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WHITHER EAST ASIAN REGIONALISM?: AN ASEAN PERSPECTIVE

Siow Yue Chia
Senior Research Fellow, Singapore Institute of International Affairs
2 Nassim Road, Singapore 258370
email: chiasy@singnet.com.sg

Abstract:

The East Asia region is catching up with the rest of the world in establishing FTAs. This is a response to the pressures from globalization, regionalism in the Americas and Europe, the rise of China and India, warming political relations with the end of the Cold War, as well as market-driven trade and investment integration and emergence of production networks. The first FTA was formed by ASEAN in 1992, but by the turn of the century ASEAN is signing or negotiating FTAs with Japan, China, South Korea, India, Australia-New Zealand and the European Union as well as entering into bilateral FTAs with the US and countries in Latin America, Africa, Middle East and South Asia. ASEAN is also considering an East Asia FTA. Can ASEAN remain in the driver's seat and be an effective hub? The FTA proliferation also has important consequences and effects for East Asia and the world trading system.

Key words: Economic integration, free trade areas, ASEAN, East Asia

1. Introduction

The Asian Financial Crisis of 1997-8 has served as a turning point in East Asia's growing fascination with regionalism. There is now a proliferation of plurilateral and bilateral economic partnership and free trade area agreements being signed, negotiated or under study and discussion.

The diverse East Asian region is becoming increasingly economically integrated. The driving forces in the 1980s and 1990s have been market-driven and private sector-driven. Since the turn of the century, integration is being increasingly driven by governments. The pace and modality have been largely established by the Association of Southeast Asian Nations (ASEAN), with the establishment of the ASEAN Free Trade Area (AFTA) in 1992 and the growing number of ASEAN Plus One and bilateral FTA agreements.

This paper first examines the market driven trade and investment integration process in East Asia in the 1980s and 1990s and particularly the rapid growth of production networks and intra-regional and intra-industry trade. It then examines the pattern and progress of ASEAN economic integration, followed by discussions of the various ASEAN Plus agreements and emerging issues. Finally the paper examines the prospects and challenges of an East Asia FTA.

2. Market-Driven Economic Integration in East Asia

The East Asian region has been experiencing rapid regionalization since the mid-1980s, and economic regionalism since the early 1990s.

Regionalization means the growing economic interdependence among East Asian economies from market-driven trade and investment flows. These have been in response to several developments: increasing adoption of outward-looking trade and development strategies and capital account liberalization by the market economies of the Asian Newly Industrialized Economies (NIEs) and Southeast Asia; market-oriented economic reforms and opening up of the transitional economies of China, and Cambodia, Laos and Vietnam; realignment of exchange rates following the Plaza Accord of September 1985 that led to a surge in outward investments from Japan and Asian NIEs to the rest of the region, creating a web of production networks and intra-regional trade; and the East Asia "economic miracle".

Regionalism refers to ongoing efforts at institutionalized free trade areas (FTA) and economic partnership agreements (EPA). The Asian financial crisis ended the economic miracle in East Asia and ushered in a new period of economic recession and uncertainty. There is also intensifying global economic competition and the economic rise of China and India. Hence, regionalism became an increasingly attractive option to manage external challenges and foster further regionalization.

2.1 Market-driven Trade and Investment Integration

Trade integration

Most East Asian economies have high trade/GDP ratios, with Hong Kong and Singapore having extremely high trade ratios due to their entrepot roles. Even China has a high trade/GDP ratio.

Table 1 shows intra-regional /total trade ratio of East Asian economies.

- For ASEAN10, the intra-ASEAN trade ratio has been rising from 17.0% in 1990 to 25.5% in 2005 (It was 15.9% in 1980). In 2005, the highest trade ratio was Laos (65.2%), Myanmar (51.2%), Brunei (34.1%) and Singapore (31.3%). Laos is landlocked and much of its trade is with and through Thailand. Myanmar has been "boycotted" by many countries in the Western world because of its poor human rights record. Brunei is an oil economy trading strongly with Singapore and Singapore is a Southeast Asian entrepot. During the period 1990-2005, the ratios have been rising for the ASEAN10 group as well as for all ASEAN10 economies except for Cambodia and Vietnam. Cambodia's ASEAN trade showed marked decline in share after 1995 (73.6%), reflecting a surge in trade with the EU and the US following normalization of trade relations. Likewise, Vietnam's ASEAN share declined after 1995 following the normalization of trade with the US. The Philippines, Thailand and Cambodia had less than 20% trade ratios in 2005 but these represent a sharp increase from the 1990 ratios.

- For ASEAN+3 (ASEAN10, China, Japan, Korea), the intra-regional trade ratio rose from 28.6% in 1990 to 39.4% by 2005 (it was 29.0% in 1980). In 2005, the most trade-integrated economies with ratios of at least 75% were Brunei, Laos and Myanmar. The Northeast economies of Japan, South Korea and China had ratios that were lower than Southeast Asia (except Cambodia). For several Southeast Asian countries, trade with Northeast Asia was quantitatively more important than trade with ASEAN partners. Rising ratios from 1990 to 2005 were experienced by all 13 economies except for Brunei, Cambodia, Laos.
- For East Asia-15 (ASEAN+3, Hong Kong and Taiwan), the intra-regional trade ratios rose from 41.4% in 1990 to 52.7% in 2005 (32.7% in 1980). In 2005, the most trade-integrated economies with ratios of at least 75% were Brunei, Laos, Myanmar as well as Hong Kong (largely because of its trade with China).

East Asia's increasing trade integration is mainly market driven. In the 1980s and 1990s many emerging East Asian economies embarked on unilateral liberalization of trade and FDI regimes and deregulation of domestic activities to restructure their economies. East Asian trade increased rapidly and continuously in the 1980s and 1990s before the Asian financial crisis reflecting the following: substantial depreciation of East Asian currencies vis-à-vis the Japanese yen following the Plaza Accord, which increased the competitiveness of East Asian products vis-a-vis Japanese products; strong recovery of East Asian economies from the 1997 Crisis and the strong growth of IT in the world economy. An outward-oriented economic development strategy emerged a a key engine of economic growth in East Asia. Per capita incomes in the NIEs are catching up with Japan and China is catching up with middle-income ASEAN economies. East Asia is the only region that is catching up and converging on the OECD and likely to meet the Millennium Development Goals.

Trade integration ratios of East Asia-15 are higher than NAFTA but lower than the highly institutionalized EU-25. In contrast, trade integration ratios for South Asia are extremely low. The growth in East Asia's intra-regional trade is driven mainly by market forces, as regional and bilateral initiatives (except AFTA) have yet to be fully implemented. Characteristics of the intra-regional trade:

- East Asia is more important as import source rather than export destination for the region's economies. Regional countries procure parts and components from within the region to make final products for export to non-regional destinations such as the US and EU.

- The commodity composition of East Asian trade changed dramatically, particularly with the development of manufactures exports in ASEAN-4 (Indonesia, Malaysia, Philippines, Thailand). Among manufactures, electronics (office machines and telecommunications equipment) show interesting developments ---the Asian NIEs became major exporters in the 1980s, Malaysia and Thailand joined the bandwagon in the 1980s, and Philippines and China in the 1990s. Many East Asian countries are large exporters of office machines and telecommunications equipment. (**Asian Development Bank 2007**)
- In 2004, East Asia's share of imports of HS61-63 amounted to less than 17% of world total ($56.5 billion), while exports amounted to 43% of world total ($146.7 billion). The imbalance implies that final demand outside East Asia was the driving force in the expansion of the region's exports. For HS85 (electrical machinery), East Asia's share of world imports increased from 34% to 39% during 1995-2004, while the region's export share increased from 48% to 54%. Similarly for HS84 (non-electrical machinery), East Asia's import share rose modestly from 23% to 24% but its export share increased more strongly from 31% to 35%. Extra-regional final demand account for East Asia's export expansion during 1995-2004.
- As trade and investment barriers fall, multinational corporations (MNCs) increasingly engage in production activities across a range of locations s with varying location-specific advantages (including abundance of specific resources and favorable geographical position). This leads to trade in intermediate products, which has become very important in East Asian trade in electronics, non-electrical machinery and transport equipment.
- China is a major factor in the dynamic growth of East Asia's intra-regional trade in 1995-2004. China is an assembly point for final products destined for global markets, indicating the strong regional orientation towards the global economy. Within the region, China has been a net importer, in contrast to its rising global trade surplus. (**Asian Development Bank 2007).**

Trade-FDI nexus and production networks

Foreign direct investment (FDI) has played a crucial role in the economic development and industrialization of most ASEAN countries. These countries also compete with each other to attract FDI and in the process lose bargaining leverage to the foreign MNCs who are able to choose and negotiate between alternative investment locations.

FDI inflows to East Asia started to increase rapidly in the latter half of 1980s, but declined sharply during the Asian Crisis. A sequential pattern marked expansion of FDI inflows to the NIEs, ASEAN4 and China from the mid-1980s to early 2000s ---first to NIEs in latter 1980s, then to ASEAN4 in end-1980s, and to China in early 1990s. Japan appears to be the largest investor in ASEAN, especially in Thailand and Indonesia. Share of Asian NIE investments in ASEAN has been increasing. Since economic reforms in 1979, China has attracted large volumes of FDI inflows. China is posing a challenge for middle-income ASEAN countries. However, the economic rise of China also offers opportunities for its neighbors in ASEAN and in northeast Asia.

Table 2 shows Japan's FDI flows in East Asia in the 2002-2006 period. The largest flows have gone to China, outstripping flows to ASEAN4 plus Singapore, although ASEAN has caught up in 2006. The JETRO (2007) survey of Japanese firms' international operations show that of 729 respondents, 71.9% have overseas bases, with 77.1% in China, 51.7% in the US and 38.4% in Thailand. Breakdown of overseas bases by functions show China at the top in sales (56.3% of all responses) and production (54.8%) and second to the US in R&D (7.1%).

Trade and FDI flows in East Asia are strongly correlated for several reasons. Many East Asian economies pursued simultaneous policies to attract FDI and promote exports. Multinational corporations (MNCs) have established regional production networks and promoted intra-industry trade and intra-firm trade in East Asia. Singapore's export performance is strongly linked to foreign MNCs based there (**Chia 2006)**. Foreign-funded firms in China contributed to about half of China's exports in 2002 (**Yu 2006).**

Kawai (2005*)* notes that linkages between trade and FDI depend on the type of FDI and underlying motives of international trade. FDI is labor-seeking; market-seeking; resource-extracting; production-fragmenting; differentiated product delivering; and services providing. The composition of FDI in East Asia has changed from labor-seeking (or assembly-based) FDI in EPZs and from resource-extracting FDI (in resource-rich ASEAN4 to more recent production-fragmenting FDI driven largely by MNC decisions to fragment their production processes into different subprocesses to be located in different economies, based on required factor proportions and relative technological capabilities. This generates vertical intra-industry trade in parts, components, semi-finished products and finished products. Liberal trade and FDI policies in host countries are essential for this type of FDI and vertical intra-industry trade to expand. What has been observed in East Asia since the late 1980s is essentially a rapid expansion of production-fragmenting FDI. Differentiated product delivering and services providing FDI would require highly industrialized market environments. As a country industrializes, it acquires technologies for the production of a variety of manufactured products and services; and at the same time faces a rising demand for differentiated products and services with rising incomes ---high quality services tend to be provided by MNCs from advanced countries. Differentiated product delivering and services providing FDI have yet to develop extensively in East Asia.

FDI and trade can be complements, especially in industries where vertical intra-industry trade is naturally developed by MNCs. Causation may also go the other way, from trade to FDI. Empirical results by Kawai and Urata (1998) for Japanese data generally confirm presence of FDI-trade linkages. The contribution of FDI to export expansion has been particularly large for middle income ASEAN countries and for China, in contrast to the experiences of NIEs. Specially, in 1990 the shares of foreign affiliates in total manufactured exports were about 20% for NIEs, but significantly higher for middle-income ASEAN and China.

Kimura and Ando (2006) describe the role of Japanese firms in the formation of international production and distribution networks in East Asia. Through Japanese FDI, East Asian developing economies have become important locations of Japanese international corporate activities. "International production and distribution networks formed in the 1990s in East Asia were unprecedented in their vertical division of labor across numerous countries." (p28). Japanese electronics companies adopt fragmentation strategies, which divide production processes into several sub-processes, each located via FDI in a country where it can be conducted most efficiently or at least cost. Typically a Japanese PC producer undertakes design in Japan, assigns production of various parts to different countries, and assembles PCs in China with parts imported from different locations. Fragmentation strategies have been made possible by standardization of production processes, which requires only assembly of components without sophisticated technologies; low tariff rates on components trade, partly because of export processing zone arrangements, and the WTO's IT Agreement to remove tariffs on IT products. Trade in components account for a large share of the electronics trade in East Asia, particularly in intra-East Asian trade.

3. Regional Trading Arrangements (RTAs) in East Asia

The ASEAN Free Trade Area (AFTA) initiated in 1992 was East Asia's first effort at forming an RTA. Prior to that, East Asia has been pursuing a multilateral trade policy, in contrast to other regions in the world. Hence East Asia is the last major economic region in the world to participate in RTAs.

3.1 Factors in RTA proliferation in East Asia

There are many factors and reasons for the growing interest in RTAs in East Asia in the 1990s, reflecting political and economic factors and developments within the region as well as elsewhere.

- *End of Cold War*: For much of post-World War II, East Asia has been divided by the Cold War. End of the Cold War led to improved political and economic relations among neighboring
  states, particularly between the ASEAN6 (Brunei, Indonesia, Malaysia, Philippines, Singapore and Thailand) and Cambodia, Laos, Myanmar and Vietnam, and between China and the rest of East Asia.
- *1997-98 Asian financial crisis*: This marks the turning point in East Asian regionalism. The Crisis demonstrated the close economic and financial interdependence among the region's economies. There was also disappointment with the role of the IMF and the "Washington consensus". This led to the ASEAN+3 monetary and financial cooperation initiative to help secure regional economic stability and resilience. The Crisis also provided the forum for formal dialogue between Southeast Asia and Northeast Asia and to the emerging idea of an East Asia economic bloc.
- *Uncertainty over progress in APEC and WTO*: The GATT/WTO process became increasingly difficult with a growing and diverse membership and a deepening agenda. The Doha Development Round was finally launched in December 2001 but its progress has met with severe difficulties. Slow progress of the Doha Round raised concerns over market access. APEC was originally established to promote open regionalism through unilateral and concerted liberalization of trade and investment but was perceived to be progressing too slowly for many of its members and there was no consensus the pursue a formal RTA.
- *Defensive reaction to regionalism elsewhere:* The 1990s has seen the formation of NAFTA and the European Single Market and expansion in EU membership and neighborhood policy. The emergence of continental blocs in the Americas and in Europe discriminate against East Asian exports. At the same time, a fragmented East Asian market is less attractive to FDI. In particular, ASEAN countries, heavily dependent on FDI, are concerned over possible investment diversion.

- *Responding to the economic rise of China:* The economic rise of China and its WTO accession is changing the global and regional trade and investment landscape. For developing East Asian economies, there is a growing desire to strengthen economic relations with China. In turn China is also showing growing interest in regional economic integration after its WTO accession has been successfully concluded.
- *Change in trade strategies of Japan and South Korea*: With Japan's loss of economic dynamism since 1990 and its exports facing discrimination in major markets in the Americas and Europe, Japanese businessmen lobbied their government to negotiate for preferential market access.
- *Domino effect*: Countries rush to form RTAs for fear of being left out of various RTA groupings and suffer negative trade and investment diversion effects. For example, in 2001, at the ASEAN-China Summit, China proposed the establishment of an ASEAN-China FTA within 10 years. This triggered a domino effect on Japan, South Korea, India, and Australia-New Zealand, as well as the US and the EU to hasten to seek similar arrangements with ASEAN.

3.2 Key Features of East Asian RTAs

RTAs that are emerging in East Asia are no longer “regional” but geographically dispersed and no longer “free trade areas” but more complex agreements.

- *Diverse geographical partnerships:* Geographical proximity is supposed to facilitate trade, but with the revolution in transportation and telecommunications, geographical distance is no longer the trade barrier it used to be. Hence partners in RTAs are no longer geographically confined to neighboring economies. Cross-regional RTAs are motivated by a variety of reasons, including: to enhance or consolidate political relationships (with US), to gain preferential entry into other FTA markets (through Mexico and Canada into NAFTA), or to secure access to major markets (US, EU, Japan, China, India, ASEAN), or to secure access to natural resources (ASEAN).
- *Diverse geometry:* RTA partners range from several countries (plurilateral) to two countries (bilateral). Conceptually, both the plurilateral and bilateral RTAs are second best options to multilateralism, since they are discriminatory and have negative trade diversion effects on excluded countries. Also conceptually, the larger the number of country partners, the smaller the trade diversion effect and the larger the economies of scale to be exploited. However, large membership also leads to loss of cohesiveness and "like-mindedness" with

consequently greater difficulty in finding common ground in negotiations.

- *Diverse economic partners*: Economic complementarity between north-south economies facilitates inter-industry trade, particularly between high tech manufacturers and primary commodity producers, such as in the Japan-ASEAN partnership. The south partners are expected to benefit from FDI and technology transfers from the north. On the other hand, south-south partnerships among economies with similar resource-based production structures, such as those in ASEAN, have to build on intra-industry trade based on new division of labor in manufacturing and services. South-south FTAs and economic partnership agreements (EPA), such as ASEAN-China, can be notified to WTO under the Enabling Clause. North-south FTAs and EPAs such as Japan-ASEAN have to be notified under the more stringent GATT Article XXIV and GATS Article V.[1]
- *ASEAN as hub*: AFTA was the first FTA, uniting the countries of Southeast Asia. There is no comparable grouping in the economically more advanced and powerful Northeast Asia. China, Japan, the two Koreas, Hong Kong and Taiwan are still burdened by their history and conflicts that obstruct active economic cooperation. The only FTA agreement in Northeast Asia so far is China with Hong Kong (CEPA) and with Macau. Instead, there are agreements and proposals for FTAs/EPAs between ASEAN and China, Japan and South Korea separately.
- *Comprehensive scope and coverage*: RTAs in East Asia are described as “new age” or comprehensive economic partnership agreements. They cover traditional liberalization of merchandise trade and services trade, as well as trade facilitation (including customs procedures, harmonization of standards), investment protection and liberalization, government procurement, competition policy, intellectual property protection, electronic commerce. They also include technical assistance and development cooperation and labor and environment. These agreements potentially allow for deeper integration and greater efficiency gains than simply removing tariffs. They are dubbed as “FTA-plus” and “WTO-plus” as the scope extends beyond the traditional FTA and beyond what is covered in the WTO. However, critics have also dubbed some of these FTAs as “WTO-minus” where they fail to conform to Article XXIV of GATT, in particular the exclusion of some key sensitive sectors and products such as agriculture.
- *Multiple and overlapping RTAs:* WTO data shows that except for Mongolia, all WTO

[1] GATT Article XXIV specifies that RTAs involving developed economies have to include “substantially all trade” and remove tariffs within a 10-year period. Recent agreements, such as between US and Australia and between US and South Korea have excluded major sensitive products and have a liberalization time frame of up to 15 years.

members are participating in RTAs, with many of them participating in multiple RTAs. East Asia is catching up in the same process. As RTAs differ in their rules of origin, product standards and conformance requirements, the result is a messy "spaghetti bowl" that raises business transaction costs and reduce the potential for economies of scale.

3.3 Evolution of the ASEAN Integration Model

It bears remembering that ASEAN (Association of Southeast Asian Nations) did not start out with an economic integration objective. It was formed in 1967 by Indonesia, Malaysia, Philippines, Singapore and Thailand to bury historical conflicts and promote regional peace and security. There was no vision or blueprint for economic integration. Economic cooperation, not integration, was the language of ASEAN for many years.

The ASEAN membership was extended to include Brunei in the 1980s and Cambodia, Laos, Myanmar and Vietnam (CLMV) in the 1990s. Membership extension achieved the political objective of uniting the countries of Southeast Asia but gave rise to a two-tier economic ASEAN, as the CLMV countries are much poorer than the ASEAN6. The wide disparities in size and level of economies, as shown in **Table 3,** has slowed the pace of ASEAN trade and investment liberalization and forced ASEAN to adopt more flexible approaches as well as initiatives to narrow the development gap.[2]

In 1977 the ASEAN Preferential Trading Arrangement (PTA) was launched, followed by various schemes of industrial cooperation in the 1980s. A serious effort at economic integration began in 1992 with the launching of the ASEAN Free Trade Area (AFTA), in response to rising regionalism in the Americas and Europe as well as the rise of China. It should be noted that ASEAN opted for a free trade area rather than a customs union, reflecting the wide diversity in tariff levels among member states and the reluctance to surrender any sovereignty over trade policy. It should also be noted that the 1992 AFTA document contains only 6 pages, and was more a document of political intent rather than a detailed and negotiated plan for economic integration. It contains only liberalization of the tradein goods through the Common Effective Preferential Tariff (CEPT). Rules of origin and tariff reduction schedules had to be negotiated later. Services liberalization was added under the ASEAN Framework Agreement on Services (AFAS) in 1995

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2 So far, efforts at narrowing the development gap have been modest, as ASEAN eschews the EU model of a regional development policy and providing structural adjustment and cohesion funds for its less developed countries and areas. A fundamental difference between the EU and ASEAN is that the latter is a grouping of developing countries, and the larger members of ASEAN6 are also less developed. Hence ASEAN has limited capacity to "redistribute" and has to depend on external donors and external private investments.

and investment liberalization under the ASEAN Investment Area agreement in 1998.

Merchandise trade liberalization under AFTA

Intra-ASEAN trade share rose from 19.2% in 1993 at the outset of AFTA (with ASEAN6) to 25.5% in 2005 (with ASEAN10). It should be noted that AFTA was created not to promote regional import substitution but to help ASEAN exports to be more internationally competitive.

AFTA originally had a timeframe of 15 years from 1993 to reduce tariffs to the 0-5 percent target. The timeframe was progressively shortened and the tariff target moved to zero. The completion date for 0-5% tariff target was advanced to 1 January 2002 for ASEAN6 (founding members plus Brunei) and set at 2006 for Vietnam, 2008 for Laos and Myanmar, and 2010 for Cambodia. The zero-tariff target was set at 2010 for ASEAN6 and 2015 for CLMV.

For ASEAN6, by January 2005, 99% of all products in the CEPT Inclusion List have their tariffs reduced to the 0-5% target, 64.2% have achieved zero tariffs, all CEPT products have been transferred into the Inclusion List, and the average tariff brought down to 1.87% as compared to 12.76% in 1993. For CLMV, 87.2% of the products have been moved into the CEPT Inclusion List and tariffs on 71.05% have been brought down to the 0-5% level. As tariffs tumbled, more emphasis is being placed on non-tariff measures and trade facilitation.

The **McKinsey Report (2003)** [3] estimated that an integrated ASEAN (with zero tariffs) could increase GDP by at least 10% and reduce operational costs by up to 20%. The Report argues that the many ASEAN initiatives have had limited impacts. For example: (i) intra-ASEAN trade share has not grown with implementation of AFTA; (ii) in 2000 less than 5% of intra-ASEAN trade made use of the AFTA tariff preferences; (iii) wide divergences exist in consumer prices of common household products in the region; (iv) economic complementarity, such as in the electronics sector, has not been well leveraged; and (v) progress with removal of non-tariff barriers has been slow, particularly with regard to harmonization of standards, implementation of mutual recognition agreements, and streamlining of customs procedures.

AFTA has also been criticized for the lack of an effective compliance and dispute settlement mechanism.[4] Compliance pressure was mainly conducted by exhortation by ASEAN officials. To remedy this weakness, the October 2003 ASEAN Summit endorsed a non-politicized and legally binding dispute settlement mechanism --- a legal unit was established at the ASEAN

[3] Commissioned by ASEAN governments to study the region's economic competitiveness.

[4] The 1996 Protocol on the ASEAN Dispute Settlement Mechanism provides for the settlement of disputes arising from implementation of ASEAN economic agreements, and the 1998 Protocol on Notification Procedures requires early notification of actions or measures that might nullify existing benefits enjoyed by other members. The Interpretative Notes of Article 6 on Emergency Measures has been streamlined to make them consistent with the relevant provisions of the *WTO Agreement on Safeguards*.

Secretariat to provide legal advice on trade disputes; an ASEAN Consultation to Solve Trade and Investment Issues was established as a non-binding internet-based problem-solving network to resolve complaints within 30 days; an ASEAN Compliance Body was established so that lodged cases can be resolved within 90 days through the use of mediation and peer pressure; a revised Protocol on Enhanced ASEAN Dispute Settlement Mechanism (modelled after the WTO) was adopted to ensure legally binding decisions and expeditious enforcement.

Services trade liberalization under AFAS

Services are generally perceived to have dynamic growth potential and the efficient provision of services (particularly banking, insurance, transport, telecommunications and logistics), is crucial to competitiveness in goods production and trade. AFAS aims at liberalizing trade in services beyond those undertaken under GATS.

However, actual services liberalization has been slow as countries remain protectionist towards various services. Negotiations began in January 1996 for specific commitments on market access and national treatment and additional commitments covering all services sectors and all modes of supply. Seven priority sectors identified for liberalization and cooperation are: financial services, maritime transport, air transport, telecommunications, tourism, business services and construction.[5] To improve on delivery of services liberalization, two modifications were adopted. The first, was to allow for liberalization of all limitations for modes 1 and mode 2 but progressive liberalization for mode 3 (right of establishment) and mode 4 (movement of natural persons). The second was the adoption of a flexible approach under the "ASEAN minus X" formula, whereby two or more ASEAN countries may negotiate services trade liberalization for specific sectors and sub-sectors, while other countries could join at a later stage when they are ready. Mutual recognition agreements (MRAs) are being negotiated to facilitate movement of experts, professional and skilled workers in ASEAN in engineering, architectural and accounting services, and nursing and medical practitioners.

Investment liberalization under AIA

AIA complements AFTA in attracting FDI, by policies and measures for a free flows of investment, technology and skills. It aims to harness the various complementary advantages of ASEAN countries and encourage investors to adopt regional business strategies and establish regional

[5] By October 1997, the negotiations resulted in the first package of offers covering tourism, maritime transport, air transport, telecommunications, and business services. This was followed by a second package and agreement to launch a new round of negotiations to cover all services and all modes of supply. The third round of services negotiations was concluded and signed in September 2004.

network operations. AIA grants national treatment to ASEAN investors by 2010 and to non-ASEAN investors by 2020, with some exceptions specified in the Temporary Exclusion List (TEL) and Sensitive List (SL).

AIA has been criticized for its distant timeframes of 2010 and 2020, discriminatory treatment of non-ASEAN investors (who are the main investors in ASEAN), and its long exclusion lists. To address the concern over falling FDI inflows after the Asian financial crisis and concern over increased competition from China, ASEAN widened the scope of AIA to include manufacturing, agriculture, mining, forestry, and fishery as well as services incidental to these sectors; in services it has been extended to include education services, healthcare, telecommunications, tourism, banking and finance, insurance, trading, e-commerce, distribution and logistics, transportation and warehousing, professional service such as accounting, engineering and advertising. As with services liberalization, the "ASEAN minus X" formula could be applied. ASEAN also speeded up implementation of the AIA. The end-dates for phasing out the TELs in manufacturing were advanced to January 2003 for ASEAN-6 and Myanmar, and January 2010 for Cambodia, Laos and Vietnam. The end-dates for phasing out the TELs in agriculture, fishery, forestry, mining and related services are 2010 for ASEAN-6 and Cambodia, 2013 for Vietnam, and 2015 for Laos and Myanmar. A General Exceptions List comprises industries and investment measures that are not open to FDI and cannot receive national treatment for reasons of national security, public morals, public health and environmental protection.

In addition to investment liberalization, AIA also includes an investment promotion program, which includes joint investment promotion missions to target countries, creation of investment websites and databases and timely publication of investment information. However, ASEAN investment promotion agencies tend to compete with each other for investments rather than cooperate on attracting investments into the ASEAN region.

ASEAN Economic Community

Faced with the growing challenges of globalization as well as intensified competition for markets and investments with the economic rise of China and India, ASEAN agreed in October 2003 to an ASEAN Economic Community (AEC), to be realized by 2020. It is argued that an integrated ASEAN with a market of over 500 million people should help ASEAN retain its attractiveness as an FDI destination and as a viable alternative to China for MNCs cautious of putting all their eggs in the China basket.

The AEC will establish ASEAN as a “single market and production base”. Initially the "single market" objective gave rise to much speculation and misconception that ASEAN would adopt the EU model. However, the EU model with its supra-nationality and surrender of national sovereignty remains unacceptable to ASEAN. Hence, AEC will have 5 core elements:

- *Free flow of goods:* This calls for elimination of all tariffs by 2010 for ASEAN6 and by 2015 for CLMV. Non-tariff barriers to be eliminated by 2015 for ASEAN10. Rules of origin to be more responsive to the dynamic changes in regional production processes and operational certification procedures to be simplified. Trade facilitation to be pursued in a more concerted and coordinated manner, including harmonize standards and technical regulations and implementation of MRAs for specific sectors and implementation of the e-ASEAN Framework Agreement.
- *Free flow of services:* This calls for removal of all restrictions and measures on for 4 priority services by 2010 and on all other services sectors by 2015. Facilitation measures cover harmonization, standardization or recognition of education or skills, licenses or certification. MRAs on education, experience and qualification for major professional services to be completed by 2010. By 2015 to complete development of core competencies (concordance of skills and qualifications) for job/occupational skills required in services sectors.
- *Free flow of investment*: This calls for opening up FDI in all industries and services to ASEAN investors by 2010 for ASEAN6 and by 2015 for CLMV. Facilitation measures include transparent and predictable investment rules, regulations, policies and procedures. ASEAN countries will develop investor-friendly one-stop investment centers or investment promotion boards and strengthen coordination among government ministries and agencies concerned.. Promote ASEAN as an integrated market and production network. Establish full network of bilateral agreements on avoidance of double taxation. Promote joint investment missions that focus on regional clusters and production networks. Enforce intellectual property rights.
- *Freer flow of capital:* This calls for freer, not free, flow of capital through removal or relaxation of restrictions on intra-ASEAN capital flows for the purpose of FDI. Promote greater linkages among ASEAN stock exchanges and remove or relax restrictions on portfolio investment between these exchanges. Develop an interlinked ASEAN Securities Market by 2010. Promote ASEAN as an asset class and the development of capital markets.
- *Free flow of skilled labor:* This excludes the free flow of unskilled labor. Facilitate the issuance of visas and employment passes for ASEAN professionals and skilled labor engaged in trade and investment related activities. Harmonize standards in education and

training. Develop and implement MRAs for professionals and technical service providers. Harmonize educational programs and training courses. Develop a Framework on Regional Competency Standards for "targeted" occupations at defined levels.

Priority sectors

A new initiative includes "fast track" vertical integration in 11 priority sectors. It has been argued that the horizontal all sector approach did not allow for synergies. Sectoral integration can be speeded up and serve as a model for integration of other sectors, by coordinating all the necessary measures for integration, such as, zero tariffs, rapid customs clearance, and harmonization of product standards and technical regulations. The 11 priority sectors identified are wood-based products, automotives, rubber based products, textiles and apparels, agro based products, fisheries, electronics, e-ASEAN, healthcare, air travel and tourism. For the goods sectors, they cover about 4,000 tariff lines or about 40% of the total tariff lines in ASEAN. As compared to AFTA deadlines of 2010 for ASEAN6 and 2015 for CLMV, tariffs will be eliminated on 85% of the products in the priority sectors by 2007 and 2012 respectively.

3.4. ASEAN Plus and Bilateral Agreements

The ASEAN Plus initiatives proliferated in the post-1997 period. ASEAN is currently negotiating ASEAN+1 agreements with China, Japan, Australia-New Zealand, India, South Korea and the EU. These are comprehensive agreements and encompass trade in goods, trade in services, investment, trade facilitation, intellectual property, competition policy, government procurement and sometimes labor and environment. They also include wide-ranging economic and functional cooperation -----in the development of agriculture, industry, fishery, forestry, energy; human resources; infrastructure; small and medium enterprises; science and technology, and information and communications technology. Additionally, they include special and differential treatment, flexibility, and capacity building for the less developed partner economies.

ASEAN+1 agreements make ASEAN a de facto hub in East Asia with attendant political and economic benefits. On the economic front, with each agreement signed and implemented, more trade and investment and institutional and procedural barriers come down --- improving ASEAN's market access, scope for scale economies, and ASEAN's attractiveness for foreign investors. The increased competition from imports and foreign investors also pressure ASEAN countries to undertake domestic structural and institutional reforms to improve competitiveness.

Collectively, ASEAN has a population of about 550 million, and a combined nominal GNP of US$630 billion (2003 figures). However, it does not yet have an integrated market. But even an integrated ASEAN has a much smaller nominal GNP than either NAFTA or EU. Hence ASEAN has to be outward looking and has readily accepted proposals to enter into economic partnership agreements from its major trading partners, while some ASEAN countries are negotiating bilateral FTAs. **Table 4** shows the comparative sizes of ASEAN and its FTA partners (China, Japan, South Korea, India and Australia-New Zealand CER. The US is only negotiating bilateral agreements with some ASEAN countries and the ASEAN-EU negotiations have yet to take off. By population size, ASEAN+3 has 2 billion people, while the largest ASEAN+1 agreement is ASEAN-China with 1.8 billion people followed by ASEAN-India with 1.6 billion people. However, a better determinant of market size is GNP, with the largest being ASEAN+3 (US$7.0 trillion) followed by ASEAN-Japan (US$5.0 trillion) and ASEAN-China (US$2.1trillion). In trade value, the largest is ASEAN+3 (US$2.9 trillion), followed by ASEAN-Japan. It is to be noted that any FTA among China, Japan and Korea would be almost 10 times the size of ASEAN's GNP and 2.5 times ASEAN's total trade.

Table 5 shows the different time frames and rules of origin for the ASEAN Plus agreements. Framework agreements were reached prior to negotiations on the various components of the EPA. For some agreements, an earlier single package intention has given way to separate negotiations on the different components. The trade in goods agreement is usually negotiated and implemented first, while agreements on services and investment are ongoing.

ASEAN-China

Although historically China has had long trade and people relations with Southeast Asia, economic relations between ASEAN and China developed only after the end of the Cold War. China first proposed an FTA with ASEAN in November 2000 as part of a process of confidence building (to allay ASEAN concerns over the China challenge in export markets and in attracting FDI), as well as to access ASEAN's sizeable regional market and energy and raw material resources. For ASEAN it would be the beginning of a new constructive relationship and China is viewed as a rapidly growing market for its products and services (including tourism), and as a new engine of growth. The EPA was made more acceptable to ASEAN (who "fears" the competitive might of China) with an Early Harvest Program focusing on agriculture and with a special and preferential treatment and flexibility offered to CLMV countries.

The *Framework Agreement on ASEAN-China Comprehensive Economic Cooperation* (CEC) was signed in November 2002. Several components are still under negotiation.

- The *Early Harvest Program* (EHP) of tariff reduction and elimination, primarily in agricultural goods, was implemented on 1 January 2004 for 3 years. There is an Exclusion List and different time frames between ASEAN6 and CLMV. The Philippines delayed its participation in the EHP.[6]

- The *Agreement on Trade in Goods* was implemented in June 2005. It provides for tariff reduction and elimination along 2 tracks. For products on the normal track, tariff reductions would be completed by 2010 for ASEAN6 and China, and by 2015 for CLMV. For products on the sensitive track, the tariff reduction schedule is determined by mutual agreement. The rules of origin are based on 40 percent value added. Countries are committed to abide by provisions of WTO disciplines on non-tariff measures, technical barriers to trade, sanitary and phytosanitary measures, subsidies and countervailing measures, anti-dumping measures and intellectual property rights and safeguards. Each ASEAN country agrees to recognize China as a full market economy.
- The Agreement on Dispute Settlement Mechanism has also been signed, while negotiations on services and investment are ongoing.

ASEAN-Japan

For decades since the early 1960s, Southeast Asia is regarded as Japan's "backyard". Japanese war atrocities were forgotten as Japan became a major trade and investment partner and the leading ODA donor in Southeast Asia. Japanese Prime Minister Koizumi proposed an economic partnership agreement with ASEAN in January 2002, seen by many in ASEAN as an effort to counter China's rising influence in Southeast Asia. A formalized relationship would help consolidate its economic relations with ASEAN and counter the impact of an ASEAN-China EPA. In turn, ASEAN welcomed being wooed by the largest economy in East Asia and its traditional engine of economic growth, and to ameliorate the growing dominance of China. For the less developed ASEAN economies, Japan is also a major investor and the largest donor of technical and development assistance.

The *Framework Agreement for Comprehensive Economic Partnership* was signed at the ASEAN-Japan Summit in October 2003. The Framework laid out the following principles --- comprehensive coverage of countries and of sectors; special and differential treatment for

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6 In contrast to Japan and South Korea, China has a less protectionist policy towards its agricultural sector. Hence several ASEAN countries were keen to take advantage of the new market access opportunity. However, Philippines was more reluctant to open up its own agricultural market to competition from China and hence delayed participating in the EHP. Thailand was the most enthusiastic, but found the EHP brings gains as well as losses --- while southern Thai producers of tropical agriculture fund a ready and expanded market in China, northern Thai producers of semi-tropical and temperate agriculture were faced with intense competition from imports from southwestern China.

ASEAN states reflecting their lower economic development levels, and greater flexibility for CLMV; flexibility for sensitive sectors of ASEAN and Japan; early implementation of cooperation in areas which could provide more immediate benefits, such as technical assistance and capacity building to ASEAN, especially for CLMV; trade and investment promotion and facilitation; trade and investment policy dialogue; business sector dialogue; mobility of business people; trade data compilation and exchange; facilitation and cooperation programs covering a wide field.

Unlike China, Japan attempts a two-track approach to Southeast Asia, with individual EPAs with some ASEAN countries and an umbrella agreement with ASEAN, as well as attempting a "single undertaking" approach rather than separate staged negotiations on goods, services and investment. The ASEAN-wide comprehensive economic partnership (CEP, including FTA) should be realized by 2012 for ASEAN6 and 2017 for CLMV. The bilateral schedules of liberalization concessions would be annexed to the umbrella agreement. Negotiation on the ASEAN-Japan FTA was launched in early 2005 but progress has been slow. The biggest obstacle appears to be Japan's reluctance to liberalize its agricultural and labor markets. Bilateral agreements have been signed with Singapore (November 2002), Malaysia and the Philippines (2006) while the signing of the bilateral agreement with Thailand has been postponed to April 2007 following the political coup in Thailand in September 2006. Bilateral negotiations with Indonesia and Vietnam are ongoing.

ASEAN-Korea

South Korean President Roh proposed a comprehensive partnership with the possibility of establishing a free trade area at the ASEAN-Korea Summit in October 2003. The joint ASEAN-Korea *Declaration on Comprehensive Cooperation Partnership* was signed in November 2004 and the *Framework Agreement on Comprehensive Economic Cooperation* was signed in December 2005. Talks on the ASEAN-Korea FTA hit a snag over tariffs on food products for ASEAN and automobiles, steel and mobile phones for Korea. Thailand, the world's top rice exporter did not sign the agreement, partly over its dispute with Korea regarding barriers on certain agricultural products under its sensitive items, including rice. Tariffs on 97 percent of about 4,000 categories of goods will be cut by 2010, with the rest by 2016. ASEAN agreed to treat goods produced at the Kaesong Industrial Complex in North Korea as made-in-South Korea. Negotiations on trade in services and investment are ongoing. The ASEAN-Korea FTA will be implemented in June 2007.

ASEAN-India

A cornerstone of India's "look East" policy, born partly of a desire to catch up with China's high profile in the region, was closer and rapid economic integration with ASEAN. Indian Prime Minister Vaijpayee offered ASEAN a trade pact during the ASEAN-India Summit in November 2002, one year after China's offer to ASEAN. Subsequent Indian Prime Minister Singh articulate his vision of a pan-Asian community.

A *Framework Agreement for a Comprehensive Economic Partnership* was signed in October 2003 and entered into force on 1 July 2004. It envisaged that tariff concessions should cover at least 80% of ASEAN-India trade. Tariff reductions were set to start by 1 January 2006 and be concluded by ASEAN5 (excluding Philippines) and India by December 2011, and Philippines and CLMV by 2016. However, negotiations to establish the ASEAN-India FTA (AIFTA) have been difficult.

The Early Harvet Program was dropped and the implementation date of AIFTA has been postponed. Difficulties arose over India's resistance to cut its high tariffs on a range of agricultural products of export interest to ASEAN.[7] Initially India presented an exclusion list of 1,414 products that represented 44% of ASEAN's total exports to India, of which over half were vegetable oil and petroleum products, and some 80% of Malaysia's exports to India (mainly palm oil, tea, pepper and textiles). The negative list from India has since been drastically pruned and India proposed imposition of tariff quotas on key ASEAN commodity exports.[8] India also wants to balance its tariff concessions on goods with market access to ASEAN's services sectors where India has a comparative advantage, but several ASEAN countries are reluctant to open their services markets. Considerable differences also exist over rules of origin and eventually both sides agreed to a 35% domestic value added plus change in tariff heading. It is expected that the agreement on Trade in Goods would be signed by July 2007.

ASEAN-EU

The Asia-Europe Meeting (ASEM) was established as an informal dialogue process in 1996. The ASEM process aims to strengthen the relationship through various high level meetings and joint projects. A ASEAN-EU FTA was mooted in April 2005, but subsequent negotiations were made

[7] ASEAN is one of the most efficient global producers of rice, palm oil, plantation crops (like coffee, tea) and spices (like pepper). India has high agricultural tariffs in the range of 70-100%. Many of the Indian producers are small and marginal farmers. India is also worried about imports of manufactures from Thailand.

[8] Indian Prime Minister Singh is under strong political pressure to protect Indian farmers, including in palm oil, tea, coffee and pepper.

difficult by EU's objection to the inclusion of Myanmar because of its human rights record.

US and Enterprise for ASEAN Initiative

At the APEC Summit in October 2002, US President Bush proposed the Enterprise for ASEAN Initiative (EAI) under which bilateral FTAs would be pursued with individual ASEAN countries. The Bush initiative did not come as a surprise as the Administration has been actively pursuing FTAs. Furthermore, ASEAN is a sizeable market and investment destination for American MNCs. Additionally, ASEAN has a large moderate Muslim population which could be a useful ally in the US campaign against international terrorism. However, it was unclear why Bush chose the bilateral route rather than an ASEAN-wide FTA, although it had already signed a bilateral FTA with Singapore. **Naya and Plummer (2005)** surmised the following reasons ---- political difficulties in including CLMV countries and economic difficulties in concluding an umbrella agreement with ASEAN's diverse economies.

So far, the US has concluded and implemented a bilateral FTA with Singapore only. However, it has several trade and investment facilitation agreements (TIFAs) with several ASEAN countries. FTA negotiations with Malaysia, Thailand, Philippines and Indonesia are ongoing or being under study.

Bilateral FTAs

Bilateral FTAs are proliferating in East Asia. They are not only between countries in East Asia but also between East Asian countries and those in North America, Latin America, Europe, Middle East, Africa and Australia-New Zealand. Singapore spearheads the bilateral trend, followed by Japan, Korea, Thailand and Malaysia. Its bilateral FTAs with Japan, South Korea, India, Australia, New Zealand and the US are the fore-runners of ASEAN's umbrella FTAs with these countries as well as the US Enterprise for ASEAN initiative.

What motivates Singapore to a dense network of bilateral FTAs since the late 1990s? It reflects Singapore's extreme dependence on an open international trade and investment environment and its growing concern with the slow, difficult and uncertain process of liberalization under the WTO, APEC and ASEAN. Its trade in goods and services is more than 3 times its GDP. It practices free trade in goods, although its bound MFN tariffs averaged 7.5%. In the services sector, trade and regulatory liberalization has accelerated in recent years, in line with the objective of consolidating and enhancing Singapore as a regional services hub. The network of FTAs goes beyond trade. They are designed to support the business community in moving up the value-added ladder and knowledge chain ---develop an integrated manufacturing center in the region; nurturing a knowledge-based economy through enhanced intellectual property protection; science and technology cooperation to boost R&D in high value industries.

Singapore's bilateral initiatives have had a domino effect on its East Asian neighbors. Some larger economies, such as South Korea, Indonesia, Thailand and the Philippines may offer more strategic value, energy and natural resources, and market size. However, bilateral negotiations are often made difficult by political sensitivities to liberalizing agriculture, key manufactures such as automobiles and textiles and garments and the need to protect farmers and small and medium enterprises from foreign competition. Growing nationalism in several countries also act as an obstacle to national treatment for foreign investors and foreign contractors in government procurements. There is also strong political objection to intellectual property rights protection that restricts easy access to cheaper generic drugs.

With the proliferation of ASEAN+1 and bilateral FTAs, a key question is the possibility of undermining ASEAN cohesion and over-stretching the negotiating and administrative resources of the less developed ASEAN economies. Also, can ASEAN remain in the driver's seat?

ASEAN Plus Three

ASEAN+3 (ASEAN, China, Japan, Korea) cooperation started as an initiative for monetary and financial cooperation in the wake of the Asian financial crisis. The grouping adopted the Chiang Mai Initiative in 2000, aimed at fostering regional financial stability and resilience and building on the earlier similar agreements among ASEAN economies. The first component comprises a network of bilateral swap and repurchase facilities to assist beleaguered central banks facing liquidity crunches. The second component is a regional monitoring and surveillance of macroeconomic and financial fundamentals and policies of member economies to pre-empt another currency attack. The third component is the development of the Asian Bond Market Initiative.

3.5 Some RTA Results and Issues

CGE modeling results

CGE modeling normally could only capture the trade creation and trade diversion effects of zero-tariff market access. It has been difficult to quantify the effects of services liberalization and investment liberalization and facilitation measures. Dynamic effects are difficult to capture. Hence CGE modeling tends to show very small GDP growth effects of FTAs. Depending on the CGE model used and data sources, various studies differ in their estimates of welfare gains to members and losses to non-members from an FTA.

CGE results generally show larger benefits from a larger FTA grouping than from smaller plurilateral and bilateral FTAs. For example, **PECC (2003)** reports the results from CGE modeling of trade liberalization in the APEC region. For APEC members, APEC-wide liberalization delivers greater benefits than smaller plurilateral and bilateral FTAs. APEC-wide trade facilitation is also likely to yield greater benefits than those among smaller groups. In turn ASEAN+3 FTA produces larger welfare gains than ASEAN+1 FTAs. Bilateral FTAs between small and medium sized economies generally cover relatively small trade flows and tend to generate relatively small economic benefits for members. Bilateral FTAs between small and large economies typically gives rise to a relatively larger economic welfare (as % of GDP) for small partners and relatively small economic welfare for large partners. **Plummer and Wignaraja (2006)** find that an APEC FTA ASEAN gain less than the present fragmented scenario. In ASEAN+3 and ASEAN+6 scenarios, ASEAN gains more (as % of GDP) than northeast Asia.

Stumbling Block Debate

The debate over the desirability of RTAs is usually couched in terms of the regionalism versus multilateralism. RTAs are perceived to be either stumbling blocks or building blocks of the multilateral trading system embedded in the WTO. Stumbling bloc arguments include:

- The proliferation of RTAs undermines the relevance of the WTO in world trade. Creation of self-contained regional legal frameworks within RTAs could lead to progressive erosion of the multilateral legal framework, for example in anti-dumping provisions, competition policy, standards and technical barriers to trade, and dispute settlement.
- Negotiating and administering multiple RTAs strains negotiating resources of countries (particularly small ones) and may hinder their ability to participate actively at the WTO level. RTAs also create vested interests determined to avoid dilution of preferential margins.
- In north-south agreements, special interest groups in developed countries (being better organized and funded) dominate the outcome of negotiations, particularly given the lack of rigor and coverage in GATT Article XXIV.

RTAs as Second Best Trade Policy

RTAs represent a “second best” approach to trade and investment liberalization. Many mainstream economists criticize RTA liberalization as being inferior to multilateral liberalization, as the latter promotes economic efficiency and improves resource allocation.

But RTAs are a pragmatic approach for policymakers when unilateral or multilateral liberalization cannot make progress to the extent desired.

- Compared to the multilateral route, RTAs enable "staggered" liberalization, to prepare domestic producers and traders for the global competition that comes with multilateral liberalization. They result in sharpening negotiating skills in preparation for the WTO, could result in domestic legal and administrative reforms, and break down domestic resistance to multilateral liberalization. They also help to lock in domestic policy reforms. It is well known that Mexico used its NAFTA membership to help lock-in domestic policy reforms. Likewise in East Asia, it is reported that membership in ASEAN has enabled Vietnam to push more aggressively its market-friendly reforms to become more internationally competitive and has helped Vietnam in its quest for WTO accession. The emergence or threatened emergence of significant RTAs may also increase the pressure on economies to participate in the multilateral negotiations.
- Unilateral liberalization does not automatically provide market access to other countries. **Wonnecott and Wonnecott (1981**) pointed out that countries engage in RTAs in order to *open up their partners' market* rather than merely to extract gains through greater domestic liberalization. Hence an RTA could be superior to unilateral liberalization if the increases in national welfare due to foreign reductions in tariff barriers exceed the losses to excluded countries due to trade diversion.
- **Plummer (2006)** also argues that *time and depth matter*, and multilateral liberalization via the WTO may not have the speed and coverage desired. Time is important when considering the present discounted value to national welfare, and free trade in an RTA is more readily achieved among like-minded countries. RTAs lead to faster agreements on liberalization. In contrast, the Uruguay Round took over 7 years and the Doha Round is still bogged down after the Declaration to launch the round in December 2001. Also, a modern comprehensive RTA enables deep integration with various WTO-plus features of more comprehensive services coverage, trade facilitation, investment liberalization and facilitation that go beyond TRIMS, competition policy, and intellectual property rights that go beyond TRIPS.

There is no definitive conclusion on the merits of RTAs and much depends on their specific objective and design. If the objective of an RTA is intended to support an inward looking development strategy, it would give rise to many problems. This approach led to downfall of many RTAs in the past in Latin America. In East Asia, regionalism is outward looking and open. The WTO is looking into tightening the disciplines governing RTAs to ensure their consistency with GATT Article XXIV and GATS V and to ensure greater transparency of RTA provisions.

Reconciling Winners and Losers in an RTA

Trade and investment liberalization, whether under the WTO or in an RTA has winners and losers. There are unequivocal benefits for consumers from lower prices and wider access to goods. Some businesses welcome liberalization because of efficiency gains and new trade and investment opportunities offered. Other businesses (including small farmers and small enterprises) fear the increased competition and lobby for the status quo of protection of the domestic market. There are also protests from healthcare, labor groups that fear the tightening of intellectual property rights would greatly reduced access to cheaper generic drugs, and higher labor standards would lead to unemployment.

Without protection, uncompetitive producers and suppliers will close down and their resources released to more efficient uses. However, if these producers and suppliers are able to reform and restructure, they could become competitive and winners. The political economy exercise is how to convince losers not to obstruct an RTA and how they can be incentivized to restructure and become more competitive.

Rules of Origin and Spaghetti Bowl Effect

Rules of origin (ROO) are necessary in FTAs (which have no common external tariffs, as in a customs union) to prevent "*trade deflection*" that is, the transhipment of products from non-partners to an RTA through a low-tariff RTA partner. However, ROO could also be used for protectionist purpose with more restrictive and complex rules for sensitive sectors, such as agricultural products and textile products. Compliance with ROO requirements could involve significant costs for business, with one estimate quoted by **PECC (2003)** putting it at 3-5% of fob export value. Very complex ROOs also increase costly disputes, with the burden of compliance costs falling more heavily on small farmers and small enterprises than large exporters.

Burdensome ROO requirements is one explanation for the low utilization rate of RTA tariff preferences. Another difficulty is the inability to meet the value added rule. With fragmention of production process across borders becoming increasingly common in manufacturing, a 40-60% value added requirement can become an impossible condition. A product usually incorporates imported inputs from many sources and may cross the border several times as it undergoes outward processing. ROO provisions on *territoriality* concerns the treatment provided to originating products that temporarily leave the cumulation area.

The current trend of countries having multiple and overlapping FTAs also give rise to the *spaghetti bowl effec*t of a complex and inconsistent web of ROOs, product standards, and conformance requirements. This increases business transaction costs and reduces the scope for economies of scale because of market segmentation. The spaghetti bowl effect also applies to the complexity of administering diverse tariff liberalization schedules.[9]

Empirical studies on the utilization of rules of origin are few. A 2006 JETRO survey shows that only 13.3% of Japanese respondent firms (overseas operations) are utilizing or planning to utilize FTA schemes in operation (including early harvest schemes) within the Asia Pacific for their export industries.

- **Table 6** shows the sample of Japanese firms utilizing the various FTAs. AFTA has the highest utilization rate of 64.9%, followed by Japan-Malaysia FTA. The Thailand-New Zealand FTA has a utilization rate of only 5.4%. On the firms' plans to utilize the FTAs, Japan-Malaysia, China-ASEAN, ASEAN/AFTA, and Thailand-India have responses of over 20%. Among Japanese exporters, FTA tariff preferences were more likely to be utilized by firms with overseas production bases. Most are large firms and in the auto/auto parts, and other transport equipment, chemicals and electric equipment industries.
- The Japanese firms were also asked about problems with overlapping rules of origin. Among the firms utilizing or planning to utilize the tariff preferences, 33.0% see "no problem at this point, but some may occur in future"; 27.8% think "the existence of different rules in the region complicates procedures to prove the country of origin and leads to increase costs"; 14.4% of the firms saw "no problem".
- Firms were also asked their views on the future direction of rules of origin. 24.7% think "the measure enabling firms to choose either the value content criterion or the change of tariff code classification should be implemented as a common rule; 20.7% think that "the value content criterion should be implemented as a common rule; 18.6% think that "the change of tariff code classification should be implemented as a common rule"; 63.9% of respondents think rules of origin should be harmonized by some means.

Sequencing of trade and financial/monetary cooperation and integration

The EU integration model starts with trade and progresses on to financial/monetary cooperation

[9] While the parties to a bilateral RTA each negotiate a liberalization schedule, the number of schedules or bilateral preferential relationships has the potential to increase dramatically. For example, a plurilateral membership of 5 could conceptually give rise to 20 bilateral schemes (n * n-l, where "n" is the. number of countries in an RTA).

and integration. However, in East Asia the 1997 financial crisis has led to the simultaneous pursuit of trade cooperation and integration in regional and bilateral FTAs and financial/monetary cooperation under the ASEAN+3 framework.

As noted earlier, financial/monetary cooperation of ASEAN+3 economies have taken the form of information sharing and surveillance mechanism, swap arrangements and development of the Asian bond market. Going forward from there, some economists and policymakers are examining the feasibility of the following ----reserve pooling and establishment of an Asian Monetary Fund, exchange rate coordination, and a common currency. Suffice it to say that the political and economic conditions in East Asia make it premature to pursue deeper financial/monetary integration in the short-term. It is at best a long-term objective.

4. An East Asia FTA – Configurations and Challenges

Current interests among East Asian scholars, analysts and policymakers are on the establishment of an East Asia FTA. A number of studies have been commissioned to study its merits and feasibility.[10]

4.1 The Case for an East Asia FTA

Political arguments

The experiences of the EU and ASEAN have shown that closer economic cooperation and integration help reduce political and military conflicts. Northeast Asia is still plagued by its historical past and current conflicts while such conflicts in Southeast Asia have been minimized by the existence of ASEAN. More interactions at the political, economic, and social and cultural levels among all segments of society will help in the long process of confidence building and community building in East Asia.

A large East Asian grouping would also increase the East Asian "voice" in international organizations and fora. An East Asian bloc is also needed to countervail economic blocs in the Western Hemisphere and Europe.

Economic arguments

Trade analysis and CGE modeling show that a larger FTA can create more benefits for its

[10] In 2001 the East Asia Vision Group submitted its report on *Towards an East Asian Community: Region of Peace, Prosperity and Progress.* This was followed by the 2002 report of the East Asia Study Group and the 2006 report of the Joint Expert Group for Feasibility Study on EAFTA entitled *Towards an East Asia FTA: Modality and Road Map.*

members than a smaller one. Also, an East Asia FTA will enable the East Asian region and individual member countries to better meet the challenges of globalization and the emergence of continental economic blocs in the Americas and in Europe.

Also East Asia has multi-layered and overlapping RTAs and consolidation is necessary to achieve economies of scale and overcome the *spaghetti bowl* effect. The removal of various trade and investment impediments will facilitate the full realization of the East Asia production network and the potentials of intra-regional trade and investment.

Simulation results by the EAFTA Feasibility Study Group (2006) show that the elimination of tariff and non-tariff barriers on trade and trade facilitation measures would increase the overall GDP of East Asia by 1.2%. However, this is a serious under-estimate as it excludes effects of FDI and capital flows and labor migration and the dynamic effects. The impacts on GDP growth will be greater for the ASEAN countries (3.6%) when compared to Northeast Asia (0.9% for China, Japan and Korea). For individual member countries, generally, the higher the level of import barriers, and/or the larger the trade/GDP ratios, the greater the gains from EAFTA.

4.2 Meeting the Challenges

However, realization of an East Asia FTA in the medium term is challenging:

- *No sense of common destiny*: Countries in East Asia need to be convinced that there is a common destiny and that the political and economic gains of economic cooperation and integration outweigh the costs from dilution of national sovereignty necessary for the creation of common institutions and common rules and policies. Historical baggage and mistrust still plagued relations among countries in northeast Asia.
- *Extra-regional orientation*: Some East Asian countries have strong external political, security, economic and technology links with non-members, particularly with the US and EU. Hence, the East Asia FTA would have to be outward looking, and engage the American and European blocs positively, and remain committed to the WTO process. East Asian regionalism should complement and not substitute for multilateralism.
- *Wide development gaps:* Differences in development levels and economic competencies pose obstacles to free intra-regional movement of goods, services and investments. Governments would be pressured by various domestic interests to protect less competitive sectors and in doing so, slow down the process of economic restructuring. Conceptually, diversities offer complementarities and prospects of specialization and efficient regional

production. Also, membership in EAFTA provides the smaller and less developed East Asian economies the opportunity to be part of mainstream East Asia and enjoy the spillover effects of dynamism and growth. However, there are also concerns of marginalization of the less efficient economies and producers and suppliers. Hence governments would be reluctant to open up their farm-, labor-intensive- and SME-sectors, as it would otherwise lead to adverse effects on employment, poverty incidence and income distribution, without adequate safeguards and financial and technical assistance for capacity building. The challenge is how to craft an RTA to provide flexibility and assistance to the less developed members without undermining the integration process. Existing RTAs have provisions for longer compliance period and a formula for temporary opting out of specific schemes

- *Who to include in an EAFTA?*: At the minimum, an East Asia FTA is pragmatically defined as ASEAN Plus Three, that is, ASEAN10, China, Japan and South Korea. However, there are alternative proposals. Japan's Trade and Industry Ministry has proposed a Comprehensive Economic Partnership Arrangement in East Asia, comprising the 16 countries that participated in the East Asia Summit (EAS) in December 2005, that is, ASEAN10, China, Japan and South Korea, plus India, Australia and New Zealand. Indian Prime Minister Singh called for a pan-Asian FTA combining all the EAS members, calling it an "arc of advantage". Proponents argue that India is rapidly emerging as a dynamic economic power like China and including it in an East Asia FTA would greatly strengthen the grouping. Opponents argue, however, that India is an integral part of the South Asian region and the South Asia Free Trade Area. Opponents to the inclusion of Australia and New Zealand argue that these two countries are not part of East Asia.
  The decision for an ASEAN+3 or ASEAN+6 configuration will depend crucially on ASEAN. However, ASEAN's response is that its priority is to complete all the ASEAN+1 negotiations first before venturing into an East Asia FTA.

4.3 Possible Roadmaps to EAFTA

The proliferation of ASEAN Plus and bilateral FTAs in East Asia opens up a number of options to realize the region-wide EAFTA.

- *Merge the Southeast Asian and a Northeast Asian agreements*: Southeast Asia already has ASEAN and the economic integration programs are well advanced. But there is no parallel among Northeast Asian economies. China, Japan and Korea would have to work towards a trilateral agreement amidst the present political climate. However, a merger of Southeast

Asia and Northeast Asia would be highly disadvantageous to ASEAN, since the 3 northeast economies have an economic weight of 90 percent and ASEAN only 10 percent.

- *Consolidate the various ASEAN Plus One FTAs:* Since ASEAN is already negotiating FTAs with China, Japan, South Korea (also Australia-New Zealand CER and India), these ASEAN Plus One agreements when realized, could serve as the basic framework for EAFTA. On the plus side, these agreements would have agreed common frameworks and liberalization schedules over large areas, reducing possible areas of dissent and dispute. On the negative side, there was no common template in the ASEAN Plus One agreements under negotiation, resulting in a spaghetti bowl that would be difficult to unravel and make convergence problematic.
- *Deepen ASEAN Plus Three:* An EAFTA could be achieved using the existing ASEAN+3 framework. It was within the ASEAN+3 framework that East Asia Vision Group, East Asia Study Group and the Joint Expert Group of Feasibility Study on EAFTA submitted their reports and recommendations. An issue would be whether ASEAN would be negotiating the FTA as a group or as 10 separate economies. It would be difficult to arrive at a consensus, given the diversity of the 13 economies. The issue of agriculture between Southeast Asia and Northeast Asia, particularly on rice, would also be difficult to resolve.

5. Conclusion

Multilateralism and regionalism will have to accommodate each other. There is no turning back for regionalism as the "genie has been let out of the bottle". However, regionalism (plurilateral and bilateral) is better than the autarkic and nationalistic policies pursued in earlier decades. Regionalism has led to trade and investment liberalization, albeit discriminatory. This has spurred structural reforms and accustom producers and suppliers to external competition. It could serve as the training ground for subsequent multilateral liberalization.

Multilateralism stresses the virtues of trade and investment liberalization but does not emphasize the equally important aspect of developing supply capabilities to take advantage of the new market opportunities. The RTAs in East Asia have incorporated transfers of investment resources and technology as well as various capacity building measures. Thus it is often viewed as more beneficial for developing countries.

However, to ensure that RTAs maximize the benefits and minimize the costs, greater efforts need to be directed to their design and their consistency with the WTO principles and disciplines. For example, RTAs should not be WTO-minus by excluding sensitive sectors and products ---a longer liberalization time frame coupled with some form of structural assistance would be a more acceptable compromise. Also, for example, harmonization of rules of origin, standards and conformance requirements with those of the WTO would minimize the spaghetti bowl effect.

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