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EMERGING OPPORTUNITIES

A FREE TRADE FRAMEWORK FOR ASEAN AND CHINA

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INTRODUCTION

In a world increasingly characterized by regional trading blocs, East Asian countries, which heretofore oriented their export-dominated economies to markets in Europe and North America, have begun to see the value in securing markets closer to home.[1] In particular, the countries of the Association of Southeast Asian Nations (ASEAN) have several reasons for pursuing regional trading blocs larger than their own, i.e. the ASEAN Free Trade Area (AFTA). Over the last year, ASEAN and the People's Republic of China have begun exploring a mutual freer trading arrangement. For ASEAN, the promise of such an arrangement includes privileged access to the world's largest market, diversification of its export markets, increased volume of trade, the potential for sharing in the foreign direct investment pouring into China, the increased international leverage that comes with being part of such a potentially powerful bloc and the potential for embedding and stabilizing the region in economic growth rather than fractious conflicts.

This policy paper takes ASEAN as its client and suggests a framework for freer trade with China that is both feasible and likely to benefit all involved parties. First, it provides some background about ASEAN. Next, it makes the case for a freer trade arrangement with China. Then, it investigates the options for such an arrangements settling on a free trade area as the most feasible. Finally, it lays out an implementation plan for the design and establishment of a free trade area between ASEAN and China.

WHAT IS ASEAN?

On August 8, 1967, Indonesia, Malaysia, the Philippines, Singapore and Thailand signed the Bangkok Declaration creating the Association of Southeast Asian Nations. The declaration committed the countries of ASEAN "to alleviate intra-ASEAN tensions, to reduce the regional influence of external actors and to promote the socioeconomic development of its member states to further hedge against Communist insurgency." The 1975 Treaty of Amity and Cooperation bound ASEAN members to "fundamental principles" of respect for sovereignty and equality of member states, right of states to be free from external coercion, non-interference in domestic matters, peaceful methods for dispute resolution, renunciation of the threat or use of force and mutual cooperation. Presently, all Southeast Asian nations are members – Brunei Darussalam joined in 1984, Vietnam in 1995, Laos and Myanmar in 1997 and Cambodia in 1999.

Originally oriented towards security concerns, ASEAN's focus shifted to economic matters in the late 1980s. Authoritarian regimes oriented towards economic growth were or came to power in several key ASEAN states – Indonesia, Malaysia, Singapore and Thailand. They favored internationalist economic approaches designed to attract foreign direct investment, develop natural resources and focus manufacturing on exports.[2] Internationalist strategies gained momentum

[1] For a more detailed discussion of the theory and history informing free trade, see Appendix A.

[2] Etel Solingen, "ASEAN, *Quo Vadis*? Domestic Coalitions and Regional Co-Operation," *Contemporary Southeast Asia* 21 (April 1999), 35.

domestically and regionally with the entrenchment of like-minded political elites, private entrepreneurship growth and the growth of the middle class. (Radical nationalist and ethno-religious groups were increasingly marginalized.)[3] ASEAN countries pursued "open regionalism," which sought to increase trade within the region without violating the minimal requirements embedded in the WTO or discriminating against extra-regional partners.[4]

CHARACTERISTICS OF ASEAN MEMBERS

There are two key economic characteristics of ASEAN countries. First, most pursue policies of export-oriented growth directed toward markets outside the region. Second, the economies of ASEAN countries tend to be stratified between the relatively high-performing countries of the "inner core" – Indonesia, Malaysia, the Philippines, Singapore and Thailand – and the low-performing economies of the "periphery" – Brunei, Cambodia, Laos, Myanmar, and Vietnam.

The inner core countries account for slightly more than 98% of ASEAN's $71 billion trade surplus.[5] Trade, especially exports, for the "inner core" countries tends to be oriented toward non-ASEAN countries. By the early 1990s, intra-ASEAN trade accounted for no more than 18% of ASEAN's total trade and intra-ASEAN investment (mostly from Singapore) for less than 10% of that total.[6] Increasingly, "inner core" countries' exports are dominated by manufactured goods. Conversely, "periphery" countries' exports are dominated by natural resource and commodity exports.

Table 1. Exports of ASEAN Countries, 1996-2000 (in millions of dollars).

MEMBER COUNTRY	1996	1997	1998	1999	2000
Brunei	2,593	2,656	1,889	2,537	3,362
Cambodia	644	862	900	980	1,223
Indonesia	50,188	56, 298	50,371	51,242	62,150
Laos	321	317	337	302	350
Malaysia	76,859	77,390	71,823	83,933	98,099
Myanmar	930	1,011	1,113	1,138	1,375
Philippines	20,543	25,228	29,496	34,210	37,295
Singapore	126,010	125,746	110,591	115,639	138,936
Thailand	54,667	56,725	52,878	56,800	67,942
Vietnam	7,337	9,269	9,365	11,540	14,308
All ASEAN	340,092	355,502	328,763	358,321	425,400

Source: ASEAN Secretariat [http://www.aseansec.org]

[3] See Alasdair Bowie and Danny Unger, *The Politics of Open Economies: Indonesia, Malaysia, the Philippines and Thailand* (Cambridge University Press, 1997).

[4] See Ross Garnaut, *Open Regionalism and Trade Liberalization* (Singapore: Institute of Southeast Asian Studies, 1996) and Linda Y.C. Lim, "ASEAN: New Modes of Economic Cooperation," in *Southeast Asia in the New World Order,* edited by David Wurfel and Bruce Burton (New York: St. Martin's Press, 1996), 19-35.

[5] ASEAN Secretariat [http://www.aseansec.org]

[6] Solingen, "ASEAN, *Quo Vadis*?" 35.

Table 2. Imports of ASEAN Countries, 1996-2000 (in millions of dollars).

MEMBER COUNTRY	1996	1997	1998	1999	2000
Brunei	2,345	2,000	1,311	1,251	1,493
Cambodia	1,072	1,092	1,073	1,212	1,468
Indonesia	44,240	46,223	31,942	30,598	37,423
Laos	690	648	553	554	437
Malaysia	72,850	73,738	54,174	61,161	77,173
Myanmar	1,888	2,160	2,431	2,366	2,172
Philippines	31,885	36,355	29,524	29,252	30,380
Singapore	123,786	124,628	95,780	104,337	127,536
Thailand	70,815	61,349	40,643	47,529	62,423
Vietnam	10,480	10,569	10,346	10,460	13,680
All ASEAN	360,051	358,762	267,777	288,720	354,185

Source: ASEAN Secretariat [http://www.aseansec.org]

The "inner core" countries have higher levels of economic development and are more integrated into global markets than the "periphery" countries. Among the "periphery" countries are three states navigating the transition from centrally-planned economies to market economies – Cambodia, Laos and Vietnam. Myanmar has pursued an autarkic socialist development model. The only periphery country performing well is Brunei, which is dependent on oil exports.[7] From 1960 to 1997, income disparities between "inner core" and "periphery" ASEAN countries have increased due in part to the rapid growth experienced by Singapore, Malaysia and Thailand and the inclusion in ASEAN of the transitioning economies.[8]

Table 3. Per Capita GDPs of ASEAN Members 1996-2000.

COUNTRY	1996	1997	1998	1999	2000
Brunei	17,328	16,565	13,201	13,870	14,094
Cambodia	310	296	262	275	289
Indonesia	1,147	1,071	463	675	723
Laos	382	347	249	274	315
Malaysia	4,769	4,684	3,349	3,621	4,016
Myanmar	126	125	123	143	155
Philippines	1,156	1,129	891	1,030	990
Singapore	25,185	27,170	21,962	23,806	25,864
Thailand	3,040	2,507	1,847	2,006	1,986
Vietnam	328	349	357	364	396
ASEAN	1,483	1,384	930	1,072	1,121

Source: ASEAN Secretariat [http://www.aseansec.org]

According to World Bank classifications, Singapore and Brunei are high income, Malaysia is upper middle-income, Thailand, the Philippines and Indonesia are lower middle-income while Myanmar, Vietnam, Cambodia and Laos are low income. ASEAN contains one of the world's richest countries, i.e. Singapore, and some of the poorest, i.e. Myanmar, Vietnam, Cambodia and Laos.[9]

[7] Donghyun Park, "Intra-Southeast Asian Income Convergence," *ASEAN Economic Bulletin* 17 (December 2000), 288.

[8] Park, "Intra-Southeast Asian Income Convergence," 289.

[9] Park, "Intra-Southeast Asian Income Convergence," 286.

These income disparities bear heavily on regional economic integration since research suggests that integration is more fruitful when economies and income levels are similar. Countries with similar levels of economic development, economic and technological infrastructure and consumption patterns are more likely to trade with each other.[10]

ASEAN FREE TRADE AREA (AFTA)

In 1992, ASEAN agreed in principle to the creation of the ASEAN Free Trade Area (AFTA) with the goal of free trade in manufactured and processed goods by 2003.[11] AFTA's framework for trade liberalization called for the elimination of trade barriers among members while permitting member countries to retain control of their trade policies with third-party states.[12] The prospects for increased internal and external trade, attraction of FDI and the nurture of economic growth were among the motivations for AFTA's formation. H.E. Rodolfo C. Severino, ASEAN's Secretary-General, describes its objective as "to create an integrated ASEAN market for trade in goods. Such an enlarged market would attract investments much more effectively than the much smaller domestic markets."[13]

The AFTA plans centers around the Common Effective Preferential Tariff (CEPT), which is the tariff range members are permitted to impose on eligible products. (Initially, fifteen product groups were identified for inclusion: vegetable oils, cement, chemicals, pharmaceuticals, fertilizer, plastics, rubber products, leather products, pulp, textiles, ceramic and glass products, gems and jewelry, copper cathodes, electronics and wooden and rattan furniture.[14]) The six original AFTA members – Brunei, Indonesia, Malaysia, Philippines, Singapore and Thailand – agreed to include at least 90% of tariff lines in the CEPT scheme by the end of 2001, reduce their tariffs to 0-5% on all included products by the end of 2002 and increase the number of tariff lines that are duty-free by 2003. Deadlines for meeting these goals were extended for Vietnam (2006), Laos and Myanmar (2008) and Cambodia.[15]

Member countries were permitted to place products on a Temporary Exclusion List (TEL). Items on the TEL are excluded from the CEPT. However, these products will eventually be phased into the CEPT according to the following timetable.

1. Excluding Cambodia, Laos, Myanmar and Vietnam, member states will phase in sensitive products to the CEPT scheme beginning January 1, 2001 with flexibility, but no later than January 1, 2003 and will complete their phasing in by January 1, 2010.

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[10] See M. Jovanovic, *International Economic Integration: Critical Perspectives on the World Economy* (London: Routledge, 1998) and P. Robson, *The Economics of International Integration* (London: Routledge, 1998).

[11] See Chia Siow Yue, "The Deepening and Widening of ASEAN," *Journal of the Asia Pacific Economy* 1, no. 1 (1996), 59-78.

[12] Jeffery Heinrich and Denise Eby Konan, "Prospects for FDI in AFTA," *ASEAN Economic Bulletin* 18 (August 2001), 142. Brunei, Indonesia, Malaysia, the Philippines, Singapore and Thailand were the original AFTA members. Vietnam, Laos, Cambodia and Myanmar jointed afterwards. These last four members have extended deadlines for meeting tariff reductions.

[13] "Regional Economic Integration," 229.

[14] Singapore Declaration, 1992.

[15] Joint Press Statement, The Twelfth Meeting of the ASEAN Free Trade Area Council, 6 October 1998.

2. Vietnam will phase in sensitive products to the CEPT Scheme beginning on January 1, 2004, but no later than January 1, 2006 and complete the process by January 1, 2013. Vietnam will complete phasing in of sugar by January 1, 2010.

3. Laos and Myanmar will phase in sensitive products to the CEPT Scheme beginning on January 1,2006, but no later than January 1, 2008 and complete the process by January 1, 2015.

4. Cambodia will phase in sensitive products to the CEPT Scheme beginning on January 11, 2008, but no later than January 1, 2010 and complete the process by January 1, 2017.

5. Member states will phase in highly sensitive products to the CEPT Scheme beginning on January 1, 2001, but no later than January 1, 2005 and complete their phasing in by January 1, 2010.[16]

General exceptions are permitted for military industries in a manner consistent with Article C of the General Agreement on Tariffs and Trade (GATT). AFTA anticipates soon including raw agricultural goods into tariff reductions. As services become an increasing part of ASEAN economies, their liberalization will also be included in AFTA.[17]

How well has AFTA met these goals? By 2001, 85% of tariff lines – representing more than 90% of manufactured goods traded – were in the minimal 0 to 5% tariff range. By 2003, average tariffs on goods traded under the CEPT will be down to less than 4%. (It is currently at 4.3%.) The CEPT already includes all electrical and electronic goods and average duties imposed on them are already in the minimal range.[18]

Despite the difficulties encountered during the 1997-1998 financial crisis, the value of intra-ASEAN trade has risen steadily. Intra-ASEAN trade comprised less than 18.6% of trade volume for ASEAN countries in 1985 and 18.9% in 1990.[19] From 1993 to 1997, it rose from just under 21% to 23.7% of total trade. In 1998, it dropped to 22% due to the financial crisis, but has since begun to rise. From 1993 to 2000, the value of trade among the six initial ASEAN signatories nearly doubled from $82.4 billion to 159.6 billion as illustrated in Chart 1.

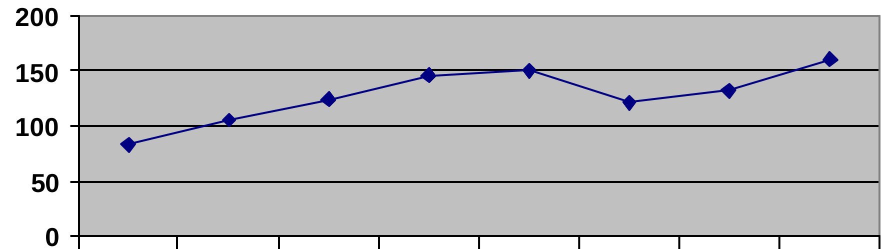
[16] Statement on Bold Measures, Sixth ASEAN Summit, Hanoi, 16 December 1998 and Joint Press Statement, The Fourteenth Meeting of the ASEAN Free Trade Area Council, Chiang Mai, 4 October 2000.

[17] "Regional Economic Integration: The Challenges Ahead. Statement by H.E. Rodolfo C. Severino, Secretary-General of the Association of Southeast Asian Nations at the Workshop on Beyond AFTA: Facing the Challenge of Closer Economic Integration, Bangkok [October 2002]." *ASEAN Economic Bulletin* 18 (August 2001), 229.

[18] H.E. Rodolfo C. Severino, "ASEAN Today: New Opportunities for Business," *ASEAN Economic Bulletin* 18 (August 2001), 225-227. However, automobiles and agricultural products remain heavily protected. (Agriculture is not included within the CEPT.) See United States Trade Representative, *2000 National Trade Estimate Report on Foreign Trade Barriers* [http://wwww.ustr.gov/reports/nte/2000/contents.html].

[19] Heinrich and Konan, "Prospects for FDI in AFTA," 155.

Chart 1. Intra-ASEAN Trade, 1993-2000



	1993	1994	1995	1996	1997	1998	1999	2000
Trade (in billons)	82.44	105.48	123.78	145.18	149.97	120.92	131.48	159.59

Intra-ASEAN exports account for nearly the same proportion of total trade as intra-regional trade for MERCOSUR (24.8% or $20.7 billion in 1997). This share is far greater than any other bloc of developing countries and in absolute terms exceeds all other such blocs (including MERCOSUR). However, intra-ASEAN export ratios are significantly lower than those of regional blocs primarily composed of developed states, e.g. more than 50% for NAFTA and the EU. Intra-regional trade accounts for 9.2% of regional GDP. Other than Singapore, which is the largest ASEAN trading partner for all other ASEAN states, ASEAN members appear to have similar enough comparative advantages that they are in competition with each other.[20]

Consequently, ASEAN trade remains directed to extra-regional markets. From 1993 to 1997, ASEAN's foreign trade grew at an average annual rate of 10.9% although this rate declined during the financial crisis. ASEAN is also the largest developing country regional bloc in global trade flows with total member exports accounting for 6.1% of global exports in 1998 (compared to MERCOSUR's 1.5%).[21]

ADDRESSING NON-TARIFF BARRIERS

Recently, AFTA has prioritized the removal of non-tariff barriers given their relative success in reducing tariff rates. The AFTA council stressed adherence to Article Five of the 1992 AFTA agreement that calls for the elimination of non-tariff barriers. Specifically, it requires the elimination of non-tariff barriers including on sensitive products by 2010 for the original AFTA members and by 2013 for Vietnam, 2015 for Myanmar and Laos and 2017 for Cambodia. It also requires that quantity restrictions on sensitive products be phased out by 2010 for the original AFTA members and by 2013 for Vietnam, 2015 for Laos and Myanmar and 2017 for Cambodia. AFTA has also developed other measures for standardizing customs procedures, harmonizing regulations and liberalizing non-tariff trade barriers.

- MONITORING OF NON-TARIFF BARRIERS. AFTA has developed a mechanism to monitor for potential non-tariff barriers, gather data and attempt to address private sector concerns about such barriers. Private sector companies were requested to forward complaints or

[20] Heinrich and Konan, "Prospects for FDI in AFTA," 152.

[21] Heinrich and Konan, "Prospects for FDI in AFTA," 152.

documentation of non-tariff barriers to their member countries and the ASEAN secretariat. The Council has agreed, in principle, to address other trade barriers including bureaucratic and administrative barriers, delays in decisions, etc. It has asked the ASEAN Chambers of Commerce and Industry and ASEAN private sectors to identify these barriers.

- ASEAN FRAMEWORK AGREEMENT ON MUTUAL RECOGNITION ARRANGEMENTS. Mutual recognition arrangements (MRAs) permit mutual recognition of differing technical standards for products across countries (like the EU approach) and reduce transaction costs through greater transparency of regulations. AFTA is developing MRAs on a sectoral basis beginning with telecommunications. Other sectors being considered are cosmetics, pharmaceuticals and electrical products.[22]

- GREEN LANE SYSTEM FOR AFTA PRODUCTS. Expanded to include all ASEAN products, the green lane system attempts to simplify intra-ASEAN trade procedures. It previously accorded expedited customs clearance for AFTA products through the presentation by importers of the CEPT Certificates of Origin. Now, procedures are being worked out by member states to expand green lane treatment to cover more products in ASEAN.

- STANDARDS HARMONIZATION. Among agricultural products, 64 pesticide maximum residual limits have been harmonized including for cabbage and tomatoes. In the manufacturing sector, international standards for 20 products were identified for use by ASEAN. These products include air conditioners, refrigerators, radio, telephone, television, video apparatus, printed circuits, monitors and generators, monitors and keyboard, mounted piezo-electrical crystal, tv and radio parts, loudspeakers and parts, inductors, capacitors, resistors, switches and cathode-ray tubes and rubber condoms and rubber gloves.

- COOPERATION IN CUSTOMS PROCEDURES. Harmonization of tariff nomenclature, customs valuation and customs procedures has been animated by five principles: consistency, appeals channels, simplicity, transparency, efficient procedures and customs mutual assistance. AFTA agreed to utilize the GATT Valuation Agreement and an ASEAN Common Customs Form for original signatories.[23]

ATTRACTING INVESTMENT

The ASEAN Investment Area (AIA) is designed "to increase its attractiveness to investments by integrating itself as a market for goods and services." It does so by permitting investments to move freely within ASEAN. Each ASEAN country opens itself up to investments from other ASEAN countries and prohibits discrimination against those investments.[24] AIA builds on previous investment protection agreements. The 1987 Promotion and Protection of Investments Agreement required fair and equitable treatment for ASEAN-based investment firms, prohibited discriminatory treatment of firms from other ASEAN member countries, protected regional firms against expropriation and guaranteed unimpeded repatriation of capital and earnings. The 1998 Framework Agreement on the ASEAN Investment Area (AIA) required members to simplify their investment

[22] Joint Press Statement, The Twelfth Meeting of the ASEAN Free Trade Area Council, 6 October 1998.

[23] Joint Press Statement, The Eleventh ASEAN Free Trade Area Council Meeting, 15 October 1997.

[24] "Regional Economic Integration," 230.

procedures and approval processes and to make transparent and predictable the laws and regulations governing foreign investment in member countries.[25]

AIA is designed to attract greater FDI from both ASEAN and non-ASEAN sources with a liberal and transparent investment environment for ASEAN investors by 2010 and all investors by 2020.[26] AIA projects include an ASEAN Supporting Industry Database providing information about supporting industries for manufacturers and suppliers in ASEAN countries, compendium of investment policies and measures in ASEAN countries and a Director of ASEAN Technology Suppliers to facilitate intra-ASEAN sourcing of technology and promote local technology suppliers to third countries.[27] ASEAN has also promoted itself jointly as one investment area in Japan, the United States and Europe.[28]

AFTA'S SUCCESS

Despite the negative effects of the Asian financial crisis on many ASEAN members, ASEAN economies are rebounding. They are working more closely together, increasing their imports and witnessing increased domestic demand. The Asian financial crisis demonstrated how integrated ASEAN economies have already become and provided the impetus for greater cooperation in financial and economic matters. ASEAN finance ministers have agreed to monitor macroeconomic developments in the region and suggest ways in which members could strengthen their economic fundamentals or push through needed economic reforms. They also have agreed to enlarge their currency swap arrangements in which members help each other in case of balance of payments difficulties.[29]

Meanwhile, the region's growth rates are projected between 4.5 and 5%. The IMF, World Bank and Asian Development Bank have periodically revised upwards their growth estimates. The exports of the six original AFTA members have surged by 7.7% from $316.6bilion in 1998 to 341.1 in 1999. Imports grew at the same rate from $259.5 billion in 1998 to 279.5 billion in 1999. The surge in imports reflects not only a rise in production requirements for exports, but also in domestic demand particularly for housing, commercial property and automotive products. Auto sales in Indonesia, Malaysia, the Philippines and Thailand rose 67% from 273,000 units in the first half of 1999 to 456,000 units in the first half of 2000. In Indonesia rose by 455% from about 24,000 to about 127,000. The automotive industry estimates that the demand for automobiles in the six major ASEAN markets – Indonesia, Malaysia, the Philippines, Singapore, Thailand and Vietnam – will hit 1.4 million units in 2003 and 1.6 million units in 2004 considerably surpassing the levels before the financial crisis.[30]

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[25] The text of the agreement is at [http://www.asean.or.id/economic/acm/30/frm_aia.htm].

[26] Heinrich and Konan, "Prospects for FDI in AFTA," 143.

[27] See Joint Press Statement, Meeting of the Fourth ASEAN Heads of Investment Agencies, Singapore, 24 July 1998.

[28] "Regional Economic Integration," 230.

[29] "Regional Economic Integration," 231.

[30] H.E. Rodolfo C. Severino, "ASEAN Today: New Opportunities for Business," *ASEAN Economic Bulletin* 18 (August 2001), 225-227.

ASEAN's experience with AFTA has produced limited success as indicated by its implementation of its goals ahead of schedule, increase in intra-ASEAN trade and ability to withstand the vicissitudes of the Asian financial crisis. So far, it has been less successful in mitigating the economic gap between the inner core and periphery ASEAN countries and increasing its FDI, which fueled economic growth in the 1980s and early 1990s. Since China's economic transformation in 1992, more of the region's FDI has flowed to China. For ASEAN, the challenge is to take advantage of the potential trade opportunities offered by the large China market, increase its own or share in China's foreign direct investment and improve efficiency and productivity of its economies.

WHY FREE TRADE WITH CHINA?

Why should ASEAN develop a freer trade arrangement with China? This section suggests four motivations: the potential trade opportunities available with China, increased attractiveness of ASEAN for FDI, improvement of efficiency and productivity of its own economies and the chance to promote regional stability. Next, it surveys the existing ASEAN-China relationship. It concludes by outlining the promise and perils of an ASEAN freer trade arrangement with China.

INCREASED TRADE OPPORTUNITIES

The case for increased trade opportunities resulting from an ASEAN-China freer trade arrangement is twofold. First, ASEAN-China trade, though small, is growing. However, additional growth in trade is thwarted by illiberal trade practices. Second, China's large potential market, evidenced by its population and GDP, suggest significant trade opportunities that ASEAN can pursue. (See Appendix B.)

The absolute magnitude of ASEAN-China trade is small, but growing. In 2000, ASEAN-China trade totaled $39.5 billion growing by an average of 0.4% annually since 1991 when trade amounted to only $7.9 billion. ASEAN countries increased their share of China's market from 6% of Chinese imports in 1991 to 9.9% in 2000. In 1996, ASEAN exports to China were worth $8.78 billion, a 102.5% increase over the 1993 figure. ASEAN countries were the destination for 6.9% of China's exports in 2000 compared to 5.7% in 1991. China's exports to ASEAN in 1996 were valued at $7.09 billion, an increase of 14.4% from 1995.[31]

Significantly, the trade numbers above exclude Hong Kong. When Hong Kong is included, the trade volume is significantly greater. In 1996, Hong Kong imports from ASEAN reached $21 billion up 8.2% from 1995. Part of these imports went through Hong Kong to China. Similarly, a majority of Hong Kong's $9.7 billion of exports to ASEAN were re-exports from China. With the return of Hong Kong to Chinese sovereignty in 1997, ASEAN-China economic relations assumed even greater importance. Including Hong Kong, China is ASEAN's third largest export market after Japan and the United States.

China's share of trade is much greater in the newer ASEAN countries, i.e. Laos, Myanmar and Vietnam, with which it shares borders. Anecdotal evidence suggests that border trade between these countries is an important element of the ASEAN-China economic relationship. Meanwhile, a significant number of ASEAN investors have set up joint ventures with the Chinese in numerous economic sectors in China ranging from real estate development and discount retail chain stores to

[31] From 1991 to 2000, China's foreign trade grew at an average annual rate of 15%. In 2000, its exports were worth $249.2 billion and its imports worth $225.1 billion.

motorcycle production and chicken farms. Chinese investors, relative newcomers in ASEAN, have also begun to establish a presence in Singapore and Indonesia.

International investors are attracted to China because of the potential of its market. According to mid-2001 estimates, China's population stood at 1.27 billion persons, which is 2.35 times larger than ASEAN's combined population. Although China's per capita GDP of $3,800 is low compared to developed countries, it is higher than ASEAN's average per capita GDP of $1,121. It is also higher than all but three of ASEAN's member countries – Singapore, Brunei and Malaysia.[32] Just as ASEAN economies now find themselves trying to keep pace with rising domestic demand in their own low- to middle-income countries, they are also well suited to deal with rising domestic demand for products in China.

INCREASED SHARE OF FOREIGN DIRECT INVESTMENT

In the 1980s and early 1990s, ASEAN countries grew rapidly, at an average pace of 7% annually. Rapid input factor accumulation especially capital from foreign direct investment was essential to this growth.[33] Since 1997, FDI into ASEAN countries has declined as a proportion of global FDI and FDI directed to developing countries. The decline has been attributed to the competition with China for FDI,[34] lack of liberalization and the Asian financial crisis. Whatever the cause, ASEAN economic policies are motivated, at least partially, by a desire to enlarge its share of FDI. Economic integration with China may help it do so.

In 1991, the ASEAN region attracted about a third of FDI flows to developing countries in 1991. From 1993 to 1996, that share hovered around 20% and began to drop precipitously thereafter falling to slightly less than 8% in 1999.[35] FDI into the Asian region has remained above 50% throughout. This suggests that ASEAN's losses in FDI have rematerialized as China's gains. FDI flows into China increased from $33.787 billion in 1994 to $40.4 billion in 1999. In 1999, China's share of FDI flows to developing countries stood at 19.4% compared to ASEAN's 7.8%. In absolute terms, ASEAN lost more than $3 billion in FDI while China gained 6.6 billion. Singapore Trade and Industry Minister George Yeo noted that in 1999, China absorbed 40% of FDI coming into East Asia and that approved investments were increasing in anticipation of China's entry into the WTO. Meanwhile, ASEAN's share of FDI going into East Asia (excluding Japan) declined from 35% in 1996 to 17% in 1999. He also observed that a survey indicated that China was the second most attractive destination for global FDI.[36] Furthermore, the Japan External Trade Organization found that ASEAN bore the brunt of the decline of Japan's FDI to East Asia in recent years. Japanese investments in Indonesia, Malaysia, the Philippines and Thailand declined by more than half

[32] ASEAN Secretariat [http://www.aseansec.org]

[33] A. Young, "The Tyranny of Numbers: Confronting the Statistical Realities of the East Asian Growth Miracle," *Quarterly Journal of Economics* 110 (1995), 641-680.

[34] This concern about competition between ASEAN and China for FDI is not shared by many in the international financial community. Many believe that FDI flows to China and the rest of Asia have been complementary and not competitive. They suggest that there is a correlation between FDI flows to China and to the rest of Asia. See Trish Saywell, "Powering Asia's Growth," *Far Eastern Economic Review* 164, no. 30 (2 August 2001), 40-43.

[35] Heinrich and Konan, "Prospects for FDI in AFTA," 146.

[36] Joseph Y.S. Cheng, "Sino-ASEAN Relations in the Early Twenty-First Century," *Contemporary Southeast Asia* 23 (December 2001), 434.

between 1997 and 1999. In the first half of 2000, Japanese FDI into Korea, Taiwan and China increased while it plunged at rates between 27% and 70% in the original five ASEAN states.[37] While Yeo's concern about increasing competition between ASEAN and China for FDI may be warranted, other explanations for ASEAN's declining share of FDI have been promulgated including investors' perceptions of increased structural instability – political and economic and lack of investment liberalization[38] as well as the effects of the Asian financial crisis.[39]

Table 4. FDI Inflows into ASEAN Member States and Other Regions.

UNIT	1992	1993	1994	1995	1996	1997	1998	1999
World	**173.80**	**219.40**	**253.50**	**328.80**	**377.05**	**473.10**	**680.10**	**865.50**
Developed Countries	119.70	133.80	146.40	208.40	219.80	275.20	480.60	636.40
Developing Countries	49.60	78.80	101.20	106.20	145.00	178.80	179.50	207.60
-Asia	29.60	54.80	63.80	68.10	92.45	101.58	96.54	105.56
Eastern Europe	4.40	6.70	5.90	14.30	12.40	18.50	17.50	20.00
ASEAN	**12.107**	**15.994**	**19.681**	**21.645**	**29.635**	**27.638**	**19.479**	**16.188**
Brunei	0.004	0.014	0.006	0.013	0.011	0.005	0.004	0.000
Cambodia	0.033	0.054	0.069	0.151	0.294	0.170	0.120	0.130
Indonesia	1.777	2.004	2.109	4.348	6.194	4.677	-0.356	-3.270
Laos	0.008	0.036	0.059	0.088	0.128	0.086	0.045	0.079
Malaysia	5.183	5.006	4.342	4.178	7.300	6.500	2.700	3.532
Myanmar	0.171	00.149	0.091	0.115	0.300	0.400	0.300	0.300
Philippines	0.228	1.238	1.591	1.478	1.517	1.222	1.752	0.737
Singapore	2.204	4.686	8.55	7.206	9.100	8.100	5.493	6.984
Thailand	2.114	1.805	1.364	2.068	2.336	3.733	7.449	6.087
Vietnam	0.385	1.002	1.500	2.000	2.455	2.745	1.972	1.609
ASEAN % Change	53.10%	32.11%	23.05%	9.98%	36.91%	-6.74%	-29.52	-16.90
ASEAN's % of Global FDI	*6.97%*	*7.29%*	*7.76%*	*6.58%*	*7.86%*	*5.84%*	*2.86%*	*1.87%*
ASEAN's % of Developing Countries' FDI	*24.4%*	*20.3%*	*19.4%*	*20.3%*	*20.4%*	*15.5%*	*10.8%*	*7.8%*

Source: Jeffery Heinrich and Denise Eby Konan, "Prospects for FDI in AFTA" *ASEAN Economic Bulletin* 18, 2 (August 2001), 147.

How might economic integration with China help ASEAN recoup some of that share of FDI? The literature suggests three tendencies about FDI movement. First, FDI tends to move from high-tariff to lower tariff markets. Second, FDI gravitates towards larger, integrated markets *ceteris paribus*. Third, within trading blocs investment tends to increase at greater rates in the economically smaller members of the bloc. These tendencies tend to show themselves when all other factors are held equal.

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[37] Cheng, "Sino-ASEAN Relations in the Early Twenty-First Century," 437.

[38] Cheng, "Sino-ASEAN Relations in the Early Twenty-First Century," 437.

[39] The Asian financial crisis seems correlated with a steep reduction in private FDI in Indonesia, Malaysia, the Philippines and Thailand. Net private bank lending and foreign portfolio equity investment have been estimated to be negative. However, most ASEAN members, Indonesia, have shown signs of resumed FDI growth suggesting that the financial crisis' effects were temporary. Heinrich and Konan, "Prospects for FDI in AFTA," 146 and 155.

Integrated markets attract more FDI than "segmented" markets primarily because they permit greater rationalization of production under similar, if not, identical regulatory frameworks. The size of the market permits multinational companies to "consolidate production and service the market with exports from fewer regional plants, each producing more output." Integrated markets, with varying comparative advantages, provides the opportunity for firms to distribute production stages throughout the integrated market taking advantage of those varying comparative advantages. They also permit industries or firms to reap greater economies of scale.[40] These propositions have been empirically demonstrated regarding US FDI in Asia.[41]

The increased FDI attracted by larger, integrated markets tend to accrue disproportionately to the economically small countries. Within ASEAN, this would mean Laos, Philippines and Vietnam.[42] However, within a larger ASEAN-China preferential trading arrangement, benefits would tend to accrue disproportionately to the ASEAN countries. Small countries tend to benefit disproportionately from greater access to larger markets. Given the sensitivity of FDI to distortions, it is difficult to predict the effects of trade liberalization on its growth.[43] However, if the European Union model resonates at all with the potential of the ASEAN-plus-China trade liberalization, then FDI can be expected to increase especially for ASEAN states.

IMPROVED EFFICIENCY AND PRODUCTIVITY

Freer trade with a larger, dynamic partner like China should also result in improved efficiency and productivity for ASEAN and Chinese firms. These effects include the potential for firms to realize economies of scale, reduced transaction costs and productivity improvements due to mutual learning.[44] A preferential trading arrangement with China should help firms realize economies of scale (i.e. industries where production technology is characterized by decreasing costs) by providing larger, more integrated markets while minimizing the barriers presented by protectionist international trade.[45] Reduced tariff and, especially non-tariff, barriers also should lead to lower transaction costs. Minimizing those transaction costs, e.g. attending to varying regulations and standards, customs charges and the like, ought to result in cheaper prices for consumers and larger profits for firms. Lastly, productivity should increase as ASEAN and Chinese firms learn from each other both in cooperation and in competition. Products of this learning process typically include work methods, plant layouts, incentive programs and management techniques.[46] Like transaction costs, productivity

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[40] Heinrich and Konan, "Prospects for FDI in AFTA," 156-157.

[41] R. E. Lipsey, "The Location and Characteristics of U.S. Affiliates in Asia," NBER Working Paper No. 6876, National Bureau of Economic Research (Cambridge, Massachusetts, 1999).

[42] Konan and Heinrich, "Foreign Direct Investment and Host Country Trading Blocs," *Journal of Economic Integration* 15 (2000), 565-84.

[43] For example, multiple layers of distortion, e.g. governmental policies or imperfect competition, may affect FDI, but remain unaffected by trade liberalization. Regional trade liberalization, which by definition is piecemeal, may also have distorting effects. See Heinrich and Konan, "Prospects for FDI in AFTA," 155-156.

[44] Joachim Fels, "Trade Effects of Greece's Accession to the European Community," *Journal of World Trade* 22 (February 1988), 97-108.

[45] W. Cordon, "Economies of Scale and Customs Union Theory," *Journal of Political Economy* (June 1972), 466-475. See also Bhagwati, "Trade Liberalization among LCDs, Trade Theory and GATT Rules," in *Value, Capital and Growth: Essays in Honor of Sir John Hicks*, ed. J.N. Wolfe (Edinburgh: University of Edinburgh Press, 1968).

[46] H. Leibenstein, "Allocative Efficiency vs. X-Efficiency," *American Economic Review* 56 (June 1966), 392-415.

gains tend to benefit most from lowering of non-tariff barriers, especially industry-specific subsidies.[47] These benefits are particularly in the emerging regional high-technology industries.

PROMOTION OF REGIONAL STABILITY

Inclusion of China in an economic integration framework with ASEAN comports with the long-term ASEAN strategy of promoting regional stability through a security equilibrium and regional cooperation. First, it seeks to balance the major powers of the Asia-Pacific region so that no power dominates. Second, it seeks to foster regional cooperation between the northeast and southeast Asian nations.

ASEAN shares with the other regional powers a common interest in maintaining regional stability.[48] ASEAN attempts to maintain balanced relationships with the major Pacific powers – the United States, China and Japan – while avoiding neglecting Russia and India. This policy is designed to prevent any major power from dominating the Asia-Pacific region. Since China does not yet have the capability or, perhaps, the intention to become the predominant power in regional affairs, it also favors a multipolarity approach and welcomes ASEAN's balance of power strategy.[49]

In the 1990s, ASEAN states were able to maintain a security equilibrium in Southeast Asia and promote security cooperation in the region because all the major powers involved had neither the intentions not the capability to dominate region. Consequently, they were willing to allow ASEAN to take the initiative in the ASEAN Regional Forum (ARF) and other regional organizations.[50] Both ASEAN and China are eager to establish multi-layered channels of consultation on a bilateral and multilateral basis that realize their common interests in stability.[51] Economic integration of China and ASEAN helps contribute to that process.

ASEAN also seeks to promote regional stability through regional cooperation. The impetus for cooperation was quickened by the Asian financial crisis. The crisis prompted ASEAN leaders to turn to Northeast Asia for assistance just as Northeast Asian nations endeavored to exploit the evolution of AFTA. By then, about half of East Asian countries' foreign trade was intraregional and roughly two-thirds of their foreign investment came from within the region. In addition, they hoped increased regionalism would enable them to deal with Western countries from a position of strength on issues such as protectionism. (ASEAN states were disappointed with the failure of the Asian Pacific Economic Community [APEC] to push the WTO to launch a new round of global trade negotiations.)[52]

In the long term, ASEAN states attach a priority to East Asian cooperation following the formula of "ASEAN+3," i.e. ASEAN as well as China, Japan and South Korea. This plan was promised as the East Asian Economic Grouping by Malaysian Prime Minister Mahathir in the early

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[47] Plummer, "ASEAN and the Theory of Regional Integration," 205.

[48] Cheng, "Sino-ASEAN Relations in the Early Twenty-First Century," 426.

[49] Joseph Y. Cheng, "China's ASEAN Policy in the 1990s: Pushing for Regional Multipolarity," *Contemporary Southeast Asia* 21 (August 1999), 185.

[50] Cheng, "Sino-ASEAN Relations in the Early Twenty-First Century," 427.

[51] Cheng, "Sino-ASEAN Relations in the Early Twenty-First Century," 421 and 423.

[52] Cheng, "Sino-ASEAN Relations in the Early Twenty-First Century," 432.

1990s.[53] The EAEG proposal was opposed by the US and that opposition convinced Japan not to support it. Without Japanese participation, the plan was dropped.[54] ASEAN states learned to pursue a much more gradual process as Singapore Prime Minister Goh Chok Tong noted. These sentiments were echoed by Prime Minister Mahathir. Integration with China would be a first step in the gradual integration process with the three Northeast Asian powers.

EXISTING ASEAN-CHINA RELATIONSHIP

After decades of strained relations between China and many ASEAN countries, relations improved significantly between China and ASEAN as well as ASEAN member countries. Below, we outline the strengthening of China-ASEAN relations. Then, we survey the outstanding disputes between China and ASEAN, especially the Spratly Islands and Thailand. Finally, we note the existing agreements binding China and ASEAN.

STRENGTHENED CHINA-ASEAN RELATIONS

Sino-ASEAN relations took a turn for the better in the late 1980s and 1990s. In November 1998, Premier Li Peng summarized four principles that would animate the China-ASEAN relationship: (1) to strictly follow the Five Principles of Peaceful Coexistence in state-to-state relations; (2) to uphold the principle of opposing hegemony under all circumstances; (3) to uphold, in economic relations, the principles of equality, mutual benefit and joint development and (4) in international affairs, to follow the principles of self-reliance, mutual respect, close cooperation and mutual support.[55] In August 1990, China restored its diplomatic ties with Indonesia and then with Singapore in October 1990 and with Brunei in September 1991. In November 1991, it normalized party-to-party relations as well as state-to-state relations with Vietnam.[56] Formal dialogues with ASEAN quickly followed normalization of relations with ASEAN states. In July 1991, Chinese Foreign Minister, Qian Qichen, attended the ASEAN Ministerial Meeting (AMM) as part of a Chinese dialogue with ASEAN. In July 1996, it became a full dialogue partner. In 1994, China joined the ASEAN Regional Forum (ARF) and started regular senior officials meetings with the ASEAN states at the deputy foreign minister level. In December 1997, it joined Japan and South Korea in a summit with ASEAN.[57]

However, it was Chinese assistance in peacefully resolving the Cambodian issue that reinforced Sino-ASEAN trust. China pushed the Khmer Rouge to accept the United Nations peace plan in 1989-1990 when its leaders were inclined to resist diplomatic pressure from Western countries. In August 1990, Li Peng declared that China would not support a dominant role for the Khmer Rouge in Cambodia and cut off military support to the Khmer Rouge. Resolution of the Cambodian

[53] Francis Fukuyama, "Asian Values and the Asian Crisis," *Commentary* 105 (February 1998), 23.

[54] Cheng, "Sino-ASEAN Relations in the Early Twenty-First Century," 432.

[55] Cheng, "China's ASEAN Policy in the 1990s," 179.

[56] Cheng, "Sino-ASEAN Relations in the Early Twenty-First Century," 421.

[57] Cheng, "Sino-ASEAN Relations in the Early Twenty-First Century," 421.

situation permitted ASEAN states to approach all major powers in the region without alienating any of them and contributed to the normalization of relations between China and Vietnam.[58]

Sino-ASEAN relations were reinforced by Chinese financial support for ASEAN states during the regional economic crisis. China's relative economic health made it possible for it to offer Thailand $1 billion to help it overcome its financial difficulties and to provide assistance to Indonesia. In December 1997, at the summit among ASEAN, China, Japan and South Korea, President Jiang Zemin pledged $4 to 6 billion for the International Monetary Fund's program to assist Southeast Asia and to take part in other assistance programs. Chinese leaders also promised not to devalue the renminbi to avoid another round of competitive devaluations among Asian currencies.[59]

Despite this increased mutual trust between ASEAN and China, skepticism about Chinese motivations and influence remains a feature of several key ASEAN states. In Vietnam, the pro-China faction remains a minority while the majority is still suspicious of Chinese strategic designs. Indonesia President (and Suharto's successor) Abdurrahman Wahid was perceived to be friendly towards China. However, rising nationalism under the administration of Megawati Sukarnoputri may exacerbate Indonesian suspicions of China. However, since the mid-1990s, Malaysian Prime Minister Mahathir has often stated that his government accepts Chinese pledges of peaceful co-existence with its neighbors and non-interference in other countries' domestic affairs. He argues that it is important to accept Beijing's promises without reservation, otherwise a China threat may become a self-fulfilling prophecy if countries begin to perceive China as a potential threat.[60]

OUTSTANDING DISPUTES

The two most pressing disputes between China and ASEAN are ownership of the Spratly Islands and the status of Taiwan. The Spratly Islands dispute is the most significant for ASEAN states. These mostly uninhabited, oil-rich islands are claimed by China and several ASEAN states, i.e. Brunei, Malaysia, the Philippines and Vietnam. (Taiwan also claims sovereignty over the Spratly Islands, but has largely been ignored in the negotiation process.)[61] Frequent diplomatic confrontations and occasional military tensions have occurred over the islands. Dispute resolution concerning them has heretofore been managed in a piecemeal and ad hoc way.[62] The search for more stable dispute resolution mechanisms and confidence-building mechanism is thus a severe test for ASEAN. At the ARF meeting in August 1995, the Chinese government has indicated for the first time that it would abide by international law in sovereignty negotiations with claimants to the Spratly Islands.[63] A joint communiqué released after the ASEAN Foreign Ministers' Meeting in July 2001 made some progress toward a code of conduct aimed at easing South China Sea tensions. However, agreement remains illusive due to Vietnamese attempts to include the Paracel Islands in

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[58] Cheng, "Sino-ASEAN Relations in the Early Twenty-First Century," 423-424.

[59] Cheng, "Sino-ASEAN Relations in the Early Twenty-First Century," 425-426.

[60] Cheng, "Sino-ASEAN Relations in the Early Twenty-First Century," 441-442.

[61] Cheng, "Sino-ASEAN Relations in the Early Twenty-First Century," 440.

[62] Xavier Furtado, "International Law and the Dispute over the Spratly Islands: Whither UNCLOS?" *Contemporary Southeast Asia* 21 (December 1999), 386-404.

[63] Cheng, "Sino-ASEAN Relations in the Early Twenty-First Century," 424.

the accord, a move opposed by China, and Philippine insistence on a provision prohibiting claimants from further occupation of the islands, another commitment China is reluctant to make.[64]

Taiwan is a less significant problem in Sino-ASEAN relations. Despite intensive diplomacy by Taiwan, ASEAN states continue to hew to the "One China" policy. Since 1993, ASEAN states have refused to support Taiwan's initiative to seek a seat at the United Nations. It has also declined to endorse the proposal from August 1999 onwards, when it was presented by twelve states with diplomatic relations with Taiwan to the UN Secretariat seeking the admission of Taiwan to the world body. However, ASEAN states would not accept interference with their economic ties to Taiwan.[65]

Taiwan's economic significance to ASEAN is obvious. China's trade with ASEAN amounted to \$20.375 billion in 1995, \$21.158 billion in 1996, \$25.164 billion in 1997, \$23.798 billion in 1998 and \$27.101 billion in 1999. In comparison, Taiwan's trade with the ten ASEAN states amounted to \$29.708 billion in 1997, \$24.52 billion in 1998, \$28.77 billion in 1999, \$38.709 billion in 2000 and \$15.912 billion in the first half of 2001. Not only does Taiwan's volume of trade with ASEAN surpass that of China, but the ASEAN states have also enjoyed a trade surplus, which was \$0.781 billion in 1998, \$0.185 billion in 1999, \$1.753 billion in 2000 and \$0.246 billion in the first six months of 2001. In terms of investment, China's commitment in the ten ASEAN states is insignificant while investment flows from the latter to China amounted to \$2.655 billion in 1995, \$3.194 billion in 1996, \$3.428 billion in 1997, \$4.223 billion in 1998 and \$3.289 billion in 1999. In the case of Taiwan, it receives very limited investment flows from the ASEAN states, but Taiwan's total investment in Indonesia, Malaysia, the Philippines, Singapore, Thailand and Vietnam amounted to \$587 million in 1996, \$641 million in 1997, \$477 million in 1998, \$522 million in 1999 and \$389 million in 2000.[66]

EXISTING SINO-ASEAN AGREEMENTS

ASEAN and China have made some preliminary agreements moving towards greater economic integration and freer trade. They include tariff reductions, common customs valuation and common public policy task forces. According to ASEAN-China agreements, China's average tariff level for ASEAN products will be reduced by 34% to 47% within five years. Other trade barriers on ASEAN products will be largely reduced. Five ASEAN members – Indonesia, Malaysia, Philippines, Singapore and Thailand – have implemented customs valuation methods in accordance with the WTO Valuation Agreement. China will implement the agreement gradually after its entry into WTO. The other member countries of ASEAN are at various stages of preparation in implementing the same with completion dates ranging from 2001 to 2005. Finally, ASEAN and China are engaged in several common public policy task forces. (See Appendix C.) At its third meeting in March 2001, the ASEAN-China Joint Cooperation Committee (ACJCC) considered new proposals in the areas of information and communications technology, human resource development, agriculture, trade and economy, transport, social security, drug abuse control, information and media, health, space technology and energy. ASEAN heads of state and China have also urged the pursuit of concrete measures toward promoting and facilitating trade, encouraging the flow of investment, promoting counter-trade, developing small and medium enterprises, enhancing research and development and harnessing the opportunities presented by AFTA.

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[64] Cheng, "Sino-ASEAN Relations in the Early Twenty-First Century," 440.

[65] Cheng, "Sino-ASEAN Relations in the Early Twenty-First Century," 443-444.

[66] Cheng, "Sino-ASEAN Relations in the Early Twenty-First Century," 445.

Trade liberalization between ASEAN and China has also occurred recently. Most favored nation (MFN) tariff rates have been falling in both ASEAN states and China. President Jiang Zemin of China made a commitment to cut average tariffs to 15% by 2000. This new liberalization effort includes substantial tariff cuts on 4,998 tariff lines. China has eliminated quotas, licensing and other import controls on 176 tariff lines subjecting more than 30% of its products to these restrictions. China's liberalization because of its accession to the WTO would provide an important opportunity for expanding current trade and investment levels between ASEAN and China. If both regions could agree on a program of further trade and investment liberalization and facilitation measures, the prospects for ASEAN-China trade and economic cooperation could be strengthened.

PROMISE AND PERILS OF ASEAN-CHINA FREE TRADE ARRANGEMENT

A free trade arrangement between ASEAN and China has promise and perils. Constructing a free trade arrangement between the two entities will require ASEAN to deal with several potential problems. It must address the potential competition of China and ASEAN for the same export markets and foreign direct investment. It must determine how to reduce tariffs on product categories with potentially large export potential for ASEAN states, e.g. Thailand's agricultural and rubber products that China may conclude are too sensitive to liberalize. In addition to reducing tariffs, it must concern itself with existing non-tariff barriers including local protectionist tactics ranging from roadblocks to punitive tariffs, petty corruption at the bureaucratic level and the unsatisfactory state of corporate management in ASEAN and China. Finally, it must address the concerns of potential losers of free trade.[67] Competition from China may hurt countries like Thailand, Indonesia and the Philippines whose economies share a similar stage of development as China.[68] With WTO admission, multinational corporations began shifting production from ASEAN countries to China with its cheaper and more deferential workforce and leading to increased unemployment in those ASEAN countries. Whether it concludes a free trade or other economic integration arrangement with China or not, these issues will have to be addressed by ASEAN if it wants to increase its magnitude and share of China's market.

On balance, the promise clearly outweighs the perils. ASEAN states obtain privileged access to the world's most populous country and largest market in a manner that permits them to increase and liberalize trade opportunities there. While some of the inner core countries may cede some industries to China, they will likely be replaced by industries servicing China's expanding middle class especially in Thailand and Singapore.[69] Integration with China also brings to shared Sino-ASEAN economic concerns the spotlight that only world powers can provide. ASEAN also positions itself to share in the benefits of the FDI increasingly funneled to China and even to increase its own share of FDI. Finally, closer economic relations help ASEAN promote regional stability through its twin policies of regional cooperation and maintenance of a regional security equilibrium.

HOW SHOULD ASEAN-CHINA FREE TRADE BE STRUCTURED?

CRITERIA

We have divided our criteria into political and economic spheres. Political factors include enhanced stability within ASEAN and between ASEAN and China and potential for greater

[67] Cheng, "Sino-ASEAN Relations in the Early Twenty-First Century," 434.

[68] Cheng, "Sino-ASEAN Relations in the Early Twenty-First Century," 447.

[69] Cheng, "Sino-ASEAN Relations in the Early Twenty-First Century," 447.

common policymaking for financial and economic issues. Economic factors include increased market efficiency, increased trade, reduction of negative spillover effects between partner countries and reduction of the economic divide between member states. Finally, inherent in any policy proposal is the question of viability or feasibility of the plan for the actual conditions.

ENHANCED STABILITY

How, if at all, does the policy option enhance stability both within ASEAN and between ASEAN countries and China? This criteria must address several factors. Is there public support for an ASEAN-China preferential trade arrangement within ASEAN countries? PTAs are not simply singular entities, but sovereign nations with their own national interests. Issues related to these decisions may be hotly contested and lead to dissent and hence instability within ASEAN countries. What, if any, type of ASEAN-China preferential trade arrangement will enhance stability among ASEAN states? Between ASEAN and China? We have already recounted the literature suggesting that trading partners are significantly less likely to engage each other in warfare.

GREATER COMMON POLICYMAKING

How, if at all, does the policy option increase opportunities for common policymaking in economic and financial policy matters? Central to the recent experience of ASEAN states was the Asian financial crisis, which was exacerbated by competitive currency devaluation. (Many East Asian nations devalued their currency in order to make their products cheaper in export markets. As one country did so, others felt compelled to do so in order to remain competitive.) This experience, along with others, has suggested the need for formal structures for common policymaking about key economic and financial policies. Whether the policymaking arrangements are ad hoc, informal continuous or formal continuous, we suggest that the option must comport with ASEAN's policy of "consensus and consultation," i.e. the building of unanimous consensus through extensive consultation.

INCREASED MARKET EFFICIENCY

How much, if at all, does the policy option increase the prospects for market efficiency? The general argument suggests that market efficiency should increase in relation to the greater liberalization of trade between partners. Increases should result from reduction of tariff barriers and non-tariff barriers. This criteria would ask in what ways and with what magnitude market efficiency would increase.

INCREASED TRADE

How much, if at all, does the policy option increase trade including trade within ASEAN, trade between ASEAN and China and external trade opportunities? This criteria can be investigated by proportion and magnitude of predicted trade increases. Within this criteria, we prioritize increases in trade between ASEAN and China followed by external trade opportunities and trade within ASEAN. We use this prioritization because ASEAN economies have been, since the 1980s, export-oriented, i.e. concerned first with developing and enlarging markets outside the region.

REDUCTION OF NEGATIVE SPILLOVER EFFECTS

How, if at all, does the policy option help reduce negative spillover effects of one country's economic ills to another? In short, does the policy option have ways of vaccinating or inoculating member countries against one ailing nation's flu? Economic downturns may become an easily spread contagion because of high levels of economic integration. Similarly, deeply integrated countries may be adversely effected by other member countries' domestic policies. Again, we privilege approaches that fit with ASEAN's long-standing "consensus and consultation" policy.

REDUCTION OF ECONOMIC DIVIDE

How, if at all, does the policy option mitigate the economic divide within ASEAN between the "inner core" and "periphery" countries? This option should provide both means for the newer, periphery countries to catch up to the other ASEAN countries and consider PTA designs that show greater flexibility for those countries. We choose not to provide material or monetary compensation to the developing countries and instead focus our evaluation on models that emphasize liberal approaches to economic growth.

FEASIBILITY/VIABILITY

How feasible and/or viable, if at all, is the policy option given the political, economic and social conditions of ASEAN, ASEAN states and China? We must gauge the willingness of ASEAN, ASEAN states and China to agree to the policy framework of the option and judge their capacity to implement the model. We should consider the attitudes of other likely actors, i.e. Japan, South Korea, Russia and the United States, toward the plan and whether any will try to scuttle that particular model. Further, we must determine if our expectations of future prospects are realistic.

Of these criteria, four have priority: feasibility/viability, increased trade, increased market efficiency and reduction of the economic divide. Even the best plan will be worthless if it is not feasible and viable. This must be the most important concern. Next, ASEAN is seeking greater external trade opportunities and that must be central to any free trade plan. Increased market efficiency and reduction of the economic divide are also both salient issues for ASEAN.

OPTIONS

Given those criteria, we investigate four policy options: maintaining the status quo, developing a common market, developing a customs union and developing a free trade area. While maintaining the status quo may seem counterintuitive, it is first necessary to ascertain whether we can achieve the benefits required by our criteria without a formal structure and the political expense involved. Each of the other remaining policy options explores ways of designing preferential trade arrangements between ASEAN and China.

OPTION 1: THE STATUS QUO

This option argues for the maintenance of the status quo, which is characterized by gradual liberalization between ASEAN countries and China and the common membership in WTO of China and five ASEAN countries. As we have discussed earlier, China has committed itself to cutting average tariffs by 34% to 47% so that they average 15% by 2000 on nearly 5,000 tariff lines and has eliminated quotas, licensing and other import controls on 176 tariff lines comprising more than 30% of its commodities. Advocates of this option will also point to increases in ASEAN-China trade since 1991. In 2000, ASEAN-China trade totaled $39.5 billion growing by an average of 20.4%

annually since 1991, when overall trade amounted to only $7.9 billion. In addition, from 1993 to 2000, ASEAN's foreign trade grew at an average annual rate of 10.9%. Further, some countries worry that freer trade with China may be a losing prospect for their countries. The status quo option meets several of our criteria. It should result in gradually greater market efficiency through reduction of economic distortions, especially tariff and some non-tariff barriers. It should also likely result in trade growth at the margins.

If trade liberalization and increased ASEAN-China trade are occurring, why consider an option other than the status quo? The most compelling reason is that trade will likely not be liberalized as quickly and as effectively under the status quo as with a preferential trade arrangement. Already, the growth of ASEAN-China trade is slowing as tariff and, more importantly, non-tariff barriers become more significant. Furthermore, the potential magnitude for increased market efficiency and increased trade are less likely than with other options. In addition, the status quo option does not provide for enhanced stability. It may, in fact, undermine ASEAN cohesiveness as China makes preferential bilateral trade agreements with individual ASEAN members. It makes no explicit provision for greater common policymaking or for reducing the intra-ASEAN economic divide. Finally, it makes no provision for reducing the possibility of negative economic spillover effects, but does have significantly less integration than any other model.

OPTION 2: THE COMMON MARKET

The common market model requires the free flow of goods, services, labor and capital such as the European Community. This free flow requires the elimination of all tariffs and non-tariff barriers and suggests further elimination of procedures that hinder the movement of individuals within the common market and the harmonization of regulatory frameworks. Member countries must develop joint policies on a variety of public policies usually necessitating the development of several formal structures. In the EU, these structures include a common central bank that sets financial policy, an increasingly robust European Parliament and other supranational structures.

This option meets all of our political and economic criteria. It is likely to enhance stability within ASEAN and between ASEAN and China as they will be deeply integrated with each other. (Within the region, this option might meet with hostility or suspicion from other major actors – Japan, South Korea, United States and even Russia – who are excluded.) The common market approach requires formal and continuous policymaking not simply in spheres largely considered economic or financial, e.g. monetary policy and external trade policy, but also many spheres considered largely political (e.g. welfare policies and visas policies) which may have external effects on other common market members. The common market should increase internal market efficiency as more economic distortions that vary by country are harmonized or eliminated than in any other model of regional integration. The enlarged, integrated market, particularly since it would include the vast potential Chinese market, should permit industries and firms to achieve economies of scale. In addition, transaction costs should be reduced more in this plan than any other under consideration. True common markets tend to result in significant trade creation. However, a caveat is in order, because these have involved developed, not developing countries. Regional integration among developing countries tends to have a more mixed record. Consequently, it is difficult to predict whether trade creation demonstrated by the European Community and later European Union would obtain in an ASEAN-China common market. Trade should increase among member states, but the extent of the increase is difficult to predict. Further, the ASEAN countries and China are focused on trade outside the region eyeing lucrative export markets in the US, EU and Japan. True common markets tend to occur primarily among members at similar development stages. The EU has developed inclusion requirements that effectively do not reduce the economic gap, but invite only similarly situated countries.

While the ability of the common market model to meet our criteria regarding reduction of the intra-ASEAN economic divide is suspect, the common market model fails primarily on the question of feasibility. At this time, it is simply not a feasible model for either ASEAN or China. Both value their independence of action, especially political action, and would be unlikely to give up so much of it. They would likely find it difficult to agree to a truly free flow of people and services in particular as well as to common agricultural, transport and energy policies. For example, the absence of long-term visas for Chinese businesspersons is an obstacle that has yet to be resolved. The third meeting of the ACJCC in March 2001 considered proposals in these areas with little success. Finally, common markets with asymmetrical economies either have failed or not even been attempted. ASEAN and China contain such asymmetrical economies and would likely make a common market less than viable. In time, an ASEAN-China common market may be feasible, but is an unwise starting point.

OPTION 3: THE CUSTOMS UNION

The customs union model develops a free trade area with total or partial elimination of tariff and non-tariff barriers among its members and adopts common tariff and trade policies for external trade. According to customs union theory, it is important to differentiate between two sources of increased trade among the member states, trade creation and trade diversion. Trade relations with external trade partners are greatly impacted by the alignment of national tariffs with the new common one. If they are lower than previous national tariffs, trade creation should occur with external trade partners. If they are higher, trade diversion should occur as more expensive suppliers from union countries replace cheaper suppliers located in non-member countries whose products are made more expensive by the common tariff. The European Community employed a modified customs union.[70]

Like the common market option, this meets most of our political and economic criteria. It promises enhanced stability by binding the member countries more closely together. It will also require formal and continuous common policymaking regarding customs and trade policies. It does not provide for structures to develop common monetary policies. (Monetary policy, especially competitive currency devaluation, exacerbated and deepened the Asian financial crisis.) It provides increased market efficiency to the extent that it removes internal tariff- and non-tariff barriers. However, it should be noted that it emphasizes tariff rather than non-tariff barriers. It will also likely result in increased internal trade. Projections of increased external trade would depend on the content of the trade policy developed. Customs unions tend to be less choosy about their members than common markets. It may reduce the economic divide through the opportunities provided by trade liberalization and likely trade diversion within the customs union. However, it may also find itself marginalized from global economy especially if the customs union pursues protectionist trade policies.

In addition, like the common market, the customs union option fails largely on the question of feasibility and viability. It ties the hands of member countries on any third party trade agreements

[70] George E. Nakos, Keith Brouthers and Robert Moussetis, "The Experience of Portugal's Accession to the European Union: What Countries Want to Join A Customs Union Should Expect," *Competitiveness Review* 11 (2001), 13 and Hamid Beladi and Subarna K. Samanta, "Foreign Technology and Customs Unions: Trade Creation and Diversion," *Journal of Economic Studies* (1990) 17, 27-35.

they would wish to pursue. As a bloc, ASEAN is also examining a potential combination with the Australia-New Zealand FTA. Individual ASEAN countries are also pursuing other bilateral trade agreements most notably Singapore with the United States. Further, China is looking into trade pacts with South Korea and Japan. In short, most of the economies of ASEAN and China are pursuing growth through exports aimed at the US, EU and Japan. None of these actors would submit to having their hands tied on common trade policies. Further, a common trade policy would no doubt bring the issue of Taiwan to the fore. As we have seen earlier, the actual volume of trade between ASEAN and Taiwan is greater than that between ASEAN and China. ASEAN wants to be free to continue this trade, which would undoubtedly be hampered if its trade with third parties had to be decided with China's agreement. Finally, customs unions bind economies together on matters of trade policy and negative repercussions for the union itself or for individual member countries are likely to have serious negative repercussions for other member countries.

OPTION 4: THE FREE TRADE AREA

Free trade areas (FTAs) are types of preferential trading groups that liberalize trade within the community, typically via reduced tariff barriers and sometimes non-tariff barriers, while permitting each member country to maintain its own trade policies vis-à-vis third party countries. Free trade areas tend to have low levels of economic integration as measured by binding, supranational policymaking and harmonization of regulatory frameworks and other trade-related policies. FTAs rarely have completely free trade. Instead, they tend to stagger reductions in tariffs and permit exclusion of socially sensitive products and other hard cases. They typically have a goal of removal of all tariffs.

The primary benefits of this model are increases in intraregional market efficiency and trade. Reduction of tariff and some non-tariff barriers within the FTA permits greater allocative efficiency by the market and induces greater trade within the FTA. It also has the benefit of leaving trade policy options for third parties unfettered. Within AFTA's free trade framework, Singapore is able to negotiate a free trade arrangement with the US, which it began doing in 2000. Since it does not interfere in trade policies with third parties, the effects on external trade ought to be negligible. Since this plan produces benefits with minimal interference in the domestic affairs of participating countries, an important principle for ASEAN and for China, it should garner support at least among the leadership of ASEAN and China. If concluded, it would likely help cement more than a decade of improving relations between China and ASEAN. This model has no provisions for common policymaking or minimization of negative economic spillover effects. FTAs may help reduce economic stratification among members to the extent that poorer countries find ways to benefit from increased trade. In some cases, FTAs develop bifurcated approaches, i.e. different sets of rules or schedules of tariff reductions for high-performing and poor-performing countries. This may help quicken the pace of income-level convergence among participating countries.

An FTA is probably the most feasible option for the ASEAN-China relationship. ASEAN is not seeking deep integration with China, but rather liberalization of the Chinese market. Though it seeks increased trade opportunities in China, it also has other foreign policy goals that require it to maintain cordial relations with the United States, Japan and other regional powers. It needs to maintain foreign policy and trade policy flexibility with third parties that FTAs afford. This option permits enough latitude to allow ASEAN states and China to pursue their own domestic policies, which is an important component of the ASEAN's Bangkok Declaration and the ASEAN-China relationship. Lastly, an FTA is similar to existing trade arrangements between China and ASEAN without necessarily extending AFTA's policies to China.

If a FTA is the most feasible option for promoting ASEAN-China FTA, why not simply extend the existing AFTA agreement and its provisions to China? AFTA strives for a deeper level of integration than ASEAN wants with China or China wants with ASEAN. Both are looking for trading partners, not for the free flow of capital and eventually services that AFTA seeks among its members. Further, if China were included as a member of AFTA, it would likely slow down AFTA's implementation as AFTA members would need to wait on China to catch up with its implementation schemes. (Extension of deadlines for "periphery" countries does not hurt as much since they have yet to become central to AFTA growth. China, however, would be.) Finally, inclusion of China into AFTA reduces the negotiating flexibility of ASEAN to tailor an agreement between it and China.

HOW SHOULD WE IMPLEMENT AN ASEAN-CHINA FREE TRADE AREA?

We recommend that ASEAN negotiate a modified free trade agreement between ASEAN, as a unified entity, and the People's Republic of China. Implementation of this free trade area has four steps. First, we must continue to strengthen the existing ASEAN-China relationship. Second, we should develop a negotiation team. This team will use our recommended negotiation framework. Finally, we should establish an ASEAN-China trade disputes panel.

STEP 1: STRENGTHEN EXISTING ASEAN-CHINA RELATIONSHIP

The first step is to strengthen the existing ASEAN-China relationship by taking advantage of existing agreements, mobilizing public support[71] and developing consensus policies, especially policies designed to prevent competitive currency devaluation. As noted above, ASEAN and China have already developed a number of joint committees for economic, financial, education and social policies. ASEAN should continue to engage in those relationships in order to develop an atmosphere of mutual trust and teamwork. We should also mobilize public support within ASEAN and respond to particular concerns that countries have. Utilizing ASEAN's long-term "consultation and consensus" approach, we should develop consensus policies for our approach to an ASEAN-China free trade area.

STEP 2: DEVELOP A NEGOTIATIONS TEAM

ASEAN should negotiate for a free trade area as a single, unified entity. This will provide greater leverage for ASEAN than would obtain with ten separate countries negotiating. The total negotiation team should include four officials from the ASEAN secretariat and two representatives from each country. Country representatives would be chosen by each country's government. In addition, to the negotiations team proper, we would also develop industry-specific task forces that include representatives of firms, labor groups and other interested parties for particular industries. At least three industries will likely be of great enough import to merit such a task force: microelectronics and semiconductors, textiles and apparels and vehicles or vehicle parts.

STEP 3: UTILIZE RECOMMENDED NEGOTIATIONS FRAMEWORK

ASEAN's recommended negotiations framework has the following components:

[71] This intra-ASEAN mobilization of public support should also be accompanied by assurances to other major regional actors – Japan, Republic of Korea and the United States – that the free trade area is designed only to facilitate trade and not to erect trade barriers with other countries in concordance with GATT Article XXIV.

- Initial application of the free trade area to manufactured products only with a commitment to examine the inclusion of agricultural products, raw materials and services in the future.

- A system of staggered tariff reductions by product category that also includes a limited temporary exclusion list.

- Increased flexibility for poorer countries to meet FTA schedules – an extra three years for Vietnam and an extra five years for Laos, Myanmar and Cambodia.

- Reduction of non-tariff barriers.

- Agreement in principle to prevent competitive currency devaluation.

APPLICATION OF FREE TRADE AREA TO MANUFACTURED PRODUCTS ONLY

The provisions of the ASEAN-China free trade area would apply initially only to manufactured products, i.e. products that are compiled, processed or otherwise manufactured. It would not initially include commodities – either raw materials or foodstuffs – or services. (ASEAN and China would be free to examine the inclusion of agricultural products, raw materials and services in the future as their own economies become more integrated.) This initial exclusion is designed to minimize conflict over food products, especially rice, and agricultural subsidies that may be difficult for many regimes to eliminate. However, the restriction to manufactured goods does include the bulk of the trade between China and ASEAN. Counting chemicals; plastics; textiles and apparel; footwear; machinery and electrical appliances; vehicles; optical precision and musical instruments; arms and miscellaneous manufactured goods, ASEAN exports of manufactured goods to China for 2000 were valued at $23.05 billion of $33.78 billion in total exports, or 68.22% of the exports ASEAN sent to China. ASEAN imports of manufactured goods from China in 2000 were valued at $19.27 billion of $24,98 billion or 77.13% of their imports from China. Machinery and electrical appliances along account for 51.66% of ASEAN imports from China and 48.4% of exports to China.[72]

STAGGERED TARIFF REDUCTIONS BY PRODUCT CATEGORY OVER TIME

The free trade area would stagger tariff reductions on manufactured products based on the product category over time. We suggest three categories – automotive vehicles and parts (A), textiles and apparel products (B), and all other manufactured goods (C). We employ the following schedule of tariff reductions:

Table 5. Tariff Reductions Schedule

	2005	2008	2012	2015
A: Automotive Vehicles and Parts	20-15%	15-10%	10-5%	0-5%
B: Textiles and Apparel Products	15-10%	10-5%	0-5%	0%
C: Other Manufactured Goods	10-5%	0-5%	0%	0%

Note: Currently, China has agreed to reduce its average of tariffs with ASEAN to 15% by 2000.

[72] ASEAN Secretariat [http://www.aseansec.org].

Here we liberalize trade on all other manufactured goods (C) most quickly. We do so, in part because this represents the bulk of the current trade between China and ASEAN and it is this trade that both parties wish to expand. In addition, liberalization of textile and apparel products will help the poorer countries within AFTA. Textile industries should migrate there as they enjoy the comparative advantage for labor-intensive production with relatively cheaper labor. Finally, automotive vehicles and parts are separated out because they already represent one of the more contentious items for ASEAN to liberalize within AFTA. We assume that they will also be difficult to liberalize within the ASEAN-China free trade area and therefore provide more time to do so.

Temporary Exclusion List and Originating Product Inclusion

Along with these tariff reductions would be a temporary exclusion list and an originating product automatic inclusion option. The temporary exclusion list would be composed of products excluded from the tariff reductions. Items that might be placed on it must be consonant with GATT provisions permitting special policies for "socially sensitive" products and military industries only. The temporary exclusion list may not comprise more than 15% of tariff lines or more than 10% of trade flows measured from the beginning year of the ASEAN-China free trade area. In addition, products composed of at least 40% of items manufactured in ASEAN or China would automatically be eligible for the lowest tariff reduction rate within its category.

RECOMMENDATION 3: GREATER FLEXIBILITY FOR POORER COUNTRIES

We provide greater flexibility for poorer countries in meeting the tariff schedules outlined in the above recommendation. Specifically, we permit an extra three years for Vietnam to meet each the tariff schedules so that its deadlines would actually be 2008, 2013, 2018 and 2023. We permit an extra five years for Laos, Myanmar and Cambodia so that their deadlines would actually be 2010, 2015, 2020 and 2025. We do so in part because these economies are at earlier stages of development, but also because most are also in the midst of transitions from centrally planned to market economies. China would not have access to these extended deadlines for three reasons. It began its transition from a centralized to market economy in 1991 before any of the economies mentioned herein. This early start is manifest in an increasingly diversified economy. Further, it has far higher rates of FDI and economic growth and increases in FDI and growth over time than do Vietnam, Laos, Myanmar and Cambodia.

RECOMMENDATION 4: REDUCTION OF NON-TARIFF BARRIERS

In order to liberalize non-tariff barriers with the least intrusive measures, we will use three approaches currently used within AFTA: development of mutual recognition arrangements, Green Lane expediting of certain products through customs, common tariff nomenclature and standardization of regulations.

- MUTUAL RECOGNITION AGREEMENTS (MRAS) and interpretive notes will be developed for different technical standards for particular products. In cases, where a consensus exists on international standards, we should defer to those international standards.

- GREEN LANE SYSTEM FOR ASEAN-CHINA products employed to simplify trade procedures between ASEAN countries and China by permitting expedited customs clearance for particular products bearing a certificate of the ASEAN-China free trade area. We can begin by limiting this to particular products and work to expand green lane treatment to cover more products.

- ASEAN HARMONIZED TARIFF NOMENCLATURE (AHTN) utilized to provide greater transparency, predictability, uniformity and simplicity in classification. We would extend this to China or, if necessary, make modifications that permit its use for China and ASEAN. Vietnam, Laos, Myanmar and Cambodia would be permitted extensions to prepare for use of AHTN.

- STANDARDS HARMONIZATION works to harmonize the standards of member countries for particular products. In some cases, we may agree simply to apply international standards and in other cases to design new ones. ASEAN should try to harmonize standards with China to those standards it has already harmonized within AFTA.

We will also use GATT/WTO rules for customs valuation since these have been agreed to for AFTA members and China is already a WTO member. We will defer discussion of simplifying and harmonizing actual customs procedures (i.e. tariff nomenclature and customs procedures) until later.

AGREEMENT TO PREVENT COMPETITIVE CURRENCY DEVALUATION

The freer trade agreement will include a codicil with agreements in principle for countries not to engage in competitive currency devaluation. Several other agreements have been signed within East Asia for the same purposes since the Asian financial crisis.

STEP 4: ESTABLISHMENT OF A TRADE DISPUTES PANEL

We suggest the establishment of a trade disputes panel, the ASEAN-China Commerce Dispute Committee (ACCDC) to collect data documenting trade barriers, monitor adherence to intellectual property rights law and other international trade norms and, where necessary, adjudicate trade disputes between countries. In order to minimize the potential for dissension within the free trade area, the ACCDC will collect data and pass cases on to the WTO for adjudication in cases involving WTO members. The only potential members of the ASEAN-China free trade area that are not members of the WTO are Vietnam, Laos, Myanmar and Cambodia. (Each has applied for membership). In cases involving at least one non-member of the WTO, the ACCDC will mediate the dispute. The trade disputes panel should be composed equally of representatives from the ASEAN Secretariat and China.

APPENDIX A: THEORY AND PRACTICE SUPPORTING FREE TRADE

Why do countries pursue regional preferential trading arrangements and what are the implications of doing so? Preferential trading arrangements (PTAs) have grown in number and increased in depth and complexity since the Cold War's end even as global trade liberalization via the World Trade Organization has widened. This section briefly surveys the modern history of preferential trading arrangements. Next, it examines the theories of free trade and the rationale for pursuing PTAs. Finally, it investigates the political ramifications of PTAs.

REGIONAL PREFERENTIAL TRADING ARRANGEMENTS

Preferential trading arrangements occur when two or more states grant each other greater access to their markets, most typically by lowering tariff barriers.[73] There have been four periods of growth for regional preferential trading arrangements: the latter half of the nineteenth century, the period between World Wars I and II, the late 1950s to early 1970s and post-Cold War period. In the first and latter periods, the growth of PTAs has been accompanied by an attempt to integrate economies in the global economic system.

By the second half of the nineteenth century, PTAs were common in Europe. In nearly all cases, they existed as customs unions among city-states and duchies that would soon unify into nation-states, e.g. German Zollverein (1820s), Swiss cantons (1848), Austrian states (1850), Danish states (1853) and Italian city-states (1860). Among nation-states, the development of bilateral agreements to lower tariffs was spurred not by national unification, but by a burgeoning rail network that drastically improved the transport of goods and by the demands of export-oriented industries that sought to better realize their economies of scale and the potential of larger markets.[74] The Cobden-Chevalier Treaty of 1860 between the United Kingdom and France, in which each state agreed to lower its tariffs against the products of the other state, was the trigger for many more such agreements.[75] While these agreements benefited the dyadic partners, they disadvantaged third-party exporters. The attempt to minimize market exclusion led to a rapid increase in similar bilateral agreements.[76] The Zollverein signed a bilateral trade agreement with France, as did Belgium. By 1866, most Western European states were party to some part of this trade network. Only Russia and the United States were left out.[77] By the end of the century, this network also included the

[73] David Lazer, "The Free Trade Epidemic of the 1860s and Other Outbreaks of Economic Discrimination," *World Politics* 51, no. 4 (1999), 449. See also Jacob Viner, *The Customs Union Issue* (New York: Carnegie Endowment for International Peace, 1950) and Ian Wooton, "Preferential Trading Agreements: An Investigation," *Journal of International Economics* 21 (August 1986).

[74] Douglas A. Irwin, "Multilateral and Bilateral Trade Policies in the World Trading System: An Historical Perspective," in *New Dimensions in Regional Integration*, edited by Jamie de Melo and Arvind Panagariya (New York: Cambridge University Press, 1993), 97.

[75] See Barrie M. Ratcliffe, "The Origins of the Anglo-French Commercial Treaty: A Reassessment," in Great *Britain and Her World, 1759-1914: Essays in Honour of W.O. Henderson*, edited by Barrie M. Ratcliffe (Manchester: Manchester University Pres, 1975) and Timothy J. McKeown, "Hegemonic Stability and the Nineteenth Century Tariff Levels in Europe," *International Organization* 37 (Winter 1983).

[76] Lazer, "The Free Trade Epidemic of the 1860s and Other Outbreaks of Economic Discrimination," 472.

[77] Paul Bairoch, "European Trade Policy, 1815-1914," in J.H. Clapham, et al, *The Cambridge Economic History of Europe* (Cambridge: Cambridge University Press, 1989), 40; Irwin, "Multilateral and Bilateral Trade Policies in the World Trading System," 92 and Sidney Pollard, *European Economic Integration 1815-1970* (London: Thames and Hudson, 1974), 118.

economies of Central Europe.[78] Thus, by the early twentieth century, the United Kingdom has signed bilateral trade agreements with forty-six states, Germany with thirty and France with more than twenty. Although it is difficult to disentangle the precise causes and effects, scholars agree that trade during this period was freer than the preceding or subsequent periods and that this period witnessed an increase in trade among European states.[79]

The network of bilateral trade agreements broke down after World War I, due in part to the requirement that Germany extend most favored nation trading status to all Allied countries, opening its markets without requiring Allied nations to reciprocate.[80] When Germany was released from this obligation in 1925, the number of countries covered by bilateral trade agreements rose from thirty in 1927 to 42 in 1928.[81] However, the international depression, accompanied by the rise of tariffs by key actors like the United States, forced the ultimate collapse of the bilateral agreements system. Except for the United States, which signed more than twenty bilateral agreements primarily with Latin American nations, most trade agreements tended to be more exclusive and were often designed to protect trade within colonial empires, e.g. 1928 French Customs Union and the British Commonwealth system of trade preferences established in 1932.[82] A prominent exception was the Rome Agreement of 1934, a multilateral PTA between Austria, Belgium, Denmark, Finland, Hungary, Italy, Luxembourg, Netherlands, Norway and Sweden.

Post-war preferential trading arrangements occurred in two periods – the period of rapid decolonization and the end of the Cold War. Seeking to reduce their political and economic dependence on advanced industrialized states, newly decolonized initiated and joined a variety of PTAs.[83] Their policies tended to encourage indigenous industrialization and import substitution.[84] Most of those PTAs floundered due to conflict about the distribution of the costs and benefits of the PTA, compensation for economic losers and allocation of industries among member states.[85] The CMEA, a PTA for Soviet-bloc states, met a similar fate.[86] Only PTAs among industrialized states

[78] Lazer, "The Free Trade Epidemic of the 1860s and Other Outbreaks of Economic Discrimination," 477.

[79] Irwin "Multilateral and Bilateral Trade Policies in the World Trading System," 91. See also Barry Eichengreen and Jeffrey A. Frankel, "Economic Regionalism: Evidence from Two Twentieth-Century Episodes," *North American Journal of Economics and Finance*, 6 (1995), 89-106.

[80] Lazer, "The Free Trade Epidemic of the 1860s and Other Outbreaks of Economic Discrimination," 478.

[81] Irwin, "Multilateral and Bilateral Trade Policies in the World Trading System," 105.

[82] Pollard, *European Economic Integration 1815-1970*, 145.

[83] Jagdish Bhagwati, "Regionalism and Multilateralism: An Overview," in *New Dimensions in Regional Integration*, edited by Jaime de Melo and Arvind Panagariya (New York: Cambridge University Press, 1993), 28 and Anne O. Krueger, *Political Economy of Policy Reform in Developing Countries* (Cambridge Massachusetts: MIT Press, 1993), 77 and 87. See also Julio J. Nogues and Rosalinda Quintanilla, "Latin America's Integration and the Multilateral Trading System," in *New Dimensions in Regional Integration*, ed. Jaime de Melo and Arvind Panagariya (New York: Cambridge University Press, 1993), 278-313.

[84] Richard W. T. Pomfret, *Unequal Trade: The Economics of Discriminatory International Trade Policies* (Oxford: Blackwell, 1988), 138.

[85] Bhagwati, "Regionalism and Multilateralism," and Faezeh Foroutan, "Regional Integration in Sub-Saharan Africa: Past Experience and Future Prospects," in *New Dimensions in Regional Integration*, edited by Jaime de Melo and Arvind Panagariya (New York: Cambridge University Press, 1993), 234-271.

[86] Pomfret, *Unequal Trade*, 94-95 and 143.

fared well since they tended to create trade.[87] The second period of PTA growth occurred after the conclusion of the Cold War. The United States, the sole superpower, took the lead in participating in and encouraging PTAs and the most complex common market, the European Community, deepened and widened its integration into the European Union. This growth also benefited from an international economic environment with high levels of economic interdependence, procedures for and willingness to mediate trade disputes and a global economic framework that sets minimal standards and structures trade relations, i.e. GATT/WTO.[88] Unlike their post-World War II predecessors, emerging PTAs emphasized export-driven growth, trade liberalization and reduced restrictions on capital flows.[89]

Since World War II, regional concentration of trade has increased. Whether measured within broad geographic areas,[90] existing PTAs[91] or a combination of geographic zones and PTAs,[92] most evidence shows growing regional concentrations of trade flows especially in Western Europe and East Asia.

Table 6. Intra-Regional Merchandise Exports Divided by Total Merchandise Exports.

REGION	1948	1958	1968	1979	1990
Africa	0.080	0.080	0.090	0.060	0.060
Asia	0.390	0.410	0.370	0.410	0.480
Eastern Europe	0.470	0.610	0.640	0.540	0.460
Middle East	0.210	0.120	0.080	0.070	0.060
North America	0.290	0.320	0.370	0.300	0.310
South America	0.200	0.170	0.190	0.200	0.140
Western Europe	0.430	0.530	0.630	0.660	0.720
World	0.330	0.400	0.470	0.460	0.520

[87] See Eichengreen and Frankel, "Economic Regionalism: Evidence from Two Twentieth-Century Episodes;" Jeffrey A. Frankel and Shang-Jin Wei, "Regionalization of world Trade and Currencies: Economics and Politics," in *The Regionalization of the World Economy*, edited by Jeffrey A. Frankel (Chicago: University of Chicago Press, 1998), 189-219 and Pomfret, *Unequal Trade*.

[88] Carlo Perroni and John Whalley, "How Severe Is Global Retaliation Risk Under Increasing Regionalism?" *American Economic Review (Papers and Proceedings)* 86 (1996), 57-61. GATT tries to minimize trade diversion by limiting PTG member-states' ability to discriminate against third parties. Article XXIV of GATT enumerates the conditions under which member states may design and join PTGs. It requires that PTGs eliminate internal trade barriers and that the external tariff for the PTGs not exceed the average level of member's preexisting external tariffs. See Bhagwati, *The World Trading System at Risk* (Princeton, New Jersey: Princeton University Press, 1991), ch. 5; Bhagwati, "Regionalism and Multilateralism," 35-36; Eichengreen and Frankel, "Economic Regionalism," 100; Michael J. Finger, "GATT's Influence on Regional Arrangements," in *New Dimensions in Regional Integration*, ed. Jaime de Melo and Arvind Panagariya (New York: Cambridge University Press, 1993), 128-48.

[89] Robert Z. Lawrence, *Regionalism, Multilateralism and Deeper Integration* (Washington, D.C.: Brookings Institution, 1996), 6.

[90] Kym Anderson and Hege Norheim, "History, Geography and Regional Economic Integration," in *Regional Integration and the Global Trading System*, edited by Kym Anderson and Richard Blackhurst (London: Harvester Wheatsheaf, 1993), 19-51.

[91] Jaime de Melo and Arvind Panagariya, "Introduction," in *New Dimensions in Regional Integration* (New York: Cambridge University Press, 1993), 3-21.

[92] Jeffrey A. Frankel, Ernesto Stein and Shang-Jin Wei, "Trading Blocs and the Americas: The Natural, the Unnatural and the Super-Natural," *Journal of Development Economics* 47 (1995), 61-95.

Source: Kym Anderson and Hege Norheim, "History, Geography and Regional Economic Integration," In *Regional Integration and the Global Trading System*, edited by Kym Anderson and Richard Blackhurst, (London: Harvester Wheatsheaf, 1993).

Table 6 demonstrates high levels of intra-regional trade, i.e. where intra-regional trade comprises 30% or more of exports, in Asia, Eastern Europe, North America and Western Europe in 1990. High global levels are largely influenced by the high intra-regional trade among the largest exporting nations in the world. Significantly, all of these areas, except East Asia, had major PTAs, e.g. EFTA in Eastern Europe, Canada-United States Free Trade Agreement in North America and the EC in Western Europe. Asia, which had few PTAs and none approaching the scale of the EC or Canada-United States Free Trade Agreement in North America, had the second highest level of intra-regional trade. This may be attributable to rapid economic growth[93] or to the wide variation in the types of political regimes, e.g. democracies in Japan and South Korea, autocracies like Vietnam and kingdoms like Thailand.[94]

Table 7. Intra-Regional Exports Divided by Total Exports of Each PTA.

REGION	1960	1970	1975	1980	1985	1990
Andean Pact	0.007	0.020	0.037	0.038	0.034	0.046
Association of Southeast Asian Nations	0.044	0.207	0.159	0.169	0.184	0.186
Australia-New Zealand Closer Economic Relations Trade Agreement	0.057	0.061	0.062	0.064	0.070	0.076
Canada-United States Free Trade Area	0.265	0.328	0.306	0.265	0.380	0.340
Central American Common Market	0.070	0.257	0.233	0.241	0.147	0.148
Economic Community of West African States	N / A	0.030	0.042	0.035	0.053	0.060
European Community	0.345	0.510	0.500	0.540	0.545	0.604
European Free Trade Area	0.211	0.280	0.352	0.326	0.312	0.282
Latin American Free Trade Association/ Latin American Integration Association	0.079	0.099	0.136	0.137	0.083	0.106
Preferential Trading Area for Eastern and Southern Africa	N / A	0.084	0.094	0.089	0.070	0.076

Source: Jaime de Melo and Arvind Panagariya, "Introduction," in *New Dimensions in Regional Integration* (New York: Cambridge University Press, 1993), 3-21.

Table 7 demonstrates that regional concentrations of trade have for the most part increased among PTA member states. However, the increase is far greater for those PTAs composed primarily of developed states and those with the deepest integration levels.

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[93] Kym Anderson and Richard Blackhurst, "Introduction and Summary," in *Regional Integration and the Global Trading System*, edited by Kym Anderson and Richard Blackhurst, (London: Harvester Wheatsfeaf, 1993), 8; Jeffrey A. Frankel, "Is Japan Creating a Yen Bloc in East Asia and the Pacific?" in *Regionalism and Rivalry: Japan and the United States in Pacific Asia*, edited by Jeffrey A. Frankel and Miles Kahler (Chicago: University of Chicago Press, 1993), 53-85; Frankel, Stein and Wei, "Trading Blocs and the Americas," 61-95 and Saxonhouse, 1993.

[94] Peter J. Katzenstein, "Introduction: Asian Regionalism in Comparative Perspective," in *Network Power: Japan and Asia*, ed. Peter J. Katzenstein and Takashi Shiraishi (Ithaca, New York: Cornell University Press, 1997, 1-44.

PHILOSOPHY OF FREE TRADE

The philosophy of free trade is based on two premises: (1) that economic systems based on a division of labor are more productive than those that are not with absolute advantage understood as an international extension of the division of labor and (2) that development and economic growth are fostered when nations order their trade relations around their comparative advantage. The first of these ideas is most frequently credited to Adam Smith and the second to David Ricardo. Below we examine both ideas and their ramifications for free trade.

Smith based his ideas on a division of labor that he argued made possible greater levels of productivity and growth than when each individual sought to produce all of his own goods. Such a division of labor not only more efficiently supplies each economic actor with goods, but also stimulates the growth of industries within economies. Smith wrote, "The division of labor … is not originally the effect of any human wisdom, which foresees and intends that general opulence to which it gives occasion. It is the necessary, though very slow and gradual, consequence of a certain propensity in human nature which has in view no such extensive utility: the propensity to truck, barter and exchange one thing for another."[95] The division of labor and the tendency toward seeking one's own self-interest maximize the share of the pie for each economic actor as well as enlarges the pie.[96]

Smith's understanding of the division of labor informed his theory of absolute advantage in trade between nations.[97] Unlike the mercantilists, who understood trade to be a zero-sum game in which one side "won" and the other "lost," Smith asserted that because of absolute advantages all trading partners win. Simply put, the theory argues that due to differences in climate, soil, natural resources, geography or natural or acquired skills of the labor force, some countries possess an absolute advantage for the production of a good.[98] Production of that good will always will be less costly in countries with absolute advantage. Consequently, it makes sense to import goods for which the country does not have absolute advantage and export goods for which it does. This idea is succinctly stated in *Wealth of Nations.*

> What is prudence in the conduct of every private family, can scarce be folly in that of a great kingdom. If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it of them with some part of the produce of our own industry, employed in a way in which we have some advantage. The general industry of the country being always in proportion to the capital which employs it, will not thereby be diminished … but only left to find out the way in which it can be employed with the greatest advantage.[99]

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[95] Adam Smith, *The Wealth of Nations* [1776] (New York: The Modern Library, 1937), 19-20.

[96] Vivian Walsh, "Smith after Sen," *Review of Political Economy* 12,1 (2000), 9.

[97] Similar ideas of absolute advantage in international trade were espoused by Josiah Tucker and David Hume before Smith published *Wealth of Nations.* See Andrea Maneschi, *Comparative Advantage in International Trade: A Historical Perspective* (Cheltenham, UK: Edward Elgar, 1998), 32.

[98] For the widespread reliance on those factors as producing absolute advantage see Arthur I. Bloomfeld, "Aspects of the Theory of International Trade in France, 1800-1914," *Oxford Economic Papers* 41 (1989), 622.

[99] Smith, *Wealth of Nations*, 425-426.

David Ricardo suggested that the real determinant of international trade ought not be absolute advantage, but comparative advantage. Comparative advantage is based on a notion of opportunity costs, i.e. that which is given up in order to produce something else. Ricardo demonstrated that a country can enjoy an absolute advantage for a good without having a comparative advantage. The comparative advantage determines whether it is more cost-effective to produce or import the product.[100]

Suppose that only two goods are produced – cars and computers. Producing 100 cars requires two units of productive resources in the US and four units in Japan while producing 1,000 computers requires three units of productive resource in the US and four in Japan. In both cases, Americans hold the absolute advantage. However, the comparative cost of producing computers is higher in the US than in Japan. Using three units of production resource to produce 1,000 computers in the US requires sacrificing the production of 150 cars. In Japan, using four units of production resource required to produce 1,000 computers requires sacrificing only 100 cars. Compared to what has to be sacrificed, Japan produces computers for only two-thirds as much as its costs in the US. Thus, even though the US enjoys absolute advantage in producing computers, the Japanese would hold the comparative advantage.[101]

Classical and neoclassical thinkers suggested several benefits that obtain from free trade. First, free trade benefits all partners including poorer nations or nations with less developed industries.[102] Second, free trade more efficiently allocates productive resources. Third, Adam Smith, Immanuel Kant and Charles Montesquieu all believed that trading partners were significantly less likely to make war with each other.[103] Lastly, free trade generates higher productive output, which Adam Smith defined as the true wealth of nations.

WHY JOIN PREFERENTIAL TRADING GROUPS?

The arguments for joining PTAs belong to three categories. The first category includes the static effects of trade including trade creation and trade diversion. The second category includes the dynamic effects of trade including economies of scale, changes in investment flows, reduced

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[100] David Ricardo, *Principles of Political Economy and Taxation*, 3rd edition, [1821] (New York: Dutton, 1978), chapter 7.

[101] However, it may be in the future advantage of the US to produce its own computers. In examining Friedrich List's work, J.S. Nicholson suggests that Ricardo is a proponent of a static version of comparative advantage while List's work suggests a more flexible dynamic approach. Ricardo's theory looks to present comparative advantage without examining ways by which national policy can develop a future comparative advantage. See Nicholson, "Introduction," in List, *The National System of Political Economy* (Fairfield, New Jersey: Augustus M. Kelley Publishers, 1991). See also Ravi Batra, *The Myth of Free Trade* (New York: Touchstone Books, 1993), 137.

[102] Robert L. Hetzel, "The Free Trade Debate: The Illusion of Security versus Growth," *Federal Reserve Bank of Richmond Economic Quarterly* 80 (Spring 1994), 46.

[103] Maneschi, *Comparative Advantage in International Trade*, 147 and Immanuel Kant, "Perpetual Peace: A Philosophical Sketch," [1795] in *Kant's Political Writings*, edited by Hans Reiss (Cambridge: Cambridge University Press, 1970). Several empirical studies appear to have at least partially demonstrated such a relationship. See Erik Gartzke, Quan Li and Charles Boehmer, "Investing in the Peace: Economic Interdependence and International Conflict," *International Organization* 55 (Spring 2001), 391-438; John R. O'Neal and Bruce Russett, "Clean and Clear: The Fixed Effects of the Liberal Peace," *International Organization* 55 (Spring 2001), 469-485; Edward D. Mansfield and Jon C. Pevehouse, "Trade Blocs, Trade Flows and International Conflict" *International Organization* 54,4 (Autumn 2000), 775-808; and John O'Neal and Bruce Russett, "The Kantian Peace: The Pacific Benefits of Democracy, Interdependence and International Organizations, 1885-1992," *World Politics* 52, no. 1 (1999), 1-37.

transaction costs and increased productivity due to increased efficiency. Finally, nation-states consider joining PTAs in order to guarantee an orbit of reciprocal freer trade with well-suited partners.

Static effects of PTAs result from one-time changes in allocative efficiency. As tariff and non-tariff barriers are loosened, capital and production should flow to those environments within the PTA that best maximize resources. These changes lead to trade creation or trade diversion. When domestic economies contract as production moves to more efficient nations, trade creation occurs. Economists tend to view trade creation as a step toward greater economic efficiency, but domestic constituencies often understand this as job flight. When PTA rules foster production in partner countries with intra-regional comparative advantage though non-partner countries actually enjoy the global comparative advantage, trade diversion occurs. Trade diversion captures trade that would normally flow outside the PTA within it.[104] Economists tend to worry that trade diversion leads to inefficiency while domestic constituencies tend to support it. Dynamic effects are continuous effects with medium- and long-term implications. They include the potential for firms to realize economies of scale, changes in investment flows, reduced transaction costs and increased productivity as companies learn from a wider range of firms.

If these static and dynamic effects obtain for freer trade, why would a country join a PTA rather or in addition to unilaterally reducing tariff- and non-tariff barriers? First, nations want to guarantee similar or reciprocal reductions in tariff and non-tariff barriers by other countries. Second, nations may seek freer trade or more integrated PTAs than the minimalist standards that the WTO requires. Third, countries may try to take advantage of region-specific conditions, e.g. the combination of capital rich-labor poor and labor rich-capital poor partner configurations exemplified in the North American Free Trade Agreement (NAFTA) or a potential monopoly for particular resources like diamonds exemplified by the Southern African Development Community (SADC). Fourth, since PTAs discriminate against industries in non-member countries, intra-PTA industries that could ward off potential competitors or increase their international market share may coalesce into formidable advocates for PTAs.[105]

POLITICAL RAMIFICATIONS OF PTAS

Designing or joining preferential trading arrangements requires consideration of (1) how to develop frameworks that account for political sovereignty concerns, (2) how to equalize the trading playing field by reducing non-tariff barriers and (3) how to deal equitably with the losers of free trade. The answers to each of these questions have significant political ramifications that often galvanize domestic opposition to joining preferential trading arrangements.

The attempt to address externalities (i.e. the effects on a third party of a transaction between two other parties) may undermine national political sovereignty. Preferential trading arrangements typically deal with the effects of national public policies, i.e. transactions between governments and their citizens, on other member countries. Less strict air and water pollution regulations in some member states may attract industry from other member countries and may produce pollution that

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[104] Michael G. Plummer, "ASEAN and the Theory of Regional Integration," *ASEAN Economic Bulletin* 14 (November 1997), 204.

[105] Frank R. Gunter, "Customs Union Theory: Retrospect and Prospect," in *Economic Aspects of Regional Trading Arrangements*, ed. David Greenaway, Thomas Hyclak and Robert J. Thornton (New York: Harvester Wheatsheaf, 1989), 9. See also Albert O. Hirschman, *Essays in Trespassing: Economics to Politics and Beyond* (Cambridge: Cambridge University Press, 1981 and Stephen Haggard, "Regionalism in Asia and the Americas," in *The Political Economy of Regionalism*, ed. Edward D. Mansfield and Helen V. Milner (New York: Columbia University Press, 1997), 20-49.

affects other member countries when they are in close proximity. NAFTA dealt with this issue by harmonizing many pollution regulations among Canada, Mexico and the United States. Lax banking and securities regulations in one member country may adversely affect the financial and economic prospects of others.[106] The increasing interconnectedness of economies tends to require deeper levels of integration. If we understand political sovereignty as the right of national citizens to structure their lives, property and public policy as they see fit, then redress of these externalities necessitates some concessions in political sovereignty.[107]

In addition, the desire to equalize the trade playing field by reducing non-tariff barriers among members often stirs opposition. Preferential trading arrangements may reduce non-tariff barriers by harmonizing regulatory frameworks. Chapter eleven of the NAFTA agreement standardized investment protection regulations in Canada, Mexico and the United States by preventing governments from enacting policies that take or diminish capital investment without due process.[108] It has been utilized in ways that hinder governmental policymaking, e.g. the effective prohibition of Canada's implementation of the same gas additive regulation as that of the US. To avoid imposing common standards, some preferential trading groups require that members honor a variety of standards or regulations.[109] Members of the European Union agree to permit transactions of goods and services under regulations, standards and certification procedures that vary by member country. Thus, wine produced in any EU country can be sold in all member countries despite differing production regulations and doctors licensed to practice in any EU country may practice in all member countries though licensing procedures differ.[110] Whether by harmonizing policies or by requiring the acceptance of other countries' policies, some worry that the reduction of non-tariff barriers interferes with the policymaking sovereignty of nation-states.

NAFTA creates legal mechanisms for firms based in one country to contest legislation in the other countries when it might interfere with their "right" to carry out their business. Thus, US forms operating in Mexico have challenged stricter environmental regulations won by the Mexican environmental movement. In Canada, the government rescinded a public-health law restricting trade in toxic PCBs as the result of a challenge by a US firm; Canada also paid $10 million to the complaining firm in compensation for "losses" it suffered under the law.[111]

Finally, the incendiary question is how to deal with the losers of freer trade among member countries. States may lose industries and jobs to other states with better-qualified or cheaper workforces, lower taxes or less strict regulations. Industries may face increased competition within the PTA that disadvantages them in the global marketplace. Firms may find that they are poorly

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106 Ralph C. Bryant, "Global Change: Increasing Economic Integration and Eroding Political Sovereignty," *The Brookings Review* 12,4 (Fall 1994), 43, 46.

107 Bryant, "Global Change," 44,

108 See the North American Free Trade Agreement, Chapter 11 [http://www.nafta-sec-alena.org/english/nafta/nafta.htm].

109 "Trading Democracy" (PBS Now Series) transcript [http://www.pbs.org/now/transcript/transcript_tdfull.html].

110 Bryant, "Global Change," 48.

111 Alejandro Russ, Arthur MacEwan, Phineas Baxandall and John Miller, "The ABCs of 'Free Trade' Agreements," *Dollars & Sense* (January/February 2001), 25.

suited to compete with other nations' firms in the same industries.[112] Similarly, workers may find that they are poorly positioned to compete with other nation's workers. Others may find their wages depressed in the short-term by reliance on labor markets in poorer countries of the PTA.[113] Post-World War II PTAs typically sought formal compensation and even targeted domestic protection for state "losers" of freer trade within the PTA. However, post-Cold War PTAs are more inclined to develop strata or orbits in which highly performing countries compete with other highly performing countries and lower performing countries with similar countries or to exclude from membership poorly performing or poorly suited countries. The prospect of being a loser in the free trade game generates opposition to PTAs.

Free trade proponents assert that critics underestimate the value of free trade to workers and the importance of competition. Workers are also consumers who benefit from the cheaper goods brought by free trade. This actually maximizes the wages they do earn.[114] Moreover, tariffs tend to be regressive costing the poor more relative to their income.[115] In addition, growth, more specifically innovation, tends to occur more quickly in competitive free trade environments than in protectionist ones.[116] Protectionism reduces incentives to increase productivity, preserves firms or industries that cannot be competitive in particular environs, e.g. steel, coal and shipbuilding in Western countries.[117] Despite the potential perils of free trade, the case can be made that free trade is a net gain for citizens as workers, consumers and producers.

[112] A more sophisticated model of this emphasizes inter-industrial factor mobility. Michael Hiscox suggests that when factors (i.e. land, labor and capital) are mobile between industries broad-based conflict over trade policy occurs along class lines and when factors are immobile between industries, conflict over trade policy occurs along industry rather than class lines. See Hiscox, "Class versus Industry Cleavages: Inter-Industry Factor Mobility and the Politics of Trade," *International Organization* 55 (Winter 2001), 2-3.

[113] Dwight D. Murphey, "A Critique of Free Trade Theory," *Journal of Social, Political and Economic Studies* 23 (Winter 1998), 443-444. In contrast to classical free trade theory that predicts a bidding up of wages, Murphey asserts that several factors including the vast outnumbering of developing countries' workers by developing countries' workers and the restructuring of economies around technology designed to require less skill to operate rather than more.

[114] Hetzel, "The Free Trade Debate," 43.

[115] Hetzel, "The Free Trade Debate," 52.

[116] Hetzel, "The Free Trade Debate," 44.

[117] See Robert Ford and Wim Suyker, "Industrial Subsidies in the OECD Countries," *OECD Economic Studies* (Autumn 1990), 49 and Hetzel, "The Free Trade Debate," 47-49.

Table 8. Trade Volume, 1995-2000 (in billions)

YEAR	IMPORTS	EXPORTS
1995	132.1	148.8
1996	138.8	151.1
1997	142.4	182.7
1998	140.2	183.8
1999	165.8	194.9
2000	225.1	249.2

Table 9. Top Trading Partners, 1999 (Trade volume in billions).

COUNTRY/REGION	IMPORTS AND EXPORTS	EXPORT	IMPORT
Japan	66.2	32.4	33.8
USA	61.5	42.0	19.5
EU	55.7	30.2	25.5
Hong Kong	43.8	36.9	6.9
ASEAN	**27.1**	**12.2**	**14.9**
Republic of Korea	25.0	7.8	17.2
Taiwan	23.5	4.0	19.5
Australia	6.3	2.7	3.6
Russia	5.7	1.5	4.2
Canada	4.7	2.4	2.3

APPENDIX C: ASEAN-CHINA EXISTING AGREEMENTS

JOINT ASEAN-CHINA COMMITTEES, TASK FORCES OR GROUPS

Through the end of June 2001, ASEAN and China have endorsed or appraised 28 cooperation project proposals. More formal joint groups are listed below with their inception date in parentheses.

- ASEAN-China Joint Committee on Economic and Trade Cooperation (1994)
- ASEAN-China Joint Science and Technology Committee (1995)
- ASEAN-China Joint Cooperation Committee (ACJCC) (1997)
- ASEAN-China Cooperation Fund (ACCF) (1997)
- ASEAN+3 (China, Japan and South Korea) Summit (1997)
- ASEAN-China Experts Group on Economic Cooperation (2000)
- ASEAN-China Working Group on Development Cooperation (2001)
- ASEAN-China Business Council (2001)

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