Trade integration in Asia: Is the region pursuing a convincing strategy for the 21st century?

Nina Arbabzadeh and PD Dr. Heribert Dieter

GARNET Working Paper No. 79/10
September 2010

ABSTRACT

First the breakdown and then the deadlock of the Doha round of trade negotiations aroused worries over the future of multilateral trade regime; closer surveys of sub-regional and cross-regional economic trends in the Asia-Pacific region have only since exacerbated this cul-de-sac, raised concerns over viability of WTO, and have questioned the status-quo structure of global governance.

It is with respect to fairly recent economic trends of mushrooming 'bilateral' and 'minilateral' preferential trade agreements in Asia, and their respective 'spaghetti bowl effect' that this paper assesses prospects of regional integration in Asia-Pacific. It aims to demonstrate China's rise, with significant geopolitical and economic consequences, as the linchpin of burgeoning preferential trade agreements, and an overall trend away from multilateral trade talks in Asia. In addition, both bilateral and minilateral PTAs are sub-optimal and threats to the multilateral trading system. The alternative approach we suggest is a customs union. This model is both more ambitious than the currently implemented preferential agreements and would contribute significantly to the liberalisation of trade in South East and East Asia.

Address for correspondence
German Institute for International and Security Affairs, Berlin
E-mail: heribert.dieter@swp-berlin.org

Acronyms:

ACFTA	ASEAN-China Free Trade Area
APEC	Asia-Pacific Economic Cooperation
ASEAN	Association of South-East Asian Nations
AUSFTA	Australia-US Free Trade Agreement
CAFTA	China ASEAN Free Trade Agreement
CER	Closer Economic Relations
EAC	East Asia Community
EU	European Union
FTA	Free Trade Agreement
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GSP	Generalised System of Preferences
MNC	Multinational Corporation
NAFTA	North American Free Trade Agreement
PTA	Preferential Trade Agreement
TAC	Treaty of Amity and Cooperation
WTO	World Trade Organisation

1. Introduction

In the midst of the global financial crisis, international trade seemed to be collapsing. In 2010, however, trade is recovering quickly two years after the crisis broke. Asian economies have of course not been hit as hard by the global financial crisis as the European and American economies. After the crisis, their recovery is once again led by trade.

In Asia, encompassing economies of South East Asia as well as Australia and New Zealand, trade integration has been shaping the economic and political debate for decades. There has always been a distinction between market-led and policy-led trade integration. The former refers to the tendency of firms to obtain raw materials, intermediate products and end products across borders from the cheapest source. The second form is government-induced trade integration, in particular the creation of preferential trade agreements such as free trade areas and customs unions.

Lines demarcating between the two types of integration are however hazy. Market-led integration is not occurring in an economic space free of government regulation, but relies primarily on the multilateral regulatory framework that has been created by governments. The multilateral regulation of trade has of course been suffering in the last decade, both because of the unwillingness of WTO member countries to conclude the Doha Round of trade negotiations and due to the increasing competition from preferential trade agreements. Policy makers as well as companies involved in international trade perceive preferential trade agreements as a substitute for multilateral regulation. This can be observed in Asia and elsewhere.

In this paper, we will analyse the evolution of trade integration in Asia in the past decade. First, we will look at the actual development of trade in the region. Needless to say much of the increase of trade in the region is due to the phenomenal rise of China as a player in international economic relations. Subsequently, we will analyse the mushrooming of preferential trade agreements in Asia. Whilst their coverage and appeal varies, all of them contain the creation of a free trade area between the participating economies as a core element. We then discuss whether this is a wise approach and analyse the limited utility of preferential trade agreements in an era of growing economic integration including the increasing use of intra-regional productions networks. Against this background, we will discuss in the next chapter the prospects and efficacy of an Asian customs union.

2. Market-led trade integration

Of course, one of the main factors for the rise of trade integration, both market-led and policy-driven, has been the rise of China, occurring in a time when the USA under George W. Bush implemented a policy of hostile unilateralism. China has utilised this opportunity to fill the void. As America put security issues in the centre of its foreign policy, China demilitarised its rhetoric and policies. In contrast to previous decades, in the 21st century China promises a common future in harmony and prosperity. China's policy shift has resulted in a remarkable revision of perceptions in East Asia, as David Shambaugh has noted earlier this decade: "Today China is an exporter of goodwill and consumer durables instead of revolution and weapons" (Shambough 2004: 65).

In the early 21st, the rise of China has been the most important development for all Southeast and East Asian countries and their economic cooperation endeavours (Ravenhill 2008: 48). In recent years, China's clever diplomacy has made a significant contribution to the rise of the country's status in the region. China, for example, was the first non-ASEAN country to sign ASEAN's Treaty of Amity and Cooperation (TAC). It signed the TAC at the ASEAN summit in Bali in 2003, and by signing this non-aggression treaty Beijing has contributed to relieving fears of China's military intentions (Narine 2007: 214). China's current popularity among policy makers in Asia is also reflected by the numerous preferential agreements it has either been able to conclude or is negotiating.

In the last three decades, China has developed into an economic hub in Asia. Both in trade and in production, other countries in the region increasingly benefit from intensive relations with China. Today, about 50 percent of China's trade is intraregional. Moreover, China does not generate a large deficit or surplus in trade with its neighbours. Even for Japan, the world's second-largest economy, China is more important than ever. In 2009, China has replaced the US as Japan's largest export market, and China is the largest importer to Japan (IMF Directions of Trade 2009).

Of course, the rise of China to the world's largest exporter has been widely debated. However, the country has also overtaken Japan as the world's third largest importer (after the USA and Germany). This makes China a sought-after partner worldwide. Furthermore, the much-discussed trade surpluses of China are solely generated in trade with OECD-countries. In 2009, the surplus in trade with the USA was 143.6 billion dollars (with exports of 221.3 billion dollars) and the surplus with the EU 108.6 billion dollars (with exports of 236.5 billion dollars). By contrast, in 2009 China generated a *deficit* in trade with most of its Asian neighbours, including Japan and South Korea.

Table 1: China's major trading partners and trade balance (countries and regions) (2009)*

	Exports to	**Imports from**	**Balance of trade (EX-IM)**
ASEAN	106,389	106,322	67
South Korea	53,638	102,501	-48,862
Japan	98,044	130,928	-32,883
Australia	20,663	39,241	-18,577
New Zealand	2,086	2,475	-389
United States	221,384	77,772	143,611
EU	236,511	127,908	108,603
Total Trade	1203,420	1003,910	199,510

**Scale: Millions, Unit: US dollars*

Source: International Monetary Fund, Direction of Trade Statistics, 2009.

In many political systems, exports are considered more important than imports. This is particularly the case in those countries that have followed a strategy of export-led growth. Virtually all Asian countries fall into that category. Thus, China's trade profile may reflect a foreign policy strategy that aims at establishing China as an indispensable nation in Asia. Of course, this assessment requires further analysis. To start with, one has to ask how the government in Beijing has been able to steer the direction of Chinese exports and imports.

Nevertheless, it is evident that Chinese foreign economic policy has been much more successful in anchoring the country as a key player in Asian economic affairs than Japan.

Since 1990, Asian economies have significantly increased their share of global trade. In 2008, the emerging Asian economies (including India, without Japan) generated as much as one third of world trade, up sharply from 21 percent in 1990 (IMF 2008).[1] While trade with the rest of the world has also increased, the growth of trade within emerging Asia has been particularly spectacular. Intraregional trade between emerging Asian economies increased more than 9 times between 1990 and 2009 to close to 1,224 billion dollars (IMF DOT 2009). Both growth and volumes are remarkable when contrasted with the European Union (EU-15). In Europe, intraregional trade reached 3000 billion dollars in 2009, an almost threefold increase from 1990 (IMF DOT 2009).

In 2009, the share of intra-East and South-East Asian exports reached close to 41 percent of overall trade (UN ESCAP 2009: 9), not much lagging behind NAFTA (52.5 percent) or the European Union (EU-15, 59.2 percent). The number is even higher for imports, indicating closer integration. Intraregional import figures for this block reached 49 percent in 2009 (UN ESCAP 2009: 9), not significantly lower than EU's intraregional imports (64 percent) (IMFDOT 2009). In 2008, at 56 percent, the overall intraregional Asian trade reached almost a parity with that of EU (Pempel 2010: 214). As noted before, the main factor driving this impressive increase of intraregional trade and intraregional division of labour has been the rise of China. From 1997-2007 China' share of intraregional trade has doubled. In 2009, share of China in intra-East and South-East Asian imports alone was close to 33 percent (UN ESCAP 2009: 8)

In general, it can be observed that China has become more important as a destination of exports at the expense of established OECD-economies. Between 1990 and 2006, for the four most advanced newly industrialised countries of Asia (South Korea, Taiwan, Hong Kong, Singapore) China as an export destination grew from 7.9 to 25.4 percent, whilst exports to the rest of the world, including OECD countries, shrank from 57.0 to 38.3 percent. Even for ASEAN-countries, which directly compete with China, trade with China grew dramatically. In 1990, only 2.2 percent of exports from Indonesia, Malaysia, Thailand, the Philippines and Vietnam went to China, while in 2006 this figure had risen to 11.1 percent (IMF 2007: 44).

---

1 Emerging Asia, according to IMF definitions, includes China, India, Hong Kong, South Korea, Singapore, Taiwan, Indonesia, Malaysia, the Philippines, Thailand and Vietnam (IMF 2007: vi).

Since January 2008, and due to ripple effects of the 2007-2008 financial crisis, these impressive figures need to be adjusted. Despite the adverse effects of the financial crisis on emerging Asia's exports, the average share of exports to China has remained at 10 percent. Export figures from Hong Kong and Taiwan to China remain high, reaching 20 and 45 percent of total exports of these countries respectively (IMF 2009: 3).

In effect, these growing economic ties have led to a rise of China-centred regionalism, which can not only be recognized in an increase of cross-border trade and investment but also in the intensification of formal integration projects, probably the most important one being the China ASEAN Free Trade Agreement (CAFTA), in effect since 2010.

3. Why has the support for multilateral regulation of trade disappeared?

There are almost 400 free trade agreements and a few customs unions already recognized by the WTO. More are currently being negotiated and all regions of the global economy are participating. This could not be said a few years ago, as the entire Asia-Pacific region, for example, largely avoided these agreements. Countries like Japan and South Korea, and even Australia, were staunch supporters of the multilateral regime. Only ASEAN countries were advancing preferential trade within their ASEAN Free Trade Area (AFTA), which started in 1992. However, this pattern has changed dramatically. In recent years, no major economy has been willing to abstain from the current trend of bilateral trade agreements.

Both the US and the European Union have actively contributed to the weakening of the World Trade Organization's position in economic governance. While both continue to rhetorically support the WTO, in practice neither is providing the leadership in trade governance that characterized earlier periods, in particular the 1970's, 1980's and 1990's.

Immediately after 1945, the newly established American hegemony created the global economic order. In the aftermath of World War II, the US used its then unchallenged material and ideological power to set in place an international institutional framework for global economic governance. Although underwritten by US hegemony, the Bretton Woods System and the GATT were multilateral in both tone and practice. Though many countries were excluded or excluded themselves from the Bretton Woods regime, such as most countries of the Warsaw Pact, the regime was open and inclusive by definition. The GATT in particular was a tremendous success. Starting with 23 countries in 1948, the list of contracting parties grew longer rapidly, reaching 128 in 1994. The GATT quickly became a central pillar of global economic governance.

As such, the US saw the GATT as beneficial to its national interest and its view of world order. However, in the first decades after 1945, the US defined its interests broadly and in a sufficiently inclusive manner. Other countries felt able to sign onto a vision that stressed the importance of due process and the rule of law. Europe, an important player in trade policy after the completion of the customs union of the European Economic Community in 1968, by and large was a constructive force in supporting the further development of the multilateral trade regime. Asian players, in particular Japan and subsequently the rapidly emerging economies of Southeast and East Asia, were loyal supporters of the GATT and later the WTO. This is best exemplified by the fact that there were hardly any preferential trade agreements in Asia prior to the year 2000.

Nowadays, towards the end of the first decade of the 21st century, the situation has changed significantly. Since the days of the administration of George Bush Sen., the US has defined its national interest much more narrowly. Whilst the rhetoric of the Clinton Administration may have been more benign and gentle, it nevertheless pushed primarily its own agenda in international affairs. This pattern continues in the first years of Obama Administration, although with a change in rhetoric as not all policy is overshadowed by security concerns (Dieter and Higgott 2007: 151-174). Whilst President Obama has so far stay refrained from implementing trade restrictions, the continuing weakness of the American economy, particularly high unemployment, may result in a protectionist policy shift before the presidential elections in 2012.

Moreover, resentment towards multilateral, rule-based regimes is still a prevalent sentiment within most US policy circles. Even more importantly, in recent years Asian economies have firmly embraced preferential trade agreements (Pempel 2006: 239-254), although these policies have been causing some friction in the transnational production networks in the region. Nevertheless, the changing policy choices of Asian governments have resulted in a further weakening of support for the multilateral trade regime.

Of course, the multilateral trading system has always depended on the support of major players. The US had been the single most important supporter of the GATT in the first two decades after its implementation, nurturing a rules-based world trading system (Irwin 2002: 225). When the European Economic Community completed the creation of a customs union in 1968, Europe became the second major player in the multilateral trading regime. Some of today's important trading nations, China in particular, were not yet members at that time, while the countries under the influence of the USSR primarily traded with each other.

As such, the US and the EC continued to shape and further the multilateral trading regime in the three decades after 1968. While the evolution of the trading regime was neither linear nor without contradictions, it is clear that the GATT can be considered a success, both with regard to the liberalization of trade and the continuously expanding membership. Furthermore, during the bipolar era, all GATT negotiation rounds eventually managed to be completed, though often after long negotiations. The most important development, however, has been the creation of the World Trade Organization in 1995, which has been providing member countries with a substantially improved dispute settlement mechanism. Prior to the creation of the WTO in 1995, dispute settlement could be blocked by the party accused of an illegitimate policy. This has changed with the WTO; it is one of the few multilateral organizations where any country can take the EU or the US to court and have a legitimate chance of rectifying the situation, though it may take some time. The implementation of the dispute settlement mechanism was not only a milestone for the creation of a rules-based system of international trade, but it can also be interpreted as one of the few building blocks of global governance.

While the use of free trade agreements as instruments of foreign (economic) policy was pioneered by the EU and the USA, the use of free trade agreements has spread to other regions. Asian nations, which had avoided such agreements for a long time, have rapidly implemented numerous FTAs. Of course, this in part reflects the unresolved rivalry between China and Japan for leadership in Asia.

China has become one of the most active players pushing bilateral agreements. According to the Asian Development Bank's Asia Regional Integration Center, as of July 2010, China is participating in a total of 25 FTA s (both bilateral and plurilateral). 15 of them are across and within the Asia-Pacific region. Of this number 8 FTAs are proposed and 3 are under negotiation.[2] In 2010, China and the ASEAN countries have created the world's largest free trade zone by number of inhabitants, the ASEAN-China Free Trade Area ACFTA.

Table 2: Preferential trade agreements by status across Asia-Pacific as of July of 2010

		UNDER NEGOTIATION		**CONCLUDED**		
COUNTRY	Proposed	Framework Agreement Signed/Under Negotiation	Under Negotiation	Signed	In Effect	TOTAL
Brunei Darussalam	4	1	1	0	8	14
Cambodia	2	0	1	0	6	9
China	8	3	3	1	10	25
Hong Kong	1	1	0	1	1	4
India	11	4	7	0	11	33
Indonesia	7	1	1	1	7	17
Japan	6	0	5	0	11	22
Korea, Republic of	10	2	8	1	6	27
Lao PDR	2	0	1	0	8	11
Malaysia	3	1	5	2	8	19
Myanmar	2	1	1	0	6	10
New Zealand	4	1	3	2	7	17
Philippines	4	0	1	0	7	12
Singapore	4	1	9	3	18	35
Taipei	1	2	1	0	4	8
Thailand	6	4	3	0	11	24
Vietnam	3	1	2	0	7	13

**Source: Asian Development Bank, Asia Regional Integration Centre Data (2010)*

1. Proposed - parties are considering a free trade agreement, establishing joint study groups or joint task force , and conducting feasibility studies to determine the desirability of entering into an FTA.

2a. Framework Agreement Signed/Under Negotiation - parties initially negotiate the contents of a framework agreement (FA), which serves as a framework for future negotiations.
2b. Under Negotiation - parties begin negotiations without a framework agreement (FA).

3a. Signed - parties sign the agreement after negotiations have been completed. Some FTAs would require legislative or executive ratification.

[2] Asia Regional Integration Center (2010), Asian Development Bank (ADB), http://www.aric.adb.org/10.php/http://www.aric.adb.org/FTAbyCountryAll.php, last access: 09/08/10

3b. In Effect - when the provisions of an FTA becomes effective, e.g., when tariff cuts begin.

In the early 21st century there is an increasing rivalry between a handful of major players who are competing for both political and economic influence. The new battlefields are preferential trade agreements. Leading powers such as the US, the EU, and China are no longer emphasizing multilateralism, but are instead pushing for preferential agreements. This reflects both the inability to cooperatively advance the multilateral regime and the damaged position of the previous hegemon, the US. Since the start of the global war on terror, the US has lost popularity in many countries that traditionally supported the United States. The unilateral moment of US hegemony may have lasted shorter than some had predicted in the late 1990s (Zuckerman 1999). The financial crisis originating from the US has only contributed further to at least a temporary weakening of the US popularity (Altmann 2009:6).

The proliferation of bilateral PTAs represents the greatest divide between entrenched economic theory and short-term political practice in the global economy since the introduction of protectionist measures in the 1930's. Both economists and political scientists agree that bilateral trade deals are suboptimal and pose major threats to the multilateral trading system. When looking closely at some of the details, the disadvantages of bilateral deals become even more evident. One major drawback is that the important and useful dispute settlement mechanism of the WTO might be diluted because of the mushrooming of preferential agreements.

The traditional debate on this issue has been characterised by the 'stepping-stone' or 'stumbling bloc' arguments. Bilateral or minilateral agreements were regarded as either contributing to improvements of the multilateral regime or undermining it. However, until today, the multilateral regime has received very little, if any, stimulus from bilateral agreements. Indeed, the lasting stalemate in the Doha-Round can at least partly be attributed to the existence of alternative, bilateral regimes.

4. Mushrooming trade agreements in Asia

A decade ago, Asian economies by and large showed very little interest in trade regimes outside the WTO. This has changed dramatically. Today, a myriad of initiatives can be observed. Although the effects of these preferential agreements, most of them bilateral, may

be negative both for the welfare of the participating countries and for the stability of the multilateral trade regime; the frenetic activities of policy makers reveal their concerns about the current regime of global economic governance.
In previous eras, i.e. before the Asian crisis of 1997/98, countries in Asia were not closely tied together in the economic domain. In both Southeast and East Asia, the dominant model of development was characterised by a unilateral opening to the world market, primarily for exports, and virtually no regional cooperation with regard to joint macroeconomic or monetary policies. One expression of the dominance of unilateral economic policies is the fact that the finance ministers of ASEAN countries had never met in their official capacity prior to 1997. The linkage between economic instability and regional stability has emerged during the Asian crisis, and policy makers have been accepting this new reality surprisingly quick. For instance since 1998, in trade alone, there has been an 80 percent rise in the number of bilateral FTAs and a 90 percent increase in the number of plurilateral (arrangements with more than two parties) FTAs in Asia (ADB Asia Regional Integration Center data 2010).

The reasons for these changes in priorities are manifold. First, traditional security issues are no longer as important as they used to be. Whilst some tensions persist, there has been a remarkable reduction in armed conflict in the whole of the Asia-Pacific. The numerous conflicts that shaped foreign policy in the past – from the Korean and Vietnam Wars to the conflicts in Southeast Asia in the 1970s and 1980s – have either been solved or are dealt with in a non-military manner. Secondly, the countries in the Asia-Pacific, in particular the countries in Southeast and Northeast Asia, have learned that economic instability is a greater concern to them than classical security risks. The Asian crisis of 1997/98 has demonstrated that the lives of millions of people can be severely affected by economic turbulence. Moreover, the stability of some political systems in the region depends on the provision of economic growth, and a period of no or limited growth may put the legitimacy of governments into question. Thirdly, the economies in Asia are growing ever closer together. The deepening of transnational production networks, the growing share of intraregional trade and substantial investment flows provide the basis on which a process of regional political cooperation, resulting in regional governance of economic affairs, is gradually being built.

The ties between Asian economies have significantly deepened over the last two decades, and this change in economic interdependence has fuelled a range of political activities to secure this cooperation. Initially, market processes have driven the deepening of ties, but in recent years, these de facto integration processes have been augmented by political initiatives, i.e. integration by agreements. Integration by markets forces and integration by agreements are certainly not excluding each other, but are related and complementary (Aminian et al. 2008: 3).

In the last decade, dynamic processes have emerged that may lead to the creation of an integrated economic space in Asia. Of course, it is highly speculative to engage in a debate on the potential shape of such a regime, its membership and its relationship with non-participating economies. Nevertheless, given the high level of economic interdependence that can be observed already, the likelihood of a formalised, de-jure integration project in Asia seems to be quite high. A potential venue for this pan-Asian project could be the ASEAN-China FTA (ACFTA), which has come into effect in 2010. This large group, comprising more than 1.7 billion people, can over time alter the nature of economic relations in Asia and may possibly also change political and security relations in the entire region (Narine 2007: 205). Whilst there are numerous bilateral preferential trade agreements either in force or currently negotiated in Asia, ACFTA has the potential to serve as the nucleus of an Asian integration project. China has not only made sure that the FTA offers sufficient rewards to the less-developed members of ASEAN (Vietnam, Cambodia, Laos, Burma), but has also succeeded in attracting support of the more advanced economies, e.g. by providing so-called early harvest programmes for agricultural exports from Thailand.

5. The limited utility of preferential trade agreements

Bilateral free trade agreements are mushrooming all over the world. The enduring standstill in multilateral trade negotiations contributes further to this trend. In particular, the European Union (EU) is now pushing for bilateral agreements, *e.g.* with Asian countries. The European Commission is promoting agreements with ASEAN countries, while at the same time considering negotiations on an agreement with China. The trade agreement between South Korea and the EU, signed in October 2009, is a major development since it is the first FTA between a major Asian economy and the EU.

A major disadvantage of free trade agreements is the administrative burden caused by rules of origin. In an entirely open world economy with no restrictions on the flow of goods, these rules of origin would not matter because it would be irrelevant where goods originate. Today, however, the origin of a product matters, in particular in preferential agreements. All free trade agreements including bilaterals, require rules of origin to establish the ‘nationality’ of a product. The reason is that in FTAs participating countries continue to have diverging *external* tariffs. One country might have a high tariff on, say, cars in order to protect domestic producers, whilst the other might have a low or no tariff on that product. Since only goods produced within the free trade area qualify for duty free trade, there have to be procedures that differentiate between goods produced within the FTA and goods from the rest of the world. Thus, the preferential system becomes complicated and expensive. On average, the cost of issuing and administering certificates of origin is estimated to be five percent of the value of a product (Dieter 2004: 281; Roberts and Wehrheim 2001: 317).

In the past 40 years, the use of rules of origin has changed significantly. After decolonisation, many developing countries used rules of origin as instruments to enhance their economic development. Rules of origin were used to increase the local content of manufactured products and to protect the infant industries in those economies against competition from imports. This function of rules of origin is of relatively minor importance today. Rather, developed countries use strict rules of origin to protect their aging domestic industries.

When criticising the negative consequences of rules of origin, there is a caveat. By paying the appropriate tariff, they can be easily overcome. Since peak tariffs continue to cause difficulties in some sectors, the protectionist effect of rules of origin should nevertheless not be underestimated. The combination of tariffs and stringent rules of origin can be an efficient instrument for the protection of a market. One example for that approach is the textile market in NAFTA, where rules of origin require the yarn to be spun in NAFTA (the yarn-forward rule) or even the fibre to be produced in NAFTA (the fibre-forward rule), which is used for many textiles containing cotton. The consequence is that Canadian or Mexican textile producers cannot source their cotton from for example African cotton producers, but instead have to buy cotton from US producers. Rules of origin are opaque protectionist instruments.

6. Which way forward: Should East Asia create a customs union?

Drawing an argument for a case of customs union in Asia is against the backdrop of a growing number of bilateral and multilateral preferential trade agreements that have created the infamous case of Spaghetti Bowl effect within trade literature. There are instances where preferential trade agreements are interpreted as 'building blocks' of greater integration and multilateral liberalization but arguments against preferential trade agreements are more so prominent as PTA's are thought to impinge upon and not enhance multilateral liberalization. If trade liberalization is principled on lower costs, higher efficiency and is against discrimination, PTAs are said to complicate all such criteria. Overlapping PTAs are argued to create 'rules of origin' complications that at times increase costs as dissemination of production networks across regions and countries makes it difficult to determine where a product truly originates from. Arguments against preferential trade agreements also claim that they are discriminatory against poorer developing countries that do not enjoy 'appropriate' conditions to join a PTA, and more progressive opposing views deem PTAs as conflicting with WTO rules and principles.

The aim to do away with complications of preferential trade agreements (mostly bilateral in nature) is to propose a model that is more aligned with principles of multilateral liberalization and regional integration. Regional integration occurs when countries reduce and eventually eradicate barriers (both tariff and non-tariff) to the free movement of goods, services, capital and labour. The mainstream model of integration agrees upon a 'certain formal intergovernmental action', which moves linearly from its incepting point of a preferential trade area, to a free trade area, to a customs union, a common market, monetary union and finally economic union/integration (Breslin 2004: 3). The argument for a case of customs union in Asia therefore is a move across this linear paradigm and closer to regional integration.

By definition a customs union contributes to the elimination of trade barriers, tariffs and quantitative restrictions on trade amongst partners and imposes a harmonised external tariff on trade with third-party countries. This is the key difference with a free trade area; however technically different, in notion and purpose a customs union is akin to a free trade area as they are both said to increase specialization and trade with welfare benefits for the parties involved. An important benefit of a customs union is that it contributes directly to trade creation, i.e.

more expensive domestic products are replaced by cheaper imports from member countries. Vis-à-vis this positive outcome stands trade diversion, which potentially substitutes higher-cost imports from members with lower-cost imports of third-party countries. Because of tariff variations between member and non-member countries discrepancy in outcome occurs, and the net gains from a customs union will ultimately depend on the greater weight of one outcome over the other.

The feasibility and desirability of a customs union in Asia is assessed through determining whether trade creation prevails over trade diversion or the other way around. The Asian Development Bank's assessment of wealth gains from an Asian customs union divides factors that affect either trade creation or diversion into two groups of static and dynamic. Static factors are market size; levels of tariffs between members and non-members before a union; pre-union volume of trade; degree of economic development across the region and within individual countries; geographical proximity and transport infrastructure; substitutability between products of member vs. non-member states; and finally degrees of correspondence between economic structures of member states. It has been argued that static factors are easier to monitor and more convenient to gather information on. Dynamic factors are proved to be more difficult to measure and are hence at times overlooked. In summary the dynamic factors are the ones that free trade in general claims to triumph, and the ones that are at times controversial, especially within the north-south trade debate.

In the following paragraphs we will evaluate individual static and dynamic measures in order to assess the possibility of a customs union in Asia. Trade creation and thus a greater welfare gain of a customs union depends first and foremost on the size of the union. Although there is no definite data available on the ideal size of a union, past examples of NAFTA and the EU provide a reference point. ACFTA constitutes 11 economies (ASEAN countries and China); together these countries have a combined population of close to 1.88 billion people and a combined gross national income of $4.27 trillion dollars. With its already large size ACFTA does not break the record of either the EU or NAFTA in size but is nevertheless deemed large enough to pass the test of size (Estrada et al. 2008: 6).

Secondly, trade creation is directly related to and dependent on tariff levels. The higher the initial tariff levels, the higher the chances of trade creation after a customs union is formed. According to Asian Development Banks data despite an overall regional trend towards trade liberalization and China’s entry into the WTO, tariff barriers are high enough for trade creation after the union. At the dawn of ACFTA and before parties signed on to its framework agreement in 2002, tariff levels on ASEAN imports to China were as high as 9.4 percent in 2001 and for the reverse trend the tariff levels were 2.3 percent. Tariff levels should however be assessed not just amongst prospective union members but also for trade with third parties, since they too are consequential for direction of trade. The higher the level and variance of tariffs between members and non-members, the higher the chance of trade-diversion after a union. According to the WTO, tariffs of China and some ASEAN countries (Indonesia, Philippines, Thailand, and Singapore) for imports from non-members range from zero to 15 percent - with agricultural products accounting for higher numbers. Given the high levels and also the broad range of tariffs, there is a good possibility that a customs union could also result in trade diversion (ADB 2008).

It only makes sense that the creation of a customs union would enhance trade if countries involved already trade extensively with each other. The previous section of this paper has already argued that China and ASEAN countries trade heavily with one another, providing a bigger share of their export and import markets at an accelerating rate. This trend is a positive sign of pre-integration of intraregional trade and supports the creation of a customs union.

Despite high and increasing levels of trade between ASEAN and China, both of their major and top-ranking trading partners are third parties such as the US, the EU, Japan, Korea and Hong Kong. As 90 percent of trade of China and ASEAN is conducted with third party countries, substitutability of products between ASEAN and China versus those of third parties is questioned. Greater substitutability of products of member-states for those of non-member states provides a fertile ground for trade creation, but existing high levels of trade with non-members suggests lower levels of substitutability and lowers the chances of trade creation (Estrada et all 2008: 7).

Another pressing issue in creation of a union lies with the disparity in pre-integration levels of development. Data for income and development levels of ASEAN as a block of ten countries suggests that ASEAN and China are fairly similar. World Bank data shows that per capita gross national incomes of ASEAN and China are almost at par, but critiques argue that across ASEAN income and development levels are far from equal especially between more mature countries like Singapore, Indonesia, and Thailand versus Lao PDR, Myanmar and Vietnam.

Since almost equal levels of income and development are preconditions for bigger intra-industry trade (therefore trade creation), if one were to only consider income and development indices for ASEAN as a whole, there is immense opportunity for intra-industry trade creation upon a union.

Drawing from historical experience (especially from the EU's experience) existence of reliable and well-structured transportation infrastructures are necessary for a customs union. Unfortunately transport means both within ASEAN, China and across the two remain underdeveloped. This short-coming is most prominent across the less developed ASEAN countries and also some parts of China which border the peripheral ASEAN states (Lao PDR, Myanmar and Vietnam). Poor transport conditions need heavy investments in order for a customs union to function.

Last but not least, complimentary or competing economic structures and efficiency gains are perhaps the most important criteria when assessing the feasibility of a customs union. As ASEAN countries are heterogeneous in terms of income and development their individual sentiment for a customs union is also disparate. Countries like Thailand, Singapore, and Cambodia (especially the two former countries that are already close economic allies of China) demonstrate a positive approach to a free trade deal with China, as they perceive China's gigantic market and abundance in cheap workforce beneficial to their interests. Despite the general fear that China will redirect investment away from ASEAN, Thailand and Singapore believe that China's attractive investment environment will help to rid investors of the haunting memories of Asian Financial Crisis and once again boost investor confidence in the region's opportunities.

The creation of a free trade area will however put ASEAN countries in direct competition with China. Tighter competition will accrue to both domestic and third party markets, and it will be up to the Asian countries to win competition over China and also gain entry or broaden their stance within the Chinese market. Given that ASEAN countries' export structures are fairly similar to China their more advantageous position after a customs union is debatable (Tongzon 2005: 193)

There are a few industries in which ASEAN and China compete directly with one another; the key industries are textile and apparel, footwear, machinery and electrical appliances. As export structures for the listed industries are fairly similar between ASEAN and China, it will be up to members to weather the higher competitive storm after a union.

China’s abundance of labour, low unit labour cost, and big domestic market that results in operation of economies of scale already gives it a competitive edge in production and export of textile and apparel. A breakdown and a more detailed analysis of the textile industry show that competitiveness across this industry is not homogenous. China has a comparative advantage in cotton textiles, and countries such as Singapore, Malaysia and Thailand enjoy a comparative advantage in synthetic fibres. Despite disparity in comparative advantages between China and other ASEAN countries, China still dominates apparels’ export market, and is not likely to import more textile as an intermediate input from ASEAN in case of a customs union. Trends show a bias for high quality imports of textile from more advanced Asian countries of Japan and Korea into the Chinese market (Tongzon 2005: 196).

The footwear industry also has a similar but somewhat different story. China dominates the footwear export market but imports a good deal of leather as an input for its footwear production. ASEAN countries enjoy a comparative advantage in leather production and can take advantage of a customs union to grab a bigger share of leather imports into China.
Unlike apparel and footwear, ASEAN countries have so far had the upper hand in production and trade of machinery and electrical appliances, such that their export structures have come to increasingly depend on the production of this group of goods. Nevertheless a customs union could potentially jeopardise ASEAN’s stance as the Chinese share of export markets in machinery and electrical appliances has been growing at an accelerating rate. Although China’s production of this bundle of goods has not caught up with ASEAN (especially with Singapore), trade liberalization due to a customs union will put ASEAN at unease.

Despite competition in low cost-labour intensive industries, there is an array of possibilities for ASEAN to tap into the Chinese market under a customs union. This is achieved through the supply of intermediate capital goods that China imports (Tongzon 2005: 204). Although import of capital goods into the Chinese market will be countered by already high imports of goods of this nature from EU, Japan and US, a free trade area will provide an opportunity for ASEAN countries to increase their exports to China by supplying more rice, sugar, tropical fruits, natural rubber, timber, pulses and vegetable oils. Chinese growth and increased prosperity will also create demand for services such as tourism, banking and finance, insurance, accounting, and professional services, medical and education services where ASEAN countries come to play an important role. A customs union will also enhance FDI flow across the bloc, providing a chance for MNC's to disseminate different stages of production across various countries depending on their comparative advantage.

In terms of cost competitiveness, where ASEAN countries face a competitive disadvantage vis-à-vis China's low unit labour costs, there are ways to increase competition through means of providing one another with input material. For instance Thailand and Indonesia can provide the rest of the ASEAN countries with fabric at a lower cost. Countries may also set up supply chains amongst themselves to lessen competitive costs and benefit from each other's complementary potential. A customs union could also potentially promote 'sub-regional' growth areas in order for countries to pool resources and/or undertake joint development of natural resources, infrastructure and industries (Breslin 2004).

By forming a customs union, the unease associated with tougher competition, in areas where ASEAN's export structures have come to depend heavily, cannot be overlooked. It nevertheless is not inconceivable for ASEAN to maintain their competitive edge especially in production of machinery and electrical appliances. Continued and increasing access to export/import markets will depend on improving the quality of existing products, innovation, and greater production efficiency (Tongzon 2005: 201). Both education and technology play a crucial role in the process of improvement. ASEAN economies need to promote either R&D or access newly available technology, for instance by attracting advanced foreign companies. Technological improvements also require ASEAN to develop efficient institutions and infrastructure to diffuse this new technology once adopted. Given data shows that in technological advancements China ranks lower than countries like Malaysia, Thailand, Singapore and Philippines (Tongzon 2005: 209), so there is certainly room for manoeuvre notwithstanding tighter competition of a free trade area.

The creation of a customs union in Asia, however defined, would certainly not be an easy task. The key stumbling bloc is the creation of a joint external tariff, which would have to consider the diverging political preferences of all member countries. In essence, most participating economies would have to liberalise trade in sectors they previously considered too problematic for liberalisation; Japanese agriculture is a case in point. Even if the more advanced economies could politically accept the opening of their hitherto protected agricultural sectors, the effects of a common external tariff on the less developed member countries of an Asian customs union are to be considered. For these less developed economies, the creation of a customs union would result in a dramatic increase in competition, and most probably many industries would not survive such a shock.

Nevertheless, given the disadvantages of the current mess in Asian trade – characterised by overlapping and inefficient preferential trade agreements on the one side and lukewarm support for the multilateral system on the other – exploring the potential of an Asian customs union is a worthwhile endeavour. One potential avenue for solving the structural obstacles outlined above would be a structured introduction of a customs union, with developed economies including China taking the lead and the poorer economies following five or ten years later.

7. Conclusions

The arguments and evidence in this paper show that, taken together, preferential trade agreements have very few advantages. They are inferior to regulating trade in the WTO, and they are not as useful as large regional agreements can be, *e.g.* the EU or ASEAN. Bilateral free trade agreements are a third-best solution for regulating international trade. They violate established conditions for economic efficiency and they are imbalanced, because they disadvantage the poorer players and systemically strengthen the more developed players.

The trend towards bilateralism is often justified with the notion that simply relying on the WTO is like doing nothing. This is not the case. Multilateralism continues to function and to represent a superior form of regulation compared to preferential trade agreements. In trade policy, pushing preferential agreements is a second-best solution, if that. Furthermore, bilateral trade agreements contain an element of discrimination which is causing concern. In the 1930s, discriminatory preferential regimes were dominating the organisation of international trade. Today, we are returning to a regime where goods originating from befriended countries have easier access to a national market than others. There is discrimination between friends and foes. The post-war trading regime had the explicit goal of non-discrimination, and today's policy makers are sacrificing this philosophy for quick, but uneven and unsustainable, economic gains.

The irony is that Asian economies, who have been major beneficiaries of today's open trade regime, have firmly embraced the trend towards preferential trade agreements. This may be due to the perception that the World Trade Organisation has, in essence, been a transatlantic organisation. Whilst it is true that the GATT and subsequently the WTO have been shaped by the transatlantic powers, preferential trade agreements are not a sound alternative to the WTO. They cause high administrative costs, do not support the creation of intra-regional production networks and do ultimately not lead to a sustainable trade regime.

One of the key foreign policy questions in the coming two decades will be the modernization of the current regime of global economic governance. John Ikenberry has pointed out that while the rise of China is a challenge, so far the Chinese have operated within the existing order and refrained from staging a full-fledged confrontation (Ikenberry 2008: 37).

For Asian and other economies, including the European Union, the current trend towards preferential trade agreements is a policy error of massive dimensions. Beyond the ever-lasting rhetoric, major players, in particular China, the EU, Japan and the USA, should abandon preferential agreements and should return to the WTO as the main platform for regulating international trade. For Asia in particular, the current spaghetti bowl of trade agreements is neither efficient economics nor providing the participating economies with enhanced political influence. The only preferential trade agreement in the region that we consider to be sensible is an Asia-wide customs union, which would reduce transactions costs significantly and stimulate intra-regional trade beyond the existing levels.

8. References

Aggarwal, Vinod K.; Moo, Min Gyo (2008)(eds.): Asia's New Institutional Architecture: Evolving Structures for Managing Trade, Financial, and Security Relations, Heidelberg/Berlin: Springer.

Altmann, Roger C. 2009 Globalization in Retreat. Further Geopolitical Consequences of the Financial Crisis. Foreign Affairs 88 (4): 2-7.

Aminian, Nathalie; Fung, K.C.; NG, Francis (2008): Integration of Markets vs. Integration by Agreements, World Bank Policy Research Working Paper, WPS4546 (March 2008).

Asian Development Bank, Asia Regional Integration Center (2010): Trade and Investment Patterns, http://www.aric.adb.org/, last access: August 19th 2010.

Breslin, S. (2004): Greater China and the Political Economy of Regionalism. East Asia 21 (1): 7-23.

Corning, P.G. (2009): ‘ Between bilateralism and regionalism in East Asia: the ASEAN-Japan Comprehensive Economic Partnership’, The Pacific Review, vol. 22, no. 2, pp. 639-665.

Dee, Philippa (2005): The Australia-US Free Trade Agreement: An Assessment, in: Pacific Economic Papers, No. 345, available at http://www.crawford.anu.edu.au/pdf/pep/pep-345.pdf (accessed 11 August 2010).

Dieter, Heribert, and Richard Higgott 2007. Linking Trade and Security in Asia: Has Washington’s Policy Worked? Aussenwirtschaft. Schweizerische Zeitschrift für internationale Wirtschaftsbeziehungen 62 (II): 151-174.

Dieter, Heribert; Higgott, Richard (1998): Verlierer Japan – Gewinner China? Außenpolitische Konsequenzen der Asienkrise, in: Internationale Politik, 10/1998 (October), pp. 45-52.

Dieter, Heribert 2009. The Multilateral Trading System and Preferential Trade Agreements: Can Their Negative Effects be Minimised?, Global Governance. A Review of Multilateralism and International Organizations 15 (3): 393-408.

Dieter, Heribert (2004): Präferenzielle Ursprungsregeln in Freihandelszonen: Hemmnisse für den internationalen Handel? Aussenwirtschaft. Schweizerische Zeitschrift für internationale Wirtschaftsbeziehungen. 59. Jg., Heft III (September 2004), pp. 273-303.

Estrada, Gemma Esther B. Donghyun Park and Innowon Park (2008): Prospects of an ASEAN-PRC Free Trade Area: A Qualitative and Quantitative Analysis. ADB Economics Working Paper Series, Asian Development Bank, Oct. 2008.

Garnaut, Ross; Vines, David (2007): Regional free-trade areas: sorting out the tangled spaghetti, in: Oxford Review of Economic Policy, Vol. 23, No. 3 (2007), pp. 508-527.

Ikenberry, G. John 2008. The Rise of China and the Future of the West. Foreign Affairs 87 (1): 23- 37.

International Monetary Fund (2009): Regional Economic Outlook, Asia and Pacific, May 2009.

International Monetary Fund Direction of Trade Yearbook 2009, http://www2.imfstatistics.org/DOT/, last access: August 19th 2010.

International Monetary Fund (2007): Regional Economic Outlook Asia and Pacific, October 2007.

Narine, Shaun (2007): Economic Security and Regional Cooperation in the Asia-Pacific: Evaluating the Economics-Security Nexus, in: Acharya, Amitav, Goh; Evelyn (eds.): Reassessing Security Cooperation in the Asia-Pacific. Competition, Congruence and Transformation, Cambridge, Mass.: The MIT Press, pp. 195-217.

Oba, Mie (2008): Regional Arrangements for Trade in Northeast Asia: Multilateral Responses to Structural Changes, in: Aggarwal, Vinod K.; Moo, Min Gyo (eds.): Asia's New Institutional Architecture: Evolving Structures for Managing Trade, Financial, and Security Relations, Heidelberg/Berlin: Springer, pp. 89-119.

Pempel, T.J. 2006. The Race to Connect East Asia: An Unending Steeplechase. Asian Economic Policy Review 1: 239-254.

Pempel, T.J. (2010): ‘Soft Balancing, Hedging and Institutional Darwinism: The Economic Security Nexus and East Asian Regionalism’, Journal of East Asian Studies, vol. 10, pp. 209-238.

Ravenhill, John (2008): Asia's New Economic Institutions, in: Aggarwal, Vinod K.; Moo, Min Gyo (eds.): Asia's New Institutional Architecture: Evolving Structures for Managing Trade, Financial, and Security Relations, Heidelberg/Berlin: Springer, pp. 35-58.

Roberts, Michael/Wehrheim, Peter (2001): Regional Trade Agreements and WTO Accession of CIS Countries, in: Intereconomics, November/December 2001, pp. 315-323.

Shambaugh, David (2004): China Engages Asia, International Security, Vol. 29 (Winter 2004/2005), pp. 64-99.

Tongzon, J.L (2005): ASEAN-China Free Trade Area: A Bane or Boon for ASEAN Countries? The World Economy 28 (2): 191-210.

United Nations ESCAP (2009): Asia Pacific Trade and Investment Report: Trade led recovery and beyond.

Webber, Douglas (2007): Trade and Security in East Asia: Political (Non-?) Integration in an Insecure Region, in: Dieter, Heribert (ed.): The Evolution of Regionalism in Asia: Economic and Security Issues, London: Routledge, pp. 145-159.

Zuckerman, Mortimer 1999. A Second American Century. Foreign Affairs 73 (3): 18-31.