

**EMERGING FTA APPROACH IN EAST ASIA AND POLICY IMPLICATIONS
FOR VIETNAM**

By

BUI Truong Giang

THESIS

Submitted to

KDI School of Public Policy and Management

in partial fulfillment of the requirements

for the degree of

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ABSTRACT

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Regionalism and bilateralism have increasingly become major trends in global pattern of economic integration nowadays. Since the late 1990s, we have witnessed a new wave of regionalism and robust emerging bilateral FTA approach in trade liberalization and economic integration in East Asia. After reviewing theoretical issues on preferential approach to trade liberalization, the thesis describes and evaluates the emerging trend of policy shift to bilateral trading arrangements by major East Asian countries since the late 1990s. It also analyzes the international economic integration process of Vietnam from the perspective of FTA with the aim to draw out policy implications for Vietnam's approaches to international economic integration in the post-WTO accession period. Vietnam targets to accede to the World Trade Organization in 2005. To prepare for the post-WTO accession period, Vietnam should soon be prepared for a balanced multi-track approach to economic integration and trade liberalization. Vietnam should take serious considerations on the options of bilateral FTA approach to deepen domestic reforms and offset the potential disadvantages as becoming "the outsider" of or excluded from a web of bilateral FTAs among the regional countries, among other negative effects.

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Dedicated to my family

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INTRODUCTION

Together with multilateralism in the global trading system institutionalized by the establishment of the World Trade Organization (WTO) in 1995, regionalism and bilateralism have increasingly become major trends in global pattern of economic integration. The European countries are the fore-runners in these trends with the establishment of quite a few free trade agreements (FTA) among themselves since the 1950s. The United States and East Asian countries, however, had been faithful to the multilateral approach until late 1980s. During the 1990s, North America and East Asia have witnessed the emerging trend of proliferation of regional and bilateral trading agreements. According to Robert Scollay and John Gilbert (2001), the central driver of the new trend in the Asia Pacific is the pursuit of regional trading initiatives by countries that had traditionally relied solely on the multilateral trading system. The first to shift was the United States with its bilateral agreement with Canada in late 1980s. Japan and Korea, the two among a few that were consistently adhered to multilateral approach until recently, have also followed a similar policy shift with a dozen of bilateral initiatives with Southeast Asian and Latin American countries. China recently follows suite with FTA negotiations with ASEAN.

Such policy shifts of major economies in the Asia-Pacific such as the U.S., Canada, Japan, China and Korea have challenged the multilateralism-based world trading system and the rest in the region for policy adjustment and paradigm change. The purpose of this thesis is three-fold: First, to review theoretical framework and issues on preferential approach to trade liberalization and integration. Second, to describe and evaluate the emerging trend of policy shift to bilateral trading

arrangements by major East Asian countries, namely Japan, China and Korea, and ASEAN since the late 1990s. Finally, to draw out policy implications for Vietnam's approaches to international economic integration in the coming years. The key policy recommendation is that to prepare for the post-WTO accession period, Vietnam should soon be prepared for a balanced multi-track approach to economic integration and trade liberalization. Vietnam should take serious consideration on the options of bilateral FTA approach to deepen domestic reforms and offset the potential disadvantages as becoming "the outsider" of or excluded from a web of bilateral FTAs among the regional countries, among other negative effects.

I. THEORETICAL FRAMEWORK OF PREFERENTIAL TRADING ARRANGEMENTS (PTAs):

Increase in world trade has accompanied with increasing number of preferential trade arrangements (PTAs). As more countries joins WTO, the same countries have simultaneously and actively established closer trading and economic ties with their neighbors and strategic partners. According to data on WTO's RTAs notifications and IMF's Direction of Trade Statistics, in 2000, about 97 percent of total global trade involves countries that are membered of at least one preferential trading arrangement (PTA), compared with 72 percent in 1990.

I.1. THE CONCEPTUAL FRAMEWORK OF PTAs:

Preferential trade arrangements (PTAs) are part of free trade approaches, which provide preferential treatment in trade among member countries. According to Panagariya (2000), preferential trade arrangements (PTAs) are agreements between two or more countries in which tariffs imposed on goods produced in the members

countries are lower than goods produced outside¹.

Preferential Trading Arrangements, termed by J. Bhagwati, refer to different levels of regional and bilateral economic integration (see Box I.1), whereas regional trade agreements (RTAs) is the collective terms used by the WTO to refer to the four following types of regional preferential trading arrangements:

1. Free Trade Agreements (FTAs): under which member countries agree to eliminate tariffs and non-tariffs on trade in goods² within the FTA, but each country maintains its own trade policies, including tariffs on trade outside the region.
2. Customs Unions: in which member countries conduct free trade among themselves and establish common tariffs and other trade policy for countries outside the group.
3. Common Markets: in which member countries go beyond customs unions by eliminating barriers to labor and capital flows across national borders within the market.
4. Economic Unions: in which member countries merge their economies further by adopting common macroeconomic policies, establishing a common currency along with other common economic institutions.

Box I.1: Terminology of Preferential Trade Agreements.

Preferential trade agreements (PTAs) are agreements between two or more countries in which tariffs imposed on goods produced in the members countries are lower than goods produced outside...

PTAs also refer to preferential trading arrangements or areas...

PTAs broadly defined include a host of trade agreements made outside of the multilateral trading system, including PTAs notified to the WTO as well as looser arrangements such as APEC...

PTAs include regional trading arrangements (RTAs), which are PTAs where countries come from the same geographic region...

In terms of their level of trade and economic integration, there are several types of PTAs. The most modest form of PTA involves preferential tariffs-but not eliminating tariffs-between two or more countries on certain goods...

Free Trade Agreements (FTAs) are PTAs in which tariffs are eliminated entirely on the goods produced in member countries, but member countries maintain their own tariff structure with non-members.

Besides the key four types of *reciprocal* PTAs mentioned above, there are trade arrangements under which one party agrees to extend *non-reciprocal* preferential treatments to imports of a country or group of countries unilaterally. Such arrangements primarily involve developed countries extending non-reciprocal preferential treatments to imports from developing countries, for example the Generalized System of Preferences (GSP), the Caribbean Basin Initiative (CBI), or the African Growth Opportunity Act (AGOA) employed by the United States.

I.2. MOTIVATIONS FOR PTAs:

Regional integration in general and preferential trade arrangements (PTAs) in particular is not only motivated solely by traditional trade gains and economic effects, but also increasingly by political rationales. Nations consider both economic and non-economic factors when selecting FTA partner(s). According to a comprehensive study by the WTO (1999), political effects such as security, bargaining power, lock-in reform and lobby pressure are key calculation for nowadays bilateral and regional FTA approach, whereas economic effects such as *competition and scale* effects, and *trade and location* effects are also key motivations.

According to Urata (2002), countries should consider both external factors (secure market, provide export opportunities for domestic companies by dismantling trade barriers between nations) as well as internal factors (economic growth from increased efficiency due to greater competition as a result of the markets being opened; FTAs as external pressure for domestic regulatory reforms) when shifting to FTA approach.

From a more comprehensive analytical framework, Mari Pangestu and Robert Scollay (2001) argue that trade motivation predominant (market access, defensive motivation or domino effect, slow progress in multilateral trade negotiation, Impatience of some individual economies with existing regional cooperation and arrangements, lack of multi and regional capacity to deal with emerging new issues, slow progress of East Asia in regional integration compared with other regions.) the policy shift to bilateralism and regionalism.

From the perspectives of smaller and developing countries, development motivations are key, as FTA approach would provide smaller states with enhanced capacity to negotiate and experience opening up in stages, push forward and lock in unilateral or overall reforms, enhance competitiveness for FDI and market, shared growth. For some particular group of countries like the case of ASEAN, political and security motivation is an appropriate explanation. The new regional or cross-regional FTA approach would help building a sense of community with neighboring economies, easing domestic political pressures in developed countries on labor and environmental issues, or even democracy requirement.

John Whalley (1998) helps answering the question why countries seek RTAs by excellent summing up the five key determinants for FTA approach as follows:

- (1) Traditional trade gains.

- (2) Strengthening domestic policy reform (Mexico in NAFTA)
- (3) Guarantees of access (Canada in CUSTA)
- (4) Strategic linkage (EU, ASEAN)
- (5) Multilateral and regional interplay, collective bargaining (US, EU).

I.3. WELFARE EFFECTS OF PTAs:

I.3.1. The Possible Economic Gains Of PTAs:

When economies come together to form a larger free trading regions or areas, they expect for possible economic gains. However, there is no guarantee that those economic gains can be achieved, as static gains can be distorted by domestic as well as international factors, for example the dominant type of competitive behavior prior to deeper economic integration (Ali M. El-Agraa, 1989). The possible economic gains from any PTAs at various levels can be attributed to:

- 1- Enhanced efficiency in production made possible by increased specialization in accordance with the law of comparative advantage, due to the liberalized market of the participating nations;
- 2- Increased production levels due to better exploitation of economies of scale made possible by the increased size of the market;
- 3- Improved international bargaining positions, made possible by the larger size, leading to better terms of trade;
- 4- Enforced changes in efficiency brought about by intensified competition between firms;
- 5- Changes affecting both amount and quality of the factors of production due to technological advances;

- 6- Factor mobility across the borders of the member nations will materialize only if there is a net economic incentive for them, thus leading to higher national incomes;
- 7- The coordination of monetary and fiscal policies may result in the cost reduction since the pooling of efforts may enable the achievement of economies of scales; and
- 8- The unification of efforts to achieve better employment levels, lower inflation rates, balanced trade, higher rates of economic growth and better income distribution may make it cheaper to attain these targets.

The first five possible economic gains are for PTAs at free trade areas/agreements (FTAs) and customs union (CU), where as the last three can only be achieved at higher level of integration or going beyond FTAs and CU.

I.3.2. The On-going Debate On Effects Of PTAs:

I.3.2.1. Positive Effects vs. Negative Effects:

A recent study by ADB (2002) argues that PTAs can contribute to the improved welfare of members and nonmembers by (1) improving communication between regional neighbors and reducing the chances of conflicts; (2) pursuing reform in areas not addressed or difficult to address on broader multilateral arrangements; (3) providing commitment mechanisms to support or reinforce domestic policy reforms; (4) and areas for experimentation and learning in trade liberalization. On the other hand, undesirable issues of PTAs include (1) rules of origin that distort comparative advantage; and (2) overlapping jurisdictions and rules of the various PTAs.

According to Findlay, Hafilah & Pagestu (2003): the risks of FTAs are: “The consequences of FTA can therefore be considered in a various categories, including

the impacts of trade diversion, the effects of retaliation, and the costs of the spaghetti bowl effects. Consequences include both domestic and international political effects. Progress in the WTO can be impeded as a result of their application. Overall, the tactic of favoritism contradicts the strategy of cooperation.”

a) Economies of scale from larger market size vs. Incentives for inefficient allocation of resources:

The very first and obvious effect of any freer trade arrangements is larger market size so as to gain economies of scale. Expanded markets thanks to reciprocal tariff cuts and trade facilitation can help firms cutting transaction costs and increase outputs.

However, critics of PTAs focus on the degree to which the trade enhanced by PTAs distorts trade patterns between members and nonmembers, and generate incentives for inefficient specification. An individual country gain most if it joins a PTA in which its comparative advantage relative to the other members is similar to its comparative advantage relative to the rest of the world; worst is when member of a PTA has a comparative advantage relative to other members that is different from its comparative relative to the rest of the world, in such case, PTAs could be impediments to the structural transformation of an economy from lower to higher value-added production (Waltz, 1997).

Exclusion of non-member leads to their worsen terms of trade (Chang and Winters 1999). Going PTA way also generates a scarcity of negotiation resources at the national level and negotiation fatigue, particularly for developing and small economies.

b) Lock-in effects vs. Stronger domestic protectionist group:

For many developing countries which need radical market and economic reforms, using “external pressure” to accelerate domestic reforms is usually utilized and gain encouraging achievements. Those supporting the PTA approach argue that going bilaterals and regionals is feasible and positive option for many developing countries, that will push forward and lock in unilateral reforms, enhance competitiveness for FDI and market.

Negative effects on the political economy of further domestic reforms are also expected, as preferential treatments under FTAs will create new and stronger set of vested interests that are opposed to further reform, because it would remove their favored positions in domestic or offshore markets. Further, bilateral negotiations are not likely to mobilize sufficient political support to deal with the very difficult and sensitive issues. FTA negotiation process will create new tensions and direct conflicts as preferential offers are discriminative and proposals to extend similar benefits to other trading partners are always disputable. Finally, even deeper political linkages are established within the group, tensions outside it will occurs, signaling diminishing quality of relationship with non-members.

c) Fostering competition and technology transfer vs. Non-competitive behaviors:

According to Summer (1991) and Lawrence (1991), reducing trade barriers will foster competition and technology transfer, therefore, joining a PTA will create more trade with at least some countries and thus contribute to development, and allow both members and nonmembers to obtain benefits of increasing openness. However, noncompetitive behaviors (leave out certain sectors; allow preferential market access

in the group; allows firms in member countries to gain first-mover advantage (Fruend 2000).

d) Good precedents for negotiation modalities and high-standard trade liberalization agreements vs. Bad precedents of sectoral exclusion:

Regional Trade Agreements can set good precedents and develop negotiation modalities that can be adopted later in multilateral negotiations (Loyd, 2002). There a number of examples of this. The Canada-US FTA in particular developed concepts and modalities in the service trade areas that were important in the development of GATS (General Agreement on Trade and Services).

Bad precedents also go hand in hand with good ones, as Jagdish Bhagwati said. One example is the exclusion of some agricultural products from the trade liberalization under the Japan-Singapore EPA; Another example is the US predilection for side agreements on environment and labor standards. The structure of FTAs always excludes (quite a few) politically sensitive sectors and will not naturally evolve to MFN-based liberalization: a spaghetti bowl structure.

1.3.2.2. Issues For Developing Countries:

a) Factor endowment complementarities in North-South PTAs:

So, what happens if a developing and an industrialized country enter into an FTA? According to the classical considerations of Viner, trade diversion effects vis-a-vis third countries are likely to dominate due to the complementary production and trade structure that generally determines North-South trade. This appraisal was criticized by some authors (see for example Piazzolo 2001, Collier and Gunning, 2000, and Venables 1999) who argued that developing countries would benefit from an FTA with an industrialized country due to their different factor endowment. As a result, the

FTA would enable them to import cheap, capital-intensive inputs and export labor-intensive manufactures, thus, stimulating the division of labor.

b) Bargaining power from South-South PTAs:

Proponents of South-South PTAs argue that the real benefit of PTAs is that they could serve as a vehicle to band countries together so that they would be able to increase their bargaining power in WTO negotiations. For small countries there may be a distinct advantage. By combining with other countries, they are in a position to get noticed, and extract more useful concessions from more powerful players. North-South PTAs are theoretically preferred than South-South ones, from comparative advantage perspectives. However, South-South trading agreements are also mutually beneficial, as negotiations among a small group of neighboring countries closely associated with each other can make it easier to reach the necessary understanding and compromise. Therefore, such approach provides a building bloc for wider liberalization under the multilateral framework.

c) Possible dynamic effects:

For developing countries, regional integration with industrialized countries offers another positive aspect, as it might help them to develop their industrial capacities due to protected access to a larger market and strong cooperation (Kreinin and Plummer 2002:30). Besides this, the increased competition could result in a more effective usage of resources and stimulate innovational effects. Next to these economic dynamics, regional trade agreements might also offer political dynamics, such as an advanced relevance in bilateral and multilateral trade negotiations due to the bundling of interests. Furthermore, the contractual agreement with an industrialized country might increase the economic and political reputation of the respective developing country and help to attract foreign direct investment (FDI)

(Padoan 2001, Collier and Gunning 2000). So, from a theoretical point of view, either the dominance of positive or of negative effects is possible. Or, as formulated by de Melo et al. (1993:160): “The literature on RI [Regional Integration] is full of the “anything may happen” type of results”.

d) Sequencing bargaining effect:

Seen from the new political economy aspect of American trade policy. Labor standard and environment are burning issues that should be considered or included in any new trade agreements by the U.S. For developing countries with limited resources, such North-South PTAs would set higher standards for trade liberalization in the South. This is called the Sequencing Bargaining Effect. Bhagwati (1994) argued that even though a multilateral bargain *simultaneously* with a group of non-hegemonic powers (the South) is profitable and hence possible, a hegemonic power (the North) will gain a greater payoff by bargaining *sequentially* with them, using bilateral and plurilateral PTA approaches, picking the countries that are most vulnerable and then moving on to the next on and so on (Bhagwati and Arvind, 1996). This is the ways how high-standard “trade and” issues, which have made multilateral track stalled, are locked into trade liberalization roadmaps of developing countries.

e) Revenue transfer effect:

PTAs’ effect on government revenue is important for developing countries, as the RIA acts as an *inefficient* way of transferring some of the country’s tariff revenue either to domestic consumers or to partner country producers. Firms benefit from preferential access to partner markets at the expense of consumers and government revenue. Transfers are important in North-South RTAs because developing countries risk losing from a RTA with the North. The reason is that developing countries typically have higher tariffs than industrial countries. Consequently, the industrial

member is likely to gain more from increased access to the partner's market than the developing member. The latter can resolve this issue by unilaterally lowering its tariffs.

Implications:

Welfare effects of PTA liberalization tend to be positive. When evaluated in pure economic terms related to only changes in trade flows, PTAs are, however, welfare reducing in the world as a whole (de Melo, Panagariya, and Rodrik, 1992; Bhagwati and Panagariya, 1996; Schiff, 1997). Negative effects can be incentives for inefficient allocation of resources; Non-competitive behaviors; multiple systems of rules with hubs and spokes and spaghetti bowl effects; creating a scarcity of negotiation resources at the national level and negotiation fatigue, bad precedents; unequal access to world market; undermining the MFN principle further; and retaliation.

There are mixed empirical outcomes regarding PTAs' effects on level of trade, government revenue, lock-in effects on reforms. PTAs' effects on level of trade differ with multilateral liberalization as it can create trade diversion rather than trade creation, which is to be further discussed in the next part. Difference between intra-PTA tariffs and external tariffs and rules of origin are most mentioned factors that generate incentives for trade diversion. PTAs effects on market side depend on size and structures of members' economies, which might generate industry-level scale effects and FDI attractiveness.

I.3.3. PTAs In The Multilateral Trading System:

1.3.3.1. Building Blocks vs. Stumbling Blocks:

a) “Open regionalism” and “Deep integration” arguments:

The proponents of regional integration coin out the concept of “open regionalism” and “deep integration”. F. Bergsten together with advocates of the current wave of PTAs defends it on the ground that it represents "open regionalism" in contrast to closed, import-substituting regionalism of 1950s and 1960s³. There are three key criteria for open regionalism: (i) open membership with positive encouragement to nonmembers to join, (ii) consistency with GATT Article XXIV, and (iii) freedom to member countries liberalize further unilaterally or with non-members on a reciprocal basis. Thus, “open regionalism”-based PTAs are stepping-stones to freer multilateral trading system.

The “Deep Integration” hypothesis advocated by R. Lawrence (1997) argues that regional arrangements promote "deeper" integration⁴. They involve "deep" integration through coordination or harmonization of competition policies, product standards, regulatory regimes, investment codes, environmental policies, labor standards and so on. He argues that such deep integration may confer gains on member countries by lowering the costs of production and improving efficiency in general. Bilateral and regional commitments also force other members of the agreements to make more progress in trade liberalization and thereby promote deeper integration in the RTA. Rajan *et al* (2001, chapter 2) give this as one reason behind Singapore’s pursuit of bilaterals. They refer to the “convoy problem” whereby the pace of integration is held back by the “least willing member”.

³ According to U.S. President’s Council of Economic Advisors, "Open regionalism refers to plurilateral agreements that are *nonexclusive and open* ... It requires first that plurilateral initiatives be *fully consistent with Article XXIV* of the GATT ... Beyond that, it requires ... *not constrain members from pursuing additional liberalization* ...", CEA (1995).

However, multiple systems of rules, Spaghetti bowl structures, and hub-and-spoke layouts would generate unequal access to world market and more importantly undermining the MFN principle. Trading agreements based on preferential treatments undermine the principle of non-discrimination of the multilateral trading system, resulting in welfare loss.

b) Spaghetti bowl effect:

The *negative effects* are also obvious as vast amounts of human, financial and political resources have gone into negotiating and concluding these agreements. The more resources are devoted to the negotiation of multiple PTAs, the less they are available for the multilateral trade process. Jagdish Bhagwati calls the web of multi PTAs, mostly overlapping free trade agreements, as the “Spaghetti-Bowl” effect⁵, saying that to avoid trade deflection, FTA agreements usually include the rules of origin for receiving the duty-free status. The roots of such Spaghetti bowl effect are exceptions in GATT/WTO framework such as GATT Article XXIV and the so-called Enabling Clause for preferentially treatments to developing countries, which have led to crisscrossing trade preferences for countries where products in major markets enjoy preferential access terms depending on where they are originated.

The proliferation of crisscrossing FTAs leads to a replacement of the nondiscriminatory MFN tariff by a spaghetti bowl whereby tariffs vary according to the ostensible origin of the product. (WB, 2004), the challenge in pursuing regional integration arrangements will be to avoid the “spaghetti bowl” effect of different rules and regulations associated with different agreements, which can add unnecessary administrative costs to firms doing business across the region.

⁴ Lawrence, Robert (1997), *Regionalism, Multilateralism and Deeper Integration*, Brookings Institution, Washington.

⁵ See Chapter 1 in Jagdish Bhagwati and Anne Krueger (1995): “*The Dangerous Drift to Preferential Trade Agreements*”, AEI Press, Washington. D.C.

c) Hub-and-spoke effect:

Another negative factor is the “Hub-and-Spoke” effect when one country concludes PTAs with several other ones⁶. To counter the open regionalism and deep integration hypotheses, Wannacott (2000) points out that FTA is less beneficial than presumed if it is part of a hub-and-spoke system, a system in which a hub country has a separate FTA with each spoke with no liberalized trade between spokes. Hub-and-spoke system generates less collective income for participants than corresponding FTA covering the same countries because: a) trade barriers remain within hub and spoke system but not FTA, b) more protective barriers create greater rent-seeking waste and c) there will be a whole additional set of inefficiencies if hub and spoke bilateral agreements are inconsistent.

The hub country will benefit in preferences and investment since it is only location with duty free access to all participating countries. Spoke-to-spoke trade suffers not only because of foregone benefits from a full FTA but also is damaged from new discrimination each spoke faces in all other spoke markets in competition with hub. Spokes face discrimination also in the hub’s market if the hub negotiates more favorable bilateral agreements with new spokes.

1.3.3.2. PTAs And Future Multilateral Trading System:

According to Baldwin’s (1993) domino theory, PTA membership will gradually expand to cover all nations, therefore complementary to multilateral trading system. Fernandez & Portes (1998) argue that PTAs serve as a focal point for the often dispersed domestic beneficiaries of liberalization to coordinate and offer strong

⁶ A hub arises where one country (customs territory) is a member of two distinct RTAs. Since the development of the new regionalism, many countries are now hubs. In the Asia-Pacific area, Singapore, the US, Canada, Mexico, Chile, Peru, Australia, New Zealand and Russia are now hubs on the basis of RTAs already in force and others such as Japan and Thailand may join them soon.

political support for continued trade reform. By other extreme, PTAs would become impediments against future moving forward of the multilateral trading liberalization, as Krugman (1991) pointed out that PTAs would reduce rather than increase demands for liberalization because vested interest groups who benefits greatly from preferential tariffs would lobby for status quo or against any changes or further expansion of preferential treatments. Levy (1997) shows that bilateral trade negotiations may alter domestic interest groups payoffs and make them more likely to block further multilateral liberalization.

According to Krishna (1998), preferential access to large markets can create excess profits for producers in member countries, thus PTAs create new interest group opposed to further multilateral liberalization. Andriamanajara (1999) also argues that a PTA shrinks the export sectors of the non-members, which in turn, leads to expansion of these members' import-competing and lobbying sectors. Therefore nonmembers become more protectionists, then undermine efforts for multilateral liberalization.

In recent study, Scollay & Gilbert (2001) point out possibility that PTAs will allow like-minded protectionist policy outlooks to acquire greater bargaining power in the multilateral framework. Pessimistically, Bhagwati (1993) and Krueger (1997) consider that PTAs will profligate and overlap such that countries become embedded in a "spaghetti bowl" of mutually inconsistent trade restrictions, undermining the multilateral approach to trade liberalization.

Implications:

The multilateral trading system, based on the GATT/WTO framework, has played a key role in post World War II global economic growth. The GATT/WTO system is built on basic principles of MFN and NT, or non-discrimination. The GATT/WTO system is not, however, without flexibility in implementation. There exist exceptions that allow member countries to deviate from the above-mentioned non-discriminatory principles. Those are provisions in GATT/Art. XX, XXI, XXIV, the Enabling Clause, GATS/Art.V, XIV, the ATC, SPS, or government procurement and tariff quota, to name a few. Of which, the PTAs come into exist thanks to exceptions under GATT/ Art. XXIV (*Territorial Application-Frontier Traffic-Customs Unions-and Free trade Areas*) and GATS/Art. V (*Economic Integration*). Legally speaking, the GATT/WTO framework bans discriminations among member countries, but allows a group of member countries move towards freer trade liberalization among themselves.

Regional economic integration through PTAs is a dynamic global trend that is shaping the world economy today. Regional integration can contribute to social welfare by generating trade creation effect and by acting as a stepping-stone towards further liberalized multilateral trading system. In this sense, regional integration is a building bloc to multilateral trade liberalization process. On the other hand, regional integration can be a stumbling bloc to multilateral trade liberalization, as overlapping regional integration arrangements might cause negative effects such as trade diversion, “Spaghetti-Bowl” and “Hub-and-Spoke” effects.

PTAs as institutional mechanism for broader cooperation: PTAs offer a potentially stronger forum for negotiation of deeper integration and wider policy reform. PTAs smaller size and easier coordination between members are considered

as an advantage in achieving deeper integration; standard, regulation, and financial structure harmonization (Laird 1999). PTAs enhance regional security: increased trade among nations reduces the chance of military conflicts (Polachek 1992, Irwin 1993). PTAs with larger markets can be seen as a form of insurance in the case of a global trade war (Perroni and Whalley 2000). PTAs can commit policymakers to reforms and prevent them backtracking on reforms once they are implemented.

Both WTO and PTAs have ability to create more credible trade policy, external commitment can support more efficient specialization, reduce resources wasted on rent-seeking, and limit delay in adjustment to competitive pressures. PTAs have a potential comparative advantage vis-a-vis multilateral arrangements as regulations can be written more tightly, creating opportunities for members to commit non-trade policy goals such as investment liberalization or political reform.

PTAs as practice for multilateral negotiations: Learning together and pooling resources; PTAs more palatable domestically in political terms as they allows reserving sensitive economic sectors and choice on partners that will not create strong competitive pressure for restructuring; internationally, PTAs as forum for diplomatic relations and increased economic integration.

Although welfare consequences of PTA liberalization tend to be positive, it is generally acknowledged that PTA liberalization does not compare favorably with multilateral liberalization if gains from trade alone are considered. However, PTAs as feasible second-best means of trade liberalization (ADB, 2002).

PTAs as trade facilitation mechanisms, not substitute for broader (multilateral) trade liberalization, because (1) there are economic limitations on the extent of gains from trade that can be achieved from trade within regional PTAs (small members with similar resource bases, manufacturing capacities and economic structures); (2) the

institutional features of the region's PTAs are not the most conducive to achieve gains from trade, trade within PTAs is generally not free (retain sectors for protection; similar forms of rules of origin may lead to manipulated and differently interpreted by national authorities); (3) aggregate economic size of some PTAs tends to be small, limiting market-size effects.

PTAs can also focus on ways to boost joint security, reduce political tensions and improve conflict resolution. To cope with government revenue losses, the need to ensure that alternative tax systems are in place before removing sources of trade tax revenue.

I.4. THEORETICAL ASPECTS OF FREE TRADE AGREEMENTS (FTAs):

Free trade agreements or areas have two main distinguishable respects: *First*, FTA member countries still possess their freedom or sovereignty to determine their extra-FTA tariffs and general commercial policies, and because this freedom may result in differing tariff rates in the member countries, which creates rooms for importing from third countries via the FTA member nations with lower tariff rates. *Second*, they will most likely introduce some sort of rules of origin⁷ (ROO) to ensure that only those commodities which are entirely or largely produced with the FTA should be treated preferentially or exempt from customs duties.

As FTA member countries differ in commercial policies and external tariffs against the rest of the world, this may lead to three key effects⁸:

⁷ Shibata (1967, pg.68) attempts to specifically incorporate the rules of origin as an integral part of the definition of a FTA: "a [FTA] is defined as in internal grouping of countries, each of which agrees to exempt from tariffs and quantitative restrictions which it generally imposes on imported products, that part of these products which have originated or are produced in the territories of the other member of the group."

⁸ The effects can also occur in production and investment. Here for simplification, only trade aspect is discussed.

- a) **Trade creation effect:** The creation of trade occurs when a member of an FTA replaces domestic production of a good with imports of the good from another member of the FTA, because the formation of the FTA has made it cheaper to import rather than domestically produce.
- b) **Trade diversion effect:** The diversion of trade occurs when a member of an FTA switches its import of a good from an efficient non-member to a less efficient member, because the removal of tariffs within the group and the continuation of tariffs on imports from non-members make it cheaper to do so.
- c) **Trade deflection effect:** The deflection of trade will occur if trade barriers of high-tariff member countries are circumvented through the importation of products originating outside the area from low-tariff member. (If no precautionary measures were taken and tariff preferences exceeded the additional transportation costs, imports would enter the FTA via the country, which applies the lowest tariff on the commodity in question.)

I.4.1. The Debate On Welfare Effects Of FTAs:

The pioneer study of Jacob Viner's (1950) discussed the concepts of trade creation and trade diversion⁹. Viner notes that since Preferential Trade Arrangements (PTAs) liberalize trade preferentially, on one hand, they create new trade between union members while, on the other hand, they divert trade from low-cost outside suppliers to high-cost within-union suppliers. The former effect arises from a union partner undermining another union member's less efficient industry and is beneficial. The latter effect, harmful, arises from a union member displacing a more efficient

⁹ Jacob Viner (1950): "*The Customs Union Issue*", CEIP, New York.

outside supplier by taking advantage of the tariff preference it enjoys in a partner country. *Unions which are primarily trade creating are beneficial and those that are primarily trade diverting are harmful to member countries taken together and to the world as a whole.*

Box I.2: When does trade diversion occur?

First, trade diversion can occur only if the country has a tariff on imports from the rest of the world, and that the cost of trade diversion cannot exceed the height of this external tariff.

Second, trade diversion arises only if partner country costs are out of line with costs and prices in the rest of the world, this will not be the case if the partner itself has low trade barriers.

Third, non-natural trading partners face higher transportation costs, which may lead to trade diversion. In reality products from different countries are not perfect substitutes, and trade faces transport costs and other barriers apart from tariffs. The presence of transport costs means that countries that are close may have lower costs of supply than more distant countries.

Finally, note that a RIA between two small developing countries is likely to only generate trade diversion and no trade creation.

Source: World Bank: Trading blocs.

Although Viner's model experienced numerous criticisms, it is still used when explaining the static effects of regional trade integration. However, along side of the static effects of regional integration, there are also several dynamic effects that can occur. In contradiction to static effects, dynamic effects of regional integration regenerate. For instance this is the case when economies of scale are exploited that are occurring due to increased market size. Companies are able to expand their production and fully load their capacities. In addition to this, the increased competition of the FTA results in an efficient factor allocation and thereby, *ceteris paribus*, to price reductions. This again increases the demand for goods and results in

growth effects. Further dynamic effects of regional integration are learning and technology effects, both, due to the close cooperation with other members of the FTA, and through investors from third countries. This is in turn stimulated by an increased market and increased economies of scale (Hoeller et al. 2000, Krugman 1991).

As proponents for regional approach, Wonnacott and Lutz (1989), P. Krugman (1991) and L. Summers (1991) utilized the concept of “natural trading partners”, saying that when union members are “natural trading partners”, they already trade a lot with each other and are geographically proximate, forming a preferential trading arrangement with close countries may be less prone to costly trade diversion than forming one with more distant countries. The risk of trade diversion is minimal. J. Frankel (1996) follows by the idea that the presence of transport costs makes regional integration among proximate countries an attractive option.

But, as offered by Bhagwati and Panagariya (1996), the natural trading partner and transport cost hypotheses has no analytical basis¹⁰. First, it is confused between small scope for trade diversion and a large outcome of it. Second, higher trade volumes at the creation of a PTA can lead to greater, not smaller, losses to a member country that comes to the PTA from a higher initial set of tariffs, since that will redistribute tariff revenues away from it to the other members with lower initial tariffs. Third, the “natural” high volume of trade occurring initially before a PTA is formed with another may itself be the “artificial” result of earlier preferences (Jagdish Bhagwati and Arvind Panagariya, 1996, the economics of PTAs). Recent empirical studies by Yeats (1996), and J. Frankel and S. Wei (1996) find out evidences on trade

¹⁰ J. Bhagwati & A. Panagariya (1996): "*Preferential Trading Areas and Multilateralism: Strangers, Friends or Foes?*" in J. Bhagwati & A. Panagariya, eds., "The Economics of Preferential Trade Agreements", AEI Press, Washington, D.C.

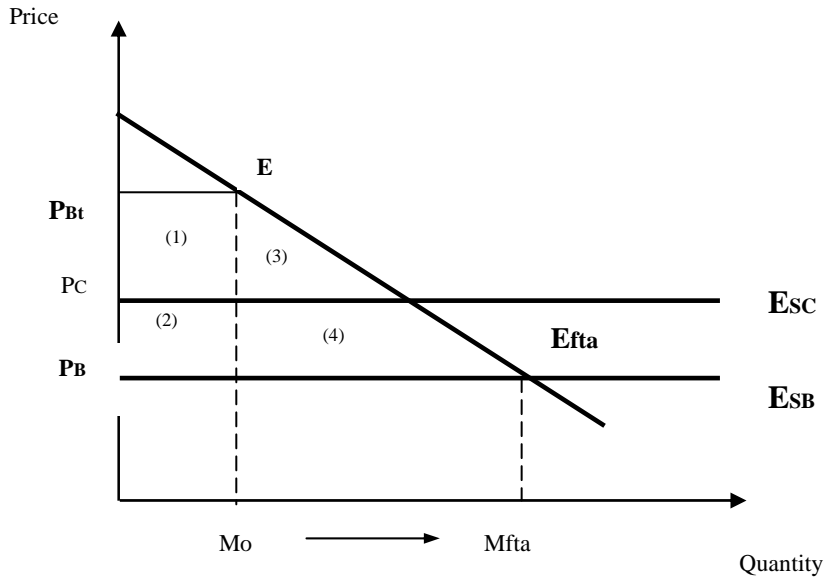
diversion in Mercosur and EC¹¹. This argument has not been resolved, Schiff (1999) argues that neither view is correct.

I.4.2. An Economic Analysis Of Welfare Effects Of A Bilateral FTA:

I.4.2.1: Vinerian Bilateral FTA Model With Constant Costs:

Figure 01: Trade Creation in Bilateral FTA Model

¹¹ Alexander J. Yeats (1996): "Does Mercosur's Trade Performance Justify Concerns about the Effects of Regional Trade Arrangements? Yes!", World Bank, mimeo; Shang J. Wei and J. Frankel (1996) "Open Regionalism in a World of Continental Trade Blocs", AEA meetings, Jan. 3-6, 1997.



In this FTA model, we have country A, country B and C is the rest of the world. Initially, non-discriminatory tariffs are applied, country A imports M_o from country B at price of P_{Bt} (with tariff) and country A's tariff revenue is (1) + (2) (Figure 01).

Trade creation:

Now that country A and country B decide to form an A+B FTA. As the result, the price level of exports supplied by country B will be lower to P_B from P_{Bt} , where as world price is still at P_C : $P_{Bt} > P_C > P_B$

Tariff Revenue Loss of A = (1) + (2)

New equilibrium point shifts from E to E_{fta} , then country A will increase imports from country to M_{fta} : $M_{fta} > M_o$.

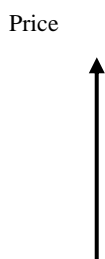
Total surplus of A = (1) + (2) + (3) + (4).

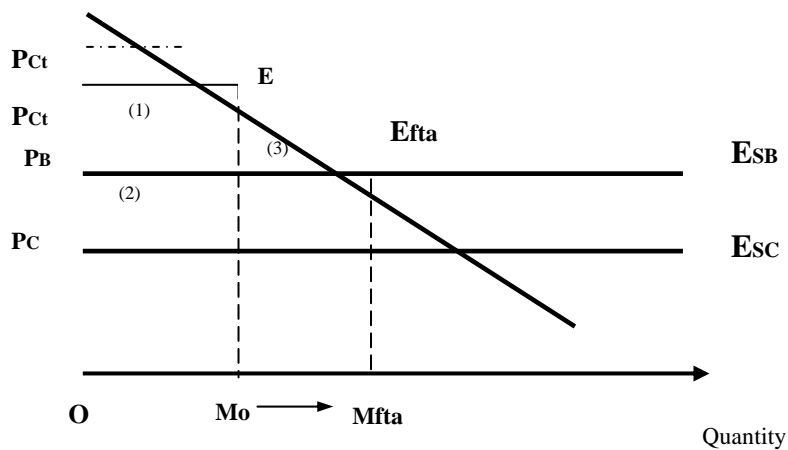
And tariff revenue of country A now is zero. Net gain for country A after forming A+B FTA is (3) + (4) (see Figure 01: Trade Creation):

$$A_{netgain} = [P_B P_{Bt} E E_{fta}] - [(1)+(2)] = (3) + (4).$$

Trade diversion:

Figure 02: Trade diversion





Assume that:

1. Country A just import from either country B or C.
2. World price (P_C) is lower than import price from country B: $P_C < P_B$.
3. With non-discriminatory tariffs, world price with tariff is lower than import price with tariff from country B: $P_{Ct} < P_{Bt}$. i.e. country B is less efficient than the rest of the world (C).

If A+B FTA is established, Tariff Revenue Loss of country A is (1) + (2).

Country A's consumer surplus = (1) + (3).

At pre-FTA equilibrium point E, country A import M_o from C due to lower price. After the establishment of A+B FTA, Equilibrium point shifts to E_{fta} , as country A's imports increase to M_{fta} . But such import amount (M_{fta}) is now supplied by country B, as importing price without tariff from country B (P_B) is lower than world price with tariff (P_{Ct}). This means trade is diverted from C (a more efficient supplier) to country B (a less efficient supplier) when A+B FTA is established.

$$A_{netgain} = (3) - (2)$$

The net gain for country A depends on whether (3) is larger or smaller than (2). Normally, (2) tends to be much bigger than (3). The resulting welfare loss occurs as loss tariff revenue is used to pay for higher cost of production, and terms of trade is worsen as import at higher price.

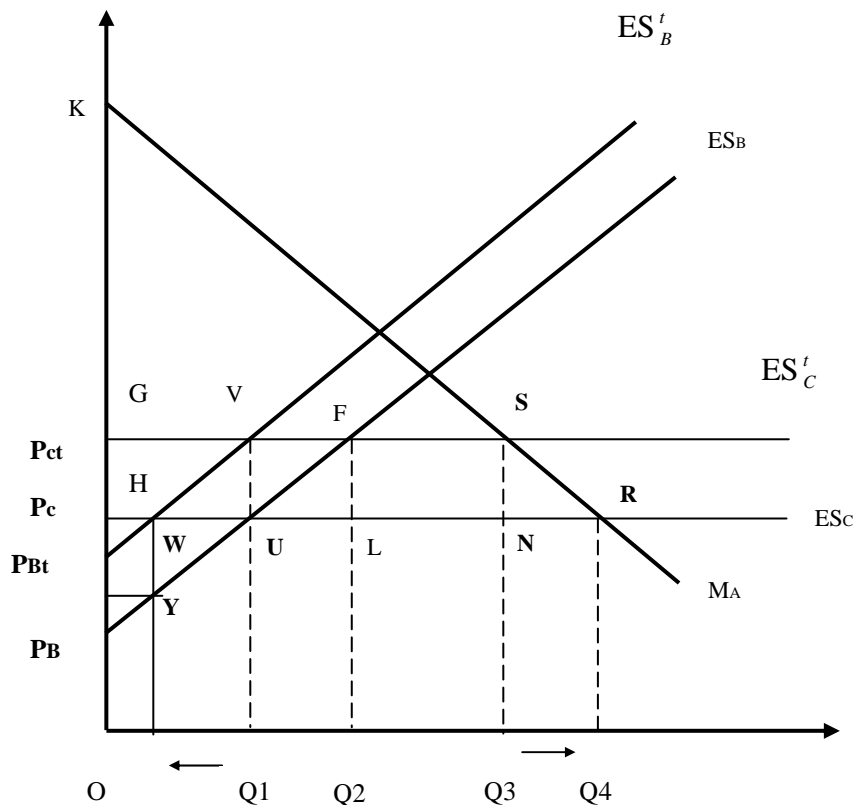
Box I.3: An example of welfare effect of trade diversion

Suppose that a country can import a good from a potential partner country at \$105 per unit, and from the rest of the world at \$100, and that in both cases the country pays \$10 in duty, making the prices paid by consumers \$115 and \$110 respectively. In this situation consumers obviously purchase from the rest of the world and pay \$110. If the country joins a RIA with the partner, imports come in duty-free so the price consumers pay for imports from the partner country falls to \$105, while imports from the rest of the world still cost consumers \$110. Consumer choices are obvious: They switch to the partner country, buying the \$105 good and saving \$5. But the government now loses \$10 per unit (the revenue it was getting on each unit of imports from the rest of the world), so the net effect for the country is a loss of \$5—the RIA has reduced real income. Another way of putting it is that the country (not the consumers) used to pay \$100 per imported unit, and now pays \$105. This is the deleterious welfare effect of “trade diversion.”

Source: World Bank: Trading Blocs, Pg. 40.

I.4.2.2. Bilateral FTA With Rising Cost From Partner Country:

Figure 03: Welfare Net Gain From Two-country FTA Model With Rising Cost



Note:

(1) = [GVWH]; (2) = [VUW]; (3) = [VFU]; (4) = [FLU]; (5) = [FSNL].

In this FTA model with increasing cost in partner country, we have country A, country B and C is the rest of the world. Export supply curve of country B (ES_B^t) is upward sloping. Export supply curve from C is flat due to constant cost assumption. Initially, importing price from B (P_B) is lower than the world price (P_C), and non-discriminatory tariffs are applied.

Country A imports Q_1 from country B and $[Q_3 - Q_1]$ from C. Upto point V, for country A importing price from country B is better than that from C.

1) *When A+B FTA is established:*

Tariff Revenue of A is (1) + (2) + (3) + (4) + (5).

New equilibrium point is shifted from W to U, country A rises import to Q_2 from B and reduces imports by $[Q_3 - Q_2]$ from C. The import amount $[Q_2 - Q_1]$ is suffering from trade diversion from C to B.

For country A: Tariff revenue for A now is only [FSNL] from C and no tariff revenue from B, and gain from trade declines by [GFLH]. Country A loses from its own trade liberalization because, the A+B FTA diverts imports from more efficient C to less efficient supplier B.

For country B: Gains from trade rises by [HUD] + [GFUH].

\Rightarrow Therefore, when the A+ B FTA is established, the net welfare loss is [FLU].

[a]

2) *When A+C FTA is established:*

The importing price for A declines to P_C , imports from B do not change but from C increase by NR. New equilibrium point shifted from S to R for A+C FTA.

For country A: Tariff revenue [GSNH] disappears, but gains from trade is consumer surplus as [KSG] + new consumer surplus as [GSNH] + new consumer surplus as [SRN] + tariff revenue from B as [HWYD].

For country B: unchanged gain from producer surplus is [HUD].

For C: due to perfectly elastic supply, C neither gains nor loses from trade before or after A+C FTA.

⇒ *Therefore, when A+C FTA is established, the world as a whole net benefit is by [SRN].* [b]

From [a] and [b], we can conclude that FTAs generate redistributive effects between countries. The world net welfare depends on comparing two areas of triangle FLU and triangle SNR:

- If triangle SNR is larger: FTA increases social welfare.
- If triangle FLU is larger: FTA decreases social welfare.

Shifts in new equilibrium point:

- 1) A+B FTA: U shifted to W.
- 2) A+C FTA: S shifted to R.

Therefore, we just have to compare the length of RN vs. UL or comparing [Q4-Q3] and [Q2-Q1]

The FTA could make member countries worst off if the FTA diverts more trade than creates, and vice versa. When forming an FTA, we must consider which FTA is good for the country as a whole (net welfare gain) by looking at the whole impacts or entire economy and figure out what kinds of industrial restructuring would occur. In most cases, the structure of the FTA will determines the net welfare effects of such FTA.

II. NEW REGIONALISM AND EMERGING FTA APPROACH IN EAST ASIA:

II.1. NEW REGIONALISM AND EAST ASIAN ECONOMIC INTEGRATION:

II.1.1. New Regionalism And East Asia:

Regional economic integration has become a world-wide phenomenon. In the wake of uncertainty about the outcome of multilateral negotiations on trade liberalization, particularly the Uruguay Round, and policy shift towards regionalism in the U.S, the number of regional trade agreements (RTAs) have rapidly increased since early 1990s and reached 250, reported to the WTO as of March 2002. New studies reveal that by the end of 2005, the number of RTAs could approach 300¹². The spread of this economic regionalism varies by region (table II.1), with over 51% located in Western Europe and the Mediterranean. While the EU is particularly active in regionalism, East Asia is the least developed region in terms of regionalism (Cheong, 2002). The sole exception of regional trade agreement in East Asia is the ASEAN/AFTA, and until recently (2001), the Northeast Asian countries - China, Japan and Korea - have not participated in any regional trade agreements.

Table II.1: Important Regional Trade Agreements in 1990s

Region	Name	Acronym
Europe	European Union	EU
	European Free Trade Association	EFTA
North America	North American Free Trade Area Agreement	NAFTA
Latin America & the Caribbean	Latin American Integration Association	LAIA
	Andean Community	ANCOM
	Central American Common Market	CACM
	Southern Cone Common Market	Mercosur
	Caribbean Community	CARICOM
Africa	Arab Maghreb Union	UMA
	Economic Community of Central African	ECCAS

¹² www.wto.org and Majluf, Luis Abugattas (2004): "Swimming in the Spaghetti Bowl: Challenges for Developing Countries under the New Regionalism", UNCTAD.

	States	
	Central African Customs and Economic Union	CACEU
	Economic Community of West African States	ECOWAS
	West African Economic Community	CEAO
	Southern African Development Community	SADC
Asia	ASEAN Free Trade Area Agreement	AFTA
	Asia Pacific Economic Cooperation	APEC
	Bangkok Agreement	-
	Economic Cooperation Organization	ECO
	South Asian Association for Regional Cooperation	SAARC
Middle East	Gulf Cooperation Council	GCC

Source: Spero & Hart (2003), pg. 256.

Box II.1: Summary of Trends of RTAs

- The number of RTAs is growing fast. By the end of September 2001, 239 RTAs had been notified to GATT/WTO, of those 100 RTAs have been notified since the creation of the WTO in 1995. As of 31 January 2002, 162 agreements remained in force.
- ***Most of the RTAs (90%) are free trade areas (FTAs).***
- RTAs comprising of two parties account for around 60% of the RTAs in force and half of those under negotiations.
- Around 30% of RTAs in force or under negotiations (regional and cross regional) involve at least one party being an RTA itself reflecting a growing consolidation of established RTAs.
- 220 regional trading arrangements (RTAs) have been notified to the WTO, with 38 being notified in the 1990-94 period and 80 since the creation of the WTO in 1995.
- The number of notified RTAs in force comes to 119 and was fewer than the total number notified, but is more than double the number in force in 1991.

Source: www.wto.org

While the process of dramatically increasing of RTAs, on the one hand, is deepening integration at the bilateral, sub-regional and regional level is actually facilitated by developments at the Multilateral Trading System (MTS), which set common trade and regulatory disciplines, then easily adapted to the regional processes. Many in this new wave of RTAs also extend beyond tariff liberalization to include

more intrusive obligations, especially on intellectual property rights, services, investment, etc. The process is further complicated by the fact that traditionally RTAs were concluded among bordering countries with comparable levels of development, while the new wave of regionalism involves diverse countries located in different time zones.¹³

In East Asia, since the mid 1990s there has been such a rapid acceleration of regional linkages as to constitute a new phase in regional development (Nick Thomas, 2001). Particularly, since the 1997 Asian financial crisis, a new regionalism has emerged in East Asia. A number of bilateral agreements have been concluded and are being negotiated or studied (Charles Harvie & Hyun Hon Lee, 2002). A key feature of this new phase is that the new regionalism in East Asia has been proceeding more rapidly on financial issues than on trade.

In what ways is the new regionalism in East Asia different from the old phase? Bjorn Hettne (1999) points out that the old regionalism was the product of a bipolar cold war era, whereas the new regionalism emerged from the multi-polar world. As far as economic integration is concerned, old regionalism was inward-oriented, protectionist, the new is described as “open” and thus compatible with an interdependent world economy. Furthermore, new regionalism is more comprehensive and multidimensional oriented, which includes trade, capital and service, but also environment, social policy, security and democracy.

According to Hettne, the “old regionalism only concerned relations between formally sovereign states, the new forms part of a global structural transformation in which non-state actors are active and manifest themselves at several levels of the global system.” In this sense, East Asian new regionalism is part of the overall

¹³ Luis Abugattas Majluf (2004): *Swimming in the Spaghetti Bowl: Challenges for Developing*

process of regionalization and globalization. The old regionalism aims to prevent the occurrence of another war in Europe, motivated by feelings of insecurity, whereas new regionalism in East Asia aims to pull their economic resources together to overcome their economic weaknesses in response to the extra-regional challenges.

According to Lloyd (2001), the emerging regional integration in East Asia has the following key features:

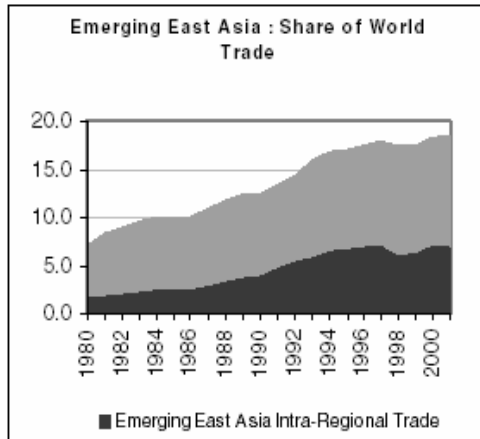
- They include a number of countries that were not previously members of any free trade area or customs union (Japan, Korea and China).
- Several countries are now members of more than one RTA.
- Several of the new agreements are “*cross-regionals*”.
- Many of the new agreements are *bilaterals*.

East Asia has achieved a high degree of market-driven regional integration, but regionalism—more formal economic cooperation and economic integration arrangements and agreements between countries—has traditionally been quite limited. The major exceptions have been the ASEAN Free Trade Area (AFTA), established in 1993, and dialogue under Asia-Pacific Economic Cooperation (APEC). According to Yeats & Nguyen (2003), recent trends in the magnitude and composition of intra-East Asian trade bode well for further integration. Comparisons show that conditions within East Asia are now very similar to those in countries that were previously able to implement such successful regional arrangements as the European Union and NAFTA.

Countries under the New Regionalism", UNCTAD, 2004.

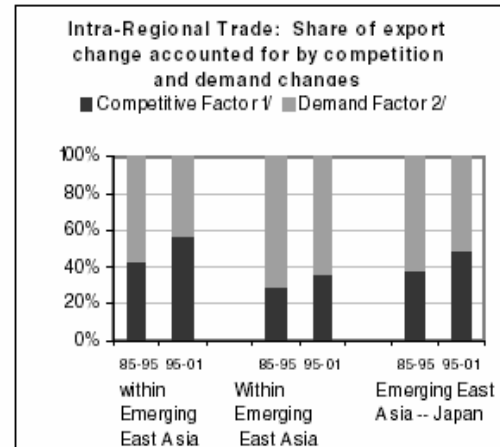
Figure II.1: Recent Trend in East Asian Economic Integration

Emerging East Asia economies' share of world exports grew . . . and trade among these economies grew even faster



Note: Emerging East Asia is ASEAN plus other newly industrializing economies plus China plus Mongolia.
Source: IMF, Direction of Trade; data reported from exporter country accounts; annual data for 1980, 1985, 1990, 1995, 2000, and 2001, Table 1.1 and Website; data reported from importers country accounts.

Regional integration driven increasingly by competitiveness and growing market share



Notes: Diversification, or change in exports due to new products, accounts for a small share.
 1/ Competitive factor = change in market share.
 2/ Demand factor = change in market size.
Source: Ng and Yeats (2003), Table 8.1 and Website.

Source: WB (2004), pg.4

II.1.2. Recent Developments In East Asian Regionalism:

Lacking of regional cooperation institutions, ASEAN is considered as an important foundation for further regional integration in East Asia. Within the context of the Cold War, the East Asian economic integration process in general and that of ASEAN in particular were slow mainly due to political factors (Yip, 2001). The ASEAN preferential trading arrangements in 1977 was the first-ever regional trade agreement concluded in East Asia. Until 1992, the ASEAN/AFTA, became the first free trade agreement (FTA) signed in East Asia. During the 1990s, with the end of the Cold War and the accelerated wave of economic globalization, the regional economic integration process in East Asia gathered pace. The ASEAN-6 has become ASEAN-10 and since 1997 the ASEAN Summit has accompanied by the ASEAN+3

framework, with the participation of leaders from ASEAN-10 and China, Japan and Korea. The ASEAN+3 is evolving into East Asian Summit, advocated at the 4th ASEAN+3 Summit in Singapore in 2000.

The 1997 Asian financial crisis has damaged the ASEAN image, but it is also an important factor that led the East Asian countries to realize the need to strengthen economic cooperation. *The ASEAN+3 framework* was established in 1997 when the Malaysia's Prime Minister Mahathir unofficially invited the leaders of China, Japan and Korea to ASEAN 30th anniversary. Since then, the evolution of ASEAN+3 framework has become a vivid evidence of the identifiable trend towards an East Asian economic community¹⁴.

Since China's proposal to promote an FTA with ASEAN during the Singapore ASEAN+3 summit in November 2000, regional trade integration has achieved remarkable developments. At bilateral level, as the AFTA became a reality on January 1st 2002, significant developments recently include the China-ASEAN agreement in November 2001 to create an FTA (ACFTA) within 10 years and the conclusion of Japan-Singapore FTA (JSEPA) in January 2002. These additional economic and trade agreements help catalyze broader integration efforts by creating bilateral building blocs within a multilateral environment. Such blocs can be implemented in a shorter time period than region-wide agreements (Nick Thomas, 2002).

On the financial side, the *Chiang Mai Initiative* launched in May 2000 has become the cornerstone for enhancing regional financial integration by increasing regional liquidity capacity through expanding the existing ASEAN swap arrangement

¹⁴ The 2nd ASEAN+3 Summit (1998) in Hanoi marked the ASEAN Vision 2020 and the establishment of the East Asian Vision Group (EAVG) to help chart the future of East Asian economic integration. At the 4th ASEAN+3 Summit (2000) in Singapore, the inter-governmental East Asian Study Group (EASG) formalized the EAVG and idea about annual East Asia Summit was discussed. The 6th ASEAN+3 Summit recently held in Phnom Penh in November 2002 is considered a significant step

network to include all ASEAN members and bilateral swap arrangements among ASEAN countries, China, Korea and Japan. In addition, a regional surveillance mechanism has been established since 1999, which was envisaged to examine the regulatory and supervisory functions in the financial sector, corporate governance and external indebtedness issues in order to prevent the recurrence of a crisis. Observing recent regional economic cooperation, it is clearly indicated that East Asia is more active in financial cooperation than in trade cooperation.

II.1.3. Determinants And Impediments To East Asian Regional Integration:

From global perspectives, such trends as technology revolutions (transportation, information and communication) and economic globalization with growing interdependence are irrevocably shaping the world economy, posing new challenges as well as opportunities for East Asian economic integration. Within such context, East Asian is in urgent needs of institutional frameworks for regional wider cooperation and deeper integration. The ASEAN leaders have recognized institutional capacity shortfall of the organization while their counterparts in China, Korea and Japan have experienced such failure of the multilateral fora, more importantly, the competitive pressure from the increasingly economic integration in Europe and North America.

According to Fred Bergsten (2000), four basic reasons for deeper integration in East Asian region are: The East Asian financial crisis, the most significant catalyst for new wave of East Asian regional integration; The failure of the WTO and of APEC to make headway on trade liberalization, a growing number of Asian countries turns to sub-regional trade arrangements for liberalization; The positive inspiration provided

to realize the East Asian Vision as the ASEAN + 3 process has matured and expanded to include regional political and security issues.

by European integration experience; and a broad disquiet with the behavior of both the United States and the European Union. Lloyd (2001), Yip (2002) and Young (2003) shares those points and explain further the new surge of bilateral FTAs by mentioning the domino effect of proliferation elsewhere, associated with fear of the loss of export markets and foreign investment, accentuated by the 1997-98 economic crisis and the desire to gain international political influence.

With East Asian nations, this is also a visionary response to the challenges of globalization of international free-market forces. The idea of moving towards closer East Asian economic integration can be interpreted partly as a response to the evolving global trading system towards three major regions, namely NAFTA, EU and East Asia. An East Asian economic community will place East Asian countries in a better position to compete more efficiently in the international markets. This motivation is quite relevant with the new regionalism rationales.

Beyond economic sense, new efforts for deeper East Asian economic integration is necessary for the region to deal with common regional problems, which are beyond the control of individual states such as regional drug trafficking, environmental pollution, illegal human migration and nuclear proliferation.

However, there is a big gap between vision and reality. The above-mentioned developments are encouraging but the East Asian economic integration is only the beginning of a long march. According to Lee (2001), building a “*politically sustainable*” East Asian community is of great significance, as quite a few obvious obstacles need to be handled. The *structural obstacles* involve political, economic and cultural heterogeneities among East Asian countries such as (1) Political and economic rivalry between Japan and China or among NIEs; (2) The dependence of regional nations on United States in terms of market, investment and security

protection; (3) The differences in economic and political systems regarding democracy vs. authoritarianism and North-South relations within East Asian region; and (4) Cultural and social heterogeneity in consumer behavior, business practices and management methods.

The institutional obstacles are (1) Effectiveness and legalization of regional institutions, (2) Redefining traditional concepts of state in the new context and (3) Institutionalization of regional cooperation are the key components. According to Lee (2001), lacking of institutions, handicapped with no clear goals and visions and effective functioning of existing institutions are obvious institutional shortcomings. The new global and regional context requires redefinition of the traditional concept of the nation-state and reposition of its role once regional institutions become socio-political cement that mitigates self-interest and opportunism. However, the biggest challenge of East Asian economic cooperation lies in the lacking of a strong and centralized institution that possesses appropriate mandate and legal capacity (Lee, 2001). The experience of ASEAN/AFTA and APEC as regional cooperative institutions has proven the need for a supra-national authority if an East Asian economic community is to be realized.

In conclusion, wider and deeper economic integration in East Asia has become an identifiable trend. Recent developments such as the ASEAN+3 framework, the Chiang Mai Initiative, and emerging and robust bilateral FTA approach such as the Japan-Singapore FTA and the China-ASEAN FTA are concrete examples of a new wave of regionalism in East Asia. The global trends such as the technology revolution and economic globalization will accelerate regional integration in East Asia but its structural and institutional problems will hinder the process. The regional economic integration process has not only been slowed down by institutional obstacles, but also

hindered by structural obstacles involving political, economic and cultural heterogeneities among East Asian countries.

Towards this end, the East Asian leaders should start with regional trade integration. Three policy options should be considered: A *bilateral* approach which results in a web of bilateral FTAs; a *sub-regional* approach which connects a Northeast Asian FTA with the existing ASEAN/AFTA; and finally a *region-wide* approach which envisions a single East Asian FTA. Considering recent developments, driving forces and impediments, the first approach is underway and become the economically second-best policy option, making the third one a far future.

II.2. EMERGING FTA APPROACH WITHIN THE CONTEXT OF EAST ASIAN NEW REGIONALISM:

II.2.1. Recent Developments And Key Features Of FTAs In East Asia:

Since the start of 1990s, moves towards economic integration have progressed rapidly around the world, in which the form of Free Trade Agreement (FTA) has played a central role. Most of concluded or proposed PTAs are in form of FTAs, rather than custom union. In the mean time, many countries, including major trading powers, are actively negotiating free trade agreements¹⁵. The number of free trade agreements in the world surged from 26 by the end of 1989 to 143 by the end of June 2002. In East Asia, only 4 such agreements had been concluded as of December 2002 (JETRO, 2003). The ASEAN Free Trade Area (AFTA) marked the very first FTA within Asia in 1993. Until recently, Korea, Japan, China, Hong Kong, and Taiwan did not have any bilateral FTA with any economies.

¹⁵ See PECC (2002): “*RTA Developments in the Asia-Pacific Region: State of Play*”.

Since 1999, bilateral FTA initiatives are rapidly emerging and proliferated in East Asia. At the end of 1998, South Korea proposed to Japan that the two countries study the possibility of a bilateral FTA. In September 1999, Singapore agreed with New Zealand to start FTA negotiations and with a number of countries like Chile, Mexico, Korea, and Japan. It was only in 1999 and 2000 that government-level negotiations and studies began to gather momentum. The pace of FTA developments accelerated in 2002 with crucial moves by China and Japan.

For Japan: According to Urata (2003), Japan started discussing possible FTAs with several countries including Singapore, Korea, Mexico, Chile, Thailand, Malaysia and others in the late 1990s. After conducting a joint-study on possible FTA with Singapore, Japan and Singapore began negotiations in 2001. Japan entered into its first bilateral FTA, the Japan-Singapore Economic Partnership Agreement in January 2002. Recently Japan has concluded negotiations with Mexico and the two governments signed the bilateral FTA in February 2004. Japan is also conducting FTA negotiations with Korea, and plans for FTAs talks with Chile and ASEAN¹⁶ (i.e. Thailand and Malaysia) in early 2004.

For Korea: the Roh Government has proposed A FTA roadmap, accordingly FTA targeted countries are: Korea concluded FTA with Chile in 2002, which was ratified by Korean National Assembly in early 2004. Korea is under negotiations FTAs with Japan and Singapore, and actively preparing for joint studies with Mexico and Thailand. Next will be negotiations with ASEAN, Mexico and EFTA. On the other hand, when favorable conditions are set domestically and externally, FTAs with large economies such as the U.S., EU, and China, or Korea-Japan-China FTA, East

¹⁶ Notably, Japan has signed with Vietnam an Investment Agreement to secure FDI activities of Japanese companies in Vietnam since November 2003.

Asia FTA will be underway. In mid-to-long term plans, FTAs with Israel, Peru, Panama, New Zealand, Australia, Canada and India will be proposed¹⁷.

China has also suddenly shifted to regional preferentialism with China-ASEAN FTA signed in November 2002. though just a new WTO member, China has concluded FTA with Thailand and initiated FTA with ASEAN by 2010. China also spend reasonable resources for discussions and studies for a deeper and stronger economic ties with such Northeast Asians as Japan and Korea, a signal towards possible FTA(s) with those two neighbors. In global scale, China is considering a closer economic ties with EU.

In the long term, China will step-by-step establish an East Asian FTA by first formulating FTAs with Northeast Asian economies such as Hong Kong, Korea and Japan, then merging with the ASEAN-China FTA. Then, China will also engage in linking South Asian nations into the would-be East Asian FTA. Finally, China will push for an Asia-Pacific FTA.

For ASEAN, at the fifth ASEAN+3 Summit in Brunei in November 2001, leaders endorsed the EAVG Report, including the development towards an East Asian Economic Community (EAEC), among other mean through the creation of a broad East Asian Free Trade Area (EAFTA). The fifth ASEAN+3 Summit and the EAVG Report were overshadowed by China's surprising proposal for an ASEAN-China Free Trade Agreement. One year later, at the sixth ASEAN +3 Summit in Phnom Penh in November 2002, China and ASEAN signed the Framework Agreement on ASEAN-China Comprehensive Economic Cooperation, which provided the foundation for negotiating an ASEAN-China Free Trade Agreement (ACFTA). Simultaneously, the

¹⁷ See Kim Won-Ho (2003): "*Korea's Regionalist Approach: FTA & NEA Hub Policy*", KIEP, Korea.

leaders of ASEAN and Japan also introduced the Joint Declaration on the Comprehensive Economic Partnership between ASEAN and Japan.

In September 2002, a Joint Declaration on Closer Economic Partnership has been signed between ASEAN and the CER countries, Australia and New Zealand. In late October 2002, at the occasion of APEC meeting in Mexico, President Bush also proposed the “Enterprise for ASEAN Initiatives” that will provide a bilateral Trade, Investment and Facilitation Agreement (TIFA) framework for the US to negotiate both bilateral and regional FTAs with Southeast Asian countries. At the first ASEAN-India Summit in November 2002, India too has offer to start FTA talks and to have free trade agreement with ASEAN within 10 years. Australia has also offer ASEAN with a possible ASEAN-Australia Summit. ASEAN’s strategy appears to evolve itself as the “hub” of competing FTAs.

For individual ASEAN member, Singapore and Thailand are the most active FTA dealers. To take first-mover advantage, after starting FTA negotiation with New Zealand in September 1999, Singapore also proposed FTAs with Chile, Mexico and Korea. In October of the same year, Singapore proposed an agreement linking AFTA with ANZCERTA. In November, it started FTA talks with Chile, and in December it proposed an agreement with Japan. So far, Singapore has actively proposed and concluded bilateral FTAs with New Zealand, Japan, Australia, EFTA and US, and been under negotiations or studies with EFTA, Mexico, Canada, Korea, India and EU¹⁸.

¹⁸ For detailed analyses of Singapore’s concluded FTAs so far, please see Low Linda (2002): “*Singapore’s Bilateral Free Trade Agreements: Institutional and Architectural Issues*”, PECC Trade Policy Forum, Joint Meeting with PECC and Inter-American Development Bank, 23 April 2002, Washington DC.

Thailand is now conducting FTA studies and negotiations with fourteen trading partners, notably Australia, India, Korea, Japan, and the U.S. The Thai Government is deploying FTA strategy actively, taking the view that bilateral agreements can set the stage for multilateral arrangements. Malaysia is catching up with primary negotiations with Japan and the U.S. On the contrary, Indonesia has shown no moves towards bilateral FTAs, as it first has to address the task of domestic economic reform. The Philippines is interested in developing export markets by concluding FTAs with developed economies as well as participating in ACFTA, and is studying the possibility of FTAs with Japan and United States (JETRO, 2003).

A race to be hubs: As proven by hub-and spoke argument, the most beneficiaries would be the hubs in the FTA game, therefore, all FTA players try to be the hubs. Such “hub-driven strategy” is most obvious in the case of ASEAN. ASEAN is making efforts to realize AFTA schemes and becoming anchor for a region-wide East Asian FTA as well as a hub of FTAs with China, Japan, the U.S., CER (including Australia and New Zealand), India, and EU. For example, ASEAN-CER FTA, ASEAN-US FTA, ASEAN-China FTA; ASEAN-Japan FTA; ASEAN-Korea FTA; ASEAN-India FTA; and ASEAN-EU FTA, to name a few.

Regional and cross-regional membership: East Asia, comprising of South East Asia and North East Asia, though slower in embracing regionalism (Urata, 2002), has willingly and actively shifted to regional trade arrangements (see table II.2). Besides Singapore, Thailand and other ASEAN members with the 1992 AFTA, the new players in FTAs game in East Asia are Japan, South Korea, China and Taiwan.

Table II.2: Definite Proposals on FTAs in the Asia-Pacific

Proposals and signed FTAs	Proposed members
<i>Bilaterals</i>	

Japan-Korea	
Japan-Singapore EPA (Summer 2002)	
Korea-Singapore	
Australia-Thailand	
<i>Regionals</i>	
Proposals and signed FTAs	Proposed members
ASEAN-China FTA (Nov. 2001)	ASEAN-10, China
ASEAN Japan FTA	ASEAN-10, Japan
ASEAN +3 FTA	ASEAN-10, China, Japan, Korea
North East Asian FTA	China, Japan, Korea
Pacific Island Countries Trade Agreement	Papua New Guinea, Pacific Islands
P5	U.S, Australia, New Zealand, Singapore, Chile
AFTA-CER	ASEAN/AFTA-10, CER-2 (Australia and New Zealand)

East Asian countries are not only establishing FTAs among themselves but also with the rest of the world. For example, Singapore has got trade arrangements with New Zealand (Singapore-New Zealand CEP 2001), or with U.S, Canada, Japan, Mexico and Australia. Japan, after its very first arrangement with Singapore (2002), has recently signed FTA with Mexico in March 10th 2004, or Korea has got her National Assembly's approval for Korea-Chile FTA in February 2004. Currently, ASEAN as a whole, Thailand and Korea are actively negotiating FTAs with the United States.

Free trade agreements are not just FTAs: The scope and coverage are much more comprehensive than the orthodox concept of free trade agreement: The current wave of FTAs is not just trade in goods, those agreements also lower barriers to services trade and investment flows, intrusive obligations for intellectual property rights etc. According to Urata (2002), FTAs include new players, FTAs are getting

larger and deeper, and FTAs are reaching farther, not necessarily in close geographical proximity.

II.2.2. Key Determinants For Policy Shifts Towards FTA Approach:

In East Asia, determinants on policy shift towards bilateralism and regionalism vary from country to country. The following part is a review of why major countries and economies in East Asia such as Japan, Republic of Korea, China, ASEAN and Singapore have actively shifted bilateral and regional FTA approach.

In Japan, the WTO system is not enough to guarantee national interests: Traditionally, Japan has assigned the highest priority in its trade policy to multilateral cooperation through the GATT and WTO frameworks, in order to reduce tariffs and other trade barriers. However, the tide of regional economic integration, including various free trade agreements (FTA) throughout the world, was stronger in the 1990s. It has become more difficult for Japan to protect its interests in the field of international trade by means of the WTO system alone.

Becoming APEC member in early 1990s, Japan had shifted from the one-track approach based on the GATT/WTO multilateral trading framework to two-track approach, comprising of global and regional approaches. The late 1990s saw a major shift in Japan trade policy from two-track approach to multi-track one, as it began to take FTAs formally and seriously. Motivations for policy shift include (1) the importance of trade liberalization to revitalize the Japanese economy; (2) FTAs provide firms with business opportunities in member countries, as FTAs remove trade barriers in their markets; (3) FTAs with East Asian countries promote economic growth and political stability in the region; and (4) Japan considers FTAs as good

precedents for rule making process within the GATT/WTO framework, particularly in the negotiations of “trade and” issues.

According to Urata (2003), three key factors that make Japan actively shift to regionalism are (1) increasing importance of intra-regional trade in East Asia; (2) Increasing importance of East Asian trading partner for Japan; and (3) rapid expansion of regional trade agreements in recent years.

For Republic of Korea, just like other North East Asian countries¹⁹, Korea is a late comer in the game of regionalism and bilateralism. Korea’s trade policy had shifted from Mercantilist expansion of trade in 1960-1970s to market opening and liberalization based on multilateral framework in the 1980s. In the context of globalization in 1990s, Korea has adopted a parallel approach of multilateralism and regionalism with the former as dominant trend. In the late 1990s, particularly after the 1997 economic crisis, Korea has actively shifted to strengthening regional and bilateral economic cooperation by introducing FTA policy.

Korea reconsiders multilateral approach to trade policy and shift to the adoption of FTA policy due to *Changing perception on regionalism*: The increasing importance of RTAs in the world trade; the recent proliferation of regional and bilateral trade arrangements and their successful performance has made Korea believe that RTAs could be a complementary force to multilateral trading approach in achieving world free trade system (Sohn, 2001).

Cheong (2001) and (2003) and Sohn (2001) explained key driving forces for Korea’s policy shift to FTA bilateral and regional approach: First, Korea is under increasing pressure from the changing international economic environment and FTAs are to diversify trade and investment relationships to adapt to emerging threat of new

¹⁹ Until recently, North East Asia was the only region of the world that had no RTAs.

protectionism in the multilateral trading system. Korea's dependence on foreign trade require securing export markets; Second, the trend of regionalism is now dominant in world trading system, Korea's trade policy must change to avoid To avoid isolation and exclusion from such RTAs; Third, FTAs would create lock-in effects to ensure continuity of domestic reforms. The 1997 financial crisis provides the lessons of maintaining economic reform and open policy to upgrade the national economic system to meet international standards and strengthen competitive edges; and finally, forming appropriate FTAs will enable Korea to create political allies, attract foreign capital, establish overseas footholds to secure stable foreign export market for Korean companies, overcome discriminatory practices under other FTAs, and increase consumer welfare.

Increasing economic interdependence requires new means for protect and maximize national interest, FTA approach helps strengthening politico-economic ties. Joining or creating regional and sub-regional trading blocs is prevailing approach to accomplish such requirement, as economic cooperation is expected to spill over to political and diplomatic cooperation, covering a wide range of issues such as security, environment, labor and cultural exchanges. By forming FTA with major trading partners, Korea will strengthen its bargaining position and enhance its political influence and diplomatic weight in multilateral fora such as WTO, OECD, and IMF.

For China, it has worked hard, domestically and internationally, for WTO accession process, which end in December 2001 with its official gaining WTO member status, then lagging behind in bilateral regional integration. The FTA approach by China is a strategic geo-economic move to response to US's containment of a rising China; to counter-balance the Korea-Japan closer economic partnership; and to allay ASEAN's fears of a China "threat".

China's strategic benefits are: The PRC would like to seize the opportunity to replace Japan as the primary driving force for economic growth and integration when Japan has been in economic recession for about a decade. Through the establishment of a China-ASEAN free trade area, the PRC will be able to weaken the US influence and have greater voice in regional matters. The PRC's another political and strategic interest resulting from the creation of a China-ASEAN free trade zone is a marginalized role in regional economy the ROC will be compelled to assume.

Angang Hu (2002) argued that the RTA has become one of the main features of economic globalization, China could not stand out of the trend. To set up FTA between North East Asian countries and ASEAN is a big step of the open strategy for China economic development. Why China focuses on establish regional FTA with NEA and SEA countries: First, the real degree of China's economic opening is relative low (9.5% of GDP in 2000) and China's long run goal of economic development is to set up an open economy. Furthermore, after joining WTO, China as well as other developing countries seeks economic growth with new system arrangements, FTA helps accelerate regional economic integration, participating in both international and regional markets. Finally, establishing FTA-based trading ties with NEA and SEA countries would help realizing the new domestic strategy of "going to the West".

For ASEAN as a group, besides political and security motivation which helps building a sense of community among neighbors, collective bargaining power with a common voice is the key determinant. The 1997 economic crisis and losing competitiveness vis-a-vis China require ASEAN's efforts to deepen intra-ASEAN integration and expanding extra-ASEAN linkage. According to Kim (2002), ASEAN members want to overcome the economic weaknesses by linking up with the larger and more powerful economies and becoming the so-called "hub" in the FTA game.

For Singapore, as a highly trade-dependent economy, it cannot stand still for the painful Asian crisis, the slow ASEAN integration and stalled multilateral trading liberalization. Domestically, for maintaining international competitiveness, Singapore is trying to transform itself towards more private sector-led economy (Low, 2002). As a believer on multilateralism, Singapore used to put highest priority to the GATT/WTO multilateral trading framework, but the changing external as well as internal environment has made Singapore reconsidered its multilateral approach towards regional and bilateral approaches. *RTAs are now complementary and supplementary to the multilateral process.* FTAs are considered as an instrument to accelerate trade liberalization and strengthen the multilateral system. They provide better business environment with lower transaction cost due to lower tariffs for exports of goods, harmonized custom procedures, improved market access for various commercial and professional services, easier entry for businessmen into other countries, better terms for investment in foreign countries. Bilateral FTAs also lock in domestic reforms and import best policy practices from advanced economies. They set a framework for Singaporean small and medium businesses to grow and expand regionally and globally, which in turn will generate more employment and revenue.

As summing up by Lloyd (2001), key determinants for East Asia's emerging FTA approach include:

- Gains from trade and factor flows and greater competition in markets²⁰,

²⁰ Some empirical calculations on economic effects of recent FTAs in East Asia have provide interesting findings: First, for Japan-ASEAN Closer Economic Partnership (JACEP), between base year of 1997 and 2020, the realization of the JACEP would augment exports by 27.5% in Japan to ASEAN and 44.2% in ASEAN to Japan, while it would boost gross domestic product by 1.99% in ASEAN and 0.07% in Japan. Second, for ASEAN-China Free Trade Area (ACFTA), if tariffs are reduced to zero by both sides, ACFTA would expand exports by USD13 bil. per year (48%) from ASEAN-6 to China and USD 10.6 bil. (55.1%) from China to ASEAN-6, while GDP would grow by 0.86% in the ASEAN-6 and 0.27% in China.

- Binding of market access for goods and prevention of contingent protection actions by fellow members (anti-dumping, countervailing or safeguard actions),
- Ease of negotiations with fewer parties,
- Benefits of deep integration resulting from the cross-border harmonization of national economic policies and regulations,
- Regional security, and
- Fear of exclusion from major markets.

II.3. PRELIMINARY ASSESSMENTS:

Besides non-economic motivations, key supporting arguments for FTA policy shift vs. WTO's multilateral approach are: First, FTA is faster among smaller and like-minded group of countries; Second, possible FTAs face less anti-globalization pressure; Third, fewer members leads to easier rule making²¹; and fourth, to strengthen political and economic influence and bargaining power in international arena, most important for small countries.

There is a race to be the FTA hubs and develop as many spokes as possible among East Asian countries. As far as the trade policy is concerned, the true nature of regionalism in East Asia is bilateralism, specifically, a "competitive hub-&-spoke bilateralism" (Young, 2003). Korea, Japan, ASEAN, Singapore and China each want to become a major hub in the network of bilateral FTAs in East Asia.

Such bilateralism in FTA approach would result in a serious "spaghetti bowl" effect, accompanied by significant distortions in trade, investment, and production in the region. Each East Asian economy has many politically "sensitive" sectors, and each FTA has been and will be designed to protect these sectors with many exclusions (box II.2) and its own complex rules of origin.

Box II.2: How bilateral FTAs in East Asia to deal with sensitive sectors

Korea-Chile FTA:

- The refrigerator and the washing machine are excluded.
- Apple, pear and rice are excluded while grape is subject to seasonal tariffs.
- Concession on more than 370 agricultural products have been withheld and will be discussed after the conclusion of the DDA round.

Japan-Singapore FTA:

- All agricultural products are excluded as a matter of principle.

ASEAN FTA (AFTA):

- The ASEAN-6 countries refuse to lower tariffs on their “sensitive” products (e.g., Indonesia’s textile and petrochemical, Philippines’ cement, and Malaysia’s automobile) to below 5%.
- Non-tariff barriers remain numerous and serious.

ASEAN-China FTA:

- China will exclude rice and palm oil.
- ASEAN countries each will request exclusion of many manufactured products.

Source: Young (2003)

It is also likely to serve more as a stumbling block than as a building block for the multilateral trading system. It will also be detrimental to the economic dynamism of East Asian region, as the spaghetti bowl effect will undermine the efficacy of such intra-regional interdependence ²².

East Asia now accepts that bilateral and regional approaches to trade liberalization and economic integration are complementary and supplementary to the stalled multilateral one. The FTA approach will not only boost domestic reforms but also secure external markets and escape from isolation and exclusion by competing FTA game in other regions. However, current FTA evolution in East Asia foretells a race to be the hubs with serious “spaghetti bowl” effect will serve as a stumbling block against the multilateral as well as the East Asian region-wide trading systems.

²¹ In game theory, the larger number of players, the harder for decision-making.

²² Young Soogil (2003): “*Strategy for Coping with a Proliferation of RTAs and Encouraging Convergence toward Regional and Global Liberalization and Integration Objectives: an East Asian Perspective*”, PECC Trade Forum Seminar, Washington, D .C., on April 22, 2003

III. THE FTA APPROACH WITHIN THE CONTEXT OF VIETNAM'S INTERNATIONAL ECONOMIC INTEGRATION:

Background:

Vietnam officially launched its comprehensive economic reform program (known as Doi Moi or Renovation) in 1986. The overall mission is to transform Vietnam from a centrally planned economy into a socialist-oriented market economy. The two pillars are domestic reforms and international integration. For the first pillar of domestic reforms, Vietnam aims at (1) Introducing market mechanism into the agricultural sector and to the price, wage, and monetary systems; (2) Undertaking domestic trade liberalization by eliminate monopoly of State-owned enterprises (SOEs) in distributing goods and services, and expand trading rights to non-state economic sectors; (3) Reforming the SOE sector and diversification of ownership types in such transitional economy as Vietnam by developing multi-sectoral economy, resulting in a boom of the private sector and entrepreneurship; and (4) Reforming banking and financial system by restructuring the state-owned banking system into a two-tier system, developing new banking and financial institutions, and revamping the public finance system ..etc.

For the second pillar of international integration, Vietnam started “open-door” policy in late 1980s within the context of American embargo by multilateralization and diversification of external relations and active integration into the world economy. Since late 1980s, Vietnam has been shifting towards an open market economy and integrating into the regional and international economies. Vietnam is now ready to become friends and partners to any country in the world.

III.1. INTERNATIONAL ECONOMIC INTEGRATION OF VIETNAM:

As a crucial pillar in comprehensive renovation of Vietnam, Vietnam has consistently conducted the policy of open-door and making friends and partnership with nations and economies in the globe. Regional and international economic integration is of highly importance, as it has brought Vietnam out of isolation during the post-Cold War period. Generally, the international economic integration process of Vietnam since Doi Moi is two-fold:

The *1986-1995 period* of unilateral integration and normalization of external economic relations, In this period, Vietnam had normalized relation with China in 1991, with the international donors via Paris Club in 1992, with the United States in 1994, and Vietnam strategically joined the ASEAN in 1995.

The so called *1995-2005 period* of active regional and multilateral economic integration and development of new bilateral economic ties. During the second half of 1990s, Vietnam has made important binding and non-binding commitments in key regional fora such as becoming member of the ASEAN Free Trade Area (AFTA) in 1996, joining Asia-Pacific Economic Cooperation forum (APEC) in 1998. Vietnam has undertaken a crucial step by signing economic and trade cooperation framework with EU in 1995 and the Bilateral Trade Agreement (VN-US BTA) with the United States in 2000, and is now actively conducting a series of working group meetings and bilateral negotiations for the target of WTO accession by 2005.

According to a rough review by Vietnam Ministry of Trade, Vietnam has concluded 86 bilateral economic and trade cooperation agreements/frameworks and signed almost 40 bilateral investment treaties with various partners so far, The following parts will introduce binding commitments by Vietnam in its key bilateral, regional and multilateral trading arrangements such as the ASEAN/AFTA and the

ASEAN-China FTA, the Vietnam-United States BTA, and tentative commitments for the WTO accession.

III.2 THE CASES OF ASEAN FREE TRADE AREA (AFTA) AND ASEAN-CHINA FREE TRADE AREA (ACFTA):

a) The Case Of ASEAN FTA:

The 4th ASEAN Summit in Singapore in 1992 agreed to establish a free trade area and signed the Framework Agreement on Enhancing ASEAN Economic Cooperation. ASEAN Economic Ministers (AEM) signed the Agreement on Common Effective Preferential Tariff (CEPT) for the ASEAN Free Trade Area (AFTA). The objectives of AFTA are to increase ASEAN competitive edge as a production base for global market. AFTA also helps enlarging the ASEAN market and provide the platform for technological transfer and development of new industries.

The key commitments under CEPT/AFTA are eliminating tariffs on all products by 2010 for ASEAN-6 original members and by 2015 for ASEAN-4 new members. Accordingly, 60 per cent of all products would be at 0% tariff rates by 2003²³. The CEPT/AFTA has also committed to eliminated all quantitative restrictions and other non-trade barriers (NTBs).

By 2003, the implementation of CEPT/AFTA has made impressive progresses. For ASEAN-6 original members, 98.8% of products are in Inclusion List (IL) of SEP T scheme, 99.6% of products are at 0% to 5% tariff rates. CEPT scheme has covered a ll products except those under General Exclusive List (GEL). With ASEAN-4 new me

²³ The CEPT scheme covers all manufactured products, processed and unprocessed agricultural products. Criteria for enjoying CEPT concession include (a) products wholly obtained or produced within ASEAN; (b) comply with the 40% local or ASEAN cumulative content rule; and (c) granted on the basis of reciprocity. The tariff cut schedule is categorized into four lists (Inclusion List (IL), Temporary Exclusion List (TEL), Sensitive List, and General Exclusion List).

members, 72.2% of products have been in IL of CEPT scheme. 55.7% of products are at 0% to 5% tariff rates.

Table III.1: Status of Products at 0-5% Tariff for ASEAN Members in 2003.

Country	Products at 0-5% Import Duty (%)
Brunei	99.18
Indonesia	100.00
Malaysia	99.26
Philippines	98.81
Singapore	100.00
Thailand	99.92
Cambodia	7.64
Laos	53.57
Myanmar	78.00
Vietnam	65.44

Source: Compiled from ASEAN Secretariat.

For Vietnam, the implementation of AFTA has significantly helped trade liberalization. As part of the broader strategy of international economic integration, Vietnam committed to implement a full package of goods for tariff cut under CEPT/AFTA upon entering ASEAN in 1995 (see box III.1). The tariff cut schedule is categorized into four lists on which Vietnam plans to lower its all tariffs in IL and TEL to a range of 0% to 5% by 2006.

Box III.1: Commitments under ASEAN Free Trade Area

Tariffs on the vast majority of tariff lines (estimated 95 percent) on ASEAN imports will be reduced to at most 20 percent by the start of 2003, and to 0-5 percent by the beginning of 2006.

Average tariffs on manufactures from ASEAN countries will be cut by 50 percent by early 2004.

Average tariffs on ASEAN imports of textiles, leather, wood products, non-metallic mineral products (e.g. glass and ceramic products) and food products will fall by more than 60 percent by early 2004.

3. Vietnam must implement the reduction of CEPT tariff rates to 0% by 2006.

Many economic sectors, particularly the SOEs, will be affected by the committed tariff reduction scheme. The unweighted average CEPT rate applicable to imports from ASEAN region is expected to decline from 10.7 percent in 2002 to 3

percent by 2006. In addition, the sensitive list is expected to be phased out by 2010. Commitments under AFTA also imply that quantitative restrictions have to be abolished. Reduced protection will put pressure on the Government of Vietnam to increase fiscal transfer and credit to SOEs and prioritized programs, which would negatively effect other sectors in the economy.

The significance of AFTA for Vietnam is that AFTA is the very first strategic commitment to economic reform and regional integration since the end of the Cold War. AFTA acts as a facilitator for export-oriented industrialization and modernization process, a momentum for improvement of efficiency of domestic production (economies of scale, management, technology, regional production linkage through FDI by TNCs), a move to gain MFN status from ASEAN countries, which promises a huge “trade creation” effect.

b) The Case Of ASEAN-China FTA:

Premier Zhu Rongji surprisingly proposed a free trade area (FTA) with the ASEAN nations when he attended an ASEAN Plus Three meeting in Singapore in November 2000. Barely a year later, the 10-nation grouping at the ASEAN summit in Brunei accepted China's proposal to create the world's largest FTA within 10 years: a market of 1.7 billion consumers and a GDP of \$2 trillion with trade worth \$1.23 trillion.

The ASEAN-China FTA (ACFTA) will be created within ten year, or by 2010. As a sweetener, Beijing offered to *unilaterally* open its own market to the ASEAN countries five years before these economies were ready to reciprocate by the “Early Harvest Scheme”, which is further discussed below. Beginning on January 1, 2002, six old ASEAN member countries (Brunei, Indonesia, Malaysia, the Philippines,

Singapore and Thailand) brought tariff rates of many Southeast Asian products down to 0-5%. The other four members (Cambodia, Laos, Myanmar and Vietnam) will begin to do so in 2006. Then, the old ASEAN member states will eliminate all tariffs and remove quantitative restrictions and non-tariff barriers in 2010. The rest of ASEAN member states will achieve these goals in 2015. In fact, the ACFTA is the extension of ASEAN member states' common effective preferential tariff (CEPT) Scheme to the PRC while the latter carries out tariff reduction programs and provides similar product lists consistent with the CEPT Scheme.

Regarding trade in goods, the key component of the ASEAN-China Framework Agreement is the *Early Harvest Program* (EHP). This program allows the reduction of tariffs on certain products before the onset of the FTA. The program would reduce tariffs on these products over 3 years: to 10% by 2004, to 5% by 2005 and zero tariffs on these products by 2006. Most of the products from Chapters 1-8 of the HS code (Harmonized System) were covered under the EHP²⁴. The EHP is scheduled to start on 1st Jan 2004 and be fully implemented by January 2006. The goods negotiations are set for conclusion on 30th June 2004 and implementation of the tariff reductions for the non-EH goods are set to commence on 1st January 2005.

Vietnam, as a new ASEAN member will have to fully implement ACFTA by 2015. However, the most obvious economic benefits out of the ACFTA include increased bilateral trade, expanded GDP²⁵, greater economic efficiency, lower costs, and increased investment, which may lead to the better research and development and

²⁴ Furthermore, China agreed to extend concessions on 130 specific manufactured goods (Annex 2, FA) to countries that felt they had not benefited as much from the EHP. Singapore and Brunei were allowed to enjoy these concessions not only from China but from Malaysia, Thailand and Indonesia as well.

²⁵ A group of specialists have conducted empirical calculations on economic effects of ASEAN-China Free Trade Area (ACFTA), if tariffs are reduced to zero by both sides, ACFTA would expand exports by USD13 bil. per year (48%) from ASEAN-6 to China and USD 10.6 bil. (55.1%) from China to ASEAN-6, while GDP would grow by 0.86% in the ASEAN-6 and 0.27% in China.

then technological innovation. The most salient economic challenges out of the ACFTA are: intensified competition in domestic markets, possible trade diversion due to a shift from lower-cost non-member states to higher-cost member states, possible loss of tariff revenues, and temporary or short-run unemployment problems.

III.3 THE CASE OF VIETNAM-UNITED STATES BTA:

Following the victory of communist North Vietnam over U.S.-backed South Vietnam in 1975, the United States ended virtually all economic interchange with unified Vietnam. Washington and Hanoi gradually began to normalize relations in the early 1990s²⁶. On July 13, 2000, after nearly five years of negotiation, Vietnam and the U.S. announced the signature of the bilateral trade agreement. Following affirmative votes in the Vietnamese National Assembly and the U.S. Congress, the VN-US BTA entered into force on December 10, 2001, when the two countries formally exchanged letters implementing the agreement.

The BTA is a major step toward fully normalizing VN-US economic relations, as it restores reciprocal most-favored-nation (replaced as normal trade relations [NTR] since 1998) treatment between the two countries, and commits Vietnam to undertake a wide range of market-oriented economic reforms. For both Vietnam and the United States, the BTA is the most comprehensive bilateral trade agreement ever negotiated by the two. In fact, the BTA is a modern “trade and” agreement, which includes not only extensive obligations related not just to import tariffs and quota, but also to transparency, dispute settlement, investment, intellectual property right protection, market access for services, and business facilitation (Box III.2).

²⁶ In 1994, President Clinton ordered the lifting of the trade embargo against Vietnam. The following year, the two countries established ambassadorial-level diplomatic relations. In 1998, President Clinton granted Vietnam its first waiver from the requirements of the so-called Jackson-Vanik amendment contained in the Trade Act of 1974, Title IV, section 402.

Box III.2: Five major area of the VN-US BTA commitments

(1) *Market Access for Industrial and Agricultural Goods.* Vietnam agrees to allow all Vietnamese firms, and over time U.S. persons and firms, the right to import and export freely from within its borders for the first time. It has agreed to sharply lower tariffs on the full range of U.S. industrial and agricultural exports, phase out all non-tariff measures, and to adhere to the WTO standards in applying customs, import licensing, state trading, technical standards and sanitary and phytosanitary measures.

(2) *Intellectual Property Rights:* Vietnam has pledged to phase in the World Trade Organization Agreement on Trade-Related Intellectual Property Rights (TRIPs) over 18 months. The bilateral TRIPs agreement goes above and beyond the WTO's TRIPs agreement by including Vietnamese commitments to protect satellite signals within 30 months.

(3) *Market Access for Services:* Vietnam has committed to uphold WTO rules such as MFN, national treatment, and disciplines on domestic regulation. Vietnam allows U.S. persons and firms to enter its services market in a wide range of service sectors, including accounting, advertising, banking, computer, distribution, education, insurance, legal and telecommunications. These commitments are phased-in over time, typically within three to five years.

(4) *Investment Provision:* the BTA includes guarantees of MFN treatment, national treatment, transparency, and protection against expropriation. Vietnam has pledged to eliminate local content and export performance requirements and phase out its investment licensing regime for many sectors. Vietnam has agreed to eliminate within five years all TRIMs that are inconsistent with the WTO, such as local content requirements.

(5) *Transparency Provisions:* Vietnam has agreed to adopt a fully transparent regime with respect to each of the four substantive areas above, by issuing draft laws, regulations and other rules for comment, ensuring that advance public notice is given for all such laws and regulations, that these documents are published and available, and by allowing U.S. citizens the right to appeal rulings made with respect to all such relevant laws and regulations.

Source: <http://vietnam.usembassy.gov>.

Under the VN-US BTA, the U.S. will extend temporary most-favored nation (MFN) status to Vietnam, a step that will significantly reduce U.S. tariffs on most imports from Vietnam, as U.S. tariff rates on Vietnamese exports will fall from their non-MFN average of 40% to less than 3%. In return, Vietnam agreed to undertake a wide range of market-liberalization measures, including extending MFN treatment to U.S. exports, reducing tariffs on goods, easing barriers to U.S. services (such as banking and telecommunications), committing to protect certain intellectual property

rights, and providing additional inducements and protections for inward foreign direct investment.

In reality, the BTA requires that Vietnam cut tariffs, typically by 25-50 percent, on only around 250 tariff lines (out of more than 6,000 total tariff lines then), mostly in agricultural products. For quantitative restriction requirements, almost all of these have been eliminated, those “bound” only for temporary duration, well ahead of BTA schedule as part of a IMF/WB agreement with the Government of Vietnam (CIEM-STAR, 2003).

The BTA after almost three years of enforcement has been a successful story, in terms of expanding trade, improving investment and business climate, and lock-in effect for domestic reforms, in Vietnam’s international economic integration²⁷. Within two years of 2001-2003, the bilateral trade value between Vietnam and the United States, with huge trade surplus for Vietnam, has reached 5.1 bil. USD, increased four times compared with just over 1.0 bil of 2001. In 2003, the United States replaced Japan, becomes the number one trading partner of Vietnam²⁸. Vietnam’s expanded exports to the U.S. are much greater than the US’s exports to Vietnam because the BTA provides a much greater reduction in trade barriers to Vietnamese products on the U.S. market than for that to U.S. ones in the Vietnamese market, though significant liberalization has been made for U.S. service providers and investors.

From sectoral perspective, manufactured goods have gained much more than primary commodities. Clothing export is the early winner of the BTA with export revenue to U.S. market increased almost 17 times in just a year, from USD 48 mil. in

²⁷ For a comprehensive assessment of economic impacts of the BTA on Vietnamese economy, please see CIEM-STAR (2003): “*An Assessment of the Economic Impacts of the US-VN Bilateral Trade Agreement- Annual Economic Report of 2002*”, National Political Publisher, Hanoi.

²⁸ CIEM (2004): “*Vietnam Economy in 2003*”, National Political Publisher, Hanoi., pg. 37.

2001 to over USD 900 mil. in 2002²⁹. In 2002 and 2003, Vietnam's exports of furniture, travel goods and footwear and other manufactured products to the U.S. have grown strongly (Table III.2).

Table III.2: Vietnam Exports to the U.S in 2002 & 2003 by Commodity Category

	2002 (USD `000)	2002 growth rate (%)	2003 (USD `000)	2003 growth rate (%)
VN's exports to US	2,394,745	128	4,554,860	90
Primary products	994,286	21	1,274,979	28
Fish & seafood	616,028	29	732,135	19
Vegetables & fruit	76,000	54	106,001	39
Coffee	53,016	-30	76,301	44
Crude rubber	11,232	300	13,282	18
Petroleum	181,125	-1	277,565	53
Other primary	56,840	92	69,695	23
Manufactures	1,400,416	502	3,290,930	135
Non-metallic mineral products	19,590	115	27,939	43
Metal manufactures	8,381	137	15,559	86
Electrical appliances	4,950	270	4,141	-16
<i>Furnitures</i>	<i>80,441</i>	<i>499</i>	<i>187,774</i>	<i>133</i>
<i>Travel goods</i>	<i>49,535</i>	<i>5,422</i>	<i>85,955</i>	<i>74</i>
<i>Clothing</i>	<i>900,473</i>	<i>1,769</i>	<i>2,380,249</i>	<i>164</i>
<i>Footwear</i>	<i>224,824</i>	<i>70</i>	<i>327,300</i>	<i>46</i>
Misc. manufactures	28,238	847	48,541	72
Other goods	84,029	297	213,472	154
Non-clothing manufactures	499,988	162	910,681	82
Non-clothing & footwear manufactures	275,164	424	583,381	112

Source: CIEM-STAR (forthcoming): "Update on 2003 Bilateral Trade between the United States and Vietnam", Hanoi, 2004.

The BTA has created positive and progressive effects on the legal system of Vietnam, as effective implementation of the BTA presumes a legal framework and

²⁹ This is why the U.S has applied textile import quota on Vietnamese products since May 01st 2003.

judicial system that can resolve commercial disputes (e.g. the catfish anti-dumping case) in line with international standards, similar to those prescribed by the WTO (CIEM-STAR, 2003). Vietnam has also made a series of legal changes and enforcement to meet the BTA obligations³⁰. Though with more standards and higher demands for trade liberalization commitments compared with theses for developing countries in the past, the overall effect of the BTA is to encourage efficient resource allocation and prepare Vietnam for accession to the WTO.

III.4. ACCESSION TO THE WTO:

Vietnam applied for membership in the WTO in 1995. In August 1996, Vietnam submitted its Memorandum on Trade Regime to the WTO Working Party (WP) on accession of Vietnam. As of June 01st 2004, the WP has conducted seven sessions with Vietnamese negotiation delegation. The first four WP sessions focused on transparency of Vietnam's trade policy and regime. The fifth WP session, held in January 2002, reviewed the status of Vietnam's bilateral access negotiations and action plans for implementation of a number of WTO agreements, including those related to investments and intellectual property rights. The sixth WP session, held in December 2002, marked the beginning of negotiations. At the seventh WP session, held in December 2003, the WP started work on key "elements" of the Draft Working Report on Vietnam accession. Vietnam has completed its transparency period and now in the process of substantive market accession negotiations with member of the WP. Up to now, Vietnam has concluded bilateral negotiations with ten WP members and the eighth WG session is to be held in June 07th 2004 in Geneva.

³⁰ For example, the new Customs Law, the amended Civil Code, the Civil Procedure Code, the amended Law on Credit Institutions, the new Law on Construction, and several sectoral Ordinances.

On commitments, Vietnam initially offered an average import tariff rate of 22 percent, which is considered as too high compared with the WTO average of 10% for manufactured goods. At the coming eighth WP session in June 2004, Vietnam plans to offer the average tariff rate of 15.5 percent³¹, which is closed to that of China when acceding WTO. On services, Vietnam made its initial offer on specific commitments in services in January 2002. The WP members require “BTA parity” starting point when negotiating with Vietnam, and Vietnam has done more than that. Out of 11 sector with 155 sub-sectors in WTO/GATS framework, Vietnam has made specific commitments to 10 sectors³² with 92 sub-sectors, compared with 8 sectors with 65 sub-sectors in the VN-US BTA.

Vietnam has also committed not to apply transitional period for obligations once becoming a WTO member. On subsidy issues, Vietnam will drop industrial subsidies when annual per capital income reach USD 1,000 and subsidize for agricultural sector up to 10% of the sector’s total output. Vietnam also commits not to apply quotas to agricultural imports and shift to tariffication. Regarding trading rights, Vietnam has committed to eliminate export ratio requirements, sectoral licensing, and quit the two-price systems in some sectors such as air travel and electricity by 2005.

The Government of Vietnam considers the accession to the WTO is top priority and a pivotal step in making the Vietnamese economy an integral part of a rule-based multilateral trading system. The WTO membership is significant for Vietnam to trade and gain access to world markets in equal terms, as by setting accepted rules among members WTO discriminated against non-member countries. WTO accession can generate considerable benefits in terms of improved legal framework and enabling

³¹ The current average tariff rate of Vietnam within AFTA scheme is 7.3% compared with 12.8% at the time of join AFTA. For a latest and comprehensive study on the structure of tariffs and protection in Vietnam, please see Athukorala, Prema-Chandra (2004): “*Trade Policy Reforms and the Structures of Protection in Vietnam*”, ADB and Vietnam Ministry of Finance, Hanoi.

environment all of which result in substantial productivity gains and incremental capital inflows (Liquin, 2002).

As a WTO member, Vietnam would also be in better position to defend its interest on the international scene. Lacking other instruments, importing countries tend to intensify the use of sanitary standards, of allegations of price dumping, to protect the interests of their domestic producers. Vietnam's exports of shrimps and gas lighters to the EU, of frozen fish fillets to the US (the catfish case), and garlic and water-proof footwear to Canada, have already suffered from trade barriers of this sort. Because Vietnam is not yet a WTO member, hence can not take advantage of its dispute settlement mechanism. In addition, dispute resolution is very costly and require technical expertise which is not readily available now in Vietnam (VDR 2003). Therefore, the Government of Vietnam has determined to gain WTO membership in 2005, as the cost of WTO accession would be higher and harder to afford³³ over time.

III.5. PRELIMINARY ASSESSMENTS:

The Government of Vietnam is taking an active and constructive approach toward trade liberalization, whether on multilateral, regional or bilateral basis. Together with steadily pursuing AFTA commitments with the 2006 deadline and enforcement of the VN-US BTA since December 2001, the top priority now is for joining the WTO in 2005.

As a trading partner, Vietnam enjoys favorable and comparative advantages in such primary industries as agricultural and fishing ones. Vietnam also have

³² Vietnam has not yet made commitments to environment service sector.

³³ The demands on new members will be higher than those current members had to meet when they joined in. Furthermore, the Doha Development Round is likely to raise the entry point. It would be, therefore, better for Vietnam to accede WTO before the conclusion of the DDA, which is scheduled for January 01st 2005.

competitive advantages in labor-intensive industries such as footwear, textiles and apparels with relatively low labor costs. However, with poor industrial base of low-tech machinery and equipment and led by inefficient state-owned enterprises, the Vietnamese industrial sectors will suffer from increasingly inflows of competitive industrial products from the region. This in turn will have negative effects on employment and income of the labors; therefore, a social protection program or safety net should be in place to curtain liberalization demerits.

IV. CONCLUSIONS AND POLICY RECOMMENDATIONS FOR VIETNAM:

There are always possible static and dynamic economic gains from various types of PTAs. The net welfare effect for PTA members depends on whether trade creation or trade diversion is prevailing. Deeper integration is preferred, as welfare improvement is more certain.

There is wide agreement that FTAs help to expand GDP and trade, attract investment, and seed up domestic structural reform, among other, but those effects vary from country to country and also between public sector and business one. For developing countries, there are possible economic gains, particularly from dynamic effects such as economies of scale, competition, and learning and technology spillover. However, challenges might come from sequencing bargaining effect, fiscal revenue transfer effect..etc.

Although welfare consequences of PTA liberalization tend to be positive, it is generally acknowledged that PTA liberalization does not compare favorably with multilateral liberalization if gains from trade alone are considered. However, PTAs as *feasible second-best means* of trade liberalization.

PTAs as building blocks or stumbling blocks: PTAs can contribute to social welfare by generating trade creation effect and by acting as a stepping-stone towards further liberalized multilateral trading system. However, overlapping regional integration arrangements might cause negative effects such as trade diversion, “Spaghetti-Bowl” and “Hub-and-Spoke” effects.

PTAs as new modalities and precedents for breakthroughs in multilateral negotiation for a: PTAs have a potential comparative advantage vis-a-vis multilateral arrangements as regulations can be written more tightly, creating opportunities for members to commit non-trade policy goals such as investment liberalization or political reform.

Major East Asian countries have shifted towards bilateral and regional economic integration. In the short term, bilateral FTAs are prevailing, in the long term, an East Asian region-wide FTA is possible with breakthrough in Japan-China negotiations and relations. Countries such as Singapore, Thailand are very active in negotiating and concluding FTAs, seriously affect the integrity of ASEAN. For FTA partners, most countries in East Asian regions target United States and Japan as their first choices. The race to bilateral FTAs might turn ASEAN into a series of spokes rather than hubs, as ASEAN members are so divergent in development levels, resulting in different schedule of trade liberalization commitments to a common FTA partner of ASEAN, such as the case of ASEAN-China FTA.

Possible welfare losses for Vietnam might occur due to trade, investment and production diversion, resulting from isolation, exclusion and discrimination in a third market which is member of certain FTAs or RTAs. Remember, nowadays, almost all WTO members are participating in at least one RTA. Losing competitiveness also

occur due to unequal access to world markets (higher tariff charges and non-tariff barriers).

The FTA could make member countries worst off if the FTA diverts more trade than creates, and vice versa. When forming an FTA, we must consider which FTA is good for the country as a whole (net welfare gain) by looking at the whole impacts or entire economy and figure out what kinds of industrial restructuring would occur. In most cases, the structure of the FTA will determine the net welfare effects of such FTA.

Together with economic effects, there are always political and diplomatic effects such as the case of ASEAN-China FTA. Whether the balance of Vietnam's national interests and relations with major powers is to be shifted by such ACFTA is too early to tell but it is the time for taking into consideration.

POLICY RECOMMENDATIONS FOR VIETNAM:

Renovation (Doi Moi) and open-door policy initiated since 1986 has significantly capitalized trade gains and development benefits for Vietnam. Though debatable on short-term adjustment costs of reducing trade barriers, trade openness is widely and empirically recognized as core for economic development. In Vietnam, international economic integration is considered as a cornerstone for economic growth and poverty reduction. In this context, a strategic thinking approach on preferential trade agreements (PTAs) in general and on free trade agreements (FTAs) in particular carries important implication for future economic growth and poverty reduction in Vietnam. Key Policy recommendations include:

(1) Focusing on capacity building for FTA research and institutions:

Serious efforts and resources for coping with global trend of bilateralism and regionalism in trade liberalization. FTA feasible studies and negotiations require expertises and resources of which Vietnam is lacking. Positively, The Government of Vietnam just decided to establish the FTA Research Commission under the Ministry of Trade in March 2004.

The Government should also encourage the establishment of non-profit economic and business research institutions. The experience of Japan and South Korea show that the business federations play a vital roles in initiating and proposing various FTA options to the Governments, whereas Vietnam is lacking of such private policy-oriented research initiatives and institutions.

(2) In the short term, accelerating the WTO accession process is top priority, which require consistent political will:

Speed up WTO accession would help gaining non-discrimination membership and MFN and NT status, so as to take advantage of GATT/WTO exceptions such as GATT Art. XXIV, Enabling clause and GATS Art. V etc. As a WTO member, Vietnam would also be in better position to defend its interest on the international scene, gaining equal access to the DSB mechanism. Moreover, the cost of WTO accession will increase over time.

(3) Then priorities should be given to conducting serious studies on FTAs with the hubs and the “best-practice” makers:

The hubs are those such as Singapore and Hong Kong, and the “best-practice” makers such as the United States and Japan. The aims are not only to prevent excluded status but also to help Vietnamese producers as well as export-oriented FIEs in Vietnam to maintain competitiveness in a third export market. To answer the

question of FTAs with whom, Vietnam should also preserve the first-mover advantages to the ones with best practices, i.e. most developed economies, which will help bring in best policy, business and management practices. Key determinants *for choosing FTA partners* include (1) The structure of comparative cum competitive advantage; (2) economic development level; (3) Geographical proximity; (4) Market size; and (5) The existence of missing trade (Sohn, 2001) The studies should inclusive to various stakeholders such as academic, business, and governmental circles.

(4) In the mid and long term, the (bilateral) FTA approach should be utilized as new policy options for post WTO accession.

The FTA approach in East Asian economic integration is a reality; Vietnam should join the trend and do not go against the tide! Going bilateral and regional FTA approach as policy options for post WTO accession. Vietnam should utilize trade liberalization and economic integration at all three fronts, bilateral, regional and multilateral. However, as a developing country with relatively small market size and modest bargaining power, GATT/WTO multilateral framework as guidelines and foundation for designing any bilateral and regional FTAs.

Vietnam's approach to international economic integration has shifted from unilateral one in first period of 1986-1995 to multilateral one in 1995-2005. In the post WTO accession period to come, Vietnam should take a more balanced approach among multilateral, regional and bilateral ones. Liberalization and integration commitments within WTO-based multilateral framework are usually narrower and shallower than regional and sub-regional ones. Similarly, regional commitments are often narrower and shallower than bilateral or sectoral ones. Whereas unilateral

approach always provide Vietnam with more room for liberalization policy measures, as the Government is more self-determined in contents, scopes and schedules of liberalization commitments. That is why unilateral initiatives are considered as active, pre-emptive and deeper commitments.

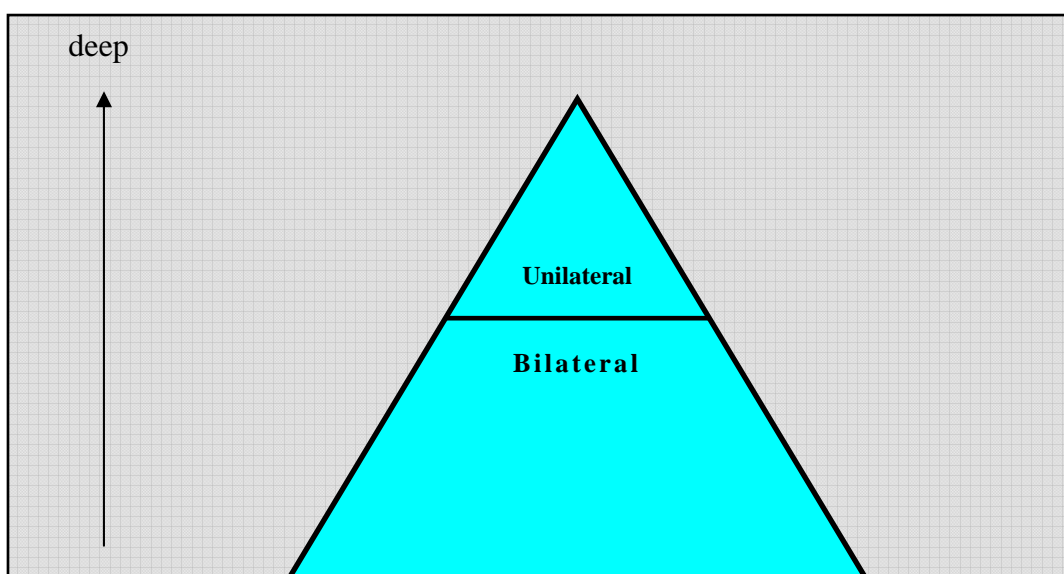
From theoretical as well as empirical perspectives, the North-South FTA modality is preferred, but South-South FTAs are also desirable for Vietnam as long as they expand foreign markets and boost domestic economic reforms.

The uncompetitive sectors with comparative disadvantages might lose in further international integration process, the Government of Vietnam should design and put in place a safeguard or safety net for those would-be losers in potential FTAs by Vietnam.

(5) Introducing a more balanced multi-track approach to international economic integration strategy for the post-WTO accession period:

In the era of co-existence of multilateralism and regionalism, Vietnam should undertake a mixed approach of multilateralism, regionalism, and bilateralism with the aims of upgrading internal reforms and deepening external integration (Figure IV.1).

Figure IV.1: Proposed Multi-Track Approach to International Integration in Post-WTO Accession Period.



Regional

WTO-based Multilateral

shallow

For this end, Vietnam needs “early winners” to keep the process politically sustainable. Vietnam has to soon formulate a regional and bilateral trade strategy to response to new regionalism in East Asia. More importantly, Vietnam should design its own international economic integration strategy, for which the mixed or multi-approach would serve as facilitating instrument. A pro-integration master-plan of active, unilateral, and strategic domestic reforms is precondition for any introduction of FTA approach into the international economic integration process of Vietnam.

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