

The Prospects of ASEAN-China Free Trade Area (ACFTA):

A Qualitative Assessment

Abstract

The economic relationship between ASEAN and China is characterized by both competition and partnership. A free trade area between the two sides is a potential means of strengthening the economic partnership. In this paper, we use customs union theory to determine whether an ASEAN-China Free Trade (ACTFA) would benefit both sides. Our analysis of relevant static factors such as the pre-ACFTA level of trade and initial tariff structures provides some grounds for optimism about ACFTA's prospects. In addition, dynamic factors such as efficiency gains due to greater competition and non-economic geopolitical factors further reinforce our optimism.

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1 Introduction

The ASEAN countries of Southeast Asia have been an integral part of the East Asian miracle. Singapore is a newly industrialized economy along with Korea, Taiwan and Hong Kong, while Malaysia, Thailand and Indonesia have also transformed themselves from stagnant agricultural economies to dynamic manufacturing economies through sustained growth and industrialization. More recently, other ASEAN countries, in particular Vietnam, are also beginning to achieve consistently rapid growth. Due to such impressive region-wide performance over a long period of time spanning more than three decades, developing countries in other parts of the world have looked up to Southeast Asia as models of economic development and nation-building. Since the Asian currency crisis of 1997-1998, however, there has been an unmistakable loss of momentum and self-confidence among the once high-flying economies of the region.

Compounding this growing uncertainty is the remarkable economic emergence of China, which is perhaps the most significant trend of the 21st century global economy. China is quickly becoming the factory of the world as it churns out and exports an ever-wider range of ever more sophisticated manufactured products. China is no longer merely a producer of mass-market low-tech items but is increasingly moving up the value chain into high-tech, high-skill items as well. Its plentiful supply of human capital and talent, along with a seemingly limitless pool of unskilled labor, is transforming the country into the global manufacturing center. This obviously poses a threat to the ASEAN economies, whose own success was based largely on producing and exporting manufactured products to the rest of the world. All the more so since, with the possible exception of Singapore, the ASEAN countries are well within the striking distance of China in terms of technological and skills gap. A specific example

of the growing economic competition between China and ASEAN is competition for FDI. There is widespread concern within ASEAN that the explosive growth in FDI inflows into China, especially in the manufacturing sector, is taking place partly at ASEAN's expense. This is a serious concern in light of the catalyst role played by FDI in ASEAN's industrialization and growth.

At the same time, the emergence of China as a globally influential economic heavyweight presents a wide range of significant opportunities for ASEAN. The relative stagnation of the region's traditional engine of growth – Japan – since the bursting of an asset bubble in the early 1990s makes it all the more imperative for the ASEAN economies to take full advantage of the opportunities provided by China's phenomenal resurgence. Above all, China represents a large and growing market for ASEAN's goods and services. While much has been made of China's role as a global exporting powerhouse, the size and growth of the Chinese economy necessarily means it has also become a globally significant buyer of exports from other countries. Indeed China's seemingly insatiable appetite for raw materials to power its rapid growth is already having a perceptible impact on the global prices of key commodities such as oil. Chinese demand for capital goods and other manufactured goods have contributed substantially to economic growth in Japan and Korea. Trade between China and ASEAN has also been growing rapidly in recent years. In the context of international trade, the 21st century is set to become the Chinese century in East Asia and beyond. The ASEAN economies would do well to position themselves to benefit from fast-growing China's fast-growing demand for goods and services.

We should point out that China's phenomenal economic performance inevitably has geopolitical implications. For one, military power is a positive function of economic power, and China's growing economic strength has been accompanied by a

corresponding growth in military capability. Although China's growing military prowess is largely targeted at Taiwan, and to a lesser extent Japan and the US, it is causing considerable concern and apprehension within ASEAN. In fact, it would be surprising if the emergence of a new regional geopolitical and military power did not cause any concern and apprehension among its neighbors. All the more so when there is a long-running dispute over the Spratly and Paracel Islands in the South China Sea involving China and several ASEAN nations. From the viewpoint of the ASEAN countries, the dispute is not only significant in and of itself, but also because it epitomizes potential conflicts between a resource-hungry China and a resource-abundant ASEAN. In any case, such geopolitical tension between China and ASEAN, although largely latent rather than explicit, has encouraged China to reach out to ASEAN and reassure the latter that it does not pose a threat.

Therefore, it is possible to view China's active interest and initiative in promoting an ASEAN-China free trade area (henceforth ACFTA) as an integral component of China's overall efforts to strengthen ties with and provide geopolitical reassurances to the ASEAN states. At the same time, it is also in the geo-political self-interest of the ASEAN countries to engage and remain on friendly terms with the emerging giant rather than to have a distant or indifferent relationship. The example of the European Union (EU) emphatically shows the effectiveness of economic integration in cementing and reinforcing geopolitical ties among the participating countries. Realistically, at this stage, economic integration between China and ASEAN refers to expanding international trade between the two sides before considering more advanced levels of integration. Stronger trade links between China and ASEAN will improve the overall relationship between the two geographical neighbors by highlighting the potential practical benefits of closer cooperation. While ACFTA has

geopolitical implications, it is first and foremost an economic initiative and the central objective of our paper to examine whether ACFTA is feasible and desirable from an economic perspective. To do so, we use the conventional theory of economic integration based on the theory of customs union.

2 Existing Literature

At this point, let us discuss some other recent works that examine ACFTA's potential impact. In what is probably the most comprehensive study of ACFTA to date, Tongzon (2005) finds that China's export structure is similar to ASEAN countries' export structure in many respects. He finds that China's top export industries, which account for 84% of its total exports, are also ASEAN's major export industries. Tongzon also finds that China enjoys a lower unit labor cost, which takes into account both wages and labor productivity, relative to ASEAN in those industries. Therefore, ACFTA can be expected to increase the competitive pressures on ASEAN producers in those industries in both third-country markets and ASEAN domestic markets. At the same time, Tongzon rightly points out that China's market liberalization under ACFTA will provide ASEAN countries with promising economic opportunities. In particular, preferential market access under ACFTA will help ASEAN exporters to compete more effectively with exporters from developed countries in industries where China has a comparative disadvantage, especially intermediate and capital goods. In addition, ACFTA will improve provide better market access to ASEAN exporters of agricultural products, mineral products and services, especially tourism, financial services and education.

Roland-Holst and Weiss (2004) empirically examine the important issue of the extent to which the exports of ASEAN and China compete with each other in light of the rapid growth of China's exports. Their main finding is that export competition

between the ASEAN countries and China has indeed intensified in major third-country markets such as the US and Japan. Applying econometric analysis to highly disaggregated data, they find that ASEAN suffered a substantial and widespread loss of export market shares to China across a majority of product categories in the period 1995-2000. In addition, the loss of market share tends to be greatest in the export products in which ASEAN economies are most specialized. It is certainly possible to interpret such evidence as confirming ASEAN's fears and concerns about the erosion of the region's short-run competitiveness relative to China. In the long run, however, Roland-Holst and Weiss see a considerable potential for complementarity between ASEAN and China. In this connection, they point to the projections of Roland-Holst (2002), which indicate that ASEAN economies are likely to experience sustained current account surpluses with China due to the latter's rapid import growth. They also point out that ASEAN is holding its own in higher value-added exports and exports to China serve as a cushion against crowding out of third-country export markets. Finally, their extensive trade flow analysis reveals that in the long run the growth of the East Asian regional economy and global export markets may accommodate simultaneous expansion of ASEAN and Chinese export capacity.

Chirathivat (2002) finds that both ASEAN and China should experience net trade gains from ACFTA, with more trade creation than trade diversion. Under ACFTA, ASEAN may play a bigger role in satisfying China's growing appetite for imported raw materials and intermediate inputs. To simulate the impact of AFTA, Chirathivat assumes that ASEAN and China eliminate all tariffs and non-tariff trade barriers, leading to a protection rate of zero. He uses simulations to estimate the effects of ACFTA's tariff liberalization and non-tariff liberalization separately. Chirathivat finds that due to tariff liberalization ASEAN's exports to China will rise by 53%

while China's exports to ASEAN will rise by 23%, and ASEAN's total exports will rise by 0.8% while China's total exports will rise by 1.9%. Non-tariff liberalization will raise ASEAN's exports to China by 187% and China's exports to ASEAN by 34%, and raise ASEAN's total exports by 2.1% and China's total exports by 6.6%. The simulation results also point to a substantial positive impact on real GDP and welfare for both ASEAN and China. The overall results suggest net trade gains for both ASEAN and China – trade creation exceeds trade diversion for ASEAN while there is almost no trade diversion for China.

A number of other studies also look at the potential effects of ACFTA. Laurenceson (2003) finds that there is already a high degree of integration between ASEAN and China in the goods and services, which implies that the impact of ACFTA on trade may be quite limited. The empirical analysis of Voon and Yue (2003) indicates that China had a competitive advantage over ASEAN in manufacturing exports to the US and this advantage increased after the Asian financial crisis. Wong and Chan (2002) point out that China poses a more competitive threat to the ASEAN economies as it moves up the manufacturing value chain away from labor-intensive products toward capital- and technology-intensive products. Liu and Luo (2004) use a market-share model to assess trade competition between ASEAN and China, and find Singapore to be the only ASEAN economy that experienced trade competition with China in manufactured goods. They also conclude that for ASEAN the opportunities associated arising from increased trade with China are much larger than the competitive challenges posed by China.

Wattanapruttipaisan (2003) analyzes the impact of ACFTA and China's entry into the WTO on the poorer ASEAN economies of Cambodia, Laos, Myanmar and Vietnam, and concludes that these economies need special and differential (S&D)

treatment and flexibility in order to participate more effectively in ACFTA. The four countries will enjoy better access to the Chinese market for many primary products and some manufactured products, but also face greater Chinese competition in a wide range of labor-intensive and technology-intensive manufactured products both at home and in third-country markets. Roberts (2004) uses the gravity trade model to examine the impact of ACFTA on ASEAN and China. He concludes that in order for the four poorer ASEAN economies to benefit from ACFTA, China and the six richer ASEAN economies will have to provide active assistance and cooperation. Using computable general equilibrium (CGE) models, Toh and Gayathri (2004) assess the quantitative impact of ACFTA on Vietnam. Their results indicate that ACFTA could bring about significant economic benefits and lower adjustment costs in connection with Vietnam's efforts in industrialization and structural change.

3 Theory of Economic Integration

In this section, we define economic integration and review the theoretical considerations behind economic integration. In particular, we look at the factors that make integration theoretically feasible and desirable. Viner (1950) pioneered the theory of customs union, the forerunner of the theory of economic integration. Regional economic integration is a process whereby various economies of a region undergo a progressive removal of the barriers to free movement of goods, services, capital and labor. Reduction or removal of tariffs and non-tariff barriers among the economies of a region will obviously promote economic integration within the region by facilitating the flow of goods. Likewise, reduction or removal of restrictions and controls on the international flows of services, capital and labor reinforces regional economic integration. Lang and Orr (1995), Molle (1994), and Robson (1987) provide overviews of the theory of economic integration.

In the context of ACFTA, economic integration realistically means the expansion of trade between ASEAN and China. The ultimate aim of economic integration is to remove all barriers to the movement of goods and services, capital and labor between China and the ten ASEAN states. At this stage, however, economic integration between ASEAN and China is in its infancy and the realistic next step forward is the removal of most impediments on trade. In other words, before more advanced stages can be even contemplated, ASEAN and China should concentrate on facilitating the flow of goods and services between the two sides.

The salient features of a customs union are (1) elimination of tariffs and quantitative restrictions on imports from member states, and (2) imposition of common external tariffs on imports from third countries. The difference between a customs union and a free trade area is that in the former there are common external tariffs against non-members as well as free trade whereas in the latter, each member retains its own tariffs against non-members. It is thus possible to view a free trade area as a variant of the customs union or vice versa. What is important for our purposes is that the theory of customs union provides the basic theoretical framework for analyzing free trade areas despite the two are not the same.

The potential benefit of a customs union is increased specialization and trade. There are both positive and negative effects in terms of welfare implications. The positive effect, trade creation, means the replacement of higher cost domestic products by lower cost imports from member countries. Trade diversion, on the other hand, refers to the replacement of low cost imports from non-member countries by higher cost imports from member nations. This diversion occurs because non-members face higher tariffs than members of the customs union. The differential tariff treatment diverts trade away from non-members toward members.

Whether there will be any net gain from a customs union depends on which effect – trade creation or trade diversion – is larger. The following criteria are relevant in answering this critical question. All of them are static in the sense that they are considerations which help us to compare the one-shot change in welfare due to a customs union – before and after its formation. A custom union is more likely to raise rather than reduce welfare (1) the larger the size of the market, (2) the higher the pre-union level of tariffs among members, and the lower and the less disparate the pre-union level of tariffs against non-members, (3) the greater the pre-union level of intra-regional trade, (4) the more similar the levels of economic development, (5) the closer the members are geographically and the better the transportation infrastructure, (6) the greater the substitutability between products of member states and products of non-member states. (7) the smaller the pre-customs union share of extra-regional trade in total trade, and (8) the more complementary the economic structures of the member states.

In addition to static factors, there are also possible dynamic benefits resulting from the removal of trade barriers and the restructuring of the economy associated with the creation of a customs union. These factors are different from static factors because they do not pertain to one-shot changes in welfare but gradually emerge over time instead. Dynamic factors include (1) greater competition and hence an improvement in efficiency, (2) gains from greater specialization, economies of scale and learning-by-doing, (3) reduction of intra-regional transactions costs, (4) some protection from adverse developments in the world markets, and (5) bargaining power vis-à-vis industrialized countries. There are also dynamic costs of polarization associated with unequal distribution of gains from the customs union.

Besides the largely economic criteria discussed in previous sections, there are a

large number of non-economic factors which determines the success or failure of economic integration. The experience of EU highlights the central role of such non-economic variables in economic integration. Some examples are a common desire to put an end to violent conflicts, a shared feeling of vulnerability, a shared goal of achieving power equity between countries in the region, and political leaders who realize that there are common problems which require common solutions. By far the most important non-economic variable is political leadership seriously committed to integration and cooperation.

4 Prospects of ACFTA

In this section, we ask ourselves the following central question – “Do the theoretical considerations we have discussed in the preceding section bode well for the success of ACFTA?” Broadly speaking, to repeat, economic integration between ASEAN and China at this stage means more trade between the two sides. At this stage, ASEAN-China trade is largely between the richer ASEAN inner core – Indonesia, Malaysia, Philippines, Singapore, Thailand and Brunei – and China. However, we can expect the poorer ASEAN periphery of Cambodia, Laos, Myanmar and Vietnam to also benefit substantially from ACFTA as their economies and trade grows in the future. In particular, the Vietnamese economy has been growing very rapidly in recent years. A single market like the EU remains a distant vision for ASEAN and China. The next realistic stage in economic integration is to move steadily toward a free trade area.

4.1 Static Factors

Here we look at the various static factors that impinge upon ACFTA’s ability to become an effective mechanism for promoting mutually beneficial trade between ASEAN and China. We have already looked at the criteria which theoretically favor the creation of a customs union in the preceding section and we are now examining

the extent to which ACFTA would satisfy those criteria.

(a) Size of Union

The theory of customs union suggests that the larger the collective economic size of the union, the larger the possibility of trade creation. While ACFTA is smaller than compared to NAFTA and EU, it is certainly large enough for an effective customs union. ASEAN comprises 10 countries with a combined 2003 population of around 537 million people and a combined 2003 gross national income (GNI) of US\$648.5 billion. China's 2003 population was 1,288 million and its 2003 GNI was US\$1,416.8 billion. Therefore, the 2003 population of ACFTA is 1.825 billion and the 2003 real GNI of ACFTA is US\$2.065 trillion. In purchasing power parity (PPP) terms, ACFTA is even bigger at US\$8,593.8 billion – China's PPP GNI is US\$6,410 billion and ASEAN's PPP GNI is US\$2,183.8 billion. While there are no well-defined objective criteria as to the optimal number of countries or the size of the market, ACFTA does appear to pass the test in this regard.

(b) Initial Tariff Structure

Recall that the higher the initial intra-regional tariffs, the larger the potential for trade creation. Due to the solid progress of the ASEAN Free Trade Area (AFTA), the tariff rates for intra-ASEAN trade are low and falling, with the elimination of all tariffs targeted for 2010. Despite a general trend toward trade liberalization in China and ASEAN, including China's entry into the WTO in December 2001, tariffs and other trade barriers between the two sides remain high enough to create significant opportunities for trade creation. According to Chirathivat (2002), China's average tariff rate on goods from the ASEAN-5 – Indonesia, Malaysia, Philippines, Singapore and Thailand – was 9.4% in 2001 while ASEAN-5's average tariff rate on goods from China was 2.3%. Furthermore, the corresponding rates of non-tariff protection are

69.1% and 9.2%. Second, the higher the level and variance of tariffs against non-members, the larger the possibility of trade diversion. According to WTO (2005), for both agricultural and non-agricultural goods, the simple average of ad valorem tariff rates of China, Indonesia, Malaysia, the Philippines, Singapore and Thailand as of 2004 are 10.4%, 6.9%, 8.4%, 6.3%, 0.0% and 15.4%, respectively. For agricultural goods, the average rates of China, Indonesia, Malaysia, the Philippines, Singapore and Thailand as of 2004 are 16.2%, 8.2%, 3.3%, 9.5%, 0.0% and 29.6%, respectively. For non-agricultural goods, the average rates of China, Indonesia, Malaysia, the Philippines, Singapore and Thailand as of 2004 are 9.5%, 6.7%, 9.1%, 5.8%, 0.0% and 13.3%, respectively. There is also a wide variance in the tariff rates of the ASEAN countries and China for different agricultural and non-agricultural product groups. Therefore, the structure of external tariffs in ACFTA does not rule out significant trade diversion. It is thus unclear whether, on balance, ACFTA's initial tariff structure will promote more trade creation than trade diversion or vice versa.

(c) Pre-Integration Intra-Regional Trade

Trade creation is more likely the greater the pre-integration intra-regional trade. Countries that trade heavily with each other stand to gain the most from the elimination of impediments to trade. On the other hand, doing away with such impediments will be of limited value to those who trade little with each other. It is clear that ASEAN and China are already important for each other as export markets and import sources. In 2003, ASEAN's exports to China and imports from China reached US\$47.3 billion and US\$30.9 billion, respectively. ASEAN has become China's fourth largest trading partner and the reverse is true as well. ASEAN's exports to China accounted for around 10% of its total exports and imports from China accounted for around 8% of its total imports in 2003. China's exports to

ASEAN accounted for around 7% of its total exports and imports from ASEAN accounted for around 11.5% of its total imports in 2004.

Moreover, ASEAN-China trade is not only substantial but also growing rapidly, from US\$39.5 billion in 2000 to US\$78.2 billion in 2003. The bilateral trade has grown even further to US\$106 billion in 2004 and rose by 25% during the first six months of 2005. Such rapid growth has increased the share and hence relative importance of the ASEAN-China trade in the trade of both ASEAN and China. In 2004, Singapore was China's 8th biggest export market and Malaysia, Singapore and Thailand were among the top 10 import sources. China is an important and increasingly important export market and import source for virtually all the individual ASEAN economies as well. Our discussion clearly suggests that the size and growth of pre-integration trade between ASEAN and China bodes well for ACFTA.

(d) Substitutability of Products

The greater the substitutability of products of member states for those of non-member states, the greater the chances of trade creation. Substitutability means the production of similar but differentiated products. For example, China can theoretically substitute semi-conductors from Taiwan with similar but slightly different semi-conductors from Singapore. In practice, although China and the ASEAN economies now export broadly similar goods, such as electronics products and components, the range of substitutable products remains relatively small. While ASEAN's trade with China is large and growing, most of ASEAN's exports go to other markets and most of its imports come from other sources. More specifically, ASEAN's biggest export markets are the US, EU and Japan and its biggest import sources are Japan, US and EU. Likewise, most of China's trade is with economies outside ASEAN. More specifically, China's most important trading partners are the US, Japan, Korea, EU

and Hong Kong. Such trade pattern provides stylized evidence suggesting limited substitutability of products. The extent to which China and ASEAN can substitute imports from other sources with imports from each other is likely to be limited.

(e) Disparity in Pre-integration Level of Development

If the pre-integration levels of development and income are similar among members, the gain from integration will be larger and integration will be easier. Similar income levels mean that consumers buy similar baskets of goods and services, increasing the opportunity for intra-industry trade – e.g. Germany and France selling cars to each other. A major reason for the success of the European Union is that all the countries are developed market economies with relatively small disparities in income levels and other structural characteristics. Broadly speaking, if we view the ten ASEAN countries as a single economy, then China and ASEAN are at similar levels of per capita income and economic development. China's 2003 per capita gross national income (GNI) was US\$1,417 while ASEAN's 2003 per capita GNI was US\$1,208. In per capita terms, China's 2003 per capita GNI was US\$4,980 while ASEAN's 2003 per capita GNI was US\$4,067.

However, ASEAN is far from being a homogeneous grouping. The range of income and economic development ranges from Singapore – a mature and developed economy – to Vietnam, Laos, Cambodia and Myanmar, which are all among the world's poorest economies. Comparing China with individual ASEAN economies, we can see that Singapore and Brunei have much higher per capita incomes than China, Malaysia and Thailand have significantly higher incomes, Indonesia and Philippines have similar incomes, and the four remaining countries have significantly lower income. The heterogeneity of ASEAN economies notwithstanding, the income and

economic development of China and ASEAN seem to be broadly similar enough to provide many opportunities for intra-industry trade.

(f) Geographical Proximity and Transportation Infrastructure

Economic integration is easier among countries geographically close countries due to lower transportation costs. However, geographical proximity translates into lower transportation costs if and only if there is a good transportation infrastructure of land, sea and air links that connect the geographical neighbors, as is the case in the EU. ASEAN and China are geographical neighbors, with Laos, Myanmar and Vietnam sharing borders with China. Furthermore, the geographical proximity is complemented and reinforced by the presence of large ethnic Chinese communities throughout ASEAN that can “speak the same language” and thus help to reduce the cost of doing business for both sides. However, unlike in the EU, the land transport network of highways and railways connecting the ASEAN countries with China is poor at present. Even the internal transportation infrastructure is inadequate in the parts of China that border ASEAN and even worse in the peripheral ASEAN countries bordering China. These add significantly to the costs of trade and further impede ASEAN-China trade. The ASEAN countries and China will thus have to make major investments in their transportation infrastructure in order to fully realize the economic benefits of their physical proximity. Those infrastructure investments should not be limited to land transportation but also extend to sea and air transportation. Better airports and ports will help ASEAN and China to take better advantage of their proximity just as better highways and railways do.

(g) Complementary or Competitive Economic Structures?

The success or failure of an economic integration area depends partly on whether the members’ economic structures are complementary or competitive. More precisely,

according to Meade (1955), trade creation will be greater if the pre-integration economic structures are competitive but potentially complementary after integration. This means that due to high tariffs and other protectionist barriers, countries within a group produce similar goods before integration. After integration, the more efficient producers will replace the less efficient ones and the number of similar goods produced falls, producing welfare gains due to specialization and economies of scale. That is, integration and the resulting reduction of trade barriers will allow countries within the group to take better advantage of their comparative advantage. China and the ASEAN economies are competitive to some extent now – trade barriers are high enough to protect domestic producers from effective competition in selected high-priority industries. The more significant issue of whether they will become complementary after ACFTA so that ASEAN and China produce less similar goods remains an open question. The most compelling indirect evidence of a potential complementary relationship between ASEAN and China is the large and rapidly growing ASEAN-China trade in recent years.

(h) Summary of Static Considerations

All in all, in terms of static theoretical considerations, there are grounds for cautious optimism about the success of ACFTA. In particular, the large and growing level of pre-ACFTA trade between ASEAN and ACFTA suggests that ACFTA will yield substantial economic benefits for both ASEAN and China. Furthermore, the large economic size of the ACFTA market, geographical proximity between ASEAN and China, and the two sides' similar levels of income and economic development all bode well for ACFTA's prospects. On the other hand, limited substitutability between ACFTA imports and non-ACFTA imports and the poor transportation infrastructure are causes for pessimism about ACFTA's prospects. Finally, it is unclear whether the

economic structures of ASEAN and China will become complementary after ACFTA. Nor is it clear whether the current structure of tariffs in ASEAN and China will lead to more trade creation or diversion. On balance, our examination of the extent to which ACFTA satisfies the theoretical criteria for integration provides some, but not overwhelming, support for ACFTA's prospects as an effective means of promoting trade between ASEAN and China.

4.2 Dynamic Considerations and Other Economic Considerations

We have seen that we can expect significant static gains from ACFTA since our consideration of the theoretical static criteria pertaining to trade creation and diversion provides cautious grounds for optimism about ACFTA's prospects. While such static benefits are clearly important, potentially large dynamic benefits provide an additional impetus for economic integration. Dynamic benefits from integration are gradually realized over a long span of time rather than immediately. Relative to static welfare gains, dynamic welfare gains are inherently harder to quantify and are usually overlooked. This does not, however, render them any less significant. If they are large enough, it is conceivable that they could justify economic integration even if the static welfare gains are uncertain or negligible.

In particular, we have to take into account the greater competition and improved efficiency that will lead to positive welfare gains for the ASEAN economies as a result of ACFTA. The economic crisis which engulfed the entire region in 1997-1998 highlighted the need for the region's economies to make improve their competitiveness and efficiency in the global economy. Fostering greater competition through deeper and broader integration with China can be highly useful in this regard. The ASEAN economies need to become more competitive and efficient in any case, and greater exposure to competition from China – the factory of the world – will only

add much-needed urgency to their efforts in this direction. The widely discussed competitive threat from China can thus serve as a blessing in disguise. In the long term, increased productivity and efficiency is their only route to sustainable economic growth for ASEAN. In this light, the dynamic benefits of economic integration are potentially large indeed. The scope for inter-and intra-industry specialization will also increase over time as ACFTA creates more inter- and intra-industry trade opportunities, producing further welfare gains. Furthermore, ACFTA will create a large market, thereby helping ASEAN countries expand production and exploit greater economies of scale. For example, Thailand could specialize in the production of automobiles for the entire region while Singapore can become a regional hub for banking and financial services.

Investment in human capital, physical capital and technological up-grading are some specific strategies for the ASEAN economies to improve their productivity and efficiency. Such efforts will enable the ASEAN economies not only to compete more effectively in big third-country markets but also to increase exports of skill-, capital- and technology-intensive exports to China. In this connection, ASEAN can learn from newly industrialized economies such as Korea, which are higher up in the manufacturing value chain than ASEAN and are benefiting substantially from China's economic resurgence. The formation of ACFTA may also increase the inflow of FDI into ASEAN by to the extent that there is a greater perception of a common market and complementarity between ASEAN and China among outside investors. ACFTA will further reinforce the widespread practice of many foreign multinational corporations (MNCs) to locate different stages of production in different countries according to the comparative advantage of each country. Finally, we can expect the growing affluence of Chinese consumers to sharply increase their demand for services

such as tourism, financial services and education, and the ASEAN economies would do well to position themselves to take advantage of this trend, especially given the preferential market access that ACFTA provides them.

4.3 Non-Economic Factors Relevant to Further Integration

Non-economic factors often play the role of catalyst in regional economic integration. In particular, as the EU's example so clearly illustrates, the political commitment, will and leadership of governments in prospective member countries is a pre-condition for successful integration because it makes close cooperation among governments possible. It is fair to say that ASEAN countries, like the EU countries, share a sense of common destiny and vulnerability. In terms of fostering effective political cooperation among its member government, ASEAN has been remarkably successful. Therefore, ASEAN countries are willing and able to speak with a single voice in negotiations with China over the formation of ACFTA. Furthermore, there seems to be an ASEAN-wide consensus about the desirability and feasibility of ACFTA. The Chinese government for its part also seems firmly committed to the ACFTA initiative as a means of forging a closer relationship with its southern neighbors. Just as importantly, the ASEAN governments and the Chinese government enjoy good working relationships and there are no historical or other non-economic obstacles that stand in the way of political cooperation.

The commitment of both ASEAN and Chinese governments to ACFTA is not motivated solely by economic factors although these are clearly important. In economic terms, from the ASEAN perspective, ACFTA represents a potential tool for benefiting from China's remarkable economic growth and more generally, to recover some of the economic dynamism that seems to have been lost since the Asian crisis. In economic terms, from the Chinese perspective, ACFTA represents a means of

expanding trade opportunities with a large and geographically close region as well as reassuring ASEAN economies concerned about competitive threats that there is a significant scope for mutually beneficial economic cooperation. As pointed out earlier, however, China's economic resurgence inevitably has significant geopolitical implications for the ASEAN countries, which are understandably uneasy about the awakening of their giant northern neighbor. At the same time, China is concerned about the concern of the ASEAN countries and eager to show that it is a good neighbor with peaceful intentions. Therefore, ACFTA is a component, albeit a central and integral component, of ASEAN and China's overall efforts to strengthen their mutual relationship, which is consistent with each side's geo-political self-interest.

It is also possible to view ACFTA as a significant example of a broader trend toward closer economic cooperation among East Asian economies in the wake of the Asian crisis of 1997-1998. Rightly or wrongly, there was widespread perception in East Asia that the crisis was largely brought about by the speculative activities of external, non-Asian investors. Such a region-wide sense of being victimized by external forces was further reinforced by what was widely perceived to be inadequate and untimely response to the crisis by the International Monetary Fund (IMF). The crisis has thus encouraged regional policymakers to explore closer intra-regional financial cooperation through the Chiang Mai Initiative and other ideas in order to prevent future crises. Simultaneously, the proliferation of regional trade agreements (RTAs) such as NAFTA is also pushing East Asian governments toward RTAs of their own such as ACFTA so as not to be left behind. The general trend toward the coexistence of the multilateral WTO trade system and RTAs means that regions are seeking to expand trade within the region as well as with the rest of the world, and East Asia is no exception in this respect. While the idea of East Asian economic

cooperation is not new, the twin forces of the Asian crisis and growing trade regionalism are giving it greater momentum.

5 Concluding Remarks

ASEAN and China are economic partners as well as economic competitors. The competitive element is most evident in the competition for export market shares in the US and other third-country markets as well as in the competition for foreign direct investment (FDI) from Japan and other industrialized countries. The competitive element has given rise to widespread concerns and fears within ASEAN about the growing competitiveness of China's manufactured exports and the attractiveness of its huge domestic market for foreign investors. All the more so since the past economic success of the ASEAN economies was built largely on exports of manufactured goods and inflows of foreign direct investment FDI. The slowdown of economic momentum throughout the region since the Asian crisis has further added to the sense of uncertainty and pessimism about China's rapid ascent. At the same time, there are unmistakable elements of potential complementarity between ASEAN and China as well. For one, while the world's attention is focused largely on China's surging exports, its less-noticed but no-less-remarkable appetite for imports, especially intermediate and capital goods, agricultural products and raw materials, represents a potential engine of growth for ASEAN economies. From the Chinese viewpoint, the sizable collective economic size of ASEAN means that the region offers a meaningful opportunity to diversify both its export markets and its import sources.

A widely discussed means of strengthening the economic partnership between ASEAN and China is to form an ASEAN-China free trade area (ACFTA). The main objective of our paper is to critically examine the economic feasibility of ACFTA as well as its desirability, especially from the ASEAN perspective. Our analysis is based

primarily on customs union theory, in particular the various criteria underlying static trade diversion versus static trade creation. On balance, our examination of the extent to which ACFTA satisfies the theoretical static criteria for integration provides some, but not unqualified, support for ACFTA's feasibility and desirability. The large and growing level of pre-ACFTA trade between ASEAN and China suggests that ACFTA will yield substantial economic benefits for both ASEAN and China. Additional favorable factors include the large collective economic size of ACFTA, geographical proximity between ASEAN and China, and the two sides' similar levels of income. On the other hand, unfavorable factors include limited substitutability between ACFTA imports and non-ACFTA imports and the poor transportation infrastructure. Factors that do not have a clear impact on ACFTA include the relationship between the economic structures of ASEAN and China, and their current tariff structures.

There are further considerations that bode well for the success of ACFTA. In particular, ACFTA can help to bring about significant dynamic improvements in the productivity and efficiency of the ASEAN economies by subjecting them more fully to the competitive pressures from a China whose own productivity and efficiency are rapidly improving. In the short run, Chinese competition will undoubtedly lead to painful structural adjustment in some manufacturing industries in which ASEAN economies have little or no comparative advantage relative to China. However, over a longer period of time, such competitive pressures will force the ASEAN economies to invest more in human capital, physical capital and technological upgrading so that they can find new areas of comparative advantage. Re-allocation of resources toward more productive activities, including activities that facilitate success in the fast-growing Chinese market, will enable the ASEAN economies to compete more effectively in the global economy in the long run. Last but not least, it is clearly in the

geopolitical self-interest of both ASEAN and China to engage rather than antagonize the other side. As such, the governments of ASEAN and China are likely to provide the political commitment, will and leadership critical for the success of ACFTA. This important consideration reinforces our sense of guarded optimism about ACFTA's potential for promoting closer economic ties between ASEAN and China.

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