

ECONOMIC INTEGRATION IN EAST ASIA

Until recently, East Asia, the world's most dynamic area for several decades now, had few regional institutions. However, the successive crises in the last ten years (financial crisis in 1997-1998, SRAS, tsunami, bird flu) have demonstrated the need for formal cooperation instruments. Trade integration is one of the aspects of regional cooperation that is beginning to take shape. Particularly, since China joined the WTO in 2001, there has been a multiplication of bilateral and multilateral free trade agreement negotiations. What form will the regional integration that emerges from this plethora of initiatives take? Here, we analyse two scenarios. One centres on an integrated and free trade ASEAN with each of four major Asian partners: China, Japan, Korea and India; the other, clearly more ambitious, consists of a complete free trade area amongst these fourteen countries. Simulations with the Mirage model show that Japan and Korea would have greater interest in the creation of a completely integrated area, whereas the ASEAN would derive greater benefits from bilateral agreements. Finally, even though the economic gains of agricultural liberalisation are potentially substantial, political considerations will no doubt exclude it for a long time yet.

■ *De facto* regionalisation

For a long time, East Asia has *remained* behindhand in the institutional process of regionalisation observed elsewhere in the world. The political divides that have crossed the area and the involvement of the United States, which did not wish to see an independent regional organisation formed in Asia, explain this situation to a large extent. At their origin, the two main regional agreements involving the East Asian economies, the ASEAN (Association of South East Asian Nations) and the APEC (Asia-Pacific Economic Cooperation) were affected by these political aspects. Though they have contributed to liberalising trade between Asian countries, neither of them has had much impact on effective regional integration.

The ASEAN is the oldest agreement. This anti-communist alliance was created in 1967 to prevent contamination by the Vietnamese revolution and initially had five members: Indonesia, Thailand, the Philippines, Malaysia and Singapore, quickly joined by Brunei. The end of the cold war led the ASEAN include an economic purpose. In 1992,

this resulted in an agreement planning the creation of a free trade area, the AFTA (ASEAN Free Trade Agreement), which the four new members of the ASEAN (Vietnam, Laos and Myanmar, then Cambodia) also joined in 1995.

All of the East Asian economies (including Taiwan) are members of the APEC. This 21-member forum (diagram 1) was formed in 1989 in reaction (from the United States, in particular) to the Malaysian proposal for an East Asian Economic Caucus¹. This grouping planned a scheme of preferential regional liberalisation from which the countries of other continents would be *de facto* excluded. In 1994, by adopting the *Bogor Goals*, the APEC set itself the objective of liberalising its members' trade and investments by 2010 or 2020 (for the least developed economies). This "open regionalism" was not devoid of ambiguities². It hardly made any progress in liberalisation when it concerned sensitive subjects for which the WTO offered a wider and, in principle, more effective theatre of negotiations³.

1. East Asian Economic Caucus.

2. On this subject, readers can refer to *The mid-term review of the Bogor Goal, Strategic issues and options*.
<http://www.apec.org.au/docs/koreapapers1/SII-AE-Paper.pdf>

3. At the APEC summit in Osaka in 1995, in the face of the United States which wanted to impose a general commitment, including agricultural products, and a precise timetable, the Asian countries (in particular Japan) successfully argued for the principle of flexibility which permitted them to selectively retain high barriers.

In the case of the ASEAN countries, AFTA provides for the progressive reduction of customs duties until there is a total liberalisation of intra-ASEAN⁴ trade by 2010 (or 2015 for the four members that joined later). However, up till now, the implementation of this agreement has had very few effects on the trade in the area. On the one hand, each country has kept its own list of "sensitive products" (mainly agricultural products) excluded from the joint mechanism, and, on the other, respecting the rules of origin (products must have a minimum 40% "ASEAN content" to benefit from the preferential treatment) has often proved too costly in relation to the preferential margin offered by the reduced tariff. Consequently, it is estimated that only 5% of intra-ASEAN trade actually came under the preferential tariff at the start of the 21st century⁵.

Overall, the whole of East Asia presents a paradoxical image. In the agricultural field, it has retained a discrimination that works against intra-Asian trade (table 1). In the industrial field, customs duties are low (apart from those affecting food products and textiles-clothing) and not very preferential for Asian exporters. However, multiple agreements negotiated case by case, particularly in the automotive and even more in the electronic sector, have allowed for the extraordinarily free and dynamic circulation of trade within industrial groups between the subsidiaries installed in the region's different countries. To attract investments, the ASEAN countries, and later China, have granted foreign businesses trade and tax privileges. Japanese companies, such as Toyota, for example, have patiently negotiated a tissue of agreements with the ASEAN countries to set up a real South East Asian

production network benefiting from these exceptional trade (exemption from duties on the import of machines and components) and tax (*tax holidays* often lasting five years) conditions.

What needs is the explosion of regional agreements negotiated over the last few years then addressing?

■ Objectives of the agreements

The preferential agreements that have multiplied since the end of the 1990s in East Asia have been instrumental in continuing the liberalisation that neither the APEC nor the WTO (at the time of the failure of the Seattle conference in 1999, in particular) seemed capable of taking any further. Regional negotiations looked like a faster and more efficient way of achieving an integration extended beyond the simple exchanges of goods to services, investments and the harmonisation of rules⁶. The same reasoning explains why bilateral agreements are negotiated by certain members of ASEAN in parallel to those negotiated by ASEAN itself.

However, these agreements only offset the limits and blockages of the multilateral (or regional) process they also respond to specific regional preoccupations.

◆ Economic security: The hypothesis we are formulating here is that the "informal" arrangements that have facilitated the regional division of labour are no longer sufficient to guarantee the security of trade now that it is expanding on a very large scale. The duties applied, which are above the levels consolidated at the WTO, could be raised again⁷; the advantages granted to foreign investors could be eliminated⁸; finally, the migrant workers could be expelled without warning (like the Indonesian workers employed in the Malaysian plantations during the 1997-1998 financial crisis). The commitments made in the framework of bilateral or regional agreements impose stronger constraints in these areas.

◆ The need for cooperations: The successive crises that have swept Asia in the last ten years - 1997-1998 financial crisis, sras crisis, tsunami natural disaster, bird flu - dramatically demonstrated the inadequacy of the intra-Asian cooperation mechanisms. Once again, informality showed its limits. Commercial integration is one component of regional cooperation that is taking shape, particularly in the framework of ASEAN+3⁹.

Table 1 - Average customs duties applied by East Asia depending on the exporting area (%)

	East Asia	Alena	EU-25
Agriculture	41.0	29.7	30.9
Food and Drink	21.8	26.4	25.8
Textiles-Clothing	7.3	7.6	7.8
Transport Equipment	4.6	2.8	8.6
Building Materials	2.9	3.6	4.4
Chemicals	2.4	3	2.7
Capital Goods	1.8	2.6	2.3
Electrical Machines	1.7	2.6	1.7
Capital Goods	1.5	1.9	2.5
Electrical Machines	1.4	1.5	2.2
Wood-Paper	1.4	1.3	1.5
Precision Equipment	1.2	1.3	2
All Products	7.4	5.5	7.2

Source: MAcMap, ITC-CEPH.

4. According to the CEPT (Common Effective Preferential Tariff). Since 1998, the ASEAN also has a framework agreement related to investment.

5. WTO, *World Trade Report* 2003, page 54.

6. Generally, economists are quite sceptical about the advantages of preferential regional agreements. For a review on this subject readers might like to refer to number 109 of *Économie Internationale* (2007) dedicated to the "new regionalism".

7. See R.E. Baldwin (2006), "Managing the Noodle Bowl: The Fragility of East Asian Regionalism", *CEPR Discussion Paper Series* n° 5561. 8. On the 8th of March, China announced that it was going to suppress the tax advantage granted to foreign businesses by adopting a single rate for all businesses.

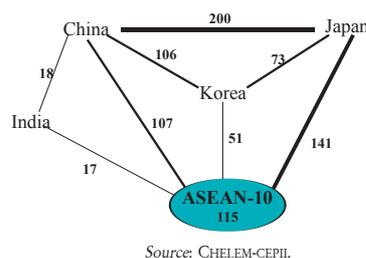
8. On the 8th of March, China announced that it was going to suppress the tax advantage granted to foreign businesses by adopting a single rate for all businesses.

9. The ASEAN's cooperation with China, Japan and South Korea, which started in 1997, was institutionalised in 1999. It includes a "political and security" part and an economic, trade and financial cooperation part.

♦ The increasing power of China: The size of its market is a powerful argument for negotiation for all of the countries in the area, with the exception of Japan, that find themselves in the position of being a relatively small country. Whilst China, which is very dependent on its imports of raw materials, must secure its sea routes, which, in a large part, pass through the straits of Malacca at the heart of the ASEAN.

Since the start of the 2000s, we have witnessed a frenzy of negotiations, summarised in diagram 1¹⁰. Obviously, the “domino effect” is at play: if a country stands aloof from the preferential negotiations, it risks seeing its exports penalised by diversion effects. This is why the 2002 Chinese proposal of opening negotiations with ASEAN with the aim of setting up a free trade area (ASEAN-China Free Trade Area, ACFTA) was quickly followed by similar initiatives on the part of Japan, then India and Korea. The framework of the AFTA is used as the basis for all of these negotiations. Thus, ASEAN finds itself at the centre of the regional process. Yet, it is not the dominant partner in Asia: the main flows are those linking Japan with China (diagram 2). Nor does it have the political dimension that could give it a driving force comparable to that of the Franco-German axis in Europe, for example. But, as well as being the oldest association, its

Diagram 2 – Main trade flows between the ASEAN countries+4 in 2005, billion dollars (sum of exports and imports)



members are the interested parties in a large number of regional initiatives and it is this relatively modest role in the region that makes ASEAN a political “centre” that is acceptable – by default, we might almost say – by the other partners.

Simulations carried out with the Mirage model have quantified the impact of trade integration within the perimeter selected.

Economic impact

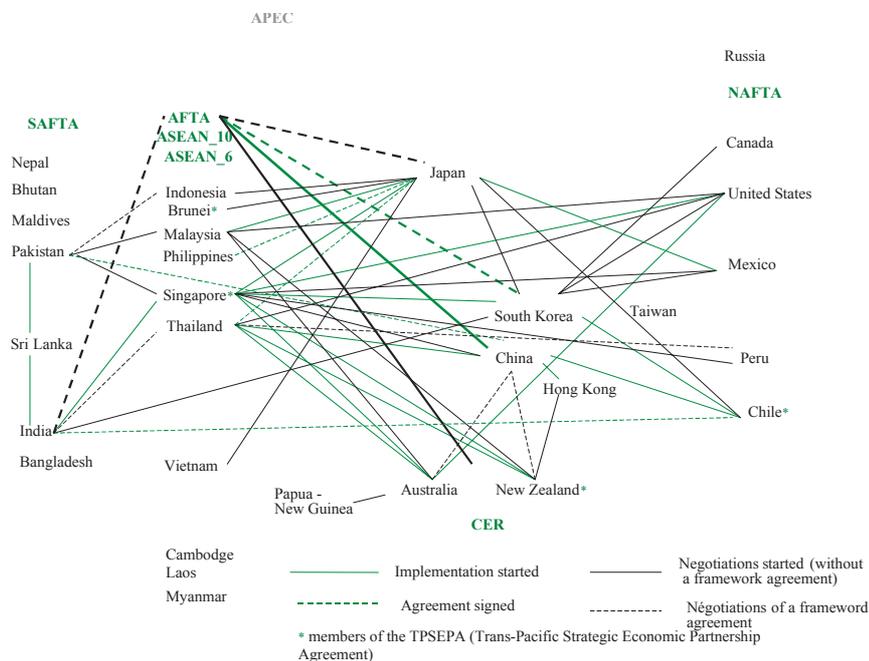
The free trade agreement simulations within the area cover all goods and services. Two methods of integration were analysed. That described above: a hub and spokes diagram centred on an integrated and free trade

ASEAN with each of the four main Asian countries: Japan, Korea, China and India (S1). Then a method of complete regional integration, in which ASEAN’s four main partners also liberalise their reciprocal exchanges (S2). Finally, a variant of diagram S1 was simulated excluding the liberalisation of a single list of so-called “sensitive” products, mainly agricultural (S3).

We can draw several lessons from these simulations (table 2)¹¹. Firstly, trade liberalisation produces significant effects for the parties involved, significantly greater than those to which these types of simulations generally lead¹².

This results from the fact that the region’s small countries (ASEAN

Diagram 1 – Regional or bilateral agreements concluded or being negotiated in the Asia-Pacific area (March 2007)



Source: Asian Development Bank, Asia Regional Integration Center, FTA Trends.

10. The diagram is centred on Asia. It does not show the agreements concluded with countries in other regions of the world, except those belonging to the APEC.

11. For the detailed results, see H. Bchir & M. Fouquin (2006), “Economic Integration in Asia: Bilateral Free Trade Agreements versus Asian Single Market”, CEPII working document, no. 2006-15, October.

12. Remember that the Mirage model only retains the effects of liberalisation that can be quantified robustly and ignores the dynamic effects whose potential importance is stressed by other empirical work. Therefore, they are minimum gains.

Table 2 – Regional free trade scenarios*
Macroeconomic impact by 2020

	GDP			Well fare**		
	S1	S2	S3	S1	S2	S3
ASEAN	4.2	3.3	2.6	2.6	1.8	1.6
Japan	0.7	2.4	0.2	0.2	0.4	0.0
Korea	0.5	3.7	0.4	-0.5	1.3	0.1
China	0.9	2.1	0.5	-0.1	-0.2	-0.1
India	2.3	4.1	2.5	-0.4	-0.3	-0.3

*S1 = Intra-ASEAN free trade and between the ASEAN and each of the 4 other countries;

S2 = Free trade between the 14 countries (10 ASEAN + 4);

S3 = S1 excluding sensitive products.

**Monetary equivalent of the national gain (or loss) following liberalisation.

Source: MIRAGE, H. Bchir & M. Fouquin (2006), *op. cit.*

members) have high openness rates (trade/GDP ratio) which make a large part of their activity sensitive to the “shock” produced on the trade. Elsewhere, among the large countries, India still has a high level of protection: regional free trade would be a very significant opening for the country. The second result concerns the decisive impact of the agricultural exception: excluding the “sensitive” agricultural products from the liberalisation reduces the gains of integration for ASEAN by more than a third (difference between S1 and S3). Finally, our simulations illustrate the advantage that ASEAN would derive from a hub and spokes agreement (S1) in which it would be the only one to have free access to the markets of the region’s large economies. A generalised regional free trade (S2), which would eliminate its preferential margin in terms of its large partners (for example, Japan, Korea and India would have the same free access to the Chinese market as ASEAN), would reduce its gains in terms of GDP or well-being by about a third. Conversely, Korea, which would gain little from a liberalisation centred on ASEAN, would be the main beneficiary for generalised free trade.

The most plausible scenario in the relatively near future is that of free trade limited to intra-ASEAN exchanges and between the ASEAN and each of its large partners, and excluding the sensitive agricultural products from the

liberalisation (S3). In practice, the majority of the population in ASEAN’s poorest countries lives on agriculture; in Indonesia, China and India, the agricultural population is still very large and needs protection. Even in Korea and Japan, where this population is much smaller, the agricultural pressure groups manage to preserve a special status for agriculture, and in particular rice growing.

The simulations’ results take into account the negative impact of diversion effects caused by liberalisation limited to the regional context. However, the lowering of barriers to trade will almost certainly extend further than the Asian context, whether it is in the framework of the WTO or in that of bi- or multilateral agreements with other partners. This is demonstrated by the negotiations between the United States and several members of ASEAN as well as the signature of the free trade agreement between the United States and Korea on the 1st of April 2007. Furthermore, during its November 2006 summit, APEC reaffirmed its will to undertake once again the project of creating a free trade area. From a European standpoint, discussions have been started with a view to forming an EU-ASEAN and EU-India partnership. Thus, the regional agreements that are multiplying in Asia seem less like discriminatory preferential agreements and more like one of the ways taken towards developing in-depth cooperation¹³ between neighbouring countries with common interests.

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13. On this theme, see in particular A. Estevadoral & K. Suominen (2007), “Sequencing Regional Trade Integration and Cooperation Agreements”, *Economie Internationale*, n° 109.

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