EAI COMMENTARY No. 23 9 December 2020

Regional Comprehensive Economic Partnership and its Implications for the Regional Supply Chain Network

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After eight years of negotiation, 15 countries across the Asia-Pacific region[1] signed the regional comprehensive economic partnership (RCEP) on 15 November 2020. This is the largest free trade agreement (FTA) in the world, accounting for one-third of global gross domestic product (GDP) and population.[2] The implementation of this mega regional trade deal is expected to smooth the development of existing regional supply chain via its extra trade and investment facilitation measures. However, RCEP fails to engage the participation of India, an important market for consumption goods manufactured in RCEP countries.

1 They include the 10 countries in ASEAN, in addition to Japan, South Korea, China, Australia and New Zealand.

2 https://asean.org/asean-hits-historic-milestone-signing-rcep/ (accessed 24 November 2020).

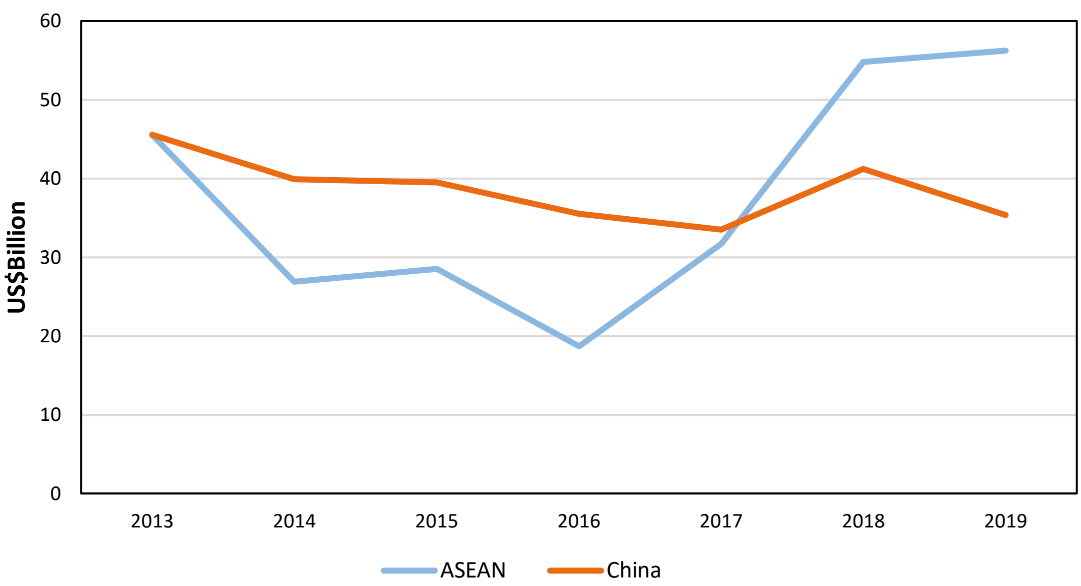
ENHANCING THE EXISTING REGIONAL SUPPLY CHAINS

The importance of RCEP is beyond its economic size. RCEP member states have played an important role in the development of global economic integration over the last few decades.[3] Most of the trade and investment are done between RCEP countries, notably between China, Japan, South Korea and ASEAN (Association of Southeast Asian Nations), in the form of the regional supply chain network.

The regional production network that centred on China as a final assembly place has been transforming over the past few years. Foreign direct investment (FDI) in China's manufacturing industries has clearly declined due to the wage hike and industrial upgrading. Meanwhile, FDI in ASEAN has been on a rapid rise. Since 2017, ASEAN has become a more favoured FDI destination than China for the manufacturing industry (Figure 1). Apart from China's economic structural changes, ASEAN was able to attract more FDI thanks to the quick development of "intra-regional" FTA as well as its free trade deals with several countries in the region. The US-China trade war since 2018 has further propelled the "China+1" strategy for global manufacturing firms.

RCEP member countries are the main sources of FDI in China and in ASEAN. In 2018, 33% of ASEAN's inward FDI was made by RCEP member countries, followed by the EU's 14% and the United States' 6%.[4] Similarly in the same year, RCEP countries accounted for 11% of China's total inward FDI, surpassing the EU (8%) and US (2%) shares in China.[5] Japan, South Korea and Singapore are the main sources of FDI for the manufacturing industry in the region.

FIGURE 1 FDI IN MANUFACTURING IN CHINA AND ASEAN, 2013-2019



Source: CEIC and ASEAN Stats data portal.

3 In 2019, RCEP countries attracted 24% of global FDI inflow and accounted for 34% of global FDI outflow. In the same year, RCEP members took 26% of total global trade. World Investment Report 2020, UNCTAD. World Trade Statistic Review 2020, World Trade Organisation, https://www.wto.org/english/res_e/statis_e/wts2020_e/wts20_toc_e.htm (accessed 24 November 2020).

4 *ASEAN Statistical Yearbook 2019.*

5 Report on Foreign Investment in China 2019, Ministry of Commerce of the People's Republic of China.

The manufacturing-oriented FDI promoted the development of "intra-RCEP" trade relations. China, Japan, South Korea, Singapore and Malaysia are the top five traders of intermediate goods among RCEP members (Table 1). Among these top five, exports of intermediate goods are especially critical to the total exports of South Korea (65%), Singapore (66%) and Malaysia (70%). On the other hand, intermediate goods accounted for a particularly high portion of the total imports of China (73%), Singapore (69%) and Malaysia (71%).

Although in terms of value the total trade in intermediate goods is not huge for the rest of the RCEP members, trade in intermediate goods still accounted for a large portion in their total trade such as in the case of Indonesia and the Philippines. The trade facilitation measures under RCEP are expected to drive the developing countries' greater trade reliance on intermediate goods as well as their overall external trade development.

In terms of the Global Value Chain (GVC) participation rate,[6] China's 35% is particularly low in 2015. The substitution of imported intermediate inputs with domestically produced intermediate inputs might have reduced the intensity of GVC participation.[7] On the other hand, Singapore, Vietnam and South Korea have particularly high GVC participation, indicating their greater involvement in the regional manufacturing production network. Overall, the GVC index has declined for most of RCEP countries in the last decade. The strengthening of domestic manufacturing production may have reduced the demand for intermediate goods from overseas.

TABLE 1 RCEP MEMBERS' TRADE IN INTERMEDIATE GOODS

	Exports in 2017		Imports in 2017		GVC participation index* (%)	
	US$ billion	% of total exports	US$ billion	% of total imports	2005	2015
Top 5 intermediate goods traders						
China	974	44	1,180	73	49	35
Japan	361	53	265	50	43	38
South Korea	348	65	229	62	64	52
Singapore	217	66	177	69	75	62
Malaysia	130	70	120	71	69	56
The rest						
Australia	122	76	69	34	44	39
Indonesia	88	66	94	72	49	37
Philippines	47	69	58	64	74	44
New Zealand	12	32	14	37	34	26
Brunei	0.3	59	1.6	57	45	47
Cambodia	n/a	n/a	n/a	n/a	42	41
Vietnam	n/a	n/a	n/a	n/a	53	56
Thailand	n/a	n/a	n/a	n/a	56	47

Note: * as percentage of total gross exports.
Source: WTO.

6 GVC participation refers to the ratio of the foreign value added content of exports and imports.

7 Xin Li, Bo Meng and Zhi Wang, "Recent patterns of global and GVC participation", *Global Value Chain Development Report 2019*, World Trade Organisation, https://www.wto.org/english/res_e/publications_e/gvcd_report_19_e.htm (accessed 24 November 2020).

INDIA'S NONPARTICIPATION RATIONALE

India is the fifth largest consumption market in the world, after the United States, EU, China and Japan.[8] India's huge consumption market potential is a factor for its attraction to RCEP members. India's participation in RCEP would be particularly noteworthy for China since China already has FTAs with all RCEP members except India and Japan. To China, India's larger and younger population would be a more important market than Japan's.

From the Indian perspective, RCEP is not an attractive deal as most RCEP members are not important markets for the country. Instead, the United States, United Arab Emirates (UAE) and EU are India's key export destinations in 2018 (Table 2). In comparison, for the other RCEP members, China is the leading export destination. ASEAN, Japan and South Korea are also key markets for other RCEP countries. As such, the multilateral trade deal would facilitate goods exported to each other's markets. However, India does not have comparative advantage in manufactured goods to allow it to benefit from greater tariff reduction in merchandise trade. Instead, the country would risk importing a greater number of cheaper goods from China and ASEAN countries if it joined the trade deal.

TABLE 2 TOP FIVE EXPORT DESTINATIONS FOR RCEP MEMBERS IN 2018

RCEP members	1st	2nd	3rd	4th	5th
ASEAN	China	EU	US	Japan	South Korea
China	US	EU	ASEAN	Hong Kong	Japan
Japan	China	US	ASEAN	EU	South Korea
South Korea	China	ASEAN	US	EU	Hong Kong
Australia	China	Japan	ASEAN	South Korea	EU
New Zealand	China	Australia	ASEAN	EU	US
India	US	UAE	EU	ASEAN	China

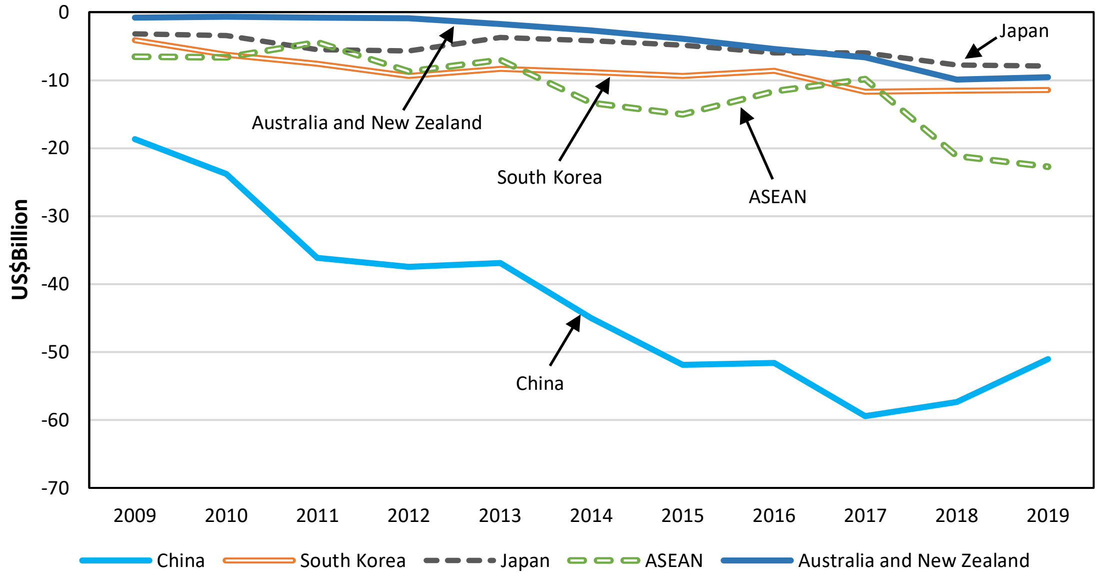
Source: ASEANstats and CEIC, World's Top Exports.

India's disadvantages in trade in goods is evidenced by its huge merchandise **trade deficit** with RCEP member states, especially with China (Figure 2). In 2019, China accounted for 30% of India's total trade deficit. In the same year, the share for all RCEP member states in India's total trade deficit was 60%.[9] India's FTA with South Korea and ASEAN went into force in 2010. With Japan, the comprehensive economic partnership took effect in 2011. Its trade imbalance with these three economies has widened since. India's concerns are therefore understandable as the mega-regional FTA like RCEP may lead to a swamp in goods in the Indian market and to stiff competition in its domestic manufacturing sectors, threatening their survival.

[8] https://data.worldbank.org/indicator/NE.CON.PRVT.CD?year_high_desc=true (accessed 7 December 2020).

[9] Data source: CEIC data.

FIGURE 2 INDIA'S MERCHANDISE TRADE DEFICIT WITH RCEP MEMBERS



Source: CEIC Data.

Unlike other manufacturing oriented economies in the region, India's economy is dominated by services. India's strength in services also allows it to run service trade surplus constantly, an area which the RCEP is weak in. Moreover, India adopts "Mode 4" for its trade in services, which involves the presence of Indian professionals in another country. This is a concern for RCEP countries as it threatens domestic employment.[10] Although the RCEP has promised some form of service sector liberalisation in the future, member countries have yet to offer concessions on cross-border movement of professionals, a key interest of India.[11]

On the other hand, even if RCEP opens more in services, India may not be in a competitive position, putting it at risk of strong competition from other RCEP states. In 2019, China was a leading service exporter in the region, accounting for nearly 5% of global service exports, outstripping India (3.5%), Singapore (3.4%) and Japan (3.3%).[12]

While staying out of the RCEP would buy India more time to develop the competitiveness of its domestic industries, it would also mean opportunity lost to enhance the competitiveness of its industries at the global level through greater trade and investment liberalisation.

REGIONAL SUPPLY CHAIN NETWORK UNDER RCEP IN PROSPECTIVE

Instead of joining RCEP, India is working with Japan and Australia to set up a network which focuses on **supply chain resilience** in the Indo-Pacific region, a response to the regional supply chain disruptions during the COVID-19 pandemic. This trilateral cooperation also aims to

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[10] https://www.thehindubusinessline.com/economy/india-may-say-no-to-rcep-pact-if-its-demands-on-services-goods-are-not-met/article28804967.ece (accessed 24 November 2020).

[11] https://foreignpolicy.com/2020/11/23/why-india-refused-to-join-rcep-worlds-biggest-trading-bloc/ (accessed 24 November 2020).

[12] Data source: WTO

reduce economic dependence on China.[13] However, this initiative seems ineffective in influencing the economic ties of RCEP countries. China continues to attract FDI in high value-added industries and services through further opening of its markets and reforms as announced in 14th Five-Year Plan. Many developing countries in ASEAN have also increasingly relied on trading with China for industrial goods to develop domestic manufacturing production at home.

RCEP is an update of the existing ASEAN Plus One FTAs (ASEAN's FTAs with the five dialogue partners, including China, Japan, South Korea, Australia and New Zealand) that incorporate some emerging trade trends.[14] As such, RCEP may not boost ASEAN's trade with other RCEP members though it is expected to facilitate trade and investment between member states. From a long-term perspective, it offers an opportunity for less developed countries to fit in the regional "flying-geese model" and develop their economies. The integration of less developed countries such as Myanmar, Laos and Cambodia could result in a more delicate division of labour in the regional manufacturing production.

For the three Northeast Asian countries, namely, China, Japan and South Korea, RCEP could reinforce economic relations even though its impact for China and South Korea could be limited as a bilateral FTA is already in force. The bigger winner is Japan as it does not have any FTA with either China or South Korea. Particularly in China's market, Japanese and Korean products are competing neck and neck. RCEP will also be an alternative platform for cooperation when political issues hindered the three countries from strengthening the trilateral ties.

Overall, the greater facilitation in trade and investment is likely to further enhance the efficiency of the regional supply chain network. Nonetheless, the greater regional economic integration does not necessarily lead to higher economic growth. As the United States and Europe are important consumption markets in the world,[15] the economic recovery in these two areas is likely to remain crucial to the development of East Asia's production activities in the foreseeable future.

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[13] https://thediplomat.com/2020/10/australia-japan-india-trilateral-sets-sights-on-supply-chain-resilience/ (accessed 24 November 2020).

[14] RCEP takes several future trend into consideration, including the age of electronic commerce, potential of micro, small and medium-sized enterprises, deepening of regional value chain, and complexity of market competition. See https://asean.org/storage/2020/11/Summary-of-the-RCEP-Agreement.pdf (accessed 24 November 2020).

[15] Analysis from ADB showed that external demand accounted for 63% of Asian value-added exports with 27% of external demand came from the United States and Europe. Asian Economic Integration Report 2017 https://www.adb.org/sites/default/files/publication/375196/aeir-2017.pdf (accessed 7 December 2020).