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I. Introduction

Globalization of economic activities developed rapidly in the post WWII period and the pace of globalization has become faster in recent years. The rapid pace of globalization is confirmed by the fact that international trade and foreign direct investment (FDI) major forms of international economic activities, increased significantly faster than GDP (Figure 1). Globalization has been brought about by a series of multilateral trade negotiations under the General Agreement on Tariffs and Trade (GATT); the liberalization of trade and investment; deregulation and privatization of national industries; and increasingly cheaper cost of foreign trade and FDI from technological developments in telecommunications and transportation.

In parallel with this move towards globalization was the trend towards regionalization in the form of regional trade agreements (RTAs); the earliest and most remarkable development of which was the regionalization in Western Europe, manifest in the creation of the European Economic Community in 1958. Other similar moves were also seen in Central and South America and Africa, but most of these were in name only and few were of any real substance. This changed in the 1990s, when establishment of RTAs became very popular throughout the world with an exception of East Asia. One important development at that time was the establishment of the North American Free Trade Agreement (NAFTA), which liberalized trade among Canada, Mexico and the USA. In East Asia, until the end of the 1990s ASEAN (The Association of Southeast Asian Nations) Free Trade Area (AFTA) was only major RTA. However, toward the end of 1990s, many countries in East Asia including Japan, Korea, and China began to consider free trade agreements (FTAs) as possible trade policies.

The purpose of the paper is to examine regionalization in East Asia with a focus on Japan. We examine the issue from two different perspectives. One is to analyze the changes in trade patterns and the other is to examine recent development on regional trade agreements in East Asia. Based on the analysis it is argued that Japan should actively seek to form FTAs with East Asian countries, not only to promote recovery of Japanese economy, but also to promote economic growth of East Asian countries.

II. Increasing Importance of Intra-regional Trade in East Asia

Table 1 shows the changing patterns of intra-regional trade for the three major regions, East Asia, the NAFTA, and the EU. The importance of intra-East Asian trade in world trade increased significantly from 8 percent in 1990 to 12 percent in 2001. The share of intra-NAFTA trade in world trade also increased over the same period, but the share was somewhat smaller, at 10 percent in 2001. The corresponding share for the European Union was significantly higher, at 22 percent in 2001, although the share had declined sharply from 29 percent in 1990.

Intra-East Asian trade increased its importance in East Asia's trade in the 1990s. The share of intra-East Asian exports in East Asia's overall exports increased from 40 percent in 1990 to 48 percent in 2001, while the share of intra-East Asian imports in East Asia's overall imports increased from 48 percent to 57 percent during the same period. These figures indicate that for East Asian economies East Asia is an important source of their imports rather than a destination of their exports. Such trade patterns of East Asia reflect largely the pattern of production under which parts and components are procured from East Asia for the production of final goods, which are then exported to outside of the regions such as North America and Europe. It is important to note that

foreign direct investment (FDI) by multinational corporations play an important role in the formation of such trade patterns.

Similar to the case for East Asia, for the NAFTA intra-regional exports as well as intra-reigonal imports in its overall exports and imports increased from 1990 to 2001. What is remarkable is the rate of increase in the share of intra-regional exports in its overall exports, as the share increased from 41 percent in 1990 to 55 percent in 2001. This rapid increase is attributable to the formation of the NAFTA in 1994, because the NAFTA members became more attractive export destinations for other NAFTA members, resulting from the formation of free trade environment.

Turning to the intra-regional trade for the EU, its importance of the EU as an export destination as well as an import source declined from 1990 to 2001. Although the importance of intra-regional trade in its overall trade declined over time for the EU, its importance is still far greater for the EU when compared to the cases of East Asia or the NAFTA.

Regionalization results from two different factors. One is natural economic development in that the benefits of agglomeration including economies of scope, scale, and speed outweigh the costs of agglomeration such as congestion. Indeed, rapidly growing economies in proximity interact each other through market and non-market channels to accelerate their economic growth. The other factor involves institutional arrangement such as regional trade agreements (RTAs) including free trade agreements (FTAs) and customs unions, which we will discuss later. The former type of regionalization may be characterized as 'market-led,' while the latter 'institution-led.' Regionalization in East Asia so far has been the first type, or market-led regionalization because of the limited developments in RTAs in East Asia. By contrast, regionalization

in the EU can be characterized as institution-led, while regionalization in the NAFTA in the 1990s can be characterized as the mixture of market-led and institution-led regionalization.

III. Increasing Importance of East Asia as A Trading Partner for Japan

We saw increasing importance of intra-regional trade in East Asia in the previous section. In this section we shed lights on the changing patterns of Japan's trade with East Asia.

Figure 2 shows Japan's trade with East Asia from 1990 to 2001. Japan's exports to East Asia increased notably from 1990 to 1995, then they started to decline in 1996. After reaching a trough in 1998, Japan's exports started to increase again in 1999. The substantial decline in 1998 was attributable to the Asia crisis, as it reduced demand for imports from Japan. As East Asian economy began to recover in 1999 and 2000, Japan's exports to East Asia increased. However, a slowdown in East Asia's economy, resulting from the burst or the IT bubble and terrorists' attacks in the US, reduced Japan's exports to East Asia in 2001. Japan's imports from East Asia during the 1990-2001 period registered similar pattern as its exports, although Japan's exports to East Asia were significantly higher when compared to its imports from East Asia throughout the period.

Let us now turn to the changing importance of Japan as a trading partner for East Asia and the changing importance of East Asia as a trading partner for Japan. According to Figure 3, for East Asia the importance of Japan in its trade declined during the 1990s. This is particularly notable for East Asia's imports, as the share of Japan in East Asia's overall imports declined from 22 percent in 1990 to 16 percent in 2001. Although the magnitude of the decline is not as large, the share of Japan in East Asia's

overall exports declined as well from 1990 to 2001.

In contrast to the declining importance of Japan for East Asia's trade, East Asia became an increasingly important trading partner for Japan in the 1990s. The share of East Asia in Japan's exports rose from 34 percent in 1990 to 39 percent in 2001 in spite of a decline in its share in 1998. Similar to the pattern observed for Japan's exports, the share of East Asia in Japan's imports rose from 32 to 42 percent during the same period.

The contrasting patterns of a declining importance of Japan for East Asia's trade and an increasing importance of East Asia for Japan's trade largely reflect the differences in economic growth achieved by Japan and East Asia. As East Asia grew more rapidly than Japan, East Asia's importance for Japan increased while Japan's importance for East Asia declined. These observations indicate that rapid economic growth in East Asia would contribute to economic growth of Japan significantly, while Japan's economic growth would have a more limited impact on East Asia's economic growth. Indeed, this finding appears to show that closer economic integration with East Asia would contribute to economic growth for Japan.

IV. Rapid Expansion of Regional Trade Agreements in Recent Years

Recent years have seen a sharp increase in the number of regional trading agreements (RTAs) (Figure 4). By the end of June 2002 as many as 162 RTAs had been notified to the GATT/WTO. Out of 162 RTAs, 111 RTAs, or approximately 70 percent of total number of RTAs, were notified after the WTO was established in 1995. Among RTAs, the most common type of agreements in recent years is FTA

Several notable characteristics may be identified from the recent developments on RTAs: i.e. widening, deepening, and diversifying. The examples of "widening"

include the European Union (EU) and the ASEAN Free Trade Area (AFTA). The EU started as a customs union under the name of the European Economic Community (EEC) with six member countries in 1958. Later new members joined and at present it has 15 member countries. By 2006 the EU is expected to expand to include 12 new members. The AFTA was formed by six ASEAN member countries in 1992 as a common effective preferential tariff agreement, under which tariff rates on intra-member trade were to be reduced to 0~5 percent within 15 years. Toward the end of the 1990s the AFTA was expanded to 10 countries by accepting four new members.

The most remarkable example of "deepening" is found in the EU. As noted above, the EU began as a customs union. During the 1990s several substantial developments took place to deepen regional integration among the EU members. In 1993 the EU became a common market, in which free movement of not only goods but also services, capital, and people was realized. In 1999 a common currency, the Euro, was created for eleven EU members. ASEAN also deepened its integration, as its members agreed to establish the ASEAN Investment Area (AIA) in 1998, where free movement of capital in the form of foreign direct investment (FDI) is to be realized among its members by 2010.

Various new types of RTAs, or diversification of RTAs, can be detected in recent years. Traditionally, RTAs dealt with the elimination of trade barriers such as tariff and non-tariff barriers. However, new types of RTAs, which include not only the elimination of trade barriers but also the elimination of barriers on service trade and FDI, have been increasing. For example, the NAFTA includes the rules on FDI, intellectual property rights, environment, and others. Moreover, some RTAs go much beyond free trade and FDI arrangement to include various kinds of cooperative programs. One such

example is Japan-Singapore FTA, which is officially named Japan-Singapore Economic Partnership Agreement (JSEPA) and was enacted in November 2002. JSEPA includes not only trade liberalization in goods and services, but also FDI liberalization, trade and FDI facilitation, and economic cooperation.

Several factors have been behind rapid expansion of RTAs in the recent years. First, trade liberalization has become increasingly difficult to be pursued on the global scale, making RTAs as an effective alternative for pursuing liberalization. A number of countries have become to realize the benefits of trade liberalization for the promotion of economic growth, as it has brought the NAFTA and the EU countries expected outcome of rapid economic growth. Despite the desire of many policy makers for promoting trade liberalization, it has become apparent that trade liberalization under the GATT/WTO has become increasingly difficult. As the number of GATT/WTO members increased, their views on the pace and the extent of trade liberalization have become diverged. Indeed, the fact that it took the GATT members eight years, twice as long a period as initially planned, to conclude the Uruguay Round (UR) negotiations, indicates the increasing difficulty in reaching a consensus on trade liberalization. The increasing difficulty in reaching a consensus was a factor that led to a failure by the WTO members to initiate a new round of trade negotiations in Seattle in 1999. Faced with the difficulty in carrying out trade liberalization on the global scale, many countries have opted to form RTAs among the like-minded countries to pursue trade liberalization.

Second, closely related to the point above, some countries consider the use of FTAs to promote structural adjustment in the forms of deregulation and policy reform, which is needed to revitalize their economies. Faced with strong resistance from the groups with vested interests, the countries cannot simply rely on internal pressures in

order to carry out structural adjustment. Instead, they rely on FTAs to undertake structural adjustment.

Third, the desire to maintain or increase market access on the part of business has contributed to the formation of RTAs. Having an access to a large market is undoubtedly important for successful business. As a result of increasing RTAs, the companies from a country without RTAs have become discriminated against in many markets. To overcome this problem and to be able to compete against companies from other countries on the same condition, companies desire strongly to form RTAs. For example, Japanese companies are said to be in disadvantageous position vis-à-vis EU companies in terms of tariff treatment in the Mexico, because the EU has an FTA with Mexico but Japan does not. To overcome this disadvantage, Japanese companies argue strongly for establishing an FTA with Mexico.

Fourth, some RTAs have been promoted to increase bargaining power against outsiders. Increased size of unified European market, which resulted from successful economic integration in the EU, had substantial impacts on other regions in the world. Indeed, the US was eager to form the NAFTA partly because of the need to build a balancing power in North America against the EU.

A similar motive for creating a counterbalance may be behind the formation of the AFTA and AIA by the ASEAN members. Faced with the emergence of China as a very attractive FDI recipient in Asia, ASEAN members, who were keenly aware of the importance of attracting FDI for their economic development, decided to improve business environment by establishing the AFTA and AIA.

V. Japan' s FTA Strategy

Japan had pursued trade policy under GATT's global framework until the early 1990s, when Japan as a member of APEC began to seek trade liberalization on regional basis in Asia Pacific. This shift in Japan's trade policy may be characterized as a shift from one-track approach based on the GATT/WTO multilateral trading framework to two-track approach, comprising of global and regional approaches. Although this is an apparent shift in Japan's trade policy, it may not be regarded as a drastic shift in that its new policy was not a major departure from the GATT/WTO. This is because APEC is not a discriminatory RTA. Specifically, in APEC trade liberalization is carried out in such as way that reduction in import barriers is applied to APEC members as well as to non-members on non-discriminatory basis. Besides, trade liberalization is carried out on a voluntary basis. As such, APEC can be considered as an organization fully consistent with the GATT/WTO principle.

The late-1990s saw a major shift in Japan's trade policy from two-track approach to multiple-track approach, as it began to consider RTAs formally. Japan started discussing possible FTAs with several countries including Singapore, Korea, Mexico, Chile and others in the late 1990s. After conducting a joint-study on possible FTA with Singapore, Japan and Singapore began negotiations in 2001. Two leaders signed an agreement on FTA in January 2002, and Japan-Singapore FTA (EPA) was enacted in November 2002. Currently Japan is engaged in negotiations with Mexico with an expectation that the negotiations would be finished before the fall of 2003. Japan is expected to start FTA negotiations with Korea and with ASEAN countries in 2003.

Several factors contributed to Japan's shift in its trade policies from single-track approach to multiple-track approach. First and foremost, policy makers

in Japan realize the importance of trade liberalization to revitalize its economy, which is suffering from a long recession. Indeed, economic reforms including fiscal, financial, and other areas have been attempted but they have not been effectively implemented yet. Trade liberalization could play a catalytic role in implementing economic reforms. Given the difficulty in getting a new round of trade negotiations started under the WTO, as was demonstrated by a failure of WTO ministerial meeting in Seattle in reaching an agreement on the new round, Japan realized that RTAs could be a useful policy tool for promoting trade liberalization.

Second, Japan considers FTAs to provide its firms with business opportunities in member countries, as FTAs remove trade barriers in their markets. This is a particularly important factor that led to negotiations with Mexico. As noted above, Japanese firms are treated discriminatorily against the EU firms in Mexico, as EU firms have free access to the Mexican market because of the EU-Mexico FTA. An FTA with Mexico would give Japanese firms the same business opportunities as the EU firms.

Third, promotion of economic growth in FTA member countries is another factor that led Japan to consider FTAs with East Asian countries. As FTAs would promote economic growth in Japan by improving allocative and technical efficiency through free trade and policy reforms as discussed above, one could expect similar impacts on FTA in partner countries. Such effect would be large if FTAs include not only trade liberalization but also other schemes such as FDI liberalization, trade and FDI facilitation, and economic cooperation (EPAs). Economic growth of the East Asian countries would contribute not only to economic prosperity and political and social stability in the region but also to Japan's economic growth. This effect is particularly important, as Japanese economy is increasingly dependent on East Asia.

Fourth, Japan is interested in FTAs as a means to contribute to the rule making process at the WTO. As was indicated above, many FTAs including Japan-Singapore FTA have rules, which are not yet established in the WTO. Indeed, newly enacted Japan-Singapore FTA includes the rules on new areas such as competition policy and trade facilitation. The new rules established under FTAs can be used as a model for the WTO.

Having discussed the factors that contributed to Japan's adoption of multiple-track trade policies including RTAs, it should be emphasized that Japan has to make important policy decisions to carry out its newly adopted multiple-track approach effectively and to contribute to achieving global free trade. First, to begin with the RTAs, it is important for Japan to establish FTAs with many countries, particularly those in East Asia, to promote policy reforms in Japan and to benefit from economic growth in East Asia. Strong resistance to liberalization of the agriculture sector is an obstacle for Japan to conclude FTAs. Policy makers have to show leadership by overcoming such resistance, in order for Japan to achieve economic recovery and to regain competitiveness.

Although Japan-Singapore FTA was concluded without trade liberalization in agricultural trade because of lack of interests on the part of Singapore, FTAs with other countries such as Mexico and Thailand would not be concluded without trade liberalization in agriculture, because of their strong interests. Moreover, the exclusion of agricultural trade from trade liberalization will not satisfy one of the conditions on RTAs under Article XXIV of the GATT/WTO, which states that substantially all the trade be liberalized under RTAs.

Second, negotiations on RTAs should be concluded speedily. One of the

merits of RTAs is their relative ease in negotiation, because the negotiation involves a small group of countries with similar views on trade liberalization. Third, as one of the objectives of RTAs should be to facilitate or promote trade liberalization on global scale, it is important to ensure that the efforts toward multilateral liberalization should not be diminished at the cost of RTAs. Furthermore, it is also important to make effective linkages among RTAs within the WTO framework. In this regard, Japan should contribute to making the rules on RTAs in the WTO unambiguous and comprehensive, and to enforcing these rules strictly.