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# **The Political Economy of the Proliferation of FTAs<sup>+</sup>**

Yung Chul Park<sup>\*</sup>  
Korea University

Shujiro Urata<sup>\*\*</sup>  
Waseda University

Inkyo Cheong<sup>\*\*\*</sup>  
Inha University, Korea

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<sup>\*</sup> yungcp@korea.ac.kr

<sup>\*\*</sup> surata@nifty.com

<sup>\*\*\*</sup> inkyo@inha.ac.kr

## **I. Introduction**

There has been a concerted movement toward freer, if not free, trade in East Asia since the early 1990s. Berg and Krueger (2003) show that individual countries in the region have achieved a great deal in reducing tariffs and lowering the non-tariff barriers. In parallel with domestic trade liberalization East Asian countries have mounted collective efforts for region wide free trade. In 1993 the ASEAN states agreed to establish an ASEAN free trade area (AFTA). They managed to reduce tariffs to a maximum of five percent among the original six members and brought into AFTA the four new members in 2003. In 1995, APEC leaders proposed a plan for bringing about free trade in Asia and Pacific by 2020 in what is known as the Bogo declaration.

Trade liberalization in individual countries as well as the regional movement for economic integration has contributed to a large increase in intra-regional trade in East Asia. In terms of imports, intra-regional trade (ASEAN+3 and Taipei, China) accounted for 46 percent of the region's total trade in 2001, when the entire region was still recovering from the crisis, up from 36 percent about a decade earlier. There is every indication that this trend will continue.

The most notable development in the process of trade integration has been the economic ascent of China: it has replaced the U.S as the most important destination of exports of all East Asian countries. Unlike other large countries, China exports a large share of its output. In recent years, its exports as a share of GDP have risen to almost 25 percent of GDP, twice the average share of other large countries. China has followed an export-led growth strategy but unlike other East Asian countries its demand for imported raw materials and other intermediate and final goods is expected grow as fast as its exports. Assuming China is able to sustain the current rate of growth, it will be the engine of growth of intra-regional trade in and reduce the dependence on the US market of East Asia.

In recent years, the APEC movement for the region wide free trade has lost its momentum and has given way to a major proliferation of bilateral free trade agreements (FTAs). ASEAN has been negotiating or discussing a number of bilateral FTAs with

other Asian countries, notably with China, Japan, and Korea, and also with the US and India from outside the region. Of the ASEAN states, Singapore has been most aggressive, as it is prepared to talk to just about anyone willing to negotiate an FTA.

Japan has taken a two-track approach in conducting negotiations for bilateral FTAs with Asian countries. In November 2002, it concluded a free trade agreement with Singapore and also signed with ASEAN a joint declaration to negotiate a framework for a comprehensive economic partnership that includes a free trade agreement. Since then, Japan has approached individual members of ASEAN such as Philippines and Thailand for a bilateral FTA. Japan and Korea have also been exploring the possibility of forming a bilateral free trade area.

Not to be outdone by Japan, China has been equally active in courting other Asian countries for bilateral FTAs. On November 4, 2002, China and ASEAN agreed on a framework to set up a large free trade area that would have a total GDP of nearly \$2 trillion. The two sides started negotiation in 2003. At a Northeast Asian summit meeting at the ASEAN+3 summit talks in November 2003, China proposed a study on a three-way free trade agreement involving China, Japan, and Korea. It has also indicated its interest in a China-Korea FTA. China's eagerness for forging free trade ties with ASEAN, where Japan has invested heavily for the past four decades, may turn the region into an economic battleground between the two countries.

If China and Japan succeed in concluding their negotiations with neighbouring East Asian countries for bilateral FTAs, they may lead to hub and spoke trade arrangements in East Asia in which as major economic powers they will emerge as hubs (Baldwin 2003). Although China and Japan may be natural hubs, ASEAN has been at the center of the movement to bilateral FTAs in East Asia. Indeed, ASEAN has been a partner other countries most sought after for bilateral FTAs: China Japan, Korea, U.S. and India have courted it. ASEAN is most likely to conclude its bilateral FTA first with China, second with Japan, and much later with other countries including the U.S. and Korea. Since the ASEAN - China FTA will be the most significant one, it will serve as a basic framework for similar agreements for other countries. ASEAN knows very well

that it could easily be marginalized as a spoke in either China's or Japan's network of bilateral FTAs. In order to avoid this marginalization and to gain access to other export markets, ASEAN has been willing to negotiate a similar FTA agreement with the US and India. ASEAN and other Asia countries will attempt to join other FTAs or establish an alliance so that they could prevent both China and Japan from taking advantage of their economic leverage by playing China against Japan or vice versa.

The purpose of this paper is to analyze the causes and possible consequences of the proliferation of bilateral FTAs in East Asia. Throughout the paper, our discussion will be directed to finding clues on whether the bilateral FTAs in Asia that are completed or under discussion could be building or stumbling blocks for regional as well as global trade integration. Section II discusses strategies of East Asian countries for negotiating bilateral FTAs to understand better why they have joined the bandwagon of bilateralism. Section III is devoted to an analysis of economic effects of the proliferation of FTAs. Section IV and V examine market access and rules of origin in East Asian bilateral FTAs. This analysis is expected to help us predict whether East Asian countries will end up creating a convoluted noodle bowl, hub and spoke systems of bilateral FTAs or a single regional FTA in the end as they are entering into negotiations for a multiple of overlapping bilateral FTAs at the same time. This is followed in section VI by an assessment of the effect of East Asian bilateralism on economic integration in East Asia. Concluding remarks are in a final section.

## **II. Strategies of East Asian Countries for Negotiating FTAs**

### **II-1. Recent Developments of FTAs in East Asia**

Until recently, East Asia was not active in the formation of regional trade agreements (RTAs), which include FTAs and customs unions (Table II-1)<sup>1</sup>. Indeed,

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<sup>1</sup> In the GATT/WTO, regional trade agreements (RTAs), which violate one of its basic principles of non-discrimination, are permitted under GATT Article XXIV with several conditions, which include liberalization of substantially all the trade of the members, not increasing trade barriers on non-members,

ASEAN Free Trade Area (AFTA) was the only major FTA until Japan and Singapore enacted JSEPA in 2002. AFTA was established in 1992 with six ASEAN member countries: Indonesia, Malaysia, the Philippines, Singapore, Thailand, and Brunei. New ASEAN members - Cambodia, Laos, Myanmar, and Vietnam - joined AFTA in the latter half of the 1990s, and currently AFTA has 10 member countries.

Table II-1. Major FTAs Involving East Asian Economies

In Action	In Negotiation	Under Study
Bangkok Treaty (1976)	Japan-Mexico*	Japan-ASEAN
AFTA (1992)	Japan-Korea	Korea-ASEAN
Singapore-New Zealand (2001)	Japan-Malaysia	Korea-Australia
Japan-Singapore (2002)	Japan-Thailand	Korea-New Zealand
Singapore-Australia (2003)	Japan-Philippines	Singapore-Chile
Singapore-EFTA (2003)	Korea-Singapore	Singapore-Taiwan
Singapore-US (2004)	Singapore-Canada	ASEAN-India
Korea-Chile (2004)	Singapore-Mexico	ASEAN-US
China-Hong Kong (2004)	Singapore-India	ASEAN-EU
Taiwan-Panama (2004)	Thailand-India*	ASEAN-CER
	Thailand-US	
	Thailand-Australia	
	Hong Kong-New Zealand	
	China-ASEAN*	

Note: '\*' indicates conclusion of the negotiation.

Source: Country sources

Among the East Asian countries, ASEAN as a group and its members individually have taken a great deal of interest in negotiating new FTAs with countries within and without the region since 2002. One of the FTAs involving ASEAN that has

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and completing the RTA process within ten years. For developing countries, more lenient conditions are applied under the enabling clause. An FTA is considered to be a shallow form of regional integration, because it only removes tariff and non-tariff barriers among the members, while a customs union is a deeper integration, as it adopts common external tariffs on non-members, in addition to the removal of tariff and non-tariff barriers on trade among the members.

received most attention recently is that with China. ASEAN and China began FTA negotiations in January 2003 and signed an agreement on an FTA concerning trade in goods in November 2004. They are scheduled to move on to FTA negotiations concerning trade in services and investment in 2005. ASEAN has agreed to begin FTA negotiations with Japan and Korea respectively in 2005. Several ASEAN members have sought to establish bilateral FTAs independently of the ASEAN's FTA negotiations. Singapore enacted or signed several FTAs with countries such as New Zealand, Japan, Australia, the USA, the EFTA, and have entered negotiations with Korea and India. Thailand is currently under negotiation similar agreements with the USA and Japan. The Philippines and Malaysia agreed to negotiate with Japan in 2004. Indonesia is expected to do the same with Japan in 2005.

Compared to the ASEAN members, Northeast Asian economies - China, Japan, and Korea - have not been active in seeking FTAs until recently. Although they have shown growing interest in FTAs, the Northeast Asian countries have managed to conclude only three FTAs: Japan-Singapore, Korea-Chile, and China-Hong Kong FTAs.

Sine joining World Trade Organization (WTO) in 2001, China has turned to bilateral FTAs as a means of expanding its trade relations with neighboring countries. China signed a framework agreement on comprehensive economic cooperation with ASEAN in November 2002. Two years later, China and ASEAN concluded negotiations on an FTA. In addition to ASEAN, China has informally proposed Japan and Korea to establish a trilateral FTA among them.

Japan has been more active in courting other countries for FTAs than China. Following the successful FTA negotiation with Singapore in 2002, Japan went on to conclude another FTA with Mexico in 2004. Japan is currently negotiating FTAs with Korea, Malaysia, the Philippines and Thailand. As the same time, it is scheduled to start negotiations with ASEAN in April 2005 and conducting a feasibility study of a possible FTA with Indonesia.

In 1998 Korea announced its plan to start FTA negotiations with Chile and also set up a joint-study group at the private level for an FTA with Japan. The Korea-Chile

FTA was enacted in 2004 after overcoming domestic opposition to liberalization of agricultural imports. Korea is currently negotiating an FTA with Singapore and planning to negotiate another one with ASEAN in 2005.

At the Leaders' Summit meeting of ASEAN+3 in 1998 the East Asian leaders agreed to create an East Asia Vision Group (EAVG), and an East Asian Study Group (EASG) two years later. The mandate for the EAVG, which composed of private sector experts, was to develop long-term visions for economic cooperation in East Asia. The EAVG presented the leaders with its recommendations in 2001, which included establishment of an East Asia FTA (EAVG 2001). The EASG, consisting of government officials, gave a positive assessment of the EAVG recommendations by acknowledging the potential role an East Asia FTA could play for trade and FDI liberalization in East Asia.

The recommendation for an East Asian FTA has not seen the light: it has not been included in the agenda of regional issues at leaders' meetings. The East Asian leaders have been reluctant to take up an East Asian FTA as they are faced with strong opposition to it from non-competitive sectors in their domestic economies. More importantly, no country has been willing to provide leadership needed for creating an East Asian FTA. However, the activities of EAVG and EASG were followed-up by establishing the 'Network of East Asian Think-Tanks (NEAT)' in 2003. NEAT, which is supported by the ASEAN+3, is to continue dialogue and deepen mutual understanding among the members. Meetings were held in 2003 and 2004 to discuss issues related to forming an East Asian Community, of which an East Asia FTA is an important component.

It should be noted that many of the FTAs discussed in this study cover not only liberalization of trade but also various types of economic cooperation. As such, some of the FTAs established in East Asia are termed as Economic Partnership Agreement (Japan-Singapore EPA), or Closer Economic Partnership Arrangement (China-Hong Kong CEPA). These new types of FTAs typically include facilitation of foreign trade, liberalization and facilitation of foreign direct investment (FDI), and economic and

technical cooperation, in addition to trade liberalization. It may be worth noting that the basic philosophy of these new types of FTAs is similar to that of Asia Pacific Economic Cooperation (APEC) forum, whose three pillars are (1) liberalization and (2) facilitation of foreign trade and foreign investment, and (3) economic and technical cooperation.

## **II-2. Factors behind the Proliferation of FTAs in East Asia**

One can identify various factors that have led to a rapid expansion of FTAs in East Asia. Some of these factors are common to many countries, while others are country specific. We identify the common factors in this section and specific ones in the next section.

First, a rapid expansion of FTAs in other parts of the world has prompted East Asian economies to form FTAs in order to maintain and expand market access for their exports. The number of FTAs rose rapidly around 1990. By the mid-1990s the world's leading economies except those in East Asia had become members of FTAs. Indeed, both of the world's two largest economic regions - North America and Western Europe - formed FTAs. This development raised to many East Asian economies specter of losing their export markets in both regions.

Second, the slow progress in multilateral trade liberalization under the WTO has been responsible for the proliferation of FTAs not only in East Asia but also in other parts of the world. Despite the multilateral efforts of many years' standing, trade liberalization under the WTO has become increasingly difficult and come to a halt. With the increase in the number of WTO members, views on the pace and the extent of trade liberalization have diverged. The increasing difficulty in reaching a consensus delayed the start of a new round.

Although an agreement was reached in Doha to launch a new round, the new round has failed to initiate substantive negotiations. It was only July 2004 that the modality of the negotiations was more or less agreed. Faced with the difficulty in pursuing trade liberalization on the global scale, many countries in other parts of the

world have opted to form FTAs with like-minded countries to open their trade regimes. Unless they join existing or create new FTAs, it was quite possible that East Asian countries could jeopardize their access to foreign markets. To overcome the possible discrimination and to secure markets for their exports, East Asian countries have become active in forming FTAs.

It should also be noted that the GATT/WTO rules could not adequately deal with newly emerging international economic activities such as FDI, service trade, mobility of labor, and others. Liberalization of border measures such as tariffs, which are the main focus of the GATT/WTO, is not adequate enough to provide foreign as well as domestic companies with the level-playing field. It is necessary to go deeper beyond the border measures and to set up the rules governing domestic markets such as competition policy, which the GATT/WTO cannot provide.

Third, some of the East Asian economies have sought to rely on external pressure FTAs can generate on promoting deregulation and structural reform of their economies. By the early 2000, domestic economic reforms in many East Asian economies had slowed down considerably, and FTAs were viewed as providing an avenue of breaking out of the stalemate.

Fourth, depending on their characteristics, FTAs could serve as channels of cooperation and mutual assistance between countries. Indeed, as noted earlier, some of the existing FTAs and prospective ones in East Asia include not only trade liberalization, but also trade and FDI liberalization and facilitation and economic and technical assistance. These features of the FTAs could lay the foundation for financial cooperation and policy coordination in general.

Fifth, an intensifying rivalry between China and Japan for the leadership role in East Asia has made choose an FTA strategy to strengthen their relationships with ASEAN and the NIEs. ASEAN and the NIEs themselves have come to use FTAs as a means of maintaining their economic influences in East Asia. These political factors, which differ from country to country, are taken up in the next section where we examine FTA strategies of individual East Asian countries.

### **II-3. FTA Strategies of East Asian Countries**

- **ASEAN**

Several motives lie behind ASEAN's decision to establish AFTA in the early 1990s. One was a rapid and substantial expansion of regional trade agreements in Western Europe and North America. Faced with the emergence of new trading blocs, ASEAN realized the need to expand intra-ASEAN trade by enlarging its internal market. Another factor was the emergence of China as a major regional trade, which quickly became a competitor. In attracting inward FDI and promoting export expansion, ASEAN countries chose to create a large integrated internal market as a defensive measure. The currency crisis in 1997-98 underscored the need to speed up the AFTA process for a collective defense against future financial crises. As a result, the target year of the completion of AFTA was moved forward. Continued rapid economic growth of China, which presented a stark contrast to low economic growth of ASEAN countries, provided added pressure on ASEAN to accelerate the AFTA process as well. Despite an emerging consensus among ASEAN members on the need to achieve a truly free trade area as soon as possible, opposition from protected industries such as automobiles in Malaysia has interfered and delayed the integration process.

Besides AFTA, ASEAN has been actively involved in forming FTAs with non-ASEAN countries in East Asia. As noted above, China was the first country to approach ASEAN for a bilateral FTA. In the beginning many ASEAN countries regarded China as a threat, because of China's growing competitive edge, and thus ASEAN's response was rather passive. However, their attitude toward China has become more active as it promised a huge market for their exports. In addition to the export market, China also offered various incentives such as an early harvest, or an advanced trade liberalization, in agricultural products and economic assistance to new ASEAN members. Despite the positive change in their attitude toward China as an FTA partner, ASEAN has indicated its interest in establishing FTAs with Japan and Korea, partly to balance strong

influence of China. Indeed, ASEAN is keen on becoming a hub of FTAs in East Asia. Knowing the difficulty for both China and Japan to lead the FTA movement because of their legacies of war and invasion and the continuing rivalry ASEAN sees an opportunity fill the leadership vacuum.

It is also important to realize that ASEAN has not confined its search for FTA partners in East Asia. They have been negotiating with countries outside East Asia such as Australia, New Zealand, and India. One may interpret ASEAN's FTA to non-East Asian countries as ASEAN's effort to enhance its bargaining power in an integrated East Asia, which is likely to be dominated by China and Japan. Among the ASEAN members, Singapore and Thailand, which have been active promoters of FTAs, attempt to use ASEAN's FTAs with non-ASEAN members to put pressures on other ASEAN members to consolidate and deepen integration of AFTA, within other countries are less forward-looking because they are concerned with the possible domestic backlash against the proposed FTAs.

#### ● **China**

China's FTA strategy has received a lot of attention in recent years. China gained access to the world market by joining the World Trade Organization (WTO) in 2001. Since then, it has also pursued a strategy of forming FTAs with neighboring countries. Hai and Li (2003) pointed out two economic factors behind China's interest in FTAs. One is to maintain and expand its export markets and the other is to reduce adjustment costs for trade liberalization committed as a condition for its entry to the WTO. Faced with the increase in FTAs in North America and Europe and in protectionist measures against Chinese exports, particularly in the form of antidumping charges, China took FTAs as a defensive solution.

China's choice of ASEAN as the first FTA partner is largely attributable to the following two factors. One is the relative ease in establishing an FTA with ASEAN compared to Japan or Korea, as China and ASEAN share similar structural characteristics. China also regards ASEAN as an attractive market for their export and

FDI because of ASEAN's huge population and growing economy. Another reason is to secure supply of energy and other natural resources, which China badly needs. There are also geopolitical factors that have shaped China's FTA strategy: China's security interest dictates maintaining peaceful and stable relationships with ASEAN. China also knows that its FTA with ASEAN will enhance its economic and political clout in East Asia.

### • Japan

Japan's FTA strategies can be characterized as passive for several reasons<sup>2</sup>. First, Japan did not initiate FTA discussions until it proposed ASEAN to establish an FTA in November 2002. Indeed, it was Singapore, Mexico, and Korea that proposed Japan to study possibilities of FTAs in the late 1990s. Until that time, Japan regarded trade negotiations under the multilateral GATT/WTO framework desirable, and thus it had a negative view on FTAs. Even though Japan initiated FTA negotiations with ASEAN, Japan did so in response to China's FTA approach to ASEAN.

Several motives of Japan's FTA strategies can be identified. First, a greater access to foreign markets is one of the important motives that aroused Japan's interest in FTAs. For internationally competitive Japanese firms, it is very important to have more business opportunities when competing with foreign companies. For example, FTAs with East Asian countries including Korea, Thailand, Malaysia and the Philippines would increase Japan's exports to these countries, which are presently protected with high tariff and non-tariff barriers. In addition, Japanese firms could expand their business in FTA member countries via FDI as FTA includes not only trade but FDI liberalization.

The market access motive has been important for its FTA with East Asian countries, as they are expected to grow economically in the future. The market access motive clearly played an important role for Japan in pursuing FTA with Mexico as well. Thanks to the NAFTA and EU-Mexico FTA, EU and US firms can export their products to Mexico without tariffs, while Japanese firms have to pay high tariffs to export their products to Mexico. These observations indicate the pressure from the business sector

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<sup>2</sup> See, for example, Urata (2003) for discussions on Japan's FTA strategy.

that played an important role in promoting FTAs for Japan.

Another motive for Japan to pursue FTAs is to stimulate structural reforms that are essential to revitalize the currently stagnant Japanese economy. In the past Japan had made use of international frameworks (e.g., GATT and OECD) and external pressures (especially, pressures from the United States) to reform its domestic structures through trade liberalization. Indeed, structural reform contributed significantly to improve competitiveness of Japanese manufacturing sector. However, in the latter half of the 1990s, liberalization was getting more difficult under the WTO framework because of slow progress in trade liberalization.

Faced with a lack of external pressures, especially from the WTO's multilateral trade negotiations, Japan became interested in FTA as one of the policy options to promote structural reform. Japan came to look at FTA in a positive perspective, because it found that the EU and NAFTA promoted structural reforms in member countries.

Possible contribution for the promotion of economic growth in East Asia is yet another motive for Japan's FTA strategy, whose focus is East Asia. This motive can be understood by the contents of FTAs sought by Japan. Japan has pursued to establish comprehensive FTAs, which have not only trade and FDI liberalization and facilitation, but also various types of economic cooperation such as human resource development and development of small and medium-sized enterprises. With these economic cooperation programs Japan hopes to promote economic growth in East Asia, which would lead to not only economic prosperity but also social and political stability.

Finally, similar to the case of China, Japan uses FTAs as a means of conducting regional policy. In particular, Japan is interested in establishing an environment under which Japanese firms can conduct business freely. By successfully concluding FTAs, Japan would like to see not only free trade and investment environment through trade and FDI liberalization in East Asia but also a region with harmonized systems in business areas of technical standards, patent systems, and others through trade and FDI facilitation.

Before ending the discussion on Japan's FTA strategy, it should be noted that

opposition from non-competitive sectors such as agriculture as well as from labor unions against liberalization of labor market for nurses and medical care providers has made it difficult for Japan to pursue its FTA strategy.

#### • Korea

As noted earlier, Korea was the first Northeast Asian country that explored the possibility of forming FTAs. Being sandwiched between China and Japan, not only geographically but also economically and politically, Korea has always been keen on maintaining its position as a balancer between the two countries. Indeed, Korea has been an active advocate of an FTA involving China, Japan, and Korea. Many also believe that a trilateral cooperative arrangement with both China and Japan could be utilized in facilitating its unification North Korea.

Like other East Asian countries, Korea saw its exporting environment worsen as the number of FTAs around the world grew rapidly toward the end of the 1990s.<sup>3</sup> Because Korea's dependence on exports is quite high, it realized the need to secure its export market by establishing its own FTAs,

Another motive for establishing FTAs is to facilitate both inward and outward FDI. FDI inflows to Korea had been very small, partly because of its protection policy before launching bilateral reform after the 1997-98 crisis. It is expected that FTAs with high-income countries would bring more FDI into the economy.

Similar to the situation in Japan, strong opposition from non-competitive sectors has slowed down Korea's pursuit of FTA strategies. Opposition groups differ from FTA to FTA. In the case of the Korea-Chile FTA it was the agriculture sector, while in the case of the Korea-Japan FTA manufacturing sectors, in particular, small and medium sized manufacturing firms rose up in arm.

### III. Economic Effects of FTAs

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<sup>3</sup> See Cheong (2003b) for the discussions on Korea's FTA strategies.

### **III-1. Theoretical Considerations**

One can classify the economic impacts of FTA into two groups: static effects and dynamic effects<sup>4</sup>. Static effects include “trade creation effect,” “trade diversion effect” and “terms of trade effect,” while the dynamic effects are “market expansion effect” and “competition promotion effect.” “Trade creation effect” means that FTA eliminates trade barriers on trade among FTA members and, therefore, creates trade among them. “Trade diversion effect” means that FTA would replace imports of highly efficient non-member countries by imports from less efficient FTA members. “Terms of trade effect” represents that FTA would expand trade volume among its parties and reduce trade with non-members, resulting in strengthening the parties’ influence on non-members and, then improve their terms of trade. “Market expansion effect” represents that trade barrier elimination among members would expand market size to achieve efficient production/distribution by realizing economies of scale. “Competition promotion effect” means that market integration would make oligopolistic industries more competitive and achieve higher productivity by introducing competitive pressures.

From the viewpoint of FTA members, the “trade creation effect,” “terms of trade effect,” “market expansion effect,” and “competition promotion effect” will give positive impacts. However, “trade diversion effect” would have adverse effects on them under certain circumstances. On the other hand, from the viewpoint of non-members, the trade diversion effect and terms of trade effect will give negative impacts, while other effects tend to have positive impacts on them. If FTA expands market size, promotes competition, and encourages economic growth in member countries, its positive effects will spread out to non-members as well. FTA option is recently gaining popularity, because governments expect FTAs to realize positive dynamic effects. However, if a country gives preferential treatment only to certain trade partners, other countries might form exclusive economic blocs in order to countervail “trade diversion

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<sup>4</sup> For the impacts of FTAs, see, for example, Winters(1991).

effects” created by such preferential treatment. In this case, the world economy will suffer from significant adverse effects like what happened during the Inter-War era.

Recognizing the negative impacts of trade diversion and of excluding non-members, one argues that FTA should cover many countries and include some highly competitive countries because such FTA will be able to minimize possible negative impacts from the trade diversion effect<sup>5</sup>. This observation indicates the importance of successful multilateral trade negotiations under the WTO. Indeed, it is the optimal outcome. However, under the circumstance that WTO process has faced problems, despite its second or third-best nature, FTAs can be a viable option. Besides, FTAs have some favorable impacts that cannot be achieved through the WTO process, as discussed in section II. Specifically, FTAs cover not only trade liberalization, but also FDI liberalization and facilitation, and economic cooperation, which are not incorporated in the WTO rules.

In addition to the impacts on trade, FTA also affects foreign direct investment (FDI). As FTA eliminates regional trade barriers and expands the market size, FDI will flow into the regional market, hoping for selling more products. In addition, if FTA enables firms to conduct efficient production in the region, foreign firms will undertake investments in the region to take advantage of favorable production environment, in order to export their products. This is called FTA’s investment creation effect. Investment may be undertaken in member countries at the expense of investment in non-member countries because of increased attractiveness of member countries for investment. This is FTA’s investment diversion effect.

### **III-2. Review of Empirical Studies**

Many empirical studies have been conducted on the economic impacts of FTAs. A large number of studies have examined the impacts on foreign trade, that is, on the issue of trade creation and diversion. According to Schiff and Winters (2003), which

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<sup>5</sup> See Schiff and Winters (2003) for useful discussions on the dos and don’ts of regional trade agreements.

conducted detailed empirical analysis on the subject, for FTAs involving developing countries trade creation was substantial while trade diversion was either non-existent or small. However, for FTAs involving developed countries such as the EU and the EFTA they observed strong impact of trade diversion. They attributed the differences in these findings between FTAs involving developing and developed countries to the differences in their trade policies vis-à-vis non-FTA members for the periods under study. Specifically, with respect to non-FTA members, developing countries liberalized their trade regimes substantially, while developed countries did not undertake substantial trade liberalization as their protection level had already been reduced to very low level. Schiff and Winters (2003) interpreted the results on developing countries to indicate that it was non-discriminatory trade liberalization, rather than FTA, that contributed to trade expansion.

Turning to the dynamic effects of FTAs, Schiff and Winters (2003) found very few ex-post empirical studies, largely because of the difficulty in obtaining the statistics necessary to carry out the studies and because of the difficulty in isolating the impacts of FTAs from other factors. Schiff and Wintrens (2003) report the results of the analysis, which were conducted by simulation analyses based on computable general equilibrium (CGE) models. According to these studies, there is potentially dynamic gain from FTAs. However, they caution that gains cannot be expected automatically from tariff reduction alone. It is important to lower barriers to entry to the market through such measures as FDI liberalization.

### **III-3. Potential Economic Impacts of FTAs in East Asia: A Review of Simulation Analysis**

Policy makers as well as researchers have shown a great deal of interest in assessing the economic impacts of FTAs in East Asia, which requires sophisticated empirical studies. However, many of FTAs in East Asia are too short in existence to obtain necessary information. In the absence of the information needed, this study relies

on simulation analyses. In this section we report the impacts of FTAs in East Asia, which are based on two types of CGE models<sup>6</sup>. One is the GTAP model and the other is the Michigan model. The GTAP model has been modified to incorporate a variety of interesting features such as international capital mobility; we review the results from two applications of the GTAP model, one with standard features including perfect competition and constant returns to scale production and the other with additional features including investment dynamics, pro-competition effect and international capital mobility. The Michigan model incorporates scale economies and imperfect competition.

We examine the impacts of FTAs on foreign trade and GDP by reviewing the earlier studies. The impacts of FTAs on trade will be examined from both global and regional perspectives. If an FTA increases global trade, an FTA is likely to result in a situation where trade creation is greater than trade diversion, thereby leading to an improvement in economic welfare for the world as a whole.

Scollay and Gibert (2001) obtains positive impacts of FTAs on world trade for all FTAs (29 combinations of different members) they examined, indicating that trade creation is greater than trade diversion. They also found that international trade of non-members decline as a result of FTAs, indicating trade diversion. For an ASEAN+3 FTA they found that the export value of the members increase by 20.34 percent, while that of non-members decline by 0.65 percent, resulting in an increase in world export value by 4.14 percent. It is important to emphasize that the larger FTAs in terms of membership would lead to a larger increase in global trade. Global trade liberalization would increase world export value by as large as 23.23 percent.

Urata and Kiyota (2003) also examine the impacts of East Asian FTA (ASEAN+3 + Hong Kong + Taiwan) on regional trade. They found the increase in intra-regional trade disproportionately compared to extra-regional trade, as expected. Specifically, the share of intra-East Asia trade in world trade would increase from 11

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<sup>6</sup> It should be noted that CGE models, as other models, suffer from several shortcomings, necessitating caution in interpreting the results. Some of the shortcomings include the followings. Specification of behavioral relationships is very simple, possibly missing intricate but important relationships. Parameters used in the model are generally not obtained from actual observations but based on educated guesses. Sectoral aggregation is rather broad, masking detailed variations. These problems of CGE models do not condemn such models, but they imply caveats.

percent to 14 percent, and the shares of intra-East Asia exports (imports) in East Asia's total exports (imports) would increase from 44 (50) percent to 53 (59) percent. They also report that trade intensity index would increase from 2.02 to 2.17 as a result of forming an East Asia FTA.

The findings from CGE model simulation exercises imply that FTAs would increase welfare of members and the world as they would increase international trade of the members as well as that of the world, while FTAs tend to reduce welfare of non-members as they lead to a reduction in foreign trade of non-members.

Table III-1. Impacts of FTAs on GDP (%)

FTA members	East Asia	ASEAN, China, Japan	East Asia
	Urata- Kiyota	Kawasaki	Kiyota
Australia/New Zealand	-0.23	--	0.1
China	1.27	3.68	2.9
Hong Kong	1.41	--	2.4
Japan	0.05	0.79	1.0
Korea	1.71	--	3.4
Taiwan	1.51	--	3.4
Indonesia	5.61	4.08	1.8
Malaysia	2.83	10.79	5.7
Philippines	2.02	4.67	3.7
Singapore	2.26	5.66	8.1
Thailand	15.90	27.16	6.1
Vietnam	8.42	19.65	--
Other Asia	-0.31	--	0.0
United States	-0.06	--	0.0
EU	-0.01	--	0.0

Note: The figures indicate the percent change from the base.

Source: Urata and Kiyota (2003), Kawasaki (2003) and Kiyota (2004)

Table III-1 shows the results of three CGE model simulations, which incorporate different features as noted above. Urata and Kiyota (2003) undertakes a standard application of GTAP model with perfect competition and constant returns to scale, while Kawasaki (2003) incorporates some “dynamic” effects including capital accumulation and the productivity enhancement effect of trade liberalization. In addition, Kawasaki (2003) allows international capital movement. Kiyota (2004) uses the Michigan model.

Three simulation results show that FTAs have positive impacts on members, while they have either relatively small negative impacts or almost no effects on non-members. As to the magnitude of the impacts, the standard static simulation by Urata and Kiyota yield smaller impacts than the other two simulation results, which incorporate “dynamic” factors. For example, for China East Asia FTA would increase its GDP by 1.27 percent if only static impacts are considered, while the impacts would be greater at 2.9 percent, if imperfect competition and scale economies are considered. The impacts will be even greater at 3.68 percent, if pro-competition effect, investment effect, and international capital mobility are considered. Similar differences in the magnitude of the impacts can be found for other countries, although the magnitude and the order of the magnitude of the impacts differ among countries.

The magnitude of the economic impacts of FTAs differs among the members. A casual observation indicates that the impacts would be large for a country with high trade dependency and/or high import protection. Compared to other members, Thailand, which is shown to register large gain in GDP from FTAs, has relatively high trade dependency and high import tariff protection, while Japan, which is estimated to have small gains, has low trade dependency and low tariff protection except for a few products including agriculture and food.

Our review of the simulation studies indicates that FTAs would yield positive economic impacts on FTA members, while the impacts on non-members may be negative. The simulation results confirm a very important policy implication that the benefits from FTAs would increase with the membership, indicating that world-wide

trade liberalization will be optimum for all countries.

Before closing this section on the impacts of FTAs by simulation models, one should note that the existing models do not incorporate the problems, which may arise from different definitions of rules of origins used in different FTAs, or the Spaghetti bowl effect. This was not a problem in our review of the literature in this section, since we only analyze the impacts of one FTA such as East Asia FTA. However, negligence of this effect would be a problem when we analyze the situation where a number of FTAs with different rules of origins are formed.

#### **IV. Market Access in Major FTAs**

GATT Article IVXX specifies requirements for regional trading blocs to be eligible for exemption from the GATT/WTO most-favored nations (MFN) principle. It states that “duties and other restrictive regulations of commerce...are eliminated with respect to substantially all the trade between the constituent territories of the union or at least with respect to substantially all the trade in products originating in such territories.” It was GATT Article IVXX that was the most controversial to construe. Indeed, it was difficult to converge how to quantify “substantially all” of total trade among the member states<sup>7</sup> and a deadline for eliminating tariffs and non-tariff barriers. Moreover, there are also differences over whether tariffs should be totally eliminated and how many of the non-tariff barriers should be included within the trade liberalization package. Even the Committee on Regional Trade Agreements in WTO has not been able to reach a conclusion over this controversy. Even though there are differences in the degree of trade liberalization, most of the FTAs have achieved substantial trade liberalization. This chapter will analyze the coverage of tariff elimination in major FTAs.

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<sup>7</sup> WTO (2002) cautiously mentions that “a threshold has been proposed at 95 percent of all HS tariff lines at the six-digit level, to be complemented by an assessment of prospective trade flows at various stages of implementation of the RTA, thereby allowing the incorporation of cases where trade is initially concentrated in relatively few products.”

FTAs include the elimination of not only tariff barriers, but also non-tariff barriers. Moreover, some FTAs include more advanced trade rules than found under the multilateral trade system. For example, disciplines on the prohibition of export duties are clearly declared in some regional trade agreements (in contrast to the WTO and other forums), including NAFTA, EU-Mexico FTA, Australia and New Zealand Closer Economic Relations Trade Agreement (ANZCERTA) and the Economic Partnership Agreement between Japan and Singapore (JSEPA).<sup>8</sup>

There are many cases of member states taking conservative positions toward tariff elimination notwithstanding the recognition that trade liberalization will be beneficial to their economies. They have made exceptions in liberalizing sensitive items and have introduced a long-term implementation for tariff eliminations. On the other hand, ANZCER and the Singapore-Australia FTA stipulate complete tariff elimination. Both agreements indicate that each party shall eliminate all customs duties on goods originating in the territories of the other party that meet the requirements for the rules of origin specified in respective agreements. However, most of the agreements permit exceptions. This chapter analyzes the content of trade liberalization focusing on tariffs to provide implications for regionalism in East Asia.

#### ● ANZCER

Australia and New Zealand have strengthened their economic relations with their bilateral FTA, which is Australia-New Zealand Closer Economic Relations (ANZCER). Twenty years ago, the two countries needed to respond to the new emerging world trading environment. First, Britain, which was the most important trading partner for both countries, had entered the European Community, and the prices of commodities on which they heavily depended had fallen permanently. With two oil shocks, the global trading environment became unstable. Investment in new plants and technology for regional and global markets required economies of scale that only a

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<sup>8</sup> NAFTA allowed export taxes on Mexican basic foods, as set out in Annex 314 of NAFTA. See OECD (2003) for the prohibition of export duties in regional trading blocs.

regional market could provide. As a result, it was natural for the two neighboring countries to seek closer economic relations.

ANZCER is a free trade agreement between Australia and New Zealand that is commonly known as the CER Agreement. The agreement was signed on 14 December 1982 and entered into force on 1 January 1983. Although the ANZCER agreement now covers trade in all goods (Chapters 1-97 of the Harmonized System, HS), it had limited coverage when it was introduced in the early 1980s. Trade in goods was more liberalized with the 1988 Protocol on Acceleration of Free Trade in Goods (fully implemented on July 1990), and all tariffs and other duties and charges were removed under the CER Agreement (with the exception of goods subject to excise). This provision is contained in Articles 4 and 5 of the 1983 CER Agreement and Articles 1 and 2 of the 1988 CER Protocol on the Acceleration of Free Trade in Goods, under which all transitional arrangements and temporary exceptions to the basic free trade rule were eliminated as of 1 July 1990.

Australia and New Zealand were able to achieve substantial bilateral trade liberalization in the early 1980s, as they had already activated the debate on preferential trade liberalization and there were fewer domestic obstacles to bilateral trade liberalization. Moreover, the two countries have similar trade systems, thus it was expected that intra-industry trade could be enlarged and trade liberalization was politically less sensitive. In addition, they adopted a step-by-step approach in liberalization. At first they permitted tariff concessions with many exceptions, and thereafter, they gradually elevated the degree of liberalization. Another reason the two countries were able to facilitate an agreement with ease was their similarities in trade structure as well as their status as advanced countries.

#### ● **NAFTA**

NAFTA has been effective since 1 January 1991 with the U.S. Congress approving the final agreement in November 1993. The United States, Canada and Mexico first started official negotiations for a trilateral FTA in North America in June

1991. Facilitating this trilateral cooperation, and thus promoting their respective national competencies, was the combination of U.S. capital, Mexican labor and resources, and Canada's resources and technology.

NAFTA has mainly been pushed by the United States, which is the strongest supporter of the multilateral trading system. The United States had wanted to build a fair and free trading environment under worldwide negotiations for trade liberalization but was not satisfied with the progress of the Uruguay Round, which was the last global round of negotiations under the GATT system.

Prior to the agreement's entry into force, the three countries were important trade partners for each other, with bilateral trade among them slightly higher than trade with any other single trading partner. NAFTA was the first comprehensive agreement to include not only tariff elimination among member countries, but also various economic issues such as services, investments, trade regulations, economic cooperation, environments and labor. Moreover, it also represents substantial liberalization in most traded goods. NAFTA classified almost all products into four categories, and the majority of these products were scheduled to be liberalized within 10 years, with a maximum 15 years for import-sensitive items.

Table IV-1. Market Access in NAFTA

Category	Share (%)	Tariff Elimination	Eligible Items by Country		
			United States	Canada	Mexico
A	50	1994.1.1 (Immediate tariff elimination)	Approx. 7,300 items - Computers, communication equipment, aviation equipment, medical supplies	Approx. 4,200	Approx. 5,900 - Machinery, electronic equipment, transportation machines (except automobiles)
B	15	1998.1.1 (4 years)	Approx. 1,200 - textiles, automobiles	Approx. 1,400	Approx. 2,500

C		2003.1.1 (10 years)	Approx. 700	Approx. 1,600	Approx. 3,300
C'	35	2008.1.1 (15 years)	Approx. 60 - Ceramic tiles, glass, watch part, sugar, winter vegetables	Dairy products, poultry	Corn, edible beans, dairy products

Source: CBO (1993), *A Budgetary and Economic Analysis of the NAFTA*

According to CBO (1993), NAFTA seems to eliminate tariffs in all products, but the agricultural sector was not fully covered by the agreement (contained in Chapter 7 of the agreement). Representing less than one percent of total intra-trade by volume, these exceptions were excluded from full elimination of tariffs under NAFTA. About 97 percent of the member countries' tariff lines (at the 8-digit level) were subject to full tariff elimination, representing more than 99 percent of intra-trade by volume.<sup>9</sup> NAFTA is an agreement that abolished tariffs, and removed quotas and the import permission system in principle; however, import restrictions are allowed when some measures deal with health, national security and environmental protection.

#### ● EU-MEXICO FTA

The EU and Mexico started to negotiate a free trade agreement in late 1998 and concluded these negotiations in late 1999. The agreement came into effect July 1, 2000. The EU had tried to enlarge and deepen its economic integration within Europe before the agreement, and the EU-Mexico FTA offered the opportunity for the EU to expand its regionalism to non-European regions.

Regarding market access, Section 2 of Articles 5 and 6 of the FTA set out tariff elimination in the manufacturing sector category by category and Appendix I (EU) and Appendix II (Mexico) note tariff elimination categories for each item. In the EU-Mexico FTA, EU divided Mexican commodities into two groups, A and B. Mexican

<sup>9</sup> Based on the CRTA (2000).

exports in Group A were to be tariff-free for the EU immediately at the effectuation of the agreement. Tariffs on Mexican exports in Group B would then be removed gradually over four years until January 1, 2003 (a quarter of applied tariff rates on imports from Mexico to be reduced in January 1, 1999), with 25 percentage points to be removed each subsequent year. Meanwhile, Mexico agreed to a longer period for implementation of its tariff liberalization. According to Appendix II of the agreement, the last day of complete elimination of tariffs is January 1, 2007. EU's exports are classified into four liberalization categories: A (immediate removal of tariffs upon effectuation of the agreement), B (removal of tariffs in four steps leading up to January 1, 2003), B+ (until January 1, 2005), and C (until January 1, 2007).

Consequently, Mexico abolished 46 percent of tariff lines right after the agreement came into effect and will completely remove tariffs on manufacturing sectors on a gradual basis. The EU first removed 67.3 percent of all tariff lines and committed to removing all tariffs by 2003.

Table IV-2. Tariff Elimination on Manufacturing Goods in EU-Mexico FTA

(Unit: HS 8 digit, No. of items (%))

	EU	Mexico
Immediate elimination (A)	5,444 (67.3)	4,380 (46.0)
Step-by-step elimination (B)	2,626 (32.7)	1,054 (11.1)
Step-by-step elimination (C)	0 (0)	4,079 (42.9)
Number of total items	8,090 (100)	9,513 (100)

Source: Author's calculation from the EU-Mexico FTA Agreement.

Market access to agricultural products is presented in Section 3 of Articles 3, 8 and 9 of the EU-Mexico FTA agreement and the schedules for tariff elimination are relatively more complicated than those for manufacturing sectors. It introduces eight categories for agricultural products: categories 1-4 are for immediate or gradual tariff elimination, but items in categories 5-7 and category 0 are scheduled for tariff

elimination after a certain period of time has passed (in the majority of cases, three years later or at the conclusion of the DDA negotiations).

As Table IV-3 shows,<sup>10</sup> the EU under the EU-Mexico FTA plans to liberalize tariffs for over 65 percent of agricultural items (1,659 items out of 2,560), yet the remaining items have been reserved for future discussions on liberalization. Mexico has committed to a similar rate, with 965 items, or 75 percent, of the total 1,302 agricultural tariff lines committed to tariff removal within 10 years after the effectuation of the agreement. However, the remaining 327 agricultural items are not scheduled for liberalization.

Table IV-3. Tariff Reduction on Agricultural Items in EU-Mexico FTA

		(HS 8 digit, No. of items (%))	
		EU	Mexico
Tariff Elimination in 10 Years	Category 1	586 (22.9)	529 (40.6)
	Category 2	437 (17.1)	214 (16.4)
	Category 3	152 (5.9)	136 (10.4)
	Category 4	484 (18.9)	96 (7.4)
Future Liberalization, Quarter, etc.	Category 5	650 (25.4)	319 (24.5)
	Category 6	5 (0.2)	4 (0.3)
	Category 7	145 (5.7)	4 (0.3)
	Category 0	101 (3.9)	0 (0.0)
	Total number of items	2,560 (100.0)	1,302 (100.0)

Note: Category 1: Immediate tariff elimination.

Category 2: Four-year elimination (25% per year).

Category 3: Nine-year elimination (11% per year).

Category 4: Eight-year elimination (beginning three years later after the effectuation of the agreement).

<sup>10</sup> Agriculture in this table includes marine and forestry products.

Category 5-7: Items for future review, allowances of quota, tariff quota system.

Source: Author's calculation from the EU-Mexico FTA Agreement.

Table IV-4 shows the outline of EU's tariff concessions by agricultural HS codes in the EU-Mexico FTA. The reservation (not included in the concession list) rates vary depending on agricultural items. For example, a small number of items are scheduled to liberalize, including meat, dairy products, raw grains, processed grains, processed meat and confectionery.

Table IV-4. EU's Agricultural Tariff Concessions in the EU-Mexico FTA

(Unit: EU's HS 8 digit)

HS	Items	Concession Categories									Note
		Total	1	2	3	4	5	6	7	0	
	Total	2,137	525	231	145	348	599	48	140	101	
1	Living animals	47	13	3	3	17	11	-	-	-	
2	Meat	233	40	18	15	42	118	-	-	-	
3	Fish and clams	-	-	-	-	-	-	-	-	-	Marine products (total 328)
4	Dairy products	175	4	-	-	1	139	7	14	10	
5	Products of animal origin	20	20	-	-	-	-	-	-	-	Exclude 2 marine products
6	Vegetable products	48	14	20	2	-	-	12	-	-	Seasonal flowers: seasonal tariffs
7	Edible vegetables	120	14	7	32	53	12	2	-	-	Many seasonal tariffs
8	Fruits and nuts	142	16	13	38	66	7	2	-	-	Multiple-stage seasonal tariffs
9	Coffee, tea	56	49	6	-	1	-	-	-	-	
10	Cereal	55	5	-	-	2	48	-	-	-	

11	Processed grains	83	-	-	8	4	71	-	-	-	
12	Oil seeds	80	75	3	2	-	-	-	-	-	
13	Vegetable juice	19	16	-	2	-	-	-	-	1	
14	Vegetable products	12	12	-	-	-	-	-	-	-	
15	Animal fat and vegetable fat	128	54	46	9	14	3	-	2	-	
16	Processed meat and fisheries	48	2	2	3	14	27	-	-	-	Excluding marine products 46
17	Sugar and sugar confectionery	47	-	-	-	-	30	1	16	-	
18	Cocoa	27	2	4	-	-	-	-	21	-	
19	Pastry products	47	1	-	-	1	-	-	45	-	Excluding marine product 1
20	Vegetables fruits delicatessen	307	7	41	26	10	10	2	5	-	
						4	2	2			
21	Other delicatessen	42	9	8	-	1	3	-	21	-	
22	Beverages, alcoholic liquors, vinegar	176	35	26	-	1	17	-	7	90	
23	Processed feed	66	31	5	-	25	5	-	-	-	Excluding marine product 1
24	Tobaccos	30	-	25	5	-	-	-	-	-	
29	Manitol, Sorbitol	5	-	-	-	-	-	-	5	-	
33	Aromatic cosmetics	33	33	-	-	-	-	-	-	-	
35	Albuminoidal substances, modified starches, glues	25	11	4	-	2	6	2	-	-	
38	Sorbitol products	4	-	-	-	-	-	-	4	-	
41	Raw hide and leather products	16	16	-	-	-	-	-	-	-	
43	Raw fur	13	13	-	-	-	-	-	-	-	
50	Raw silk and silk waste	4	4	-	-	-	-	-	-	-	

51	Wool and animal fur	16	16	-	-	-	-	-	-	-
52	Raw cotton	6	6	-	-	-	-	-	-	-
53	Raw flax and hemp	7	7	-	-	-	-	-	-	-

Note: 1) Including marine products but excluding forest products (thus, differing from the number of agricultural products in this table that include forest products).

2) Refer to Table IV-3 for categories in the first row.

Source: Author's calculation based on the EU-Mexico FTA Agreement.

#### ● CHILE-MERCOSUR FTA

Chile is well known for unilateral, regional and multilateral progressive trade liberalization. Chile lowered tariffs to 15 percent at the end of 1980s to 11 percent in 1991, and then adopted a five-year plan to reduce tariffs by 1 percentage point per year to 6 percent by January 2003. The Chile-MERCOSUR agreement was negotiated as a part of the Montevideo Treaty. On 25 June 1996, Chile and MERCOSUR signed an Economic Complementation Agreement committing both sides to mutually reduce tariffs so as to achieve free trade within a period of 8-15 years. The accord went into effect on 1 October 1996.

The objective of the agreement was to maintain and expand preferential tariff arrangements between Chile and MERCOSUR, especially in the area of agriculture. The basic timeline for tariff reductions is as follows: (1) for tariffs on products that had been negotiated between MERCOSUR and Chile within the framework of a bilateral agreement, 10 years were allowed for the removal of tariffs at the most; and (2) for sensitive products classified as exceptions at the beginning of the bilateral negotiation, the tariff-removal period would be 15 years.

In June 1996, after two years of negotiations, Chile signed the FTA with MERCOSUR. The Chile-MERCOSUR FTA includes a commitment to gradually and automatically eliminate all tariffs. This was the first FTA in Latin America to include all

products for free trade.<sup>11</sup> The Chile-MERCOSUR agreement also prohibits the implementation of new trade restrictions and commits the parties to identify and dismantle non-tariff barriers. In the agreement with MERCOSUR, Chile achieved a formula that allows tariffs to be lowered over an extended period (more than 10 years). In particular, it was decided that tariffs would be reduced on sensitive items such as wheat and flour within 18 years. The reduction in tariffs was differentiated according to sensitivity: in the manufacturing sector, 40 percent of tariffs were to be reduced simultaneously with the agreement coming into effect, gradually decreased, and then finally eliminated in 2004. The items that are included in the general tariff reductions account for 65 percent of trade between the two countries.

In sensitive sectors, 30 percent of tariffs are to be reduced at the implementation of the agreement and reduced tariff rates will remain unchanged until 2003. Thereafter, they are to be totally eliminated over a period of three years, with total tariff elimination by 2006. The sensitive sectors account for 19.1 percent of Chilean exports to MERCOSUR including oranges and cherries. In special sensitive sectors, 14 percent of tariffs are reduced in the four years after the implementation of the agreement (2000) and the remaining tariffs are to be completely eliminated 2007.

Table IV-5. Market Access in Chile-MERCOSUR FTA

	Total numbers of eligible items	Numbers of agricultural items and examples	
Items for long-term tariff elimination	Chile 158	89	Wheat and processed goods, Edible oil, Meat, Rice, Certain processed fruits, Coffee, Wine etc
	MERCOSUR 143	42	Fruit (Apple, Pear, Peach, Plum) Certain processed fruits, Coffee, Wine etc
Sensitive items	Chile 290	90	Corn, Oat, Barley, Pork, Poultry Chocolate, Bread etc

<sup>11</sup> Although the Chilean economy is fairly open, Chile had difficulties in concluding an FTA with MERCOSUR, as its agricultural sector (particularly temperate zone agriculture) remains highly protected. However, the FTA was strongly supported other potential beneficiaries, mainly manufacturing and service-producing industries with large export potential with an enlarged market. The Chilean governmental position was vital in overcoming the opposition raised by domestic agricultural interests.

	MERCOSUR 311	87	Olive, avocado, Orange, Cherry, Apricot Edible oil, Chocolate, Bread, Processed fruits
Special sensitive items	Chile 193	0	
	MERCOSUR 210	1	Fresh tomato

Source: Cheong (2001).

For items for long-term tariff elimination (Chile 158 items, MERCOSUR 143 items), MFN tariff rates will be applied for 10 years until 2005. Subsequently, they should be decreased according to a certain rate during the following five years and completely removed by 2011. In Chile, the tariffs on wheat and flour will be totally eliminated within 18 years (by 2014) from the beginning of the FTA, and sugar within 16 years (by 2012).

The initial rate of reduction for tariffs on 65 percent of MERCOSUR's exports to Chile is 40 percent, and they will be completely phased-out over eight years. The other 27 percent will be decreased over 10 years and the remaining 8 percent within 15 years. Similarly, tariffs that levied on 60 percent of Chile's exports to MERCOSUR will be eliminated within eight years, 26 percent within 10 years and the rest within 15 years.

#### ● THE ASEAN FREE TRADE AREA (AFTA)

ASEAN began in 1967 with five member countries, Indonesia, Malaysia, the Philippines, Singapore, and Thailand, with the aim of securing political stability in the Indochina region. Economic cooperation within the region has progressed through trade liberalization and industry cooperation since the first Summit in Bali in 1976. In early 1990s, ASEAN members confronted many challenges in the new international economic environment. These include the expansion of regionalism (e.g., Europe), the need to cope with multilateral trade negotiations, reforms and market opening in the old socialist countries, and huge inflows of investment into China. Consequently, ASEAN countries felt the need for a more powerful economic cooperation program. Against this background, a Common Effective Preferential Tariff (CEPT) was proposed at the 22<sup>nd</sup>

ASEAN Economic Minister's Meeting (AEM) in October 1990. Soon after, Thailand proposed an ASEAN Free Trade Area (AFTA) in June 1991.

The agreement on AFTA was concluded in January 1992. The initial plan was to reduce tariffs of member countries on industrial products to 0-5% by 2008. However in 1994, the deadline for tariff reduction was moved forward to 2003 and coverage was expanded to include agricultural products. Due to the financial crisis in 1997, a few regressive measures were implemented such as tariff increase on certain products and the introduction of an import license system in Thailand, the Philippines, and Malaysia. However, at the 6th ASEAN Summit in December 1998, all members agreed in principle that AFTA would become effective in 2002, which is 1 year before the date set 1994. Table IV-6 shows the current enforcement status of the CEPT scheme. Although the targeted tariff rates were 0-5% rather than zero tariffs, in the case of ASEAN-6 (old members), 98% of the total items are included in the liberalization list.

Unlike Northeast Asia, Southeast Asia got a head start in developing regionalism, launching AFTA in January 2002. Nevertheless, Southeast Asia has not shown much interest in extending AFTA to Northeast Asia to form an East Asian FTA. There are several possible explanations for this, and the fact that the industrial structure of Southeast Asian countries is not conducive to economically benefiting from an FTA is one of the reasons. With AFTA, industries in member countries did not stand to gain much from the agreement and thus did not exert pressure to accelerate economic integration.

A considerable part of the manufacturing sector was established through foreign direct investment and major components were brought in from parent companies located overseas. These characteristics made it difficult to satisfy the preferential rules of origin under AFTA. Currently, the volume of intra-regional trade is around 25% of AFTA's total exports, and 60% to 70% of that is composed of transactions between Singapore, Malaysia, and Indonesia. If trans-shipments from Singapore's free port are excluded, the volume of regional trade is only 5%. The only industries that benefited from AFTA were probably the oil and mining sectors. Even in Malaysia, where the

volume of regional trade with other ASEAN countries amounts to 20% to 25%, only 3% of the goods exported to ASEAN are subject to AFTA's Common Effective Preferential Tariffs (CEPT). Thus, AFTA has failed to attract the interest and support of the private sector and its expansion to other regions such as Northeast Asia has been limited.

To be eligible, several criteria need to be fulfilled, namely, the product must already have been included in the 'Inclusion List' of the CEPT schemes of both the exporting and the importing countries. All other categories of products, including those in the 'Temporary Exclusion List,' will not be eligible. The tariff rate in the exporting country for the same product must be at or less than 20 percent. If the tariff in the exporting country is above 20 percent, concessions can only be given when the CEPT of the importing country is also above 20 percent. The product in question must be of ASEAN origin and it must have at least 40 percent domestic ASEAN content. This refers to both a single country or cumulative ASEAN content.

Table IV-6. CEPT Product List for the Year 2002

Country	Inclusion List (IL)	Temporary Exception List (TEL)	General Exception List (TEL)	Sensitive List (SL)	Total
Brunei Darussalam	6276	0	202	14	6492
Indonesia	7176	21	68	4	7269
Malaysia	8867	233*	63	73	9236
Philippines	5606	35	16	62	5719
Singapore	5821	0	38	0	5859
Thailand	9104	0	0	7	9111
Total ASEAN 6	42850	289	387	160	43686
Percentage	98.09	0.66	0.89	0.37	100.00
New Members of ASEAN:					

Cambodia	3115	3523	134	50	6822
Laos	1247	2142	74	88	3551
Myanmar	2387	3017	47	21	5472
Vietnam	3573	1007	196	48	4824
Total	10322	9689	451	207	20669
Percentage	49.94	46.88	2.18	1.00	100.00
Total ASEAN 10	53172	9978	838	367	64355
Percentage	82.62	15.50	1.30	0.57	100.00

Source: ASEAN Secretariat.

Table IV-7. Average Tariff Rates of Year 1999-2003

Country	Year 1999		Year 2001		Year 2003	
	Tariff Lines	Average	Tariff Lines	Average	Tariff Lines	Average
Brunei Darussalam	6264	1.55	6264	1.17	6273	0.96
Indonesia	6931	5.36	7176	4.36	7176	2.18
Malaysia	8374	3.22	8417	2.6	8417	2.06
Philippines	5431	7.36	5431	5.24	5431	3.79
Singapore	5739	0	5772	0	5772	0
Thailand	9062	9.58	9067	7.26	9067	4.63
ASEAN 6	41801	4.8	42127	3.67	42136	2.41
Cambodia	-	-	3115	10.39	3115	7.93
Laos	1247	7.54	1247	6.58	1247	5.66
Myanmar	2356	4.45	2356	3.32	2356	3.19
Vietnam	3570	7.09	-	-	-	-
ASEAN 4	7173	6.3	6718	7.2	6718	5.85
Total ASEAN 10	48974	5.02	48845	4.16	48854	2.88

● **JSEPA**

Japan concluded its first FTA with Singapore in January 2002. The agreement, officially entitled the Agreement between Japan and the Republic of Singapore for a New-Age Economic Partnership (JSEPA), targets a wide range of economic cooperation issues, including e-commerce, that are beyond tariff elimination. This agreement is expected to promote economic partnership and linkages of the two countries in a comprehensive manner not only in trade and investment, but also in such areas as financial services, information and communication technology and human resource development.

Singapore unilaterally liberalized its tariffs over all goods, except four processed foods including beer. In the agreement, only Japan reduced tariffs, and according to the government of Japan,<sup>12</sup> the agreement eliminated over 98 percent of tariffs on the items traded between the two countries (as of 2000, based on monetary value), and eliminated tariffs on approximately 94 percent of Japan's imports from Singapore.

In this agreement, Japanese tariff reductions are classified into five tariff concession categories. Tariffs in Category A were to be eliminated immediately, and tariffs under Category B are to be removed by 1 April 2006. Tariff for items under Categories C1-C3 and D will be eliminated step-by step in 2003, with different initial tariff rates for each. Japan excluded 629 items (HS 6 digit) from trade liberalization (Table IV-8).<sup>13</sup>

Table IV-8. Tariff Concession in the JSEPA

	No. of HS 6 digit		Imports From Singapore (2003)	
	No.	Share (%)	Imports (mil. \$)	Share (%)
A	4,586	87.80	4,338	96.22
C1	4	0.08	0	0.12

<sup>12</sup> Refer to Japan's Ministry of Foreign Affairs's homepage. [<http://www.mofa.go.jp/region/asia-paci/singapore/agree0201.html>]

<sup>13</sup> JSEPA only presents items that are subject to tariffs elimination, not showing exceptions from liberalization. Thus, although these excepted items are not shown in the appendix of the agreement, the excluded items can be found by reviewing total HS codes of Japan.

C2	1	0.02	0	0.00
C3	1	0.02	1	0.00
D	2	0.04	1	0.03
Exceptions	629	12.04	163	3.62
Total	5,223	100	4,508	100

Note: 1) Items under Category A immediately eliminate tariffs, Category B from 1 April 2006.

2) Items under Categories C1 – initial tariff rates of 2.8 percent when the agreement comes into effective, step-by step elimination from 2003 to 2010 (January 1). Items under C2 – initial tariff rates of 3.1 percent. Items under C3 initial tariff rates of 3.9 percent. Items under D – initial tariff rates of 6.5 percent.

Source: Author's calculation from the JSEPA Appendix.

According to a previous analysis using 2003 Japanese import data, 96 percent of total imports from Singapore are instantly liberalized. However, in the case of calculating the number of items under the HS 6 digit scheme, the share of liberalization decreases to 88 percent. Most exceptional items are agricultural products; some 384 items (HS 6 digit) that account for 58 percent of agricultural products are designated for exclusion from liberalization. While reckoned by the amount of imports, 90 percent of total agricultural imports from Singapore are excluded from liberalization. Singapore is not competitive in exports of agricultural products considering its economic structure, thus a great portion of these is not produced in Singapore. Nevertheless, the agreement implies that Japan wanted to prevent illegal imports of non-Singaporean agricultural products through Singapore. Such imports can be intercepted by applying the rules of origin specified in the agreement.

Table IV-9. Agricultural Tariff Concession in the JSEPA

	No. of HS 6 digit		Imports From Singapore	
	No.	Share (%)	Imports (mil. \$)	Share (%)
Liberalization	281	42.25	17	10.12
Exception	384	57.74	151	89.88
	665	100	168	100

Source: Author's calculation from the JSEPA Appendix.

### ● Korea-Chile FTA

The Korean government has been searching for partners for FTAs since the late 1980s. It concluded its first FTA in October 2002 after several years of delay. The agreement was ratified by the national assemblies of the Chile and Korea in February 2004 and was implemented in April 2004.

The first FTA completion can also be seen as the starting point of Korea's FTA promotion policy, and it has established a base on which its economic integration into the Asia-Pacific region through bilateral FTAs with major trade partners such as Japan and Mexico, ASEAN and the United States can be promoted. The Korea-Chile agreement is a comprehensive FTA that covers liberalization of all sectors including agricultural, service investment, trade regulation, government procurement and intellectual property rights.

Korea and Chile share a similar liberalization ratio in that both countries have committed to eliminating tariffs over a 10-year period on 96 percent of items covered by the agreement. For a few sensitive items, however, tariff concessions will be applied flexibly to minimize the impact on Korea's weaker industries, especially agriculture. Korean tariff concession categories are more complex than Chile's, allowing a 16-year phase out at the most. Korea's tariff concessions are divided into 10 categories: immediate tariff elimination, five-year phase-out, seven-year, nine-year, 10-year, 16-year, seasonal tariffs, items that will be liberalized after the conclusion of the DDA, items given quarter, and exceptions. On the other hand, Chile's six concessions categories are: immediate tariff removal, five-year phase-out, seven-year, 10-year, and 13-year and exceptions.

Korea lifted tariff immediately on 9,740 items (87.2 percent, HS 10 digit) out of 11,170 items in total. Out of the 9740 items, 9,121 are industrial products, 224 agricultural products, 118 forestry products and 277 marine products. On the other hand,

the ratio of items to be liberalized within 10 years is 96.3 percent, which includes all forestry and marine products and 70.7 percent (907 items) of agricultural products.

Table IV-10. Outline of Korea's Tariff Concessions

(Unit: HS 10 digit, (%))

Category	All	Manufacture	Agriculture	Forestry	Fishery	Examples (agricultural)
Immediate	9,740 (87.2)	9,122 (99.9)	224 (15.6)	118 (54.6)	277 (69.4)	Assorted feed
5-year	701 (6.3 )	-	545 (38.0)	69 (31.9)	86 (21.5)	
7-year	41 (0.4)	1(0.01)	40 (2.8)	-	-	Fruit juice, chicken
9-year	1 (0.01)	-	1 (0.07)	-	-	Other juices
Seasonal tariff (10-year)	1 (0.01)	-	1 (0.06)	-	-	Grape
10-year	262 (2.34)	-	197 (13.76)	29 (13.43)	36 (9.02)	Tomato
16-year	12 (0.11)	-	12 (0.84)	-	-	Apple juice
TRQ+DDA	18 (0.16)	-	18 (1.3)	-	-	Beef, turkey
DDA	373 (3.3)	-	373 (26)	-	-	Garlic, dairy products
TRQ	24 (0.2)	-	24(1.7)	-	-	Beef, poultry
Exceptions	21 (0.2)	-	21 (1.4)	-	-	Rice, apple, pears
Total	11,170	9,123	1,432	216	399	

Source: Cheong (2003a)

Chile's immediate abolishment ratio is 41.4 percent and includes 2,422 items out of 5,854 items, which is lower than Korea's. The immediate liberalization ratio for manufacturing goods, for which Chile does not have competitive advantage, is 30.6 percent, while those for agriculture and marine products are 98-100 percent.

Table IV-11. Chile's Concession Outline

(Unit: Chile's HS 8 digit, (%))

Category	All	Manufacture	Agriculture	Forestry	Fishery	Examples
Immediate	2,422 (41.4)	1,478 (30.6)	649 (89)	96 (100)	199 (99)	Color TVs, auto parts
5-year	2,018 (34.4)	1,992 (41.3)	24 (3.9)		2 (0.9)	Trucks, polyethylene
7-year	14 (0.2)	14 (1.92)				Rubber plates
10-year	1,194 (20.4)	1,180 (24.5)	14 (1.9)			Batteries
13-year <sup>1)</sup>	152 (2.7)	152 (3.2)				Steel, textiles and garments
Exception	54 (1)	12 (0.3)	42 (5.7)			Refrigerators, washers
Total	5,854	4,828	729	96	201	

Note: 1) Phase out from 6-13th year after the agreement goes into effect, with no tariffs to be reduced until the fifth year after the implementation of the FTA.

Source: Cheong (2003a)

## V. Rules of Origin in East Asian FTAs

### V-1. Theoretical Survey on ROO

One of the differences between Customs Union (CU) and free trade agreement (FTA) is the authority of charging tariffs on the imports from non-member countries. CU member countries introduce common tariff rates against non-member countries, and they cannot change tariff rates voluntarily without consultation with other member countries.<sup>14</sup> However, FTA member countries can set tariff rates (not higher than WTO bound rates) independently. Because tariff rates of the member countries of an FTA are

<sup>14</sup> CU also needs ROO during the transitional period toward the implementation of common external tariffs.

different, trade deflection can happen.<sup>15</sup> In order to prevent trade deflection, FTA member countries introduce specific rules, regulating that goods satisfying the rules be imported into FTA member countries with preferential treatments in terms of tariffs. These rules are called as rules of origin (ROO).

There are 3 criteria (methods) for defining ROO in FTAs. One of criteria is Change in Tariff Classification (CTC) or “tariff shift.” CTC is widely used in regional trading agreements (RTAs), and is preferred by the World Customs Organization (WCO), which promotes the simplification and harmonization of the ROO. CTC is based on the Harmonized System (HS), classifying goods at a two-digit chapter level, a four-digit heading level, a six-digit subheading level or an eight (ten)-digit level. The second rule is the requirement of Regional (local) Value Contents (RVC), implying the requirement that the product should acquire a minimum regional value in exporting country or a region of a RTA.<sup>16</sup> The third rule is the requirement of Technical Process (TP), requiring specific production process for an item.

RVC can be calculated in two ways: Build-down or Build-up method.

Build-down method is:

$$RVC = \frac{AV - VNM}{AV} * 100$$

Build-up method is:

$$RVC = \frac{VOM}{AV} * 100$$

where RVC is the regional value content, expressed as a percentage; AV is the adjusted value; VNM is the value of non-originating materials that are acquired and used by the producer in the production of the good; VOM is the value of originating materials that are acquired or self-produced, and used by the producer in the production of the good.

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<sup>15</sup> Trade deflection means that a good imported via a low tariff FTA member country is re-exported into a country with high tariff without paying tariffs.

<sup>16</sup> The rule of regional value contents can be considered with various ways such as export values, import value, value of parts included in an article. However, we do not consider these separately, regarding all methods as regional value contents.

Most RTAs employ multiple criteria for setting ROO, rather than applying a single rule. According to WTO (2002), while ROOs in many FTAs are based on CTC, RVC and TP are also widely used. Rather, combinations of three methods are widely used in an FTA rather than a single method.

Table V-1. Frequencies of CTC, RVC and TP in RTAs

RTA (no. of RTAs)	CTC	RVC	TP
CU (6)	6	4(35-60%)	-
FTA and PTA (87)	83	75(35-60%)	74

Note: Numbers in parentheses imply the minimum requirement ratios.

Source: Modified from WTO (2002, p8)

Each criterion of defining ROO has advantages and disadvantages, and it is not easy to conclude which rule is most desirable.<sup>17</sup> However, even though a specific rule is used, the stringency of the criterion can be changed depending on member country's position towards trade liberalization. For example, chapter change will be more stringent than changes in heading or subheading, when CTC method is employed. In case the RVC criterion is used, 60% regional value contents rate will be more stringent than 40%.

Some elements of ROOs are designed to promote intra-regional trade, although ROOs in general constitute protectionist practices. For example, Cumulation<sup>18</sup> and *De Minimis* are commonly introduced in RTAs in order to facilitate producers under certain conditions to use intermediate inputs from the region of another RTA or the 3<sup>rd</sup> country. *De Minimis* is called a tolerance rule in literature on the ROO and it is found in 88 out of 93 RTAs surveyed, according to the WTO (2002, p9). In most cases, the *De Minimis* rule is applied to less than 10% of total value of final products to be sourced from non-

<sup>17</sup> Parmeter (1997, p342) states that "although FTAs require rules of origin, there is a problem: there is no completely satisfactory rule of origin." Regarding merits and demerits of methods of setting ROO, refer to Parmeter (1997) and Essevadeordal (2003).

<sup>18</sup> Cumulation can be classified as bilateral cumulation, diagonal cumulation and full cumulation. Refer to Essevadeordal (2003) regarding the classification of cumulation.

member countries.<sup>19</sup>

ROOs act like trade barriers, since they cause extra costs in production and management. Producers/exporters need to pay costs for calculating production costs and producing bookkeeping related documents.<sup>20</sup> Also, extra costs will incur in complying with technical and specific process and regional value contents as specified in the ROO protocol, and these costs will be added to prices of exporting goods.<sup>21</sup>

As ROOs become more stringent, the compliance costs will rise, undermining the gains in terms of trade creation that can be obtained from an FTA. APEC (2004, p76) states, “The complexity and stringency of ROO employed in RTAs has given rise to concerns over the diversionary effects that ROO may have on trade and investment flows.”

## **V-2. Analysis of ROO in Major FTAs**

This section provides an overview of ROOs in major FTAs with a view to assessing the stringency of ROOs in East Asian FTAs. Most FTAs have several hundred pages for the ROO protocol, and thus requires a large amount of time and efforts to understand the structure and technical aspects of the ROO in an FTA. The existing literature on the topic is also limited.<sup>22</sup>

For the analysis of ROOs, several FTAs are chosen in this paper. They are the NAFTA and EU-Mexico FTA, which represent the first generation FTAs by US, and EU. Examples of FTAs signed or under negotiation by East Asian countries are ASEAN Free Trade Area (AFTA) and China-ASEAN, Japan-Singapore (EPA), US-Singapore, Korea-Singapore, and Korea-Chile FTAs. In this section, we will compare the stringency of

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<sup>19</sup> EC-South Africa FTA sets 15% *De Minimis* rule, but this is an exception.

<sup>20</sup> Regarding empirical researches on administrative costs in a FTA and costs of preparing documents for preferential treatment, refer to Koskinen (1983) and Herin (1986), respectively.

<sup>21</sup> Several empirical researches on the costs of stringent ROO under NAFTA show substantial costs to intra-regional traders and producers. For example, Cadot *et al* (2002) found that the utilization rate of NAFTA preferences is as low as 64% due to stringent ROO in part. Regarding more information on the costs of ROO, refer to Essevadeordal (2003, pp.8-9).

<sup>22</sup> Comprehensive analysis of ROO in major RTAs can be found in Brenton (2003), Essevadeordal (2003), and WTO (2002).

ROOs of East Asian FTAs with that of US and EU FTAs. Before presenting the result, it is worth mentioning that the ROO in AFTA and China-ASEAN FTA, which specify 40% regional value contents across all items are the simplest ROO in the world.<sup>23</sup> The criterion of 40% regional value contents was introduced by AFTA, when the Common External Preferential Tariff (CEPT) scheme was agreed upon in 1992. During the negotiation for an FTA between China and ASEAN, China accepted the AFTA ROO and concluded the negotiation at the end of 2004.<sup>24</sup> But other FTAs by East Asian countries have chosen to introduce more complicated rules of origin.

#### ● ROOs in US and EU FTAs

NAFTA is the first FTA with comprehensive coverage including trade, investment, services, and trade rules. In promoting FTAs, the U.S has imposed quite stringent ROOs based on the change of heading, specific requirements for HS chapters, and complicated criteria for the regional value content. Essevadeordal (2003, p348) evaluates that US specifies rules of origin of “substantial transformation” in its FTAs. CTC in chapter, heading and subheading is most widely used, with additional requirements of specific process and regional value contents. *De Minimis* rule is 7% in NAFTA, lower than in other FTAs.

Since then, several countries have followed the structure of NAFTA ROO with minor modifications for some items.<sup>25</sup> A rigid ROO of “wholly obtained or produced entirely” is applied to primary industry, and each of non-originating materials used in the production of the good must undergo an applicable change in tariff classification set out in Annex 401 of the agreement. Technical processes are required for many items. Regional value contents ratios are as high as 50-60% depending on calculation methods.<sup>26</sup> The agreement specifies a more stringent rule for automobiles (HS8702-

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<sup>23</sup> Similarly simple ROO can be found in ANZCER (Australia-New Zealand FTA), with 50% RVC rule. However, it specifies additional requirement that the last manufacturing process should be performed in the exporting territory for some items. However, 40% rule is applied in AFTA without extra requirements.

<sup>24</sup> China lead the negotiation with ASEAN for a bilateral FTA. In 2003, China provided Early Harvest Package to ASEAN countries in order to attract ASEAN countries to the negotiation table.

<sup>25</sup> The framework of the NAFTA ROO became the basis of ROOs in many FTAs, concluded by Canada, Chile, Mexico, Japan, Korea, etc.

<sup>26</sup> NAFTA has two approaches for calculating the regional contents: One is the transaction value method,

8704) with 62.5% under the net cost method.

In other FTAs, the US introduces a lower regional value contents ratio. For example, in the US-Chile FTA, 35% (Build-up) and 45% (Build-down) were adopted for some of HS34. A similar ROO is used for the US-Singapore FTA. However, a little more stringent ROO was introduced in the US-Australia FTA, especially for textile and footwear. In case of footwear (HS64), the regional value contents ratio is set 55% (Build-down) with an additional requirement of subheading change. The US experience suggests that the stringency of ROO depends on FTA partners.

EU's ROO heavily depends on PANEURO, which establishes a highly uniform ROO across EU's FTAs such as the EU-EFTA FTA and the EU-Mexico FTA. EU-Mexico FTA adopts a wide range of rules in defining the ROO. In general, EU ROOs are rather restrictive. The EU ROO is dominated by changes in heading, although regional value contents ratios range from 20% to 50%, with 20% for HS30. One problem with the EU ROO is that the agreement imposes complicated rules for producers. For example, special requirements are specified for sugar and cocoa in defining the ROO for HS 18-22.

#### ● ROOs in East Asian FTAs

Singapore has been receptive to a loose ROO, while US has imposed a stringent ROO, as seen in the NAFTA agreement and its recent FTAs with other countries. Singapore adopted the position of the US for the ROO in the bilateral FTA with the US. The US-Singapore FTA, which was concluded in 2003, basically follows the framework of the NAFTA ROO.

Chapter 3 of the US-Singapore FTA contains the rules of origin, and the requirements on specific items are given in Annex 3A. Heading changes are required for HS01-HS24, in addition to “wholly obtained or produced entirely” for primary products.<sup>27</sup> These are also applied to HS49-HS60, although subheading changes are specified for HS27-HS48. For apparel and clothing (HS61), a strong rule is adopted by

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and the other is net cost method.

<sup>27</sup> This rule for primary products such as cattle, rice, etc. is widely accepted in RTAs.

specifying that apparel and clothing must be both formed from yarn and finished in the territory of a Party.” For some HS chapters such as HS73, 78, 81, 84, 85, and 90, regional value contents ratios are required as 35% in the Build-up method and 45% in Build-down method. *De Minimis* is set as 10%.

Japan and Korea were predisposed to introduce a complex and stringent ROO to placate strong domestic opposition to trade liberalization.<sup>28</sup> However, with gaining experience in FTA negotiations, they are likely to relax stringency of their ROOs. Japan’s first FTA - the Japan-Singapore EPA - specifies “wholly obtained or produced entirely” rule and products for preferential treatment in the FTA should have undergone sufficient transformation in a Party. Cumulation and *De Minimis* are accepted but the agreement specifies different shares of *De Minimis* with lower than or equal to 10 percent.

Heading changes are required for HS01-24, HS38 (chemical products), HS85 (machinery), with subheading changes or regional contents requirements (liquor and cordials). A regional contents requirement of 60% (with a combination of subheading changes) is required for other chapters of HS. For textile fabrics and articles (HS59), fabric should be made with yarn from a Party.

The Japan-Mexico FTA has an improved ROO than the Japan-Singapore EPA in several aspects. *De Minimis* is introduced at 10% for all items. Chapter, heading, and subheading changes are used for HS01-63. However, a stringent ROO is introduced for Mexico’s major exports such as footwear (HS64) and natural resources like copper and zinc. The rule for these items specifies heading or subheading changes with a 50-55% regional contents requirement.

The ROO of Korea-Chile FTA is also a variation on that of the NAFTA, with stringent and complex specifications for sensitive items. In particular, Heading changes are required for HS01-HS10, which are agricultural and fishery products. In order to prevent transshipment of agricultural products, *De Minimis* is specified at 8%. A

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<sup>28</sup> Esdevadeordal (2003, p12) states that “the ROO of Japan-Singapore EPA are complex, as evidenced by the more than 200-page ROO protocol.” Similar comments can be found in Esdevadeordal (2003, p12) for Korea-Chile FTA.

combination of heading change and regional value contents is used for several chapters such as HS19, 29, 30, 31, 38, etc. In general, low regional contents ratios are given with 45% for Build-down method and 35% for Build-up. For some of HS84, a 30% of regional contents ratio is specified, when the Build-up method is used in calculating the regional contents ratio. However, an exceptionally high regional contents ratio is specified for HS200892-200899 (preparations of vegetables, fruits, nuts or other parts of plants). This is to curb the exportation of illegal juices and similar products.

Although it was announced that the Korea-Singapore FTA was concluded, there are still several issues to be resolved between the two countries. And detailed information on the agreement will not be available until both parties officially sign the agreement. According to mass media reports, both countries agreed for 10% *De Minimis* rule, with exception for textile, which was dealt to be sensitive in the Japan-Singapore EPA. Unlike the FTA with Chile, the Build-down method is widely used with ratios of 45%, 50% and 55%.

### **V-3. Overall Assessment**

East Asian countries have a relatively short history of FTAs. They are facing strong domestic opposition mounted by the sectors that are likely to be adversely affected by trade liberalization. Understandably their first FTAs allowed a broad range of goods for exemption from trade liberalization. AFTA, the first regional trade arrangement in East Asia, took recourse to the legal status of the Enabling Clause, which allows developing countries to establish RTAs without satisfying the requirements set in GATT Article 24. Most of the excepted goods are agricultural products, which are most sensitive in Japan and Korea, although the coverage of market access in those countries may increase with more FTAs concluded,

Trade deflection, which can occur in FTAs, distorts the trade pattern; ROOs could curb trade deflection. However, the compliance of stringent and complex ROOs increases costs for production and trade. Therefore those countries joining in FTAs

would be better off by simplifying and harmonizing preferential ROOs.

EU and US introduced stringent ROOs in their RTAs in 1990s. East Asian countries have heavily depended on the frameworks of existing FTAs, especially that of NAFTA. As a result, their ROOs include very restrictive elements. As seen in Table 2, ROOs in East Asian FTAs are similar to those of Western FTAs in terms of CTC, RVC ratio, Cumulation, and *De Minimis*.

Table V-2. Summary of ROO in Major FTAs

	NAFTA	EU-Mexico FTA	AFTA	China- ASEAN FTA	Japan- Singapore FTA	Korea- Chile FTA
CTC	Yes	Yes	Not necessary	Not necessary	Yes	Yes
RVC Ratio	60-50%	50-30%	40%	40%	60-40%	45-30%
Cumulation	Yes	Yes	Yes	Yes	Yes	Yes
<i>De Minimis</i>	7%	10%	No mention	No mention	8-10%	8%

However, AFTA and the China-ASEAN FTA have a very simple and uniform format for the ROO. This is simpler than the WTO recommends, and cannot be found in other RTAs. AFTA and the China-ASEAN FTA do not need CTC criterion since they require only one criterion of 40% RVC ratio. Korea and Japan are expected to improve their ROOs in terms of CTC, *De Minimis* and other production processes for some items. In negotiating FTAs with ASEAN, which proposes a simple ROO for bilateral FTAs, both Japan and Korea are likely to yield to ASEAN's demand.

## VI. Negotiated Liberalization or Protectionism?

In the preceding two sections, this study has examined the details of agreements of East Asia's bilateral FTAs that are completed or under negotiation with the focus on the market access and rules of origin to judge whether they will facilitate or stand in the

way of regional trade integration. There are only a few agreements concluded, and other proposed FTAs leave these crucial elements for further negotiations. For these reasons, our survey does not throw much light on how discriminatory the existing and proposed East Asian FTAs will be in regard to the market access and rules of origin. Depending on how one interprets the objectives of the East Asia's FTAs, one can be either an optimist or pessimist on the prospect of multilateral trade liberalization in the region. This section begins with a pessimistic scenario and ends with an optimistic outlook.

Pessimists would argue that the proliferation of the bilateral FTAs might not necessarily lead to region-wide trade liberalization. It is not altogether clear whether bilateral FTAs will create incentives for and hence stimulate further intra-regional trade in East Asia. Even the causes of the proliferation have not been fully understood. The slow progress in multilateral and regional trade liberalization, in particular the deadlock in the Doha Development round has been pointed out as one important cause. Since 1998, trade liberalization has disappeared from the APEC agenda with the breakdown of the Early Voluntary Sectoral Liberalization program and security issues have taken over its place (Ravenhill 2004).

Knowing that multilateral or regional trade negotiations can be protracted processes, some of the East Asian countries such as Korea may wish to enter into bilateral FTAs to signal their commitment to trade liberalization or not to lose their access to the exports markets other FTAs hold out. ASEAN states appear to be attracted to bilateral FTAs with China and Japan for their access to large export markets the two countries offer. There is indeed no shortage of arguments suggesting that bilateral FTAs could be complementary to and to the extent that they can be concluded quickly can become building blocks for global trade liberalization under the WTO. Bilateral FTAs, it is often pointed out, have other advantages in that they could provide rules in various areas such as FDI and labor mobility that are not covered by the WTO.

While these advantages may be real, the spread of bilateralism in East Asia could have dangerous consequences. As the simulation studies surveyed in section III show, the bilateral movement is likely to produce an outcome inferior to a large FTA

such as an East Asian FTA or a China-Japan-Korea FTA, because East Asian bilateral FTAs could, among other things, divert more trade from low-cost to high-cost producers. If indeed, both China and Japan succeed in creating hub-and-spoke networks of bilateral FTAs, then Baldwin (2003) cautions that these networks have a danger that the spoke countries could be marginalized both economically and politically while giving leverage to the hub economies. The networks of bilateral FTAs where China and Japan are hubs could lead to further proliferation of bilateral FTAs and thereby make East Asia less attractive to foreign direct investment, a problem Baldwin calls the noodle bowl problem. This problem would surface, if the spokes attempted to negotiate bilateral FTAs with one another among themselves as widely expected as they would.

China and Japan may be motivated to negotiate bilateral FTAs with other East Asian countries in order to protect and strengthen their political and strategic interests in East Asia. If this were the case, then the proliferation of the bilateral FTAs would not necessarily speed up trade liberalization either in individual countries, rendering them as stumbling blocks for regional and global trade liberalization and integration. This is because these politically motivated bilateral FTAs could turn into strategic alliances rather than economic unions.

Indeed, there is concern that some of the bilateral FTAs concluded, negotiated, or under consideration in East Asia are examples of negotiated protectionism rather than negotiated liberalization, because they tend to leave out politically sensitive sectors such as agriculture by making a rather self-serving interpretation of GATT Article XXIV.8 that stipulate that the preferential agreement eliminates duties and restrictions on not all but substantially all trade between the participants (Ravenhill 2004). Developing economies in East Asia can also take advantage of their exemption to Article XXIV.

As the countries engaged in negotiating bilateral FTAs in East Asia resort to many provisions for rules of origin to give selective protection to domestic industries as shown in the preceding section, they will strengthen domestic protectionist forces while weakening the domestic pro-liberalization coalition. At the same time, different rules of origin and coverage of imports for liberalization in different bilateral FTAs could create

a bewildering spaghetti bowl of complex and incompatible agreements, thereby inhibiting broadening of the geographical scope of integration (Ravenhill 2004). If this happens, then consolidating different bilateral FTAs for region wide trade liberalization will not be easy because of the difficulty of standardizing different FTAs into one agreement. This means that it is highly unlikely that an East Asian FTA will emerge by itself as a result of amalgamation of bilateral FTAs (Cheong 2002). Given the intensifying rivalry between China and Japan for regional leadership, the two countries may make it more difficult to create an East Asian FTA.

In the end the pros and cons of bilateral FTAs will have to be judged on the basis of their contribution to regional and global trade liberalization. So far there is little evidence that dispels Ravenhill's concern that the new wave of bilateral FTAs in East Asia will not be supportive of region wide free trade. As Ravenhill puts it, "the move to bilateralism in the Asia Pacific appears to have come at the expense of transregional APEC grouping" as evidenced by the fact that none of them makes any mention of possible extension to other parties. Ravenhill also observes that East Asian governments preoccupied with bilateral FTA negotiations often do not find time or resources to engage in regional and multilateral free trade negotiations.

In contrast to a bilateral approach to trade negotiations, the ASEAN+3 has established a multilateral framework for financial market integration. The growing enthusiasm for the bilateralism in trade has overshadowed and even raised the possibility of derailing region wide financial liberalization and integration. The most serious consequence of the two divergent movements will be that following the bilateral approach to trade liberalization, different countries participating in regional financial integration may demand not only different time tables of financial liberalization, but also different conditions and exemptions for participating in financial cooperation.

The bilateral FTAs could also complicate the leadership issue for regional financial integration. One possibility is that if China succeeds in forming an FTA with ASEAN, it may use its leverage to determine the scope and speed of financial liberalization and integration in East Asia that China can accommodate. Since China

and ASEAN except for Singapore have underdeveloped financial systems, their interest in and strategy for regional financial integration may collide with that of other countries in the region. If this were to happen, the proliferation of bilateral FTA could slow down and even bring to an end financial cooperation and integration in East Asia.

Many East Asian trade officials and experts would argue that the pessimistic scenario is not firmly grounded in facts and FTA strategies of the ASEAN+3 members. All East Asian countries depend on trade for growth and industrialization and knowing that an economically integrated East Asia will offer new investment opportunities and help sustain rapid growth, East Asian policymakers cannot afford degeneration of the FTAs into a convoluted noodle bowl. The optimists argue that there is consensus among East Asian leaders that the establishment of East Asian FTA would be desirable, as it would promote economic prosperity, social and political stability in the region, these separate FTA developments would in the end lead to the formation of an East Asia FTA. As a piece of evidence for their optimism, they show the AFTA and the ASEAN-China ROO, which is the simplest of all.

Are there any plausible scenarios for this desirable outcome? This section proposes several approaches that could help establish an East Asia FTA (EAFTA). One approach is to establish three ASEAN+1 FTAs - ASEAN+China, ASEAN+Japan, and ASEAN+Korea FTAs - first and then consolidate all three into an ASEAN+3 FTA. Another approach would construct a China-Japan-Korea FTA (CJKFTA) and then combine it with the AFTA. The creation of the CJKFTA may be pursued in four different ways. Three different FTAs involving the three countries - a China-Japan FTA, a China-Korea FTA, and a Japan-Korea FTA - are to be established first and then amalgamated into a CJKFTA. The three countries may also launch a plan for negotiating a CJKFTA without going through the bilateral FTA stage. Finally, ASEAN and the three northeastern members could agree to create directly an ASEAN+3 FTA without going through any intermediate stages described above. The inclusion of Taiwan to the ASEAN+3 FTA may be pursued after a China-Taiwan FTA is completed.

The preceding these approaches are not mutually exclusive, but overlapping ones.

Recognizing that ASEAN+China FTA negotiations have been completed, and the negotiations for ASEAN+Korea and ASEAN+Japan FTAs are scheduled to begin in 2005, the most realistic approach would be to conclude the three ASEAN+1 FTAs first and then integrate them into an ASEAN+3 FTA. In this approach the target dates for the completion of the three FTAs can be set, for example, as 2010 for the ASEAN+China, 2009 for the ASEAN+Korea, and 2012 for the ASEAN+Japan. ASEAN+3 countries could then start ASEAN+3 FTA negotiations as soon as ASEAN and Japan finish their bilateral negotiations by setting the target year for the establishment of the ASEAN+3 FTA.

In the meantime, CJK should pursue FTA negotiations bilaterally and trilaterally. For the Japan-Korea FTA, which is already under negotiation, should be completed on schedule by the target year of 2005. Negotiations for a China-Korea FTA and a China-Japan FTA should start as soon as possible. Before starting negotiations for bilateral, trilateral, and regional FTAs, the three countries may benefit from setting up a study group involving government officials, business representatives, and academics to examine the possible contents and identify the impacts and obstacles to establishment of various FTAs. The work of this group could be used to achieve consensus on and increase the awareness of importance of FTAs in respective countries, which would in turn contribute to the formation of bilateral FTAs and eventually an EAFTA.

While the three Northeastern countries are engaged in bilateral or trilateral FTA negotiations, if ASEAN+3 countries may lay out a plan for constructing an EAFTA to speed up regional trade liberalization, although the likely development may be a sequential one in which completion of the three ASEAN+1s will be followed by C-J, C-K, J-K FTAs before concluding the EAFTA.

Several issues need special attention in negotiating bilateral and trilateral FTAs in East Asia. One is the definition of the rules of origin. As described in the preceding section, FTAs involving East Asian countries have different ROOs. The same rules of origin have to be adopted to establish an EAFTA. A liberal definition of the ROO is preferable in order to achieve a freer trading environment and at present, the ASEAN's

40 percent (cumulative) value added rule appears to be the most desirable option.

Another issue is the contents of the EAFTA. Considering diverse economic backgrounds including the level of economic development of the countries in East Asia, it is important to cover not only trade and FDI liberalization and facilitation but also a variety of technical and economic cooperation programs such as human resource development and technology transfer. Programs for cooperation are needed to improve quality of human resources and technological capability of less developed countries, so that the gap between the developed and developing members of East Asian could be reduced. Closing the gap will help promote social and political stability of the region as well as regional trade integration. For the technical and economic cooperation, more developed members have to provide generous and effective support to less developed members.

All East Asian economies will face opposition to FTAs at home, in particular that from non-competitive sectors. To deal with the opposition, East Asian economies should provide temporary safeguard in the form of income support and/or education/training, so that those adversely affected workers could be transferred to other productive jobs. It is also important to garner public support for FTAs. In this regard, the mass media and educational sectors can play very important roles for obtaining wider support for FTA by letting the general public understand the benefits as well as costs of the trade agreements. Finally, it is the strong political leadership with a future vision that will make the formation of an East Asia FTA possible.

## **VII. Prospects for Trade Integration in East Asia in Lieu of Conclusions**

In reading endless series of press releases by East Asian governments and ASEAN+3 and journalistic accounts of bilateral FTAs under negotiation or discussions and the CMI and ABMI, many observers may be inclined to conclude that the region is at a historical turning point in economic integration. Up close, and delving into the latest developments in regional trade and financial integration, however, it will not take much time or intelligence to conclude that East Asia is not Europe and way off in constructing basic economic and political foundations for economic integration. For the next several years, the ASEAN+3 states will be preoccupied with negotiating bilateral FTAs with one another and with other countries from different regions. This fervor of bilateralism will overshadow and put on the backburners any further discussion of or new initiatives for region wide trade liberalization: even if a number of bilateral FTAs were to be completed, they would not make much headway in achieving region wide free trade insofar as the East Asian bilateralism poses new trade barriers in terms of the market access and ROO.

The proliferation of bilateral FTAs has also weakened the cohesiveness of the ASEAN+3 as a regional grouping because the member countries are not constrained by geographical contiguity in searching for bilateral FTA partners. It has distracted ASEAN+3 leaders from financial cooperation and policy coordination, although there is a clear need for coordination at the regional level for stabilizing bilateral exchange rates among the ASEAN+3, which will in turn help promote free trade in the region.

Despite these developments, the leaders of ASEAN+3 realize the importance of cooperation and policy dialogues among the members on many regional issues such as the growing transpacific imbalance that may require a region wide collective response. They also find that the ASEAN+3 framework provides useful fora for policy dialogues, if not coordination. For these reasons, it is expected that East Asian policymakers will continue to search for a more realistic modality of coordination in their bilateral FTA

strategies. However, policy coordination for FTAs, bilateral, trilateral, or regional, will not be easy.

One of the impediments to trade integration in East Asia is, unlike in Europe, the region's lack of historical experience in cooperation for regional economic and political integration. Whatever economic benefit trade and financial integration may bring, they are unlikely to be realized in the near future if each country is unwilling to cooperate in the political arena. Although the ASEAN+3 members have so far shown remarkable solidarity in working together for the development of the CMI and ABMI, it remains to be seen whether China, Japan, and other members of ASEAN+3 could overcome their differences in regional issues to sustain the integrationist movement and steer the proliferation of FTAs to regional trade integration.

The most serious institutional and political constraint on regional trade integration is the failure of the ASEAN+3 countries to coordinate their respective FTA negotiations. The two regional initiatives - CMI and ABMI - are motivated and put into implementation to achieve financial stability and integration in East Asia. The ASEAN+3 fora are organized around finance ministers and central bank governors and their deputies. Trade officials do not participate in any of the ASEAN+3 meetings, and as such trade issues are not included in the ASEAN+3 agenda. There is no plan for expanding the ASEAN+3 framework for the coordination of trade policies. There is therefore an unfortunate dichotomy between trade and finance in the ASEAN+3 group. The discussion on financial integration and cooperation has been carried on within the confines of ASEAN+3, but not trade policy including FTA negotiations.

A second institutional constraint is related to the need to coordinate the activities of ASEAN+3 with other regional arrangements such as APEC regional forums. At some point in the future, the leaders of the ASEAN+3 may have to decide on the mode of cooperation and division of labor in promoting regional growth and stability between these institutions and the ASEAN+3. Many of the thirteen ASEAN+3 countries have been engaged in policy review and dialogues through the APEC sub-

arrangements. They will have to settle the question of whether the thirteen countries constitute an appropriate grouping for regional trade integration in East Asia.

Perhaps the single most important obstacle to regional integration is the absence of leadership that could balance different interests of different countries in East Asia. The European experience shows that regional integration cannot progress very far without a leadership that can keep participating countries as a coherent group dedicated to achieving a set of common objectives. PRC and Japan, which could provide the needed leadership, have not been able to agree on a number of regional issues.

PRC and Japan have different interests in and, therefore, different strategies for economic integration in East Asia. China has shown its lack of interest in regional integration as it has assumed a greater global role in recent years as a *de facto* member of the G-7. On regional economic issues, as far as China is concerned, its bilateral FTA with ASEAN may be vital to consolidating its strategic interests. Any economic gains it offers are of secondary importance. From the perspectives of Chinese policymakers, integration with ASEAN, South Asian, and central Asian countries may carry more significance both economically and geo-politically than, or take precedence over, financial cooperation or free trade with either Japan or South Korea. While China is a military superpower, it is still a developing economy with a huge gap in terms of technological and industrial sophistication vis-à-vis Japan. Although China has been growing rapidly, it has a long way to go before catching up with Japan. These differences in the economic and military status of the two countries suggest that China and Japan may, even if they manage to reconcile their troubled past, find it difficult to work together for a bilateral FTA and for regional integration in East Asia.

PRC borders Russia and many of the South Asian and central Asian countries in addition to several ASEAN members. It is natural, therefore, for China to seek expansion and deepening of its trade and financial relations with these countries. In fact, for this reason, in November of 2001, it joined the Bangkok agreement on a free trade area that includes the South Asian countries. China has also taken a leading role

in establishing the Shanghai cooperation organization, a cooperative arrangement among Russia, Kazakhstan, Kyrgyzstan, Tajikistan, and Uzbekistan, and China.

In contrast, Japan has not been able to articulate its strategic interests in East Asia. In particular, the geographical contiguity of East Asia from the Japanese perspective has not been altogether clear. For example, Japan suggested formation of ASEAN+5, but the two countries to be added to ASEAN+3 were not clear. At one point, the five countries were China, Japan, Korea, Australia, and New Zealand. At another, Australia and New Zealand were replaced by Chinese Taipei and Hong Kong. There is also the suspicion that Japan is not interested in free trade or financial integration per se in East Asia, but in countering China's penetration of ASEAN. Many analysts believe that Japan's involvement in regional economic integration is therefore motivated by its desire to maintain its traditional pole position.<sup>29</sup>

On top of this suspicion, Japan is perceived to be insensitive to and unwilling to resolve its wartime legacy and disputes on historical and territorial claims. Japan has also been gripped by a decade-long recession and unable to restructure its economy, in particular its financial sector making many East Asian countries apprehensive about supporting any regional initiative for financial integration promoted by Japan. These structural problems have combined with the lack of its strategy for East Asian development to undermine Japan's ability to bring East Asian countries together for regional cooperation and integration.

What, then, are the likely courses of trade integration in East Asia? Answers to these questions will largely depend on future developments in China's trade relations with the rest of East Asia. PRC has become or soon will become the largest trading partner to all East Asian countries.

China has already become Japan's largest trading partner in terms of exports. In view of this development, it is quite possible that despite the differences in their strategies, both China and Japan could come to realize that region wide trade liberalization and integration would serve their interests in the long run. If Japan

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<sup>29</sup> See David Wall (2002).

believes it inevitable that economic integration in East Asia will be centered on China, and China realizes that Japan will continue to be the major source of capital and technology, then the two countries could cooperate for deeper trade integration in the region. This is a very unlikely scenario, however.

Another scenario focuses on the possibility of China assuming a more central leadership role in regional integration and thereby forming an FTA hub. Knowing that the ASEAN members will be more attracted to their FTA negotiations with China than with Japan, China may decide to use its market leverage to negotiate deeper financial and trade integration with ASEAN. In this case, an ASEAN-China FTA will emerge first. The ASEAN+3 will then be divided into ASEAN + China, Japan and Korea.

How viable would a regional arrangement such as ASEAN+1 be economically and security wise? China is not a full-fledged market economy and a communist society. It is also questionable whether ASEAN's interest would be served when it establishes a free trade area with a super military power that has an underdeveloped and closed financial system as the dominant partner. In order to diffuse China's dominance, ASEAN will attempt to establish bilateral FTAs with other countries as it has with Japan and Korea.

What options would be available to Japan and Korea in case China chooses to pursue both trade and financial integration with ASEAN and become an FTA hub? This question leads to third and fourth scenarios. Japan is proposing a Korea-Japan FTA and similar agreements to ASEAN and its individual members. This strategy, if successfully carried out, will divide ASEAN+3 into two sub-groups, making both China and Japan FTA hubs. A fourth scenario is the one in which Japan (and possibly Korea) expands the spectrum of their FTA partners to include Australia, New Zealand and other countries from South Asia. This expansion strategy could increase its leverage in dealing with China. Korea, which could be an important partner to Japan, has been cautious in negotiating a bilateral arrangement with Japan because the domestic opposition and the concern that such an agreement could strain its relations with China, which is its largest export market.

Perhaps, the most realistic scenario is that the ASEAN+3 countries will muddle through, discussing modalities of policy dialogue and coordination for bilateral FTAs without making any substantial progress, largely because China will be less than enthusiastic about taking the leadership role in promoting East Asia's economic integration. China is a large economy and growing rapidly so that it can capture benefits of multilateralism through unilateral liberalization and, therefore, does not have many incentives to join any regional agreements except for a free trade pact with ASEAN.

In the midst of confusion and uncertainty, paradoxically ASEAN may emerge as an FTA hub with China, Japan, and Korea as spokes. ASEAN may also prevail in imposing its ROO in negotiating its bilateral FTAs with the three northeastern countries. Will this development move ASEAN+3 a step closer to creating an East Asian FTA? Not likely. The completion of the three FTAs will not make any easier for the spoke countries to agree to free trade among themselves.

There is always hope, however. As shown by Lee, Park, and Shin (2004), the benefits in terms of trade creation accruing from the proliferation and overlapping of bilateral FTAs will decline. At the same time, the costs arising from different rules of origin and excluded sectors in different bilateral FTAs will increase. This development could discourage a further increase in bilateral FTAs or make East Asian countries realize the need for coordinating their trade policies, thereby producing incentives for laying the groundwork for regional trade integration in East Asia.

Against this expectation, there has been an unmistakable shift in East Asia away from ASEAN+3 to a broader group of countries for trade integration. The movement may paradoxically weaken solidarity of ASEAN+3 and may in fact defeat the very objective it has set out to achieve, which is regional economic integration centering on ASEAN+3. This may not be an undesirable development depending on the outcomes of the proliferation of FTAs. What is clear, however, is that, given the possibility that the proliferation could undermine multilateral trade liberalization efforts as the East Asian experience indicates, the global community will have to come up with a new

multilateral approach that could ensure smooth amalgamation of the existing RTAs into a single global trading system.

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Text of FTA agreements:

- AFTA
- ANZCER
- NAFTA
- EU-Mexico FTA
- Chile-Mercosur
- Japan-Singapore EPA
- Korea-Chile FTA
- Korea-Singapore FTA
- US-Singapore FTA