

## Overview

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Emerging East Asian economies<sup>1</sup> have seen their share of world exports more than triple in the past quarter-century, from 5.4 percent in 1975 to 18.7 percent in 2001. Their trade with one another has grown faster than their trade with any other market, and now makes up 6.5 percent of global trade.<sup>2</sup> Broad measures of development in East Asia have improved at the same headlong pace; since 1990, more than 280 million people have seen their incomes rise above a poverty threshold of US\$2.00 a day.

But performance has varied sharply over time and across the region. Most recent trends show mildly rising inequality within countries including China, Vietnam, and the Philippines, and a widening income gap between richer economies such as Singapore and Hong Kong (China) and the poorest, Lao People's Democratic Republic (Lao PDR) and Cambodia.<sup>3</sup> Both trends are of concern to policymakers interested in a stable, prosperous region, and both trends have been linked with economic liberalization.

Against this background, some analysts estimate that East Asia would still benefit more than any other region from global liberalization<sup>4</sup>—because of the potential shown by its dynamic exporters—and that it could achieve much of the benefits of liberalization through regional integration—because of the complementarity of production and exports among what are very diverse economies. The potential gains to the region from global liberalization are estimated at hundreds of billions of U.S. dollars by 2015. Increasingly, the development agenda in the region, with its focus on growth, jobs, and social stability, and the trade policy agenda, with its focus on market access and competitiveness, have become intertwined.

Pursuit of a “trade for development” strategy in East Asia will not be easy. It involves economic change, at a time when policymakers are trying to manage major financial and corporate restructuring, repair overstretched social safety nets, respond to the challenges posed by China, listen to the greater plurality of voices and interest groups competing for political power, and adapt to sometimes vicious global economic cycles. At a time when stability is seen as a key to investor confidence and a return to high growth, it is not surprising that there is resistance to still further change.

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<sup>1</sup> Emerging East Asia is defined here as the Association of Southeast Asian Nations (ASEAN), plus other newly industrializing economies, plus China, plus Mongolia. ASEAN members are Brunei Darussalam, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Vietnam.

<sup>2</sup> Not much less than the 7.7 percent share of global trade among the North American economies when the North Atlantic Free Trade Association was formed in 1995.

<sup>3</sup> East Asia is perhaps the most diverse region in the world. The income per capita, in purchasing power terms, of Singapore, for example, is 25 times that of Lao PDR, and the gap between the two in institutional capacity to manage development may be even greater.

<sup>4</sup> World Bank, *Global Economic Prospects*, 2002.

## Why push integration now?

Two economic events of historic proportions provide the context for East Asian development today.

The currency and financial crisis of 1997-98 still affects every aspect of economic policymaking. Among the aftershocks of the crisis, the challenge posed by the apparent failure of the East Asian development model—the intellectual force behind the so-called Miracle<sup>5</sup>—may be the most far-reaching in its implications. The crisis shattered a deeply held and broadly shared view of the policy keys to development success, and has called for a review of what now needs to be done to build on the basic tenets of macroeconomic stability, high savings and investment, rapid expansion of education, and a strong export orientation.<sup>6</sup> Many in the region consider the crisis to have been a “defining moment.”<sup>7</sup>

The second major event was China’s accession to the World Trade Organization (WTO) in November 2001—the culmination of a 15-year-long bid for membership. China’s economy is already one of the largest in the world, and its prominence as an economic force in the region has clearly risen since the crisis.<sup>8</sup> China’s strong currency and strong growth, set against the weakening currencies and weak growth of other developing countries in the region, have meant that China’s gross domestic product (GDP) now surpasses that of the rest of emerging East Asia combined.<sup>9</sup> China is expected to be the world’s largest recipient of foreign direct investment in 2002. And, with its trade growing rapidly, China has become an important destination for exports from the rest of the region, as well as being a fierce competitor in third-country markets.<sup>10</sup> Because of its size and diversity, China resists easy definitions of its comparative advantage in terms of high-tech or low-wage manufacturing, and following its WTO accession its comparative advantage may change appreciably. Thus it is no surprise that many policymakers in the region feel the need to understand the trends at work in China before they can formulate their own development strategies.<sup>11</sup> Typically, too, they recognize that overcoming the formidable challenges of implementing China’s WTO commitments will be as important for the rest of East Asia as it is for China itself.

The region is now shaping its responses to these two events. The integration agenda discussed in this volume covers three areas:

- Widening opportunities in trade arrangements
- Development orientation for a behind-the-border agenda
- Reinforcing social stability through broad sharing of benefits.

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<sup>5</sup> World Bank (1993).

<sup>6</sup> See World Bank (2000) for a first assessment of the new policy and institutional agenda.

<sup>7</sup> World Bank (2002b).

<sup>8</sup> China is widely seen as having contributed to stability in 1997-98 by maintaining a stable exchange rate in the face of major devaluations of other currencies. Few scholars give credence to the notion that competition from China was the cause of the Asian crisis.

<sup>9</sup> The ratio of China’s GDP to the rest of emerging East Asia GDP was 1:2 in 1996 and 1:1 in 2002.

<sup>10</sup> China’s share of East Asian exports has grown significantly over the last decade: from 10 to 20 percent for Singapore, Korea, and Taiwan (China); and from 2 to 5 percent for ASEAN.

<sup>11</sup> World Bank (2002b).

These are discussed in the following sections of this overview, the concluding section of which outlines priority areas for action.

## **Context: recent trends in trade and poverty reduction**

Rapid and sustained growth in international trade has long been a hallmark of successful growth and development strategies in East Asia. Well known are the success stories of the newly industrializing economies such as the Republic of Korea, as well as middle-income economies such as Malaysia and the transition economy of China. More recent entrants to world markets include low-income economies such as Cambodia and Vietnam.

Intraregional trade in East Asia has grown faster than trade with any other market, and while the largest economies account for the bulk of this trade, the regional trade of most smaller economies has also grown. Trade integration has been market-led, stemming from a combination of unilateral reforms, fulfillment of multilateral commitments, and a “flying geese” pattern of relocation of production processes.<sup>12</sup> Intraregional trade has been driven not only by growing demand but increasingly by improved competitiveness in regional markets, as reflected in increased market shares (Figure 1). China has been particularly dynamic, but almost all countries increased their competitiveness in regional markets during 1995-2001.<sup>13</sup> This was accomplished without loss of competitiveness in other markets; East Asia continued to expand its market shares in European Union and North American Free Trade Association (NAFTA) markets in the same period.

The product composition of intraregional trade has become highly concentrated. The top 30 exports now account for more than half of total trade, with 38 percent in just four subsectors: office machinery, telecommunications equipment, electronics, and textiles and clothing (Figure 2).

One of the major factors in the concentration of intraregional trade has been the remarkable increase in international production sharing, as reflected in the growth of trade in components or partly assembled goods. China is increasingly a central player in production networks. While Japan remains an important center of production-sharing operations in East Asia and is the origin of about one-third of all regional exports of components for assembly, China is finding niches; its exports of parts and components grew by almost US\$20 billion during 1996-2001. At the same time, other East Asian economies have been finding their own niches within China’s markets (Figure 2).

East Asian trade profiles have become more mutually complementary, and the degree of complementarity for emerging East Asia is now comparable to that of the EU (6) and

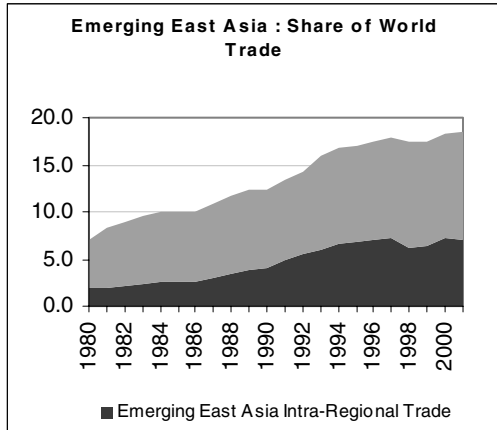
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<sup>12</sup> See Kawai and Urata (2002).

<sup>13</sup> Exceptions were Singapore, Cambodia, and Brunei.

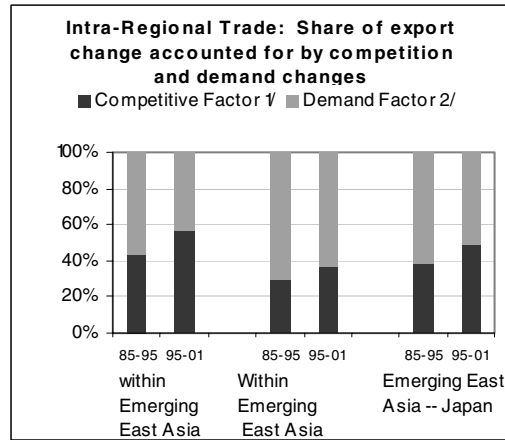
**Figure 1: Trends in regional trade**

**Emerging East Asia economies' share of world exports grew . . . and trade among these economies grew even faster**



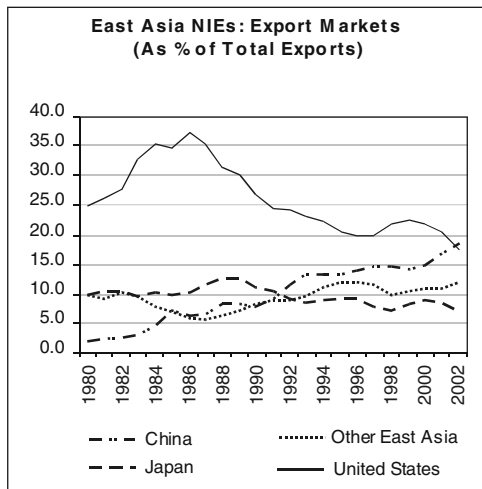
*Note:* Emerging East Asia is ASEAN plus other newly industrializing economies plus China plus Mongolia.  
*Source:* IMF, Direction of Trade; data reported from exporter country accounts; annual data for 1980, 1985, 1990, 1995, 2000, and 2001, Table 1.1 and Website; data reported from importers country accounts.

**Regional integration driven increasingly by competitiveness and growing market share**

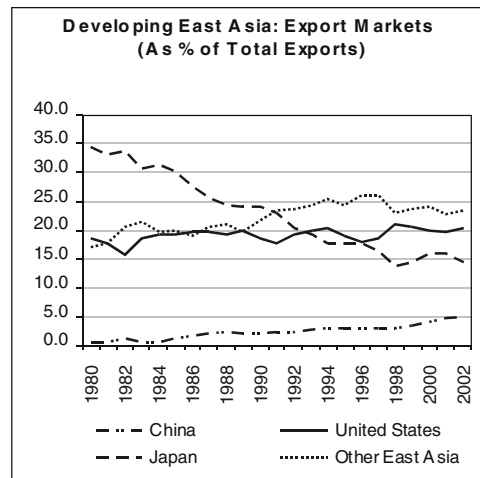


*Notes:* Diversification, or change in exports due to new products, accounts for a small share.  
 1/ Competitive factor = change in market share.  
 2/ Demand factor = change in market size.  
*Source:* Ng and Yeats (2003), Table 8.1 and Website.

**Exports to China are particularly dynamic**



*Note:* East Asia NIEs = Hong Kong/China, Korea, Singapore, Taiwan/China.  
*Source:* IMF, Direction of Trade; data reported from exporter country accounts.



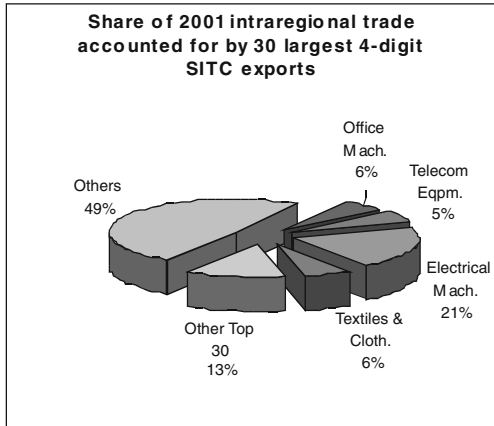
*Note:* Developing East Asia = Indonesia, Malaysia, Philippines, Thailand, Cambodia, Lao PDR, Mongolia, Myanmar, Vietnam.  
*Source:* IMF, Direction of Trade; data reported from exporter country accounts.

NAFTA.<sup>14</sup> The exceptions are low-income countries such as Cambodia, Lao PDR, and, to a lesser extent, Vietnam—perhaps not surprisingly, given that a country's trade structure becomes more like the world trade structure as the country's income rises.

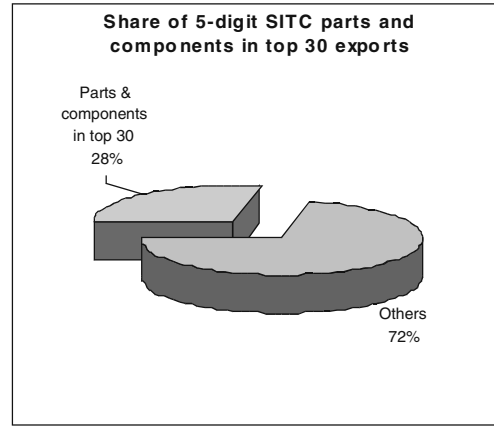
<sup>14</sup> Based on a complementarity index of more than 60 for emerging East Asia. In contrast, indices for previously failed arrangements ranged from values of 7 to 22. See Ng and Yeats (2003).

Figure 2: Intraregional trade

Intraregional trade is increasingly concentrated . . . and production sharing is major determinant

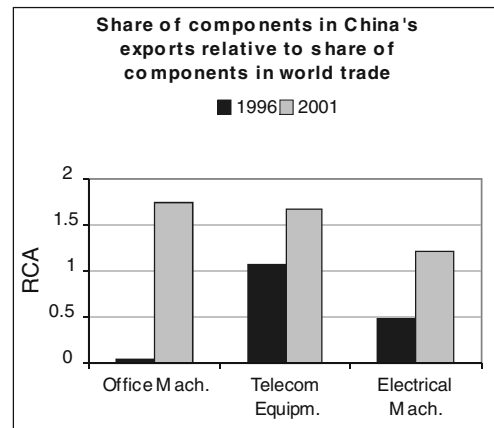
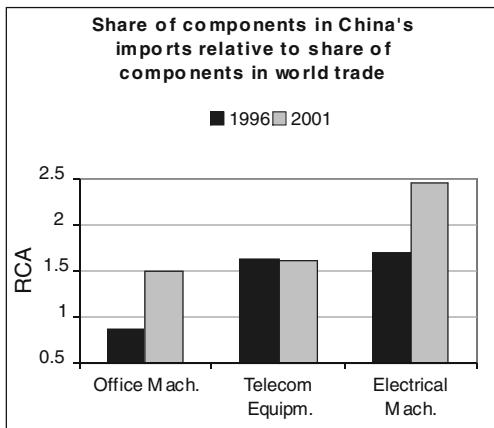


Source: Ng and Yeats (2003), Table 11.1.



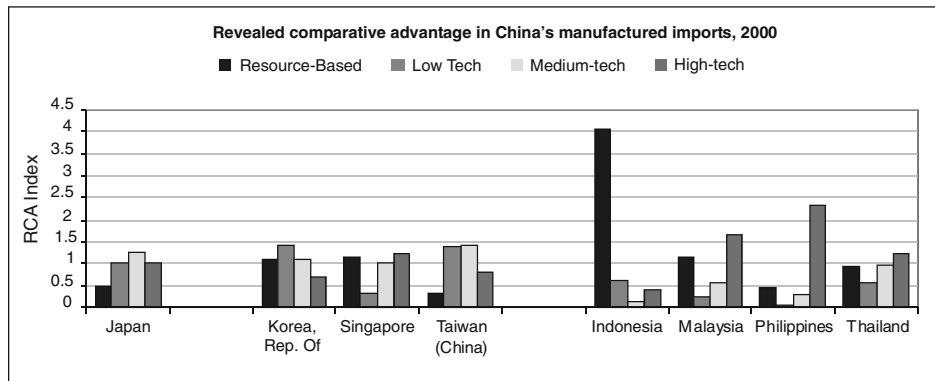
Note: non-top 30 exports account for an additional \$8.3 billion or 4 percent of total non-top 30 exports.  
Source: Ng and Yeats (2003), Table 16.1.

China increasingly central player in production networks



RCA = Revealed Comparative Advantage.  
Source: Ng and Yeats (2003).

Rest of East Asia finds niches in China's import markets



Source: Lall (2003).

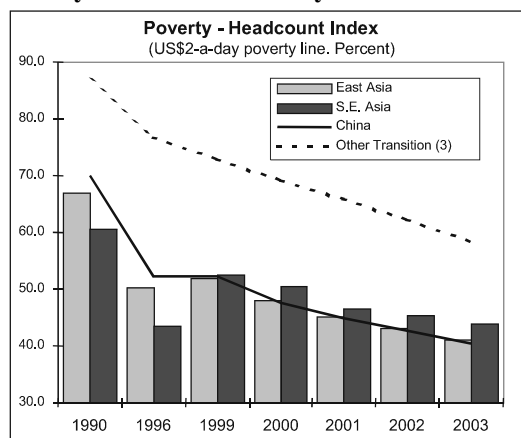
Poverty also has been markedly reduced in emerging East Asia. Well ahead of schedule, the region has attained the Millennium Development Goal of reducing extreme poverty incidence by half. On the basis of a higher poverty line of US\$2 per day, two-thirds of the population was poor in 1990; this has declined to about two-fifths today (Figure 3).

Even so, roughly 13 percent of the people of emerging East Asia were living on less than US\$1 a day in 2001. Intercountry differences are wide, with the proportion ranging from virtually zero in Korea and Malaysia to more than 30 percent in Cambodia and Lao PDR. Using the US\$2 a day poverty line, estimates for 2001 range from virtually zero in Korea to more than 75 percent of the population in Cambodia and Lao PDR.<sup>15</sup>

Rising income inequality has also become a cause for concern.<sup>16</sup> The most recent estimate of the Gini coefficient for interpersonal inequality within emerging East Asia is 46, higher than that in high-income countries (40), though lower than that in Latin America (58). Part of the increase has been driven by mildly rising inequality within countries, including China, Vietnam, and the Philippines. But the bulk of the interpersonal inequality within emerging East Asia—70 percent—is driven by inequality across location and across countries (Figure 3).<sup>17</sup> Policies and institutions that contribute to fuller integration of the low-income countries and regions of East Asia will be critical to addressing income inequality in East Asia and contributing to a stable region.

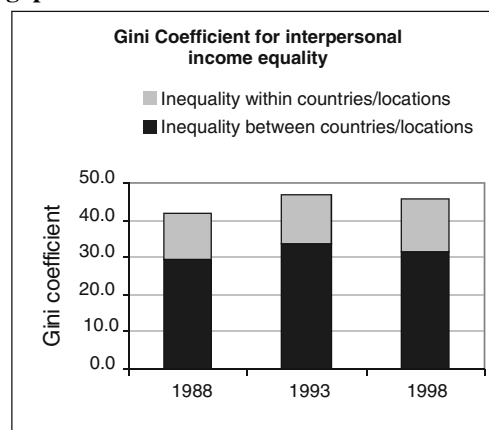
**Figure 3: Poverty and inequality**

**Poverty has declined steadily**



Source: World Bank (2003a).

**Inequality is cause for concern . . . driven by gap between countries and locations**



Note: "Country" is defined such that both China and Indonesia are divided into rural and urban parts.

Source: Milanovic (2003). Based on household survey data.

<sup>15</sup> World Bank (2002A).

<sup>16</sup> Milanovic (2003). The Gini coefficient for interpersonal inequality in emerging East Asia was estimated at 42.0 in 1988 and 46.8 in 1993.

<sup>17</sup> This contrasts with Latin America, where the bulk of inequality reflects differences within countries, and only 19 Gini points are attributable to between-country differences. For East Asia, the definition of country is such that both China and Indonesia are divided into rural and urban areas.

## Widening opportunities in trade arrangements

*Combining the ASEAN and Chinese economies “would give birth to a market of 1.8 billion consumers or almost one-third of humanity.”*

Philippines President Gloria Arroyo, May 2002

Today the region’s policymakers see trade and investment integration as key elements of strategy. Although a few trade barriers were erected in response to the Asian crisis, they were minor and temporary.<sup>18</sup> Indeed, instead of more protection, the crisis produced a new impetus for openness. A multitrack approach is being followed, with support for a new global round of trade negotiations as well as for regional and bilateral arrangements.

Liberalization of trade and investment policies is recognized as a way to spur efficiency gains. As such, it fits well with the new emphasis in Asia on innovation in firms and on economy-wide productivity growth to replace the old model of growth through physical and human capital accumulation.<sup>19</sup> There is ample evidence that export-oriented firms and those with foreign equity participation are far more productive than domestic-oriented firms, with productivity differentials of 40 percent in Indonesia and the Philippines and 15-20 percent in Thailand and Korea.<sup>20</sup> Moreover, China’s restructuring provides an impetus for establishing new regional production networks, initially in electronics, that would promote highly productive firms. For now, these production networks are oriented toward export to developed countries, but the growing markets within East Asia provide a potential complementary source of demand.<sup>21</sup>

Policies can support these natural economic forces, and the drive to liberalize is shaping new institutional arrangements. The willingness of the world’s richer countries to target the needs of developing countries in the context of the Doha Development Agenda is helpful, but the outcome of these negotiations is still uncertain. And regional and bilateral agreements fit well with other political aims of East Asian countries, giving these agreements a momentum that the global discussions have yet to achieve. ASEAN has moved to a two-tier system to permit its more advanced members to accelerate trade reform, while launching new initiatives to integrate its less developed members, Cambodia, Lao PDR, Myanmar, and Vietnam. At the same time, the speed with which the China-ASEAN framework agreement has been launched and the ideas for a new Japan-ASEAN partnership are creating new alliances in favor of liberalization within the region.

### ***China’s role in the region: WTO accession will link it further***

In line with its own reforms, China has been a growing economic force in East Asia. Exports to China have been dynamic over the last decade, particularly for the newly industrializing

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<sup>18</sup> The dangers of protectionism and of vested interests capturing political support in specific cases should not be underestimated. Recently, Vietnam imposed restrictions on motorcycle imports and Indonesia on garments.

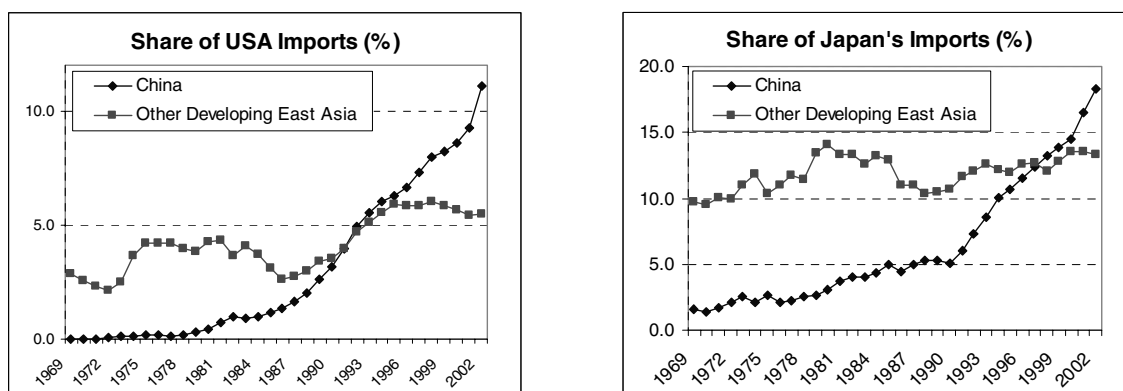
<sup>19</sup> World Bank (2003).

<sup>20</sup> Hallward-Driemeier, Iarossi, and Sokoloff (2002).

<sup>21</sup> China’s domestic market is the largest of these, but recent trends show Korea, Thailand, and other economies growing on the strength of domestic consumption demand.

economies but also for the rest of developing East Asia as shown in Figure 2 above, while shares to the United States and Japan have been flat or declining. China's trade with major markets also has been expanding, but not at the expense of East Asia.

**Figure 4: China's trade in third markets is expanding . . . But not at East Asia's expense**



Source: IMF, Direction of Trade.

Membership in the WTO and the reforms associated with membership give China the opportunity to play an even larger and growing role in the world economy, and in the regional economy, amplifying pre-existing trends.

### What WTO accession means for China: Sectoral shifts

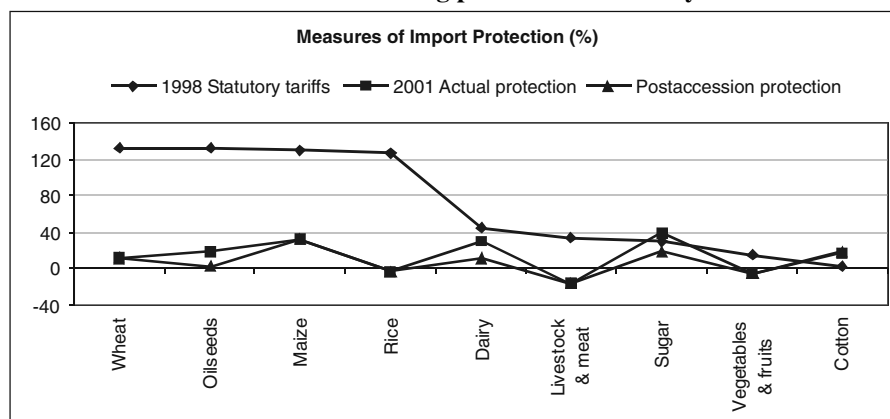
As explained in Chapter 1, assessing the implications of a major economy-wide reform such as that involved in China's WTO accession is inherently difficult. Much of the impact will be to reinforce the structural changes already under way. The experience with other trade events such as the formation of NAFTA suggests that the actual overall impact will be much greater than suggested by *ex ante* modeling, largely as a result of productivity and other changes that are hard for models to capture.

In *agriculture*, the reduction in protection is in fact likely to be far less—and the sectoral shift less dramatic—than others are predicting.<sup>22</sup> Nonetheless, China's agricultural trade liberalization plan is the expected source of about half of the efficiency gains from the WTO accession package. Reduced protection and greater scope for imports are likely in a range of products including oilseeds, sugar, and dairy products (where the principal form of protection has been tariffs, which are being reduced substantially) and cotton (where export subsidies are now ruled out). And demand will sharply increase for other raw materials and natural resources such as wood and energy products. (Figure 5.)

<sup>22</sup> Assessments of the impact of WTO accession on China's agricultural sector based on limited comparisons between statutory tariffs and the rates agreed on in the accession process would be misleading. Recent research reveals that overall protection for crops such as rice, wheat, and maize is far less than indicated by statutory tariff rates. Huang and Rozelle (2002).

**Figure 5: Reduced agricultural protection in China**

**China is following a strategy of reducing agricultural protection  
... albeit from a lower starting point than commonly measured**



Source: Chapter 1. Average statutory rates taken from Schmidhuber (2001) and www.chinavista.com.

China's decision to contain agricultural protection has more far-reaching implications.<sup>23</sup> This use of WTO rules as a commitment device will focus policymakers on other types of policies that are needed to deal with the very real problems of rural poverty—such as improving rural education and reducing barriers to labor mobility. At both regional and global levels, China's commitment to a low-protection agricultural regime sets the stage for its interests to coincide with those of countries that call for the opening of large and currently highly protected markets for labor-intensive agricultural exports.

In *industrial products*, the accession agreement builds on the substantial liberalization already undertaken. The 6-percentage-point reduction in average tariffs that remains to be implemented is small relative to the 33 percentage points achieved over the last decade; the number of products subject to import licenses has already fallen from about two-thirds of tariff lines to less than one-twentieth.<sup>24</sup>

In the case of automobiles, a massive sectoral rationalization is expected to lead to scale economies that could more than offset the impact of the reduction in protection, making China's automobile industry internationally competitive.<sup>25</sup>

Another major impact of accession will be a strong expansion in China's textiles and clothing sectors. Importing countries have committed to abolish the quotas on textiles and clothing originally imposed under the Multi-fiber Arrangement (MFA); and the United States and other countries have agreed to impose Most-Favored-Nation (MFN) tariffs on China. Analysis indicates that China's clothing production could more than double, and its textile

<sup>23</sup> The decision contrasts with the costly and wasteful path to everhigher protection followed by previous high-growth East Asian economies.

<sup>24</sup> See Ianchovichina and Martin (2002) and Lardy (2001), respectively.

<sup>25</sup> The positive impact on the automobile sector is a relatively new finding from François (2002), as discussed in Chapters 1-2.

production expand by nearly 50 percent, as a result of WTO accession combined with the proposed phase-out of quotas as part of the Agreement on Textiles and Clothing.<sup>26</sup>

These estimates, however, omit some important potential elements of trade policy, namely, the application of antidumping and safeguards measures against China—and the possibility that China itself will increasingly apply such measures. One feature of the accession agreement is the Product-specific Transitional Safeguard Provisions, lasting over a 12-year period, which may be applied to China by any member and may then trigger actions against the diversion of Chinese exports to other markets, with special textile safeguards for three years. These provisions are particularly troublesome since no such measure targeted specifically at China existed before China's accession.<sup>27</sup> Similarly, as regards antidumping provisions, China will potentially remain vulnerable for up to 15 years to nonmarket economy provisions that dramatically increase the probability of dumping being found and the relevant antidumping duties being applied. China's own increased use of antidumping and safeguard measures would be legal and consistent with the rules-focused approach to WTO implementation. But one hopes such scenarios can be avoided, since they would be inconsistent with the focus on development that has characterized China's trade reform agenda since the beginning of the reform era.

China's trade in *services* was the subject of one of the most radical services reforms ever negotiated in the WTO. The important feature of China's commitments is that they focus on market access, and do not discriminate between domestic and foreign suppliers. Yet restrictions remain on the form of establishments, such as requirements for joint ventures, and on geographic scope.<sup>28</sup> One area of services with an important bearing on trade is the activities that make up the logistical chain. Logistics account for 30-40 percent of the wholesale cost of manufactured goods. China's WTO commitments promise increased competition and reduced costs in several areas, including through the development of third-party logistical firms. With China expected to be the largest market for telecommunications in the world by 2010, its commitments in that sector also are profound in that they allow foreign entry to a wide range of activities.

### **What WTO accession means for China: Ways of doing business**

The implications for China of accession to the WTO go beyond the specific commitments in its accession package. Changes in the ways of doing business—elimination of dual pricing, phasing out of restrictions on trading, more uniform administrative arrangements, and judicial review—are likely to result in dynamic gains that will outweigh those based on comparative-static estimates of efficiency gains. Every 1 percent productivity gain in the services sector from expanded competition and foreign entry, for example, implies welfare gains of US\$10 billion and a GDP increase of 2.2 percent, equivalent to the total estimated static gain from China WTO accession.<sup>29</sup>

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<sup>26</sup> See François and Spinager (2002). The agreement requires the elimination of quotas by January 2005.

<sup>27</sup> The situation also highlights the importance of improving this area of WTO rules.

<sup>28</sup> The number of sectors with guaranteed unrestricted access is still lower in China than in most other countries for cross-border trade and consumption abroad (modes 1 and 2) and essentially zero for establishment trade (mode 3).

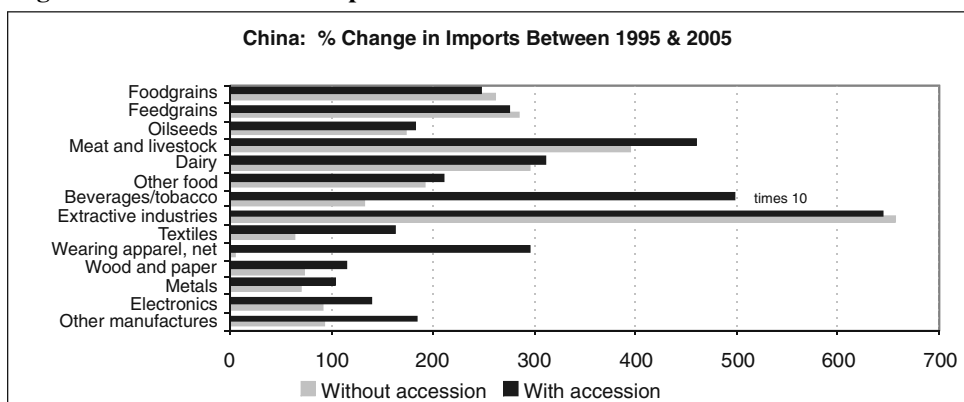
<sup>29</sup> Ianchovichina and Walmsley (2002).

### What WTO accession means for the rest of East Asia: Opportunity more than threat

*Opportunities in China's markets: China will import more from East Asia.* The foremost opportunity for the rest of East Asia is to export more to China's growing and more open markets. China's imports are expected to grow from 3 percent of global GDP in 2000 to more than 6 percent by 2005. All groups of countries in East Asia will benefit, but evidence suggests the scope is especially large for Japan and the newly industrializing economies, but still significant for the middle-income countries and the lowest-income countries.

The sectoral landscape described above suggests significant export opportunities for developing East Asian economies. For countries such as Indonesia and Thailand, the weighted average tariff on their top 100 export products falls by a half as the result of China's accession, and some of their top agricultural and raw material exports—rubber, sugar, urea, and to a lesser extent rice—will benefit from a reduction in nontariff barriers. They also have scope for increased interindustry trade and production sharing as China grows, for example, in electronics and other manufactures.

**Figure 6: What will China import more?**



Source: Ianchovichina and Martin (2001).

For the lowest-income countries such as Cambodia and Lao PDR, there also will be opportunities. The decline in these countries' weighted average tariff for the top 100 exports to China is quite small (from 4.3 to 2.6 percent for Cambodia and from 7.3 to 6.0 percent for Lao PDR), and only about 10 percent of Cambodia's exports and less than 1 percent of Lao PDR's exports, including wood and rubber, will face fewer quantitative restrictions. However, given trade intensity with China, they will benefit from China as a powerful source of external demand, including for cross-border activity that is not necessarily well captured in official statistics.

*Implications for domestic markets: Imports from China.* China's accession also offers the rest of the region the opportunity to import cheaper and more efficiently produced intermediate inputs into production processes. For example, chemicals already represent nearly 10 percent of imports from China into Indonesia and Thailand. And China is increasingly a central player in production networks. By 2001, China was exporting more than US\$20 billion in parts and components to others parts of emerging East Asia, representing up to 20 percent of those countries' parts and components trade. Continued growth in imports of parts and components from China will represent an opportunity for the rest of emerging East Asia to

benefit from China's growing role in global production networks. Consumers of finished-goods imports also will benefit directly.

To benefit from these opportunities, it will be important to resist the growing protectionist pressures for imposition of excessive safeguard measures to protect domestic producers. In Thailand, local manufacturers are complaining about low-cost imports of electrical appliances and motorbikes from China. Indonesia recently imposed temporary safeguard measures for garment imports, and Vietnam did so on motorbikes. Such decisions can only prolong the shifts in production that are necessary to realize regional comparative advantages, and distract policymakers from facilitating the adjustment of workers through appropriate labor market and safety net policies and programs.

*Competitive challenge: Exports to third markets.* China's WTO entry also implies increased competition in third markets. If recent Chinese export performance (Figure 4) is an indicator, the expansion of China's presence in major markets will not necessarily crowd out other East Asian exports.

Nonetheless, certain exports appear at risk. Clearly, the apparel and textiles sectors in other East Asian countries will face additional competition in markets that are currently constrained by quota restrictions. The market-by-market and product-by-product analysis in Chapter 2 indicates that for Thailand, for example, only about 15 percent of exports to the United States are at risk from increased competition from China, but that 25 percent of exports to Japan are at risk. For Indonesia, the second and third most important exports to the United States—footwear and video-recording and -reproducing apparatuses—face direct competition with China, as do about a quarter of exports to Japan.

Among lower-income countries, Cambodia is particularly exposed because its exports are highly concentrated in apparel. Roughly 30 percent of Cambodia's exports to the United States have similar unit values to Chinese exports, indicating direct competition. Another 67 percent are in categories where China is currently quota-constrained and competition from China is likely to increase. This prospect highlights the urgency for such countries to speed up their governance and other reforms to ensure that alternative production networks develop.

Nonetheless, on balance, China represents more of an opportunity than a threat to the rest of East Asia. Certain challenges will need to be met, and adjustments made. However, the scope for dynamic gains from a dynamic China is large across the range of countries in East Asia.

### ***Regional interdependence***

Recent trends in the magnitude and composition of intra-East Asian trade bode well for further integration.<sup>30</sup> Comparisons show that conditions within East Asia are now very similar to those in countries that were previously able to implement such successful regional arrangements as the European Union and NAFTA.

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<sup>30</sup> See also Ng and Yeats (2003).

East Asia has achieved a high degree of market-driven regional integration, but regionalism—more formal economic cooperation and economic integration arrangements and agreements between countries—has traditionally been quite limited, as explained in Chapter 3.<sup>31</sup> The major exceptions have been the ASEAN Free Trade Area (AFTA), established in 1993, and dialogue under Asia-Pacific Economic Cooperation (APEC). However, the past several years have seen a plethora of proposals for new bilateral and regional trade arrangements: the Framework Agreement for ASEAN-China Economic Cooperation, signed in November 2002; an East Asia-wide Free Trade Agreement; a more recent proposal by Japan for an ASEAN-plus-Japan Free Trade Agreement; and bilateral agreements under negotiation, in particular by Japan, Singapore, Korea, and Thailand.

### **Scope for gains from regionalism**

Addressing intraregional barriers can ensure continued dynamism in regional trade and investment flows—including in response to China's growing role. The stated motivation of several initiatives, including the Framework Agreement for ASEAN-China Economic Cooperation, is to take advantage of complementarities and build on existing strengths in order to make the region collectively more efficient and competitive, and thereby also attract investment. The regional agreements under consideration are increasingly comprehensive in scope, going beyond the removal of tariffs and nontariff barriers on trade in goods to include trade facilitation measures such as conformity of standards and procedures across national boundaries, and trade in services. The New-Age Partnership between Singapore and Japan announced in January 2002 is notable in this regard.

The countries in the region could reap worthwhile economic benefits from increased regionalism focused on removal of border barriers, according to analysis using the standard models for evaluating benefits from regional trading arrangements (Table 1). As is typical in these models, the gains are shown to be greater the wider the country and sectoral coverage of the regional arrangements. Notably, the gains for ASEAN countries are shown to be greater than those for the other countries in the region. Given that the lower- and middle-income countries of ASEAN are likely to benefit less from China's WTO accession than the newly industrializing economies, greater regionalism in East Asia can help augment those benefits, offsetting any bias in favor of newly industrializing economies and spreading the gains across a wider set of economies.

It is troubling that most regional arrangements have provisions for excluding sensitive sectors. The welfare gains increase markedly when sensitive or highly protected sectors, notably agriculture, are included. Within AFTA, the lack of progress in this dimension has been disappointing. The exclusion of agriculture roughly halves the gains from ASEAN-China or ASEAN+3 proposals for ASEAN countries.

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<sup>31</sup> See Schiff and Winters (2003) for a discussion of regionalism from the perspective of developing countries more broadly.

**Table 1: Renewed regionalism provides scope for gains in East Asia**

<i>Proposal</i>	<b>Effect on economic welfare of various regional trade proposals</b>				
	<i>% of GDP (% of GDP excluding agricultural liberalization)</i>				
	<i>ASEAN</i>	<i>China</i>	<i>Korea</i>	<i>Japan</i>	<i>USA</i>
China+Korea+Japan	-0.26 (-0.16)	+0.1 (-0.2)	+1.0 (+0.6)	+0.1 (+0.2)	+0.0 (+0.0)
ASEAN-China	+0.9 (+0.5)	+0.0 (+0.1)	-0.1 (-0.1)	+0.0 (+0.0)	+0.0 (+0.0)
ASEAN-Japan	+1.1 (+0.2)	-0.1 (-0.1)	-0.2 (-0.1)	+0.0 (+0.1)	+0.0 (+0.0)
ASEAN+3	+1.5 (+0.6)	+0.1 (-0.2)	+1.1 (+0.8)	+0.2 (+0.2)	-0.1 (+0.0)
ASEAN+3+CER	+1.3 (+0.6)	+0.0 (-0.1)	+1.1 (+0.9)	+0.2 (+0.2)	-0.1 (+0.0)
APEC Liberalization (MFN)	+0.7	+0.5	+0.7	+0.4	-0.0
APEC Preferential Liberalization	+0.8	+0.6	+0.9	+0.4	+0.0

*Note:* (1) Calculations for ASEAN include only Indonesia, Malaysia, the Philippines, Singapore, Thailand, and Vietnam. (2) CER includes Australia and New Zealand. (3) Figures in parentheses refer to net welfare effects when agriculture is excluded.

*Source:* Scollay and Gilbert (2002) for FTA proposals and Scollay and Gilbert (2001) for APEC liberalization proposals.

The greatest welfare gains, however, are likely to come from addressing the deeper integration agenda being proposed here: In particular, the benefits from integrating trade in services and overcoming technical barriers to trade are likely to be many times those from reducing border barriers alone. Gains from liberalizing services trade are felt not only within the service sector itself but also within other sectors, since services are vital inputs in their production processes. Manufacturing in East Asia has been held back by the lag in services liberalization in East Asia relative to other regions, and action to integrate trade in services could help restore its global competitiveness. Simulation results from China, consistent with findings from other parts of the world, indicate that even small productivity gains of 1 percent in services outweigh those based on static border trade efficiency gains alone.<sup>32</sup>

The policy scope for enhancing efficiency in services, as well as in other sensitive sectors such as agriculture, may well be wider initially in a regional context than in a global context, as discussed in more detail below. Most regional partnerships agreed upon or under discussion include the services sector. Since the liberalization of services may be necessary for industries to benefit fully from the removal of regional barriers to goods trade, it may be preferable to give the service sector a high priority from the start of any negotiations.

### **Making East Asian arrangements a steppingstone to global integration rather than a bloc-ed world: Moving on multiple fronts**

Liberalization goals can be well served by moving on multiple fronts. In East Asian goods trade, traditional concerns that a regional arrangement will merely divert, rather than create, trade are less worrisome because bilateral trade is already significant, because a relatively low-tariff bloc already exists, and because many of the region's economies, especially the more developed, are moving to lower average tariffs. And, to generate momentum, a number of measures can be taken before formal arrangements are agreed. The "Early Harvest" approach in the ASEAN-China Framework Agreement exemplifies this. China has extended Most-Favored-Nation status to the low-income non-WTO member countries, Lao PDR and

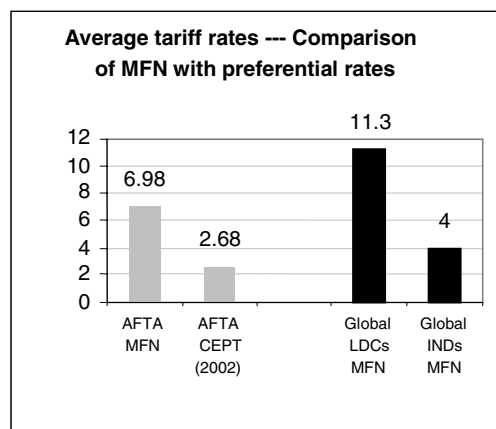
<sup>32</sup> Ianchovichina and Walmsley (2002) for China; Hoekman and Konan (2000) for the European Union and Egypt; Brenton (2003) for the European Union and Russia.

Cambodia. The agreement provides accelerated access for key products to China and ASEAN markets (ahead of the MFN schedule that is part of the WTO accession agreement).

The challenge in pursuing regional integration arrangements will be to avoid the “spaghetti bowl” effect of different rules and regulations associated with different agreements, which can add unnecessary administrative costs to firms doing business across the region. One way to avoid this danger would be for the region to agree on rules of origin that are as liberal as possible. The exchange of ideas on a regional basis can help.

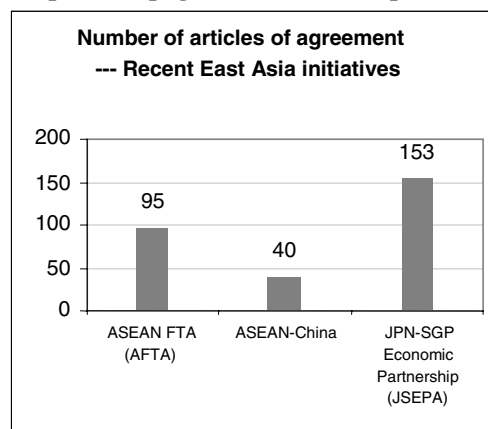
**Figure 7: Regional trade arrangements**

**Low tariff bloc reduces trade diversion**



Source: World Bank (2001b) and [www.aseansec.org](http://www.aseansec.org).

**Multidimensional nature of agreements compounds spaghetti bowl and impedes merging**



Source: [www.aseansec.org](http://www.aseansec.org) and [www.mofa.go.jp](http://www.mofa.go.jp).

Without tackling sensitive sectors in regional trade arrangements—and ultimately at the global level, many of the potential economic benefits alluded to earlier will not be realized. In this regard, China’s approach to agricultural policy offers scope for the liberalization of agriculture in a regional setting, which could set in place a favorable political dynamic for more open agricultural sectors overall.

Another way to proceed would be to unbundle proposed agreements into components for deeper integration that could realistically be agreed on and would yield immediate results, in terms of increased efficiency and development of intra-industry trade and production networks. In the case of China and ASEAN, for instance, two-way business transactions are already proliferating, and—long before government policymakers began to act—businesses had recognized and responded to the China challenge. Such transactions could be facilitated and enhanced by an agreement that focuses on trade and investment facilitation, such as customs.

It also would be preferable to focus attention and resources on as few regional arrangements as possible but to make them broad in scope and country coverage, especially for small economies that have limited capacity to evaluate the development implications of these arrangements. Finally, a further benefit from stronger regional cooperation could be to link issues of common interest to an effective multilateral stance, whether in services liberalization or discipline on antidumping measures.

### ***Expanding market access globally***

One of the motivating factors behind the move to regional integration in East Asia is disappointment with the pace of multilateral trade liberalization in products of most interest to developing countries. As discussed in Chapter 4, there appears to be a growing consensus about the negative impact on poverty reduction of trade barriers on products that are exported by the poor—particularly agricultural products and labor-intensive manufactures such as textiles and clothing, which are the sectors that confront the greatest entry barriers in high-income countries. One of the disappointments of the Uruguay Round was its failure to achieve greater market access in these products. The Doha Development Agenda launched in November 2001 has the potential to make the world trading system more conducive to development. It includes a large number of policy reforms that can and should be undertaken by high-income countries that will generate significant benefits for ordinary people in developing East Asia.

#### **Trade in textiles and clothing**

The textiles and clothing sector poses a special challenge for East Asia. Many countries of the region have a large garment export business employing sizeable numbers of low-skilled workers, many of whom are female. These businesses will be threatened by competition from China, posing both a macroeconomic threat to the balance of payments (from lost exports) and a social threat of lost jobs and lower wage incomes for many of the poorest households.

Implementation of agreements for further trade liberalization in textiles and garments is critical to social stability in East Asia. Under the Agreement on Textiles and Clothing (ATC) as part of the Uruguay Round, quota restrictions were to be gradually abolished over a 10-year period (that is, no later than January 2005) in three stages, and remaining quotas were to be subject to a progressive increase in their rates of expansion. However, implementation to date has been disappointing. Acceleration of the quota phase-out under the ATC would have a significant impact on poverty by sustaining or increasing employment in these industries. It would help maintain export growth in low-income East Asia, for example, permitting 20 percent more exports from Vietnam. It also would help protect workers in middle-income economies, for example, an estimated 50,000 jobs in Thailand for garment workers and 10,000 for textile workers, of whom about 20,000 are from poor households. Finally, it would benefit workers in the sector within China, who are mainly women drawn from poor, remote regions, and could result in 5 million fewer poor Chinese overall.<sup>33</sup>

At the same time, some economies in East Asia will lose. Garment industries in several countries have depended on quotas, benefiting from some of the rents accruing from preferential access to EU and US markets. Garment exports from higher-income economies such as Korea are likely to decline. And in Cambodia, in particular, ATC implementation is likely to put pressure on employment and wages in the garment sector. A broader agenda will need to be pursued to open up other trade opportunities.

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<sup>33</sup> See Kalima and Krumm (2002), which draws on a combination of labor market surveys, World Bank income distribution data, and computable general equilibrium (CGE) modeling results.

### **Agricultural and rural-based trade**

Reduction of trade barriers in agriculture is particularly important for poverty reduction. Agriculture is the main livelihood for poor households: for more than 90 percent in Cambodia and Vietnam, more than 75 percent in Indonesia, and roughly 70 percent in Thailand and the Philippines.<sup>34</sup>

Gains from agricultural liberalization by higher-income countries are estimated at more than \$10 billion for developing East Asia, and triple that once dynamic productivity gains are taken into account.<sup>35</sup> In contrast to the move toward increased transparency in trade policy for manufacturers, agriculture remains protected in myriad ways. Reform of agricultural subsidies and domestic support programs in developed countries has particularly large dynamic benefits for East Asia.<sup>36</sup> Products such as palm oil, rice, and sugar, as well as fish, crustaceans, and fruits and vegetables could gain directly from reduction in ad valorem and specific tariffs and nontariff barriers, including quotas. As laid out in Chapter 4, an important set of trade barriers appears to be tariff escalation in agroprocessed goods; this is illustrated in products of interest to East Asia: coffee and vegetables. Increasingly, barriers take the form of meeting standards. For the products of concern to the poor and poor countries of East Asia, the key issues are conformance with health and safety regulations, notably maximum pesticide residue levels and difficulties with understanding and administering standards.

Trade barriers are not only an issue for developed countries; emerging economies of East Asia themselves maintain high barriers. Regional agricultural markets already are large. China's commitment to a regime of low protection in agriculture is fortunate for other countries that are well placed to supply it with imports, providing a direct boost to their foreign exchange earnings and to the incomes of poor households. The China-ASEAN trade agreement, with its "early harvest" provisions, provides another avenue to ensure that poor agricultural households have every opportunity to benefit from trade opportunities in the region. There may be further scope to address the sensitive food security and safety issues initially within the context of East Asian arrangements.

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<sup>34</sup> World Bank (2002a).

<sup>35</sup> World Bank (2002c), *Global Economic Prospects*. Real income gains for Korea and developing East Asia are estimated at US\$11 billion, assuming fixed productivity and US\$32 billion with endogenous productivity, excluding production subsidies, compared to baseline income in 2015. Static gains are slightly less including production subsidies, but dynamic gains would increase to US\$76 billion. China would capture one-third of static gains and two-thirds of dynamic gains.

<sup>36</sup> The direct impact of domestic support programs is of less relevance to East Asia because this support is concentrated in products that are not of crucial importance to East Asia developing countries, with the exception of rice. Products such as fruits, vegetables, and spices together account for only 7 percent of the developed countries' total domestic support payments.

## Development orientation for a behind-the-border agenda

*Trade policies do not stand alone. Mutually supportive companion policies are also necessary.*

WTO Director General Supachai, November 2002

Many of the mechanisms required to maximize the benefits of trade and investment liberalization are “behind-the-border” institutional and regulatory reforms. Each of the new regional and bilateral partnerships reflects this business reality. Technical barriers and product standards, logistics, service sectors, intellectual property rights, competition policy, and environmental and labor standards have become as important a part of the private sector environment as trade policy itself. These “behind-the-border” issues also feature prominently on the Doha Development Agenda. The thrust is to place trade policy within a broader framework of development and poverty reduction.

### ***Technical barriers and standards: Balancing trade with consumer interests***

As traditional barriers to market access decline, trade facilitation measures become more critical. Conformity with health and safety standards can be one of the most decisive determinants of access.<sup>37</sup> Many of the standards in use represent legitimate consumer interests, but there has been a rise in the use of technical regulations, such as standards, to further commercial policy in multilateral, regional, and global trade. An important problem for exporters is that different national governments often apply different technical specifications to meet the same goal.

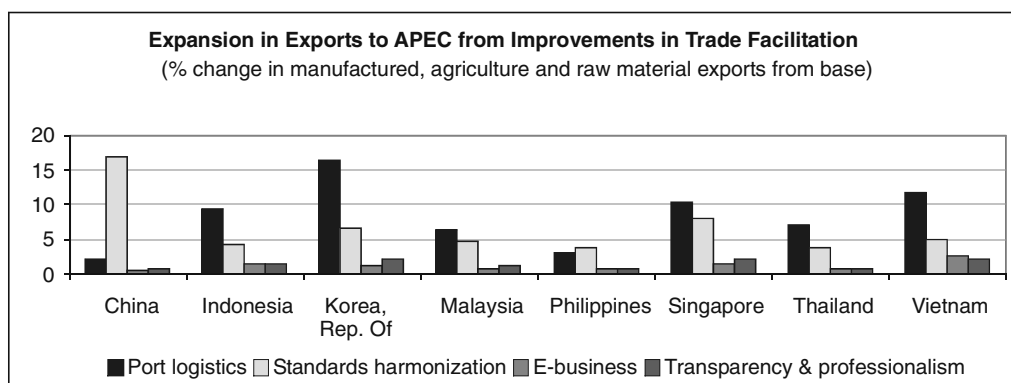
For East Asian developing countries, importing countries’ sanitary and phytosanitary standards can impose significant additional costs that impede exports. For example, applying the strictest EU standard rather than the international Codex standard for aflatoxin is estimated to cause export losses of US\$350 million for Thailand, US\$380 million for China, and US\$15 million for Vietnam in cereals and dried fruit. Conversely, the adoption of a Codex standard on tetracycline could double Thailand and China’s beef exports.<sup>38</sup> Exporting countries also have to contend with importers’ use of precautionary measures, such as the EU import ban on genetically modified organisms (GMO), which hurts Thailand’s tuna exports as well as China, which is the third largest GMO producer in the world.

The WTO rules in this area aim at ensuring that technical regulations, voluntary standards, and testing and certification of products do not constitute unnecessary barriers to trade. Under the Sanitary and Phytosanitary Standards (SPS) Agreement, WTO members are encouraged to adopt internationally recognized standards but are free to apply stricter ones. The agreement recognizes importing countries’ right to implement SPS measures that diverge from international norms but requires them to provide scientific justification for such measures and applies risk assessment mechanisms.

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<sup>37</sup> Many nonreciprocal preference schemes have had a low rate of uptake by developing countries, including those in East Asia, in large part because of stringent rules of origin. For example, Cambodia made use of only 36 percent of its entitlement under the EU’s Everything But Arms initiative in 2001. Brenton (2003).

<sup>38</sup> Otsuki and Wilson (2001) and (2002).

**Figure 8: Better logistics and harmonized standards are key to expanding trade**

Source: Wilson and others (2002).

In many cases, East Asian economies will want to adopt unilaterally the international standards being set.<sup>39,40</sup> China is further strengthening its food safety regulations and capacity to implement these regulations as part of its WTO accession and is adopting a number of authentications and labeling systems. Compliance with SPS in export markets can induce changes in production systems and supply channels; it is likely to require modernization of standards infrastructure as well as information and training. Countries may need to seek technical assistance and support for additional projects in this area. A Standards and Trade Development Facility to address this need is being established, to be administered by WTO in collaboration with the World Bank, the World Health Organization (WHO), the United National Food and Agriculture Organization (FAO), Codex, and others.

At the same time, East Asian countries can benefit from rationalizing standards in a regional and global context. Cooperation on standards is one of the important issues generally encompassed in regional arrangements. Recognizing that foreign standards can achieve the same level of social or consumer protection as domestic standards, mutual recognition agreements (MRAs) are one option. Such agreements have mainly been used between developed countries, but ASEAN currently has signed two MRAs, with plans for an additional 20 products, thus avoiding duplication of testing and conformity assessment.

### ***Transport and logistics***

The commodity mix in East Asia is changing rapidly from resource-based commodities to low- and medium-technology goods to high-tech goods (Table 2). Logistics improvements, essential for moving up the value chain, have very high payoffs in East Asia, as discussed in Chapter 5. High-value agriculture (flowers, fruits, seafood) and manufacturing (electronics) demand sophistication not only in production but also in logistics handling. Timeliness matters, and a fast, reliable supply chain is essential.

<sup>39</sup> For example, by Codex Alimentarius; Organization for Animal Health; International Organization for Epizootics; and Hazard Analysis Critical Control Point (HACCP).

<sup>40</sup> For example, in Malaysia, the Ministry of Health operates a voluntary certification program for private firms in the food-processing sector. This program was introduced in 1996-97 in response to EU requirements for HACCP in fish processing plants.

**Table 2: East Asia is moving up the value chain**

	Structure of manufactured exports by country					
	<i>Resource-based</i>		<i>Low-/medium-technology</i>		<i>High-technology</i>	
	% by value		% by value		% by value	
	1985	1996	1985	1996	1985	1996
Hong Kong	2.1	4.4	78.5	66.7	19.4	28.9
Singapore	42.3	12.7	25.4	21.9	32.3	65.4
Korea	7.8	9.4	72.1	55.0	20.1	35.6
Taiwan	8.7	5.1	70.6	54.1	20.7	40.8
Indonesia	72.2	34.9	25.1	50.4	2.7	14.7
Malaysia	53.7	17.8	15.2	21.8	31.1	60.4
Thailand	42.1	14.5	44.8	49.1	13.1	36.4
China	11.7	9.8	78.9	69.7	9.4	20.5

Source: Lall (1998).

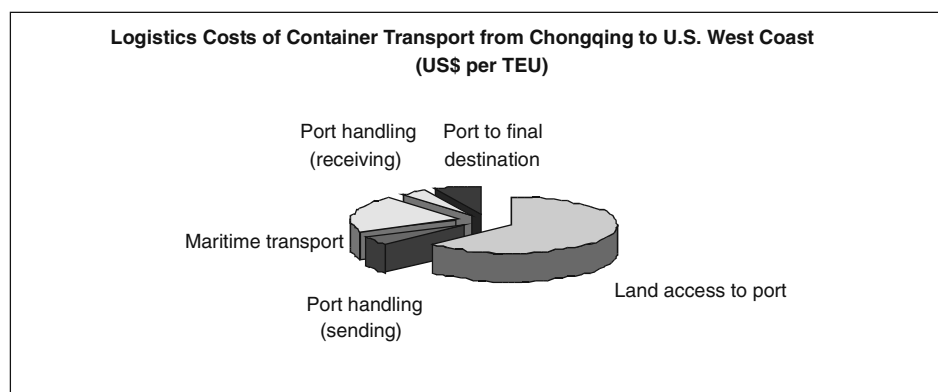
In East Asia, the key logistical bottlenecks seem to be high internal land transport costs and port logistics. This is in sharp contrast to external transport costs: with the sharp decline in trans-Pacific shipping costs over the last decade, producers in many parts of East Asia can reach the US market more cheaply than inland areas or neighboring countries. For example, the inland transport costs of moving goods from some remote regions of China en route to external markets are roughly ten times the inland transport costs at the other end (Figure 9). Port logistics have been identified as a high priority (Figure 8): modest improvements could lead to more than \$50 billion in additional exports from emerging East Asia to the rest of APEC, with an even larger impact on efficiency of imports.<sup>41</sup>

High inland transport and logistics costs are a particular impediment for the poor in remote areas or landlocked countries. In Lao PDR, poor inland transport contributes to a 25 percent differential in paddy prices for farmers. On the island of Mindanao in the Philippines, agricultural producers are plagued by poor access roads, lack of storage facilities and inadequate trading areas, leading to small volumes and high costs, compounded by inter-island shipping with high tariffs, product deterioration, and cargo losses. In Mongolia, poor transport between Ulaanbaatar and central regions contributes to a 40-85 percent price difference for the flour staple. Constraints on internal logistics also impede the shipment of food commodities from surplus to deficit areas, worsening food security.

High logistics costs are a greater impediment to trade in differentiated products than to trade in homogenous products, suggesting that, by strengthening infrastructure services, East Asian economies can influence their comparative advantage and, particularly, their prospects for expanding production of more sophisticated products.<sup>42</sup>

<sup>41</sup> Wilson et al. (2002).

<sup>42</sup> Fink, Mattoo, and Neagu (2002), *Assessing the Impact of Communication Costs on Trade*, forthcoming as a World Bank Policy Research Working Paper.

**Figure 9: Inland costs for remote regions are multiples of those elsewhere**

Source: Carruthers and Bajpai (2001).

Improving logistics involves investing in transport infrastructure but also introducing complementary policies outside the transport sector. Transport regulatory agencies can improve logistics performance by allowing paperwork clearance for inland travel of containers and removing distortionary queuing pricing for commodities accessing the transport system. Multimodal coordination is essential to promote seamless freight movement. In Korea, for example, inland container terminals and the development of intermodal exchanges have made it easy for containers to reach cities far from the ports. Coordination is also critical regarding urban land use, standards, licensing, and security. Examples of helpful urban land use policies include diverting traffic around congested areas and providing space for landside container storage.

Better cross-border trade facilitation—customs, e-commerce, paperless clearance, electronic processing, and safety measures—can stimulate trade throughout the region. Some studies show that for emerging East Asia, modest improvements in trade facilitation could expand trade by more than US\$200 billion.<sup>43</sup> Customs is the most obvious example. In some East Asian countries such as Singapore, trade documentation takes only 15 minutes to clear and 2-3 days for customs documentation and clearance of sea cargo. By contrast, customs clearance takes a minimum of five days in Manila and seven days in Jakarta. In China, trade documentation clearance takes a day, whereas sea containers can take 30-35 days to clear.<sup>44</sup> Addressing corruption in customs has been highlighted in several countries, including Cambodia and Vietnam, as critical to private sector trade.<sup>45</sup>

Certain logistics needs are best served by the private sector. This is particularly the case in ports, freight forwarding, third-party logistics, warehousing, trucking, and the bus industry. Foreign entry may play an important role in increasing competition and the quality of logistics.

<sup>43</sup> Wilson (2002). See Figure 8.

<sup>44</sup> Janet Tay Consultants (2002).

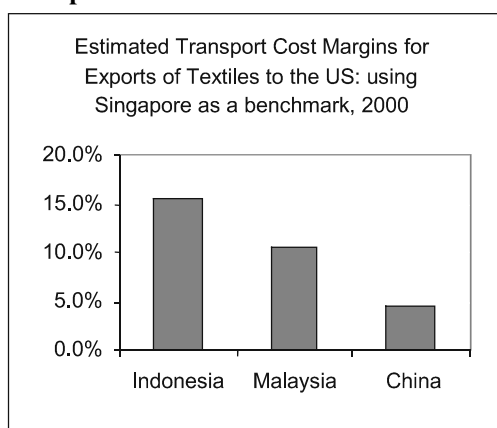
<sup>45</sup> World Bank (2001)—Cambodia IF Report; World Bank (2003)—Vietnam Export Study.

### *Services sector liberalization*

East Asia has lagged behind other developing regions in liberalizing trade in services.<sup>46</sup> Evidence suggests that the productivity gains associated with more efficient services are particularly high, and that competitiveness in high-value, differentiated agriculture and in manufacturing depends on efficient business services. Static gains for developing East Asia and Korea from services liberalization throughout the developing world are estimated at about US\$270 billion, or 10 percent higher income, by 2015.<sup>47</sup>

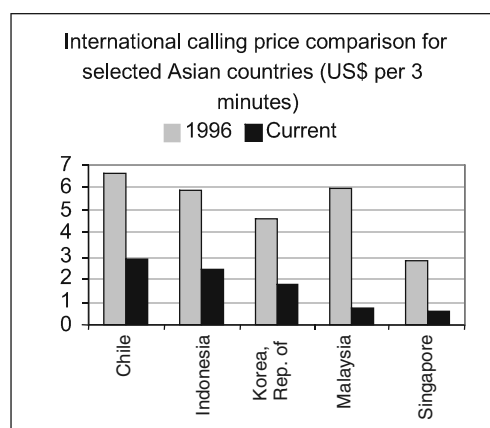
**Figure 10: Costs of producer services**

**Significant scope for reduction of transport costs . . .**



Source: Bureau of Economic Statistics, U.S. Dept. of Commerce.

**and telecommunications costs**



Source: International Telecommunications Union and operative Websites.

To realize gains, reforms in the service sector need to be designed with broader development objectives in mind and an eye to introducing competition, ensuring effective regulation to remedy market failure, and providing essential services to the poor. Pro-competitive regulation is particularly important in network-based services such as transport, telecommunications, and energy services. In East Asia, the importance of regulatory and pro-competitive reforms to complement privatization has not always been fully appreciated (Figure 11).

<sup>46</sup> See Mattoo et al. (2001). McKinsey (2001) also underscores the inefficiency of many East Asian service industries.

<sup>47</sup> World Bank (2002c), *Global Economic Prospects*, regional disaggregation of Table 6.3.

**Figure 11: Regulatory and competition reforms have not kept pace with privatization**

**Regulatory and competition reforms have not kept pace with privatization**  
**Sequence of fixed-line telecom reform in selected Asian countries**

	1991	1992	1993	1994	1995	1996	1997	1998	1999
<b>China</b>									
Privatization									
Competition							LD		
Regulation									
<b>Indonesia</b>									
Privatization					19%				
Competition							23%		
Regulation									
<b>Korea</b>									
Privatization			10%	20%		29%			
Competition	ILD					LD			Local
Regulation									
<b>Malaysia</b>									
Privatization	25%								
Competition									
Regulation				ILD		Local, LD			

Source: Fink, Mattoo, and Rathindran (2002).

In this context, international trade agreements in services offer East Asia three main benefits: improved access to markets abroad and greater openness at home through reciprocal liberalization; credibility of reforms as the result of binding international commitments; and regulatory cooperation. In some services where East Asian countries have a stake in cross-border trade—for example in data processing and other information technology-enabled services—they could secure access to other countries' markets through legally binding commitments from their trading partners. Some countries in East Asia have the potential to export significant transport, logistics, tourism, and business services to China. East Asia also has a stake in temporary labor mobility, as for example when its construction workers or accountants work abroad.

A nonpreferential approach to market opening, negotiated within a multilateral context, may be important for overall efficiency; it ensures that access is provided by the most competitive providers and avoids conferring a first-mover advantage on inferior regional suppliers.

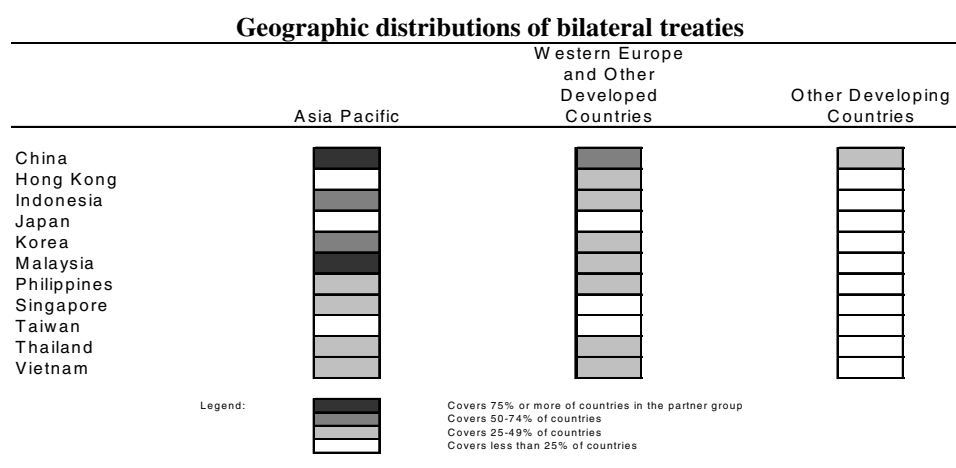
Nonetheless, regional arrangements may provide the advantages of greater policy space for regulatory cooperation and learning-by-doing. East Asia is actively pursuing services liberalization in the context of the regional arrangements outlined above. Even preferential liberalization can improve the status quo, given that many existing barriers are frictional (such as unnecessary qualification requirements for foreign professionals and border hurdles for foreign transporters). Initial opening among regional partners may provide opportunities for learning-by-doing and lessen concerns that foreign competition would prematurely drive out potentially competitive domestic providers. Regulatory cooperation, such as the harmonization and mutual recognition of domestic regulations in financial, professional, and a range of other services, may be more feasible in a regional context.

*Investment and competition policies*<sup>48</sup>

Raising the productivity of investment in East Asia requires harnessing the full force of competition inherent in global markets. Lower barriers to international trade and investment can be a powerful pro-competitive force, as in the services sector, where investment is one of the major modes for trade in services. The greatest potential for making investment more productive is through unilateral enactment of domestic reforms to remove domestic policy barriers to competition. International agreements on investment and competition can provide benefits through reciprocity. However, most of the remaining restrictions on reciprocal market liberalization and nondiscrimination are in the services sector. There already exist vehicles at both the regional and multilateral (General Agreement on Trade in Services GATS) levels for realizing gains potentially arising from service investment commitments.

International agreements that focus on establishing protection to investors cannot be expected to expand markedly the flow of investment to new signatory countries; many protections are already contained in the bilateral investment treaties of East Asian countries, and even these relatively strong protections do not seem to have increased investment flows to their signatories.

**Figure 12: Many protections for investors are already contained in bilateral trade treaties**



Source: Bora (2001).

Policy barriers to trade are the most important restraint on competition. Another restraint on competition is frequent recourse to antidumping and other types of contingent protection. Antidumping laws were originally created to counteract the predatory practices of foreign sellers into a home market. In practice, more than 90 percent of the antidumping cases investigated would never have been launched if a competition standard—potential threat of injury to competition—had been used as a criterion.<sup>49</sup> Since 1995, more than 1,800 antidumping investigations have been initiated, many of them against East Asian exporters.

<sup>48</sup> Discussion based on World Bank, *Global Economic Prospects and the Developing Countries*, 2003.

<sup>49</sup> Messerlin (2000).

In 2001, the countries most often subject to investigations included China (53), Korea (19), and Indonesia and Thailand (16 each).

Large international companies with market power can form cartels that fix prices, allocate markets, and restrain competition. The uncovering of several international cartels in the late 1990s has encouraged prosecutions, including by Korea. There may be further scope for initiatives to discipline international cartels, ranging from extending the reach of industrial nations' anticartel laws to notification and information exchanges by national enforcement authorities to a multilateral agreement.

### ***Intellectual property rights: Nurturing domestic innovation***

Given the recent surge in knowledge-intensive trade and investment flows, intellectual property rights (IPRs) have become a mainstream topic in global trade discussions. As the subject of the 1995 Trade-Related Intellectual Property Rights (TRIPs) agreement, IPRs have in fact become a contentious issue in the WTO, with developing countries concerned that across-the-board upgrading is premature, given their positions as users rather than producers of technological innovations. Much of the debate has focused on the impact of more stringent rights on East Asia as a user of technology created elsewhere, but strengthened IPR regimes also play a role in local technology generation, by compensating inventors and creators.

Within the more advanced emerging economies and parts of China, stronger IPR regimes, successfully enforced, could stimulate innovation in technology, as outlined in Chapter 6, provided other conditions are favorable. Korea's dramatic success in patenting may be particularly relevant: The number of Korean patents registered in the United States grew quickly in the late 1990s, propelling Korea to sixth in the U.S. patent ranking, overtaking India, Brazil, and Singapore. Korea's strengthened IPR regime played a role, but so did industrial upgrading, a big push in research and development from the *chaebols*, and the government's selective targeting of the semiconductor/electronics industry, where Korea has emerged as a leading innovator worldwide. Given that impending TRIPs-related obligations mandate stronger patent protection, it will be worthwhile for countries to identify complementary policies to boost innovative activity among private firms in their economies.

For a broader range of middle- to low-income East Asian economies, copyrights might offer more scope for gains, given the considerable talents of software developers, musicians, artists, and authors. Indonesia is one example where there is potential for expansion in copyright-sensitive industries as rights are improved and successfully enforced, particularly for the software industry, small film industry, and investment in artist development by music-recording companies.

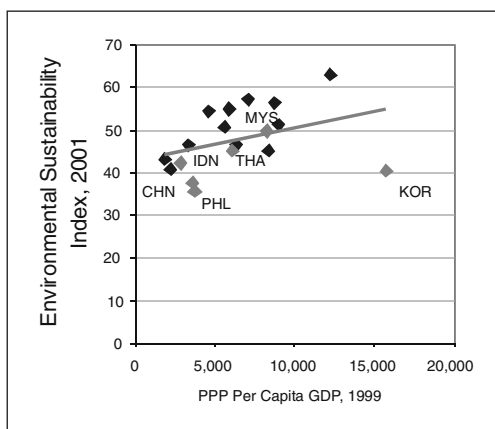
Traditional knowledge happens to be concentrated in lower-income nations, and its protection is generally expected to have direct benefits for poverty reduction. Often overlooked is that protecting traditional knowledge and genetic resources also promotes efficient innovation in agriculture and biosciences. Yet traditional knowledge needs to be combined with R&D activity, which is heavily concentrated in industrial countries, for mutual benefit from derived products. Chapter 6 identifies a number of difficult conceptual and practical obstacles that will need to be overcome before substantive progress can be

made in protecting or compensating the ownership of traditional knowledge. In East Asia, the Philippines is experimenting in this field with existing and pending legislation.

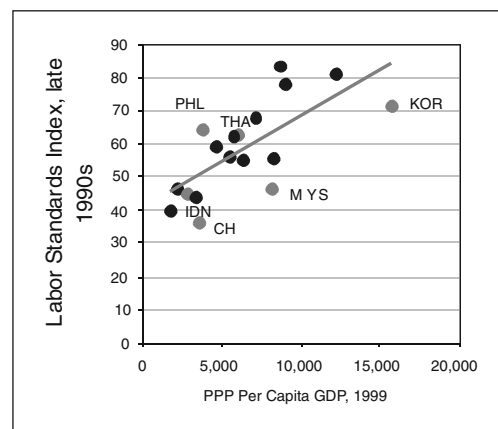
### *Environment and labor standards*

In general, environmental standards and workers' rights are weaker in East Asia than in other parts of the world with similar income levels; indices of environmental sustainability and regulation place East Asia near the bottom, as do indices of labor standards (Figure 13). Many observers have assumed that the region's weak standards play a role in its strong export competitiveness and ability to attract foreign investment. And within the region there is great suspicion that efforts to introduce higher standards in global trade talks are back-door ways for rich countries to deny new export opportunities to developing countries.

**Figure 13: Environment and labor standards are generally lower in East Asia**



Source: Esty and Cornelius (2002) and World Bank (2001b).



Source: Verite (2002) and World Bank (2001b).

In fact, there is little or no evidence that stricter environmental and labor standards would hurt trade.

As documented in Chapter 7, econometric evidence contradicts the “pollution haven hypothesis,” showing no significant relationship between environmental regulation and exports of pollution-intensive manufactures for East Asia. Analysis shows that exports and investments in East Asia in the most sensitive sectors (pollution-intensive industries and labor-intensive industries) appear to benefit when standards are raised. The argument is that standards help set transparent “rules of the game,” which then promote technological upgrading and skills development from which all parties benefit. Thus, the evidence suggests that East Asian countries can raise their environmental standards without adversely affecting their exports and investment inflows.

Regarding the impact of trade on the environment, evidence suggests that, while trade-induced growth adds to pollution and output of dirty industries, this effect is outweighed by the demand for a cleaner environment as a country raises its income and acquires better technologies. For example, an analysis of the effects of trade liberalization on water pollution

in Chinese provinces during 1987-95—a period in which there was both an extensive pollution levy system and significant opening to trade—illustrates that trade opening was beneficial to the environment overall.<sup>50</sup>

The links between trade competitiveness and labor standards are equally complex. As with trade and the environment, causality operates in both directions: Weak labor standards and poor working conditions may influence trade flows and patterns, but labor standards themselves are policies determined by many factors, including openness to trade. Within East Asia, labor standards appear to be strengthening. The number of International Labour Organization (ILO) fundamental ratifications has been increasing, and there is no evidence of backsliding on regulations or legislation. While better labor standards and improved working conditions could raise the costs of labor, workers who are treated poorly may simply react with inefficient efforts, which could raise costs overall. Hence, it is not clear that weaker labor standards would improve trade competitiveness.

Econometric evidence suggests that stronger labor rights are associated with higher export performance in East Asia (Figure 14). This is particularly the case for core labor standards, including rights of free association and a ban on child labor. This suggests that East Asian countries can introduce core labor standards, based on social concerns, without undue concern that their export competitiveness will suffer.

**Figure 14: No evidence of pollution haven for exports...**

Impact of Environmental Standards on Pollution-Intensive Exports from Developing Countries	
Regression coefficients	
1999	
<b>Model 1</b>	
Environmental Sustainability for East Asia	0.10
<b>Model 2</b>	
Environmental Regime for East Asia	0.80

Source: Chapter 7.

**No evidence of negative impact of labor standards on exports**

Impacts of Labor Standards on Labor-Intensive Exports from Developing Countries	
Regression coefficients	
1999	
<b>Model 1</b>	
Free Association Rights for East Asia	0.34
<b>Model 2</b>	
Core Labor Standards (Verite) for East Asia	0.10
<b>Model 3</b>	
ILO Conventions for East Asia	-0.10

Source: Chapter 7.

<sup>50</sup> Dean (2002).

## **Reinforcing social stability through broad sharing of benefits**

*[W]hen trade is harnessed to effective economic policies and positive poverty reduction strategies, it can act as a powerful force for change.*

*Oxfam, **Rigged Rules and Double Standards**, 2002*

To pursue these trade arrangements and behind-the-border agendas, East Asian policy makers will need a supportive authorizing environment. To be effective, trade policy must be widely perceived as reinforcing social stability and not contributing to further inequalities. Since the crisis of 1997-98, many Asian countries have become more democratic and their authorities more broadly accountable for economic policy decisions. Important constituencies question the distribution of benefits that are produced by complex trade negotiations.

Evidence on how trade policies affect different groups in society must be brought into the policy debate more squarely in East Asia. Here it is important not simply to generalize from other countries' experiences; East Asia has specific characteristics that determine the distribution of benefits from trade. This understanding is critical for designing a set of measures that enable the poor and the population more broadly to take fuller advantage of the growth opportunities from trade.

### ***Impact of trade reforms on households***

At the household level, the impacts of the changes induced by specific trade policy reforms are complex. Policymakers need tools to understand better how households will be affected so as to guide their policy sequencing and identify concrete risk-mitigation measures where needed.

One of the more promising approaches is a micro simulation-cum-computable general equilibrium modeling approach that draws on the richness of detail available from a modern integrated household survey to provide a reasonably detailed “map” of predicted welfare impacts by location and socioeconomic characteristics.

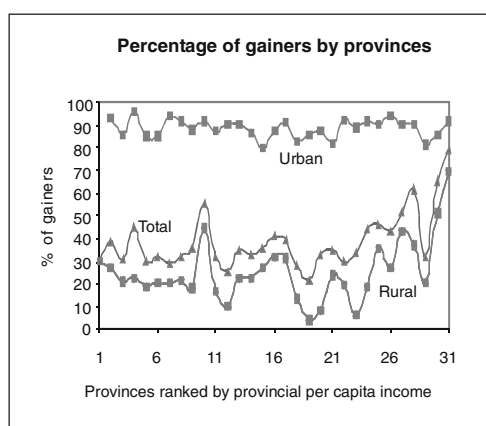
Chapter 8 applies this approach to assess who within China will gain from the accession to the WTO. It finds that, overall, the reduction in tariffs, quantitative restrictions, and export subsidies associated with accession will have only a small immediate impact on mean household income, inequality, and the incidence of poverty. But importantly, all gains accrue to urban households. Rural families in some provinces will suffer income losses. The severest impacts will be felt in the northeast region covering Heilongjiang, Jilin, Liaoning, and Inner Mongolia—a region in which rural households depend more heavily on feed grain production (for which falling prices are expected from WTO accession) than those elsewhere in China. The most vulnerable households are those dependent on agriculture, with relatively fewer workers and weak economic links to the outside economy through migration.<sup>51</sup>

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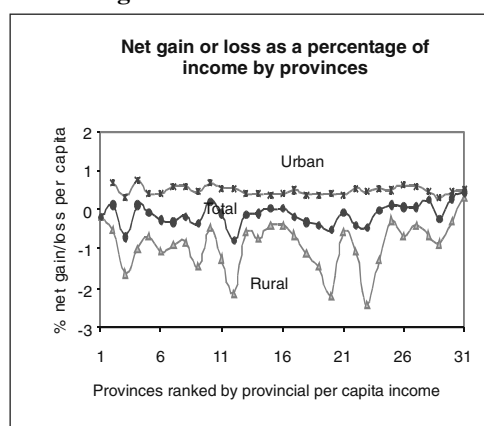
<sup>51</sup> A similar approach assessed the impact of the ASEAN Free Trade Association and the U.S. bilateral agreement on aggregative Vietnam household groupings. See Center for International Economics (2002). That analysis suggests that the benefits are spread across the income deciles and across rural and urban areas.

**Figure 15: How China's WTO accession affects household incomes**

**All gains from China WTO accession accrue to urban households**



**Some regions suffer rural income losses**



Source: Chapter 10

These impact analyses suggest that encouraging labor flexibility is key to protecting households adversely affected by reforms. Workers need skills to be flexible, and they need to be allowed to move occupationally and geographically. In some cases, labor market reforms must be carried out in parallel with trade reforms. In China, for example, while there is a considerable degree of labor mobility (as evidenced by the large migrant population), restrictions and impediments remain. With increased labor flexibility, all households—not only urban—can potentially benefit from WTO accession. In Vietnam, expanding the labor market options for vulnerable rural households and urban workers affected by enterprise restructuring will be critical. Impact “mapping” can also be used to guide targeted safety net programs.

### ***Sectors important to social stability: Specific micro interventions***

In any economy, a handful of sectors tend to be critically important in social stability and the poor. The extent to which poor people, especially poor producers, benefit from expanded trade opportunities depends on not only trade policy but also complementary measures designed to tackle behind-the-border constraints to efficient production and exports. These include measures to foster the development of competitive markets and public action to provide information, reduce transaction costs (often linked to corruption), deliver public services, and address market and collective action failures. Poor producers are not only economically disadvantaged but often politically powerless, and when their interests are pitted against those of more powerful actors, they often lose. Understanding the institutional and political economy underpinnings of the organizational structure of a particular commodity or a sector is crucial for designing a set of measures that enables the poor to take fuller advantage of greater access to markets.

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However, the poorest rural deciles benefit the least, and there may be potential vulnerabilities in individual households.

Chapter 9 applies this approach to rice in Cambodia and Vietnam and cashmere in Mongolia. In Cambodia and Vietnam, as in much of East Asia, most of the poor earn a living by growing rice. In Mongolia, the livestock herding tradition is centuries old and provides a livelihood to the bulk of the rural population. Domestic resource-cost estimates confirm that these two commodities offer scope for efficient and expanding international trade opportunities. Domestic trade policies in rice and cashmere in these economies, by and large, no longer represent important impediments. This suggests a role for value-chain analysis to identify the sectoral institutional and policy constraints between the two ends of the supply chains for rice and cashmere that reduce the ability of poor producers to benefit from these expanding trade opportunities.

As presented in Chapter 9, value-chain analysis for these two sectors highlights the considerable impediments that exist both to upgrading the value of rice and cashmere production and to increasing the share of poor producers in the value chains. In all three countries, powerful constituents appropriate rents through explicit preferences (credit for state-owned enterprises [SOEs] in Vietnam, export tax in Mongolia), industrial structure (near monopsony for a few millers in Cambodia), and corrupt practices (illegal fees) that are tolerated while poor producers remain trapped in low-productivity states in the absence of improvements in public service delivery (poor road network, inadequate research and extension, and so forth). The analysis shows that the poor can benefit from expanded opportunities presented by global integration provided that these institutional constraints are addressed. Giving voice to poor producers' interests by placing these issues on the policy agenda is crucial for fostering reforms that unleash the productivity potential of poor people and increase their bargaining power.

The trading arrangements and behind-the-border agendas discussed above are also critical to ensuring a broad sharing of the benefits from trade in key commodities. Reducing market access barriers is critical for sectors that are central to social stability, including agricultural staple crops such as rice. Relieving transport and logistics constraints in remote areas is an important component of realizing efficiencies along the value chain. Many of the people who have yet to benefit from East Asia's successful trade strategies are located in these more remote areas.

### ***Trade and stability***

Employment and earnings stability is another important element in ensuring a supportive authorizing environment for trade. In most of the region's economies, labor is flexible; the adjustment to demand shocks takes place through wages, protecting employment, and spreading the gains or losses over the broad labor force.<sup>52</sup> The East Asia financial crisis and more recent global slowdown have brought concerns with volatility to the fore. Trade liberalization, it is argued, may have increased the exposure of the economy to more and larger shocks in the tradable goods sectors. If a sector faces larger or more frequent shocks, workers in that sector may experience greater fluctuation in employment or earnings and, hence, greater job and earnings insecurity. Adjustment can be costly, with loss in efficiency

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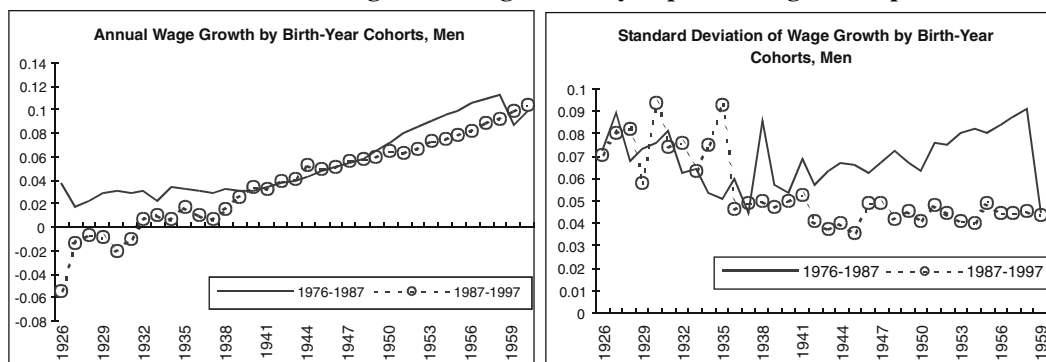
<sup>52</sup> The most severe test of this occurred during the Asian crisis. Except in Korea, unemployment in the crisis countries was kept to manageable levels, while most of the adjustment fell on wages.

and displacement of workers. There is particular concern that volatility transmitted via trade liberalization may make workers more vulnerable, and that poorer workers might be hurt disproportionately.

Our analysis for East Asia suggests that trade liberalization has *not* resulted in increased volatility or vulnerability for wage workers. As outlined in Chapter 10, research in three countries (Korea, Thailand, Indonesia) examined the relationship among trade, idiosyncratic shocks, and fluctuations in workers' earnings and employment. The first comparison made is between periods of different degrees of openness to trade; the second is among industries characterized by different degrees of trade exposure. While the analysis is constrained by data availability, it finds no correlation between greater exposure to trade and greater variability in earnings or employment. Indeed, worker cohorts experienced lower year-to-year fluctuation in their earnings during the 1990s—characterized by fewer trade barriers—than in the previous decade. There is some evidence that employment is more volatile in trade-intensive industries; at the onset of the East Asia financial crisis, employment

**Figure 16: Trade and stability in labor markets**

**Korea: No evidence of higher earnings volatility in periods of greater openness**

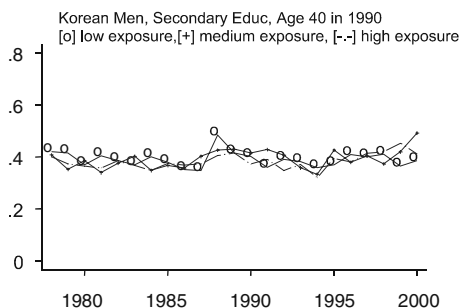


Source: Kim (2002).

Source: Kim (2002).

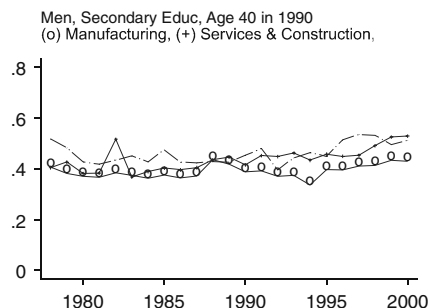
... nor in sectors more exposed to trade

**Korea: Standard deviation of log real wages of a cohort (male, born 1950, with secondary education) in low, medium, and high trade exposure groups, 1976-2000**



Source: Kim (2002).

**Indonesia: Trend of average log of real wages of male by broad sectors (manufacturing versus services), 1986-2000**



Source: Kim (2002).

fluctuated more widely in the more trade-intensive industries than in the less trade-intensive industries. However, employment in these industries recovered rapidly, with little long-term adverse impact.

The analysis does find a clear relationship between vulnerability and workers' educational level and gender: Workers who have little education and those who are female are much more likely to fall into poverty. In Indonesia, for example, the proportion of unskilled workers falling from high-paying jobs into low-paying jobs was two to three times that of skilled workers. Hence, while trade openness makes an important contribution to growth and does not worsen vulnerability, policies to reduce the vulnerability of workers must also focus on broadening education and developing skills.

## **Concluding remarks**

East Asia is emerging from the financial and currency crises of 1997-98 with a new perspective on development. East Asian policymakers are turning to the region as well as to the rest of the world to develop a coherent set of economic policies that can deliver stability, growth, and regional integration. Strategies that promote cross-border flows of trade, investment, and other financial flows are promising, and several bilateral, regional, and multilateral initiatives have been advanced to pursue this agenda.

To succeed, these strategies must have two features. First, they must provide a compelling vision for how integration can deliver broadly shared growth and prosperity. There is a concern in Asia that a narrowly focused approach to globalization, as in the 1980s and early 1990s, has worsened the income distribution within countries and widened the gap between the richer and poorer countries of the region. The new strategies must therefore move beyond the perspective of trade policy to broader approaches that emphasize the links between trade and social stability and the coherence with overall development, stability, and growth. For this reason, the chapters in this volume contain several studies of the impact of integration on poorer countries, and on vulnerable groups within countries.

Second, as strategies for integration move beyond the narrow confines of trade policy, they must increasingly deal with second-best issues and trade-offs, including in areas hitherto treated as sensitive: for example, balancing user rights and incentives for innovation in deciding on an intellectual property rights regime; deciding where to allocate scarce resources to reduce logistics costs and improve competitiveness; introducing appropriate environmental and labor standards; and expanding liberalization into services and agriculture.

To guide countries on the priorities in these areas, an empirical approach is required; East Asian countries are diverse and each has a different set of priorities. But the chapters in this volume suggest some broadly applicable priority areas for action, as defined below.

- *Broadening agreements to include services.* Several international studies<sup>53</sup> suggest that the gains from liberalizing services could be substantial, and this is an area where East Asia has lagged behind other developing regions. With the emergence of China as a low-wage, efficient manufacturer, other countries in the region will find it socially very difficult to compete in international markets on the basis of wages. Instead, they must rely on better producer services and reduced corruption to improve their competitiveness.
- *Adapting agricultural trade policies.* China's approach to agricultural trade liberalization offers scope for the region, especially Southeast Asia, to benefit significantly.<sup>54</sup> China will emerge as a major importer of agricultural and natural resource-intensive commodities. There is evidence to suggest that if agriculture can be liberalized in a regional setting, as in the proposed ASEAN-China Free Trade Agreement, then a favorable political dynamic can be set in place that will lead to more open agricultural sectors overall. As regards the region's agricultural exports to the developed world, countries need to improve their ability to meet sanitary and phytosanitary standards through better laboratories, standards, and negotiation of mutual recognition agreements, and rich countries need to reduce the degree of cascading tariffs in agricultural processing.
- *Easing adjustment in labor-intensive industries.* Certain sectors, especially garments, are likely to be seriously affected by expanded output and exports from China. The region's more developed economies will be able to shift out of garment-making into higher-value-added industries, and the presence of current account surpluses today implies that the external adjustment should be manageable. For other countries, supply-chain analysis suggests that there is scope for greatly improving competitiveness in garments and other manufacturing industries by improving logistics and reducing the costs of corruption.
- *Improving logistics.* Logistics play a critical role both in determining aggregate levels of trade and in ensuring that development benefits spread beyond coastal regions. For East Asia's less open and accessible countries and regions, the development of more tightly integrated domestic markets and logistics systems is a high priority. Besides promoting an appropriate mix of transport modes, complementary institutional actions are needed to extend better transport services to remote areas and to establish better conditions for market development. Beyond strengthening physical infrastructure, governments also need to undertake improvements in the regulatory environment and in the conditions for cross-border facilitation.
- *Framing policies on intellectual property rights.* Strong protection of intellectual property rights encourages innovation, but is not a magic bullet; other conditions (including investments in skills and provision of a competitive business environment) are also needed. Several of the region's more advanced countries, and parts of China, can hope to stimulate technological advances if they better protect intellectual property and pay more attention to competition policy.<sup>55</sup> Stronger copyright laws, provided they can be enforced, may yield some significant gains for domestic software industries as well as the arts and music sectors. As to traditional knowledge, a number of important conceptual

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<sup>53</sup> See *Innovative East Asia and The Future of Growth*, World Bank (2003b), on producer services.

<sup>54</sup> As noted above, the adjustments that take place in China's agricultural sector as a result of WTO accession may be smaller than some other analysts suggest, because China's current practices are already more liberal than implied by statutory rates.

<sup>55</sup> World Bank (2003b).

and practical problems need to be sorted out before progress can be made in protecting its ownership or linking traditional knowledge issues to WTO agreements or other mechanisms for managing research and development.

- *Reconsidering environmental and labor standards.* There is no evidence from East Asia to support the argument that improved environmental and core labor standards would unfairly affect manufacturing competitiveness. Quite the reverse: Evidence suggests that East Asian countries can raise their environmental and core labor standards without adversely affecting their exports and investment inflows. The fierce resistance of many in the region to considering these issues in line with broader development strategies may be misplaced.
- *Safeguarding and benefiting the poor.* The fear that globalization has increased volatility seems to be misplaced. Available evidence for East Asia suggests that greater openness to trade does not make workers more vulnerable; indeed, greater openness has in fact stabilized wage incomes and employment across all skill categories. Women workers and workers with little education are noticeably more vulnerable than others to falling into poverty, emphasizing the need for policies to broaden education and develop skills. To ensure that the poor within countries benefit from openness, policies are also needed to support workers' geographic and occupational mobility, as are specific actions to reduce transport and marketing costs to improve farm-gate prices for products that the poor rely on.

This rich agenda suggests scope for East Asian countries to build on the international commitment to a new development round of trade negotiations based on the Doha Agenda, and on their own commitment to deepening regional economic ties. Countries must operate on three levels. Internationally, they can influence the negotiations, and should pay particular attention to standards and to liberalization in agroindustries and services. Regionally, they can achieve deeper integration, which offers prospects for gains in sensitive sectors. Nationally, they need to take a more comprehensive approach to policy than hitherto, moving beyond narrow trade and industry interests focused on protecting specific manufacturing subsectors, to adopt a strategy with sectoral components that are aligned to encourage integration as a means to deliver on growth, stability, and poverty reduction.