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Policy Insights

Towards an East Asia Free Trade Area

by Shujiro Urata

East Asia is starting to embrace free trade agreements. What will be the consequences?

FTAs and East Asian Economies

In recent years East Asia has seen the emergence of a number of new partnership agreements (NPAs, also known as economic partnership agreements or comprehensive partnership agreements). The cornerstone of these deals is the conclusion of free trade agreements (FTAs), which remove tariff and non-tariff barriers on international trade among the member countries. These alliances also promote foreign direct investment (FDI) and economic and technical co-operation. The Japan-Singapore Economic Partnership Agreement (JSEPA), which was signed in November 2002, is a typical example of an East Asian NPA.

One of the characteristics of the development of freer trade within East Asia has been that FTAs have been accompanied by NPAs, which include trade and FDI facilitation and economic assistance. These schemes reduce the adjustment costs of trade liberalisation.

Until 2002, when Japan and Singapore signed JSEPA, the ASEAN (Association of Southeast Asian Nations) Free Trade Area (AFTA) was the only major FTA in the region. AFTA was established in 1992 between six countries: Brunei, Indonesia, Malaysia, the Philippines, Singapore and Thailand. New ASEAN members, Cambodia, Laos, Myanmar, and Vietnam joined AFTA in the latter half of the 1990s. ASEAN members have become active in FTA discussions with other countries in recent years on both an individual and a collective basis (see Table 1).

China's active FTA strategy has attracted much attention. Since joining the WTO in 2001 the country has not only secured access to the world market, it has also started to develop regional trade. China, which already has a FTA with Hong Kong, is looking to establish a three-way FTA partnership with Japan and Korea. It is also negotiating the terms of a FTA with ASEAN.

The proliferation of FTAs in the region over the past decade has given birth to the idea of establishing a FTA that would encompass the whole of East Asia. The "East Asia Vision Group", which was set up by the 1998 Leaders' summit meeting of ASEAN+3 (China, Japan, and Korea) to look into the long-term possibilities for greater economic co-operation, put forward recommendations that included the introduction of an East Asia FTA. This topic has not as yet been put on the Leaders' agenda.

Why FTAs are becoming so popular in East Asia

- The success of FTAs in Europe and the Americas has illustrated the benefits of trade liberalisation to many East Asian economists; it has also obliged the countries of the region to bring down their own trade barriers in order to remain competitive.

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Table 1. **FTAs and East Asian Economies**
(as of end January 2004)

In Action	Under Negotiation	Under Study
Bangkok Treaty (1976)	China-ASEAN	Japan-ASEAN
AFTA (1992)	Hong Kong-New Zealand	Korea-ASEAN
Singapore-New Zealand (2001)	Japan-Mexico	Korea-Singapore
Japan-Singapore (2002)	Japan-Korea	Korea-Australia
China-Hong Kong (2003)	Japan-Thailand	Korea-New Zealand
Singapore-Australia (2003)	Japan-Philippines	Singapore-Chile
	Japan-Malaysia	Singapore-Chinese Taipei
	Korea-Chile(concluded)	Thailand-US
	Singapore-EFTA (concluded)	Thailand-Peru
	Singapore-US (concluded)	ASEAN-India
	Chinese Taipei-Panama (concluded)	ASEAN-US
	Thailand-Bahrain (concluded)	
	Thailand-India (concluded)	
	Thailand-Australia	

- The popularity of FTAs is largely due to the difficulties that the World Trade Organisation has encountered in trying to promote freer trade on a global scale. Regional trade agreements (RTAs), which establish both FTAs and customs unions, violate, however, one of the basic principles of GATT/WTO – that of non-discrimination. GATT Article XXIV states that RTAs are permitted on condition that practically *all* trade between member countries be liberalised, that there be no increase in trade barriers to non-members, and that the RTA process be completed within ten years.
- Many countries, including those in East Asia, believe that GATT/WTO rules can not adequately deal with rising phenomena such as FDI, trade in services and the increasing mobility of labour. Border measures such as tariffs, which are the main focus of GATT/WTO, can not provide foreign as well as domestic companies with a level playing field. The inherent limits of border measures call for the development of rules – such as competition policy – covering domestic systems. Many countries share the view that GATT/WTO is unlikely to provide such legislation expeditiously, and have started using FTAs to deal with the problem.
- East Asian economies have become interested in using FTAs as a way of promoting deregulation and structural reforms in the domestic market. The privatisation programmes that many East Asian countries underwent in the 1990s improved economic growth. Today, as many of the region's economies are recovering from the financial crisis of the late 1990s, and as scope for further deregulation becomes more limited, external pressures such as FTAs can be very effective in the pursuit of structural reforms.
- The lack of adequate international assistance during the recent economic crisis illustrated the need for improved solidarity between the countries of the region. This is one of the reasons that recent FTA initiatives in the region involve economic co-operation programmes, or NPAs.
- In their competition to emerge as the dominant force in the region China and Japan have each used FTAs to strengthen their relationships with ASEAN and theNIEs. In November 2002 China agreed to start FTA negotiations with ASEAN; the following day Japan proposed an economic partnership framework to the self-same alliance. ASEAN and the NIEs also use FTAs as a means of both maintaining and increasing their influence within East Asia.

Effects of Creating an East Asia FTA

The influence that FTAs have on trade can be classified into two types: static and dynamic. The first includes trade creation, trade diversion and terms of trade effects. Removal of trade barriers among the members would promote trade among them (trade creation effect) sometimes at the expense of imports from non-members (trade diversion effect). Furthermore, if a FTA leads to a reduction in imports from non-members, FTA members are likely to experience the improvement in their terms of trade *vis-à-vis* non members (terms of trade effect). Trade creation effects and terms of trade effects lead to an increase in economic welfare of the members, while trade diversion effect is likely to reduce economic welfare of the members because imports from most efficient suppliers in non-members are replaced by imports from less-efficient producers from the members. It is important to note that for non-members trade diversion effect and terms of trade effect lead to harmful impacts on their economic welfare.

The introduction of a FTA also has dynamic effects. These include a scale effect and competition enhancement, which are beneficial to both member and non-member countries. By increasing market size, FTAs give companies the opportunity to exploit larger economies of scale. The pro-competition effect is also increased, because competition in member countries' markets is likely to intensify as a result of trade liberalisation. This in turn encourages the development of new products and technologies. Increased competition and larger economies of scale lead to product improvement and a lowering of prices, which is good for consumers in both member and non-member countries. Increased competition can also be used to promote domestic reform.

In addition to their influence on foreign trade, FTAs are likely to increase FDI flows into member countries and divert FDI from non-member to member countries, as trade liberalisation makes markets within the FTA moreattractive. This, of course, has a damaging effect of the economies of non-member countries.

Urata and Kiyota (2003)[1] provide simulation results which indicate that economic growth and welfare would accrue to all member states, following the introduction of a FTA, with the increase in national prosperity being particularly marked in the ASEAN countries (see Table 2). Thailand stands out within this category: they estimate that Thai GDP would increase by 16 per cent. The current, particularly high level of protection explains this exceptional rate of growth.

The introduction of an East Asian FTA would shrink the economies of a number of non-member states. This phenomenon occurs when exports to a FTA are substituted by trade between member countries as a result of preferential treatment. Shrinkage would be more marked in countries such as Australia/New Zealand and Other Asia – for which East Asia represents a far more important export market – than it would be for the United States or the European Union.

1. Urata, S. and K. Kiyota (2003), "The Impacts of an East Asia FTA on Foreign Trade in East Asia," *NBER Working Paper* No. 10173.

Table 2. **Effects of an East Asia FTA on Real GDP and Welfare**

	GDP	Equivalent Variation	
	(Changes from base data, %)	(Changes from base data, $ million)	(Changes divided by GDP in 1997, %)
Australia/New Zealand	-0.23	-1 342	-0.29
China	1.27	5 485	0.64
Hong Kong	1.41	3 389	2.42
Japan	0.05	8 199	0.19
Korea	1.71	7 805	1.75
Indonesia	5.61	10 209	4.89
Malaysia	2.83	2 279	2.15
Philippines	2.02	602	0.77
Singapore	2.26	2 944	3.69
Chinese Taipei	1.51	5 597	1.87
Thailand	15.90	19 790	12.54
Vietnam	8.42	1 446	6.61
Other Asia	-0.31	-1 803	-0.34
United States	-0.06	-7 059	-0.09
European Union	-0.01	-1 807	-0.02

Source: Urata and Kiyota (2003).

It should be noted that these estimates may be rather conservative as they do not take into account the dynamic effects that the introduction of a FTA would inevitably have. The economic impact of the FTA would be further enhanced if additional measures of integration, such as economic co-operation and trade and FDI facilitation, were to be included in the reform.

The advantages of FTAs and NPAs are not purely economic. In introducing a NPA, member countries increase their mutual reliance. Greater regional co-operation helps to reduce political and social frictions. Social and political stability encourages further economic growth.

Obstacles to Creating an East Asia FTA

The introduction of a FTA in East Asia would be likely to encounter fierce opposition from non-competitive sectors, which would be forced to go through painful structural adjustment in order to remain viable. This problem is specific to FTAs covering countries at very different stages of economic development, as is the case in East Asia. When there is a level playing field the transition to a more open market is facilitated by higher levels of horizontal intra-industry trade.

The production levels of non-competitive and "sensitive" sectors would decline following the introduction of an East Asian FTA. Particularly vulnerable industries include agriculture in Japan and Korea, and transport machinery in China, Chinese Taipei, Malaysia, Indonesia and a number of other countries. Given that agriculture is already in decline in Japan and Korea, it would be desirable purely from the point of view of resource allocation to lower production levels even further. Lobbying by farmers and their political supporters, however, would make it very difficult for the governments of these countries to sign up to an East Asia FTA. Automobile production in the developing countries of East Asia is a potential growth area, but the introduction of a FTA in the region would be likely to undermine what is at present a non-competitive sector. This would be a great disappointment to affected countries, so would represent a source of opposition to any region-wide FTA plan.

As the history of the formation of the EEC/European Union shows, strong political leadership is a prerequisite to economic integration between a relatively large number of nation states. China and Japan would be the obvious powers to take the lead in the creation of an East Asia FTA, but so far co-operation between these two countries remains limited in the trade policy area. They see themselves as rivals rather than partners and have divergent views on such issues as political system and regional security.

Although most of the countries within East Asia now have democratic political systems, some are still ruled by authoritarian regimes. Though this consideration may hinder the setting up of an East Asian FTA, over time the economic and political ties that such an agreement could create would be likely to foster a common view of regional security.

Finally, it is often heard that historical conflicts between China, Japan and Korea stand in the way of a future partnership in the form of an East Asia FTA. The European experience, however, shows that economic integration can be a way of drawing a line under a troubled past and that, over time, ever closer economic and social ties can help secure a more harmonious future.

Ways Forward

Many of the countries of East Asia are hoping, in the long term, to achieve deeper economic integration. Although the hurdles standing in the way of the creation of a region-wide FTA are numerous, they are not insurmountable.

Perhaps the biggest stumbling block is the structural adjustment that an East Asian FTA would impose on member countries, with increased pressure being put on unprofitable industries. Scheduling trade liberalisation in sensitive sectors as a part of a FTA deal would help ease the transition period. GATT/WTO rules allow members of a FTA ten years to complete the process of economic integration. East Asian countries would be well advised to use this breathing space to instigate suitable adjustment policies. For example, workers likely to lose their jobs as a result of increased competition should be provided with training and financial aid so that they can improve their chances of finding work in more productive industries. NPA programmes stipulate that financial resources for these schemes should be shared between member states. The more developed countries of a hypothetical East Asian FTA, namely Japan, Korea, Chinese Taipei and Singapore, would be expected to help other member countries upgrade the skills of workers in vulnerable industries. Japan can provide assistance to other countries of the region in developing competitive small and medium-sized enterprises, which would help ease the transition process.

East Asian countries need to deepen mutual understanding at all levels of society and to increase awareness of the potential benefits of an integrated regional market. Leaders' meetings should be held at least annually, as they represent a crucial forum for improving regional co-operation. Televised debates can be used to supplement face-to-face meetings. Policy makers from across the potential FTA member states should work in close consultation with one another. Cross-country links should be established wherever possible, be these between civil servants, business people or academics. The setting up of frameworks such as student exchange programmes is effective in fostering closer regional ties. Such initiatives can be established independently, but they would be more effective if they were co-ordinated under NPAs.

Finally, the countries of East Asia should not regard the introduction of an integrated regional market as being an end in itself, but rather as a step towards achieving global freer trade under the WTO. This is particularly important given that an East Asian FTA would have an adverse effect on non-member trade partners. To avoid an East Asia FTA becoming a stumbling block to global freer trade, the affected countries should make every effort to promote multilateral trade negotiations under the WTO and establish FTAs with countries from outside the region.

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