.

## 7.2.2 An Institutional Bargaining Game Approach

Applying the institutional bargaining game framework by Aggarwal and Koo in Chapter One (Fig. 7.1), this section focuses on the origin of ASEAN. The latter is the only successful example of a minilateral geographically concentrated security institution in Southeast Asia. Originally comprising Indonesia, Malaysia, the Philippines, Singapore and Thailand, ASEAN has expanded to include all ten Southeast Asian countries as of 1999. The nature of the Association has been to provide a framework for dialogue through which subregional peace and stability can be enhanced. ASEAN is no substitute for existing bilateral alliances, but it has differed in that its issue scope has gone beyond security. ASEAN's founding document, the 1967 Bangkok Declaration, stated its aims of "economic growth, social progress and cultural development in the region."<sup>6</sup> ASEAN remained a weak arrangement during its early years, but its significance and institutional strength increased as a result of the first ASEAN summit of heads of state and government held in Bali in February 1976, as well as ASEAN's diplomatic involvement in the Cambodian Conflict in the 1980s.

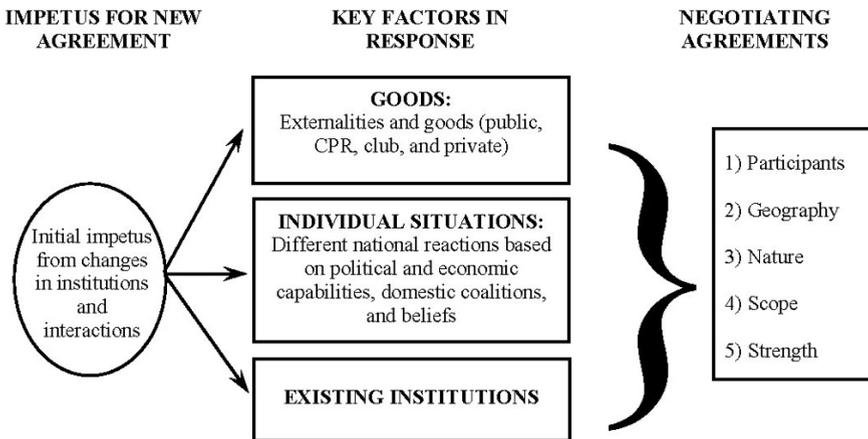
Having briefly described ASEAN's institutional trends in terms of geographical focus, nature, issue scope and strength, let us explain in more details the events that led it to assume these characteristics. A regional shock preceded the formation of ASEAN in 1967. In September 1963, Indonesian President Sukarno opposed the formation of the Federation of Malaysia and in response initiated a campaign known as Confrontation. The latter destroyed the viability of Maphilindo, an arrangement created through the Manila Agreement of 1963 and based on pan-Malay brotherhood. ASA had previously been established in 1961 but Sukarno had refused to take part because he viewed it as a Western-aligned organization. ASA's opera-

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<sup>6</sup> ASEAN (1967)

tions were interrupted in mid-1963 due to the steady deterioration of Malayan-Philippine relations over the Philippines' claim to Sabah.

Consequently, regional cooperation in Southeast Asia required a transformation in the political environment. This later emerged as a result of Sukarno's gradual political downfall and a change in Indonesia's political leadership. Lt. General Suharto assumed executive powers in March 1966 and initiated a new era in Indonesian politics known as the New Order. The new military leadership focused on domestic stability and economic development and adopted a pro-western and anti-communist political orientation. Simultaneously, the election of Ferdinand Marcos as president of the Philippines in November 1965 led to the normalization of relations with Malaysia in June 1966. This regional process of reconciliation explains why ASEAN eventually succeeded where other groupings had previously failed.



**Fig. 7.1: Origins of trade and security arrangements<sup>7</sup>**

In terms of the model, the good being demanded can be defined in terms of regional peace and stability. Most of the Southeast Asian governments tended to be authoritarian or inheritors of traditional political cultures that were authoritarian, patrimonial or hierarchical. These former colonies, with their newfound independence, held national sovereignty to be inviolate and sought to build the necessary state capacity to maintain it. The regional order was in a major state of flux since these newly independent states were divided by historical animosities and dissimilar security interests.

<sup>7</sup> Adapted from Aggarwal (1998)

During the Cold War, when its stated orientation was the containment of Soviet-led communist expansion, the U.S. adopted a strategy toward Southeast Asia that differed from its strategy in Europe. In Europe, the U.S. was able to forge an enduring collective alliance among states that shared a commitment to Western liberal political values and open trade regimes. In Southeast Asia, considering the antagonism amongst the Southeast Asian states and states' concerns about maintaining national sovereignty and territorial integrity, the United States implemented its policy of containment in the western Pacific through a series of bilateral and limited multilateral security treaties and pacts. To restrain any Soviet influence, the U.S. provided assistance to governments that could maintain order and control local communists or other perceived threats, even if that meant supporting authoritarian regimes. This arrangement suited the various incumbent governments in Southeast Asia that wanted to safeguard their authority and build state capacity. Consequently, for many Southeast Asian states, the U.S. presence during the Cold War provided a positive externality/good in the form of internal and regional stability. The U.S. had long been considered "the single most important player in ensuring the region's strategic equilibrium."<sup>8</sup> Yet the end of Confrontation and the new military regime in Jakarta stimulated the provision of regional security through a new institutional structure to supplement existing bilateral alliances.

Why did the Southeast Asian states deem it necessary to build ASEAN even though the U.S. military presence in the region provided internal and regional stability? In other words, why were the bilateral alliances viewed as insufficient to maintain regional stability and security? Here, we must turn to the domestic situations of ASEAN's founding members in the mid-1960s. In the post-Confrontation period, the Indonesian leadership needed to regain its neighbors' trust.<sup>9</sup> Jakarta wanted to attain rehabilitation at the regional level. It was keen to restore its credibility and persuade its neighbors that it should no longer be viewed as a source of threat. Moreover, it wished for a stable regional environment free from external intervention that would enhance domestic political stability and economic development. Malaysia was keen to end its standoff with Indonesia and to improve relations with neighboring states. To cooperate with a former aggressor to its newly obtained sovereignty was a calculated risk for Malaysia. ASEAN was viewed in Kuala Lumpur as an opportunity to institutionalize the end of confrontation with Indonesia and improve relations with other neighboring states. An amelioration of regional relations was also important for both Malaysia and Singapore in light of Britain's 1967 an-

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<sup>8</sup> De Castro (2000:62)

<sup>9</sup> Leifer (1989); Emmers (2003)

nouncement that it would withdraw all its military forces east of Suez. Singapore remained suspicious of Indonesia and Malaysia and wanted to register its newly obtained sovereignty.<sup>10</sup> Prime Minister Lee Kuan Yew wrote in his memoirs that "Singapore sought the understanding and support of its neighbors in enhancing stability and security in the region."<sup>11</sup> Thailand was reliant on the United States against its communist neighbors. Like Bangkok, Manila wanted to complement its defense ties with Washington by establishing a regional security arrangement that would improve the climate of relations in Southeast Asia. Moreover, the Philippines wanted to reaffirm its Southeast Asian identity and build better relations with its neighbors.

These domestic objectives led to the convergence of shared interests. This resulted primarily from a common emphasis on domestic sources of insecurity. The ASEAN states were being challenged domestically by insurgencies, including irredentist and separatist movements. By participating in ASEAN, they expected to gain from increased subregional stability, enabling them to pay closer attention to domestic development. The convergence of interests also resulted from similar regional concerns that originated from the fear of the long-term consequences of the American intervention in Vietnam and China's ambitions in Southeast Asia. Most participants were apprehensive of the declining U.S. power in the region. In short, the members viewed ASEAN as a diplomatic instrument to increase regional cooperation and consultation with the objective of improving domestic security. In that sense, the Association was perceived as complementary to the externality/good provided by the bilateral alliances.

In terms of political regimes and elite beliefs, the founding members were a group of conservative political regimes where the decision-making power was generally concentrated in the hands of an authoritarian ruler or a small group of political/military elites. The regimes suffered domestically from weak institutions and socioeconomic problems.<sup>12</sup> Domestic sources of insecurity, including irredentist and separatist movements, were threatening the survival of the political regimes. In terms of beliefs, elites expected that subregional stability would enable them to pay closer attention to domestic development. National and regional stability were thus regarded as indivisible. In contrast to the non-Communist Southeast Asian states, the Indochinese countries shared strong Marxist ideological affinities. The communist victories in Phnom Penh and Saigon in April 1975

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<sup>10</sup> Leifer (2000)

<sup>11</sup> Lee (2000:369)

<sup>12</sup> Suryadinata (1996)

and in Laos by the end of the year polarized the region along ideological lines.

With respect to the existing institutions, a minilateral geographically concentrated arrangement was regarded as complementary to bilateral alliances. That said, the founding members did not all agree on the role of external powers. The Philippines, Singapore, Thailand, and to a lesser extent Malaysia all relied on their close security ties with the U.S and regarded their security as dependent on extra-regional defense ties. By contrast, Indonesia believed in the development of domestic and regional capabilities to reduce external intervention. This ambivalence was later accommodated in the Zone of Peace, Freedom, and Neutrality (ZOPFAN) principle of 1971. It registered a call for regional autonomy but did not restrict the right of the ASEAN members to rely on defense links with external powers and host foreign bases on their territory.

In terms of institutional outcome, ASEAN is a minilateral geographically concentrated security institution. In terms of nature and issue scope, it has sought to improve the climate of relations and to operate as an instrument to avoid the recurrence of conflict in Southeast Asia. Essentially a confidence-building exercise, the arrangement has rejected military cooperation and focused instead on a comprehensive approach to security. Concluded at the 1976 Bali summit, the Treaty of Amity and Cooperation (TAC) in Southeast Asia has operated as a code of conduct for regulating interstate relations based on peaceful co-existence and the avoidance of conflict. The move toward an ASC will be discussed later in the chapter.

### **7.3 New Security Arrangements in the Post-“Triple Shocks” Period**

Table 7.2 categorizes various Southeast Asian security accords after the Cold War. States in the region have sought since 1989 to strengthen their individual armed forces to guarantee their security. They have aimed therefore to modernize their defense forces and acquire naval capabilities to patrol maritime claims. However, the 1997-98 East Asian financial crisis delayed modernization programs. New bilateral geographically concentrated arrangements have also been established. The Southeast Asian states have developed a network of overlapping bilateral collaborations known as the

**Table 7.2: Post-Cold War security arrangements in Southeast Asia**

Strength	Number of Actors			
	Unilateral	Bilateral		Multilateral
		<i>Geographically concentrated</i>	<i>Geographically dispersed</i>	
		<i>Geographically concentrated</i>	<i>Geographically dispersed</i>	<i>Geographically dispersed</i>
<b>Strong</b>	Modernization Program under "Armed Forces of the Philippines Modernization Act" (1995)			
	6 <sup>th</sup> Malaysian Plan (1991-95) on military modernization of defense forces			
	New Paradigm doctrine (Indonesia) (1998)			
	Singapore Homeland Security (2004)			
	Philippines Defense Reform Program (2004)			

**Table 7.2 (cont'd.): Post-Cold War security arrangements in Southeast Asia**

Strength	Number of Actors				Multilateral	
	Unilateral	Bilateral		Mimilateral		
		<i>Geographically concentrated</i>	<i>Geographically dispersed</i>	<i>Geographically concentrated</i>		<i>Geographically dispersed</i>
<b>Weak</b>		<p>Singapore-Thailand Enhanced Partnership (STEP) (1997)</p> <p>Philippines-Singapore Action Plan (1998)</p>	<p>Agreement on Maintaining Security (Indonesia-Australia) (1995)</p> <p>Agreement between Malaysia and New Zealand on Defense Cooperation (1996)</p> <p>Visiting Forces Agreement (Philippines-US) (1998)</p>	<p>ASEAN Concord II (2003)</p> <p>The Brunei-Indonesia-Malaysia-the Philippines-East Asian Growth Area (BIMP-EAGA) (1994)</p> <p>Greater Mekong Sub-region (GMS) (2004)</p>	<p>Asia Pacific Economic Cooperation (APEC) (1989)</p> <p>ASEAN Regional Forum (1994)</p> <p>Council for Security Cooperation in the Asia-Pacific (CSCAP) (1993)</p> <p>Asia-Europe Meeting (ASEM) (1995)</p> <p>ASEAN Plus Three (1998)</p> <p>Shangri-La Dialogue (2002)</p>	<p>Container Security Initiative (CSI) (2002)</p> <p>Proliferation Security Initiative (PSI) (2003)</p>

“spider web” approach.<sup>13</sup> It has involved cooperation among national defense forces in information exchange, cross-border agreements, training exercises, and naval operations against sea piracy.

### **7.3.1 Categories of Post-“Triple Shocks” Security Arrangements**

Bilateral geographically dispersed arrangements have continued to play a central part in Southeast Asian security. While not a formal ally, Singapore has developed closer military ties with the United States. Despite its often anti-Western rhetoric, Malaysia has also perceived the U.S. presence as necessary to preserve regional stability.<sup>14</sup> The Philippine Senate denied a new base treaty with the U.S. in September 1991, leading to a complete withdrawal from Subic Bay Naval Base and Clark Air Base by November 1992, though the two countries have remained military allies under the 1951 Mutual Defense Treaty. Moreover, Manila signed a Visiting Forces Agreement with the U.S. in February 1998. Brunei has relied on an agreement with Britain (renewed in December 1994) that guarantees the presence of a battalion of Ghurkha Rifles in the Sultanate. Indonesia signed a security agreement with Australia in December 1995. However, Jakarta revoked it in 1999 over the East Timor crisis.

Existing minilateral geographically concentrated institutions have been expanded and deepened, with ASEAN itself growing from six members in 1995 to ten in 1999. In 2003 the ASEAN heads of state and government endorsed the Bali Concord II, adopting a framework for the establishment of a Security Community, an Economic Community and a Socio-Cultural Community in Southeast Asia by 2020. New minilateral geographically concentrated arrangements have also been formed including the Brunei-Indonesia-Malaysia-the Philippines-East ASEAN Growth Area (BIMP-EAGA) in 1994 and the Greater Mekong Subregion (GMS) in 2004 with the participation of Cambodia, China, Laos, Myanmar, Thailand, and Vietnam. The GMS has focused primarily on environmental security in the Mekong area.

The creation of minilateral geographically dispersed arrangements since 1989 has been spectacular, including the Asia-Pacific Economic Cooperation Forum (APEC), the Council for Security Cooperation in the Asia Pacific (CSCAP), the ASEAN Regional Forum (ARF), the Asia-Europe Meeting (ASEM), and the APT. Many of the new institutions were ex-

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<sup>13</sup> Tan et al. (2002)

<sup>14</sup> Mak (2004)

panded from existing ASEAN frameworks. The ARF grew out of the ASEAN Post-Ministerial Meeting Conference (ASEAN-PMC) process, while the APT evolved out of ASEAN. Finally, in December 2005, heads of state and government from the ten ASEAN members, China, Japan and South Korea, as well as Australia, India and New Zealand gathered in Kuala Lumpur for the inaugural session of the East Asia Summit (EAS).

### 7.3.2 An Institutional Bargaining Game Approach

**Table 7.3: Key security institutions in Southeast Asia**

Org. Name	# of members at establishment	# of members now	Issue scope at establishment	Issue scope now	Strength at establishment	Strength now
ASEAN	5	10	Medium	Broad	Weak	Medium
ARF	18	25	Narrow	Medium	Weak	Weak
APT	13	13	Narrow	Medium	Weak	Weak

#### *The End of the Cold War*

This section analyzes changes in ASEAN, the ARF and APT (Table 7.3) since the end of the Cold War. ARF's founding in 1994 followed the reduction of Soviet and American forces in the region. The Southeast Asian states were concerned about East Asia being dominated by a more assertive Japan and a rising China. Moreover, the smaller Southeast Asian states were eager to maintain their diplomatic status in the regional arena. These circumstances at the end of the Cold War were an impetus to reshape the regional order through the birth of Asia-Pacific multilateralism. In terms of its geographical focus, the ARF is the first geographically dispersed security arrangement in the Asia-Pacific. When it comes to its nature and issue scope, the ARF is based on the principles of inclusiveness and cooperative security and is meant to focus on dialogue, confidence building and the sharing of information. In terms of institutional strength, the ARF has been relatively successful in engaging the great powers and promoting confidence building; however, it has generally failed to move toward preventive diplomacy.

Let us discuss the circumstances that led the ARF to assume these institutional trends. The end of the Soviet-U.S. and Sino-Soviet rivalries acted as the external shock leading to the resolution of the Cambodian Conflict (1979-1991) and a transformed security environment in Southeast Asia.

The disintegration of the Soviet Union in December 1991 dramatically reduced Russia's regional role.<sup>15</sup> The Soviet collapse and budgetary constraints forced the U.S. to reconsider its military deployment in East Asia.<sup>16</sup> The relative Chinese influence in the region increased based on its sustained economic development and modernization of military capabilities.<sup>17</sup>

The end of bipolarity questioned whether the provision of security and stability could continue through the San Francisco system. The increased level of uncertainty led to a search for new security arrangements that were broader in scope and able to address a series of emerging challenges. Most such arrangements, including the ARF, adopted a minilateral geographically dispersed form.

Let us examine the individual situations of the Southeast Asian states. For many of them, the immediate post-Cold War era was characterized by anxiety over the withdrawal of the U.S. military.<sup>18</sup> It was feared that an American redeployment would lead to a power vacuum resulting in rising competition among the major Asian powers. In particular, most Southeast Asian states were disturbed by the prospect of a remilitarized Japan and concerned that China would take advantage of the transformed security architecture to aggressively extend its influence.

Conscious of its vulnerability, Singapore recognized the need for a stable security environment guaranteed by external powers. It reached an agreement with Washington in November 1990 allowing the U.S. Air Force and Navy to use its military facilities more extensively. Singapore was also in favor of extending the subregional security dialogue to the Asia-Pacific. Its foreign policy in the post-Cold War era may thus be "described as one of activism in search of political, economic, and strategic space."<sup>19</sup> Thailand was similarly preoccupied with securing a favorable distribution of power in Southeast Asia. It further developed its relations with the U.S. and Japan in light of a rising China. Thai Prime Minister Chatichai Choonhavan also took advantage of the transformed geopolitics of the region in order to adopt a "New Look Diplomacy" and to improve relations with the Indochinese states.<sup>20</sup> Finally, while previously reluctant

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<sup>15</sup> Dibb (1995)

<sup>16</sup> Stuart and Tow (1995)

<sup>17</sup> Segal and Yang (1996)

<sup>18</sup> Buszynski (1992)

<sup>19</sup> Singh (1999:85)

<sup>20</sup> Rolls (1994)

to openly support the American presence, Indonesia and Malaysia responded to the U.S. withdrawal from the Philippines by allowing U.S. ships to be repaired and serviced at their facilities.

In terms of political regimes, decision-making power in many Southeast Asian countries remained firmly situated within the hands of an authoritarian ruler. In terms of beliefs, many in Southeast Asia saw the end of the Cold War as an opportunity for the region to shape its destiny. For example, former Malaysian Defense Minister Datuk Najib stressed that “the new strategic environment with no clear paradigms yet clearly provides an opportunity for the destiny of the region to be decided by and for ourselves.”<sup>21</sup>

With respect to the existing institutions, the model of bilateral geographically dispersed arrangements was not fundamentally questioned at the end of the Cold War era. Instead, most Southeast Asian states continued to regard Asia-Pacific multilateralism as a complement to bilateral ties rather than a substitute. Singapore’s Foreign Minister Professor S. Jayakumar would later declare in 1999 that the ARF “is an important vehicle to supplement our bilateral relations with the major powers.”<sup>22</sup>

The Southeast Asian countries shared some common expectations about Asia-Pacific multilateralism.<sup>23</sup> First, the creation of a region-wide arrangement was generally regarded as a way to promote continued U.S. involvement in the region and to encourage China to good international behavior.<sup>24</sup> However, Indonesia was concerned with extending the ASEAN model to the wider region due to its traditional support for ZOPFAN, though Jakarta eventually supported the ARF primarily because it was apprehensive of China’s rising influence.<sup>25</sup> Second, the Southeast Asian countries hoped that they could preserve their diplomatic position by playing a leading role in Asia-Pacific multilateralism. This could be achieved by establishing a dialogue among China, Japan and the U.S.

The formation of a new arrangement was dependent on the participation of the great powers. While the administration of U.S. President George H.W. Bush had initially been unwilling to support multilateralism in the Asia-Pacific, his successor Bill Clinton welcomed the establishment of a security forum. He envisaged it as part of American foreign policy in Asia and as a diplomatic complement to bilateral ties. Although initially cau-

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<sup>21</sup> Cited in Goh (1997:17)

<sup>22</sup> Jayakumar (1999)

<sup>23</sup> Tan et al. (2002)

<sup>24</sup> Leifer (1996)

<sup>25</sup> Leifer (1999)

tious, Japan had come to support the idea of the ARF by 1993. Tokyo perceived it to be a means of advancing its security role without raising fears of an assertive Japan. Finally, China was concerned that the ARF would be used to exert pressure on the Taiwan issue and to limit its rise to great power status, but Beijing could not afford to be left out of the arrangement and thus joined as a "consultative partner".

In terms of negotiated agreements, the emergence of Asia-Pacific multilateralism entailed an extension of the ASEAN model of security cooperation to the wider region. This culminated in the first ministerial meeting of the ARF in Bangkok in July 1994 gathering 18 foreign ministers.<sup>26</sup> The ARF is geographically dispersed and still the only region-wide security arrangement in the Asia-Pacific. The role of Track Two organizations should also be identified. The idea of using the ASEAN-PMC as a forum for a regional security dialogue was first proposed in 1990 by the ASEAN Institutes of Strategic and International Studies (ASEAN-ISIS).

ARF's activities have also been complemented and influenced by CSCAP. The latter was created in 1993 as a non-governmental (Track Two) network for the promotion of security dialogue and regional cooperation in the Asia-Pacific. CSCAP currently has 22 members from across the Asia-Pacific region. Its activities take place through six Study Groups (SGs): Regional Peacekeeping and Peace building, Countering the Proliferation of Weapons of Mass Destruction (WMD), Capacity-building for Maritime Security Cooperation, Enhancing the Effectiveness of the Campaign against International Terrorism, Trafficking, and Multilateral Security Frameworks for Northeast Asia. Each SG has its own work plan, holds meetings, and produces reports and memoranda on key regional security issues for the consideration of the ARF.

In sum, the ARF was an attempt by the ASEAN states not only to transmit to the Asia-Pacific norms, principles, and an informal process of dialogue and consultation, but also a mode of conflict avoidance and management developed by the Association since 1967. The expansion of the geographical focus was thus evident. Although the ARF was meant to concentrate on traditional security questions, its formation also led to a widening of the issue scope. The 1995 Concept Paper stated that the ARF would progress through three stages of security cooperation: confidence building,

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<sup>26</sup> In 1994, the ARF participants were Australia, Brunei, Canada, China, the European Union, Indonesia, Japan, Laos, Malaysia, New Zealand, Papua New Guinea, the Philippines, Russia, Singapore, South Korea, Thailand, the United States and Vietnam. Cambodia was admitted in 1995, India and Myanmar in 1996, Mongolia in 1998, North Korea in 2000, Pakistan in 2004, and Timor Leste in 2005.

preventive diplomacy and conflict resolution mechanisms. The Concept Paper therefore emphasized a three-stage approach to security cooperation and conflict management never endorsed by ASEAN since its formation. Post-9/11, the ARF also started to focus on terrorism, sea piracy and other transnational threats. The institutional strength of the ARF has remained limited however. The preference for an informal security dialogue has led to resistance toward further institutionalization. Moreover, the ambition to move beyond confidence building has not been endorsed by all the ARF participants, primarily China. The ARF has also suffered from structural limitations that affect its institutional strength. Its large membership confines its capacity to maintain internal coherence and complicates the decision-making process, thus making it ill-equipped to address a series of security issues in the Asia-Pacific.

### ***The Asian Financial Crisis***

This section reviews the formation of the APT. The first APT summit of heads of state and government met in Kuala Lumpur in December 1997. The summit both derived from the process leading to the first ASEM gathering in March 1996, which had brought the 13 East Asian nations together, as well as from the Asian financial crisis. It was decided in Hanoi in 1998 that the summit would meet annually. APT participation consists of the ten ASEAN countries, China, Japan, and South Korea. The arrangement is geographically dispersed although it is still concentrated in the East Asian region. Track Two interactions have also played a role in its development. The East Asia Vision Group (EAVG), gathering together official and non-official representatives from the 13 East Asian nations, articulated a vision later submitted to the APT summit in November 2001.<sup>27</sup> The nature of the APT process is a manifestation of East Asian regionalism and represents “an attempt by ASEAN to achieve economic security with other East Asian, as opposed to Asia-Pacific partners.”<sup>28</sup> Its issue scope is focused on economic and financial questions although it has also been involved in non-traditional security issues, like health security during the SARS crisis. In terms of institutional strength, the APT has been an active economic institution (e.g. Chiang Mai Initiative), but does not yet have the structural capabilities to address security.

Let us review in more detail the circumstances that led to the formation of the APT by starting with the external shock. The Asian financial crisis

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<sup>27</sup> See Press Statement by the Chairman of the 7th ASEAN Summit and the 5th APT Summit, Bandar Seri Begawan, Brunei, 11/5/2001.

<sup>28</sup> Collins (2003:180)

(AFC) was a shock that engulfed many of the Southeast Asian economies. It started in July 1997 with the collapse of the Thai baht and triggered a region-wide financial and currency meltdown. In Southeast Asia, the countries hit hardest were Indonesia, Malaysia and Thailand.<sup>29</sup> The affected countries had to rely on international help, especially from the International Monetary Fund (IMF) and the World Bank. The shock was aggravated by the failure of regional institutions, particularly APEC, to respond to the crisis.<sup>30</sup>

The provision of domestic and regional security and stability was undermined by a non-traditional security challenge. The AFC demonstrated the interconnectedness of regional and global financial markets and reaffirmed the region's economic insecurity.<sup>31</sup> The nature of the threat somewhat reshaped institutional structures and influenced their priorities, but also provided opportunities for negotiating new arrangements. The latter, as embodied in the APT, were based on a growing recognition of the relationship between economics and security.

Let us examine the domestic situations of the affected countries. The consequences of the AFC facilitated regime change in Indonesia and Thailand. It caused a rise in the participation of the middle class and a call for greater governmental accountability and transparency, which Acharya termed the "democratic contagion effect."<sup>32</sup> Prior to the AFC, decision-making power in Indonesia was concentrated in the authority of Suharto, as there were no institutional constraints on presidential power.<sup>33</sup> While Suharto's legitimacy was founded on economic prosperity, economic development had been biased towards specific groups and parts of the country, which aggravated the effects of the AFC.<sup>34</sup> The crisis contributed to the democratic transition process. Student demonstrations calling for *reformasi* eventually led to the resignation of Suharto in May 1998.

The impact of the AFC on the political situation in Thailand was also significant. The inability of the government to react and the public's loss of confidence led to the resignation of Prime Minister Chavalit Yongchaiyudh in November 1997, thereby paving the way for a more democratic

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<sup>29</sup> The Indonesian rupiah fell by 85.4 percent, the Malaysian ringgit fell by 46.4 percent, and the Thai baht fell by 55.5 percent. See National Institute for Defense Studies (2005).

<sup>30</sup> Ravenhill (2001)

<sup>31</sup> Emmerson (2005)

<sup>32</sup> Acharya (1999:419)

<sup>33</sup> MacIntyre (1999)

<sup>34</sup> Collins (2003)

political system under Prime Minister Chuan Leekpai. His Foreign Minister, Surin Pitsuwan, would in June 1998 call for a more flexible interpretation of the non-interference principle in ASEAN. In Singapore, the People's Action Party (PAP) government emerged from the AFC as one of the strongest advocates of economic and financial transparency in Southeast Asia.<sup>35</sup>

In terms of elite beliefs, the crisis ended the Asian values debate that some leaders had used to justify their authoritarian rule. Moreover, the AFC challenged the "ASEAN Way," an informal process of interaction defining ASEAN diplomacy. The views of Malaysia's Prime Minister, Mahathir bin Mohamad, on the crisis should also be highlighted. He interpreted the AFC to be a Western conspiracy against Asia, believing the crisis to be "a well planned effort to undermine the economies of all the ASEAN countries."<sup>36</sup> He articulated his dislike of Western-style institutions such as the IMF and the WTO.<sup>37</sup> Mahathir's conception of East Asian regionalism had previously been articulated in the East Asian Economic Group (EAEG) that excluded Australia, Canada, New Zealand and the United States.

With regard to existing institutions, the AFC highlighted the inadequate responses of ASEAN, APEC, and the IMF. ASEAN was powerless against the economic turmoil and the affected members had to depend on bilateral initiatives to overcome their economic difficulties.<sup>38</sup> The effects of the AFC were aggravated by the fact that ASEAN was confronted with other difficulties, including the haze crisis of 1997 and problems linked to the expansion of membership. APEC's response was also insufficient, leading to a loss of confidence in the arrangement. Successive APEC summits failed to effectively adopt and implement measures to address the crisis.<sup>39</sup> Finally, regional initiatives were rejected by Western powers. The Japanese Ministry of Finance had in the early stages of the crisis proposed the establishment of an Asian Monetary Fund (AMF), but the proposal was blocked by the U.S., the European Union, and the IMF at a meeting in September 1997.<sup>40</sup> In short, the AFC underscored the need for a new over-

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<sup>35</sup> Wee (2001)

<sup>36</sup> Rüländ (2000:428-429)

<sup>37</sup> Harris (2000)

<sup>38</sup> The negotiation of relief packages between the IMF and Indonesia, the Philippines, and Thailand were settled via bilateral tracks. Wesley (1999)

<sup>39</sup> Chang and Rajan (1999)

<sup>40</sup> Rüländ (2000)

lapping arrangement capable of better defending the Southeast Asian countries against future shocks.

In sum, the Asian financial crisis was a crude reminder that the region was vulnerable to non-traditional security challenges in such intertwined economies. It also exposed the weaknesses of the existing institutions like ASEAN or APEC in dealing with such issues and similar non-traditional threats like the haze crisis. The crisis not only threatened the domestic stability and legitimacy of some of the regimes but also challenged the effectiveness of the "ASEAN Way." It therefore accented how indispensable overarching arrangements like the APT were.

As in the case of the ARF, the APT constituted an ASEAN attempt to move beyond a subregional approach to cooperation. The APT was also meant to widen the scope of cooperation in East Asia by incorporating issues deriving from the economic-security nexus. In particular, it was expected to tackle economic sources of insecurity through financial and other forms of cooperation. Yet the new arrangement has not been given sufficient institutional strength to address economic insecurities caused by the forces of globalization, such as the prevention of a new financial crisis. The complexity of Sino-Japanese relations has also continued to undermine the APT's institutional strength. Nonetheless, although this geographically dispersed arrangement is not well equipped to deal with the security concerns of the region, it has brought some elucidation in effectively handling non-traditional security challenges like the SARS crisis in 2003.

### ***The 9/11 Attacks and the Bali Bombings***

This section discusses the notion of an ASC as a response to the 9/11 attacks and the Bali bombings. The ASC includes the ten Southeast Asian countries and is a minilateral and geographically concentrated framework. It reiterates the principles of national sovereignty and non-interference as the core ASEAN principles. In terms of its nature and issue scope, the ASC adopts a comprehensive approach to security and stresses the willingness of the ASEAN members to "rely exclusively on peaceful processes in the settlement of intra-regional differences."<sup>41</sup> The ASC should not be regarded however as "a defense pact, military alliance or a joint foreign policy."<sup>42</sup> Moreover, as in the 1971 ZOPFAN Declaration, the ASC does not restrict the right of states to rely on bilateral geographically dispersed arrangements to ensure their security. It remains to be seen whether the ASC will be successful.

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<sup>41</sup> Declaration of ASEAN Concord II (Bali Concord II) (2003)

<sup>42</sup> Ibid.

Let us discuss the circumstances that led to the initial formulation of an ASC. The terror attacks in the U.S. on September 11, 2001 and the Bali bombings on October 12, 2002 were a third shock that directly affected Southeast Asia's security relations. The attacks increased the fear of transnational terrorism in Southeast Asia and overshadowed other sources of regional instability.<sup>43</sup> Since 2002, Jemaah Islamiah (JI) has been identified as a significant grouping with links to Al-Qaeda.<sup>44</sup> JI is said to be fighting for the creation of a *Daulah Islamiah Nusantara*, a pan-Asian Islamic state that would incorporate Indonesia, Malaysia, Singapore, and Brunei as well as areas of Cambodia, the Southern Philippines and Southern Thailand. JI was responsible for an attack against the Philippine Ambassador to Indonesia in August 2000, the Bali bombings on October 12, 2002, and the bombing of the Marriott Hotel in Jakarta on August 5, 2003. The Bali plot, which left more than 200 dead, was reportedly the final outcome of meetings in early 2002 in Thailand, where attacks against Singapore and soft targets such as tourist spots in the region were also considered. Although 9/11 led to a diminished sense of security among many Southeast Asian nations, it was the Bali bomb blasts that demonstrated the shift from hard to soft targets and highlighted the threat of radical Islamist terrorism in Southeast Asia.

Let us examine the situations of the Southeast Asian countries and the beliefs of their political elites. Responses by the individual countries varied according to their own threat assessments, domestic political concerns and sensitivities. Indonesia's President Megawati Sukarnoputri travelled to Washington shortly after 9/11 and promised support in the anti-terrorism campaign. Yet domestic politics, public sentiment and her own ambivalence prevented her from taking effective steps. Moreover, the fall of the Suharto regime in 1998 had not only transformed Indonesia's domestic political environment but had resulted in the return of exiled radical Muslims demanding political space.<sup>45</sup> The country's first-ever direct presidential election in 2004 led to the victory of former Security Minister Susilo Bambang Yudhoyono. Having adopted a series of measures, Yudhoyono has also been aware that his counterterrorism policies must not be perceived by the general public to be anti-Muslim or pro-American.

In Malaysia, Prime Minister Mahathir bin Mohamad took advantage of 9/11 to discredit the Islamic Party of Malaysia (PAS) by portraying it as a party of Islamic militants. Yet similar to Indonesia, Malaysia has had to

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<sup>43</sup> Acharya (2004)

<sup>44</sup> Gunaratna (2002)

<sup>45</sup> Abuza (2005)

balance the demands of its Muslim majority whilst ensuring its engagement in the international anti-terrorism campaign.<sup>46</sup> In response to 9/11, the Philippines offered its facilities to U.S. naval vessels and aircrafts and formed an Inter-Agency Task Force Against International Terrorism.<sup>47</sup> Philippine President Gloria Macapagal Arroyo was also quick to label Abu Sayyaf as an international terrorist movement and accepted U.S. financial aid and military assistance. In January 2002, 600 U.S. forces were deployed to Basilan Island to provide operational assistance against Abu Sayyaf under the umbrella of the Balikatan military exercises.

Singapore has traditionally been concerned about terrorist attacks due to its geographic location and strategic alignment with the U.S.<sup>48</sup> The arrest of JI militants in December 2001 and the discovery of bomb plots fuelled the city-state's own sense of vulnerability. In addition to the adoption of domestic measures, Singapore was the first Asian country to sign the Declaration of Principles for the Container Security Initiative (CSI) with the U.S. in September 2002 and to join the Proliferation Security Initiative (PSI) core group in March 2004. In contrast, countries like Thailand, Cambodia, Laos, and Vietnam did not at first feel particularly concerned by the terrorism threat in Southeast Asia. Since 2004, however, Bangkok has had to face the escalation of Islamic militancy in its southern provinces.

With regard to existing institutions, the aftermath of 9/11 saw a strategic re-engagement of the United States in the region as indicated by closer military ties with the Philippines. Following the Bali bombings, U.S. President George W. Bush even identified Southeast Asia as the second front in the war on terror. In terms of minilateral arrangements, ASEAN adopted the 2001 ASEAN Declaration on Joint Action to Counter Terrorism, which aimed at enhancing intelligence sharing and developing regional capacity-building programs. ASEAN also signed a Joint Declaration for Cooperation to Combat International Terrorism with the U.S. in August 2002. With only limited relevance in terms of counterterrorism, such declarations still have significant symbolic value.<sup>49</sup> Nonetheless, it is interesting to note that many of the regional responses to terrorism have occurred at a sub-ASEAN level through bilateral and trilateral agreements. The anti-terrorism pact signed by Indonesia, Malaysia, and the Philippines in May 2002 may be observed, for example, as "an indication that the association

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<sup>46</sup> Batley (2003)

<sup>47</sup> Banlaoi (2002)

<sup>48</sup> Singh (2002)

<sup>49</sup> Ramakrishna (2005:31)

is unable to achieve a coordinated response among its entire membership.”<sup>50</sup>

In terms of new agreements, Indonesia suggested at the 36<sup>th</sup> ASEAN Ministerial Meeting in Phnom Penh in June 2003 the establishment of an ASC in Southeast Asia by 2020, following a Singaporean proposal to establish an ASEAN Economic Community (AEC). The Indonesian initiative represented a reaction to the threat posed by terrorism and other transnational threats. It also indicated a re-engagement of Indonesia with ASEAN after having been absorbed with domestic difficulties since 1998. After the endorsement of the ASC at the 9<sup>th</sup> ASEAN Summit in Bali in October 2003, Jakarta introduced over 70 proposals to forge an ASC by deepening cooperation in areas related to political and security cooperation. The proposed plan of action included a call for the establishment of an ASEAN Peacekeeping Force, the setting up of an Anti-Terrorism Centre, as well as the promotion of democracy and human rights.

Ideologies and elite beliefs influenced the intra-ASEAN responses to the Indonesian proposals. Cambodia, Laos, Myanmar, and Vietnam wanted ASEAN to remain a diplomatic arrangement based on the principles of national sovereignty and non-interference.<sup>51</sup> The main points of contention were related to references to domestic political governance. ASEAN’s membership has traditionally included military regimes, authoritarian political systems, absolute monarchies and multi-party rule democracies.<sup>52</sup> Consequently, the promotion of democracy would have represented a significant change. It was also unsurprising that many members rejected the peacekeeping force initiative, given that it would have challenged the “ASEAN Way” and given the arrangement a “greater role as a collective provider of regional order and security.”<sup>53</sup> Vietnam’s Foreign Minister, Nguyen Dy Nien, stated that a peacekeeping operation would be difficult to organize because “each country has its own policy about politics and the military.”<sup>54</sup>

In sum, 9/11 led to the rejuvenation of U.S. engagement with the region at the bilateral level, especially with countries which were already afflicted by terrorism. The states had failed to control the threat unilaterally. Apart from the minilateral arrangement between the U.S. and ASEAN to counter terrorism, the Southeast Asian states proactively entered into various bilat-

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<sup>50</sup> Collins (2003:207)

<sup>51</sup> Emmers (2005)

<sup>52</sup> Nesadurai (2003)

<sup>53</sup> Haacke (2005:211)

<sup>54</sup> “ASEAN’s Peace”. Straits Times (Singapore) 3/8/2004

eral and trilateral agreements. The Bali bombings and other incidents in the region brought to the forefront the menace that many of the Southeast Asian states were already facing. This became a significant motivation behind the states committing to establish the ASC by 2020.

While the geographical focus of the ASC project is limited to Southeast Asia, its issue scope moves ASEAN beyond its traditional objectives of confidence-building and conflict avoidance and management. The ASC is very much an attempt by the ASEAN countries to respond to a series of transnational threats facing Southeast Asia today, ranging from terrorism, sea piracy, undocumented migration, pandemics, to environmental degradation. It is too soon however to assess the institutional strength of the ASC. The latter is still being negotiated by the ASEAN members and is not expected to be established before 2020. Yet the watered-down version of the ASC Plan of Action agreed by the 2004 ASEAN Ministerial Meeting might be an early indication of its future institutional limitations and restraints. The plan no longer included the peacekeeping force provision, the more flexible application of the non-interference principle and other controversial ideas. The Plan of Action was later adopted at the ASEAN Summit in Vientiane in November 2004.<sup>55</sup>

## 7.4 Future Scenarios for Southeast Asian Security

This section explores possible developments in Southeast and East Asian security and examines how such changes may impact regional security arrangements. It first highlights key forces for change in the coming 10 to 15 years. Based on previous discussions, three variables are considered: the U.S. presence in East Asia, China's role in the region, and regional dynamics in Southeast Asia.<sup>56</sup>

A pivotal question is whether the United States will continue to dominate the East Asian security structure. The U.S. is likely to remain the military hegemon for years to come although its exercise of power will be complicated by the rise of China and India. Related to this question are the close relations linking the U.S. to its regional allies and its involvement in multilateral arrangements. The long-term relevance of bilateral and multilateral security structures may be undermined by a rise of unilateralism in U.S. foreign policy. In East Asia, the Bush administration has repeatedly

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<sup>55</sup> Chairman's Statement of the 10th ASEAN Summit (2004)

<sup>56</sup> Goh (2005)

indicated its preference for flexibility and mobility over formal and institutionalized arrangements.<sup>57</sup>

Turning now to the role of China in Southeast Asian security, China was often described as a threat in the 1990s. The territorial dispute over the Spratly Islands was (and to a lesser extent continues to be) the most prominent problem afflicting China and the four Southeast Asian claimant states (Vietnam, the Philippines, Malaysia, and Brunei). The Chinese government's passage of the Law on Territorial Waters and Contiguous Areas in 1992 caused tremendous concern in the region at the time. Part of the defense modernization and expansion by Southeast Asian states was a consequence of a contingency arising due to this issue. This was clearly demonstrated in February 1995 when China encroached on Mischief Reef in the Spratlys, which was also claimed by the Philippines. Manila reacted by substantially expanding its defense budget in order to acquire warships and aircrafts in the event that it needed to defend its claims in the Spratlys. Former Philippine Defense Secretary Orlando S. Mercado went as far as to describe China's occupation of Mischief Reef in 1995 and its building of several structures in 1999 as a strong indication of China's "creeping invasion" of the "disputed South China Sea chain."<sup>58</sup> China also had military skirmishes with the Philippine Navy in the waters of the Kalayaan Island Group and Scarborough Shoal, further raising the apprehensions of Vietnam and Malaysia as well. Jakarta was also concerned by China's overarching claim to much of the South China Sea, which seemed to overlap with Indonesia's Exclusive Economic Zones and include part of the Natuna Islands.

The China threat perception has gradually changed among Southeast Asian policy elites however. China has added diplomatic activism to its growing economic and military growth. Shambaugh notes that at both the bilateral and multilateral levels, "Beijing's diplomacy has been remarkably adept and nuanced, earning praise around the region."<sup>59</sup> China's "charm offensive" toward ASEAN contrasts with its previous suspicion of multilateralism. Nonetheless, considerable uncertainties remain. One is related to the evolution of China's domestic order and what sort of impact it might have on regional stability. Another involves the possibility of a damaging crisis between China and Japan or between China and the United States over Taiwan. Finally, it is still to be seen whether China will continue to

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<sup>57</sup> Tan (2005)

<sup>58</sup> BBC Reports of Tuesday BBC, 5/25/1999

<sup>59</sup> Shambaugh (2005:64)

be an accommodating rising power vis-à-vis the Southeast Asian states. One incident is worth noting in this respect.

In July 2004, Singapore's then-Deputy Prime Minister Lee Hsien-loong visited Taiwan as a private citizen. Breaking with all earlier practice, China formally protested and threatened massive economic sanctions. While he initially resisted, Lee relented when China cancelled a major Singapore trade show in Shanghai. He stated that "if a war breaks out across the straits, we will be forced to choose between the two sides...But if the conflict is provoked by Taiwan, then Singapore cannot support Taiwan."<sup>60</sup> Although his father and predecessor, Lee Kuan Yew, had visited Taiwan several times during his tenure as Singapore's prime minister, such a reaction from China was unprecedented. The reason seems to be that China now believes it no longer needs to put up with actions taken by its Southeast Asian neighbours that it disapproves of.

Regional dynamics in Southeast Asia, defined in terms of domestic changes and evolving security concerns, represent a third variable. The Southeast Asian region has been undergoing democratization (Indonesia, the Philippines, and Thailand until the military coup of September 2006) and has faced a series of non-traditional security challenges (financial crisis, terrorism, SARS). Such changes in regional dynamics raise a series of questions. First, will the transition to democracy be sustained and how will it impact the stability of key states and the security of the region? Moreover, will internal changes and the growing role of non-state actors have an impact on Southeast Asia's institutionalization? Finally, will the nature of the challenges facing the region lead to further institution-building as suggested by current efforts to develop an ASEAN Community and Charter?

For each of the three variables, two simplified scenarios can be drawn. The scenarios apply to ASEAN and the ASEAN-initiated arrangements (ARF, APT, and EAS). In the case of the U.S. presence, the scenarios are an active versus a non-active participation in multilateral regional arrangements. For China's role, we first assume ongoing domestic order, dependent on sustained economic growth and political stability, as well as Beijing's continuing participation in security arrangements. By holding on these issues, the scenarios only relate to the nature of China's involvement in regional arrangements and consist of an accommodative versus an assertive participation. With regard to the third variable, the scenarios are stronger versus weaker regionalism in Southeast Asia.

The best possible outcome for the ASEAN-led initiatives would be active U.S. participation, accommodative Chinese involvement, and strong

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<sup>60</sup> "Singapore PM to Back Beijing If Taiwan Caused War," Associated Press, 8/22/2004

regionalism in Southeast Asia. The worst would be passive U.S. participation, an assertive China and weak Southeast Asian regionalism. The former would lead to a stronger ARF complemented by arrangements more limited in their participation and geographical scope like ASEAN, the APT and the EAS. Most of the Southeast Asian states would be satisfied with an institutional framework where multilateral arrangements complement one another in the promotion of peace and stability. The worst outcome would lead to weaker institutional mechanisms, resulting in negative consequences when the region experiences new security shocks. The Southeast Asian countries would also be uncomfortable with an assertive Chinese leadership. Chinese assertiveness could consist of Beijing pressing for change in the norms of cooperation, a restrictive position on agenda setting, and an exclusive approach excluding non-Asian participation.

Alternative outcomes should also be considered. Passive U.S. participation, an accommodative China, and weak regionalism in Southeast Asia would further weaken the ARF and enhance Chinese influence in the APT and the EAS. The negative impact on the ARF of passive U.S. participation was felt when U.S. Secretary of State Condoleezza Rice decided not to attend the ministerial meeting in Vientiane in July 2005. In contrast, Beijing has made a strong diplomatic push and has been successful in promoting its influence.

Strong regionalism in Southeast Asia combined with passive U.S. participation would most likely not succeed in restraining an assertive China. Yet it is unlikely that Washington would continue to adopt a passive position if China were to move toward assertive diplomacy. Interestingly, the U.S. has indicated its concern about the exclusive model of the EAS, leading to the speculation that it may want to join the arrangement at a later stage.

It is essential to remember that the variables discussed in the case scenarios are not necessarily exclusive or independent of each other. Rather, a change in one variable can quite considerably affect the trend in another. Southeast Asian regionalism has traditionally developed with supportive but passive U.S. participation and a limited Chinese role in the subregion. Yet China's recent activism with regard to regional institutions has been effective not only in changing the Southeast Asian perspective of China, but also in breathing new life into regional multilateral initiatives. The leadership in Beijing has since become an active participant in the ARF, the region's only multilateral security arrangement. It is also involved in other initiatives such as the Mekong River Project to further promote economic cooperation. Even greater economic integration is projected with the signing of the ASEAN-China Free Trade Area (ACFTA) planned for some time between 2010 and 2015. Engagement between China and ASEAN is even more impressive. Over the last few years, the two coun-

tries have undertaken a series of steps to broaden and strengthen their relationship, several of which have considerable significance for the international relations of the Asian region. As a result, an active Chinese diplomacy has benefited the regional dynamics in Southeast Asia.

These achievements need not be at the expense of the U.S. however, especially with regard to Southeast Asia. U.S. influence remains strong and deeply rooted, as are its institutional arrangements in terms of alliances, base access and visiting forces agreements. As far as the Southeast Asian states are concerned, such ties are strategies that these states have adopted in securing their own vital interests in the region. Such strategies need not be a zero-sum game in which Beijing's gain must be regarded as the United States' loss and vice versa. It is counterproductive to present the Southeast Asian states with an 'either-or' option while choosing between the U.S. and China. Such conditions have changed as a result of a rising China and its new diplomatic activism. With an accommodative involvement, even more so in the case of an assertive Chinese role, Southeast Asian regionalism would benefit from a more active U.S. participation that looks beyond the narrow issues of terrorism and maritime security.

In short, while other variables (e.g. the role of India) could be included, the three factors mentioned here will most likely be the key forces for change and impact on institution building in Southeast and East Asia. Two possible developments should be examined closely in the coming years. First, will ASEAN move toward a new era of legalization and institution building based on a growing sense of community and identity as suggested by recent developments (ASEAN Communities and Charter)? Second, it will be interesting to see whether the ASEAN-led security initiatives in the wider region will succeed in complementing each other or instead, compete and cancel each other out.

## 7.5 Conclusions and Implications

Southeast Asia accommodates a great variety of security structures, ranging from unilateral measures to bilateral and minilateral (geographical concentrated and dispersed) arrangements. The nature of such arrangements also varies from military alliances to institutional expressions of cooperative and comprehensive security. Southeast Asian security relations are thus influenced by a series of complementary security structures and approaches. Moreover, the formation and characteristics of the security arrangements have been influenced by the post-"triple shocks" period.

The chapter has claimed that the institutional changes have primarily been in terms of geographical focus and issue scope rather than institutional strength. Since the end of the Cold War era, Southeast and East Asia

have seen the emergence of new geographically dispersed institutions, particularly the ARF and the APT, as well as Track Two groupings like CSCAP. The geographical focus has thus been extended to the wider East Asian region and beyond. These security structures are meant primarily to supplement rather than to replace existing bilateral ties and alliances at a region-wide level. Similarly, the issue scope has also been extended in recent years. Since the financial crisis, there has been a growing recognition of the close relationship between economics and security. Having traditionally adopted a comprehensive approach to security, ASEAN perceives the construction of security and economic communities in Southeast Asia as complementary and mutually reinforcing. The objective is to move toward deeper economic integration while developing a region free from military conflict. By focusing on economic development as a solution to economic insecurity, the APT has sought to incorporate economic-security linkages as part of its cooperative structures. Finally, existing institutions are taking on new security roles since 9/11 and the Bali bombings. ASEAN, the ARF and even APEC, originally formed to encourage trade and investment liberalization, have been accorded a role in the campaign against terrorism. Yet it has not just been about terrorism. Issues like health, sea piracy, transnational crime and others have been discussed at the highest diplomatic levels. The hard and soft aspects of security have therefore increasingly been included on the agendas of regional arrangements.

Nonetheless, despite the existence of a growing number of complementing and overlapping structures, unilateral security arrangements in Southeast Asia continue to suffer from an institutional deficit that somewhat limits their structural capacity to respond to security challenges. The wider geographical and issue focus has thus not been tied to significant changes in institutional strength. Countries in the region are still protective of their sovereignty and unwilling to give up national autonomy to supra-national structures. Strong adherence to national sovereignty and territorial integrity has remained the core principles of ASEAN diplomacy. However, this is not to say that a consensus exists among the member states on the need to preserve the status quo. While the new members have been resistant to institutional change, some of the original participants like Indonesia, the Philippines and Thailand have pushed for a more flexible application of the non-interference principle. Such debates within ASEAN may result in a multi-layered or two-speed arrangement including members opting for the current level of institutionalization and others moving forward in specific areas.

Similar institutional limitations exist in the ASEAN-led initiatives in East Asia and the Asia-Pacific. The ARF has enjoyed some success in confidence building and in integrating regional great powers into a security

dialogue. Yet it is questionable whether the ARF will succeed in moving from confidence building to preventive diplomacy, as stipulated in the 1995 Concept Paper. Moreover, the great powers have lost some interest in the ARF as indicated by the failure of the foreign ministers of the U.S., Japan, China, and India to attend its 2005 ministerial meeting. The APT does not have the institutional strength to effectively address changes in security. In particular, no consensus exists between its two key participants, China and Japan, on the security approach the institution should adopt. The complex relations between Beijing and Tokyo will most likely continue to undermine the APT. As a result, the ARF and the APT should in the short to medium-term be expected to remain as a confidence-building exercise in the region.

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## 8. India's Shifting Trade Policy: South Asia and Beyond

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### 8.1 Introduction

Since 1991, India's economy has undergone a remarkable transformation. Moving away from years of inward-looking economic policies, it has become a significant force in the global political economy. This chapter focuses on the evolution of India's new economic policies, particularly in trade, within the context of the larger transformation of Asia's economic and security architecture after the Cold War.

We utilize the institutional bargaining game framework introduced in Chapter One of this book to analyze the interplay of external shocks and internal political changes and explain shifts in India's trade policies. In particular, the three shocks of the fall of the Soviet Union, the Asian financial crisis of 1997-98, and the terrorist attacks of September 11, 2001 prove to be significant drivers of India's policies.<sup>2</sup> However, we also find that India's balance of payments crisis of 1991 and the decision of both In-

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<sup>2</sup> See the introduction to this volume by Aggarwal and Koo for a discussion of the analytical framework of this chapter.

dia and Pakistan to test nuclear weapons in 1998 were also critical factors. Moreover, as the framework suggests, one needs to look at the interplay between shocks and key domestic political changes in India to explain policy changes. Specifically, we show how India moved away from its import substitution industrialization (ISI) policy to a more liberal domestic economic model and an increasing focus on improving its export competitiveness. In addition, we analyze India's recent turn toward bilateral trade agreements in the context of frustration with lack of progress in the Doha Round of the World Trade Organization (WTO)—a policy strategy common to Asian countries more broadly.

This chapter is organized as follows. Section 8.2 examines the context of the key shocks and dynamics that have influenced policymakers' choices in South Asia as well as in the broader Asian region. Section 8.3 then considers the historical evolution of India's policies in the aftermath of the three broad shocks, focusing on how each altered the dynamics of India's economic policies. Section 8.4 provides some possible scenarios for India's future trade policy based on our anticipation of possible new developments and India's likely responses. Finally, in Section 8.5 we offer some concluding thoughts.

## 8.2 The Cold War Security and Economic Environment

In the Cold War era, the so-called "San Francisco System," codified largely through the 1951 San Francisco Peace Treaty between the U.S. and Japan, provided Asian states with a mixture of bilateral and multilateral institutions.<sup>3</sup> It offered many Asian states, particularly Japan, access to the American market in return for a bilateral security alliance with the U.S. It also encouraged the United States' Asian allies to participate in broad-based, multilateral forums such as the United Nations (UN), the General Agreement on Tariffs and Trade (GATT) and the International Monetary Fund (IMF).

Although the San Francisco system was particularly important in East Asia, it is critical to keep in mind that it did not include all of Asia. Some states, such as China, allied with the Soviet Union while other smaller powers were either formally or informally tied to those two countries. For its part, India resisted this Cold War alignment of states and attempted to pursue a non-aligned security strategy (with an increasing tilt to the Soviet

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<sup>3</sup> This discussion of the San Francisco System draws on Aggarwal and Koo's introduction.

Union after 1971) and an inward-looking policy of ISI.<sup>4</sup> In India's case, as we shall see below, the fall of the Soviet Union, combined with its 1991 balance of payments crisis, came as a combined shock that threw its traditional economic policy into question.

In terms of regional agreements in South Asia, the Cold War context also affected efforts to create minilateral agreements (involving more than two countries but not universal membership). The South Asian Association for Regional Cooperation (SAARC) was such an example. This accord was born out of the efforts of the smaller countries of South Asia such as Bangladesh, Nepal and Sri Lanka, which may have preferred a geographically concentrated minilateral regional framework to a region dominated by India's bilateral relations with its neighbors. Discussions in various international gatherings from 1977 led to the first foreign secretary-level meeting in 1981 and the first meeting of the heads of state in 1985. SAARC had the unenviable distinction of overseeing a reduction in intra-South Asian trade. Intra-regional trade as a proportion of total trade within the region dropped from 3.2 percent in 1980 to 2.4 percent in 1990.<sup>5</sup>

Indo-Pakistani security relations are central to understanding SAARC's inefficacy during and after the Cold War. Rival elite beliefs about national identity locked South Asia's two largest countries in a deadly conflict since the partition of India in 1947. Pakistan was created as a separate state at the time of India's independence, thus securing the interests of the Indian Muslims. India, on the other hand, had held that it would be a secular nation where people of all religions could leave peaceably.<sup>6</sup>

The geopolitics of the Cold War further complicated Indo-Pakistani relations. Given the U.S. support for Pakistan and its close ties with China during the Cold War, India could not have won the 1971 war without Soviet support. India signed a Treaty of Friendship and Cooperation with the Soviet Union that brought the security concerns of both countries very close to each other. This was a significant blow to India's stature as a non-aligned country. On the other hand, Pakistan, which had maintained close ties with the U.S. during the Cold War, became a frontline state after 1980

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<sup>4</sup> A combination of high tariffs, an overvalued exchange rate, and import, financial and industrial controls characterized India's strategy of import substituting industrialization. This strategy biased economic activity toward production for the home market rather than for exports.

<sup>5</sup> Dash (1996:202)

<sup>6</sup> Ganguly (1986)

and benefited enormously from U.S. aid in return for supporting the United States against the Soviets in Afghanistan.<sup>7</sup>

The Cold War also deeply affected India's efforts to link up with the Association of Southeast Asian Nations (ASEAN) countries. In Indonesia, Suharto replaced Sukarno after a bloody regime change in Indonesia and pledged allegiance with the U.S in 1966. When ASEAN was established in 1967, it comprised a distinctly pro-American grouping that included Indonesia, Thailand, the Philippines and Singapore. They consolidated themselves against communism by proposing the Zone of Peace Freedom and Neutrality (1971) and the Treaty of Amity and Cooperation (1976).

The strategic rift between India and Southeast Asia hardened in the 1980s when Indira Gandhi recognized the Vietnam-backed Heng Samrin regime in Cambodia, which had friendly ties to the Soviet Union. Moreover, India did not support Indonesia's candidature for the Chairmanship of the Non-Aligned Movement at the New Delhi summit in 1983. When Rajiv Gandhi became Prime Minister, though, ASEAN countries grew optimistic about India's willingness to convince Vietnam to withdraw from Cambodia given his pro-liberal economic policy bent and his open mind about the U.S. Vietnam, on the other hand, would not tolerate the Chinese-sponsored Khmer Rouge, which the ASEAN countries preferred to Soviet domination. India's tilt toward Vietnam and Soviet Union was most easily visible during the visits of the Indian and Soviet Foreign Ministers to Vietnam, thus disappointing ASEAN members.

Southeast Asia worried about the rise of India's power both within and beyond South Asia during the Cold War. Most worrisome for ASEAN countries was the birth of India's blue water navy that was building the capacity to secure its interests in Southeast Asia. India had acquired a Soviet-built nuclear-powered submarine and an aircraft carrier. Indonesia accused India of letting the Soviets use its naval bases while Singapore's Prime Minister Goh Chok Tong worried about the U.S.'s withdrawal from its bases in the Philippines in light of India's rising naval power.<sup>8</sup>

India's trade with the ASEAN countries was also affected by the Cold War as well as its own ISI policies, which made India commercially less attractive over time. India could not attain the status of an ASEAN dia-

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<sup>7</sup> Jimmy Carter was trying to discipline Pakistan toward more democratic governance when the Soviet Union invaded Afghanistan. President Carter had to change his position on Pakistan and President Ronald Reagan had to offer substantial military and financial aid in return for Pakistan's support for the United States' fight with the Soviet-backed regime in Afghanistan.

<sup>8</sup> On the relations between India and ASEAN during this period, see Sridharan (1995) and Sridharan (1996), Chapter 7.

logue partner during the Cold War—a status that would have facilitated commercial relations between India and ASEAN and which had already been accorded to the European Economic Community, Australia, New Zealand, Japan, United States and Canada in the 1970s. Any possibility of India becoming a dialogue partner was ruled out after its support for the Heng Samrin regime in Cambodia in 1980. Bilateral meetings between Indian and Malaysian officials spent a disproportionate amount of time on the Cambodian issue. Mahathir bin Mohamad, one of the proponents of South–South solidarity, stated unambiguously that India's position on the issue had adversely affected its relations with Malaysia.

India's declining competitiveness due to its ISI policy also hurt its interests in Southeast Asia. ASEAN countries accessed capital and technology from advanced industrial countries, most notably Japan. However, India's restrictive investment laws ensured that there would be little room for ASEAN investments in India. Intra-industry trade in the presence of less restrictive investment laws could have been a trade-promoting factor in Indo-ASEAN trade. As ASEAN globalized faster than India, India became more dependent on trade with ASEAN than vice-versa. India's imports from ASEAN, which were 0.86 percent of its total imports in 1975, rose to 6.2 percent in 1990. Its exports to ASEAN countries, which were 2.6 percent of its global exports in 1975, were about 4.2 percent of its exports in 1990. On the other hand, India's trade with Singapore as a proportion of Singapore's trade with the rest of Asia came down from 15.49 percent to 12.03 percent between 1980 and 1990. Singapore was consistently the most important trading partner for India in the ASEAN region during this period.<sup>9</sup> Nevertheless, India's trade with ASEAN countries was more robust than its trade with South Asian countries.

Before we analyze the transformation of India's trade policies from the pre-Cold War era until the present, it is useful to systematically categorize India's accords based on their strength, the number of actors involved, and the geographical characteristics of the accords, as we show in Table 8.1. Table 8.2 provides a more dynamic analysis by considering how arrangements have changed in terms of their membership, scope, and strength.

As Tables 8.1 and 8.2 clearly illustrate, India's trade policy has shifted away from a regional focus on SAARC and a multilateral focus on the WTO. India is now involved in a large array of accords and is actively negotiating unilateral and bilateral accords. In particular, India's turn to the

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<sup>9</sup> On the politics of Indo-ASEAN economic relations from the late 1970s up to the early 1990s, see Sridharan (1996), Chapter 8; Asher and Rajan (1995:176).

**Table 8.1: India's trade arrangements**

<i>Strength</i>	<i>Number of Actors</i>					
	<i>Unilateral</i>	<i>Bilateral</i>		<i>Multilateral</i>		<i>Multilateral</i>
		<i>Geographically concentrated</i>	<i>Geographically dispersed</i>	<i>Geographically concentrated</i>	<i>Geographically dispersed</i>	
<b>Strong</b>	(1)	(2)	(3)	(4)	(5)	(6)
	Policy of ISI Shift toward a more export oriented strategy (1991)	India-Sri Lanka (2000) India-Mauritius negotiations	India-Thailand (2003) India-Singapore CECA (2005) India-Japan (study group) India-EU (study group)	SAARC (1985) SAFTA (2004) BIMST-EC (1997)	India-GCC negotiations	GATT/ WTO (1947)
<b>Weak</b>					ASEAN+6 ASEAN-India Framework Agreement (2002) India-New Zealand (under study)	

Table 8.2: Evolution of India's trade arrangements

Org. name	# of members at establishment	# of members now	Issue scope at establishment	Issue scope now	Strength at establishment	Strength now
ASEAN+6	16	16	Narrow	Narrow	Weak	Weak
ASEAN-India Framework Agreement	11	11	Broad	Broad	Weak	Weak
SAARC / SAFTA	7	7	Broad	Broad	Weak	Weak
BISTEC / BIMSTEC	4	7	Broad	Broad	Weak/under negotiation	Weak/under negotiation
India-Sri Lanka	2	2	Broad	Broad	Strong	Strong
India-Thailand	2	2	Narrow	Narrow	Strong	Strong
India-Singapore	2	2	Broad	Broad	Strong	Strong

negotiation of bilateral agreements has accelerated in the wake of the July 2006 breakdown in WTO negotiations. Examining how this evolution of policy has taken place from the pre-Cold War era to the current one is the task to which we now turn.

### **8.3 The Evolution of India's External Economic Policies in the Post-Cold War Era**

The turn of the decade from the 1980s to the 1990s proved to be a decisive combination of shocks for India's traditional economic and security policies. In 1991, the brewing balance of payments crisis came to a head. That same year, the collapse of the Soviet Union and the end of the Cold War rendered India's "non-aligned" policy obsolete. India's response to this twofold crisis was a dramatic move toward domestic liberalization and the beginning of its "Look East Policy" (LEP). But just as the LEP appeared to be bearing fruit, the Asian financial crisis of 1997-98, together with India's decision to test nuclear weapons and Pakistan's own subsequent tests sharply set back relations with ASEAN and other East Asian countries. In this dramatically changed environment, India turned to its neighbor, Sri Lanka, to pursue trade liberalization. The next shocks of the 9/11 attacks and then the United States' turn to bilateral trade agreements dramatically altered both the security and economic contexts for India. Its relations improved with the U.S. relatively quickly, but it was also forced to imitate other states in their pursuit of bilateral agreements—given the paralysis of the Doha Round of the WTO.

To analyze the changes in India's economic policies, particularly in trade, we use the institutional bargaining game approach discussed in Chapter One of this book. In brief, the approach focuses on identifying key shocks that potentially alter the existing equilibrium. These shocks can change the nature of goods that are being sought by states and their reaction will be a function of their individual situations. These individual situations are defined by the position of the state in the international system, its domestic political configuration, and elite beliefs. State responses in creating or modifying existing institutions will be influenced by the pre-existing broader institutional context (for example, regional agreements will be constrained by the WTO). Finally, we consider the specifics of the new arrangements in terms of their strength, nature, scope, number of actors, and geography. These arrangements can, in turn, be affected by new shocks over time, setting in motion a new bargaining game.

### 8.3.1 Liberalizing and Looking East

India had long followed a classic ISI policy that had been advocated by a wide variety of economists including its lead exponent, Raul Prebisch. The so-called "License Raj" was marked by a maze of import controls, an overvalued exchange rate to facilitate the importation of necessary capital goods, the promotion of heavy industry, selective financial incentives to the private sector, and a large state sector. The lack of competition created powerful entrenched coalitions between business and labor interests that could not be overcome by the state during the Cold War years. Organized business wanted freedom to operate within the protected Indian market but did not want to risk exposure to foreign markets. Organized labor, which constituted less than 10 percent of India's work force, was happy with job security and labor laws that protected them while the majority of workers in the unorganized sector endured hardships.<sup>10</sup> Inviting competition from other countries within or outside the region needed the support of a political economic coalition that would be willing to adjust to competition.

The Government's reports from the late 1970s had acknowledged the problem of low productivity, the dearth of development finance, and the need for export promotion. Indira Gandhi's second tenure (1980-83) had taken note of these problems.<sup>11</sup> Indeed, Rajiv Gandhi had tried to initiate economic liberalization since 1984, but substantial promotion of competitiveness and exports could not be achieved in the 1980s. Even Rajiv Gandhi's comfortable majority in the Parliament could not overcome the political impediments standing in the way of India's tryst with globalization. India remained one of the most autarkic economies in the world at a time when China was embracing global economic integration and the Soviet model was crumbling.<sup>12</sup> A clear statement of India's economic liberalization program required a change in executive and technocratic orientation in conjunction with an exogenous shock: a balance of payments crisis.

#### ***Dual Shocks: Balance of Payments Crisis and the Collapse of the Soviet Union***

The beginning of the 1990s brought with it dramatic economic change. By the end of the 1980s, India found itself in dire straits. Its fiscal deficit had

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<sup>10</sup> On India's inflexible labor laws, see Zagha (1999).

<sup>11</sup> On Mrs. Gandhi's second tenure, and a critical look at past policy, see Dhar (1988) and Sengupta (2001).

<sup>12</sup> On the political economy of import substitution opposing trade orientation in the 1980s, see Kohli (1990), Chapter 11.

increased rapidly to over 8 percent of GDP, inflation in 1991 was nearly 14 percent, and its external debt had increased from \$18 billion in 1980 to nearly \$72 billion by 1991.<sup>13</sup> In the context of this negative secular trend came the Iraqi invasion of Kuwait in 1990. The result of this development was threefold: remittances from Indian workers in the Gulf states fell as they fled the region, exports to Kuwait and Iraq declined, and India faced a dramatically higher oil bill as the price of oil skyrocketed.<sup>14</sup> The adverse credit rating assigned by Moody's in October 1990 pointed to a rise in the debt-service ratio, the debt-export ratio, the budget deficit and dependence on short-term commercial borrowings. Between January and June 1991, gold had been shipped to the Union Bank of Switzerland and the Bank of England to shore up foreign exchange reserves. Despite this, India was on the verge of a liquidity crisis in June 1991, with insufficient foreign exchange to cover a fortnight of imports.<sup>15</sup> It was in this economic context that India found itself with the need to take dramatic action.

In the security realm, the end of the Cold War from 1989 to 1991 dramatically altered India's security and economic environment. India's non-alignment policy, with a tilt toward the Soviet Union after 1971, quickly became obsolete. Without the Soviet Union, India now had to cope with China directly and also seek some type of accommodation with the only superpower, the U.S. As we shall see, this dramatic change also led to a sharply different dynamic with Southeast Asia in particular, and helped to set in motion the LEP. But in addition to power changes, the market that the Soviet Union provided for internationally uncompetitive Indian goods (resulting from the inefficiencies generated by the ISI policy) also rapidly disappeared. Tables 8.3 and 8.4 show the trends in India's exports and imports from the 1980s to the current period.

The export pattern clearly shows a dramatic drop in exports to the Soviet Union (and then Russia) between the 1980s and the 1990s. Other important shifts include an increase in exports to ASEAN countries (with a fall after the Asian financial crisis), a rise in exports to the U.S. followed

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<sup>13</sup> OECD, *External Debt of Developing Countries*, various.

<sup>14</sup> See Joshi and Little (1994).

<sup>15</sup> Mukherji (2007), Chapter 5.

**Table 8.3: India's merchandise exports (in millions of US\$)<sup>16</sup>**

Year	1980	1985	1990	1995	1998	2000	2005
World Exports	8,440.55	8,265.36	17,813.00	30,537.20	33,662.70	42,624.40	97,918.1
Exports to China (excluding HK & Macao)	28.55	21.45	18.02	282.92	499.90	758.23	6,444.83
% of total exports	0.34	0.26	0.10	0.93	1.49	1.78	6.58
Exports to China (HK and Macao)	165.74	153.76	545.13	1,822.55	1,894.90	2,609.43	4,267.78
% of total exports	1.96	1.86	3.06	5.97	5.63	6.12	4.36
Exports to Republic of Korea	64.20	73.44	163.60	394.29	347.83	457.25	1,624.64
% of total exports	0.76	0.89	0.92	1.29	1.03	1.07	1.66
Exports to Japan	775.83	920.61	1,656.00	2,130.40	1,713.62	1,767.22	16,362.64
% of total exports	9.19	11.14	9.30	6.98	5.09	4.15	2.43
Exports to US	967.03	1,563.34	2,693.68	5,304.65	7,102.75	9,083.25	16,362.50
% of total exports	11.46	18.91	15.12	17.37	21.10	21.31	16.71
Exports to EU	2,088.65	1,679.26	5,068.49	8,398.13	9,197.72	10,369.80	21,900.10
% of total exports	24.75	20.32	28.45	27.50	27.32	24.33	22.37
Exports to USSR/FSU	1,409.99	1,693.37	2,867.61	1,128.01	894.13	1,090.37	1,272.60
% of total exports	16.70	20.49	16.10	3.69	2.66	2.56	1.30
Exports to ASEAN	300.24	199.30	748.79	2,348.51	1,835.33	2,749.32	9,992.11
% of total exports	3.56	2.41	4.20	7.69	5.45	6.45	10.20

<sup>16</sup> International Monetary Fund, Direction of Trade Statistics, 2006. In 1980, ASEAN consisted of Indonesia, Malaysia, Philippines, Singapore, and Thailand. Brunei Darussalam joined the agreement in 1984, and is included in the data from 1985-2004. Vietnam joined in 1995, and is included from 1995-2004. Laos and Myanmar joined in 1997, and so are included from 1998-2004. Finally, Cambodia joined in 1999, and is included from 2000-2004. Data for FSU after 1990.

**Table 8.4: India's merchandise imports (in millions of US\$)<sup>17</sup>**

Year	1980	1985	1990	1995	1998	2000	2005
World Imports	14,822.20	16,329.00	23,991.40	34,483.60	42,161.80	50,335.80	134,690
Imports from China (excluding HK and Macao)	83.43	103.93	30.73	811.47	1,102.35	1,448.60	9,829.12
% of total imports	0.56	0.64	0.13	2.35	2.61	2.88	7.30
Imports from China (HK and Macao)	27.36	53.85	157.66	243.10	416.20	843.58	2,058.34
% of total imports	0.18	0.33	0.66	0.70	0.99	1.68	1.53
Imports from Republic of Korea	172.54	205.45	325.46	716.90	1,296.25	988.68	4,134.73
% of total imports	1.16	1.26	1.36	2.08	3.07	1.96	3.07
Imports from Japan	815.07	1,363.56	1,800.83	2,234.33	2,385.50	2,015.60	3,473.12
% of total imports	5.50	8.35	7.51	6.48	5.66	4.00	2.58
Imports from US	1,865.21	1,769.89	2,634.84	3,343.91	3,659.60	3,152.25	7,590.74
% of total imports	12.58	10.84	10.98	9.70	8.68	6.26	5.64
Imports from EU	3,494.72	4,515.23	8,009.32	9,171.22	10,779.50	10,690.40	22,166.70
% of total imports	23.58	27.65	33.38	26.60	25.57	21.24	16.46
Imports from USSR/FSU	1,233.22	1,574.23	1,321.73	1,112.91	761.09	721.00	2,689.16
% of total imports	8.32	9.64	5.51	3.23	1.81	1.43	2.00
Imports from ASEAN	877.23	838.95	1,474.01	2,295.52	4,136.77	4,381.72	10,236.88
% of total imports	5.92	5.14	6.14	6.66	9.81	8.70	7.60

<sup>17</sup> International Monetary Fund, Direction of Trade Statistics, October 2005. In 1980, ASEAN consisted of Indonesia, Malaysia, Philippines, Singapore, and Thailand. Brunei Darussalam joined the agreement in 1984, and is included in the data from 1985-2004. Vietnam joined in 1995, and is included from 1995-2004. Laos and Myanmar joined in 1997, and so are included from 1998-2004. Finally, Cambodia joined in 1999, and is included from 2000-2004. Data only for FSU after 1990.

by a drop, and then a rise in exports to China—issues that we discuss later in the paper.<sup>18</sup> We can also discern a similar (albeit less dramatic) change in import patterns, with Russia playing a dramatically less important role after 1990 and China and South Korea a more significant role.

### ***Factors Affecting India's Response***

In view of the dramatic changes we have seen in India's balance of payments problems and the collapse of the Soviet Union, we now consider the factors behind its responses. With respect to the goods involved at the security level, it quickly became clear that India would have to find an accommodation with the only superpower. India was no longer in a position of being able to pursue a non-aligned policy and continue to seek benefits from the semi-public good nature of the balance of power that existed during the Cold War. In the earlier era, the standoff between the U.S. and the Soviet Union generated a public good that gave India room to maneuver and pursue an independent policy. As a result of India's new initiatives on this score, Indo-U.S. relations began to improve slowly during the 1990s. More cooperative relations included the U.S. being granted refueling rights during the Gulf War, joint naval exercises, and the establishment of a Defense Policy Group in the mid-1990s.<sup>19</sup>

With respect to trade issues, the public good aspects of the GATT-based trading system that had created open markets for its members (technically a club good) were potentially diminished with possible crowding in some sectors. India was hardly alone in its liberalization drive, with much of Latin America moving away from ISI policies in the aftermath of the 1980s debt crisis. Thus, as India made the transition to a more export-oriented model, it was under pressure to compete not only with East Asian but also Latin American producers for markets in rich countries. In some sense, then, the public good character of market access to developed country markets began to have more of a common pool resource characteristic as export competition increased.

In terms of its individual situation, the coalition to promote an outward looking policy remained shaky. The balance of payments crisis had empowered the P.V. Narasimha Rao minority government to undertake reforms. Yet with entrenched interests generated by ISI, reform was hardly simple and opposition slowed the pace of economic liberalization. The

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<sup>18</sup> Note that the IMF figures are for merchandise trade, and do not include service exports that are about 50 percent of India's exports to the U.S. in the last few years.

<sup>19</sup> Tomar (2002)

anti-competitiveness coalition was quite strong when Rajiv Gandhi came to power. His attempts did not succeed to a substantial extent even though he came to power in 1984 with a spectacular majority in the Parliament following the assassination of his mother Indira Gandhi. Although the budgets of 1984 and 1985 had made some headway, subsequent budgets had to roll back reforms, due largely to political pressure from within the Congress Party.<sup>20</sup> This anti-liberalization coalition remained powerful even after the balance of payments crisis of 1991. In particular, the so-called “Bombay Club” of industrialists began to voice their protest about competition from MNCs about allowing entry to multinationals after 1993, and trade unions struck against the “exit” policy that would displace jobs.<sup>21</sup>

At the elite level, however, the commitment to liberalization was strong and a consensus on the need to liberalize had been evolving among the technocratic elite prior to the crisis. Various government studies had emphasized the importance of promoting trade, and Rajiv Gandhi had made efforts to promote liberalization, albeit without success, in the 1980s.<sup>22</sup> India’s most intensive period of autarkic import substitution lasted from 1969 until 1974. A very gradual process of economic liberalization had begun after 1974. The process gained some momentum when Indira Gandhi came to power in 1980, and when Rajiv Gandhi assumed office in 1984. Despite this, while Indian economic policy was beginning to promote competitiveness and private enterprise, it still remained far too closed an economy by the standards of the rest of the world.<sup>23</sup>

Finally, with respect to institutions, although India was a member of the GATT, as a developing country it had special provision (Part IV of the GATT), which allowed it to pursue an ISI policy. During the negotiations leading up to the Uruguay Round, India had been an active opponent to service sector liberalization and also served as leader of the so-called group of 10 that had called for services to be excluded from the GATT negotiations.<sup>24</sup> Thus, at least with respect to global negotiations, India had been seen as particularly recalcitrant.

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<sup>20</sup> Kohli (1991), chapter 11; Rubin (1985:942-957)

<sup>21</sup> Mukherji (2005b:20-21)

<sup>22</sup> Mukherji (2005b)

<sup>23</sup> Nayar (2005:1885-1890)

<sup>24</sup> Aggarwal (1992)

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***Domestic Liberalization and the "Look East" Trade Policy***

The Indian response to the 1991 crisis is well documented. The Narasimha Rao government came into power as a minority government. While Rao was personally seen to be relatively weak and simply a caretaker, he found a way to politically support economic policies that would take India away from import substitution and toward export promotion and competitiveness. With the appointment of Manmohan Singh as Finance Minister, who had shifted away from a highly interventionist perspective to a more liberal one, the Rao government surprised critics and supporters alike. His credentials as both an economist and a practitioner of economic policymaking placed him in a position where he could pursue home-grown economic reforms that could sustain themselves in a plural polity. There is now clear evidence to suggest that Narasimha Rao and Manmohan Singh made virtue of necessity and pushed the reform agenda in a manner that impressed the IMF.<sup>25</sup> The response to the crisis in 1991 was substantially different from before because committed technocrats could use the crisis as a tactical weapon to promote India's competitiveness and export orientation.<sup>26</sup>

The reforms defined a new relationship between the state and the market in India. Industrial licensing was almost entirely abolished between 1991 and 1993. The average weighted tariffs were reduced from 72.5 percent to 29 percent within a decade. The currency was substantially devalued and in August 1994, the Rupee became convertible on the capital account. India's stock market was reformed, allowing it to become a source of funds for making Indian industry competitive. Reforms in the telecommunications sector were spectacular by world standards and became a great asset for the booming information technology sector.<sup>27</sup> What made these reforms interesting was that they were a home-grown process rather than one driven by IMF or World Bank dictates. Two examples illustrate the home-grown nature of India's adjustment: India was slow to reduce its fiscal deficit, and the telecommunications sector was made competitive without

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<sup>25</sup> See Sen (1998); Singh (1964). These views have benefited from personal interviews with Montek Ahluwalia, Deputy Chairman – Planning Commission, New Delhi, December 2005; Jagdish Bhagwati, University Professor, Columbia University, New York, November 1997. See also Bhaduri and Nayyar (1996:50)

<sup>26</sup> This view is based on interviews with Montek Ahluwalia, Deputy Chairman Planning Commission, New Delhi and Rakesh Mohan, Deputy Governor, Reserve Bank of India, Mumbai in December 2005.

<sup>27</sup> See Mukherji (2005b) for a good discussion of the political economy of reform in 1991.

funds from the World Bank and without privatizing government-owned operators.<sup>28</sup>

In the liberalization context, a turn to the dynamic economies of East Asia may have seemed natural. India's engagement with Southeast Asia also had to wait till 1991. Yet this was not as obvious a turn as one might have expected. ASEAN-Indian relations had remained tense during much of the 1980s with India viewing ASEAN as a puppet of the U.S. in its anti-communist stance and ASEAN seeing India as increasingly entrenched in the Soviet camp. Indeed, India had attempted to create a counter-proposal to the creation of ASEAN, viewing it as a Cold War bloc to be resisted.<sup>29</sup> Although ASEAN made various overtures to cooperate with India in the late 1970s, the latter's recognition of the Heng Samrin regime in Kampuchea, which was backed by Vietnam, chilled Indian-ASEAN relations once again. Throughout the decade, with minor exceptions, relations failed to improve.

Many analysts focus on the LEP as being a key focus for India's economic strategy almost immediately after the liberalization policy and the end of the Cold War.<sup>30</sup> Yet at this point, India was considerably more focused on mending relations with the major powers and international economic institutions in view of its dire need for financial resources and inward investment to transform its ISI-based economy to an export-oriented one. The attractiveness of the apparently successful East Asian model and the need to find trade opportunities led India to seek closer relations with ASEAN. Countries like Singapore were quick to grasp both the economic and strategic potential of the end of the Cold War and India's economic liberalization program. The end of the Cold War meant that the ASEAN countries were more comfortable dealing with India in the absence of the Soviet threat. Additionally, India's integration with the global economy opened it up as an investment destination, market and a source of imports. Senior Minister Goh Chok Tong played a key role in generating an "India fever" in Singapore in 1996. As part of the new "Look East" effort, the Rao government promoted a number of visits by high-level ministers, and

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<sup>28</sup> On telecommunications reform see Mukherji (2006); and, on stock market reform see Gent (2004).

<sup>29</sup> See Kaul (2001) for an analysis of ASEAN-India relations during the Cold War. The following discussion of Cold War relations draws heavily on her analysis.

<sup>30</sup> Mukherji (2005a)

Prime Minister Rao himself traveled to Japan and most of the Southeast Asian countries between 1993 and 1995.<sup>31</sup>

Relations with ASEAN improved rapidly, with India becoming a sectoral dialogue partner in 1992 on trade, investment, tourism, and science and technology. Following the ASEAN summit in 1995, India became a full dialogue partner (along with China and Russia). Meanwhile, on the security front, India made overtures to join the ASEAN Regional Forum (ARF). ARF had been established in July 1994 with 18 members, including the ASEAN states, dialogue partners, observers, and consultative partners. In 1996, India secured membership in ARF. It is worth noting that India's overtures in its LEP met with an interested ASEAN, who in the aftermath of the fall of the Soviet Union began to worry increasingly about China's rising power.<sup>32</sup> In this sense, the LEP served both India and ASEAN's needs.

With respect to the LEP, another initiative known as BIMST-EC (the Bangladesh, India, Myanmar, Sri Lanka, Thailand-Economic Cooperation group) also officially came into existence in June 1997.<sup>33</sup> This grouping had been brewing some time and came to fruition as a result of Thailand's initiative.<sup>34</sup> It was interested in creating a Bay of Bengal-based economic cooperation agreement in keeping with its "look west" policy. For India, BIMST-EC also provided an additional stepping-stone to ASEAN through Thailand and created a grouping that excluded Pakistan.

Despite these various efforts, commentators were skeptical about the progress of the LEP even before the Asian financial crisis had fully manifested itself. As *The Hindu* noted in an editorial on July 25, 1997:

If the investors from Southeast Asia are disappointed that economic reforms are not extended to the critical areas such as financial services in the non-banking sector or aviation, Indian businessmen and officials realize that their expectations from ASEAN were pegged too high. South East Asia may be a major trading partner, but not yet a leading investor.<sup>35</sup>

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<sup>31</sup> Saint-Mezard (2003)

<sup>32</sup> Grare and Mathoo (2003:13-14)

<sup>33</sup> BIMST-EC's name was changed to the Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation (BIMSTEC) in 2004 to preserve the acronym but to address the entry of Nepal and Bhutan.

<sup>34</sup> Saint-Mezard (2003:39-41)

<sup>35</sup> "The Hindu-Editorial: Consolidate the partnership". *The Hindu* (Chennai), 7/25/1997, 20

Thus, despite significant reform and liberalization in India, problems in implementing the LEP still remained.

### **8.3.2 Looking for Alternatives: the LEP in Flux and the Turn to Sri Lanka**

As the Asian financial crisis struck hard in much of East Asia, India's LEP faced a major challenge. Many began to question whether the eastward turn was wise while others questioned a policy of globalization in view of the vulnerabilities of the East Asian economies to financial speculation and capital movements. Of greatest impact was the disillusionment in East Asia with the aid provided by the IMF and the U.S., leading them to turn increasingly toward attempting to develop their own regional trade and financial arrangements. India was relatively unprepared for the dramatic shift toward preferential trading arrangements that took root and accelerated thereafter. It did, however, manage to undertake an accord with Sri Lanka in the context of a continued difficult relationship with Pakistan and little progress in SAARC. Both its relationship with Pakistan and East Asia were, of course, sharply affected by the Indian and Pakistani nuclear tests in 1998.

#### ***Shocks: The Asian Financial Crisis and Nuclear Tests in South Asia*<sup>36</sup>**

When the Thai baht began to falter in June 1997, few analysts foresaw the financial crisis that it would create. In December 1996, the IMF's report, *Thailand: The Road to Sustained Growth*, raised no concerns. By April 1997, when speculative pressures against the baht began to rise, the IMF and the U.S. government were openly urging the Thai government to force banks to declare their bad debts and begin to clean up the financial system. Even after Thailand was forced in early July to announce a managed float of the baht, devaluing it by about 20 percent, it refused to apply new economic measures or openly seek IMF assistance. For their part, however, the IMF and the United States did not treat Thailand's currency crisis as a serious problem.

Thailand finally requested IMF assistance in August 1997. On August 20, it signed a letter of intent with the IMF in Tokyo, after which the IMF authorized \$17 billion to rescue the Thai economy. In return, Thailand agreed to a series of economic and financial reforms. Yet the IMF's medicine only exacerbated financial troubles. The abrupt announcements of

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<sup>36</sup> This subsection draws on Aggarwal (2000).

bank closures only served to inflame the panic rather than instill confidence and added to the ongoing liquidity squeeze, making it more difficult for existing banks to continue normal lending operations.<sup>37</sup> Credit all but dried up. Meanwhile, by August, the United States had dropped out of the process, being conspicuously absent during the loan negotiations. The United States strategy appeared to backfire almost immediately as the currency crisis continued to spread beyond Thailand. Despite the IMF's intervention, the financial crisis, largely driven by currency speculation, continued to spread to the Philippines, Malaysia, Indonesia, and most importantly, South Korea. The IMF eventually promised the Philippines \$1.1 billion in aid, Indonesia up to \$40 billion, and South Korea up to \$60 billion.

With the U.S. failing to financially participate in the Thai rescue package, the Japanese took the lead in September 1998 with a proposal for an Asian Monetary Fund (AMF) to be backed by \$100 billion that they had lined up in commitments in the region. But the IMF and U.S. attempted almost immediately to quash this initiative, with the Treasury leading the charge. Instead of directly confronting American opposition, the APT countries set up a currency swap scheme in Chiang Mai, Thailand, in 2000 as a "firewall" against future financial crises.<sup>38</sup>

In addition to these trends in finance, East Asian countries also began to consider the negotiation of preferential trading arrangements with each other. The Asia Pacific Economic Cooperation (APEC) forum, the pan-Pacific agreement that included North American countries, Chile, Peru and most East Asian countries, had proved ineffectual in dealing with the Asian financial crisis and in advancing trade liberalization. In this context, East Asian countries began to show a strong interest in securing their trade position, initially through the negotiation of bilateral preferential trading arrangements. The most active state was Singapore, which negotiated agreements with New Zealand (2000) and then with Japan (2002). Meanwhile, the ASEAN group held its first meeting with China, Japan, and South Korea, creating the ASEAN Plus Three grouping in 1997. By 2000, the ASEAN Plus Three was making plans to create a free trade agreement.

With respect to the second "shock", soon after the Bharatiya Janata Party (BJP) came to power for the second time on March 19, 1998, India tested several nuclear devices in May 1998. This decision also threw India's LEP into further turmoil as ASEAN countries (and most Western countries) expressed their dismay at the tests (which were soon followed by Pakistani tests). Yet in this case, Indian diplomacy, through a series of

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<sup>37</sup> Bresnan (1998:4)

<sup>38</sup> See Amyx (2003) for details.

meetings with key players in the region and working through ARF, appears to have prevented the Philippines and Thailand from promoting a hard-line position to condemn India.

### ***Factors Affecting India's Response***

We next turn to India's changing policies in the post-1997 period. Turning first to goods, the altered security environment with the end of the Cold War created a need for India to seek new alignments and ensure its security. In the absence of any club goods or public goods that would guarantee India's security, India sought to pursue "private" goods through the Pokhran II tests in May 1998. In the trade realm, the Asian financial crisis was followed by an increasingly regionalizing club and the pursuit of bilateral club goods by key players in the region.

In terms of its evolving international situation, India had moved forward with cooperation with the U.S., but still had not positioned itself clearly in either security or trade. In security, the U.S. perceived India a regional player that was primarily focused on Pakistan. At the same time, it aspired to a larger global role, but its military position did not put it in that role. Similarly, in the economic realm, India had begun to grow relatively rapidly, and its trade was increasing. Still, despite a significant push toward an export-oriented model, its share of global trade had only crept up to 0.6 percent in 1995-96, up from 0.41 percent in 1992-93.<sup>39</sup> By contrast, China already accounted for 1.9 percent of world exports in 1990, increasing to 4 percent by 2000.<sup>40</sup>

India's domestic coalition also faced difficulties with fluctuating governments and anti-liberalization pressures. Reforms had slowed and there was considerable concern about India's ability to sustain a continued liberalization policy. In terms of elite views, there still appeared to be a strong commitment to a multilateral approach to trade liberalization, albeit with exceptions for developing countries and pressure to keep some restrictions on trade. With respect to nuclear weaponization, as Amitabh Mattoo notes, there was a strong shift among elites in support of India moving to develop nuclear weapons between the 1974 test and 1994 (before the tests).<sup>41</sup>

Finally, in terms of institutional context, India faced the challenge of an indefinite extension of the Non-Proliferation Treaty in 1995 and the con-

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<sup>39</sup> [http://www.wto.org/english/tratop\\_e/tpr\\_e/tp71\\_e.htm](http://www.wto.org/english/tratop_e/tpr_e/tp71_e.htm).

<sup>40</sup> <http://www.imf.org/external/np/speeches/2005/011005.htm>

<sup>41</sup> Mattoo (2001:102)

clusion of the Comprehensive Test Ban Treaty in 1997.<sup>42</sup> This led to concern about growing institutional constraints on India's efforts to move toward great power status and increasing freedom of maneuver. With respect to trade, as we have seen, the primary context in which India operated was the WTO. The LEP had not resulted in any significant institutionalization beyond creation of BIMST-EC while SAARC's 1993 decision to create a free trade agreement had yielded little growth in intra-regional trade or significant institutionalization.

### ***India's LEP in Flux and the Turn to Sri Lanka***

With the East Asian crisis in full bloom in 1997-98 and India's nuclear tests, economic cooperation with Southeast Asia was hindered significantly. Merchandise exports to ASEAN declined from \$2.349 billion to \$1.835 billion between 1995 and 1998, and as a percentage of India's total exports from 7.69 percent to 5.45 percent. Meanwhile, as ASEAN countries' currencies underwent rapid devaluation in the crisis, imports to India from the region simultaneously surged from \$2.3 billion to \$4.1 billion, growing from 6.7 percent of India's total imports to 9.8 percent during the same three-year period.

Concern about India's LEP was nicely expressed with the phrase "India Looks East But Asia Looks Away," in an article in *The Hindu* on December 1, 1999. Raja Mohan, whose perspective appeared to be widely shared, argued that "India is increasingly seen in the region as the "Middle Kingdom", obsessed with its own domestic political wrangling and unprepared for a serious regional engagement." He went on to note that the LEP appeared to be in trouble, arguing "The mild 'India fever' that gripped South East Asia in the mid-1990s has long evaporated." And he pointed out that "India's nuclear tests followed by increased political tensions with the U.S., Japan and China put it in a difficult position vis-à-vis the rest of Asia. Renewed hostilities with Pakistan have reinforced the traditional image of a perennially squabbling subcontinent, that few in South East Asia have the desire to get entangled in."

Even as East Asia's states recovered economically, India still appeared to be facing difficulties in implementing its LEP and pursuing economic liberalization more generally. As *The Straits Times* (Singapore) reported on January 20, 2000 on the occasion of Singaporean Prime Minister Goh Chok Tong's visit to India:

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<sup>42</sup> RAND (2001) based on Tellis 2001.

Visiting Prime Minister Goh Chok Tong said yesterday that the government in India had to try and change its mindset to fully capitalize on its 10-year-old "Look East" policy. He also said that the private sector should pressure the government to change its mindset in support of globalization.<sup>43</sup>

Yet all was not lost. India continued to play catch up with the LEP and invigorate the general rhetoric with actual policy changes. It moved to set up an economic cooperation agreement with Singapore, links to Myanmar, and cooperation agreements with Laos in late 2000. Jaswant Singh colorfully described the state of the LEP when he noted, "We have been talking about looking east but so far it has been a bit like the Delhi water supply. You turn on the tap and there is the sound of the promise of water but it's usually air. This has to change."<sup>44</sup> At the same time, India faced a perception of South Asia as being outside of "Asia" with its efforts to join APEC coming to naught. Indeed, despite significant efforts, India had been unable to join APEC and a moratorium on membership had come into effect in 1997 for 10 years, thus impinging on the LEP and India's efforts to insert itself firmly into the East Asia institutional context. Meanwhile, India continued various efforts to link its economy to Southeast Asia. One effort, the Mekong-Ganga Cooperation (MGC) initiative, attempted to give more substance to the LEP, which was clearly by this time seen to be in trouble. India also continued to press forward with BIMSTEC.

In short, the changes wrought by the Asian financial crisis, which led East Asian states to increasingly focus on regional and bilateral efforts amongst themselves, seemed to have created difficulties for India's LEP. Indian policymakers clearly recognized this and made a strenuous effort to play catch-up. One of the most significant of these catch-up efforts was the decision to pursue India's first preferential agreement with Sri Lanka. The treaty was signed in 1998 and became operational in 2000. Improvements in security relations and interdependence concerns aided this process. Sri Lanka-India trade was ridden with vulnerability concerns before 1998. These vulnerability concerns had impeded the progress of Joint Commissions since 1968. There had been fears that Sri Lanka would be flooded with Indian products.

The end of the Cold War was a background condition. Sri Lanka was considered too pro-West during the J.R. Jayawardane presidency. The significant event that pushed the countries toward friendlier relations was the

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<sup>43</sup> "India gov't. 'should try to change its mindset'", *Straits Times* (Singapore), 1/20/2000, 17.

<sup>44</sup> *Straits Times* (Singapore), November 15, 2000, 27.

assassination of Rajiv Gandhi and India's withdrawal of support for the Liberation Tigers of Tamil Eelam (LTTE), an anti-government force in Sri Lanka that was responsible for the assassination. Indo-Lanka relations improved dramatically after Narasimha Rao became Prime Minister. Subsequently, Prime Ministers Gujral, Vajpayee and Singh have continued the positive momentum in Indo-Lanka relations. The departure of the Indian Peace Keeping Force was followed by an unprecedented level of activity within the Joint Commissions and subsequent High Commissioners were viewed as being sympathetic to Sri Lankan concerns.<sup>45</sup>

The removal of the security irritant was accompanied by India's quest to increase its trade. The U.S. trade sanctions in the aftermath of the Indian nuclear and the Asian financial crisis increased India's resolve to have a successful sub-regional trade agreement with Sri Lanka. India was willing to grant more than reciprocal concessions to Sri Lanka.

Given India's growing commercial might it was in Sri Lanka's interest to lock India into a preferential trade relationship. Aided by an excellent study of the World Institute of Development Economics Research (WIDER) and ably complemented by technocratic activism of the Presidential Advisor Lal Jayawardane, Sri Lanka found good reason to lock a willing India into a trade relationship. The success of India's economic liberalization program saw India surpassing Japan as Sri Lanka's leading exporter in 1996. India supplied 10.4 percent of Sri Lanka's imports compared with 9.2 percent coming from Japan. In 1997, out of a total trade of \$560 million Sri Lanka's exports to India were a paltry \$ 42.7 million. Sri Lanka's exports to India as a share of its total exports declined from 1.1 percent in 1990 to 1.0 percent in 1996.<sup>46</sup>

There was much opposition to the agreement from small industrialists, farmers and trade unions in Sri Lanka. An agreement could be reached after a number of asymmetrical and favorable concessions were made by India. India granted zero-duty concessions on 1,000 items compared with Sri Lanka's 300. India's negative list covered 24 percent of the goods while Sri Lanka's covered 49 percent of its products, ably protecting competing

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<sup>45</sup> Personal interview by Rahul Mukherji with Saman Kelegama, April 9, 2003. Kelegama is the Director of the Institute of Policy Studies, Colombo. See also Kelegama (1999:91-92)

<sup>46</sup> See WIDER (1991); WIDER (1993); Jayawardane (2001); Kelegama (1999). The technocratic activism was explained to Rahul Mukherji by Lal Jayawardane in a personal interview in Colombo in April 2003. He was the most powerful technocratic force within Sri Lanka that pushed this agreement.

producers. The adjustment period for India was three years while that for Sri Lanka was eight years.<sup>47</sup>

**Table 8.5: Trade flows between Sri Lanka and India<sup>48</sup>**

Year	India's imports from Sri Lanka (millions of Rupees)	India's exports to Sri Lanka (millions of Rupees)	Import-Export Ratio
1998	35,837.7	2,279.4	16.1
1999	36,012.9	3,320.3	11.1
2000	45,477.1	4,217.3	11.1
2001	53,750.0	6,265.7	8.61
2002	79,847.1	16,152.9	5.1

The results of these asymmetrical concessions were favorable for Sri Lanka. Between 1998 and 2002, the ratio of Sri Lanka's imports from India to its exports to India declined from 16:1 to 5:1 (Table 8.5). The preferential exports of Sri Lanka had grown by 620 percent in 2002.<sup>49</sup> India is the biggest foreign investor in Sri Lanka, and at the time of this writing the two countries were negotiating to broaden the Comprehensive Economic Partnership Agreement to include services by late 2007.<sup>50</sup>

The Indo-Lanka Free Trade Agreement (ILFTA), which reflected growing sub-regional interdependence within South Asia, was aided by the end of the Cold War and India's trade potential resulting from the economic liberalization program. The nuclear sanctions and the Asian financial crisis made India desperate to look for partners within the region. It was only when security relations warmed after the assassination of Rajiv Gandhi that commercial considerations drove Sri Lanka toward a preferential trading relationship.

<sup>47</sup> The opposition to the Indo-Lanka Agreement is clear from Sri Lankan newspaper articles of 1998 and 1999. Only big business supported the agreement. On this, we benefited from Mukherji's interviews with Saman Kelegama, Lal Jayawardane, Jayanta Kelegama, Ken Balendra, Stanley Jayawardane, and Patrick Amarsinghe in April 2003.

<sup>48</sup> Kelegama (2003: 3153)

<sup>49</sup> Kelegama (2003:3153-3154)

<sup>50</sup> "Sri-Lanka India Comprehensive Economic Partnership Agreement in early 2007", Colombo Page 11/18/2006. See <http://www.colombopage.com/archive/November18140900SL.html>

### 8.3.3 Post-9/11: A New Security and Trade Environment

The third set of shocks and its aftermath for India's trade policy are the attacks of September 11, 2001, the U.S. and East Asian shift to preferential trading arrangements, and the collapse of the Doha Round in 2006. These attacks dramatically altered both the security and economic environment in which India operated as the U.S. dislodged the Taliban in Afghanistan and invaded Iraq to remove Saddam Hussein. In the case of Afghanistan, closer relations between the U.S. and Pakistan were a natural result of this need for a frontline ally. Yet here, the outcome was not as detrimental to India's interests as might have been feared in view of the aftermath of the Soviet invasion of Afghanistan in 1979 and the installation of Babrak Karmal that led to massive U.S. aid to Pakistan.

As the U.S. turned its trade policy in a more bilateral direction and began to use institutions such as APEC and ARF to promote an anti-terrorist agenda, East Asian countries responded with an acceleration of bilateral and regional trade efforts. In this case, unlike India's response to the Asian financial crisis of 1997-1998, when it was caught flat-footed, India responded more aggressively and has made significant inroads in successfully pursuing its "East Asian" agenda as well as new initiatives such as a possible bilateral trade agreement with the European Union.

#### ***New Shocks: 9/11, Kargil and Parakram, and Trade Promotion Authority***

The most dramatic event in the transformation of U.S. foreign policy after the end of the Cold War is undoubtedly the aftermath of the 9/11 attacks on New York and Washington D.C. The invasion of Afghanistan, intended to destroy the al-Qaeda terrorist network and remove its Taliban sponsors from political power, had proven to be a relative success. In March 2003, the anti-terrorist effort was carried to Iraq, with the deposing of Saddam Hussein. The controversy over Saddam's links to al-Qaeda and the question of weapons of mass destruction are clearly beyond the scope of this paper. Suffice it to say that the ensuing debacle in which the U.S. now finds itself has yet to be resolved, with calls for American troop withdrawals being criticized by Bush administration officials.

Two other crises influenced India's policies. First, the Kargil invasion by Pakistani forces, in which forces crossed over the Line of Control in Jammu and Kashmir, led to a flurry of activity by the United States. President Clinton brokered an agreement that led to Pakistani withdrawal of its troops from the region. But soon thereafter, India's Operation Parakram, a large scale Indian mobilization of troops from January through November 2002, dramatically increased tensions. India launched this mobilization as an effort to engage in coercive diplomacy to deter Pakistan from further

support of cross-border terrorist activities. The immediate precipitant was the attack on the Indian parliament in December 2001 that was attributed to Lashkar-e-Taiyaba and Jaish-e-Mohammad, which India argued had been allowed by Pakistan to operate freely. Yet this mobilization effort did not lead to significant reductions in Pakistani support for such groups, and raised the prospects of a major war between India and Pakistan that once again led to U.S. diplomatic efforts to prevent further conflict.

Another key event was the passage of Trade Promotion Authority by the U.S. House of Representatives in December 2001. This was soon followed by Senate passage of the trade bill in May 2002, and final passage of the jointly agreed House-Senate Trade Promotion bill in August 2002. Even as the House passed the bill, U.S. Trade Representative Robert Zoellick was gearing up for the U.S. emphasis on a multipronged trade liberalization effort. As the press release commented, "The United States will press ahead with negotiations on a Free Trade Area of the Americas, free trade agreements with Chile and Singapore, and global trade negotiations under the auspices of the WTO."<sup>51</sup>

Finally, in July 2006, the Doha Round of the WTO was suspended. The major issues of contention concerned reciprocal concessions in agriculture and manufacturing. The developing countries called for sharp cuts in agricultural subsidies in both the U.S. and the EU, which in turn pressed developing countries to lower and bind their manufacturing tariffs. At the time of this writing in the summer of 2007, although the round has resumed, its outcome is uncertain. Yet in the aftermath of the Doha Round many key players have moved toward negotiating bilateral trade negotiations, posing a challenge to India to follow this trend.

### ***Factors Affecting India's Response***

With respect to goods, security still remained in flux. In the aftermath of 9/11, the U.S. began to reorient its focus away from its previous concern with ensuring that China's rise would not pose a threat to the U.S. to a policy of pursuing specific private goods. The U.S. was less concerned with the provision of Asian security and playing a balancing role in the region, and more concerned with pursuing terrorists and working with states who perceived the terrorist threat to be paramount.

In terms of trade "goods", although the U.S. continued to work with other WTO members, it was increasingly interested in securing bilateral and minilateral trade agreements. East Asian states had already begun to negotiate trade agreements, with Singapore taking a leading negotiating

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<sup>51</sup> U.S. Mission Geneva, Press Release, 12/6/2001

role in the region following the 1997-98 crisis, but this trend toward the conclusion of such bilateral accords sharply accelerated. Singapore continued to enter into trade accords with many other countries, including the European Free Trade Agreement (EFTA) countries, Australia, the U.S., Jordan, South Korea, Panama, and India (discussed below) and had a host of other negotiations underway.

China, Japan, South Korea, and other states in East Asia also joined the FTA bandwagon. At the APT meeting in Brunei in 2001, China proposed an ASEAN-China FTA and signed a surprise agreement in November 2002 with the 10 ASEAN countries pledging free trade. The proposed FTA is scheduled to take effect in 2010 for the six original members of ASEAN (ASEAN-6), and in 2015 for the less developed members (Cambodia, Laos, Vietnam and Myanmar). Under the agreement, China has accorded Most Favored Nation treatment to Cambodia, Laos, and Vietnam (which are not members of the WTO), has written off \$220 million of debt, and promised an "early harvest" of tariff reductions on hundreds of agricultural products, with discussions on goods, services, and investments to be held sooner rather than later.

Challenged to do the same and to demonstrate a continued Japanese capability to lead within East Asia, Japan proposed a Japan-ASEAN FTA at the ASEAN summit in 2002. It also hosted the ASEAN-Japan Commemorative Summit in December 2003, confirming its enthusiasm for promoting collaboration with ASEAN members. Japan also had agreements or was in negotiations with Mexico, South Korea, Malaysia, Thailand and the Philippines. Meanwhile, South Korea signed its first FTA with Chile, proceeded to conclude negotiations with Singapore, EFTA, and ASEAN, and held discussions with Japan, Mexico, Israel, the U.S. and others. Clearly, bilateral club goods was the name of the new game.

In terms of India's individual situation, as we have seen, the conflict with Pakistan continued to be high on the agenda. India also found itself in a rapidly changing dynamic. With its economic position as a key player in the software industry and rapid economic growth, the security-economic dynamic involving China, Russia, the U.S., Pakistan, ASEAN countries, and others was in tremendous flux.

With respect to India's domestic coalition, liberalization over the years since 1991 has created an increasingly outward-oriented focus, although protectionist elements still remain strong. With respect to interest groups, it is quite clear that the emergence of a service sector, with a high-tech focus in part of it, has been an important factor supporting the global turn. Services now account for over 46 percent of India's GDP, up from 40 per-

cent prior to the reform.<sup>52</sup> The service sector also provides a nice complement for India's manufacturing sector, thus providing a good fit and strong incentive for trade cooperation. And as Christophe Jaffrelot has noted, "India's capacity in the high-tech sector was also an important element in the relaunching of relations between India and the Southeast Asian countries after the peak of the Asian crisis was over."<sup>53</sup> And in contrast to the earlier opposition that the liberalization policy faced from the so-called "Bombay Club", one of its leading members, Rahul Bajaj, "has finally realized that he needs to diversify his manufacturing base globally to compete effectively in the international market. He has decided to set up two assembly operations in Indonesia and Brazil."<sup>54</sup> In particular, the banking industry has argued that FTAs had helped Indian banks to expand globally.<sup>55</sup>

Still, free trade agreements or the prospects of them are seen by some industries in India as a threat to their viability. Discussing the FTA that India negotiated with Thailand, the head of the auto manufacturers association in India worried that: "...perhaps without intending to, the Thai FTA could end up hurting India's manufacturing industry."<sup>56</sup> A powerful lobbying group, the Federation of Indian Chambers of Commerce and Industry (FICCI) has also raised concerns about India's current bilateral trade agreement strategy. As Chetan Bijesure noted in a recent interview, "bilateral agreements with which Indian industry faces strict competition in strategic sectors should be minimized."<sup>57</sup> He went on to note that the Thai FTA had failed because of the increased competition that Indian industry faced in autos and electronics. In the context of negotiations with ASEAN, he called on the government to continue to protect weak sectors from competition.

More generally, with respect to trade liberalization, other lobbying groups have also expressed doubts. The Associated Chambers of Commerce and Industry (ASSOCHAM) has also been critical of liberalization, arguing that the FTAs signed with Sri Lanka and Thailand have not benefited India and that other countries have used Sri Lanka and Thailand to

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<sup>52</sup> Virmani and Batra (2004:6)

<sup>53</sup> Jaffrelot (2003:63)

<sup>54</sup> Bajaj Report, *The India Express*, 7/25/2005

<sup>55</sup> "Consolidation of banks imperative to compete globally: FICCI". *The Press Trust of India*, 9/24/2006

<sup>56</sup> *Asia Times Online*, 2/13/2004

<sup>57</sup> Interview, November 2006.

dump products in India.<sup>58</sup> Yet ASSOCHAM has not been entirely opposed to trade liberalization; they conducted a survey of Indian industry about an FTA with the EU and concluded that a specialized FTA in services, targeting knowledge sectors like IT, bio-tech, and pharmaceuticals would be of great benefit.<sup>59</sup> ASSOCHAM's concerns are primarily about the costs of short-run adjustment problems that FTAs bring. They still believe that in the long run FTAs will bring gains for Indian industry, provided that the agreements are drafted carefully, particularly in areas like rules of origin.<sup>60</sup> ASSOCHAM has come out in favor of standardizing the format of rules of origin for all future FTA negotiations, in effect pushing for stringent guidelines in the ASEAN negotiations to avoid weakening India's bargaining position on such issues in the future.<sup>61</sup>

In terms of multinational corporations' incentives, a large number of Indian multinational corporations have begun to look eastward already, thus helping to push India to focus on the east. The information technology sector, which has companies with operations in Southeast Asia are the major proponents of free trade with Southeast Asia. These would include large companies like the Tata Consultancy Services and the powerful industry organization—National Software and Service Companies (NASSCOM). Their interests were taken into consideration in the Comprehensive Economic Cooperation Agreement (CECA) with Singapore, which allows for the easy movement of natural persons and recognition of professional standards.

And for their part, elites have been increasingly pushing the need to not only see India as a global player, but also to more firmly "insert" India into Asia. In calculating where to turn for India's prospective FTA partners, elites focused in part on the balance of trade. Thus, in the case of Thailand, it appears that the Government of India decided on Thailand in view of India's balance of trade surplus. Yet, as noted in terms of the reaction of domestic coalitions, the rapid reversal in the balance of trade with Thailand in the 82 liberalized products created a panic, and Thailand has responded by suggesting that additional items be liberalized to improve India's trade balance in liberalized goods.

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<sup>58</sup> "FTA With Sri Lanka, Thailand Not Benefiting India: ASSOCHAM". *Asia Pulse*, 2/6/2006

<sup>59</sup> "India Inc for Services FTA". *Indian Express*, 9/6/2005

<sup>60</sup> "FTAs Will Create Adjustment Problems in Short Term: ASSOCHAM". *Hindustan Times*, 10/19/2005

<sup>61</sup> "Do Not Tamper With RORs Already in Place for ASEAN: ASSOCHAM". *Hindustan Times*, 6/17/2005

Finally, with security institutions such as ARF relatively ineffective, security remains relatively uninstitutionalized in the region. Still, ASEAN has shown a willingness to involve India in regional maritime activities and the U.S. has conducted exercises with India.<sup>62</sup>

### 8.3.4 Toward a New Trade Policy?

With the security context and economic context rapidly in flux since 2001, how has India's trade policy evolved? We can examine its new orientation by briefly examining its approach to negotiations at the multilateral, mini-lateral, and bilateral level.

#### *Global Negotiations*

With respect to global multilateral negotiations, India played a highly active role in the Doha Round of the WTO. It has become a key member of the informal Group of 4 that includes U.S., the EU, and Brazil. Throughout the negotiations, Kamal Nath, India's chief negotiator and the commerce and industry minister, has argued vociferously for sharp cuts in agricultural tariffs by the U.S. and EU. When the latter responded by calling for India and other major developing countries to bind their industrial tariffs to no more than 16 percent, India responded by arguing that "India had already made it clear that the rich nations cannot seek a price from developing countries for scrapping farm subsidies since it was a correction of a historic imbalance."<sup>63</sup>

The standoff on the tradeoff between industries tariff cuts by developing countries and cuts in agricultural tariffs and subsidies by the rich countries has continued to this day. The U.S. government has responded to the stalemate with hints that India will lose its position as a preferential trading partner if its actions continue.<sup>64</sup> Indian rhetoric has become confrontational as well. In October of 2006, Indian Prime Minister Manmohan Singh accused developed countries of obstructing the Doha Round, "hit out at developed countries for their 'myopia' and asked them not to allow their 'short-term national interests' to prevail at the cost of promoting free

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<sup>62</sup> See Chapter Nine of this volume by Eswaran Sridharan.

<sup>63</sup> Global News Wire, Financial Times Information, 4/6/2006

<sup>64</sup> "India May Lose U.S. Preferential Trade". The Statesman Ltd., Source: Financial Times Information Limited – Asia. 8/9/2006

trade and combating poverty.”<sup>65</sup> As of this writing, negotiations have been revived in the WTO, but the fate of the Doha Round still remains uncertain.

### ***Minilateral Negotiations***

India also secured an invitation to the December 2005 East Asia Summit meeting and is now one of 16 participants (ASEAN plus South Korea, Japan, and China; Australia, New Zealand, and India). The EAS finds its roots in conceptions of creating an East Asian regional bloc to counter the regionalism in North America and Europe. Although China prefers an even more restricted membership that follows the ASEAN +3 format, Japan has pushed for the inclusion of Australia, New Zealand, and India.

On a narrower minilateral basis, India and ASEAN continue to pursue negotiations on a proposed FTA. The Indians have given the ASEAN negotiators a negative list of 490 items, down from the initial number of around 1400 items that they proposed in 2005.<sup>66</sup> This concession has still been met with protest by ASEAN countries, which say it covers too many goods of interest to them. Agricultural products, followed by textiles, appear to be the main points of contention on the Indian list.<sup>67</sup> Palm oil in particular is of major interest to Malaysia and Indonesia; India has offered to negotiate a separate agreement for palm oil, cutting tariffs to about 50 percent, in order to speed negotiations along.<sup>68</sup> Talks on services and investment are expected to occur once substantial progress has been made in the talks on trade in goods.<sup>69</sup> Unlike the Thai agreement that has led to concerns about the impact of the FTA, these same concerns appear less applicable to the potential ASEAN FTA because India's exports to

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<sup>65</sup> “India PM criticized developed countries on trade in Cambridge speech”. British Broadcasting Corporation, 10/11/2006

<sup>66</sup> “Monday, India, ASEAN to meet next month for FTA talk,” The Press Trust of India, 10/16/2006

<sup>67</sup> “Doha Talks Failure Giving the India-ASEAN FTA a New Thrust,” Business Line, 8/24/2006. See also, M K Venu, “India, ASEAN set negative list cap at 5 percent of trade,” The Economic Times, 1/15/2007.

<sup>68</sup> Damodaran, Rupa, “India Proposes Separate Agreements on Palm Oil,” Business Times (Malaysia), 8/26/2006

<sup>69</sup> “ASEAN, India agree to resume free trade talks; more tariff cuts demanded,” BBC Worldwide Monitoring, 8/24/2006

ASEAN have been growing faster than ASEAN's exports to India.<sup>70</sup> Joint Secretary of the Union External Affairs Ministry Mukta Tomar has expressed the hope that the ASEAN FTA framework could begin to be implemented in 2007, and also related that the "thrust in India's foreign policy in the last 15 years was to increase connectivity with the neighboring countries and groups like BIMSTEC, ASEAN and SAARC with the north-east so that the region could become a hub in trade and commerce."<sup>71</sup>

The India-ASEAN FTA negotiations have gained momentum but the Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation (BIMSTEC), which was supposed to be signed by July 2006, may now be delayed. The initiative involves Bangladesh, India, Myanmar, Sri Lanka, Thailand, Nepal and Bhutan. Negotiations have been bogged down by debates over rules of origin, negative lists and the non-tariff barriers of developing countries. BIMSTEC involves all the countries of South Asia except Pakistan and India's neighbors in Southeast Asia. If successful, this agreement will bring South Asia closer to Southeast Asia. Given that BIMSTEC's FTA essentially duplicates the regional FTAs that India will have with ASEAN and the South Asia Free Trade Agreement (SAFTA), it may be that India's interest in BIMSTEC is due to a desire to hedge its bets against potential problems with Pakistan in SAFTA.

The talks between India and the Gulf Cooperation Council (GCC)—composed of Qatar, Oman, Bahrain, Kuwait, UAE and Saudi Arabia—to develop a FTA stalled in late 2006. Concerns over weak enforcement of IPR laws in GCC countries, different legal systems among the various GCC members, and the costs of standards compliance in GCC countries have held up the FTA talks; this has led members of the GCC to seek individual FTAs with India.<sup>72</sup> Moreover, the Indian petrochemicals and plastics industry with an investment of 500 billion Rupees is feeling the threat from this FTA. In particular, Oman, with which India has the strongest economic ties, would like to conclude an FTA with India immediately, while India would like to wait and enter into agreements jointly with the 6 GCC countries.<sup>73</sup> India has already begun discussions for individual FTAs

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<sup>70</sup> "Doha Talks Failure Giving the India-ASEAN FTA a New Thrust," *Business Line*, 8/24/2006

<sup>71</sup> "FTA likely with ASEAN, BIMSTEC nations: official," *The Press Trust of India*, 9/19/2006

<sup>72</sup> "Weak IPR Makes GCC-6 Seek Individual FTAs with India", *Financial Express*, 9/15/2006

<sup>73</sup> *Ibid.* For opposition from Indian industry see, "Now FTA with Gulf runs into trouble", *Times of India*, June 9, 2006; "India-GCC FTA Talks in April: Nath",

at the ambassadorial level, though the pace of talks is currently undisclosed.<sup>74</sup> An FTA with the GCC members is expected to boost India's pharmaceutical and chemical industries.<sup>75</sup> The articles covering India-GCC interaction repeatedly emphasize the importance of joint ventures. The India-GCC negotiations for an FTA got underway after a Framework Agreement on Economic Cooperation was signed in 2004; the talks proceeded with the expectation that trade in goods, services, and investment would be covered.<sup>76</sup> Oman especially was trying to expedite the trade talks by pushing for a fast-track mechanism.<sup>77</sup> In addition to IPR and standards compliance cost concerns, Indian industry and agriculture expressed reservations about the impact that the proposed FTA might have on vegetable oils, tobacco, and polymers.<sup>78</sup>

### ***Bilateral Agreements***

Finally, on a purely bilateral basis, India has concluded trade agreements with Thailand (2003) and a Comprehensive Economic Cooperation Agreement with Singapore in 2005. It has also been involved in talks with Japan and there is some movement on a possible accord with the EU.

The Indo-Thai Free Trade Agreement was an example of political strategy rather than careful trade policy driving India's Look East policy. An Indo-Thai Free Trade Agreement was signed in October 2003 with 82 items earmarked for duty reduction within the early harvest scheme. Within months Thailand's trade surplus was 400:1, with Thailand's comparative advantage emerging in auto components and consumer durables. Subsequently, a study by the Indian Credit Rating Agency (ICRA) found that Thailand had a comparative advantage in these areas owing largely to the duty structure in India. The result was that truck makers like Ashok Leland were trying to set up factories in Thailand. Industrialists hurt by the agreement worried that the government, even if it needed to conduct trade

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The Hindu, March 27, 2007; and, for lack of political will on India's side, see N Janardhan, "India-UAE ties: Time to pull no punches", Gulf in the Media, March 25, 2007.

<sup>74</sup> Ibid.

<sup>75</sup> Ibid.

<sup>76</sup> "IT, energy and ICT, new focus areas for India-Gulf cooperation", Hindustan Times, May 17, 2006

<sup>77</sup> "Oman Seeks Fast-Track Mechanism for India-GCC FTA", Asia Pulse, 9/5/2006

<sup>78</sup> "Industry For Change in Gulf FTA", Financial Express, 6/2/2006

agreements for strategic and political reasons, should have conducted consultations with business. Indo-Thai trade is faced with issues concerning rules of origin. India wants restrictive rules that ensure that products manufactured in other countries do not receive easy access to India via Thailand.

The Comprehensive Economic Cooperation Agreement between India and Singapore was signed on June 29, 2005 to bind more firmly India's commercial relations with Singapore. This was a way of rewarding Singapore's initiatives to bring India closer to Southeast and East Asia. Since Singapore is an open economy there was limited scope for preferential market access available to India via this initiative. The quid pro quo was to allow Singapore greater access to the Indian market in return for Singaporean investment and easier entry of Indian skilled professionals into Singapore. The CECA also provided for service sector liberalization and mutual recognition of degrees in various professions. Singapore accepted a restrictive rule of origin criteria that required 40 percent value addition and a change in tariff heading under the harmonized system code for a product to be considered as one originating from Singapore. India was keen on such a definition after it found that Sri Lanka was being used as a base from which to sell the products of other countries, taking advantage of less restrictive rules of origin for Sri Lankan goods.<sup>79</sup> The CECA needed negotiations with domestic industry in sectors such as automobiles, chemicals, banking and textiles, which felt threatened by competition. By subjecting Indian industry to greater levels of competition in a graduated way, CECA was also likely to make it more competitive.

Lastly, starting in July 2005, Japan and India convened a bilateral joint study group to explore the possibility of signing an FTA between the two countries. It issued a report that was adopted in July 2006 by then-Japanese Prime Minister Koizumi and Prime Minister Singh, following the G8 summit.<sup>80</sup> The report recognizes the potential for further economic engagement and paves the way for the launch of official FTA negotiations later in 2006.<sup>81</sup> In September 2006, Singh expressed a desire to launch bilateral trade agreement negotiations with the new Abe administration.<sup>82</sup> Comprehensive Economic Partnership Agreement (CEPA) negotiations are likely to get underway in the fall of 2007, with the Japanese hopeful for

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<sup>79</sup> Mukherji is grateful to Aparna Shivpuri Singh for pointing this out to him.

<sup>80</sup> "Japan, India adopt FTA report to pave way for negotiation", BBC Worldwide Monitoring, 7/17/2006

<sup>81</sup> Ibid.

<sup>82</sup> "India wants to start FTA talks with Japan: Singh", Japan Economic Newswire, 9/26/2006

a conclusion by the end of 2008.<sup>83</sup> The bilateral joint report says that sensitive sectors, industrial imports into India and agricultural imports into Japan, should be treated flexibly, but it is hoped that the FTA will cover goods, services and investment.<sup>84</sup> India's strategy with these talks seems to be an attempt to spur greater Japanese investment, particularly in infrastructure,<sup>85</sup> and to leverage its complementarities in software with the Japanese hardware industry.<sup>86</sup> The non-state electronics industry associations of Japan and India have signed an agreement in an attempt to bring more Japanese investment to India; these domestic Indian actors appear to be in favor of greater liberalization.<sup>87</sup>

Indian and Japanese views on Asian trade seem to converge to a greater extent than the views of China and India. While China is keen to develop a free trade area in Asia that would involve itself and the ASEAN countries along with South Korea and Japan, Japan wants a larger area that would also include India, Australia and New Zealand. While India is not enthusiastic about promoting a free trade area with China, it is taking measures to increase its trade with Japan.

In sum, in the post-9/11 era, India has coped remarkably well and has successfully been "catching up" with the flurry of bilateral and minilateral East Asian-based economic cooperation initiatives. Its liberalization project also appears to be moving relatively well. Whether these trends are likely to continue are, of course, unknown, but we can examine these questions in a speculative manner, a task we take up in the next section.

## 8.4 The Future of India's Trade Policy: Scenarios

How is India's trade policy likely to evolve over time? Clearly, making predictions is not easy as some significant shocks could once again dramatically alter both the security and economic context in which India is

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<sup>83</sup> "CEPA Agreement Beneficial for India, Japan: Japanese Ambassador", Asia Pulse, 8/9/2006

<sup>84</sup> "Japan, India adopt FTA report to pave way for negotiations", BBC Worldwide Monitoring, 7/17/2006

<sup>85</sup> "India wants to start FTA talks with Japan: Singh", Japan Economic Newswire, 9/26/2006

<sup>86</sup> "Japan, India adopt FTA report to pave way for negotiations," BBC Worldwide Monitoring, 7/17/2006

<sup>87</sup> "Japan, India sign electronic goods treaty Bilateral Trade", Financial Times (Asia Edition), 9/7/2006

operating. What we have seen to this point is that India's trade policy has been a product of dramatic changes in the security and economic environment. In terms of the driving force behind policy changes, in all three post-shock periods (Cold War/Balance of Payments crisis; Asian financial crisis; and 9/11, U.S. TPA, and Indo-Pakistan security issues) the primary combination of factors has been India's changing economic and security position, combined with elite-led strategies. What is most striking in view of the research described here is the *absence* of a significant pro-trade coalition. The sectors with some weight that are in favor of liberalization are the ones such as the software and services sector and the pharmaceuticals sector. The National Association of Software and Services Companies is one example of pro-trade industry association. Given the greater weight of protectionist propensities in Indian industry, any changes in the trade balance that adversely affects Indian industry leads to protectionist pressures. This absence of a deep-seated commitment to market opening and elite-led bilateral strategies that are often focused on security casts doubt on the long-run ability of India to conclude and implement strong bilateral and minilateral trade liberalization.

In looking at the future of India's trade policy, we cannot predict major shocks that might radically alter its path, but we can consider several factors that might influence future outcomes. First, it is likely that the U.S. focus on fighting terrorism will continue, leading to stronger links between security and trade issues. With respect to economic institutions, the Doha Round of the WTO remains troubled, while U.S. trade promotion authority will expire in the summer of 2007. APEC is unlikely to be dramatically revived as a trade forum, and thus the bilateral and regional focus looks to be well entrenched. Given India's interest in the U.S. for security and trade, it is likely that it will forge closer trading ties with the U.S. even though a free trade agreement may not be politically feasible.

From a security perspective, the nuclearization of the subcontinent has led to a standoff that may increase the willingness of both India and Pakistan to work out their outstanding conflicts. Indeed, the recent overtures toward reconciliation between India and Pakistan appear to have advanced and India was confident enough to not oppose Pakistan's admission to ARF in 1994. India still seeks to become a UN Security Council member, along with other contenders, but this does not appear to be the most important factor driving its security strategy. And in its relations with the U.S., the American interest in fostering a power to balance China leads it to look favorably on India's rise. Moreover, with India's own longstanding battle against terrorists, the U.S. and India have a strong alignment of interests on this dimension. Improved Indo-U.S. relations have had a positive impact on Indo-Pakistan relations.

From an economic perspective, India maintains a strong position and is increasingly seen to be a driver of regional growth in Asia and possibly the global economy as well. There has been some backlash against job outsourcing in the U.S. and a corresponding fear that high-paying American jobs will shift to high-paying industries to India, but with American multinationals rushing to enter the Indian (and Chinese) market, there is a strong countervailing force in the U.S. against anti-Indian protectionist pressures.

In terms of India's own domestic liberalization strategy and elite commitment, its focus on becoming a global power, increasing its economic weight in world affairs, and continuing on its rapid growth path has prevented the formation of a significant counter-liberal coalition. Despite changes in government, there have been few changes with respect to the overall economic strategy and the strategy of major firms in India except at the margins. Yet while there is little pressure for a return to the policies that created the "Hindu" rate of growth, the drive to liberalize has been primarily elite-led. It remains to be seen if a powerful business coalition will continue to grow and sustain an activist outward trade orientation that goes beyond framework arrangements to real trade liberalization.

While India's globalization, aided by a small pro-trade coalition, is likely to push the technocratic elite toward agreements with ASEAN, BIMSTEC, and Japan, opposition from protectionist lobbies could delay the process. India's trade surplus with neighbors such as Sri Lanka and Bangladesh is becoming significant.<sup>88</sup> The recent unilateral concessions made by India for the least developed SAARC countries will benefit Bangladesh. This could be a way of wooing Bangladesh toward closer trade ties with India in light of improved security relations between the two countries in recent times. Despite some warming of Indo-Pakistani relations, substantially improved trade ties between the two countries will probably need to wait for further improvement in security relations.

Finally, in terms of institutional architecture and trade, India is likely to continue its strong focus on East Asia and continued effort to become an integral part of the dynamic Asian economy. Its relations with China on this score are surprisingly good, and there is increasing talk of a China-India FTA. For now, the trade figures on both the export and import side suggests that continued exchange and economic cooperation is likely to continue. If this is the case, Pakistan will potentially be further marginalized in this new economic dynamic relationship, particularly if the U.S. reduces its anti-terrorist activities in that region. Of course, security concerns between India and China, and between the U.S. and China, have by no

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<sup>88</sup> Mukherji (2006:103-115)

means abated and thus for the foreseeable future, an India-China FTA is unlikely.

## 8.5 Conclusion

We have argued that the shift in India's trade policy from import substitution toward trade promotion resulted in part due to changes in the external context and in part due to domestic changes in elite views about the need for export orientation for India's development. The paper suggests that trade and security concerns are intimately connected. External shocks may alter security considerations, which affect the trade potential; they may also directly alter expectations about the need for a preferential trading engagement. These variables explain the persistence of the autarkic phase, the drive to export orientation, and subsequently greater dependence on bilateral and minilateral trade promotion measures. The nature of goods provided by the bipolar or unipolar world orders in the realm of security and trade generated the international context within which India strategized its trade. For example, multilateralism may lead to the provision of club or public goods such as trade rules within the WTO but its failure to contribute to trade promotion could lead to the proliferation of minilateralism or bilateralism.

The Cold War balance and India's import substitution reflected the convergence of India's security and economic needs. Strategic relations with the USSR and the lack of need to pursue trade as a route to development complemented themselves well. For example, India's trade with the USSR was substantial, and its need for markets in countries with ties to the U.S. such as the ones in Southeast and East Asia was not significant. India's trade within South Asia with neighbors with closer ties to the U.S. was insignificant during the Cold War.

External shocks such as the end of Cold War created a situation where India could not depend on the security benefits derived from the Cold War balance of power. By this time, there had occurred enough internal thinking within the Government of India to convince the technocrats that import substitution was no longer a viable development strategy. Moreover, the Gulf War-driven oil shock, which brought India very close to a balance of payment default, drove home this point in a very telling manner. In the changed scenario, when the USSR as a security and trading partner became much less important, India was drawn closer to the U.S. and its allies in both security and trade. India was offered dialogue partner status in ASEAN and membership in the ASEAN Regional Forum, neither of which had materialized during the Cold War years.

The Asian financial crisis and India's nuclear tests were drivers for the search for bilateral trade agreements within South Asia, culminating in the Indo-Lanka Free Trade Agreement. The crisis hurt India's exports to Southeast and East Asia because of economic decline coupled with the devaluation of currencies of the countries in the region. The nuclear tests and consequent U.S. trade sanctions increased India's resolve to conclude a preferential trade agreement with Sri Lanka. Indo-Lanka relations had improved considerably after the assassination of Rajiv Gandhi by the LTTE. The ILFTA was a model of asymmetrical concessions that India was willing to make in search of markets at a time when the markets for Indian exports seemed restricted elsewhere.

The post-Cold War security and trade context did not change but the global trend toward bilateral and minilateral agreements in the context of the failure of the multilateral negotiations pushed India toward bilateral and minilateral agreements. This coincided with the post-9/11 period when U.S. security concerns focused more on combating terrorism than containing China. India successfully signed its most comprehensive preferential trade agreement with Singapore (CECA) in 2005 and another with Thailand in 2003. India was actively negotiating an agreement with ASEAN and had participated in the East Asia summit. It was also working toward preferential agreements with Japan and New Zealand, while its trade relations with China had become cordial. India was negotiating an agreement along with other BIMSTEC countries, comprising countries in the Bay of Bengal region, Bhutan and Nepal.

External shocks have helped changed the strategic and economic context. The domestic context also changed with a technocratic view in favor of trade promotion supported by export-oriented sectors like services, software and pharmaceuticals. The interests of these sectors were in opposition to the majority view within Indian industry, used to years to import substitution. The changed international and domestic context first pushed India toward trade promotion with the U.S. and countries friendly to the U.S. Subsequently, when the multilateral system seemed inadequate for India's trade promotion, it pushed for bilateral and minilateral agreements. External shocks and the changed domestic political economy favoring trade promotion will remain important considerations for understanding the trajectory of India's trade policy given the complementarity between strategic and economic considerations.

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# 9. The Evolution of Post-Cold War Regional Security Institutions in South Asia

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## 9.1 Introduction

This chapter analyzes the evolution of the regional security institutions in South Asia in the post-“triple shocks” period of 1989 onward, including the evolution of not only the regional security architecture in South Asia but also its interaction with the evolving regional security architecture in Southeast and Northeast Asia. With regard to the latter, I limit myself primarily to China, which shares *de facto* borders and a history of security interaction with South Asia, and a passing reference to North Korea and Japan. Where relevant, I also analyze the interaction of regional security institutions with multilateral regimes. My focus is on the strength, scope, and nature of regional security institutions, the depth of their institutionalization, and the timing of their evolution.

Overall, I follow the framework articulated by Aggarwal and Koo in Chapter One of this volume. One major difference I must mention at the outset is a *deviation* from the post-“triple shocks” framework suggested. That is, while I retain the notion of post-“triple shocks” to characterize the post-1989 period and its sub-periods, I have altered one of the sub-periods and defining shocks from the 1997-98 Asian financial crisis to India and Pakistan’s 1998 nuclear tests. As far as South Asian security is concerned, the nuclear tests constituted the defining event. By contrast, the Asian financial crisis of 1997 did not precipitate an economic collapse in South Asia, particularly not in its dominant economy, India, whose GDP contin-

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ued to grow 5-6 percent annually as it had following the 1991 economic reforms. However, I retain the other two landmark events as timeframe markers: the end of the Cold War (1989) and the events of 9/11, although I must add that 9/11 does not work very well as an impetus for changes in security relations between South Asia (mainly India) and either Southeast Asia or East Asia (mainly China), being more additive than revolutionary.

The basic argument of the chapter is that regional security institutionalization cannot progress beyond limited war-prevention measures as long as there are severe territorial and border conflicts within a region. Despite the presence of a weak regional cooperation organization since 1985, South Asia has failed to build regional *security* institutions due to the conflict between its two major powers, India and Pakistan. The conflict, which began in 1947, was aggravated by the Cold War and continued into the post-Cold War period. However, after reaching a peak of tension following the 1998 nuclear tests and confrontations in their wake up to 2002, tensions have begun to decline at least partly due to the influence of the United States in encouraging conflict resolution after the 9/11 attacks. Consequently, there has been no meaningful *regional* interaction between South Asia as a region and East and Southeast Asia, only growing *bilateral* security interactions primarily between India and China and India and Southeast Asia. What have been growing in South Asia, and between India and China, are military confidence-building measures (CBMs), but these are very narrow in scope, relatively weak (especially those between India and Pakistan) and limited in nature to the prevention of border clashes or war by accident or misperception. It is still premature, therefore, to talk of regional security institutionalization in South Asia. However, the end of the Cold War has promoted a thaw in India-China relations and confidence-building, which are enhanced by the growth of trade. Moreover, mutual anxieties generated by the 1998 nuclear tests have promoted India-Pakistan confidence-building, which has been reinforced by the impetus of 9/11 and shifts in U.S. and consequently Pakistani security policies.

In terms of the institutional bargaining game model, given the relative absence of security institutions, the key factors in response to any impetus are *individual* national security situations. The outcomes are agreements on CBMs and increased security interactions but not (yet) security institutions. Tables 9.1 and 9.2 summarize the growth of regional security arrangements in South Asia.

**Table 9.1: Institutional security arrangements in South Asia**

Strength	Number of Actors				
	Unilateral	Bilateral		Multilateral	
		<i>Geographically concentrated</i>	<i>Geographically dispersed</i>	<i>Geographically concentrated</i>	<i>Geographically dispersed</i>
<b>Strong</b>	Karachi Agreement (1949-65)	Indo-Soviet Treaty (1971-1991)			Chemical Weapons Convention (1997, all South Asian states)
	Indo-Nepal Treaty (1950)	Sino-Indian border agreement (1993)			
	Indo-Bhutan Treaty (1950, 2007)	Sino-Indian border management CBMs (1996)			Non-Proliferation Treaty (5 South Asian states except India and Pakistan)
	Indo-Pak Air Space Violation Agreement (1991)	Sino-Indian border management CBMs (2005)			
	Indo-Pak Prohibition of Attack on Nuclear Installations (1991)	Sino-Pakistan Boundary Agreement (1963)			
	Lahore Declaration and MOU (prior notification of ballistic missile tests) (1999)	Sino-Pakistan Science and Technology Agreement (1976)			
		Sino-Pakistan Nuclear Cooperation Agreement (1986)			
		Sino-Pakistan Treaty (2005)			

**Table 9.1 (cont'd.): Institutional security arrangements in South Asia**

Strength	Number of Actors					
	Unilateral	Bilateral		Milateral		Multilateral
		<i>Geographically concentrated</i>	<i>Geographically dispersed</i>	<i>Geographically concentrated</i>	<i>Geographically dispersed</i>	
<b>Weak</b>	Composite Dialogues (1997, 2004)	Sino-Bangladesh Defense Cooperation Agreement (2003)	SAARC (1985)	BIMSTEC (1997)		
	Simla Agreement (1972)			India-ASEAN Treaty of Amity and Cooperation (2003)		
	Indo-Bangladesh Treaty (1972)			ASEAN Regional Forum (1996)		
	Indo-Sri Lanka Accord (1987)					East Asian Summit (2005)

**Table 9.2: Key security arrangements in South Asia**

Org. Name	# of members At establishment	# of members now	Issue scope at establishment	Issue scope now	Strength at establishment	Strength now
SAARC	7	8	Medium	Medium	Weak	Weak
Indo-Sri Lanka Accord (1987)	2	2	Medium	Narrow	Strong	Weak
Simla Accord (1972)	2	2	Narrow	Narrow	Medium (1972-89)	Weak (1989-)
Indo-Bangladesh Treaty (1972-97)	2	2	Narrow	Narrow	Medium	Not renewed
Indo-Nepal Treaty (1950)	2	2	Narrow	Narrow	Strong	Strong
Indo-Bhutan Treaty (1950, 2007)	2	2	Narrow	Narrow	Strong	Strong

**Notes to Tables 9.1 and 9.2**

- 1) Defunct, purely Cold War era treaties like the Southeast Asian Treaty Organization (SEATO) and the Central Treaty Organization (CENTO, or the Baghdad Pact), both of which included Pakistan, are not included. Also Table 9.1 includes lesser agreements of narrower scope on confidence-building as well as agreements whose scope goes beyond South Asia while Table 9.2 is limited to major overarching agreements within South Asia.
- 2) The labeling of strength as Strong/Medium/Weak refers only to the security component of the arrangements above, most of which are broad ones in which scope is not limited to security issues. The coding is done with retrospective effect, that is, whether the agreements have been robust in their observance and implementation since their inception, e.g., the Simla Agreement (1972), which committed both parties to peaceful resolution of disputes, is coded as “weak” because it has been violated by subsequent armed conflict. Likewise, the Indo-Sri Lanka Accord (1987) is “weak” because of subsequent non-implementation of many of its measures; the Indo-Bangladesh Treaty (1972) is coded “weak” for the same reasons.

- 3) Regarding the coding of issue scope for the security components of the above arrangements, consultation/talks, non-aggression/non-interference agreements, military confidence-building and border management are coded as “narrow”. Joint military/naval operations for narrowly specified purposes such as naval exercises, or India’s peacekeeping operation in Sri Lanka are coded as “medium”, and formal military guarantees are coded as “broad”.

## 9.2 The Cold War Security Architecture in South Asia

My basic argument in this section is that the security arrangements of South Asia have been poorly institutionalized because of basic territorial differences between India and Pakistan and their different alignments with the superpowers during the Cold War, particularly after 1971. The evolution of the region’s security architecture during the Cold War was as follows.

India and Pakistan emerged as independent nation-states in August 1947 following the ending of British rule and the partition of British India into two new states, the Muslim-majority areas of Western Punjab, Sindh Baluchistan, the North-West Frontier Province, and Eastern Bengal becoming Pakistan and the rest remaining India. Sri Lanka followed in 1948. Nepal and Bhutan were traditionally formally independent monarchies but de facto British protectorates. Bangladesh emerged as an independent state in 1971 with the secession of East Pakistan. The Maldives gained independence in 1965.

The security interactions of the region, overwhelmingly dominated by developments between India and Pakistan, evolved as follows. The rulers of the formally independent principalities of India, which were in effect British protectorates, were given the choice to accede to either one of the two new states and so merged into either India or Pakistan. In the case of one of these principalities, Jammu and Kashmir, the ruling Maharaja, a Hindu, ruled over a Muslim-majority state that was nonetheless multi-religious, multilingual, multiethnic and also included non-Muslim majority areas in Jammu and Ladakh, contiguous with West Pakistan. The Maharaja delayed accession amid mounting tensions. In October 1947, a few days after Pakistani-supported tribal irregular forces invaded Kashmir, the Maharaja acceded to India and Indian forces intervened to push back the invaders, leading to the first Indo-Pakistan war of 1947-48. Although the Instrument of Accession was itself not conditional upon a plebiscite, Lord Mountbatten accepted it in the hopes that the question of accession should be settled with respect to the wishes of the people once the soil had been cleared of the invader. India took the matter to the UN Security Council

and at the end of the war the ceasefire line left one-third of the original state (including the Northern Areas) under Pakistani control. However, India did commit itself to a UN-supervised plebiscite as mandated by the UN Security Council Resolution of August 13, 1948 and the UN Commission on India and Pakistan (UNCIP) Resolution of January 5, 1949 read together, that is, subject to conditions laid down in Part II Truce Agreement A of the UN Security Council Resolution of August 13, 1948.<sup>2</sup> The main conditions were the withdrawal of Pakistani troops from all of Jammu and Kashmir, a condition that Pakistan never fulfilled. Pakistan, on the other hand, has always rejected the accession as illegitimate and fraudulent, arguing that the Maharaja signed it under duress. Rival territorial claims over Jammu and Kashmir have remained unresolved since then and have been the main issue between India and Pakistan and the main security issue in South Asia, impeding the institutionalization of cooperative security arrangements in the region.<sup>3</sup>

While Pakistan became an American ally, receiving U.S. military aid from 1954 and joining the SEATO and the CENTO in the mid-1950s, India shortly afterward became one of the co-founders of the Non-Aligned Movement, and from 1956 began to draw closer to the Soviet Union, which emerged as a supplier of economic assistance. India began to argue from 1954 onwards that the changed circumstances made the plebiscite irrelevant, basing itself on the non-fulfillment by Pakistan of the conditions preceding a plebiscite. India also argued that the elections held in Kashmir under Indian auspices—and from 1962 as part of the Indian general elections—were equivalent to a plebiscite in which the Kashmiris opted for India. Pakistan maintains that Kashmir, as a Muslim-majority state contiguous with Pakistan, should have gone to Pakistan and regards it as the unfinished business of the Partition of India.

The next major landmark in India-Pakistan relations was the war of 1965, which began when armed Pakistani-supported tribesmen from the Northwest Frontier Province infiltrated Kashmir in the hopes of sparking a general uprising against India. The war was inconclusive and failed to incite the hoped-for Kashmiri uprising. This was preceded by the 1962 Sino-Indian border war which India lost, as a result of which about a fifth of the original state of Jammu and Kashmir came under Chinese control, a part of which resulted from Pakistan's ceding a portion of the part under its con-

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<sup>2</sup> Ganguly (2002:158-161)

<sup>3</sup> There is a voluminous literature on the Kashmir issue. For some leading examples, and recent debates, see Ganguly (1998), Thomas (1992), Lamb (1991), Jha (1996), and the roundtable on Jha's book in: *Commonwealth and Comparative Politics* 36:1 (March 1998).

trol to China in 1963. India now controls slightly under half of the original Jammu and Kashmir state. In October 1964, China developed a nuclear capability. The net result of these developments was that India perceived a two-front threat from China and Pakistan, whose diplomatic closeness and strategic cooperation vis-à-vis India have grown steadily since the 1960s, gaining momentum in the 1980s and 1990s. India twice sought security guarantees against China from the United States and the UK, once in late 1964/early 1965 and again in April 1967, but was rebuffed both times. All of these factors led India to refuse to sign the Nuclear Non-Proliferation Treaty (NPT) of 1968, thereby retaining its nuclear option.<sup>4</sup>

In 1971, the secessionist mass movement in what was then East Pakistan received covert Indian support, leading to a December 1971 war in which India defeated the Pakistani army in the eastern part and secured the independence of Bangladesh. This improved India's strategic position and was followed by the first Indian nuclear test in 1974. In 1976, India restored diplomatic relations with China after fourteen years of rupture. In its relations with the superpowers, India drew progressively closer to the Soviet Union in the 1960s, culminating in the Indo-Soviet Treaty of 1971. Although the treaty itself was more of a non-aggression and cooperation pact rather than a formal military alliance, it marked India's distinct tilt toward the Soviet Union and continued to sway India's foreign policy during the 1970s and 1980s.<sup>5</sup> The Soviet Union emerged as a key supplier of military equipment to India, and Russia remains so to this day. Relations with the United States reached a low in 1971 when the U.S. aligned with Pakistan in the Bangladesh war and remained correct but cool during the next two decades, until well after the Cold War, with South Asia being an area of marginal significance to U.S. foreign policy.

The 1971 war left India as the dominant country on the subcontinent. In 1972, India and Pakistan signed the Simla Agreement to settle hostilities.<sup>6</sup> India returned 90,000 Pakistani prisoners of war, but did not press for the dropping of Pakistani claims to Kashmir. Both countries agreed to eschew the use of force and, without prejudice to their respective positions on Kashmir, conduct negotiations either bilaterally or in any other mutually agreed-upon way. Moreover, India and Pakistan agreed to respect the Line of Control (LoC), as the 1948 ceasefire line was renamed. In effect, this enabled India to bilateralize the Kashmir issue, thereby staving off the pos-

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<sup>4</sup> See Ganguly (1999:148-177) for the above account.

<sup>5</sup> See Ganguly (2002:164-167) for the text of the Indo-Soviet Treaty.

<sup>6</sup> See Ganguly (2002:168-169) for the text of the Simla Agreement.

sibility of third-party intervention of any kind and maintaining the status quo.

However, developments in the 1980s worsened India's strategic position despite a major arms buildup, the launching of a missile program, and the gradual maturing of its nuclear program during that decade. The Soviet invasion of Afghanistan in 1979 precipitated a deepening of U.S.-Pakistani cooperation to support the Afghan resistance, in which China, which was at loggerheads with the Soviet Union until the end of the Cold War, also joined. This led to massive military and economic aid to Pakistan while turning a blind eye to the Pakistani nuclear program and Sino-Pakistani cooperation on nuclear and missile technology transfers. By early 1987, Pakistan had a minimal nuclear weapons capability in place.<sup>7</sup> These developments during the 1980s, and especially after 1987, enabled Pakistan to clandestinely support first the Sikh separatist movement in Punjab and the Kashmir separatist insurgency, which broke out from the end of 1989, without having to fear a conventional military response from India.

Lastly, turning to the smaller South Asian countries (all of which border India but not Pakistan or each other), India forged bilateral peace and friendship treaties with narrow-scope security components (that is, mutual non-aggression) with Nepal (1950), Bhutan (1950, renewed in 2007), Bangladesh (1972, not revalidated in 1997), and Sri Lanka (1987).

### 9.3 Negotiating New Security Arrangements in the Post-“Triple Shocks” Period

The post-Cold War period, dating from the end of 1989 with the fall of the Berlin Wall and the Soviet withdrawal from Eastern Europe, or from the end of 1991 with the dissolution of the Soviet Union, was a major turning point for Indian foreign and security policies. The end of global bipolarity pulled the rug out from under the feet of non-alignment as a foreign policy paradigm, which India had skillfully exploited to acquire economic and military resources from both superpowers while maintaining autonomy. It also ended the deterrent effect on China of the Indo-Soviet Treaty of 1971.

The 1989-91 period also saw two important domestic developments and one international development that affected India's foreign policy and security. The first was the ending of the Congress Party's four-decade political hegemony. The Congress Party, which had ruled India with a parliamentary majority from 1947-1989 (with the exception of the period from

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<sup>7</sup> “We have the bomb, says Pakistan's Dr. Strangelove,” *The Observer*, London, 3/1/1987.

1977-79) lost the 1989 election. In the six elections from 1989 to 2004, no single party has achieved a parliamentary majority, leading to a series of minority and coalition governments and a fragmented multi-party system nationally, complicating cohesive economic and foreign policy decision-making.<sup>8</sup> The second major development was the launching of a comprehensive economic liberalization program from June 1991. At first it was a response to a balance of payments crisis that necessitated recourse to an International Monetary Fund (IMF) stand-by loan. It has, however, sustained itself up to the present (early 2007) as a gradual program of long-term structural adjustment toward a globalizing market economy, going beyond mere stabilization policies, unlike earlier IMF-supported stabilization episodes following balance-of-payments crises in 1957, 1966, 1973, and 1981. The third development, which was international rather than domestic in scope, was the outbreak in December 1989 of the Pakistan-supported insurgency in Kashmir, which has posed a serious security threat in itself as well as a threat of war with Pakistan.

### **9.3.1 Domestic Sources of Security Policies in South Asia in the Post-“Triple Shocks” Period**

Domestic developments in India in the post-“triple shocks” period, along with the return of democracy to Pakistan in 1988 and to Bangladesh and Nepal in 1990, have had contradictory effects. On the one hand, economic liberalization in India and elsewhere in the region created the potential for regional economic integration and amelioration of political differences. The fragmentation of the party system in India due to the relative decline of the centrist Congress, along with the rise of the hard-right, anti-Muslim Bharatiya Janata Party (BJP) on the one hand, and left-of-center parties on the other, created potential space for movement toward peace and reconciliation in the region. During the period between 1989 and 1998, the region did see some initial movement toward the economic regionalism. This was evidenced by India’s 1996-98 Gujral Doctrine of non-reciprocal concessions to India’s smaller neighbors, during which the Ganga Waters Treaty was signed with Bangladesh, settling a contentious issue that had bedeviled bilateral relations. However, all this was trumped by Pakistani support of the Kashmir insurgency, Sino-Pakistani collaboration in the Pakistani nuclear weapons program, and the rise of a powerful right-wing opposition led by the BJP.

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<sup>8</sup> See Sridharan (2002) for an account of the fragmentation of the party system and the patterns of coalition politics.

The post-Cold War period has witnessed heightened tension between India and Pakistan due to the ongoing Pakistan-supported insurgency in Kashmir, this despite the gradual growth of economic and other ties as part of the anemic but nevertheless real progress of the regional cooperation process under the aegis of the South Asian Association for Regional Cooperation (SAARC).<sup>9</sup> SAARC had been formed in December 1985 at Bangladesh's initiative and consisted of the seven South Asian countries of India, Pakistan, Bangladesh, Sri Lanka, Nepal, Bhutan, and the Maldives. It aims to promote regional cooperation, particularly in economic matters. However, its progress has been hampered by India-Pakistan tensions and by the fact that they were on opposite sides during the Cold War. Unlike the European Union, SAARC has no common political values such as democracy, human rights, minority rights protection, etc., and bars discussion of domestic issues or bilateral conflicts. It is also unique among regional organizations in that it is overwhelmingly dominated by one state, India, which constitutes about three-quarters of SAARC members' total population and economy, and by the fact that none of the other states have common borders with each other while all have common borders with India. Taken together, these factors have contributed to SAARC's relative weakness.

Domestic politics in Pakistan, including the democratic interregnum of 1988-99 under successive governments, did not cause any softening of its stance on Kashmir. Indeed, the period saw Pakistan adopt an increasingly hard line on Kashmir and increase its support for a full-blown insurgency since December 1989. Diplomatically, at since 1994, Pakistan has linked improvement of economic and other relations including progress towards a South Asian Free Trade Area (SAFTA) under the aegis of SAARC to progress on the resolution of the Kashmir dispute. This was at least partly due to the shadow of the military on its democratic governments; the military has been in power since General Pervez Musharraf's coup in 1999. Thus, Pakistan's policy toward India under all governments since at least 1994 has been contingent on the resolution of the Kashmir issue, the Pakistani position being that there can be no improvement of relations unless there is movement on this "core" issue. In this sense, and in its clandestine military support of the separatist insurgency, Pakistan remains an actively revisionist power. India, while formally claiming Pakistan-Occupied Kashmir, has never actively sought to press its claim.

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<sup>9</sup> See [www.saarc-sec.org](http://www.saarc-sec.org) for the activities of SAARC. For SAARC intra-regional trade see RIS (2004:47-61).

### **9.3.2 The Weak Institutionalization of India-Pakistan Security Relations**

Security relations between India and Pakistan are not institutionalized by a security treaty. Rather they have gradually become weakly institutionalized over the years since the early 1990s by a series of CBMs.<sup>10</sup> CBMs are institutionalized interactions at political and military levels such as regular meetings, communications, transparency measures, restraint measures to prevent each state from perceiving the other's moves as war-like and thereby reducing the danger of war by accident or misperception. However, it may be premature to label as institutionalization a collection of CBMs that have been implemented with varying degrees of effectiveness. As regards their strength, scope and nature, they remain mostly very weak, limited in scope to very specific military issues and limited in nature to the prevention of accidental war. The history of military CBMs dates back to the late 1940s. The 1949 Karachi Agreement, which helped maintain peace along the 1949 Ceasefire Line until the 1965 war, can be considered the earliest CBM-like agreement. The Simla Agreement of 1972, following the 1971 war, contains clauses similar to the guiding principles of the Helsinki Final Act of 1975 in Europe, and was successful in maintaining peace along the Line of Control in Jammu and Kashmir until Pakistan began to support the Kashmir insurgency in December 1989.

The first concrete military CBM was the hotline between the two Directors-General of Military Operations that the two countries agreed to operationalize after the 1971 war. It was, in practice, ineffective. Following the near-war situation in 1986-87 during India's Operation Brasstacks military exercise near the border, the United States nudged both states to agree to some CBMs to avoid accidental war.

#### ***The End of the Cold War***

The end of the Cold War resulted in the establishment of several CBMs in the early 1990s including revitalizing the hotline between the Directors-General of Operations and Management (DGMOs) to usage on a weekly basis. Additionally, Pakistan and India entered into the Agreement on Advance Notice of Military Exercises, Maneuvers and Troop Movements, the Agreement on Prevention of Air Space Violation (both signed in April

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<sup>10</sup> In this section, I draw heavily on the accounts in Ganguly and Greenwood (1992), and Misra (2004), and press clippings over 2004 and 2005 too numerous to cite, and an interview with Dr. Ashutosh Misra of the Institute of Defense Studies and Analysis, New Delhi, who tracks India-Pakistan talks, on October 28, 2005.

1991 and ratified in August 1992), the Agreement on Prohibition of Attack on Nuclear Installations, and the Accord on Chemical Weapons. The latter was signed in August 1992 and reaffirmed India and Pakistan's adherence to the 1925 Geneva Protocol; both parties signed on to the Chemical Weapons Convention in the late 1990s).

The most important of these is the agreement not to attack each other's nuclear installations. This idea originated in 1985 in the meeting between Prime Minister Rajiv Gandhi and General Muhammad Zia ul Haq in the aftermath of the 1984 crisis of a possible Indian preventive strike on Pakistan's nuclear facilities, and was the brainchild of strategic expert K. Subrahmanyam.<sup>11</sup> It was eventually signed on December 31, 1988, by Prime Ministers Rajiv Gandhi and Benazir Bhutto, ratified in January 1991, and implemented starting in January 1992. Both sides exchange a list of nuclear installations on January 1 of each year and commit to refrain from attacking such installations, directly or indirectly.

### ***The Effects of the May 1998 Nuclear Tests***

Relations between India and Pakistan reached their nadir following nuclear tests by both countries in May 1998. Pakistan, emboldened by the shield of its explicitly demonstrated nuclear capability, launched the Kargil operation of May-July 1999 in which Pakistani forces, masquerading as Kashmiri freedom fighters, crossed the Line of Control to a depth of several kilometers in the heights of the Kargil sector of the Ladakh region of Jammu and Kashmir. This was a classic case of the "stability-instability paradox" of deterrence theory, where the possession of nuclear capability may embolden states to follow adventurist policies.<sup>12</sup> They were pushed back to the extent of 70-80 percent of the intrusion before Pakistan requested U.S. intervention. On July 4, 1999, Pakistani Prime Minister Nawaz Sharif and U.S. President Bill Clinton reached an agreement to evacuate Pakistani troops from Kargil while India closely monitored the talks.<sup>13</sup> Pakistan appears to have learned from Kargil the infeasibility of using a nuclear shield to alter the status quo on the ground through military adventures. This lesson seems to have opened up space for the tentative peace process since 2004.

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<sup>11</sup> Ganguly and Hagerty (2005:44-67)

<sup>12</sup> See Krepon and Gagne (2001) for a set of analyses on the stability-instability paradox in South Asia.

<sup>13</sup> See Riedel (2002) for a participant account of the American diplomatic intervention in the Kargil conflict.

Further, in the Lahore Declaration and Memorandum of Understanding, of February 1999, both sides agreed to additional nuclear CBMs including a range of declaratory, transparency, communication, notification and consultative measures, including, most importantly, prior notification of ballistic missile tests. The impetus for these CBMs was the fear of accidental war breaking out due to misinterpreted missile launches. However, both sides have exploited a major loophole in the missile testing notification agreement by acquiring cruise missiles, which are not covered by the agreement since the agreement is limited to ballistic missiles only.

The outbreak of the Kargil war in May 1999 and Operation Parakram in 2002 led to a collapse of mutual confidence although the key CBMs continued to be implemented. The composite dialogue process was suspended since October 1998 following the nuclear tests of May 1998. The last round of talks had been held in October 1998 on CBMs and Jammu and Kashmir.

### ***The Effects of the 9/11 Attacks***

In the aftermath of 9/11, the security situation in South Asia has been significantly changed by Pakistan's renewed strategic closeness to the United States. While Pakistan declined the United States' request to invade Afghanistan through its territory and dislodge the Taliban in late 2001, it allowed its airspace to be used as a staging area for bombing and paratroop operations in Afghanistan. Pakistan also cooperated in cracking down on Al-Qaeda and Taliban extremists within its own borders. In the process it acquired significant economic and military aid from the United States, revived its economy and strengthened its conventional defenses vis-à-vis India. However, as noted earlier, the United States has since 1999 encouraged a process of dialogue and CBMs between India and Pakistan, which is an ongoing process with ups and downs.

Relations between Pakistan and India plummeted further following an attack on the Indian parliament on December 13, 2001. In response to the attack, the Indian military launched Operation Parakram, a ten-month mobilization along the Indian-Pakistani border that lasted from December 2001 to October 2002. Operation Parakram brought about a near-war situation in May-June 2002 and the United States had to unofficially facilitate a retreat from brinkmanship. The Indian mobilization failed to cow Pakistan or to decrease its level of support for the Kashmir insurgency significantly.

In April 2003, a policy shift by India that began with a fresh initiative announced by Prime Minister Vajpayee led to an improvement in relations and an uneasy calm following the Vajpayee-Musharraf meeting on the sidelines of the January 2004 SAARC summit in Islamabad. The Joint Statement issued after the meeting marked a breakthrough in that 1.) Paki-

stan agreed to resume the composite dialogue in all its facets without preconditioning it on a resolution of the Kashmir issue, marking a shift of position held since 1994, and 2.) it agreed not to permit any territory under its control to be used for supporting terrorism in any manner. Following the resumption of the composite dialogue, the number of hotlines between DGMOs and Foreign Secretaries was increased to two in June 2004 and upgraded to make them “dedicated” and “secure”. More information was to be given in the pre-notification of missile tests, and both sides reaffirmed their unilateral moratoria on further nuclear tests.

Since the resumption of dialogue from April 2003 there has been, from June 2004, a resumption of the composite dialogue process agreed to between Indian Prime Minister Inder Kumar Gujral and Pakistani Prime Minister Nawaz Sharif in 1997. This process has been aided by a ceasefire that has been in effect since November 2003 along the international border, the LoC and the Actual Ground Position Line on the Siachen Glacier following the Kargil crisis and the crises of 2002. The composite dialogue process covered eight “baskets” of issues, including five which were directly concerned with security—Jammu and Kashmir, Siachen, Wullar Barrage/Tulbul Navigation project (on the Indus river), Sir Creek (boundary in Gujarat/Sindh), Terrorism and Drug Trafficking, Economic and Commercial Cooperation, Peace and Security, and Promotion of Friendly Exchanges. As of mid-2007, it is still too early to call the composite dialogue process and the CBMs discussed earlier a security institution.

In general, India-Pakistan CBMs have not been very effective. As Sumit Ganguly and Ted Greenwood have said: “CSBMs (confidence and security building measures) cannot serve in South Asia, any more than elsewhere, as substitutes for tackling underlying sources of conflict. They are also of limited value when states deliberately choose to go to war.”<sup>14</sup> They conclude that CSBMs would not have made a difference in the three wars between India and Pakistan or the “proxy wars” in Kashmir in the 1990s or Siachen (and later Kargil) since these were all calculatedly launched, whereas CSBMs are useful only for preventing wars by accident or miscalculation. The *roots* of conflict need to be addressed and visions for a viable and stable regional peace and cooperation framework need to be developed.

At the regional level, despite the existence of SAARC since December 1985, there has been no institutionalization of security relations. This is primarily because of the tense relationship between India and Pakistan. Bilateral relations cannot be discussed at SAARC under its charter. The most that SAARC has come up with is the 2002 declaration at its annual heads

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<sup>14</sup> Ganguly and Greenwood (1992:2)

of government summit (reiterated in 2004) condemning terrorism in all its forms.<sup>15</sup> The only other meaningful point was a mention in the Islamabad declaration of the Twelfth SAARC Summit of January 2004 that the members of SAARC are “particularly mindful of the security concerns of small states,”—a gesture toward its five smaller member states— which called for strict adherence to the UN Charter, international law and universally accepted principles and norms related to sovereign rights and territorial integrity.<sup>16</sup> Therefore, all security dialogues in SAARC remain bilateral, not even minilateral (with the exception of the declaration on terrorism, which has no operational substance). SAARC’s bilateralism effectively means that security dialogues are between India and each of the other countries on a “hub-and-spoke” basis since India is the only country to share a border with any of the others.

Since neither India nor Pakistan are members of the NPT, the only multilateral security arrangements of the region are the smaller countries’ membership in the NPT and the adherence of all to the Chemical Weapons Convention. However, there might be some other multilateral security regime participation from the region if the bilateral Indo-U.S. agreement on civilian nuclear cooperation, the broad framework of which was agreed to in July 2005, actually comes about.<sup>17</sup> This would require amendment of the U.S. Atomic Energy Act and also U.S. agreement to relax the provisions for India regarding the cartel called the Nuclear Suppliers Group (NSG). If so, it might possibly lead to Indian participation in the NSG in terms of modifying its export control laws on nuclear products, now unilaterally and voluntarily observed, possible Indian adherence to the Missile Technology Control Regime (MTCR), another technology cartel, and possible participation in the U.S.-promoted Proliferation Security Initiative (PSI), an arrangement outside international law which entails boarding ships suspected to be trafficking in Weapons of Mass Destruction (WMD) and their parts and components.

To summarize, despite the composite dialogue between India and Pakistan since 2004 and the continued implementation of pre-existing CBMs in the period since 9/11, India-Pakistan security relations remain underinstitutionalized. The strength, scope and nature of the security relations between

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<sup>15</sup> See Islamabad Declaration, p. 4, on <http://www.saarc-sec.org/main.php?id=14&t=7.1>.

<sup>16</sup> See Islamabad Declaration, p. 6, on <http://www.saarc-sec.org/main.php?id=14&t=7.1>.

<sup>17</sup> Delhi Policy Group (2005)

them and at a regional level remain weak, limited in scope and limited in nature to the prevention of accidental war.

### **9.3.3 Security Relations with China and Southeast Asia**

There is no institutionalized security relationship between South Asia and China since there is no institutionalized security arrangement within South Asia. Rather, the two South Asian states with a de facto border with China—Pakistan and India—have independent security relationships with China.

#### ***The India-China Security Relationship during the Cold War***

India and China have had a strained security relationship that has improved in the post-“triple shocks” period. Following the October-November 1962 India-China border war, diplomatic relations were severed and not restored until 1976. Relations have improved gradually since then resulting in a visit by Prime Minister Rajiv Gandhi to Beijing in December 1988.<sup>18</sup> The key problem in India-China relations has been the disputed nature of the border, a legacy of British rule in India, the boundaries established by the British having never been accepted by the Chinese, both in the western sector (the Ladakh region of Jammu and Kashmir) and in the eastern sector (the MacMahon Line drawn by the British in the north-east of India). An India-China Joint Working Group on the Boundary Question was established, which has since then been through several rounds of negotiations.

#### ***The Pakistan-China Security Relationship during the Cold War***

The Pakistan-China security relationship emerged after India’s defeat in the India-China war of 1962. In 1963, Pakistan signed a boundary agreement ceding about 5,000 square miles of territory to China in the extreme north of the part of Jammu and Kashmir State that it controlled, north of the Karakoram Range bordering Chinese Xinjiang. Military cooperation followed, with China providing diplomatic support for Pakistan in the 1965 and 1971 wars with India, and becoming Pakistan’s principal arms supplier in the post-Cold War period. A 1976 Science and Technology Cooperation agreement between China and Pakistan opened the way for cooperation in nuclear energy. More significantly, China (and later with

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<sup>18</sup> See Ganguly (2004). I also draw upon information gleaned from an interview with Sujit Dutta, China expert at the Institute of Defense Studies and Analysis, New Delhi, 10/28/2005.

China's tacit acceptance, North Korea) has transferred nuclear warhead and missile technologies to Pakistan since the late 1970s, enabling Pakistan to become a nuclear weapons power. A nuclear cooperation agreement signed in 1986 formalized nuclear cooperation including the supply of reactors. China and Pakistan remain undeclared allies although this stops short of a formal military alliance, being limited to mutual non-aggression.

### ***The Pakistan-China Security Relationship after the Cold War***

In the post-Cold War period, Pakistan and China have maintained a collaborative arms supply and defense production relationship. Additionally, despite China's accession to the NPT in 1992, it has secretly provided nuclear and missile technology and components to Pakistan. Pakistan's other significant security relationship with East Asia—revealed in the post-9/11 exposure of the A.Q. Khan smuggling network—has been with North Korea, in which Pakistan exchanged nuclear technology for North Korean missile technology and components. Despite its accession to the NPT, China has been able to invoke a grandfather clause allowing it to continue supplying technology and equipment for Pakistan's nuclear power plant at Chashma under IAEA safeguards.<sup>19</sup>

### ***The India-China Security Relationship after the Cold War***

In the post-“triple shocks” period, there have been three major bilateral security agreements between India and China. Their origins lay in the Rajiv Gandhi initiative of 1988, which was partly prompted by the waning of the Cold War under Mikhail Gorbachev and the latter's attempts to normalize the border dispute and relations with China. India viewed normalization as a weakening of the Soviet Union's implicit guarantee to protect it from Chinese intervention in a possible India-Pakistan war. Following the end of the Cold War, India pursued a more cooperative relationship with China. The impetus for such a policy shift was threefold. First, the collapse of the Soviet Union in 1991 ended the implicit Soviet guarantee. Second, from 1990 onward there was a heightening of India-Pakistan tensions over Kashmir, including a near-war crisis in May 1990. Third, since 1988 the five meetings of the Joint Working Group on the border issue between In-

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<sup>19</sup> See Perkovich (2004:199-203), Tellis (2001:46-49), and Sidhu and Yuan (2003) for Chinese and North Korean nuclear and missile technology proliferation to Pakistan.

dia and China had successfully built up trust between the two countries.<sup>20</sup> India's economic liberalization also led it to look eastward for new trading opportunities, including with China.

The first of the major bilateral agreements was the Agreement on Maintenance of Peace and Tranquility along the Line of Actual Control on the Indo-China Border, of September 1993, signed during the visit of Indian Prime Minister P. V. Narasimha Rao.<sup>21</sup> The agreement was essentially a set of military CBMs and border management measures in which both sides agreed to respect the Line of Actual Control established after the 1962 war without prejudice to their claimed positions.

The second agreement was the November 1996 Agreement on Confidence-Building Measures in the Military Field Along the Line of Actual Control in the India-China Border Areas.<sup>22</sup> This was an enlarged set of military CBMs and border management measures, including advance notification of military exercises, separation and standoff agreements, management of airspace, and military restraint and communication measures, whose regular implementation contributed to confidence-building.

The next and third agreement was the Protocol on Modalities for the Implementation of CBMs in the Military Field Along the Line of Actual Control in the India-China Border Areas, of April 2005.<sup>23</sup> This builds on the agreements of 1993 and 1996 and includes enhanced transparency and institutionalization of military communications along the border.

These three agreements have been much stronger and more stable than those with Pakistan. There have been no border clashes or exchanges of fire. However, their scope has been limited to the measures listed above and their nature has been that of prevention of border clashes through accident or misperception.

### ***India and Southeast Asia after the Cold War***

During the Cold War, there was practically no security relationship between South Asia and Southeast Asia. In the post-“triple shocks” period, India's relationship with Southeast Asia has grown rapidly. India adopted a “Look East” policy from 1993, motivated primarily by economic consid-

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<sup>20</sup> Ganguly (2004:122-124)

<sup>21</sup> For the text of the 1993 agreement see:  
<http://www.geocities.com/siafdu/confidence1.html>.

<sup>22</sup> For the text of the 1996 agreement see:  
<http://www.stimson.org/?sn=sa20020114290>.

<sup>23</sup> For the text of the 2005 agreement, see: <http://www.mea.gov.in>.

erations given the rapid economic growth of the East and Southeast Asian region. However, in the security sphere it has taken the form of Indian membership of the ASEAN Regional Forum (ARF) since 1996. Before this, India was a sectoral dialogue partner of ASEAN from 1992-95 and from 1996 a full dialogue partner. The rest of South Asia has no meaningful institutionalized security relationships with Southeast Asia.

### ***The Effects of the May 1998 Nuclear Tests on South Asia's Relationship with China and Southeast Asia***

China condemned the Indian and Pakistani nuclear tests of May 1998 but blamed India as the initiator. China's security relationship with Pakistan continued, including the transfer of missile technology, and clandestinely, nuclear technology. However, during the Kargil war, and on Kashmir and India-Pakistan relations, China's overall stance has evolved toward a more neutral position than was the case in the past.<sup>24</sup> There is no clear reason why this happened but there are several possible reasons. First, the 1993 and 1996 border CBMs helped to warm relations between China and India. Second, India's acquisition of a medium-range nuclear missile capability was perceived to be a matter of time (the successful April 2007 test of an Indian missile with a potential range of over 1,800 miles appears to support this interpretation). Third, Pakistani adventurism in Kargil was seen as high-risk behavior. Finally, India was emerging as a fast-growing economy.

The Southeast Asian countries disapproved of the 1998 nuclear tests but relations continued to improve despite this brief setback, partly because India's economy continued to grow despite the Asian economic crisis of 1997 and the existing institutional foundation of the relationship, that of being a full dialogue partner of ASEAN and a member of the ARF, had been laid. The security relationship of India with Southeast Asia is overwhelmingly naval. Indian ships had been visiting Vietnam since the 1990s and joint naval exercises were held off the coast of Vietnam in 2000, but not since then. Both countries viewed China as a potential threat.

### ***The Effects of the 9/11 Attacks on South Asia's Relations with China***

India-China relations continued their gradual improvement after 9/11. There are several possible reasons for this acting in combination, although there is no definitive evidence. One interpretation is that China, having witnessed Pakistan's new alliance with the United States despite its heavy Islamic fundamentalist influences, began to fear that Pakistan was not a

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<sup>24</sup> Sidhu and Yuan (2003:65)

stable and reliable partner. Again, while there is no clear reason, China may have also privately blamed Pakistan for fallout from 9/11, including the implantation of a U.S. military presence in Afghanistan and Central Asia on China's western borders. However, the China-Pakistan Treaty of Friendship, Cooperation and Good Neighborly Relations of April 5, 2005, reiterated the mutual non-aggression security relationship. Additionally, for the first time ever, in November 2003, two Pakistani warships sailed to China for naval exercises just before a somewhat larger Sino-Indian naval exercise in the East China Sea. Another round was held in 2005 off the Pakistan coast. Finally, a recent development has been the signing of a Sino-Bangladesh defense cooperation treaty in 2002 that was basically one of arms supply. These naval developments should be seen in the context of South Asia's post-9/11 naval engagement with Southeast Asia discussed in the next sub-section below.

In recent years, India-China relaxation along the border has been driven by the increased volume of trade (China became India's second largest trading partner in 2004-05) and by the Chinese perception that it should not allow the United States to use India as a counterweight against it. A mixture of cooperation and rivalry characterizes the relationship. However, during the 2002 border tension between India and Pakistan, as in Kargil, the Chinese position was less pro-Pakistan than in earlier times. In the April 2005 agreement, China implicitly recognized Sikkim as a part of India, something it had not done since the formerly independent state's merger with India in 1974, though India has always recognized Tibet as a part of China and supported a one-China policy on Taiwan. Thus this third agreement of 2005 has been a little broader in scope although limited to prevention of border clashes due to accident or misperception.

These agreements still fall far short of an institutionalized, treaty-based comprehensive security relationship between China and India, let alone South Asia. Significantly, there was a proposal put forward by then-Indian Foreign Minister Natwar Singh in 2005 for a shared doctrine between India, Pakistan and China, but China is unlikely to entertain it.

I cover the emerging naval interaction of India with East Asia (China, Japan, Russia, and the United States) in the next sub-section as it is intimately tied, in impetus and responses, to India's naval cooperation with Southeast Asia, which in turn is partly a response to moves by the United States and China.

***The Effects of 9/11 on South Asia's relations with Southeast Asia***<sup>25</sup>

After 2001, Indian naval cooperation with some of the ASEAN states has developed in the form of coordinated patrols and limited naval exercises in ASEAN waters.<sup>26</sup> The impetus for this came from gradual developments beginning in the mid-1990s in Southeast Asia. The effect of 9/11 has, thus, been additive rather than revolutionary. India has been drawn into a naval relationship with Southeast Asia at the encouragement of the United States and Singapore, primarily because the Indian navy is the largest naval force among the Indian Ocean littoral states and because of the vital importance of the security of the sea lanes across the Indian Ocean from the Gulf to the Straits of Malacca to world trade and energy flows. In 1994, when the 1982 UN Conference on the Law of the Sea (UNCLOS-3) agreements came into force, it assigned extensive Exclusive Economic Zones (EEZs) to the littoral states, all of which, except Singapore, lacked the naval capabilities to defend their new responsibilities (the 1997 Asian financial crisis also constrained naval expansion). The extended EEZs also meant that island possessions assumed greater economic importance since sovereignty over them would bestow extensive EEZs and undersea oil and gas resources. This accentuated conflicts between Chinese claims in the South China Sea and various ASEAN states. By 1995, the United States had withdrawn its military bases in the Philippines. China in the meantime has expanded and modernized its navy and continues to do so. Japan is constrained by its constitution from playing an active naval security role, while Australia is too far away. The Straits of Malacca are also plagued by unconventional naval threats including piracy and, after 9/11, the threat of terrorism on the seas. The United States' post-9/11 approach to terrorism is considered heavy-handed and not wholly endorsed by Malaysia and Indonesia. The latter rejected the U.S.-proposed Regional Maritime Security Initiative, which was suspected to be more about U.S. control of the seas than it was about assisting regional navies in combating maritime threats.

In October 2003, India signed the Treaty of Amity and Cooperation (TAC) with ASEAN. However, this falls short of a security treaty relationship with ASEAN or with any of the member states, so the military rela-

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<sup>25</sup> I am not separating the 1998-2001 and post-9/11 phases here because all of the security interaction that developed after 9/11 had its roots in developments since the mid-to-late 1990s.

<sup>26</sup> For the information in this section on naval cooperation, I draw heavily on Khurana (2005), and interviews with Commander G.S. Khurana, an Indian Navy officer who served in the Andaman Islands and participated in patrols and exercises with Southeast Asian and Chinese Navies (10/28/2005 and 10/30/2006).

tionship cannot be described as institutionalized in either dispersed bilateral or minilateral form. In economic, political and naval affairs, Singapore is India's key partner in ASEAN, while in security affairs Vietnam and India also share a longstanding relationship given that both have perceived China as a threat.

Reports since the July 2004 ARF meeting indicate that ASEAN countries are favorably disposed to integrating India into regional maritime security arrangements, though Malaysia and Indonesia harbored reservations for many years. This reluctance may have stemmed from their perception that the United States was pushing for India's greater participation in regional security arrangements, generating concerns about U.S. counterterrorism policy both regionally and globally. Indeed, the United States has been supportive of India's integration, the latter having provided a naval escort for high-value U.S. vessels in the Straits of Malacca in October-November 2002. India is already a part of both the Asia Maritime Security Initiative (AMARSECTIVE-2004) of June 2004, and the Regional Cooperation Agreement on Combating Piracy (Re-CAAP) of November 2004.<sup>27</sup> India has been conducting coordinated patrols of maritime boundaries Malaysia and Indonesia in the Andaman Sea since 2002, and agreed in April 2005 to conduct similar patrols with Thailand. Additionally, India has conducted regular exercises with the Singapore Navy since 1993, and in March 2005 the first such exercise was held in the South China Sea. Naval visits to Vietnam have taken place since the 1990s and in July 2005 India's aircraft carrier, *Viraat*, visited Vietnam. Part of India's incentive to develop a presence in the Straits of Malacca and the South China Sea is economic, while part of it is to counter China's presence in Myanmar's Cocos Islands in the Bay of Bengal. These motivations dovetail to some extent with the interests of both the United States and ASEAN states. However, the relationship also has elements of cooperation as evidenced by Indian-Chinese naval exercises in the East China Sea in November 2003 and off India's western coast in October 2005.

The most recent and so far most ambitious series of naval exercises by that India has participated in was held in March and April of 2007 and included Southeast Asia, Japan, China, Russia, the United States, and New Zealand. The exercise consisted of a five-warship fleet engaging in regular annual exercise with the Singapore navy, followed by a trilateral U.S.-

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<sup>27</sup> AMARSECTIVE-2004 entails anti-piracy cooperation among regional coast guards and was initiated by Japan's Coast Guard. Re-CAAP is a Japan-initiated treaty signed by Japan, China, South Korea, the ASEAN states, India, Bangladesh and Sri Lanka. See Singapore government press release, 4/28/2005, at: <http://app.sprinter.gov.sg/data/pr/2005042801.htm>.

Japan-India naval exercise off Yokosuka, Japan, followed by bilateral exercises with the Chinese and Russian navies, followed by bilateral exercises with the Philippine and Vietnamese navies on the return journey, and ending with another visit to Singapore and participation in the multilateral Western Pacific Naval Symposium-related exercises in late May. This seems to represent a spreading of India's naval wings in the Western Pacific in a way that balances its relations with different countries and avoids the appearance of teaming up with the U.S. and Japan to counter China.<sup>28</sup>

However, this emerging relationship is too limited, recent and lacking in depth to be characterized as an institutionalized geographically dispersed bilateral (with any ASEAN country) or minilateral (with ASEAN) security relationship between India and Southeast Asia, or dispersed bilateral or minilateral security relationship between India and Northeast Asia, let alone between South and Southeast Asia.

## **9.4 Scenario Analysis for Regional Security Arrangements in South Asia**

From the foregoing account, security relations within South Asia are only very weakly institutionalized and not robust enough to withstand disruption. The same applies to security relations between India and China and between India and Southeast Asia. These are limited to military CBMs in the former relationship and joint naval patrols and low-level exercises in the latter. Little economic cooperation has taken place between India and Pakistan except for a 1960 treaty on the sharing of the Indus basin waters, which has endured all of the wars. This is despite some albeit limited progress in regional economic cooperation in South Asia since the 1990s.

In attempting to speculatively draw up a scenario for regional security in the next five to ten years, I argue, basing myself on recent international relations theory, that there is likely to be increased economic cooperation between India and Pakistan and within the region generally, beginning with bilateral cooperation and extending to minilateral regional cooperation, because of the relationship between the two countries' nuclearization and economic cooperation.<sup>29</sup> I would argue, based on the hypothesis of reduced relative gains sensitivity for both India and Pakistan, especially the

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<sup>28</sup> Sandeep Dikshit, "India embarks on series of joint naval exercises", *The Hindu*, 4/2/2007; P.S. Suryanarayana, "A wave of defense diplomacy", *The Hindu*, 3/10/2007.

<sup>29</sup> See my argument in Sridharan (2005).

latter, that economic cooperation in this tense bilateral relationship is contingent on *either* prior security cooperation to pre-empt the possibility of war, *or* nuclear deterrence as a substitute.

The 1998 nuclear tests, the failed attempt to change the status quo by force in Kargil, and the fact that India was effectively deterred from exercising a limited punitive conventional strike option in 2002, all imply a state of *de facto* deterrence.<sup>30</sup> Pakistan's options have changed in two ways, both of which would probably make it less inclined to resist greater economic cooperation in the future, as well more inclined to agree to institutionalized war-prevention measures (including those undertaken at the behest of the United States). First, explicit nuclearization with a demonstrated missile capability has assured Pakistan's security in a way that reduces the sensitivity to relative gains in the military sphere. Second, the 1999 Kargil crisis, the 2002 Operation Parakram confrontations and the U.S. role in ending the former and scaling down the latter have demonstrated to Pakistan that despite its nuclear capability it cannot use military force to coerce India over Kashmir. This appears to be confirmed by the subtle policy shifts since January 2004, which include mutual agreement to a composite dialogue process not preconditioned by progress on the "core issue" of Kashmir, talks on the demilitarization of Siachen and the fact that since November 2003 there has been a ceasefire along the international border and the Line of Control in Kashmir.

Following from these two points, Pakistan is *more* secure vis-à-vis a possible Indian military threat than ever before, as well as *less* able to threaten conventional force to resolve the Kashmir dispute. It therefore has less to fear and much to gain from greater economic engagement with India. When viewed through the prism of cumulative relative gains there are incentives for economic cooperation for both countries without having to fear an adverse fallout on security, particularly in common projects such as gas pipelines and linking of electricity grids. Such common projects can create stakes in continuing cooperation, catalyze trade and investment over time, remove certain issues from the arena of conflict—as the Indus Waters Treaty removed river waters—while enlarging areas of common interest and contributing to forward movement on conflict resolution.

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<sup>30</sup> While there is no doubt that India was effectively deterred, it is also likely that restraint was also partly self-restraint so as to keep the focus on Pakistan as an aggressor in Kargil. Whether the *de facto* deterrence in place is a stable one can be debated, but the fact is that existential and then explicit deterrence has demonstrably been present in the three major eyeball-to-eyeball crises in 1990, 1999, and 2002, none which escalated into full-scale conventional war.

In turn, greater economic cooperation in trade and infrastructure will over time lead to greater stakes in peace and greater willingness to institutionalize, more strongly than at present, a range of military CBMs, perhaps upgrading these to a comprehensive non-aggression treaty. That in turn should open the door to a regional-level security treaty. This would have to precede any meaningful inter-regional security architecture, as distinct from bilateral Indian interactions with China, Japan, and ASEAN, between South Asia and Southeast Asia or China/Northeast Asia.

## 9.5 Conclusions and Implications

Based on our analysis, one can draw the following conclusions and implications for the institutionalization of regional security arrangements in South Asia, and derivatively for the institutionalization of inter-regional security arrangements between South Asia and the Southeast Asian and Northeast Asian regions.

First, as long as the India-Pakistan territorial and ideological conflict over Kashmir remains unresolved and there is no non-aggression pact between the two countries (let alone a comprehensive peace pact), SAARC will not be able to institutionalize security arrangements and speak as a region on security issues. This is the most important reason for the absence of security regionalism in South Asia. Nuclear deterrence tends to freeze the status quo. For Pakistan, India remains a structural threat against which it seeks continued external power support, principally from China but also from the United States since being granted the status of a major non-North Atlantic Treaty Organization (NATO) ally in return for its cooperation in the war on terrorism. Additionally, factors militating against the institutionalization of security cooperation in South Asia include the deteriorating state of Indo-Bangladesh relations and the Sri Lankan ethnic conflict. Indo-Bangladesh relations have become testy since the advent of the Bangladesh National Party government in 2001, one of whose coalition partners is the pro-Pakistan Jamaat-e-Islami party. India accuses Bangladesh of clandestinely harboring Assamese separatists and Islamist terrorists. The Sri Lankan ethnic conflict also complicates security regionalism in South Asia as India is inhibited from taking a stand for domestic political reasons, including the weight of Tamil parties in its national coalitions since 1996, and its bad experience with intervention in Sri Lanka by the Indian Peacekeeping Force in 1987-90.

Second, as long as the Sino-Pakistan security alignment and supply relationship continue, as is most likely, India will perceive them as a threat. This will be further accentuated by the building of the proposed highway from the Khunjerab Pass on the Sino-Pakistan *de facto* border all the way

through Pakistan to ports/naval bases on the Baluchistan coast and the offering to China of naval facilities there, if this occurs. This implies that India and Pakistan will tend to deal separately with ASEAN and with China.

Third, growing economic cooperation within the region will only slightly mitigate but not transcend this state of affairs, as in Northeast Asia, particularly given the much more limited scope for, and ratio of, intra-regional trade in South Asia due to India's overwhelming dominance.

Fourth, rapidly growing Sino-Indian trade will mitigate but not transcend the implications of China's basic alignment with Pakistan, at least so long as the Sino-Indian border problem, which has been put on the backburner by the 1993, 1996, and 2005 agreements, is not comprehensively resolved.

Fifth, the one factor that might push both India and Pakistan toward more serious conflict resolution efforts, and which has been operating over the years since 1999, is American pressure toward this end. The continuing tension between the two nuclear-armed South Asian states, which are gradually adding to their fissile material and bomb stockpiles and their missile capabilities, is not in the interest of the United States, which recognizes that apart from the need for war-preventive CBMs there is a need to push for some sort of mutually acceptable—that is, domestically saleable—solution to the Kashmir conflict. Pakistan, while seen as a major non-NATO ally whose cooperation is vital for the pacification of Afghanistan and the war on terror generally, is also seen as an unstable authoritarian state whose politics are heavily suffused with Islamic fundamentalism and terrorism, which in turn feeds on the sense of grievance fostered by the festering Kashmir conflict. American economic leverage in combination with General Musharraf's objective of pushing Pakistan in the direction of "enlightened moderation" and the failed attempt to change the status quo by force in Kargil war, have provided the impetus for Pakistan to shift its support to the more moderate factions of the separatists in Kashmir and explore less-than-maximalist solutions with India since 2004. Whether this process eventually comes to fruition depends on whether General Musharraf is able to consolidate his hold, marginalize the extremists and sell a compromise package to the Pakistani public and military establishment. For the United States, a successful compromise will help it continue its growing relationship with India while maintaining its cooperation with Pakistan without being forced to choose one side over the other.

Sixth, likewise, the growing naval cooperation of India with Southeast Asia is at least partly the result of American encouragement, although retarded by Malaysian and Indonesian reservations about U.S. plans and perceived intentions. A more vigorous Chinese naval modernization and presence west of the Straits of Malacca could also push India and the Southeast Asian nations toward greater naval cooperation.

All in all, South Asia will most probably remain a region approximating Northeast Asia in lacking comprehensive regional security arrangements. The leading power, India, will likely continue to deal individually with the other regions. SAARC as a regional organization will likely not play a meaningful role in regional and inter-regional security arrangements.

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# 10. The Past, Present, and Future of Asia's Institutional Architecture

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## 10.1 Introduction

Asia's institutional order is in flux. The erosion of Asian countries' traditional confidence in bilateral alliances and multilateral globalism is increasingly visible, manifesting itself in the burgeoning interest in intra- and extra-regional free trade agreements (FTAs), regional financial institutions, and cooperative security dialogues. The sudden shift in Asia's institutional equilibrium has led to an extensive and thriving literature on the theory and practice of Asian regionalism.

Only a decade ago, it was widely believed that Asian countries were inherently incapable of managing their own economic and security affairs in an institutionalized manner. Asia seemed to be poor soil for implanting a sense of community and regional institutions in the post-World War II era, even when other parts of the world were busy surfing the wave of regionalism—albeit with varying degrees of success—following the birth of the European Community in 1958. Southeast Asia has been divided along ethnic, religious, and ideological lines for the past decades. Northeast Asia remains equally separated as a result of Japanese colonialism and Cold War confrontation. And more generally, conventional analysis separated South Asia from their East Asian counterpart.

In Asia, by many accounts, economic and security coordination at the minilateral level remained under-institutionalized for over five decades

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<sup>1</sup> We would like to thank Jonathan Chow for his useful comments on this concluding chapter.

following the end of the Second World War. A series of proposals for a more exclusive regional economic club largely failed. And unlike Europe in the security arena, Asia has lacked an equivalent to the North Atlantic Treaty Organization (NATO) and the Organization for Security and Cooperation in Europe (OSCE) in the Euro-Atlantic region. Many scholars have attributed the lack of formal regionalism in Asia to the hub-and-spoke alliance network of the San Francisco system, under which economic and security issue areas were managed by a transregional mix of bilateral and multilateral institutions, as opposed to intraregional unilateralism. This peculiar mixture became a defining feature of institutional cooperation in Asia and especially East Asia.

Among others, Peter J. Katzenstein has argued that East Asian regionalism is best understood as “market-driven network-style integration in contrast to the exclusive character of Europe’s emphasis on formal institutions.”<sup>2</sup> For him, Asian regionalism operated not only under the auspices of a private-public link between private *keiretsu* networks and the Japanese government but also through the efforts of overseas Chinese across Asia. As such, he argued that East Asian regionalism was shaped primarily by bottom-up economic integration that obviated or at least substituted for formal rule-based regional institutions.

Indeed, the San Francisco system offered America’s Asian allies access to the U.S. market in return for bilateral security agreements. At the same time, U.S. allies were strongly encouraged to participate in broad-based, multilateral forums in institutions such as the United Nations (UN) in security and the General Agreement on Tariffs and Trade (GATT) and the International Monetary Fund (IMF) in trade and finance. Aside from informal networks based on corporate and ethnic ties, the San Francisco system created few incentives for Asian countries to develop exclusive regional arrangements.

In recent years, however, we have seen dramatic changes in perceptions about and responses to Asia’s long-standing trade, financial, and security order. In the post-“triple shocks” period, which we characterize as being marked by the end of the Cold War, the financial crisis of 1997-98, and the attacks of September 11, 2001, the new dynamics of rivalry and cooperation among states at both the intraregional and transregional levels are redefining institutional pathways in Asia. Whereas the traditional postwar trade, financial, and security order focused on bilateral alliance structures, global economic and security institutions, and informal corporate and ethnic solutions, the new institutional environment in Asia now revolves

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<sup>2</sup> Katzenstein (1997:3)

around the proliferation of FTAs, regional financial cooperation, and bilateral and minilateral security dialogues.

How effective will these burgeoning regional and interregional institutions be in managing Asia's increasingly complex economic and security ties? What are the intrinsic linkages between trade and security arrangements? What do these new trends mean for the future of Asia? The future institutional trajectory of Asia is still open, but this volume has explored both recent efforts and possible future scenarios for the region to understand the types of institutional solutions that may be feasible in Asia. Based on an institutional bargaining game approach, contributors to this book provide a rich theoretical and empirical analysis of trends and prospects both within and among Northeast, Southeast, and South Asia.

The remainder of this chapter proceeds as follows. Section 10.2 presents a discussion and evaluation of our theoretical argument. We then consider the broad shifts in Asia's economic and security environment that we have seen based on John Ravenhill's and Keiichi Tsunekawa's chapters, respectively, in Section 10.3. Section 10.4 highlights the key findings of subregional chapters on Northeast Asia, Southeast Asia, and South Asia. Section 10.5 examines the key links between security and trade issues in the formation and evolution of new institutions. Finally, in a more speculative vein, Section 10.6 evaluates the prospects for Asian regional integration in trade and security in a rapidly changing context and its implications for both Asia and other regions of the world.

## **10.2 Evaluating an Institutional Bargaining Game Approach to Explaining Asian Institutional Change**

How well does the institutional bargaining model presented in Chapter One and used by the contributors to this volume help to illuminate the process of institutional transformation in Asia? To address this question, we begin by briefly reviewing our approach. Our analysis focuses on how the traditional institutional equilibrium in Asia has come under heavy strain in light of the "triple shocks". The institutional transformation that we are interested in explaining can be characterized along several dimensions, including the number of actors involved in an accord (unilateral, bilateral, minilateral, and multilateral) and whether the accord is geographically concentrated or dispersed (see Table 1.1 in Chapter One). Other important elements that help to define new institutional arrangements include the strength, nature, and scope of accords.

The model we present in Chapter One used shocks as driving factors in altering actors' incentives. We argue that actors' responses will be driven by three key elements: 1) the types of "goods" that are involved; 2) actors'

individual bargaining situations based on their international and domestic context and beliefs; and 3) pre-existing institutions. We characterize goods in terms of whether they are public, common pool resources, club goods, or private goods. With respect to goods, we argue that in trade and finance, Asian states have over time become disillusioned with the public good provision aspects of the GATT/WTO club and the IMF, leading them to more directly seek club goods on a bilateral and minilateral basis. Similarly, the public goods aspects of the San Francisco system in security also appear to be increasingly fragile, leading states to seek security through club goods.

Turning to countries' individual bargaining situations, the rise of China has become a key factor in actors' international calculations. Now, security, finance, and trade are increasingly linked (a fact we discuss later in this chapter), increasing the politicized nature of trade and finance in particular and leading states to use both economic and security institutions to help them address the changing balance of power in the region. At the domestic level, we find that the increasing democratization of states in the region has had a mixed effect: on the one hand, this trend has increased prospects for cooperation; on the other hand, democratization has led to the rise of nationalistic and protectionist interests, making negotiations in trade and security more volatile. Finally, at the level of beliefs, we find a shift toward a view that regional (and bilateral accords in trade) may provide a means of coping with the changes that have taken place in the San Francisco system with the changing role of the U.S. and the rise of China.

Lastly, with respect to pre-existing institutions, the problems of the WTO and APEC in fostering trade liberalization, and the IMF in dealing with the Asian financial crisis, have made concerns with nesting new trade or financial accords within these institutions less compelling. In particular, as the U.S. and the EU, among others, pursue their own bilateral and minilateral arrangements in trade, Asians have begun to increasingly pursue their own institutional arrangements. And in security, the concern with maintaining the San Francisco system has given way to the search for a new security architecture in the region that would be significantly less centered on the U.S.

How does this approach compare to that of other analysts of institutional transformation in Asia? At the most basic level, few analysts have attempted to actually contrast and compare change in trade, financial and security institutions in the three subregions of Northeast Asia, Southeast Asia, and South Asia. For the most part, scholars have focused their attention on one or another of these subregions, and thus the lack of a unified framework has made it difficult to theoretically understand the institutional transformation of Asia from a broader regional perspective.

An exception to this generalization is the work of Peter J. Katzenstein, particularly his ambitious book *A World of Regions*. In that volume, Katzenstein builds on his previous collaborative work to argue that the Asian region (as well as Europe) has been deeply affected by Asian countries' relationships to the U.S. In his view, the dynamics of the relationship of key states in each of these regions, namely Japan and Germany, have been a core element in determining the nature of regional arrangements in Asia and Europe, respectively. In addition, Katzenstein focuses on the lack of common cultural identity among Asians in contrast to Europe, and also the ties that bind the U.S. to Europe based on longstanding connections driven by European immigration. Finally, he emphasizes the wariness of Asian states toward formal institutions that might impinge on their post-colonial independence or cause any interference in their domestic affairs.

Although we find Katzenstein's approach to be closer to our analysis in terms of a multi-causal approach that is sensitive to power, norms, and economic changes, we are less convinced by his commitment to "analytical eclecticism." Because this approach fails to tightly categorize types of institutional arrangements and adequately differentiate among types of accords, we find the dependent variable inadequately specified, preventing an analysis of important nuances and shifts in types of trade, financial, and security arrangements. Furthermore, although many of the causal factors that we and Katzenstein identify are similar, the lack of a clear conceptual framework that addresses the impact of different variables makes it difficult to link these factors to clearly specified institutional outcomes in Asia. Although this problem is less evident in Katzenstein's own single-authored work, his edited volume *Beyond Japan* illustrates the problems in having authors examine trends in Asia in a systematic and comparable analytical fashion.<sup>3</sup> Of course, in comparing approaches, the most important question is the extent to which one or another perspective is helpful in illuminating and possibly anticipating future changes in Asia.<sup>4</sup> It is to our empirical findings that we now turn.

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<sup>3</sup> As discussed below, in Chapter Two, Tsunekawa attempts to bridge Katzenstein's analytical eclecticism and our institutional bargaining game approach.

<sup>4</sup> For details of our evaluation of Katzenstein's work, see Aggarwal and Koo (forthcoming).

### 10.3 The Evolution of Economic and Security Institutions in Asia

The second part of this book provides a broad overview of trade, financial, and security institutions in Asia. In Chapter Two, John Ravenhill discusses how the “triple shocks” have affected the development of regional and transregional economic institutions. First, the end of the Cold War provided the prerequisite for launching region-wide inter-governmental collaboration—such as APEC—by removing residual ideological constraints from the calculus of economic cooperation between countries that had once been in opposing blocs. In the decade since the Asian financial crisis, economic institutions have proliferated at multiple levels, including the regional and trans-regional levels. In particular, Ravenhill highlights a growing desire both for collaboration on an “Asian” basis, and for the pursuit of trade agreements on a much more “practical” scale, that is, either bilaterally or minilaterally. Finally, he argues that the external logic created by the 9/11 attacks was of less significance in its impact on economic collaboration than were developments within Asia—most notably, the rapid growth of the Chinese and Indian economies.

While acknowledging a variety of economic and diplomatic purposes that Asia’s new economic institutions may serve, Ravenhill concludes with some cautious notes on their future, particularly with respect to FTAs. These accords, be they bilateral or minilateral, are inherently exclusive rather than inclusive. He argues that we cannot assume that the negotiation of such agreements will necessarily have a positive impact on economic and diplomatic relations, warning that trade negotiations can actually do lasting damage unless concluded within a reasonable period of time. As he notes, this has not always been the case in Asia as seen in the negotiations between Japan and South Korea and between the Association of Southeast Asian Nations (ASEAN) and India. Furthermore, the “club” or “positional” goods characteristic of FTAs may aggravate conflict, particularly when participation in the new FTAs across the region is not even. For instance, Taiwan has effectively been excluded from negotiating arrangements with other Asian countries by Beijing’s insistence that the “one China” principle must extend to trade agreements. Similarly, most of the lower-income countries in the region have also been excluded as they simply are not attractive partners except as part of a larger coalition (in this instance, ASEAN). Ravenhill also predicts that FTAs could have a destabilizing influence on the region if China and South Korea sign an agreement but neither side enters into similar arrangements with Japan. In this regard, Ravenhill’s view clearly contrasts with Katzenstein, whose Japan-centric

view of Asian regionalism argues that “FTAs tend to be stepping stones, not stumbling blocks, for porous regions.”<sup>5</sup>

In Chapter Three, Keiichi Tsunekawa examines how the “triple shocks” have shaped the development of regional security institutions throughout Asia. While sympathetic with Katzenstein’s view that regional phenomena in Asia are so complex that a variety of theoretical approaches is necessary to capture their multiple facets, Tsunekawa explicitly adopts a constructivist approach that emphasizes how cognitive and perceptual shifts interact with material structures such as military power and existing institutions. As he suggests, the role of actors’ shifting perceptions looms particularly large in the face of America’s weakening bilateral alliances, the strengthening of the U.S.-Japan alliance, the growth of minilateral organizations to manage regional security (particularly ASEAN and its derivative organizations in Southeast Asia), and China’s deepening engagement in regional security mechanisms. The latter development is clearly illustrated by China’s proactive role in the ASEAN Regional Forum (ARF), the Shanghai Cooperation Organization (SCO), and the Six Party Talks (SPT).

Tsunekawa holds that a key question for regional security institutions is whether their scope should be expanded to include more extra-regional actors or whether their membership is best confined to states located within Asia. In his view, the resolution of this question depends largely on America’s China policy. As China continues its economic growth and adopts an increasingly assertive stance on the regional stage, it will undoubtedly heighten perceptions of threat among policymakers in Washington. If the U.S. perceives China as a competitor, it may eschew minilateral forums in favor of broader cross-regional ones where China’s influence can be diluted. If, on the other hand, bilateral relations between China and the U.S. grow warmer, Washington may play a larger role in creating and strengthening regional security organizations to share the burden with Beijing.

The second critical bilateral relationship in the region in Tsunekawa’s view is between Japan and China. Historical rivalries have helped to foster threat perceptions on both sides, inhibiting the formation of any robust security institution in Northeast Asia. For him, defusing popular nationalism, altering threat perceptions, and solving major existing conflicts would certainly be necessary (if not sufficient) conditions for establishing a strong regional security institution. Similarly, the relationship between India and Pakistan is key to the subregional order in South Asia, and more broadly its relations with the rest of Asia. As long as India and Pakistan continue to fear the outbreak of war between them, the South Asian Association for

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<sup>5</sup> Katzenstein (2005:25)

Regional Cooperation (SAARC) will continue to languish in irrelevance as the norm of consensus will essentially enable them to veto each other.

Finally, Tsunekawa notes that ASEAN has been the most successful model of regional security cooperation in Asia by fostering norms of cooperative security and promoting conflict resolution through non-violent means. Although ASEAN and its derivative institutions are limited by their consensus-based decision-making process, they are nevertheless important in allowing for the development of greater trust among decision-making elites and socialization into norms of peaceful dispute resolution. Yet, as he cautions, confidence-building does not necessarily translate into mutually satisfactory solutions to stubborn geopolitical disputes, although it may help to prevent such disputes from spiraling out of control. Ultimately, for security to progress beyond the confidence-building stage, individual states must first settle their unfinished business and remove the sources of threat perceptions.

## 10.4 Subregional Developments

In the third part of this book, the authors of subregional chapters capture the new dynamics of Asian regionalism which involve a complex interplay among the key players in the region. To quickly summarize the main findings, at the heart of the shifting balance of Northeast Asian regionalism are the rise of China and the resultant triangular relationship among the U.S., Japan, and China. The complex balance of power in this part of the region does not allow for a single pacesetter, thus motivating these major powers to consider sharing (and competing for) regional leadership and influence with each other through multilateral economic and security forums including the ASEAN Plus Three (APT), the East Asia Summit (EAS), the Northeast Asian Cooperation Dialogue (NEACD), and the SPT. Southeast Asia is a unique subregion in that it features the widest variety of regional institutional arrangements in Asia. Despite its structural limitations, ASEAN has shown a certain degree of institutional resilience and adaptability in the emergence of Asian regional institutions such as the ARF and the APT. As Helen Nesadurai and Ralf Emmers note below, while ASEAN may not be the leader, it has served as the gravitational center of Asian regionalism, thus bringing together otherwise mutually suspicious neighbors such as China, India, and Japan. To that extent, many have recognized that ASEAN's principal contribution to Asian regionalism has been normative and social, rather than material and structural.<sup>6</sup> Finally, South Asia re-

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<sup>6</sup> Acharya (2003)

mains essentially inhospitable to dialogues intended to resolve regional security and trade issues. In particular, subregional conditions set by the enduring rivalry between India and Pakistan fail to meet the minimal levels of trust and incentives for official and unofficial dialogues to institutionalize their trade, financial, and security relations. Nevertheless, the rise of India as an economic powerhouse and its integration into East Asian economic networks have galvanized interest in forming cooperative regional institutions in trade, financial, and security issue areas.

### **10.4.1 Northeast Asia**

In Chapter Four, Mie Oba discusses the development of trade and finance institutions in Northeast Asia, highlighting the cooperation and rivalry between Japan and China. As she demonstrates, the triple external shocks have dramatically transformed elite beliefs and perceptions in the two regional powers regarding bilateral and minilateral economic arrangements. On the one hand, Japanese policymakers no longer consider FTAs as an inferior option to the multilateral trading system of the GATT/WTO, while Chinese leaders recognize that engagement in regional institutions outweighs the potential political cost of being constrained by them. On the other hand, the political cleavages between China and Japan over territorial issues and historical animosities pose critical obstacles to deeper regional institutionalization. Moreover, China and Japan offer different visions of a regionally integrated economic community, with Japan advocating the inclusion of external actors such as Australia, New Zealand, and India, while China prefers a more exclusively East Asian membership.

Can these differences be reconciled? Oba argues that images of being a “great power,” a “global power”, a “regional power”, or even an “Asian country” can influence policy directions and filter perceptions of exogenous events. She argues that self-perceptions and ideal images of each country held by a handful of political and business elites can disproportionately affect the identity of the country, thus distinguishing the contemporary institutional changes in Northeast Asia from their earlier counterparts during the Cold War period. Although it is still unclear as to what constitutes “Asia” or “Asian identity” beyond a collection of national identities, she argues that political and business leaders in China and Japan (as well as South Korea) have dramatically improved their relationships with one another as a result of sharply expanding economic ties over the past few decades. While such interactions will not settle all of the disputes and confrontations in Northeast Asia in the short run, Oba presents an optimistic picture that they will nevertheless provide Northeast Asian countries with the basic conditions for improving their relationship in the long run

and lay the groundwork for a potentially robust regional institutional architecture.

In Chapter Five, Min Ye examines security institutions in Northeast Asia, showing how global, regional, and domestic level forces are shaping a new security multilateralism. She begins with an observation that after each of the three external shocks, traditional security mechanism centered on bilateral alliance ties appeared insufficient to cope with structural changes and volatile security threats in the region, while new dynamics of domestic and transnational politics has nurtured a new sense of security interdependence.

On the one hand, the U.S. is clearly more concerned with counterterrorism and homeland security, while its key regional ally, Japan, tries to expand its international role and become a “normal state.” In the meantime, anti-U.S., anti-Japan, and anti-China sentiments are on the rise in South Korea, while China is conspicuously more nationalist in its regional diplomacy, especially toward Japan. As Ye aptly points out, all these trends have the potential to upset regional stability.

On the other hand, transnational economic actors and local governments in China, Japan, and South Korea have a considerable stake in regional stability and peace. Ye argues that minilateral cooperation—such as the ARF, the Korean Peninsula Energy Development Organization (KEDO), the APT, the Northeast Asian Cooperation Dialogue, and the Six Party Talks—has provided a more pragmatic means than bilateralism to address regional issues. For instance, China’s nationalist domestic audience is more likely to disapprove of any bilateral compromises that China would make with Japan than a diplomatic bargain in a multilateral setting. Similarly, the South Korean government is less likely to be constrained in multilateral diplomacy in the region than bilateral interactions with either Japan or China. Similarly, Japan’s drive to become an international power is more likely to succeed without setting off regional alarm bells if such growth is managed within multilateral frameworks. Although their strength and effectiveness remain unclear, Ye concludes that the variety of channels for security interactions in Northeast Asia certainly indicates promising signs for regional cooperation.

#### **10.4.2 Southeast Asia**

In Chapter Six, Helen Nesadurai investigates the establishment of new economic institutions in Southeast Asia, focusing on elite perceptions of trade and investment diversion in the wake of the “triple shocks”. Most notably, the Asian financial crisis prompted strong interest within ASEAN to build regional capabilities for preventing and responding to future crises. As she notes, however, this required the help of ASEAN’s richer Northeast

Asian neighbors and explains why financial cooperation proceeded under the auspices of the APT rather than ASEAN. Although the APT aspires to a comprehensive regional cooperation agenda covering both trade and non-traditional security, it is presently best known for its projects in regional *financial* cooperation, namely the Chiang Mai Initiative (CMI) and the Asian Bond Market Initiative (ABMI).

Nesadurai demonstrates that the 9/11 terrorist attacks had little effect on Southeast Asia's drive toward trade and financial cooperation but did provide a boost for APEC, renewing Washington's interest in the organization as the site for a variety of trade security initiatives, including counterterrorism. Furthermore, the need to secure access to markets and investment also accounts for the turn by a number of Southeast Asian countries to bilateral FTAs as insurance policies in a post-9/11 world. Singapore has been the most active proponent of bilateralism, while Thailand and Malaysia are not far behind.

The most compelling explanation for these changes, according to Nesadurai, is the central role played by elites' interpretations of external events. These interpretations provided the political space for those elites to initiate new institutions and review the designs of existing ones. Nesadurai argues that external shocks and events are always interpreted through the prism of what they mean for "economic growth" because growth remains a central basis of political legitimacy in Southeast Asia and acts as a guarantor of domestic regime security. In this regard, her view sharply contrasts with the conventional cultural explanation that the wariness of Asian states for formal institutions impinges on their deep-seated aversion to any intervention in their domestic affairs.

In Chapter Seven, Ralf Emmers examines a variety of Southeast Asia's collective security measures, focusing on the three most important arrangements: ASEAN (including the ASEAN Security Community or ASC), the ARF, and the APT. As held widely, ASEAN and its various region-wide initiatives have been at the core of the overlapping multilateral security structure in the region. Yet, in the post-"triple shocks" period, the erosion of the U.S. defense commitment, on the one hand, and the growing presence of China, on the other, has complicated the picture in Southeast Asia.

Against this background, Emmers claims that the institutional changes in Southeast Asia have occurred primarily in terms of widening geographical and issue scopes rather than institutional strength. As noted by other chapter writers as well, ASEAN's geographic expansion resulted in its institutional merger with Northeast Asian countries in various security and semi-security forums such as the ARF, the APT, and Track Two dialogues. Yet he argues that, despite the existence of a growing number of complementing and overlapping structures, minilateral security arrangements in

Southeast Asia still lack institutional capacity to effectively manage common security problems, both conventional and unconventional. Unlike the willingness to delegate part of their economic sovereignty to international institutions, Southeast Asian countries are still protective of their sovereignty and unwilling to give up national autonomy to supra-national structures.

Not surprisingly, it is questionable whether the ARF, despite its institutional utility, will succeed in moving from confidence building to preventive diplomacy. This view can be supported by the fact that great powers have lost their interest in the ARF, as indicated by the failure of the foreign ministers of the U.S., Japan, China, and India to attend its 2005 ministerial meeting. In addition, the APT does not have the institutional strength to effectively address changes in security, mainly because no consensus exists between its two key participants, China and Japan, on the security approach the institution should adopt. As a result, Emmers reaches a skeptical conclusion, arguing that ARF and APT are likely to remain as moderate confidence-building exercises rather than evolving into full-fledged security institutions.

### **10.4.3 South Asia**

In Chapter Eight, Vinod K. Aggarwal and Rahul Mukherji focus on the evolution of India's new economic policies within the context of the larger transformation of Asia's economic and security architecture. Aside from the triple shocks, the authors find that India's balance of payments crisis in 1991 and the decision of both India and Pakistan to test nuclear weapons in 1998 were also critical factors.

As the authors show, India's import substitution industrialization (ISI) policy reflected the convergence of India's security and economic needs. During the Cold War period, strategic relations with Moscow fostered India's trade with the Soviet Union, whereas its need for regional export markets in the U.S. bloc was not significant. Since 1991, however, India's economy has undergone a remarkable transformation, departing from its ISI policy to a more liberal domestic economic model and an increasing focus on improving its export competitiveness.

Most notably, Aggarwal and Mukherji hold, the fall of exports to crisis-ridden East Asia, on the one hand, and India's nuclear tests (and consequent U.S. trade sanctions), on the other, prompted Delhi to seek bilateral trade agreements within South Asia, culminating in the signing of the Indo-Lanka FTA (ILFTA) in December 1998. For the authors, the ILFTA was a model of asymmetrical concessions that India was willing to make in search of markets at a time when the markets for Indian exports seemed restricted elsewhere.

In the post-9/11 period, India's institutional engagement with Asian economies is truly remarkable, enhancing its efforts to build on its Look East Policy (LEP). While SAARC has failed to facilitate free trade due to the fragile security situation between India and Pakistan and the Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation (BIMSTEC) remains nascent, India has strengthened its economic ties to Southeast and Northeast Asia as illustrated by its participation in a number of bilateral FTAs. After successfully concluding the FTA with Thailand in 2003, India signed the Comprehensive Economic Cooperation Agreement (CECA) with Singapore in 2005. India is actively negotiating FTAs with ASEAN and South Korea and has participated in the East Asia Summit. It is also working toward preferential agreements with Japan and New Zealand, while its trade relations with China have become increasingly cordial. Moreover, it continues to lobby strongly for an ASEAN Plus Six (APS) arrangement that would include Australia, New Zealand, and India, in addition to the APT. Aggarwal and Mukherji conclude that all these changes point to the possibility of further broad regional integration in the future.

In Chapter Nine, Eswaran Sridharan analyzes the evolution of regional security institutions in South Asia following the end of the Cold War, the Indian and Pakistani nuclear tests of 1998, and the 9/11 attacks. He argues that regional security institutionalization is extremely constrained by severe territorial and border conflicts within the region, particularly between India and Pakistan. To some extent, the threat of nuclear war resulting from the 1998 nuclear tests generated an impetus for confidence-building measures to improve transparency. Nevertheless, Sridharan presents a rather pessimistic view that existing forums such as SAARC will not be able to institutionalize security arrangements as long as the India-Pakistan territorial conflict over Kashmir remains unresolved. In addition, he notes that factors militating against the institutionalization of security cooperation in South Asia include the deteriorating state of Indo-Bangladesh relations, the Sri Lankan ethnic conflict, and Sino-Pakistan security cooperation that threaten India.

Sridharan contends that growing economic cooperation within the region will only slightly mitigate but not transcend this state of affairs, particularly given the much more limited scope for, and ratio of, intra-regional trade in South Asia due to India's overwhelming dominance. Relatedly, rapidly growing Sino-Indian trade will mitigate but not transcend the implications of China's basic alignment with Pakistan, at least so long as the Sino-Indian border problem, which has been shelved rather than fully resolved.

Nevertheless, it should be noted that cross-regional security relations between South Asian countries and the U.S. as well as East Asia countries

have improved. The 9/11 attacks have created an impromptu triangular relationship among India, China, and the U.S., stabilizing the otherwise hostile Sino-India relationship. The improvement of South Asia's relationship with Southeast Asia has also been dramatic since India launched its LEP in the early 1990s. Pakistan followed suit by signing the Treaty of Amity and Cooperation (TAC) with ASEAN and joining the ARF in 2004. Most recently, India has become the one of the most popular destinations for Northeast Asian countries' trade and investment. All in all, Sridharan concludes that South Asia itself will most likely lack comprehensive regional security arrangements, but that India's economic integration with the East Asian region indicates that the merger of two subregions in security terms remains a distinct, albeit uncertain, possibility.

### **10.5 The Nexus between Trade and Security**

With the key findings of subregional chapters on Northeast Asia, Southeast Asia, and South Asia in mind, we now turn to examine the prominent links between security and trade issues in the formation and evolution of new institutions. Although financial issues have been linked to security, our interest in the scholarly literature on trade and security leads us to focus on the latter. How trade and security might be connected has attracted extensive scholarly attention in the field of international relations and international political economy. As John Ravenhill notes in Chapter Two of this volume, countries may pursue FTAs for a variety of strategic and diplomatic purposes, from confidence-building among countries with little contact with one another, to winning diplomatic points over regional rivals, to establishing an international legal personality, to locking extra-regional powers into the region. In a similar vein, Mireya Solis and Saori Katada persuasively show that, aside from prospective economic benefits, East Asian countries' cross-regional FTA initiatives have been strongly driven by security and diplomatic leverage considerations.<sup>7</sup>

Indeed, many Asia scholars agree that economic regionalism has implanted norms and institutional forms, and became precedents for Asian countries when reformulating their regional security architecture.<sup>8</sup> In particular, many contemporary Asian FTAs aim to build "security-embedded" trade ties, thus providing the context for regional security institution-building. Security institutions, in turn, are regarded as instrumental in im-

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<sup>7</sup> Solis and Katada (2007)

<sup>8</sup> Job (2003:254-255)

proving the conditions of economic prosperity. In what follows, we briefly consider four examples of security-embedded FTAs in Asia.

First, Singapore considered security as the single most important motive for entering an FTA with the U.S. in 2003, while it considered economic benefits of the agreement insignificant due to its traditional openness and the small size of its economy. At the same time, Singapore has approached China both economically and diplomatically so that the U.S.-Singapore FTA would not irritate Beijing. As a result, Singapore and China have made conscious effort to improve their political and economic relations for the past years. Singapore's dual approach to the U.S. and China clearly show the nexus between trade and security institutions in Asia.<sup>9</sup>

Second, the ASEAN-China FTA (ACFTA) is also security-embedded in that for both China and ASEAN, security concerns—rather than pure economic considerations—drove an interest in the creation of the ACFTA.<sup>10</sup> China's rapid rise has raised fears about its intentions in the region and its likely foreign objectives. In response, China has chosen to use not only purely security forums like the ARF and the SCO, but also economic and other soft institutional mechanisms—such as the 2002 Code of Conduct in the South China Sea and the 2003 TAC with ASEAN—to diminish concern about its rise. Indeed, Beijing's proactive participation in a variety of regional institutions reflects a broader trend towards a “cooperative security” in the region.<sup>11</sup>

Third, the South Korea-U.S. FTA (KORUS FTA), which was concluded on April 1, 2007, shows how countries can simultaneously, albeit implicitly, pursue economic benefits and strategic interests in trade negotiations. In addition to the goal of maximizing the gains from trade and investment, South Korea wanted to hedge against the growing strategic uncertainties in Northeast Asia by cementing its economic ties with the U.S., while the U.S. realized that an FTA with South Korea would give Washington a strong foothold to maintain its strategic and economic presence in the region. Furthermore, the KORUS FTA has the potential to alter the dynamics of the diplomatic and security relations in Northeast Asia where the balance of power is shifting due to the rise of China, the normalization of the Japanese state, and the nuclear adventurism of North Korea.<sup>12</sup>

Fourth and finally, in the case of India's relations with the rest of Asia, the interplay of security and trade concerns has been paramount, a point

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<sup>9</sup> Pang (2006)

<sup>10</sup> Kwei (2006)

<sup>11</sup> Shambaugh (2004); Yahuda (2005)

<sup>12</sup> Lee and Koo (2006); United States Trade Representative (2007)

that Aggarwal and Mukherji have emphasized in this volume. India's ISI strategy was intimately tied to the Cold War and its links to the Soviet Union in export markets. And the end of the Cold War helped to drive India's economic liberalization strategy and subsequent turn to a more export-oriented focus in the face of shrinking markets in the Soviet Union. It also helped India to reorient its policy toward other parts of Asia. The Look East Policy helped India to secure membership in the ARF, policies that India could not pursue in light of its tilt toward the Soviet Union. The nexus between trade and security continued after India and Pakistan tested nuclear weapons tests in 1998. Together with the Asian financial crisis, India's LEP encountered problems with declining growth in East Asia and significant criticism by East Asian states of the nuclearization of South Asia. In this context, India concluded an FTA with Sri Lanka in its drive to continue its trade openness strategy. As relations improved with the U.S. and East Asia in the post-9/11 period, India continued this bilateral strategy, in part to maintain its credibility, and in part to balance against China, by signing FTAs with Thailand (2003) and Singapore (2005) and actively negotiating with ASEAN, Japan, South Korea, New Zealand, and the EU.

## **10.6 The Future of Asia's New Institutional Architecture**

In an effort to understand the shifting institutional dynamics in Asia, this book utilizes a common framework that focuses on the role of external shocks, goods, countries' individual bargaining situations, and the fit of new accords with existing arrangements. Specifically, we focus on the "triple shocks": the end of the Cold War, the Asian financial crisis of 1997-98, and the 9/11 attacks. With respect to goods, we argue that disturbances in the traditional mechanism to provide trade liberalization, financial stability, and regional security have motivated countries to seek club goods as a viable alternative to the diminishing supply of public goods. This observation undermines the myth that the combination of bilateral and multilateral arrangements under the San Francisco system and loosely structured production networks will be a viable alternative to tighter formal institutionalization at the regional level.

Despite the many positive developments for the past few decades, there continues to be a view that the Asian region remains largely inhospitable soil in which to cultivate multilateral institutions, as most countries still stick to the notion of Westphalian sovereignty and non-interference. At the same time, there has been a spate of scholarly attempts at creating future scenarios for how regional and transregional Asian institutions in trade and

security might evolve.<sup>13</sup> Yet, in light of the “triple shocks” and the resultant changes in Asian countries’ preferences for collective goods, we argue that insufficient efforts have been made to systematically link the dynamic interaction of key powers with broader institutions in both the trade and security issue areas. For instance, it is not enough to claim that “FTAs tend to be stepping stones, not stumbling blocks, for porous regions”<sup>14</sup> or that “the emerging regional security architecture will be firmly grounded in national self-reliance, with strong and important bilateral connections, and a gradually thickening but still very thin veneer of multilateralism.”<sup>15</sup> Instead, we must explore the conditions under which these agreements are likely to evolve into broader accords as well as the conditions under which they might undermine global institutions by failing to be firmly nested in those institutions.

As noted in the previous section, the findings of this volume indicate that economic regionalism will provide the context for regional security institution-building, rather than the other way around. At the same time, the security context is critical for the future of regional economic institutions. Using our institutional bargaining game approach designed to systematically examine the dynamic interaction of key powers and broader institutions, we construct simplified scenarios of possible institutional paths that Asia is likely to take, focusing primarily on the links between trade and security. For us, the future of Asia’s new institutional architecture primarily depends on the following causal variables: 1) the strength of broad-based, global institutions such as the UN and the WTO; 2) the China-Japan, China-India and India-Pakistan regional rivalries; 3) economic complementarity among countries; and 4) the “balance of interests” between the U.S. and the EU concerning Asia as their trading and security partner.

For instance, if the global trading regime of the WTO weakens, considerable institutional space and a multiplicity of options are likely to emerge at the regional level. In this case, if China and Japan reach a political alliance, the formation of a strong Northeast Asian Free Trade Area (NEAFTA) is highly likely. If economic complementarities exist among the member countries, they will broaden the scope of product coverage; otherwise, we can expect a strong but narrow (or sectoral) NEAFTA. By contrast, if there is no alliance between China and Japan, a NEAFTA is not

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<sup>13</sup> For instance, see Acharya (2003), Aggarwal and Koo (2005a, 2005b), Alagappa (2003), Ball (2000), Buzan (2003), and Katzenstein (2005, 2006).

<sup>14</sup> Katzenstein (2005:25)

<sup>15</sup> Ball (2000: 143)

a possibility.<sup>16</sup> A similar logic of spillover effects can be applied to economic cooperation in other parts of Asia—particularly with respect to India and Pakistan.

Will Asia remain a porous region? The decade-long perception among Asians that Western regional arrangements are forming against them may well rekindle the notion, promoted by former Malaysian Prime Minister Mahathir bin Mohamad, of an exclusive East Asian bloc—be it the East Asia Summit or APT (or ASEAN Plus Six)—or a new regional hierarchy centered on China. In contrast, if either the U.S. or the EU (or both) maintains a strong focus on the region, Asia will remain an open region.<sup>17</sup>

Currently, the U.S. maintains its economic and diplomatic focus on the Free Trade Area of Americas (FTAA) and the EU continues on an eastward and southward expansion path. Nevertheless, it is unlikely that either the U.S. or the EU will disengage from Asia. Among others, the China and India factor will entice them to stay actively involved in the shaping of Asian regionalism. The U.S., for its part, has recently called for the creation of a Free Trade Area of the Asia Pacific (FTAAP). And with India, the U.S. has been actively pursuing stronger ties, including agreement on nuclear materials. Europeans have continued to work with East Asia through the Asia-Europe Meeting (ASEM) process and have begun negotiations with India, South Korea, and ASEAN countries for a free trade agreement. But if these efforts do not prove fruitful—and currently, the prospects for an FTAAP are politically dim<sup>18</sup>—the likelihood of a more exclusive region in Asia, be it APT or APS, will grow.

To this point, China has pursued regional arrangements in a politically astute manner, using such accords to allay suspicions about its rising power and to prevent the region from being overly influenced by external powers. Aside from exclusive or hybrid security institutions in the region such as the ARF, the SCO, and APEC, China began to use FTAs with its neighbors to build “security-embedded” trade ties. A key element in the dynamic of regionalism in Asia will revolve around China, India, Japan, and South Korea’s ability to come to an accommodation on who “belongs” in an Asian agreement. Currently, various formulae such as an inner circle based on APT and an outer circle of APS have been vetted, but the institutional contours of Asian regionalism remain in flux.

The KORUS FTA illustrates the new great power dynamics of security-embedded FTAs. Many in China (as well as in Japan) have expressed con-

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<sup>16</sup> Aggarwal and Koo (2005a)

<sup>17</sup> Aggarwal and Koo (2005b)

<sup>18</sup> Aggarwal (2006)

cern that the accord would put their country at a competitive disadvantage in the U.S. and South Korea market and pose a potential security threat. Such recognition has motivated Beijing (and Tokyo as well) to seek an FTA with Seoul.<sup>19</sup> Ironically, then, just as the Europeans helped to promote East Asian unity through the ASEM process, by pressing them to negotiate as a group, American actions may help to foster integration among Asian countries through its negotiation of bilateral trade accords, leading to an outcome that it is seeking to avoid.

Asia currently stands at a crossroads. How Asia designs its regional institutions will undoubtedly have major implications for the shape of trade, finance, security, and political cooperation. If Asian states decide to restrict the development of regional institutions in favor of a new hub-and-spoke system centered on China or some other form of bilateralism, it will inhibit economic growth, create artificial barriers to cooperation, and limit the region's ability to compete in the global market. Given the proliferation of bilateral FTAs and the weakness of regional arrangements, this is a very real possibility. There is a brighter alternative, though. If Asian actors take regional cooperation seriously and set aside parochial national interests, they may yet be able to tap their vast collective political and economic resources and maximize their potential for peaceful and prosperous growth.

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<sup>19</sup> Lee and Koo (2006); *Chosun Ilbo* (2007)

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