

Section 6

TURMOIL IN THE WORLD TRADING REGIME AND MEGA-FTAs IN EAST ASIA

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1. Standpoint of Middle Powers

The US-China confrontation has changed its nature from a trade war or a tariff war at first to a confrontation between superpowers. At the same time, the interpretation of the key words “national security” and “sensible technologies” has also broadened. The scope of US policy toward China was not just the rule-breaking tariff policy, but it has also expanded to a series of measures imposed on Huawei, export regulations, foreign investment regulations, inward investment regulations, government procurement restrictions, and “clean network” construction. After the Biden Administration was established, issues have broadened further to those that are difficult to compromise on, such as human rights and democracy. On the other hand, Chinese diplomacy has become aggressive not only toward the US, but also toward other nations. In addition to a series of assertive policies called “wolf warrior diplomacy,” China has also announced various arbitrary policies symbolized by the Export Control Law enacted in December 2020.

Japan’s stance on China is identical to the US’s in many aspects. There are many issues on which Japan basically shares common values with the US, such as protection of intellectual property, state-owned enterprises, data flows, national security, democracy, and human rights. On the other hand, regarding the arbitrary interpretation of national security and sensible technologies, there are some aspects on which Japan cannot easily agree. Japan and Japanese firms want to maintain favorable economic relations with both the US and China. International trade relations differ from security relations in nature and do not necessarily see a distinction between friends and enemies. Even with some aspects where the same values cannot be shared, it is possible to establish trade and investment relations. Further, the US does not expect complete decoupling with China. Currently, many American firms continue Chinese businesses particularly in the financial and high-tech areas, and American consumers enjoy great benefits brought from the economic relations with China. In fact, China’s exports to the US have grown significantly.

The nations sandwiched between the US and China—Japan, South Korea, Taiwan, ASEAN, Australia, New Zealand and India—will be called “middle pow-

ers” hereinafter. Each middle power maintains a different political and psychological distance with the US and China, but they all have a deep economic connection with both nations.

What fears do middle powers have? The first fear is to be urged to choose between the US and China and forced to stand at the forefront of unreasonable confrontation. Middle powers want the scope of decoupling to be clarified, but superpowers have some incentives to leave it ambiguous. The second fear is that superpowers will form agreements that are convenient only for themselves. For example, the Phase One agreement signed in January 2020 includes commitments that may damage third countries, such as the compulsory quotas imposed on imports from the US by China. In fact, the modeling and simulation of the agreement shows a result that many third countries will obtain negative welfare effects¹⁾. The third fear is that the rule-based trading regime will weaken. If rules are loosened by the confrontation between superpowers, an incentive for nations to restrict themselves with the rules will diminish, especially for superpowers. For that reason, a danger of superpowers imposing forbidden trade policies on nations that will never retaliate against them will increase, depending on the political situation at that moment. No rule keeper fluctuates the norms of the whole world.

Under these circumstances, it is unfortunate that middle powers have no means of completely controlling the confrontation between superpowers. In particular, what international trade policies can do is limited, but this does not mean that they can do nothing. What we should aim for using international commercial policies are to stabilize the global trade order as much as possible and to establish a trade policy system to achieve a rule-based trading regime in every way possible. Working on this challenge requires the formation and utilization of mega-Free Trade Agreements (FTAs).

2. The Current Situation of Factory Asia

(1) The Pivotal Role of ASEAN

Firstly, we will look at the current situation of Factory Asia, as the background.

East Asia, which includes Northeast Asia and Southeast Asia, has led the world in international production networks (IPNs) or the second unbundling, particularly in the machinery industry, and has established Factory Asia since the 1990s²⁾. Emerging and developing nations have actively adopted develop-

1) Refer to, for example, Freund, Maliszewska, Mattoo, and Ruta (2020).

2) Refer to Ando and Kimura (2005), Baldwin (2016).

ment strategies with active participation in IPNs, and multinational firms such as Japanese firms have contributed to the expansion and deepening of IPNs. In the backdrop to this has been the long-lasting peace and the rule-based trading regime in East Asia.

ASEAN's commitment to Factory Asia is strong. China's presence has steadily grown in East Asia since it joined the World Trade Organization (WTO) at the end of 2001. Looking at the trends in the trade of machinery, the large volume of China's exports is conspicuous. However, China's machinery exports are mostly to the rest of the world, and the ratio of exports to East Asia is small. That is, IPNs including China take the form of strong ties with nations other than those in East Asia. In contrast, ASEAN has close import and export relations with Japan, China and South Korea. Although the relative weight against China has been shrinking, ASEAN has continued to function as the IPNs' hub.

To maintain its status as the hub, ASEAN established the ASEAN-plus-one FTAs network in addition to the economic integration of ASEAN itself. Further, it has played an active role in the conclusion of the East Asia Regional Comprehensive Economic Partnership (RCEP). Why has ASEAN particularly promoted the RCEP? It does not make sense for ASEAN to have considered only tariff elimination with the RCEP. Tariffs within ASEAN are already almost nil without exception. With ASEAN-plus-one FTAs completed by 2010, ASEAN already concluded FTAs with six neighboring nations. The nations newly tied with FTAs based on the RCEP are all non-ASEAN countries: Japan-Korea and Japan-China, as well as India-China, Australia and New Zealand at the time when India was participating in the negotiations. Therefore, unless tariff elimination between ASEAN and non-ASEAN countries is advanced much more than in ASEAN-plus-one FTAs, ASEAN may suffer from a negative trade diversion effect because an increase in trade between non-ASEAN countries would push down ASEAN's exports. Nevertheless, the leaders of ASEAN have promoted the RCEP because they expect a positive trade creation effect produced by the whole Factory Asia being activated by the RCEP, in addition to other effects such as rules of origin (ROOs) and trade facilitation rather than tariff elimination. Further, they expect that ASEAN can secure its centrality in the economic integration in East Asia.

We, however, should note that the degree of each ASEAN country's participation in IPNs is significantly different. This means that such a situation has the potential risk of weakening ASEAN's centrality. When considering the direction of not only ASEAN, but also the whole Factory Asia, the important point is how to maintain the solid ties within ASEAN. In particular, it is essential that Indonesia, which accounts for 40% of ASEAN's economy and population, will continue its commitment to free trade and investment and lead ASEAN.

(2) COVID-19

Amid the outbreak of COVID-19 in China followed by the pandemic, concerns over the vulnerability of global value chains (GVCs) arose. Some journalists argued that the era of GVCs was over and that factories in emerging and developing countries should return to home countries (reshoring). In contrast, another insisted that facilitating the decentralization of production bases even further would raise the robustness of supply chains and that the excess concentration of production in China should be avoided. In addition, there was also an argument suggesting that firms should improve risk management because we are entering an era of “just-in-case” rather than “just-in-time.” However, in the end supply chains in East Asia, especially IPNs, have been retained as they were. Looking back now, it seems that these arguments slightly overreacted to the initial shock in some aspects.

Three factors are responsible for these overreactions³⁾. Firstly, COVID-19 accompanied by city lockdowns and social distancing was a shock to supply chains, and the nature of the shock was not properly perceived. Unlike global financial crises and the Great East Japan Earthquake in the past, this time three kinds of shocks occurred on different timings and in different places: negative supply shocks, positive demand shocks, and negative demand shocks. Negative supply shocks first occurred in February 2020 in the form of imports of intermediate and final goods from China being disrupted, and then occurred in various other countries as the infection spread. However, imports from China rapidly recovered in the following month, and the shocks in other nations settled down in a relatively short time. Meanwhile, facial masks and medical related products were hit by positive demand shocks. When concerns over the supply of so-called essential goods including foodstuffs, not just medical products, temporality increased, confusion spread because some countries restricted exports, prioritizing their own citizens (this is perceived as negative supply shocks by the other nations). However, the excess demand was resolved relatively quickly, except for the current vaccination issue.

Rather than these two kinds of shocks, the most worrisome was actually the third shock of negative demand shocks caused by the depressed global economy⁴⁾. However, the unprecedented mitigation policies implemented by each nation have kept the financial sector sound and the asset market has also not collapsed, meaning that the situation will not worsen so much. In the recovery process, positive demand shocks occurred concerning teleworking and stay-at-

3) The following is an argument by Ando, Kimura and Obashi (2021).

4) Kimura (2020) noted the risk that negative demand shocks would be prolonged.

home related products such as telecommunication equipment and dishwashers that were needed when working remotely. This supported economies, but it is a so-called k-shaped recovery because the impact differs depending on the type of industry and business.

Secondly, empirical studies on the Asian Currency Crisis, the global financial crises and the Great East Japan Earthquake have proven that IPNs, which are particularly sophisticated among GVCs, are robust against various supply and demand shocks⁵. This fact, however, was not generally well recognized. IPNs could certainly be a channel to transmit shocks, but relationship-specific transactions, which are established through investments based on a medium- to long-term outlook, are not easily interrupted (robust) and are quick to recover even if interrupted (resilient) compared to normal transactions in a spot market. This means that IPNs can play a role as a built-in stabilizer in a time of crisis. As a matter of course, firms designed and operated IPNs before the COVID-19 crisis, considering a trade-off between the efficiency brought by the decentralized location of a business base and the risk associated with it. Even though firms may review IPNs with newly acquired information, there will be no change to them continuing to operate IPNs down the road.

Thirdly, it can be pointed out that the deterioration of the US-China relationship caused overreactions toward the decoupling movement. The voices insisting that business bases in China should leave became stronger, especially in Japan, because the negative supply shocks that initially started from China and the positive demand shocks that hit medical-related products were connected with an alert against China. Labor-intensive processes have been relocated to third countries for several years due to soaring wages in China. In addition, the relocations of sensitive technologies and rare earth-related production bases have also been observed to some extent. But for many Japanese firms, Chinese operations are important and large-scale withdrawals from China have not happened yet. We should continue to pay close attention to the decoupling movement going forward.

To make IPNs more robust and resilient, it is necessary to expand and deepen them by refining the investment environment and improving connectivity. Although the form that the manufacturing industry should take will significantly change amid the digital transformation, task-by-task specialization is unlikely to lose its superiority for a while. On considering complementarity with digital technologies, the advantages of Factory Asia should be used for the time being.

5) Refer to Ando and Kimura (2021).

3. Japan's Mega-FTAs Strategies

The mega-FTAs strategies, which Japan has been working on since 2013, reached a turning point when the RCEP was signed in November 2020. Once the RCEP comes into effect down the road in January 2022, Japan will be tied to almost all its major trade partner nations based on FTAs. If Japan seeks new FTA partners, they will be the Common Market of the South (MERCOSUR), Brazil, and South Africa, but these FTAs are unlikely to produce significant economic effects. However, Japan should not lose interest in FTAs, and on the contrary, it is important for Japan to deal with the new phase by using the characteristics of mega-FTAs as “living agreements.”

Table 1-6-1 compiles the status of recent Free Trade Agreements (FTAs) negotiations involving Japan. Japan's participation in the negotiation of the Trans-Pacific Partnership Agreement (TPP) has come up in conversation since the administration period of the Democratic Party of Japan. Around the time when the second Abe administration was inaugurated in December 2012 and Japan officially announced its desire to participate in the TPP negotiations in March 2013, the formation of mega-FTAs between major nations and the participation by many nations have become fully fledged. Japan's participation in the TPP negotiations also greatly stimulated the start of the Japan-EU Economic Partnership Agreement (Japan-EU EPA) and the RCEP negotiations. Although the US withdrew from the TPP soon after the Trump Administration was established in January 2017, the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) was finalized under Japan's initiative. Currently, the CPTPP has come into effect in eight nations. The Japan-EU EPA also reached agreement and came into effect in February 2019. Despite the prolonged negotiations, the RCEP was finally signed by 15 nations excluding India in November 2020 and will be in effect in January 2022 among countries that have completed domestic clearance.

For the past five years, international trade and investment have been exposed to a great risk. While rule-based trading regime has weakened and the US-China confrontation has intensified, the formation of mega-FTAs has rather been accelerated. In the backdrop to this has been a change in the expected role of mega-FTAs.

The roles previously assigned to mega-FTAs were first, further liberalization and second, international rule making. The WTO should have played these roles as the negotiation forum since its establishment in 1995, but it has hardly functioned for this because it faced opposition from major developing nations on every occasion. Meanwhile, economic globalization has steadily progressed,

Table 1-6-1

Recent Free Trade Agreements Involving Japan

	Start of negotiations	Signed	Came into effect	Participating countries
Trans-Pacific Partnership Agreement (TPP)	Jul. 2013 (Japan participated in the negotiations)	Feb. 2016	Not in effect (US withdrew in Jan. 2017)	Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, the US and Vietnam
Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP)	→	Mar. 2018	Dec. 2018	Mexico, Japan, Singapore, New Zealand, Canada, Australia, Vietnam, Peru (already effective in all of the above), Brunei, Chile and Malaysia
Japan-EU Economic Partnership Agreement (Japan-EU EPA)	Apr. 2013	Jul. 2018	Feb. 2019	Japan and 28 EU nations (27 nations in Jan. 2020 due to Brexit, the UK being included until the end of 2020 as a transition period)
Trade Agreement between Japan and the US and Agreement between Japan and the US Concerning Digital Trade	Apr. 2019	Oct. 2019	Jan. 2020	Japan and the US
Japan-UK Comprehensive Economic Partnership Agreement (Japan-UK EPA)	Jun. 2020	Oct. 2020	Jan. 2021	Japan and the UK
East Asia Regional Comprehensive Economic Partnership (RCEP)	May 2013	Nov. 2020 (excl. India)	Jan. 2022	10 ASEAN nations, Australia, China, Japan, South Korea, and New Zealand (in effect only with countries that have ratified it)

and the level of liberalization and the coverage of international rules based on the WTO have become totally insufficient. Impatient major nations decided to step into liberalization and international rule making with mega-FTAs, although they are fully aware that it is the second-best choice. The significance of these two roles is not lost.

In addition to these roles, the third role was recently added to mega-FTAs, which is to maintain the rule-based trading regime. The vulnerability of the rule-based trading regime increases the risk that each nation will deviate from the trade rules and norms that are usually trusted. The policy risk emerging from it will be a great hindrance for international businesses.

There are incentives, especially for superpowers, to use arbitral trade pol-

icies depending on their political motivation at that time without fear of retaliation. The US-China confrontation creates exactly a political environment that encourages this. Further, the WTO's function for settling disputes has notably weakened, because the Biden Administration, following on from the Trump Administration, has been blocking the appointment of the WTO's Appellate Body members. If that is the case, it is unavoidable that nations other than superpowers will also easily deviate from the existing norms. Even mega-FTAs cannot completely cut off the bad flow, but they are expected to be a deterrent to a certain extent.

Looking at Japan's recent FTAs from such a viewpoint, it is apparent that the third role has strongly been perceived. The CPTPP shows high-level liberalization and new standards for international rule making, and at the same time, it clearly intends that the middle powers sandwiched between the US and China will unite and protect the rule-based trading regime as much as possible. The UK decided to start accession negotiations in June 2021. Not limited to the UK, the CPTPP is also expected to develop as a forum for the middle powers that will unite and aspire to free trade and investment. The conclusion of the Japan-EU EPA was also accelerated, aiming to jointly protect the trade order disturbed by the Trump Administration. The Trade Agreement between Japan and the United States alone was hurriedly concluded not to aspire to free trade, as symbolized by the word "free" being omitted, but mostly to avoid the US's rule-breaking trade policies. The Japan-UK EPA was also concluded using the Japan-EU EPA as a model in order to stabilize Japan-UK economic relations after Brexit.

4. The Significance of the RCEP

The RCEP was finally signed in November 2020 and will be in effect in January 2022 among signatories with ratification. What role can the RCEP play? We can see its significance from the aspect of three roles. The first role, liberalization, receives a harsh evaluation. The tariff elimination rate based on the number of items, including those being gradually eliminated, stands at 91% for all participating nations, which is almost at the same level as existing East Asia FTAs. However, the rate is low for partners newly tied with FTAs; that is, the rates of Japan toward China and South Korea are 86% and 81%, and of China and South Korea toward Japan are 86% and 83%, respectively. It is also unusual for a different tariff elimination schedule to be set by a partner nation. Considering that the tariff elimination rate required for mega-FTAs by the CPTPP are set at 99–100% (95% only for Japan to protect the agriculture), the RCEP should endeavor to

raise the degree of liberalization, using opportunities such as the fifth-year review after coming into force.

Meanwhile, rules of origin (ROOs) are more trade-friendly than the CPTPP, and the aspects of custom procedures and trade facilitation can also be highly evaluated. Regarding trade in services, the RCEP tried to adopt a negative-list approach (listing services on hold for liberalization). The nations that did not complete the approach are about to progress the transition procedure from a positive-list approach (listing services to be liberalized). For investments, ROOs have promised a liberalization with a negative-list approach and have also stipulated royalty regulations and the prohibition of performance requirements, including technology transfer requirements. As we have seen, the RCEP have many aspects that are more advanced than the existing ASEAN plus one FTAs. Once an agreement comes into force, it will bring certain economic effects.

The second role, international rule making, is highly evaluated on the point that it comprehensively covers various policy modes. The major policy modes that are included in the CPTPP but not in the RCEP are only state-owned enterprises, labor, and environment. However, there are only a few rules asking for strong commitments, such as significant changes in each nation's domestic policy. Instead, the RCEP can be positioned as the starting point for negotiations when trying to involve China in international rules down the road.

Attention is being considerably focused on intellectual property (Chapter 11), e-commerce (Chapter 12), and government procurement (Chapter 16). For intellectual property, the RCEP has made a stronger commitment to trademarks than the WTO's Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS). Regarding e-commerce, the three principles of the CPTPP are free cross-broader data flows, the prohibition on data localization requirements, and the prohibition on forced disclosure of source code, and the RCEP specifies the former two even though their effectiveness remains doubtful. Government procurement has not been included in the previous FTAs in East Asia that much and its contents are limited to transparency, promotion of cooperation, and future outlook, but it has taken a step forward.

We should pay attention most to the third role, the contribution to the maintenance of the rule-based trading regime. It is extremely meaningful that the nations where Factory Asia is being developed, including China in East Asia, show their rule-oriented stance, being tied with one trade agreement. In addition, Chapter 18 stipulates that the RCEP Ministerial Meeting and the RCEP Joint Committee shall be held annually, and that four subordinate committees and an administration office shall be established. Although this is an imitation of ASEAN's progressive economic integration model, ordinarily it can deepen

the agreement step by step and function as one of the stable communication channels when a dispute occurs. It does not mean that the RCEP will solve all issues, but it is expected that the establishment of such a forum including China will be effectively used. Unfortunately, India dropped out in the middle of the negotiations, but it should definitely come back to the RCEP if it wishes to join Factory Asia down the road.

5. Conclusion

The US-China confrontation and the conflict between liberalist nations and China in the political and security arenas do not seem likely to settle down easily. However, the economic relations created through trade and investment are continuing and the conflict does not mean that both the US and China intend to completely cut off their economic relations. Although international trade policies, including mega-FTAs, will not solve all issues, it is necessary to continue to strive in order to maintain the rule-based trading regime. We should start with what we can do to begin with.

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