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Economic Integration and Regional Cooperation in East Asia: A Pragmatic View

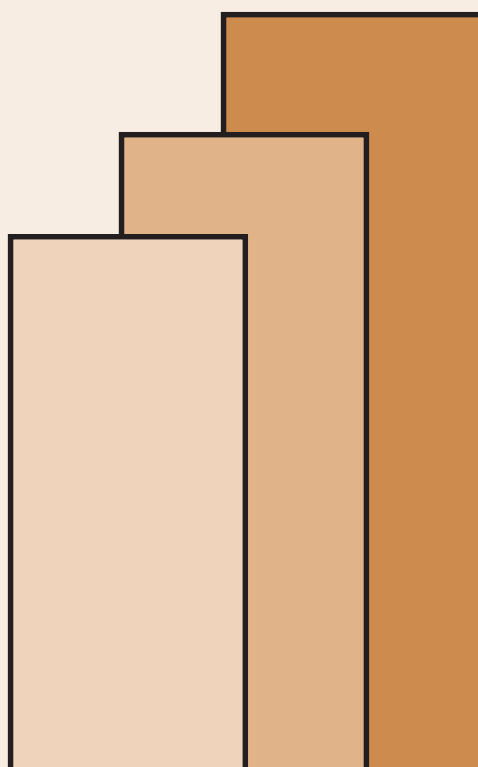
Josef T. Yap

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Economic Integration and Regional Cooperation in East Asia: A Pragmatic View

Josef T. Yap¹

Abstract

Intra-regional trade and investment among the ASEAN+3 countries—and the entire East Asia—has been progressing at a robust pace over the past 25 years. The process of economic integration could be aptly described as “regionalization” or market-driven integration. In contrast, the European Union has followed ‘regionalism’ which refers to formal economic cooperation and economic arrangements. Over the past decade, efforts at promoting closer regionalism in East Asia have been stepped up for various reasons, including: i) a response to the experience and lessons of the 1997 financial crisis; ii) the gridlock in the Doha round, success of NAFTA, and expansion of the EU; and iii) the mitigation of political factors that prevented closer cooperation in the past, e.g. competition between China and Japan. However, the structure of East Asia regionalism should be analyzed carefully, in particular because the direct economic benefits of an East Asia FTA are questionable. Therefore, the configuration of the proposed East Asian Community must be developed pragmatically. It is argued that at this stage the EAFTA and EAC should still be promoted but with the view that their benefits are primarily political. The political windfall will likely lead to significant economic benefits, particularly in terms of narrowing the development gap in the region and advancing common interests in a global-rules setting. The political and institutional imperatives of establishing the EAFTA or EAC at this stage depend largely on whether countries of the region seek to expand economic ties or whether they would want to secure the political gains from closer integration and cooperation.

Key words: East Asia Free Trade Agreement, East Asian Community, regionalization, regionalism, narrowing the development gap

I. Introduction

Efforts at economic integration and regional cooperation in East Asia have stepped up during the past decade. Many factors have contributed to the increase in pace. One, the 1997 financial crisis made it clear that countries in the region have to fend for each other and depend less on multilateral institutions and countries outside the region. Two, the gridlock in the Doha round, the success of NAFTA, and the expansion of the EU have made regionalism a more attractive option. Three, the rapid development of China has made East Asia a more viable market. Four, market based regionalism—or what has been termed regionalization—in the form of intra-regional trade and investment has progressed even in the absence of formal agreements. There

¹ President, Philippine Institute for Development Studies (PIDS). This paper was prepared for the Third East Asia Congress organized by the Institute of Strategic and International Studies Malaysia, 10-11 December 2005 and revised on December 22, 2005. Part of this paper was presented at The Fifth Asian International Forum, Fukuoka, Japan 31 August – September 1, 2005. The author would like to acknowledge the research assistance of Ms. Jennifer C. De Castro and Mr. Jose Maria B. Ruiz. The usual disclaimer applies.

is a view that consolidating the gains requires ‘regionalism,’ i.e. a more formal structure for the relationship.²

Lastly, several so-called driving forces have mitigated the importance of centrifugal forces—mostly political in nature—that have historically hampered the evolution of an East Asian community. The latter include factors such as competition and antagonism between Japan and China, disgruntlement and suspicion among some about US regional leadership—with other countries embracing it unconditionally—and an absence of a kind of overwhelming geopolitical challenge that helped postwar Europe to cohere (Munakata, 2001). Added to this is the diversity in forms of government in the region, epitomized by the recent controversy surrounding Myanmar’s chairmanship of ASEAN.

The centripetal forces that have heightened interest for closer political and economic relations include:

- The end of the Cold War, which broke down artificial walls that impeded closer cooperation among countries of the region.
- A growing frustration with unilateral approaches by the US and ‘market fundamentalism’ symbolized by the Washington Consensus has made East Asian countries feel the need for greater bargaining power vis-à-vis pressure from the US and US-dominated institutions.
- The desire for East Asian economies to have an effective mechanism for cooperation based on geographic proximity, de facto integration and challenges of ‘compressed development’ through rapid industrialization and institutional transition to adapt to globalization (Munakata 2002, 2001). In particular, there is a proposal that East Asia must reduce its dependence on exports outside the region and base its economic growth more firmly on domestic or regional demand in order to stabilize the global as well as regional economy.

These factors have become more compelling in the aftermath of the recent escalation of international terrorism and the concern over the possible spread of the avian flu virus.

At this point in time, East Asian nations are faced with two fundamental and related decisions. The first is whether they should promote an East Asia Free Trade Area as proposed by the East Asia Study Group in 2002. This has concomitant issues including the extent of the membership, e.g. should India and Australia be included? Second, it should be assessed whether the structure of economic integration and overall cooperation should go beyond an FTA and at the same time be more formal. In other words, should regionalism be promoted with the end goal of an East Asian Community? This paper aims to provide the reasons, challenges and possible responses to the formation of the EAFTA and an East Asian Community. A more pragmatic set of objectives of closer regional cooperation is offered.

² An analogy is marriage after developing a wonderful inter-personal relationship.

II. Economic Integration in Southeast Asia

Regional economic integration consists of agreements among countries in a geographic region to reduce, and ultimately remove, tariff and non-tariff barriers to the free flow of goods, services and factors of production among each other. Since the mid-1980s East Asia has been experiencing ‘regionalization’ or market-driven integration. The process has been spurred by unilateral reforms in individual economies and the logic of the ‘flying geese’ pattern of relocating production processes to cheaper areas abroad as domestic costs rise (Pangestu and Gooptu 2003). The East Asia experience can be contrasted to what is termed ‘regionalism’ which refers to formal economic cooperation and economic arrangements. The European Union is the foremost example of successful regionalism.

The more prosperous countries of Southeast Asia—Brunei Darussalam, Indonesia, Malaysia, the Philippines, Singapore, and Thailand, referred to as the ASEAN-6—have moved towards regionalism in 1992 by agreeing to form the ASEAN Free Trade Area or AFTA which became effective in 2002. Ironically, this was the first formal arrangement in East Asia. Since then there has been a proliferation of trading arrangements especially after the 1997 crisis, most of which are bilateral in nature. The recent admission of the CLMV countries—Cambodia, Lao PDR, Myanmar and Viet Nam—to ASEAN makes the latter a potential force in the global arena.

Even without a formal regional trade agreement (RTA) intra-regional trade among the 10 ASEAN member countries expanded steadily. In 2004, intra-ASEAN trade was 22.2 percent of total exports of these countries compared to 19 percent in 1990 and 17.4 percent in 1980 (Table 1). However, this is relatively low compared to the EU-15, where intra-regional trade was 47 percent of total exports in 1960 and 61.1 percent in 2004. Meanwhile, trade among the ASEAN+3 countries has consistently been larger than intra-ASEAN trade, reaching 34.8 percent in terms of exports in 2004.

While the full potential impact of AFTA has yet to be observed, there are several reasons to doubt that regional economic integration will progress substantially in Southeast Asia. First, trade between Malaysia and Singapore—which accounted for 38 percent of total intra-ASEAN exports in 2004—has historically dominated regional trade. Second, it has been observed that due to rapid progress in unilateral liberalization in each of the AFTA member countries, the difference between the preferential AFTA tariff and the MFN tariff for non-AFTA economies is quite small. As a result, the share of intra-ASEAN trade conducted at the preferential AFTA tariff has also been small (Soesastro 2001; Lloyd and Smith, 2004). Intra-ASEAN trade hardly changed after the formal onset of AFTA in 2002.

One reason for the discouraging performance of intra-ASEAN trade is the slow progress with respect to non-tariff barriers and deepening integration. As explained by Lloyd and Smith (2004):

“ASEAN has no provision relating to export incentives. There are no data on export incentives distorting intra-ASEAN goods trade. There is no provision for liberalizing government procurement. AFTA has no provision for the prohibition or mitigation of anti-dumping actions

taken by one ASEAN member country on imports sourced from another ASEAN member country, as there is in some RTAs.”

Corollary to this observation is the very low utilization rate of the CEPT preferential rates, which suggests considerable administrative difficulties on the part of exporters and importers in ASEAN in meeting the rules of origin requirements. This argument was analyzed more extensively in the McKinsey Report commissioned by the ASEAN Secretariat and submitted in September 2003.

Third, the wide differences in levels of economic development, industrial competence and commitment to free trade has made it difficult to forge consensus on economic integration (Chia 2000). A related reason is that there has been limited complementarity among the economies, except perhaps between Brunei and Singapore, on the one hand, and the other countries, on the other. However, Brunei and Singapore have small populations and cannot perform the role that Germany and France did in the EU. At present, a modest degree of complementarity exists between the middle-income Southeast Asian economies and the CLMV countries. Lastly, Southeast Asia was—and remains—too small to be economically crucial for individual member countries. Economic relations with countries outside the region will likely be dominant in the foreseeable future.

Table 1. Intra-Regional Trade in East Asia

	1980	1985	1990	1995	2000	2004
ASEAN (X)	17.4	18.6	19.0	24.6	23.0	22.2
ASEAN (M)	14.4	17.2	15.2	18.3	22.5	22.6
ASEAN+3 (X)	29.0	26.4	26.8	35.0	33.7	34.8
ASEAN+3(M)	29.0	32.3	30.6	39.5	41.2	43.8
NOTE: X – exports; M – imports <i>Source of Basic Data: IMF Direction of Trade Statistics (DOTS) CD-ROM, October 2005</i>						

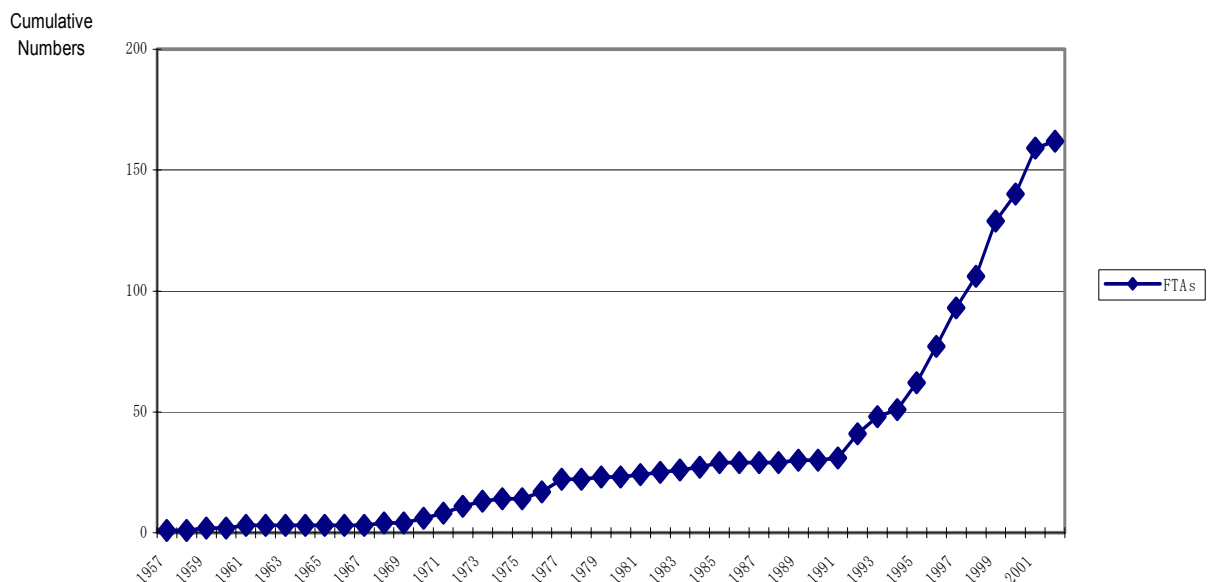
In this context, the role of formal regional arrangements in Southeast Asia is more to facilitate and support unilateral reforms and contribute to multilateral liberalization than advance regional integration and intraregional trade and investment (Pangestu and Gooptu 2003). This is consistent with the evolution of regionalization in East Asia which has been fuelled by spontaneous market forces directly linked to the restructuring of the Japanese and other economies in the area. The general outcome for most of the Southeast Asian countries was greater international trade—exports and imports—fuelled by an inflow of foreign direct investment.

III. The Viability and Relevance of Bilateral, Sub-regional and Regional FTAs

These constraints to economic integration in Southeast Asia have generated three general responses. The first has been to implement programs to broaden and deepen integration among ASEAN member countries. This has been the thrust of the Vientiane Action Plan which drew inputs from a report submitted by McKinsey & Company to the ASEAN Secretariat in September 2003.

The second response has been to encourage sub-regional and bilateral free trade agreements or FTAs. Singapore and Thailand, in particular, embarked on ‘pathfinder’ economic bilateralism (Dent 2004). The two countries have taken the lead in entering into bilateral trade agreements with countries within and outside East Asia. The recent proliferation of FTAs involving East Asian countries reflects a global trend (Figure 1).

Figure 1. Global FTAs Reported to GATT/WTO



Source: Slide from Professor Shujiro Urata’s presentation entitled “East Asian Integration: Opportunities for Fukuoka and Japan” Fifth Asian International Forum, held in Fukuoka, Japan on 31 August – 1 September, 2005.

The last response has been to revive the idea of an East Asia Free Trade Area or EAFTA, specifically the concept that ASEAN+3—and eventually the entire East Asia—is a more feasible grouping in terms of regionalism. In this sense, the constraints facing AFTA have become an added impetus for East Asian regionalism. As noted earlier, intra-regional trade among the ASEAN+3 countries is much higher than that involving only ASEAN member countries. Moreover, the empirical evidence indicates that ASEAN member countries will benefit more by expanding the coverage of their regional trade arrangement (Table 2). The benefits are generally higher if the agriculture sector is included in the RTA.

Table 2. Renewed regionalism provides scope for gains in East Asia
Effect on economic welfare of various regional trade proposals
% of GDP (% of GDP excluding agricultural liberalization)

Proposal	ASEAN	China	Korea	Japan	USA
China+Korea+Japan	-0.26 (-0.16)	+0.1 (-0.2)	+1.0 (+0.6)	+0.1 (+0.2)	+0.0 (+0.0)
ASEAN-China	+0.9 (+0.5)	+0.0 (+0.1)	-0.1 (-0.1)	+0.0 (+0.0)	+0.0 (+0.0)
ASEAN-Japan	+1.1 (+0.2)	-0.1 (-0.1)	-0.2 (-0.1)	+0.0 (+0.1)	+0.0 (+0.0)
ASEAN+3	+1.5 (+0.6)	+0.1 (-0.2)	+1.1 (+0.8)	+0.2 (+0.2)	-0.1 (+0.0)
Asean+3+CER	+1.3 (+0.6)	+0.0 (-0.1)	+1.1 (+0.9)	+0.2 (+0.2)	-0.1 (+0.0)
APEC Liberalization (MFN)	+0.7	+0.5	+0.7	+0.4	-0.0
APEC Preferential Liberalization	+0.8	+0.6	+0.9	+0.4	+0.0

Note: (1) Calculations for ASEAN include only Indonesia, Malaysia, the Philippines, Singapore, Thailand, and Viet Nam. (2) CER includes Australia and New Zealand. (3) Figures in parentheses refer to net welfare effects when agriculture is excluded.

Source: Table 1, Overview chapter of Krumm and Kharras (2003).

Including Japan and Korea in an FTA will also increase the resources that can be invested in the region, similar to the role Germany and France played in the EU. Their inclusion will also resolve the problem of limited complementarity in Southeast Asia.

However, the promotion of FTAs is not without its drawbacks. The analysis in this section looks at FTAs as a whole and the disadvantages attributable to each specific response, i.e. the proliferation of sub-regional and bilateral FTAs and the EAFTA proposal.

The Economic Benefits of FTAs May be Overstated

Establishing an FTA or RTA is supposed to generate economic benefits through two main channels: 1) competition and scale effects; and 2) trade and location effects (World Bank 2000). By joining an FTA, economic growth will be spurred by increased specialization, greater trade, and/or a country's inclusion in a global value chain. However, the simple fact is that countries in East Asia which experienced high rates of economic growth did so without the benefit of an FTA.³ China was not even a signatory of GATT or an original member of the WTO. In other words, an FTA is not crucial to economic growth.

It should be emphasized that the impediments to faster economic growth are largely internal. For example, the study of the East Asian miracle points to four main factors: outward orientation, a modernized agriculture sector, bureaucratic efficiency, and a relatively equitable distribution of income. Moreover, outward orientation by these countries was not achieved through joining an FTA.⁴ The Philippines is a clear example where unimpressive economic growth is largely due to internal factors. It is

³ The author is indebted to Dr. Claude Barfield of the American Enterprise Institute who made this point during the Fifth Asian International Forum, held in Fukuoka, Japan on 31 August – 1 September, 2005.

⁴ Neither was outward orientation a result of trade liberalization.

quite obvious that economic resources would be better allocated if these were channeled to agricultural productivity, improving governance, and strengthening institutions rather than finalizing the Japan-Philippines Economic Partnership Agreement, negotiating the China-ASEAN Free Trade Agreement, or pursuing an FTA with the US and other countries.

Meanwhile, intra-regional trade in East Asia has progressed significantly and currently compares favorably with NAFTA and the EU-15 even without the benefit of a formal FTA (Figure 2). However, there is a noticeable discrepancy between intra-regional export trade and intra-regional import trade (Table 1). This gap may be closed by an FTA.

One final observation is that trade between selected ASEAN member countries and China has been growing rapidly even without the benefit of an FTA. Table 3 also shows the same trend for trade between Japan and China and some analysts have even predicted that the share of Japanese exports destined for China will surpass 20 percent in 2005. The share of ASEAN and Japan exports going to Australia is shown for illustrative purposes. Despite the initial optimism surrounding APEC, exports from to Australia from ASEAN and Japan have stagnated in the past decade.

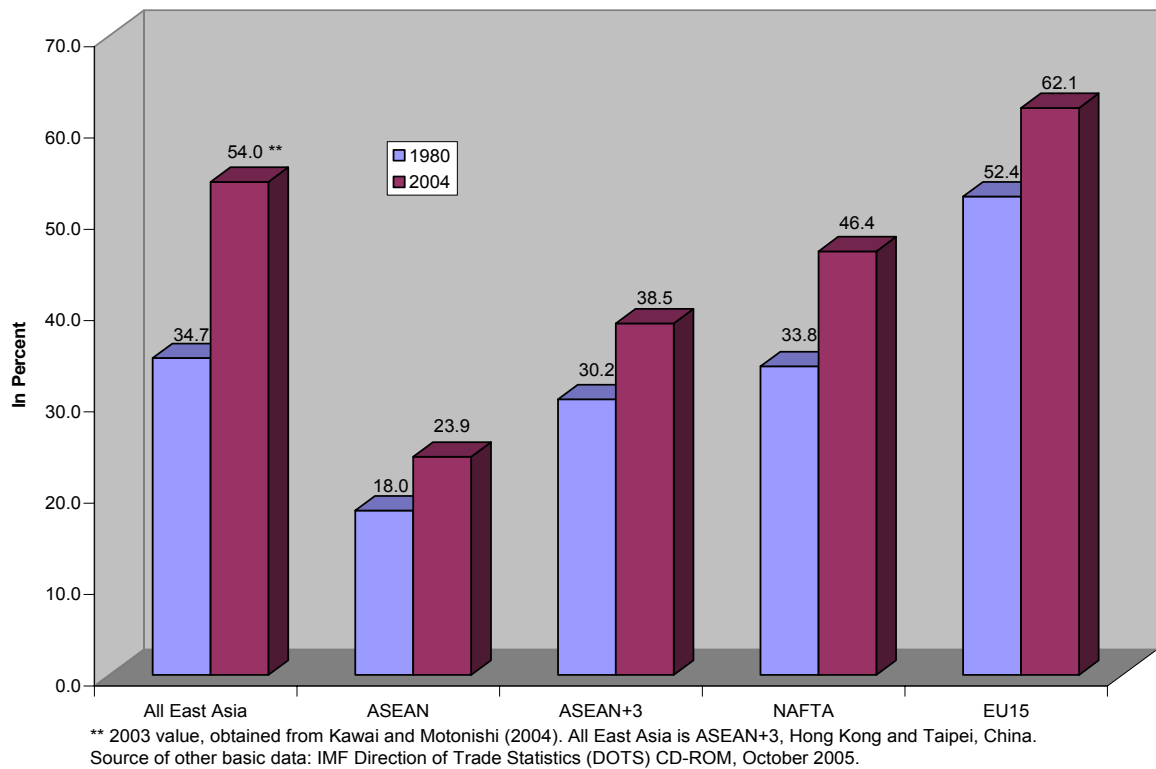
The advanced stage of economic relations in the region is acknowledged when analysts speak of *de facto* economic integration. Advocates of FTAs should explain why it is necessary to institutionalize this relationship. The issue becomes more important in view of the resources and effort required to negotiate these agreements.

Sub-regional FTAs Generate Region-divergent Pressure

The recent proliferation of preferential trade agreements has profound implications on the process of regionalism in East Asia. On the one hand, agreements that are conducted among countries in the region are viewed as region-convergent while those that are conducted with countries outside the region are considered region-divergent. On the other hand, sub-regional agreements—whether or not all parties are located in East Asia—are deemed to fragment regionalism (Bonapace 2005). Bilateral agreements have dominated recent sub-regional PTAs.

Some recent sub-regional trade arrangements among East Asian states will likely support the evolution of an East Asian Community. Examples of these are the Japan-Singapore Economic Partnership Agreement and similar arrangements with Thailand, Malaysia, and the Philippines; the ASEAN-China FTA project; and the Japan-Korea FTA which officially started negotiations in December 2003. Region-convergent bilateralism posits that intensifying bilateralism can make positive contributions to the development of regionalism, for example through its construction of a bilateralized sub-structural—or lattice—base of international relations from which regionalized links may build (Dent 2004).

Figure 2. Intraregional Trade (as share of total trade)



**Table 3. Share of China and Australia in ASEAN and Japan Exports
(in percent)**

	1995		2000		2004	
	China	Australia	China	Australia	China	Australia
Indonesia	3.8	2.0	4.5	2.4	6.4	2.6
Malaysia	2.6	1.5	3.1	2.5	6.7	3.3
Philippines	1.2	0.8	1.7	0.8	6.7	1.2
Singapore	2.3	2.2	3.9	2.3	8.6	3.7
Thailand	2.9	1.4	4.1	2.3	7.3	2.5
Japan	5.0	1.8	6.3	1.8	13.1	2.1

Source of basic data: IMF Direction of Trade Statistics (DOTS) CD-ROM, October 2005.

Meanwhile, agreements made with countries outside the region can be considered as region-divergent. These will likely deflect trade away from regional partners and create friction among members when dealing with a common third country. A country that is outside an FTA may be put at a competitive disadvantage if some members of the FTA are important destinations of its imports. For example, once the US-Thailand FTA is completed other ASEAN member countries may be put at a disadvantage vis-à-vis trade with the US. It should be noted that despite announcing an “Enterprise for ASEAN” initiative, the US has actually embarked on a series of bilateral FTAs with individual ASEAN countries. It is not clear whether the individual FTAs will be consistent with the overall AFTA framework.

An argument has been made that bilateralism by nature will be region-divergent since the underlying philosophy is Darwinian in nature: “It is better to catch up with those

who are faster than to be dragged back by those who are slower.”⁵ Bilateral agreements—or sub-regional agreements in general—can undermine the solidarity of regional agreements (just as regional agreements may undermine WTO provisions); they may intensify regional inter-state rivalry; and they may reinforce power asymmetries and exacerbate existing inequalities in the region (Dent 2004).

Hence, one challenge that faces the East Asia Community is the trend towards the proliferation of sub-regional preferential trading arrangements that are mostly bilateral in nature and the attendant region-divergent pressure.

Large Disparity in Economic Development Will Reduce Benefits of FTA

There is a considerable amount of disparity in the level of development of countries in East Asia, as measured by the coefficient of variation of per capita GDP in PPP dollars (Table 4). The gap in East Asia or Southeast Asia is much wider than comparable regional groupings in Europe, South Asia, Latin America and North Africa. Moreover, compared to the Europe and Latin America, East Asian countries have a lower level of development. The disparity is larger when only Southeast Asian countries are considered as compared to East Asia.

An existing large disparity in the level of development will likely lead to divergence or greater disparity in development when an FTA or RTA is formed. Systematic analyses of the comparative advantage of customs union members⁶ show that countries with ‘extreme’ comparative advantage do worse than those with comparative advantage intermediate between partner and the rest of the world (Venables 2003). The analysis shows the possible drawbacks of “South-South” integration schemes, showing how they may draw manufacturing production into richer countries at the expense of poorer members of the region. It also suggests that low income countries are better served by integration with high income countries. An explanation for these possible outcomes is contained in the Appendix.

Based on this analysis the following inferences can be made:

1. This is another reason why AFTA—which is essentially a “South-South” integration scheme—is not presently a viable regional grouping. Not only is the disparity among the countries wide, it is likely that further integration will cause the CLMV countries to fall further behind relative to the middle income countries like Malaysia and Thailand. Hence, the programs and proposals to broaden and deepen economic integration among ASEAN member countries should be re-evaluated.
2. The EAFTA is a more viable regional grouping because it will mitigate the disadvantages of a “South-South” configuration.
3. Nevertheless, including all East Asian countries in an RTA—or even more problematic an East Asian Community—will likely lead to overall divergence rather than convergence. A likely scenario is that the middle income countries will converge

⁵ As stated by George Yeo, Singapore’s current Foreign Minister, in October 2003.

⁶ The analysis of Venables (2003) focuses on the effect of the formation of a customs union. The arguments can readily be extended to the formation of an FTA.

towards the high income countries while the lower income countries will not benefit as much.

Table 4. Summary Measures for Europe 34, East Asia 14, SEA 11 and Other Regions, 2003		
	Mean	CV
Per Capita GDP (PPP\$) SEA 11	6,937	113.1
Per Capita GDP (PPP\$) East Asia 14	9,090	101.9
Per Capita GDP (PPP\$) Europe 34	18,286	71.3
Per Capita GDP (PPP\$) Accession-12	13,491	29.7
Per Capita GDP (PPP\$) South Asia	2,321	37.3
Per Capita GDP (PPP\$) North Africa	5,306	30.0
Per Capita GDP (PPP\$) Latin America	8,223	32.0
NOTES: 1) CV is the coefficient of variation. The higher is the measure, the higher the disparity. 2) SEA 11 are the ASEAN member countries plus Timor L'este. The East Asia 14 are the SEA 11 plus Japan, Korea and China. 2002 value was used for Myanmar. 3) Europe 34 is composed of the 15 EU member countries the 12 Accession countries (including Bulgaria and Romania which will follow in 2007) and the so-called CIS-7 (Armenia, Azerbaijan, Georgia, Kyrgystan, Moldova, Tajikistan, and Uzbekistan). 4) South Asia covers India, Pakistan, Nepal, Bangladesh, Sri Lanka, Bhutan, and Maldives. 5) The North African countries are Algeria, Egypt, Morocco, and Tunisia. 6) The Latin American countries included are Argentina, Brazil, Chile, Mexico, Paraguay, Peru and Uruguay. Source of Basic Data: 2005 UNDP Human Development Report (implying that the data are for 2003)		

The data in Table 5 support these three inferences. The convergence picture generally improves when the ASEAN countries are grouped with their Northeast neighbors. For example, the coefficient of variation for the ASEAN-5 exhibits an increasing trend.⁷ This is reversed when these five countries are combined with Japan, Korea, and China (Group C). The disparity is largest when all ten ASEAN member countries are compared as a group. It can be observed that the disparity of the ASEAN+3 is lower than the ASEAN-10 and the coefficient of variation declines further when the lower income countries are not included (Group C).

The key message in this section is that while the EAFTA is a more viable grouping in terms of the likelihood of lowering the disparity in economic development, the inclusion of lower income countries will make the convergence process less probable or at least more difficult. The same difficulty in achieving convergence exists whether one considers ASEAN or the ASEAN+3.

⁷ A phenomenon that was documented by Karras (1997). His analysis showed that the process of convergence was very strong in EU, slow in Latin America, and non-existent in Southeast Asia.

Table 5. Disparity Among Countries in Selected Regional Groupings (coefficient of variation of per capita GDP in PPP\$)								
Regional Grouping	1980	1985	1990	1995	2000	2001	2002	2003
ASEAN-5	73.5	74.3	79.4	82.6	90.2	89.9	88.8	86.7
Group A	86.7	80.7	75.2	64.1	56.2	56.7	54.9	53.7
Group B	91.8	86.3	81.7	68.3	64.9	64.1	63.1	61.6
Group C	89.2	87.7	85.3	75.1	72.9	71.9	71	77.1
ASEAN-10				117.0*	110	110.1	108.2	106.4
ASEAN10+3				102.8*	100.1	98.2	97.1	96.1
EU-15**	19.7	19.6	18.9	23.5	32.6	32	34.9	34.4
Notes: 1. ASEAN-5: Indonesia, Malaysia, the Philippines, Singapore, Thailand. The CV in 1950 was 34.4 percent. 2. Group A: China, Japan, Korea, Singapore 3. Group B: Group A plus Malaysia and Thailand 4. Group C: Group B plus Indonesia and the Philippines 5. *Figure is for 1998. 2002 value was used for Myanmar in 2003. 6. **If Luxembourg is excluded, the CV declines over time, reaching 17.7 percent in 2003. The CV in 1950 for the EU-15 was 43.2 percent. Source of Basic Data: World Bank and UNDP Human Development Report								

IV. Why EAFTA or EAC Still Matters

Despite the difficulties and drawbacks surrounding FTAs, they should still be pursued by countries. However, because FTA negotiations require resources, developing countries should be prudent on what FTAs to consider. Moreover, countries should be aware of the actual benefits of FTAs in order to determine the extent of negotiations.

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This section points out that the primary benefits of FTAs are political in nature. However, securing the political windfall could readily lead to economic gains. The case of narrowing the development gap is explained in detail.

Since the benefits of FTAs are primarily political, then concern over region-divergent FTAs and the possibility that FTAs are WTO-inconsistent should not matter. The section on managing sub-regional FTAs attempts to address this issue.

Benefits of FTAs are Primarily Political in Nature

Granted that the economic benefits of FTAs may be overstated, it is acknowledged that the primary purpose of integration is primarily political and the economic consequences—good or bad—are side effects of the political payoff (World Bank 2000). The argument is that making an FTA work requires political commitment, which translates more readily into political gains. This section looks at some of the major political reasons for entering into an FTA.

Entering into formal arrangements enhances regional peace and security. This was actually the main impetus for European integration. The China-ASEAN FTA, for example, should pave the way for a faster resolution of the Spratlys issue. In this

regard, the insistence by ASEAN on accession by prospective partners to its Treaty of Amity and Cooperation is an important cornerstone in improving peace and security in the region.

A formal arrangement should help countries either lock-in domestic reforms or accelerate implementation of proposed reforms. International agreements can act as commitment mechanisms, providing policymakers with the needed leverage to overcome domestic resistance to reforms. An FTA can also provide a government with credibility, thereby boosting domestic and foreign investment in the country.

An East Asian FTA should make member-countries more mindful of the development gap in the region. One possible objective of an FTA is a desire to help neighboring countries stabilize and prosper, both for altruistic reasons and to avoid spillovers of unrest and population (Schiff and Winters 2003). The response may not be unlike the tributary system established by the ancient Chinese emperors. In the modern context, narrowing the development gap will strengthen ASEAN and a strong ASEAN will be an effective bridge between countries of Northeast Asia. One possible set of arrangements to narrow the development gap is discussed below.

Finally, an FTA will boost the political bargaining power of the countries involved by signaling they have agreed to band together to pursue common interests. Having China on its side will definitely enhance the political stature of ASEAN and vice-versa. One area that can be revived through advocacy by a China-ASEAN front is the reform of the international financial architecture. Efforts toward such measures were sidelined by indifference of the US Treasury.

Another important area that could be addressed jointly is the trans-Pacific macroeconomic imbalance. Currently, policy proposals to correct this imbalance that are played up in the media are focused on revaluing East Asian currencies, particularly the yuan. A united East Asian front could throw its weight towards a solution that emphasizes fiscal consolidation by the US, which makes more economic sense. For example, imposing a 50 percent fuel tax in the US will address many outstanding problems: 1) the surge in international fuel prices and depletion of oil reserves; 2) instability of international capital flows; 3) the US fiscal deficit; and 4) the trans-Pacific macroeconomic imbalance itself.

*Narrowing the Development Gap*⁸

This section deals primarily with the regional response to the need to integrate the lower income countries in a meaningful way. The challenge is partly to design development strategies that would counter the ‘unilateral approaches by the US and market fundamentalism.’ It can be argued that assuring convergence in economic development or at least accelerating the convergence process requires more direct government intervention not only at the national level but the regional level as well. This follows mainly from the textbook theory of public goods that is the basis for such things as infrastructure, free public school education, and free or subsidized health care. Developing economies need the capability—in terms of infrastructure,

⁸ This section draws heavily from Yap (2005).

technology, and human resource development—to maintain a competitive business environment and economic and social stability in order to capitalize on the benefits of liberalization (Munakata 2002). Viewed from another perspective, developing countries have to achieve a minimum threshold level of economic and social development to participate effectively in both the regional integration and globalization processes.

One approach stems from an observation by Langhammer (1997) that even if ASEAN has very little to learn from Europe's highly institutionalized way of implementing and enforcing integration, it still could draw a lesson on how the EU handled the issue of widening membership to encompass lesser developed neighboring countries through its social chapters and social cohesion fund.⁹ This is related to the need to reform EU-wide redistribution policies to accommodate the accession countries. ASEAN has actually implemented a cost-sharing scheme to accommodate CLMV countries. It also set up a cost-sharing fund and established the ASEAN foundation, a vehicle for receiving private sector contributions. In addition, the transition period for these countries to comply with the requirements of the ASEAN Free Trade Area (AFTA) was extended.

There is a strong likelihood that ASEAN will be financially constrained to help the CLMV countries in a significant way. This is another reason why the East Asia Community is more viable. There would be more resources available to create an EAC regional development fund. At present, financial cooperation among the ASEAN+3 countries is progressing fairly rapidly in terms of expanding the Chiang Mai initiative and developing the Asian Bond Market, the primary objective of which is to build efficient and liquid bond markets in Asia, enabling better utilization of Asian savings for Asian investments. The Asian Bond Market also aims to mitigate currency and maturity mismatches in financing.

Meanwhile, CLMV countries benefit a great deal from the usual assistance from bilateral and multilateral institutions. Apart from these traditional sources, the comprehensive economic partnership agreements espoused by Japan deserve closer scrutiny (Yamazawa and Hiratsuka, 2003). For example, in the case of the Japan-Singapore Economic Partnership Agreement, the two countries agreed to cooperate in financial services, information and communication technology and human resource development. The implication is a more direct channel of addressing structural concerns, at the same time promoting greater regional integration.

Narrowing the development gap can also be achieved through other regional cooperation efforts. For example, it has been proposed that higher income members of ASEAN should expand programs for labor training at primary, secondary, and tertiary levels and additional special programs for selected groups such as public sector employees who are to administer an expanding set of single market policies (Lloyd and Lee 2004). This can be dovetailed with the proposal to accelerate the implementation of the General Agreement on Trade in Services (GATS) particularly those provisions related to the movement of natural persons. This can result in the

⁹ The EU set up the European Regional Development Fund which has four components: the European Social Fund, which focused on skills training and further education; the Financial Instruments for Fisheries Guidance; the European Agricultural Guidance and Guarantee Fund, and the Cohesion Fund, which emphasized transport and environment projects.

freer flow of skilled labor and professionals among ASEAN member states, likely benefiting the CLMV countries in terms of increased access to health and education services.

Another area for closer regional cooperation is the adoption of core standards for labor conditions. This would include weighing the need for specifying a minimum level of social welfare provision across countries of East Asia. The benefit of setting these standards lies mainly in preventing a ‘race to the bottom’ where countries try to attract foreign investment by providing labor at a very low cost. Deciding on these matters at the regional level has the advantage of reducing the perception that these standards are a covert means of protectionism by developed countries

Managing Sub-regional Trade Agreements

Even if the economic benefits of FTAs are questionable, it would be advisable to guard against possible region-divergent FTAs. The latter may undermine the solidarity in the region, therefore putting at risk the political benefits of the FTAs.

Some practical advice on the best way to respond to the proliferation of sub-regional agreements was given in a forum hosted by the Asian Development Bank (Chow, et al. 2005):

- Multi-speed approach to integration is the practical way forward. Countries whose capital and labor are less sector specific and entrepreneurs more adaptable will have lower adjustment costs and thus could integrate first. However, any design for a sub-regional RTA should anticipate enlargement.
- Agreements should be formulated according to standard WTO format. Specifically, the “spaghettization” of trade agreements that might undermine regional commitment should be managed in a manner that liberalizes trade while maintaining a standardization and consistency with WTO principles. Meanwhile, there should be a systematic review and amendment of GATT Article XXIV.
- Inconsistencies with WTO should be isolated and made distinct, so that eventual integration with WTO can avoid wholesale renegotiation.

The proliferation of sub-regional agreements in East Asia should provide an incentive for non-member countries to seriously become members or else enter into a similar agreement. However, the priority should still be the establishment of an EAFTA. Moreover, this strategy is not crucial since developing countries are usually not in a position to conduct extensive negotiations. Earlier sub-regional agreements can provide benchmarks for future ones. For example, ASEAN member countries entering into bilateral FTAs with the US should insist that any concession granted to Thailand and Singapore should apply to their own agreements. Similarly, Thailand and Singapore should monitor the other agreements and insist that concessions made to other countries can be applied to theirs on a retroactive basis.

One area that merits immediate attention is the progress of economic integration at the ASEAN level. Granted that intra-ASEAN trade has major limitations, it is still useful to determine how ASEAN can be enhanced as an investment area—the so-called

ASEAN Investment Area or AIA. The latter can be an integral part in the process of vertical integration of multinational firms and the development of a regional value chain. Moreover, progress in economic integration among ASEAN member countries will facilitate the process of building an East Asian Community.

Some measures that have been proposed include (Lloyd and Smith 2004, pages 81-82):

- State a precise objective of economic integration efforts which is preferably ASEAN as a single market covering goods, services and direct capital markets.
- Definite starting and end dates and set timetables for all border, beyond-the-border and across-border measures covered by the choice of objective.
- There be an investigation of all the measures which currently prevent the free movement of goods and services and capital between member economies. This investigation should include business laws and other laws and regulations affecting corporate activities, as the achievement of a single market for goods, services and direct capital will require the harmonization of a range of business laws that affect trade in these markets.
- There should be a detailed examination of rules of origin prior to any reform of these rules. One possible reform is a waiver of rules of origin requirements when the tariff rates in the exporting and the importing country are similar.
- In the goods market, the achievement of a single market requires that all tariff items be in the Inclusion List, other than GATT Article XX exceptions.
- In the services markets, there should be a negative list approach rather than a positive list approach and those services on the negative list be reviewed with the object of removing them.
- Sector-based modalities be used primarily where it is not possible to design rules that are uniform across sectors.

Similar measures should apply to the proposed EAFTA.

V. Political and Institutional Imperatives for the EAFTA: A Roadmap

The main point presented in this paper is that the primary benefits of the proposed EAFTA are mainly political although the political windfall will likely lead to significant economic gains. The question then becomes whether policymakers will accept this argument and act accordingly. A related issue is whether the process of building the EAFTA—i.e. the political and institutional imperatives—will depend on its primary objective. In other words, elements of the roadmap may differ depending on whether the main objective of the EAFTA is to expand existing economic relations or to secure political gains. It can be argued that even if the elements of the roadmap are the same, at the very least the priorities will be different.

In this section two roadmaps are drawn depending on the acknowledged objective of the EAFTA. The possibility that the EAFTA is not the appropriate avenue to secure political gains is also considered.

If the Main Impetus for EAFTA is Economic...

The immediate goal would be to deepen integration among ASEAN member countries along the proposals of the 2003 McKinsey report as advocated by Soesastro (2005). This will include measures enumerated earlier (Lloyd and Lee 2004). This will then be followed by considering two options similar to those recommended by Zhang (2005). His proposals deal with building the EAFTA anchored on existing processes.

The first option is to negotiate EAFTA on the basis of the three “10+1” FTAs, i.e. China-ASEAN, Japan-ASEAN, and Korea-ASEAN. It is envisioned that the three FTAs will set the basic structure, principles and contents for an EAFTA, and the major issues relating to EAFTA will be settled by the three separate FTAs.

The second option is to negotiate EAFTA on the basis of three “10+1” FTAs and Northeast Asian FTAs, i.e. among China, Japan and Korea whether multilateral or bilateral. The key is the Northeast Asian FTAs since the three “10+1” agreements are in progress. Currently, the Japan-Korea FTA is still under negotiation and is expected to be concluded in the near future. The critical part is China’s involvement. While China has shown interest in initiating discussions and negotiations on a bilateral or multilateral FTA among the three countries, Japan has not put an FTA with China on its agenda even if the trilateral study group has extensively studied the feasibility of a Northeast Asian FTA (Zhang 2005). At this stage the first option of building an FTA is more feasible.

In this context, it is important to address the trade impact of the various sub-regional FTAs. Practical recommendations to address possible region-divergent FTAs were presented earlier (Chow, et al. 2005). Meanwhile, the comprehensive economic partnership agreements being promoted by Japan vis-à-vis ASEAN member countries could be scaled down in the case of the CLMV countries. Bilateral agreements could instead be negotiated under the umbrella of the Japan-ASEAN FTA. This alternative is likely contingent on the accession of Lao PDR and Viet Nam to the WTO.

It should be noted that the crucial factor remains to be strengthening ASEAN and this involves narrowing the development gap among the member countries. As emphasized earlier the latter will not be achieved by merely deepening regional economic integration. Direct interventions at the regional level are necessary and this will be difficult to accomplish without East Asian countries establishing political rapprochement.

If the Main for Impetus for EAFTA is Political...

The first order of business would be for the countries of the region to agree on a vision similar to what was achieved in Bali Concord II. The vision should be specific and go beyond the theme of regional cooperation underlying the proposals of the EASG. What we recommend is to aim for a single market, but without any binding timetable. Subsequently, the countries should identify concrete steps that would improve economic and political relations in the medium term.

First, the countries could adopt the Treaty of Amity and Cooperation as a building bloc for peace and security. This task has been achieved when Japan and Korea acceded in 2004 while China signed in October, 2003. There could even be an explicit statement about the need for a peaceful and equitable resolution of the Spratlys problem.

Second, the countries could declare a set of common interests they intend to pursue in global fora. This could include the reform of the international financial architecture and the resolution of the problem of trans-Pacific macroeconomic imbalances. These common interests could be determined in future ASEAN+3 summits.

Third, the countries should declare that narrowing the development gap is a primary objective. Hopefully this will lead to a proposal to establish the East Asia Regional Development Fund, modeled closely after its EU counterpart. This is quite different from the regional financing facility proposed by the EASG, which is only an extension of the Chiang Mai Initiative.

But this still begs the question of how to secure these political gains since it is likely that establishing the EAFTA and securing political gains from more advanced East Asian regionalism (i.e. the EAFTA) will both require political rapprochement, especially among the “plus three” countries. This is similar to the view that East Asian countries still lack sufficient political will to promote economic integration (Wang 2005). The essential issue then becomes how to achieve political rapprochement or political reconciliation, or how to build the political will.¹⁰

In the meantime, East Asia should continue using the ASEAN+3 process as the primary mechanism for expanding economic integration, and later strengthen the APT. At present ASEAN+3 deals solely with regional cooperation, with the most advanced area being regional financial and monetary cooperation. The focus on financial and monetary matters is justified because regional financial stability is required to support the relatively high and increasing intra-regional trade, investment, and economic interdependence. Moreover, East Asia lags substantially in terms of intra-regional financial integration.

Regional financial and monetary cooperation in the ASEAN+3 framework involves a policy dialogue and surveillance process that is increasingly becoming effective. The process is an appropriate venue to explore common interests that could be projected in a global rules setting (Grenville 2003). It also has a peer review mechanism that could provide the leverage needed by policymakers to advance domestic economic reform. The trajectory of cooperation will eventually require establishing a Secretariat that will independently handle the surveillance process. This could be the starting point of closer economic integration leading to greater efforts to secure the political gains.

Meanwhile, to overcome political and non-economic obstacles, e.g. competition between Japan and China, Urata (undated) proposes that East Asian countries need to deepen mutual understanding at all levels, from top leaders to young people, to

¹⁰ A small but encouraging step was accomplished when the heads of state/government of the ASEAN+3 countries issued a joint statement for the first time at the end of the 9th ASEAN Plus Three Summit in Kuala Lumpur. The long-term goal of establishing an East Asian community was reiterated although the word ‘community’ remains un-capitalized.

increase the awareness of the importance of an integrated regional market and regional political and social stability. Leaders' meetings should be held regularly and policy makers should establish close communication links. This was echoed by Yuan (2005), who proposed that Beijing and Tokyo should develop mechanisms for regular high-level exchanges on issues of bilateral concern. He argues that lack of dialogue allows worse-case scenario assessments to influence policy formulation, further heightening mutual suspicions and leading to acrimony.

Businessmen, bureaucrats, academics and students should participate in exchange programs and the framework for such exchange programs should be established. This is aptly described as contact at the grass-root level.

It goes without saying, that if the primary purpose of regionalism is to secure the political gains of closer integration and cooperation, then there should be less emphasis on sub-regional FTAs. This automatically renders irrelevant any proposal to conduct bilateral agreements between Japan and the CLMV countries, even if these be in the form of comprehensive economic partnership agreements.

Should Regionalism Be Promoted in East Asia?

One important issue that has to be addressed is whether regionalism should be pushed more vigorously in East Asia, with the view that it could accelerate development and convergence in the region. This is the spirit behind the ASEAN Economic Community as outlined in the Bali Concord of October, 2003. A framework similar to the EU is apparently the end-goal as gleaned from the objective "to create a stable, prosperous and highly competitive ASEAN economic region in which there is a free flow of goods, services, investment and a freer flow of capital, equitable economic development and reduced poverty and socio-economic disparities in year 2020."

The goal of emulating the EU brings to fore the crucial differences between the European and East Asian integration experience. It has been observed that these differences are related to the depth of economic integration, the institutional density of regional arrangements, the content and negotiating devices of regional rules and the procedures for ensuring these rules are respected (Guerrieri and Falautano, 2000). In particular, the EU is considered to be a highly legalistic institution, and the political integration objective had facilitated the shift in political sovereignty to the supranational institutionalized way of implementing and enforcing integration (Langhammer 1997). The economic reality of increased interdependence came later for Europe while in East Asia the intensity of economic interaction was the basis for considering greater integration (Munakata 2002).

Given the present circumstances—which is dominated by overt political animosity among Korea, Japan, and China and the wide development disparity among countries in the region—regionalism can simply start with a long-term vision for institutionalizing economic integration and agreeing on pragmatic steps in the medium-term. This was the proposal laid out earlier. What is certain is that economic relations in East Asia must go beyond regional cooperation schemes outlined in the EASG. This will enable the countries to secure the political benefits and the concomitant economic gains outlined earlier.

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Appendix

Trade and Convergence Among Nations

One reason for promoting Regional Trading Agreements is the evidence that countries that trade intensively tend to exhibit a relatively high incidence of income convergence (Ben-David 2000). This may be partly due to the economic benefits of forming RTAs which are conveniently classified into competition and scale effects and trade and location effects (World Bank 2000). However, the latter cannot readily explain convergence. The issue at hand is also slightly different from the impact of trade liberalization on convergence (see for example Parikh and Shibata 2004).

A possible explanation for convergence among countries that trade intensively is that trade acts as a conduit for the dissemination of ideas (Ben-David 2000) particularly if foreign direct investment is brought into the picture. Hence, trade provides countries with an access to technology and a means of enhancing their technological capability. This allows them to catch-up with trading partners who have a higher level of development and technological capability.

This view can be dovetailed with the earlier analysis that a customs union may likely lead to divergence of incomes among member countries especially if the disparity is initially large. The large disparity may likely indicate that some countries are not in a position to absorb the new technology and hence they may not be able to take advantage of the economic opportunities. Another way of viewing it is that these countries have not attained the “minimum threshold level of economic and social development to participate effectively in both the regional integration and globalization processes.” One way to help countries attain this threshold level of development is the establishment of the East Asia Regional Development Fund.

Table A.1 shows the intra-group trade shares among selected grouping similar to those in Table 5. It will be useful to determine whether the degree of integration correlates with the degree of convergence.

Table A.1 Intra-Group Trade Shares in Selected Regional Groupings (based on exports)						
Regional Grouping	1980	1985	1990	1995	2000	2004
ASEAN-5	16.7	17.8	18.1	22.4	21.4	20.3
Group A	13.1	15.4	14.2	19.4	19.8	22.7
Group B	20.0	21.4	22.2	29.8	28.1	29.6
Group C	27.4	25.5	26.2	33.5	32.4	33.3
ASEAN-10	17.4	18.6	19.0	24.6	23.0	22.2
ASEAN+3	29.0	26.4	26.8	35.0	33.7	34.8
EU-15	52.4	51.8	58.1	55.4	62.1	61.1
Notes: 1. ASEAN-5: Indonesia, Malaysia, the Philippines, Singapore, Thailand 2. Group A: China, Japan, Korea, Singapore 3. Group B: Group A plus Malaysia and Thailand 4. Group C: Group B plus Indonesia and the Philippines Source of Basic Data: IMF Direction of Trade Statistics (DOTS) CD-ROM, October 2005.						

It can be observed that the groups that experienced a relatively large change in the intra-group trade share exhibited greater tendency towards convergence and a narrower disparity in 2002. For example, Group A composed of the “plus 3” countries

and Singapore recorded a 9.2 percentage point increase in the intra-group trade share between 1980 and 2004. During that period, the disparity as measured by the coefficient of variation of per capita GDP, showed a sharp downward trend. Meanwhile, intra-group trade among the ASEAN-5 hardly changed between 1980 and 2004. This is one reason that the level of development of these countries has diverged over time.

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