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The New Regionalism in East Asia: Implications for Indonesia *

Introduction.

Movement towards formation of new regional and cross-regional preferential trading arrangements involving East Asian and Pacific countries has gathered strength in the past few years. The move to promote free trade agreements (FTAs) on the part of East Asian economies may be viewed as a defensive response to other regional and global developments that will be elaborated upon below. The tendency for more countries to join in preferential trading arrangements threatens to create a parallel, yet separate, architecture alongside the multilateral trading system. Indonesia must take notice of the new East Asian regionalism as it involves some of its largest trading partners.

Rise in Notifications to WTO.

Since the WTO has come into being in 1995, there has been a noticeable increase in the number of preferential trading arrangements. Presently, over 200 regional trading arrangements have been notified to the WTO and 159 such agreements are in force.¹ Of these 159 agreements, 129 have been notified under GATT Article XXIV, 12 under General Agreement on Trade in Services (GATS) Article V and 18 under the Enabling Clause (applicable to developing countries). The vast majority of notified agreements (115) are free trade agreements (FTAs) with only 14 in the form of customs unions (CUs) or common markets.

Many of the new regional preferential trading arrangements globally are centered around the two main "hubs" for international trade, the United States and the

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¹ See the World Trade Organization homepage: www.wto.org for details.

European Union (EU). However, numerous new players are now endeavoring to establish preferential agreements.

A framework is needed to understand the recent proliferation of preferential trading agreements. Economic theory instructs that such arrangements are likely to have questionable, at best, impacts on overall international economic well-being. There is even uncertainty regarding the impacts upon the parties entering into such agreements.²

Understanding of the potentially harmful effects of preferential trading agreements begins with a focus on the discriminatory nature of such arrangements. Ultimately, the question centers on whether or not such arrangements advance or retard the multilateral system in liberalizing trade and bringing greater amounts of trade under a rules-based system. This is an extremely important issue, given that the GATT/WTO system has served the world so well since 1947. The East Asian region, including Indonesia, has certainly gained a great deal from the open multilateral trading system as exports from industries in these rapidly industrializing countries had access to major markets and made substantial inroads in terms of market share in the major industrialized countries.³ Not least of these gains arose from the trade and investment liberalization undertaken by the East Asian countries themselves, on a non-discriminatory basis.

The New Regionalism: Opportunity or Threat?

A plethora of discriminatory regional arrangements are being studied and some are already being negotiated, including at least 20 new initiatives involving East Asian countries in the past three years, with more possibly in the offing (see the Table below).

² Panagariya (1999 and 2000) and Bhagwati and Panagariya (1996) present arguments in this respect.

The New Asian Regionalism: Free Trade Agreements

FTAs Involving Singapore:

1. Singapore-Japan FTA (under negotiation, 1999)
2. Singapore-New Zealand FTA (signed 1999)
3. Singapore-Canada FTA (proposed 2000)
4. Singapore-India FTA (proposed 2000)
5. Singapore-Mexico FTA (negotiation 2000)
6. Singapore-EU FTA (proposed 2000)
7. Singapore-USA FTA (negotiation 2000)
8. Singapore-Australia FTA (negotiation 2000)
9. Singapore-EFTA FTA (proposed 2000)

FTAs Involving Japan:

1. Japan-Korea FTA (proposed 1998)
2. Japan-Mexico FTA (proposed 1998)
3. Japan-Chile FTA (proposed 1998)
4. Japan-Singapore FTA (negotiation 1999)
5. Japan-Canada FTA (proposed 1999)

FTAs Involving Korea:

1. Korea-Japan FTA (proposed 1998)
2. Korea-Mexico FTA (proposed 2000)
3. Korea-New Zealand FTA (proposed 2000)
4. Korea-Chile FTA (proposed 2000)

Other FTAs Involving E. and S.E. Asian Countries⁴:

1. AFTA (ASEAN FTA)
2. AFTA-CER (ASEAN FTA with Australia and New Zealand)
3. PAC5 FTA (Singapore, Australia, New Zealand, Chile and USA)
4. Hong Kong-New Zealand FTA (proposed 1999)

Source: Author's Compilations

³ See Lloyd and Toguchi (1996). James and Movshuk (2000) provide updated analysis of import penetration in manufacturing in Japan, South Korea, Taiwan and the US.

⁴ China has proposed an ASEAN-China FTA in 2000, however, it is unlikely to move forward soon. Other initiatives involving ASEAN and East Asia such as "ASEAN Plus Three" (China, Korea, Japan) are not likely to form into a preferential trading bloc in the near future. However, Japan, Korea and China themselves have had discussions of a possible tripartite FTA.

The emphasis on regional and cross-regional free trade agreements in East Asia is in part a response to moves towards increased economic integration in Europe (the eastward expansion of the EU) and in the Western Hemisphere (the Free Trade Area of the Americas—FTAA). The shift from pure multilateral approaches in countries such as Japan and Korea and the activism in seeking FTAs within the region and outside, particularly on the part of Singapore, can also be viewed as a response to the failure of the Seattle Ministerial to launch a new WTO round.⁵

The East Asian countries that are actively negotiating new FTAs are all relatively developed and industrialized economies (Singapore, Korea and Japan). The partners they are approaching are also advanced industrial countries or relatively advanced developing countries such as Chile and Mexico. Singapore has made it clear that it is impatient with the progress in trade liberalization with its ASEAN partners in its pursuit of FTAs with numerous relatively advanced economies both in the region and across the oceans.⁶ The phenomenon of “cross regional FTAs” involving partners such as Singapore and Mexico is also noteworthy.

It is instructive to consider the effect these arrangements may have on member and non-member countries. Consider, for example the perspective of Taiwan or Indonesia, which are not invited into any of the new arrangements arising in the region (save for Indonesian participation in AFTA—the ASEAN Free Trade Agreement). For example, bilateral free trade agreements are in the works between Singapore (Indonesia’s third largest market, Taiwan’s 5th biggest market) and several other major Asian and Pacific partners. Moreover, Japan (Indonesia’s largest export market, Taiwan’s 4th largest market) and Korea (Indonesia’s 4th biggest market in

⁵ Low (2001) covers the Singaporean strategy.

⁶ ASEAN partners are concerned that Singapore may become a “back door” through which imports may enter the region. ASEAN has taken several initiatives of its own, notably the ASEAN plus 3 (APT) with Korea, China and Japan.

1999 and 2000 and Taiwan's 6th biggest export market) are in the process of discussing the terms and conditions of a closer economic relationship, including the possibility of a free trade agreement.⁷

Indonesia has limited its participation in regional arrangements to Association of Southeast Asian Nations (ASEAN) Free Trade Agreement (AFTA) and the Asia Pacific Economic Cooperation (APEC) forum. APEC, however, is a voluntary, non-binding accord.⁸ If Indonesia remains outside the rapidly developing regional arrangements, Indonesian exports will face tariff discrimination in some of the major Asian markets just as is already the case in Europe and the Western Hemisphere.⁹

A Framework for Analysis of Regional Trading Arrangements.

The standard framework for analysis of the effects of regional agreements on economic welfare in member and non-member countries, is based upon the concepts of trade creation and trade diversion.¹⁰ Trade creation arises when member countries substitute lower-cost imports from the partner country for domestic production. Consumer benefits from the displacement of inefficient domestic producers by imports from efficient producers within the block more than outweigh losses in domestic producer surplus and government tariff revenue, thus enhancing economic well-being. Trade diversion takes place when tariffs are reduced on imports from inefficient producers in partner countries but are maintained on the efficient producers outside the block. Thus, imports from high-cost producers displace lower-cost imports from non-members. Consumer losses from trade diversion exceed the gains

⁷ IDE/JETRO (2000), James (2001), and Yamazawa (2000) provide discussion of the analysis of Korea-Japan trade ties and the outlook for a free trade agreement.

⁸ Indonesia has also supported so-called "growth triangles" but these are essentially informal in nature.

⁹ The severity of the impact on Taiwan and Indonesia in terms of market share cannot be determined without careful empirical analysis of trade composition and tariff and non-tariff barriers and price elasticities of demand. It may be useful to examine the effects of a Korea-Japan FTA in this context in order to gain perspective on the likely trade diversion that may be caused.

in producer surplus within the block. In addition to the losses in consumer benefits, one must also take into account lost tariff revenue in evaluation of these agreements.¹¹ This effect depends on the so-called "margin of preference" or the difference between most favored nation tariffs and preferential tariffs.¹²

The proliferation of FTAs as opposed to CUs, however, makes it imperative to conduct analysis devoted to the particular nature of such arrangements, which depend upon rules of origin for enforcement of tariff preferences, as was first pointed out in Shibata (1967). The framework for analysis using the traditional measures of trade creation and trade diversion is very difficult to implement empirically and very few applications of the framework are free of serious flaws.¹³

Although the standard framework provides a useful starting point in theory, coming up with empirical estimates of the effects of free trade agreements with existing data requires special simplifying assumptions. Analysis of an FTA must take into account the trade-diverting effects of rules of origin and trade in intermediate goods involving at least three countries. Alternative assumptions to the model of perfect competition regarding market structure, such as imperfect competition and trade in differentiated products are also important considerations. Dynamic considerations such as investment and migration are sometimes accommodated in computable general equilibrium (CGE) models.¹⁴

¹⁰ Viner (1950) is the seminal work on this topic. While Viner confines his analysis to customs unions, it is applicable to other forms of regionalism.

¹¹ As Panagariya (1999: 58) points out, any FTA is likely to create trade in some sectors and divert trade in others. However, he asserts losses from trade diversion are likely to outweigh gains from trade creation, because of large revenue losses on diverted imports.

¹² Preferential tariffs are commonly assumed to be zero, but in practice they often are reduced gradually as is the case in NAFTA and AFTA. Non-tariff barriers that are maintained for non-members but that are waived for members increase the margin of preference but are difficult to quantify into tariff equivalents.

¹³ Among the most serious of these is obtaining accurate values for key parameters such as cross price elasticities of demand between domestic products, member products and non-member products.

¹⁴ CGE models are used to simulate the effects of such agreements but the results arbitrarily depend upon the assumptions made, particularly with respect to parameters such as elasticity of demand.

The ambiguous welfare impact of such arrangements is obvious, and the presumption towards the trade-diverting effect is reinforced once more realism is put into the models used. For example, analysis extending the model to imperfect competition (Krishna and Krueger 1994) finds that harmful effects of rules of origin on non-members become more pronounced. Such rules can vitiate the trade-creating effect of FTAs (James 1997, James and Stephenson 1995) and, under imperfect competition, could well lead to reduced output, a decreased volume of trade and higher prices.

The problem with analysis of the current generation of free trade agreements in East Asia is that it must be *ex ante*. It is extremely difficult to identify and quantify trade creation and trade diversion effects of preferential trading arrangements *ex post*, let alone *ex ante*. The data required are often difficult to observe or to collect. Moreover, in the real world parameter values may change, rendering analysis based on historical data questionable at best. Given these computational difficulties in assessing trade diversion and trade creation effects *ex ante*, an alternative method that makes use of data that are readily accessible and reasonably timely is recommended in carrying out empirical analysis of the possible effects of preferential trading arrangements. The single most relevant issue for Indonesia in assessing the impact of the various preferential arrangements under study or negotiation in the region is their potential for trade diversion to member countries at the expense of Indonesian exports. Methods of undertaking this type of analysis are discussed in the following section.

Quantitative Analysis of Preferential Trade Agreements.

It is of considerable importance to distinguish between Singapore and countries with which Indonesia has no preferential arrangements. As Singapore is a

free port, there is very little protection and trade diversion from Indonesia to the partner country in the Singapore market is not a large concern. Hence, trade diversion effects of FTAs involving Singapore only require analysis of the partner country, whereas agreements involving countries with which Indonesia has no such agreements require analysis of both partners' markets (e.g. Chile and Korea). Analysis can be undertaken making use of import and export data and tariff information.

Export data may be used to calculate indices of revealed comparative advantage (RCA) for Indonesia and member countries of various free trade agreements. It is recommended that RCA values be calculated at the 3-digit SITC, 6-digit HS or 4-digit ISIC level.¹⁵

RCA values of unity or above are said to convey a country's revealed comparative advantage in an industry, while values below unity reveal a comparative disadvantage in that industry.¹⁶ Once RCA values have been calculated for Indonesia and the partner country or countries in the FTA, they should be ranked and rank correlation coefficients should be calculated. This procedure will allow one to examine whether or not Indonesian comparative advantage is similar to either partner country and indicate whether or not the country is competitive or complementary to Indonesia.¹⁷

¹⁵ SITC data allow one to disaggregate the analysis to 217 product categories using 3-digit classification. ISIC data allow one to examine market share in apparent consumption of the importing country. However, these data are based on firm-level observations that do not allow for multiple-product firms.

¹⁶ The recommended formula for RCA values is that of Balassa (1965):

$$RCA_{cn} = (X_{cn}/X_{ct})/(X_{wn}/X_{wt})$$

Where RCA_{cn} is the index of revealed comparative advantage for country c in a particular industry n ; X_{cn} is the value of exports of country c in industry n ; X_{ct} is total exports of country c ; X_{wn} is world exports of industry n and X_{wt} is total world exports.

¹⁷ See Noland (1997) for an alternative methodology for examining export similarity.

Import data of the partner countries should then be used to compare import values and market share of Indonesia with the member countries, using HS or alternative classifications. The import data (obtained from national sources for the most recent year available or from international trade data bases such as *Statistics Canada*)¹⁸ should then be matched with tariff information (tariff classifications are by HS).¹⁹ The tariff information can be obtained from national sources or from the APEC Secretariat home page. Margins of preference may be obtained by comparing MFN tariffs with preferential tariffs.²⁰

An application of this approach is found in James and Movshuk (2000) for the case of Taiwan with Japan and Korea being the FTA member countries. Maximum and average values of imports from Japan and Taiwan in Korea are examined in order to estimate the potential amount of trade a Korea-Japan FTA might divert from Taiwan.²¹ The mean and maximum values of trade that may be diverted from Taiwan to Japan in the Korean market is estimated at \$1,795.5 million and \$3,353.7 million, respectively, in current prices.

A similar analysis could be conducted for Indonesia. As an example of why Indonesia must be concerned with market access in Korea, should Korea enter into preferential trade with partners such as Japan, Singapore, Mexico or China, consider textiles.²² In 2000, Indonesia exported over \$40 million of cotton yarn and fabric to Korea, despite the relatively high tariffs on these products in the Korean market (the tariff on cotton yarns (HS 5203-5207) is 15.1% and the tariff on cotton fabrics (HS

¹⁸ International trade data are published by sources such as the UN with a two-year lag. Hence, national sources are likely to be more up to date. However, international data from sources like *Statistics Canada* may be of better quality as these data are adjusted for re-exports and are consistent between importers and exporters.

¹⁹ Import data in other classifications (SITC or ISIC) may be concoded with HS if necessary.

²⁰ As most of the agreements are still being negotiated, some assumption must be made about the level of preferential tariff. Commonly, a zero tariff is assumed for flows among members of the FTA.

²¹ Taiwan is found to be competitive in the pattern of trade specialization with Japan and Korea.

5208-5212) is 18.1%. If Korea eliminates tariffs on cotton yarn and fabric imports from FTA partners, there could be a substantial negative impact on Indonesia, depending on the partner and the level at which the preferential tariff is set. Tariffs on synthetic yarns and fabrics (also a major export of Indonesia to Korea) are even higher with peak tariffs of 24.1%. In 2000, Indonesia exported over \$22 million of polyester yarn to Korea.

Exports of textiles and apparel to Japan, even greater than those to Korea, are also subject to tariffs typically exceeding 10%. Hence, preferential trade arrangements between Japan and partners that export textile products could prove to be trade-diverting for Indonesian producers. Numerous other examples could be cited.

It is clear that Indonesia needs to carefully evaluate the potential trade diversion from preferential trade arrangements involving its major trade partners. Once such an evaluation is completed, the necessary course of action, if any, can be determined.

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²² While the negotiation of the Korea-Japan FTA is "frozen", it remains a possibility. Korea and China may also decide to move ahead following a study of the proposed FTA between them.

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