

## East Asian Free Trade Agreement : Move toward a new regionalism in Asia ?\*

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### 1. Introduction

More recently, there is much of renewed interests to form regional integration arrangements in East Asia. The situation has much changed from, previously, where the region used to resist to such a formation. There was only ASEAN which represented the only one formal regional grouping among developing countries, solely for the Southeast Asian region. However, by the turn of the new century, a wave of proposals for various kinds of regional integration arrangements have been pursued much more than ever before, even in East Asia. For many, one could ask for the rationale in such initiatives and implications that would follow from such a creation.

Indeed, regional trade liberalization, in brief, is an important and complex issue on an increasing globalized economy. It requires difficult answers about whether and, if so, how and with whom regional preferential integration should be pursued (Bhagwati and Panagariya (1999), Dutta (1999), and Winters (2001)). To make such an assessment requires one to focus on some of the important questions that need to be answered. The issue of costs and benefits will come first to mind and whether the formation of regional integration arrangements will help to raise or to lower welfare. Then, there is also the debate over the virtues and dangers of regional preferential treatment and whether these arrangements can reinforce or hinder multilateral trade liberalization. Answers to these questions have never been easy.

As East Asia is about to embark on, its own vision of a region-wide free trade arrangement, as part of a step towards an East Asian Community (East Asia Vision Group Report (2001)), it is timely to look closely at the formulations and recommendations of such an establishment. This is to ensure that an East Asian Free trade Agreement (EAFTA) is well conceptualized to bring about more opportunities for the region, thus is also contributing to the multilateral trade liberalization and global competition. The key questions are, what the costs and benefits of this attempt, and what are the pay-offs? This is particularly important when one considers additional requirements of "deeper integration" in an EAFTA which hopes to improve welfare both regionally and globally for East Asia.

This paper sets a less ambitious goal which is to discuss some of the key issues that appear to the author. As the formation of an EAFTA will englobe quite a wide range of issues, it is interesting to focus on some that might appear to be meaningful for the region. Why an EAFTA has to emerge? And what does it mean to East Asia? These are two important questions raised in section 2. Then, the relevant approach provided in section 3 will help to set the question for whether EAFTA represents more or less than an FTA in East Asia. Implications for regional partners will be assessed in section 4. As section 5 will discuss the political economy of the EAFTA, especially, issue related to the formation as an enlarged version of an AFTA before the conclusion will be drawn in the final section.

### 2. Why East Asian FTA could emerge?

One may start by asking whether there is any strong reason for East Asia to join in a preferential trading area as this could also be interpreted as a shift away from a multilateral trading arrangement for which the region used to be known (Yamazawa (1992), Young (1993), Abe (1996). Indeed, East Asia depends much on open world trade as much as the region needs to integrate with countries around the world. Successful industrialization in the past is much related to how well the region trades with different countries and not specifically with the East Asian region.

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It has been argued and confirmed that increased trade and investment have been central to rapid growth in East Asia (Petri (1995), Harrison (1996)). The region's emergence in world trade and capital transactions has also been accompanied by a growing share of intra-regional transactions (Langhammer (1995), Lloyd and Maclaren (2000)). Thus, a strong growth has also contributed to a strong growth on intra-regional transactions and trade dependence of these countries (Frenkel (1997) : 100). The recent Asian crisis had somewhat slowdown growth, trade and investment, but it seems not to decelerate the efforts of these countries to trade and invest more with each other.

## A c q u i r i n g   i n t e r n a l   c o n d i t i o n s

One could say a driving forces of growing intra-regional transactions are basically related to internal conditions, thus making East Asia a natural trading and economic partnership. <sup>(1)</sup> East Asia is the home of almost two billion population (see Table 1). China alone is making rapidly its economic presence in an integrating world economy. Japan, even with the recession, is still considered to be the second largest economy of the world. Korea is now a developed economy and recovered from the depth of its own crisis. And at least the five original members of ASEAN<sup>(2)</sup> are still considered to take part fully in this regional configuration and new economic constituency.

Expansion of intra-regional trade is closely related to growth in regional output and income. This is quite clear for East Asia. However, the link is neither linear or uniform across the products. Rising income level is one of the major factors that determines demand and that there are significant differences among products with respect to their income elasticity. One expects East Asia to get the benefits of the sheer size of its own markets which keep growing with demand, faster than the rest of t h e w o r l d .

It appears also that East Asian economies were more open in the 1960s and 1970s than most other developing countries. Liberalization of their markets had successfully arisen again in the 1980s and 1990s, mostly as a result of unilateral actions. Tariffs, as the main forms of barriers to entry, had been reduced. However, trade liberalization involved non-tariff measures and applied selectively to different products are more difficult to estimate and compare across countries. <sup>(3)</sup> In fact, these non-tariff features were prominent in the world trading system during the period of 1980-1998 (UNCTAD (2002) : 60). It remains to be seen how these border measures are dismantling in East Asia in order to s u p p o r t   t h e   n   g r o w t h   a n d   f u r t h e r   i n t e g r a t i o n .

The development of international and regional production networks has also worked for the benefits of the world economy. This also includes the East Asian economies where the globalization and regionalization of production processes through production sharing and sourcing affect a wide range of product groups (Abonyi (2001)), Doner and Haggard (2001)). These networks have evolved from simple arrangements involving pairs or small group of countries and firms to more complex networks involving multiple and linked locations throughout the region. Participation in these networks gives much advantages for the middle-income and developing countries in the region, but also requires a b e t t e r   u n d e r s t a n d i n g ,   e s p e c i a l l y   f o r   t h e   g o v e r n m e n t   r o l e . <sup>(4)</sup>

At the moment, trade in parts and components has become an integral part of industrialization in the motor vehicles, computers and office machines, telecommunication equipment and electrical circuit equipment (UNCTAD (2002) : 63). The fact that trade in parts and components has grown strongly over the past few years, especially in the electronics and motor vehicle industries, suggests that the rapid development of global and regional production sharing has been a critical factor in the rapid expansion of trade in these products as well as in the rising share of developing countries in the

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<sup>(1)</sup> These factors are, for instance, geographical and cultural proximity, size and complimentarity in resource e n d o w m e n t   a n d   i n d u s t r i a l   s t r u c t u r e .

<sup>(2)</sup> Indonesia, Malaysia, the Philippines, Singapore and Thailand. Brunei can count also in this category although its small size and its later admission as an ASEAN member in 1984.

<sup>(3)</sup> To make precise comparisons with other countries, it requires summary measures of government border policies with respect to goods trade, for example.

<sup>(4)</sup> Policy prescriptions advanced by the multilateral institutions, such as macroeconomic stability, openness to trade and investment, provision of infrastructure, labor movement, for example. Also, there is a need for actors at each location whether national, provincial and local to develop not simply a new set of policies, but also institutions that facilitate business-government cooperation and coordination.

world trade.<sup>(5)</sup> For other products like textiles and clothing, the development of international production sharing in the region has been associated also with the provision of preferential market access. For instance, the MFA quota restrictions have had an important impact on production location and expansion of trade in East Asia.<sup>(6)</sup> Preferential tariffs provided under the AFTA seems to give rise to FDI and intra-industry trade for several products located in the region.

## R e s p o n s e t o c h a n g i n g e n v i r o n m e n t

In fact, intra-regional trade in East Asia was well developed in the early decades of the 20<sup>th</sup> century. Japan played such a dominant role which resulted in strong economic linkages between Japan and other economic areas of East Asia. The second World War had much damaged these linkages. As a result, trade patterns in East Asia were redirected towards the United States. Chinese trade with East Asia also collapsed as the country turned to the communist regime (Ikenberry (2000) : 39-40). The decline of intra-regional trade was in parallel with the period of strong growth in the 1960s of several Northeast Asian economies like Japan, Korea and Taiwan. It was this strong growth that had helped other East Asian countries to follow suite thus finally helped trade within the region to increase again in ways that were consistent with world trade patterns.<sup>(7)</sup>

The exchange-rate realignments since the 1980s had tremendous impact upon shift in regional trade. Indeed, with the yen appreciation against the US dollar, Japan imports grew from the region. Also, Japanese firms had to relocate its plants to several countries in ASEAN like Thailand, Malaysia and Indonesia thus also sent Japanese intermediate goods into these countries. Korea and Taiwan had followed these trends. Hence, the currency realignments became an important factor that marked the region into greater intra-regional trade and investment interdependence. Japan, Korea and Taiwan had expanded their ties to the ASEAN countries and also among themselves through trade, investment and technology transfer (Chirathivat (1992)).<sup>(8)</sup> Thus, from the mid 1980s up to before the Asian crisis, the rapid growth of intra-regional trade in East Asia was more of a general process of regional economic expansion.

In the meantime, one could say that the region is moving into a growing intensification and diversification of trade among countries, individually and collectively. Also, East Asia has come more integrated among themselves as much as it remains dependent on export markets outside the region like the United States and the European Union, for example. Even with the latest China's integration into the global economy, China sets its own goal clear to be export-led growth development by trade and investment with much of the region and the world. In fact, China, save from the Asian crisis, is still emerging strongly with its economic presence in regional and global trade and investment (see Table 2 ) .

Against this background, the idea to form an East Asian FTA is not new. The latest initiative in favor of this regional arrangement began as far back a decade ago with Malaysian Prime Minister Mahathir Mohamad's proposal for an East Asian Economic Grouping. The U.S. threatened Japan not to join such a grouping, thus given some thought to other East Asian countries as well. The project aborted, but the debate is still on. The aftermath of the Asia crisis has given up hope to such a revival that Asian countries need to cooperate more closely in an Asian Economic Community (AEC) in order to benefit more greatly within a globalized changing environment.

The renewed impetus for an EAFTA is also in response to subsequent proliferation of such movements centered in the Americas and Europe. Thus, the region needs to evaluate what this would mean for East Asia if the region is moving into such a direction. Whether this regionalism will interact in good terms with the multilateralism and will not be a "stumbling bloc", but rather a "building bloc" in achieving global free trade. East Asia can not play with this puzzle that would endanger the multilateral trading system from which the region has much benefited up to the present. Also, what would happen

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<sup>(5)</sup> Trade based on specialization within vertical production networks accounts to up 30 per cent of world exports, and that it has grown much by 40 per cent in the last 25 years (UNCTAD (2002) : 63).

<sup>(6)</sup> Where countries that had exhausted their quotas in industrial markets shifted production to new locations, using them as bases for exports .

<sup>(7)</sup> Trade was not biased or shown any sign of moving toward intense intra-regional exchanges.

<sup>(8)</sup> For example, Japanese FDI realized in 1988-1989 in Malaysia, Thailand and Indonesia was two-third of all investment combined in the earlier post war years .

to East Asia if they do not from an EAFTA while the proliferation of such initiatives is still going on elsewhere in the world.

### 3. Toward a comprehensive conceptual framework

If an EAFTA has to emerge, one could ask for what would be the appropriate framework to apply to the region. Since East Asia comprises countries of almost two billions population in a vast area, there are still at different stages of economic development, thus yet to including differences in political regime, institutions, social groups and values that may involved in the process of liberalized exchanges among them. This is because, in the process of regional integration, the increasingly liberalized movement of goods and services, factors of production<sup>(9)</sup> and tastes will alter prospects and give new challenges. There are opportunities for major increase in income and wealth for participants in the process. There are also threats of lost income, unadapted sectors, national institutions who may be left

#### S c o p e a n d f r a m e w o r k

In order to find an appropriate framework, one may start by asking what are the aims of the regions vis ā vis to this initiative the long run (see Table 3). There is a need to look closely at the long term objectives, to watch closely the market forces operating in the region in order to benefit its dynamics and find ways to manage interdependence among countries. The term “open regionalism” as expressed in the APEC process, will this apply to East Asia? The term is important if East Asia would like to adapt its very first liberalization of the exchange process.<sup>(10)</sup> Also if an EAFTA is not an ended objective, one could ask whether this EAFTA is a mean to move to the Asian Economic Community (AEC) which could be more desirable in the long-run (Dutta (2002)).<sup>(11)</sup> In other words, the role of regional economic integration through an AEC will become more significant for the success of the region in the process of further globalization.<sup>(12)</sup>

If the move toward an AEC is an important impetus for forming an EAFTA, then there could be a chance for success in such an enterprise. As the AEC will englobe a wider scope and vision, this could help an EAFTA to fit in an interesting perspective and to escape from conflicts right at the start. Trade liberalization is known to involve much efforts from all countries involved. Japan, is known, for its own non-tariff measures against agricultural imports. China is just about to start its own unilateral liberalization under the WTO. Korea, although adamant to move in an EAFTA, might be faced with some protests from social groups back home. And most ASEAN countries already under the AFTA, are still unsure how to face the trade liberalization of the neighboring northern countries. All this requires the will of the countries to cooperate and build trust in the longer term.

In its design, an EAFTA might have to fit in a broader scope like an AEC. The challenge is also to overcome with a clear objective and to undertake a reasonable economic framework. Countries gains by grouping, the magnitude of the benefit to either of the parties depends on different industries and actors that devolve upon the others. Conflicting national interests might arise (Gomory and Baumol (2000) : 109). The transfer of an industry from one country to another will generally benefit the acquiring country at the expense of the other. This would have direct implications for the design of a nation's trade policy as many countries of East Asia might not yet give up the kinds of trade protection they have previously to the barriers elimination.

Apart from conflicting national interests, it might also be argued that trade liberalization, per se, involving tariff and non-tariff measures might not survive its own course if these efforts are not supplemented by a certain kind of harmonization like trade facilitation. This trade facilitation offers a soft approach in parallel to the hard approach of trade liberalization which would involve more trade negotiations. The move toward a free trade integration in this sense could be gradually but persistent and consistent with the overall pursuits. Liberalization sequencing through reasonable timeframe will

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<sup>(9)</sup> Capital, technology and labor through migration and as embodied in trade in goods and services.

<sup>(10)</sup> Will discuss more extensively in section5.

<sup>(11)</sup> As this would involve intra-community macro and micro-economic parameters.

<sup>(12)</sup> Experiences of the EU and lessons to be learnt for Asia are great in this area.

allow markets and industries to adjust and not to be a threat to both developed countries like Japan and Korea and remaining developing countries like ASEAN and China.

**T r a d e c r e a t i o n a n d t r a d e d i v e r s i o n**

There are also major concerns about the consistency of such agreements with global trade liberalization within the WTO (de Melo and Panagariya (1993)). Bhagwati argues for “first best” theories of pure trade liberalization and “second best” to justify regional bloc formation. He later argues there would be a few chances where the bloc formation could offer a greater welfare than the process of multilateralism. This would involve a so-called dynamic time-path question (Bhagwati and Panagariya (1996) : 43-47). This concern is well justified but has to be consistent with the justification that such a formation is in the direction of pure “trade creation” and positive “trade diversion” rather than the welfare reducing dealt within a Vinerian perspective (Viner (1950)).<sup>(13)</sup>

This approach has adopted a view on regional trading arrangements as a combination of trade creation and trade diversion. If regional costs are above international price levels, trade liberalization at the regional level tends to give rise to trade diversion. But if economic integration causes regional costs to fall and could be below international costs, by lowering barriers to exchange among members, preferential trade arrangements would give rise to trade creation. In sum, trade diversion, moves them away from global suppliers at costs that are lower than its own this leads to an increase in trade among member of the regional agreement. This increase has also been called “trade creation” even though trade could not be the lowest cost suppliers.

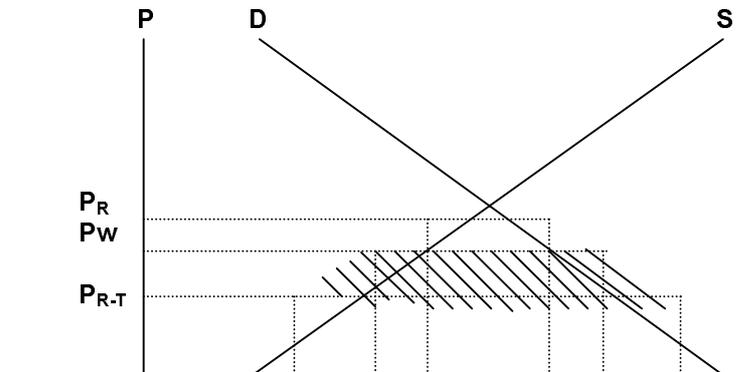
**T r a n s a c t i o n c o s t s**

Transaction costs, as could be broadly defined, are introduced in the cost function of the regional trading partners (in Figure 1). This is to illustrate how the cost reduction through open regionalism strategies could convert trade diversion into pure trade creation, making the regional partner the least-cost supplier.<sup>(14)</sup> In this sense, transaction costs involve in the process of exchange would include those of transportation, communications, bureaucratic red tape, transshipping because of customs and border regulations, all of which are significant for the East Asian region.<sup>(15)</sup>

Thus, this definition of transaction costs including transportation costs and other costs of exchange, coupled with the existence of economics of scale, is important to resource allocations and geographic location of industry across space (Krugman (1991)).

In figure 1, the difference between  $P_R$  and  $P_{R-T}$  represents transaction costs per unit of output under a broadly defined regional partner in which location matters importantly to comparative advantage. When barriers are removed, internal price of the region falls to  $P_{R-T}$

**Figure 1 : Trade creation and trade diversion with transaction costs (broadly defined)**



<sup>(13)</sup> Regional integration may divert trade towards less efficient regional sources, regional integration, however, decreases transactions costs and enlarges the market, so that regional producers become more efficient.

<sup>(14)</sup> Transaction costs are viewed as costs that arise when individuals exchange ownership rights to economic assets and enforce their exclusive right. Costs of arranging a contract ex-ante and monitoring and enforcing it expose as opposed to conventional production costs, which are cost of executing a contract. (Eggertsson (1990) : 1 )

<sup>(15)</sup> These may amount to ten or more percentage point in total value added (Reynolds (1995) : 11).

$\overline{\hspace{10em}}$   $Q$   
 $Q_5 \quad Q_1 \quad Q_3 \quad Q_4 \quad Q_2 \quad Q_6$

through integration, the regional trading partner establishes a competitive position in the activity at the global level. This is shown as costs are now below those of the world  $P_w$ , so that a protection is no longer needed. Under this dynamic hypothetical case, the regional economy is able to eliminate its external barriers and still increase regional trade through trade creation.<sup>(16)</sup> This is the case of “open regionalism” where a shift of trade toward the region represents favorable trade diversion (Reynolds (1999): 12).

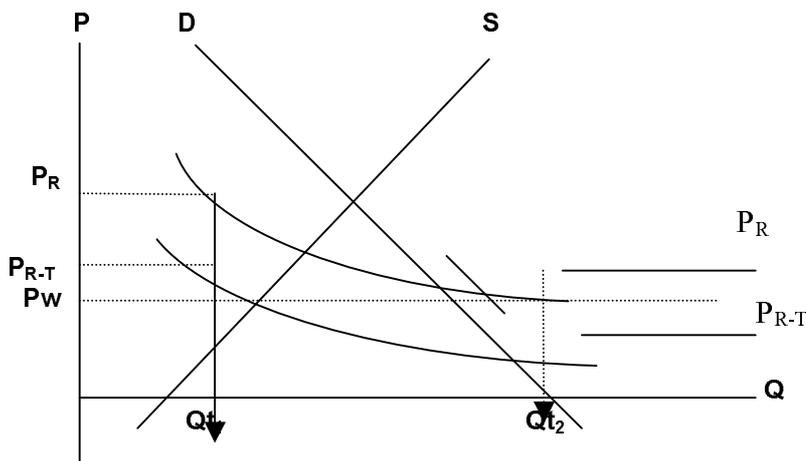
**M a r k e t w i d e n i n g**

The impact of transaction costs reduction can also be shown through market widening in figure 2. Through increased access for regional producers, there is the case of increasing returns to scale. East Asia is well placed to gain “external economies of scale”.<sup>(17)</sup> Under favorable conditions under increasing returns, which are particularly found in knowledge-intensive industries as embodied by skilled labor, regional trade arrangements can be trade creating since they may push cost curve below international competitive levels. The East Asian countries are competitive in several knowledge-driven industries owing to large work force of relatively educated population will low wages.

The removal of barriers to trade lower costs. As shown in figure 2, cost curve shifts downward, reflecting scale economies realized through production expansion to serve a widening regional market. Increasing returns to scale are possible by linking individual markets of a region into a broader region-wide economy as well as assessing the international market in general. Comparative static gains are presented here as follows:

- At  $Qt_1$ , both  $P_R$  and  $P_{R-T}$  are still higher than  $P_w$ . The quantity produced is still small even without barriers to trade, the product in a regional market is still trade-diverting as compared to the one outside the region;

**Figure 2 : Dynamic effects of trade diversion and trade creation with market widening and increasing returns**



- On the other hand, due to the medium and long-run effects of integration, continuous reduction of barriers to trade is having strong impact for production expansion in a region-wide market integration. At  $Qt_2$ , product at the region becomes more cheaper than the international market.

<sup>(16)</sup> Because it has relied not upon the erection of eternal barriers, but the reduction of internal barriers to external competition.  
<sup>(17)</sup> At the level of an industry or country rather than internal to a firm.

The more the regional partners pool their skilled labor,<sup>(18)</sup> the more they can benefit from economies of scale. At one point in time, they could easily expand through “open regionalism” in the international market. For China and many other East Asian countries, integrating can give rise to scale economies, just as their large cities like Hong Kong and Singapore through international integration.<sup>(19)</sup>

The process of market widening however require careful attention to social and political implications if it is not to be distorting and destabilizing (Reynolds (1995) : 17). Tradable as much as nontradable sectors are to be taken into consideration, inducing increase both domestic and foreign investment to serve the expanded regional demand and supply effects. Cross-border investments to take the advantage of the new opportunities would be increased by policy harmonization among regional partners.

**R u l e s o f o r i g i n**

There are also the issues in which FTAs, in many ways, might differ from customs union. For a free trade area, it had been assumed that since each country maintains its external tariff's structure, average external tariff levels remain unchanged was automatically satisfied. Krueger (1997) proves, however, the assumption can be shown to be incorrect as rules of origin can serve as additional trade barriers in an FTA in ways that cannot be under a customs union. Thus an understanding of differences between FTAs and customs union become important, especially for issues like overlapping FTAs which several East Asian countries are now running into (Chirathivat (2001)).<sup>(20)</sup>

Krueger (1997a) outlines three related consequences; First, “trade deflection” could happen as each good and service enters through the member country with the lowest tariff and is transshipped. Thus, a need for rules of origin is to be established. Second, an FTA may “export protection” from one regional partner to another through incentives created by rules of origin. Third, different protection rates in an FTA implies the producer in regional partners cannot be facing common prices of tradables or of nontradables that use significant quantities of tradables as inputs. How important of these consequences are depend on the structure of protection existing in members of the FTA, and the economic response to them.<sup>(21)</sup>

There are also transaction costs related to enhancing border-crossing procedures in an FTA. Costs are related to documenting products and verifying them prior to border crossing. Thus, continuous treatment of transactions across borders could be cumbersome, hence may not be effective to promote exchange in an FTA. Necessary documents to prove the origin of exchange entails costs which may cause producers to pay relevant duties rather than incur the costs of proving origin.<sup>(22)</sup>

In principle, from the welfare point of view, “an FTA cannot lead to any more trade creation than can a customs union and when rules of origin export any protection, an FTA leads to more trade diversion than does a custom union” (Krueger (1997b) (1999)). In other words, rules of origin are the main cause that can result in trade diversion under an FTA which, under a customs union, this will not occur. In consequence, there can be no prospect of an FTA evolving into a “single market” unless tariff-rate unification a la customs union is undertaken at a later date. This is quite a big target if an EAFTA is aimed to survive its own course in the long run. It needs to challenge several critical issues related to each regional partner’s freedom, preparedness and common interests in the long run.

**4. Implications for regional partners**

If a regional trading bloc is to be formed, there are costs and benefits that need to be assessed thoroughly. As a regional preferential treatment involves directly the reduction of trade barriers in each

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<sup>(18)</sup> This may require a region-wide migration.  
<sup>(19)</sup> Major gains in East Asia may derive from “open regionalism” to the extent that regionalism is extended to internal integration of markets and related institutions.  
<sup>(20)</sup> The issue of overlap is an issue that arises with FTAs and not all customs union.  
<sup>(21)</sup> Each is likely to have consequences for economic behavior and hence the impact of FTA.  
<sup>(22)</sup> It is estimated that these costs in the context of EAFTA is at 3-5 per cent of f.o.b. price. (Krueger (1997), ( 1 9 9 1 )

regional partner, it requires careful consideration of all major aspects of direct effects of FTA and changes in economic policy that might follow. For the ASEAN countries, they might live with these experiences for some years already with their own AFTA. But, so far, as there will be a more or less ASEAN+3 with a population moving up to almost two billion in number, this will be evidently the largest F T A i n t h e w o r l d .

For the former ASEAN-6, average tariff rates collected from Japan, China and Korea stand quite differently. The level is high for Japan (19.9 per cent) and low for Korea (4.6 per cent) and China (2.34) (see Table 4). This is mainly due to the products of motor vehicles and parts and some other manufactured products in which ASEAN countries tax heavily on its imports. On the other hand, average tariff rates collected from ASEAN products also stand differently in the three countries. Japan represents the lowest level (2.2 per cent) among the three while China stands for the highest (9.4 per cent). Obviously, China imposes a high trade barrier for ASEAN products in most agricultural exports thus including, processed rice, vegetable oils and fats, sugar, beverages and tobacco products, and in various manufactured exports like wearing apparel, motor vehicles and parts and electronic equipment.

As for trade barriers among the three Northeast Asian countries, China represents the most protected countries in terms of its average tariff rates collected from Korea and Japan (see Table 5). Korea stands in the middle and Japan, the least protected, in terms of this tariff collection. In terms of product categories, China collects a high tariff from Japan for the products like vegetable and oils, food products, textile, wearing apparels, motor vehicles and parts. In the case of Korea, they will be subject to high tariff collection for products like vegetable and fruit, fishery, animal products, vegetable oil and fats, beverages and tobacco products, textile, wearing apparels and motor vehicles and parts. As for Korea and Japan, they are also quite protective for their agricultural imports and some manufactured products. These are animal products, milk, sugar, food products, fruit, vegetables, textile, wearing a p p a r e l s .

In a FTA, if the principle is fully implemented, the regional framework by abolishing trade barriers allows trade expansion among regional partners which could be realized through trade creation and trade diversion effects as mentioned in section 3. The removal of trade barriers is supposed to lower costs, increase intra-regional trade and increase economic efficiency. This will help to boost real income in the regional economies as resources flow to sectors where they can be more efficiently and productively utilized. In order to look at changes resulting from such a FTA, it requires to apply analytical tools which will give results for further interpretation.

To stimulate the effects of an EAFTA, one could apply a general model application known as the Global Trade Analysis Project (GTAP). In such an application, it assumes that rates of trade protection are reduced to zero which is the ultimate goal to eliminate all tariff and non-tariff measures. Based on the average level of production in ASEAN, China, Japan and Korea, one could assess the macroeconomic impact of tariff elimination as follows :

- Essentially, ASEAN seems to gain the most in an increase in real GDP at market prices of 3.36 per cent, mainly from its own internal effects while Japan stands to gain the least of this increase of only 0.08 per cent (see Table 6). China and Korea, meanwhile, will gain each an increase in real GDP at market prices of 1.66 per cent and 1.86 per cent respectively. These gains are mainly derived, for both countries, mainly from the regional effects in a FTA.

- In terms of net welfare, ASEAN also stands to gain the most. However, this gain is also shared among the other three countries. ASEAN, similar to China, looks to be net gainer as the costs of rise in land price, wage rate and reduction of capital price are taken into consideration.

- Also, most countries seem to gain much higher trade expansion with the tariff elimination (see Table 7). China stands to gain the most in all other markets while the country also sees other regional partners gaining better market access into its own place.

- The result also shows a low degree of trade diversion both for ASEAN and China. On the other hand, it seems to be that Japan's and Korea's export to the third markets could be slowed down by the FTA, especially in the EU and the USA. Overall trade diversion in a FTA is equivalent to 6.5 per cent for the U.S. and 4.7 per cent for the EU.

- China would most likely profit from costs advantages of input imports from the regional partners like ASEAN which would help China to be more competitive and export even more to third markets. ASEAN, also, would gain from input price decrease for intermediate and capital goods imports which would encourage most ASEAN countries to invest and export more to the region and the world.

The implications of tariff liberalization is clear to a certain extent. The assessment of non-tariff liberalization, on the other hand, is not an easy exercise since it involves various measures which are not easily captured. As tariff equivalent of non-tariff measures is not easily estimated, this study applied the non-tariff measures incidence to measure the non-tariff protection which has been integrated within the model : ( 2 3 )

- Overall, the impact of non-tariff liberalization is not an easy exercise since it involves various measures which are not easily captured (see Table 8) The average level is generally higher than the one of tariff. For instance, the average non-tariff protection of China against ASEAN imports into the country is exceptional higher than most bilateral trading partners. China alone imposes such a high protection for Japan and Korea as well. Korea, on the other hand, seems to be the least protected country among all regional partners, then followed by Japan and ASEAN.

- Average non-tariff rates of ASEAN collected from the three countries are high for products like poultry and seafoods, vegetable oil and fats, food products, petroleum and coal products and motor vehicles and parts. (see Table 8) on the other hand, average non-tariff rates of Japan, China and Korea, collected from ASEAN products are high for forestry products, daily products, processed rice, beverage and tobacco products, and paper products and publishing.

- As for average tariff rates of China collected from Japan and Korea are high for products like plant-based fibres, livestock, vegetable oil and fats, beverage and tobacco products, motor vehicles and parts (see Table 9) Meanwhile, Japan concentrate its protection on products from China and Korea on mostly products like livestock, forestry, meal products, processed rice and food products. Finally, Korea opts to protect its products from import competition from China and Japan on most agricultural products like vegetable, fruit and nut, livestock, wool and silk worm cocoon, daily products and processed rice.

- The result of the non-tariff measures' macroeconomic impact, as shown in Table 10, is mostly significant for China as its overall GDP could rise up to 6.3 per cent and its overall welfare is also substantial. ASEAN and Korea seem to gain quite remarkably for its GDP rise, welfare and price. Japan, at the bottom, for its benefit gained in term of GDP. However, in terms of welfare, it is still meaningful result for Japan as much as its rise for rental price of capital as Japan finds its own position to finance more widely for regional partners.

- China gains for its GDP at the expense of its own trade balance worsening, and even more than the one of ASEAN. Japan seems to gain with a trade surplus more than the rest. Korea has not much been affected by its own trade balance with the region. China seems to be a net gainer for its exports to the third markets as its products become more price competitive and supply to most major countries like the USA and the EU (see Table 11). ASEAN seems to expand much to the Chinese market. This concentration at the Chinese market could happen at the expense of a reduction of trade flows ASEAN's major markets like the USA, the EU and others. Japan and Korea seems to have a similar fate of its trade with China and the rest of the world.

The overall result points to the fact that there would certainly be trade gains for regional partners. China seems to gain the most in terms of its rise in GDP and trade with regional partners and the world. As for the other regional partners like ASEAN, Japan and Korea, they could also gain from these efforts of trade liberalization. ASEAN could gain from its GDP rise, relatively more than Japan and Korea. However, it seems that all ASEAN, Japan and Korea seem to be busy exporting their inputs like intermediate products and capital goods to supply China's need to produce and trade with the rest of the world.

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<sup>(23)</sup> Based on TRAINS developed by the UNCTAD, core NTMs are classified into three categories : quantitative controls, price controls and financing. This is not including measures like automatic licensing, monopolistic controls, technical barriers, and others.

It look like China could come out as net gainer as trade creation will easily offset trade diversion with the rest of regional partners. On the other hand, others' attention on China would get a slight trade diversion as they could be busy looking at opportunities to trade. It remains to be analyzed how these countries could use these opportunities to strengthen their economic partnerships. With strong growth of China, ASEAN and Korea, this could be interesting picture in terms of the regional future growth and development.

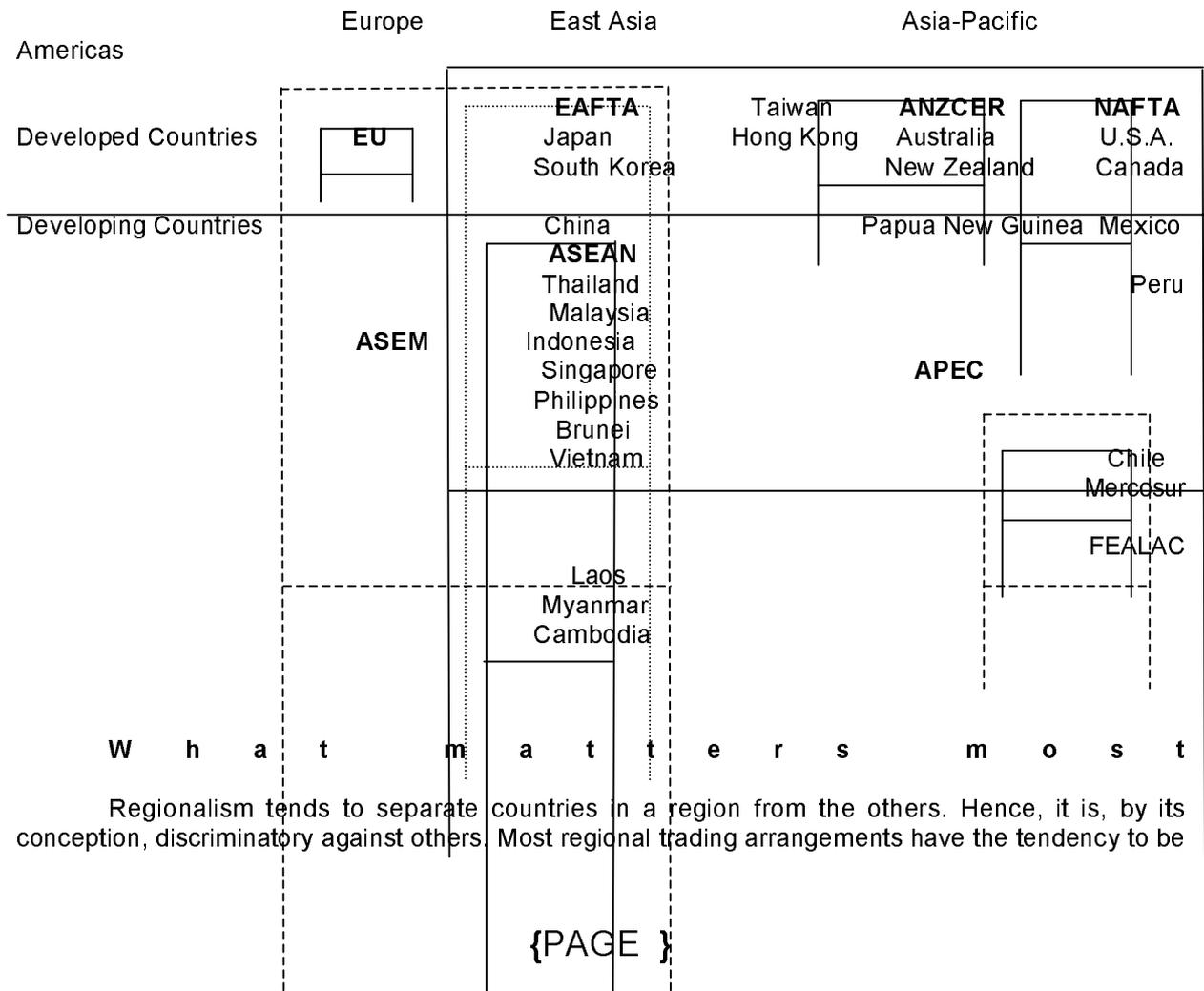
**5. Political economy of the setting**

Up to the present, East Asia, as a whole region, has been slow to develop a region-wide initiative for institutionalized integration. The outward orientation of their economies with the rest of world is successful as shown by trade patterns, investment orientation and technological transfer and development. New East Asian-wide trade liberalization could still have substantial trade creating effects within the region. However, these countries are still worrystate of extra-regional effects which prevent them from going further with thought and action along these lines.

The rise of East Asia from the mid 1980s up to before the Asian crisis provoked an idea of the Asian regionalism. Any regionalist formation in East Asia is meant to be the East Asian response to emerging trade blocs in Europe and in Americas (see Chart 1) However, welfare implications of continental trading blocs could lower welfare for each continent (Stein and Frankel (1994)). After the Asian crisis, there were multiple bilateral preferential trading arrangements (PTAs) with partial internal liberalization. Welfare in this case, is still to be verified for countries involved. At the same time, there is much debate about a new regionalism in Asia, in the areas like finance as much as trade and others. There are issues of the prospects for a further spread of economic progress and for an expansion of the interdependency mechanisms in the region.

**Chart I**

**Regional Integration Schemes among the Three Blocs from An ASEAN Perspective**



protective among themselves. This makes regionalism filled within the definition of inward-looking orientation (Manfield and Milner (1997)). One could ask whether East Asia is moving its own vision to F T A t o w a r d t h i s d i r e c t i o n .

By contrast, “open regionalism” has been adopted as a concept in moving the APEC process and its members. The term “open” would make sense if it means, membership is open to all and that the concessions given to members are simultaneously extended to other as well. (Ariff (2001)).<sup>(24)</sup> In practice, it is inconceivable to see membership is “open” for all for any regional grouping.

More often, membership in regional groupings is strictly defined in any given geographical areas. However, it is possible to see for regional groupings to extend intra-regional concessions and privileges to non-members (Chirathivat (1996)). ASEAN, for example, has been able to multilateralize regional tariff reductions under AFTA. Several countries of ASEAN like Indonesia, Malaysia, the Philippines and Thailand have extended some of their AFTA tariff rates unilaterally to the rest of the world. This makes for a viable argument to escape from unnecessary steps toward trade diversion. Thus, ASEAN is quite close to what one may term “open regionalism” although it is by no means to o p e n .

In fact, intra-ASEAN tariff reductions, after the completion of the first round of ten years, this year, seem to be faced with little resistance from industry. ASEAN entrepreneurs are seeing the benefits in the long-run and the deals within reciprocal arrangements. ASEAN governments aim to push regional trade liberalization as a step toward global free trade. In this sense, regional integration of ASEAN seems to move in line with global free trade, thus making a lot of difference from the usual version of regional integration framework which used to know (Ariff (2001)). ASEAN looks at AFTA not as an inward-looking trade liberalization, but rather as a “training ground” that would prepare them for g l o b a l c o m p e t i t i o n .

Precisely speaking, ASEAN extra-regional trade linkages have been much stronger and far more meaningful than intra-regional trade patterns. AFTA or intra-ASEAN trade liberalization has been explored to give each country a greater potential and an edge toward an investment – driven area in an expanded ASEAN. Hence, the main objective of AFTA is not to increase intra-ASEAN trade per se, but rather to provoke attention to the ASEAN region as an area to invest, produce and compete efficiently within the global economy. As an outward-looking regionalism, ASEAN sets clear objectives to establish linkages with other countries and regional groupings that would create more opportunities a n d n e w c h a l l e n g e s f o r t h e r e g i o n .

#### D e f i n i n g c h o i c e s

When it comes to move forward from the concept to the reality, East Asia will encounter a number of choices to be made. One could list at least a few issues as follows (The World Bank ( 2 0 0 0 ) : 6 3 ) :

#### - D e f i n i n g r e g i o n

The definition of a region remains to be clear. For the moment, this proposal is aimed for East Asia. So, this initiative could involve all countries and economies in Northeast Asia and Southeast Asia, all included. However, there might be a question about the so-called initiative “Asian Economic Community”. Does that mean that East Asia would exclude itself from the rest of Asia? If not so, the East Asian region needs to make it clear from the beginning about any intentions of exclusiveness.

#### - N u m b e r o f a c t o r s

If the new regionalism is contained only to the region of East Asia, then, regional institutions need to resolve collective action problems. It is widely recognized that such problems tends to become more severe as the number of actors increases. Country size and level of development, political differences might add as additional factors to the number of actors. There will be issues of regional

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<sup>(24)</sup> If this was the interpretation, open regionalism is nothing but anti-regionalism. In other words, open regionalism is hardly a variant of regionalism .

institutions to overcome collective action and dispute settlement, problems among a number of states and their economic political and social differences that would have to be taken into consideration.

At the moment, the idea seems to favor an ASEAN+3 grouping. If that is the case, what would happen to Taiwan and Hong Kong, for example, along the process? If all ASEAN countries are fitting in, how would the less developed countries of ASEAN like Cambodia, Laos, Myanmar and Vietnam adjust themselves. There are even some proposals to begin with such as ASEAN 5+3 (Dutta (2002)). Hence, the number of members are fundamental to the prospects for a regional agreement's success.

- **D e p t h o f r e g i o n a l i n t e g r a t i o n**

Like various regionalism around the world, East Asia needs to address the degree to which integration deepens overtime among parties to a regional arrangement and the rest of the world. As discussed above, the region could assess its own regional objectives, institutions and mechanisms to achieve the set goal. The regional institutionalized integration must achieve along the line of a successful market-driven integration. The depth of regional integration is to be carefully planned for the benefits of coordination among members and to escape from costly conflicts that need an establishment of dispute-settlement mechanisms. As mentioned earlier, trade facilitation in East Asia, may be, more desirable, at the beginning in order to create awareness of benefits for regional partners. Then, regional trade liberalization could be progressively supplemented to increase a more competitive environment in East Asia in the global economy.

- **R a n g e o f a c t i v i t i e s t o i n t e g r a t i o n**

The immediate question which would occur to one's mind is whether a regional integration aims to engage mainly in intra-regional trade in goods or rather to wider its coverage beyond merchandise trade like trade in services and investment.<sup>(25)</sup> Also, if the coverage is also involved with agricultural products, what would be the potential outcome for countries, like Japan, Korea and even China, if they have to liberalize their trade in agricultural products and to allow a greater market access for the Southeast Asian products in their market. There are also aspects of cross-border factors of production like labor and capital movements that need to be treated seriously in regional integration exercises.

**6. C o n c l u s i o n**

Prospects for emerging integration trends have increased in East Asia. Even with the Asian crisis, the process of economic growth and industrialization seems not to be deterred as economic recovery now takes place quite satisfactory in most of the crisis-stricken countries. A deepened economic interdependency, through trade, investment and technological transfer, between countries in the region has been one of the factors contributing to this comeback of dynamic expansion. At the same time, an outward orientation of these countries with the rest of the world has been instrumental in keeping this region globally competitive.

The revival of institutionalized-led integration in East Asia, as opposed to market-driven integration carried out up to present, is again back to the debate. Efforts to date of East Asian countries to construct such formal regional economic institutions have met with little success. To respond to the establishment of strengthening of regional integration institutions of Western Europe and the Americas, the discussion is whether East Asia is ready to having another one too. In the meanwhile, there is much proliferation of bilateral, subregional preferential arrangements conducting increasingly in the region as much as elsewhere in the world.

If East Asia is to set for its own institutionalized integration, what does this additional regional institution mean for East Asia? As a vast region covering of almost two billion population, there is still many differences, from a populous China to a tiny country like Brunei, or from an open economy like Singapore to a military regime like Myanmar, or even from a highly industrialized country like Japan to an agrarian-based society like Laos. East Asia needs to look closely at conditions and environment in which they are moving for further integration.

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<sup>(25)</sup> Investment and services are the two most important areas beyond merchandise trade where there are gains from widening the scope of integration (The World Bank (2000) : 89).

The conceptual framework for a new Asian regionalism has been mixed. The investigations from a Vinerian perspective on regional integration as a combination of trade creation and trade diversion have to be clear from its beginning. Intra-regional liberalization could benefit a reduction in transaction costs, hence making regional production globally competitive. This exercise could also help to market widening and allowing for economies of scale to operate fully for firms produced and invested in the region. Hence, better resources allocations resulting from goods and services exchange together with factors of production could not be underestimated. However, if the region solely concentrates its efforts on a FTA per se, it could prevail with difficulties arising from rules of origin as countries practice quite differently border controls and regulations related to it.

An assessment of a bloc formation has been made in order to evaluate the impact of regional partners in a partial equilibrium model. It assumes that if countries reduce each one's own tariff protection to zero, there would be trade gains, but differently distributed among partners. Overall, there will be a net welfare increase as a result of a rise in real GDP and trade expansion. Japan and Korea could face with a certain degree of trade diversion. China, on the other hand, would profit from input imports from most regional partners to remain competitive and even exports more to the third markets. Non-tariff barriers are, for the moment, more difficult to assess in these countries hence the accuracy of estimation result is to be interpreted with careful consideration.

Moving on to different facets of the political economy of the setting, it requires even more the involvement of different actors involved. East Asia has to go beyond the usual formation of regional institutions elsewhere. It requires finding its own new regionalism that fits them most. There will be policy choices from the start in a wide range of topics like name, countries involved, its depth and its coverage, for instance. All these remind us that any initiative the region might take its own decision in this regard is of real importance. Any shortsight or complacent view, or even prematured action is to be disregarded as it could threaten the prospects of future integration of East Asia in the world economy.

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