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THE SEQUENCING OF REGIONAL TRADE INITIATIVES

IN EUROPE AND EAST ASIA

FINAL REPORT

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IN EUROPE AND EAST ASIA

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0. EXECUTIVE SUMMARY

The principal objective of this report was to shed light on the sequence of integrative measures that East Asian nations are likely to take in the decades to come. Particular reference has been made to existing theories of regional integration and to European experience.

The report begins by distinguishing between the conceptual explanations for the *intertemporal sequence of collectively-agreed measures undertaken by parties to a regional trade agreement* and those arguments that refer to *numerous other aspects* of regional integration. Five such explanations were found in the extant economics and international relations literatures and point to the importance of technocratic entrepreneurship, geopolitical factors, domino regionalism (a positive economic theory of the enlargement process in regional trading agreements), policy complementarities, and cross-border spillovers. The very fact that five lines of causation were identified suggests that any predictions concerning the sequencing of regional integration in East Asia are necessarily tentative. It is not credible to assert that this type of analysis can yield both precise and accurate predictions. Nevertheless, there are enough persistent and observable economic and geopolitical forces whose likely impact on sequencing can be discerned.

Next the report describes *the evolution of trade and financial initiatives in East Asia to date*. It cannot be said the nations in East Asia have not made progress in integrating their markets to the extent seen in Europe because they have never tried liberalising initiatives on market access and the like—as the AFTA agreement and measures taken in response to APEC leaders' declarations demonstrate. It is rather that the latter initiatives have not reached their full potential, either because of backsliding from agreed commitments or, worse, a failure to implement non-binding promises. Consequently, East Asian nations have turned to proposing bilateral trade agreements and thirty such measures were identified in this study. Having said that, it is important to appreciate that only a small proportion of these proposed initiatives have in fact translated into signed binding commitments. What is more, to date no trade agreement between the three largest economies in the region (China, Japan, and Korea) has been signed. On financial matters, East Asian nations have little to show for six years of post-crisis discussions other than a one billion dollar Asian Bond Fund and a series of bilateral foreign exchange swapping agreements, the total value of the latter amounts to less than three percentage points of the region's trillion dollar-plus of foreign exchange reserves.

Our analysis of East Asian trade flows and tariff protection reveals that *a free trade area between any two of the three large North East Asian economies is likely to inflict considerable harm on exporters from non-parties*. *This harm is likely to induce a political dynamic that can lead to enlargement of the free trade area*; specifically, the harm will induce exporters in non-parties to urge their governments to join the bilateral trade agreement. Moreover, each enlargement of such an agreement will inflict more harm on the exporters from remaining non-members and that, in turn, is likely to trigger further

applications for entry. This dynamic—termed domino regionalism—is likely to result in a free trade area for manufactured goods in East Asia—although the precise features of the resulting regional agreement will surely be conditioned by the exceptions that nations can obtain (negotiate) for their industries along the way. *The first wave of East Asian regionalism, therefore, is likely to focus exclusively on trade in manufactures*, avoiding the political difficulties inherent in agricultural trade reform.

The second wave of East Asian regionalism is likely to centre on expanding its functional scope to include service sector reforms. This is because the export competitiveness of goods is becoming increasingly dependent on the quality, availability, and cost of national transportation and communication infrastructures in the originating economy *and* in all of the economies the goods have to pass through in order to reach their destination markets. This argument is particularly relevant for firms that are members of international production networks and that face wafer-thin profit margins. Exporters, as well those importing firms that rely on the timely delivery of parts, components, and final goods, are likely to lobby their governments about the need for reforms in service sectors at home and abroad, providing the political impetus for a regional initiative on service sector reform. Moreover, given the large differences in national incomes in the region, and the heavy outlays associated with many infrastructure projects, a regional initiative on service sector reform will probably be coupled with the development of mechanisms for transferring resources between member states. Alternatively, the Asian Development Bank may be asked to play a greater role in supporting the infrastructure projects and reforms necessary to meet the terms of any regional initiative.

Another important policy area in which the functional scope of regional integration in East Asia may well expand is in exchange rate and macroeconomic policy coordination. Apart from the signing of a small number of bilateral currency swap arrangements and the creation of monitoring and surveillance mechanisms, the nations in East Asia appear *at present* to have little stomach for more ambitious regional measures in this area of policy. Instead, currently they prefer to each accumulate massive stocks of foreign exchange reserves and to intervene in the currency markets on their own to reduce the volatility of their currency's bilateral exchange rate with the U.S. dollar. Once tariff barriers have, by and large, been eliminated during the first wave of regional integration of East Asian integration envisaged here, firms will have even fewer cushions to shield them from the effects of sharp exchange rate fluctuations. Should a bout of extreme currency market instability overwhelm these stocks of foreign reserves, then interest is certain to grow among exporters, importers, and policymakers in regional mechanisms to coordinate exchange rates and macroeconomic policy.

In summary, as far as the likely course of the second wave of East Asian regional integration is concerned, expansion of its functional scope to include disciplines on service sector rules and policies is plausible and may well be accompanied by measures in the exchange rate area. It should be noted, however, that the impetus for each differs markedly and that the probability that both happen simultaneously and in a coordinated fashion is slim.

1. INTRODUCTION

The latest wave of international market integration has seen a proliferation of bilateral and regional trading arrangements at the same time as the multilateral trading system has struggled to expand in scope. By and large, these developments have resulted in falling tariff and non-tariff barriers, fewer restrictions on inward foreign direct investments and, in some cases, the narrowing of regulatory differences. As the leading case of regional integration, the European Union (EU) and its predecessor the European Economic Community, is often held up as an example to other nations contemplating liberalisation with neighbours beyond their World Trade Organization (WTO) commitments.

Dissatisfied with the pace of reforms under the Asia Pacific Economic Cooperation (APEC) forum and wary of the United States' (US) influence after the financial crisis of 1997-8 and of China's growing strength, East Asian policymakers have sought lessons from the experience of other regions in devising initiatives to strengthen ties between their economies.[2] (This is not to suggest that there is agreement within or outside East Asia as to what those lessons are.)

An important issue when devising a programme of regional integration is that of *sequencing*. Which policy instruments—of the many whose effects can spill over national borders—should be taken up in the earlier stages of regional integration and which instruments should be left until later? This concern about what might be called the *functional scope* of regional integration over time is coupled with questions of *membership* of the regional initiatives and of the choice of *institutional mechanisms* to implement agreed measures and to mediate, and in some cases to transfer resources, between member states. Regional agreements and institutions also have to respond to unforeseen shocks and disruptions to the world trading and financial systems and to the long-term consequences of technological developments and changes in corporate strategies. The *robustness* of any sequence of regional initiatives to perturbations will, therefore, be an important determinant of success too.

[2] Some of the important characteristics of selected European and non-European regional trading arrangements can be found in Appendix A to this report. This Appendix also contains a comparison of recent macroeconomic performance in Europe and East Asia.

This report, which comprises six chapters and two appendices, examines different conceptual and empirical analyses of regional integration to ascertain the factors which have determined the sequence of current regional integration initiatives in East Asia and in the European Union and sketches some of the next steps likely to be taken by the former. This study is organised as follows. Chapter 2 describes the principal dimensions of regional trade agreements, discusses the very notion of sequencing of such agreements, and summarises the five leading analyses of the intertemporal steps that regional trade agreements have taken or ought to take. This latter discussion—including, in particular, an account of the theory of "domino regionalism" where one regional initiative triggers other initiatives—provides the conceptual framework for

subsequent chapters. The recent experience in East Asia with regional integration initiatives on trade and investment matters is described in Chapter 3 and highlights the fact that, as of yet, no major dominoes have fallen.

The fourth chapter describes the growing intensity of competition in East Asian markets, especially in response to the rise of China and other distinct supply side changes, and notes the fact that most nations in East Asia have tariffs on manufacturers that are still of a considerable magnitude. The argument advanced in this chapter is that the essential economic preconditions for domino regionalism are in place. One important finding of the analyses in chapters 3 and 4 is that once a bilateral free trade area is signed between any two of the big three North East Asian economies, other dominoes are likely to fall quickly. On this view, within a decade or so of the first big domino falling, intra-East Asian trade in manufacturers is likely to be substantially freer than it is at the moment. Thus, the likely form of the first wave of East Asian regional integration is a free trade area for manufactured goods.

Chapter 5 considers the pressures that might result in any future region-wide agreement on free trade in manufactures in East Asia being extended to include other policy areas. On the basis of existing research, two such policies are identified as being relevant for this region: exchange rate policies (with its associated implications for macroeconomic policy) and the liberalisation of service sectors. An argument is made that—unless there is another pronounced bout of competitive devaluations in the region—firms are more likely to pressure governments to open up service sector markets to greater competition than to push for more formal exchange rate coordination in a second wave of regional integration in East Asia. Concluding remarks and implications for policymaking are presented in chapter 6. Two appendices of supporting material are included at the end of the study.

2. DIMENSIONS OF REGIONAL TRADE AGREEMENTS, THE NOTION OF SEQUENCING, AND AVAILABLE EXPLANATIONS FOR THIS PHENOMENON

So as to provide the necessary terminological and conceptual building blocks for the rest of this report, this chapter describes four important dimensions of regional trade agreements, defines the notion of sequencing in regional initiatives, and summarises five conceptual arguments that shed light on the paths taken by regional trade initiatives over time.

2.1 Four important dimensions of regional trade agreements

Regional agreements on *economic* matters can differ on (at least) four dimensions: their objectives, their scope, the nature of commitments made by the parties, and the institutional arrangements (if any) created by the agreement. The objectives could be broad and far-ranging (such as the desire to integrate all or most of a region's markets), narrow (such as the desire to harmonise a single government measure), or something in between (such as taking whatever measures are needed to reduce the volatility of bilateral exchange rate movements).

Turning to the scope of an agreement, this can differ in terms of national

membership, sectors and entities covered, and policy instruments affected by the agreement. With respect to the latter, one can distinguish between agreements covering only trade policies (such as *pure* free trade areas and customs unions), agreements covering investment matters (such as bilateral investment treaties), agreements concerning immigration policies, and agreements covering financial instruments (such as the swapping of foreign currency reserves). Over time many regional agreements have grown in scope to include not only trade measures but also investment measures and the like, yet (perhaps confusingly) the term regional trade agreements (RTA) is still used to describe these multi-policy initiatives. Some have preferred to use the term "regional integration initiatives[3]" and, even though this term is probably more accurate, it has not gained widespread currency. For the purpose of this report the term regional trade agreement is used.

The third important dimension of regional trade agreements concerns the nature of the commitments entered into. Here there are two distinctions worth drawing. The first is between binding and non-binding commitments; and where the former are found, the associated matter arises as to the nature of any enforcement mechanism or dispute resolution mechanism. The second distinction is between commitments by parties *not* to do something (such as discriminating against foreign firms in some fashion) and commitments to do something (such as to enact and implement a new regulatory law). Sometimes this second distinction is stated as one of *negative* versus *positive* commitments; and it is worth noting that both the economic effects of, and enforceability of, these two types of commitments tend to differ markedly.

The fourth dimension of such agreements concerns the balance between inter-governmental components of such agreements and any supra-national elements. Some trade agreements involve the creation of independent secretariats with clearly defined policy-planning, policy-proposing, enforcement, monitoring, or implementation roles.

2.2 Defining the sequence of regional trade agreements and other preliminary remarks

Before turning to the analytics of the *sequencing* of regional trade measures it is important to specify precisely what is meant by this term. By sequencing we mean the *steps* that *a number* of sovereign nations take—along the four dimensions described above—*during and after* the formation of a regional trade agreement (RTA). This definition implies that sequencing refers to more than the creation of a RTA; therefore, an explanation of RTA formation is not an explanation of sequencing. It should also be noted that this definition does not imply that the *same* number of sovereign nations must be involved in the RTA over time, thus allowing for admission of states to a RTA.

[3] See, for example, Schiff and Winters (2003).

One desirable characteristic of an explanation of sequencing is that policymakers and private sector interests are forward-looking in their decision-making and not myopic. This is not to say that decision-makers accurately perceive all of the potential shocks or technological changes that can impinge upon an economy or group of economies; rather that, when considering a set of intertemporal steps that a RTA can take,

policymakers take account of the likely effects over time.

As will become clear when reviewing the extant literature, another important distinction is between an explanation of the steps that a RTA has taken and an argument about the most desirable set of steps that a RTA should take. What has been and what ought to be are quite different matters.

Given that the relevant literature on regional integration has identified a large number of motives for signing RTAs (including geopolitical, economic, and technocratic reasons), as well as the fact that numerous shocks that impinge on regions (financial, exchange rate-related, macroeconomic, and even disease-related—recall SARS), the likelihood that the predictions of any elaborate explanation of sequencing will be at all accurate is pretty slim. Moreover, since economic analyses tend to focus on a limited number of variables so as to generate sharper predictions, the likelihood that in fact some omitted factor undermines the predictive power of such analyses is quite high. Perhaps the best one can hope for is to shed light on some of the effects and dynamics that are triggered by policymakers' decisions and exogenous shocks.

With these preliminary comments in mind, we now turn to the conceptual arguments in the economics and international relations literatures on the sequencing of RTAs. The first point to be made in this regard is that, unlike accounts of single episodes of regional integration, very few scholars and analysts have actually offered rationales for the sequence of steps taken by a region towards further integration. There is a slightly larger literature that examines the complementarities between trade policy and other reforms that can be accomplished in a RTA—and, as we shall see, arguably these have some bearing on the optimal sequence that a regional trade agreement ought to take.

2.3 Explanations of the sequence of actual measures taken in regional trade agreements

Three such explanations are outlined in this section.

2.3.1. Technocratic entrepreneurship

This explanation was advanced by amongst others Jean Monnet, arguably one of the fathers of European regional integration (see Duchêne 1994). Moravcsik (1998) in his masterful overview of the theories of regional integration characterises this explanation as follows:

> "(European) integration has been driven primarily…by a technocratic process that reflects the imperatives of modern economic planning, the unintended consequences of previous decisions, and the entrepreneurship of disinterested supranational experts" (page 4).

Here pride of place is not given to national policymakers or to sectional economic interests, but rather to a group of integration-minded officials that shape the ongoing process of regional integration taking account of the imperatives of the day. Admittedly these imperatives may have changed since Monnet's day (from an era of widespread

and growing state intervention to support the post-World War II social settlement to one where relatively less intervention in markets is coupled with greater flows across national borders of capital, labour, and ideas) and with it the necessary technocratic expertise. Yet, in principle, the size and composition of a region's community of technocratic experts could—once economic co-operation is formally permitted—shape the subsequent sequence of sectors and policies that come under the influence and control of regional agreements and institutions. Indeed, the very dependence of generalist political leaders on technocrats for policy advice could strengthen this dynamic. One interesting question in the East Asian context is whether financial sector, exchange rate, and trade experts could ever acquire the same influence that some feel Monnet and his colleagues had in the 1950s and 1960s?

2.3.2. Geopolitics and mercantilism or concerns about competitiveness

A group of international relations experts, known as Neo-realists, have argued that regional integration in Europe was spurred on by the geopolitical factors impinging on that continent after the Second World War, by persistent pressure from the United States during the Cold War, and then by mercantilistic motivations by European policymakers in the 1960s and 1980s. In his survey of such thinking (and of theorising on regional integration in general), Hurrell (1994) argues that:

> "Proponents of such a view, for example, emphasize the fundamental importance of the geopolitical framework within which the moves towards European integration took place…the ending of the Cold War makes it easier to understand the extent to which the dramatic shift within Europe in the 1940s and early 1950s from war and competition to regional co-operation and then to the promotion of regional integration depended on a very particular set of geopolitical circumstances: the erosion and then collapse of the colonial empires on which the power of Britain and France had been built; the immense physical destruction and psychological exhaustion of the thirty-year European civil war; the perception of a burgeoning threat from the Soviet Union; the long-predicted transformation in the scale of power and the emergence of a new class of superpowers (with whom the traditional nation states of Western Europe acting alone could no longer hope to compete); and the powerful pressure from the USA to move towards greater regional co-operation" (page 47).

He goes on to note that:

> "For the neo-realist, US hegemony was especially important. Neo-realists highlight the degree to which integration was spurred by direct US encouragement and pressure.…They also stress the extent to which European integration—which was in reality subregional integration—was embedded within a transatlantic security framework. This meant that the immensely difficult tasks of politico-military co-operation and security could be left to one side. The acceptance of security dependence was therefore one of the essential compromises on which European co-operation and integration was built—a fact that makes it vital to examine the relationship

between economics and security issues in other parts of the world.

> "Neo-realism focuses attention both on power-political pressures and on the dynamics of mercantilist economic competition. This suggests to the neo-realist that 'outside-in' pressures have continued to influence the path of European integration, but that these have had ever more to do with mercantilist economic rivalry. Thus already in the 1960s de Gaulle placed greater weight on European co-operation (albeit in the form of a *Europe des parties*) as a means to countering *le défi americain* and reducing what he saw as the 'exorbitant privilege' of the USA. Equally, the relaunch of European integration in the 1980s can be interpreted as a response *au défi japonais* and the loss of competitiveness….From this perspective the economic objectives of regional integration do not derive from the pursuit of welfare, but from the close relationship between economic wealth and political power and from states' 'inevitable' concern with relative gains and losses" (page 48).

On this view, the initial choice of economic sectors for regional integration (coal, steel, and atomic energy) was driven by the legacy of past *and* the potential for future conflicts. Moreover, the emphasis of market integration initiatives, and to some extent the deregulation and harmonisation in the 1980s, was driven in part by the perceived need to expand scale and to consolidate into larger firms so as to better compete against stronger non-European competition. What is less clear, however, is the whether the steps undertaken in the 1950s and early 1960s in response to geopolitical factors were taken with the expectation that mercantilism (or at a minimum, concerns about competitiveness) would play a more important role in subsequent decades.

In thinking through the implications of this line of reasoning for East Asia, it is interesting to note that three important powers are said to vie for influence in this region: the United States and Japan and, more recently, China. Moreover, concerns about competitiveness *within East Asia as well as outside of it* appear to manifest themselves in South East Asian policymakers' anxieties about Chinese economic prowess and in the Japanese government's apparent recent interest in bilateralism and regionalism. Any geopolitical explanation of the *sequence of bilateral or regional measures* undertaken by nations within East Asia would, however, have to take into account the fact that some of these factors are recent and some are of longer standing.

2.3.3. Domino regionalism

The most developed economic theory as to why RTAs grow in members over time (or "enlarge") is that of "domino regionalism," which was first formalised by Richard Baldwin (see Baldwin 1994). Baldwin sought to explain why nations were eager to join regional trading agreements and, in particular, how initiatives within a RTA can induce other nations to apply to join that agreement. He motivated his theoretical analysis by developments in North America and in Europe in the late 1980s and early 1990s, arguing in the former case:

> "The idiosyncratic event in the Western Hemisphere was the US-Mexico FTA

> [free trade agreement], which was itself motivated by the unilateral reforms undertaken by Mexico in the 1980s. Announcement of the US-Mexico FTA destroyed the *status quo* of trade relations in the Americas. Other countries in the region, which are heavily dependent on the US market, were faced with a *fait accompli*. Mexico-based producers would gain preferential access to the US market, thereby increasing the competition facing third country exporters and diverting foreign investment to Mexico. Despite continuing opposition to its first regional liberalization—the US-Canada Free Trade Agreement—Canada decided that it had to be at the negotiating table. Other countries in the Hemisphere, such as Chile, Brazil, Argentina, Uruguay and Paraguay enquired about the possibility of bilateral FTAs with the US. Faced with a flood of requests for bilateral FTAs, the Office of the US Trade Representative encouraged South American countries to form regional groups among themselves before applying *en groupe* for an FTA with the US." (page 14).

(In Europe Baldwin argued that the completion of the Single Market programme of reforms—reinforced by the collapse of the Soviet Union—was the event that triggered enlargement negotiations with the remaining members of the EFTA agreement and the formerly communist states of Eastern Europe.)

Baldwin showed that a political economy dynamic can trigger falling dominoes of enlargement. Firms, he argued, would lobby to protect their profits (formally their quasi-rents) that accrued from prior and unrecoverable investments in product development, training, marketing, and production capacity which are necessary to export to an important foreign market. A firm that currently exports goods *into* a RTA from outside will find its relative competitiveness and profitability reduced by any measures taken by members of that RTA which either lower the costs of firms within the RTA or results, more generally, in more intensified competition within the RTA. To protect its profits stream an exporter outside the RTA will be willing to finance the lobbying of its government, and possibly of its country's political parties and industry associations, to gain admission to the RTA in question. Here admission is not sought because the "outsider" firms are publicly-minded—rather it is because such firms want to narrow any differences in treatment (whether at the border or within the RTA) between firms inside the RTA and those outside of it. In sum, the creation of a RTA or "deeper" integration within an existing RTA can trigger subsequent demands for enlargement—and nothing prevents this process "snowballing" with one phase of enlargement inducing other applications for admission which, in turn, could result in further enlargement.

It should be noted, however, as Panagariya (2000) does, that although Baldwin's analysis accounts for why nations want to join an existing RTA, it does not consider the willingness of existing RTA members to permit enlargement. Moreover, Baldwin's framework does not explain why the RTA deepened integration in the first place (recall that geopolitical or technocratic factors are not considered in his analysis.) Furthermore, as a positive analysis of why nations join regional trade agreements, Baldwin's approach does not consider the normative question of whether such domino regionalism enhances world welfare.[4] Nevertheless, Baldwin's approach identifies clear economic lines of causation which he contends can be applied to understanding the

entire evolution of *certain aspects* of European regional integration and that—in his view—has clear implications for the potential course of regional integration in East Asia (see Baldwin 2002).

With respect to the sequence of European regional integration, Baldwin argues that in the 1950s European nations split into two camps according to their preferences towards the depth and extent of integration. The "federalists" (as he terms them) went on to create the European Economic Community (EEC) by signing the Treaty of Rome, so laying the foundations for deeper economic integration, some pooling of sovereignty, and separate treatment for agriculture. The so-called "intergovernmentalists" created the European Free Trade Association (EFTA) with the United Kingdom as the dominant economy and here integration was limited to improving the terms upon which manufactures were traded between members. The discrimination inherent in these two agreements hurt EEC exporters to EFTA and visa versa. EFTA firms, however, were hurt more because the total size of the EEC's economy was larger; and this factor helped trigger the UK's application to join the EEC in 1961.

[4] The following analogy might suggest that it does not. Individuals may decide it is wise to join street gangs but that does not make street gangs a good thing.

The UK application for membership to the EEC raised the prospect of even greater harm to the interests of exporters located in the other EFTA countries. As the realisation of the potential consequences of UK entry sank in, and as the likelihood of UK admission increased, these factors strengthened the support given by such exporters to those political forces in the remaining EFTA members that were supportive of EEC entry. Prospective UK membership triggered a domino in the form of applications for EEC admission by Denmark, Norway, and Ireland. Once the EEC enlarged to nine members, Baldwin argues, the remaining EFTA members (Iceland, Sweden, Norway, and Switzerland) eventually signed free trade agreements with the EEC. According to Baldwin this made Western Europe a "virtual free trade zone" for manufacturers.

The next domino that fell was set off by the creation of the Single Market reinforced, as we noted earlier, by the collapse of the Soviet Union. (The latter is said to have relaxed diplomatic pressure from the Soviets on Austria and Finland not to join the EEC—suggesting that some geopolitical arguments can reinforce the thrust of Baldwin's economic calculus.) The consequence of this domino falling were discussed earlier and completes Baldwin's account of the *evolution of the membership* of the EEC and the European Union since the 1950s.

Interestingly, for our current purposes, Baldwin also applied his framework to shed light on the potential trajectory of further regional integration in East Asia (again, see Baldwin 2002). He starts by arguing that there is a loose historical analogy between Japan's and China's positions in East Asia and the UK's and France's corresponding roles in European integration in the 1950s and 1960s. Japan, he views, is a reluctant "regionalist" just like the UK. China, however, is seen as pursuing economic integration mainly for (alas unspecified by Baldwin) political reasons. One such reason could be to expand China's "sphere of influence" in foreign policy.

Baldwin argues that "real" regionalism has not started in East Asia—which could be taken to mean that the commitment to adhere to binding agreements on trade and

commercial policies in the region has been, until recently, weak at best. Moreover, he claims that the ASEAN economies are too small to form a sufficiently important economic block (that conceivably could set off dominoes.) Instead, he views two possible "sparks" that might set off regional integration in East Asia. These sparks could generate different paths to more liberalised trade in the region, and need not lead to the same end point.

The first potential spark is a free trade agreement between China and the members of ASEAN. In Baldwin's view such an agreement will be dominated by China and is so likely to benefit her exporters relatively more. (This outcome may result from the sectors that are deliberately excluded from any such free trade agreement[5]; ie. China may demand the exclusion of sectors that harm its import-competing firms relatively more than in ASEAN. Of course, to be consistent with WTO rules on preferential trade agreements, all included sectors would have zero tariffs on trade between the members of this agreement.) Baldwin argues that Japanese and Korean firms would soon want to join this agreement—encouraging their respective governments to apply for admission to the hypothesized Chinese-ASEAN FTA. (Baldwin does not consider the interesting question as to whether a joint application for admission by Japan and Korea might redress the relative imbalance towards Chinese interests in a China-ASEAN agreement.) A FTA involving China, Japan, Korea, and ASEAN would then result.

[5] It appears that Baldwin developed this argument before China joined the World Trade Organization (WTO). Consequently, he raised the possibility that a China-ASEAN preferential trading agreement need not involve zero tariffs on imports into China. Such an agreement would violate WTO rules on RTAs which China, in principle, is now bound by. We have amended Baldwin's argument without changing the spirit of it—namely that the distribution of benefits in a China-ASEAN free trade area is likely to skewed towards China.

The second "spark" could be the signing of a free trade area between Japan and Korea, which together account for approximately 17 percent of the world's gross domestic product. This sizeable (bilateral) block would trigger applications for membership from China and the ASEAN nations, spurred on by their respective exporters. Baldwin argues that, in this case, Japan and Korea would surely anticipate the need to specify the means by which enlargement would be effected—what he calls the "docking arrangements." He identifies three such arrangements. The first are "hub and spoke" arrangements with Japan at the centre of a web of bilateral agreements. The second is a "matrix" of bilateral agreements between all interested parties; an outcome that would presumably take longer to negotiate and involve considerable amounts of "red tape" (in the form of rules of origin and the like.) Thirdly, an EFTA-style East Asian-wide agreement could be signed where duty-free market access would be granted on members' exports of manufactures. The latter docking arrangement would require some form of inter-governmental structure to administer it, which Baldwin anticipates could involve either decision-making by consensus or the allocation of one vote per member.

Baldwin developed these arguments in a presentation to Japanese policymakers and urged that country's officials to avoid the "UK's mistake" of seeking to join an important regional agreement four years after it came into being. (The cost to the UK of

not being an initial member of the EEC was, on this argument, not having a "seat at the table" when the Treaty of Rome was negotiated.) Instead, Baldwin argues that Japan and Korea should design a regional trading agreement in consultation with China and the ASEAN nations and should adopt an EFTA-like "docking arrangement" that is less threatening to the latter nations.

Whether or not one agrees with Baldwin's final policy recommendations, arguably he has correctly identified the effect that a Japan-Korea free trade agreement[6] would have on focusing the minds of policymakers and exporters in the region. Indeed, such an agreement may well quickly trigger applications for admission, potentially transforming the role that binding intra-regional commitments play in shaping East Asian national trade policies in a decade or so. For this reason, in the next two chapters we explore whether the underlying trade patterns, the intensity of competition in East Asian markets for manufactures, and the margins of tariff preference on manufacturing goods (implied by a free trade agreement) are sufficient that manufacturing exporters throughout East Asia are likely to respond aggressively in their respective domestic political arenas to the formation of either a Japan-Korea FTA or a China-ASEAN FTA.

It is also worth noting that Baldwin's explanation applies exclusively to trade in goods and services and to trade policies that affect the profitability and interests of exporters. He did not apply his analysis to exchange rate fluctuations[7] which, arguably, can have the similar effects on exporters' profitability; a point that is developed in chapter 5. We now turn to arguments that might shed light on the optimal sequence of initiatives by a set of regional trade partners.

2.4 Arguments concerning the optimal sequence of regional integration

The following distinct but related arguments can each rationalise why a regional trade agreement expands beyond measures to integrate manufactured goods markets into other policy domains and into more elaborate institutional structures (including supranational structures.)

[6] Such an agreement is, in fact, being quietly explored in Seoul and Tokyo in "study groups" and the like.

[7] Having said that, we know of no statement by Baldwin to suggest that this framework could not be adapted to address the implications of exchange rate instability for the incentives of exporters to lobby their governments to join bilateral or regional initiatives to curb such instability. This consideration may be of greater importance now that financial capital flows relatively unimpeded across many nations' borders.

2.4.1. Policy complementarities and the "preservation of the original bargain"

As noted above, the initial motivation for many RTAs is to integrate markets for manufactured goods. Members of a RTA reciprocally exchange market access "concessions" on a preferential basis. However, the extent to which those market access improvements are realised in practice can be contingent on government measures other than trade policy and on firm reactions. For example, a more competitive exporter may find its ability to compete in a regional trade partner's market

impaired by foreign government subsidies to the firm's weaker rivals; providing a rationale for coupling goods market liberalisation with regional rules on state aids. Likewise, exclusive "vertical agreements" between a nation's manufacturers and distribution companies that require the latter only to sell the former's products can significantly impede regional trading partners' market access. *Securing and maintaining* market access, then, may require some RTA-wide rules on and institutional mechanisms to implement competition law. This is another example of what is often referred to as a policy complementarity between a non-trade government measure and trade reforms, where the former is needed to secure the objectives of the latter.[8]

Policy complementarities of this nature suggest that effective RTAs *should* not confine themselves to trade liberalisation in manufactured goods. (In the service sector the argument is stronger as the three of the four modes of supply are directly affected by policies that are not traditionally regarded as trade policy; specifically, measures towards foreign investments—both greenfield and cross-border mergers and acquisitions—and measures towards temporary and permanent migration.) Having said that, policy complementarities *alone* may not account for the *sequencing* of reforms—although the former may shed light on a desirable end point of a sequence of regional reforms that commences with liberalising trade in manufactured goods. Once one allows for constraints *at a point in time* in technical expertise or limits on the willingness to pool sovereignty regionally, then one can conceive of a RTA moving sequentially over time towards an arrangement that more effectively exploits complementarities across policy domains.

[8] Another form of policy complementarity is relevant here; that is, when the gains from trade reform in one sector (manufactured goods) are contingent on the degree of reform in other sectors (perhaps in the transportation and communication sectors.) In this case the complementarity is across distinct sectors within the same economy.

Another important point to bear in mind is that the full extent of policy complementarities may be more readily apparent in hindsight than at the time when a RTA was initially conceived. Thus, a problem—response—problem—response—dynamic emerges where officials amend and expand the policies covered by (and the institutional structure of) a regional trade agreement. A pertinent example follows: despite the considerable EU experience with competition law reinforcing regional trade reforms, in East Asia one rarely hears acknowledgement that reducing trade barriers in that region needs to be coupled with an international initiative to tackle those anti-competitive practices that reduce the benefits of trade liberalisation. It seems that a certain amount of self-discovery (or learning from ones' own mistakes) is necessary and this may account for a RTA taking measures that sequentially realise policy complementarities over time.

A similar dynamic that may account for policy complementarities being sequentially realised is what might be called exporter-led pressure to preserve the original bargain on trade in manufactured goods. Actual and potential exporters to a regional trading partner may discover that, after the original regional measures to liberalise trade in manufactured goods have been implemented, other government policies prevent market access improvements from translating into additional export sales. Such exporters may lobby their own governments to expand regional rules into

those complementary policy domains to preserve what they regard as the originally-bargained for market access. In this manner, rules on standards (their nature and mutual recognition), on customs procedures, and on certain non-tariffs barriers (such as anti-dumping) may well follow the implementation of measures to liberalise manufactured goods trade. The process of self-discovery in a region, therefore, need not only be confined to government officials. In sum, the above arguments explain why a RTA should not confine itself to liberalising trade in manufactures *and* points to some of the other factors that have to be invoked so as to *develop* an argument based on policy complementarities *into* an explanation for the sequencing reforms in a RTA.

2.4.2. Cross-border spillovers from national policy measures, the “grand bargain,” and credible commitment mechanisms.

A separate argument for a RTA involving many different policy domains can be based on the trade-offs across policies that generate cross-border spillovers. The latter are the effects of a government’s policies on the economic interests of another nation that are mediated through the price mechanism. One recent salient example is the adverse effect that production and export subsidies to cotton producers in the United States are said to have had on cotton farmers in four developing countries in Africa. The recent debate over the potential European-wide consequences of French government subsidies to Alstom is another example. In short, with cross-border trade in goods and financial assets, the effects of a nation’s policy mix (including policies traditionally thought of as “domestic measures”) need not be confined to within its own borders.

While it has long been recognised that cross-border spillovers *can* rationalise international collective action with net potential benefits for the nations participating in such action, it need not be the case that each national participant individually benefits from every collective measure. Put another way, a collective act may be welfare improving overall but the distribution of gains may leave some nations worse off. This very fact is one of the reasons why “issue linkage” is said to have arisen in regional trade agreements. Policy measures can be combined in a RTA to form a “grand bargain” in which each national participant is better off if it *signs up for and implements* the *entire* package.

The possibility that a nation may be worse off should it implement an element of the grand bargain provides, in turn, the rationale for incorporating what are often referred to as “credible commitment mechanisms” into a RTA. These mechanisms can involve monitoring by a supra-national body, enforcement by a supra-national court, and the development at the national and international levels of a community of experts and commercial interests that push for the faithful implementation of agreements entered into by members to a RTA. In sum, then, cross-border spillovers can account for why a RTA could incorporate binding disciplines on many (perhaps on-the-face-of-it unrelated) issues as well as (subtle or overt) supra-national mechanisms to enforce compliance. However, yet again, other factors must be appealed to explain why a RTA would sequence reforms. What other factors must be added to the above explanation to yield a theory of sequencing of regional reforms?

The factors mentioned earlier as to why policy complementarities are exploited

over time (limited technical expertise and political will as well as self-discovery) could be relevant in this context also. However, a distinct factor is technological change and other policy reforms that alter the strength of cross-border spillovers and, by implication, the set of feasible grand bargains. A RTA could, therefore, evolve from grand bargain to grand bargain over time; altering the relative weight put on different policy measures within a set of regional rules.

Technological and policy developments in the financial sector and the growing emphasis on macroeconomic policy co-operation and coordination among EEC/EU member states in the 1980s and 1990s could be an example of such a dynamic. For better or for worse, during the 1980s and 1990s many nations liberalised their financial markets and eased restrictions on cross-border flows of short-term funds. Coupled with innovations in information and communication technologies, a large pool of highly reactive “hot money” has developed. Three of the factors that such money reacts to are actual and expected interest rate differentials across countries for comparable assets, and the credibility of central government measures to fix exchange rates (or to limit their fluctuation), and its commitment to fiscal austerity. In such a world, national macroeconomic policy choices can have sizeable cross-border effects which, in turn, spillover into the trade arena as exchange rates are a determinant of exporters’ competitiveness and profitability. Numerous studies of bilateral trade flows have shown that exchange rate volatility reduces observed trade flows—the political-economy counterpart to this finding, therefore, is that exporters may find such volatility is just as inimical to their interests as trade policy measures that frustrate access to foreign markets more directly. Consequently, a bout of substantial or extreme exchange rate volatility may generate corporate pressure for regional measures to constrain exchange movements or, in the limit, to eliminate such fluctuations entirely. (Indeed, some have argued that these very factors account for the increasing prominence given to macroeconomic and exchange rate matters in regional trading agreements, see Movarcsik 1998.)

In short, new circumstances therefore can account for a RTA expanding its remit into macroeconomic and exchange rate matters. Moreover, on this view, the sequence of issues that ought to be tackled by a RTA evolves partly in response to technological changes and other non-RTA-related policy changes.

2.5 Summary

In this chapter, five distinct arguments were advanced for the sequence of measures that regional trade agreements might adopt and that they ought to follow. Sequencing, it could seem, can be a function of many factors—technical expertise, intra-regional and extra-regional geopolitical factors, political dynamics triggered by current intra-regional block discrimination against from exports from non-members, the logic of policy complementarities and cross-border spillovers reinforced by inertia, capacity constraints, and self-discovery, and technological and seemingly unrelated policy changes in the financial sector. The next chapter discusses the evolution of regional trade initiatives in East Asia since 1989, and is followed by a chapter which examines whether the pre-requisites for domino regionalism are in place in East Asia.

The latter discussion sheds light on both the degree of, and changes in, intensity of competition in the East Asian manufacturing sectors and on the remaining barriers to intra-regional trade.

3. THE EVOLVING NATURE OF TRADE AND FINANCIAL INITIATIVES IN EAST ASIA

Since 1989 international trade reform initiatives in East Asia have changed markedly in functional scope and membership. Until the late 1990s there was considerable interest in a pan-pacific initiative (APEC) that sought to stimulate domestic reforms but did not involve the signing of binding commitments. Dissatisfaction with the pace of progress in that fora set in and some nations in the region have turned to bilateral trade initiatives which have tended to focus almost exclusively on liberalising trade in manufacturing goods. (In South East Asia, discontent with the progress of a sub-regional agreement—the ASEAN Free Trade Area or AFTA—has reinforced the shift towards bilateral trade agreements, especially in Singapore.) A few of those bilateral trade agreements have now been signed but, as yet, they do not cover much of the intra-regional trade in East Asia. Moreover, at present the small number of recently signed bilateral agreements have not triggered a domino-like reaction that Baldwin (1994, 2002) analysed. (This is not to say that the dominoes will never fall in the future or that the pre-requisites for such dominoes falling have not been met, see chapter 4.) This chapter describes the twists and turns of regional trade measures and bilateral trade agreements in East Asia since 1989.[9]

3.1 Dissatisfaction with the pace of multilateral trade reform

Although this study focuses on regional initiatives, it is worth bearing in mind that East Asian nations could *in principle* pursue trade and investment reforms either unilaterally or through negotiations at the World Trade Organization. The latter has traditionally been the more politically palatable than the former, principally because export interests are often willing to support proposed WTO agreements that offer greater market access abroad. On paper at least, the completion of the Uruguay Round negotiations brought under the WTO umbrella new disciplines on trade and investment in services, on intellectual property rights, and on agricultural protection rules, in addition to the typical reductions in tariffs on manufactured goods. Countries signed this agreement as a single undertaking, which prevented them from cherry picking only those constituent agreements that best suited their interests (Hoekman and Kostecki 2001).

[9] Some of the evidence discussed in this chapter draws on Yusuf and Evenett (2002). It should be noted that use to which this evidence is put here is markedly different.

The signing of the Uruguay Round multilateral trade agreement in April 1994 proved to be the high-water mark of support for WTO-based trade reforms. Since then, many developing economies have found it very difficult to comply with various commitments and are falling behind several deadlines. Moreover, the cost of implementing many WTO agreements is thought to have been much higher than

anticipated, becoming a source of disquiet among policymakers (Finger and Schuler 1999). And to rub salt into the wounds, the perception has grown that industrial countries had “back loaded” their new commitments to trade reform, noticeably in textiles and apparel; essentially postponing market access gains for developing countries until nearly 2005 (Finger and Schuknecht 1999). Thus, the impression arose that developing countries had to comply quickly with costly Uruguay Round commitments, while industrial countries postponed their own painful but needed reforms.

This particular legacy of the Uruguay Round did not provide an auspicious backdrop to the WTO ministerial meeting in Seattle in November 1999. Many negotiators from developing countries (notably from India, Pakistan, and Egypt) argued that a new round should not be launched before concerns about implementation and burden sharing under the Uruguay Round have been addressed. Industrial nations appear to have regarded these concerns as a smoke screen; that is, as tactical arguments marshalled to stall further trade liberalisation. Consequently, few imaginative proposals were offered in Seattle aimed at winning over the leading developing nations. Worse still, at that time, U.S. negotiators pushed for the creation of a WTO Working Group that would consider the relationship between trade and labour standards. Then-U.S. President Clinton remarked at a meeting before arriving in Seattle that in the future he would like to see trade sanctions used to enforce codified labour standards. This confirmed the fears of poor nations that the creation of the Working Group foreshadowed measures that would erode any export competitiveness based on lower labour costs (Schott 2000).

These divisions between industrialised and developing nations were reinforced by disagreements among the United States, Japan, Canada, and the European Union. The United States wanted agricultural subsidies and protection to receive priority in any new negotiations, while Japan and the European Union did not. Canada and the European Union wanted protection for so-called cultural industries to be preserved, while the United States did not. Japan, for her part, was keen to see reforms to the WTO Antidumping Code, which the United States implacably opposes. With such wide-ranging disagreements on the content of a new trade round, it is perhaps not surprising that the Seattle meeting collapsed in recriminations. Protestors further disrupted what were already fraught negotiations.

Since the failure of the Seattle ministerial meeting, numerous attempts were made to galvanise support for a new multilateral trade round. Discussions intensified in the run up to the Doha WTO ministerial meeting in November 2001, and significant differences narrowed. For example, the European Union no longer sought wide-ranging disciplines on national investment regimes and competition laws; but she continued to argue for bringing all of the so-called Singapore issues under the WTO umbrella. In addition, the United States has dropped its insistence on discussions on labour standards. Enough convergence was accomplished that a “development round” was launched at the Doha WTO Ministerial. The subsequent failure of the Cancun Ministerial in September 2003 represents a reversion to form; further adding to the bad blood felt since the conclusion of the Uruguay Round and raising the question as to whether multilateral trade negotiations on the Doha Development Agenda can be successfully concluded by

December 2004. Such considerations have reinforced the tendency of some nations—especially those on both sides of the Pacific—to turn increasingly to regional and bilateral initiatives.[10]

[10] Having said that, at the latest APEC summit of Heads of State in October 2003, members of this forum called for the swift resumption of negotiations on the Doha Development Agenda. At the Cancun Ministerial Meeting, WTO ministers mandated that the WTO's General Council should meet by 15 December 2003 to consider the appropriate scope of the Doha Round.

3.2 Regional and pan-pacific trade and financial initiatives since 1989

At first East Asian nations reacted to the difficulties experienced in completing the negotiations on the Uruguay Round by pursing a pan-pacific reform initiative (APEC) and, in South East Asia, by agreeing to form a sub-regional free trade area under the auspices of ASEAN. Unfortunately, as the following discussion makes clear, neither ASEAN's nor APEC's trade initiatives have lived up to their proponents' initial expectations.

3.2.1. ASEAN and the AFTA

The Association of South East Asian Nations (ASEAN) was formed in 1967 with the five following founding members: Indonesia, Malaysia, the Philippines, Singapore, and Thailand. The initial objective was to foster regional stability and to promote political and economic co-operation. Throughout the 1990s, the latter goal came to dominate, and the original ASEAN members agreed in 1992 to create an ASEAN Free Trade Area (AFTA). Trade reform at first focused on tariff reductions on manufactured goods. In 1995, however, the ASEAN members agreed to expand the AFTA to include services, intellectual property rights, investment negotiations, and non-tariff barriers. Furthermore, the ASEAN members agreed in 1998 to accelerate the rate at which tariffs were reduced to between zero and 5 percent, with the overall target set of eliminating tariffs on manufactured goods trade by 2003.

During the 1990s ASEAN's membership expanded to include Vietnam, in 1995; Laos and Burma, in 1997; and Cambodia, in 1999.[11] These new members are not expected to phase out tariffs and other trade barriers as quickly as the original members, generating fears that a two-speed ASEAN would be created.[12] Vietnam has until 2006, while Cambodia, Laos, and Burma have until 2008 to reduce their tariffs below five percent. Another wrinkle has been the use of "exclusion" lists and similar methods to avoid phasing out tariffs on sensitive agricultural and manufacturing items.

[11] Brunei Darussalam joined ASEAN in 1984 after gaining independence from the United Kingdom.

This ambitious programme of trade reform has, however, been called into question in recent years. In January 2000, Malaysia reneged on its commitments to reduce tariffs on automobile parts. Even though ASEAN ministers agreed in May 2000 to allow Malaysia to retain these tariffs until 2005, confidence in the movement toward freer trade in this sub-region was shaken. Other members (notably Thailand) have subsequently announced that they, too, are reconsidering their commitments to

liberalising their automobile industries in light of Malaysia's move. This backsliding effectively undermines plans to allow automobile parts to move tariff-free across ASEAN's borders, a scheme that has attracted applications from fifty foreign investors, including Volvo, Honda, and Toyota.[13]

Malaysia's move was blamed, in part, on the after effects of the East Asian financial crisis, which analysts claimed undermined the viability of its car industry. Given the severe downturn in South East Asian exports in 2001, and the slowdown in the world economy in 2001 and 2002, pressures to protect national firms in the ASEAN regions have intensified. Taken together, these considerations help to explain why one of the AFTA's most vocal supporters—Singapore—has changed its approach and has been aggressively negotiating bilateral trade agreements; a point discussed at greater length in section 3.3 below. Looking beyond South East Asia, ASEAN's attempts to forge closer economic and political ties with three of its north-eastern neighbours (China, Korea, and Japan) have yet to come to fruition.

Geopolitical and strategic concerns overwhelm trade and investment priorities in ASEAN and its related fora, as evidenced by the cautious reception given to China's proposal for a free trade area (FTA) with the ASEAN economies. Concerns that this potential FTA might become a vehicle for greater Chinese influence in South East Asia prompted suggestions that it be expanded to include Korea and Japan. Yet, "ASEAN plus 3" appears to be going through a "teething stage," and the scope of this particular regional free trade initiative is unclear.

12 *Oxford Analytica*, "Problematic Newcomers," 20 September, 2001.

13 *Oxford Analytica*, "Free Trade Retreat," 4 May, 2000. The scheme in question was known as the ASEAN Industrial Cooperation Scheme (AICO).

Looking around the Pacific region, it would appear that the forum that most advanced intra-regional co-operation and liberalisation during most of the 1990s was the APEC. APEC was founded in 1989 when representatives of twelve nations, meeting in Canberra, issued a "work program" for future economic co-operation across the Asia-Pacific region.[14] At subsequent meetings, progress was made on trade facilitation measures. China, Taiwan, and Hong Kong joined the APEC group in 1991, and APEC's profile was further raised when the United States invited the heads of state of the APEC economies to a summit in 1993. This marked a turning point in U.S. attitudes towards APEC; the United States afterwards issued a "vision statement" that recognised the growing economic interdependence across the Pacific and within East Asia. Inter-governmental co-operation picked up on a range of trade, investment, and other issues, and commitments were fleshed out in greater detail at the subsequent 1994 and 1995 APEC summits at Bogor and Osaka, respectively.

Recognising the deep historic divisions and rivalries within the region, APEC was founded on three core principles: consensus, voluntarism, and unilateralism. APEC members tended to move together, by consensus, or not at all. Reforms agreed to in this forum are not codified in explicit regional agreements with rules, enforcement mechanisms, or formal ex-post monitoring. Nations implement reforms unilaterally, principally through published "Individual Action Plans (IAPs)" of measures taken in

fifteen regularly-updated policy areas, but they frequently extend those benefits to non-members as well. This formula has been useful in encouraging nations to reform their economies and to shore up domestic support for these reforms. At the Bogor Summit, APEC leaders declared that their reforms are meant to move APEC members towards pan-pacific free trade by 2010 for industrial nations and by 2020 for developing nations.

[14] The twelve nations are Australia, Brunei, Canada, Indonesia, Japan, Korea, Malaysia, New Zealand, Philippines, Singapore, Thailand, and the United States.

Even those sympathetic to APEC's vision, goals, and methods, however, have become increasingly frustrated at this initiative's lack of progress towards its collectively-agreed goals. In its first policy report the APEC International Assessment Network (APIAN) argued that APEC has developed a form of "soft institutionalism" where "[d]uring its first decade, APEC has created a set of norms, procedures and structures that define its essence" (APIAN 2000, page 4). Their argument ran as follows:

> "[W]e believe that this soft institutionalism served APEC well during its infancy. Many of those who criticise APEC for not accomplishing more fail to understand the nature of soft institutionalism and why the region's realities allowed no other choice. We also believe that as APEC enters its second decade, it must constantly engage in self-examination. It must consider whether its soft institutionalism is facilitating decision making, whether the vision and mandates of the leaders are being transformed into tangible actions, and whether APEC officials are receiving the critical feedback integral to sound governance.
>
> "What may have been realistic at the outset may have become an avoidable obstacle to further achievement. What may have seen hopelessly idealistic at the beginning may have become more feasible as members gain confidence in APEC and in each other. What seemed dangerous may now appear comfortable and desirable." (APIAN 2000, pages 4-5.)

Central among these concerns are the slow adoption of APEC's reform agenda; the wide diffusion of trade and investment reform efforts; the member nations' failures to set specific and observable goals beyond their Uruguay Round commitments; and APEC's weak mechanisms for evaluating member actions and its lack of incentives for encouraging members to align their actions with collectively agreed-on goals.

The Trade Policy Forum of the Pacific Economic Cooperation Council expressed similar concerns over APEC's lack of progress. It found that:

> "[g]enerally, the Individual Action Plans lack detail, or do not shed sufficient light on the medium and longer term policy developments. Progress is more significant in areas where APEC has focused on collective actions" (PECC 1999).

This PECC analysis revealed that the IAPs contained only moderate coverage of non-tariff barriers and few unambiguous commitments to liberalise services. In contrast, it found, by and large, clear commitments and programmes in tariff reductions, investment liberalisation, removal of impediments to the movement of business people, and

implementation of Uruguay Round reforms.

Where APEC has sought to liberalise a particular sector, however, it has accomplished concrete results. The first WTO agreement on trade in information technology products, which reduced barriers to trade in this critical component of the knowledge-based economy, was originally negotiated among APEC members in 1996 before being extended quickly to include all WTO members at the Singapore WTO ministerial meeting of the same year. This agreement provided for the elimination by January 2000 of tariffs on all information technology-related goods. Signatories to this agreement now represent more than 90 percent of the buyers and sellers in the $500 billion-plus global trade in information technology.[15]

In sum, while APEC reform initiatives have accomplished tangible improvements in selected aspects of the trans-pacific business environment, given its current schedule, future reforms are likely to fall short of this group's potential. It is perhaps a testament to the difficulties in stimulating regional and multilateral trade reform in recent years that several nations in East Asia have turned to a third option: negotiating bilateral reductions in trade barriers.[16] Even those long-time sceptics of the benefits of preferential trade reform—Japan and Korea—have begun actively exploring the potential for bilateral trade agreements with other East Asian nations.[17]

[15] Wilson (1998).

[16] For an economic analysis of some proposed and potential bilateral and subregional initiatives, see Scollay and Gilbert (2001a,b).

[17] See, for example, details of Japan's change in trade strategy in *Financial Times*, "Japan Ponders Free Trade Alliances," 6 June, 2001.

3.2.2. Post crisis regional financial initiatives: Towards a regional bond market?

Perhaps unsurprisingly the East Asian financial crisis spurred discussions of potential regional initiatives on financial and macroeconomic matters. Many in East Asia saw the cause of the 1997-1998 financial crisis as either mistakes by certain multilateral financial institutions (in particular the IMF[18]) or as the consequence of Western currency speculators.[19] Moreover, it has been argued that East Asian nations provided much of the funds to crisis-affected nations in the region. Jansen (2003), for one, claims that 62 percent of the Thai "bailout" package in 1997 was financed by Asian countries. These perspectives have reinforced the desire of many in East Asia to look within the region for solutions to any financial difficulties that they may face.

Although the focus of this report is on the more recent regional integration initiatives, it is worth noting that during the East Asian financial crisis Japan proposed the formation of an Asian Monetary Fund (AMF). According to one of its leading proponents—the former Vice Minister of Finance for International Affairs in the Japanese Ministry of Finance, Eisuke Sakakibara—"it was the desire to create a policy alternative to the IMF prescription that motivated the proposal to create the AMF"

(Sakakibara 2001). This proposal did not make any headway in the face of both strong opposition from the United States government and evident divisions within the Japanese government. Instead, the Manila Framework Group was established in 1997 to promote regional cooperation and surveillance mechanisms and to consider measures that might enhance the IMF's effectiveness in tackling future financial crises and contagion.[20] The Deputy Finance Ministers and Central Bankers of the fourteen members of this Group meet regularly and discuss developments within the East Asian region, including bank and corporate restructuring as well as macroeconomic performance and stability. While such dialogue is probably helpful in aligning expectations and in sharing best practices, it should be noted that no binding commitments have been entered in to by the partiers nor have any formal institutions been created.

[18] Indeed it is telling that leading Korean economists refer to the economic crisis that hit their nation in 1997 as the "IMF crisis."

[19] In this regard the accusations of then-Prime Minister Mahathir of Malaysia are well known and need not be repeated here.

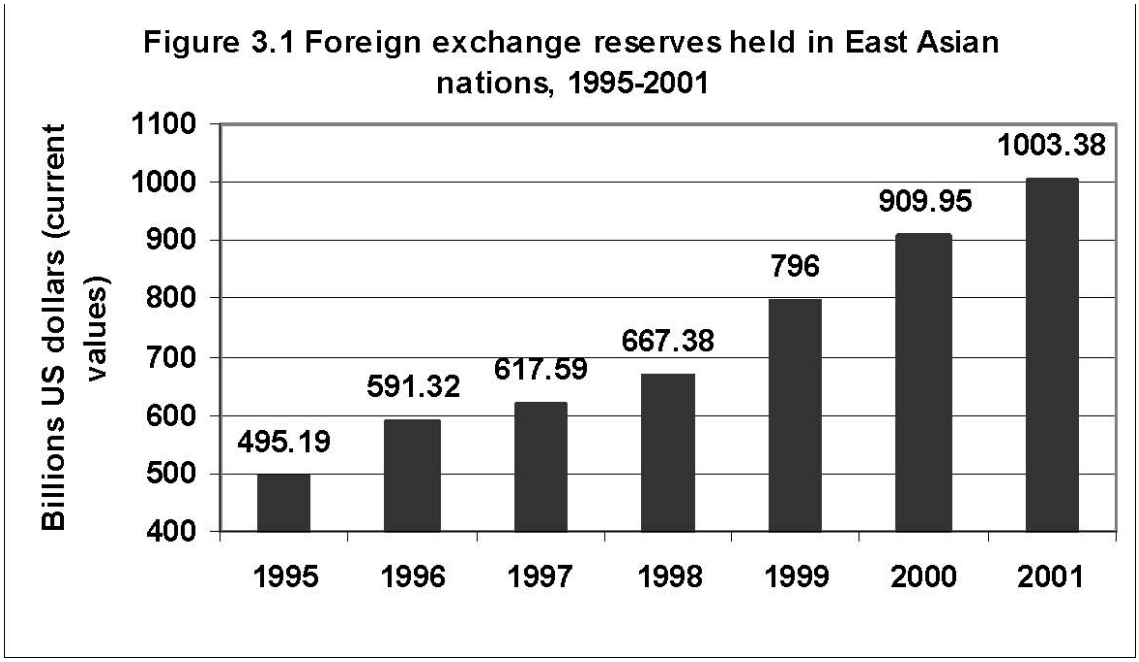
[20] The members of the Manila Framework Group are Australia, Brunei Darussalam, Canada, China, Hong Kong SAR, Indonesia, Japan, Korea, Malaysia, New Zealand, the Philippines, Singapore, Thailand, and the United States of America.

The fact that certain non-East Asian nations are members of the Manila Framework Group suggests that it is better characterised as a pan-pacific initiative rather than as an East Asian initiative. It is noteworthy, therefore, that in October 1998 the Finance Ministers of the ASEAN countries signed a separate Terms of Understanding that established the ASEAN Surveillance Process. The objectives of this Process were to monitor sectoral, social, as well as macroeconomic policies, to strength the relevant policy-making capacity within ASEAN members, and to share information between parties. Participation in this Process and its associated meetings was (and is) voluntary and no power to take policy measures was vested in the collective body.

The ASEAN Surveillance Process was subsequently expanded to include the three major North East Asian economies (China, Japan, and South Korea), creating the ASEAN+3 Surveillance Process. Both initiatives are supported by the Regional Economic Monitoring Unit of the Asian Development Bank. Proponents of these initiatives contend that they have improved transparency and the quality of macroeconomic information supplied by members, that better information may reduce the risk of financial contagion, and that surveillance is a pre-requisite for economic policy coordination, mutual support in times of crisis, and cooperation on exchange rate management. It should be remembered that many of these benefits are prospective in nature and that these cooperative arrangements have not been tested yet in a time of financial stress. Hence, it is difficult to take a strong position on the success of these two macroeconomic surveillance mechanisms.

It is also worth bearing in mind that, during and after the launch of these initial regional initiatives, East Asian nations were taking important national decisions about macroeconomic and foreign exchange rates policies that would influence, in part, subsequent financial initiatives within the region. We, therefore, briefly describe these developments in national policymaking and note that, although many East Asian nations

appear to have taken similar national decisions in this regard, there is little to suggest that these measures were taken in concert.



As figure 3.1 and table 3.1 make clear East Asian governments responded to the financial crisis of 1997-1998 by substantially increasing their central banks' respective holdings of foreign exchange reserves. By 2001, the nine economies listed in table 3.1 had accumulated over one trillion U.S. dollars of foreign exchange reserves—with the three major North East Asian economies (Korea, China, and Japan) increasing their reserves the most. It was felt that such reserves would provide nations in the region with more ammunition to counter financial speculation and the associated potential for considerable outflows of "hot money." Another factor behind the accumulation of these reserves was the desire of national governments to hold their nominal exchange rates steady against the U.S. dollar during a period of rising bilateral trade surpluses. Central banks bought U.S. dollars from their own country's successful exporters and held those dollars as cash or bought U.S. Treasury bills. (In fact, in 2003 Japan bought over U.S.$170 billion of U.S. Treasury bills—a substantial proportion of the U.S. budget deficit for that year. More generally, it appears that many East Asian nations have, through their purchases of U.S. Treasury bills, effectively financed a large proportion of the recent government spending spree in the United States. Alternatively put, East Asian nations appear to be buying the very Treasury bills which directly or indirectly result in greater demand for East Asian manufactured products!)

East Asian countries also sought after the crisis to reduce the share of their external debt that has short term maturities (more precisely, debt requiring repayment—or roll-over—in less than a year.) Before the financial crisis in 1996, 18 percent of Asian economies debt was in short term maturities. Six years later, that proportion had fallen to only 8 percent (see figure 3.2.)

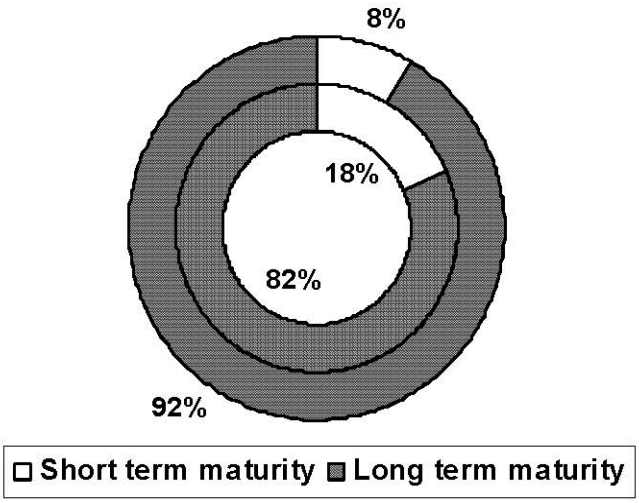
Table 3.1: Foreign reserve holdings in East Asia.

Billions of US dollars (current dollars).

Economy	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
China	22.39	52.91	75.38	107.00	142.70	149.10	157.70	168.20	215.60	286.41
Indonesia	11.26	12.13	13.71	18.25	16.59	22.71	26.45	28.50	27.25	
Korea	20.23	25.64	32.68	34.04	20.37	51.97	73.99	96.13	102.70	120.81
Malaysia	27.25	25.42	23.77	27.01	20.79	25.56	30.59	29.52	30.47	34.58
Philippines	4.68	6.02	6.37	10.03	7.27	9.23	13.23	13.05	13.44	16.06
Singapore	48.36	58.18	68.70	76.85	71.29	74.93	76.84	80.13	75.37	81.37
Thailand	24.47	29.33	35.98	37.73	26.18	28.83	34.06	32.02	32.35	38.92
Hong Kong	42.99	49.25	55.40	63.81	92.80	89.65	96.24	107.50	111.10	
Japan	98.52	125.80	183.20	216.60	219.60	215.40	286.90	354.90	395.10	451.46
Total for all of the above economies	300.15	384.68	495.19	591.32	617.59	667.38	796	909.95	1003.38	

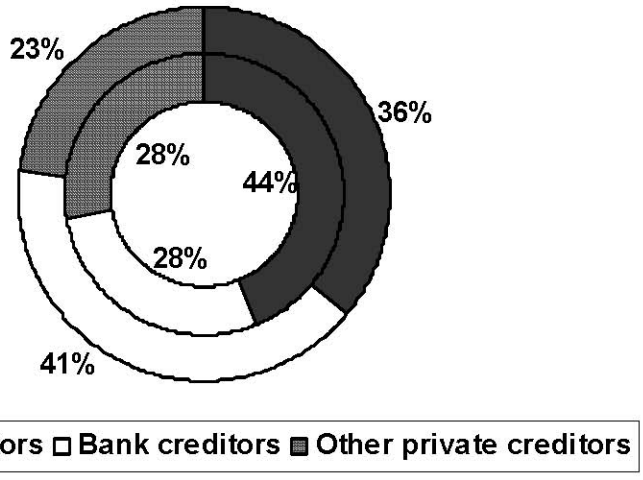
Source: International Monetary Fund, *International Financial Statistics.*

Figure 3.2: The falling share of short term debt in total external debt in Developing Asia, 1996 and 2002 (outer ring).



Another change of some significance to our discussion is the growing reliance of East Asian nations on bank-financed debt (see figure 3.3). Lending by other private creditors (including bond issuance) fell from 41 percent in 1996 to 28 percent of the total debt of developing economies in Asia in 2002. To summarise, in the aftermath of the 1997-1998 financial crisis East Asian nations can be thought of as coupling “mutual support” (regional initiatives) with considerable amounts of “self help,” principally reducing their dependence on short term debt and increasing their capacity to deal with sharp changes in investor sentiment and substantial short term capital outflows.

Figure 3.3: The growing reliance on bank-financed debt in Developing Asia, 1996 and 2002 (outer ring).



East Asian economies further reinforced their available foreign exchange reserves by agreeing numerous bilateral currency swap arrangements. Since the launching of the Chiang Mai Initiative in May 2000, fifteen bilateral foreign exchange swap agreements have been signed by December 2003. These bilateral agreements allow a party to call on specified quantities of another party's foreign exchange reserves. Typically, these agreements specify that 10 percent of the total committed reserves are immediately available to a party. The other 90 percent is only available after the successful conclusion of an agreement with the IMF (that presumably seeks to address the economic circumstances that have induced the run on the party's currency in the first place.)

Table 3.2 lists the parties to these agreements and the amount of reserves made available in each bilateral agreement. Together a total of $26.5 billion of foreign exchange reserves has been committed to these agreements. While impressive, this sum pales in comparison to the total reserves held by the nine East Asian economies listed in table 3.1. In fact, at the end of 2003 the total funds committed to these bilateral swap agreements ($26.5 billion) amounts to only 2.64 percent of the 2001 total of reserves held by these nine economies. (Since 2001, the total reserves held by these economies is said to have risen, further lowering this percentage!)

Having said that, for certain East Asian economies these bilateral swap agreements could expand considerably the reserves available to their central banks (see table 3.3). In the case of the Philippines, full access to the reserves covered by its bilateral swap agreements would expand its total reserves by 37 percent. The comparable percentages for Thailand and Indonesia are 18 and 14 percent, respectively. Given the North East Asian nations hold the preponderance of foreign exchange reserves in East Asia, at present these bilateral swap agreements appear to bolster (with the exception of Singapore) the capacity of ASEAN countries to manage capital flight.

Another noteworthy feature of the current set of bilateral swap agreements is the prominent role given to the IMF in "conditioning" access to the relevant foreign exchange reserves. Apart from the irony of East Asian nations letting the very multilateral institution that many felt was responsible for the 1997-1998 financial crisis effectively act as a guardian of their own foreign exchange reserves, the question arises as to whether these swap agreements can accurately characterised as a purely regional mechanism for influencing financial markets. Lastly, it is worth noting that these swap arrangements do not require countries to cede sovereignty over national policymaking, which has been central to European approaches to intra-regional exchange rate management for over 15 years.

Table 3.2: Bilateral swap agreements since by East Asian nations, 2001-2003.

Parties to an agreement	Currencies	Status	Size
Japan and Korea	US$/Won	Concluded on 4 July 2001	US$2 billion
Japan and Thailand	US$/Baht	Concluded on 30 July 2001	US$3 billion
Japan and Philippines	US$/Peso	Concluded on 27 August 2001	US$3 billion
Japan and Malaysia	US$/Ringgit	Concluded on 5 October 2001	US$1 billion
China and Thailand	US$/Baht	Concluded on 6 December 2001	US$2 billion
Japan and China	Yen/Renminbi	Concluded on 28 March 2002	US$3 billion
China and Korea	Reniminbi/Won	Concluded on 24 June 2002	US$2 billion
Korea and Thailand	US$ and Won/Baht	Concluded on 25 June 2002	US$1 billion
Korea and Malaysia	US$ and Won/Ringgit	Concluded on 26 July 2002	US$1 billion
Korea and Philippines	US$/Peso	Concluded on 9 August 2002	US$1 billion
China and Malaysia	US$/Ringgit	Concluded on 9 October 2002	US$1.5 billion
Japan and Indonesia	US$/Rupiah	Concluded on 17 February 2003	US$3 billion
China and Philippines	Renminbi/Peso	Concluded on 31 August 2003	US$1 billion
Japan and Singapore	US$	Concluded on 10 November 2003	US$1 billion
Korea and Indonesia	Won/Rupiah	Announced on 23 December 2003	US$1 billion
Total amount			US$26.5 billion
Expressed as a percentage of East Asian countries' total foreign exchange reserves in 2001			2.64%

Source: Jansen (2003) and updated by this author.

Table 3.3: Bilateral swap agreements as a share of available reserves, by East Asian economy.

East Asian economy	Maximum reserves that in principle this economy can call upon under existing bilateral swap agreements (US$ billion)	Maximum reserves that can be called upon as a percentage of own national reserves in 2001. (%)
Philippines	5	37.20
Thailand	6	18.55
Indonesia	4	14.68
Malaysia	3.5	11.49
Korea	8	7.79
Japan	16	4.05
China	7.5	3.48
Singapore	1	1.33

Note: Data on reserves is taken from Table 3.1 and data on the maximum amount of foreign currency available from swap agreements is taken from Table 3.3.

Since the Chiang Mai Initiative many senior policymakers in the Asia-Pacific have given considerable attention to establishing regional bond markets. Last year (2003) saw a flurry of meetings on this subject and resulted in at least one concrete initiative, which is discussed later. Given that discussions on these matters are ongoing any evaluation of proposals for regional bond markets is necessarily tentative and could quite possibly be very quickly overtaken by events. Nonetheless, research for this report had led to enough substantial material to merit a discussion here.

Before discussing in some detail the recent initiatives to stimulate the development of East Asian bond markets, a few other preliminary remarks are in order. First, in some East Asian economies national bond markets exist. Furthermore, government and corporate bonds issued by East Asian entities can in principle be traded in the highly-liquid and well developed global financial markets. The question immediately arises as to whether the development of regional bond markets will merely duplicate existing national and global markets. Such considerations, among others, led Jansen (2003) to identify the following potential contributions of a regional bond market:

> "agents operating on Asian bond markets may be better informed about economic conditions in the region and about corporate performance."

> “many of the countries in East Asia may be too small to develop very efficient, deep and liquid domestic bond markets. On the other hand, corporations from these countries may be too small to have access to truly global markets: regional markets may offer a solution.”
>
> “East Asian countries generate substantial savings. An Asian bond market would enable Asian investors to put together a more diversified portfolio with improved return-risk profiles.”
>
> “if a regional market would make it possible for issuers to issue bonds in their national currency, this would shift the exchange rate risk from the issuers to the investors who may have better opportunities for diversifying and hedging.”

On the face of it, these four arguments are fairly unpersuasive. The first argument amounts to a conjecture about the behaviour of agents in a regional market after it has been formed—and since such a market does not exist in East Asia today, then the hypothesis cannot be evaluated! More constructively, here European experience might be relevant because, in principle, one could examine whether financial participants in the integrating European bond markets are better informed than those operating out of global financial centres, such as New York and London. An associated concern is that it is unclear why regional investors would have stronger incentives to collect and to analyse information than global investors.

With respect to the second argument, for regional markets to have some value-added over the national alternative, presumably one would have to argue that whatever obstacle (or obstacles) that prevented the formation of national bond markets in “small” East Asian economies does not exist—or is more easily overcome—at the regional level. If, for example, the reasons that a nation does not have a bond market where long term maturities are efficiently issued and traded are insecure property rights, few legal rights of redress for lenders, and a record of bankruptcy and macroeconomic instability, it is difficult to see why potential investors in a regional bond market would be willing to overlook these significant national characteristics.

Like the first argument, the third of Jansen’s arguments requires empirical substantiation. It is not clear *a priori* why a regional market must offer better opportunities for diversification than the wide range of financial instruments available on global financial markets.

With respect to the fourth argument, the willingness of any investor—in a national, regional, or global bond market—to lend to a borrower in the latter’s national currency depends in large part on the expectations about the value of that currency in the future and on the liquidity of the associated currency markets. It is not clear how the formation of a regional bond market will induce potential bond holders to ignore or downplay these risks. In the light of this discussion, it may well be worth asking the following question: if regional bond markets are the solution, then what is the problem?

The second preliminary remark is that the impact of introducing a new set of

financial instruments (regional bond markets) is determined, in large part, by the demand for such instruments. Given the reluctance of a considerable number of private-sector financial institutions to lend to many East Asian governments in anything other than U.S. dollars and for a limited (short) term, the question arises as to whether a regional bond market initiative can be structured in such a way as to alter this state of affairs. A related question concerns the liquidity of any secondary market for regional bonds.[21]

Turning now to recent initiatives on regional bond markets in East Asia, four distinct groupings and proposals can be identified. Only the first grouping of East Asian governments has taken concrete steps. Nevertheless, progress in the three other fora is feasible in the near to medium term and are therefore worth discussing here.

Regional markets have been discussed extensively in the so-called Executives' Meeting of the East Asian Pacific Central Banks (EMEAP). This forum has eleven members (the Reserve Bank of Australia, the People's Bank of China, the Hong Kong Monetary Authority, the Bank of Indonesia, the Bank of Japan, the Bank of Korea, Bank Ngara Malaysia, the Reserve Bank of New Zealand, Bangko Sentral ng Philipinas, the Monetary Authority of Singapore, and the Bank of Thailand.) The goal of EMEAP is to strengthen cooperation among members' central banks and to that end three working groups have been established.

One of those working groups (on financial market development) studied the feasibility of implementing a scheme to pool foreign currency reserves so as to create a bond fund. On 2 June 2003, EMEAP members announced the creation of an Asian Bond Fund. Members agreed to contribute in total approximately one billion U.S. dollars to a fund that would be administered by the Basle-based Bank of International Settlements (BIS). A committee of EMEAP members and officials from the BIS would then invest the Fund's resources in U.S. dollar-denominated bonds issued by sovereign governments and quasi-sovereign bodies of all but three EMEAP countries. (Japan, Australia, and New Zealand were excluded because their governments already have well developed national bond markets to draw upon. Despite being excluded in this manner, these three nation's central banks contributed a total of U.S. $175 million to the Asian Bond Fund.)

[21] Rhee (2003, page 13) raises a similar point.

The precise criteria employed to determine the composition of the portfolio of the Asian Bond Fund has yet to be specified. Moreover, it is not known whether the Fund could (or would) liquidate its holdings of a member government's bonds and what the circumstances are that would trigger disposal. Furthermore, it is unclear whether the Fund could be used to buy a member government's bonds from the private sector in times of financial distress. These details are quite important determinants of the Fund's likely impact. If the Fund is set up in a way such that it is inconceivable that it would ever liquidate a member's bonds, then the Fund's formation essentially amounts to a transfer of resources (potentially without repayment!) from the Fund's contributors to those members whose state bonds are invested in.

With respect to the disposal of a member's bonds by the Fund, there must be some doubt as to whether diplomatic considerations (that point to non-disposal and avoiding the implied "loss of face") would ever be superseded by economic considerations. Moreover, the question arises as to whether the private sector would buy a disposed-of bond and on what terms. Indeed, if the private sector believed that the Fund (which is administered in part by central bankers from the region) knows more about a member government's economic condition than private investors, then the latter are likely to be reluctant to buy any government bond that the Fund wants to sell, except at a sharp discount. This suggests that little or no secondary market for such bonds will develop.

Taken together these considerations—plus the facts that the currency of denomination of the financial assets the Fund will invest in is U.S. dollars and the relatively small size of the Fund's resources compared to the total foreign currency reserves in the East Asian region—suggest that the Asian Bond Fund is actually less about developing a liquid market for governmental bonds in the region and more about finding alternative uses for foreign exchange reserves. In fact, it is hard to escape the impression that as currently constituted the Asian Bond Fund is effectively funding inter-governmental transfers of financial resources or, in plain language, a one-off increase in aid.[22] This may well change in the future especially if the amount of funds committed by each EMEAP member to the Fund grew enough that each participating government took a strong interest in the macroeconomic and related policies of other members. This, in turn, may foster regional cooperation on macroeconomic policy, driven by the desire of each member not to see its contributions to the Fund eroded by inappropriate national policies of other members and their consequences.

The Finance Ministers of the APEC countries are the second body to have taken an active interest in regional bond market development in the Asia Pacific. At their tenth meeting in Thailand on 4-5 September 2003, ministers "supported" an APEC Regional Bond Market Development Initiative. According to the Thai Ministry of Finance, a key proponent of this Initiative, the relevant elements of this Initiative include:

> "…(1) the promotion of the development of securitization and credit guarantee markets in enhancing the efficiency of bond markets; (2) the issuance of new products, including long-term, local currency-denominated debt instruments, derivatives, and asset-based securities and (3) the cooperation to attain domestic and regional conditions which are essential to facilitate cross-border bond market activities" (Thai Ministry of Finance 2003, page 2.)

Although this Initiative is wider in terms of membership than those participating in the Asian Bond Fund hitherto few, if any, resources or collective steps have been committed to it.

The ASEAN+3 nations have launched a similar initiative to the APEC Initiative described in the last paragraph, becoming the third group to deliberate on the merits of regional bond markets in East Asia. At a December 2002 meeting in

Chiang Mai, Thailand, the ASEAN+3 Asian Bond Market Initiative (AMBI) was "endorsed." The objective of this particular Initiative is to:

[22] This is almost certainly not the intention of the EMEAP members.

> "…develop efficient bond markets in Asia which would enable the private and public sectors to raise and invest long-term capital without currency and maturity risks. The AMBI emphasizes the need for a joint and comprehensive set of actions by the ASEAN+3 countries in two broad areas that are (1) facilitating access to the market by a wide variety of issuers and (2) creating an environment conducive to developing bond markets" (Thai Ministry of Finance 2003, page 2).

Accordingly, several working groups have been formed (including ones on Creating New Securitized Debt Instruments and on Credit Guarantee Mechanisms) on 28 February 2003, with meetings following thereafter. Another three working groups were established later and were up and running by June 2003. However, as of yet, no tangible collective action measures have been agreed to by the ASEAN+3 members in this area. At best one can argue that inter-governmental dialogue, essentially between experts, may lay the foundation for future initiatives.

The fourth forum to weigh in on regional bond market development is the Asia Cooperation Dialogue (ACD). Formed in 2000, this Dialogue comprises the ASEAN+3 governments and several South Asian countries including, importantly, India. Of particular relevance to this discussion is that on 20-22 June 2003 eighteen ACD nations endorsed the Asian Bond Fund initiative described earlier. Moreover, Taiwan, Brunei, and India agreed to join several East Asian nations in the creation of a second ("new") Asian Bond Fund. This latter fund would differ from the EMEAP-inspired Fund in that purchases of local currency-denominated debt would be allowed (as well as U.S. dollar-denominated government debt.)

Although many details remain to be worked out, the second Asian Bond Fund would be significant in that the exchange rate risks (with all of its implications for bond pricing and interest rates) differ between local currency- and U.S. dollar-denominated bonds. Having said that, unless many of the concerns about the creditworthiness of state borrowers and the liquidity of secondary bond markets are addressed, it is difficult to see how this second Asian Bond Fund could attract more private sector participation than its predecessor (the first Asian Bond Fund.)

Drawing this discussion to a close, it is evident that little has really been accomplished in terms of formal cooperation—backed up by substantial resources—among East Asian countries on financial matters. In the aftermath of the East Asian financial crisis, and despite all of the pro-regional rhetoric, East Asian governments have placed far more emphasis on what might be referred to as "self help" compared to "mutual support." Even when the latter strategy has been pursued, interestingly, intra-regional support is often conditional on the approval of, or organised under the auspices of, international institutions (IMF, BIS) located and run from outside of the region! When it comes to unconditionally committing substantial resources to collective action on financial matters, East Asian governments appear to blanch. This is so even though the European

experience in this regard is fairly well understood within East Asia. The point is often made by East Asian experts that integration of capital markets in Europe followed monetary union (see, for example, Rhee 2003). Yet, typically, those experts also argue that a regional bond market development in East Asia could lay the foundation (that is, precede) full monetary union.

Perhaps the biggest irony of all is that currently the greatest impetus to regional "mutual support" in East Asia on financial matters is the very fact that "self help" has led the governments in the region to accumulate well over a trillion U.S. dollars of foreign exchange reserves. The possibilities created by reserves of this magnitude—and growing doubts about the wisdom of holding short term treasury bills in a volatile and recently depreciating currency, the U.S. dollar—seem to be driving recent initiatives rather than any serious attempts at regional institution building. If this is the correct interpretation of recent events, then any subsequent decision to run down the currently high levels of national reserves would postpone further steps towards regional measures on financial matters. The continued prominence of this technocratic-driven component of regional integration in East Asia cannot be assured.

3.3 The recent interest in bilateral trade agreements in East Asia

Table 3.4 contains a list of thirty recent bilateral trade agreements that have been proposed, are being negotiated, or have been signed and which involve at least one East Asian nation. In addition, there are six further sub-regional, region-wide, or pan-pacific initiatives that, if completed, could result in binding commitments being adopted by parties. As this table makes clear, Singapore and Korea have been especially active in bilateral trade negotiations and initiatives; the former is a party to 21 of the 36 initiatives, the latter a party to 11 initiatives. Announcing initiatives and signing them, however, are two different matters. In this regard it is worth noting that only eight of the 36 trade initiatives in table 3.4 have been signed. (Of course, signing deals and implementing them is yet another matter.)

The current patchwork of bilateral trade agreements is not likely to have had much impact on either trade flows or the region's welfare for two reasons. First, the amount of trade reform involved in some of the completed deals is actually quite small, suggesting that these bilateral arrangements will have limited impact. The "Closer Economic Partnership" agreement signed by Singapore and New Zealand in November 2000, for example, will eliminate tariffs on trade in goods. In reality, this means that Singapore must remove its one remaining tariff on New Zealand's imports (on beer), and the only significant tariff barriers that New Zealand must eliminate are on textiles, clothing, and footwear—which account for a very small share of the value of their total bilateral trade.[23] In contrast, freer trade in services is to be phased in over ten years, with loopholes built in to allow for delays in

implementation. In other bilateral trade negotiations, notably between Japan, Korea, and their trading partners, matters relating to the agricultural sector have been excluded. For example, the bilateral trade agreement negotiated between Japan and Singapore focuses on liberalising investment regulations and service sectors.

Second, given the limited scope of some of the proposed arrangements, it should not be surprising that the estimated gains for the nations signing them are very small. In an empirical assessment of many potential bilateral agreements, Scollay and Gilbert (2001) estimate that the gains to bilateral signatories of agreements to eliminating tariffs are almost always worth less than one-half of one percent of the parties' gross domestic products. Since these findings include the estimated effects of eliminating tariffs on imported agricultural goods, which few nations appear willing to countenance, the actual gains are likely to be much smaller.

[23] *Oxford Analytica*, "New Zealand: Singapore Trade Deal," 14 November, 2000.

Table 3.4: A list of proposed and actual regional trading agreements involving at least one East Asian economy

Parties	Type of agreement	Status	Year initiative launched or latest relevant milestone
Bilateral or trilateral initiatives			
Singapore-Mexico	Free trade area	Under negotiation	1999
Singapore-Chile	Free trade area	Under negotiation	2000
Singapore-Korea	Free trade area	Proposal and under study	2000
Singapore-Taiwan	Free trade area	Proposal and under study	2000
Singapore-Canada	Free trade area	Under negotiation	2001
Singapore-New Zealand	Closer Economic Partnership	Implemented	2001
Singapore-India	Comprehensive Economic Cooperation Agreement (including free trade area)	Under study	2002
Singapore-Japan	New Age Economic Partnership	Signed	2002
Singapore-Australia	Free trade area	Signed	2003
Singapore-EFTA	Free trade area	Signed	2003
Singapore-Jordan	Free trade area	Signed	2003
Singapore-New Zealand-Chile	Free trade area	Under negotiation	2003
Singapore-Sri Lanka	Comprehensive Economic Partnership Agreement (including Free trade area)	Signed	2003
Singapore-USA	Free trade area	Signed	2003
Korea-China	Free trade area	Proposal and under study	
Korea-Japan	Free trade area	Official discussions and under study	1998
Korea-Australia	Free trade area	Subject of official discussions	2000
Korea-Mexico	Free trade area	Official discussions and under study	2000
Korea-New Zealand	Free trade area	Official discussions and under study	2000
Korea-Thailand	Free trade area	Proposal and under study	2001

Korea-USA	Free trade area	Under negotiation	2001
Korea-China-Japan	Economic cooperation	Joint task force established	2003
Korea-Chile	Free trade area	Signed	2003
Japan-Mexico	Free trade area	Under negotiation	1998
Japan-Australia	Trade and economic framework	Official discussions	2002
Japan-Canada	Free trade area	Proposal and under study	2002
Hong Kong-New Zealand	Closer Economic Partnership (including Free trade area)	Under negotiations	2001
Thailand-Croatia	Free trade area	Proposal	2001
Thailand-Czech Republic	Free trade area	Proposal	2001
USA-Taiwan	Free trade area	Proposal	2002
Region-wide or region-plus initiatives			
ASEAN	AFTA	Signed and implementation ongoing	1992
ASEAN-Australia-New Zealand (“ASEAN+CER”)	Closer economic relations	Official discussions and under study	1999
ASEAN-China	Free trade area	Official discussions and under study	2001
ASEAN-Japan	Comprehensive Economic Partnership	Official discussions	2002
ASEAN-Korea	Free trade area	Official discussions	2002
ASEAN-China-Japan-Korea (“ASEAN+3”)	Free trade area	Official discussions and under study	2000
Singapore-Australia-New Zealand-USA-Chile (“Pacific 5”)	Free trade area	Proposal	1998

Source: Pangestu and Gooptu (2003), updated with internet searches and newspaper reports.

Table 3.5 reports the estimated welfare effects for non-members of a number of potential regional trade agreements in East Asia. One of the key findings is that, although the magnitudes are small (compared to national incomes), East Asian nations outside a proposed RTA tend to suffer for the traditional trade diversion reasons. For example, in a free trade area between Japan and Korea, China is expected to lose nearly $175 million. Much of the latter loss will be borne by China's exporters in terms of reduced profits. Furthermore, a Japan-Korea free trade area is estimated to generate in total over a billion dollars of welfare losses for other countries.

For our purposes, the estimates in table 3.5 take on a special significance given the role that discrimination against non-members' imports by a RTA plays in Baldwin's theory of domino regionalism. As noted above, China suffers if Japan and Korea form a bilateral free trade area and provides the impetus for the former to seek to join the latter trade agreement. Should China gain entry this will effectively create a free trade area throughout North East Asia which, according to the estimates reported in table 3.5, is likely to result in South East Asian nations alone losing over a billion dollars, a large part of which will be in the form of reduced profits for ASEAN exporters. These losses, in turn, will provide a strong incentive to ASEAN nations to join a North East Asian-wide free trade agreement which, should this come to pass, would effectively create a region-wide free trade area.

To summarise, no bilateral deal to date has set off a domino dynamic towards greater regional integration in East Asia. Having said that, any bilateral free trade agreement between two of the three major North East Asian economies is likely to trigger such a dynamic. Moreover the arguments developed in this (and the next) chapter suggest that once the dominoes start to fall in East Asia they will do so relatively quickly, with the likely result being that a region-wide free trade area in manufactured goods emerges within a decade or so.

Table 3.5 Estimated welfare effects for Asian economies of six potential regional trade agreements, US$m (1997 prices)

Economy	Singapore-Japan RTA	Japan-Korea RTA	Japan-Korea-China RTA	ASEAN plus Japan, Korea, and China RTA	ASEAN plus Japan, Korea, China, Australia, and New Zealand RTA	APEC (MFN reform)
China	-3.8	-172.3	249.1	441.0	118.9	1726.5
Indonesia	-1.4	-54.5	-251.9	621.8	420.6	734.9
Japan	-33.8	1430.6	5285.1	8208.5	7900.8	8819.4
Korea	0.4	291.8	5535.2	5700.9	5559.8	5261.9
Malaysia	0.9	-53.7	-248.1	182.7	72.8	94.2
Philippines	0.5	-22.6	-96.5	22.9	-108.4	747.4
Singapore	60.1	-30.4	-135.7	116.2	158.6	-1183.2
Thailand	1.1	-49.0	-269.2	1641.3	1553.4	1988.3
Memos:						
Number of economies worldwide gaining more than $250m ($100m)	0 (0)	2 (2)	3 (4)	6 (8)	7 (8)	25 (26)
Members	26.2	1722.4	13880.5	20345.3	24069.5	30508.4
Non-members	-33.5	-1370.9	-7644.8	-11491.1	13494.1	14721.3
World	-7.3	351.6	6235.7	8853.6	10575.5	45229.7

Source: Scollay and Gilbert (2001). The numbers in the table refer to millions of US dollars.

4. ARE THE PRE-REQUISITES FOR DOMINO REGIONALISM MET IN EAST ASIA? THE INTENSITY OF COMPETITION IN EAST ASIAN MARKETS AND THE CURRENT PATTERN OF TARIFF BARRIERS

This chapter assess whether the major preconditions for domino regionalism are currently in place in East Asia. It does so by examining the intensity of intra-East Asian trade flows (to ascertain the extent to which exporters from East Asian economies currently supply customers within the region and so have an interest in the terms upon which access to such markets is granted now and in the future), the perceived intensity of intra-East Asian competition (which influences the extent to which the creation of a RTA among a number of East Asian nations would hurt exporters from excluded countries), and the degree of current tariff protection on manufactured goods (which determines the margin of preference created by a free trade area.) Sections 4.1 and 4.2 are devoted to these matters.

The chapter goes on to discuss the underlying factors that are altering the intensity of competition in East Asian markets. Three factors are stressed: the impact of prior trade and investment reforms, the continuing integration of China into the world economy, and the spread of regional and cross-border production networks that are linking production facilities across East Asia more tightly than ever before. Should these factors continue to intensify the degree of competition in East Asia's markets, then this will increase the probability that any major bilateral FTA in North East Asia triggers a domino regionalism dynamic.

4.1 Intra-regional trade growth in East Asia and the prevailing pattern of tariff protection

Recently, Ng and Yeats (2003) conducted a detailed analysis of East Asian trade patterns and their evolution from 1985 to 2001. For our purposes the following six findings are of particular interest[24]:

> "From 1975 to 2001, East Asia's share of global exports expanded more than three fold (to just under 19 percent), and doubled from 1985 to 2001. The region presently originates the same share of global exports as NAFTA. Intra-regional exports, expressed as a share of world trade, experienced an even sharper expansion rising more than six fold during 1975-2001" (page 2).
>
> "Over 1985-2001, the share of East Asia's exports to the region rose from 24 to 35 percent with Indonesia, Taiwan (China), Korea, and the Philippines experiencing significantly higher directional trade changes. This shift was, in part, due to the fact that global import demand in East Asia was more buoyant than in any other major market" (page 5).
>
> "The five largest regional exporters account for 80 percent of East Asian intra-trade. At the other extreme, the five smallest regional traders, namely, Brunei, Cambodia, Lao PDR, Mongolia, and Vietnam, have a

combined regional export share under 2 percent. If size is measured by gross domestic product somewhat greater inequalities are observed as China alone accounts for 43 percent of regional GDP, as opposed to its 30 percent share of intra-regional trade" (page 8).

"The relative importance of China as a destination for regional exports significantly increased since the mid-1980s, and this trend appears to have sharply accelerated since 1995. In part, China's maintenance of a stable exchange rate, in the face of major devaluations in other East Asian currencies, appears to have contributed to its recent increased importance as a regional market" (page 15).

"Even after the influence of their relatively close proximity is accounted for East Asian intra-trade must be generally classified as highly 'intense.' Also, the intensity of trade within the region increased markedly over the full 1985-2001, and the shorter 1995-2001 period. For example, in 1985 only 40 percent of all East Asian bilateral trade flows were greater than expected, based on the countries' share in world trade, as opposed to 61 percent in 2001. Trade relations between East Asian countries have been growing sharply in terms of their intensity and importance!" (page 19).

[24] Appendix B reports all of the principal findings of Ng and Yeats' analysis.

"A trade 'complementarity' index shows growing similarities between the types of goods East Asia exports, and the goods imported, was a potent factor promoting the expansion of intra-trade. The current East Asian values for this index are very similar to those for countries like the original EU (6) members at the time of the formation of the European Economic Community" (page 23).

The share of intra-regional trade in total trade is reported by country in table 4.1 for the years 1985, 1995, and 2001. Interestingly, a clear pattern of increased sourcing of imports from within the East Asian region emerges. (Only China and Vietnam saw small falls in the share of imports sourced during 1995-2001, however, in the former case the share in 2001 is more than double the level in 1985 and in the case of the latter, the fall was from a very high base.) Overall, in 2001 just under 45 percent of the region's total imports were sourced from within East Asia; with this share rising since 1985 by on average one percentage point per year.

With respect to intra-regional export shares, these rose from 1985 to 1995 (from an average of 23.7 percent to 37.5 percent) and then remained constant or fallen slightly (to an average of 35 percent in 2001.) The latter fall can be attributed in part to the growth of the region's exports to the United States during the latter's substantial boom from 1995 to 2001. All in all, East Asian nations undertake considerable amounts of trade with each other and will therefore have a keen interest in the terms—including trade barriers such as tariffs—upon which they can export to each other's markets.

Table 4.1: The share of intra-regional trade in East Asian imports and exports: 1985, 1995, and 2001.

Economy	Economy	Percentage of intra-regional trade in total national exports		Percentage of intra-regional trade in total national imports		
		Percentage of intra-regional trade in total national exports		Percentage of intra-regional trade in total national imports		
1985	1985 1995	1995	2001 2001	1985 1985	1995 1995	2001 2001
Brunei	32.2	37.0	32.8	55.2	62.3	70.8
Cambodia	52.2	70.1	10.6	68.9	84.1	89.4
China	35.1	39.1	30.8	23.0	52.1	49.8
Hong Kong	27.5	35.6	35.2	46.8	54.6	60.0
Indonesia	9.9	25.0	27.2	13.8	25.8	37.3
Korea	10.1	34.1	34.1	13.4	18.7	25.8
Laos	75.2	55.1	60.3	64.5	81.2	90.7
Malaysia	38.1	43.5	42.0	44.2	45.2	51.6
Mongolia	4.7	29.2	49.6	7.5	24.7	39.1
Philippines	17.5	23.5	34.4	34.1	33.6	37.1
Singapore	35.1	43.8	44.9	39.2	42.2	43.5
Taiwan	14.8	39.6	41.1	12.7	22.3	31.4
Thailand	25.5	31.9	33.5	33.4	31.6	36.2
Vietnam	48.8	31.0	29.3	33.4	68.1	64.9
All of the above economies	23.7	37.5	35.0	29.4	39.8	44.5

Source: Ng and Yeats (2003), Table 5.1. Original source for the trade data was the IMF's *Direction of Trade Statistics*.

Turning now to the barriers facing exporters to East Asian markets, table 4.2 reports the average tariff rates for the major product categories by country in the World Trade Organization's Integrated Trade Database. Comparators with the EU, Canada, and the United States are also included. In this table the trade categories 5-9 refer to manufactured goods. One fact that stands out is that China and Korea have tariffs on manufactured goods that equal, and often greatly exceed, those in Europe and North America. The pattern of tariff protection in South East Asia is mixed, but typically their tariff rates are below those for comparable products in North East Asia but above those levied in Europe and North America.

These findings, along with long-standing suspicion that non-tariff barriers

seriously impede access to Japanese markets[25], and the fact that the three largest economies in the region are in the North East, suggest that any bilateral trade agreement that involves Japan, Korea, or China is likely to alter significantly the relative competitiveness of firms exporting to the parties to any such agreement. If the trade statistics reported by Ng and Yeats (2003) can be interpreted as suggesting that competition within East Asian markets is intense and growing over time, then the shifts in competitiveness induced by such a bilateral trade agreement on manufactured goods would likely induce a political response by exporter in nations that are outside of such an agreement. These findings underpin the contention that once one big domino falls in North East Asia, others are likely to quickly follow.

[25] See Lawrence (1993) for a statement of this view and Saxonhouse (1993) for a critique.

4.2. Perceptions of the nature and intensity of competition in East Asian markets: evidence from a recent survey of Japanese manufacturing affiliates in East Asia

Further evidence of the growing intensity of competition in East Asian markets is provided in a survey by the Overseas Research Department of the Japan External Trade Organization (JETRO) in November 2002 (JETRO 2003). JETRO asked 3,967 affiliates of Japanese multinational corporations that are located in South and East Asia a number of questions about their operations and the perceived sources of competition for their products. Valid responses were received from 38.3 percent of these companies (1,519 affiliates.) Sixty percent of respondents were found in ASEAN nations, a quarter in China (excluding Hong Kong), 7 percent in Taiwan, and 4 percent in India.

The first important finding is that, as reported in table 4.3, Japanese affiliates in ASEAN nations and in Korea feel under considerable competitive pressure from foreign rivals. In contrast, the principal source of rivalry in China to Japanese affiliates appears to come from other firms located in China. The responses reported in table 4.4 confirm that competition from firms located in China is seen as particularly intense—although some Chinese-based Japanese affiliates perceive fierce strong competition from Japan-based rivals too, suggesting that, overall, there is considerable commercial rivalry within North East Asia.

Table 4.2: Simple average MFN applied tariff rates by MTN category, selected East Asian economies

MTN Categ-ory MTN Categ-ory	Description Description	China China	Hong Kong Hong Kong	TaiwanTaiwan	Indonesia Indonesia	Japan Japan	Malaysia Malaysia	PhilippinesPhilippines	KoreaKorea	SingaporeSingapore	Economy Economy Thailand Thailand	EUEU	Canada Canada	USAUSA
1	Wood, pulp,paper, and furniture	14.1	0	4.6	7.9	1.3	10.9	8.9	5.9	0	13.8	2.2	1.5	0.8
2	Textiles andclothing	26.8	0	9.4	14.0	7.6	13.5	12.6	10.1	0	25.4	8.5	12.2	9.4
3	Leather, rubber,footwear, and travel goods	17.7	0	5.9	10.7	6.7	14.0	7.7	8.0	0	26.3	4.2	6.1	4.4
4	Metals	9.8	0	6.0	8.5	1.4	9.3	5.9	6.1	0	12.5	2.5	2.3	2.2
5	Chemicals andphotographic supplies	**11.4**	**0**	**3.7**	**6.6**	**2.3**	**3.6**	**4.2**	**7.3**	**0**	**10.4**	4.9	3.0	3.4
6	Transport equipment	**23.3**	**0**	**11.6**	**12.1**	**0**	**18.5**	**8.2**	**5.5**	**0**	**23.6**	4.1	5.5	3.2
7	Non-electricmachinery	**14.4**	**0**	**4.9**	**2.3**	**0**	**3.7**	**3.5**	**6.4**	**0**	**9.2**	1.7	1.4	1.2

8	Electricmachinery	**16.1**	**0**	**5.3**	**7.7**	**0.2**	**6.7**	**5.0**	**6.1**	**0**	**13.2**	2.5	2.3	1.9
9	Mineral productsand precious stones and metals	**12.1**	**0**	**4.2**	**6.0**	**0.8**	**8.8**	**5.5**	**5.9**	**0**	**10.0**	2.0	1.7	1.9
10	Manufacturedproducts not elsewhere specified	**18.0**	**0**	**4.8**	**10.3**	**1.1**	**5.1**	**5.5**	**6.8**	**0**	**15.0**	2.6	2.8	2.1
11	Fish and fish products	21.5	0	27.1	5.0	5.9	2.4	9.0	16.2	0	57.6	11.2	1.1	1.1
12	Fruit andvegetables	22.6	0	28.7	5.0	8.4	2.9	10.4	55.6	0	58.9	9.8	2.7	7.8
13	Coffee, tea,maté, cocoa, and preparations	26.1	0	13.8	4.9	11.6	9.0	18.9	55.3	0	60.0	5.8	1.4	2.6
14	Sugars andsugar confectionary	27.9	0	27.3	3.8	10.1	2.8	18.9	20.1	0	46.3	11.4	4.0	6.2
15	Spices, cereal,and other food preparatio	31.4	0	20.2	5.2	12.5	2.6	9.0	111.8	0	42.5	5.0	3.7	3.1

16	ns Grains	54.4	0	2.8	2.0	1.0	0	18.5	192.5	0	5.4	11.5	2.2
17	Animals andproducts thereof	20.7	0	26.3	4.6	7.8	0.5	27.1	24.7	0	50.3	5.3	4.4	3.4
18	Oil seeds, fats and oils and their products	31.1	0	8.2	4.0	1.7	1.7	6.3	14.3	0	28.0	3.2	3.1	9.1
19	Cut flowers,plants, vegetable materials; lacs, etc.	12.4	0	9.2	5.7	0	0	3.2	28.1	0	38.5	2.4	0.7	1.2
20	Beverages andspirits	50.6	0	28.1	80.0	9.4	9.4	10.7	29.1	0	0	11.3	4.4	1.8
21	Dairy products	40.3	0	18.6	5.0	3.6	3.6	5.0	72.2	0	35.8	7.7	7.4	13.5
22	Tobacco	56.7	0	25.4	10.7	8.4	33.2	0	39.7	7.3	204.2			
23	Otheragricultural products	12.3	0	3.7	4.4	0.7	0.7	3.2	10.1	0	29.1	1.3	0.8	0.8
Simple average MFN tariff		24.9	0	13.0	9.8	4.3	5.9	9.4	31.8	0	28.9	6.7	4.0	12.5

rate Median tariff rate	21.5	0	9.2	5.7	2.0	3.7	8.2	14.3	0	26.3	4.9	3.0	2.6

Source: WTO Integrated Trade Database, as reported in Bora (2003).

Table 4.3. Over the last two to three years, where have Japanese overseas manufacturing affiliates perceived the greatest rivalry to their ability to supply the market in which they are based, by overseas location?

Economy/economies	Percentage of firms reporting severe rivalry from local manufacturers only	Percentage of firms reporting severe rivalry from imports only	Percentage of firms reporting severe rivalry from both imports and local manufacturers
ASEAN	24.2	17.4	45.8
Korea	30.0	13.3	53.3
China	54.2	1.9	36.2
Taiwan	29.8	9.6	57.7

Source: Assembled from figure 11, JETRO (2003).

Table 4.4. Over the last two to three years, where Japanese overseas manufacturing affiliates reported strong rivalry from imports, which countries' exporters were perceived as supplying such rivalry?

Economy/economies	Percentage of firms reporting severe rivalry from shipments by Japanese firms	Percentage of firms reporting severe rivalry from shipments by Chinese firms	Percentage of firms reporting severe rivalry from shipments by US firms	Percentage of firms reporting severe rivalry from shipments by European firms
ASEAN	19.9	57.1	13.3	10.2
Korea	27.8	33.3	22.2	11.1
China	41.5	-	12.7	30.5
Taiwan	38.5	43.1	16.9	20.0

Source: Assembled from figure 13, JETRO (2003).

The responses reported in table 4.5 suggest that more Japanese manufacturing affiliates believe that competition for their products has intensified faster in recent years in Asia (including Japan and China) than in other regions of the world, such as the USA and Europe. In fact, on this measure the perceived differences in the rate at which inter-firm rivalry grew in Europe and in Asia are quite striking. Consistent with this overall picture, is the finding that Japanese affiliates see reducing outlays and "cost cutting" as a very important component of their current strategies (see table 4.6 below).

Table 4.5. Perceptions of Japanese overseas manufacturing affiliates of where competition has become more severe in recent years.

Economy where affiliate is located	Percentage reporting that competition for their products is intensifying					
	Worldwide	In USA	In Japan	In Europe	In China	In Asia
ASEAN	21.2	6.5	17.4	2.7	14.2	36.1
Korea	20.0	5.0	-	5.0	35.0	30.0
China	25.4	10.7	34.8	4.1	-	24.6
Taiwan	14.3	11.0	12.1	3.8	34.1	25.3

Source: Assembled from figure 17, JETRO (2003).

Table 4.6 Reported current strategy of Japanese manufacturing affiliates, by overseas location.

Economy where affiliate is located	Percentage of affiliates reporting that "further cost-cutting" was necessary to improve competitiveness	Percentage of affiliates reporting that "expansion of scale" was the most appropriate business strategy for their firm
ASEAN	80.6	45.8
Korea	72.7	41.5
China	76.3	69.9
Taiwan	79.4	23.7

Sources: Assembled from figures 17 and 18-1, JETRO (2003).

This survey yielded another finding that is pertinent to our study (see table 4.7). It appears that a substantial percentage of Japanese overseas manufacturing affiliates believe that traditional reductions in border measures (customs duties and procedures) are the most important benefit from any Japan FTA with ASEAN. Therefore, these firms priorities at the moment are not for stronger investment rules, greater liberalisation of services, and enhanced patent protection that one might think are important matters for sophisticated multinational corporations.

Table 4.7 Perceptions of benefits of a Japan-ASEAN FTA as reported by Japanese overseas manufacturing affiliates

Consequence of an ASEAN FTA with Japan	Percentage of respondents in … that perceive benefits from the likely stated consequence of a FTA with Japan			
	ASEAN	Korea	China	Taiwan
Abolition of customs duties	78.1	81.3	78.3	70.7
Simplification and harmonisation of customs clearance procedures	61.5	50.0	72.1	63.6
Simplification of mutual recognition procedures	19.2	21.9	21.4	31.3
Liberalisation of services	11.9	9.4	9.1	15.2
Improvements in investment rules	11.1	18.8	9.7	18.2
Free movement of individuals	11.0	3.1	12.5	4.0
Easier acquisition of patents	3.0	3.1	4.6	3.0
Acceleration of economic co-operation between members of the FTA	1.9	9.4	3.1	4.0

Source: Assembled from figure 26, JETRO (2003).

4.3 Prior national reforms to trade and investment regimes

Our discussion now turns to the policy and commercial factors that are responsible for the intensification of competition within East Asia's markets. First, prior trade and foreign direct investment reforms are discussed and, as will become clear, these policy measures have added pressure on firms to cut costs and to enhance productivity. FDI reform facilitated the relocation of some manufacturing plants to lower-wage economies and in the region and contributed to development of export platforms in East Asia. These effects of trade and FDI reforms are in addition to enhancing market access within East Asia.

The East Asian region has garnered considerable benefits from its relatively open policies towards foreign trade and investment. The evidence of these benefits continues to grow, as the literature can attest.[26] Kim (2000), for example, demonstrates the beneficial effects of trade liberalisation on firm productivity in Korea and in reducing the market power of domestic firms as measured by price-cost mark-ups. In addition, Lawrence and Weinstein (2001) revisit the determinants of sectoral productivity growth in Japan during its growth spurt in the 1960s and

1970s, finding that import competition provided an additional stimulus to firms to enhance their productivity.

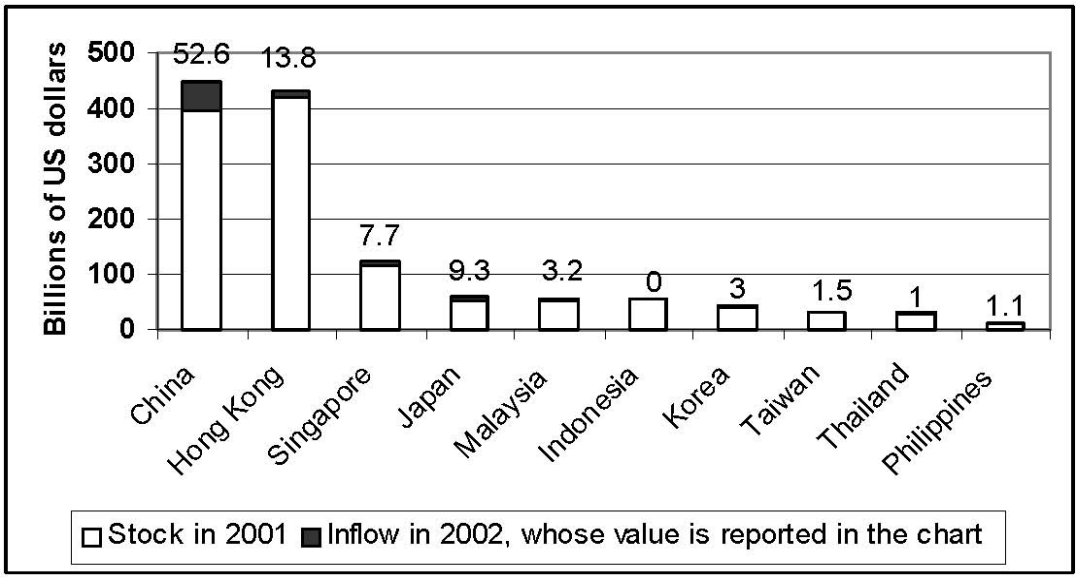
[26] For a useful overview of the benefits of lowering barriers to trade and investment in East Asia, see Lloyd and MacLaren (2000). This paper also highlights the benefits from future service sector liberalisation. For more broad ranging surveys on the consequences of trade and investment openness for growth, see Bhagwati and Srinivasan (1999), and, for a sceptical view, consult Rodrik (1999).

Another channel by which openness has raised domestic economic growth in East Asia is through the importation of equipment. Mazumdar (2001) presents evidence that non-tariff barriers reduce the importation of equipment and that this, in turn, depresses productivity growth in the importing nation. Unlike Lee (1995), an often cited study of the effects of equipment on growth in developing countries, Mazumdar adopts an approach that enables him to better discriminate between the contributions to productivity growth of domestically produced equipment and of imported equipment. Taking best advantage of cutting-edge equipment typically requires well-educated and scientifically proficient managers and employees; it is not surprising, therefore, to find Miller and Upadhyay (2000) confirming that, among developing economies, the growth-promoting effect of openness is greater in nations with more human capital.[27]

[27] Borensztein *et al* (1998), in an often cited paper, found a similar conditional effect of the stock of human capital on the benefits of foreign direct investment.

Figure 4.1. FDI Stocks in East Asia, 2002

Source: UNCTAD (2003), appendix B2.



The recent literature on the contribution of trade reform pales when compared to the mushrooming literature on the beneficial effects of foreign direct investment on East Asia's growth performance.[28] Figure 4.1 provides an indication of the scale of inward FDI inflows in 2002, as well as the stock of existing FDI in several East Asian economics. In 2002, the total stock of FDI in mainland China was four times as large as that in any other economy in the region (excluding Hong Kong). Even though there has been some amount of "round tripping" of funds from the Chinese mainland through Hong Kong (which is then invested back in the mainland and erroneously measured as foreign direct investment), the FDI stock in East Asia is now firmly concentrated in the economies of the north-eastern part of the region.

The relative importance of the numerous rationales for FDI differ across the economies in the region. Some foreign investors are motivated by a desire to supply the recipient nations' markets, whereas in many industries, FDI in China and in other lower wage economies such as Indonesia, is principally directed towards export platforms (Hill and Athukovala 1998; Hanson and Feenstra 2001). Although the latter motivation is a long-standing one (see, for example, Wells 1993), in recent years a new development has emerged. As the examples in the section 4.4 will make clear, firms are systematically creating regional production networks that locate each stage of a production process in the economy in which that function is best performed (along some quality or cost metric). This results in shipment of parts and components across more than one national border before the final product is assembled and delivered to customers, contributing to greater intra-regional trade flows.

[28] For recent overviews of the effects of FDI on developing economies, see Graham (2000) and Moran (1998, 2001). Ito and Kreuger (2000) contains analyses specific to East Asia. Hill and Athokovala (1998) provide an overview of the region's recent experience with FDI up to the mid-1990s (their paper only reports FDI data through to 1996.) JETRO (2003) also provides some up-to-date Japanese inflow and outflow data on FDI.

In Korea inward FDI is increasingly in the form of mergers and acquisitions, and such foreign investments can be expected to introduce managerial innovations as well as potentially fusing Korean firms into multinational corporations' networks of activities throughout the world (Mody and Negishi 2001). Likewise, foreign investment in Japan is playing a role in restructuring certain under-performing manufacturing and financial firms. These include GE Capital's acquisition of the Japan Leasing Corporation, Renault's investment in Nissan, and Daimler Chrysler's purchase of a stake in Mitsubishi Motors (JETRO 2001).[29] In both Japan and Korea, increasing amounts of FDI are being directed towards the distribution sector, especially retailing—as evidenced by the numerous investments made by the French supermarket chain Carrefour and by its British rival Tesco. These firms are injecting greater competition into one of the most inefficient sectors of East Asia's economy, to the potential benefit of consumers.[30]

Recent research has shed light on the factors underlying the FDI flows described above. Urata and Kawai (2000), for example, examine the differences in overseas investment behaviour of small, medium, and large Japanese firms. Since the late 1980s, smaller Japanese firms have invested abroad in larger numbers, joining the long-standing practice of the large Japanese conglomerates. Urata and Kawai confirm that, irrespective of size, such overseas investment decisions are driven by the availability of low-wage labour, the quality of infrastructure in the potential recipient, measures of good governance practices, and a sizeable local market. They found evidence, however, that smaller Japanese firms are more sensitive to each of these factors than larger firms. In addition, smaller Japanese firms place a greater premium on investing in areas with existing agglomerations of similar firms. The desire to control costs is also an important determinant of overseas foreign direct investment by Japanese multinationals, according to evidence presented in Mody *et al* (1999).[31]

[29] See Blomstrom *et al* (2000) for an analysis of the role of both inward and outward FDI in restructuring Japanese manufacturing and service sectors.

[30] See, for example, *The Economist*, "A Hyper Market," April 7, 2001. This article describes the popularity among Asian consumers of foreign retailers of everyday products.

In sum, even though East Asian nations have reaped considerable benefits from relatively open regimes towards foreign direct investments, the magnitude of these benefits has depended on the presence of complementary factors, such as the availability of disciplined and well-trained employees, competitive factor and service markets, and a focus on excellence in both service and manufacturing innovation. Moreover, trade and FDI reforms have resulted in greater intra-regional rivalry between firms—competition that is likely to intensify further in the years ahead as the region adjusts to China's ongoing integration into the world economy.

4.4 China's continuing integration in the world economy

China's membership of the World Trade Organization was secured in an agreement with its key trading partners in 2001 and represents an important milestone in a reform process that began in 1978. The consequences for the location of production within the region of China's integration into the world trading system has given many analysts and policymakers cause for concern. Korea, for example, is said by some to be trapped in a "nutcracker," caught in between a capital-rich Japan and a labour-rich China.[32] Similar fears have been expressed in Malaysia and Singapore.

[31] See also the evidence in Basu and Miroshnik (2000). Chen and Ku (2000) find that controlling costs is an important motive for Taiwanese overseas investors.

[32] This use of the term "nutcracker" appeared first in a 1998 report by McKinsey and Co.

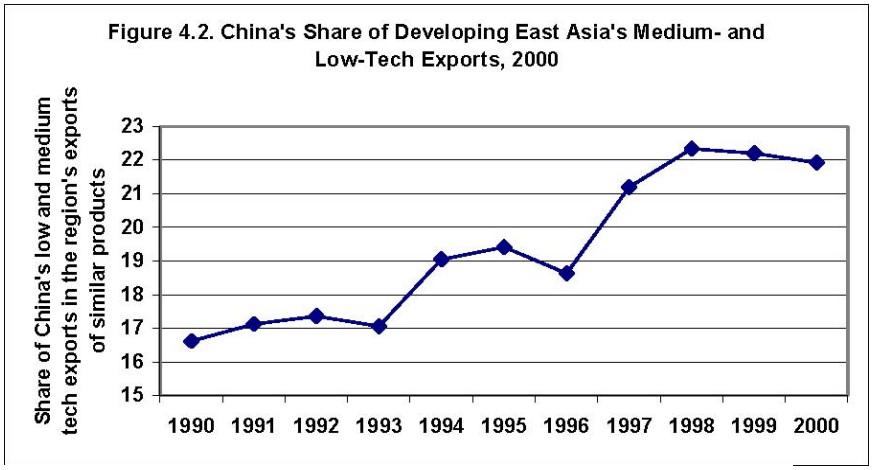
Before assessing these views, one should recall the magnitudes involved. To be sure, China has a large workforce (705.9 million people in 2000), of which approximately 190 million people were in the predominantly non-tradable tertiary (principally services) sector.[33] As we have already seen, China is the largest recipient of foreign direct investment in the region.[34] The export-oriented nature of this FDI is borne out by the surge in Chinese exports, particularly of manufactured products. In 1996, China exported $129 billion worth of manufactures, a figure that had risen to $252.5 billion by 2002.[35] During the same period, Chinese imports grew from $138.8 billion to $295.2 billion, providing a vibrant market for other nations' exports. Not all of these imports are destined for the Chinese marketplace, as some are parts and components are assembled into other goods or modified before being re-exported. Indeed, an analysis of the trade in telecommunication parts and equipment showed that firms are increasingly sourcing these products from China, with more than fifty countries sourcing parts from China between 1995 and 1997, compared to four countries between 1983 and 1985 (Evenett and Venables 2001).

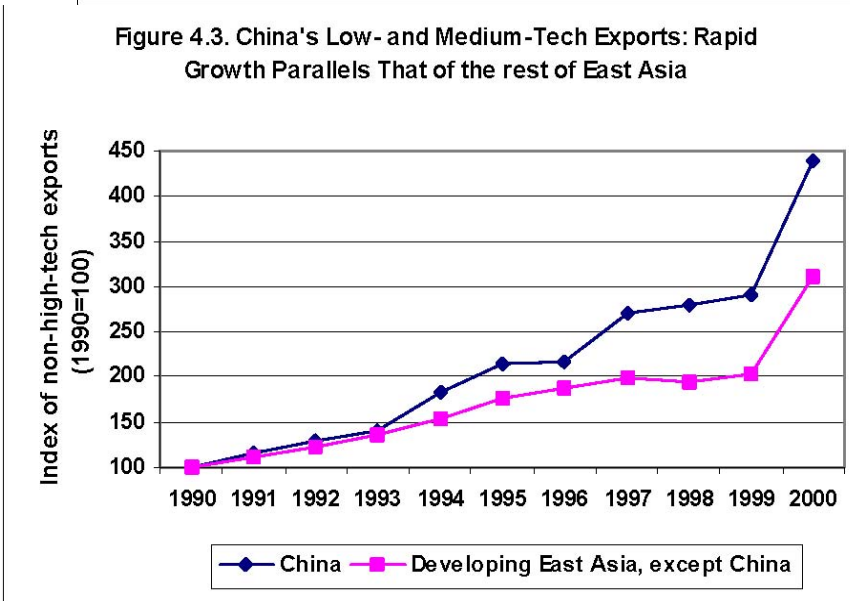
A major concern for the industrialising East Asian economies is whether competition from Chinese industries will undermine the competitiveness of their exporters, especially in medium- and low-tech goods. As figure 4.2 makes clear, China's share of all such exports from East Asian economies (except Japan) was less than 23 percent in 2000. Although this share has increased over time, from 1990 to 2000 the other developing economies in East Asia saw their exports of medium- and low-tech goods rise more than threefold in real terms (see figure 4.3). Taking this evidence together, it is thus difficult to argue that Chinese export growth in the 1990s has seriously curtailed aggregate exports of the rest of developing East Asia (although this might have been the case for some particularly labour-intensive products). However, these findings are clearly consistent with greater competition between Chinese and ASEAN exporters of lower and medium-tech products.

[33] These figures were taken from the statistical appendix of *Economist Intelligence Unit* (2001) and the *Financial Times* survey on China, 8 October, 2001.

[34] For analyses of the determinants of Chinese FDI, see Cheng and Kwan (1999, 2000) and Wei (2000).

[35] The source for the 2002 trade data is the WTO (2003), Appendix Table IA.3.





Source for the last two figures: Yusuf and Evenett (2002).

Even though China's integration into the world economy is unlikely to decimate the manufacturing industries of the rest of East Asia, firms elsewhere in the region will certainly be called upon to adjust. The manner in which these firms adjust is highly contingent on policies other than trade and FDI reforms, and points to some important policy complementarities whose implications for further regional integration in East Asia are developed in the next chapter.

Part of the adjustment by non-Chinese manufacturing firms may involve relocating some relatively more labour-intensive production stages to China (and other lower-wage economies in the region such as Vietnam) and coordinating commercial activities across many borders. Low tariffs and lower transportation costs (especially in air transport) make it viable to ship parts and components

across many borders before they are sent to customers as finished products. More important, perhaps, is the quality of telecommunications and information technology, which facilitate the coordination and organisation of activities over vast distances. In fact, it was the formation of such production networks and global supply chains that enabled many a Western firm in the 1990s to respond effectively to rising import competition from numerous developing nations, including East Asia economies.

It is important to recognise that information and communication technologies and efficient transportation systems have made possible both faster responses to changed consumer demands and the customisation of products. The U.S. textile industry provides perhaps the best example of the use of these advances to respond to import competition (Abernathy *et al* 1999). Producers deal with consumers' wide range of tastes by offering a greater variety of products, the fashion component of which yields larger profit margins than do basic apparel products. However, to avoid getting stuck with lots of unsold stock (which is costly to store and often must eventually be heavily discounted to clear, so lowering profits) retailers and wholesalers use advances in, principally, bar code technology and computer programmes that analyse sales data and facilitate better predictions of demand. Supplying a range of varied tastes means each product will be made in smaller quantities and that changes in demand need to be more easily detected. To meet particular demands and to minimise inventories, retailers and wholesales now place a larger number of smaller orders with their suppliers, and they expect fast turnarounds. Likewise, suppliers demand quick responses from the firms supplying them with fabrics, buttons, dyes, and so on, as well as from logistics firms. For this section of the clothing market, the cost of production is not the only major determinant of a firm’s competitiveness. Inventory management, accurate assessment of demand patterns, and rapid delivery are at a premium.[36] Analysts argue that a firm's capacity to integrate all relevant technologies (information, communication, and production) is critical to competing effectively in this industry (Abernathy *et al* 1999). This entire strategy, however, can fatally undermined when governments do not provide adequate and cheap access to information and communication technologies and transportation infrastructures. This suggests a role for complementary policy initiatives to support export competitiveness, a point developed in the next chapter.

Thun (2000) provides evidence that the Taiwanese counterparts of U.S. textile and apparel firms have ensured their own survival by concentrating on adding value in commercial activities other than the production process. To be sure, these firms have increasingly relocated production stages to the Chinese mainland to take advantage of the lower wage costs there. But they have also focused on earning their profits from what is becoming a large distinct branch of management practice, supply chain management. That is, they locate suppliers in China, monitor the quality of their work, transmit orders and deal with buyers, organise shipments, and sometimes engage in rudimentary marketing. Their expertise in managing supply chains has grown to such an extent that some such firms have departments that provide technical expertise and computer programmes

which enable other firms to better manage chains of suppliers and respond to demand shocks.

Taiwan's shoe industry has evolved in a similar manner and is equally dependent on an efficient service sector infrastructure. Hsing (1999) describes how product cycles in casual shoes grew from two to eight per year in the mid-1980s. This forced Taiwanese shoe manufacturers to supply smaller orders placed at more frequent intervals. Reinforcing this shift was the deliberate choice of Taiwanese shoe manufacturers to offer a greater variety of shoes, including fashion shoes made with synthetic materials, special orders, and work shoes.[37] The result has been the creation of networks of shoe manufacturers whose tentacles extend into the lower-wage East Asia economies.

[36] The latter is often referred to as "rapid replenishment" of stocks.

[37] In contrast, in the 1970s and 1980s rivals located in other countries tended to concentrate on supplying a narrower range of goods. At that time, for example, Korea produced primarily athletic shoes, and Brazil focused on fashion shoes made with genuine leather.

The foregoing examples demonstrate what is often called "value migration," the process by which the principal source of value added in a commercial activity shifts from one stage to another. In the examples above, value-added derives increasingly from organisation, coordination, marketing, logistics, and the ability to accurately forecast demand—rather than from the actual production process itself. Hanson and Feenstra (2001) provide striking evidence of the profitability of being an intermediary in the supply of differentiated products, which provides the very incentive for better East Asian firms not to leave the field as intra-regional competition intensifies. Hanson and Feenstra calculated, industry-by-industry, the average percentage increase (or mark-up) in unit prices of goods first imported from China by Hong Kong merchants, then processed or marketed, and finally re-exported. During the period 1988 to 1998 the median mark-ups were stable, ranging from 28 percent to 34 percent, suggesting that substantial profits can be garnered from coordinating economic activity in and beyond China.

Although many of the same factors are at work in the textile and automobile industries, there is one clear difference: the ability to integrate an enormous number of different parts and components in a seamless fashion and to continue to do so even when innovations in one part call for changes in others, is a critical determinant of a successful car company. Dyer and Mobeoka (2000) analyse how Toyota—a world leader in this respect—has accomplished this through the facilitation of knowledge sharing among firms in a network. To encourage suppliers to share knowledge about innovations, Toyota invests heavily in supplier start-ups and discourages short-term opportunism by retaining key suppliers over many years. In this case, both the network organiser and the suppliers earn profits principally from innovations, and network formation and communication are themselves facilitated by information technology.

The evolution of the East Asian hard disk drive (HDD) industry affords another compelling example of how firms can compete on dimensions other than production cost. As McKendrick *et al* (2000) have documented, during the 1990s

suppliers of hard disk drives competed on time-to-market schedules, time-to-volume, and reliability (or the reduction in defects), as well as on production costs (of which wage costs were an important component). Personal computer manufacturers demanded enhanced performance from HDD producers on all of these dimensions. Locations such as Singapore and Penang—which in the 1980s were the initial recipients of overseas investment by American firms in HDD production—found they could retain this industry even while wages rose as their economies grew. This outcome was reinforced by the desire of U.S. HDD firms to maintain a portfolio of different production sites, which act as an insurance policy against disruptions to any one economy or plant—which can be caused by exchange rate movements, labour unrest, or interruptions in supply or outbound shipments. This led to the creation of what McKendrick *et al* (2000) call a regional production system throughout East (but principally South East) Asia.

An important key to the continuing success of the Singaporean HDD industry, however, was the product's increasing technical complexity. McKendrick *et al* (2000) argued that

> "no other location possessed the depth of engineering resources to make them. Singapore also assumed a more explicit role in developing and managing the regional production network, functioning as a transfer station for the introduction of new product(s). Finally, the country began to diversify into new niches, including media, drive design, and other branches of data storage" (page 165).

In short, Singapore was where new disk drives were tested, errors corrected, and initial production runs executed. Only after development in Singapore would production of newer versions of disk drives move to different production sites in South East Asia (such as Thailand and Malaysia). Even then, some purchasers with specific or technically demanding needs maintain connection with Singapore firms for their small production runs.

To summarise, competition from lower wage locations is neither new nor a specifically China-related phenomenon. Many industries in Western nations have been successfully adjusting to this type competition for decades. The dimensions of time, customisation, and reliability are proving to be as important to commercial success as controlling production costs and low wages. It is because of advances in information and communication technologies that firms can better customise products, analyse demand patterns, and organise production and suppliers. Moreover, government policies other than trade policies are playing a growing role in smoothing the adjustment to the rise of competition from China; such complementary policies have facilitated the creation and flow of ideas within and across borders, and ensured that low-cost and high-quality logistics and communications facilities are available to domestic firms.

4.5 Does East Asia meet the preconditions for domino regionalism?

It may be worth recalling that Baldwin's analysis of domino regionalism suggests that exporters outside of a RTA are likely to lobby their government to

seek entry to the latter when there is much at stake, commercially speaking, from doing so. The stakes for exporters are larger when

the level of existing exports to the RTA is larger.

the rate of tariff preference given to exporters within the RTA is larger.

the perceived intensity of competition within the region is higher (so that the effect of any level of preference is greater.)

On the basis of the data reported in this chapter, and bearing in mind that three North East Asian nations have national incomes far larger than their South East Asian counterparts, the preconditions for domino regionalism are likely to be met for any significant free trade area in manufactures that involves China, Korea, or Japan. A RTA involving two of the three North East Asian economies is almost certain to set off dominos in the rest of the region—the end result of which is likely to be (with some sectoral exceptions) free trade in manufactured goods within the region in a decade or so.

The discussion in this chapter concerning firm and national responses to the continued integration of China into the world economy suggests that, in the coming years, export competitiveness is likely to be determined more and more by factors other than tariff rates and preferential market access. More efficient national transportation systems and cheap reliable access to information and communication technologies are likely to move up the list of demands of exporting firms. An interesting question is whether those demands translate into pressure for any regional trade agreement on manufactures to be eventually expanded to include service sector liberalisation. If so, this would be an example of how an emergent policy complementarity influences the sequencing (and functional scope) of regional integration. The potential for this complementarity and others to set off a second wave of regional integration in East Asia is further examined in the next chapter.

5. ONCE THE DOMINOES FALL WHAT ARE THE LIKELY PRESSURES TO EXPAND THE FUNCTIONAL SCOPE OF REGIONAL INTEGRATION IN EAST ASIA?

In chapter 2 it was argued that the optimal scope of a regional trade agreement can be determined in part by complementarities between non-trade policies and firm competitiveness. Along with limitations in political will and technical capacity or with a process of “self discovery,” policy complementarities can account for the sequence of initiatives that are undertaken by nations in a region. In this chapter we consider the potential for expanding the functional scope of an East Asian free trade area in manufactures that might emerge should the dominoes, considered in prior chapters, actually fall. The extant literature suggests

two policy areas with strong and growing links to export competitiveness, namely exchange rate policy and service sector reform. Each is considered in turn.

5.1 The premium on exchange rate stability in East Asia

As noted in chapter 3 financial co-operation has been the subject of much discussion within East Asia, especially after the region-wide financial crisis began in July 1997. These discussions have resulted in a number of bilateral swap agreements signed between nations in the region.[38] The underlying economic phenomena can be described as follows: the growing trade and investment interdependencies throughout East Asia are likely intensify in the years ahead, and as a result national exchange rate regimes will assume even greater importance. This is because firms will need to finance more overseas investments, purchase more machinery from abroad, and cover payments to foreign suppliers before receiving receipts from customers—all of which requires foreign currency. Furthermore, uncertainty over key bilateral exchange rates is especially important when currency hedging is either unavailable to or too expensive, as it is for many firms in the region.[39] What is more, the potentially adverse consequences of one nation's exchange rate policies for other economies in the region highlights the role of spillovers and may well *eventually* call for a re-examination of the case for regional initiatives in the area of macroeconomic policymaking and exchange-rate coordination.[40]

[38] See pages 27 and 28 above. For an in-depth perspective on the issues raised here see Bergsten and Park (2002), Henning (2002), and Sakakibara and Yamakawa (2003a,b).

Immediately after the East Asian crisis, a widely held view was that only two types of exchange rate regimes were viable in developing economies: a freely floating currency or a fixed rate locked in by a currency board (or currency union.)[41] Intermediate positions on reducing exchange rate volatility—such as "soft pegs," managed floats, and so on—were seen as too costly. Sharp investors, it was thought, would attack any perceived peg. Worse still, a peg would induce moral hazard on the part of those local firms and banks that did not take into account exchange rate risk when borrowing from abroad—believing that the government's commitment to the peg effectively eliminated that risk.[42] When such a peg eventually collapses, the associated "liability dollarization" (so called because much overseas borrowing is in U.S. dollars), undermines the financial balance sheets of borrowers that must now raise more domestic currency to repay their dollar-denominated loans. On this view, short of adopting a hard region-wide currency peg, the policy implication is that East Asian nations should implement floating exchange rate regimes which give them a measure of monetary autonomy.

Subsequent research has cast doubt on this bipolar choice of national exchange rate regimes. There is now a greater appreciation of the costs of exchange rate volatility—especially against the U.S. dollar—which is reviving interest in alternative exchange rate arrangements.[43] The first piece of relevant

evidence is that much of East Asia's imports and exports are invoiced and paid for in U.S. dollars. The sheer liquidity of foreign exchange markets for the U.S. dollar makes parties more willing to accept and to make payments in that currency (Cooper 1999). Table 5.1 offers an example:[44] In 1999 and 2000, the overwhelming proportion of Thailand's imports and exports were invoiced in U.S. dollars. Other studies suggest that trade with the United States and trade in less differentiated and homogenous products tend to be invoiced in dollars.[45] These findings are particularly germane to our discussion as East Asia's trade with the United States has increased sharply since the onset financial crisis in 1997.

39 Dominguez (1998, 1999) found that Japanese firms tend not to hedge as much as they might, implying that their profitability is dependent in part on the yen's value against the U.S. dollar and other currencies.

40 Currie (1993) and Bryant (1995) provide overviews of the economics of the coordination of macroeconomic policies by nations.

41 Goldstein (1999) and Williamson (2000).

42 Eichengreen (1998) is a widely cited account of the East Asian crisis and its implications for the so-called "global financial architecture."

Two implications follow. First, given the relatively large imports-to-GDP ratios of nations in East Asia, one can expect fluctuations in a nation's exchange rate with the U.S. dollar to feed directly into its price level. For this reason, McKinnon has repeatedly argued that the U.S. dollar provides the nominal anchor to the price levels of economies in East Asia.[46] Second, each nation in the region has a keen interest in the bilateral exchange rate between other economies in the region and the U.S. dollar. Recall that one of the findings in Ng and Yeats (2003) is that the economies in the region compete aggressively in exporting similar parts and components throughout the world. Moreover, since East Asian nations tend to trade similar products in a number of industries with short order-to-fulfilment cycles, a devaluation by one nation's currency against the U.S. dollar quickly has an adverse effect on the rest of the region's exports to the U.S market and elsewhere. That is, a considerable region-wide spillover occurs from any one nation's devaluation against the dollar. In passing, this accounts for the concerns occasionally expressed by South East Asian nations about fluctuations in the U.S. dollar/yen rate and about any rumours concerning possible devaluation of the Chinese yuan.

43 Of particular note are the papers by Calvo and Reinhart (2000a,b) who demonstrate that a large number of developing economies take active measures to stabilise their bilateral exchange rates with the U.S. dollar (or the German mark, for developing economies located in Europe). They also demonstrate that these nations make more frequent use of their reserves and nominal interest rates to stabilise their bilateral exchange rates than does the U.S., Japan, and Australia, nations with truly free floats. Calvo and Reinhart argue that exchange rate volatility has detrimental effects on trade flows and, given developing economies' tenuous access to international credit markets, that depreciations lead to recessions. They label this reluctance on the part of developing countries to float their currencies as a "fear of floating." For evidence on the this fear in Korea, see Park *et al* (2000).

44 Nations in the region other than Thailand have a similar pattern of dollar-dominated invoices for import and export transactions. For example, see McKinnon and Schnabl (2003) for

evidence on Korean invoicing patterns.

[45] Dominguez (1999) summarises the findings in this literature, which admittedly is rather dated. (Most of the contributions to this literature were published before 1990, and little has been published on this subject since.)

[46] For a recent statement of this view, see McKinnon and Schnabl (2003). McKinnon and Onho (1997) discuss the merits of various bilateral exchange rate arrangements between Japan and the United States at greater length.

Table 5.1. Dollar invoicing in Thailand's imports and exports

Currency	Percentage of Thai import payments made in a given currency in a given year							
	1993	1994	1995	1996	1997	1998	1999	2000
US dollar	74.3	77.1	80.7	80.1	80.4	80.7	79.2	79.0
Thai baht	0.6	0.7	0.5	0.8	1.7	1.7	2.2	2.4
Japanese yen	11.8	11.0	9.4	9.6	9.0	9.6	11.9	12.2
Deutsche mark	5.1	4.6	3.6	3.5	3.5	2.9	2.7	2.1
Pound sterling	1.5	0.9	0.9	1.1	0.8	0.6	0.4	0.4
Euro	0.0	0.0	0.0	0.0	0.0	0.0	0.3	0.9
Singapore dollar	1.4	1.4	1.1	1.0	1.0	0.8	0.8	0.8
Other currencies	5.3	4.3	3.8	3.9	3.6	3.7	2.5	2.2
Currency	Percentage of Thai exports payments made in a given currency in a given year							
	1993	1994	1995	1996	1997	1998	1999	2000
US dollar	91.8	90.5	91.0	91.7	92.0	90.6	87.6	87.0
Thai baht	0.9	1.6	2.4	1.3	2.1	2.6	3.7	3.9
Japanese yen	3.9	4.7	4.1	4.5	3.3	3.7	5.2	5.7
Deutsche mark	1.0	0.8	0.5	0.5	0.4	0.7	1.5	1.2
Pound sterling	0.8	0.6	0.3	0.4	0.3	0.4	0.3	0.2
Euro	0.0	0.0	0.0	0.0	0.0	0.0	0.2	0.6
Singapore dollar	0.8	0.7	0.5	0.4	0.4	0.3	0.3	0.2
Other	0.8	1.1	1.2	1.2	1.5	1.7	1.2	1.2

currencies

Source: Downloaded on November 15, 2003, from the Bank of Thailand's website at www.bot.or.th/bothomepage/databank/EconData/TradePayment/.

The spread of production networks throughout the region is likely to increase the sensitivity of trade flows to bilateral exchange rates against the U.S. dollar. In the hard disk drives industry, for example, leading U.S. firms keep a portfolio of production facilities throughout East Asia and can switch orders among them with great speed (McKendrik *et al* 2000). More generally, Rangan and Lawrence (1999) found considerable evidence to suggest that U.S. multinational firms' sourcing decisions are very sensitive to bilateral exchange rates.[47]

To date, East Asian nations have sought to independently stabilise their bilateral exchange rates against the dollar and to reinforce their capacity to do so by holding significant reserves of foreign currency in their central banks (see table 5.2). To the extent that stabilising each nation's bilateral rate with the U.S. dollar also stabilises the cross-exchange rates throughout the region, some of the threat of adverse spillovers has abated.

Looking further ahead, one of the most interesting questions is whether East Asian nations can further diminish intra-regional exchange rate volatility by agreeing to pool monetary sovereignty in a system of fixed exchange rates or even a currency union. Given that these nations have by and large foregone the right to conduct their own monetary policies by informally pegging to the U.S. dollar, one might expect other alternatives (involving the same or less loss of monetary autonomy) to be actively considered. This has not been the case, however. East Asian nations seem content to follow a strategy of "self help"; of intervening in currency markets to reduce fluctuations against the dollar. Indeed, it would probably take a substantial shock to key bilateral exchange rates—possibly the collapse of either the U.S. dollar, the Japanese yen, or the Chinese renminbi peg—that overwhelmed the existing foreign currency reserves held by East Asian nations to induce policymakers to reconsider regional approaches to exchange rate determination. At that point European experience with the European Monetary System (EMS) and the launching of the euro will be especially relevant, not least the fact that the necessary supra-national institutions and oversight is far ahead of the prevailing institutional architecture in East Asia.

[47] If exchange rate collapses are followed by a drying up of working capital, then firms in supply chains may no longer be able to raise funds quickly to purchase the raw materials and components needed to produce parts and components for assembly operations and other purchasers. The dependence of each firm in the supply chain on the financial viability of other firms in the chain reinforces the case for stabilising intra-regional as well as bilateral exchange rates.

In sum, after the development of regional free trade in manufactures, the effects of exchange rate fluctuations will no longer be cushioned by firms hiding behind tariff barriers. Should a substantial currency market shock not be contained

by the existing national reserves of foreign currency, and result in increased incentives for East Asian nations to engage in competitive devaluations, then policymakers are likely to come under considerable pressure from affected exporters to explore the role that exchange rate and macroeconomic coordination might play in a second phase of regional integration. The potential for expanding the functional scope along this dimension appears, therefore, to be highly contingent and certainly cannot be assured.

Table 5.2 Foreign currency reserves held by East Asian monetary authorities.

Economy	Year				
	Foreign exchange reserves held in 1996	Foreign exchange reserves held in 2000		Foreign exchange reserves held in 2002	
	$US billion	Percent of GDP	$US billion	Percent of GDP	$US billion	Percent of GDP
China	107.0	13.1	168.3	15.4	188.2	14.2
Hong Kong	63.8	41.4	107.6	65.8	-	-
Indonesia	24.0	10.6	27.4	18.5	-	-
Korea	34.0	6.5	96.1	21.0	119.3	23.9
Malaysia	27.0	26.7	29.1	32.6	32.6	32.0
Philippines	10.0	12.1	13.0	27.4	16.0	20.3
Singapore	77.0	83.7	80.4	82.2	-	-
Taiwan	88.0	31.5	106.7	36.4	-	-
Thailand	37.7	20.7	31.9	26.0	35.1	28.0

Source: Bergsten and Park (2002), table 2.

[48]

5.2 Service sector reforms

The slow progress in recent years in implementing reforms through APEC can be attributed in part to their excessive scope—both in terms of sectors covered and of membership—and to the absence of binding commitments and some sort of (overt or subtle) enforcement mechanism. The currently fashionable “bilateral” response has been to narrow the scope of trade initiatives along two dimensions—membership and sectoral coverage (manufacturing). Yet over time, as export competitiveness increasingly depends on national transportation and communication infrastructures, firms may well encourage their governments to liberalise service sectors on a national or regional basis. Region-wide reforms—which involve a degree of reciprocity—are likely to be easier for political leaders to “sell” to national electorates. Exporters may also favour a regional initiative if it

enhances their capacity to more efficiently supply foreign markets. Moreover, pressure from firms to exploit the complementarities between export competitiveness and service sector reform is likely to grow over time as international production networks and the like spread. The rest of this section is devoted to presenting some evidence on the importance of service sector exports to East Asia and to highlighting some of the evidence on differential performance in service sectors across the region; differences that may well be narrowed if incumbent firms were induced to move towards regional and worldwide best practice.

The experience of industrialised countries (and some fast growing industrialising economies) has shown that as economies develop financial, logistical, and transportation services grow in importance. The benefits of reform in these sectors are thought to be sizeable too. Mattoo *et al* (2001) find that economies with fully liberalised telecommunications and financial services sectors can grow up to 1.5 percent per annum faster than those with more restrictive policies. As well as reducing the costs to firms of purchasing these services, a reduction that in turn bolsters their competitiveness, direct exports of services tend to expand as well. Table 5.3 indicates just how important service exports are already to leading East Asian economies.

[48] Some of the evidence discussed in this section draws on Yusuf and Evenett (2002). It should be noted that use to which this evidence is put here is considerably different.

	Share of Services in Total Exports	
	Year	
Economy		
	1987	1997
Hong Kong	22	58
Philippines	6	37
Singapore	6	30
Thailand	4	22
Korea	3	16
Malaysia	2	16
Japan	4	14
Indonesia	2	11
Mimeo		
USA	9	25
Italy	8	23
UK	10	23
France	11	22
Germany	4	13

Table 5.3. Service Trade in East Asia, 1987 and 1997

Source: Holmes and Hardin (2000).

Considerable scope exists for reducing barriers to trade and foreign direct investment in service sectors in East Asia. Recent econometric analysis reveals the restrictiveness of national non-tariff barriers in several service sectors.[49] Table 5.4 presents estimates of these barriers, on a one-hundred point scale, for several East Asian nations, making clear just how far Korea, the Philippines, and Thailand are behind world best practices.[50] In the case of telecommunications, figure 5.1 shows that Japan is the only economy in the region whose communications sector comes close to approaching the efficiency of its U.K. and U.S. counterparts.

[49] See Warren and Findlay (2000) for details.

[50] The paucity of credible data on barriers to service sector trade and investment accounts for the somewhat dated nature of the numbers reported here.

Table 5.4. Indices of the Restrictive Effect of Policies Toward Foreign Direct Investment, 1997

(No restrictions=0, Maximum Value of Index=100)

Economy	Business Services	Communications	Distribution	Financial Services	Transportation Services
Hong Kong (China)	2	35	5	23	9
Japan	6	35	5	36	11
Malaysia	32	42	8	61	12
Singapore	26	52	25	38	25
China	36	82	28	45	46
Indonesia	56	64	53	55	53
Korea	57	69	63	88	57
Philippines	48	76	48	95	98
Thailand	78	84	78	88	78
Mimeo					
United States	1	35	0	20	3

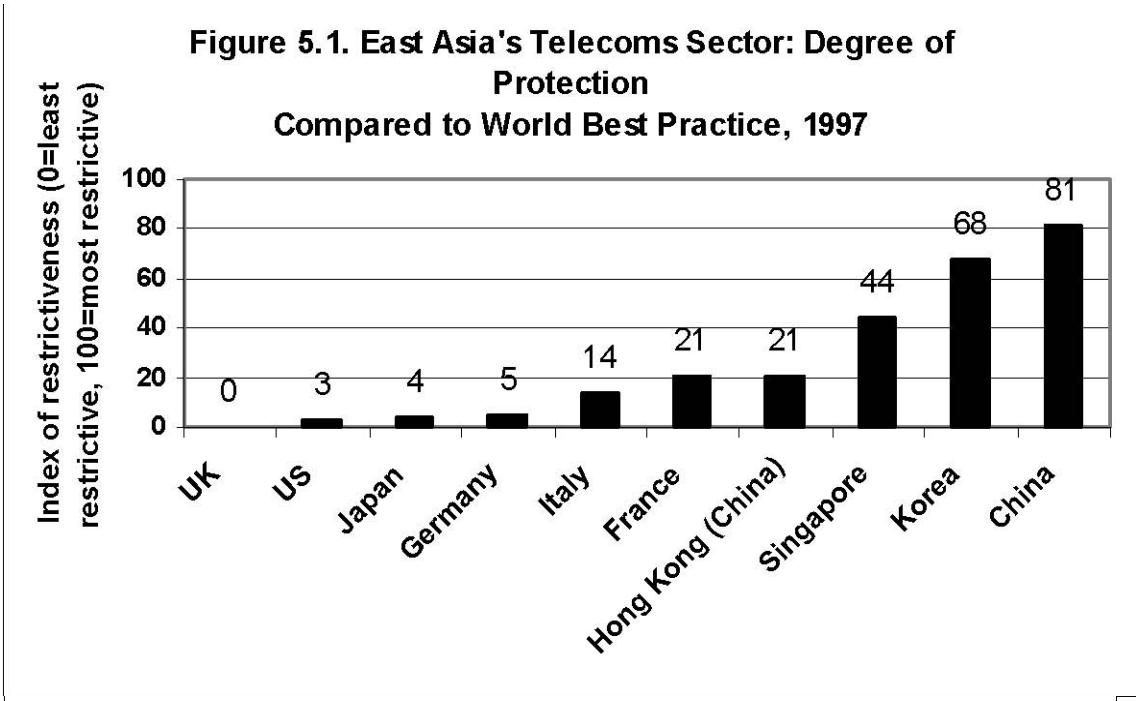
Source: Hardin and Holmes (1997).

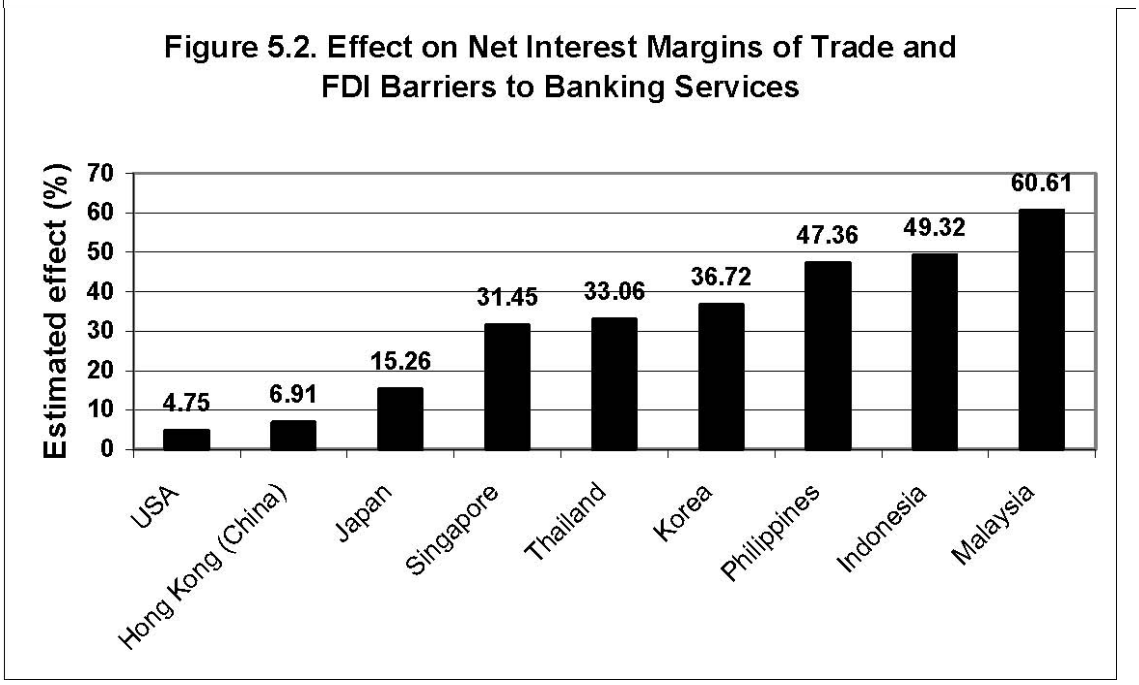
Note: The East Asian economies are ranked by the simple mean of the sectoral indicies of FDI restrictiveness. Hence, Hong Kong (China)'s mean restrictiveness in lowest and Thailand's is the highest.

Barriers to foreign direct investment have been found to detrimentally affect the performance of national banking sectors; and are an area ripe for regional liberalisation. Figure 5.2 summarises the findings of one study of the effects on the margins charged by domestic banks of restrictions on overseas trade in banking services and on investments in banks.[51] These border barriers can be expected to ease the competitive pressures on domestic banks, enabling them to charge higher margins and earn supra-normal profits. The results reported in figure 5.2 show just how distortive those barriers can be. For instance, Malaysian domestic banks charge interest margins 60.61 percent (three-fifths) higher than would be the case in the absence of such barriers. The flip side to these higher margins is reduced investment by firms, in both exporting and domestically-oriented industries.

[51] Kalirajan *et al* (2000).

Source: Warren (2000).





Source: Kalirajan *et al* (2000).

5.3 The potential for greater functional scope in East Asian integration

This chapter has identified two policy areas whose effects on exporters' competitiveness may well form the basis for a second series of steps towards regional integration in East Asia. In doing so the logic relating policy complementarities to the optimal scope of regional integration, which was outlined in chapter 2, is applied to the context of East Asian reform after the potential

establishment of a free trade area in manufactures. The likelihood of the functional scope expanding into one of these two policy areas—exchange rate and macroeconomic policy coordination—is highly contingent on a substantial convulsion in regional or global financial markets. In contrast, the pressure to expand the functional scope to include service sector reform is likely to grow over time as exporters focus on the remaining factors which undermine their capacity to supply regional and world markets at the lowest possible cost.

6. CLOSING REMARKS

The principal objective of this report was to shed light on the sequence of integrative measures that East Asian nations are likely to take in the decades to come. Particular reference has been made to existing theories of regional integration and to European experience.

Our first task was to distinguish between conceptual explanations for the intertemporal sequence of collectively-agreed measures undertaken by parties to a regional trade agreement and those arguments that refer to numerous other aspects of regional integration. Five such explanations were found in the extant economics and international relations literatures and point to the importance of technocratic entrepreneurship, geopolitical factors, domino regionalism (a positive economic theory of the enlargement process in regional trading agreements), policy complementarities, and cross-border spillovers.

The very fact that five lines of causation were identified suggests that any predictions concerning the sequencing of regional integration in East Asia are necessarily tentative. This type of analysis simply cannot yield precise predictions. Nevertheless, there are enough persistent and observable economic and geopolitical forces whose likely impact on sequencing can be discerned.

The evolution of trade and financial initiatives in East Asia to date is interesting both for our purposes and in its own right, and for this reason a whole chapter was devoted to this matter. It cannot be said the nations in East Asia have not made progress in integrating their markets to the extent seen in Europe because they have never tried liberalising initiatives on market access and the like—as the AFTA agreement and measures taken in response to APEC leaders' declarations demonstrate. It is rather that the latter initiatives have not reached their full potential, either because of backsliding from agreed commitments or, worse, a failure to implement non-binding promises. Consequently, East Asian nations have turned to proposing bilateral trade agreements and thirty such measures were identified in this study. Having said that, it is important to appreciate that only a small proportion of these proposed initiatives have in fact translated into signed binding commitments. What is more, to date no trade agreement between the three largest economies in the region (China, Japan, and Korea) has been signed.

Our analysis of East Asian trade flows and tariff protection reveals that a free trade area between any two of the three large North East Asian economies is likely to inflict considerable harm on exporters from non-parties. This harm is likely to

induce a political dynamic that can lead to enlargement of the free trade area; specifically, the harm will induce exporters in non-parties to urge their governments to join the bilateral trade agreement. Moreover, each enlargement of such an agreement will inflict more harm on the exporters from remaining non-members and that, in turn, is likely to trigger further applications for entry. This dynamic—termed domino regionalism—is likely to result in a free trade area for manufactured goods in East Asia—although the precise features of the resulting regional agreement will surely be conditioned by the exceptions that nations can obtain (negotiate) for their industries along the way. The first wave of East Asian regionalism, therefore, is likely to focus exclusively on trade in manufactures, avoiding the political difficulties inherent in agricultural trade reform.

The second wave of East Asian regionalism is likely to centre on expanding its functional scope to include service sector reforms. This is because the export competitiveness of goods is becoming increasingly dependent on the quality, availability, and cost of national transportation and communication infrastructures in the originating economy *and* in all of the economies the goods have to pass through in order to reach their destination markets. This argument is particularly relevant for firms that are members of international production networks and that face wafer-thin profit margins. Exporters, as well those importing firms that rely on the timely delivery of parts, components, and final goods, are likely to lobby their governments about the need for reforms in service sectors at home and abroad,[52] providing the political impetus for a regional initiative on service sector reform.[53] Moreover, given the large differences in national incomes in the region, and the heavy outlays associated with many infrastructure projects, a regional initiative on service sector reform will probably be coupled with the development of mechanisms for transferring resources between member states. Alternatively, the Asian Development Bank may be asked to play a greater role in supporting the infrastructure projects and reforms necessary to meet the terms of any regional initiative.

[52] It should be noted that the pressures to undertake service sector reforms at the regional level are likely to be attenuated somewhat if nations unilaterally implement such reforms for other reasons—or if another multilateral initiative on service sector liberalisation was agreed at the World Trade Organization.

Another important policy area in which the functional scope of regional integration in East Asia may well expand is in exchange rate and macroeconomic policy coordination. Apart from the signing of a small number of bilateral currency swap arrangements and the creation of monitoring and surveillance mechanisms, the nations in East Asia appear *at present* to have little stomach for more ambitious regional measures in this area of policy. Instead, currently they prefer to each accumulate massive stocks of foreign exchange reserves and to intervene in the currency markets on their own to reduce the volatility of their currency's bilateral exchange rate with the U.S. dollar.[54] Once tariff barriers have, by and large, been eliminated during the first wave of regional integration of East Asian integration envisaged here, firms will have even fewer cushions to shield them from the effects of sharp exchange rate fluctuations. Should a bout of extreme currency market

instability overwhelm these stocks of foreign reserves, then interest is certain to grow among exporters, importers, and policymakers in regional mechanisms to coordinate exchange rates and macroeconomic policy.

In short, as far as the likely course of the second wave of East Asian regional integration is concerned, expansion of its functional scope to include disciplines on service sector rules and policies is plausible and may well be accompanied by measures in the exchange rate area. It should be noted, however, that the impetus for each differs markedly and that the probability that both happen simultaneously, and in a coordinated fashion, is slim.

[53] See table A.4 in Appendix A.

[54] Currently, the opportunity cost of holding such foreign exchange reserves does not appear to have been an important factor in decision-making by the regions' policymakers. This may change if policymakers come to believe that the level of reserves necessary to ensure exchange rate stability with the U.S. dollar grows in the future.

The above account of the likely sequence of regional integration initiatives in East Asia (with relatively free trade in manufacturers followed by service sector reforms and possibly exchange rate coordination) employs three of the five conceptual arguments for sequencing noted earlier and described in chapter 2 of this report; namely, domino regionalism, policy complementarities, and cross-border spillovers. This is not to say that technocratic entrepreneurship and geopolitical factors will be irrelevant. With respect to the former, for example, it is inconceivable that regional measures on services could be devised without the active involvement (if not outright encouragement) of sector-specific technocratic experts. Similar arguments surely apply in the area of exchange rate management, as they have done in recent discussions on regional bond market development in East Asia.

The role of geopolitical factors is perhaps more difficult to chart. Some such factors are of long standing, others are more recent but are likely to endure into the future, and include U.S. economic and military prowess and growing Chinese clout. It is unclear quite how these longer term factors will affect the sequence of regional integration measures. On the one hand, a confident and outward-looking United States could encourage the formation of an East Asian trade block so as to facilitate subsequent trade negotiations on pan-pacific liberalisation measures. On the other hand, the U.S. may fear that the emergence of an East Asian block will be too economically powerful, too disadvantageous to American exports, and a threat to its competitiveness. As a result, the U.S. may negotiate enough bilateral trade agreements with key East Asian economies, pressuring the latter not to sign up to any proposals for a region-wide free trade area. Such pre-emptive bilateralism on the Americans' part may forestall regional moves towards freer markets in East Asia. Likewise, the growth of Chinese clout may encourage or repel other nations in the region from entering into bilateral trade agreements with her. Indeed, it is possible that a U.S.-Japan-Korea free trade area could, along with reinforced security guarantees, emerge in response to aggressive behaviour on China's part.

Worse still, some of the potential geopolitical events may be uncertain in

timing, if they occur at all. Five such events can be readily identified: worsening Japanese and Chinese diplomatic and military relations, a conflict between North and South Korea, a Chinese invasion of Taiwan, and political instability and disorder in China and in Indonesia. The latter two potentialities may, respectively, result in “defensive” integration by Japan and Korea and may galvanise a sub-regional initiative in the ASEAN nations (excluding Indonesia). Worsening Japanese and Chinese relations may put a halt on moves towards free trade in manufactures in North East Asia. Alternatively, moves towards freer trade may be part of a set of measures to patch up any major disagreement between Japan and China. Concerning conflicts between North and South Korea and between China and Taiwan, it is inconceivable that regional integration initiatives would remain on the front burner during such a conflict, and for a time afterwards. Such conflicts would immediately draw the United States into the fray, adding a further geopolitical element. All in all, perhaps the best way to think about the likely impact of these geopolitical factors is that they are likely to punctuate the steps towards regional integration in East Asia that follow from the economic logic developed in this report.

European economic interests, especially those of exporting firms, overseas investors, and their respective European employees, could be substantially affected by the sequence of East Asian regionalism envisaged here. Should a domino-regionalism dynamic in North East Asia be set off, European exporters will find that a growing proportion of their competitors from East Asia have more preferable access to East Asia’s major markets than they do. As the most-favoured nation tariff rates reported in table 4.2 made clear, many East Asian nations still have tariffs on industrial goods over 10 percent. This implies that any domino regionalism dynamic will generate substantial discrimination against European exporters. Table 6.1 reports estimates of the lost welfare (comprising principally of lost profits for exporters) for four European nations should six potential East Asian and pan-Pacific free trade areas be established. In line 10 of this table the total losses

Table 6.1. Estimated welfare effects for non-Asian economies of six actual potential regional trade agreements in East Asia, US$ millions (1997 prices)

Economy	Singapore-Japan RTA	Japan-Korea RTA	Japan-Korea-China RTA	ASEAN plus Japan, Korea, and China RTA	ASEAN plus Japan, Korea, China, Australia, and New Zealand RTA	APEC (MFN reform)
France	-1.5	5.4	8.2	-86.1	-157.1	1018.8
Germany	-3.8	-60.1	-398.6	-803.6	-984.3	1849.4
Italy	-1.6	-13.4	-96.4	-200.9	-347.9	1023.0

UK	-1.2	-26.2	-40.9	-233.5	-581.9	2363.8
Canada	-0.7	-13.4	-96.4	-200.9	-347.9	1023.0
United States	-3.3	-381.1	-2487.6	-4131.7	-4758.9	271.6
Memos:						
Number of economies worldwide losing more than $250m ($100m)	0 (0)	1 (2)	5 (9)	3 (11)	5 (14)	4 (6)
Total welfare effect on the four listed EU members	-8.1	-94.3	-527.7	-1324.1	-2071.2	6255
Total welfare effect for all non-members of the RTA	-33.5	-1370.9	-7644.8	-11491.1	13494.1	14721.3

Source: Scollay and Gilbert (2001). The numbers in this table refer to millions of US dollars.

to exporters of the four largest EU economies (France, Germany, Italy, and the United Kingdom) are reported. Interestingly, the total losses to these four economies only exceed half a billion dollars (in 1997 prices) once all three of the major North East Asian economies form a free trade area. Free trade areas involving fewer or smaller economies pose little overall threat to EU overseas commercial interests, although some exporters may be hurt more than others.

One potential implication of the results in table 6.1 is that it may be in the EU's interests to negotiate a free trade agreement with the ASEAN+3 nations, after the latter nation's have negotiated a free trade area amongst themselves. (European exporters are estimated to lose well over a billion dollars in profits after the formation of a free trade area among the ASEAN+3 nations.) Such an EU-ASEAN+3 free trade area would accelerate the formation of a so-called "world of regions" where each region negotiates on commercial matters with other regions.

Further reinforcing the momentum towards a "world of regions" is the likely behaviour of the United States. According to the estimates in table 6.1, U.S. exporters are likely to lose over four billion dollars after the formation of a free trade area between the ASEAN+3 nations, an amount three times the size of the losses for European exporters. On the assumption that the interests of U.S. exporters are more or less reflected in U.S. trade strategy, these estimates imply that, once the domino regionalism dynamic takes off in East Asia, the EU and the U.S. may find themselves in competition to negotiate a free trade agreement with the ASEAN+3 countries. These considerations may have implications for the timing and nature of any EU approach to the ASEAN+3 nations concerning trade policy, and for the

latter nations' likely negotiating strategy. Moreover, the emergence of regional blocks could have considerable implications for negotiations in other international economic fora, in particular the World Trade Organization.

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Appendix A: Some comparisons between existing regional trading agreements and between macroeconomic conditions in European and East Asian economies

Existing regional trading agreements in East Asia, Europe, and the Americas (see table A.1 for a selection of them) differ markedly along the four dimensions identified in chapter 2; namely, in their objectives, scope, nature of commitments, and institutional arrangements. For example, the European Union has a far larger membership than the Closer Economic Relations Trade Agreement, entered into by Australia and New Zealand. Moreover, AFTA and the EU differ considerably in the supra-national components of these agreements, with the latter placing far

greater emphasis on supra-national bodies such as the European Union and the European Court of Justice. In addition, APEC and the EU differ critically on the matter of binding versus non-binding agreements. Finally, given the focus of this Report on sequencing and inter-temporal changes, it is noteworthy that the scope of some RTAs have changed considerably over time, as European experience can attest.

Table A.1 Membership of selected regional trade agreements

Acronym	Full name of regional trade agreement	Member economies
AFTA	Association of Southeast Asian Nations Free Trade Area, entered into force 28 Jan 1992	Brunei, Darussalam, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Viet Nam
APEC	Asia Pacific Economic Cooperation, created in 1989	Australia, Canada, Chile, China, Hong Kong, Indonesia, Japan, Korea, Malaysia, Mexico, New Zealand, Papua New Guinea, Peru, Philippines, Russia, Singapore, Thailand, United States, Viet Nam.
CER	Closer Economic Relations Trade Agreement, entered into force 1 Jan 1983	Australia and New Zealand
EFTA	European Free Trade Association, entered into force 3 May 1960	Iceland, Liechtenstein, Norway, and Switzerland
EU	European Union, entered into force 1 Jan 1993	Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Netherlands, Portugal, Spain, Sweden, United Kingdom
Mercosur	Southern Common Market, entered into force 29 Nov 1991	Argentina, Brazil, Paraguay, and Uruguay
NAFTA	North American Free Trade Agreement, entered into force 1 Jan 1994	Canada, Mexico, and United States

It is also instructive to compare selected East Asian and European RTAs along some well-established trade-related benchmarks and to compare the macroeconomic performance of selected East Asian and European economies. Table A.2 reports for seven RTAs the share of each members' exports that are shipped to other members in the same RTA. These so-called intra-RTA export shares are reported for 1980 to 2000. Interestingly, for some prominent RTAs these shares seem to rise and then to level off. This share in the EU reached approximately two-thirds in 1985-89 and stabilised thereafter. APEC's comparable share reached about three-quarters around 1995 and has remained stable since. (Note that APEC was formed in 1989 and that most of the growth of the intra-APEC export share occurred before 1990; perhaps raising the question of whether the growth of intra-regional trade lead was codified by forming APEC rather than the latter leading to much of a rise in intra-regional trade.) In contrast to post-RTA

formation patterns in Europe and in the Asia-Pacific, NAFTA's intra-RTA export share continued to growth through to the year 2000, reaching 58.82 percent. (Again, however, much of the increase in export share occurred before NAFTA was signed, perhaps coinciding with the signing of the Canada-US Free Trade Agreement in 1987.) It would seem, then, that these export shares differ somewhat across regions and in their evolution over time.

Table A.2. Intra-RTA export shares, 1980-2000

RTA	1980-84	1985-89	1990-94	1995-99	2000
AFTA	20.75	18.94	22.51	24.81	24.54
APEC	66.30	72.18	73.08	74.31	75.24
CER	7.99	8.41	9.13	10.73	9.25
EFTA	16.53	16.39	13.73	12.60	11.82
EU	62.00	65.05	66.47	65.08	66.94
Mercosur	9.94	8.52	15.94	24.84	22.35
NAFTA	41.29	46.68	48.17	53.15	58.82

Source: Clarete, Edmonds, and Wallack (2002) using IMF trade data.

Another way to examine the propensity of members of a RTA to export to one another is to compare the percentage of their exports that they ship within the RTA to their percentage share of world exports. The ratio of the former to the latter provides a measure of so-called intra-RTA trade intensities (relative to the overall propensity to export) and are reported for seven RTAs in table A.3. Interestingly, in the AFTA the computed intensity falls over time; suggesting that the creation of this RTA was associated with a considerable expansion of exports by AFTA members to all foreign markets, not just to ASEAN partners. In contrast, these intensities have fallen in the EU, suggesting a different degree of engagement over time by EU firms with non-EU markets. Moreover, it is worth noting that the computed trade intensities for Mercosur and for NAFTA exhibit the same patterns as those for the EU; raising the question of whether East Asian experience in this regard is the exception rather than the rule.

Table A.3: Intra-RTA trade intensities, 1980-2000

RTA	1980-84	1985-89	1990-94	1995-99	2000
AFTA	4.22	4.78	3.78	3.72	3.97
APEC	1.60	1.61	1.57	1.53	1.50
CER	4.15	4.62	5.81	7.08	6.76
EFTA	2.35	2.12	2.02	2.10	2.24
EU	1.52	1.54	1.60	1.66	1.70
Mercosur	5.58	7.48	11.70	13.16	14.31

NAFTA	1.83	1.82	2.04	2.18	2.15

Source: Clarete, Edmonds, and Wallack (2002) using IMF trade data.

Tables A.4 and A.5 provide some indicators of the macroeconomic commonalities and differences across selected East Asian and European economies. In particular, table A.4 highlights the considerable diversity across the East Asian region in incomes per capita. Examination of table A.5 reveals that in the 1990s East Asian nations have higher investment rates than the four European nations listed there (France, Germany, Italy, and the United Kingdom) and more positive external balances.

Table A.4: Summary macroeconomic statistics 2001

Selected East Asian and European economies	Exports of goods and services (% of GDP)	External balance on goods and services (% of GDP)	Foreign direct investment, net inflows (% of GDP)	GDP growth (annual %)	GNI per capita, PPP (current international $)	Gross capital formation (% of GDP)	Inflation, consumer prices (annual %)
Cambodia	53.19	-8.13	3.32	6.30	1790	17.90	-0.60
China	25.83	2.42	3.82	7.30	3950	37.92	0.34
Hong Kong, China	143.90	5.31	14.10	0.15	25560	25.81	-1.61
Indonesia	41.08	8.50	-2.26	3.32	2830	17.04	11.50
Japan	10.44	0.63	0.15	-0.58	25550	25.46	-0.73
Korea, Republic of	42.91	2.35	0.76	3.03	15060	26.69	4.06
Malaysia	116.34	18.38	0.63	0.39	7910	28.86	1.42
Philippines	49.27	1.84	2.51	3.40	4070	17.99	6.12
Singapore	173.56	21.71	10.05	-2.04	22850	24.27	1.00
Thailand	66.26	6.06	3.33	1.80	6230	24.03	1.66
Vietnam	54.73	-2.03	3.97	6.84	2070	30.88	-0.43
France	27.91	1.57	4.01	1.83	24080	20.11	1.63
Germany	34.97	1.89	1.71	0.56	25240	20.00	2.48
Italy	28.27	1.60	1.37	1.78	24530	19.75	2.79
United Kingdom	27.12	-2.16	4.43	2.21	24340	17.17	1.82
Summary statistics:							
East Asia & Pacific	40.76	4.68	3.00	5.50	3790	30.97	
EMU members	36.63	1.73	3.41	1.44	23800	20.80	
OECD member states	*22.60*	*-0.28*	1.98	0.74	27130	*22.29*	

Source: World Bank, World Development Indicators online
Note: Data in italics is for 2000, not for 2001.

Table A.5: Key macroeconomic indicators of selected East Asian and European

East Asian and European economy	Consumer price inflation, average annual rate	GDP deflator, median annual growth rate	Real exports of goods and services, mean annual growth rate	Real imports of goods and services, mean annual growth rate	Labour force, average annual growth rate
Cambodia	4.48	9.17	17.16	12.97	2.62
China	7.18	5.92	17.26	16.58	1.19
Hong Kong, China	5.22	5.90	9.22	9.54	1.96
Indonesia	13.28	8.88	6.56	4.75	2.46
Japan	0.83	0.10	4.38	3.56	0.63
Korea, Rep.	5.07	7.06	15.66	10.91	2.04
Malaysia	3.55	3.68	12.36	11.44	3.04
Philippines	8.54	7.93	7.39	6.16	2.78
Singapore	1.72	2.23	..	..	2.51
Thailand	4.51	4.49	10.63	6.39	1.51
Vietnam	3.67	16.95	26.69	30.02	1.87
France	1.72	1.67	6.66	5.66	0.79
Germany	2.24	2.03	4.46	5.63	0.26
Italy	3.72	3.93	5.87	4.79	0.55
United Kingdom	3.05	2.87	6.16	6.45	0.28

Source: World Development Indicators online
Note: .. Data unavailable in the WDI

Appendix B. Findings of a recent detailed analysis of East Asian trade flows.

Ng and Yeats (2003) conducted a detailed analysis of the major trends in international trade flows in East Asia. In the summary of their findings that follows the term “intra-trade” refers to trade between the economies in East Asian region (taken, for the purpose of their study, to include Brunei, Cambodia, China, Hong Kong, Indonesia, Korea, Laos, Malaysia, Mongolia, Philippines, Singapore, Taiwan, Thailand, and Vietnam.) Please note that six of the 19 findings below were reported on pages 39 and 40 of this report. Ng and Yeats’ principal findings are:

1. “From 1975 to 2001, East Asia’s share of global exports expanded more than three fold (to just under 19 percent), and doubled from 1985 to 2001. The region presently originates the same share of global exports as NAFTA. Intra-regional exports, expressed as a share of world trade, experienced an even sharper expansion rising more than six fold during 1975-2001” (page 2).
2. “Over 1985-2001, the share of East Asia’s exports to the region rose from 24 to 35 percent with Indonesia, Taiwan (China), Korea, and the Philippines experiencing significantly higher directional trade changes. This shift was, in part, due to the fact that global import demand in East Asia was more buoyant than in any other major market” (page 5).

3. “The five largest regional exporters account for 80 percent of East Asian intra-trade. At the other extreme, the five smallest regional traders, namely, Brunei, Cambodia, Lao PDR, Mongolia, and Vietnam, have a combined regional export share under 2 percent. If size is measured by gross domestic product somewhat greater inequalities are observed as China alone accounts for 43 percent of regional GDP, as opposed to its 30 percent share of intra-regional trade” (page 8).
4. “Over 1995-2001, East Asia’s exports to China grew at an annual rate of 11.5 percent, which was far above the corresponding 3.8 percentage growth rate for world trade. China’s internal contra-cyclical policies, and its maintenance of a stable exchange rate during this period, are generally viewed as important factors helping to contain the effects of the East Asian financial crisis. Furthermore, the profile of China’s imports and exports is changing in directions that facilitate the international segmentation of production processes. As a result, the interdependence of China and the East Asian countries has been rapidly increasing” (page 10).
5. “Overall, East Asian average intra-trade shares for both imports and exports increased significantly during 1985-2001, thus, indicating increased dependency on regional trade. Seven of the 14 East Asian countries now draw on regional suppliers for 50 percent, or more, of their imports, while only Lao PDR directs more than one-half its exports to the region. Increased dependency is reflected in all countries’ regional import and export shares, although China’s increasing reliance on non-regional markets for its exports constitutes an important exception. Available evidence does not indicate that smaller countries are more dependent on regional markets for trade” (page 13).
6. “The relative importance of China as a destination for regional exports significantly increased since the mid-1980s, and this trend appears to have sharply accelerated since 1995. In part, China’s maintenance of a stable exchange rate, in the face of major devaluations in other East Asian currencies, appears to have contributed to its recent increased importance as a regional market” (page 15).
7. “Even after the influence of their relatively close proximity is accounted for East Asian intra-trade must be generally classified as highly ‘intense.’ Also, the intensity of trade within the region increased markedly over the full 1985-2001, and the shorter 1995-2001 period. For example, in 1985 only 40 percent of all East Asian bilateral trade flows were greater than expected, based on the countries’ share in world trade, as opposed to 61 percent in 2001. Trade relations between East Asian countries have been growing sharply in terms of their intensity and importance!” (page 19).
8. “A trade ‘complementarity’ index shows growing similarities between the types of goods East Asia exports, and the goods imported, was a potent factor promoting the expansion of intra-trade. The current East Asian values for this index are very similar to those for countries like the original EU (6) members at the time of the formation of the European Economic Community” (page 23).

9. “An empirical procedure is used to isolate the effects of demand, diversification and competitiveness changes in East Asia’s regional exports. The results show that a markedly improved ability to compete played a major role in the expansion of East Asian intra-trade since the mid-1980s. Separate tests for the 1995-2001 period indicate East Asian market shares continued to grow in spite of the effects of the financial crisis. Similar analyses involving the exports to the EU (15), NAFTA, and Japan shows East Asia’s improved competitiveness also occurred in major global markets” (page 25).

10. “East Asian exporters made broad based competitive gains in local markets against all major non-regional suppliers during 1985-2001.On average, East Asia increased its regional import share by about 18 percentage points for the 30 largest products in intra-trade (which implies trade gains of approximately $78 billion). NAFTA and Japan experienced the largest competitive losses in East Asian markets as their import shares fall by seven to eight percentage points, respectively” (page 29).

11. “Since 1985 the product composition of East Asian intra-trade changed dramatically as the share of manufacturing and transport equipment rose by over 26 percentage points. At present, these goods account for almost one half of all goods traded within the region. A similar pattern is observed in non-regional trade as the share of machinery and transport equipment rose from 18 to 46 percent from 1985 to 2001. In both regional and non-regional markets, mineral fuels and crude materials exports registered the largest decline in relative importance” (page 32).

12. “East Asian intra-trade is dominated by 30 four-digit SITC products that accounted for just over one half of this exchange in 2001. Within this group, electronic products are of major importance, as are several SITC categories used to record trade in components of various manufactured goods. The latter reflects the rapid expansion in East Asian production sharing operations in which various stages of a manufacturing process are undertaken at different geographic locations. Very strong similarities are observed in the lists of largest products exported to regional and non-regional markets” (page 37).

13. “Summary measures of export concentration suggest very little diversification of exports occurred over 1985-2001 in East Asian intra-trade. However, there are instances involving Korea, the Philippines and Taiwan (China) where exports became more concentrated. The underlying statistics show the trend toward increased concentration of exports in these cases was largely due to a remarkable export expansion for electronic products, or for office machinery parts and components. This greatly increased the importance of these products relative to other exports” (page 41).

14. “Manufactured goods that are high skill and highly technology intensive in production comprise a large share of East Asia’s fastest growing products in regional trade. Electrical machinery accounts for about one-fifth (by value) of this exchange. East Asia is in the enviable position of having many of its fastest growing regional exports included on a list of its largest export products” (page

44).

15. “A growing level of intra-industry trade can improve a country’s prospects for development and growth, expand the range of products available to consumers, and also increase its interdependence in the global economy. Available evidence shows that East Asian intra-industry trade has been steadily growing in relative importance. These trends are evident in trade both within the region, and in trade with major global markets” (page 45).

16. “According to the Asian Development Bank, recent evidence pertaining to MERCOSUR shows that a regional trade agreement can distort the composition and direction of member countries’ trade in ways that incorporate major economic inefficiencies. Although East Asians RTAs (like ASEAN) are weaker a reorientation may be occurring. However, an analysis of regional trade changes shows these negative trends are <u>not</u> occurring within East Asia even though the relative importance of intra-trade has been growing very rapidly. Rather East Asia’s global and regional exports appear to be evolving in ways that are fully consistent with these countries’ comparative advantage” (page 49).

17. “Trade in parts and components has grown steadily in East Asia and now accounts for about $66 billion, or over one-fifth of all intra-trade in manufactured goods. Regional trade in parts of office machinery and telecommunications equipment now total about $43 billion” (page 53).

18. “Japan is an important center or “hub” of production sharing operations in East Asia originating about one-third ($38.7 billion) of all regional exports of components for assembly. Over 70 percent of Indonesia’s regional imports of components originate in Japan, while the corresponding share for Korea, the Philippines, and Taiwan exceeds 50 percent” (page 56).

19. “Japan, which has the highest unit wage costs in the region, now only has a comparative advantage in the assembly of about one-fifth of the 60 component product groups, which is sharply lower than the results for China, Thailand and Indonesia. China, for example, has a comparative advantage in the assembly of 53 percent of component product groups, while the corresponding share for Indonesia is ten percentage points higher” (page 62).

The sequencing of regional integration in Europe and the Asia-Pacific

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oxford SAID BUSINESS SCHOOL

The importance of understanding sequencing

- Is there any underlying economic, political, or geo-strategic logic that can account for the seemingly choatic proliferation of preferential initiatives in the Asia-Pacific?
- What are the intertemporal and cross-sectional implications for the scope and membership of preferential initiatives in the Asia-Pacific?
- What are the systemic concerns are raised by different sequencing scenarios?

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Leading scholarly explanations for sequencing

- Technocratic entrepreneurship.
- Geo-politics (security and economic dimensions).
- "Domino regionalism."
- Policy complementarities and the "preservation of the original bargain."
- Cross-border spillovers, "grand bargains," and credible commitment mechanisms.
- *See sections 2.3 and 2.4 of the circulated report.*

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Technocratic entrepreneurship

- "(European) integration has been driven primarily…by a technocratic process that reflects the imperatives of modern economic planning, the unintended consequences of previous decisions, and the entrepreneurship of disinterested supranational experts" (Moravcsik 1998 page 4).
- Relevance for Asia-Pacific?
- At best in some sectors (financial regulation, bond markets)?

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Geo-politics

- Membership of preferential agreements evolves over time to accommodate the interplay between security concerns and relative economic strength.
- Manifestations in European experience.
- Implications for Asia-Pacific:
  - Fight against terrorism.
  - Rise of China and India.

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Domino regionalism (1)

- Economic theory advanced by Richard Baldwin.
- Desire to preserve (or increase) exporters' profits provides the driving force as to why nations want to join existing preferential agreements.
- Does not explain why existing members of a PTA accept the applications from outsiders.
- He claims it can account for the evolution of membership of the EU since 1950.

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Domino regionalism (2)

- Baldwin applied his theory to East Asia in a seminar in Tokyo in 2002.
- ASEAN economies are too small to set off the a domino dynamic in East Asia.
- Possible sparks: China-ASEAN agreement or Japan-Korea agreement.
- "Docking arrangements": "hub-and-spoke" and "matrix."

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Policy complementarities

- Focus is not on membership but "depth" of regional integration.
- Preservation and expansion of the "original bargain" is the motivation.
- Could explain expansion of disciplines into:
  - Standards and non-tariff barriers.
  - Alternative modes of supply beyond mode 1.
  - Competition rules to prevent erosion of market access.

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Cross-border spillovers

- Application of the traditional case that spillovers can create for international collective action.
- Preferential agreements expand to include packages of policies (or “grand bargains”) that individually have a zero-sum feature to them.
- Zero-sum aspect of some policies requires:
  - adoption of enforcement mechanisms, or
  - pooling of a given policy function in a central body.

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Concluding remarks

- Despite mountains being written on regional integration surprisingly little serious research has been done on sequencing.
- Parting thoughts:
  - Are the five arguments above exhaustive, complementary, or mutually exclusive?
  - Can we say anything specific about time horizons?
  - Could the five explanations be used for scenario planning?

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