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Integrating Asia

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In Asia, investment ties provide the political foundation for legal agreements, not vice versa.

Full recommendations, page 4.

Summary:

Intra-regional investment, not trade or government-to-government agreements, drives Asia-Pacific economic integration. Such investment promotes competition among the United States and its major Asian trading partners, but also creates advantages for American firms through the formation of cross-national production networks (CPNs). The United States can best exploit these advantages through a regional trade and investment strategy that complements its traditional bilateral approach to political and economic presence-building in Asia—maintaining an open market at home, while building regional partners there.

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This policy brief draws on the results of two studies. The first was conducted by the University of California's Institute on Global Conflict and Cooperation (IGCC): Barry Naughton, ed., The China Circle: Economics and Electronics in the PRC, Taiwan, and Hong Kong *(Brookings Institution Press, 1997) and was supported by The Rockefeller Brothers Fund and Ford Foundation. The second was jointly conducted by IGCC and the Berkeley Roundtable on the International Economy (BRIE): Michael Borrus, Dieter Ernst, and Stephan Haggard, eds.,* Integrating Asia: American, Japanese and Chinese Investment Networks in the Electronics Industry *(forthcoming), and was generously supported by the Japan-United States Friendship Commission, the United States-Japan Foundation, and the Alfred P. Sloan Foundation.*

The explosion of Japanese investment in Asia since the mid-1980s, plus the recent growth of overseas Chinese networks, have generated fears that a closed economic bloc might emerge in Asia. Three developments suggest that such fears are exaggerated.

Since the early 1980s, American firms have exploited Asia's economic heterogeneity by knitting together their own cross-national production networks (CPNs) in the region. The rise of Chinese business networks centered around the "China Circle"—the increasingly integrated economy that encompasses Taiwan, Hong Kong and the Chinese southern coastal provinces of Guangdong and Fujian—has challenged Japanese firms and complemented these new U.S. CPNs. And increasing competition for investment by middle-income Asian nations has also resulted in a closer alignment of U.S. business interests with these emerging economic powers, especially with reference to market access issues (see sidebars).

Critics of free trade and "runaway shops" see U.S. offshore production in Asia as evidence of declining American competitiveness. However, IGCC-BRIE studies show that virtually the opposite is the case: American investment networks in Asia exploited the region's technological capabilities and production capacity to maintain American leadership in the electronics industry.

Cross-National Production Networks in Asia

Cross-national production networks (CPNs) involve dividing the value chain, from product definition, research, and development, through letting contracts for manufacturing services and component sources, to distribution and after-sales service. These functions are parceled out across international borders to affiliates and specialized independent producers. In the electronics industry, companies in Thailand and China assemble printed circuit boards, software is written in Bangalore, Malaysian and Philippine companies assemble components, and Taiwan and Korea specialize in higher value-added services and products such as digital design services and semiconductor memory.

IGCC-BRIE studies show that the development of such networks by American firms has enhanced U.S. competitiveness. The Asian CPNs of American multinationals provide an alternative supply base for key components, reducing dependence upon Japanese companies. By concentrating scarce resources on defining new products and standards, U.S. producers emerged as international industry leaders.

As Asian partners focused resources on their part of the value chain, fierce regional competition kept prices down and encouraged innovation. As costs rose in the newly industrializing economies of Korea, Taiwan, Hong Kong and Singapore, local firms from these countries moved up the value chain at home. U.S. CPNs thus nurtured direct competition with Japanese producers of core products like consumer electronics and memory chips.

At the same time, rising Asian firms invested heavily in their own overseas networks. The result was a further deepening of the regional division of labor and an overall production organization that is now cheaper, faster, and more responsive than either Japan's industrial group structure or the vertically-integrated giants such as IBM.

Bilateralism and Regionalism

The U.S. government can best exploit its existing advantages by complementing its traditional *bilateral* approach with an Asia-Pacific *regional* trade and investment strategy, including in relations with China and Japan.

Chinese Powerhouse?

Beijing believes it can exploit its large market to pursue an industrial strategy based on protection, restrictions on investment, forced technology transfer, and the creation of large industrial groups. These strategies have reached their limits. China's attempt to foster national champions has generally been a failure. It is the large number of independent firms, many with strong foreign links, that have spearheaded China's export drive. The U.S. bilateral trade deficit with China reflects the offshore operations of overseas Chinese networks—a shifting of exports from Taiwan and Hong Kong onto the mainland. This restructuring is now largely complete. The specter of a high-technology, low-wage export powerhouse is thus exaggerated. China remains largely a story of textiles, toys, and low-end electronics assembly.

National Differences in Investment Networks

National differences among investment networks in Asia persist and have important competitive implications. U.S. networks tend to be open, disposable, and decentralized. Any firm from anywhere can become a partner if competitive on price, quality, and time to market, but alliances shift rapidly as needs change or competition produces a better alternative. Most significantly, U.S.-led CPNs aggressively exploit increasing technical specialization throughout Asia and devolve significant decision-making onto partners.

In contrast, Japanese networks tend to be based on affiliates or long-term relationships. They are more centralized, with most key decisions still taken in Tokyo. The Japanese strategy minimizes value added outside of Japan in order to maximize control over the value chain. The result is sluggishness, or outright failure, to fully tap rapidly developing technological and production capabilities in the region. Emerging Korean networks resemble their Japanese counterparts.

Overseas Chinese investors from Taiwan and Hong Kong have pursued yet another approach. Chinese networks *appear* to be closed because of the importance of language and personal relationships *(guanxi)*. In fact, Chinese networks are quite open. Chinese firms based in Taiwan and Hong Kong have exploited multiple supplier arrangements to maximize flexibility and speed-to-market by shifting large segments of labor-intensive manufacturing to mainland China, while fostering new high value-added activities at home. These networks fit neatly into the regional architecture pioneered by American firms.

Given internal pressures in China for further reform, the United States should take a firm stand with respect to the terms of China's WTO accession. The United States should avoid the temptation to trade economic concessions for short-term political gains, and peg the extension of full benefits to China's compliance with its WTO obligations.

The WTO dispute settlement is more likely to garner regional support than our current bilateral stance. The United States should seek support from Asian partners who are also increasingly affected by China's arbitrary trade and investment policies, and use the WTO to develop precedents in areas relevant to our management of relations with China, such as subsidies.

Japanese Surplus

Japan's trade policies, long addressed bilaterally, also constitute a *regional* policy problem: Asia-Pacific trade is still characterized by a marked triangular pattern, in which Japan's intra-regional investment produces for export to North America and Europe, contributing to the region's trade surpluses. The problem of Japan's trade surpluses is thus not unique to the United States; the China Circle and other middle-income countries remain heavily dependent on Japan for much of the capital equipment and certain high-technology components upon which industrial production is based.

The bilateral strategy of dealing with Japan has yielded results by forcing dialogue on the range of anti-competitive practices that can hinder trade and investment in particular industries. However, as with China, the United States needs to rally *Asian* support for its Japan policies. Bilateralism has made it more difficult for the United States to garner Asian allies in pressuring Japan to open up its economy. Indeed, fear of bilateral pressure has the effect of aligning Asia *with* Japan *against* the United States.

Developing a Regional Strategy

The long-standing U.S. policy of maintaining an open market at home is critical in maintaining U.S. economic competitiveness in Asia. Exposure to international competition has helped American industries (such as financial services and petrochemicals) adopt new technologies quickly and dominate product and standards definition (such as business systems, personal computers, and communications equipment).

While the Asia-Pacific Economic Cooperation (APEC) forum provides a natural venue for pursuing a regional strategy, the United States should not be overly preoccupied with reaching legally binding agreements.

Equally important is the use of APEC as a venue for expanding business participation in regional policy discussions and deepening U.S. investment ties with Asian partners. Increasing investment provides the basis for regional agreements, not the other way around. The recent International Technology Agreement, that eliminates tariffs on high-technology products traded extensively in Asia, provides an example.

In any event, pressing for a regional investment code in APEC pushes on an open door; countries can only participate in rapidly changing production networks if they provide a hospitable policy environment. The United States is the premier market for the launch of innovative new products. Rather than expend scarce resources on investment codes, the U.S. needs to encourage domestic firms to exploit their existing bargaining power with countries such as South Korea, where conducting business remains difficult.

The new Asian networks offer the United States opportunities to forge new political alliances to support reform in the region. The U.S. should seek regional support for the elaboration of strong intellectual property norms and elimination of barriers to trade rooted in government standards, including through mutual recognition agreements (MRAs). The U.S. government could illustrate its commitment to a regionally-based trade and investment strategy by creating a deputy assistant secretary of state for regional economic affairs within the East Asia and Pacific bureau.

Conclusion

The United States' ability to remain engaged in Asia is not simply a question of military strategy or domestic political will. It also rests on a strong economic presence in the region and the ability to innovate products and services of interest to America's trade and investment partners there. A regional trade and investment strategy and active promotion of American firms in the region complements the traditional U.S. bilateral approach and guarantees continued economic engagement and influence in Asia. ❖

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How to sustain American competitiveness in Asia:

1. **Maintain an open market at home.**
2. **Use APEC less for binding legal agreements and more to deepen regional investment and commercial ties.**
3. **Gain regional support for reducing trade barriers in China and Japan.**
4. **Use the WTO to settle disputes and foster China's acceptance of liberalized trade norms.**
5. **Create a deputy assistant secretary of state for Asia-Pacific economic affairs.**

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