



DESIGNING

EAST ASIAN FTA

**RATIONALE
AND •
FEASIBILITY**

Edited by Zhang Yunling •



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Foreword

This is a research report on East Asian FTA (EAFTA) done by the study group chaired by me. The research started from March of 2004 and was jointly projected by Institute of Asia-Pacific Studies, Chinese Academy of Social Sciences (IAPS, CASS) and Institute of Developing Economies of Japan External Trade Organization (IDE-JETRO). Each side organized its own research team and conducted independent study but with the close consultation and cooperation between the two sides.

Chinese study group has 7 members from CASS, Academy of International Trade and Foreign Economic Cooperation, Ministry of Commerce, Institute of Foreign Economic Studies, State Commission of Economic Development and Reform and Development Research Center under the State Council. The report was drafted by: Zhang Yunling for Part I and VI, Zhou Xiaobing for Part II, Zhang Bowei for Part III, Chai Yu for Part IV, Xu Changwen (together with Wang Le, Song Zhiyong and Zhang Wei) for Part V and Liu Xiangfeng for Appendix (business survey). Based on the draft and the result of simulation, I, as the chair of the group, rewrote them into an integrated report. This report is a product of the collective effort of the study group, not my own. IDE-JETRO study group also gave their valuable comments. However, I would take the full responsibility for any shortcomings and possible incorrectness.

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I hope this research report could be a valuable contribution to the development of East Asian cooperation, and especially to the establishment of EAFTA. I would sincerely thank all members of the study group who wrote their draft papers and Dr. Zhao Jinping who provided valuable comments. My gratitude goes to IDE-JETRO who provided support for the study and special thanks to Mr. Osamu Watanabe, Chairman and CEO of JETRO who initiated this project.

Zhang Yunling
Chair of the Study Group
Director, Professor of IAPS, CASS
December 30, 2005

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I Overview

East Asian cooperation and integration, currently known as “ten plus three” (TPT), namely 10 ASEAN countries plus China, Japan and Korea^①, has received noticeable progress. The process starting from 1997 has made notable achievements: an institutional framework for regional cooperation has been set up through annual leaders’ meetings, ministers’ meetings and senior officials’ meetings, real progress in financial cooperation by Chiang Mai Initiative, preferential trade arrangements (PTAs), like AFTA, China-ASEAN FTA (CAFTA), Japan-Singapore closer economic partnership agreement (JSCEP), as well as sub-regional development projects. With the progress achieved, East Asian regionalism is emerging, which gradually leads to the regional institutional building.

I - 1 Rationale for PTA

The basic reason for regionalism is that it provides more and better market access for the countries through preferential trade arrangement (PTA). Compared with the multilateral approach, regional arrangement is much more flexible and also faster since problems that would take years to solve in global negotiations can be dealt with more

① In this report China only refers to People’s Republic of China, or Mainland China, Korea refers to Republic of Korea, Hong Kong and Taiwan are used only in the term as economic region.

quickly. PTA, also known as CEP (close economic partnership) can cover the areas not yet covered or covered poorly by WTO arrangements, thus as WTO-Plus. Seeing from the current agreements made, usually the following areas are more or less included in PTA or CEP:

Liberalization

- Market access for trade in goods through eliminating tariffs;
- National treatment of imports from partner countries;
- Reducing non-tariff measures on trade, e. g. import and export restrictions;
- Investment liberalization, providing national treatment;
- Market access for trade in services, opening service sector;
- Government procurement.

Facilitation

- Standards and conformance measures dealing with the technical barriers to trade and sanitary measures;
- The movement of natural and business persons;
- Rules of origin, imposing value-added percentages as criteria to preferential treatment;
- Transparency of laws and regulations.

Protection

- Safeguard measures, through restricting import;
- Dispute settlement procedures, disputes settling through consultations, conciliation, mediation or good offices before resorting to arbitration;
- Protecting intellectual property rights;
- Fair competition between imports and domestic produced goods.

Cooperation

- Economic dialogue on macro-economic level;
- Financial and monetary measures;
- Infrastructure development;
- Sub-regional development;
- Capacity building in human resource and management;
- Economic assistance.

As a matter of fact, the role of PTA is to provide not just gains in market access, but also efficiency through competition. In many cases, PTA was used as a strategy for the policy makers to facilitate reform and restructure.

Furthermore, if regionalism goes to the direction of an integrated regional institution, it may increase bargaining power in international negotiations (for example, WTO).

East Asian regionalism started to emerge mostly after 1997, i. e., after the Asian financial crisis. The lesson of the crisis tells that only market functioned economic integration is very vulnerable and the regional cooperation strongly needs to deal with the crisis and to reduce the future risks. However, East Asian strengthening economic integration provides the foundation for making regionalism with progress.

I -2 East Asian Economic Convergence

Economic convergence in East Asia started mainly by a "flying geese model" led by Japan and followed by "four dragons" (Korea, Singapore, Hong Kong and Taiwan), as well as some Southeast Asian countries and later China. This model helped to build up a "vertical" chain through capital flow, technological transfer and supply of manufacturing parts, thus formulating a high level intra-regional integration based on market exchange. Until the mid-1990s, intra-

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regional trade in East Asia was as high as 50% .

Nevertheless, during that period of time, there was few regional institutional building. ASEAN started its AFTA as early as 1992, but its role as a leader in facilitating FTA in whole East Asia is marginal since its early goal of liberalization mainly aimed at improving its own internal environment for attracting FDI.

1997 financial crisis was an important turning point since it changed both environment and structure of East Asian economic growth and integration. Due to the long stagnation of its economy and also the negative impact of the financial crisis, Japan is no longer the “locomotive” of East Asian economic growth, thus, came the end of “flying geese model”. Southeast Asian region was plunged into the serious recession and economic difficulties because of the financial crisis and political instability.

But with China’s continuous economic dynamism and increasing FDI flow to China, both the regional growth pattern and the convergence structure were changed. A broader network of production and service in East Asian region has been gradually developed with increasing share of exchanges of parts, components and other intermediate products, reflecting the development of intricate intra-regional production networks, in which production processes are subdivided among many different countries.^① FDI flow plays a key role in creating this network. The network based on exchange of trade and capital has profound impact on East Asian economic development since it has created a kind of “parallel developments” for the economies in the region. This is different from the traditional “flying geese model” that is based on the vertical and hierarchic transfer of technologies. This is also called a phenomenon of “bamboo capitalism” since this culminating feature of FDI-driven supply chain has created diverse and vibrant local industries around East Asian region. The further supply

① World Bank, *East Asia Update: Looking beyond Short Term Shocks*, April 2003, p. 15.

chains (the root system) are decomposed and extended geographically, the faster and more profuse will be the proliferation of new enterprises.^① This East Asian convergence goes beyond market integration by desiring governmental cooperation and institutional building.^②

As a matter of fact, regionalism finds its rationale in not only economic benefits, but also political interests. Compared with other regions, East Asia is late in forging regional PTA and other institutional establishments. Aside from intra-regional desire for a closer partnership, East Asian new regionalism is also considered to be a rational response to the progress of other regions, especially to the success of EU and the establishment of NAFTA.^③ By definition, East Asian economic integration started from as early as the 1960s based on regional economic growth and market approach, while the process of regional cooperation through regional institutional arrangement or formation through governmental efforts began only from the late 1990s. East Asian market based integration shows its vulnerability. Thus, this new initiative for regional cooperation will certainly help to enhance and facilitate further integration of East Asian region.

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- ① David Roland-Holst Iwan Aziz, Ligang Liu, *Regionalism and Globalism: East and Southeast Asian Trade Relations in Wake of China's WTO Accession*, ADB Institute Research Paper Series No. XX, January 2003, p. 16.
 - ② Shujiro Urata argued "a shift from market-led to institutional-led regional economic integration in East Asia", paper prepared for the conference on Asian economic integration organized by Research Institute of Economy, Trade and Industry, Tokyo, Japan, April 22-3, 2002, p. 1.
 - ③ It is considered that Prime Minister Mahathir's proposal of forming East Asian Economic Caucus (EAEC) is a direct response to NAFTA. Drysdale, Peter and Kenichi Ishigaki, (eds.), *East Asian Trade and Financial Integration: New Issues*, Asia-Pacific Press, Canberra, 2002, p. 6.

I - 3 Current Status

Among all institutional buildings, EAFTA is the most important. However, the road towards EAFTA does not start from a totally new base since East Asian region has already multi-layered PTAs or FTAs.

In East Asia, the first FTA proposal was put forward in 1998 for a Japan-Korea FTA, which is now still under negotiation. Later there are more FTAs in the region, both within East Asia, and with countries in other regions, some concluded, some still under the negotiation. ① Japan-Singapore CEP (JSCEP) was a pioneer in making a new kind of FTA in the region since it covers more areas than traditional liberalization—covering trade, investment, services, the dispute settlement mechanism, and economic and technical cooperation at various functional levels between the two countries. But China took the lead in making a large scale FTA between China and ASEAN as a group. China-ASEAN CEP Agreement was signed in 2002, which started with an early harvest program focusing on liberalization of agricultural trade in goods and an agricultural cooperation agreement. The CAFTA agreement for trade in goods was signed in November of 2004 and started implementation from July of 2005. In 2003, Japan signed CEP agreement with ASEAN and now is negotiating bilateral FTAs with some individual ASEAN economies (Thailand, Malaysia, the Philippines and Indonesia) and is also preparing an overall FTA agreement with ASEAN as a group. Aside from the negotiation with Japan, Korea seems to follow China and Japan to start the negotiation with ASEAN soon.

① For East Asian-non East Asian agreements that concluded, see Singapore-US FTA, Korea-Chile FTA, Japan-Chile and Japan-Mexico FTA, Singapore-Australia FTA, Thailand-US FTA. China is currently negotiating FTA with Chile, Pakistan, New Zealand, as well as Gulf Economic Cooperation Council. ASEAN is now negotiating with CER and India for FTA.

The degree of FTAs varies. Aside from liberalizing goods for trade, most of them commits to facilitating trade, harmonizing quality and other regulatory issues, building infrastructure and streamlining customs procedures. Liberalization of trade in services and investment is also included. Usually, FTAs, as CEP by nature, have provisions of human resource development (HRD) and technical assistance.

More importantly, the role for East Asian FTAs (or CEPs) is to make rules and to develop the legal mechanism among countries in the region. The arrangements and agreements both at the bilateral or sub-regional levels are rules making in nature in considering the principle of international standards, or "WTO consistent". In East Asian relations, this has profound significance since both "rule of standards" and "rule of law" will help to improve the systems of the regional members and to create a reliable foundation for the regional cooperation process. Thus, the regional arrangements will help to develop a new regional system based on increasing common or shared interests and rules among all parties. The institutional building in the region creates "public property" for countries in the region to maximize their interests.

Furthermore, from dynamic perspective, the gains from trade and investment facilitation under the framework of FTAs (or CEPs) (including improving infrastructure, management, human resources, etc.) may be much beyond gains created by lowering tariffs. This new kind of regional economic cooperation in East Asia will improve the long-term environment for the regional economic development.

I -4 Need an Integrated Approach

Due to its diversity, East Asian FTA started with a multi-layered approach. This approach can provide incentives for individual countries and the sub-regional group like ASEAN in realizing their best-expected gain. However, it may also create new barriers in the regional trade and investment:

- The regional market becomes divided because of different arrangements, which will reduce the gains from the scale of the regional market;

- Business cost will increase due to the complicated or contradicted regulations (for example, rules of origin), which is counter-productive to the network based economic integration;

- The region will not be possible to realize the goal of the community building without an integrated regional market.

All theoretical study shows that a larger FTA can create more benefits than a smaller one. That is to say, in East Asia, benefits of EAFTA exceed any other FTA arrangement, either the bilateral FTA, or the sub-regional. The study result presented here shows that every country will gain from EAFTA. The foundation of EAFTA lies in the high level integration characterized by FDI-trade network relations. But the potential of the integration is far from realized fully due to the barriers by either tariff or non-tariff measures.

By calling for an integrated approach in moving towards EAFTA, it does not intend to stop all existing bilateral or sub-regional arrangements. What we try to do here is to search a feasible road map for approaching EAFTA based on the existing arrangements.

II Foundation and Rationales of EAFTA

II -1 East Asian Economic Integration

Growing East Asian Intra-regional Trade

Foreign trade plays a very important role in promoting East Asian economic integration and development. Over thirty years since the 1970s, East Asian foreign trade has maintained a high growth rate. Up to 2003, the combined trade volume of the ten economies of East Asia^① amounted to US\$ 3.6 trillion or 23.5% of the world's total, their exports accounted for 25.4%, and imports for 21.8%.^② During the same period, trade between East Asian economies grew at a faster rate than their trade with the outside partners. As a result, we see a rising share of intra-regional trade in East Asia, which has laid a firm foundation for the increasing integration of East Asian economies.

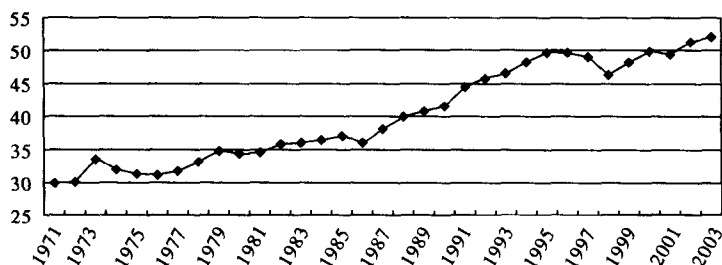
East Asian intra-regional trade reached 30% or so in the 1960s. The situation had not changed for almost a decade. At the beginning of the 1970s when the oil crisis damaged the world economy, the intra-regional trade in East Asia displayed a rising

① Including China, Japan, Korea, Hong Kong, Taiwan, Singapore, Indonesia, Malaysia, the Philippines and Thailand. Hong Kong and Taiwan refer to economic region in this report.

② The data are from International Trade Statistics 2004, http://www.wto.org/english/res_e/statis_e/its2004_e/its04_bysubject_e.htm.

tendency that lasted to 1995. Accordingly, East Asian intra-regional trade increased to one-half of its total foreign trade, higher than that of NAFTA.

From the mid-1970s to mid-1990s, it witnessed an accelerated trend of East Asian intra-regional trade, from 31.14% to 37.22% in the first decade during 1976-1985 and from 36.19% to 49.14% in the second decade from 1986 to 1995. In the late 1990s, with breakout of East Asian financial crisis, East Asian intra-regional trade initially saw a sharp decline, and then with recovery of East Asian economy, its intra-regional trade restored the momentum of growth. By 2002, the share of intra-regional trade surpassed the pre-crisis level, and reached 52.2% in 2003.



Source: UN Merchandise Trade Databank.

Figure II-1 Trends in Share of East Asian Intra-regional Trade (%)

Unstable Factors

In spite of rising share of intra-regional trade in East Asia, in the past four decades, intra-regional trade grew unsteadily.

The fluctuation of growth rates of East Asian intra-regional trade was mainly attributed to the external factors. The United States (the US) is a key factor influencing East Asian trade. In general, the trading pattern between East Asia and the US is relatively stable, despite a tendency of declining share. With establishment of NAFTA, trade