

Economic Integration in Extended East Asia:  
Toward a New Trade Regime\*

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## Abstract

This paper provides an overview on the recent development of FTA networking in extended East Asia and assesses the quality of FTAs with novel information on the utilization of FTAs, rules of origin, WTO plus elements, and others. It finds that East Asian FTA networking has been an effective driving force of promoting freer trade and investment, particularly through further activating international production networks. Politico-economic logics, namely race to the bottom, domino effect, and juggernaut effect seem to explain the rapid development of FTA networking quite well. The paper concludes that East Asia and Asia-Pacific may become a focal point of multilateralizing regionalism.

Key words: regionalism, free trade agreements, rules of origin, the World Trade Organization, political economy of trade policies

JEL classification: F13, F15

## 1. Extended East Asia and a new trade regime

East Asia or extended East Asia used to be relatively slow in the worldwide boom of regionalism.<sup>1</sup> By the year 2000, only two free trade agreements (FTAs) had been negotiated and concluded in extended East Asia: Australia-New Zealand Closer Economic Relations (CER) and ASEAN Free Trade Area (AFTA). However, since then, the area has become one of the most active regions in FTA networking.

Compared with other regions such as Europe, North America, and Latin America, FTA networking in extended East Asia has three distinctive characteristics. The first is on the structure. Bilateral and plurilateral FTA networking has been developed in an open setting, rather than limiting the membership and deepening integration. FTAs are highly flexible policy tools in terms of (i) the speed in negotiation and conclusion, (ii) the scope of policy modes included in agreements, and (iii) the sequencing in concluding multiple FTAs. Extended East Asia has fully taken advantages of such properties of FTAs and has developed FTA networking from ASEAN to multiple ASEAN-plus-one FTAs, and FTAs with countries beyond the region.

The second is the variety of its participants. East Asia is a mixture of countries widely different in income levels and stages of development. The recent participation by Australia, New Zealand, and India further enhanced diversity. As a consequence, FTAs in this region are not simple legal concessions for the symmetric liberalization of trade regime but are accompanied with various asymmetric elements regarding development issues. Deepening economic integration and narrowing development gaps are essential combination that is placed in the core of FTAs.

The third is the contents. East Asia has developed unprecedented international production networks, particularly in machinery industries. FTAs have actively been utilized for further activating such networks.

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<sup>1</sup> In this paper, “East Asia” primarily indicates ASEAN10 (Brunei, Indonesia, Malaysia, the Philippines, Singapore, Thailand, Cambodia, Laos, Myanmar, and Vietnam) plus 3 (China, Japan, and Korea) while “extended East Asia” means ASEAN10 plus 6 (China, Japan, Korea, Australia, New Zealand, and India).

FTAs in East Asia thus often include practical policy measures, inside or outside of the formal agreements, to improve business environment for international production networks, rather than pursuing a rule-oriented comprehensive coverage of various policy modes.

These characteristics of FTAs in extended East Asia may become a trigger for pushing forward the frontier of novel trade regime in the world. Negotiations on the Doha Development Agenda (DDA) under the World Trade Organization (WTO) are now going very slowly with its miserably shrinking agenda. When countries would like to have a political agenda for freer trade, practical regionalism in an open setting with a mixture of developed and developing countries, rather than the WTO, is likely to be at the center stage of international trade regime.

Some academic support for this argument has recently appeared. Mainstream trade economists used to maintain strong skepticism on regionalism since Viner (1950), preferring unilateral or multilateral trade liberalization to preferential/discriminatory arrangements. However, admitting the reality that regionalism stays, scholars including Richard Baldwin start examining the political economy of regionalism carefully and find strong forces heading for freer trade in regionalism if proper arrangements are accompanied with.<sup>2</sup> It claims that our immediate task is to seek ways to realize “multilateralizing regionalism,” and extended East Asia may be a focal point in this new wave.

The paper plan is as follows: the next section provides an overview on the recent development of FTA networking in extended East Asia and surrounding Asia-Pacific region. Section 3 assesses the quality of FTA networking in extended East Asia with novel information on the utilization of FTAs, rules of origin, WTO plus elements, and others. Section 4 provides some thought for interpreting FTA networking in East Asia in the context of new political economy literature on regionalism as a trade liberalizing forces. Section 5 concludes the paper.

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<sup>2</sup> See Baldwin (2006).

## 2. FTA networking in extended East Asia

FTA networking in extended East Asia is a very recent phenomenon. Table 1 presents the development of hub-and-spoke FTA system centered by ASEAN. Four ASEAN+1 FTAs, namely ASEAN-China, ASEAN-Japan, ASEAN-Korea, and ASEAN-CER (Australia and New Zealand), have been concluded by now, and ASEAN-India is also announced to be at the stage of “negotiation completed.” Although the contents of these FTAs widely vary, a hub-and-spoke FTA system has almost completed in extended East Asia.

===Table 1===

In terms of the relative economic size as well as investing capability, ASEAN is not all a big player. Much larger economies are at the other ends of spokes. One obvious condition that ASEAN is allowed to be a hub of FTA networking is a delay in FTA connections among China, Japan, and Korea, due to long-lasting political and emotional reasons. ASEAN has taken advantage of it and has paid tremendous effort to stay in the driver’s seat of East Asian economic integration. ASEAN concluded ASEAN Free Trade Area (AFTA) in the early 1990s and accelerated trade liberalization after the Asian currency crisis in the latter half of the 1990s. ASEAN now seeks deeper economic integration under the initiative of ASEAN Economic Community (AEC). At the same time, ASEAN has provided efficient venues for ministerial and summit meetings for neighboring extended East Asian countries.<sup>3</sup>

There are a number of initiatives that pursue region-wide economic integration. East Asian Free Trade Area (EAFTA) and the Comprehensive

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<sup>3</sup> The recent cancellation of a number of ministerial and summit meetings in Pattaya, Thailand in April 2009 due to anti-government demonstration is generating some doubt on ASEAN’s ability to keep providing convenient venues for international meetings. On the other hand, China, Japan, and Korea had the “first” summit meeting, held independently of other international gatherings, in Fukuoka, Japan in December 2008 and announced to have an annual meeting as such.

Economic Partnership in East Asia (CEPEA) are such efforts currently under expert group studies, heading for ASEAN+3 and ASEAN+6 economic integration, respectively. However, due to difficulties for China, Japan, and Korea to get together in the short run, such initiatives for region-wide FTA formation seem to lose a bit of steam these days. ASEAN may not have strong enthusiasm in forming a region-wide FTA either because the hub-and-spoke system is even more comfortable for them in playing as a hub despite its smallness in size. The concept of “East Asia” as a unit of formal economic integration seems to be gradually blurred.

Countries in extended East Asia are also active in negotiating and concluding FTAs with countries outside the region. The overlapping region in active FTA networking is Asia-Pacific. Figure 1 shows the current status of FTAs among nine advanced APEC (Asia-Pacific Economic Cooperation) countries: seven OECD (Organisation for Economic Co-operation and Development) countries, Singapore, and Chile. As of December 2008, out of 36 bilateral combinations, 20 pairs have already concluded FTAs, and six pairs are under negotiation. In the recent APEC meetings, the US proposal on FTAAP (APEC-wide FTA) has been on agenda. Although a FTA that covers all 21 APEC member economies does not seem to be feasible in the short run, it may be possible for likeminded countries/economies to get together and start forming a plurilateral FTA under a “dock-and-merge” strategy and gradually increasing the participants. The Trans-Pacific Partnership (TPP) including the US and P4 (“Pacific Four” including Brunei, Chile, New Zealand, and Singapore) were announced to initiate a full-scale negotiation in September 2008. Australia and Peru also announced to participate in it in November 2009. These moves may develop a core of Asia-Pacific economic integration.

==Figure 1==

Unlike economic integration in Europe, FTA networking in extended East Asia and Asia-Pacific has developed as an open-end system and has gradually weaken a solid regional concept with exclusive membership. As

the WTO loosens its grip in the international trade regime, new types of regionalism in extended East Asia and Asia-Pacific may become a prototype of “multilateralizing regionalism” to promote freer trade in the world.

### 3. The evaluation of FTA networking in extended East Asia

Let us now examine and evaluate the contents of FTAs in extended East Asia. First, we will review the background of FTA networking in the region, particularly from the historical viewpoint of the interaction between *de facto* and *de jure* economic integration. We will then assess various aspects of the liberalization of trade in goods and other policy modes. At the end, the interpretation in the context of political economy will be presented.

#### (1) *De facto* and *de jure* economic integration in East Asia

In East Asia, *de facto* economic integration head-started before *de jure* economic integration. The most significant event on the side of *de facto* economic integration was the formation of international production networks from the beginning of the 1990s. Although cross-border production sharing and off-shoring/outsourcing to less developed countries (LDCs) are observed in the US-Mexico nexus, the Western-Eastern Europe, and other regions, international production networks in East Asia are distinctive in (i) their significance for each economy in the region, (ii) their extensiveness in covering many countries and regions at the same time, and (iii) their sophistication in combining various types of intra-firm and arm’s length (i.e., inter-firm) transactions.<sup>4</sup>

The formation of international production networks was backed up by rich series of piecemeal policy reform. In the mid-1980s, Thailand and Malaysia during a recession made a significant step of policy changes for inward foreign direct investment (FDI). Other ASEAN countries followed them with time lags of several years. In order to attract FDI, these

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<sup>4</sup> As for the characteristics of East Asian production networks and the background policy environment, see Ando and Kimura (2005) and Kimura (2006).

countries openly listened to various requests raised by multinationals for trouble-shooting and accumulated piecemeal investment liberalization and facilitation. In addition, the initiative of information technology agreements (ITA) supported by APEC and WTO realized free trade in semiconductor-related electronic parts and components in the latter half of the 1990s. Note that these policy reforms were not based on regionalism but primarily on unilateral liberalization. AFTA was concluded in 1992 but provided a mere advertisement effect in attracting FDI in order to compete with China emerging as a strong FDI attractor. The actual trade liberalization based on AFTA was minimal until the end of the 1990s.

Regionalism in East Asia went up to a center stage after the Asian currency crisis. ASEAN started to make a collective effort to keep incoming FDI by accelerating its integration process and to incorporate latecomers in ASEAN. East Asia as a whole acted together to establish an anti-crisis vehicle in international financial cooperation and ended up with the establishment of the Chiang Mai Initiative. The effort of forming FTAs was launched by the Japan-Korea talk in 1998, followed by the formation of Northeast Asia and ASEAN FTAs. The last three countries in extended East Asia, namely Australia, New Zealand, and India, also recently deepened their relationship with ASEAN.

FTA negotiations were largely motivated by the existing *de facto* economic integration in the region. In the negotiation process of these FTAs, major agenda became (i) the restructuring of import-substituting industries such as automobiles, domestic electric appliances, iron & steel, and petrochemicals by removing remaining trade barriers and (ii) the further activation of intra-regional production networks by conducting trade/FDI liberalization and facilitation. These will reflect the contents as well as the usage of FTAs in the region.

## (2) Liberalization of trade in goods

### Liberalization coverage

One of the obvious criteria for evaluating the quality of FTAs is the



degree of the cleanness of liberalization for trade in goods. Reflecting the hub-and-spoke system of FTAs centered by ASEAN, the liberalization coverage of FTAs varies with AFTA the highest.

AFTA was concluded as a FTA under the enabling clause of the WTO and did not follow all the disciplines that the WTO imposed. A major deficiency is the length of interim agreement. The WTO asks countries to complete substantially all the trade liberalization within ten years.<sup>5</sup> In the case of AFTA, since the initiation of tariff reduction in the early 1990s, already more than 15 years have passed. However, the liberalization coverage of the Common Effective Preferential Tariff (CEPT) scheme of AFTA that specifies gradual tariff reduction schedule is pretty high. Under the CEPT scheme, each member country classified traded commodities into the inclusion list (IL), the temporary exclusion list (TEL), the general exception list (GEL), and the sensitive/highly sensitive list (SL/HSL) and gradually moved items from TEL, GEL, or SL/HSL to IL. By now, the original member countries, i.e., Brunei, Indonesia, Malaysia, the Philippines, Singapore, and Thailand, have eliminated TEL and have retained GEL and SL/HSL only for very limited commodities (less than 1%). Commodities in IL are now with 0-5% tariffs, which are also supposed to be zero by 2010.<sup>6</sup> Although AFTA has been criticized as a lenient FTA for long, it turns out to be a clean FTA in terms of the liberalization coverage.<sup>7</sup> In addition, ASEAN recently harmonized traded commodity classification up to the most detailed level.

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<sup>5</sup> 1947 GATT XXIV5(c) stated “reasonable length of time,” which is further specified as “10 years” by the Understanding on the Interpretation of Article XXIV of the General Agreement on Tariffs and Trade 1994.

<sup>6</sup> Latecomers of ASEAN, i.e., Vietnam, Laos, Myanmar, and Cambodia, are supposed to eliminate tariffs for almost all commodities by 2015 or 2018.

<sup>7</sup> As of August 2008, the percentage of tariff lines with zero tariffs is 85.4% in Brunei, 80.0% in Indonesia, 82.6% in Malaysia, 82.9% in the Philippines, 100% in Singapore, and 80.0% in Thailand, which clear the interim target of 80%. The average tariff rates are 1.95% for ASEAN10 and 0.97% for ASEAN6 in 2008. See JETRO (2009, p. 24).

ASEAN-China FTA (ACFTA) and ASEAN-Korea FTA (AKFTA) apply similar tariff reduction scheme to CEPT though they are less clean than AFTA in the liberalization coverage. ACFTA started lowering tariffs under the interim agreement in July 2005 while the so-called Early Harvest Program for agricultural and fishery products (HS01-08) was implemented from January 2004. The interim agreement classified commodities other than those under the Early Harvest Program into (i) normal track 1, (ii) normal track 2 (within 150 items), (iii) sensitive track (less than 400 items and less than 10% of trade values), and (iv) highly sensitive track (less than 100 items and less than 40% of items in the sensitive track). The due dates for tariff elimination are 2010 and 2012 for (i) and (ii), respectively. For (iii), the existing tariffs can be retained until the end of 2011, will be reduced to less than 20% by 2012 and 0-5% by 2018. As for (iv), tariffs should be reduced to less than 50% by the beginning of 2015. Items classified in sensitive and highly sensitive lists differ across countries though some important electric machinery and transport equipment are included. AKFTA has a resembled scheme and the similar level of liberalization coverage.

Japanese bilateral FTAs with ASEAN countries set up a higher standard for ASEAN countries than ACFTA or AKFTA. For Japanese bilateral FTAs with Brunei, Indonesia, Malaysia, the Philippines, Singapore, Thailand, and Vietnam, the zero-tariff coverage after ten years in terms of trade values on the ASEAN side is 99.94%, 90% (96% including iron and steel for specific use), 99%, 97%, 100%, 97%, and 88%, respectively. The zero-tariff coverage after ten years on the Japanese side is often lower though: 99.99%, 93%, 94%, 92%, 95% (97% after the five-year review), 92%, and 95%, respectively.<sup>8</sup> The lower liberalization coverage on the Japanese

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<sup>8</sup> These figures are obtained from the homepage of the Ministry of Foreign Affairs, Government of Japan (<http://www.mofa.go.jp/>). Note that the measurement of liberalization coverage in terms of trade values is sensitive to the trade pattern in the base year, which may not properly reflect high spikes of protection. Kuno and Kimura (2008) show that the liberalization coverage of some bilateral FTAs concluded by Japan in terms of the number

side is due to heavy protection on agriculture-related commodities.<sup>9</sup> The asymmetric liberalization commitments are the reflection of Japan's negotiating power in Southeast Asia as well as the existence of side payments in the form of investment promotion and economic/technical cooperation from the Japanese side.

The recently concluded ASEAN-Japan FTA (AJCEP) applies the CEPT-style tariff reduction scheme. On the Japan side, 90% of commodities (in terms of trade values) will have immediate tariff removals, additional 3% will have within-ten-year gradual tariff removals, and the rest will be excluded from liberalization or have certain reduction of tariffs. As for ASEAN6, 90% (in terms of both trade values and the number of tariff lines) will have immediate tariff removals or within-ten-year gradual tariff removals, and the rest will be excluded from liberalization or have certain reduction of tariffs. ASEAN latecomers will have a looser schedule of tariff removals or reduction.

In summary, AFTA is now completing a clean FTA in terms of the liberalization coverage for trade in goods, but other FTAs in East Asia still include dirty aspects. Although manufactured goods are widely covered in liberalization schemes, some specific items, particularly agriculture-related commodities in Japan, retain substantial protection. The recent entry of Australia and New Zealand in the game of FTA networking in the region has provided a certain pressure on protectionism though completely clean trade liberalization in East Asia as a whole is yet to come.

### FTA utilization

Tariff reduction or removal does not automatically mean freer trade.

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of tariff lines is substantially lower than the announced figures based on trade values.

<sup>9</sup> As for the agricultural protection in FTA negotiations by Japan, see Ando and Kimura (2008) and Mulgan (2008a, 2008b). Kuno and Kimura (2008) analyze the nature of heavily protected agricultural products focusing on their geographical concentration of production in Japan. Low coverage of liberalization for agricultural products becomes an obvious obstacle to Japan's further extending FTA strategies.

Only after utilizing preferential tariffs, trade liberalization effects are realized. FTAs in East Asia, particularly AFTA, have for long been criticized for their low levels of utilization. The situation, however, has drastically changed these days.

Thailand and Malaysia disclose the data of FTA utilization on the official customs data basis. Table 2 presents two countries' exports with utilizing the CEPT scheme of AFTA. As of 1998, CEPT was barely utilized, which confirms the old criticism. However, the utilization ratios have substantially increased since then. In 2007, 31% of Thailand's intra-ASEAN exports and 19% of Malaysia's intra-ASEAN exports utilize CEPT where exports to Singapore are excluded because MFN-applied import tariffs in Singapore are zero for almost all products. These ratios are not small because the denominator, total intra-ASEAN exports, includes exports of commodities for which MFN import tariffs are already zero or very low particularly under ITA and for which duty-drawback system is applied as investment incentive.

==Table 2==

Table 3 tabulates exports utilizing various FTAs by Thailand and Malaysia. ACFTA and AKFTA do not seem to be well utilized so far, perhaps due to the slow liberalization process or the low public awareness. On the other hand, the Thailand-Australia FTA and the Early Harvest Scheme items in the Thailand-India FTA present very high utilization ratios, 66% and 98% respectively in 2007. Table 4 presents FTA utilization in imports by Thailand. While FTAs with China and India are barely used, AFTA, Thailand-Australia FTA, and Thailand-New Zealand FTA are relatively well utilized.

==Table 3==

==Table 4==

Japan External Trade Organization (JETRO) annually conducts an extensive questionnaire survey on foreign affiliates of Japanese firms, which recently starts including questions related to FTA utilization. The new results (JETRO (2009, p. 22-30)) show that among manufacturing affiliates of Japanese firms in ASEAN conducting exporting activities, 23.0% use FTAs, and 23.3% consider using FTAs. Among those with importing activities, 19.7% use FTAs, and 24.4% consider using FTAs. The questionnaire further asks affiliates not even considering using FTAs for reasons why. Among exporting affiliates without any intention of utilizing FTAs, 37.6% of them say “duty-drawback system on the import side exists,” 22.9% claim “there does not exist a FTA with trading partners,” and 19.9% state “MFN tariffs at destination are low so that FTAs are not advantageous.” Very small proportion of exporting affiliates raises troublesome administrative procedures or their ignorance of FTAs as reasons for not utilizing FTAs. Similarly, among importing affiliates without any intention of utilizing FTAs, 48.9% of them say “duty-drawback system for imports are applied,” 13.4% claim “domestic sales on which tariffs are imposed is small,” 13.1% state “there does not exist a FTA with trading partners,” and 12.8% advocate “MFN tariffs are already low.”

The questionnaire also asks some additional questions. One is the minimal preferential margin with which exporting affiliates stop using MFN tariffs and start utilizing FTAs. The average margin across exporting affiliates located in ASEAN is 5.2%. Another is the preferential tariff rate equivalent to the administrative cost of obtaining duty-drawback system. The average across importing affiliates located in ASEAN is 1.9%.

Hayakawa, Hiratsuka, Shiino, and Sukegawa (2009) employ the micro data of JETRO survey and regress the utilization of FTAs on individual affiliates' characteristics. They find that the utilization of FTAs or the intention to utilize FTAs is positively associated with the size of affiliates and negatively associated with the number of commodity items with zero tariffs. The relationship with the proportion of local procurement presents an inverted-U pattern.

Overall, considering other policy arrangements to avoid being taxed

such as zero MFN tariffs, duty-drawback system, and others, the utilization of FTAs seems to be fairly high in ASEAN. However, further facilitation in utilizing FTAs may be required, particularly for small and medium enterprises.

### Rules of origin (RoO)

Possible negative consequences of RoO are one of the major concerns in regionalism. So-called spaghetti bowl or noodle bowl phenomenon refers to trade deterrent effects that are generated by the complication of trade regime, particularly regarding RoO, due to the unorganized proliferation of bilateral/plurilateral FTAs. However, the logic of trade deterrence due to additional FTA is not very clear. Adding another FTA on the top of existing FTAs would certainly enhance the complication of trade regime. However, if private people think a new preferential tariff system too complicated, they will simply continue to use MFN tariff system or other FTAs. It is very unlikely that additional FTA reduces trade; instead, the issue we concerned should be whether additional FTA promotes trade or not. In that sense, RoO may indeed work as a counteracting force against trade liberalization by FTAs. Strict and unfriendly RoO may act for protectionism by nullifying the usage of preferential arrangements.

Estevadeordal, Harris, and Suominen (2007) provide an extensive survey on RoO in FTAs in the world. They conclude that RoO in intra-Asian FTAs tend to be less restrictive and complex than their counterparts in Europe and the Americas. Sample firm surveys in East Asian countries conducted by Kawai and Wignaraja (2009) suggest unexpectedly little Spaghetti/noodle bowl phenomena though further facilitation seems to be needed. We are accumulating evidences that RoO in FTAs in East Asia does not work as a major obstacle to promoting freer trade.

Medalla and Balboa (2009) carefully examine RoO in FTAs in East Asia, review best practices in applying RoO, and propose a direction for improvement. First, they claim that alternative or co-equal system of RoO is less restrictive than other arrangements and is thus to be promoted. RoO is classified by the testing methodology in identifying the origin of goods.

Frequently used tests are the value-added measure test, the tariff heading criterion test, the specified processes test, and the combination of these, “both” or “either.” The value-added measure test looks simple in text but is not user-friendly for some products such as machineries consisting of numerous parts and components. A practical way of avoiding unnecessary user cost as well as saving the cost of negotiation is an alternative or co-equal system in which meeting one of the designated tests, for example, either the value-added measure test or the tariff heading criterion test, may suffice.

Table 5 tabulates the number of tariff lines applying various types of RoO in AFTA, ACFTA, AKFTA, and AJCEP. ACFTA reflects an old style of RoO that applies the value-added measure test or regional value content (RVC) test for large number of tariff lines. AFTA used to have a similar pattern but recently switched to a co-equal system applying either RVC test or tariff heading criterion test (CC, CTH, or CTSH in the table) for a large number of tariff lines. AKFTA and AJCEP also apply co-equal system extensively.

==Table 5==

Second, Medalla and Balboa recommend wider application of *de minimis* principle. This principle specifies a maximum percentage of non-originating material to be used without affecting origin, which can substantially reduce the cost of proving the origin of products in the value-added measure test. Third, although RoO in East Asia seem to be relatively simple and liberal, they recommend further facilitation in the procedure to obtain the certificate of origin.

In summary, RoO is certainly important in order to capture the benefit of liberalization effort in FTAs, and there still exists room for further facilitation. However, negative consequences of the complication of RoO seem to be limited in East Asia.

Regionalism promoting multilateral liberalization

There has been a long-lasting debate on whether trade liberalization in regionalism is a building block or a stumbling block for worldwide trade liberalization. Various political economy models can justify both stories, and the issue is thus empirical. In this context, the paper by Estevadeordal, Freund, and Ornelas (2008a, 2008b) is a path-breaking work. It employs extensive time-series data set of tariff levels in selected Latin American countries, both on the FTA basis and the MFN basis, and rigorously proves that tariff reduction in FTAs tends to be followed by tariff reduction at the MFN level. Calvo-Pardo, Freund, and Ornelas (2009) replicate the exercise for ASEAN and find the same pattern. Trade liberalization in FTAs seems to promote multilateral trade liberalization.

As pointed out by Ando (2007), we observe in East Asia and other parts of the world that MFN-based liberalization often surpasses gradual liberalization in FTAs so that the utilization of FTAs loses its sense at least temporarily. Trade liberalization on the FTA basis seems to be an effective trigger for trade liberalization at the MFN level, particularly in East Asia.

## (2) Liberalization in other policy modes

Taking advantage of their flexibility, FTAs in the world have increasingly included various policy modes other than policies on trade in goods. Trade in services is a natural extension on which GATS Article V imposes certain discipline. The actual liberalization of trade in services in intra-East-Asian FTAs, however, is relatively modest because countries in the region do not have strong international competitiveness in most of the services sectors.

ASEAN has ambitiously set the target of ASEAN Economic Community (AEC) in 2015, and the liberalization of trade in services is one of the major efforts. ASEAN Framework Agreement on Services (AFAS) was signed in December 1995, and with seven sequential rounds of negotiations between 1996 and 2009 under the purview of ASEAN Economic Ministers (AEM), the path of liberalization toward “substantially eliminating restrictions to trade in services among ASEAN countries” has



gradually been specified. Air travel, healthcare, e-ASEAN (telecommunications and IT services), and tourism as well as logistics are set as priority sectors to realize liberalization earlier, and all the other sectors will follow by 2015 with services negotiations in every two years. As a result, ASEAN is supposed to achieve a free flow of services by 2015 with flexibility. In addition, seven mutual recognition agreements (MRAs) have been concluded for professional services. The effort of ASEAN is certainly ambitious though how far the actual liberalization is realized is still to be tested.

ACFTA and AKFTA include agreements on trade in services, both of which were signed in 2007. However, the structure of the articles closely resembles to GATS, and the contents do not extensively explore GATS plus. Bilateral FTAs between Japan and ASEAN member countries include a number of GATS plus due to sector-by-sector negotiations. However, agreements are not entirely comprehensive, which reflects relatively weak services sectors in Japan.

As for investment, ASEAN concluded the ASEAN Comprehensive Investment Agreement (ACIA) in February 2009, which is an upgraded version of ASEAN Investment Area (AIA) in 1998, as a part of the comprehensive efforts toward AEC. ACIA includes liberalization, promotion, facilitation, and protection with applying a negative list approach for reservations. How far the reservations will be eliminated is not sure at this moment though.

ACFTA and AKFTA are supposed to include investment after additional negotiations though the contents have not been disclosed yet. As for Japan, although AJCEP does not include a meaningful article on investment, bilateral FTAs between Japan and ASEAN countries as well as bilateral investment treaties with Cambodia (signed in June 2007) and Laos (signed in January 2008) deal with investment. They intend to explore investment liberalization including pre-entry and post-entry national treatment, ban on some performance requirements, and investment facilitation in addition to investment protection. These obviously reflect interests of Japanese firms extending business all over East Asia.

Other elements in intra-East-Asian FTAs reflect development stages and private sector's interests of each country in the region. ASEAN has pursued AEC under the scheme of AEC Blueprint (ASEAN (2008)) in which various policy areas and topics other than policies on goods, services, and investment are listed (Table 6). We observe that the contents that seem to be workable are highly practical and relevant to political and economic conditions of ASEAN.

==Table 6==

FTAs concluded by Japan in the region are also highly pragmatic. For example, the Japan-Indonesia EPA concluded in August 2007 as well as related documents include practical items, in addition to trade in goods, services, and investment, such as energy and mining resources, movement of natural persons and related cooperation, customs procedure, government procurement, competition, and intellectual property rights, and cooperation. ACFTA and AKFTA also reflect the status of international relations as well as industrial connections; economic cooperation is always an important sub-element in FTAs.

In East Asia, WTO+ works strongly. However, the context is not for pursuing the legal comprehensiveness of economic integration. Rather, the motivation of introducing WTO+ is pragmatic for serving diplomatic purposes or responding to requests of private sector extending international production networks. In the end, facilitation and cooperation are often emphasized more than liberalization.

#### 4. Politico-economic interpretation

The recent literature of political economy on trade policies challenges the issue of why countries promote freer trade despite the existence of strong resistance from import-competing sectors. East Asia has obviously made big steps toward freer trade. The East Asian economic integration is certainly a relevant topic in the political economy literature. Following the framework that Baldwin (2006) proposes, we can present a list

of episodes that politico-economic interpretation seems to work well.

#### (1) Race to the bottom

The politico-economic logic of “race to the bottom” claims that developing countries may rush into trade liberalization while competing with each other, for example, in attracting FDI by multinationals. As pointed out by Baldwin (2006), trade liberalization in ASEAN before the Asian currency crisis seems to fall into the case.

From the latter half of the 1980s and the early 1990s, ASEAN forerunners drastically changed their FDI-hosting policies from “selective” to “open in principle,” recognizing multinationals as essential elements in their industrialization. The emergence of China as a massive FDI attractor in 1992 and after intensified the sense of emergency on the ASEAN side at the risk of losing inward FDI. At that time, import-substituting industries run by multinationals or local firms were still preserved with trade barriers, but aggressive unilateral tariff reduction or removal started from parts and components in order to attract network-forming FDI.

Shifts toward freer trade were initiated in the first half of the 1990s and were followed by more comprehensive trade liberalization under the initiative of ITA in the latter half of the 1990s. Note that in this process, the GATT or WTO did barely take initiatives. Tariffs were largely reduced and removed unilaterally in terms of applied MFN tariff rates rather than GATT or WTO committed concessional tariff rates, which generated huge “tariff bindings overhang.” Grips of the WTO on ASEAN are still weak even now; in a number of countries in the region, bound ratios (the ratio of bound tariff lines) are still substantially lower than 100%, and tariff bindings overhang (gaps between bound MFN tariff rates and applied MFN tariff rates) are large (Table 7).

==Table 7==

Policy changes toward freer trade driven by regionalism started after the Asian currency crisis. Before the crisis, AFTA was used as a sort of

collective advertisement and did not work as an effective collective forum for trade liberalization. Unilateral trade liberalization based on the “race to the bottom” story is the most convincing interpretation for trade liberalization by ASEAN before the Asian crisis.

## (2) Domino effect

There are at least two episodes on which the story of “domino effect” of participating in regionalism by multiple countries seems to work well. The first is the expansion of ASEAN. ASEAN started with Indonesia, Malaysia, the Philippines, Singapore, and Thailand in 1967, and Brunei joined in 1984. Although the original motivation of ASEAN was rather political because of the Vietnam War, AFTA was launched in 1992 as a core agreement heading for regional integration. The following annexation by Vietnam (1995), Laos (1997), Myanmar (1997), and Cambodia (1999) was obviously motivated by the fear of being left over when other neighboring countries were taking steps toward regional integration. The original member countries were also generous in accepting these countries with extensive special and differential treatments.

The second is the formation of ASEAN+1 times X hub-and-spoke system of FTAs. Japan and China apparently competed with each other in concluding FTAs with ASEAN. Japan agreed with Singapore to initiate a tripartite (government, industry, and academics) study on a FTA in December 1999, officially started negotiating over an FTA with Singapore in January 2001, and signed it in January 2002. Then Prime Minister Koizumi in parallel proposed Comprehensive Economic Partnership between Japan and ASEAN, also in January 2002. On the other hand, China was largely tied up with the WTO accession issue up to the middle of 2000<sup>10</sup> and obviously felt a bit lagging behind for involving itself in rising regionalism.

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<sup>10</sup> The official accession was granted in December 2001. Bilateral negotiations over China’s accession with Japan, the United States, and the EU were agreed in July 1999, November 1999, and May 2000, respectively. The United States endorsed permanent MFN status for China in October 2000.

Chinese Prime Minister Zhu Rongji took a top-down approach and suddenly proposed the formation of a study group with ASEAN in November 2000, which was followed up by the China-ASEAN FTA proposal in November 2001 and the conclusion of the framework agreement in November 2002. Such a quick move of China then in turn stimulated Japan, and Japan initiated a set of negotiations over bilateral and plurilateral FTAs. In parallel, other countries including Korea and India also negotiated over FTAs with ASEAN.

Unlike Western Europe in the context of European integration, ASEAN is not a huge market or a dominating economy for neighboring countries. China's motivation for FTA networking was mainly political. At that timing, China was looking for friendly neighbors, and ASEAN was a natural choice for deeper commitments. Japan thought more of economic interest. The FDI stock of Japan in ASEAN was and is even now larger than that in China, and Japan had a strong incentive for taking opportunities to improve investment climate in ASEAN. From different incentive schemes, the two countries competed with each other in concluding FTAs with ASEAN. Then ASEAN successfully became a focal point in the regionalism in East Asia, also attracting countries other than Japan and China.

### (3) Juggernaut effect

The story of Juggernaut effect focuses on the politico-economic interactions between exporting industries and import-competing industries. In order for exporting industries to enjoy trade openings in the partner country of a FTA, they first need to persuade import-competing industries to remove trade barriers for exporting industries of the partner country. Internal negotiations between exporting industries and import-competing industries can end up with freer trade under the FTA scheme. Furthermore, in a dynamic setting, FTA conclusions may strengthen the political power of exporting industries vis-à-vis import-competing industries, and thus even freer trade can be promoted over time. Such a story is also convincing in a number of episodes in East Asian FTA networking with some twists.

In the case of ASEAN, export industries are basically multinationals or local firms with strong links with them, and thus multinationals and their local chambers of commerce are major actors in the promotion of freer trade and better investment climate. On the other hand, import-competing industries consist of three groups: (i) small local firms without much political voice, for example, in food processing and light industries, (ii) large local firms, typically state-owned, with certain political power such as in iron & steel and petrochemicals, and (iii) import-substituting multinationals in electric machinery and automobiles, for example. (ii) and (iii) can present some effective resistance against freer trade, and interactions with freer trade supporters formulate the politico-economic background of FTA negotiations. We observe that freer trade supporters become stronger over time, which accelerates FTA conclusions. AFTA was a sort of a practice round in order to adjust for freer trade, preparing more thorough trade liberalization in FTAs with outsiders.

Japan's case presents harsh domestic interactions between globalizing manufacturing firms and import-competing agricultural sector. Compared with the concession at the level of Uruguay Round, FTA negotiations, other than the one with Singapore where no liberalization was conducted in agriculture, forced the agricultural sector to make additional, though modest, trade openings. However, the liberalization coverage does not reach the high standard.

We observe that the liberalization coverage tends to increase over time and politico-economic power is visibly weakened as the number of concluded FTAs goes up, which is consistent with the story of dynamic Juggernaut effect. Kuno and Kimura (2008) examine the liberalization coverage of agricultural sector in Japan-Singapore, Japan-Mexico, and Japan-Malaysia FTAs. In these three FTAs, among 196 agricultural items at the level of HS 4 digit, 139 have tariff removals within 10 years for 80-100% sub-items. On the other hand, only 17 items are untouched in these negotiations. All of these products with rice as the only exception present high concentration in production sites. In other words, trade protection is largely backed up by local pressure groups on the narrow

geographical basis. These sub-sectors are certainly to be highlighted and isolated in the Japanese political scene.

The existence of side payments in FTA negotiations between Japan and ASEAN allows Japan not to proceed thorough trade liberalization of import-competing sector, namely agriculture, and some “dirty” elements are left over in these FTAs. However, Japan cannot use the same kind of side payments when negotiating FTAs with developed countries such as Australia, New Zealand, and the United States. By now, agricultural protection has been well recognized as major obstacles for Japan to pursue aggressive FTA strategies. Some scholars express impenetrable difficulties in reforming notorious agricultural sector and pursuing FTAs with high liberalization coverage.<sup>11</sup> However, the issue is the power balance between free trade supporters and protectionists. Whether the former can claim large benefits or not may be the key to make the Juggernaut effect work.

##### 5. Where to go from now on

Unlike the European integration, economic integration in East Asia has not been driven by a unified political will of governments in the region. Unlike economic integration in North America, there does not exist a single dominant hegemon or leader in East Asia, either. Decentralized forces of political economy have pushed forward FTA networking in East Asia, and an open-end FTA system has been formulated. Functional deepening of economic integration is likely to continue in order to further activate international production networks. The mechanics of international production networks would work for narrowing development gaps across countries and regions in East Asia, which would present a successful case of inclusive or pro-poor growth. If we calmly review the accomplishment of economic integration so far, East Asian-wide consolidation of FTAs does not seem to be impossible, at least for trade in goods and some elements of

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<sup>11</sup> See Mulgan (2008a) for example. She points out the decentralized nature of Japanese negotiating team for FTAs, which reflects the multi-polar bureaucratic system in Kasumigaseki.

functional WTO+. For the coming ministerial meetings in August 2009, study groups of EAFTA (ASEAN+3) and CEPEA (ASEAN+6) are preparing to propose possible paths of FTA consolidation in East Asia.

However, due to the lack of FTAs among Japan, Korea, and China, an East Asian-wide consolidated FTA does not seem to be realized in the coming few years. Rather, the move of Asia-Pacific FTA networking is likely to proceed earlier. FTAs in Asia-Pacific, possibly led by TPP initiative, would have characteristics different from East Asian FTAs; they tend to have higher coverage of trade liberalization and more rule-oriented. Singapore, Australia, New Zealand, and possibly Korea seem to be ready to be on board. If such an initiative goes forward, how will Japan, China, and ASEAN respond? New forces of political economy will certainly emerge in such a case.

All in all, FTA networking has developed in an open setting in East Asia and Asia-Pacific. The development has been backed up by the logic of political economy. With economic dynamism, East Asia and Asia-Pacific are likely to become a focal point of multilateralizing regionalism.

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