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The Fragility of East Asian  
Regionalism

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# Managing the Noodle Bowl: The Fragility of East Asian Regionalism

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## Abstract

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

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## 1. INTRODUCTION

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

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

- Each nation’s industrial competitiveness is heavily dependent on the smooth functioning of Factory Asia—in particular on the free flow of intraregional trade.
- The tariff-cutting that created Factory Asia was done unilaterally by the Association of Southeast Asian Nations (ASEAN) and the People’s Republic of China (PRC); these tariff cuts were not “bound” in the World Trade Organization (WTO) and so are not subject to WTO discipline. What this so-called “bindings overhang” means is that East Asian tariffs could go back up overnight without violating any WTO rules (indeed, we saw some of this during the 1997 crisis). Because the smooth functioning of Factory Asia is in everyone’s interest, this lack of WTO discipline would not be a serious problem if there were some mechanism for managing conflicts—making sure that small problems did not tumble out of control due to a lack of communication and coordination.
- The third source of fragility is the lack of top-level management in the region to substitute for WTO discipline. European regionalism has both top-level management (the European Union, or EU) and WTO discipline (Europeans have bound their tariffs at very low levels). The same is true of North American regionalism.

The implications of these three facts are straightforward. While it has long been recognized that East Asia is short of “international public goods,” progress on setting up such goods has been hindered by a lack of vision.<sup>2</sup> Questions such as “who should take the lead?” and “what should be the long-run goals?” have no easy answer and so have been left unanswered. The time for East Asian vision, however, is gone. What East Asia needs now is management, not vision. And the need is pressing. Given its vast political, cultural and economic diversity, East Asia has always been a region prone to conflict among small nations. (It is also prone to conflicts among big nations but that is true of all regions of the world). Given the extreme supply-side integration of the region, such small-country conflicts could pose a threat to the competitiveness of Japan, Republic of Korea

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<sup>2</sup> See, for example, Fukuyama (2005), Severino, R. et al (2005), or the East Asian Vision Group’s report, available at the ASEAN website.

(Korea), PRC, and ASEAN firms in US and European markets. For example, a serious commercial dispute between Malaysia and Thailand, say, or Indonesia and Malaysia, could hinder the production of Japanese firms. If a simple bilateral conflict spun out of control and began to spread—as happened in Europe during the 1930s—Japanese firms might find it very difficult to provide low-cost, high-quality products to European and American markets in a timely fashion. The same is true for Korean, PRC, and ASEAN firms.

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

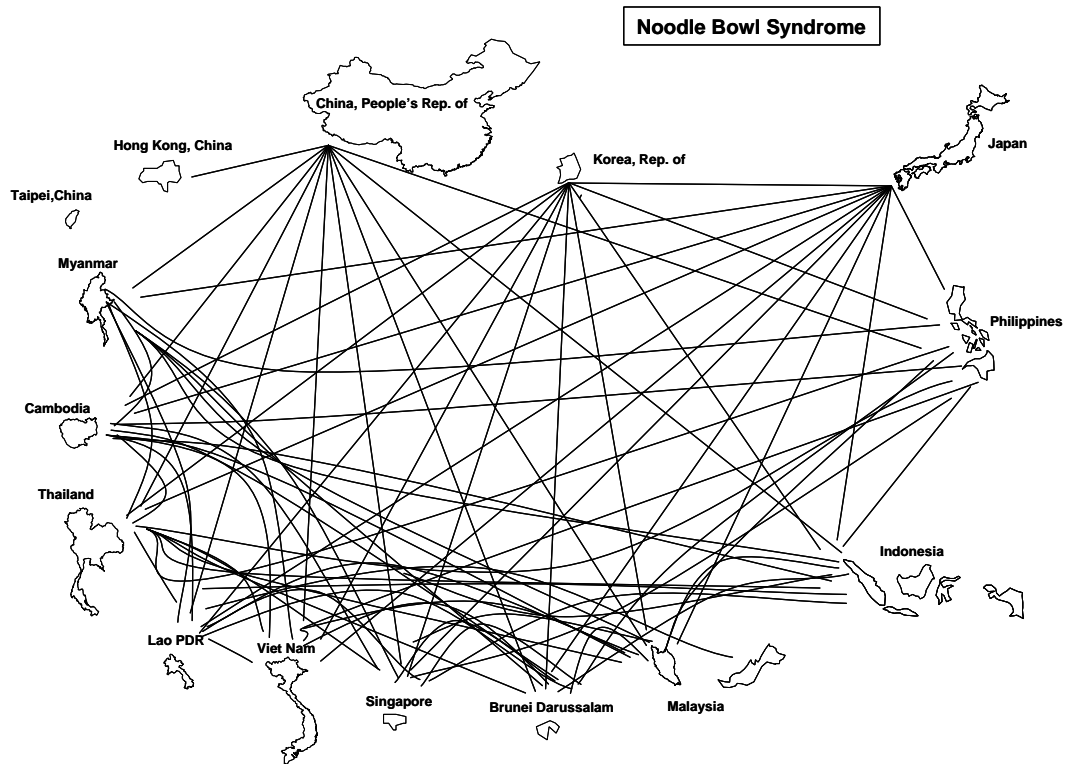
The rest of the paper is organized in four sections. Section 2, presents the state-of-play in East Asian regionalism, arguing that its trade arrangements are marked by a "Noodle Bowl Syndrome" (an unorganized tangle of bilateral trade deals). This section also explains how the Noodle Bowl was created by distinguishing three phases: "rampant unilateralism" 1980–1990, "regionalism delayed, unilateralism accelerated" 1990–2000, and "real regionalism" 2000 to present. It argues that the development of Factory Asia drove the first two phases, but PRC's FTA demarche toward ASEAN triggered a domino effect in the region that led to the current tangle of FTAs.

Section 3 fleshes out the argument that East Asian trade is fragile. It also contends that East Asia is about to experience a series of shocks as real tariff discrimination appears in the region for the first time. Section 4 presents some ideas on how the region might manage this fragility in the short-run and remove it in the long-run through the development of an East Asian free trade association modeled on Europe's "other" regional arrangement, the European Free Trade Association (EFTA). The final section presents concluding remarks.

## 2. CURRENT STATE OF PLAY

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

Figure 1: East Asia's Noodle Bowl Syndrome



Note: The map shows FTAs signed or under negotiation as of January 2006. East Asia is defined here as the 10 members of ASEAN, PRC, Japan, and Korea.

Source: Author's compilation.

### 2.1. The East Asian Noodle Bowl<sup>3</sup>

Figure 1 makes the point graphically. The figure shows each FTA that has been or is near to being signed. Specifically, by the end of 2005, the region had signed what amounts to 57 FTAs. The ASEAN-PRC FTA (ACFTA) is counted as 10 separate deals due to ASEAN's rather unique method of preferential liberalization. The reality is extremely complex, but roughly speaking, PRC and each ASEAN country chooses its own "sensitive list" and bilateral market access

<sup>3</sup> The mess was first dubbed the "Noodle Bowl Syndrome" in Baldwin (2004), but it should be thought of as the East Asian version of Bhagwati's famous spaghetti bowl problem (Bhagwati 1991, p. 77).

depends upon the interaction of the two lists. Nations do not get preferences for items on their own list and are not granted preferences for items on the counterparty's list. All bilateral links inside the ASEAN FTA (AFTA) are listed separately for the same reason. The fractured nature of ASEAN's basic approach to preferential trade implies that the degree of market access faced by an AFTA exporter of any particular product varies according to the ASEAN destination-market concerned. For example, we cannot view the Malaysia-Indonesia preferential tariff structure as identical, or even close to the Singapore-Philippines preferential tariff structure. Thus AFTA acts as if it were 45 bilateral trade relationships (10 times 9 divided by 2). Fortunately, the existence of ASEAN implies that 55 bilaterals are not completely dissimilar—ASEAN has imposed some discipline on rules of origin, product exclusion practices and phase-in modalities. Finally, Japan has signed FTAs with Malaysia and Singapore with these being *de jure* as well as *de facto* separate agreements. See Whalley and Banda (2005) for a detailed assessment of ASEAN's trade deals.

By the end of 2006, however, it seemed likely that the region would have at least 13 more deals—10 *de facto* bilaterals from the impending ASEAN-Korea FTA, and 3 more bilaterals between Japan and the advanced ASEANs—Indonesia, Philippines, and Thailand. That brings the total to 70. Japan may also conclude FTAs with Viet Nam and Brunei Darussalam and ASEAN as a whole, bringing the total to at least 75. Of course, a reasonable person could count these differently and come up with a different number, only serving to strengthen the basic point: in the Noodle Bowl, it is unclear just how many deals there are in the region.

How did East Asian trade relations get so tangled?

## 2.2. No real regionalism yet

Strange as it may seem, despite Figure 1 there is as yet no real regionalism in East Asia. Regionalism means preferential trade liberalization, or discriminatory trade liberalization, because preference is just another word for discrimination. By that definition, there is not yet any real regionalism in East Asia. The two most commercially important signed sets of arrangements—the ASEAN-PRC FTA and the ASEAN-Japan bilaterals—are supposed to be phased in over the next 5 years, but they have not yet undertaken any serious discriminatory tariff cutting. The only scheme that has been substantially implemented—AFTA—is not actually used (more on this below).

How was Factory Asia established without any real regionalism?

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

- **Phase I: Rampant Unilateralism**—From the mid-1980s to 1990, tariffs on intraregional trade came down, but this was due to unilateral tariff cutting driven by competition for investments and jobs related to the development of what can be called Factory Asia.
- **Phase II: Regionalism Delayed, Unilateralism Accelerated**—From roughly 1990 to 2000, East Asia witnessed an acceleration of unilateral tariff cuts as PRC's emergence heightened the competition among East Asians for jobs and

investment linked to an ever-expanding Factory Asia. Additionally, two formal arrangements began—the ASEAN FTA (AFTA) and Asia-Pacific Economic Cooperation (APEC)—but neither created much discrimination nor had much effect on trade flows, as we shall see.

- **Phase III: Rampant Regionalism**—In November 2000, PRC Premier Zhu Rongji triggered a domino effect by suggesting that the PRC might be interested in an FTA with ASEAN. This idiosyncratic initiative presented the nations excluded with a new situation, which in turn strengthened pro-FTA political forces in them, especially in Japan and Korea. The result was a sequence of FTAs, each of which served to further strengthen the pro-FTA forces in all economies across the region. The ASEAN-Japan FTAs, the Korea-ASEAN FTA, and the Japan-Korea FTA are direct reactions to the PRC-ASEAN FTA, according to the author’s reading of history.

Consider each phase in turn:

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

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

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

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

Japanese businesses reacted by seeking lower cost manufacturing sites for labor-intensive stages of production; the obvious solution was to move these stages of manufacturing off-shore to nearby East Asian nations. This tendency, which has been called the “hollowing out” of the Japanese economy, started the development of Factory Asia or the “Asian Manufacturing Matrix.”<sup>4</sup> Instead of making Japanese goods in Japan and selling them in the US or Europe, a new pattern of “triangle trade” emerged. Firms headquartered in Japan would produce certain hi-tech parts in Japan, ship them to factories in ASEAN for labor-intensive stages of production (including assembly) and ship the finished products to western markets or back to Japan. This division of East Asia into headquarter (HQ) economies and factory economies strengthened as Hong Kong, China;

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<sup>4</sup> The best papers on Factory Asia are Ando (2004), Ando and Kimura (2004, 2005), Kimura and Ando (2003, 2005), Ng and Yeats (2003), and Fukao, Ishito, and Ito (2003).



Korea; Singapore; and Taipei,China were similarly hollowed out and likewise their most labor-intensive production stages off-shore to East Asian economies where low wages more than compensated for low labor productivity.

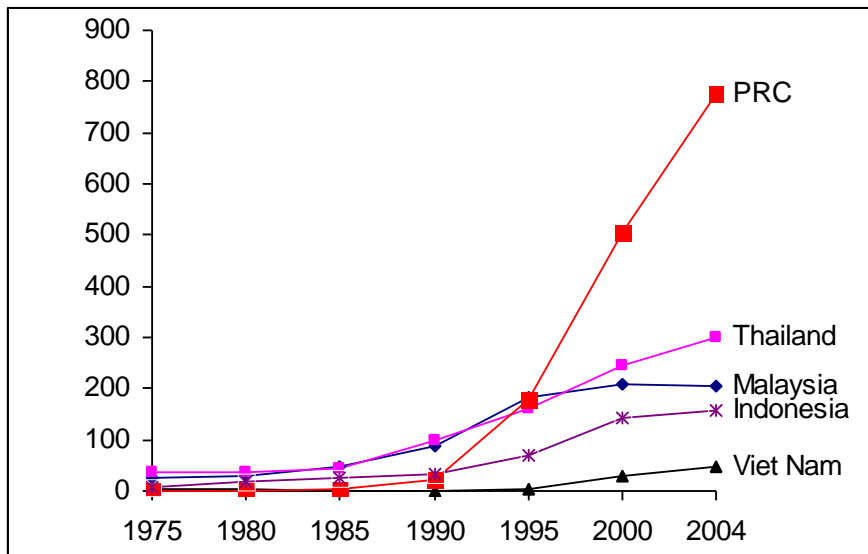
- **Reduced cost of moving goods and ideas**—Advances in information technology and the falling costs of transportation, especially air freight, facilitated and accelerated the development of the Asian Manufacturing Matrix by making complex production structures easier and cheaper to manage, while at the same time making them more flexible and more reliable.

- **The PRC**—PRC’s opening up and domestic pro-market reforms brought something like a half billion low-wage/low-productivity workers to the gates of Factory Asia. This accelerated the erosion of the HQ economies’ comparative advantage in labor-intensive production processes while simultaneously expanding the attractiveness of moving industries off-shore. In short, the PRC added a pull-factor to push-factors, quickening the hollowing out of the HQ economies (Hong Kong, China; Japan; Korea; Taipei,China; and Singapore).

**Development of the Asian Manufacturing Matrix**

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

Figure 2: Japanese plants in Emerging East Asia, 1975–2004  
Emergence of the PRC.



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

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

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

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

The top panel shows the situation in 1985 when the Matrix was very simple. With the exception of Singapore, East Asian nations sourced imported manufactured inputs from Japan and the rest of the world—all the rows are dominated by zeros except those of Japan and the rest of the world (mainly the US and Europe). By 1990 (second panel), the Matrix was more complex: Triangle trade still dominated the picture, with the low-wage nations (first five columns) buying inputs from Japan and the rest of the world, but providing no inputs in return. Now, however Hong Kong, China; Korea; and Taipei,China have joined Japan as HQ economies after their own hollowing-out phase, and new triangle trade appeared. This involves the shipment of parts from the new HQ economies to the factory economies (the PRC and the advanced ASEAN economies of Indonesia, Malaysia, Philippines, and Thailand) and can be seen from the emergence of new non-zero entries in the rows for Korea; Singapore; Taipei,China.

By 2000, the matrix was truly complex. Firms based in the factory economies began to source parts from other factory economies rather than from the HQ economy alone. In particular, PRC, Malaysia, and Thailand became important suppliers of parts to other factory economies, including each other. In short, the input-output matrix went from simple triangle trade to a much more complex situation where factory economies were both producers and buyers of parts and components.

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

(Share of column economy’s manufactured input purchases from the row economy; numbers less than 2% and purchases from one’s own economy are zeroed out)

<b>1985</b>	PRC	Indonesia	Malaysia	Philippines	Thailand	Singapore	Taipei,China	Korea	Japan
Indonesia						6%			
Malaysia						11%			
Philippines									
Thailand						10%			
PRC				2%		2%			
Taipei,China									
Korea									
Singapore		3%	7%						
Japan	3%	12%	15%	4%	9%	9%	8%	9%	
Rest of World	5%	15%	17%	9%	10%	39%	9%	7%	3%
<b>1990</b>	PRC	Indonesia	Malaysia	Philippines	Thailand	Singapore	Taipei,China	Korea	Japan
Indonesia									
Malaysia						6%			
Philippines									
Thailand									
PRC						4%			
Taipei,China			3%	4%	3%	3%			
Korea				2%		2%			

Singapore			8%	2%	3%				
Japan		8%	10%	9%	15%	21%	10%	8%	
Rest of World	3%	21%	16%	14%	17%	36%	11%	8%	4%
<b>2000</b>	PRC	Indonesia	Malaysia	Philippines	Thailand	Singapore	Taipei,China	Korea	Japan
Indonesia						2%			
Malaysia				4%	4%	10%	2%		
Philippines									
Thailand			4%	3%		3%			
PRC			3%	2%	4%	4%	2%		
Taipei,China			5%	6%	3%	3%			
Korea		3%	4%	8%	3%	3%	4%		
Singapore			14%	6%	4%				
Japan	2%	6%	16%	22%	16%	17%	14%	7%	
Rest of World	3%	11%	9%	7%	10%	23%	8%	5%	2%

Notes: The columns would total 100% if each economy's supply of inputs to its own manufactured sector were included (often greater than 50%) and if numbers less than 2% had not been zeroed out.

Source: IDE-JETRO, Asian input-output matrix (seven sectors) for 1985, 1990, and 2000; see, for example, [www.ide.go.jp/English/Publish/Books/Sds/082.html](http://www.ide.go.jp/English/Publish/Books/Sds/082.html).

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

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

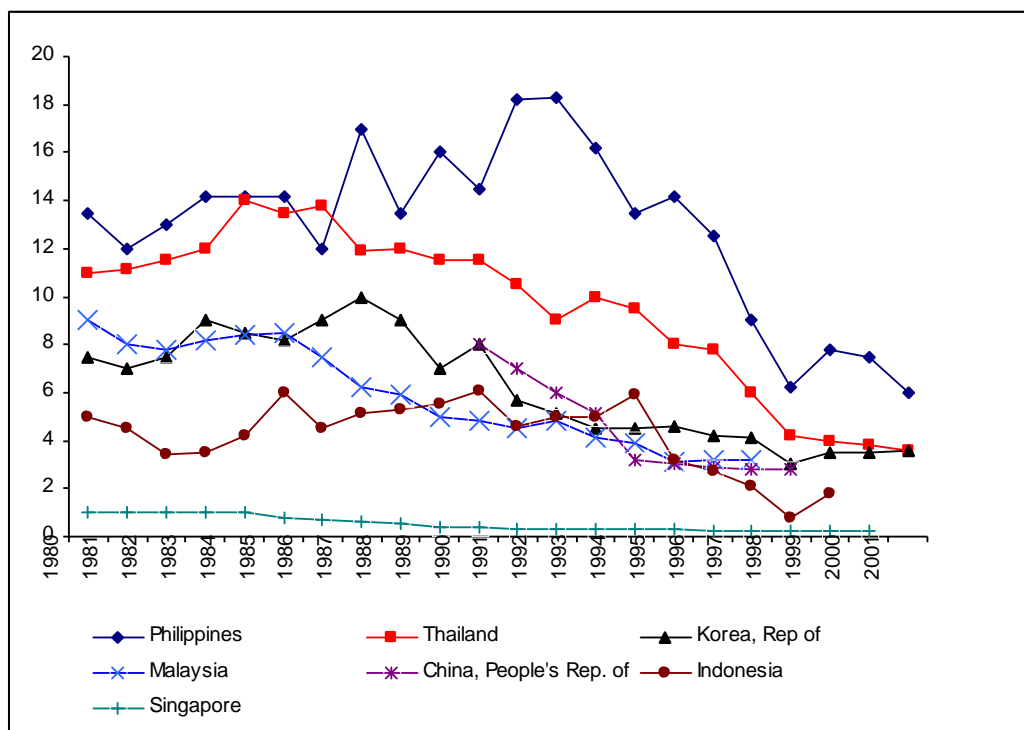
### Impact on East Asian tariffs: rampant unilateralism

The strategy of Japanese firms to move portions of their production off shore fit in nicely with the export-track of the dual-track development strategies pursued by the factory economies. To attract these investments, ASEAN unilaterally reduced tariffs on triangle trade in what may be viewed as a "race to the bottom." Often this came in the form of "duty drawbacks" and duty-free treatment for plants located in Export Processing Zones (EPZs).<sup>5</sup> While it is hard to find direct evidence that the unilateral tariff cutting in this phase was caused by competition for Factory Asia investment, anecdotal evidence is abundant—for example, Kuchiki (2003, 2005).

Regardless of what caused it, unilateral tariff cutting is obvious from Figure 3. The figure shows the average tariff calculated as total tariff revenue divided by total imports. This is the broadest definition of the average applied tariff since it encompasses all tariff schemes, including duty drawback arrangements.

<sup>5</sup> Duty drawbacks involve the suspension of tariffs on parts and components that are imported, partially processed, and then re-exported. EPZs are geographically specific areas in which specified goods are imported and exported duty-free because they do not leave the EPZ and thus do not influence the local market.

Figure 3: **Unilateral Tariff Reductions in Selected East Asian Economies (%)**



Note: Tariff revenue divided by total imports.  
Source: Ando and Kimura (2005).

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

### 2.2.2. Phase II: Regionalism Delayed, Unilateralism Accelerated

The second phase began in 1991 with the call by then Malaysian prime minister Mahathir bin Mohamad for an East Asian Economic Community (EAEC). While this led to the ASEAN Free Trade Agreement (AFTA) in 1992, Mahathir's vision for the region was much broader. His vision, however, was not appreciated in Washington, which feared that an Asia-only economic bloc might come to involve or even be dominated by the PRC. The US was still quite uncertain in the early 1990s about the PRC's motives, and its economic resurgence caused US concern. According to the author's reading of history, the US countered Mahathir's vision by pushing APEC forward in 1993. The US was adopting a well-known strategy in the regionalism game—undermining a preferential trade arrangement by proposing a larger one.<sup>6</sup> The diversionary tactic worked: East

<sup>6</sup> Best known was the strategy used by the United Kingdom (UK) to delay or prevent the formation of French-German trade bloc in the 1940s and 1950s. As the largest importer in the region, the

Asian economies cared and still care far more about the US market, and the US security role in the region was still seen as reassuring in the rapidly shifting post-Cold War world. The “exclusively Asian” aspects of Mahathir’s vision struck many in the region as too risky. In 1993, the oxymoron “Open Regionalism” was embraced by nations throughout the region and APEC’s Bogor Goals were adopted. This is why Phase II is called “regionalism delayed.” The source of the tag-line “unilateralism accelerated” should be clear from Figures 3 and 4.

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

### **Extremely low utilization rates under AFTA**

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

The second piece of evidence is that almost no trade took advantage of AFTA’s preferential (discriminatory) tariff rates. This is not widely recognized because the ASEAN Secretariat promotes statistics that measure progress by counting the *number* of tariff lines that have been partially or fully liberalized, not on the share of intra-ASEAN trade that is conducted over the preferential tariff. As we shall see, almost no one uses AFTA preferences.

Information from the late 1990s shows that AFTA preferences were not being used ( Figure 4). Overall, less than 3% of intra-ASEAN trade benefited from AFTA’s preferences. Getting the preferential tariff rate requires the importer to prove that the good actually originated in ASEAN (to avoid tariff fraud, whereby goods from third nations are transshipped through an ASEAN country to gain preferential access). In AFTA this requires “Form D.” As it turns out, the vast majority of traders found it more advantageous either to pay the MFN applied rate (and thus avoid the administrative cost and delay of Form D) or to take advantage of other schemes such as duty drawback programs or duty-free treatment in export processing zones.

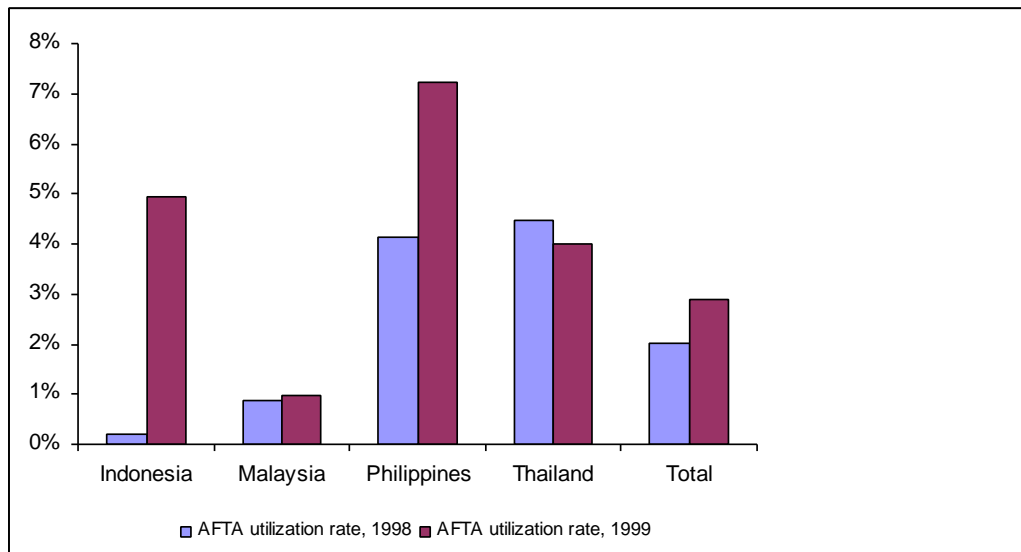
Figures for 2002 are not much better: according to JETRO (2003) only 11.2% of Thailand’s imports from AFTA took advantage of AFTA’s Common Effective Preferential Tariff (CEPT). Malaysia’s data suggest that just 4.1% of its exports to AFTA enjoyed the CEPT preference. By comparison, utilization rates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

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possibility of improved access to the UK market was very attractive to exporters on the continent. Thus when the UK proposed a Europe-wide FTA as an alternative to deep economic and political integration among the six proposed members, many Europeans were interested precisely because the broader formation would also include preferential access to the UK market. The British-inspired proposal did undercut some of the political and economic pressure for deep integration, but the six eventually rejected it and went on to ratify the Treaty of Rome, ultimately setting up what became the EU. The UK attended the initial meeting but withdrew at an early stage (see Baldwin and Wyplosz, 2006, Chapter 1 for details).

Figure 4: **AFTA Utilization Rates** (percent of Intra-ASEAN imports)

Source: PriceCooperWaterhouse, Presentation to the 10th Meeting of the ASEAN Directors-



General of Customs, 24 July 2002

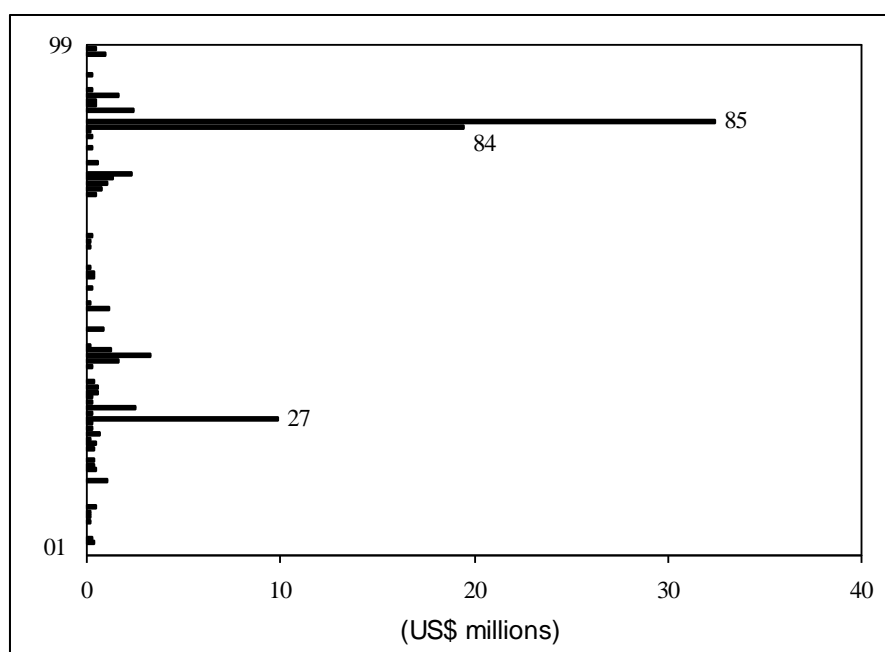
### **Why are AFTA preferences not used?**

The reason for the low utilization rates is simple—AFTA’s margins of preference on the high trade-volume goods are too small to compensate for the administrative cost and delay of applying for preferential tariff treatment. Evidence for this can be seen in Figure 6 and Table 2. Figure 6 plots the intra-Asian trade for each of the 99 HS chapters for the year 2003. Each bar represents the value of trade in a single chapter. Of course, most of the labels are illegible, but that is because most of the bars are equally small. Intra-ASEAN is completely dominated by computer/machinery and electrical equipment (HS chapter 84 and 85, respectively), although there is also non-negligible trade in lubricants, fuels and oil (HS 27).

Table 2 shows that the MFN tariffs on these high-volume goods are very low (less than 2%) so AFTA’s preferences are irrelevant. Experience from the EU and NAFTA shows that even modest costs and/or delays from complying with rules of origin will induce exporters to pay the MFN rate if the MFN rate is low. Given that the margins of preference are razor thin—between zero and 1.5%—it is no surprise that AFTA was almost never used.

A second salient point from Table 2 sheds some light on APEC’s irrelevance. Low East Asian tariffs in the table are for the goods involved in Factory-Asia trade, namely general machinery, electrical machinery (including electronics), and specialty petroleum derivatives. This unilateralism was not extended to other manufactured goods such as transport machinery (cars and trucks), or light industry. This outcome is perfectly logical when thinking of unilateralism as driven by competition for Factory-Asia jobs and investment, but it makes little sense when one thinks about APEC’s volunteerism.

Figure 6: Intra-ASEAN Trade by HS Chapter Product, 2003



Source: ASEAN Secretariat website.

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

Sector:	Exporter to East Asia			Preference margins:	
	East Asia	North America	EU	over North American Exporters	over EU Exporters
Mining products (HS25-27)	1.7	2.6	1.7	0.9	0.3
General machinery (HS 84)	1.5	1.9	2.5	0.4	1.4
Electrical machinery (HS 85)	1.4	1.5	2.2	0.1	-0.3
Others	1.4	1.7	2.6	0.3	-0.6
Wood and paper	1.4	1.3	1.5	-0.1	0.5
Precision apparatus	1.2	1.3	2	0.1	0.7
Agriculture	41.0	29.7	30.9	-11.3	10.7
Light industry	26.8	8.3	12.8	-18.5	4.1
Food and beverages	21.8	26.4	25.8	4.6	9.8
Textiles and clothing	7.3	7.6	7.8	0.3	-3.1
Transportation machinery	4.6	2.8	8.6	-1.8	5.3
Pottery products	2.9	3.6	4.4	0.7	-1.3
Chemicals	2.4	3	2.7	0.6	-1.4
Basic metals	1.8	2.6	2.3	0.8	-0.7
All products	7.4	5.5	7.2	-1.9	1.5

Note: Tariff data for 2002; see Freudenberg and Paulmier (2005) for details of the calculations.

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

Tariff liberalization in most economies is determined by the balance of political forces within each nation or economy. To understand why a government finds it politically optimal to remove a tariff that it previously found optimal to impose, one has to focus on domestic political factors. Group photos of APEC leaders in colorful shirts are not a driving force. To have an effect on tariffs a trade initiative has to alter the array of pro- and anti-trade forces within an economy. For

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

### **2.2.3. Setting the stage for Phase III**

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

#### **Asian Financial crises**

The spectacular growth of East Asian economies in the mid-1990s came to a screeching halt with the 1997 Asian financial crisis. The big exception was the PRC, which escaped almost unscathed (Figure 5), firming up its role as *primus inter pares* in the gallery of East Asian developing nations. The Asian crisis had an important influence on East Asian regionalism, although it was not, in the author's reading of history, a pivotal event. In particular

- It deeply shook East Asians' faith in development strategies and the heavy emphasis on US and European markets.
- It created a sense of commonality among East Asian nations and networking among policy elites.
- Many East Asian firms that had been protected from global competition by high tariffs suddenly found themselves faced with the full fury of globalization; the resulting "industrial restructuring" was far from systematic and it certainly was not optimal, but it did act as a brutal form of natural selection. The average East Asian firm that survived the 1997 crisis was systematically more capable of standing up to international competition than the average East Asian firm before the crisis. This was important since it exogenously reduced the anti-liberalization pressure from import-competing firms. On the margin, this shift in political economy forces within each nation made it politically optimal to remove some tariffs that East Asian governments previously found it politically optimal to retain.
- It revealed the unsuitability of APEC as a vehicle for regional cooperation.
- PRC's economic stability during the storm gave the country a big boost in its competition for new jobs and factories from the ever-growing Asian Manufacturing Matrix (see Figure 5).

#### **PRC's looming WTO membership**

Although the Asian crisis is usually viewed as the key turning point, PRC's WTO membership was far more important to re-arranging the alignment of pro-trade and anti-trade forces in the region. As the 1990s drew to a close, PRC's long-running attempt to join the WTO began to look like it would succeed. PRC membership, many believed, would provide an external lock-in of the reforms the nation had unilaterally adopted. This, in turn, greatly heightened the attractiveness of PRC as a location for FDI from the HQ economies (Hong Kong,



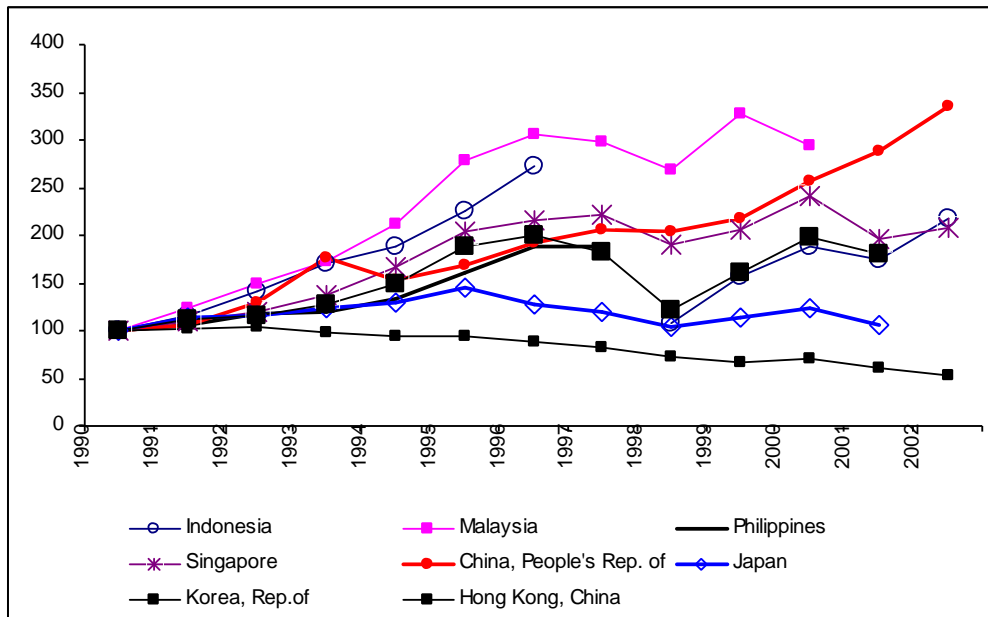
China; Japan; Taipei,China; Korea; and Singapore). This became an increasingly serious worry for the other factory economies in the region, especially Indonesia, Malaysia, Philippines Thailand, and Viet Nam. And this set the stage for the next phase of Asian regionalism.

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

At the November 2000 PRC-ASEAN Summit, PRC premier Zhu Rongji broached the idea of an FTA between PRC and ASEAN. This initiative came as something of a surprise to ASEAN members, but it was in line with PRC's behavior in the 1990s. One key element of PRC's economic development strategy of the 1980s and 1990s was the desire to avoid antagonizing non-PRC states. Since PRC's success in attracting industrial jobs and investment was increasingly viewed as a threat by some in ASEAN, Zhu Rongji decided to make a big-hearted gesture that he hoped would assuage the ASEAN concern over PRC competition for Factory-Asia jobs and investments.

The PRC offer was generally welcomed by ASEAN and led, 3 years later, to the ASEAN-PRC Free Trade Agreement (ACFTA), which promises to eliminate tariffs on almost all bilateral trade between PRC and the 10 ASEAN members by 2010 (2015 for Cambodia, Myanmar, Lao PDR, and Viet Nam, or CMLV). The first domino triggered by the PRC move was among ASEAN itself. During the ACFTA talks, ASEAN agreed to adopt the same deadlines and zero-tariff goals for intra-AFTA trade.<sup>7</sup>

Figure 5: **Manufacturing Growth Index, 1990–2002** (1990 = 100)



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

<sup>7</sup> Before the 2003 Bali II accord, AFTA preferences had to be between 5% and 0%; afterward, intra-AFTA should be zero. The AFTA deadlines were also rearranged to match ACFTA deadlines.

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

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

### **Japan's and Korea's reaction**

According to the domino theory and the historical precedents in Europe and North America, "Plan A" for Japan should have been to redress the discrimination by joining ACFTA. This path, however, was blocked. ACFTA was not an organization that outsiders could join.<sup>8</sup> With Plan A out of the running, a Plan B was needed. This was always going to be convoluted since its goal was to redress possible discrimination from a trade bloc without formally joining the trade bloc. Experience in other parts of the world in regionalism suggested two Plan-B responses: (i) form a separate trade bloc with other excluded nations (Japan-Korea FTA), and (ii) seek bilaterals with the smaller/more-susceptible members of the new trade bloc (Japan-ASEAN bilaterals). The Japanese government opted to follow both. The Korean government faced a similar situation and adopted similar solutions.

If the Japan-Korea FTA gets signed, it is likely to trigger another domino effect since PRC will face the possibility of discrimination in two of the three largest economies in the region. A Korea-US FTA would also trigger a domino effect, but unless the US proves willing to radically alter its FTA "template"—the basic FTA deal offered to the many other nations that have signed or are negotiating FTAs with the US—the Korea-US FTA is likely to be politically unpalatable to Korea.<sup>9</sup> Moreover, the US side is likely to have political difficulties with a Korea-US deal, even if it follows the template, because the Korean manufacturing sector is far more competitive than that of other US FTA partners. Of course, high-minded geostrategic reasons may offset the opposition of US and Korean special interest groups, so anything can happen, but such reasons do not yet appear to be pressing.

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<sup>8</sup> See Baldwin (2006) for details on the East Asian version of the Domino Theory.

<sup>9</sup> The administration of George W Bush has had a hard time putting together a congressional majority for FTAs and so prefers to use "templates" (combinations of concessions and exemptions by the US and concessions and exemptions by the counterparty) that have won congressional approval in the past.

### **2.3. Summary**

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

## **3. FRAGILITY AND EMERGING TENSIONS**

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

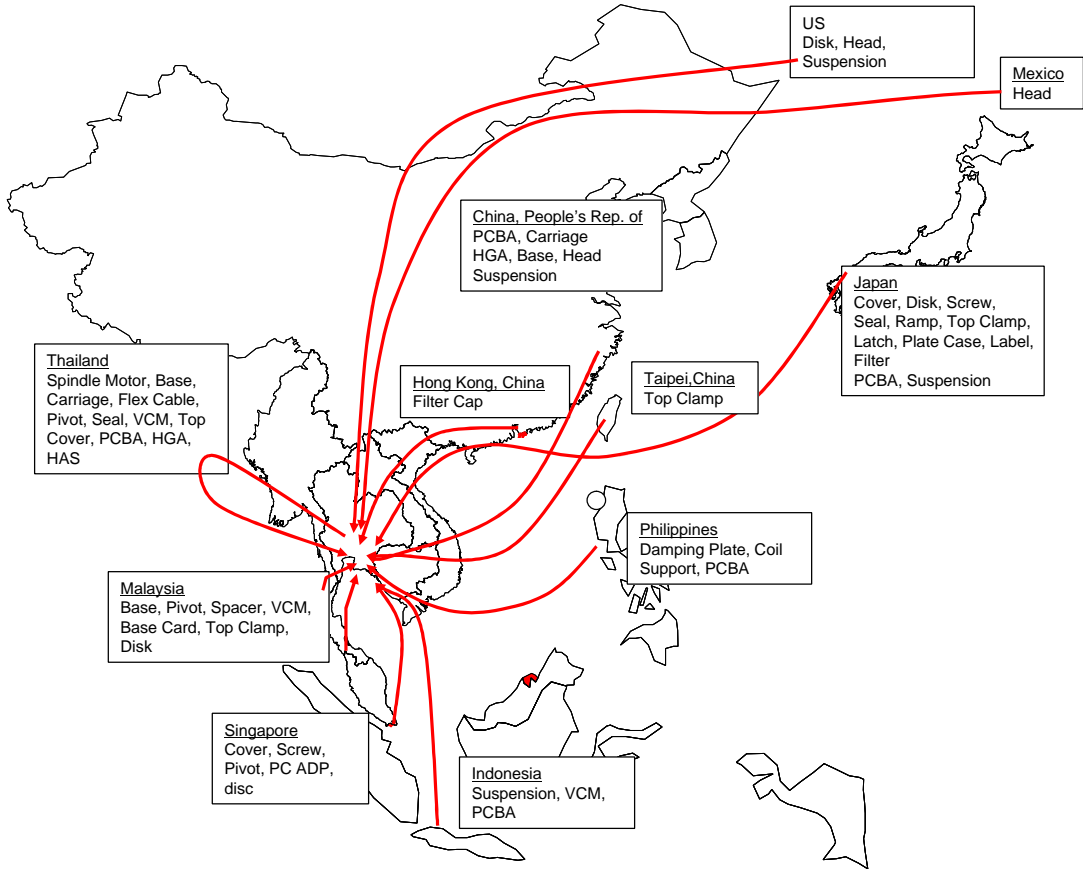
### **3.1. Sources of fragility**

The fragility of the East Asian system stems from the extreme interdependence of economies' competitiveness, the lack of WTO discipline, and the lack of top-level management to deal with noodle bowl complexity.

#### **3.1.1. The Noodle Bowl Syndrome**

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

Figure 6: An Example of Interdependence in Factory Asia



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

Source: Adapted from Hiratsuka (2005). Figure 2

### 3.1.2. Interdependence in Factory Asia

Factory Asia started simple, but now all manufacturing sectors East Asia are tightly interlinked via regional trade. The facts and figures can be found in the bottom panel of Table 1 for 2000. Figure 7 makes the point by example. The diagram shows the sources of the various parts of a disk-drive that is assembled in Thailand by the affiliate of a Japanese company. The disk itself is sourced from the US, Japan, and Malaysia, the filter cap comes from Hong Kong, China, and so on. Of course, the disk itself consists of several parts, some of which are imported from the US, Japan, and/or Malaysia, and the same can be said of most of the parts listed. If the ultimate source of every bit of a disk drive were traced out, the map would be impossibly complex. And one should note, that the disk-drive itself is an intermediate good that will be shipped somewhere and assembled—together with an equally complex web of sourced parts—into some electronic device.

The key point here is simple:

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

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

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

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

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

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

There are two key aspects to this historical precedent:

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

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

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

Why can't this work for East Asia?

### East Asia's Tariff Bindings Overhang

The East Asian Manufacturing Matrix depends upon four HQ economies, Japan; Korea; Taipei, China; and Singapore, and six factory economies, PRC, Indonesia, Malaysia, Philippines, Thailand, and Viet Nam. Table 3 shows the extent to which GATT Article 2 disciplines the trade of these economies.

Table 3: **Bound and Applied Tariffs in East Asia**

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

Note: n.a. = Not available

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

Source: WTO country profiles, 2005.

Japan, like the US and the EU, has bound almost all its tariffs at quite low rates; the simple average bound tariff is just 2.3%. Japan's average applied rate is almost identical.<sup>10</sup> Since Japan's tariff bindings (Final bound) match the tariffs that Japan actually charges (Applied), it would be impossible for Japan to raise its tariffs much without violating GATT's Article 2. This fact alone makes it almost unthinkable for domestic political forces in Japan to ask the government for such a thing. In other words, Japan's post-war tariff cutting is WTO disciplined.

The situation for Korea is broadly similar. Almost all its tariffs are bound at moderate rates—the average is 10%—but the MFN tariffs that Korea actually charges is below the level at which they are bound. This means that Korea could raise its MFN tariffs by 3 percentage points on average without violating Article 2. In the world of trade diplomacy, this is called a “binding overhang” because much of Korea's unilateral tariff cutting over the past two decades is not covered by commitments not to raise them. Note that once one takes account of all the

<sup>10</sup> The applied average is a bit higher to “continent protection” duties such as antidumping and countervailing duties.

special tariff treatment that Korea unilaterally extends to its imports, the *real* average Korean tariff is just 3.2% (Import duties as a share of total imports). GATT's Article 2 discipline provides an important firebreak should the Korean government ever find itself in a tariff-raising firestorm of domestic political pressure, but not as much as it provides to the Japanese government.

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

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

Viet Nam is not yet a WTO member, so the Article 2 firebreak would do nothing to help the government resist domestic political pressure for higher tariffs in the event of a raging trade dispute. Taipei, China's situation is similar to Korea's. Singapore is a paragon of WTO discipline; the city-state bound almost all its tariffs at zero.

#### **3.1.4. Lack of Top-level Management in Factory Asia**

No organization or government is making sure things run smoothly in East Asia, although there are several bodies that deal with various bilateral problems.<sup>11</sup> In a region as interdependent as East Asia, however, bilateral bodies may very well prove insufficient for dealing with complex trade disputes that involve several nations in the region—especially disputes that lead to “reverse domino” effects, that is, tariff hikes in one nation that are reactions to tariff hikes in other nations.

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

If we think of East Asia as a magnificent factory, then duty-free trade flows are the conveyor belts that bring the parts from one stage of processing to the next. But this is not a linear factory of the type common in the 20<sup>th</sup> century. Factory Asia is a 21<sup>st</sup> century, just-in-time factory where the inputs are arriving

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<sup>11</sup> For example, the PRC-ASEAN FTA says it will set up a dispute settlement arrangement, but it does not appear to be in place yet. The Japan-Malaysia FTA sets up a bilateral dispute settlement arrangement and it is likely that the other Japan bilaterals will have similar mechanism. AFTA has something of a dispute settlement procedure, but given the extremely disjointed nature of ASEAN, it is not very effective and has not been chosen as the focal dispute settlement body for ASEAN's FTAs with PRC, Japan, and Korea.

continuously from all directions. If even a few “conveyor belts” break down, it will disrupt production in many parts of the factory. This intense interdependence has fostered and been fostered by unilateral tariff cutting, but this trade liberalization is not disciplined by WTO rules. Nor is there any top-level management to ensure that localized trade disputes do not spread and thus threaten the smooth functioning of the system as a whole.

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

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

### **3.2. Emerging Pressures**

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

East Asia has no experience with discriminatory trade liberalization. The many FTAs that are in place have not yet created discrimination. As argued above, none of the FTAs in the region that are likely to be effectively implemented—the Japan-ASEAN bilaterals, the PRC-ASEAN FTA and perhaps the ASEAN-Korea FTAs—have yet cut bilateral tariffs in a serious way. The region’s other arrangement, AFTA, created almost no discrimination since no one used it. Why does this matter?

Real regionalism means discriminatory tariff liberalization, and discrimination sometimes creates tension. For example, the PRC will soon grant better market access to a Malaysia-based firm than it does to a Japan-based firm—a fact that will surely bother Japanese firms. In other regions of the world, such tensions have led to policy reactions, some of which have been disruptive to trade. The most common policy reaction has been to abort the implementation of the discriminatory liberalization. This is often the case when it comes to South-South FTAs like the PRC-ASEAN arrangement.<sup>12</sup>

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

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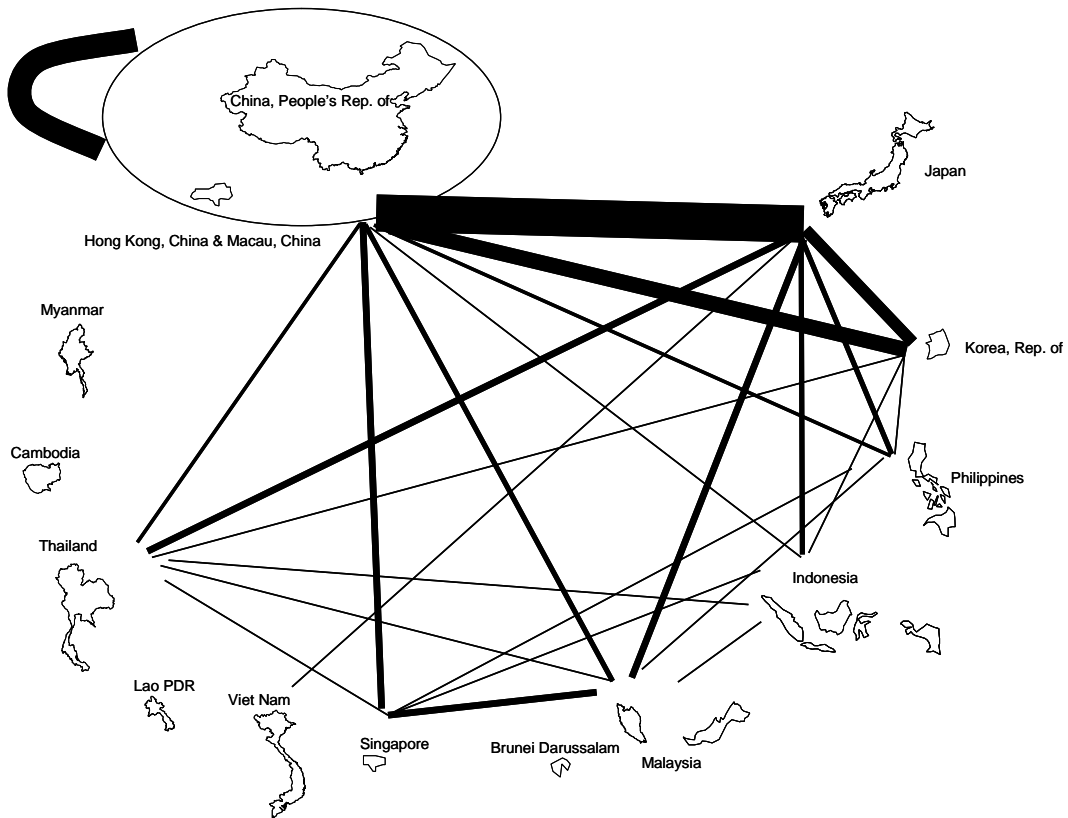
<sup>12</sup> If the preferences lead to the delocation of firms from one developing economy to another (usually the larger of the two since firms prefer to locate in the large market), the “losing” economy often calls off the deal. Indeed, of the hundreds of regional trade deals in the world, only a couple of dozen actually influence trade and only a couple of those are South-South arrangements.



will do, East Asia will witness the emergence of a complex pattern of tariff discrimination.

Figure 7 shows a striking fact—the biggest trade flows in the region are the only ones not covered by FTAs. The diagram shows the importance of the various bilateral trade flows in the region with small flows zeroed out to improve readability. The three largest bilateral trade flows—PRC-Japan, PRC-Korea and Japan-Korea—will probably not be covered by FTAs by the end of 2006. Thus, it is exactly the biggest flows in the region that will face discrimination. Korean firms selling into PRC will face discrimination compared to Thai firms; PRC firms selling into Japan will face discrimination compared to Malaysian firms, and so on. If the Japan-Korea FTA gets signed, then PRC will face discrimination in both Japan and Korea compared to Korean firms on the one hand and Japanese firms on the other.

Figure 7: **East Asian Bilateral Trade Flows Rounded to Nearest 1% of Regional Flows** (line width proportional to %)



Source: IMF DOTS database.

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

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

East Asian regionalism could have developed from visionary beginning, but it did not. Vision takes time, a lot of time; Europeans, for example, discussed the

continent's trade arrangements for more than a decade before the EEC was formed. In East Asia, events just moved too fast. In just 4 years—from 2000 to 2004—the notion of economically significant FTAs in Asia went from unlikely to obvious. All East Asian economies have a stake in ensuring that regional trade is well managed, but nothing and no one takes responsibility for this “collective action” problem. This is why the pressing need is for management, not vision. This section considers some aspects of a regional management effort that could keep the status quo running smoothly while discussion of vision proceeds.

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

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

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

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

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

in the region more solid than what the WTO offers under the Enabling Clause and more adapted to regional needs than the discipline it offers under Article 24.

## **4.2. Management priorities**

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

### **4.2.1. Priority #1: Bind the MFN Applied Rates**

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

### **4.2.2. Priority #2: Transparency and Confidence Building Deliverables**

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

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

The new East Asian regional management effort could also agree minimum standards for East Asian FTAs—trade agreements that meet these conditions could be called ASEAN+3-compliant. Of course, the point of departure would have to be a set of conditions mild enough to fit all existing FTAs (just as the GATT had to legalize existing preferences in 1947, such as those of the British Commonwealth). But even this would be an improvement over the current lack of

discipline faced by the FTAs that are notified under the Enabling Clause. The value of such a set of standards would become apparent if nations failed to fulfill the liberalization promises they made in the FTAs. Given the vast differences around the world, the WTO has found it impossible to improve the discipline of FTAs, especially those notified under the Enabling Clause. In a sense, this ASEAN+3-compliant status would provide a level of discipline intermediate to Article 24 and the Enabling Clause. Such a thing might prove attractive to other South-South FTAs.

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

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

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

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

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

The crucial dividing line between intergovernmental and supranational lies in decision-making. If the regional organization can make decisions that bind all the members, yet need not be approved by each member, then we can say that the

organization is supranational. For example, the EU decides its common external tariff—including antidumping duties—on the basis of majority voting. Consequently, EU members frequently find themselves having to adopt trade policies that they do not want.<sup>13</sup> In intergovernmental organizations such as NAFTA and EFTA, all nations must agree to everything.

#### **4.3.1. EFTA: the Appropriate European Model for East Asia**

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

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

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

- (i) Mitigate the hub-and-spoke bilateralism that has emerged in the region; this would be especially beneficial to small East Asian nations that have fallen into the spoke trap (Baldwin 2004).

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<sup>13</sup> A recent example came with the EU-PRC conflict over textile quotas. Several nations including the Netherlands, Sweden, and the UK did not want quotas against PRC exports, but they were out-voted in the Council of Ministers, so they were forced to restrict the trade. See Baldwin and Wyplosz (2006) for details on the EU's trade policy setting institutions and procedures.

- (ii) Avoid the noodle bowl problem by bring coherence to preferences and rules of origin.
- (iii) Create “conditionally open regionalism” in East Asia, which would result in many of the efficiency aspects of APEC’s Open Regionalism while still harnessing the critical political forces that are generated by preferential trade liberalization.
- (iv) Because Japan and Korea are developed nation members of the WTO, the arrangement would need to obey article 24 disciplines. This discipline would also make it less threatening to third nations or economies.

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

## **5. CONCLUDING REMARKS**

As of early 2006, preferential tariff liberalization had yet to begin in East Asia. The PRC-ASEAN FTA and the Japan bilateral FTAs with ASEAN members are just starting to be phased in; the only FTA in the region that is close to being implemented, AFTA, does not count because almost none of intra-ASEAN trade uses the preferences. Because discrimination is another word for preferential, it can be said that East Asia has not yet seen what happens when tariffs are cut on a discriminatory basis. To date, the smooth growth of intraregional trade has been driven by unilateral tariff cutting. Consequently, the remarkably harmonious state of regional trade relations during the last two decades gives us little indication of how the system will react to future tensions, including those arising from the impending discriminatory tariff liberalization.

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

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