

# Trade integration in East Asia

## Turning away from Multilateralism towards Regionalism?

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Since the end of World War Two, East Asian countries have oriented their trade relations towards the West. Intra-regional trade was very low for a long time and their major exports markets were in the United States and Europe. Even Japan was not a major destination for exports from South East Asian nations. Taiwan and South Korea, both former colonies of Japan, shifted their trade patterns away from exporting to Japan. While the communist states in the region were closed economies, the non-communist states maintained high trade barriers between themselves. Those countries looked to the multilateral trade system (MTS) as the preferred means to advance economic growth and development. There was no enthusiasm for constructing a regional trade block along the lines of the European model.

East Asian countries were among the staunchest supporters of the General Agreement on Tariffs and Trade (GATT) which oversaw the golden age of trade liberalisation and economic growth in the post war era. 'In GATT we trust' was the credo of East Asian countries. The World Bank (1993) attributed East Asia's 'economic miracle' to its openness to trade and its ability to integrate into the global economy. In contrast to other regions, East Asia kept conspicuously away from regional trade agreements (RTAs). The oldest regional organisation in Asia, the Association of South East Asian Nations (ASEAN), directed its energy towards regional co-operation on security issues for the first twenty-five years of its existence.

That picture of East Asia has changed dramatically. Since the end of the Cold war, and China's rise to economic power, trade patterns have changed in East Asia. According to the Asian Development Bank, (2006), intra-regional trade in East Asia now makes up 55 per cent of the region's total trade, up from 35 per cent in 1980. That surpasses the intra-regional trade of the North American Free Trade Agreement (NAFTA) at 46 per cent and is comparable to that of the European Union (EU) in the early 1990s.

The institutional landscape of East Asian trade is now being radically transformed.<sup>1</sup> In recent years, it has rapidly evolved into a kaleidoscope of free trade agreements (FTAs) producing a complex array of arrangements including plurilateral and bilateral agreements. Prior to 1998, the only significant regional

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\* The views expressed in this paper are the author's personal views and do not represent the position of the United Nations.

<sup>1</sup> There is a large literature on this, see in particular, Crawford and Fiorentino (2005), Sen (2006), UNESCAP (2005, 2006), and Vandoren (2005).

trade agreement was the ASEAN Free Trade Agreement (AFTA). Today there are 16 FTAs in the process of implementation, a further 22 under negotiation, and more than a dozen others in the pipeline. Every East Asian country has at least one bilateral trade agreement with its Asian neighbours, and many have several overlapping agreements (Asian Development Bank, 2006).

Those recent developments have provoked a debate on whether East Asia is turning away from multilateralism and towards regionalism. An increasing number of countries in the region have diverted their resources into concluding regional trade agreements since 2000, thus questioning East Asia's full commitment to the Doha round of multilateral trade negotiations in the World Trade Organisation (WTO). Multilateralism seems to have taken a backseat to regional trade activity. ASEAN-10 has embarked on a process of deepening and widening with the aim of becoming a fully fledged economic community. Since the Asian financial crisis ASEAN + 3 (China, Japan and South Korea) co-operation in financial and monetary affairs has gathered increasing momentum.

More recently, Framework Agreements between the ASEAN +3 group have created the emerging regional architecture for progressive trade liberalisation. Those developments could provide the building blocks for an East Asian Community (EAC) that would lead to a regional economic block along the lines of the European Union (EU). Or, alternatively, a broader East Asian grouping of ASEAN + 6, which would also include Australia, New Zealand and India, may be in the making.

The objective of this paper is to provide a qualitative assessment of the current state of play on RTAs in East Asia and to explore if, and to what extent, there is a real shift away from multilateralism. First I will outline the global context in which East Asia's new regionalism has emerged. Second, I will discuss the issue of WTO compatibility regarding regional trade agreements and how it may impact on their outcomes. Thirdly, I will analyse the potential for WTO-plus liberalisation emanating from RTAs in East Asia. Finally, I will draw conclusions regarding the future direction of trade integration in East Asia.

## **I. East Asia's emerging regionalism in the global context**

Moves towards regionalism in East Asia must be understood in the global context of recent trade policy developments. Over the past two decades we have seen the emergence of two paradoxical developments in trade policy making. On the one hand, the multilateral trade system (MTS) has grown and expanded to 150 member countries. That reflected a vote of confidence by the new members, many of whom were developing countries. In 2001, China's accession to the World Trade Organisation (WTO) was celebrated as the entry of the largest developing country in the world. China's accession required significant liberalisation of its trade regime. But China was willing to pay that price, which reflected its confidence that entry into the MTS would be extremely

beneficial for economic growth and development. Vietnam joined ASEAN only in 1994 and today is East Asia's latest successful tiger economy. It has followed in the footsteps of China and become the latest WTO member.

The creation of the WTO in 1995, brought to a conclusion the most ambitious round of multilateral trade negotiations to date. Global trade rules were extended to the new area of services and intellectual property rights. Entrenched agricultural protectionism in developed countries was finally tackled. And a strengthened dispute settlement body was put in place to give teeth to the rules based system.

Despite this success, however, multilateral trade liberalisation has progressed all too slowly. The political economy of agricultural trade liberalisation has proved so difficult that it has brought North-South conflict to crisis level. The new trade issues, including investment, competition and government procurement have proved to be so controversial that they have now been eliminated from the WTO. As a result of those accumulating problems, the Doha round of negotiations was suspended in 2006 and the successful conclusion of those negotiations in the future remains uncertain.

Thus, despite the expansion of trade rules that accompanied the establishment of the WTO, it was followed soon after by unprecedented growth in the number of regional trade agreements (RTAs)<sup>2</sup>. More RTAs were notified during the first decade of the WTO than during the half-century under the GATT. RTAs covering goods and services have been applied in a wide array of designs including bilateral, plurilateral, regional and inter-regional trade agreements. As RTAs have grown to cover both goods and services, more than half of world trade is already conducted within them (Gavin and Van Langenhove, 2003).

East Asian countries have become increasingly open and integrated into the global economy over the past 50 years. Japan first, followed by the four tigers – Korea, Taiwan, Singapore and Hong Kong, then ASEAN-5, and, more recently, China, now followed by Vietnam. Openness to trade and investment have been paramount as demonstrated by the high ratio of trade to GDP of 130 per cent for South East Asian countries. Likewise, openness to foreign direct investment (FDI), has been very high - with a ratio of FDI stocks to GDP of approximately 40 per cent of GDP (Sally, 2006). The new ASEAN-4 countries (Cambodia, Laos, Myanmar and Vietnam) are less integrated into the global economy and continue to have higher levels of protectionism – but that is changing now as shown by Vietnam's accession to the WTO

Integration into the global economy has been promoted since the 1980s when East Asian countries embarked on market-oriented reforms of their domestic

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<sup>2</sup> The generic term RTA covers free-trade areas (FTAs), under which partner countries agree to liberalise trade between them, and customs unions (CUs), which go a step further by agreeing on the implementation of a common external tariff. RTAs also cover preferential agreements to liberalise trade in services.

economies. As a result of those reforms the original ASEAN-5 countries have relatively liberal trade policies. Average tariffs are relatively low, non-tariff barriers have been reduced and the regime for FDI in manufacturing is very open. But progress on liberalisation of services has been much slower. And, in the new ASEAN-4 countries, which have lower levels of economic development, tariff levels remain relatively high. However, tariff reduction schedules for the ASEAN-4 are already in place to bring them into conformity with more advanced ASEAN members.

Openness to global competition is reflected in the dynamic, evolving comparative advantage of East Asia. Japan and the four tigers have moved up to higher value-added goods and services. Most of China's trade is still in manufacturing goods as it has comparative advantage in labour intensive and lower value-added products. ASEAN-5 is now experiencing increasing erosion of its labour-intensive production by China, so it is now moving more into services. The new ASEAN-4 countries will continue to exploit labour-intensive industries as China moves up the value added ladder.

China has made significant progress on internal and external liberalisation. During the first period of reform in the 1980s, China concentrated on internal reform and agriculture. The following decade was a period of considerable external liberalisation in trade and investment. China has consolidated its liberalisation through accession to the WTO and its foreign trade continues to grow at impressive rates.

The volume of China's foreign trade increased from \$360.63 billion in 1999 to \$1.1 trillion in 2004, or at an annual exponential rate of 23.3 per cent. China's trade with Asia represented 57 percent in 2004 and its imports from Asian countries in the same year accounted for 65 percent. Of its total imports in 2004, China's trade with ASEAN-10 accounted for 13.7% of its total foreign trade compared with 14.7% with the US, which was only slightly larger (Chow, 2006).

East Asian countries will continue to pursue a path of trade openness and integration into the global economy. The largest destinations for the exports of East Asian countries, including China, are still outside of Asia. They will continue to be global traders and remain committed to the multilateral system as the best means to maximise global trade.

The WTO has been most successful in liberalisation of traditional trade policy, such as the reduction of tariffs on goods trade – from which East Asian countries have greatly benefited. But for sustained economic growth in the future, East Asia will need to tackle new areas. Its economic success has been built on the back of manufacturing. That manufacturing today relies on regional production networks for global competitiveness. There is now growing realisation that regionally integrated production networks need to be supported by efficient service networks. East Asian countries have been much less successful in liberalising services than manufacturing. Agriculture also presents potential for further liberalisation in East Asia. China has taken a very liberal

attitude towards agriculture making it one of the most open, rapidly growing economies for agricultural trade today. That offers potential benefits to East Asia and especially South East Asian countries. Where multilateral trade liberalisation has not achieved substantial progress, the question arises whether regional trade liberalisation can now provide more bang for the buck? To the extent that regional liberalisation can provide WTO-plus liberalisation, we may expect to see enhanced activity in that sphere for the foreseeable future.

## **II. Regional Trade Agreements and WTO compatibility**

Although regional trade agreements are negotiated outside of the multilateral system, they are not completely autonomous; they must be 'WTO compatible', legally speaking. Because they are departures from the principle of MFN (most favoured nation), they must be notified to the WTO and assessed for conformity with the rules. This is intended to minimise the adverse effects of RTAs on third parties and to prevent them from becoming narrow discriminatory entities. WTO rules governing RTAs aim to ensure that the relationship between the two levels of trade policy making are mutually complementary.

The rapid proliferation of RTAs over the past decade has launched a new debate about their compatibility in practice. The Committee on Regional Trade Agreements (CRTA), established in 1996, was given the mandate to monitor and assess the conformity of RTAs with WTO rules. But lack of progress by the CRTA in fulfilling its mandate has merely served to highlight the legal loopholes and lack of clarity of WTO rules on a number of key issues.

The essential requirement for RTAs to be in conformity with Article XXIV is that they eliminate all 'duties and other restrictive regulations of commerce...with respect to substantially all the trade' between RTA members. The key concept of substantially all trade (SAT) does not mean *all* trade, or free trade *per se*. There is no agreement among WTO members on what a generally acceptable benchmark for SAT should be.

In practice two SAT benchmarks have been discussed. One is a quantitative approach, based on the percentage of existing trade covered by the agreement, and the other is qualitative benchmark based on assessing the percentage of tariff lines covered. Although no definitive interpretation exists, the percentage of trade approach is considered by the European Union (EU) and many other WTO members to have been fulfilled if 90 per cent of total trade existing prior to the agreement is covered at the end of the implementation period. But Australia, supported by the United States, considers that an RTA must cover 95 per cent of total tariff lines under the harmonised system for it to be in conformity with WTO rules.

The major issue lurking behind this debate is the treatment of agricultural trade liberalisation in RTAs. Under the percentage of trade approach, entire sectors

such as agriculture could be excluded from liberalisation. Indeed they frequently were excluded by the European Union in the past. But that was merely a reflection of the treatment of agriculture at the multilateral level, the EU argues. And, since the WTO only began to liberalise agricultural trade in the 1990s, it would be unrealistic today to treat it on a par with industrial liberalisation that has progressed gradually over the past fifty years, they say.

Article XXIV also lacks precision on transition periods, saying that the liberalisation should be completed within a 'reasonable length of time'. This has been somewhat clarified to say that it should exceed ten years only in 'exceptional cases'. In practice, however, many RTAs have implementation periods going well beyond the ten years. There is a lack of authoritative guidance on the meaning of *exceptional cases*. An understanding exists that developing country RTAs may apply twelve-year implementation periods, but great uncertainty exists over implementation periods for RTAs between developed and developing countries.

Less stringent conditions regarding RTAs are applied to developing countries as part of the general special and differential treatment provisions accorded to them under WTO rules. The special provisions are provided under the Enabling Clause<sup>3</sup> resulting from the Tokyo Round in 1979. Developing countries may enter into regional trade agreements among themselves for mutual reduction of tariffs on goods. While they are not required to undertake comprehensive liberalisation, they must not 'raise trade barriers' in the process of forming an RTA.

In the case of services, the General Agreement on Trade in Services (GATS) also provides for regional economic integration based on guidelines similar to that for trade in goods. GATS Article V agreements are required to provide for 'substantial sectoral coverage' and may not 'a priori' exclude any of the four modes of supply<sup>4</sup>. However, there is a development dimension in the GATS pertaining to agreements between developed and developing countries requiring less stringency on the part of the latter.

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<sup>3</sup> *Decision on Differential and More Favourable Treatment Reciprocity and Fuller Participation of Developing Countries*, GATT, L/4903, 28 November 1979.

<sup>4</sup> The four modes of supply as defined by the GATS are as follows:

*Mode 1: Cross-border supply* - Service delivered within the territory of the Member, from the territory of another Member

*Mode 2: Consumption abroad* - Service delivered outside the territory of the Member, in the territory of another Member, to a service consumer of the Member

*Mode 3: Commercial presence* - Service delivered within the territory of the Member, through the commercial presence of the supplier

*Mode 4: Presence of a natural person* - Service delivered within the territory of the Member, with supplier present as a natural person

What are the implications of this legal grey area for regional integration in East Asia? In contrast to the multilateral system, whose rules-based system, provides predictability and stability for firms in the market, the proliferation of RTAs could exacerbate the 'noodle bowl' scenario some see already existing. East Asian countries may interpret WTO rules with various degrees of flexibility resulting in the fact that each RTA differs in terms of coverage, scope and time frames for implementation. The risk inherent in such a situation is increased fragmentation of trade rules, increased transaction costs for firms leading to reduced predictability and stability of trade rules.

East Asia is a very diverse region with enormous disparities of wealth, economic development, market and negotiating power. Disparities in GDP per capita, between Japan, the richest country, and the poorest countries of ASEAN, are some ten times greater than what exists in Europe. Asymmetries in economic and market power between countries are huge. China's market, with over one billion consumers, is three times larger than the combined consumers of the total ASEAN-10 countries. A commitment to building an East Asian Community would, therefore, have to contain provisions for equitable development.

The flexibility of WTO rules governing RTAs will not facilitate policy making towards social cohesion in the region. RTAs between Japan and ASEAN countries will be subject to the requirements of Article XXIV, which are the more stringent requirements and could be challenged by third parties under the WTO dispute settlement body. By contrast, RTAs between China and ASEAN countries will come under the Enabling Clause whose requirements are comparatively 'softer' in WTO legal terms and very unlikely to be subject to any challenge by third parties.

The question of North-South regional trade agreements has become the focus of increasing controversy in the WTO and what would constitute an acceptable development dimension in those agreements. The Doha negotiations aim to make the WTO provisions on special and differential treatment for developing countries more precise and operational, but so far has made little progress. The current state of the rules give no clear guidance as to how that could be achieved. Likewise the treatment of agriculture has important North-south ramifications in East Asia too.

East Asian countries have diverging economic interests that may lead to a variable geometry of institutional configurations. Simulation exercises conducted by Bhir and Fouquin (2006) explore various scenarios in which East Asia's regionalism may evolve towards increasing bilateralism or a genuine regional internal market. RTAs are expanding under flexible WTO rules but this gives no assurance that a seamless integrated market will emerge in the region.

### **III. Regional trade agreements and WTO-plus liberalisation**

Regional trade liberalisation is beneficial for economic welfare to the extent that it can maximise 'trade creation' and minimise 'trade diversion' (Viner, 1950). In other words, the larger the amount of new trade generated between the partners to the RTA, in relation to the flows of trade re-directed from external, more efficient producers to internal, less efficient producers, the greater the value added from regional trade liberalisation. Experience has shown that regional trade agreements tend to generate WTO-plus liberalisation where they succeed in dealing with non-tariff barriers better than at the multilateral level. The following sections will explore the potential for regional liberalisation on all three fronts of manufacturing, agriculture and services.

- *Manufacturing*

East Asia countries have been deservedly praised for their liberalisation in manufacturing. Their success has resulted from combining their own unilateral liberalisation with multilateral trade liberalisation in the WTO. Consequently, tariff levels in East Asian countries are already low - between five to ten percent on average. And, in practice, their applied tariffs are much lower than their bound MFN (most favoured nation) tariffs. Overall, this has produced a low tariff environment in East Asia which indicates small preference margins and low potential for trade creation. Therefore, some economists suggest that further trade liberalisation in East Asia will only yield small increases in additional income.

Regional trade liberalisation started in East Asia with the ASEAN free trade agreement (AFTA) which set ambitious goals in the early 1990s. In the case of AFTA, although very few if any exceptions to the Common Effective Preference Tariff (CEPT) remain among the core ASEAN members, the level of tariff preference utilisation has been remarkably low (Baldwin, 2006a). Although intra-ASEAN trade is 'covered' within the AFTA, the vast majority of it is still conducted on an MFN basis. As a result, the implementation of AFTA itself is unlikely to generate significant trade creation. Very low MFN tariff rates on intensively traded manufactured goods throughout East Asia tend to reflect a similar pattern. To date Asia has concentrated on manufacturing trade through regional production networks. The term 'Factory Asia' describes the sophisticated value chains that enable production lines for a single product to span multiple countries (Baldwin, 2006b). Indeed, the tariff preference utilisation rate for Thailand and Malaysia in 2002 was only 11.2 per cent and 4.1cent, respectively. Thus, for manufactured products, which are by far the most important intra-regionally traded good in value terms, RTAs are unlikely to contribute much to trade creation.

Numerous factors have contributed to the low levels of intra-regional trade among ASEAN members including the setback suffered from the Asian financial crisis in 1997-98 and the loose institutional structure of ASEAN which is weak on implementation. From a purely trade perspective, one of the most important reasons perhaps concerns rules of origin (ROO).

Preferential rules of origin define the share of inputs that have to be used, or production processes that have to be performed inside an RTA to satisfy the requirement of origination. The rationale for ROO is to avoid trade deflection, that is, to prevent non parties to the RTA to benefit from preferences. But ROO may be used for protectionist purposes resulting in the distortion of production, trade and investment patterns. The end result is higher administrative costs for firms which may impact negatively on the utilisation of preferences.

Still, it must be borne in mind that as average MFN tariff rates decrease and, correspondingly, margins of preference as means to maintain competitiveness also decrease, non-tariff barriers such as rules of origin become relatively more important. Therefore, if Asian RTAs are to progress towards more complete liberalisation in East Asia, the need for regional cumulation of ROO spanning multiple RTAs would be an obvious area for further consideration. Such a development would enhance trade creation within the region.

But China's FTA with ASEAN, which has been the most important trigger for RTAs in East Asia, has already greatly amplified regional trade creation. The Framework Agreement for comprehensive economic co-operation, signed in 2002, aims to establish an FTA with ASEAN-6 by 2010, which will include the latest ASEAN-4 members by 2015. The Agreement on Trade in Goods was completed in 2004, in which it was agreed that, China will eliminate tariffs on 93 per cent of goods from ASEAN and ASEAN will lift tariffs on 90 per cent of all imports from China under the normal track for liberalisation. Over and above that, a fast track Early Harvest provision, agreed by all ASEAN members, will expedite the liberalisation of agricultural products. The Agreement on Trade in Services was concluded in January 2007.

The China-ASEAN free trade agreement (CAFTA) will create a regional market of 1.7 billion consumers with increased trade, intensified competition and increased specialisation by the year 2010. Simulations conducted by the ASEAN Secretariat predict that CAFTA will increase ASEAN's exports to China by 48 per cent and China's exports to ASEAN by 55 per cent. China has now become the fourth largest trading partner with ASEAN after the US, Japan and the EU in descending order of importance. But there will also be increased adjustment costs resulting from tougher competition, given the similarity of structures in ASEAN and China.

CAFTA represents a high quality RTA with extensive coverage of liberalisation in trade with a transition period of only 6 years for ASEAN-6 and ten years altogether for ASEAN-10. More recently, ASEAN has signed Framework Agreements with Japan and Korea which will pave the way for future FTAs between ASEAN+3 countries. The inclusion of agriculture in the CAFTA represents a definite plus to WTO liberalisation but such progress is unlikely to reverberate widely throughout the region. Whereas China has used agriculture as a facilitator for general trade liberalisation, Japan's experience of negotiating bilateral trade agreements with Singapore and Thailand have shown agriculture to be a stumbling block.

- *Agriculture*

While the value of total agricultural trade in East Asia pales in comparison to that of manufactured goods, RTAs in the region have a much higher potential to impact the relatively insignificant agricultural trade flows that do exist and are likely to grow over time. This is due to the fact that average MFN tariffs on agricultural products are high throughout the region and thus carry the potential for much larger margins of preference. Unlike the WTO, RTAs only deal with market access and do not address the issues of domestic agricultural support and export subsidies, which may alleviate some difficulties (Pasadilla, 2006).

Agriculture is the most contentious area for multilateral trade liberalisation. It is also an extremely sensitive sector in East Asia. Korea and Japan have the highest agricultural protectionism in the world as measured by the Organisation for Economic Co-operation and Development (OECD) in terms of producer subsidy equivalents (PSEs). They are 64 per cent in Korea and 57 per cent in Japan, which is far higher than the average of 31 per cent in OECD countries.

By contrast, China provides a comparatively low level of support to agriculture having a PSE of only 6 per cent. China has made significant progress on agricultural reform since 1978. China currently has about 200 million small farms with an average size of just 0.65 ha, and low incomes. With limited arable land and a large rural labour force, China has comparative advantage in labour intensive products such as fruit and vegetables and disadvantage in land intensive products such as grains and oilseeds (OECD, 2005). ASEAN countries still have about one third of their labour force in agriculture, so that any talk of liberalisation that would result in increased unemployment would be politically difficult to accept, although the contribution of agriculture to GDP is relatively small – about ten percent.

AFTA has shown gradual liberalisation of agriculture that was thought impossible a decade ago. Although there were difficulties with liberalisation of rice, they have been overcome and the majority of agricultural products have been included. The coverage of agriculture in AFTA is actually more complete than most functioning RTAs today. Among the ASEAN-6 members, the highest percentage of agricultural tariff lines formally excluded from liberalisation was not more than 10 per cent (Tsai, 2006).

Over the long-term, changing patterns of consumption as the countries of the region become more affluent are likely to change the political economy dynamics behind agricultural liberalisation within regional RTAs. A great deal of uncertainty hovers over the actual impact that regional RTAs will have on agricultural trade in the region, particularly as most RTAs have not addressed agriculture. Still, it is logical and significant nonetheless that unless MFN tariffs on agriculture throughout the region drop significantly over time, progress on agricultural liberalisation will be confined to RTAs.

The China-Asean FTA is cited as an example of strong growth in intra-regional agricultural trade occurring alongside a framework RTA. For example, China has significantly increased its exports of certain fruits such as apples, pears and grapes to Thailand, while it has also substantially increased its imports of other fruits including fresh longan, durian, mangosteen and mango from Thailand. Possibly more significant, the likelihood that China will become a major agricultural importer in the coming years also highlights the potential for increased discontinuity between regional and multilateral trade in agricultural products. While trade in agricultural products within Asia is negligible in comparison to trade in manufacturers, pockets of highly competitive production exist.

The case of the Framework Agreement between China and ASEAN is illustrative of the potential that regional RTAs can have on regional agricultural trade flows. Although United States apple producers considered China an attractive import market for apples during negotiations for China's accession to the WTO, China has since overtaken US as the largest producer of apples and today represents four times the US production. This has led to Chinese apples displacing US fruit in many ASEAN economies, for instance, in Singapore where it supplies almost 60 percent of the market – US sales declined by half over the previous five years.

However, changing patterns of agricultural production and consumption throughout the region may actually be more important over the long-term. The case of China is once again illustrative. Chinese exports of broccoli to Japan have tripled since 1995, while US exports have declined by a third in the same market. China is also among the top producers of tomato paste and apple juice in the world, and accounts for half of global vegetables and melons up from a just over a third in 1995. However, the expansion of vegetable cultivation in China by 90 per cent has reduced farmland for staple crops by 10 per cent (Wattanaputtipaisan, 2005). Over the long-term, China is expected become a substantial importer of wheat, high-quality rice and soybeans as well as other cereals for food and beverages, which will produce significant export opportunities for international producers.

Although China has increased its agricultural exports, the expectations of its millions of farmers following WTO accession have not been met. Chinese exports have experienced major problems in meeting the requirements of sanitary and phytosanitary (SPS) standards, not only in Japan but also in Europe and the United States. A whole range of food products including seafood, vegetables, fruits, tea, honey and poultry meats have frequently encountered SPS problems sometimes leading to total import bans (Dong and Jensen, 2004). China is not alone in facing such problems. Thailand's exports could also be substantially raised if some appropriate solution to SPS problems could be found.

Given the current infancy of RTA development within East Asia, it is difficult to assess how they will impact regional and extra-regional agricultural producers. It is too early to tell whether preferential trade in agricultural products will increase intra-regional trade and reduce access for extra-regional producers such as the US, particularly as intra-regional RTAs may also be negotiated in the meantime.

- *Services*

In the WTO, services liberalisation has for long been viewed as a developed country interest. Hence, many developing countries have resisted liberalisation including a number of East Asian countries. Compared to manufacturing, Asia has lagged behind on services liberalisation. But there is now increasing realisation that weakness in the services sector can hurt competitiveness in the broader context. The chain of production networks across East Asia is its greatest manufacturing strength. But a chain is only as strong as its weakest link. Therefore, strengthening services links that support manufacturing need to be addressed

Liberalisation of trade in services is increasingly seen as a vital tool for development. The World Bank has estimated that the potential gains from services liberalisation would be four times greater than those from goods liberalisation. Although the basic arguments for liberalisation of trade in services are similar to those of trade in goods, some sectors such as banking, transport, and telecommunications services provide the essential infrastructure for a modern economy and by virtue competitive manufacturing sectors. Services have a much greater potential to benefit the economy as a whole.

Trade in services has grown faster than merchandise trade in recent years. A similar trend can be observed in foreign investment where services account for over 50 per cent of recent FDI flows. Services are no longer an economic activity associated with high-income industrialised countries. While the share of services in GDP steadily rises with the level of income, recent trends have shown that services are among the fastest growing sector in low- and middle-income developing countries. Asian countries stand to benefit from further liberalisation of services. Asian countries rank among the top twenty-five countries exporting services. Importing countries will benefit from technology, skills and experience transferred through trade and investment.

While multilateral liberalisation on services has been relatively slow, likewise, progress on liberalisation within ASEAN has also been incremental. Few if any RTAs within the region contain dramatic departures from GATS services commitments. Ironically, it is the increasing competitive pressure from China in labour intensive manufactures that is a key driving force behind renewed interest within ASEAN for strengthening regional liberalisation of trade in services.

An efficient ASEAN services sector is increasingly seen as the foundation for increasing the scope for efficiency gains and value added within the ASEAN manufacturing sector to compete with China. To support liberalisation of services, ASEAN Economic Ministers established the goal of achieving the free flow of services within ASEAN by 2015 (ASEAN, 2005). The ASEAN Agreement on Services (AFAS), which was signed in 1995, aimed to enhance liberalisation in the region. The goal was to achieve GATS plus liberalisation – focusing on the 5 major sectors which are similar to the WTO ranking list. However, intra-ASEAN liberalisation has turned out to be weak, no doubt a result of the financial crisis, and fall far short of GATS plus.

Underpinning ASEAN's renewed commitment to liberalise trade in services, is the continuing commitment by ASEAN Ministers to progressively eliminate all forms of restrictions that affect national treatment and market access limitations by 2015 'with flexibility'. A key element of the ASEAN approach is to conduct Mutual recognition agreements (MRAs) in support of the free movement of professionals and skilled labour in ASEAN. And progress continues under efforts to develop sectoral MRAs. ASEAN concluded an MRA on Engineering Services in 2005 and expects to complete an MRA on Nursing Services at the 12th ASEAN Summit.

Transportation services are a focus of attention within ASEAN for liberalisation. Efforts are under way by ASEAN Transport Ministers to implement arrangements to accelerate the integration of the air travel sector. An ASEAN Multilateral Agreement on the Full Liberalisation of Air Freight Services is being finalised and an ASEAN Multilateral Agreement on Air Services is being developed.

Multilateral liberalisation of trade in services has made slow progress since the conclusion of the GATS at the end of the Uruguay Round. Although the GATS is based on principles of MFN and national Treatment (NT), liberalisation of services has proved to be more complex and difficult than trade in goods. Prospects for speeding up liberalisation of services in the future are uncertain as the present sectoral approach is unlikely to change. The procedure of negotiating detailed national commitments, sector by sector, places countries in a defensive position, with each intent on defending its national status quo.

One of the major reasons for the success of the GATT in liberalising merchandise trade was its procedure for streamlining the negotiating process between the large numbers of heterogeneous countries into an efficient multilateral mechanism which minimised the mercantilist elements of countries trade policies. The rules approach sets up general rules and principles and then specifies exceptions in a 'negative list' that is contained in an annex to the final agreement. The 'positive list' approach of GATS is much more cumbersome.

Liberalisation at the regional level may produce WTO-plus market access commitments in a number of ways. They include transforming unilateral liberalisation into legally binding commitments at the regional level, and ability

to address regulatory barriers through regional mutual recognition agreements and/or harmonisation of standards. There are also risks involved in regional rule making outside of the WTO.

Just as in goods, RTAs can also contribute to fragmentation of rule making in services. Currently, in East Asia there are two models of service liberalisation. The 'GATS-consistent' model, which is used among Asian countries, replicates the WTO model at regional level.<sup>5</sup> But East Asian countries that have signed FTAs with the United States follow the NAFTA horizontal approach which pursues a faster track to liberalisation.<sup>6</sup>

East Asia's experience of financial liberalisation in the 1990s underscores the dangers of fast track liberalisation. There is need for specific measures in banking, where regulatory co-operation and harmonisation of standards play a vital role in ensuring stability. Prior to liberalisation, the domestic regulatory environment needs to be harmonised and co-operation between prudential regulatory authorities needs to be strengthened (Gavin, 2001). In the absence of such measures, liberalisation runs the risk of severe disruptions to national financial systems that can spill over to neighbouring countries in the region.

## **Conclusions and prospects for the future**

Progress towards regional trade integration has been slower in East Asia than in other parts of the world, notably in Europe and North America. But recent developments including the Asian financial crisis, China's trade liberalisation and slow progress on multilateral trade negotiations have given a new impetus for change.

Whether commitment to multilateralism is indeed weakening and a regional trade block is now emerging, it is too early to say. Definitive answers can not be given at this point in time for a number of reasons. Firstly, the number and complexity of RTAs, each with different contents and time frames, as well as being at a different stage of implementation, makes any systematic analysis impossible. Moreover, WTO rules governing RTAs lack clarity and precision implying that the way in which RTAs will be implemented on the ground may vary significantly. Ultimately of more importance will be the motivation of different countries for entering into RTAs, especially where non trade factors such as political and strategic reasons have played an important role.

The current policy state of play is a patchwork of bilateral and plurilateral FTAs, the ultimate direction of which is hard to decipher. The dominant pattern at present appears to be a hub and spoke type of regionalism with China as hub and ASEAN the spokes. This is driven by China's political as well as economic

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<sup>5</sup> This approach distinguished between the four modes of supply, employs a positive list approach, and liberalises on a vertical sectoral basis.

<sup>6</sup> The NAFTA approach takes a horizontal approach with a single set of commitments across modes 1,2 and 4, while commercial presence in Mode 3, is covered separately under an investment chapter. It also takes a negative list approach to liberalisation.

interests. Economic development plays an increasingly important role in China's diplomacy posture portraying itself as 'the big brother' that helps small developing countries through trade, technology transfer and development aid (Conde, 2007). However, China's ability for continued leadership in the future will depend on its ability to maintain high economic growth and to manage its large inequalities internally between urban and rural areas.

Japan, although it is the most advanced and powerful economy in the region, is currently prevented from playing a leadership role because of its agricultural protectionism. That has proved to be a major stumbling block in its negotiations for FTAs with ASEAN countries. Furthermore, Japan's RTAs with developing Asia must be compatible with Article 24 of the WTO which limits its room for manoeuvre compared to China's relative freedom from constraints under the Enabling Clause. Japan too is motivated by political factors. It would prefer a broader Asian-Pacific FTA of ASEAN+6 as a means to counteract the growing power of China in the region.

For now, there is no agreement among academics on the foreseeable impact of Asia's new regionalism on the MTS. Some see it in a positive light emphasising that the proliferation of RTAs will result in competitive liberalisation that triggers faster and deeper integration than what could be achieved by multilateral liberalisation. The new RTAs have more comprehensive coverage than traditional ones as they often include stronger provisions on services, investment, trade facilitation and government procurement in addition to greater liberalisation of industrial and even agricultural products. The 'Early Harvest' provisions in at least one agreement has already led to significant liberalisation in the difficult area of agriculture.

But others see the worsening of the 'noodle bowl' scenario composed of multiple, overlapping trade arrangements that will create confusion and increased transaction costs for businesses. Their concern is that increasing levels of discrimination may cause trade frictions leading to increased disputes and retaliation that would weaken the WTO system.

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