

# A 3 bloc dance: East Asian regionalism and the North Atlantic trade giants

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## 1 INTRODUCTION

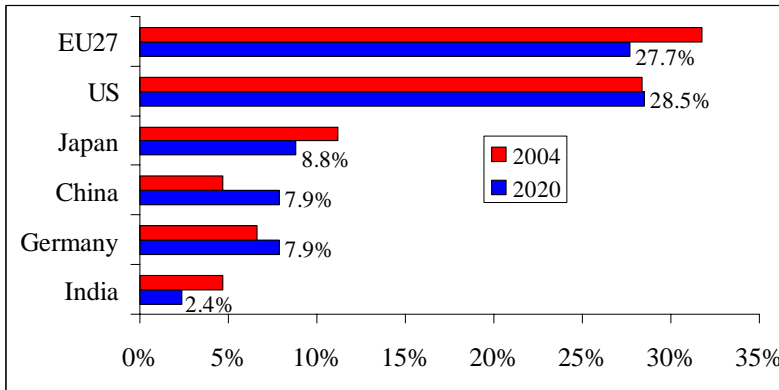
The world is traditionally described as consisting of three trade blocs – the EU, North America and East Asia – even though only the first two have substantial institutional underpinnings. While the blocs have remained fairly distinct up till now, they are starting to ‘dance’ and the dance is being held in East Asia.

East Asia – the region that eschewed regionalism for so long – now finds itself at the heart of global regionalism. East Asia is rapidly pursuing regional integration with ASEAN at its heart, but individual East Asian nations have signed or are pursuing bilateral FTAs with countries from outside the region. Most notably, both of the North Atlantic trade blocs have begun to pursue bilateral FTAs with East Asian countries. The US has signed FTAs with Singapore, Australia, and Korea, and started negotiations with Malaysia and Thailand (the fate of US-Korea is unclear under the Obama administration). The EU is negotiating an FTA with ASEAN, India, and Korea.

This paper explores some of the novel political economy forces that may be generated by these new cross-regional trade initiatives by the two existing trade ‘hubs’ – the EU and US. The paper starts by reviewing some background facts that illustrate the importance of Asia as a trade block. It then goes on to consider the current state of trade agreements in Asia and then the arrangements between the US and the EU on the one hand and Asian nations on the other. The paper moves from fact to conjectures with some discussion of various medium run scenarios and their implications for the world trade system. The paper concludes by suggesting that the 3-bloc dance may force the US to push for a global free trade agreement in industrial goods – something like the Information Technology Agreement but covering most industrial sectors.

## 2 THE BACKGROUND FACTS

East Asia is the fastest growing region in the world and having been so for many years now, it has become a market that no major trading nation can afford to ignore. As the numbers in Figure 1 show, the EU and US are forecasted to remain the largest markets by far, but China should match Germany by the end of the next decade. Note that since we are interested in market potential – i.e. the ability of people to buy imported goods – the size of the market is measured as nominal GDP in dollars.

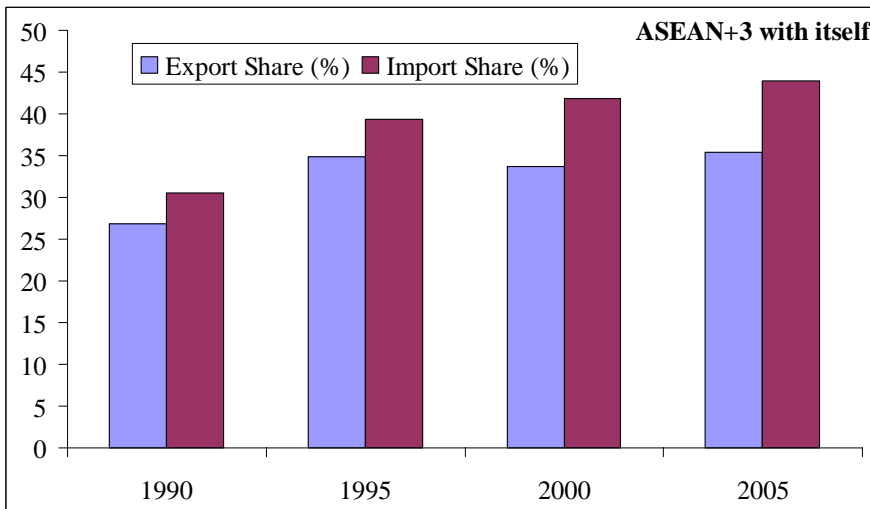


**Figure 1: Current and future (2020) shares of world nominal GDP.**

Notes: Nominal GDP in dollars; adjustments for local prices (PPP corrections) are useful for working out living standards but misleading for trade market-size purposes. After all, the fact that non-traded goods are cheap in China does not help the Chinese purchase EU automobiles.

Source: 2004 for EU from WEO 2007 and authors' calculations, 2020 from Winters and Yusuf (2007).

East Asia has also embarked on intra-regional integration that seems to be working. The region's share of trade with itself has jumped from about 25% to over 40% on the import side between 1990 and 2005 (see Figure 2).



**Figure 2: ASEAN+3's trade share with itself, 1990-2005**

Source: ADB's Asian Regional Integration Centre website.

The rise in intra-regional trade is marked by three quite unusual features.

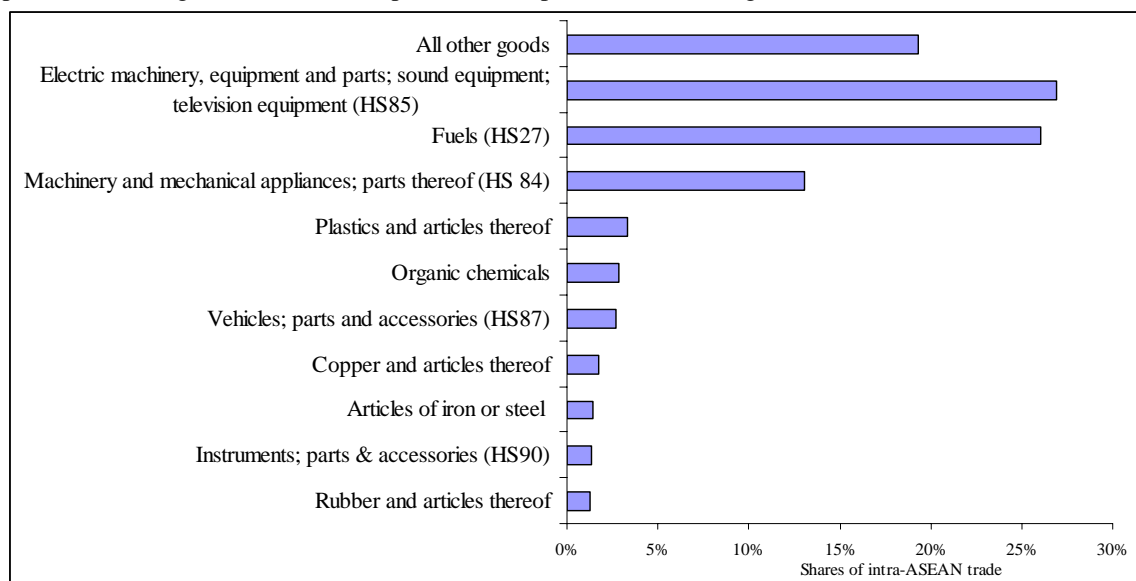
1. Much of this trade is the outcome of 'Factory Asia' (Baldwin 2008, Ando and Kimura 2005).

Asian manufacturing depends upon a dense network of intra-regional trade and investment that has spread the production of manufactured goods across the region thus spurring a fabulous growth in parts and components. Many of the final goods, however, are not sold in the region, but rather exported around the world, especially to the North Atlantic trade giants, the EU and US.<sup>1</sup> What this means is that much of the intra-regional trade is 'caused' by the extra-regional exports. The high intra-regional share in Figure 2, in other words, is not so much a sign of Asia turning in on itself as it is of Asia cooperating with itself to produce goods with world-beating price-quality ratios.

This can be seen in a variety of ways. ASEAN, which is just one part of Factory Asia, does a lot of trade with itself but most of this is in electrical and mechanical machinery (intra-bloc oil exports from

<sup>1</sup> See Figure 3.5 in ADB (2008); the US and EU's direct and indirect share in final demand of goods produced in East Asia is 43.2%.

Brunei and Indonesia are an important exception). Figure 2 uses the most recent data to show this pattern. These figures do not isolate parts and components from final goods.



**Figure 3: ASEAN trades most machines and electronics with itself, 2006**

Source: ASEAN Secretariat web site.

Athukorala and Kohpaiboon (2008) classify highly disaggregated goods into final goods, and parts and components and then re-aggregate these for the region. A précis of their findings is presented in Table 1. This gives a statistical picture of Factory Asia for the manufacturing sector as a whole as well as for the subsector dealing with motor vehicles. The table shows that for East Asia as a whole 71% of all its exports of parts and components go to East Asia itself. By contrast, less than half of East Asian exports of final manufactured goods are sold within the region – the major markets for final goods are the EU and the US.

**Table 1: Intra-regional import shares of parts vs final goods, by region and sector (2005-06 average, %)**

	<i>East Asia</i>	<i>EU15</i>	<i>NAFTA</i>	<i>ASEAN</i>
<b>Manufacturing</b>				
Parts and components	71	56	42	25
Final goods	48	61	32	20
<b>Motor vehicles</b>				
Parts and components	53	75	59	18
Final goods	31	72	50	15

Source: Authors calculations based on data from Table 6, Athukorala and Kohpaiboon (2008).

Note: ASEAN+3 = ASEAN nations plus China, Korea and Japan.

Note: Much of the trade in electronic components is subject to global free trade as a result of the 1997 Information Technology Agreement negotiated at the WTO. For these ITA goods, preferences are irrelevant since all tariffs are bound at zero. MFN tariffs and thus preferences can be important in final electronics, however.

A comparison with the EU15 and NAFTA blocs shows that this is not inevitable. The EU15, for example, actually exports a higher fraction of its final manufactures to itself (61%) than parts and components (56%). This is because much of the EU15's offshoring of parts-and-components-processing is in Central Europe or the Mediterranean nations (i.e. Factory Europe includes the whole Euro-Med area). NAFTA, which does much of its parts-and-components-processing in Mexico and/or Canada, see a more East Asian-like pattern, with only 32% of its final manufactures exports going to itself, but 42% of its manufactures parts and components. Interestingly, ASEAN is between East Asia

and the NAFTA case. The reason is that many of the final goods producers are in Japan, China, Korea, Honk Kong, or Taipei China.

2. Preferential trade liberalisation is just starting to affect the region.

The commercially most important arrangements that have been signed – the ASEAN FTA (AFTA), the China-ASEAN FTA (CAFTA), the Japanese bilaterals with the major ASEANs (JAFTAs), and the Korea-ASEAN FTA (KAFTA) – are supposed to be phased in by 2010, but they are just starting to create serious discrimination on tariffs. A very large amount of the preferential tariff cutting to date has been accompanied by unilateral extensions of the tariff cuts to MFN trade, at least in manufactured goods (which dominate these nations’ imports).

As Table 2 shows, a good share of these nations’ imports is already MFN duty-free. Moreover, many of them have unilaterally lowered their MFN applied rates substantially below their bound rates, especially in non-agricultural goods. Starting with the developing nations in the region, we see that the average applied rates on manufactured goods (non-ag) are in the range of 6 to 9 percent, although the bound rates are much higher. Zero tariffs are not uncommon, ranging from 55 percent of the tariff lines in Malaysia to just 3 percent in the Philippines. On the other extreme, there are not many really high tariffs. The percent of tariff lines over 15 percent ranges from 24% for Malaysia to just 2% for Indonesia and the Philippines. Generally, the richer nations in the region (Japan, Taipei and Korea) tend to have lower tariffs over all, and very few high tariffs – at least as far as non-agriculture goods are concerned. All across the region, agriculture goods face very high tariff barriers.

**Table 2: MFN applied and bound tariffs in East Asia, 2007**

	Non-Ag goods					Ag goods	
	Tariff averages		% of tariff lines			Bound	Applied
	Bound	Applied	Duty free	Binding coverage	Tariffs > 15%		
China	9	9	7	100	13	16	16
Thailand	26	8	21	71	17	40	22
Malaysia	15	8	55	81	24	76	12
Indonesia	36	7	24	96	2	47	9
Philippines	23	6	3	62	2	35	10
Korea	10	7	17	94	2	59	49
Taipei	5	5	32	100	2	18	18
Japan	2	3	55	100	1	23	22
Others:							
Australia	11	4	45	97	5	3	1
India	36	12	4	70	8	114	34

Source: WTO (2008).

Note: Singapore’s and Hong Kong’s tariffs are almost all zero.

Australia and India, two other nations near the region, have very different trade policies. India is highly protectionist in agricultural goods, but less so in non-agriculture goods, even though its applied MFN average is twice that of, say, the Philippines or Indonesia. Australia, by contrast, has very low tariffs across the board.

The overall message from these numbers is that there are few MFN tariffs in the region where duty-free preferential rates would make much difference – except in agriculture, where all the nations tend to applied high or very high tariffs.

The average numbers in Table 2 hide a very clear pattern in the unilateral tariff liberalisation that was the main driver of trade liberalisation in the region. This pattern lines up closely with the creation of Factory Asia, and it was what created such a large gap between the bound and applied rates in

manufactures. The key is that much of the unilateral liberalisation concerned parts and components rather than final goods, as the examples in Table 3 illustrate.

**Table 3: Tariffs on engines and cars in selected ASEAN nations.**

	Malaysia		Indonesia		Philippines		Thailand	
	MFN	CEPT	MFN	CEPT	MFN	CEPT	MFN	CEPT
<b>Small engines</b>								
- Of a cylinder capacity not exceeding 50 cc	25	0	0	0	0	0	10	0
- Exceeding 50 cc but not exceeding 110 cc	30	0	0	0	0	0	10	0
- Exceeding 110 cc but not exceeding 250 cc	5	0	0	0	0	0	10	0
- Exceeding 250 cc but not exceeding 1,000 cc	5	0	0	0	0	0	10	0
<b>Small vehicles (new, completely built up)</b>	30	5	55	5	30	5	80	5

Note: CEPT = Common Effective Preferential Tariff; More precisely engines means: "Reciprocating piston engines of a kind used for the propulsion of vehicles of Chapter 87"; Small cars means: "Other vehicles, with spark-ignition internal combustion reciprocating piston engine: Of a cylinder capacity.

Source: ASEAN Secretariat website, accessed May 2009.

The table looks at ASEAN tariffs on a particular component (small engines) and a particular final good, small vehicles. What we see is that apart from Malaysia, the MFN tariffs on the engines are much lower (often zero) than they are on the final good. Indonesia, for example, lets engines in duty free but charges a 55 percent MFN tariff on final vehicles using the engines, creating an enormous effective rate of protection for the assembly of such goods. Malaysia and Thailand, which have more substantial motor industries than the other two, also charge tariffs on the engines, but they still charge higher tariffs on the final goods.

As far as preferences are concerned, we see that very large margins of preferences are beginning to appear inside ASEAN. The Common Effective Preferential Tariff (CEPT) must, according to ASEAN's FTA rules, be between zero and 5 percent. As the table shows, all four of these major ASEANs have set the CEPT at its maximum. By 2010, the CEPT should fall to zero, widening the preference margins even more.

### 3. There is no regional leader to coordinate or guide regionalism.

In all other major trade areas (EU, North America, the Southern Cone, Southern Africa, etc.) the dominant economy takes the lead in organising free trade agreements. In East Asia, the two natural leaders – Japan and China – have been reluctant to play this role and no clear alternative has emerged. Korea has not been active in organising regional trade arrangements (although Korean thinkers have been important in discussing it) and ASEAN – which has emerged as the de facto focal point – is not institutionally capable of taking a strong leadership position.

## 2.1 Current state of Trade agreements in Asia

Asian regionalism is complicated. Dozens if not hundreds of trade deals are under discussion, under negotiation, or already signed.<sup>2</sup> Even limiting the universe to the deals that have been signed or are near signing, it is clear that East Asian regionalism is marked by a "Noodle Bowl Syndrome."

### 2.1.1 How we got here

FTAs in East Asia are spreading like wildfire, but until quite recently the region was the only region of the world, where regional trade agreements were rare. Baldwin (2008a) argues that this outcome can

<sup>2</sup> See the web site <http://aric.adb.org/> for the most up-to-date account.

be explained by an Asian version of the domino theory of regionalism.<sup>3</sup> The reasoning is clearest when distinguishing three phases of East Asian regionalism.

- Phase I (mid 1980s to 1990). During this phase, regional tariff cutting was driven nation's desire to attract the manufacturing jobs being offered private firms (mostly from Japan, Korea, Hong Kong, Singapore and Taipei) while they were setting up "Factory Asia".
- Phase II (1990 to 2000). This phase saw intra-regional trade expand rapidly as the gradual opening of China accelerated the development of Factory Asia.

Phase I and II of East Asian regionalism are sometimes called 'de facto' regionalism since there few formal trade agreements. While the idea for formal deals had been in the air at least since Mahathir's 1990 call for an East Asian Economic Group, the US delayed the move with the diversionary tactic of APEC. However, two events at the end of Phase II set the stage for the "FTA wildfire." First, the 1997 Asian Crisis revealed the hollowness of APEC, and, second, China's continued economic success, pacific behaviour, and impeding WTO membership foretold the end of the East Asian status quo.

- Phase III (2000 to today) was initiated by China's suggestion, in November 2000, that it might be willing to negotiate an FTA with the ASEANs (Sheng, 2003).

The domino effect that China triggered continues to operate even in 2009. The rapidly lengthened list of FTAs within East Asia has drawn in most the nearby countries into the FTA wildfire – most notably India, Australia and New Zealand.

We turn now to briefly reviewing the intra-East Asian agreements.

### 2.1.2 The Noodle Bowl Simplified

One branch of the Impressionist movement, Pointillism, consists of paintings made up of thousands of small coloured dots. Focusing on the dots provides the viewer with much information but little understanding. To get the big picture, one has to step back and ignore many of the details. A similar thing is true of East Asian regionalism. The situation seems hopelessly complex, but it becomes clearer when one ignores the FTAs that are inconsequential from the broader international trade perspective. For example:

- Singapore has signed a world-beating number of agreements.

Singapore is a small economy by world standards and two-thirds of its GDP is generated by its service sector, with trade-related services like shipping, insurance, finance and customs clearing services playing an important role. Moreover, the City-State long ago unilaterally lowered its tariffs to zero, so an FTA with Singapore either avoids substantial liberalisation or it is a unilateral concession by Singapore's counterparty. Consequently, the proliferation of Singapore's FTAs can be usefully omitted from thinking about East Asian regionalism. While Singapore accounts for about a tenth of intra-East Asian trade, its imports were duty free during all three phases.

- Likewise, the trade deal between China and Hong Kong, and China and Macao are no more relevant to the picture than a free trade deal between Tokyo and Hokkaido would be.

In particular, since Hong Kong maintains zero MFN tariffs and exports few goods to China that compete with exports from East Asian nations, its preferential deal with China essentially irrelevant to East Asian regionalism.

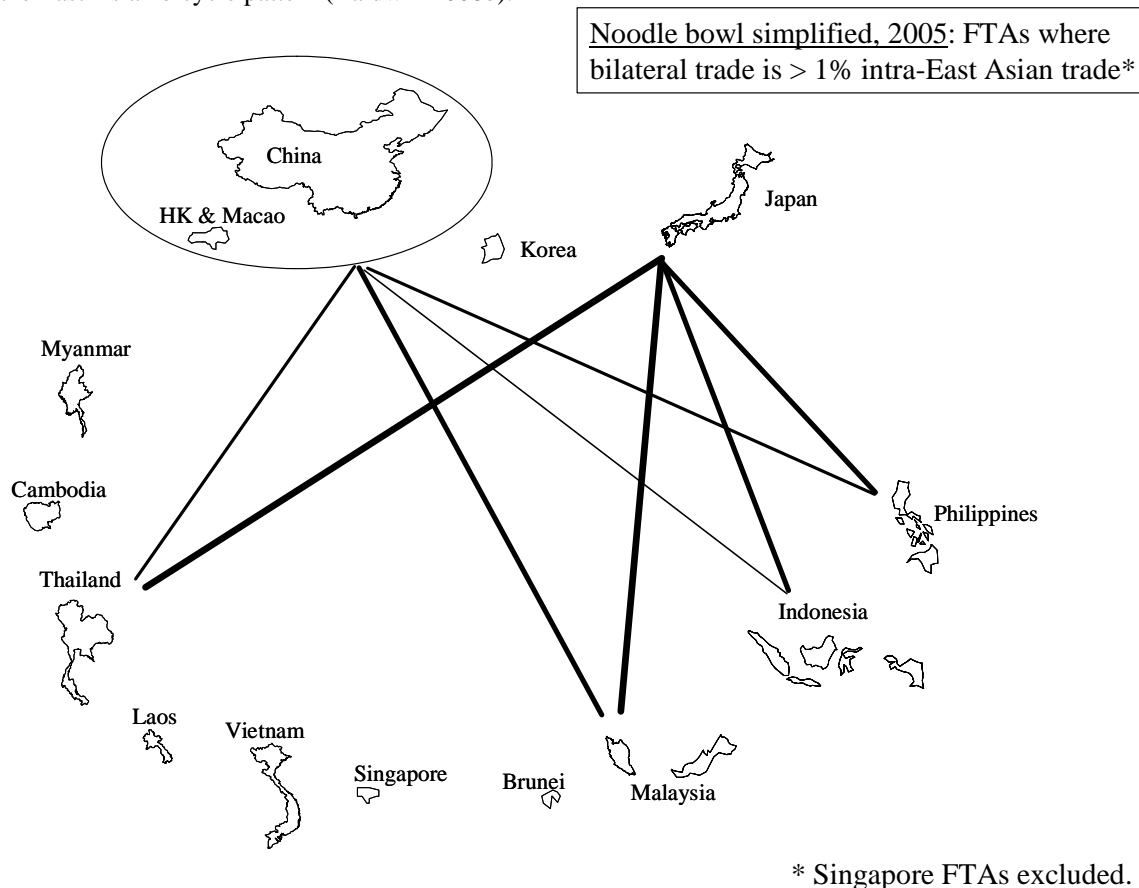
- Most bilateral trade flows in East Asia cover trade volumes that are inconsequential.

To make this point, Figure 4 shows all the East Asian FTAs that have been signed as of January 2006 which cover at least 1% of intra-East Asian trade based on 2002 figures. (The thickness of the lines is proportional to the volume of trade.) All FTAs involving Singapore have been excluded for the reasons given above.

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<sup>3</sup> The domino theory was proposed in the early 1990s to explain spreading regionalism in North America and Europe, see Baldwin (1995).

The trade volume requirement immediately eliminates all of the intra-ASEAN FTAs except the Thailand-Malaysia link and Singapore's link with the four biggest ASEAN traders, Malaysia, Thailand, Indonesia and the Philippines; the no-Singapore condition eliminates these 4 bilaterals. When we have simplified the noodle bowl by only focusing on bilaterals that might be of consequence to third nations in the region, the picture is quite stark. We immediately see that 'real' East Asian regionalism is – by our definition – marked by a hub-and-spoke arrangement with two hubs, Japan and China. It is important to note that many of the negative aspects of hub-and-spoke regionalism are mitigated by AFTA, but from a systemic point of view, the key trade arrangements in East Asia – i.e. the trade deals that cause concern to third nations – are dominated by China and Japan. This is what has been called the East Asian bicycle pattern (Baldwin 2008b).



**Figure 4: Noodle Bowl Simplified.**

Note: East Asian FTAs signed by 1 January 2006 that cover bilateral trade that exceeds 1% of total East Asian trade.

By focusing on the trade ties that really matter from a political economy perspective, we can more easily organise our thinking about Asian regionalism. In mid-2008 East Asian regionalism has four pillars:

- The Japan-ASEAN bilaterals;
- The China-ASEAN FTA;
- The Korea-ASEAN FTA, and
- The FTA-like agreement among the ASEANs themselves, namely AFTA.

These four pillars are very different in terms of the legal, political and institutional solidity. The Japan-ASEANs bilateral are by far the most solid and commercially important. They read like EU or US FTAs with pages of legalese that foresee solutions to many possible difficulties, and they are notified to the WTO under Article 24 (which implies a higher level of discipline than the Enable Clause, which has been used for the FTA involving China and the ASEANs). Moreover, given the extremely asymmetric dependence of Japanese exporters on the individual ASEAN markets concerned on the one

hand, and dependence of exporters in the ASEANs on the Japanese markets on the other, these FTAs are very likely to be implemented as they are written. The ACFTA shares the asymmetry of export dependence and so is likely to be implemented, as long as the freeing up of trade does not lead to massive relocation of industry from the ASEANs to China. The Korea-ASEAN FTA does not feature large asymmetries in export dependence – none of the parties cares greatly about the others' markets – so no one will have a large stake in ensuring the agreement actually becomes effective. Finally, AFTA is useful in that it is a vehicle for much technical coordination of trade liberalisation issues (harmonisation of the finer HS categories, and rules of origin, etc.), even if it has not resulted in substantial intra-regional trade liberalisation (most of this was accomplished via unilateral tariff cutting between 1985 and 2000).

Next we turn now to the main agreements.

### **China-ASEAN**

China's unexpected offer in 2000 to sign an FTA with the ASEANs triggered a domino effect in the region. The effect, however, occurred in slow motion. It was only after years of difficult discussions that China and the ASEANs signed an FTA in December 2004.

### **Japan-ASEAN and bilaterals**

Japan proposed an FTA with the ASEANs in January 2002 and the parties signed a Joint Declaration in November 2002 to establish closer economic relationships that could include an FTA. In October 2003 they adopted a Framework Agreement laying out further steps, but progress was slow with the agreement being signed only in April 2008.<sup>4</sup>

Since progress on the ASEAN deal would clearly be slow, Japan also embraced bilateralism – negotiating bilateral deals with those ASEANs where the mercantile interest is greatest on both sides, namely Malaysia, Thailand, Indonesia, Singapore, Brunei, and the Philippines. All of these deals have been signed over the past years: Malaysia (December 2005), Thailand (April 2007), Indonesia (August 2007), Singapore (December 2002), Brunei (June 2007), and the Philippines (September 2006).

The Japan-Malaysia FTA (JMFTA), signed in December 2005, sets an extremely important precedence for East Asian regionalism. Indeed, the deal revealed what became the basic pattern for FTAs between the industrialised East Asian nations – Japan and Korea – and the rapidly industrialising East Asian nations such as Indonesia, Thailand, Malaysia, the Philippines and Vietnam. Due to extremely well-entrenched special interest groups, Japan's government finds it impossible to liberalise most agricultural goods, but especially rice and beef. Japan's FTA partners use this impossibility as a lever to win concessions from Japan on their favourite import-substitution industrial sector. In the case of Malaysia, the favoured sector is automobiles. However, in the JMFTA the Malaysian government has been very farsighted by agreeing to phase out tariffs, but insisting that Japan provides technical assistance for its car industry. Presumably the idea is that auto tariffs will in any case have to be phased out eventually and this JMFTA provides an opportunity for boosting Malaysian auto industry competitiveness in advance. It is also possible that Malaysia felt compelled to make concessions on autos, since it knew Japan was also talking about cars with its rivals in Indonesia and Thailand, and ASEAN did not coordinate four bilateral talks with Japan.

### **Korea-ASEAN**

Korea – whose market is far less important to ASEAN exporters than China's or Japan's – is playing catch-up in the FTA department. The FTA processes between the ASEANs on one hand and China and Japan on the other formally started with Framework Agreements in 2002 and 2003 respectively.

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<sup>4</sup> See <http://www.mofa.go.jp/policy/economy/fta/asean/agreement.html> for the latest progress on ratification.



Korea's first step, a Joint Declaration, came a year later in October 2003 and its Framework Agreement with ASEAN was signed in 2005, and even then difficulties between Thailand and Korea prevented publication of the AKFTA framework.

The differences between Korea's and Japan's experience with the ASEANs are extremely revealing and help illustrate the political economy forces that tend to create hub and spoke trade arrangements. For both Korea and Japan, rice is an extremely sensitive issue in domestic politics, while rice is an important export for several ASEANs but especially for Thailand. When the rice issue came up in the Japan-Thai FTA talks, Japan's large market and high level of imports from Thailand gave it the bargaining leverage necessary to exclude rice from Japan-Thailand liberalisation. Something like 15% of all Thai exports go to Japan, so the market-access gains to Thai manufactures exporters were a prize that compensated the failure to gain better access for Thai rice. Simultaneously, the large size of the Japanese auto industry made Thai car producer believe that it was essential to maintain their protection against Japan. Thus the fact that Japan was so large compared to Thailand was critical to establishing the economic basis of the political deal, rice for autos. Moreover, Japanese FDI has been critical in Thai industrialisation over the past two decades.

Korea, by contrast, was not able to get a deal with ASEAN as a whole in December 2005, since Thailand insisted that Korea could not exclude rice from its preferential market opening.

Why would Thailand let Japan do something that it would not allow Korea to do? Korea absorbs only 2% of Thai exports and Korean FDI has not played as significant a role in Thailand's development. Moreover, while the Japan-Thai trade relationship is lopsided (Thailand cares far more about the Japanese market than Japan does about the Thai market), the Korea-Thai relationship is more balanced, and balanced at a very low level – neither nation depends upon the others' market for more than a percentage point or two of its exports. Because neither Korean nor Thai exporters care a great deal about each others' markets, the protectionist tend to win when it comes to the Korea-Thailand link (low exclusion index), but tend to lose when it comes to the Japan-Thailand link (high exclusion index, i.e. hub-spoke).

### **Japan-Korea FTA: talks deadlocked**

Japan and Korea are two of the three large economies in Asia and together they absorb something like a third of all intra-East Asian trade – a figure that would be even higher if one ignored the trans-shipment trade of Singapore and China's trade with itself (Hong Kong). What this means is that a tie up between these two nations would create an almost irresistible domino effect in East Asia. The resulting shape of East Asian regionalism would be quite positive since the basis, the JKFTA, would be an Article 24 disciplined arrangement between two nations with relatively low MNF tariffs. For these reasons, the Korea-Japan trade relationship is one of the most important links as far as the development of East Asian regionalism is concerned (the other is Japan-China).

The two countries began talks in 2003. Progress, however, has been difficult and discussions all but came to a halt in 2005. Prospects for an early agreement look grim. The talks ran up against the fundamental incompatibility of the two nations' development strategies and current situation. For decades, Korea's trade policy has been aimed at turning the Korean economy into something similar to Japan's – an exporter of medium and hi-tech manufactured goods to Western markets. Despite Korea's significantly higher tariffs on such goods, Korea runs a large and persistent trade deficit with Japan in these goods – the goods that Korea is counting on for its future growth. Given the asymmetry in MFN tariffs on such goods, a free trade agreement would do more to foster Japanese access to the Korean market in such goods than it would do to foster Korean access to the Japanese market in the same goods. This is why it will be difficult for an 'industry-only FTA' between the two partners to be viewed as 'balanced' by the Korean side.

It is conceivable that Japanese promises to boost investment and technology transfers to Korea in the concerned sectors could counter-balance this asymmetry, but such an offer may be seen as

incompatible with Japan's desire to hold on to its own edge. Another conceivable source of balancing concessions by Japan would be in the area of agriculture. Although Korea's farm sector is heavily protected and far from competitive by world standards, Japan's fantastically high agricultural protection means that Korean farmers would have a comparative cost advantage in the Japanese market. Since Korean farmers are a major source of political difficulties for Seoul's trade policies, a Japan-Korea FTA that won new markets for Korean farmers might have a chance of counter-balancing the potential opposition of Korean manufacturers. Japan, however, seems quite unlikely to make any significant concessions in agriculture in the context of an FTA.

In summary, Korea's development strategy makes it difficult to open up its industrial sector to Japanese competition. Japan's political strategy makes it difficult to open up its farm sector to Korean competition. Until these two positions soften, agreement will require the push from an overarching geopolitical reason for signing the deal.

### 2.1.3 Asia beyond East Asia

The list of Asian nations signing or negotiating FTAs is truly impressive. As usual, however, most of the players are too small to matter for global trade relations. Here we focus on India, Australia and New Zealand.

#### Australia and New Zealand

The 10 ASEANs, and Australia and New Zealand launched negotiations in 2004 on a free trade agreement. Progress was slow, but the parties agreed a deal in 2009 covering goods, services and investment. Australia and New Zealand already have bilaterals with Singapore and are negotiating with China, India, Japan and Malaysia; New Zealand already has an FTA with China and is negotiating with Malaysia.

#### India

Fearing that its exporters might be left behind in the scramble for Asian FTAs, India has launched trade talks with ASEAN, China, Japan, Australia and New Zealand. Since India appears reluctant to remove its industrial and agricultural tariffs even bilaterally, none of these negotiations promise to deliver agreements in the foreseeable future. The signing of the ASEAN-India FTA, for example, was postponed in 2009 due to the global economic crisis.

### 2.1.4 East Asian dominos

To see how the FTA mania spread, Table 4 shows the developments by year, ignoring the less important events. What we see is that once the China-ASEAN FTA talks got started in 2001, the dominos fell rapidly. Japan jumped whole heartedly into the FTA business, starting talks with the major ASEANs and ASEAN as a whole by 2004. New Zealand joined the game in 2003 with approaches to Thailand and China. Australia, which was initially reluctant, opened its FTA strategy in East Asia with talks on an FTA with ASEAN (joint with New Zealand with which it had a deep RTA since the 1980s). India joined in 2006.

**Table 4: Chronology of East Asian domino effects**

<i>Year</i>	<i>Event</i>
2000	Chinese premier proposes FTA with ASEAN
2001	China ASEAN FTA (CAFTA) talks started China joins WTO (after 15 years of negotiation)
	Japan-Singapore Economic Partnership Agreement (EPA) talks started
2002	Japan-Singapore EPA signed

2003	ASEANs adjust their own FTA to match the deadlines and goals emerging in China-ASEAN FTA talks; specifically the goal being zero tariffs by 2010 (instead of just less than 5% as in the 1993 ASEAN PTA agreement)
	Japan-Korea EPA talks started
	Japan-Malaysia EPA talks started
	Japan-Thailand EPA talks started
	New Zealand - Thailand FTA talks started
	China-Thailand FTA on farm goods signed
2004	China-Hong Kong & Macau trade agreements signed
	CAFTA signed
	Japan-Philippines EPA talks started
	Korea-Malaysia FTA talks started
	China-New Zealand FTA talks started
	New Zealand - Thailand Closer Economic Partnership Agreement signed
2005	Japan-ASEAN EPA talks started
	Japan-Malaysia EPA signed
	Japan-Indonesia EPA talks started
	Australia & New Zealand FTA talks with ASEAN started
2006	Japan-Philippines EPA signed
	Japan-Viet Nam EPA talks started
	Japan-Brunei EPA signed
	Korea-ASEAN FTA signed
	Korea-India FTA talks started
2007	Japan-Indonesia EPA signed
	Japan-Thailand EPA signed
	Japan-Australia EPA talks started
	Japan-India EPA talks started
	Japan-Brunei EPA signed
	China-ASEAN FTA in services signed
2008	Japan-Viet Nam EPA signed
	Australia & New Zealand FTA with ASEAN signed
	New Zealand-China FTA signed
2009	Korea-Australia FTA talks started
	Korea-India FTA signed
	Korea-New Zealand FTA talks started

Source: Authors' compilation.

### 3 ASIAN TALKS WITH EUROPE AND WITH THE US

Trade relations between Asia and small European nations have proceeded rapidly. The European Free Trade Association (EFTA) has already signed an FTA with Korea (2006) and Singapore (2003). Switzerland, the only industrial exporter in EFTA, has signed an FTA with Japan. The willingness of EFTAs to leave out agriculture – especially sensitive items such as beef and rice – has made it relatively easy to find common ground on bilateral FTAs with East Asian nations. This fact augurs well for the much more commercially important trade pacts that the EU is contemplating, but the situation is

different. Following a tradition dating back to the Cold War, EFTA ignores politically sensitive aspects such as democracy, and social and environmental policy. The EU, by contrast, does not and this poses problems.

### **3.1 The EU and Asia**

Since mid 2007, the EU has been negotiating an FTA with ASEAN as a whole. These talks are complicated by the fact that the EU would have trouble signing an agreement with a military dictatorship such as Myanmar. This may eventually lead the EU to embrace the Japanese dual track system of negotiating with ASEAN as a whole (slowly) and with the economically most important ASEANs individually. Indeed, talks on the EU's standard less-than-FTA bilateral deals, so-called Partnership and Cooperation Agreements, have already been launched with the major ASEANs.

While the EU is willing to exclude agriculture – a fact that makes trade agreements easier with most ASEANs – the ASEANs have their own reservations. There are also important commercial issues on the side of the ASEANs who wish to continue protecting some elements of their industry from Europe's high-tech advantage.

The EU launched talks with both India and Korea in 2007. Negotiations with India have proven problematic. As in the case of ASEAN, India does not seem willing to accept that a free trade agreement involves zero tariffs on most goods. Moreover, the service-sector access that India seeks is generally controlled by individual EU member states and so difficult to include in the talks.

Discussions with Korea have been more successful, but talks are still under way when this paper went to press.

### **3.2 The US and Asia**

As part of the Bush Administration's ambitious FTA agenda, talks were begun with a number of Asian nations. They have been concluded with Singapore, Australia and Korea. The Singapore and Australia FTAs are in place, but the US-Korea arrangement is in deep political trouble in both the US and Korea.

A series of talks between some of the major ASEAN nations – Thailand and Malaysia in particular – were launched in 2004, but have come up against a variety of objections by the Asian nations to the US's 'FTA template' which includes insistence that partners allow (eventually) free trade access to the US's major agricultural exporters as well as issues such as intellectual property rights, government procurement liberalisation, and conditions touching on labour and the environment. Observers generally place a low probability on the deals being signed in the medium term. The expiration of the US Administration's fast-track authority, known as Trade Promotion Authority (TPA), has not helped matters. Nor have the parliamentary manoeuvres by Democratic Party leaders in the US Congress, which seem to question the applicability of the procedure to agreements reached under the old TPA. The Obama Administration has not yet formulated a clear trade policy, but has given hints that it wants to re-negotiate the US-Korea deal, and it appears to have decided to lapse all other FTA talks started by the Bush Administration.

The US continues its cooperation and broad initiatives under the APEC aegis, but this tactic has so far yielded little in the way of value added and seems set to yield little more in the medium term. The sum of these factors seems to have brought the US's bilateral initiatives in Asia to a full halt.

### **3.3 Policies to address the emerging noodle bowl syndrome**

Many of the FTAs discussed above have not become effective yet, but they will. With the 2010 deadline for full implementation of the ASEAN FTA and the ASEAN+1 agreements approaching, real

discrimination is starting to appear and the issue of the “noodle bowl” effect will arise. It is not yet clear how Asia will deal with this, apart from continuing with their policy of reducing MFN applied rates to keep down the preferences. Asia could learn some lessons from other regions that have faced similar issues such as Europe.

The first point is that problems with rules of origin (ROOs) are at the heart of the noodle bowl problem. That is, if a single firm must adopt its product to meet multiple rules of origin, costs can raise and trade can be inhibited. Kawai and Wignaraja (2009) present evidence from a firm-level survey that suggests that the Asian noodle bowl is a problem for large firms that sell to many destinations, but since most firms only sell to a single destination, the issue of overlapping rules of origin does not affect them. The European experience shows that the problem of overlapping rules of origin can be overcome.

In the European and Mediterranean spheres, the problem was tackled by the so-called Pan-European Cumulation System, or PECS. This involved the adoption of common ROOs and allowing regional cumulation (as is the case now in ASEAN) among all the participating nations, which now includes all EU, all EFTA and all the Euro-Med partners (i.e. the nations with coastlines on the Mediterranean Sea). While harmonising ROOs inside ASEAN is feasible (indeed with the widespread use of value added criteria, the job is substantially done), great difficulties arise when considering the “+3” nations. It would seem virtually impossible to get Japan, Korea and China to agree to use ASEAN rules. Indeed, the Japan+1 FTAs with some ASEANs have adopted rules that are quite different to ASEAN ROOs.

Given the lack of a regional hegemon and the rather modest leverage that ASEAN has over the trade giants in the region, this ‘do as ASEAN does’ recommendation is probably impractical – although it is certainly a goal worth striving for.

The second lesson from the EU is that large and small trading firms were the ones that pushed hardest for taming the tangle. This was especially so in sectors – like clothing – that involved important international supply chains spread across Europe and the Mediterranean. This phenomenon is, of course, widespread in East Asia. Thus we can be hopeful that this constituency will push for a multilateralisation of Asian Regionalism (Athukorala and Archanun, 2008).

This is probably what has been behind much of the unilateral reduction of MFN applied tariffs on parts and components. In short, East Asian nations have unilaterally tamed the tangle of ROOs by making them irrelevant in the most heavily traded goods – mechanical and electrical machinery. They have done this by setting their applied MFN tariffs to zero or at least lowering them in line with preferential tariffs so as to avoid the emergence of significant margins of preference. This makes the tangle of ROOs irrelevant, since it is not worth applying for preferential tariff treatment. Certainly in the short-run, the continuation of ASEAN’s unilateral MFN tariff cutting is the most direct way to avoid the Noodle Bowl syndrome from affecting trade flows.

ASEAN would be the perfect forum for talks on multilateralising East Asian regionalism. Ideas would range from duty-free zone for all industrial goods – something like the Information Technology Agreement of 1997 but covering all industrial goods (with as few exceptions as politically possible) to adoption of a single list of ROOs and many options in between. In the meantime, continuation of ASEANs’ unilateral MFN tariff cutting is the most direct way to avoid the Noodle Bowl syndrome from affecting trade flows.

#### **4 CONJECTURES CONCERNING THE FUTURE IN EAST ASIAN REGIONALISM**

Now we move from facts to conjecture – the discussion of possible future developments as the three blocks continue to dance in East Asia. Over simplifying to make the point, we use our experience with regionalism to formulate three scenarios going forward.

- All the planned FTA work.

In this vision of the future, the US deals with Korea, Malaysia and Thailand go through with perhaps others with Indonesia and the Philippines following. The EU completes its arrangements with the major ASEANs – Singapore, Malaysia, Indonesia, Thailand, and the Philippines, as well as with India. The ASEAN-centric arrangements get implemented and substantially eliminate tariffs within the region. This would be a world where almost all the world’s largest trade flows are duty free – the trans-Atlantic flows, trade among Japan and Korea, and most of China’s exports being the main exception.

If this does happen, it is likely that the rest of the barriers would eventually fall, since there would be little de facto protection. Leaving China aside, a world with this level of regionalism would be one where domestic prices would be very close to what they would be under MFN free trade, in which case the MFN tariffs have little political economy benefits. One exception to this is the protection that tariffs would provide to developing nations’ industry from the Chinese export machine.

The EU’s superior access to India would be very likely to spark some resentment in the US, but perhaps not too much – probably not enough to force the US to drop its FTA demands that India cannot live with.

- The EU-Asia FTAs work, but the US-Asia FTAs do not.

This would be a world where both the US and China were largely outside a very large, virtual free trade zone for industrial goods. Both nations are important players in the world trade system and the US in particular would probably not take this sitting down. If the most direct redress were not available to it (i.e. signing FTAs that leave out various US demands) for domestic or international political reasons, the US is likely to think of something else.

The last time it looked like it might be excluded from Asia regionalism, the US pushed APEC. This time around, it would have to be even more ambitious. One possibility is that it would revive its zero-for-zero proposal from the Uruguay Round but on a much larger scale – a global free trade pact in industrial goods. While this sounds farfetched, it might be the best and perhaps only way the US could avoid having its exporters face discrimination in all its non-NAFTA export markets. Perhaps such an initiative would resemble the Information Technology Agreement (ITA), but covering almost all industrial goods. As in the ITA there would be no special and differential treatment and the accord would go into effect only if a sufficiently large number of nations signed up.

- Neither EU-Asia nor US-Asia FTAs work.

This would approximate the status quo with a bit more intra-Asia integration. Just as the status quo is fairly stable from the global perspective, this outcome would be as well. More specifically, it would not involve any of the discrimination and trade diversion that is the political-economy engine that drives the domino effect.

## **5 ASIAN REGIONALISM AND CROSS-BLOC FTAS: TERMITES OR LIBERALISATION TRIGGERS?**

The topic of this paper concerns how the three classic trade blocs are interacting and how this might affect the world trade system going forward. However, the discussion also raises the issue of whether Asian economic integration in general and EU-Asian free trade agreements in particular will be a building block or a stumbling block on the road to global free trade. Jagdish Bhagwati has recently and eloquently argued that regional trade arrangements – like those being signed at such a frenetic pace in and with East Asia – are acting as termites in the world trade system (Bhagwati 2008). That is to say, they may be slowly, but steadily riddling the pillars supporting the multilateral system with tiny holes that may eventually produce a catastrophic collapse.<sup>5</sup>

There is a clear logic to this reasoning – after all, FTAs clearly do distract policy makers. The basic logic underlining Bhagwati’s ‘stumbling bloc’ approach might be called the “leadership theory of trade

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<sup>5</sup> For a review of the stumbling bloc/building bloc literature see Panagariya (2000) or Baldwin (2008).

policy.” It reflects the belief that trade policy is driven primarily by the independent will of governments. As he writes in his most recent book about events in 1986: “When the Uruguay Round was launched, there was a distinct possibility, as I have argued, that the United States could have exercised its huge weight in the trading system and as a political superpower to tell the European Union that resort to Article 24 had to be proscribed, or else the United States would retaliate on other fronts. Instead, the United States joined in, which then led Asia to abandon its principled opposition to PTAs.” (Bhagwati 2008 p. 91).

This quote makes it clear that Bhagwati views trade policy as a “leadership” issue rather than the outcome of special interest politics.<sup>6</sup> Bhagwati’s “leadership” view of trade policymaking spontaneously leads to the prediction that regionalism and multilateralism are substitutes, i.e. that preferential trade blocs are stumbling blocks on the road to global free trade. After all, policy makers have only so much ‘leadership’ to spend. If they push for FTAs, it will be hard to get GATT Rounds done. The logic, however, is at odds with abundant empirical work showing that trade policy is endogenous to the political economy system (see the recent survey Gawande and Krishna, 2008). Moreover, the prediction that regionalism and multilateralism are substitutes rather than complements is at odds with the historical evidence.

### 5.1 Are RTAs and MTNs substitutes?

Students of postwar trade policy know that major nations often embrace regional and multilateral initiatives at the same time. The major steps forward for the multilateral system have been synched with major steps in regionalism and/or unilateralism. For example:

- In 1947, the US drove forward the drafting of the GATT and a large multilateral tariff cut, while in the same year setting up the Marshall Plan, which started preferential liberalisation inside Europe.
- In 1964/65, the Kennedy Round was launched, and regionalism started in North America with the US and Canada signed their first preferential agreement (the Auto Pact).
- In 1973, the Tokyo Round was launched, and regionalism in Europe advanced with EEC enlargement and simultaneously completion of West Europe’s virtual free trade zone in industrial products via EC-EFTA bilateral FTAs. The US took another step towards North American regionalism in 1974 as the US Congress authorising a deepening of the US-Canada Auto Pact. Canada, however, was uninterested.
- In 1986, the Uruguay Round was launched, and European and North American regionalism took major steps forward. Europe launched a radical deepening of its regionalism (the Single Market programme), and Canada and the US agreed to start talks on broadening their existing preferences into a full-blown FTA. The mid 1980s was also when developing nations embarked on their impressive unilateral tariff cutting, especially in Latin America and East Asia.
- In 2001, the Doha Round was launched, and East Asian regionalism took a major step forward. Japan and China joined the regionalism game by launching the China-ASEAN

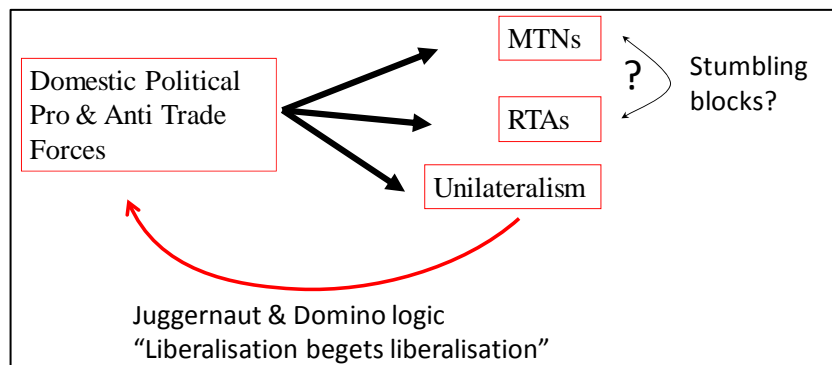
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<sup>6</sup> Leave aside Bhagwati’s mistaken facts (it was Canada that changed its mind in 1986, not the US). The US had been interested in a US-Canada FTA since the 1970s. Specifically, the Trade Act of 1974, Section 612, authorized the President to agree an FTA with Canada and the 1979 Trade Act (section 1104) required the President to study FTAs with Canada and Mexico and the resulting report to Congress recommended that further regionalism beyond the Auto Pact be explored. Mexico and Canada proved uninterested, however, as they were still fearful of exposing their industries to duty free access by American industry (more on this below).

FTA talks, and the Japan-Singapore Economic Partnership Agreement talks. 2001 was also the year that the Bush Administration began its aggressive pursuit of new bilateral FTAs. There is a theory that explains this synchronicity.

## 5.2 Juggernaut and domino logic versus the leadership theory of trade policy

According to the endogenous trade policy literature (e.g. Grossman and Helpman 2002), the fundamental determinants of trade policy are special interest groups. As Figure 5 illustrates, this logical approach – which eschews the possibility of Bhagwati’s heroic leaders – has quite different implications for how one should think about regionalism and multilateralism.



**Figure 5: Political economy view of regionalism and multilateralism**

The US stance, for example, towards regionalism is dictated largely by its exporter’s political might balanced against that of its import competitors. In 1986 when US-Canada FTA talks were agreed to and the Uruguay Round was launched, the US exporters were in the ascendancy and could force through a trade liberalisation agenda that had been stalled since the end of the Tokyo Round in the late 1970s. Since Canada was the US’s largest trade partner by far, US pro-trade forces were naturally interested in a Canada-US FTA (CUSFTA), and indeed since Canada had no comparative advantage in the most protected US industries (textiles, apparel, shoes, steel, etc.), even US import-competing groups were not especially opposed to CUSFTA. As US exporters were independently securing extended guarantees on investments, services and intellectual property, they also embraced the Uruguay Round’s ambition agenda.

In the figure this direction of causality is indicated with the straight arrows. The basic assertion is that special interest politics – or more precisely the economic power of exporters and import-competitors as filtered through the nation’s political system – are the ‘cause’ of trade policy, and this is true for unilateral, regional and multilateral policy. In this view, the question of stumbling blocks and building blocks is fundamentally flawed. A nation’s stances on regional and multilateral liberalisation are two endogenous variables drive by the same third causes. The proper formulation in this case is to investigate the third causes, not the spurious correlation between two left-hand side variables.

But why do we so often observe a synchronicity of liberalisation efforts? One explanation comes from the so-called “juggernaut theory”.<sup>7</sup> This explanation allows for a feedback mechanism between earlier policy choices and the strength of various special interest groups, as shown by the lower curved arrow in the diagram. This feedback creates a dynamo by which reciprocal trade liberalisation strengthens pro-trade political economy forces and weakens those of anti-trade forces (Baldwin 1994, Staiger 1995). More specifically, as tariffs come down reciprocally – either multilaterally or regionally – import competing sectors get smaller and typically less influential in trade policy formulation. Similarly, as trade partners lower their tariffs, exporters grow in size and political strength with the

<sup>7</sup> See Baldwin (1994).



improved access to foreign markets. The result is that reciprocal liberalisation tends to reshape the political economy landscape inside each nation in a way that makes future liberalisation more likely.

Of course the necessary entry and exit takes time, and indeed most liberalisations are phased in over many years. It is thus the time dimension which leads to the episodic, synchronized nature of trade liberalisation. In the case of the US's embrace of multilateralism and regionalism in 1986, the answer is that it took many years for the effects of the Tokyo Round cuts to readjust sufficiently political economy forces around the world. Around the mid-1980s, the governments of leading nations around the world, who had participated in the Tokyo Round liberalisation found that it was politically optimal to further liberalise. Or, to use Bhagwati's imagery, the termite damage is not to the world trade system, but rather to the wooden struts holding up protectionists' political power.

A second mechanism is the so-called domino effect whereby the signing of one FTA tends to lead to the signing of more FTAs. The basic notion (Baldwin 1994) is that as FTAs reduce the exports of third nations to the area, they also stimulate third-nation exporters to engage in new political economy efforts to get their government to redress the new discrimination. In many cases, third-nation governments respond by signing new FTAs with one or both of the partners, who have recently integrated.

## 6 CONCLUDING REMARKS

Until very recently, the world could roughly be described as three trade blocks centred on the US, the EU and East Asia, although East Asia's concentration of regional trade has never had an institutional underpinning. Since 2004, however, we have witnessed a series of negotiations that seek to open preferential trade channels between the Asian bloc and the EU and US blocs. If only some of these initiatives succeed, discrimination will appear. If history repeats itself, such discrimination is likely to trigger a domino effect – one that will tend to induce further liberalisation.

One not unlikely outcome is that several of the EU-Asian FTAs materialize but none of the US-Asian arrangements come to fruition – especially after the Democratic parties convincing victory in the 2008 elections. In this case, the US would find itself as an outsider with few options. One of the best of those options, however, would be to eliminate discrimination by pushing for global free trade in industrial goods.

Maybe three blocks can dance together after all.

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