

Economic Integration in North East Asia and Mongolia

Amarjargal Renchinnyam

Institute of Economic Research, Hitotsubashi University, Tokyo, Japan

Abstract. Recent explosion of regional trade agreements, with new characteristics can play an important role in defining and exploiting comparative advantage of developing countries, such as Mongolia. Mongolia sees integration into the world economy as a means to overcome economic and social problems and facilitate the process of transformation. As an integral part of it, Mongolia is interested for a more economic cooperation in the Northeast Asia. However, the NEA economic cooperation will be mainly determined by political considerations and bilateral interactions of the key players in the region. Using gravity model, authors presents the empirical model of Mongolia's trade, with emphases on geography and the effect of hypothetical integration into NEA and FTA with Japan.

JEL classification: F15, H56, H77, P26

Key Words. Mongolia, transition, FTA

This paper was supported by the grant of The Japan Foundation. The author also has benefitted from the hospitality of IER, Hitotsubashi University.

Contact information: Institute of economic research, Hitotsubashi University, Tokyo, Japan
Email: amraa@ier.hit-u.ac.jp

INTRODUCTION	3
I. SOME ASPECTS OF REGIONAL ECONOMIC COOPERATION AND FTA	6
II. <i>POLITICAL AND ECONOMIC DEVELOPMENTS IN NEA</i>	9
A. Bilateral Relations	9
B. Regional Organizations	12
III. JAPANESE APPROACH TOWARD FTA	15
A. The Policy Shift	15
B. Development of FTAs	17
C. Japan Singapore FTA (JSEPA)	18
IV. POSSIBLE EFFECT OF FTA ON MONGOLIA'S TRADE	21
A. Model	21
B. The Data	22
C. The Empirical Results	23
<i>CONCLUSIONS</i>	24
REFERENCE:	24

INTRODUCTION

In 1990, with an artificially created structure of the economy such as 33.23 per cent share of manufacturing in GDP, with a degree of urbanization almost 60 per cent, with trade dependence from COMECON countries almost 97 per cent, Mongolia has initiated transition to the market economy. Economic distortions were represented by repressed inflation level 7.6 times, black market exchange rate premium 1400 per cent, and with terms of trade loss. An addition, without reform history, market memory institutions, and geographical disadvantage Mongolia was facing tremendous challenge.

With a collapse of CMEA and breakdown of the Soviet Union, whose assistance accounted almost 1/3 of GDP, Mongolia's economy has been simply ruined. See Chart 1.

Mongolia has faced an unprecedented shock in the modern history of the world. As Peter Boone (1994:330) argues "... this collapse is far greater than those experienced by other countries during the great Depression, and it matches the decline experienced by Japan and Italy as a result of wartime destruction. Absorption declined by 15-27% in Czechoslovakia, Hungary, and Poland from 1989 to 1991. During the Great Depression, absorption fell by 33% of GDP in United States, and 14-22% in major European countries. Even during wartime the decline in absorption in Japan and Italy was on the order of 50% of GDP." See Table 1.

Mongolia has started the process of economic and political transition simultaneously. The process of democratic institutions building, macroeconomic stabilization, internal and external liberalization of the economy and privatization took a decade. (see Hahm, Hongjoo 1993, Murrell 1996, Nishimura, Yoshiaki 1999)

What are results? Inflation rate is down to single digit (for example in 1993 it was almost 400 per cent), more than 2/3 of GDP are produced by private sector, which did not exist in 1990. Since 1995, Mongolia is enjoying economic growth¹ and pre reform GDP has been reached in 2000.

Despite such a progress, especially with comparison with other former socialist countries, Mongolia is facing several problems. The most urgent and important issue is poverty reduction, although between 1994-2000 the poverty has been stabilized at the level 36 percent of population, according to Living Standards Measurement Survey (LSMS).

¹ Economic growth slow down to 1 percent in 2000, 2001

Poverty can be overcome only through economic growth. Thus maintaining sustainable, high economic growth is the centerpiece for Mongolia's reform. In order to reach and maintain high economic growth Mongolia needs to deepen structural changes of the economy. In this regard, international cooperation, integration into regional economy, strengthening bilateral economic ties through FTA is becoming a priority of economic policy.

Table 1. Comparisons of the Decline in National Purchasing Power During Depression, Wartime and Economic transformation (% of GDP)

		External financing	Change in GDP	Terms of Trade	Total
Formerly Socialist					
Mongolia	1989-1991	-37.1	-18.0	-6.6	-61.7
Czechoslovakia	1989-1991	0.0	-18.6	-5.4	-24.0
Hungary	1989-1991	0.0	-11.2	-3.7	-14.9
Poland	1989-1991	0.0	-19.9	-2.9	-22.8
Great Depression					
France	1929-1932	1.1	-14.6	Na	-13.5
Germany	1929-1932	1.3	-19.1	Na	-17.8
United Kingdom	1929-1932	-4.3	-17.8	Na	-22.1
United States	1929-1933	0.0	-32.6	Na	-32.6
Wartime					
Austria	1937-1946	Na	-36.0	Na	-36.0
Italy	1938-1946	Na	-49.7	Na	-49.7
Japan	1938-1946	Na	-50.5	Na	-50.5
Spain-civil war	1935-1940	Na	-25.7	Na	-25.7
USSR	1938-1946	Na	-8.3	Na	-8.3

Source: P. Boone 1994:331.

Stanley Fischer et al. (2000) has found that for eastern European former socialist countries, "... the prospect of joining the European Union has been a powerful spur to reform". Gerard Roland (2001) sees that expected access of central European countries into the EU, "enhanced incentives to create patterns of law enforcement, law compliance and protection of property rights." This factor definitely determined the extent of reform in case of eastern European countries. However, Mongolia has no such a stimuli. Due to it is geographic

location, Mongolia was excluded from major activities of EU and in Asia there is no such a institutions like EU.

The process which are going in former socialist countries, is institutional transformation, which involves the creation of institutions of democracy and governance, free press; new social norms and values; openness to private organizations and to entrepreneurship; a network of regulators; and a new network of contractual relationships, both domestic and abroad. (see Gerard Roland 2001; Jeffrey Sachs, Wing Thye Woo and Xiaokai Yang, 2000)

From this prospective, Mongolia should pursue a strategy of comprehensive and deep reform, especially regarding the policy of building “soft infrastructure” necessary for market economy. At the given level of economic development, Mongolia is unable to deal alone with the problems mentioned above. More involvement into regional and world economy is key to the success. In this context the concept of North East Asian economic cooperation, bilateral FTAs with a leading regional and international economies is an interesting topic for research in Mongolia.

The paper is organized as follows. Section I, briefly discusses some aspects of regional economic cooperation and FTA in general. It stresses the role of FTA in defining and exploiting comparative advantage of developing countries. Because of Mongolia’s interest, Section II covers some aspects of political and economic development in NEA. Section III, evolves Japanese approach toward FTA. Section IY, presents the empirical model of Mongolia’s trade, with emphases on geography and the effect of hypothetical integration into NEA and FTA with Japan.

I.SOME ASPECTS OF REGIONAL ECONOMIC COOPERATION AND FTA

According to WTO (2002) the proliferation of regional trade agreements taken an unprecedented rate. “As of October 2002, 255 RTAs have been notified to the GATT/WTO.1 Of these, 213 agreements were notified under GATT Article XXIV, of which 131 are still in force today; 20 agreements were notified under the Enabling Clause;² and 22 under GATS Article V.” Recent regional trade agreements cover much wider area such as investment, industrial cooperation, technology, environment, telecommunications, transportation, energy, financial cooperation, macroeconomic policy coordination, factor mobility, intellectual property rights, quarantine procedures, tourism, service sector. It is notable that FTA as a form of regional trade agreements (RTA) are concluded between geographically non-contiguous countries. Shortly we can talk about a new RTA.

Supportive and supplementary nature of RTA to multilateral trading system is acknowledged by WTO. The new RTA has more flexibility than WTO. Formation of bilateral FTAs is also seen as a way to overcome the so-called “convoy problem” whereby the “least willing member” (“foot-dragger”) holds the pace of trade integration back. (Ramkishen S et al. 2002).

Trade creation vs. Trade diversion effect of RTA has been traditional focus point of study. However with emerging a new characteristics of RTA an approach to the regional integration issue should be more broad. For example, the new RTA has more political content than previously. That is why it become essential to include political institutions to analyse RTAs. Growth of RTA number should be analysed in light of globalization, technology development and geopolitical considerations.

Stanley Fischer sees “[I]ntegration into the world economy is the best way for countries to grow” (cited from Rodrik Dani, 2000). However, it is wide disagreement among economists on the effect of trade to the growth. According to Baldwin, Robert E (2002) it is so due to manner of defining issue of study, scope of the study and data quality.

Rodrik Dani, (2000) see integration into the world economy costly² and it is “not only closes off alternative development path, it also crowds out possibly more urgent priorities by diverting human resources, administrative capabilities, and political capital away from other

²For typical developing country about \$150 million to implement requirements of the WTO on custom valuation, sanitary etc.,

tasks". He stated that there are not a significant link between trade barriers and rate of economic growth.

The position of those who stand on multilateralism (for example Bhagwati Jagdish ed., 2002) is understandable and acceptable within the range of the assumption author put in it. However, reality is much richer than any model. Any attempt to reject FTA only because of some kind of pure theoretical "let's assume" based approach is not reasonable.

International trade based on comparative advantage, which can be improved endogenously through economies of specialization (Grossman, G.M.; Helpman, E, 1990). Close economic cooperation and trade ties through RTA led to deeper division of labor and specialization at the international level, which in turn lead to extent of market (Xiaokai Yang and Dingsheng Zhang September 2001:5). This aspect of RTA is an important for the developing countries. Conclusion of RTA leads to a trade liberalization which allows for a developing country are acquired a new comparative advantage. Thus with a newly acquired comparative advantage a negative role of natural factors such as geographic location, size of country or population become less relevant.

Dynamic effects of RTA are channeled through knowledge, accumulation of physical and human capital and accelerated domestic reform. For example, loss of tariff revenue associated with a FTA can be stimulus for fiscal reform. Also FTA could change incentives for foreign and domestic investors. (See Emiko Fukase and L.Alan Winters 1999). For example, Japanese firm has special advantage such as an access to the sources of finance, special managerial and marketing skills. Facing competitive pressure on the domestic market, companies with intangible assets has a strong incentive for expanding production abroad. And if a host countries can provide some additional investment incentives such as cash grants, fast depreciation schemes, tax credits and so on the dynamic effect of RTA will be realized fully.

On the other hand, for developing countries it is not obvious where to invest. Investment decision means to choose a sector of specialization, to find its comparative advantage, at the given level of initial conditions (labor, capital, natural resources, geography etc.). For example, simply mimicking more advanced one will not guarantee a success. On contrary, by close integration these countries can work out those sectors of the economy, which is really supplementary to the regional and world economies.

Regionalism is multidimensional process, which involve economic integration and political cooperation. In addition, the formation of regional integration is multistage process:

first stage to create environment for future formal economic cooperation, than establishing an institutions for consultation and coordination. Among the major obstacles to the regional cooperation Schiff and Winters (2002) mentioned lack of trust between regional countries and complexity and the financial requirements for regional cooperation. Walter Mattli (1999) distinguishes demand and supply side conditions for the integration to succeed. On the supply side, institutional theory attaches a greater role to political leaders. As he argues, willingness for RTA depends on the payoff of integration to political leaders. However, because of collective action problems (Prisoners' Dilemma, Coordination Dilemma) additional difficulties occur. Establishment of "commitment institutions", such as centralized monitoring and third-party enforcement, can solve these problems.

Most recent economic approach to the integration process is based on the positive methodology, which analyze conditions that are sufficient to create economically efficient an economic integration. Such approaches are static and they are not taking into account changes on the institutional side.

According to Walter Mattli (1999) a key supply condition for successful integration, is the presence of an undisputed leader among the group of countries seeking closer ties. Such a state serves as focal point in the coordination of rules, regulations, and policies; it may also help to ease distributional tensions by acting as regional 'paymaster'.

It is said that RTA's is a reflection of globalization at the regional level. The process of globalization has been seen by many developing countries not as an opportunity but as a threat. At the multilateral level even with the reduction of tariffs etc., small developing countries are excluded due to non-tariff barriers such as production, labor or environmental standards etc.

II. POLITICAL AND ECONOMIC DEVELOPMENTS IN NEA

As an integral part of it, Mongolia is interested for a more economic cooperation in the Northeast Asia. However, the NEA economic cooperation will be mainly determined by political considerations of the key players in the region and bilateral interactions of Russia, China, Japan, and US.

A. Bilateral Relations

Russia-China. After the collapse of Soviet Union, Russia is actively assessing its new role and destination. Initial believes that Europe will accept Russia - did not realize. On the other hand, Russia wants to see bipolar world, in the geopolitical sense.

Facing enormous economic and social problems domestically, Russia sees integration into the world economy as a means of economic and political transition. In this line, Russia's approach toward NEA can be examined.

Among others, Russia's policy toward East Asia is based on worries about the future of the Russian Far East (RFE), and advantages from trade and economic cooperation with the fastest growing Asian economy. This policy of Russia is in line with a concept of "from the security system towards a system of economic cooperation in northeast Asia". Anna V. Shkuropat (2002)

It is expected that Russia and China relation, based on several mutual strategic interest, will be closer in coming years. Both countries has been interested to promote an emerging "multipolar world structure", and to oppose any attempts of hegemony by any single country. As President Putin stated in July 2000, "China for us is really a strategic partner in all spheres of activity."

As Alexander Lukin (2001) argues, China is interested to play Russian card to reject American hegemony and possibly is even "ready to fight it...to the last Russian". Nevertheless, the current Russian-Chinese accord is very far from the anti-American bloc, it is clear that both sides still seek cooperation with other parts of the world, including the West and the US.

As for economic cooperation between two countries, trade has reached US \$8 billion; which is tiny in comparison with China-U.S trade of US\$115 billion in 2000. China is an important market for Russian weapons and raw materials. However, when it comes to

industrial products and technology, Russian officials often complain that the Chinese are unwilling to grant Russian producers the same terms that other Western competitors enjoy. Chinese business interests would like to sell more of their products to Russia and to be engaged in more cooperative projects with Russian businesses in the RFE, in order to boost economic development in China's Northeastern provinces.

Russia's main concern regarding China is Chinese "population threat." Because of immigration issue, some Russians express doubt in the usefulness of border cooperation, and claims that "the very transformation of the border into a zone of active economic interaction radically diminishes the level of its security."

Russia-Japan. It is interesting to note that the idea of NEA credited to Japan back in 1960s however due to failure of USSR and Japan normalization talks in 1973, the idea of regionalism shifted to southward. The idea returned at the end of 1980s. Sea of Japan coastline region as a "left behind" pushed Japan for regional economic cooperation. Also NEA – is important as the origin of Japanese culture. (See Gilbert Rozman 1999)

Historically access to resources in Russian Far East was dominant in Japanese strategy. Thus, it is expected that Japan would have interests on long-term economic ties with Russia. Since 90's, relation between two countries has become more pragmatic. Japan has expressed its interest in exploitation resources in Russian Far East, namely oil and gaz. Recently Japan proposed to build 4000 km pipeline from Siberia to Nahodka, with estimated cost of US\$ 5 billion. With its 80 per cent dependence on oil supply from Middle East, Japan looking for new sources. In this respect, Russia and NEA will be strategically important for Japan.

Despite the huge potentials, economic ties between two countries are developing slowly. The reason for that is a legacy of WWII and cold war. So called "northern territory issue", which has been articulated by Japan in many years is still unresolved. For the Japan, the "northern territory" has more political than economic meaning.

China-Japan. Political and economic diplomacy of China in NEA³ is increasing. While keeping political and military pressure on Taiwan, China is pursuing the strategy of economic engagement with Taiwan, like allowing commercial flight between two countries. In case of intensive economic cooperation between these two, it is expected that not China but Taiwan will first initiate unification talks.

³ Sometimes Taiwan and Russian East Siberia are included into geographical scope of NEA.

After September 11, an important shift in Japan's security policy can be traced. Logistical assistance through the deployment of Japanese Maritime Self-Defense Forces was provided to U.S. troops in Afghanistan and during Iraqi crisis. The fact marks an important change for Japan and for the region. The precedent set by this action will be a part of a new security situation in Asia. Japan was able to reinterpret its Constitution in a way that theoretically it made possible to send its SDF anywhere in the world. Taken into account the historical background, the shift in Japanese security policy is closely monitored not only by China but also by other NEA countries.

China's rise⁴ as a superpower is pressing Japan in many aspects. For example, in case early conclusion of FTA between China - ASEAN will make Japanese position weak in south East Asia. That is why Japan had no choice but to rush toward FTA with ASEAN.

As it's recalled by Hatakeyama Noboru (2003) he "had the opportunity to meet Singapore Prime Minister Goh Chok Tong. He asked me if Japan was ready for the situation when China would go faster than Japan in entering FTA negotiations with ASEAN."

China already signed with ASEAN a Framework Agreement (FA) for comprehensive economic cooperation between ASEAN and China Nov. 4, 2002. Hatakeyama Noboru (2003) outlined several moment on future FTA. The FTA will cover not only trade in goods but also trade in services, and even rules and regulations on FDI. Initially understood as a 10 years long negotiation, has turned out to be the implementation period of the FTA. Since both ASEAN countries and China are developing countries, they are qualified to use the Enabling Clause of WTO. However, according to the FA, they will not use this clause. Instead, they are going to base their FTA right on Article 24th of GATT and on Article 5th of GATS which are supposed to be used between developed countries. Also so-called "early harvest" items would be offered mostly to ASEAN countries from China.

China has proposed an FTA with Japan, but Japan has not responded positively to the proposition. MoFA (2002) considering that "... China has joined the WTO only recently and it has to implement a number of commitments that were made upon WTO entry, it is appropriate for Japan to monitor how China liberalizes its trade regime before discussing the possibility of an Economic Partnership Agreement (EPA) with China. Having said this, Japan

⁴ Gap between US and Chinese semiconductor manufacturing technology has narrowed from between 7-10 years to 2 years or less. ("US-China current traed and investment policies and their impact on the US economy", oral testimony of Kevin kearns, june 14, 2001 p125 cited in USCC report, p2)

has to study the possible impacts of an EPA with China, in order to formulate Japan's EPA strategy in East Asia.”

B. Regional Organizations

Major institutions that involve NEA countries are ARF, APEC, ASEAN, Shanghai Cooperation Organization and Tumen River Development Program.

ARF is anticipated to serve as a security forum through confidence building, preventative diplomacy, and conflict resolution. Since DPRK affiliation in 2000, ARF become the only organization in Asia where all countries of NEA are represented.

Although originally formed as a means to promote open trade, APEC actually known as a summit meeting, to discuss mainly political and security issues. On the economic issues working committees of APEC are active, however it needs more backing from members.

There is competition among China, Japan and Korea in promoting cooperation with ASEAN. As mentioned early, ASEAN and the China endorsed the proposal for a Framework on Economic Cooperation and agreed to establish an ASEAN-China Free Trade Area within 10 years. ASEAN and Japan agreed to study a possible ASEAN-Japan Free Trade Area. ASEAN and Korea agreed to explore ways to enhance trade and economic links.

These are potentially important developments; however the historic tensions translated into deep-seated security and political divisions can complicate the pace of regionalism.

Originally formed to consider border issues Shanghai Cooperation Organization, is steadily expanding scope. Issues of economic cooperation, security, drug-trafficking and combat extremism and terrorism are included into authorization of the organization.

The Tumen River Development Program (TRADP), the most formally structured intergovernmental dialogues in Northeast Asia.

The idea of a “Tumen River Golden Triangle” originated by China a decade ago led to ambitious proposal to construct an “international city” linking free economic zones in Northeast China, North Korea, and Russia's Far East into a “Tumen River Economic Zone”.

Landlocked Mongolia has supported the project hoping to get access to ports in Korea and the Russian Far East. Mongolia sees a Tumen River basin as a strategic “hub” for international trade and, as an instrument to improve cooperation and enhance regional security.

Despite slow progress, the project managed to implement several interesting studies such as feasibility studies on cross-border and international transport (road, rail and ports), investment promotion and investor services, environmental protection, and tourism.

TRADP initiated a several Action Programs such as protection of the region’s environment and endangered species; the Tumen River Investor Services network supported by South Korea; an Asian Development Bank-financed strategic study on development options for eastern Mongolia and adjacent areas of China; and the concept of a Northeast Asia/Tumen Investment Corporation.

However, the TRADP should strengthen the institutional framework to become operationally sustainable, and to contribute to economic development in the region through more concrete actions in areas such as trade and investment, transport and communications, environment, tourism, and energy.

An addition to above some sub regional developments such as Yellow sea economic zone, Korea-Japan strait zone, East sea economic sphere, North-South Korea cooperation zone, Sino-Russian cross boarder cooperation, Mongolia -Russian boarder free economic zone should be monitored.

One of major player in NEA is the USA. US are looking closely at political and economic development in the region. The United States has an interest to engaging China in stable regional interdependence. It is expected to help to reduce regional tension and lighten America’s security burden in the region. Japan, if it becomes more open and trusted in the region, can be a more effective U.S. ally in dealing with diverse pressure in post-cold war Asia. On the other hand, Washington views the for example, ASEAN+3 process with mixed reactions. Moreover, there are some views in the United States, which has expressed concerns that the Shanghai Cooperation Organization signals a possible anti-American condominium in Central Asia. (Catharin Dalpino and Bates Gill, 2002, p90)

As mentioned early, North East Asian regional economic cooperation has been and will be mainly affected by political factors. In this regard, some new development in NEA after the events of September 11, 2001 can be mentioned. New political relationships were emerged between Washington, Moscow and Beijing. U.S President George Bush included North Korea in an “axis of evil” and later, situation has worsened. North Korea abandoned Non Proliferation Treaty and threatening by preemptive strike.

Although China and Russia has channel to North Korea, neither China nor Russia has resources to provide the kinds of economic and technological assistance to North Korea needs. South Korean “sunshine” policies are slipping. The problem is that, North Korea is “recognizing” only US. It urgently wants to get American assistance, without damage to its political regime. There is not a military solution in Korean peninsula that is why interaction and close cooperation between major players are in demand.

The problem of regional security is multidimensional process. Thus, the approach to the issue should be also multidimensional and shall be carried out in a complex way. (Amarjargal.R 2003)

The Northeast Asia is attracting attention of leading powers for its economic potential and political development. On the other hand, challenges and complications facing the region are clear for the players. To find a political solution to the problem, more economic approach should be applied.

As it's widely known, along with the world's openness and globalization, there is a clear international trend toward strengthening the regional economic integration. Similar trend can be observed in Northeast Asia. However, it has to be admitted that existing instruments of Northeast Asian economic cooperation do not fully correspond to the scale and dynamics of the economies in the region.

III. JAPANESE APPROACH TOWARD FTA

A. The Policy Shift

Among G7 Japan is the last country that accepted FTA. As a most beneficiary of multilateralism (free rider), Japan officially was arguing that FTA has a discriminatory aspect against non-member countries and therefore FTAs violate, at least, the spirit of GATT. However, such explanations do not reflect real reason of Japanese affection toward multilateralism. More reasonable explanation for that is the historical and political motivation. For example, Kojima Akira (2001) says “multilateralism has been seen by Japanese as way to return to the international community after WWII. That is why Japan was demonstratively pursuing multilateralism through GATT/WTO and UN. From that standpoint, Japan has intentionally avoided, the conclusion of FTA”.

One can make a conclusion that Japanese position toward FTA dictated by political rather than economic consideration for many years.

In late 1990s, Japanese position toward FTA has shifted. MITI (2000) recognized rapid expansion of regional trade agreements and accepted RTA’s “as supplements to the multilateral trading system by the WTO”. Also the evolution of Japanese approach toward FTA can be traced by positions of Ministry of Foreign Affairs (MoFA). (For example see Kojima Akira (2001), Naoko Munakata (2001), Tatsushi Ogita (2002)

One of important players on FTA is Japanese business community represented by Keidanren. It sees FTA “as a step toward closer economic relations”. Keidanren is proposing to approach FTA by using criteria such as: an opportunity to expand trade with the country, natural endowment (raw materials and labor force), potential for further growth, ability to be center of production and export in the region. Japanese business see bilateral political ((historical and social) relations, the attitude toward Japan, and the comparison of both countries industrial (economic) structure as an important factors and it has an interest to get equal condition for competition. Keidanren (1999) is in favor of accepting “phased tariff elimination and abolition of investment barriers”.

The reasons for the shift of policy can be grouped as change of external and internal environment. Among external factors, several issues can be identified. Failure of several WTO/GATT Rounds, sophistication of WTO negotiation mechanism (time consuming nature

of WTO drastically contrast with FTAs flexibility)⁵ and raised dissatisfaction with multilateral approach. As the result, many countries, especially major competitors of Japan, became members of different FTA⁶. Also in 90's, regionalism has become evaluated positively. In light of such clear development, Japan was facing possible isolation. Politically and economically, the cost of isolation is not acceptable for Japan.

Asian economic crisis, seriously challenged development patterns in Asia. Most importantly Japanese economic model has lost its attractiveness for many Asian countries. China's rise as a super power, China centered economic development and the formation of economic coalition without Japan somehow demanded Japanese response.

Future role of Japan in Asia will depend on it is ability to reform rigid domestic political and economic structure to became more open and flexible. This is a way for Japan to obtain trust of Asian countries and positively contribute to regional and global security. (see Kojima Akira 2001, Urata Shujiro 2003, Hatakeyama Noboru 2003)

Among internal factors, following aspects can be highlighted. International cooperation, namely FTA has been seen as possible "peer pressure" to promote domestic structural reform. MITI White Paper on International Trade 2000 noted the "policy reform effect" as positive.

Table 2. Changing competitiveness of the Japanese economy

	1980	1990	2000
Overall	4	3	16
Internationalization	11	11	17
Financial sector	3	3	21
Corporate sector	2	3	13
Education	10	4	7
Infrastructure	12	12	10
Science & technology	2	2	2
Information technology	-	-	14

Source: adopted by from Urata Shujiro (2003)

⁵ The number of WTO members stands at 144

⁶ USA initiated NAFTA, in 1994. The EU has become reality and expanding to eastward. South Asian economies initiated the ASEAN Free Trade Agreement (AFTA) in 1992.

Japan needs comprehensive reform in domestic arena. Since early 1990s, Japan is in stagnation. Non performing loans based crisis of the banking system, deflation, over regulated economy, shocking low level FDI to Japan, lost international competitiveness etc., is only top of iceberg. According to Urata Shujiro (2003), since 1990s Japan has lost economic dynamism. Japan's overall competitiveness (focusing on eight areas - science and technology, the corporate sector, the financial sector, the government sector, infrastructure, education, internationalization and IT) declined dramatically from the fourth and third places in 1980 and 1990 respectively to 16th place in 2000. See Table 2.

An addition to above, Hatakeyama Noboru (2003) and Keidanren (1999) point out the actual damage of isolation being felt by Japanese companies. For example, U.S. companies can export goods to Mexico free of tariffs, in principle, thanks to NAFTA. Also EU companies can do the same, thanks to the EU-Mexico FTA that started in July 2000. However, Japanese companies have to pay tariffs, when they export goods to Mexico. As seen in, Howard J.Wall(2002) Japanese trade (as share of total trade) with NAFTA since 1994 and with EU since 1992 are declining, showing that Japan has been “excluded”.

One more factor can be noted. Kojima Akira (2001) argues “because of US pressure to liberalize ... were viewed by many Japanese as a “hegemonic foreign pressure” and again provoked anti-American feeling. This is was also fact affecting to adopt FTA by Japanese”.

B. Development of FTAs

Interplay of change of external and internal environment led to shift of policy regarding FTA. Naoko Munakata (2001) credited FTA promotion in Japan to late Prime Minister Obuchi. However, as Hatakeyama Noboru (2002) argues, the idea of FTA was initiated by Mexico in 1998. Subsequently Japan has been approached by Korea, but agreement was concluded with Singapore. It is clear that Japan was making political calculation among possible partners and has chosen “least damaging” Singapore.

Japan has negotiating FTA with Mexico, Chile, Korea, Brazil and Australia. Canada, New Zealand, Thailand, Taiwan are initiated FTA talks with Japan. Regarding South Korea and ASEAN countries, Japanese position is as quickly as possible to conclude FTA.

In case of other bilateral agreements, Japan – US agreement can be most challenging. The United States is the number one agricultural supplier to Japan. Americans have concerns about Japanese industrial products entering freely American market. Hatakeyama

Noboru(2002) argues that an FTA between Japan and the United States can be reached by covering the services sector at start.

Regarding criteria and scope of FTA (See MoFA 2002) Japan is looking for economic significance. However, effects of FTA “depend crucially upon their particular characteristics” Christopher Edmons and Jean-Pierre Verbiest (2002). FTA is not only economic but also, and mainly, political phenomena, so judging FTA by its economic effect is not enough. Broader aspect of FTA such as an instrument of economic integration and deepening economic partnership with LDC should be taken primarily account. These aspects of FTA are important for Japan to regain leadership position in the region. That is why, according to Urata Shujiro (2003), FTA should include not only trade and FDI liberalization and facilitation but also economic and technical assistance.

Along with the static economic effects of FTA, Japan is interested on dynamic effects such as: removal of barriers, strengthening of competition pressures on internal markets, and productivity improvement.

Taken into consideration structure and institutions of the economy and politics, promotion and real implementation of FTA favored policy should be hard and demanding for Japan⁷. The problem is that whole structure of Japanese economy based on the system, which is against removal or reduction protection in various form, direct and indirect subsidies, especially in sensitive sectors. Such a stand will have implications for those countries, which look for closer cooperation with Japan.

C. Japan Singapore FTA (JSEPA)

JSEPA is far broader than simple FTA. The coverage of JSEPA is inclusive compared to other FTAs in the region.

Why Singapore has been chosen to be Japan’s partner? Ramkishan S. et al. (2002) is indicating that Japan has “over-representation” for Singapore’s exports as well as sources for imports. Despite statements that economic benefit should be dominant in FTA talks, in recent years, the dominant strategy for Japanese approach toward FTA has been politics. An absence of “sensitive” areas such as agriculture, fisheries has been the main reason for Japan’s willingness to conclude an FTA with Singapore. These so called “sensitive” areas economically meaningless for Japan, however politically is very important.

⁷ For example, Japan deliberately choose to name agreement with Singapore not FTA.

Important political factor is migration. Natural person's movement restrictions to Japan are unjustified heavy comparing to other advanced countries. For Singaporeans, these artificially created barriers have been partially removed, which is regarded by Japanese as an important concession. It is hardly to expect that Singaporean will flood Japan. Measures are also being taken towards the mutual recognition of professional qualifications.

As a result of policy shift toward FTA, Japan is looking for next potential partners. By definition, the first FTA should be successful and so Singapore, as one of advanced trading country (stepping stone) has an economic structure suitable for Japan. JSEPA expected to be model for next generation of FTA.

Urata Shujiro (2003) Hatakeyama Noboru (2003) Kojima Akira (2001) mentioned one important aspect of JSEPA. In face of domestic political and economic problem, JSEPA has been seen as an instrument to push reform in Japan.

Shortly, other arguments for FTA with Singapore such as similar income levels, geographic proximity, economic benefit etc., were supplementary to political one.

Singapore's drive towards FTAs also had political context. Tommy Koh (2000) makes this point convincingly in the context of the proposed US- Singapore FTA. He state that FTAs could also serve as a conduit by which Singapore draws attention to itself and enhances the city-state's political recognition and profile with the integrating partners and carves out for itself a pivotal role in regional and multilateral trade.

Time Table of JSEPA

1999 December, visit Singapore P.M

2000 March 7-8, the first meeting for JSEPA study group

2000 September, report finished

2000 October, negotiation has started

2002 January 13, signed

2002 May 8, Diet approval

2002 October 30, exchange of diplomatic notes for the JSEPA

2002 November 30, came into effect

As for JSEPA above the standard package, some new elements have been introduced⁸. For example, steps to develop the necessary infrastructure for “paperless trading”, mutual recognition of test results and certification by accredited conformity assessment bodies in either country; establishment of a Joint Committee on Tourism; twinning well known shopping districts of Ginza and Orchard Road; reduction of technical and technological obstructions to ICT trade; and to catalyze and facilitate the ongoing expansion of e-Commerce transactions. Broadband, financial services, investment facilitation and movement of natural Persons are also covered by JSEPA.

The JSEPA has taken steps to: (a) promote mutual recognition of and cooperation with regard to competition policies; (b) put in place a set of procedures and regulations pertaining to government procurement; (c) undertake collaborative measures and cooperative activities on Intellectual Property (IP); (d) step up cooperation in Science and Technology and human resource development; (e) and establish provisions for orderly dispute settlement.

In general, JSEPA makes transaction cost of trade between two countries less, which are expected lead to significant economic gains.

One interesting point is a different interpretation of the JSEPA’s openness. Policy makers in both Japan and Singapore have often expressed the view that the JSEPA is open to other “like-minded” countries in Southeast Asia and elsewhere. (Business Times, Singapore, December 5, 2000). In fact, while proclaiming the JSEPA as being “forward-looking” and “a model of cooperation for the region”, the Japanese Prime Minister, Junichiro Koizumi ruled out the possibility of extending the agreement to other Southeast Asian countries citing agriculture access as a potential problem area (Low, 2002).

⁸ About details of JSEPA see <http://www.mofa.go.jp/policy/economy/fta/index.html>

IY. POSSIBLE EFFECT OF FTA ON MONGOLIA'S TRADE

A. Model

To question about possible effect of FTA on Mongolia's trade, we choice to use gravity model. The gravity model is popular among economist, due to its simplicity and "predictive power". Moreover, the model gives an opportunity to include additional instrumental variables into the model, which makes the model more flexible.

In the macro-econometrics, a problem of simultaneity has remained largely intractable. What are needed is good instrumental variables, which are truly exogenous, and yet are highly correlated with trade. (Jeffrey A.Frankel at al. 1996a, p4)

Idea of the gravity model is based on the assumption that trade between two economies is positively related to the sizes of the trading economies and negatively to the distance between them.

$$T_{ij} = f(Y_i, Y_j, D_{ij}) \quad (1)$$

In most literature, the gravity model has been appreciated on its empirical success at predicting trade flows. An addition to them, Jeffrey A.Frankel at el.(1996a, p4) accentuated on improved theoretical foundation of the model and emerged interest among economist in geography and other physical factors which can affect the economy.

Using gravity model for Mongolia is new. Until now, nobody used the model for Mongolia. The landlocked position of the country, remoteness and contrasting size of the trading partners' economy are expected to show all power of gravity model.

Based on (1) the model developed in the paper has the following form:

$$T_{wm} = \alpha + \beta Y_w + \gamma Y_m - \delta D_{wm} + e \quad (2)$$

where T_{wm} is Mongolia's export to and import from respective countries, Y_w, Y_m are GDP of m and w countries, D_{wm} distance between m and w, and e for error term.

We use simple ordinary least squares (OLS) as an estimation methods. We estimate that model will provide sufficient R^2 and the negative impact of distance will be significant.

B. The Data

To estimate equation (2) we use bilateral trade data from ADB (Key Indicators 2001: Growth and Change in Asia and the Pacific), trading partners GDP data from IFS data set and data for distance has been retrieved from <http://www.indo.com/index.html>. All data cover period 1984-2001.

Bilateral trade data was rescaled into thousand and GDP data into million US dollar. Among trading partners of Mongolia, the share of China, United States, USSR/Russia, South Korea, Japan, UK, and Germany is 82.8 per cent. It is interesting that Mongolia trade mostly with an advanced countries, share of developing countries negligible. One issue should be mentioned in particularly. Prior 90's, as a former socialist country Mongolia's trade direction was mainly toward Europe, toward former socialist (COMECON) countries, among them Soviet Union was undisputable dominant. See Chart 2.

In most literature on bilateral trade it is common to use per capita income. In this case, we use nominal GDP in current exchange rate. Logic is simple. Trade is conducted at international prices and thus GDP per capita or at PPP has no bearing on trade levels. Also, from the viewpoint of a small economy like Mongolia, the GDP's of trading partners are exogenous as well. (Jeffrey A. Frankel et al. 1996a, p5)

IFS data set had some missing data for Russia GDP. We have used data from Kuboniwa, Masaaki (1997). USSR's data of Net Material Product was converted into GDP, at the official exchange rate 0.60 ruble/US\$. One can argue about such methods; however we estimate that due to huge contrast between USSR and Mongolian economies that period of time, some deviation in nominal figures can be neglected.

The distance was taken between Ulaanbaatar and respective capital city of trading partners. This approach can be criticized, however preciseness in this case related to two neighboring countries Russia and China. Although cross-border trade with Russia and China are growing, their shares in total volume are not significant. Historically Mongolia's major export products to and import from Soviet Union has destination in European part. Similar path can be observed with China.

All data on the Ln functional form and observation period is 1984-2001.

C. The Empirical Results

The functional form of the equation (2) is taken following form has been estimated.

$$\ln T_{wm} = \alpha + \beta \ln Y_w + \gamma \ln Y_m + \delta \ln D_{wm} + e \quad (3)$$

The empirical results of the estimation presented at the Table: OLS results. As it was expected all basic variables has expected sign and statistically significant. The role of distance had, as expected a huge negative effect. The estimation shows that because of distance Mongolia lost an opportunity to double the trade.

However, R square that we got was unexpectedly low (0.186). Then, we started to look at other variables, which can explain Mongolia's trade performance. As mentioned early, Mongolia is facing tremendous transformation since 1990. Thus it was included dummy variable REFORM, into equation (3) with the values for the years 1984-1990 as one and after as 0. We were expecting that because of more openness, Mongolia's trade performance will be much better after 1990, thus expected sign was negative. Estimation proved that the trade in pre-reform years was by 1.48-point lower than after.

Taken into consideration Mongolia's landlocked position, which should affect trade significantly, we added another dummy variable Border, with value 1 for Russia and China and 0 for others. The estimation shows that Mongolia trade with border countries outperforming other non-border trading partners by 2.15 point.

During the years of socialism, Mongolia was highly dependent from one country, namely USSR. Almost untouched Russian Siberia and Far East, rapidly growing northeast part of China provide a huge trade opportunity for Mongolia. Nevertheless bearing in mind, lessons from it socialist past, Mongolia is looking for trade diversification opportunity. Since 90's the direction of Mongolia's trade has changed dramatically. Among which, it is clear re-orientation toward Asia.

That is why, as a second best policy choice, we introduced another two dummy variables such as hypothetical FTA with Japan and joining NEA. The estimation shows that in case of FTA with Japan, Mongolia's trade performance will improve by almost by half. In case of NEA, the estimation was statistically insignificant, however, in an economic since it will have somehow trade creation effect.

At the final estimation, the negative impact of distance somehow diminished to 20 per cent of trade. To offset negative impact of distance on trade Mongolia should seek for the open trade policy, including FTA with new trading partners.

CONCLUSIONS

Recent explosion of regional trade agreements, with new characteristics can play an important role in defining and exploiting comparative advantage of developing countries, such as Mongolia. Mongolia sees integration into the world economy as a means to overcome economic and social problems and facilitate the process of transformation. As an integral part of it, Mongolia is interested for a more economic cooperation in the Northeast Asia. However, the NEA economic cooperation will be mainly determined by political considerations and bilateral interactions of the key players in the region. Using gravity model, authors presents the empirical model of Mongolia's trade, with emphases on geography and the effect of hypothetical integration into NEA and FTA with Japan. The results of the study has shown that by promoting open trade policy, through integration into regional economy or developing bilateral trade agreement Mongolia can reduce the negative impact of remoteness.

REFERENCE:

1. About JSEPA see <http://www.mofa.go.jp/region/asia-paci/singapore/jsepa.html>
2. ADB (2002) Key Indicators 2001: Growth and Change in Asia and the Pacific retrieved on December 27, 2002 from http://www.adb.org/Documents/Books/Key_Indicators/2001/mon_ki2001.xls
3. Alexander Lukin (2001)"Russia's Image of China and Russian-Chinese Relations," CNAPS Working Paper, May 2001
4. Anna Shkuropat(2002), "New Dynamics in Northeast Asia: The Russian Factor" CNAPS Working Paper, July 2002
5. Asian Development Bank (2002), The Asian Development Outlook 2002.
6. Baldwin, Robert E (2002) "Openness and Growth: What's the Empirical Relationship?" the paper presented at the International Seminar on International Trade (ISIT): Challenges to Globalization, A CEPR/NBER/SNS conference, May 24-25, 2002, Stockholm, Sweden. Retrieved: January 30, 2003, from <http://www.cepr.org/meets/wkcn/2/2316/papers/baldwin.pdf>
7. Bhagwati Jagdish ed., (2002) "Going Alone. The Case for Relaxed Reciprocity in Freeing Trade" MIT Press, London.
8. Boone, Peter (1994), "Grassroots Macroeconomic Reform in Mongolia" Journal of Comparative Economics 18, 314-328
9. Catharin Dalpino and Bates Gill (2002), "Brookings NorthEast Asia Survey 2001-02", Center for NorthEast Asian Policy Studies, The Brookings Institutions. Retrieved: on February 20, 2003, from <http://www.brookings.org/dybdocroot/fp/cnaps/papers/survey02.htm>
10. Christopher Edmons and Jean-Pierre Verbiest (2002) "The Role of Preferential Trading Arrangements in Asia", ERD Policy Brief No.8
11. de Melo, Martha, Cevdet Denizer, Alan Gelb, and Stoyan Tenev. 2001. "Circumstances and Choice: The Role of Initial Conditions and Policies in Transition Economies." World Bank Economic Review 15(1): 1-31.
12. Distance data retrieved from <http://www.indo.com/index.html>
13. Emiko Fukase And L.Alan Winters (1999) " Possible Dynamic Benefits of ASEAN/AFTA Accession for the New Member Countries" World Bank, Washington, D.C
14. Gerard Roland (2001) The Political economy of transition" WDI Working Paper 413
15. Gilbert Rozman (1999), "Backdoor Japan: The Search For A Way Out Via Regionalism And Decentralization". Journal of Japanese Studies 25:1 1999
16. Grossman, G.M.; Helpman, E, (1990) "Comparative advantage and long-run growth" American Economic Review, Vol. 80 Issue 4, p796-815
17. Hahm, Hongjoo (1993) "The Development of the Private Sector in a Small Economy in Transition: The Case of Mongolia" World Bank Discussion Paper No.223, Washington, DC.
18. Hatakeyama Noboru (2003) "Short History Of Japan's Movement To Ftas" Journal Of Japanese Trade And Industry Nov/Dec 2002 -Jan/Feb 2003
19. Howard J. Wall (2002), "Has Japan been Left Out in the Cold by regional Integration?" The Federal Reserve Bank of St. Louis
20. Jeffrey A.Frankel, David Romer (1999),"Does Trade Cause Growth?" American Economic Review 89, no. 3, June 1999, 379-399.
21. Jeffrey A.Frankel, David Romer and Teresa Cyrus (1996a)"Trade and Growth in East Asian Countries: Cause and Effect?" NBER Working Paper No. 5732, August 1996.
22. Jeffrey Sachs, Wing Thye Woo And Xiaokai Yang, (2000) "Economic Reforms And Constitutional Transition", Annals of Economics and Finance, 1,423-479.
23. Keidanren (1999), "Report on the Possible Effects of a Japan-Mexico Free Trade Agreement on Japanese Industry" Working Group on Japan-Mexico Bilateral Treaties Japan-Mexico Economic Committee, from <http://www.keidanren.or.jp/english/policy/pol099.html>

24. Kojima Akira (2001) "Free Trade Agreements As Constructive Regionalism" *Journal Of Japanese Trade And Industry* January/February 2001, 20
25. Kuboniwa, Masaaki (1997), "Economic Growth in Postwar Russia; Estimating GDP", *Hitotsubashi Journal of Economics*, 38, 1:21-32
26. MITI 2000: 122-3) (White paper on international trade: general remarks)
27. MoFA (2002), Japan's FTA Strategy (Summary), Ministry of Foreign Affairs, October 2002 Retrieved from on 2003-02-14
<http://www.mofa.go.jp/policy/economy/fta/strategy0210.html>
28. Murrel, Peter, Karen Turner Dunn, and George Korsun (1996), "The culture of policy making in the transition from socialism: Price policy in Mongolia" *Economic Development and Cultural Change* 45, 175-194
29. Naoko Munakata (2001), "Evolution of Japan's Policy Toward Economic Integration", Center for Northeast Asian Policy Studies (CNAPS), The Brookings Institution.
30. Nishimura, Yoshiaki (1999) "Reconsideration on Transitional policies for the Transformation from Socialist Planned Economy to the Market Economies", *The Economic Review*, October 1999
31. Ramkishan S. Rajan Rahul Sen (2002) "The Japan-Singapore "New Age" Economic Partnership Agreement: Background, Motivation And Implications" paper presented at the Trade Policy Issues Workshop, 25 February - 1 March 2002, Singapore Organized jointly by the Technical Cooperation Directorate (TCD), Ministry of Foreign Affairs (MFA), Singapore; the Asian Development Bank, Manila; and the ADB Institute, Tokyo. Retrieved: on February 10, 2003, from
http://www.adb.org/Documents/Events/2002/Trade_Policy/JAPSIN.pdf
32. Ricardo Hausmann, Dani Rodrik (2002) "Economic Development as Self-Discovery" NBER Working Paper 8952, NBER
33. Rodrik Dani, (2000) "Can integration Into The World Economy Substitute for A Development Strategy", ABCDE –Europe Conference in Paris June 26-28, 2000. World Bank Retrieved: January 30, 2003, from
<http://ksghome.harvard.edu/~drodrik.academic.ksg/ABCDE-Paris.pdf>
34. Rodrik Dani, (2002) "Institutions, Integration and Geography: In Search of the Deep Determinants of Economic growth" in Rodrik, ed., *In Search of Prosperity: Analytic Country Studies on Growth*, Princeton University Press, Princeton, NJ, 2003
35. Rodrik, Dani Arvind Subremanian and Francesco Trebbi, (2002) "Institutions Rule: The Primacy of Institutions Over geography and Integration In Economic Development", CID Working paper n97, Harvard.
36. Schiff, Maurice and Winters, L. Alan (2002) "Regional Cooperation, and the Role of International Organizations and Regional Integration" Working Paper 2872, World Bank, Washington D.C
37. Stanley Fischer, Ratna Sahay (2000), *The Transition Economies After ten Years*" NBER Working Paper 7664.
38. Tatsushi Ogita (2002), "An Approach Towards Japan's FTA Policy" IDE APEC study Center, Working Paper Series 01/02- No.4
39. Urata Shujiro (2003) "Formation of Economic Partnership Agreements -The Last Chance for Japan to Become a Regional Leader in East Asia" *Journal of Japanese trade and industry* January/ February 2003,
40. Walter Mattli (1999), "Explaining regional integration outcomes" *Journal of European Public Policy* 6:1 March 1999: 1- 27
41. WTO (2002), "Report (2002) of the Committee on Regional Trade Agreements to the General Council", World Trade Organization 25 November 2002
42. WTO, (2002) "Regional trade integration under transformation" WTO Secretariat, Geneva, 26 April 2002
43. Xiaokai Yang and Dingsheng Zhang (September 2001) "Economic Development, International trade, and Income Distribution" Retrieved: January 25, 2003, from
<http://www.inframarginal.com/column/xkyang/yangs-papers/Ineq1.htm>
44. "US-China current trade and investment policies and their impact on the US economy", oral testimony of Kevin Kearns, June 14, 2001 p125 cited in USCC report, p42

Chart 1. Mongolia's GDP, 1984-2001

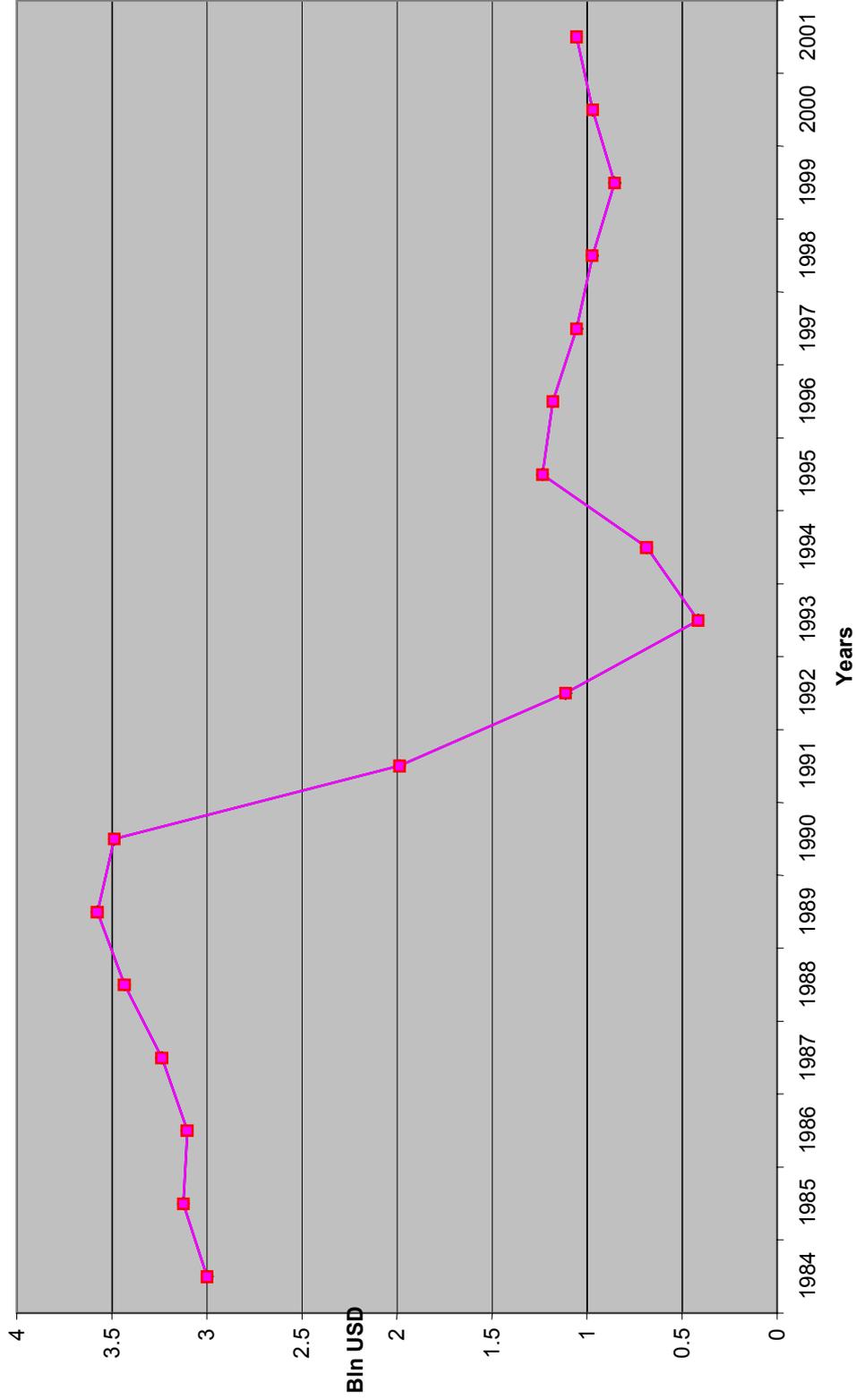


Chart 2. Share of Major Trading Partners, 1984-2001

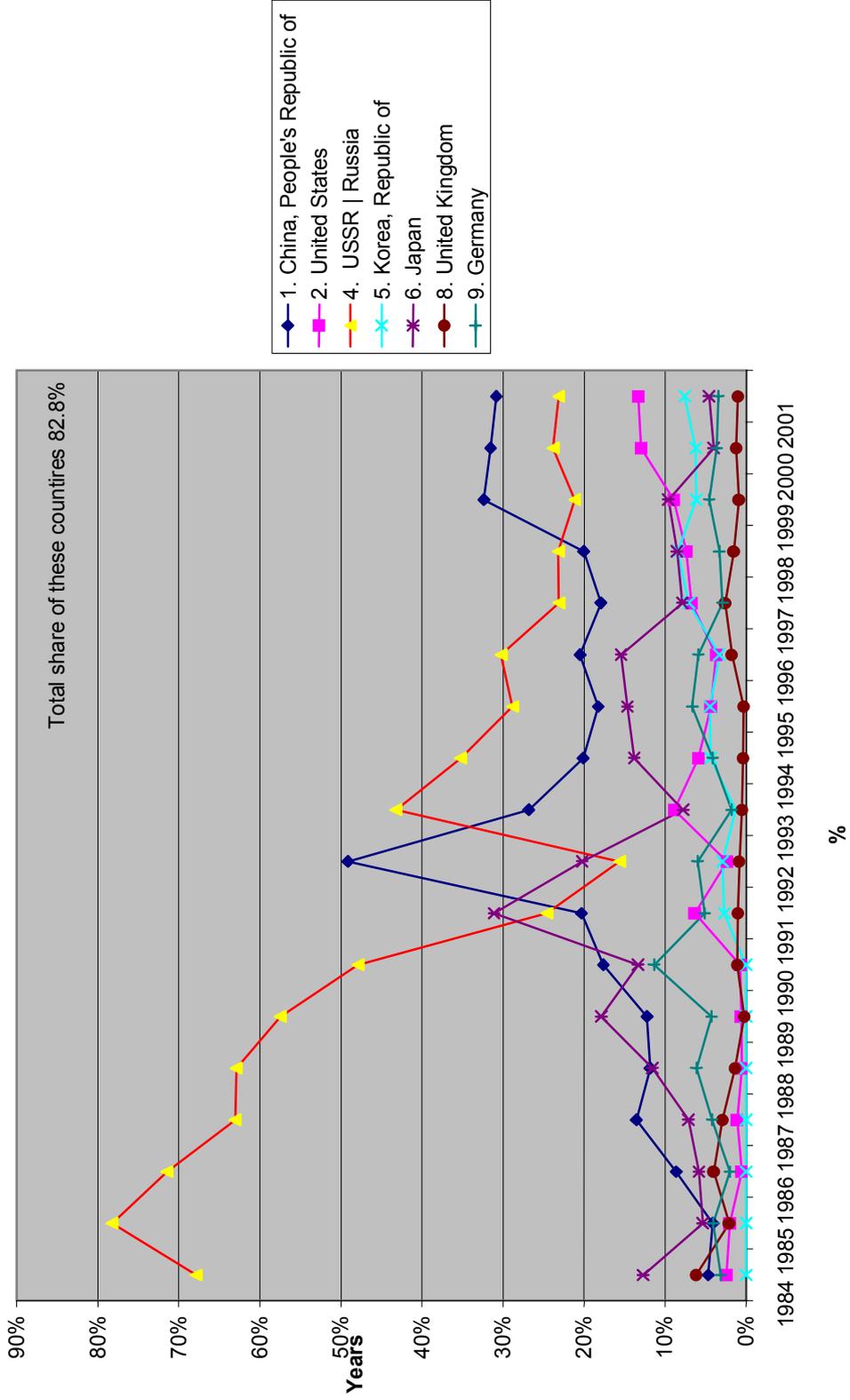


Chart 3 Mongolian Total Dynamics, Min USD

