

## The boom in FTAs: let prudence reign

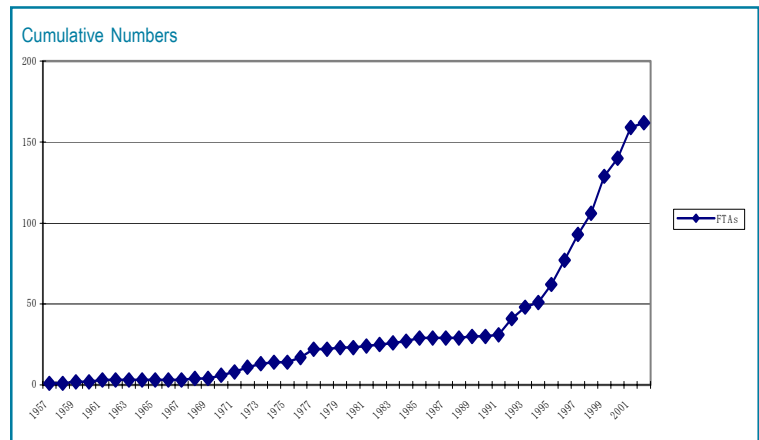
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Over the past decade, efforts at promoting closer regionalism in East Asia have been stepped up for various reasons, including: (1) a response to the experience and lessons of the 1997 financial crisis; (2) the gridlock in the Doha Round, success of the North American Free Trade Agreement (NAFTA), and expansion of the European Union (EU); (3) the mitigation of political factors that prevented closer cooperation in the past, e.g., competition between China and Japan; and (4) the perception that the Association of Southeast Asian Nations (ASEAN) economic integration will not progress unless other East Asian economies are involved.

There have been three general trends in terms of East Asian economic integration. The first has been to implement programs to broaden and deepen integration among ASEAN member countries. This has been the thrust of the Vientiane Action Plan which drew inputs from a report submitted by McKinsey & Company to the ASEAN Secretariat in September 2003.

The second response has been to encourage sub-regional and bilateral free trade agreements or FTAs. Singapore and Thailand, in particular, em-

Figure 1. Global FTAs reported to GATT/WTO



Source: Slide from Prof. Shujiro Urata's paper titled "East Asian integration: opportunities for Fukuoka and Japan" presented at the Fifth Asian International Forum in Fukuoka, Japan on 31 August - 1 September 2005.

barked on 'pathfinder' economic bilateralism. The two countries have taken the lead in entering into bilateral trade agreements with countries within and outside East Asia. The recent proliferation of FTAs involving East Asian countries reflects a global trend (Figure 1).

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This *Notes* is based on PIDS Discussion Paper Series No. 2005-32 titled "Economic integration and regional cooperation in East Asia: a pragmatic view" by the same author. The author is President of PIDS. The views expressed are those of the author and do not necessarily reflect those of PIDS or any of the study's sponsors.

The third broad trend has been to revive the idea of an East Asia Free Trade Area or EAFTA, specifically the concept that ASEAN+3—and eventually the entire East Asia—is a more feasible grouping in terms of regionalism. In this sense, the constraints facing the ASEAN Free Trade Area (AFTA) have become an added impetus for East Asian regionalism. It should be noted that intraregional trade among the ASEAN+3 countries is much higher than that involving only ASEAN member countries (Table 1). Moreover, the empirical evidence indicates that ASEAN member countries will benefit more by expanding the coverage of their regional trade arrangement (Table 2). The benefits are generally higher if the agriculture sector is included in the regional trade arrangement (RTA).

**Table 1. Intraregional trade in East Asia**

	1980	1985	1990	1995	2000	2004
ASEAN (X)	17.4	18.6	19.0	24.6	23.0	22.2
ASEAN (M)	14.4	17.2	15.2	18.3	22.5	22.6
ASEAN+3 (X)	29.0	26.4	26.8	35.0	33.7	34.8
ASEAN+3 (M)	29.0	32.3	30.6	39.5	41.2	43.8

Note: X – exports; M – imports  
Source of basic data: IMF Direction of Trade Statistics (DOTS) CD-ROM, October 2005

**Table 2. Effect on economic welfare of various regional trade proposals (% of GDP excluding agricultural liberalization)**

Proposal	ASEAN	China	Korea	Japan	USA
China+Korea+Japan	-0.26 (-0.16)	+0.1 (-0.2)	+1.0 (+0.6)	+0.1 (+0.2)	+0.0 (+0.0)
ASEAN-China	+0.9 (+0.5)	+0.0 (+0.1)	-0.1 (-0.1)	+0.0 (+0.0)	+0.0 (+0.0)
ASEAN-Japan	+1.1 (+0.2)	-0.1 (-0.1)	-0.2 (-0.1)	+0.0 (+0.1)	+0.0 (+0.0)
ASEAN+3	+1.5 (+0.6)	+0.1 (-0.2)	+1.1 (+0.8)	+0.2 (+0.2)	-0.1 (+0.0)
Asean+3+CER	+1.3 (+0.6)	+0.0 (-0.1)	+1.1 (+0.9)	+0.2 (+0.2)	-0.1 (+0.0)
APEC Liberalization (MFN)	+0.7	+0.5	+0.7	+0.4	-0.0
APEC Preferential Liberalization	+0.8	+0.6	+0.9	+0.4	+0.0

Note: (1) Calculations for ASEAN include only Indonesia, Malaysia, the Philippines, Singapore, Thailand and Vietnam.

(2) CER includes Australia and New Zealand.

(3) Figures in parentheses refer to net welfare effects when agriculture is excluded.

Source: Table 1, Overview chapter of Krumm and Kharras, *East Asia integrates: a trade policy agenda for shared growth*. The World Bank, Washington, D.C., 2003

## The economic benefits of FTAs may be overstated

Establishing an FTA or RTA is supposed to generate economic benefits through two main channels: 1) competition and scale effects; and 2) trade and location effects. By joining an FTA, economic growth is expected to be spurred by increased specialization, greater trade, and/or a country's inclusion in a global value chain. However, the simple fact is that countries in East Asia which experienced high rates of economic growth did so without the benefit of an FTA.<sup>1</sup> China was not even a signatory of the General Agreement on Tariffs and Trade (GATT) or an original member of the World Trade Organization (WTO). In other words, an FTA is not crucial to economic growth.

An example that strongly supports this argument is the comparison between two developing countries, as has become fashionable in recent years. Country A is a member of an FTA, the other members being two large and highly industrialized countries. Country B's accession to an FTA is scheduled for 2009; it is not yet a member of the WTO, and the FTA it is joining does not include any large industrialized countries. However, Country B has been attracting a great deal more foreign direct investment (FDI) than Country A. Country B's economic growth has averaged 5 percent a year since introducing market reforms at the end of the 1980s. In contrast, Country A's economic growth per capita between 1990 and 2003 averaged just over 1 percent. Country A is Mexico and Country B is Vietnam.

It should be emphasized that the impediments to faster economic growth are largely internal. For example, the study of the East Asian miracle points

<sup>1</sup> The author is indebted to Dr. Claude Barfield of the American Enterprise Institute who made this point during the Fifth Asian International Forum held in Fukuoka, Japan on 31 August – 1 September, 2005.

to four main factors: outward orientation, a modernized agriculture sector, bureaucratic efficiency, and a relatively equitable distribution of income. Moreover, outward orientation by these countries was not achieved through joining an FTA.<sup>2</sup> The Philippines is a clear example where unimpressive economic growth is largely due to internal factors. It is quite obvious that economic resources would be better allocated if these were channeled to agricultural productivity, improving governance, and strengthening institutions rather than finalizing the Japan-Philippines Economic Partnership Agreement, negotiating the China-ASEAN Free Trade Agreement, or pursuing an FTA with the US and other countries.

Meanwhile, intraregional trade in East Asia has progressed significantly and currently compares favorably with NAFTA and the EU-15 even without the benefit of a formal FTA (Figure 2). However, there is a noticeable discrepancy between intraregional export trade and intraregional import trade (Table 1). This gap may be closed by an FTA.

One final observation is that trade between selected ASEAN member countries and China has been growing rapidly even without the benefit of an FTA. Table 3 also shows the same trend for trade between Japan and China and some analysts have even predicted that the share of Japanese exports destined for China will surpass 20 percent in 2005. The share of ASEAN and Japan exports going to Australia is shown for illustrative purposes. Despite the initial optimism surrounding APEC, exports to Australia from ASEAN and Japan have stagnated in the past decade.

The advanced stage of economic relations in the region is acknowledged when analysts speak of *de facto* economic integration. Advocates of FTAs should explain why it is necessary to institutionalize this relationship. The issue becomes more

important in view of the resources and effort required to negotiate these agreements.

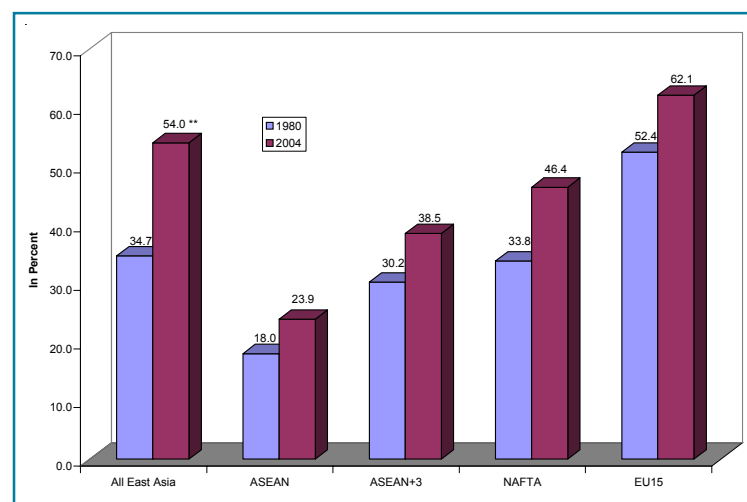
### Policy implications

Policymakers in the Philippines should realize that FTAs are neither necessary nor sufficient for economic growth. Hence, there should be a de-emphasis on the current trend to negotiate FTAs, most of which are knee-jerk reactions to the initiatives of other countries.

As a rule, despite the difficulties and drawbacks surrounding FTAs, they could still be pursued by countries. However, because FTA negotiations require resources, developing countries should be prudent on what FTAs to consider. Moreover, countries should be aware of the actual benefits of FTAs in order to determine the extent of negotiations.

Granted that the economic benefits of FTAs may be overstated, it is acknowledged that the primary purpose of integration is primarily political and the economic consequences—good or bad—are side effects of the political payoff.<sup>3</sup> The argu-

Figure 2. Intraregional trade (as share of total trade)



<sup>2</sup>2003 value obtained from Kawai and Motonishi, *Is East Asia an optimum currency area?* Paper delivered at the Conference on Financial Interdependence and Exchange Rate Regimes in East Asia sponsored by the Japan Ministry of Finance Policy Research Institute, December 2-3, 2004.

All East Asia is ASEAN+3, Hong Kong and Taipei, China

Source of other basic data: IMF Direction of Trade Statistics (DOTS) CD-ROM, October 2005

<sup>2</sup> Neither was outward orientation a result of trade liberalization.

<sup>3</sup> World Bank, *Trade blocs. Policy Research Report*, Washington, D.C., 2000

ment is that making an FTA work requires political commitment, which translates more readily into political gains. It is also argued that the political windfall leads to significant economic gains.

Entering into formal arrangements enhances regional peace and security. This was actually the main impetus for European integration. The China-ASEAN FTA, for example, should pave the way for a faster resolution of the Spratlys issue. In this regard, the insistence by ASEAN on accession by prospective partners to its Treaty of Amity and Cooperation is an important cornerstone in improving peace and security in the region.

A formal arrangement should help countries either lock-in domestic reforms or accelerate implementation of proposed reforms. International agreements can act as commitment mechanisms, providing policymakers with the needed leverage to overcome domestic resistance to reforms. An FTA can also provide a government with cred-

ibility, thereby boosting domestic and foreign investment in the country.

An East Asian FTA should make member countries more mindful of the development gap in the region. One possible objective of an FTA is a desire to help neighboring countries stabilize and prosper, both for altruistic reasons and for the avoidance of possible spillovers of unrest and population.<sup>4</sup> The response may not be unlike the tributary system established by the ancient Chinese emperors. In the modern context, narrowing the development gap will strengthen ASEAN and a strong ASEAN will be an effective bridge between countries of Northeast Asia.

Finally, an FTA will boost the political bargaining power of the countries involved by signaling their agreement to band together to pursue common interests. Having China—and Japan and Korea for that matter—on its side will definitely enhance the political stature of ASEAN and vice-versa. One area that can be revived through advocacy by a China-ASEAN front is the reform of the international financial architecture. Efforts toward such measures were sidelined by indifference of the US Treasury.

Another important area that could be addressed jointly is the trans-Pacific macroeconomic imbalance. Currently, policy proposals to correct this imbalance that are played up in the media are focused on revaluing East Asian currencies, particularly the yuan. A united East Asian front could throw its weight toward a solution that emphasizes fiscal consolidation by the US, which makes more economic sense. For example, imposing a 50 percent fuel tax in the US will address many outstanding problems such as: 1) the surge in international fuel prices and depletion of oil reserves; 2) instability of international capital flows; 3) the US fiscal deficit; and 4) the trans-Pacific macroeconomic imbalance itself. ☐

**Table 3. Share of China and Australia in ASEAN and Japan exports (in percent)**

	1995		2000		2004	
	China	Australia	China	Australia	China	Australia
Indonesia	3.8	2.0	4.5	2.4	6.4	2.6
Malaysia	2.6	1.5	3.1	2.5	6.7	3.3
Philippines	1.2	0.8	1.7	0.8	6.7	1.2
Singapore	2.3	2.2	3.9	2.3	8.6	3.7
Thailand	2.9	1.4	4.1	2.3	7.3	2.5
Japan	5.0	1.8	6.3	1.8	13.1	2.1

Source of basic data: IMF Direction of Trade Statistics (DOTS) CD-ROM, October 2005

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<sup>4</sup> Schiff, Maurice and L. Alan Winters, *Regional integration and development*. The World Bank, Washington, D.C., 2003