# RCEP: Integrating Asia beyond trade

## Gauging the impacts of creating the world's largest trading bloc

**Aidan Yao,**
Senior Economist (China)
Macro Research – Core Investments

**Shirley Shen,**
Economist (Emerging Asia)
Macro Research – Core Investments

### Key points

- The creation of the world's largest free-trade-zone under the Regional Comprehensive Economic Partnership represents Asia's defiance against protectionism for a continued pursuit of economic integration
- Despite wrapped as a trade deal, the key source of gains from RCEP may not actually come from increased trade activity – mainly because most RCEP members already had bilateral free-trade agreements amongst them
- China, Japan and Korea should be the main beneficiaries of reduced trade barriers as RCEP fills the void of free-trade agreements for them. These gains will accrue over time as existing tariffs are phased out
- More important than trade could be the accelerated formation of regional supply-chains. By unifying trade standards – particularly in relation to the Rules of Origin – RCEP could reduce transaction costs and encourage production networks to spread across Asia
- RCEP could also bring geopolitical ramifications to both insiders and outsiders of the pact. Closer economic connections could reduce friction and foster regional stability. The US could see its geopolitical influence weaken in Asia along with reduced economic ties. India may face economic and political marginalisation for not being on the RCEP train, although it could join later

### Creation of the world's largest trading bloc

The recent signing of the Regional Comprehensive Economic Partnership, or RCEP, has created the world's largest trading bloc, accounting for roughly a third of the global economy and population (Exhibit 1). Initiated by the Association of Southeast Asian Nations (ASEAN) in 2011, RCEP has brought together 15 nations – including the 10 ASEAN members, China, Japan, South Korea, Australia and New Zealand – creating a large and diverse economic zone with members of different size, culture, custom and economic development.

Exhibit 1: Spreading global supply chains boosts trade

| | RCEP | CPTPP |
|---|---|---|
| Implication | A single trade agreements within Asia | Agreements with countries in Asia Pacific and America |
| Date signed | November 15, 2020 | March 8, 2018 |
| Member countries | **Asia:**<br>China, Japan, Australia, New Zealand, Korea<br>**ASEAN:**<br>Vietnam, Brunei, Malaysia, Singapore, Indonesia, Philippines, Thailand, Cambodia, Laos, Myanmar | **Asia:**<br>Japan, Australia, New Zealand<br>**ASEAN:**<br>Vietnam, Brunei, Malaysia, Singapore<br>**North America:**<br>Chile, Mexico, Canada<br>**Latin America**<br>Peru |
| Effective from | Once 6 ASEAN economies and half of non-ASEAN parties have approved | December 30, 2018 |
| Tariff exemption | Eliminate tariffs on 90-93% of goods trade | Eliminate tariffs on 99% of goods trade |
| Economic size | $26 trillion (30% of world) | $11 trillion (13% of world) |
| Trade share | $10 trillion (27% of world) | $5.7 trillion (15% of world) |
| Population size | 2.3 billion (30% of world) | 500 million (7% of world) |
| FDI inflow | $422 billion (26% of world) | $310 billion (19% of world) |
| Benefits | Common rule of origin within APAC | Geographic diversity, greater depth |
| Shortfalls | Less comprehensive than other agreements | Limited provisions after US withdrawal |

*Source: World Bank and AXA IM Research, as of January 2021*

Compared to the other regional trade deal – the Comprehensive and Progressive Agreement for Trans-Pacific Partnership, or CPTPP, RCEP is larger and broader in its coverage (Exhibit 1). However, for the gains in economic breadth, it compromises the quality of standards in order to draw consensus from countries of different economic status. For example, RCEP aims to eliminate trade tariffs on 90% of exports over the next 20 years, compared to CPTPP that removes 99% of tariffs over 15 years. More importantly, CPTPP imposes higher standards on market accessibility, intellectual property protection, state-owned enterprises as well as on labour and environmental rules. These non-tariff criteria are the true differentiators of the two agreements.

For now, RCEP's more flexible and inclusive approach has won support from a larger group of nations. CPTPP, on the other hand, represents the highest trade standard today and will create its own gravitational pull for those vying for top economic rewards. These two spheres are not mutually exclusive, and given the existing overlaps (Exhibit 2), there is a potential for them to merge further[1]. The emergence of these large regional trade deals – at a time when protectionism is on the rise and multilateral institutions, like the World Trade Organization, have been marginalized – offers hope that globalisation can still function as a source of economic prosperity for a large swath of the world.

Exhibit 2: Spreading global supply chains boosts trade

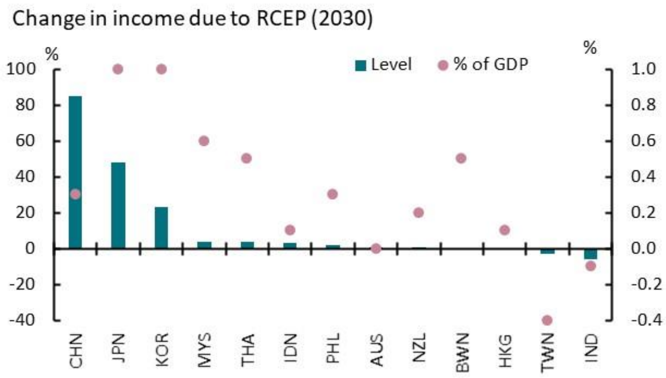

*Source: AXA IM Research, as of January 2021*

## Don't hold your breath for immediate gains

Notwithstanding its structural significance, RCEP – as predominantly a trade agreement – may not bring many immediate benefits from increased trade flows. This is because bilateral free-trade agreements (FTAs) have already proliferated between RCEP members that have either already, or are expected to, drive down tariffs in the coming years. The incremental gains from the regional pact is therefore less than meets the eye.

That said, the 'holes' that RCEP can be expected to fill are non-trivial. Neither China and Japan, nor Japan and Korea, have existing bilateral FTAs[2], which saw China's exports to Japan, for example, levied by a weighted average tariff rate of 2.5% in 2018. These barriers are expected to decline under RCEP over time. After the transition is completed, most of China's exports of electronic products, machineries, car parts and textile goods to Japan will be tariff-free. Similarly, 86% of Japan's industrial exports to China will be exempted of duties, while 92% of its exports to Korea will be levy-free, up from the current 19%. These make China, Japan and Korea the biggest beneficiaries of the trade pact in dollar terms (Exhibit 3), while India and Taiwan – which are not part of the agreement – look set to be the biggest losers. One study[3] estimates that RCEP will add $165bn to Asian economies in 2030, boosting the region's GDP by 0.3%.

Exhibit 3: Distribution of income gains from RCEP




*Source: PIIE and AXA IM Research, as of January 2021*

## Supply-chain integration matters more

Compared to the modest trade gains, a more important source of growth could be the expansion of supply-chains in the region. Our previous report[4] discussed how the combination of China-US trade tensions, the pandemic and rising costs in China have together created a catalyst for multinational corporations to reposition their production capacities. The creation of RCEP, which consolidates the Rules of Origin (RoO), could accelerate this trend by 1) enabling businesses to adhere to one set of rules under RCEP, instead of multiple RoOs from separate FTAs, and 2) allowing inputs from RCEP members embedded in any final products to automatically qualify for tariff waiver. These innovations will help to reduce transaction costs and encourage inter-regional supply-chain formation. One study puts the total savings from reduced export costs at $90bn once the transition is completed[5].

[1] Beijing is actively investigating feasibility to join the CPTPP according to this year Central Economic Working Conference, while many non-Asian countries have expressed interests to cooperate with RCEP.

[2] China, Japan and Korea have been discussion a tri-party FTA since 2012. RCEP now forms a base from which future negotiations can be accelerated.

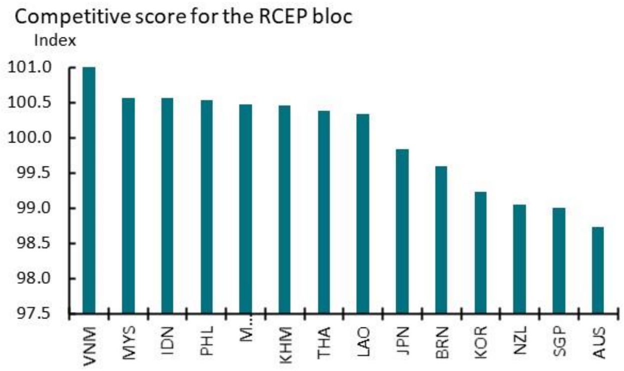
[3] Petri, P. and Plummer, M., "East Asia Decouples from the United States: Trade War, COVID-19, and East Asia's New Trade Blocs", PIIE Working Paper, June-2020

[4] Yao, A. and Shen, S., "Preserving Made-In-China in deglobalization", AXA-IM Research, 2-September-2020

[5] Dib, G., Huang, F. and Poulou, A., "RCEP: Common Rule of Origin Could Boost Regional Trade By Around USD90bn Annually" Allianz Research, 17-November 2020

But just as the gains from trade will not be evenly distributed (Exhibit 3), the distribution of supply-chains could also be lopsided. Our previous study[6] tried to identify the potential winners from this shift of production process by measuring economic competitiveness based on labour costs, infrastructure quality, ease to do business, cost of living, regulatory environment and economic openness. Exhibit 4 shows a composite index of these factors, with a greater weight on labour costs to reflect the cost-sensitive nature of this upcoming production shift. Less-developed countries, such as Vietnam, Malaysia and Indonesia, rank higher than their developed peers due to cost competitiveness.

### Exhibit 4: Economic competitiveness of RCEP members




*Source: World Bank and AXA IM Research, as of January 2021*

On paper, these results are intuitive. But history shows that cost effectiveness is rarely enough to turn a country into a magnet of foreign investment. Other tenets of competitiveness, such as economic openness, ease to do business, infrastructure quality and regulatory environment, do matter for determining the extent to which an underdeveloped country can capitalize its cost effectiveness. In this regard, these countries should learn from China to undertake drastic reforms to align their economic standards to those agreed by the pact.[7] One country, which has done just that and been rewarded handsomely for its actions, is Vietnam. Exhibit 5 shows that Vietnam has been the single biggest beneficiary of supply-chains moving out of China in recent years, and it remains a top destination for new investment according to recent surveys.[8]

In allowing others to imitate Vietnam's success, RCEP has allowed for a long transition period to accommodate the structural changes of the less-developed members. With external conditions ripe – RCEP lowering market barriers and China expanding its supply-chain networks – these countries now stand a chance to expediate their economic catch-up by pursuing the right reforms and embracing closer integration in the world's fastest growing region.

### Exhibit 5: Top gainers of China's loss of market share

| Sector | China's loss of global export share (in % of global exports) | Top three gainers | Increase in export share (in % of global exports) |
|---|---|---|---|
| Footwear | -5.05 | Vietnam | 1.53 |
| | | Indonesia | 0.24 |
| | | Cambodia | 0.11 |
| Stone and Glass | -4.11 | Japan | 0.68 |
| | | Thailand | 0.44 |
| | | Australia | 0.31 |
| Metals | -2.06 | Vietnam | 0.17 |
| | | Korea, Rep. | 0.15 |
| | | Indonesia | 0.10 |
| Textiles and Clothing | -1.47 | Vietnam | 1.03 |
| | | Cambodia | 0.26 |
| | | Myanmar | 0.19 |
| Mach and Elec | -1.18 | Vietnam | 0.47 |
| | | Korea, Rep. | 0.31 |
| | | Japan | 0.18 |
| Hides and Skins | -0.86 | Singapore | 0.37 |
| | | Vietnam | 0.35 |
| | | Indonesia | 0.09 |
| Plastic or Rubber | -0.57 | Thailand | 0.23 |
| | | Vietnam | 0.16 |
| | | Indonesia | 0.12 |

*Source: World Integrated Trade Solution (WITS) and AXA IM Research, as of January 2021*

## Not to downplay geopolitical significance

Beyond the economic significance, the geopolitical consequences of RCEP should not be downplayed. By successfully piecing together the world's largest trading bloc, ASEAN could gain more of a voice on the global stage and become a pivotal force in the Asia Pacific as China and the US compete for influence.

China, as an avid supporter of the trade deal, gets to demonstrate its continued pursuit of liberalisation and opening up. Together with the recent signing of the China-EU Comprehensive Agreement on Investment and voicing intention to join the CPTPP, these actions help to dispel fears that China is turning inward with its latest development plan that aims for self-sufficiency in areas such as core technology. In addition, a closer economic integration with other Asian partners can help China to secure supply-chains and provision of vital resources, such as energy from Australia and technology from Japan and Korea. This will also make decoupling from China more expensive for third parties, as they may have to face the risk of losing the entire RCEP market.

The two potential losers are the US and India. The former will see its *economic* influence in the region weaken as members of RCEP pursue closer inter-regional cooperation. This will likely push Asian countries further into the arms of China, which was already the largest trading partner to most RCEP members before the trade deal was signed. Reduced economic leverage may also weaken the US's ability to form political alliance – even with traditional allies, such as Australia and New Zealand – against the rise of China.

[6] See footnote 4.

[7] Our research shows that productivity-enhancing reforms for the domestic economy was a larger contributor to China's economic boom post its WTO accession than increased export gains. See Yao, A., "China: Rebalancing to a New Path" AXA-IM Research, 1-March-2018

[8] https://english.nna.jp/articles/3703

India could also lose out from withdrawing from RCEP. The economic costs are obvious as its exports will not receive the same preferential treatment as others, and the Indian government missed an opportunity to channel external forces to propel domestic reforms. Without the economic membership, India could also be marginalized from other regional cooperation going forward. The good news is that the door is not shut for India to join RCEP in the future. By eventually adding the region's third largest economy, a bigger and more inclusive RCEP could be more effective in delivering prosperity and stability for all.



DISCLAIMER

This document is for informational purposes only and does not constitute investment research or financial analysis relating to transactions in financial instruments as per MIF Directive (2014/65/EU), nor does it constitute on the part of AXA Investment Managers or its affiliated companies an offer to buy or sell any investments, products or services, and should not be considered as solicitation or investment, legal or tax advice, a recommendation for an investment strategy or a personalized recommendation to buy or sell securities.

It has been established on the basis of data, projections, forecasts, anticipations and hypothesis which are subjective. Its analysis and conclusions are the expression of an opinion, based on available data at a specific date. All information in this document is established on data made public by official providers of economic and market statistics. AXA Investment Managers disclaims any and all liability relating to a decision based on or for reliance on this document. All exhibits included in this document, unless stated otherwise, are as of the publication date of this document. Furthermore, due to the subjective nature of these opinions and analysis, these data, projections, forecasts, anticipations, hypothesis, etc. are not necessary used or followed by AXA IM's portfolio management teams or its affiliates, who may act based on their own opinions. Any reproduction of this information, in whole or in part is, unless otherwise authorised by AXA IM, prohibited.

This document has been edited by AXA INVESTMENT MANAGERS SA, a company incorporated under the laws of France, having its registered office located at Tour Majunga, 6 place de la Pyramide, 92800 Puteaux, registered with the Nanterre Trade and Companies Register under number 393 051 826. In other jurisdictions, this document is issued by AXA Investment Managers SA's affiliates in those countries.

In the UK, this document is intended exclusively for professional investors, as defined in Annex II to the Markets in Financial Instruments Directive 2014/65/EU ("MiFID"). Circulation must be restricted accordingly.



AXA Investment Managers SA
Tour Majunga – La Défense 9 – 6 place de la Pyramide 92800 Puteaux – France
Registered with the Nanterre Trade and Companies Register under number 393 051 826