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## **MANAGING THE NOODLE BOWL: THE FRAGILITY OF EAST ASIAN REGIONALISM**

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## **ABSTRACT**

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The paper argues that East Asian regionalism is fragile since (i) each nation's industrial competitiveness depends on the smooth functioning of 'Factory Asia' – in particular on intra-regional trade; (ii) the unilateral tariff-cutting that created 'Factory Asia' is not subject to WTO discipline (bindings); (iii) there is no 'top-level management' to substitute for WTO discipline, i.e. to ensure that bilateral trade tensions - tensions that are inevitable in East Asia – do not spillover into region-wide problems due to lack of cooperation and communication. This paper argues that the window of opportunity for East Asian 'vision' was missed; what East Asia needs now is 'management' not vision. East Asia should launch a 'New East Asian Regional Management Effort' with a reinforced ASEAN+3 being the most likely candidate for the job. The first priority should be to bind the region's unilateral tariff cuts in the WTO.

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Keywords: East Asia, management not vision, noodle bowl and regionalism

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# Managing the Noodle Bowl:

## The fragility of East Asian Regionalism

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January 2006

### Abstract

The paper argues that East Asian regionalism is fragile since (i) each nation's industrial competitiveness depends on the smooth functioning of 'Factory Asia' – in particular on intra-regional trade; (ii) the unilateral tariff-cutting that created 'Factory Asia' is not subject to WTO discipline (bindings); (iii) there is no "top-level management" to substitute for WTO discipline, i.e. to ensure that bilateral trade tensions – tensions that are inevitable in East Asia – do not spillover into region-wide problems due to lack of cooperation and communication. This paper argues that the window of opportunity for East Asian 'vision' was missed; what East Asia needs now is 'management' not vision. East Asia should launch a "New East Asian Regional Management Effort" with a reinforced ASEAN+3 being the most likely candidate for the job. The first priority should be to bind the region's unilateral tariff cuts in the WTO.

### 1. INTRODUCTION

East Asia is one of the wonders of the world. Like some gigantic, impossibly complex and wonderfully efficient factory, the region churns out millions of different products with world-beating price-quality ratios. It does this by sourcing billions of different parts and components from plants spread across a dozen nations. East Asian corporations set up "Factory Asia" and they are running it now. Following the analogy, corporations are Factory Asia's "mid-level managers" and middle management is doing a marvellous job, keeping things running smoothly and profitably, solving any number of big and small problems along the way. But where is Factory Asia's "top-level" management? Whose job would it be to ensure that bilateral trade tensions – tensions that are inevitable in East Asia – do not get out of hand or spill over into region-wide problems?

This paper argues that the current state of East Asian regionalism is fragile due to three facts.

- Each nation's industrial competitiveness is heavily dependent on the smooth functioning of 'Factory Asia' – in particular on the free flow of intra-regional trade.

- The tariff-cutting that created Factory Asia was done unilaterally by the ASEANs and China; these tariff cuts were not ‘bound’ in the WTO and so are not subject to WTO discipline. What this so-called ‘bindings overhang’ means is that East Asian tariffs could go back up overnight without violating any WTO rules (indeed, we saw some of this during the 1997 crisis). Since the smooth functioning of Factory Asia is in everyone’s interest, the lack of WTO discipline would not be a serious problem, if there were some mechanism for managing conflicts – making sure that small problems did not tumble out of control due to a lack of communication and coordination.
- The third source of fragility is the fact that there is no “top-level management” in the region to substitute for WTO discipline. European regionalism has both top-level management (the EU) and WTO discipline (Europeans have bound their tariffs at very low levels). The same is true of North American regionalism.

The implications of these three facts are straightforward. While it has long been recognised that East Asia is short of “international public goods,” progress on setting up such goods have been hindered by a lack of vision.<sup>1</sup> Questions such as “who should take the lead?” and “what should be the long-run goals?” have no easy answer and so have been left unanswered. The time for East Asian vision, however, is gone. What East Asia needs now is management, not vision. Moreover the need is pressing. Given its vast political, cultural and economic diversity, East Asia has always been a region prone to conflict among small nations (of course, it is also prone to conflicts among big nations but that is true of all regions of the world). Given the extreme supply-side integration of the region, such small-country conflicts could pose a threat to the competitiveness of Japanese, Korean, Chinese and ASEAN firms in the US and European markets. For example, a serious commercial dispute between, say, Malaysia and Thailand, or Indonesia and Malaysia could hinder the production of Japanese firms. If a simple bilateral conflict spun out of control and began to spread – as happened in Europe during the 1930s – Japanese firms might find it very difficult to provide low-cost, high-quality products to European and American markets in a timely fashion. The same is true for Korean, Chinese and ASEAN firms.

It should also be noted that a new source of tensions is about to appear in the region. The commercially important elements of East Asian regionalism, the China-ASEAN FTA and the Japan-ASEAN bilaterals are just starting to cut tariffs on a discriminatory (i.e. preferential) basis. Such discrimination has led to trade tensions in other regions. Although East Asia may be lucky enough to avoid such problems, the extreme interdependence of East Asians’ competitiveness suggests that such things should not be left to luck. The region should establish a “New East Asian Regional Management Effort” with a reinforced ASEAN+3 being the most likely candidate for the job. The first priority should be to bind the region’s unilateral tariff cuts in the WTO.

### **Plan of paper**

The rest of the paper is organised in four sections. The next section, Section 2, presents the state-of-play in East Asian regionalism, arguing that East Asian trade arrangements are marked by a ‘Noodle Bowl Syndrome’ (an unorganised tangle of bilateral trade deals). This section also explains how the Noodle Bowl arose by distinguishing three phases: ‘rampant unilateralism’ 1980-1990, ‘regionalism delayed, unilateralism accelerated’ 1990-2000, and ‘real regionalism’ 2000 to present. It argues that the development of ‘Factory Asia’ was the driving force in the first two phases, but China’s FTA demarche towards ASEAN triggered a domino effect in the region that led to the current ‘noodle bowl’ of FTAs.

Section 3 fleshes out the argument that East Asian trade is fragile. It also contends that East Asia is about to experience a series of shocks as real tariff discrimination appears in the region for the first time. Section 4 presents some ideas on how the region might manage this fragility in the short-

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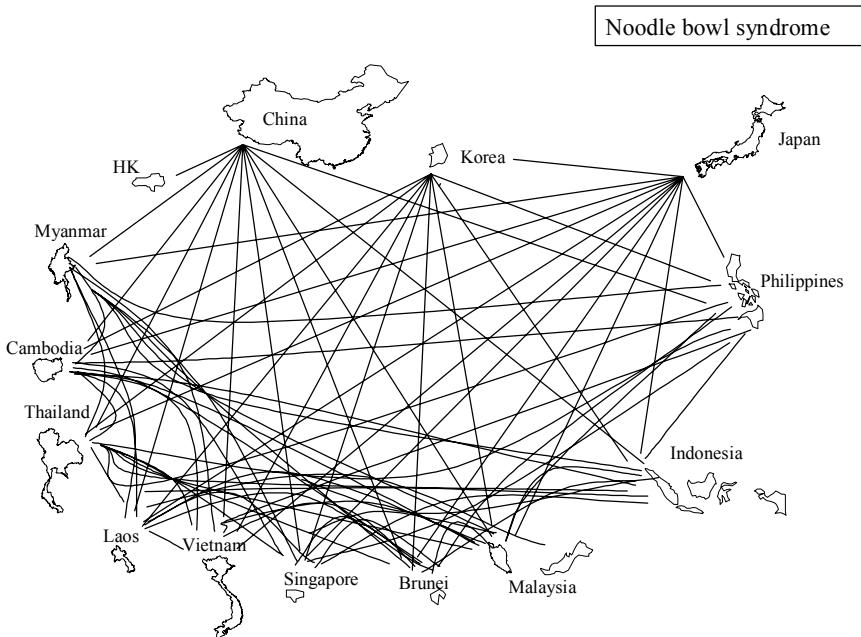
<sup>1</sup> See e.g. Fukuyama (2005), Severino, R. et al (2005), or the East Asian Vision Group’s report on ASEAN’s website.

run and remove it in the long-run through the development of an East Asian free trade association modelled on Europe's 'other' regional arrangement, EFTA. The final section presents concluding remarks.

## 2. CURRENT STATE OF PLAY

When it comes to East Asian regionalism, the state of play is easily summarised – it is a mess. Dozens if not hundreds of trade deals are under discussion, under negotiation, or already signed. Even limiting the universe to the deals that have been signed or are near signing, it is clear that East Asian regionalism is marked the "Noodle Bowl Syndrome."

**Figure 1: The East Asian 'Noodle bowl' syndrome.**



Note: The map shows FTAs signed or under negotiation in January 2006. East Asia is defined here as the 10 ASEANs, China, Japan and Korea.

Source: Author's compilation.

### 2.1. The East Asian Noodle Bowl<sup>2</sup>

Figure 1 makes the point graphically. The figure shows each FTA in the region that has been or is near to being signed. Specifically, by the end of 2005 the region had signed what amounts to 57 FTAs. The ASEAN-China FTA (ACFTA) is counted as 10 separate deals due to ASEAN's rather unique method of preferential liberalisation. The reality is extremely complex but roughly speaking China and each ASEAN chooses its own 'sensitive list' and bilateral market access depends upon the interaction of the two lists. Nations do not get preferences for items on their own list and are not granted preferences for items on the counterparty's list. All bilateral links inside the ASEAN FTA (AFTA) are listed separately for the same reason. The fractured nature of ASEAN's basic approach

<sup>2</sup> The mess was first dubbed the "Noodle Bowl Syndrome" in Baldwin (2004), but it should be thought of as the East Asian version of Bhagwati's famous spaghetti bowl problem. It is difficult to track down the exact spaghetti-bowl cite since even Bhagwati does not provide a references when he uses the term. The first reference I could find was a column by New York Times journalist Peter Passel, where he quotes Bhagwati as saying: "spaghetti bowl of tangled, inconsistent trade standards that just can't be good for efficiency." February 4, 1997.

to preferential trade implies that the degree of market access faced by an AFTA exporter of any particular product varies according to the ASEAN destination market concerned. For example, we cannot view the Malaysia-Indonesia preferential tariff structure as identical, or even close to the Singapore-Philippines preferential tariff structure. Thus AFTA acts as if it were 45 bilateral trade relationships (10 times 9 divided by 2). Fortunately, the existence of ASEAN implies that 55 bilaterals are not completely dissimilar – ASEAN has imposed some discipline on rules of origin, product exclusion practices and phase-in modalities. Finally, Japan has signed FTAs with Malaysia and Singapore with these being *de jure* as well as *de facto* separate agreements. See Whalley and Banda (2005) for a detailed assessment of ASEAN's trade deals.

But by the end of 2006, it seems likely that the region will have at least 13 more deals – 10 *de facto* bilaterals from the impending ASEAN-Korea FTA, and 3 more bilaterals between Japan and the advanced ASEANs, Thailand, the Philippines and Indonesia. That brings the total to 70. Japan may also conclude FTAs with Vietnam and Brunei and ASEAN as a whole, bringing the total to at least 75. Of course, a reasonable person could count these differently and come up with a different number, but that just serves to strengthen the basic point. A classic aspect of the Noodle Bowl Syndrome is that it is not entirely clear how many deals there actually are in the region.

How did East Asian trade relations get so tangled up?

## 2.2. No real regionalism yet

Strange as it may seem given Figure 1, there is as yet no real regionalism in East Asia.

Regionalism means preferential trade liberalisation, i.e. discriminatory trade liberalisation, since preference is just another word for discrimination. By that definition, there is not yet any real regionalism in East Asia. The two most commercially important sets of arrangements that have been signed – the ASEAN-China FTA and the ASEAN-Japanese bilaterals – are supposed to be phased in over the next five years, but they have not yet undertaken any serious discriminatory tariff cutting. The only scheme that has been substantially implemented – AFTA – is not actually used (more on this below).

How did Factory Asia get established without 'real' regionalism?

The answer to this question reveals many critical facts about the region and many aspects of East Asian trade relations that are highly unusual by global standards. In answering the question, it is useful to distinguish three phases of East Asian regionalism.

- **Phase I, Rampant Unilateralism:** From the mid 1980s to 1990, tariffs on intra-regional trade came down but this was due to unilateral tariff cutting in the region driven by competition for investments and jobs related to the development of what can be called Factory Asia.
- **Phase II, Regionalism Delayed, Unilateralism Accelerated.** From roughly 1990 to 2000, East Asia witnessed an acceleration of unilateral tariff cuts as China's emergence heightened the competition among East Asians for jobs and investment linked to the ever expanding Factory Asia. Additionally, two formal arrangements began – the ASEAN FTA (AFTA) and Asian-Pacific Economic Cooperation (APEC) – but neither created much discrimination nor had much effect on trade flows, as we shall see.
- **Phase III, Rampant Regionalism.** In November 2000, Chinese Premier Zhu Rongji triggered a domino effect by suggesting that China might be interested in an FTA with the ASEANs. This idiosyncratic initiative faced excluded nations with a new situation which in turn strengthened pro-FTA political forces in the excluded nations, especially Japan and Korea. The result was a sequence of FTAs, each of which served to further strengthen the pro-FTA forces in all nations in the region. The ASEAN-Japan FTAs, the Korea-ASEAN FTA and the Japan-Korea FTA are direct reactions to the China-ASEAN FTA according to my reading of history.

Consider each phase in turn.

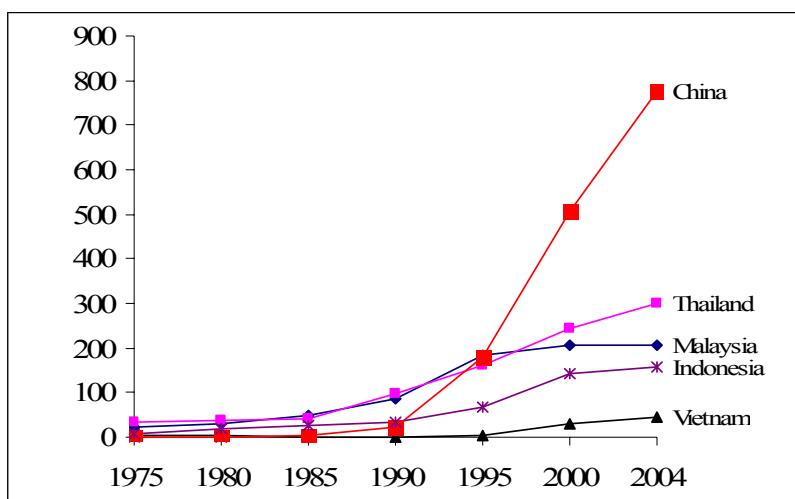
### 2.2.1. Phase I: Unilateralism and competition for Factory Asia jobs

East Asian trade was suppressed before 1985 by three factors: by the very unequal distribution of economic size within the region (Japan was the only large economy), by the great disparities in development levels in the region (which implied the natural trade pattern would follow the North/South template of inter-industry trade and this entails low trade volumes), and finally by the ‘dual track’ development strategies widely adopted in the region that blocked the imports of manufactured goods for final consumption while simultaneously fostering manufactured exports to nations outside the region (Ando and Kimura 2004).

Starting in the mid 1980s, three interlinked factors launched the expansion of intra-Asian trade and what might be called ‘rampant unilateralism.’ The factors are:

- **Erosion of Japan’s comparative advantage in manufacturing.** The phenomenal growth of Japanese incomes and wages in the 1980s and 1990s eroded the nation’s comparative advantage in manufacturing. Specifically, Japanese productivity growth in labour intensive processes was outstripped by overall Japanese productivity growth. Wage growth, of course, is linked to overall productivity, so rising Japanese wages were not fully compensated by labour productivity growth in labour-intensive activity and unit labour costs in labour-intensive processes started to rise.

**Figure 2: Placement of Japanese plants in East Asia, 1975 – 2004; Emergence of China.**



Note: The figure shows the sum of plants in the auto and electrical machinery industries.

Source: "The Coming Age of China-plus-One," Fujita and Hamaguchi (2006) presentation at IDE-JETRO workshop January 2006 (original based on data from "Kaigai shinshutsu kigyo soran" various years).

Japanese businesses reacted by seeking lower cost manufacturing sites for labour-intensive stages of production and the obvious solution was to off-shore these stages of manufacturing to nearby East Asian nations. This tendency, which has been called the ‘hollowing out’ of the Japanese economy, started the development of what can be called “Factory Asia” or the ‘Asian Manufacturing Matrix’.<sup>3</sup> Instead of Japanese goods being made in Japan and sold in the US or Europe, a new pattern of so-called ‘triangle trade’ emerged. Firms that were headquartered in Japan would produce certain hi-tech parts in Japan, ship them to factories in ASEAN nations for labour-intensive stages of production (including assembly) and then ship the final products to Western markets or back to Japan. This division of East Asia into HQ economies and factory economies

<sup>3</sup> The best papers on what I call Factory Asia are Ando (2004), Ando and Kimura (2004, 2005), Kimura and Ando (2003, 2005), Ng and Yeats (2003), and Fukao, Ishito and Ito (2003).

strengthened as Taiwan, Korea, Singapore and Hong Kong experienced their own ‘hollowing out’ and followed the lead of Japanese manufacturing companies in off-shoring the most labour-intensive production stages to East Asian nations who had a comparative advantage in such task (i.e. nations whose low wages more than compensated for their low labour productivity).

- **Reduced cost of moving goods and ideas.** Information technology advances and the falling costs of transportation, especially air freight, facilitated and accelerated the development of the Asian Manufacturing Matrix by making complex production structures easier and cheaper to manage while at the same time making them more flexible and more reliable.
- **China.** China’s opening up and domestic pro-market reforms brought something like a half billion low-wage/low-productivity workers to the gates of ‘Factory Asia.’ This accelerated the erosion of the HQ nations’ comparative advantage in labour-intensive production processes while simultaneously expanding the attractiveness of the off-shoring solution. In short, China added a pull-factor to push-factors and this quickened the hollowing out of the HQ economies (Japan, Korea, Taiwan, Singapore and Hong Kong).

#### **Development of the Asian Manufacturing Matrix**

Figure 2 shows the number of plants from Japanese electrical machinery and automobile industries that set up in the listed East Asian nations (plainly, the number of plants is only a rough indicator of the actual degree of off-shoring). The off-shoring process started gradually but picked up speed in the late 1980s. Between 1975 and 1990, the total number rose three and a half times with almost half of this increase coming between 1985 and 1990. The figure also shows that China was not a major player in the competition for plant locations prior to 1990. The big locations in Phase I were Thailand and Malaysia. These plants generated new trade, almost all of it in machinery and much of it in parts and components.

The typical “triangle trade” involved a Japanese firm sending high-end parts to an affiliated plant located in, say, Thailand. In some case the good would be shipped back to Japan for either final sale or further processing, but often the good was shipped for final consumption to the US or European market.

More direct evidence on the development of the Asian Manufacturing Matrix comes from the IDE-JETRO international input-output table. This shows the country of origin of imported manufactured goods purchased by the manufacturing sector of each East Asian economy. Table 1 has three panels corresponding the Matrix in 1985, 1990 and 2000.

The top panel shows the situation in 1985 when the Matrix was very simple. With the exception of Singapore, East Asian nations sourced their imported manufactured inputs from Japan and the rest of the world – all the rows are dominated by zeros except those of the Japan and the rest of the world (mainly the US and Europe). By 1990 (second panel), the Matrix was more complex: ‘Triangle trade’ still dominated the picture with the low-wage nations (first 5 columns) buying inputs from Japan and the rest of the world but providing no inputs in return. Now, however, Japan is not the only headquarter economy. Taiwan, Korea, and Hong Kong experienced their own hollowing-out phases and new triangle trade appears. This new triangle trade involves the shipment of parts from the new HQ economies to the ‘factory economies’ (China and the advanced ASEANs, Indonesia, Malaysia, the Philippines and Thailand). This can be seen from the emergence of new non-zero entries in the rows for Taiwan, Korea and Singapore.

By 2000, the matrix was really complex. Firms based in the ‘factory economies’ began to source parts from other factory economies rather than from the HQ economy alone. In particular, Thailand, Malaysia and China became important suppliers of parts to other ‘factory economies’ including each other. In short, the input-output matrix went from simple triangle trade to a much more

complex situation where the ‘factory economies’ were both makers and buyers of parts and components.

**Table 1: Widening and deepening of the Asian Manufacturing Matrix, 1985, 1990, 2000.**

(Share of manufactured inputs bought by column nation’s manufacturing sector from the row nation; numbers less than 2% are zeroed out; own-nation purchases are also zeroed out)

<b>1985</b>	China	Indonesia	Malaysia	Philippines	Thailand	Singapore	Taiwan	Korea	Japan
Indonesia						8%			
Malaysia						16%			
Philippines						0%			
Thailand						0%			
China				2%		14%			
Taiwan						3%			
Korea									
Singapore		3%	7%						
Japan	3%	12%	14%	4%	9%	12%	7%	8%	
RoW		15%	19%	19%	14%	11%	10%	16%	8%
<b>1990</b>	China	Indonesia	Malaysia	Philippines	Thailand	Singapore	Taiwan	Korea	Japan
Indonesia							5%		
Malaysia									
Philippines									
Thailand									
China						3%			
Taiwan			3%	4%	3%	3%			
Korea				2%		2%			
Singapore			7%	2%	3%				
Japan		8%	10%	8%	14%	18%	10%	8%	
RoW	8%	23%	20%	21%	22%	44%	17%	13%	5%
<b>2000</b>	China	Indonesia	Malaysia	Philippines	Thailand	Singapore	Taiwan	Korea	Japan
Indonesia						2%			
Malaysia				3%	4%	12%	2%		
Philippines									
Thailand			4%	3%		3%			
China		2%	3%		4%	5%	2%		
Taiwan			5%	5%	3%	3%			
Korea	2%	3%	4%	8%	3%	4%	4%		
Singapore			13%	6%	4%				
Japan	2%	7%	15%	20%	16%	19%	14%	7%	
RoW	4%	16%	20%	20%	17%	38%	15%	11%	4%

Notes: The columns would sum to 100% if we had included each nation’s supply of inputs to its own manufactured sector (a number that is often greater than 50%) and if we had not zeroed out the low numbers (less than 2%). RoW equals Rest of World.  
Source: IDE-JETRO, Asian input-output matrix (7 sectors) for 1985, 1990 and 2000; see, for example, [www.ide.go.jp/English/Publish/Books/Sds/082.html](http://www.ide.go.jp/English/Publish/Books/Sds/082.html).

This rise of China’s position in the Matrix is especially noteworthy between 1990 and 2000. At the beginning of the decade, it neither bought nor sold much manufactured inputs in East Asia. By the end of the decade, we see many entries for the Chinese column (which shows its purchase pattern) and the Chinese row (which shows which nations depend a lot on inputs from China). The flourishing of intra-ASEAN trade is also clear from the comparison of 1990 and 2000.

The message of Table 1 is clear. By 2000, the competitiveness of manufacturing firms in East Asia depended in a serious way on the smooth functioning of regional trade. A disruption of trade between, say, Malaysia and China, could cause serious problems for Japanese and Korean firms trying to sell in the US.

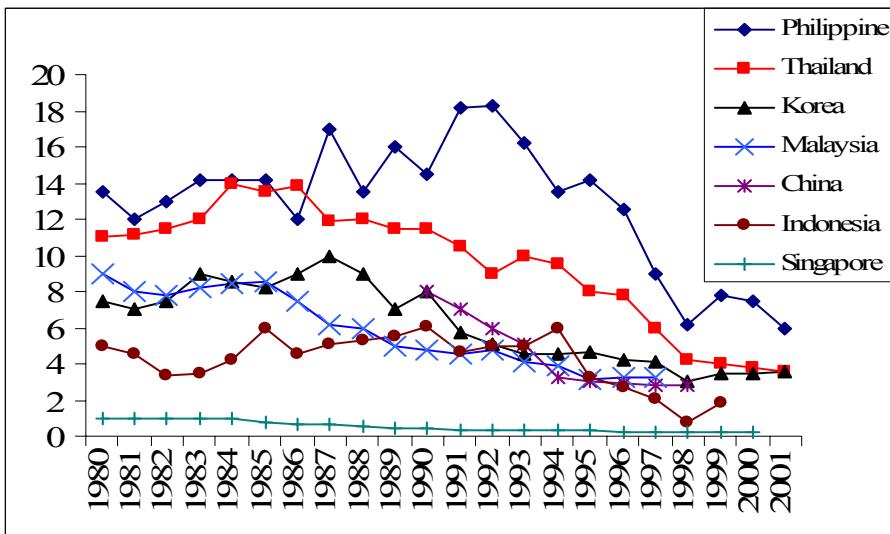
#### Impact on East Asian tariffs: rampant unilateralism

Japanese firms’ off-shoring strategies fit in nicely with the export-track of the dual-track development strategies being pursued by the ‘factory economies’. To attract such investment, the ASEANs unilaterally reduced their tariffs on triangle trade in what may be viewed as a ‘race to the bottom’. Often this came in the form of ‘duty drawbacks’ and duty-free treatment for plants located

in Export Processing Zones (EPZs).<sup>4</sup> While it is hard to find direct evidence that the unilateral tariff cutting in this phase was caused by competition for Factory Asia investment, anecdotal evidence is abundant, see for example Kuchiki (2003, 2005).

Regardless of what caused it, the unilateral tariff cutting is obvious from Figure 3 and Figure 4. Figure 3 shows the average tariff calculated as total tariff revenue divided by total imports. This is the broadest definition of the average applied tariff since it encompasses all tariff schemes, including duty drawbacks arrangements. Figure 4 shows a much narrower measure of average tariff, but one that more directly measures the extent to which tariffs were unilaterally reduced. Specifically, Figure 4 shows the applied MFN tariff rates on machinery trade (the category that accounts for the bulk of these nations' imports).

**Figure 3: Unilateral tariff cutting in Phase II.**



Notes: Tariff revenue divided by total imports.

Source: Ando and Kimura (2005).

Both figures clearly show why the first two phases is called ‘unilateralism.’ It is useful to think of this sort of tariff cutting as ‘quasi-regionalism’ because its effect is to reduce tariffs only on intra-regional trade, but it was not formally discriminatory. It was, in other words, *de facto* preferential tariffs liberalisation that involved no *de jure* preferences. It has also been called Asian-style regionalism (run by businessmen rather than lawyers and diplomats).

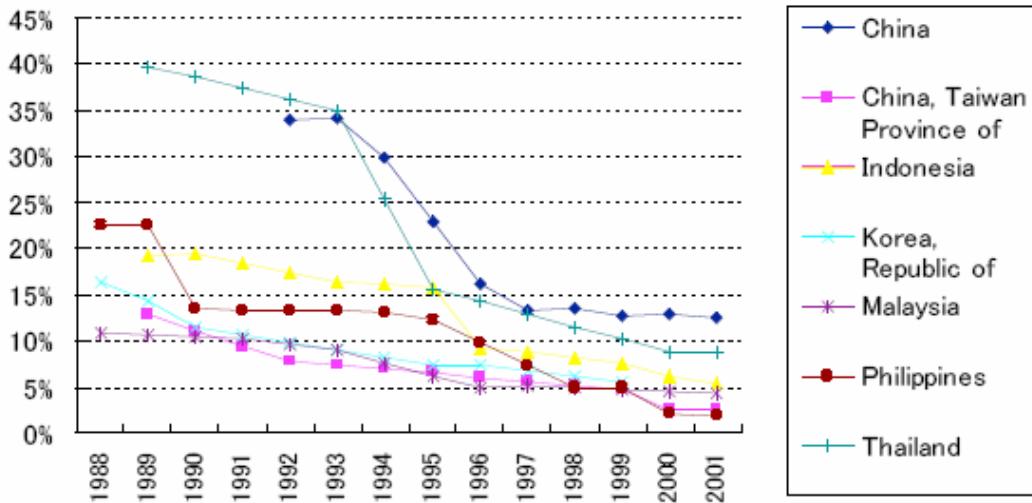
### 2.2.2. Phase II: Regionalism delayed; Unilateralism Accelerated

The second phase began in 1991 with the call by Malaysian Premier Mahathir for an East Asian Economic Community (EAEC). This led to the ASEAN Free Trade Agreement (AFTA) in 1992, but Mahathir’s vision for the region was much broader. His vision, however, was not appreciated in Washington. The US feared that an Asian-only economic bloc might come to involve or even be dominated by communist China, a nation whose economic resurgence caused concern (the US was still quite uncertain about Chinese motives in the early 1990s). According to my reading of history, the US countered Mahathir’s vision by pushing the Asian Pacific Economic Cooperation (APEC) in 1993. The US was adopting a well-known strategy in the regionalism game – undermining on

<sup>4</sup> Duty drawbacks involve the suspension of tariffs on parts and components that are imported, subjected to some processing and then re-exported. EPZ are geographically specific areas in which specified goods are imported and exported duty-free since they goods do not enter into commerce in the country’s market but rather stay physically in the EPZ.

preferential trade arrangement by proposing a larger one.<sup>5</sup> The US's diversionary tactic worked. East Asian nations cared and still care far more about the US market, and the US's security role in the region was still seen as reassuring in the rapidly shifting post-Cold War world. The 'exclusively Asian' aspects of Mahathir's vision struck many in the region as too risky. In 1993, the oxymoron "Open Regionalism" was embraced by nations throughout the region and the APEC's "Bogor Goals" were adopted. This is why Phase II is called 'regionalism delayed.' The source of the tagline "unilateralism accelerated" should be clear from Figure 3 and Figure 4.

**Figure 4: Formal unilateralism; reductions in applied MFN tariffs on**



Source: Kimura, Takahashi, and Hayakawa (2005), Figure 6.

APEC was explicitly designed to rule out preferential trade liberalisation which is and always has been the defining element of regionalism. AFTA did little more to foster regionalism. By contrast, the unilateral tariff-cutting that had begun in the 1980s accelerated in the new decade.

#### Extremely low utilisation rates under AFTA

How can we be sure that the average tariff shown in Figure 3 does not reflect AFTA's preferential tariff cuts? We have two bits of direct evidence. First, Figure 4 shows that the average applied MFN rate for the sectors responsible for most trade in the region (machinery) came down more or less in tandem with the average rate shown in Figure 3 so at least much of the tariff cutting came from unilateral reductions in non-discriminatory tariffs.

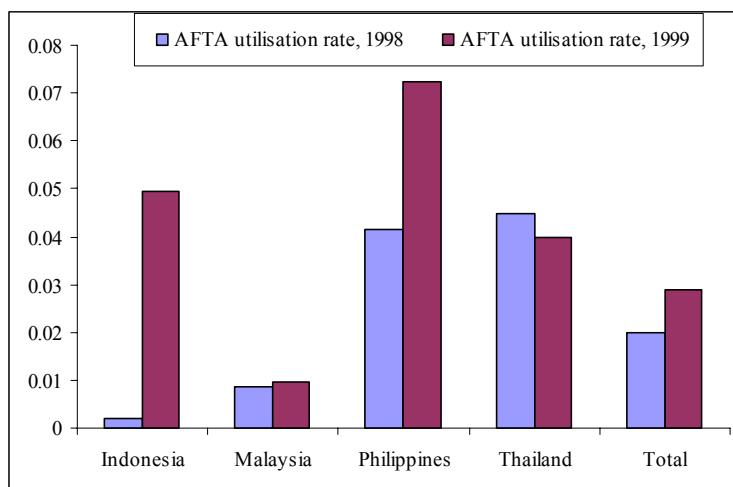
The second piece of evidence comes from the fact that almost no trade took advantage of AFTA's preferential (i.e. discriminatory) tariff rates. This is not widely recognised since the ASEAN Secretariat promotes statistics that measure progress by counting the number of tariff lines that have been partially or fully liberalised, not on the share of intra-ASEAN trade that is conducted over the preferential tariff. As we shall see, almost no one uses AFTA preferences.

<sup>5</sup> Most famously, this same strategy was used by the UK to delay or prevent the formation of French-German trade bloc in the 1940s and 1950s. As the largest importer in the region, the possibility of improved access to the UK's market was very attractive to exporters on the Continent. Thus when Britain proposed a Europe-wide FTA as an alternative to deep economic and political integration among the Six, many Europeans were interested exactly because the broader formation would also include preferential access to the UK's market. The British inspired proposal did undercut some of the political economy pressure for deep integration, but the Six eventually rejected it and went off to write the Treaty of Rome and set up what became the EU. The UK attended the initial meeting but withdrew at an early stage (see Baldwin and Wyplosz 2006 Chapter 1 for details).

Information from the late 1990s shows that the AFTA preferences were not being used; see Figure 5. Overall less than 3% of the intra-ASEAN trade benefited from AFTA's preferences. Getting the preferential tariff rate requires the importer to prove that the good actually originated in ASEAN (to avoid tariff fraud whereby goods from third nations are transhipped through an ASEAN country to gain preferential access). In AFTA this requires "Form D." As it turns out, the vast majority of traders found it more advantageous to either pay the MFN applied rate (and thus avoid the administrative cost and delay of Form D) or to take advantage of other schemes such as duty drawback programmes or duty-free treatment in export processing zones.

Figures for 2002 are not much better according to JETRO (2003). That paper reports that only 11.2% of Thailand's imports from AFTA took advantage of AFTA the Common Effective Preferential Tariff (CEPT). Malaysia's data suggest that just 4.1% of its exports to AFTA enjoyed the CEPT preference. By comparison, utilization rates below 50% are considered very low for European FTAs (Augier Gasiorek and Lai Tong 2005).

**Figure 5: AFTA utilisation rates**



Source: PriceCooperWaterhouse, Presentation to the 10th Meeting of the ASEAN Directors-General of Customs, 24 July 2002

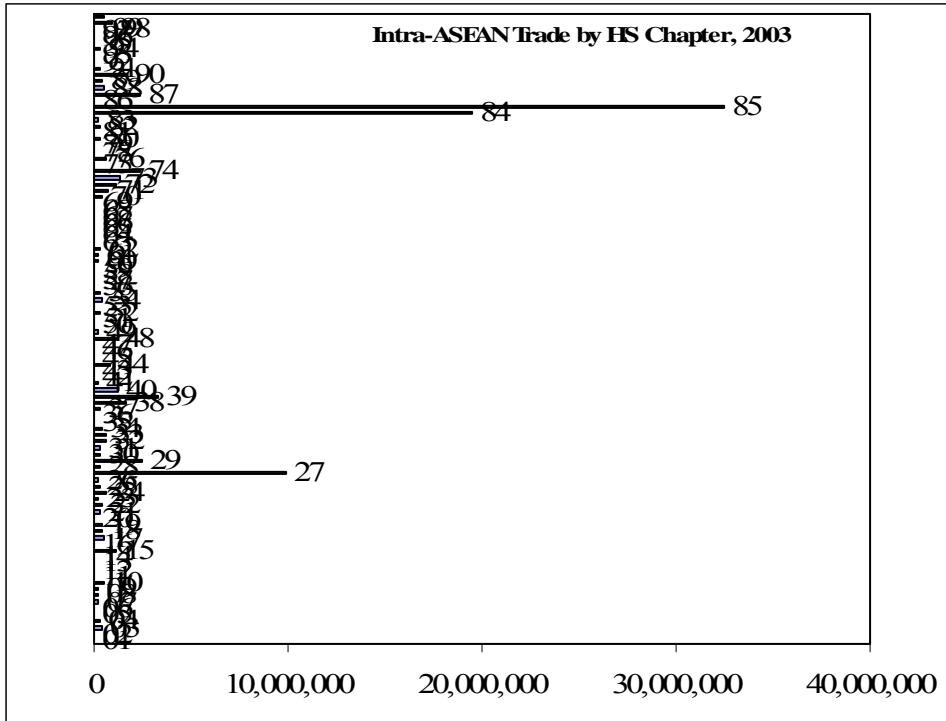
#### Why are AFTA preferences not used?

The reasons for the low utilisation rates are simple – AFTA's margins of preference on the high trade-volume goods are too small to compensate for the administrative cost and delay of applying for preferential tariff treatment. Evidence for this can be seen in Figure 6 and Table 2. Figure 6 plots the intra-Asian trade for each of the 99 HS chapters for the year 2003. Each bar represents the value of trade in a single chapter. Of course, most of the labels are illegible but that is because most of the bars are equally small. Intra-ASEAN is completely dominated by Computer/machinery and Electrical equipment (HS chapter 84 and 85 respectively), although there is also non-negligible trade in Lubricants, Fuels and Oil (HS 27). Table 2 shows that the MFN tariffs on these high-volume goods are very low – less than 2%, so AFTA's preferences are irrelevant. Experience from Europe and NAFTA shows that even modest costs and/or delays from complying with rules of origin will induce exporters to pay the MFN rate, if the MFN rate is low. Given that the margins of preference are razor thin – between zero and 1.5% – it is no surprise that AFTA was almost never used.

A second salient point from Table 2 sheds some light on APEC's non-role. The low East Asian tariffs in the table are for the goods involved in Factory-Asia trade, namely General Machinery, Electrical Machinery (including electronics) and speciality petroleum derivatives. This unilateralism was not extended to other manufactured goods such as Transport Machinery (cars and trucks), or Light Industry. This outcome is perfectly logical when thinking of the unilateralism as

being driven by competition for Factory-Asia jobs and investment, but it makes little sense when one thinks about APEC's volunteerism.

**Figure 6: Intra-ASEAN trade by HS Chapter, 2003**



Source: ASEAN Secretariat web site.

**Table 2: Intra-East Asian preference margins vis-à-vis EU and North America**

Sector:	Exporter to East Asia			Preference margins:	
	East Asia	North America	EU	over N.Amer. Exporters	over EU Exporters
Mining products (HS25-27)	1.7	2.6	1.7	0.9	0.3
General machinery (HS 84)	1.5	1.9	2.5	0.4	1.4
Electrical machinery (HS 85)	1.4	1.5	2.2	0.1	-0.3
Others	1.4	1.7	2.6	0.3	-0.6
Wood and paper	1.4	1.3	1.5	-0.1	0.5
Precision apparatus	1.2	1.3	2	0.1	0.7
Agriculture	41	29.7	30.9	-11.3	10.7
Light industry	26.8	8.3	12.8	-18.5	4.1
Food and beverages	21.8	26.4	25.8	4.6	9.8
Textiles and clothing	7.3	7.6	7.8	0.3	-3.1
Transportation machinery	4.6	2.8	8.6	-1.8	5.3
Pottery products	2.9	3.6	4.4	0.7	-1.3
Chemicals	2.4	3	2.7	0.6	-1.4
Basic metals	1.8	2.6	2.3	0.8	-0.7
All products	7.4	5.5	7.2	-1.9	1.5

Note: Tariff data for 2002; see the paper for aggregation schemes.

Source: Author's reorganisation of data drawn from Freudenberg and Paulmier (2005), Table 3.

Tariff liberalisation in most nations is determined by the balance of serious political forces within each nation. If one wants to understand why a nation's government finds it politically optimal to remove a tariff that it previously found politically optimal to impose, one has to focus on domestic political factors in each nation. Group photos of APEC leaders in colourful shirts cannot be considered a driving force. If a trade initiative is to have an effect on tariffs, it has to alter the array of pro- and anti-trade forces within the nations concerned. For example rising competition for Asian

Manufacturing Matrix investment created new, pro-liberalisation forces within the East Asian factory economies. By contrast, nothing in the APEC process had an independent impact on the domestic political forces inside APEC nations. Of course, APEC leaders were happy to assign credit to the Bogor-process for liberalisation that was done for totally unrelated reasons. From a public relations perspective, it is better to present liberalisation as part of a broad, inclusive process rather than the result of a race-to-the-bottom competition among East Asia developing economies.

### 2.2.3. Setting the stage for Phase III

Two events at the end of Phase II set the stage for the ‘real’ regionalism that started in Phase III.

#### Asian Financial crises

The spectacular growth of East Asian economies in the mid-1990s came to a screeching halt with the 1997 Asian financial crisis. The big exception was China; it escaped almost unscathed (see Figure 7) and this firmed up the nation’s role as *primus inter pares* in the gallery of East Asian developing nations. The Asian crisis had an important influence on East Asian regionalism, although it was not, in my reading of history, a pivotal event. In particular:

- It deeply shook East Asians’ faith in their development strategies and their heavy emphasis on US and European markets.
- It created a sense of commonality among East Asian nations and networking among policy elites.
- Many East Asian firms that had been protected from global competition by high tariffs suddenly found themselves faced with the full fury of globalisation; the resulting ‘industrial restructuring’ was far from systematic and it certainly was not optimal, but it did act as a brutal form of ‘natural selection.’ The average East Asian firm that survived the 1997 crisis was systematically more capable of standing up to international competition than the average East Asian firm before the crisis. This was important since it exogenously reduced the anti-liberalisation pressure from import-competing firms. On the margin, this shift in political economy forces within each nation made it politically optimal to remove some tariffs that East Asian governments previously found it politically optimal to retain.
- It revealed the unsuitability of APEC as a vehicle for regional cooperation.
- China’s economic stability during the ‘storm’ gave the country a big boost in its competition for new jobs and factories from the ever-growing Asian Manufacturing Matrix (see Figure 2 and Figure 7).

#### China’s looming WTO membership

Although the Asian crisis is usually viewed as the key turning point, China’s WTO membership was far more important in re-arranging the alignment of pro-trade and anti-trade forces in the region. As the 1990s drew to a close, China’s long-running attempt to join the WTO began to look like it would succeed. Chinese membership, many believed, would provide an external lock-in of the reforms the nation had unilaterally adopted. This, in turn, greatly heightened the attractiveness of China as a location for FDI from the HQ economies (Japan, Taiwan, Korea, HK and Singapore). This became an increasingly serious worry for the other factory economies in the region, especially Indonesia, Malaysia, Thailand, Vietnam and the Philippines. And this, set the stage for the next phase of Asian regionalism.

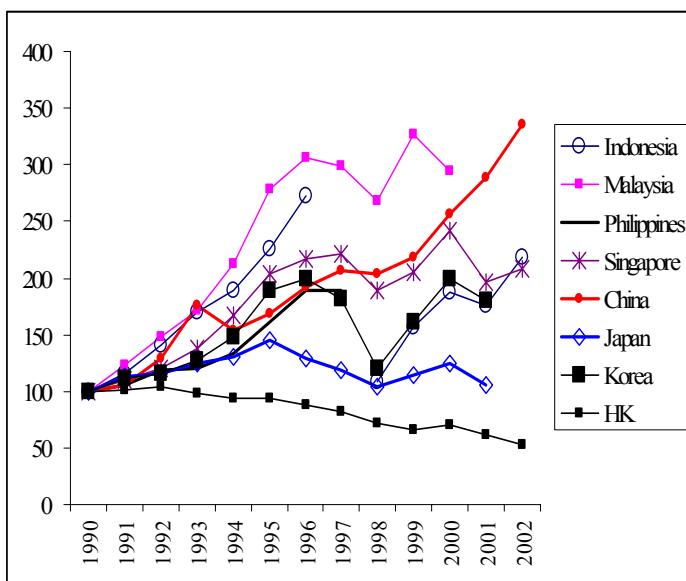
### 2.2.4. Phase III of Asian Regionalism: China triggers a domino effect

At the November 2000 China-ASEAN Summit, Chinese premier Zhu Rongji broached the idea of an FTA between China and ASEAN. This Chinese initiative came as something of a surprise to

ASEANs but it was in line with China's behaviour in the 1990s. One key element of the Chinese economic development strategy of the 1980s and 1990s was the desire to avoid antagonising non-Chinese states. Since China's success in attracting industrial jobs and investment was increasingly viewed as a threat by some ASEAN nations, Zhu Rongji decided to make a big-hearted gesture that he hoped would assuage ASEANs' concerns over Chinese competition for Factory-Asia jobs and investments.

The Chinese offer was generally welcomed by the ASEANs and led, 3 years later, to the ASEAN-China Free Trade Agreement (ACFTA), which promises to eliminate tariffs on almost all bilateral trade between China on one hand and the 10 ASEANs on the other by the year 2010 (2015 for the poorer ASEANs). The first domino triggered by China's move was among the ASEANs themselves. During the ACFTA talks, the ASEANs agreed to adopt the same deadlines and zero-tariff goals for intra-AFTA trade.<sup>6</sup>

**Figure 7: Total manufacturing growth, 1990 – 2002.**



Source: Daisuke Hiratsuka (2006); UNIDO Statistics Database, 3-digit ISIC Code (Rev.2); total manufacturing output.

China's proposal to the ASEANs set off alarm bells all around the region, but especially in the main HQ economies, Japan and Korea. Preferential liberalisation between two of Japan's major markets – China and ASEAN – would create discrimination against goods shipped from Japan. ACFTA markets absorbed more than a third of Japanese exports in 2003, with the figure set to rise much higher if China's boom continues as expected. Importantly, the level of discrimination might be substantial since China and the ASEANs have relatively high MFN tariffs on many industrial goods, especially the sort of finished products at which Japan excels – consumer electronics, autos and the like. If Europe's experience is a guide, Japanese firms might react to such discrimination by moving more production facilities to locations inside ACFTA. Korea faced an isomorphic problem.

In the early years of the new century, no one knew what ACFTA might become, but Japan and Korea simply had to have a plan in case major tariff discrimination did arise. In short, China's demarche in November 2000 triggered a domino effect that has produced the noodle bowl that East Asian regionalism is today.

<sup>6</sup> Before the 2003 Bali II accord, AFTA preferences had to be between 5 and 0%; afterwards, intra-AFTA should be zero. The AFTA deadlines were also re-arranged to match the ACFTA deadlines.

### Japan's and Korea's reaction

According to the domino theory and the historical precedence in Europe and North America, 'Plan A' for Japan should have been to redress the discrimination by joining ACFTA. This path, however, was blocked. ACFTA was not an organisation that outsiders could join.<sup>7</sup> With Plan A out of the running, a Plan B was needed. This was always going to be convoluted since its goal was to redress possible discrimination from a trade bloc without formally joining the trade bloc. Other parts of the world's experience with the regionalism game suggested two Plan-B responses: (i) form a separate trade bloc with other excluded nations (Japan-Korea FTA), and (ii) seek bilaterals with the smaller/more-susceptible members of the new trade bloc (Japan-ASEAN bilaterals). The Japanese government opted to follow both. The Korean government faced a similar situation and adopted similar solutions.

If the Japan-Korea FTA gets signed, it is likely to trigger another domino effect since China will face the possibility of discrimination in two of the three largest economies in the region. A Korea-US FTA would also trigger a domino effect, but unless the US proves willing to radically alter its FTA "template" – i.e. the basic FTA deal offered to the many other nations that have signed or are negotiating FTAs with the US – the Korea-US FTA is likely to be politically unpalatable to Korea.<sup>8</sup> Moreover, the US side is likely to have political difficulties with a Korea-US deal, even if it follows the template since the Korean manufacturing sector is far more competitive than that of other US FTA partners. Of course, high-minded geo-strategic reasons may offset the opposition of US and Korean special interest groups, so anything can happen, but such reasons do not yet appear to be pressing.

### 2.3. Summary

In early 2006, East Asian regionalism looks like it will be built on four pillars: the China-ASEAN FTA, the Japan-ASEAN bilaterals, the Korea-ASEAN FTA, and AFTA. The Japan-Korea FTA is looking unlikely as of January 2006, but if it does get done, it will form a fifth pillar and certainly trigger another round of domino effects. In short, trade relations in East Asia are a mess, or more precisely, it looks like they may soon become a mess since virtually no discriminatory liberalisation has yet occurred in the region. AFTA is not used and the other FTAs have only just started cutting tariffs. If commitments are followed, however, things will soon change. All the signed FTAs promise to eliminate bilateral tariffs in 5 years (by the end of 2010; 2015 for the poorer ASEANs). If that actually happens, discrimination will emerge in a big way.

## 3. FRAGILITY AND EMERGING TENSIONS

East Asian regionalism is based on a fragile system that will soon be subject to new tensions. This section fleshes out the facts and logic behind these points.

### 3.1. Sources of fragility

The fragility of the East Asian system stems from the extreme interdependence of nations' competitiveness, the lack of WTO discipline, and the lack of top-level management in the face of the noodle-bowl complexity.

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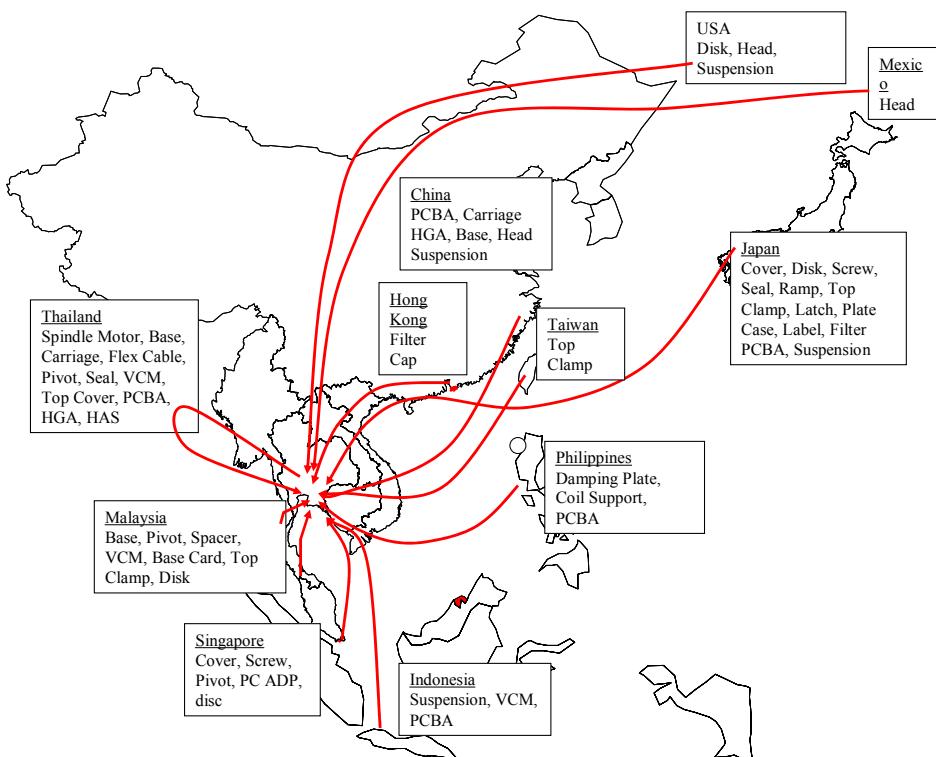
<sup>7</sup> See Baldwin (2006) for details on the East Asian version of the Domino Theory.

<sup>8</sup> The Bush administration has a hard time putting together a Congressional majority for FTAs and so prefers to use with new agreements 'templates' (i.e. combinations of concessions and exemptions by the US and concessions and exemptions by the counterparty) that have won Congressional approval in the past.

### 3.1.1. The Noodle-bowl Syndrome

This level of complexity shown in Figure 1 implies that trade relations in the region are heavily interlinked. Since the degree of protection among any two nations can alter political pressures for protection in other nations – that is the basic mechanism of the domino theory – the overlapping and intersecting nature of the Noodle Bowl is a source of fragility. The outcome of a trade dispute between, for example, Japan and Malaysia in the auto industry has the potential to cause problems for Malaysian-Indonesia trade relations, yet the Japan-Malaysia problems would be handled by a dispute-settlement body that is completely unrelated to the one that would handle Malaysian-Indonesia problems. While various agreements and institutional arrangements may spontaneously coordinate when common problems arise, the complexity of the system makes this outcome far from certain. Who, for instance, would be in charge of convening a meeting of East Asian leaders in the event of a local trade dispute threatened to spin out of control?

**Figure 8: An example of interdependence in ‘Factory Asia.’**



Note: This shows the nations where parts are sourced for a hard-disk drive assembled in Thailand; the disk drives are then shipped on to various markets to be used in various electronics.

Source: Adapted from Hiratsuka (2005). Figure 2

### 3.1.2. Interdependence in Factory Asia

Factory Asia started simple, but now the all nations' manufacturing sectors are tightly interlinked via regional trade. The facts and figures can be found in the bottom panel of Table 1 for 2000.

**Error! Reference source not found.** makes the point with an example. The diagram shows the sources of the various parts of a disk-drive that is assembled in Thailand by the affiliate of a Japanese company. The disk itself is sourced from the US, Japan and Malaysia, the filter cap comes from Hong Kong, etc. Of course, the disk itself consists of several parts, some of which are imported from the US, Japan and/or Malaysia and the same can be said of most of the parts listed. If we traced out the ultimate source of every bit of a disk drive, the map would be impossibly complex. And one should note, that the disk-drive itself is an intermediate good that will be shipped somewhere and assembled – together with an equally complex web of sourced parts – into some electronic device.

The key point here is simple.

- The competitiveness of firms from each East Asian nation now depends upon good trade relations of all East Asian nations. The Japanese firm's disk-drive business can be hurt by trade trouble between China and Malaysia, between Thailand and Indonesia, or indeed between almost any pair of nations in the region. The Japanese government may be able to look after Japan's trade links with other East Asians, but it would be virtually powerless to mediate a dispute among other East Asians.

It is not useful to highlight scary, low-probability events, but it is crucial to point out that regional trade flows are the key to each East Asian nation's competitiveness in the world economy. If something happened to disrupt intra-regional trade.

### **3.1.3. Lack of WTO discipline: The bound versus applied tariff 'overhang'**

The interdependence of the region's manufacturing sectors is quite common worldwide, even if the phenomenon is taken to extremes in East Asia. How do North America and Europe deal with the system-fragility created by trade in intermediate inputs? There are two answers:

- When it comes to the trade where the interdependence is most marked – intra-regional trade – North America and Europe have well-functioning "top-level management." The US makes sure NAFTA trade runs smoothly and the EU does the same for trade in the European and Mediterranean region.
- There is also a trans-Atlantic exchange of investment and intermediate goods in the manufacturing sector, but just as China and Japan find it impossible to agree who should fill the CEO post when it comes to East Asian trade, the US and EU cannot decide who should be in charge of trans-Atlantic trade. Instead, they let WTO discipline provide the top-level management.

In performing this role, the most important of the WTO's rules is Article 2 – tariff bindings. Article 2 commits members to 'bind' their MFN tariffs. In plain language, a tariff binding is a commitment to never raise a tariff that is 'bound' in the WTO. As the result of 50 years of GATT Rounds, European and North American MFN tariffs are bound at very low rates since they came down in tandem with intra-regional preferential tariff-cutting. Article 2 discipline is one reason that North Atlantic regionalism had a happy ending. The discrimination caused by regionalism on either side of the Atlantic was tamed by multilateral tariff cutting and Article 2 discipline.

There are two key aspects to this historical precedent.

- Progressive MFN liberalisation made sure that margins of preference never got too big. Since discriminatory market access is a major source of inter-bloc trade tension, the GATT Rounds tended to prevent deeper and wider preferences from fuelling inter-bloc trade tensions.
- WTO bindings of EU tariffs on US exports and US tariffs on EU exports meant that a broad trans-Atlantic tariff-war would be GATT illegal.

Of course, the WTO permits all manner of exceptions – antidumping duties, countervailing duties, safeguards and the like – but these are both limited to specific products and require specific and well-disciplined procedures. Moreover, the US and EU could, as sovereign states, decide to ignore WTO rules, but doing so could not be taken lightly.

To use an analogy, think of trade disputes as forest fires that can sometimes get out of hand. The WTO's rules do not make the world trade system fireproof, but tariff bindings act as an enormous 'firebreak.' Nations must think long and hard before they violate Article 2. More to the point, a government can face down domestic calls for retaliation by claiming that such moves would be GATT-illegal and would therefore have negative repercussions far beyond the specific trade dispute.

Why can't this work for East Asia?

#### East Asia's tariff bindings overhang

The East Asian Manufacturing Matrix depends upon four HQ economies, Japan, Korea, Singapore and Taiwan, and 6 factory economies, China, Malaysia, Thailand, Indonesia, the Philippines, and Vietnam. Table 3 shows that extent to which GATT Article 2 disciplines the trade of these nations.

**Table 3: Bound and applied tariffs in East Asian**

	Binding Coverage	Final bound <sup>/1</sup>	Applied <sup>/1</sup>	MFN duty free imports, Share in total imports	Import duties as share of total imports
Japan	99.6	2.3	2.5	57.6	n.a.
Korea	94.5	10.1	6.7	21.9	3.2
China	100.0	9.1	9.5	24.3	2.7
Malaysia	83.7	14.9	9.1	80.8	3.1
Thailand	74.7	24.2	13.3	n.a.	3.4
Indonesia	96.6	35.6	6.7	51.2	1.2
Philippines	66.8	23.4	5.8	45.6	5.4
Vietnam					
Taiwan	100.0	4.8	5.5	53.5	n.a.
Singapore	69.2	6.3	0.0	100.0	0.3

Notes: /1 Simple average of ad-valorem duties, non-agricultural goods. Vietnam is in the process of joining the WTO.

Source: WTO country profiles, 2005.

Japan, like the US and the EU, has bound almost all its tariffs at quite low rates; the simple average bound tariff is just 2.3%. Japan's average applied rate is almost identical.<sup>9</sup> Since Japan's tariff bindings ("Final bound") match the tariffs that Japan actually charges ("Applied"), it would be impossible for Japan to raise its tariffs much without violating the GATT's Article 2. This fact alone makes it almost unthinkable for domestic political forces in Japan to ask the Government of Japan for such a thing. In other words, Japan's post-war tariff cutting is WTO disciplined.

The situation for Korea is broadly similar. Almost all its tariffs are bound at moderate rates – the average is 10% – but the MFN tariffs that Korea actually charges is below the level at which they are bound. This means that Korea could raise its MFN tariffs by 3 percentage points on average without violating Article 2. In the world of trade diplomacy, this is called a 'binding overhang' since much of Korea's unilateral tariff cutting in the past two decades is not covered by commitments not to raise them. Note that once one takes account of all the special tariff treatment that Korea unilaterally extends to its imports, the 'real' average Korean tariff is just 3.2% ("Import duties as a share of total imports"). GATT's Article 2 discipline provides an important firebreak should the Korean government ever find itself in a tariff-raise firestorm of domestic political pressure, but not as much of a firebreak as it provides to the Japanese government.

China's binding overhang is worse than Korea's by some measures. For example, counting all the unilateral tariff breaks China extends, its tariff revenue is only 2.7% of the value of imports, but its unweighted average binding is 10%. Of course, the WTO allows China to unilaterally withdraw the unilateral tariff concessions it made in its duty-drawback and Export Processing Zone deals, so the gap between the actual and bound rates means that the WTO does not provide much of a firebreak when it comes to the Chinese government resisting domestic calls for tariff hikes in the event of an intra-East Asian trade dispute.

The binding-overhang problem is much, much worse for the four big ASEAN economies (Malaysia, Thailand, Indonesia, and the Philippines). A much narrower range of their tariffs are

<sup>9</sup> The applied average is a bit higher to 'continent protection' duties such as antidumping and countervailing duties.

bound, and these are bound at very high rates, 15 to 35%. These nations unilaterally grant duty-free MFN treatment to over half their imports (this is part of ‘rampant unilateralism’ above), and the real average tax on imports is extremely low, about 3% for the biggest traders, Malaysia and Thailand, about 1% for Indonesia and only 5% for the Philippines. What this means is that the governments of the ASEAN4 could not tell would-be trade-war-makers in their domestic polity that they cannot raise their tariffs without violating their WTO commitments. If a tariff-raising ‘forest fire’ breaks out in the domestic political environments of these nations, WTO discipline will do very little to stop its spread.

Vietnam is not yet a WTO member, so the Article 2 firebreak would do nothing to help the Vietnamese government resist domestic political pressure for higher tariffs in the event of a raging trade dispute. Taiwan’s situation is similar to Korea’s. Singapore is a paragon of WTO discipline; the City-State bound almost all its tariffs at zero.

### **3.1.4. Lack of top-level management at “Factory Asia”**

No organisation or government is making sure that things run smoothly in East Asia, although there are several bodies that deal with various bilateral problems.<sup>10</sup> In a region as interdependent as East Asia, however, bilateral bodies may very well prove insufficient for dealing with complex trade disputes that involve several nations in the region – especially disputes that lead to ‘reverse domino’ effects, i.e. tariff hikes in one nation that are reactions to tariff hikes in other nations.

### **3.1.5. Summary of East Asia’s System-Fragility**

If we think of East Asia as a magnificent factory then duty-free trade flows are the conveyor belts that bring the parts from one stage of processing to the next. But this is not a linear factory of the type common in the 20<sup>th</sup> century. Factory Asia is a 21<sup>st</sup> century, just-in-time factory where the inputs are arriving continuously from all directions. If even a few of the ‘conveyor belts’ breakdown, production in many parts of the factory will be disrupted. This intense interdependence has fostered and been fostered by unilateral tariff cutting, but this trade liberalisation is not disciplined by WTO rules. Nor is there any top-level management to ensure that localised trade disputes do not spread and thus threaten the smooth functioning of the system as a whole.

If some unpredictable event starts a fight among even of small subset of the “middle-level managers,” everyone could be harmed. Such an outcome would harm all involved, so one hopes the middle-level managers could be persuaded to settle their differences. But whose job would it be to sit everyone down in one room to talk things out?

“Fragile” may be too strong a word for this system; indeed it might withstand all manner of pressures, but that would be by happenstance, not by design. No one designed “Factory Asia” and no one is in charge of making sure it continues running smoothly.

## **3.2. Emerging Pressures**

Why should one be concerned about the system? After all, things have gone well for a couple of decades, so why worry? This is wishful thinking based on a false premise.

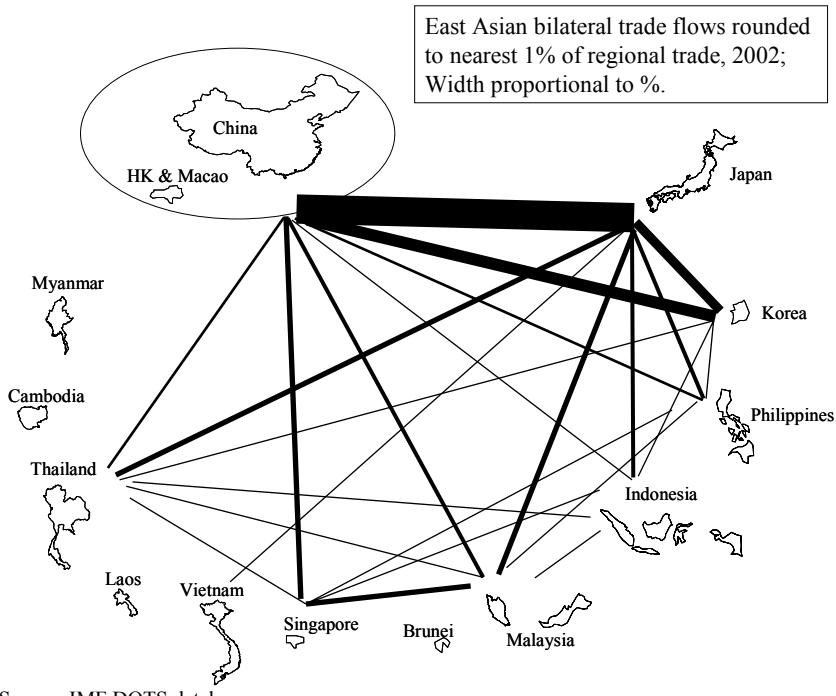
East Asia has no experience with discriminatory trade liberalisation. The many FTAs that are in place have not yet created discrimination. As argued above, none of the FTAs in the region that are likely to be effectively implemented – the Japan-ASEAN bilaterals, the ASEAN-China FTA and

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<sup>10</sup> For example, the China-ASEAN FTA says it will set up a dispute settlement arrangement, but it does not appear to be in place yet. The Japan-Malaysia FTA sets up a bilateral dispute settlement arrangement and it is likely that the other Japan bilaterals will have similar mechanism. AFTA has something of a dispute settlement procedure but given the extremely disjointed nature of ASEAN, it is not very effective and has not been chosen as the focal dispute settlement body for ASEAN’s FTAs with China, Korea and Japan.

perhaps the ASEAN-Korea FTAs – have yet cut bilateral tariffs in a serious way. The region's other arrangement, AFTA, created almost no discrimination since no one used it. Why does this matter?

**Figure 9: East Asian bilateral trade flows rounded to nearest 1% of regional flows.**



Source: IMF DOTS database.

Real regionalism means discriminatory tariff liberalisation and discrimination sometimes creates tension. For example, China will soon grant better market access to a Malaysia-based firm than it does to a Japan-based firm – a fact that will surely bother Japanese firms. In other regions of the world, such tensions have led to policy reactions, some of which have been disruptive to trade. The most common policy reaction has been to abort the implementation of the discriminatory liberalisation. This is often the case when it comes to South-South FTAs like the China-ASEAN arrangement.<sup>11</sup>

A nastier outcome, however, is also possible. The classic case was the round of tariff escalations among the European trade blocs in the 1920s and 1930s. But even without referring to the nightmare-scenario of inter-war Europe, it is clear that bilateral liberalisation can increase pressure on governments to offset some pressure on domestic industry by raising protection against exports from excluded nations. For example, the liberalisation of the Malaysian auto sector with respect to Japan might lead to new political pressures inside Malaysia to raise tariffs against, say, Korean firms, or, to delay liberalisation with other ASEANs. If the FTAs signed or near signing in early 2006 actually do what they say they will do, East Asia will witness the emergence of a complex pattern of tariff discrimination.

Figure 9 shows a striking fact – the biggest trade flows in the region are the only ones not covered by FTAs. The diagram shows the importance of the various bilateral trade flows in the region with small flows zeroed out to improve readability. The three largest bilateral trade flows – China-Japan, China-Korea and Japan-Korea – will probably not be covered by FTAs by the end of 2006. Thus it is exactly the biggest flows in the region that will face discrimination. Korean firms selling into China will face discrimination compared to Thai firms; Chinese firms selling into Japan will face discrimination compared to Malaysian firms, etc. If the Japan-Korea FTA gets signed, then China

<sup>11</sup> If the preferences lead to the delocation of firms from one poor nation to another (usually the larger of the two since firms prefer to locate in the large market), the ‘losing’ nation often calls off the deal. Indeed of the hundreds of regional trade deals in the world, only a couple of dozen actually influence trade and only a couple of those are South-South arrangements.

will face discrimination in both Japan and Korea compared to Korean firms on the one hand and Japanese firms on the other.

The logical implication of this fragility is obvious. The time for East Asian vision is gone; the time for East Asian management is now.

#### **4. NEW EAST ASIAN REGIONAL MANAGEMENT EFFORT (NEARME)**

East Asian regionalism could have developed from visionary beginning, but it did not. Vision takes time, a lot of time; Europeans, for example, discussed the Continent's trade arrangements for more than a decade before the EEC was formed. In East Asia, events just moved too fast. In just 4 years – from 2000 to 2004 – the notion of economically significant FTAs in Asia went from unlikely to obvious. All East Asian have a stake in ensuring that regional trade is well managed, but nothing and no one takes responsibility for this ‘collective action’ problem. This is why the pressing need is for management, not vision. This section considers some aspects of a regional management effort that could keep the status quo running smoothly while discussion of vision took their course.

##### **4.1. A New East Asian Regional Management Effort: Institutions**

Because the need for management is pressing, it seems clear that the region should rely on existing institutional arrangements; it would take years to set up a new organisation. Given this constraint, ASEAN+3 is probably the best suited body for the management effort.

It is very easy to criticise ASEAN+3 – for example it is unwieldy to have so many leaders in one place when they differ so greatly in terms of economic and trade importance – but it has many positive sides. Chief among these is that it already exists, so all manner of delicate diplomatic issues can be avoided (just the question of who should participate could take years to resolve). Second, ASEAN+3 has a track-record of cooperation and thus has some credibility in the region. Third, it is not viewed as a creature of any single regional or non-regional power. Fourth, it has not been viewed as a threat to nations outside the region. Fifth, it encompasses all the nations whose competitiveness in European and American markets depends upon intra-regional trade flows, i.e. the set of nations who have the greatest stake in ensuring that intra-regional trade is well managed, without including any significant nation that is a bystanders when it comes to this ‘collective action problem.’ Sixth, it would be very easy to enlarge the group to include new members if and when the need arose.

ASEAN+3’s institutional foundations, however, would need some firming up. Although it is not an institution *per se*, it could quickly begin to operate as one by acquiring a secretariat of its own. A structure for the political direction of the grouping is already in place, but it would need a secretariat of its own with a high-quality staff of experts (legal, economic, customs and trade matters).

The GATT – i.e. the WTO before the 1994 Marrakech accord – would provide a good role model for the New East Asian Regional Management Effort (NEARME). The GATT operated as an international organisation without actually being an international organisation. Indeed, although it would be a very bad idea to call the new body an “Asian WTO,” (given the fate of the Asian IMF idea) this is effectively what NEARME would be. The GATT operated on a consensus basis, engaged in ‘soft law’ surveillance, enforcement and adjudication, and yet was the keystone to managing the rapid development of the world trade system in the post-war period. More to the point, many economists believe that GATT’s rules and its peer-pressure approach was responsible for the fact that FTAs in Europe and elsewhere did not threaten the multilateral system. The GATT, in short, was the “management effort” that ensured waves of regionalism in the rest of the world have gone smoothly. By focusing on regional issues and tailoring itself the East Asian sensitivities,

NEARME could foster a level of management, i.e. discipline, in the region that is more solid than what the WTO offers under the Enabling Clause and more adapted to regional needs than the discipline it offers under Article 24.

## 4.2. Management priorities

The immediate priority of this new regional management effort could be to ensure that the emerging pattern of tariff discrimination does not get in the way of the smooth function of Factory Asia. In other words, the overriding priority should be to protect the current very favourable status quo in East Asian trade relations.

### 4.2.1. Priority #1: Bind the MFN applied rates

The first priority in the new East Asian regional management effort should be to trim the ‘bindings overhand’ and thus bring WTO constraints on East Asia’s low tariffs into line with the political constraints (the fact that all would lose from a tariff war). The first step would be to convince the ASEAN+3 nations to bind their applied rates in the WTO. The invigorated ASEAN+3 body should, as a bloc, insist that nations doing this get full credit in the Doha Round market access talks. Indeed, this move might encourage other developing nations to bind their applied rates and this, in turn, would prove to be a very positive contribution to unblocking progress in the ongoing WTO round. As a bonus, it would give the new organisation a high and strongly positive international profile, demonstrating to the world that the new grouping was WTO-friendly. Binding the non-preferential rates would also improve the investment climate in the region since it would make trade policy more predictable.

### 4.2.2. Priority #2: Transparency and confidence building deliverables

The second priority for a new East Asian regional management effort would be to improve transparency in the region. There are several obvious ‘deliverables’ here.

ASEAN+3 could set up an information clearinghouse for preferences, rules of origin and the like. Indeed, as part of the new management effort, the participating nations could commit themselves to ‘notifying’ the new ASEAN+3 secretariat of any and all trade policy or legal changes that affect trade in the region. In the rosiest scenario, the new management could implement a scheme like the one that the EU pushed on the Euro-Med region, namely the Pan-European Cumulation System (PECS). In the late 1990s, Europe was marked by a ‘spaghetti bowl’ of FTAs that was as complex as East Asia’s Noodle Bowl is today. The EU managed the spaghetti bowl by harmonising the tariff structures of all the various bilaterals, imposing a common set of rules of origin and insisting on cumulation throughout the region. The EU hegemonic role in the region was critical to this effort. While there is no East Asian hegemon to play a similar role, so the outcome is unlikely to be as harmonious as PECS, the new NEARME could take measures to reduce the inconsistencies among East Asian bilaterals.

The new East Asian regional management effort could also agree minimum ‘standards’ for East Asian FTAs – trade agreements that meet these conditions could be called “ASEAN+3 compliant.” Of course, the point of departure would have to be a set of conditions that was mild enough to fit all the existing FTAs (just as the GATT had to ‘legalise’ existing preferences in 1947 such as those of the British Commonwealth). But even this would be an improvement over the current lack of discipline faced by the FTAs that are notified under the Enabling Clause. The value of such a set of standards would become apparent if nations failed to fulfil the liberalisation promises they made in the FTAs. Given the vast differences around the world, the WTO has found it impossible to improve the discipline of FTAs, especially those notified under the Enabling Clause. In a sense, this

'ASEAN+3 compliant' status would provide a level of discipline intermediate to Article 24 and the Enabling Clause. Such a thing might prove attractive to other South-South FTAs.

If history is any guide, the domino effect in East Asia will spread to many, many more countries in the neighbourhood. In Europe, for example, the playing out of several waves of domino effects has left the EU with preferential trade deals with every WTO members except nine. It is therefore conceivable that the 13 members of the ASEAN+3 group will end up signing a very large number of bilaterals in the coming years. It would be very helpful to the smooth functioning of Factory Asia to have agreed some discipline on the nature of these arrangements before they are signed.

As it stands, there is no systematic surveillance and enforcement mechanism covering all the East Asian FTAs. Given the diverse political situation of nations in the region, such surveillance and enforcement would have to be of the 'fair broker' or technocratic type. There is no way that ASEAN+3 members could agree to give such a body any sort of 'teeth' like those that the EU's Commission has, but the very existence of an unbiased observer and reporter of facts can often go a long way to resolving dispute or avoiding them in the first place. Just to take one example, nations have often been known to implement subtle measures that 'nullify and impair' the effect of tariff reductions they have committed to. If the tariff cutting was done in the context of the WTO, an aggrieved party could always ask a WTO panel to make a determination on the matter. In East Asia, there is no single body for investigating such claims. Actually, the old GATT panels are a better analogy than current system of WTO panels. Before the Uruguay Round, the findings of GATT panels could be blocked – and occasionally they were – but the very existence of such a fair-broker body reduced trade tensions around the world.

While the over-riding need in East Asia is for management, the region will need a longer term solution eventually.

#### **4.3. Longer run goals for a New East Asian Regional Management Effort**

The goal of regional organisations throughout the world is generally twofold: to foster political harmony and economic efficiency, all without actively causing harm to non-members. A very broad range of organisational and institutional arrangements have been used to attain these goals. These arrangements lie on a continuum of supranationality. At the supranational end of the spectrum is the EU with its legal system, supremacy of the EU Court, and decision making by majority voting. At the other end of the spectrum are the many purely intergovernmental arrangements such as NAFTA. In between are regional trade arrangements – such as the European Free Trade Association (EFTA) – that are intergovernmental in terms of decision making but which have institutions and organisation that induce and lock-in cooperation.

The crucial dividing line between intergovernmental and supranational lies in decision making. If the regional organisation can make decisions that bind all the members, yet need not be approved by each member, then we can say that the organisation is supranational. For example, the EU decides its common external tariff – including antidumping duties – on the basis of majority voting. Consequently, EU members frequently find themselves having to adopt trade policies that they do not want.<sup>12</sup> In intergovernmental organisations such as NAFTA and EFTA, all nations must agree to everything.

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<sup>12</sup> A recent example came with the EU-China conflict over textile quotas. Several nations including Sweden, the Netherlands and the UK did not want quotas against Chinese exports, but they were out voted in the Council of Ministers so they were forced to restrict the trade. See Baldwin and Wyplosz (2006) for details on the EU's trade policy setting institutions and procedures.

#### 4.3.1. EFTA: the appropriate European model for East Asia

The EU model is a non-starter for East Asia. Imagine how ridiculous it would be to propose an East Asian organisation in which China would have to adopt a trade policy it disagreed with because Korea and Japan voted for it. When the EU was born, the transfer of national sovereignty to a supranational trade body was goal and economic integration was the means. This attitude, which is rare even in Europe today, is not part of any East Asian government's plans. And this fact is completely independent of the question of existing conflicts among potential members of any such arrangement. Whether we are talking about Japan and China, Indonesia and Singapore, or Thailand and Korea – this group of countries would not accept the pooling of sovereignty that an Asian-version of the EU would imply. EU-style supranationality – even supranationality limited to trade policy – is not for Asia, not now and not for the foreseeable future.

NAFTA provides an alternate template, but it too is wrong for East Asia. NAFTA is one of the few regional arrangements outside of Europe that really ‘works’ in the sense of liberalising trade that would not otherwise have been liberalised and significantly shifting trade patterns (Holmes 2005). However, NAFTA’s success has nothing to do with its institutional arrangements. It works since a single nation is in charge, *de facto*. The US market is 18 times that of Mexico’s and 12 times that of Canada. Since market size equates with negotiating power in trade arrangements, it is easy to see why NAFTA works. A single nation has 90% of the negotiating power and yet really cares about the organisation’s success for political, geo-strategic and commercial reasons. NAFTA’s institutions are not notably more developed than those of ASEAN, indeed in many ways ASEANs is more highly structured since at least it has a permanent Secretariat.

It seems likely that the European Free Trade Association (EFTA) provides the best model for the long-run shape of East Asian economic integration since EFTA is purely intergovernmental but it has an efficient secretariat and enough institutional structure to deal with new challenges such as new members and expansion of the integration regime. In its early days, EFTA included advanced industrial nations (e.g. UK and Switzerland) but also developing nations (Portugal) and produced ‘special and differential’ (SDT) rules for Portugal. Given the great disparities in the East Asia, the Asian EFTA should also include SDT-like policies and a ‘structural funds’ set up as in the EU. This arrangement would:

- Mitigate the hub-and-spoke bilateralism that has emerged in the region; this would be especially beneficial to small East Asian nations that have fallen into the spoke trap (Baldwin 2004).
- Avoid the ‘noodle bowl’ problem by bring coherence to preferences and rules of origin.
- Create “conditionally open regionalism” in East Asia, which would result in many of the efficiency aspects of APEC’s “Open Regionalism” while still harnessing the critical political forces that are generated by preferential trade liberalisation.
- Since Japan and Korea are developed nation members of the WTO, the arrangement would need to obey article 24 disciplines. This discipline would also make it less threatening to third nations.

Note that since Japanese MFN tariffs are very low, and Korean MFN tariffs are relatively low, membership in this arrangement would expose Union members to something close to world market prices. This has two merits. It greatly reduces the scope for inefficient switches from low-cost non-member suppliers to high-cost member suppliers (trade diversion). It also means that joining the Union would almost surely foster further liberalisation, as in the case of Mexico (see Baldwin 2004).

### 5. CONCLUDING REMARKS

As of early 2006, preferential tariff liberalisation had yet to begin in East Asia. The ASEAN-China FTA and the Japan bilateral FTAs with ASEANs are just starting to be phased in; the only FTA in the region that is close to being implemented, AFTA, does not count since almost none of

intra-ASEAN trade uses the preferences. Since ‘discrimination’ is another word for ‘preferential,’ we can say that East Asia has not yet seen what happens when tariffs are cut on a discriminatory basis. To date, the smooth growth of intra-regional trade has been driven by unilateral tariff cutting. Consequently, the remarkably harmonious state of regional trade relations during the last two decades gives us little indication of how the system will react to future tensions including those arising from the impending discriminatory tariff liberalisation.

Given the extreme interdependence of almost all East Asian manufacturers on intra-regional trade and given the near total absence of WTO discipline on the tariff reductions that made all this possible, the prospect of trade tensions should be worrying to all the governments and companies in the region. To date, the middle management of Factory Asia – the private companies – have done an excellent job of keeping East Asian trade running smoothly. But middle management cannot solve all problems. If shocks to the system led some nations to start raising tariffs, rounds of tariff retaliation could lead to substantial disruption of intra-East Asian trade. Of course, everyone would be hurt by this, but it would not be the first time in the course of human events that small-minded disputes caused huge problems due to a lack of ‘top-level’ management. Avoiding such outcomes requires a broader perspective than that of any one nation or trade arrangement can provide. In short, managing the noodle bowl should be a priority for all East Asian governments and companies.

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