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Trade and Investment Policies and Regional Economic Integration in East Asia

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Abstract

The global economic crisis has affected the East Asian economies via trade and investment. The export-led model which had been responsible for the “East Asian Miracle” now must redirect the basis of growth from exports sent to the US and Europe to regional and domestic demand. Regional trade integration has been market-led through production networks and foreign direct investment (FDI). Since the proliferation of bilateral and plurilateral free trade agreements (FTA) and economic partnership agreements (EPA) has not resulted in an integrated regional market, it is important that East Asia seek an arrangement for a region-wide FTA/EPA. Currently, there are proposals for an ASEAN+3, an ASEAN+6, Pan-Asia, and Asia Pacific initiatives. While proponents of a region-wide FTA/EPA highlight its benefits, skeptics and critics point to the difficulties of reaching consensus in a region with widely varying political, economic, and social systems. Ultimately it will depend on a political-economic decision based on a cost-benefit analysis of liberalization, facilitation, and cooperation in a region-wide FTA.

JEL Classification: F13, F14, F26, O24

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1. INTRODUCTION

The global crisis has affected East Asian economies through trade and investment rather than financial contagion. Initially a sharp fall in external demand from the US and Europe caused a plunge in exports and economic growth for all countries in East Asia, save for the People's Republic of China (PRC). Foreign direct investment (FDI) inflows continued to grow in 2008, albeit at slower rates than in 2006–2007, partly reflecting an increase in cross-border mergers and acquisitions. However, in 2009, all East Asian countries, including the PRC, faced downturns in FDI inflows, particularly as cross-border mergers and acquisitions plunged, and outward FDI by Asian investors declined.

Individual East Asian economies adopted uncoordinated fiscal stimulus packages as short-term policy responses to the crisis. For the longer term, the region must direct its growth strategies away from a heavy dependence on export demand from North America and Europe and more towards regional and domestic demand. In this context, regional cooperation and integration takes on added importance.

2. TRADE AND INVESTMENT POLICIES AND MARKET-DRIVEN INTEGRATION

The economies of East Asia have become increasingly integrated through trade and investment flows since the mid-1980s. Economic integration has been largely market-driven. Although bilateral and regional FTAs have proliferated since the late 1990s, few have yet been implemented fully (except for the ASEAN Free Trade Area [AFTA]), so that their impact on trade and investment growth has so far been limited.

2.1 Development of Trade Policies

The “East Asian Miracle” has been widely attributed to the openness of East Asia to foreign trade and, for most economies, FDI as well. Since the 1960s, a succession of East Asian economies abandoned inward-looking development strategies in favor of more open trade and investment regimes. Following Japan's export-led model in the 1950s and 1960s, the newly industrialized economies (NIEs) of Hong Kong, China; Singapore; the Republic of Korea (hereafter Korea); and Taipei, China developed manufactures for export. The Plaza Accord of 1985 saw the sharp revaluation of the Japanese yen and enabled the NIEs to accelerate their exports of the labor-intensive manufactures in which Japan was losing comparative advantage. By the late 1980s, these economies, in turn, were losing their competitive edge in labor-intensive activities as a result of rising labor costs, and, together with attendant exchange rate movements and technological change, competitive advantage moved to the next tier of countries. The ASEAN4 (Indonesia, Malaysia, Philippines, and Thailand) responded to the outward surge of investors from Japan and the NIEs by liberalizing their FDI and trade policies. The inward FDI boom contributed to the export boom in manufactures, particularly in electronics. The next tier of countries to adopt the pro-export route was Cambodia, Lao People's Democratic Republic, Myanmar, and Viet Nam (CLMV), and the PRC.

The East Asian Miracle was brought to a halt by the onset of the Asian financial crisis of 1997. Some economies (Thailand, Korea, Indonesia, Malaysia, and Philippines) were more affected than others. It should be noted that countries in East Asia did not resort to protectionism, but continued to maintain open trade policies and further liberalized their investment regimes. However, as the region recovered from the 1997–1998 crisis, its economic performance plunged once again, this time by a financial and economic crisis that

originated in the US in 2008. East Asia has again largely refrained from protectionist measures and is maintaining open trade and investment through implementation of FTAs.

East Asian countries generally pursue a three-pronged trade strategy of unilateral trade liberalization, liberalization under the World Trade Organization (WTO), and regionalism.

2.1.1 Unilateral liberalization

Economists argue that unilateral liberalization improves an economy's efficiency and competitiveness and is definitely preferable to bilateralism and regionalism since it has no resource-distorting and trade-diverting effects. In East Asia, Hong Kong, China and Singapore are the two economies with the most advanced state of unilateral liberalization of trade and investment regimes. Such enlightened self-interest is, however, not the norm. More commonly, governments are confronted with non-competitive economic sectors and strong lobby groups for protection. It should be noted that while unilateral liberalization improves domestic efficiency and competitiveness, there is no assurance of non-discriminatory access to the world's markets, which are increasingly riddled by discriminatory trading arrangements. Under the Asia-Pacific Economic Cooperation's (APEC) open regionalism, voluntary and unilateral liberalization is advocated with peer review of "individual action plans" of members. That this is not enough is evident from the fact that APEC members have entered into bilateral and plurilateral FTAs with each other as well as with non-APEC countries.

2.1.2 Liberalization under the World Trade Organization

Except for the Lao People's Democratic Republic (Lao PDR), the East Asian economies are members of the WTO. Cambodia, Viet Nam, and the PRC are recent WTO members and had to undergo a prolonged and rigorous process of WTO accession. Successive rounds of multilateral trade negotiation (MTN) have achieved a considerable liberalization of trade in goods, particularly with regard to industrial tariffs. The record remains poor on agriculture and services liberalization. The Doha Round, launched after much delay in December 2001, is in serious danger of collapse and many countries have taken insurance in bilateralism and regionalism.

Unilateral and multilateral trade liberalizations have reduced average levels of applied tariff protection and especially nontariff barrier (NTB) protection. In East Asia, apart from Singapore and Hong Kong, China liberalization of trade policies is most apparent for the PRC, ASEAN-4 (Indonesia, Malaysia, Philippines, and Thailand), and Viet Nam. The PRC and Viet Nam have seen considerable liberalization as part of WTO accession requirements.

2.1.3 Regionalism and bilateralism

Countries are concerned over the inability of the Doha Round to deliver and need an insurance policy. Additionally they desire to pursue deeper and faster WTO-plus liberalization and facilitation with their major trading and investment partners. In East Asia, bilateralism is thriving among like-minded pairs of countries, as it is easier to negotiate and achieve deeper integration. Too many bilateral FTAs, however, could create a "noodle bowl" problem unless there is a common template. East Asia also has various ASEAN-plus initiatives with different groups of countries and different scope, but no trilateral or bilateral agreement exists among the PRC, Japan, and Korea. On economic grounds, the bigger the regional grouping, the larger the benefits due to economies of scale, increased trade creation, and reduced trade diversion. Too large a regional grouping, however, results in a lack of "like-mindedness" and could end up with shallow integration and large exclusion lists and carve-outs.

ADB (2006) argues that uncoordinated bilateral liberalization jeopardizes gains, which could be captured either through cooperative multilateral approaches or through non-discriminatory regional agreements. First, the potential for trade diversion as opposed to

trade creation is greater in a series of overlapping bilateral agreements. Second, crisscrossing bilateral agreements also risk marginalizing peripheral countries with small markets. Investment decisions are not easily reversible, and can have a cumulative influence on economic advantages. Therefore, even if bilateral preferences were to eventually give way to multilateral liberalization, polarizing impacts of bilateralism could be long-lasting. Third, proliferation of bilateral/regional FTAs reflects countries' strategic and political interests as well as their commercial interests in institutionalizing market-driven integration processes. The pursuit of overlapping FTAs, however, has resulted in multiple agendas for integration. Harmonizing these agendas to tap the potential of nondiscriminatory approaches to liberalization and to expand the reach of integration constitutes a significant challenge. Fourth, bilateralism is on a strong upswing, but it crisscrosses regions. Multiple and overlapping FTAs create a noodle bowl effect.

Plummer (2005) notes that reducing distortions will depend on the inclination of bilateral agreements. If the FTAs are intended to protect special interest groups and to turn countries inward, they are likely to act as a stumbling block to broader liberalization. If, however, they aim at deepening integration, they may present additional opportunities to those currently accommodated within the multilateral framework. Singapore's Minister of Trade and Industry, Lim Hng Kiang, has recently¹ defended the forging of bilateral FTAs as a first step—they build up confidence and capacity, as well as a consensus for liberalization and for bringing down barriers. Beyond that, the options are docking, merging, and/or enlargement of existing agreements.

2.2 FDI Policy Regimes

The ownership, location, and internalization (OLI) conceptual framework in Dunning (1988) is useful in explaining FDI. FDI requires the presence of OLI advantages, as otherwise it would be preferable for a firm to either produce at home and export the goods and/or to license the technology rather than venturing overseas.

Location advantages of host countries vary with the motivation of the investing firm. First, for resource-seeking investments, it is the possession of specific natural resources. Investments abroad are to acquire resources at a lower cost than could be obtained at home; also companies expanded abroad to secure access and supplies of natural resources such as oil and gas in Brunei Darussalam and Indonesia. Second, for market-seeking investments, it is the size and growth potential of the host market (such as in the PRC), including preferential access to markets in regional trading arrangements; market seekers could also be suppliers who invest abroad to follow their customers when they go overseas. Market-seeking FDI is the most common type of strategy for developing country multinational corporations (MNCs), particularly for those investing in neighboring countries during the early stage of their internationalization.

Third, efficiency-seeking FDI aims to rationalize the structure of investing companies to benefit from geographically dispersed activities; efficiency seekers are likely to concentrate their production to take advantage of location-specific factors such as labor, skills, technology, or physical infrastructure. Usually these firms are experienced, large MNCs that are engaged in global and regional production networks. Production networks have grown rapidly in East Asia, driven by policy liberalization that opens up national markets to FDI; rapid technological change which forces firms to tap world markets and share the costs and risks, while falling transport and communication costs makes it economical to integrate distant operations; as well as increasing competition among firms. Efficiency-seeking FDI from developing countries are commonly found among MNCs in East Asia in electrical and electronic products, garments, and information technology services. Fourth, firms seeking strategic asset investments abroad acquire assets of foreign companies to promote their

¹ Opening address at a PECC Conference in Singapore on 9 October 2009.

long-term objectives. Strategic asset-seeking investments are more common among MNCs from developed countries, although developing country MNCs are also increasingly likewise engaged. During the Asian financial crisis of 1997–1998 and the current global financial crisis, many government and private investors acquired strategic stakes in foreign financial institutions.

2.2.1 Elements of a Successful Foreign Direct Investment Policy Regime

An environment conducive to foreign (and local) business requires political, social, legal, and macroeconomic policy and institutional frameworks. The World Bank's *Ease of Doing Business* ranks 185 economies according to various criteria: starting a business, dealing with construction permits, employing workers, registering property, getting credit, protecting investors, paying taxes, trading across borders, enforcing contracts, and closing a business. Table 1 shows Singapore ranking top among ASEAN countries (and globally), followed by Thailand, Malaysia, Viet Nam, Brunei Darussalam, Indonesia, Philippines, Cambodia, and Lao PDR. Among northeast Asian countries, Japan and Korea rank behind Singapore and Thailand, while the PRC ranks behind Singapore, Thailand, and Malaysia.

Table 1: Ease of Doing Business in East Asia

	Singapore	Thailand	Malaysia	Vietnam	Brunei Darussalam	Indonesia	Philippines	Cambodia	Lao PDR	Myanmar	ASEAN+9 Average	Japan	Rep. of Korea	PRC	Japan-Korea-PRC Average	EastAsia Average
Rankings based on 183 global economies																
Ease of doing business	1	12	23	93	96	122	144	145	167	na	89	15	19	89	41	77
Starting a business	4	55	88	116	153	161	162	173	89	na	111	91	53	151	98	108
Dealing with construction permits	2	13	109	69	75	61	111	145	115	na	78	45	23	180	83	79
Employing workers	1	52	61	103	4	149	115	134	107	na	81	40	150	140	110	88
Registering property	16	6	86	40	183	95	102	116	161	na	89	54	71	32	52	80
Getting credit	4	71	1	30	113	113	127	87	150	na	77	15	15	61	30	66
Protecting investors	2	12	4	172	119	41	132	73	182	na	82	16	73	93	61	77
Paying taxes	5	88	24	147	22	126	135	58	113	na	80	123	49	130	101	85
Trading across borders	1	12	35	74	48	45	68	127	168	na	64	17	8	44	23	54
Documents to export (number)	4	4	7	6	6	5	8	11	9	na	7	4	3	7	5	7
Time to export (days)	5	14	18	24	28	21	16	22	50	na	22	10	8	21	13	20
Cost to export (US\$ per container)	456	625	450	734	630	704	816	732	1860	na	779	989	742	500	744	770
Documents to import (number)	4	3	7	8	6	6	8	11	10	na	7	5	3	5	4	6
Time to import (days)	3	13	14	23	19	27	16	30	50	na	22	11	8	24	14	20
Cost to import (US\$ per container)	439	795	450	901	706	660	819	872	2040	na	854	1047	742	545	778	835
Enforcing contracts	13	24	59	32	160	146	118	141	111	na	89	20	5	18	14	71
Closing a business	2	48	57	127	37	142	153	181	183	na	103	1	12	65	26	84

PRC = People's Republic of China.

Source: compiled from World Bank, *Doing Business 2010*.

Singapore has maintained an FDI policy regime characterized by the following features: First, it adopted a comprehensive approach to maximize its location advantages, as FDI policy is part and parcel of Singapore's development strategy. Second, it has mostly removed any entry and ownership restrictions and performance requirements. Foreign investors are generally accorded right of establishment and national treatment (except for selected services), and are represented on various national advisory and policymaking councils and committees together with their local counterparts. There are no restrictions on foreign borrowings from the domestic capital market and no foreign exchange controls or limits placed on repatriation of capital, dividends, interest, and royalties. Third, it has taken steps to ensure ample "supply side" factors that facilitate business and reduce costs. These include hard physical infrastructure (free trade zones, industrial estates, transport, power and water supply, and telecommunications) and soft infrastructure (labor and skills, as well as institutions). Fourth, it has provided generous fiscal and financial investment incentives. There is a large literature on the use of fiscal and financial incentives, with critics arguing that they are not effective in attracting FDI, are a drain on fiscal resources, and distort resource allocation. To minimize their negative effects, their use should be targeted and time-bound and used only as "icing on the cake" rather than the core of measures to attract FDI. Singapore's core business attractions include: political and social stability, stable industrial relations, low level of public sector corruption and high level of public sector competence, macroeconomic stability, and transparent legal and regulatory framework. In addition, investors enjoy strong intellectual property rights protection, pool of skills and professionals from the country's tertiary educational and training institutions as well as ready access to foreign workers and professionals, well-developed physical infrastructure of industrial estates, science parks and world class sea and air transportation and logistics support, and telecommunications, and water and power supplies. Singapore policymakers also ensure policy coherence and effective policy implementation.

In contrast to Singapore, many East Asian countries' FDI policies contain restrictions and performance requirements that negate the package of investment incentives offered. The former seeks to protect local interests and extract maximum benefits from FDI for the host country while the latter seeks to enhance location advantages. Most countries show a continuing liberalization of their FDI regimes, but not all have been able to maintain stable and coherent policies due to domestic political and business pressures, resulting in an uncertain investment climate. Many of the bilateral and regional FTAs have investment provisions covering investment liberalization, facilitation, and protection. The ASEAN investment provisions also include joint investment promotion.

2.3 Trade and Investment Patterns

2.3.1 Production networks and parts and components trade

In recent decades, East Asia has seen a dramatic shift in trade patterns toward machinery and transport equipment, parts, and components. Several factors explain this structural shift. First, rapid advances in production technology enabled businesses to repurpose stages of production into portable components so that different tasks can be performed in different locations according to their competitive advantages. Second, technological innovations in transportation and communications have improved the speed, efficiency, and coordination of geographically dispersed production processes. Third, policy reforms have lowered barriers to trade and investment as tariffs and NTBs in manufactures have declined and spurred their trade.

Resource-poor NIEs have relied on manufactures for export expansion from the beginning of their industrialization phase. Resource-rich Southeast Asian economies have relied on exports of primary products, but since the 1970s, the export product mix has shifted increasingly towards manufactures. Hence, all East Asian economies have been pursuing export-oriented industrialization in recent decades. Manufactures now account for more than

70% of exports for most countries. Machinery and transport equipment accounts for more than half of manufactures exports, particularly in Philippines, Malaysia, Korea and Singapore but are also rising rapidly in Indonesia and Viet Nam. In South Asia, machinery and transport equipment shares of manufactures exports are much less. Most machinery and transport equipment exports are in information and communication technology (ICT) products, while in Thailand, motor vehicle exports have seen rapid growth. The PRC alone accounted for 24% of the world's ICT exports in 2006, up from 3% in 1992. Exports of labor-intensive goods so important to manufactures exports in the mid-1980s have declined in relative importance, with the share of textiles, clothing, and footwear in total manufactures exports of developing Asia (that is, excluding Japan) falling from 25% in 1992 to 11% in 2006, but still remaining high in South Asia, with 93% in Bangladesh and 84% in Pakistan.

Though developing Asia has seen the rapid rise in intra-industry trade in parts and components, with the most notable rise in the PRC, such trade is less important in South Asia. The share of parts and components in total manufactures exports has increased from 16% in 1992 to 25% in 2006 and concentrated in ICT products and electrical machinery; the shares were 40% in northeast Asia (with the PRC 19%) and 26% in ASEAN, but only 7% in India. Parts and components also account for a growing share of developing Asia's total import basket as well, rising from 22% in 1992 to 36% in 2006; in the PRC, parts and components account for a much larger share of imports than exports while in other Asian developing countries the reverse holds true.

Production networks are associated with the growth of MNCs and FDI in East Asia. FDI from Japan and NIEs (as well as MNCs from the US and Europe) played a significant role in the development of Asian production networks. Asian, American, and European MNCs with global distribution and marketing capabilities have invested in affiliates in Southeast Asia and the PRC or linked up with Asian contract component suppliers. Market-driven integration through production networks is a growing phenomenon since the mid-1980s and has been well documented. The attractiveness of East Asian economies as production and investment platforms has been enhanced by various developments and measures that reduce the barriers and costs of trade. On the demand side is the progressive reduction of trade barriers through unilateral liberalization and successive rounds of trade liberalization under the WTO and General Agreement on Tariffs and Trade. On the supply side, technological advances have lowered transportation costs and there have been massive investments in transportation and telecommunications infrastructure to improve spatial connectivity. Regional cooperation efforts such as Greater Mekong Subregion focused on investments that improve physical connectivity between neighboring countries and opened new opportunities for trade and helped deepen integration within the region.

2.3.2 Need to rebalance trade

The strong link between G2 (US and EU) imports and developing Asia's exports is due to the nature of intra-Asian trade, one that is driven by vertical integration of production chains with demand for final goods lying outside the region. More than 70% of intra-Asian trade consists of intermediate goods used in production, and, of this, half is driven by final demand outside Asia (ADB 2009). In contrast, final demand by the PRC accounted for only 6.4% of Asian trade, which was only half the contribution from Japan and slightly below one-quarter of that from the US. Hence G2 economies are still the ultimate export destinations for final goods leaving Asia, when taking into account direct exports as well as indirect exports through intermediate goods trade for assembly and production within East Asia but eventually exported to G2 economies.

Export-led growth has contributed to the East Asian economic miracle and will continue to spur growth in the region. However, the global financial crisis has highlighted the need to rebalance growth and, in particular, for East Asia to reduce the dependence on exports of final goods to G2 economies. East Asia's large current account surpluses have also contributed to global imbalances that contributed to the global financial crisis. Critics argue

that even without the global financial crisis, East Asia is paying a heavy price in welfare costs by saving too much and consuming too little as well as in the opportunity cost of failing to use the region's savings productively. There is a growing realization among East Asian policy makers that the pre-crisis export-led growth model is unsustainable and East Asian countries have to rebalance growth towards regional and domestic demand.

Strengthening regional cooperation and integration can help East Asia cope with adverse external shocks and promote a more balanced trade structure. An integrated regional market through trade and investment liberalization and facilitation measures is conducive to economies of scale and specialization and intra-industry trade in differentiated products, as well as to reducing the cost burden from trade-related regulations. More robust domestic demand in individual countries would increase the demand for final goods and thus increase the relative importance of final goods in intra-regional trade.

3. RISE IN ASIAN REGIONALISM

3.1 Factors in the Surge of Bilateral and Plurilateral Free Trade Agreements/Economic Partnership Agreements in East Asia

Table 2 lists FTAs/EPAs in East Asia. The surge over the past decade in economic, trade, and investment cooperation and integration agreements reflects political and economic, as well as intra-regional and extra-regional, dynamics. These are:

Table 2: Free Trade Agreement Status in East Asia* by Country, as of January 2009

	Concluded, signed, or implemented	Under negotiation	Proposed	Total
Brunei Darussalam	6	3	4	13
Cambodia	4	3	2	9
Indonesia	6	4	6	16
Lao PDR	6	3	2	11
Malaysia	7	9	3	19
Myanmar	4	4	2	10
Philippines	5	3	4	12
Singapore	17	11	4	32
Thailand	9	9	6	24
Viet Nam	5	4	2	11
Subtotal ASEAN	69	53	35	157
PRC	9	4	10	23
Japan	10	5	4	19
Korea	6	7	10	23
Australia	7	7	4	18
New Zealand	6	5	3	14
India	9	13	9	31
Subtotal "+6"	47	41	40	128
Total East Asia*	116	94	75	285

PRC = People's China; Lao PDR = Lao People's Democratic Republic.

Note: * East Asia defined as ASEAN+6 countries

Source: Author's compilation from ADB-ARIC database

- *Geopolitical:* The end of the Cold War and the economic rise of the PRC have resulted in warming political ties between the PRC and the rest of East Asia. The economic rise of India and its "look East" policy has also enhanced its political and

economic relations with East Asia. FTAs/EPAs have increasingly become instruments of political diplomacy.

- *Economic:* While tariff barriers have fallen under successive WTO rounds, many barriers to trade and foreign investment remain and provide incentives for some FTAs to further liberalize and deepen integration and develop regional production networks and supply chains. Countries have strong reasons to liberalize through FTAs. They may face less resistance from vested interests fearing foreign competition and, if the outcome of preferential liberalization proves successful, support for opening multilateral markets may be strengthened. Individual countries are also pursuing bilateral FTAs to deepen relationships with specific countries or driven by the domino effect when neighboring and competitor countries enter into FTAs.
- *Need for regional cooperation:* Several developments have heightened the need for regional cooperation. First, the Asian financial crisis of 1997–1998 provided the opportunity for regional, political, and financial cooperation to resolve the crisis and develop regional resilience, resulting in the Chiang Mai Initiative, Regional Surveillance Mechanism, and Asian Bond Market Initiative. Second, regionalism in North America and Western Europe poses threat and demonstration effects—concern over discriminatory market access for East Asian exporters and positive demonstration effect of the benefits from regionalism. Third, the rapid growth of East Asian economies and intra-regional trade and investment flows calls for some institutionalization to manage emerging conflicts and tensions. Fourth, there is growing recognition that in an era of globalization, nation states have to cooperate to deliver regional public goods and mitigate the global and regional public “bads.” Fifth, disappointment with the lack of progress in the Doha Round and in APEC trade and investment liberalization pressured countries to establish FTAs as insurance. Finally, the current global financial and economic crisis is spurring regional cooperation to mitigate negative effects and rebalance growth towards regional and domestic demand.

3.2 Characteristics of Asian Regionalism

Asia’s regionalism has developed differently from Europe’s and has taken on a different structure, even though the media, as well as some official announcements, refer to a “Europe-type” regionalism. Asian regional integration has been driven more by markets than governments. Asian governments have been reluctant to adopt the more structured European-style regionalism and this reflects several factors, including an unwillingness to cede national sovereignty (many achieved political independence only in recent decades and are still in the process of nation-building); wide disparities in economic development, social structures, and political systems; the persistence for many East Asian countries of economic ties (trade, investment, capital flows) that are still more closely linked with US-Europe than with the region; and continuing debate on what constitutes the “region”.

The formation of FTAs² and EPAs is a recent phenomenon, unlike in other parts of the world. Asian economic regionalism in recent decades has been mainly market-driven, and particularly by the development of regional production networks. Since Asia’s exports of final goods are mostly destined for markets in North America and Europe, Asia’s regionalism focuses on supporting market relationships rather than supplanting them and on sustaining its openness to global markets. Intra-regional bilateral and plurilateral FTAs are paralleled by FTAs with extra-regional countries and groups.

² East Asia has only undertaken FTAs (necessitating ROOs to prevent trade deflection), and has so far eschewed customs unions, which require harmonization of external tariffs.

Traditional FTAs focus mainly on liberalization of trade in goods through elimination of tariffs and NTBs. However, Asia's "new age" FTAs/EPAs go beyond goods liberalization to encompass FTA-plus and WTO-plus features of trade facilitation, investment liberalization and facilitation, intellectual property rights protection, competition policy, mutual recognition agreements, government procurement, and labor mobility. A key feature is special and differential treatment for the less-developed members of the FTA/EPA, including capacity building in economic and social areas.

Since governments are reluctant to cede management and control, Asia lacks strong regional institutions. Many subregional organizations, often overlapping, cooperate in various areas. The ASEAN Secretariat is small and poorly funded and lacks a large professional staff to gather and synthesize information (like the Organisation for Economic Co-operation and Development [OECD]), monitor compliance of various agreements and commitments, and undertake analytical work. The Economic Research Institute for ASEAN and East Asia (ERIA), funded by Japan, has been established to undertake some of the analytical work on East Asia.

3.3 Evolving Regional Economic Architecture

Numerous regional groupings and forums have emerged, giving rise to overlapping and confusing groupings of varying geometry. Most of these groupings are ASEAN-centric—ASEAN's agreements on trade in goods (AFTA), trade in services (AFAS), ASEAN Investment Area (AIA) and ASEAN Economic Community (AEC); ASEAN+1 agreements (with PRC, Japan, Korea, India, Australia-New Zealand, European Union and Gulf Cooperation Council), ASEAN+3 (East Asia Free Trade Area or EAFTA), and ASEAN+6 (Comprehensive Economic Partnership in East Asia or CEPEA). Others include South Asia FTA, Trans-Pacific Strategic Economic Partnership (TPSEP), and the Asia Pacific Economic Cooperation (APEC) forum.

Table 3 shows the number of plurilateral and bilateral FTAs that the East Asian economies have signed or are under negotiation and study. Singapore heads the list with 32 FTAs, followed by India (31), Thailand (24), PRC (23), and Korea. In terms of bilateral FTAs signed, Singapore leads with 18, followed by Japan and India (each 13), and Australia (11), while the PRC and Korea have the largest number of FTAs under negotiation or study. The CLMV countries have few or no bilateral FTAs, reflecting their relative lack of attractions for other countries and their limited negotiating capabilities; their focus has been on ASEAN+1 agreements.

Table 3: Plurilateral and Bilateral Free Trade Agreements of ASEAN+6 Countries

	Under negotiation, concluded or implemented									New FTAs	Total FTAs
	Plurilateral FTAs*			Bilateral FTAs			Total plurilateral & bilateral				
	Intra- regional**	Cross- regional	Total	Intra- regional**	Cross- regional	Total	Intra- regional**	Cross- regional	Total		
Brunei											
Darussalam	6	2	8	1	0	1	7	2	9	4	13
Indonesia	6	2	8	1	1	2	7	3	10	6	16
Malaysia	6	3	9	4	3	7	10	6	16	3	19
Philippines	6	1	7	1	0	1	7	1	8	4	12
Singapore	6	4	10	6	12	18	12	16	28	4	32
Thailand	6	3	9	6	3	9	12	6	18	6	24
Cambodia	6	1	7	0	0	0	6	1	7	2	9
Lao PDR	6	2	8	1	0	1	7	2	9	2	11
Myanmar	6	2	8	0	0	0	6	2	8	2	10
Viet Nam	6	1	7	1	1	2	7	2	9	2	11
PRC	1	3	4	6	3	9	7	6	13	10	23
Japan	1	1	2	10	3	13	11	4	15	4	19
Korea	1	3	4	5	4	9	6	7	13	10	23
Australia	1	2	3	7	4	11	8	6	14	4	18
New Zealand	1	3	4	6	1	7	7	4	11	3	14
India	1	8	9	6	7	13	7	15	22	9	31
FTA incidence	66	41	107	61	42	105	127	83	210	75	285

PRC = People's Republic of China, Lao PDR = Lao People's Democratic Republic, FTA = free trade agreements.

Notes: * plurilateral = FTA involving more than two countries

Notes: ** intra-regional defined here as among the ASEAN+6 group of countries

Source: Author's compilation.

There are also proposals on regional communities. Building a regional community that encompasses political, economic, security, social, and cultural dimensions requires a broader vision than an FTA/EPA and could only be a long-term objective given the wide political, economic, social, and cultural diversity of the region, strong nationalism among countries, and historical mistrusts and current economic rivalries between Japan and the PRC. Even an economic community such as that of Europe has required coordination and harmonization of external tariffs and macroeconomic policies of member states. The AEC has a much more limited objective, although it was launched in 2003 in parallel with an ASEAN political-security community and an ASEAN sociocultural community. It should also be remembered that ASEAN has existed as a regional grouping since 1967.

In May 2009 at the Shangri-la Dialogue in Singapore, Australian Prime Minister Rudd proposed an Asia Pacific Community, linking economics to the long-term security priorities of the Asia Pacific. He argued that, “managing major power relations, particularly in the context of the rise of the PRC and India, will be crucial for our collective future. This will place a premium on wise statecraft, particularly the effective management of relations between the US, Japan, PRC, and India” (Dysdale 2009). In turn, Japanese Prime Minister Yukio Hatoyama proposed an East Asian Community (EAC), presumably including economic, political, and security dimensions, to President Hu of the PRC in Beijing in September 2009.³ The idea has generated much interest as well as controversy. When pressed at the November 2009 Summit in Singapore, Hatoyama was vague as to the nature and membership of his proposed EAC. US President Barack Obama argued that: “As an Asia-Pacific nation, we expect to be involved in discussions that shape the future of this region, and to participate fully in appropriate organizations as they are established and evolve.”⁴

3.3.1 ASEAN

Although ASEAN was formed in 1967, its economic integration efforts began seriously only in 1992 with AFTA, followed in 1995 by the AFAS and in 1998 by the AIA.

While goods trade liberalization is now far advanced (with zero tariffs in January 2010 for Brunei Darussalam, Indonesia, Malaysia, Philippines, Singapore, and Thailand), progress has been slower in services trade liberalization and investment liberalization. However, with growing concern over market and investment competition from the rise of the PRC and India and the need for the ASEAN states to be internationally competitive, the grouping agreed on wider and deeper integration. The AEC was adopted in 2003, with a completion date first set at 2020 but subsequently advanced to 2015.

The AEC has the goals of, “a single market and production base”; a, “competitive economic region”; “equitable economic development”; and, “integration into the global economy”, but stops short of the EU-style economic community. A single market and production base encompasses the free flow of goods, services, investments, and skilled labor; freer flow of capital; and 12 priority sectors in goods and services for accelerated development. The competitive economic region encompasses competition policy, consumer protection, intellectual property rights, infrastructure development, taxation, and e-commerce. Equitable economic development is to be achieved through small and medium-sized enterprise (SME) development and the Initiative for ASEAN Integration aimed at capacity building of the CLMV countries. Integration into the global economy is to be achieved through a coherent approach towards external economic relations and enhanced participation in global supply

³ As reported in *Asahi Shimbun* (English language edition), 23 September 2009.

⁴ As reported by Anthony Rowley in *Business Times* on 20 November 2009 during Obama’s visit to Singapore for the APEC Summit and the US-ASEAN Summit. The Japanese government line will continue stressing that the US has a significant role to play in Asia, but without specifying that this should be as a member of an EAC. Moreover, “a cornerstone of an EAC would be an FTA among all its members, and the US Congress has no appetite for an FTA with China, Japan or even South Korea at present.”

networks. In addition, the ASEAN Comprehensive Investment Agreement replaces the AIA, with more liberalization features and inclusion of investment protection.

ASEAN economic integration has to deal with the wide development gaps among its members, which challenges the political will and the capacity to move forward together on integration efforts to meet global and regional challenges. Given its history and political systems, there is also a strong reluctance to cede national sovereignty to accelerate regional integration.

3.3.2 ASEAN Plus One

ASEAN has become an FTA hub. Its diplomatic and economic importance is seen in the number of FTAs/EPAs it has signed or is negotiating with major economic partners. The offer by the PRC to negotiate a comprehensive economic cooperation agreement was closely followed by similar overtures by Japan, Korea, Australia-New Zealand, and India. ASEAN is also negotiating with the European Union and the Gulf Cooperation Council. There is a notable absence of a ASEAN-US agreement so far, although under the ASEAN Enterprise Initiative, the US has implemented a bilateral FTA with Singapore, and is in negotiations with Indonesia, Malaysia, and Thailand, as well as having bilateral trade and investment framework agreements with a number of ASEAN countries. A major problem is that FTAs with the US have to follow a common US template, which includes government procurement, environmental, and labor standards, areas that are highly sensitive to some ASEAN countries. There is also the political issue of Myanmar, although under the Obama Administration the US has agreed to “engage” with the present Myanmar regime.

The five ASEAN agreements with PRC, Japan, Korea, Australia-New Zealand, and India are in various stages of negotiation, ratification and implementation. They are all FTA-plus and WTO-plus agreements as they include not only trade in goods and trade in services, but also other features. In all cases, the framework agreements provide for economic cooperation and technical assistance in a wide number of areas, as well as special and differential treatment for the low income members of ASEAN. An emerging problem is that there is no common template, in particular no common rules of origin, standards, and exclusion lists, reflecting the sensitivities and bargaining strengths of the respective countries. This makes convergence problematic and gives rise to the “noodle bowl” effect.

The negotiating process also varies. While some are single undertakings, others are being negotiated and implemented in phases, with trade in goods followed by trade in services and, finally, investment.

- *ASEAN-China Comprehensive Economic Cooperation* is an agreement among developing countries and is notified to the WTO under the Enabling Clause. It started with a 3-year “early harvest” program of liberalization mainly in agricultural products. Initially an expressed single undertaking, the goods agreement was actually completed first, followed by the services agreement and the investment agreement. Notably, ASEAN agreed to treat the PRC as a “market economy”. The PRC has also signed bilateral FTAs with Thailand and Singapore.
- *ASEAN-Japan Economic Partnership Agreement* is a developed and developing country agreement notified to the WTO under General Agreement on Tariffs and Trade Article XXIV and General Agreement on Trade in Services Article V. It is an umbrella agreement of bilaterals between Japan and individual ASEAN countries. Bilateral EPAs have been completed with Singapore, Philippines, Indonesia, Malaysia, Viet Nam, and Brunei Darussalam but there appears to be no common template among them, contributing to a noodle bowl problem.⁵ Among the key

⁵ Dr Ponciana Intal Jr, at the ADBI Conference on Asian Architecture and Global Governance on 29–30 October 2009 also pointed to the unequal bargaining leverage of developing ASEAN countries vis-à-vis developed Japan, resulting in the perception that some ASEAN countries achieved better deals than others. He

features are the concession for entry into Japan of selected professionals, mainly in the health care sector from the Philippines and Indonesia, and cooks and artisans from Thailand, as well as Japan's offer of economic and technical assistance and capacity building, particularly to the CLMV countries.

- *ASEAN-India Comprehensive Economic Cooperation*: India offered ASEAN a trade pact in November 2002, presumably as part of its "Look East" strategy. ASEAN welcomed the initiative as India is a rising economic power in the region. A framework agreement was signed in October 2003. The FTA on goods involved prolonged negotiations. India has high agricultural tariffs of 70%–100% and many small and marginal farmers, and resisted tariff cuts on a range of products of strong export interest to some ASEAN members. Initially India presented an exclusion list of 1,414 products (including textiles, rice, vegetable oil, and petroleum products) that represented 44% of ASEAN's total exports to India in 2004 and affecting 80% of Malaysian exports to India. The FTA on goods was finally signed in August 2009. It allows for reduction of tariffs on highly sensitive items and special products including palm oil, pepper, coffee, and black tea by 2019. Tariff rates on items sensitive with the ASEAN5 (that is excluding Singapore) and important to India's trade system will be reduced gradually until 2016; rates on Normal Track 1 items will be reduced and finally eliminated by 2013 and by 2016 for Normal Track 2 items. ASEAN countries like Cambodia and Myanmar receive 3–5 years longer to achieve the same tariff goals. There is also an exclusion list, which will be reviewed every year. Negotiations on services and investment are ongoing and are expected to be concluded by August 2010.

3.3.3 Japan–People's Republic of China–Korea Trilateral or Bilateral Agreement?

There is as yet no Japan–PRC–Korea trilateral or bilateral FTA, although feasibility studies and discussions have been ongoing for quite a while, and reflect historical mistrusts as well as ongoing economic rivalries. However, negotiation on a trilateral agreement is expected to be initiated in 2010.

4. RATIONALE AND CHALLENGES OF A REGION-WIDE FREE TRADE AGREEMENT

Asia is a huge and diverse economic region, and it would be best to examine an FTA for East Asia first, before embarking on the larger and more ambitious Pan-Asia FTA or Asia Pacific FTA. The region-wide approach is superior to the hitherto subregional and bilateral approaches to FTA formation, in terms of both the static welfare effects from trade creation and trade diversion and the dynamic effects from increased competition, economies of scale, and utilization of economic resources.

4.1 Case/Rationale for Region-Wide Free Trade Agreement

There are geopolitical and economic reasons for establishing a region-wide FTA and economic cooperation in East Asia:

4.1.1 Political Gains

The ASEAN experience has shown the usefulness of economic cooperation and integration in reducing geopolitical tensions and conflicts. A large grouping would also increase the East Asian voice in international organizations and forums. The Joint Expert Group on EAFTA

concluded that Japan's approach of bilateral EPAs was less salutary than a reliance on purely ASEAN-Japan EPA similar to an ASEAN-PRC FTA or ASEAN-Korea FTA.

Phase II Study (2009) also argues that EAFTA would increase awareness of common destiny, institutionalize dialogues and contracts, and increase mutual understanding and cooperation.

4.1.2 Economic Gains

Economic gains include increased market access to goods, services, skills, and technology; increased market size to permit specialization and realization of economies of scale; FDI activities and technology transfer of MNCs, and simplification of rules of origin, tariff schedules and standards. Various computable general equilibrium (CGE) modeling studies⁶ have shown that a larger region-wide FTA will result in more economic benefits than smaller bilateral and plurilateral FTAs. The region-wide FTA, with the removal of barriers to trade and investment and freer flows of capital and labor, will facilitate regional production networks and supply chains and incentivize individual countries to undertake reforms and economic restructuring to better meet the challenges of globalization, as well as regionalism and protectionism in the Americas and Europe.

The case for a regional agreement also rests on the continued progress of market-driven integration and on managing its consequences. It can help eliminate remaining barriers on trade and investment transactions, encourage behind-the-border regulatory changes that affect integration, manage the spillovers generated by their close links, and coordinate positions to secure the best possible terms in wider regional and global negotiations (Petri 2008). A larger and integrated market with reduced investment barriers would spur entry of more FDIs into natural resources, manufacturing, and services, as well as infrastructure development to improve regional spatial connectivity.

4.1.3 Countering the “Noodle Bowl” Effect

A region-wide FTA holds possibilities for compatible rules of origin (ROOs), product and technical standards, and conformance requirements, thus avoiding market fragmentation and a “noodle bowl” effect from the proliferation of multilayered and overlapping FTAs. At present, each FTA/EPA has its own ROO regime. Harmonization of ROO regimes could also focus on the issuance of Certificates of Origin (such as self-certification), and enhancing cumulation rules for FTAs. Electronic customs clearance can dramatically reduce transaction costs. Product standards and conformity assessment measures could also be harmonized or mutually recognized on a region-wide basis.

The Joint Expert Group EAFTA Phase II Study argues that an important rationale is to overcome the proliferation of FTAs that impairs regional production networks and intra-regional trade through the noodle bowl effect. It is recognized that establishing compatibility across the large number of plurilateral and bilateral FTAs would be difficult in practice and that it may be necessary to progress step-by-step.

4.1.4 Facilitate the rebalancing of growth in East Asia

The global crisis has led to sharp declines in East Asian export demand from the US and Europe and demands policies to rebalance growth. East Asian countries, then, need intra-regional trade to support East Asia against external shocks and sustain regional economic growth.

4.2 Computable General Equilibrium Modeling Results

In traditional customs union theory, a customs union can contribute to more efficient allocation of resources within the region, but possibly at the expense of resource allocation

⁶ See for example, Kawai and Wignaraja (2007).

between members and non-members, thus making the welfare implications ambiguous. Viner argued that trade diversion costs take place if the formation of a customs union causes a member to switch imports from a low-cost non-member to a higher-cost member; on the other hand, trade creation benefits take place if a member imports more from another member who is also a low-cost supplier. Besides the static welfare effects, the customs union also confers several dynamic benefits due to increased competition, economies of scale, stimulus to investment, and better resource utilization. However, the Vinerian focus often seems inadequate as the majority of recent economic agreements involve much investment liberalization and facilitation and many behind-the-border liberalization issues.

Empirical studies of FTAs have used CGE models to quantify the income and welfare effects of eliminating import tariffs on goods trade and liberalizing cross-border services trade, as well as sector-level gains and losses, and to perform an analysis of the future of economic integration in the region.⁷ Depending on the CGE model employed (and the data sets used), these studies differ in their estimates of the welfare gains to members and losses to non-members from an East Asia FTA. Serious shortcomings are the studies' inability to incorporate ROO and NTBs and the liberalization of services trade barriers, as well as their inability to incorporate an FTA's dynamic investment effects. ROOs and NTBs could protect domestic industries far more than import tariffs. It is also common knowledge that all ASEAN countries view the positive investment effects as a major benefit of signing on to FTAs. Thus Kawai and Wignaraja (2007) caution that CGE studies are best used in conjunction with other empirical tools such as analyses of the complex structure of FTAs and enterprise perception studies of the benefits of FTAs. Their CGE study incorporates trade in services and trade facilitation. Their scenarios for EAFTA (ASEAN+3) and CEPEA (ASEAN+6) as well as for ASEAN-PRC, ASEAN-Japan and ASEAN-Korea are shown in Table 4.

⁷ For a list of CGE studies on ASEAN, ASEAN+1 and ASEAN+3, see Kawai and Wignaraja (2007).

Table 4: Income Effects of Alternative Plurilateral Free Trade Agreement Scenarios

	Compared to 2017 baseline (at constant 2001 US dollar)									
	ASEAN+PRC FTA		ASEAN+Japan FTA		ASEAN+Korea FTA		ASEAN+3 FTA		ASEAN+6 FTA	
	US\$ million	% change	US\$ million	% change	US\$ million	% change	US\$ million	% change	US\$ million	% change
ASEAN:	44,211	3.72	28,831	2.43	8,088	0.68	62,186	5.23	67,206	5.66
Indonesia	6,924	2.30	2,834	0.94	1,475	0.49	7,884	2.62	8,588	2.86
Malaysia	7,551	4.02	4,453	2.37	1,339	0.71	10,391	5.54	11,869	6.33
Philippines	2,556	2.13	1,915	1.59	630	0.52	3,177	2.64	3,431	2.85
Singapore	6,854	4.13	3,171	1.91	793	0.48	7,943	4.79	9,002	5.43
Thailand	16,324	7.39	14,107	6.39	2,640	1.20	26,728	12.10	28,346	12.84
Cambodia	68	0.75	30	0.33	15	0.16	107	1.20	109	1.21
Viet Nam	3,371	4.68	2,119	2.94	1,136	1.58	5,293	7.35	5,490	7.63
Others	563	0.50	203	0.18	60	0.05	661	0.59	370	0.33
Northeast Asia:	9,756	0.11	18,624	0.21	7,256	0.08	165,720	1.85	172,087	1.93
PRC	19,103	0.58	(4,475)	(0.14)	(2,351)	(0.07)	41,502	1.26	43,598	1.33
Japan	(3,965)	(0.08)	24,943	0.51	(1,308)	(0.03)	74,825	1.54	77,137	1.59
Korea	(5,382)	(0.67)	(1,844)	(0.23)	10,916	1.37	49,393	6.19	51,351	6.43
Other "East Asia":										
Australia	1,046	0.18	(1,204)	(0.21)	(9)	0.00	(2,376)	(0.41)	22,546	3.91
New Zealand	166	0.21	(73)	(0.09)	12	0.02	(216)	(0.27)	4,136	5.24
India	(809)	(0.10)	(658)	(0.08)	(370)	(0.05)	(2,371)	(0.30)	19,270	2.42
World	81,998	0.17	45,134	0.09	14,173	0.03	213,919	0.45	259,837	0.54

PRC = People's Republic of China. () = negative.

Source: Kawai and Wignaraja (2007), Chia (2009).

Plummer and Wignaraja (2007), using ADB's General Equilibrium Model for Asian Trade considered six policy scenarios.⁸

1. Fragmentation scenario: continuation of present bilateral and plurilateral FTAs. This is the least attractive for all regions and countries and may give rise to the noodle bowl effect.
2. ASEAN+3 FTA scenario: free trade among ASEAN PRC+Hong Kong, China; Japan; and Korea. In this scenario, the welfare of members increases with Northeast Asia and ASEAN witnessing gains of 0.37% and 2.02% respectively. Non-members would incur modest losses.
3. ASEAN+6 FTA scenario: free trade among ASEAN+3, India, Australia and New Zealand. Northeast Asia (0.58%), and ASEAN (2.06%) would be expected to capture even greater gains than under ASEAN+3. However, non-members would be likely to experience greater losses.
4. Asia-wide FTA scenario: free trade among all Asian countries. Gains would accrue to the rest of Asia, with marginal gains to Northeast Asia and ASEAN and losses to non-members.
5. APEC FTA scenario: free trade among APEC members. Gains would accrue to Northeast Asia and US but ASEAN would have fewer gains compared to Scenario 1. The rest of Asia and Europe outside of APEC would also lose relative to Scenario 1.
6. Global trade liberalization scenario: complete abolition of import tariffs and export subsidies. This is the most attractive but unrealistic scenario, given that even the WTO process has been beset by uncertainties on the timing and depth of any multilateral agreement to reduce trade barriers.

ASEAN+3 and ASEAN+6 would have different impacts on the three Northeast Asian economies. Korea would be expected to see largest gains (3.49%) under ASEAN+3, and increased under ASEAN+6 (3.94%). The PRC+Hong Kong, China would experience small losses under ASEAN+3 which reduce somewhat under ASEAN+6; the expected welfare losses in the PRC are a puzzle and preliminary research has attributed them to special features of regional trading patterns in Asia which induce a deterioration in the PRC's terms of trade. Within ASEAN, the largest gains would accrue to Malaysia, Viet Nam, and Thailand, but gains would fall somewhat for Malaysia and Thailand under ASEAN+6.

Whalley (2006) cautions that the use of gravity models for an analysis of the impacts of the tariff barrier change may yield little if the agreements are complex. Hence the scope of the agreements raises the following questions: What is the coverage of trade in these FTAs? What is the utilization rate of the FTA preferential tariffs? How significant are NTBs and the various WTO-plus provisions?

- **First, how much of trade is covered by the free trade agreements?** Measuring the ratio of a country's bilateral trade with its FTA partners to the country's total trade with the world is relatively easy from available trade data. In East Asia, generally, ASEAN countries have higher trade shares of FTAs than the larger Northeast Asian economies. Both the plurilateral and bilateral FTAs show high degrees of extraregional orientation.
- **Second, utilization of free trade agreement preferential tariffs:** It is more difficult to measure the extent of a country's trade that utilizes FTA preferential

⁸ The estimates of the economic impacts of FTA scenarios were prepared using ADB's General Equilibrium Model for Asian Trade. It has strong microfoundations and captures detailed interactions among industries, consumers, and governments across the global economy and it is ideally suited for the analysis of structural changes over periods that are sufficiently long to allow markets to adjust and rigidities to work themselves out. Among other assumptions, the General Equilibrium Model for Asian Trade incorporates firm heterogeneity, fixed trade costs and imperfect competition.

tariffs because of various exceptions and exclusions, lack of data on utilization rates of tariff preferences, and lack of data on the source and destination of a country's services trade. An ADB study on tariff utilization in a number of East Asian countries shows that utilization rates are generally low, which means that CGE modeling results of tariff reduction or elimination may be overstated (Kawai and Wignaraja 2009a).

A low margin of preference (MOP) between Most Favored Nation (MFN)-applied tariffs and FTA preferential tariffs indicate little incentive for businesses to utilize FTA preferences when set against the administrative costs of obtaining ROO certification. However, for MNCs trading in huge volumes, even a small percentage margin could translate into large dollar amounts saved.

The simple average MFN-applied tariffs are generally much lower than the simple average MFN-bound tariffs. There is wide variation of average MFN-applied tariffs among East Asian countries, ranging from double-digit for Cambodia, Viet Nam, Korea and India at one extreme to zero for Singapore and under 4% for Brunei Darussalam, Australia, and New Zealand at the other extreme (Chia 2009). For each country, there are wide variations in individual tariff rates. The percentage share of HS6-digit subheadings with MFN-applied tariffs varies among ASEAN countries. There are also instances of prohibitive tariffs, with MFN-applied tariffs exceeding 1,000%. The coefficients of variation of MFN-applied tariffs are very high for Singapore, Brunei Darussalam, Japan, and Korea. Hence simple average MFN-applied tariffs give little guidance on MOP at the HS6-digit tariff lines.

- ***Third, significance of non-tariff Barriers and World Trade Organization-plus provisions:*** How significant are the NTBs for trade in goods and in new areas such as services, MRAs, investment, intellectual property, competition policy, and movement of persons? As tariffs have fallen over the years, NTBs (such as customs valuation and procedures) have become more prominent; they are less transparent and quantifiable, and often act as a more serious trade barrier than tariffs. Also, trade in goods is only part of the comprehensive economic partnership and comprehensive economic cooperation agreements; of growing importance are the liberalization of services and investments.

4.3 Challenges of a Region-Wide Free Trade Agreement

In East Asia and the broader Asia Pacific, there are multiple structures with different and sometimes overlapping membership and goals. This reflects a realistic appraisal of the diverse political, cultural, and economic interests in the region. There are several proposals on the table. Given the existing ASEAN+1 agreements, what will be the additional benefits of a region-wide FTA and what kind of region-wide FTA will be available? The challenge is to develop the right framework for regional cooperation and integration. The eventual choice will depend on definition of the "region", the type of economic community or FTA/EPA envisaged, and the political and economic benefits of each proposal. The issues are:

- ***Is there common political vision?*** Countries in East Asia need to be convinced that the political and economic gains of economic cooperation and integration outweigh the costs of surrendering national sovereignty to build common institutions, rules, and disciplines. The deeper the integration envisaged, the greater the need for a common political vision. One lesson from the failure of the Free Trade Area of the Americas (FTAA) negotiations is the lack of a common political vision among the larger participants (Stephenson 2007). In East Asia, while ASEAN has gone some way towards the objective of building the community, countries in Northeast Asia are still plagued by historical mistrusts and economic rivalries, although Japanese Prime Minister Hatoyama has proposed to his counterpart in the PRC a vision of an East Asian community.

- ***How to handle the wide development gaps?*** The region-wide FTA will encompass a broad mix of economies at different levels of economic development and industrial and technological competence. It would be difficult to reach consensus on the scope and speed of achieving a “high quality” FTA and economic partnership. Among the poorer economies and less efficient producers and suppliers, it raises concerns of marginalization; hence governments would be reluctant to open up their less competitive farm sectors, labor-intensive industries, and SMEs without adequate safeguards and financial and technical assistance for capacity building. Among the richer and more competitive economies, there would be public resistance to financial transfers through taxation (as in the case of the EU) in the absence of political and social integration. Still, there are positive aspects to regional diversity. For one, it offers economic complementarities and prospects of specialization and efficient regional production. Also, it enables the smaller and less developed East Asian economies to be part of regional and global production networks and supply chains and enjoy the spill-over effects from regional dynamism and growth.
- ***How to “handle” PRC-Japan-Korea?*** There is still no bilateral or trilateral FTA among PRC, Japan, and Korea where the biggest trade flows take place in the region. A region-wide FTA would not be realized without in effect constituting an FTA among the three countries.
- ***How deep is intra-regional economic linkage?*** East Asian trade and investment activities are oriented towards markets and investors outside the region, particularly North America and Western Europe, although there has been rapid growth of intra-regional trade in recent years. Table 5 shows intra-regional trade in 2007. Only Indonesia has intra-regional exports exceeding 50% under EAFTA and only Indonesia, Malaysia, Singapore, and Australia have intra-regional exports exceeding 50% under CEPEA. However, dependence on intra-regional imports is significantly higher. All EAFTA members, except the PRC and Japan, have intra-regional imports exceeding 50%, while all CEPEA members, except PRC, Japan, and India, have intra-regional imports exceeding 50%. Furthermore, as noted in the Asian Development Outlook 2007 (ADB 2007), product fragmentation in East Asia has resulted in intra-regional trade being dominated by trade in parts and components (72.7%), while trade in final goods is still largely destined for non-regional markets (78.8%).

Table 5: Intra-regional Exports and Imports of East Asia Free Trade Area and Comprehensive Economic Partnership in East Asia in 2006

% of region/country exports to:									
Region/country	ASEAN	PRC	Japan	Rep. of Korea	EAFTA	India	Australia	NZ	CEPEA
Indonesia	16.72	8.49	20.85	6.71	52.77	4.49	3.08	0.33	60.67
Malaysia	23.69	8.84	9.19	3.81	45.53	3.36	3.39	0.43	52.71
Philippines	11.34	4.88	17.46	3.23	36.91	0.43	1.45	0.36	39.15
Singapore	30.30	10.13	4.90	3.63	48.96	3.41	3.82	0.54	56.73
Thailand	17.31	9.77	11.71	1.94	40.73	1.86	3.80	0.41	46.80
Cambodia	3.56	1.67	3.11	0.20	8.54	0.03	0.37	0.24	9.18
Viet Nam	13.66	6.37	11.96	2.75	34.74	0.30	7.31	0.20	42.55
PRC	6.60		8.33	4.55	19.48	1.97	1.48	0.18	23.11
Japan	11.14	14.79		7.55	33.48	0.89	2.03	0.34	36.74
Korea	8.64	21.82	7.08		37.54	1.76	1.25	0.19	40.74
India	7.97	6.39	2.30	1.73	18.39		0.76	0.09	19.24
Australia	9.15	12.16	16.94	7.54	45.79	5.90		5.35	57.04
New Zealand	9.65	5.49	9.49	3.62	28.25	0.72	20.87		49.84
% of region/country imports from:									
Region/country	ASEAN	PRC	Japan	Rep. of Korea	EAFTA	India	Australia	NZ	CEPEA
Indonesia	43.01	13.84	9.32	6.02	72.19	1.98	2.53	0.63	77.33
Malaysia	39.17	13.65	10.79	4.28	67.89	1.24	1.49	0.37	70.99
Philippines	23.11	13.20	15.90	7.46	59.67	0.99	1.46	0.57	62.69
Singapore	23.32	15.17	9.79	6.16	54.44	2.98	1.65	0.24	59.31
Thailand	22.80	11.30	23.15	4.10	61.35	1.42	3.10	0.39	66.26
Cambodia	48.17	20.93	2.51	6.56	78.17	0.03	0.78	0.03	79.01
Viet Nam	25.70	21.57	9.74	10.12	67.13	0.30	1.68	0.48	69.59
PRC	12.12		17.38	14.03	43.53	1.58	2.68	0.24	48.03
Japan	15.24	20.21		5.22	40.67	0.65	4.28	0.48	46.08
Korea	11.09	21.71	20.03		52.83	0.96	3.75	0.36	57.90
India	15.27	15.68	3.94	4.26	39.15		4.88	0.12	44.15
Australia	20.01	13.72	10.43	3.51	47.67	0.82		4.00	52.49
New Zealand	14.14	9.06	9.48	2.92	35.60	0.53	28.35		64.48

PRC = People's Republic of China; NZ = New Zealand; EAFTA = East Asia Free Trade Area; Comprehensive Economic Partnership in East Asia.

Source: compiled from APTIAD database; Chia (2009).

- **Unraveling the noodle bowl?** Petri (2008) argues that the steps required to multilateralize a complex of FTAs could require difficult negotiations. First, many of the FTAs in place are far from comprehensive. Even a full set of comprehensive FTAs would differ from a global agreement in ROOs, which limit preferences to exports primarily produced in the exporting economy. ROOs could thus impose tariffs on products that result from production chains spanning several countries within a bilateral FTA network. Major international firms now run extensive arrays of production sites and so have a strong interest in eliminating ROOs that limit their ability to allocate production efficiently among operations. Each country would have many sensitive sectors and products. Hence it is politically burdensome for governments to embark on formation of a region-wide FTA — these countries have just concluded important plurilateral and bilateral FTAs within a short period of time, and their economic benefits have yet to be materialized. Additionally, for some countries there are ongoing FTA negotiations to cope with. So the governments are also under administrative strains.

4.4 How to Move Forward: East Asia Free Trade Area or Comprehensive Economic Partnership in East Asia?

Both EAFTA and CEPEA are ASEAN-centric proposals on East Asia. Both are comprehensive economic partnership agreements with FTA-plus and WTO-plus features, and include special and differential treatment and economic cooperation provisions to assist low-income countries. The PRC has long favored ASEAN+3, while Japan has proposed an ASEAN+6 configuration. This has split the ASEAN membership, with some favoring ASEAN+3 and others favoring ASEAN+6. It is noted that both proposals exclude the politically sensitive membership of Hong Kong, China and Taipei, China.

ASEAN+3 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 later the regional surveillance mechanism and the Asian Bond Market Initiative. The EAFTA or ASEAN+3 was first proposed by the East Asian Vision Group in 2001 and comprises the countries of ASEAN10, PRC, Japan, and Korea. There was the 2001 Report of the East Asia Vision Group and the 2002 senior officials Report of the East Asia Study Group. The latter report was adopted at the ASEAN+3 Summit in 2002 and contains medium- and long-term measures such as the convening of an East Asia Summit and an expert group to study the feasibility of an East Asia FTA. The expert group was appointed in 2005 and submitted its first report in mid-2006 and final report in 2009. The final report stressed the need to adopt a common ROO.

The East Asia Summit (EAS) was convened in Kuala Lumpur in December 2005⁹ followed by Cebu in January 2007 and Singapore in November 2007, with the participation of ASEAN+3 countries as well as Australia, New Zealand, and India. The fourth EAS was held in Hua Hin (Thailand) in October 2009. CEPEA, or ASEAN+6, was first proposed by Japan in 2006, and stretched the definition of East Asia to include the EAS members of India, Australia, and New Zealand. Regarding the question of why Japan is pushing ASEAN+6 despite the existence of ASEAN+3, it would seem to arise out of Japanese concerns that the PRC's rapid economic growth and huge market was exerting an overwhelming influence on political and economic trends.¹⁰ More recently, the PRC is playing a bigger role in regional financial cooperation, a position that used to be occupied by Japan, especially after the 1997 Asian financial crisis. The CEPEA option would result in a larger trade creation effect than EAFTA. Including Australia, New Zealand, and India would reduce the leadership competition between the PRC and Japan in an East Asia FTA. However, this option would also have difficulties in that most ASEAN countries as well as PRC, Australia, and New Zealand have comparative advantages in agriculture, while Japan, Korea, and India are highly protectionist in agriculture. The less developed ASEAN countries are concerned about opening up their economies to competition from PRC, Japan, and Korea as well as Australia, New Zealand, and India without prior capacity building to improve their supply-side competitiveness.

Table 6 shows both EAFTA and CEPEA. They encompass countries marked by a wide diversity in size of population and GDP, level of development as proxied by per capita GDP, and trade openness. CEPEA would encompass the most populous trade bloc in the world. CGE modeling results by Kawai and Wignaraja (2007) show that CEPEA confers more benefits and less negative trade diversion effects than the smaller EAFTA. For ASEAN, the gains are bigger under CEPEA, and under both scenarios the largest percentage gains are by Thailand followed by Viet Nam and Malaysia with the smallest gains by the CLMV

⁹ Russia was invited to the First East Asia Summit as observer.

¹⁰ Some media reports suggest that Japan was motivated by the need to counterbalance the PRC. However, Dr Masahiro Kawai pointed out at the ADBI Conference on Asian Architecture and Global Governance on 29-30 October 2009 that ASEAN+6 was also at the request of Japanese businesses with operations in Australia and ASEAN.

countries. For PRC, Japan, and Korea, the gains are bigger under CEPEA; under both scenarios, Korea has the largest percentage gains. As non-members, Australia, New Zealand, and India experience losses (trade diversion effects) under EAFTA, with the largest percentage loss by Australia. However, they gain as members in the CEPEA scenario, with New Zealand having the largest percentage gains.

Table 6: ASEAN's Free Trade Agreement Partners in ASEAN Plus One Agreements

	Population 2007 million	GNI size 2007 US\$ billion	GNI per capita 2007 US\$	Exports 2007 US\$ billion	Imports 2007 US\$ billion	Total trade 2007 US\$ billion
ASEAN-10	564	1,144.6	2,029	863.3	773.2	1,636.5
PRC	1,320	3,120.9	2,360	1,217.9	955.8	2,173.7
ASEAN-PRC	1,884	4,265.5	2,264	2,081.2	1,729.0	3,810.2
ASEAN's % share	29.9	26.8	89.6	41.5	44.7	43.0
Japan	128	4,813.3	37,670	712.8	621.0	1,333.8
ASEAN-Japan	692	5,957.9	8,610	1,576.1	1,394.2	2,970.3
ASEAN's % share	82	19.2	23.6	54.8	55.5	55.1
Rep. of Korea	49	955.8	19,690	371.6	356.6	728.2
ASEAN-Korea	613	2,100.4	3,426	1,234.9	1,129.8	2,364.7
ASEAN's % share	92	54.5	59.2	69.9	68.4	69.2
PRC-Japan-Rep. of Korea	1,497	8,890.0	5,939	2,302.3	1,933.4	4,235.7
ASEAN-10	564	1,144.6	2,029	863.3	773.2	1,636.5
ASEAN's % share	37.7	12.9	34.2	37.5	40.0	38.6
Australia-New Zealand	25	877.5	35,100	168.1	196.2	194.1
ASEAN-Australia-New Zealand	589	2,022.1	3,433	1,031.4	969.4	1,830.6
ASEAN's % share	96	56.6	59.1	83.7	79.8	89.4
India	1,123	1,069.4	950	145.2	216.7	361.9
ASEAN-India	1,687	2,214	1,312	1,008.5	989.9	1,998.4
ASEAN's % share	33	51.7	154.6	85.6	78.1	81.9
United States	302	13,886.5	42,740	1,163.2	2,017.0	3,180.2
ASEAN-US	866	15,031.1	17,357	2,026.5	2,790.2	4,816.7
ASEAN's % share	65	7.6	11.7	42.6	27.7	34.0

PRC = People's Republic of China.

Source: Author's compilation from trade statistics.

4.4.1 East Asia Free Trade Area Study Report

The Joint Expert Group on EAFTA Phase II Study (2009) has recommended the following to realize EAFTA:

- An EAFTA would need to have the following qualities and elements: high quality in terms of market access for goods and services; global standard investment agreements; comprehensive and concrete trade/investment facilitation measures; cooperation measures for less developed countries; simple and liberal ROOs with full cumulation; and an organized plurilateral FTA with common modalities and a dispute settlement mechanism, rather than the sum of numerous bilateral FTAs.
- It should be negotiated among 13 countries using the existing ASEAN+1 FTAs as a reference. Given the number and diversity of members, it would not be easy to launch without strong political leadership. It could begin with consolidation of existing ASEAN+1 FTAs, with the following features and principles: First, it should produce additional tangible benefits by enhancing both intraregional trade and production networks in East Asia. Second, it should be feasible, demanding minimum political and administrative burdens to the governments of member

countries. Third, it should be friendly to the less developed countries, providing special and focused efforts to enable them to effectively participate in and benefit from an EAFTA. Fourth, it should have simple and liberal ROOs. Fifth, to minimize political and administrative burdens, instead of renegotiating tariff elimination schedules and service liberalization from scratch, it should consolidate the existing AFTA, ASEAN-PRC (ACFTA), ASEAN-Korea (AKFTA) and ASEAN-Japan (AJCEP). Since there is no bilateral FTA among PRC-Japan-Korea, full negotiations should be done among themselves. Finally, it would be necessary to ensure that an EAFTA become a building block towards establishment of an open global trading environment.

- Major recommendations of the report are: First, a gradual and realistic strategy should be pursued. Initially, existing FTAs should be consolidated and a unified ROO regime be created and the multiple tariff concessions and commitments made in AFTA and the ASEAN+1 agreements should be harmonized (to the extent possible). Since ACFTA and AKFTA include agreements on trade in services and investment, further work would be needed to incorporate trade in services and investment in the EAFTA. Second, concrete trade and investment facilitation measures should be implemented to enable all participating countries, especially the less developed, to fully realize the benefits of an EAFTA. These could include ROO-related measures, customs procedures and standards, with specific cooperation programs directed to them. Third, the overall EAFTA negotiations should be launched at the latest by 2012.

Proponents of “gradualism” favor a sequential approach in expanding the membership of an initial East Asia FTA. With AFTA already in place, EAFTA is viewed by many as the next logical phase, to be followed by CEPEA. It is critical that India, Australia, and New Zealand have firm foundations for cooperation in place, and they need to speed up FTA negotiations with ASEAN.

There are several challenges to be met in a progression from an EAFTA to a CEPEA. First, there are serious problems with consolidation and/or convergence of the various ASEAN, ASEAN+1 and bilateral FTAs in East Asia with respect to scope and coverage of trade, services, and lists of exclusions; ROOs, technical barriers, and product standards as well as mutual recognition of service providers; and FDI and other WTO-plus provisions. Second, once the template is set by ASEAN+3, it would be difficult for accession by Australia, New Zealand, and India to result in ASEAN+6. The late joiners may not like nor be in a position to accede to all the agreements settled in ASEAN+3. If the level of integration is confined to trade and investment, then progression from ASEAN+3 to ASEAN+6 over a period of time would not pose a serious problem as the more protectionist members would eventually conform. However, monetary and financial integration, community building, and a common political vision that includes India, Australia, and New Zealand would require a longer timeframe. Third, ASEAN must act as the regional hub. It is a non-threatening subgroup “trusted” by PRC, Japan, Korea, India, Australia, and New Zealand and can balance the hegemonic ambitions of the large countries. However, to counter centrifugal forces from the larger economies, the ASEAN countries need to deepen their own economic integration process. Fourth, relationships with the US and EU are important for the region. One possible approach is for East Asia to strengthen economic ties with the US through East Asia-NAFTA or APEC FTA and with the EU through the ASEM process. On the part of East Asia, there are reservations among some countries of an FTA with the US; likewise, on the part of the US there are possible reservations on an FTA that includes the PRC, while Myanmar is problematic for both the US and EU.

4.4.2 Comprehensive Economic Partnership in East Asia Study Report

At the Second EAS in January 2007, it was agreed to launch a Track Two study on CEPEA among EAS economies to deepen integration. The CEPEA Phase I Study Report¹¹ was submitted to CEPEA economic ministers in August 2008 and to the EAS in December 2008. The Phase II Study Report was submitted to the EAS Economic Ministers in Bangkok on 15 August 2009, at the same time that the EAFTA Phase II Report was received. The divided positions of ASEAN members as well as PRC, Japan and Korea are reflected in the ASEAN Summits in Hua Hin, Thailand in October 2009. No definitive conclusion has been reached on the choice between EAFTA or CEPEA and the next stage is the formation of an official study group to review the two proposals together.

The objectives of CEPEA are set out as deepening economic integration, narrowing development gaps, and achieving sustainable development through the three pillars of economic cooperation, trade and investment facilitation, and trade and investment liberalization, as well as institutional developments. Recommendations of the report are:

- The structure of CEPEA should be composed of the three pillars of economic cooperation, trade and investment facilitation, and trade and investment liberalization. Discussions should begin among East Asian governments on cooperation and facilitation measures and on work plans for collective actions in areas such as environment, energy, logistics, and facilitation issues.
- Discussions should begin immediately among the governments of member countries on concrete steps to realize CEPEA as a comprehensive framework that includes cooperation, facilitation, and liberalization. These steps should include an institutional development aspect, where inputs from the private sector and experts are weighed adequately.
- The scope of the discussions should include stocktaking of cooperation measures and implementing status of existing ASEAN+1, practical issues on trade such as streamlining of procedures and harmonization of ROOs, and a concrete timeframe for future negotiated cooperation, facilitation and liberalization measures.

Nezu¹² highlights the problem with CEPEA. Unlike the countries in ASEAN, countries such as Japan, PRC, Australia, and India have yet to conclude bilateral FTAs among themselves. For Japan, bilateral FTA negotiations with Korea, Australia, and India have progressed while those with the PRC and New Zealand have not begun. Korea seems unenthusiastic about FTA negotiations with Japan, as the latter's tariffs on industrial products have already been reduced to zero or near zero; on the other hand there are concerns that eliminating Korea tariffs would allow Japanese industrial products to flood the Korean market. Japanese opposition to the liberalization of agricultural products with Australia and New Zealand is strong, while their counterparts regard Japan's requests to exclude agricultural products from negotiation as unacceptable.

4.5 How to Move Forward: A Pan-Asia FTA Scenario?

India is keen not only to join an East Asia-wide FTA, but also to promote a Pan-Asia FTA scenario.¹³ Nagesh Kumar (2006) argues the need for an overarching Pan-Asia framework to facilitate exploitation of considerable synergies for mutual benefit. There are substantial welfare gains from economic integration in scenarios of progressive integration, with welfare gains up to 3% of the region's GDP. Integration also offers Asia great potential for rapid and

¹¹ Report of the Track Two Study Group on Comprehensive Economic Partnership in East Asia, Final Version, 20 June 2008. Monograph.

¹² Risaburo Nezu, Fujitsu Research Institute, 9 September 2009. Nezu chairs the Phase I and Phase II of the CEPEA Study Report.

¹³ India has also expressed an interest in joining APEC.

sustained growth, a lead in economic convergence, rising growth rates, and benefits for poorer countries. It will also transfer the growth stimulus from the PRC and India to their neighbors. Kumar also argues the case for an ASEAN+3+India or Japan-ASEAN-PRC-India-Korea (JACIK) scenario. Francois and Wignaraja (2008) have undertaken a CGE model to estimate the effects of JACIK and a region-wide FTA including South Asia in ASEAN+3 (see Table 7).

Table 7: National Income Effects (compared to 2017 baseline)

	ASEAN+3		ASEAN+3+India		ASEAN+3+South Asia	
	US\$ million	%	US\$ million	%	US\$ million	%
Northeast Asia						
PRC	41,502	1.3	43,289	1.3	43,454	1.3
Hong Kong, China	(1,051)	(0.3)	(1,713)	(0.5)	(1,811)	(0.6)
Japan	74,825	1.5	78,080	1.6	78,650	1.6
Korea	49,393	6.2	51,545	6.5	52,100	6.5
Taipei, China	(10,493)	(2.0)	(10,770)	(2.1)	(10,957)	(2.1)
Southeast Asia						
Cambodia	107	1.2	106	1.2	79	0.9
Indonesia	7,884	2.6	8,818	2.9	9,090	3.0
Malaysia	10,391	5.5	12,014	6.4	12,376	6.6
Philippines	3,177	2.6	3,521	2.9	3,495	2.9
Singapore	7,943	4.8	9,285	5.6	9,717	5.9
Thailand	26,728	12.1	28,220	12.8	28,534	12.9
Viet Nam	5,293	7.4	5,449	7.6	5,428	7.5
South Asia						
Bangladesh	(297)	(0.3)	(355)	(0.3)	1,874	1.7
India	(2,371)	(0.3)	17,779	2.2	18,240	2.3
Pakistan	(824)	(0.5)	(862)	(0.6)	298	0.2
Sri Lanka	(117)	(0.4)	(123)	(0.4)	631	2.0
Others						
Australia	(2,376)	(0.4)	(2,946)	(0.5)	(2,987)	(0.5)
New Zealand	(216)	(0.3)	(183)	(0.2)	(169)	(0.2)
EU27	6,786	0.1	9,248	0.1	10,300	0.1
United States	(4,966)	0.0	(3,214)	0.0	(1,924)	0.0

PRC = People's Republic of China. EU = European Union. () = negative.

Source: Francois and Wignaraja (2008), Economic Implications of Asian Integration.

4.5.1 ASEAN+3+India Scenario

The CGE model shows that when the ASEAN+3 scenario is expanded to include India (JACIK), some additional gains are visible for East Asia. PRC, Korea, and Japan would collectively gain US\$7.2 billion from the inclusion of India compared to ASEAN+3. ASEAN economies also gain US\$5.7 billion more, with Thailand, Malaysia, and Singapore benefiting somewhat more than others as a percent of 2017 baseline GDP. India would gain strongly with 2.2% of baseline income. Negative effects on India's South Asian neighbors are magnified relative to the ASEAN+3 scenario. India's exports would see a tremendous boost, equal to 21.3% of baseline exports, while there would be a negative impact on other South Asian exporters.

Kumar argues that welfare gains would be significantly higher for all partners in JACIK than in a framework excluding India and gains to the region would be higher than India's gains, possibly due to the dynamism and synergies that India brings in terms of services and software to the hardware and manufacturing prowess of East Asia. East Asia has emerged as India's largest trade partner with the Indian economy getting increasingly integrated with East Asian production chains, especially in knowledge-based segments such as chip design, embedded software, and research and development. Indian companies are also evolving

Asian production networks; complementary demographic trends; and geographic, historical, and cultural bonds with East Asia. The share of East Asia's trade in India is near one-third of India's total trade, with East Asia taking precedence over EU or US as a leading trade partner.

4.5.2 ASEAN+3+ South Asia Scenario

The CGE model under this scenario shows substantial gains for South Asia. India and Pakistan are projected to see exports rise by 22.7% and 7.0% respectively. The South Asian economies already have trade directed toward East Asia, reflecting the higher incomes and greater size of export markets in East Asia. This means that for most of the economies of South Asia, deeper integration with East Asia has the potential to bring modest income gains along with associated export growth. Also, for the South Asian economies, it is clear that if India looks East, they need to follow suit.

On the other hand, it matters little for most East Asian economies, as their projected gains are mostly within East Asia. Malaysia, Singapore, and Thailand, which geographically bridge East Asia and South Asia, enjoy more substantial projected gains. Most of the East Asian gains follow directly from India's membership; the other South Asian countries have only a limited impact on East Asia. Hence Francois and Wignaraja conclude that the politics will be complex, with East Asian countries gaining most from access to India, while South Asian economies stand to gain if India makes sure their full region is included.

4.6 How to Move Forward: An APEC Free Trade Agreement or an Expanded Trans-Pacific Strategic Economic Partnership Scenario?

Unlike the earlier proposals which are ASEAN-centric, the APEC Free Trade Agreement (FTAAP) and Expanded Trans-Pacific Strategic Economic Partnership (TSEP) arrangements are trans-Pacific.

The Asia Pacific Economic Cooperation (APEC) forum was formed in 1989 to promote trans-Pacific economic cooperation. Its current membership of 21 economies represents diverse political and economic systems and development levels. Unlike EAFTA and CEPEA, it includes Hong Kong, China and Taipei, China but excludes the ASEAN economies of Cambodia, Lao PDR, and Myanmar as well as India. APEC's founders opted for open regionalism, with voluntary and unilateral trade and investment liberalization to achieve the Bogor goals of free trade for the developed economies by 2010 and for the developing economies by 2020. Attainment of the Bogor goals is so far illusory, although there are Individual Action Plan peer reviews of APEC economies. The focus of action in recent years has been the high profile, annual APEC Leaders Summit and trade and investment facilitation, as well as economic and technical cooperation projects.

An APEC Business Advisory Council proposal for an FTAAP has so far met with lukewarm response. Bergsten (2007) argues in favor of an FTAAP: first, the Doha Round is faltering badly and an FTAAP launch could catalyze the round. Also, it offers an alternative and fall-back plan should Doha fail. Second, it would provide the largest single liberalization in history, prevent competitive liberalization in the Americas, prevent a split in the Pacific, and remove the problem of FTA proliferation and the noodle bowl effect in the Asia Pacific. Third, it would channel the PRC-US economic conflict into a more constructive and less confrontational context. Fourth, it would help revitalize APEC.

Critics argue that the FTAAP proposal would fundamentally change the nature of APEC into a negotiating forum. Aggarwal (2007) also argues that successful negotiation of a high-quality FTAAP is not politically feasible at present or in the near term due to growing protectionist tendencies in the US Congress, and, in particular, the highly controversial American trade deficit with the PRC. Also, priority interests in the PRC and Japan appear to

favor an East Asia FTA. Even if there were a unity of vision among PRC, Japan, and US, the negotiations would take several years and would tie up negotiating resources and cause postponement of other negotiations that are of high priority to some key APEC economies. In ASEAN, some countries are not at all prepared politically or otherwise, to enter into an undertaking of the magnitude of an FTAAP. Second, to be of “high quality”, the FTAAP must also cover highly sensitive sectors such as agriculture and complicated behind-the-border issues. However, APEC is large and diverse and encompasses many protectionist interests. To achieve a high-quality FTAAP would be much more politically demanding than the Doha goals; hence there is no particular advantage to the FTAAP. The FTAAP carries high risks of diverting rather than galvanizing the Doha Round.

In 2006, APEC members endorsed the FTAAP as a long-term prospect for the region. Since then, APEC has been studying various options for achieving the FTAAP including streamlining the ROOs among existing FTAs to minimize the noodle bowl effect, reducing compliance costs and increasing FTA utilization rates, and docking-merging-enlarging some of the existing FTAs so that they form a larger regional FTA over time. At the APEC 2009 meetings in Singapore in November, APEC Ministers requested further studies on the possible benefits and challenges of establishing an FTAAP (APEC Secretariat 2009).

In the interim, greater attention should be given to the expansion of the existing TSEP. The TSEP encompasses the four relatively small and open APEC economies of Brunei Darussalam, Chile, New Zealand, and Singapore. The unique features of TSEP are its trans-Pacific membership, its openness to accession by other APEC members,¹⁴ and its “big bang” approach to trade in goods liberalization. For the latter, Singapore has MFN zero tariffs; New Zealand would immediately eliminate all tariffs; Chile would immediately eliminate 89.3% of its tariffs, 9.57% within 3 years, and the remaining 1.13% within 6 years; and Brunei Darussalam would eliminate 99% of its tariffs phased in over time. There are breakthroughs in agricultural trade liberalization, notable since Chile and New Zealand are both southern hemisphere agricultural exporters. For services trade liberalization, TSEP adopts the more liberalizing negative list approach. There is no investment chapter. There are cooperation commitments in various areas as well as a labor cooperation memorandum of understanding, and an environmental cooperation agreement. The value-added effect of the TSEP agreement seems small, as they cover four small and already very open APEC economies that are also actively engaged in other plurilateral and bilateral FTAs. However, a “coalition of the willing” could expand the high-quality TSEP into a widening circle of APEC economies, particularly if some larger APEC economies such as the US signal interest in joining.

The US first committed to the TSEP talks in the final months of the George W. Bush Administration, triggering interest in TSEP also from Australia, Peru, and Viet Nam. The first round of negotiations with the US was scheduled for March 2009, but was postponed pending a thorough review of US trade policy under the new Obama Administration. Elms (2009) noted that by early November there were signs that the US would favor action on the TSEP due to three factors. First, was the signing of the FTA between the EU and Korea. Second, the ASEAN+3 and ASEAN+6 were starting to pick up steam. Japan’s proposal for an East Asian community and Australia’s proposal for an Asia-Pacific community would further marginalize the US. Third, the TSEP would give the US a seat at the economic table and a more meaningful engagement than APEC. Hence, at a meeting in Tokyo in November 2009, prior to the APEC Summit in Singapore, President Obama announced, “The United States will also be engaging with the Trans-Pacific Partnership countries with the goal of shaping a regional agreement that will have broad-based membership and the high standards worthy of a 21st century trade agreement.”¹⁵ However, skeptics note that

¹⁴ Initial negotiations were among Chile, New Zealand, and Singapore. Brunei Darussalam joined at a later stage.

¹⁵ President Barack Obama in a speech in Tokyo prior to attending the APEC Summit on 15 November 2009 in Singapore. The USTR clarified that the US was going to participate in formal negotiations.

President Obama has to deal with the issue of high US unemployment and a protectionist Congress back home. Further, the TSEP would have to incorporate stronger labor and environmental provisions that would not go down well with some APEC economies.

4.7 How to Move Forward: A Multi-Track Scenario?

A negative noodle bowl effect from multiple and overlapping FTAs in East Asia has been widely discussed in the literature. However, Petri (2008) suggests that Asian FTAs can be more constructively seen in terms of a trade agreements matrix, in which multiple negotiations produce an orderly progression of agreements to liberalize all potential bilateral relationships and move the region toward a coherent system of freer trade. The various approaches to deeper economic integration are complementary paths that should eventually lead to deeper international integration and an open global trading system.

Petri notes that the real policy challenge is to ensure that these efforts evolve consistently, without sacrificing continued integration with any key trading partner. Bilateral and multilateral negotiations are already so far advanced that an aggressive multi-track strategy (parallel regional, trans-Pacific and global initiatives) may be the only way to create a new global framework and could potentially make that possible more rapidly than skeptics anticipate. Petri argues that the network of bilateral agreements is already significant. The multiple forces, both internal and external, are driving countries to expand these agreements. The growing density of bilateral agreements has dynamic effects: as more agreements are concluded, more become attractive. FTAs are likely to yield domino liberalization. The cost-benefit calculations faced by countries tilt increasingly from bilateral to multilateral agreements as the number of bilateral agreements expands. This happens because the costs involved in administering many agreements tend to rise with the number of agreements in force, while the value of preferential access to various markets tend to fall as those markets provide similar preferential access to more competitors.

5. ISSUES OF FTA UTILIZATION, RULES OF ORIGIN, NOODLE BOWL AND TRADE FACILITATION

5.1 Challenge of Low Free Trade Agreement Utilization

Francois and Wignaraja (2009) view improving FTA utilization as probably the most important challenge facing Asian FTAs, as several studies have highlighted the low utilization rates of Asian FTAs (Baldwin 2006).

An ADB enterprise survey (Kawai and Wignaraja 2008) of exporting firms covering Japan, Korea, Philippines, Singapore, and Thailand estimated utilization of FTA preferences based on the frequency of firms that utilize them. The results show that firms tend to utilize FTA preferences more frequently than previously thought, but still at unsatisfactorily low rates. Of the 609 sample firms, 22% use FTA preferences and 44% either use or plan to use FTA preferences. Japanese and Thai firms have higher utilization rates while firms from Korea, Philippines, and Singapore have lower utilization rates. Results suggest that using FTAs entails large fixed costs such as learning about FTA provisions, tailoring business plans to complex tariff schedules, and obtaining certificates of origin, and that large firms are better able to muster the requisite financial and human resources than SMEs. Reported reasons for not using FTAs— the most significant reason being a lack of information on FTAs (45%), followed by low margin of preference (26%), delays and administration costs associated with rules of origin (25%), existence of export processing zones and the Information Technology Agreement (11%) and nontariff barriers (9%). FTA utilization could be encouraged by raising awareness of FTA provisions on phasing out tariff schedules; improving MOP at product

level; reducing administrative procedures for ROO; and business associations and governments could make information more transparent, particularly for SMEs.

5.2 Challenge of Burdensome Rules of Origin Regimes

Rules of origin (ROO) are necessary in FTAs to determine origin of goods and prevent trade deflection. Stringent ROO requirements, however, are often used as a protectionist instrument. To achieve the full benefits of an FTA, ROOs should not only prevent trade deflection, but should be trade facilitating as well. Striking a balance is a difficult challenge. Restrictive ROOs, particularly the case with textiles and garments, make it difficult for exporters to satisfy the ROO requirement to enjoy the preferential tariffs. Costs imposed on exporters by ROOs in record-keeping and documentation, production downtime, and switches to more expensive input mixes can more than offset the cost advantages of tariff preferences.

For manufactures, there are commonly three types of ROOs to measure substantial transformation and qualification for FTA tariff preferences. These are value added content (VA), change in tariff classification (CTC), and specific process (SP) rules. There are also variations within each type of ROO rule. The majority of FTAs has adopted a combination of ROOs rather than rely on a single rule. Problems with ROO are:

- ***Value added rule is simple in principle but difficult to comply with:*** The simplest ROOs (until recently) are found in AFTA and the ASEAN-PRC FTA which specified a 40% regional VA across all manufacturing sectors. But AFTA members, especially CLMV, are often unable to cumulate the necessary local/regional content, partly due to the high degree of production fragmentation, with half of its trade in electronics and machinery where production networks are widespread. The import content (from non-ASEAN sources) of exports is high, making it difficult to comply with the 40% VA rule. Further, countries with low labor costs find it more difficult to comply with a given VA requirement than high labor cost countries. The VA rule is also vulnerable to exchange rate fluctuations that affect imported input costs.
- ***High administrative cost of compliance to prove origin:*** The cost of proving origin is high—computation of costs, invoicing, and other documentation demands inherent in VA rules are complex, especially for SMEs from less developed economies. ROO administration and compliance involve costs. For example, for AFTA, there is the time and paperwork involved in obtaining Form D and the large amount of documentation required to prove origin (including invoices and other evidence on each input used in the final product). These problems are particularly acute for SMEs and firms with time-sensitive products. The requirement that all Form Ds should be issued by designated government departments significantly increases the compliance costs compared to other FTAs where private sector associations are permitted to issue COs. Also, customs valuation differs across countries, with pre-export inspections required by AFTA adding to costs, transactions remaining time-intensive and requiring face-to-face contact with officials, and incoming goods enjoying preferences being randomly subjected to post-audit checks (see Medalla and Yap 2008).

There is general agreement that the ROO regime should be simple and unrestrictive, so as to reduce compliance costs of businesses and administration costs of trade and customs officials, as well as minimize the potential for rent-seeking and corruption. In practice, a simple and less restrictive ROO regime means using a single rule that is the least restrictive. In fact, this has been followed by ASEAN early on, with the use of VA rule for almost all products. However, because of the prevalence of product fragmentation, production processes may be so splintered that the exports do not qualify for the 40% rule. Hence the ASEAN ROO was overhauled in 2003, with the introduction of CTC as a general alternative

rule “applicable to all products which cannot comply with the 40% local/ASEAN content requirement” in four sectors (wheat flour, wood-based products, aluminum products, and iron and steel) and later extended to ASEAN priority sectors.

The CTC rule has its own problems. While it is easier for customs authorities to implement, and SMEs might find it easier to comply by showing import and export invoices with different classification codes, there is the problem of determining the level of disaggregation of the Harmonized System (HS) codes to satisfy “substantial” transformation, which would vary across commodities.

Another area that requires reform is full cumulation of ROO. This is important for regional production networks, as it allows the more advanced countries to outsource labor-intensive production stages to low-wage partners. Coupled with simple ROO, this full cumulation provision will make it easier for regionally based firms to exploit economies of scale (Brenton 2003). ASEAN is further refining its cumulation rule and developing a “partial” cumulation approach so that even goods of “partial” origin, not having satisfied the 40% threshold, can be cumulated as part of regional VA; the percentage VA requirement was reduced to 20% of ASEAN content.

5.3 Challenge of Multiple and Overlapping Free Trade Agreements and the Noodle Bowl

Multiple and overlapping FTAs give rise to different tariff reduction/elimination schedules; different product and technical standards and conformance requirements; different product and services exclusions (including modes of supply); different restrictions and provisions on foreign investments; and different coverage of WTO-plus issues such as facilitation, intellectual property rights, competition policy, government procurement, environmental standards, and labor mobility.

Most discussed in the FTA literature is the multiple and divergent ROOs that give rise to the noodle bowl effect (Kawai and Wignaraja 2009a). Divergent ROOs across FTAs lead to fragmented rather than integrated regional markets, added administrative costs for traders and customs officials and production costs for producers, and low FTA utilization rates. Manchin and Pelkmans-Balaoing (2007) argue that the cost of operating in several FTAs might become so high that producers in the spoke countries might only be able to trade under one single FTA and this is an inferior outcome compared to a liberalized multilateral trading regime under the WTO.

Kawai and Wignaraja (2007) examined the ROOs adopted by 30 concluded FTAs in East Asia and found the following key features: relatively simple and liberal ROO provisions of AFTA and generality in application; existing ASEAN+1 FTAs more or less consistent with AFTA ROO, with the use of 40% regional value added; most sensitive sectors for most countries include automotive, textile, and garment sectors; a trend toward using CTC as an alternative rule, albeit being defined for specific products; a greater tendency for more restrictive ROO in Japan; and a trend towards progressively more liberal ROO regimes in East Asia. For major automotive and automotive parts in 11 major FTAs, the VA rule is generally 40% for AFTA and ACFTA but a higher 45% for AKFTA, 40% for Japan-Thailand and 60% in Japan-Malaysia for HS8702 and HS8711.

Kawai and Wignaraja (2009b) report the results of the ADB firm-level survey. The evidence suggests that multiple ROOs impose only a limited burden on firms in East Asia—of the 465 firms that responded to the question on this issue, 27% reported that multiple ROOs do significantly add to business costs, while the bulk of sample firms did not think that they were a problem at present. Firms from Singapore had the most negative perceptions regarding multiple ROOs (38%), while Korea firms had the least negative perceptions (15%), probably because Singapore has the largest number of implemented FTAs. Larger firms have more negative perceptions of multiple ROOs than SMEs, probably because large firms tend to

export to multiple markets and are more likely to complain about issues of multiple ROOs. In contrast, smaller firms tend to export to single markets and hence do not have much basis for complaining. Firms are supportive of having alternative ROOs for the same product for several reasons—if they cannot qualify under the VA content requirement, they could use another ROO rule to qualify; also the VA content rules require confidential information on costs, and many suppliers and firms are often reluctant to divulge such information.

The above two authors argue that the finding of a limited burden imposed by multiple ROOs does not mean that policymakers should be complacent about the issue. As the number of concluded agreements increase, it is possible that multiple ROOs may become more problematic for firms. Hence supportive measures such as encouraging rationalization of ROOs and upgrading their administration are needed to mitigate the negative effects of the noodle bowl in the future. Widespread gains are possible by pursuing a simplified approach to ROOs involving harmonized ROOs, cumulation of value contents, and co-equality of ROOs. Other measures are increased use of IT-based systems of ROO administration, and training programs for SMEs. Introduction of a trusted trader program, as in the case of the North American Free Trade Agreement, would allow successful applicants to self-certify their own certificates of origin, instead of government agencies or business associations issuing certificates of origin.

The EAFTA II Study Report recommends that a ROO regime for the EAFTA should entail the following key features: more liberal ROOs (co-equal rules on a single, least restrictive rule, such as CTC at 4- to 6-digit level); restrictive ROOs targeted at sensitive products to be limited and replaced by longer phase-out periods of tariff elimination; full cumulation and roll-up (absorption) processes; “*de minimis*”¹⁶ provisions; use of self-certification balanced by some monitoring system; SME-friendly capacity building training; greater harmonization of customs procedures and toward a HS customs classification; and adequate provisions to control potential abuse. The report notes that a unified ROO regime would produce the following benefits:

- First, it would reduce transaction costs for ASEAN exporters and alleviate burdens for customs officials because there would be only one set of harmonized ROOs for all East Asian countries. Thus more firms would be able to benefit from the EAFTA preferential rates than those of AFTA or the three ASEAN+1 agreements. Compliance costs could be further reduced by making EAFTA ROOs more simple and liberal and by improving its administrative processes.
- Second, a unified ROO regime with full cumulation would help foster deeper integration and the spread of regional production networks based on freedom of sourcing of inputs throughout East Asia. This is important to create the environment where the regionally based firms are able to source from the most efficient sources in the world at world prices. In addition, it would make it much easier for low-income countries to meet the 40% VA rule, allowing them the greatest flexibility in terms of sourcing inputs.

6. CONCLUSION

Asia in recent years has been playing “catch up” with other regions in establishing bilateral, plurilateral, and regional FTAs/EPAs. So far these FTAs/EPAs do not appear to have strong negative trade and investment diversion effects, as they are aimed at enhancing the international competitiveness and economic dynamism of the region and individual countries rather than protecting domestic markets from foreign competition. They also have many

¹⁶ The *de minimis* rule allows for a specified max percentage of non-originating materials to be used without affecting origin.

WTO-plus features that extend and deepen liberalization and economic integration beyond areas mandated by the WTO. They also contribute to economic cooperation initiatives and measures that deliver regional public goods and mitigate against regional and global public “bads”.

There are moves to establish region-wide FTAs as well. There are obvious benefits from such an initiative in terms of the larger political and economic impacts and gains. And as wider regional and subregional FTAs/EPAs are negotiated and implemented, the need for countries to engage in bilateral FTAs will diminish with time, as the larger FTAs/EPAs bring larger benefits to individual countries. Also, as the number of bilateral FTAs rise rapidly, gains diminish as exclusive preferential market access disappears.

There are several region-wide FTA proposals on the table. The choice depends on political as well as economic considerations. A region-wide FTA for East Asia would rest on the choice between EAFTA and CEPEA. Larger configurations are an APEC-wide FTA and a Pan-Asian FTA. However, these are not necessarily mutually exclusive choices. An East Asia FTA could usefully coexist with an APEC-wide FTA, the former serving to build up an East Asian community and regional economic resilience, while the latter seeking to engage both sides of the Pacific. The East Asia FTA could progress from EAFTA to CEPEA. The Asia-Pacific FTA could progress from the Trans-Pacific Strategic Economic Partnership “coalition of the willing” to an eventual FTAAP.

Measures need to be put in place to improve the FTA utilization rates. It makes no sense that the tremendous efforts and resources being put into negotiating FTAs meant to benefit businesses are not being used by businesses. Some simplification of the Certificate of Origin process as well as streamlining and harmonization of the various ROOs is called for. A region-wide FTA could solve the noodle bowl problem. The scholarly community has been highly critical of the noodle bowl effect. However, the ROO is not necessarily the main impediments to regional and global trade.

Economic integration requires trade and investment liberalization and facilitation as well as economic cooperation. The less competitive economies are resistant to entering into region-wide FTAs unless there are measures to improve their capacity to take advantage of the benefits of economic integration. Hence the various plurilateral FTAs/EPAs have a built-in agenda of economic cooperation and a region-wide FTA would also need to cover human resource development, SME development, technology transfer, product and technical standards (SPS) know-how, and physical infrastructure and logistics development to improve the capacity of the less developed economies and groups to benefit from economic integration. While trade and investment liberalization measures are often viewed as win-lose situations in which the less developed are disadvantaged, facilitation measures are viewed more positively. These include improving product and technical standards (including SPS on agricultural and food products), improving customs procedures and valuations (including use of e-windows), access to trade financing, and no serious misalignment of exchange rates. Economic cooperation and facilitation would enhance the benefits to be expected from trade and investment liberalization and ensure a level playing field.

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