



# Trade-Investment Nexus and Economic Growth in East Asia

# 11

Shujiro Urata

## Abstract

SDG 8's goal is to promote sustained, inclusive, and sustainable economic growth; full and productive employment; and decent work for all. This chapter examines the experiences of East Asian developing countries in achieving rapid and inclusive economic growth by focusing on the role of international trade and foreign direct investment nexus created through global value chains (GVCs) by multinational corporations (MNCs). GVCs enabled participating companies and countries to improve productivity, contributing to economic growth. The factors attributable to the participation in GVCs include high competitiveness of local companies and open business environment created by the Asian government. Moreover, construction and maintaining well-functioning soft (e.g., education and legal systems) and hard (e.g., transportation and communication systems) infrastructure by the government and international donors contributed to the creation of business-friendly environment. Faced with growing protection-

ism and the threats of growing US-China rivalry, infectious diseases, climate change, etc., maintaining an open and transparent rules-based business environment is crucially important to further achieving sustained, inclusive, and sustainable economic growth. In the light of absence of effective global economic order, exemplified by ineffectiveness of the World Trade Organization in trade liberalization as well as dispute settlement, regional economic frameworks such as the CPTPP and RCEP in the Asia and Pacific region would be proven to be effective to achieve the goal.

## Keywords

Global value chains · Free trade agreements · Infrastructure

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SDG 8: Promote sustained, inclusive and sustainable economic growth, full and productive employment, and decent work for all.

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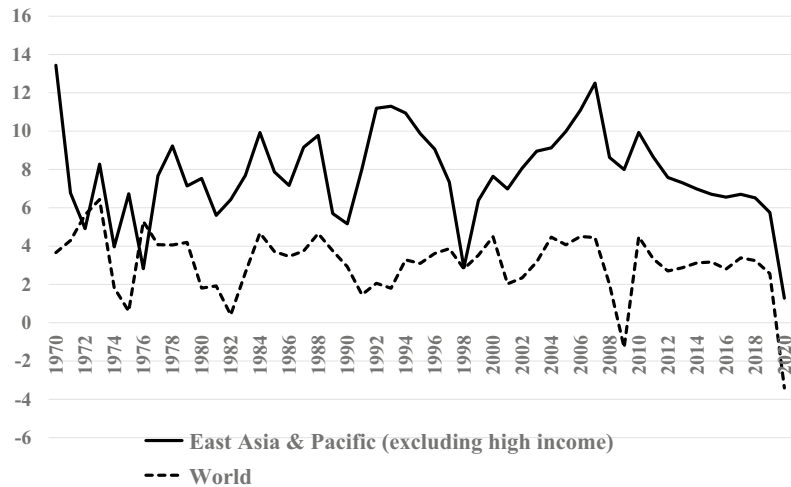
S. Urata (✉)  
Waseda University, Tokyo, Japan  
e-mail: [surata@waseda.jp](mailto:surata@waseda.jp)

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## 11.1 Introduction: Asia's Rapid Economic Growth

Among the United Nations' 17 sustainable development goals (SDGs), the objective of SDG 8 is to "promote sustained, inclusive, and sustainable economic growth; full and productive employment; and decent work for all." Among the world's developing countries and economies, those in East Asia have been relatively successful in achieving some of these objectives. The most

**Fig. 11.1** GDP growth rates for East Asia and the world (%).<sup>2</sup> Source World Bank, World Development Indicators online



obvious indication of their success is that many of these countries have achieved high, sustained economic growth for several decades. This chapter examines how East Asian countries<sup>1</sup> are achieving the objectives outlined in SDG 8 and attempts to provide guidance for other countries that are eager to achieve stronger economic growth. In our analysis, we focus on the roles of international trade and foreign direct investment (FDI), which have contributed significantly to development in East Asian countries.

We begin by presenting some facts about East Asia's rapid economic growth, and in the following sections, we analyze the role of foreign trade and FDI in achieving that growth.

East Asia has been an engine of economic growth for the world economy since the end of World War II although the main drivers of that growth have changed over time, shifting from Japan to the Newly Industrializing Economies, namely South Korea, Taiwan, Hong Kong, and Singapore, then to China, and the several member countries of the Association of Southeast Asian

Nations (ASEAN), including Indonesia, Malaysia, Thailand, Vietnam, and the Philippines. As shown in Fig. 11.1, economic growth measured by the annual growth rate of gross domestic product (GDP) for East Asia has been higher than the rest of the world in the post-war period.

Rapid economic growth in developing East Asian countries has been accompanied by an improved quality of life. The number of people in poverty has declined significantly, based on declines in the percentage of people living below the poverty line for the East Asian countries for which data are available: China 66.3% (1990) to 0.5% (2016), Indonesia 68.5% (1984) to 2.7% (2019), Lao PDR 31.1% (1992) to 10% (2018), and Vietnam 52.3% (1992) to 1.8% (2018).<sup>3</sup> From 1960 to 2020, GDP per capita in current US dollars for East Asian developing countries increased approximately 90 times, and the gap in GDP per capita in USD between East Asian developing countries and high-income countries declined sharply from 46 times in 1990 to 5.3 times in 2020. A large number of job opportunities were generated over the period from 1991 to 2019, with the number of employed workers increasing from 1.22 billion to 1.37 billion before declining to 1.34 billion in 2020 due to the

<sup>1</sup> In this chapter, the term "East Asian countries" refers to developing countries in East Asia, specifically China, South Korea, and the members of the ASEAN: Brunei, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Vietnam. It excludes Japan unless otherwise noted. Due to data availability, in some cases countries in the Pacific region are included.

<sup>2</sup> East Asia includes developing countries in East Asia and the Pacific.

<sup>3</sup> Data used in this paragraph are obtained from the World Bank's World Development Indicators online. Poverty here is defined as people living on less than US\$1.9 a day in 2011 purchasing power parity USD.

COVID-19 pandemic. Life expectancy at birth rose from 45 in 1960 to 75 in 2019, while the infant mortality rate declined from 45 per 1000 births in 1990 to 12 in 2019.

Various factors have been identified as drivers of the rapid economic growth in East Asia,<sup>4</sup> including high savings and investment, sound macroeconomic policies, highly educated and dedicated workers, a well-functioning infrastructure, and others. Among these, outward-oriented development strategies such as import liberalization and export promotion, which are discussed later in this chapter, played an important role in achieving rapid economic growth.

Despite sharing the common characteristic of rapid economic development and growth, the East Asia region is a collection of diverse countries not only in economic terms but also in noneconomic aspects. The countries are diverse in size (measured in terms of GDP, population, and land area), level of economic development, and endowment of natural resources. Among East Asian countries, China has the largest population, GDP, and land area, while Brunei has the smallest population (3/10,000th the size of China) and GDP (8/10,000 as large as China), and Singapore is the smallest in terms of land area (8/100,000th of China). Among East Asian countries, Singapore has the highest income per capita and Myanmar has the lowest (1/50th of Singapore). Similarly, there is diversity with respect to noneconomic aspects such as religion, culture, and political system. It should be noted that the diverse economic characteristics found in East Asia have led to an interesting and unique economic development pattern, which we discuss later in this chapter.

The remainder of this chapter is structured as follows. Section 11.2 discusses the role of foreign trade and FDI in achieving rapid economic development and growth, with a focus on global value chains (GVCs) created through FDI by multinational corporations (MNCs). Section 11.3 examines the changing environment with respect to trade and investment policy in East Asia, which has seen an emergence of free trade

agreements (FTAs). Section 11.4 concludes and provides several policy implications that would be helpful for other developing countries seeking to achieve economic development and growth. It also discusses challenges for East Asia to achieve inclusive growth.

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## 11.2 Nexus of Trade and Investment and Global Value Chains

One of the notable characteristics of the economic growth pattern in East Asia is the rapid expansion of trade and FDI during the period of high economic growth. According to Fig. 11.2, the ratio of trade (exports and imports) to GDP rose from 50% in 1980 to a high of 78% in 2006 before starting to decline, reaching 42% in 2020. This decline is mainly due to China's influence, which expanded domestic production and sales substantially as a result of its rapid economic growth. Somewhat in contrast to the pattern observed for the trade-to-GDP ratio, the ratio of inward FDI stock to GDP increased throughout the period 1980–2020, with some fluctuations, rising from 3% in 1980 to 26% in 2020. As we discuss more in detail later, trade and FDI increased more or less in tandem by interacting with each other.

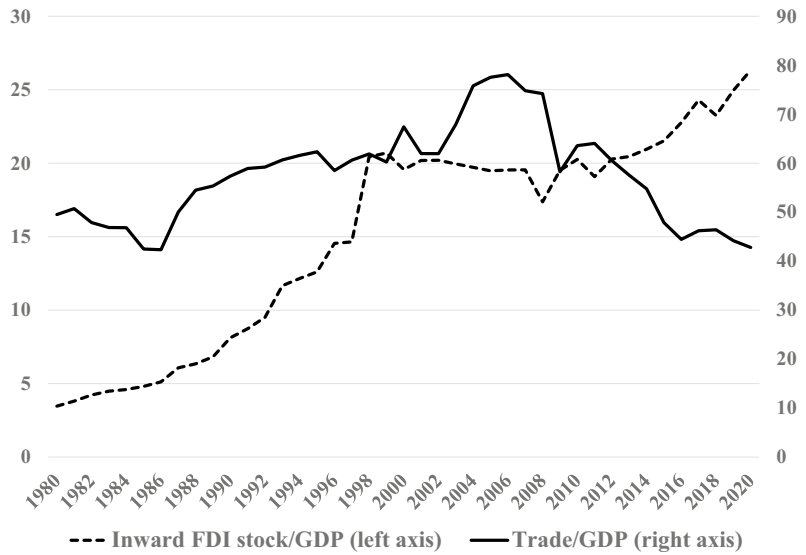
### 11.2.1 Expansion of Intra-regional and Machinery Parts Trade

International trade in East Asia has experienced several notable structural changes. First, intra-regional trade, which refers to trade among East Asian countries, has expanded rapidly. The ratio of intra-regional trade to overall trade for East Asia increased from 25.7% in 1985 to 37.2% in 2012 and then declined slightly to 34.9% in 2019 (Fig. 11.3).<sup>5</sup> Within East Asia, China has become an important source of import and a significant export destination for many East Asian countries. For China, the importance of

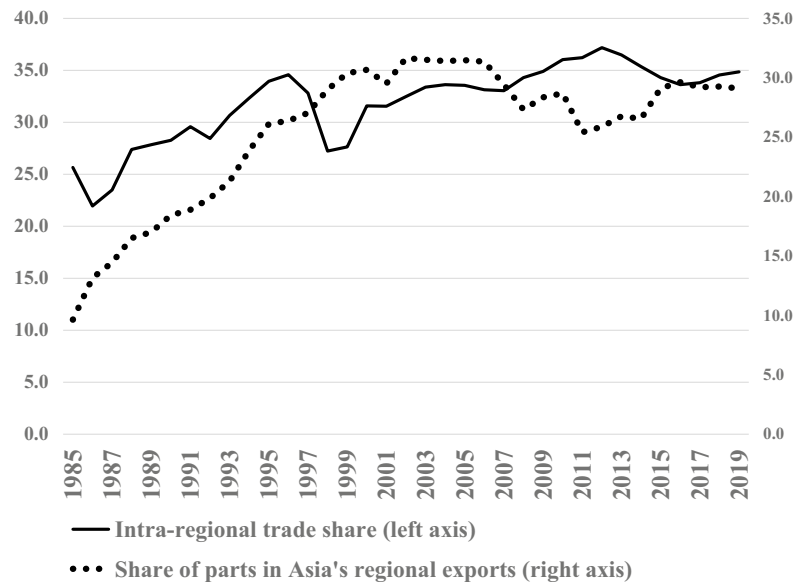
<sup>4</sup> See, for example, the World Bank (1993) and Asian Development Bank (2020).

<sup>5</sup> In Fig. 11.3, East Asia includes Japan.

**Fig. 11.2** Trade and inward FDI (% of GDP). *Source* World Bank, World Development Indicators online, UNCTAD, UNCTADstat online



**Fig. 11.3** Intra-regional trade and parts trade as shares in total trade in East Asia (%). *Source* Computed from RIETI-TID database

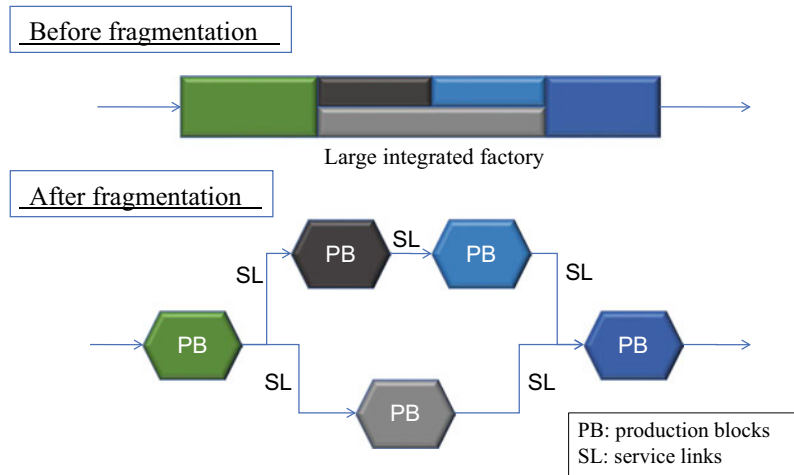


countries outside of East Asia, such as the US and the European Union (EU), has also increased. This rapid expansion of intra-regional trade can be explained mainly by the rapid economic growth of East Asian countries. It is natural for a rapidly growing country to increase its demand for imports and its ability to supply exports, leading to an expansion of trade. However, it should also be noted that GVCs in East Asia, formed through FDI by multinational corporations (MNCs), also contributed to an

expansion of intra-regional trade, as will be discussed later in this chapter.

Second, the product composition of trade for East Asian countries changed significantly. Specifically, the importance of manufactured products increased significantly for many countries in the region, which is attributable to successful industrialization. Specifically, the share of manufactured exports to total merchandise exports for East Asia's developing countries increased sharply from 27% in 1985 to 85% in

**Fig. 11.4** Fragmentation strategy. *Source* Kimura et al. (2010)



2005 and remained at that level through 2020. Among manufactured exports, exports of machinery products, particularly electric and electronic machinery and their parts, expanded markedly (Fig. 11.3).

These two notable developments regarding international trade in East Asia, namely increases in intra-regional trade and parts and components trade, are the result of regional production networks known as GVCs, created by MNCs.

### 11.2.2 Formation of Global Value Chains

Japanese MNCs that use a large number of parts and components began to establish factories in East Asia, in the early 1980s, undertaking FDI to take an advantage of low production costs. This process of internationalizing production was accelerated by a sharp appreciation in the Japanese yen in the mid-1980s, which increased the cost of Japanese products in foreign markets. Many Japanese MNCs implemented a fragmentation strategy, in which an integrated production system is fragmented into a number of production blocks. Each block specializes in producing one or a few specific parts, and the production blocks are connected by service links (Fig. 11.4), creating GVCs. MNCs in South Korea and Taiwan followed Japan's MNCs in implementing a fragmentation strategy as those countries'

currencies appreciated. In implementing a fragmentation strategy, MNCs set up factories for part production in countries where those parts can be produced at a low cost. Through these GVCs, MNCs can achieve efficient production systems, in which production factors, such as labor, capital, and technology, are allocated and used efficiently.

Next, we examine how deeply East Asian countries are involved in GVCs. There are several ways to measure the extent of a firm's or country's participation in GVCs. One is to use information about a firm's transaction pattern. If a firm imports inputs and exports outputs, it is considered a participant in one or more GVCs. Another approach is to use information on international trade and production at sector level. More specifically, data on value-added trade constructed from world input-output tables are used to measure the extent of GVC participation by country.<sup>6</sup> In this approach, GVC participation is generally assessed by two approaches, namely backward and forward participation. Backward participation refers to the ratio of the "foreign value-added content of exports" to the country's total gross exports.<sup>7</sup> This is the "buyer" perspective or sourcing side of GVCs, in which a country imports intermediate

<sup>6</sup> See, for example, the World Bank (2020) for useful information about GVCs with respect to economic development.

<sup>7</sup> Adopted from WTO (2016).

inputs to produce its exports. Forward participation refers to the ratio of the “domestic value-added sent to other countries relative to the country’s total gross exports. It captures the domestic value-added contained in inputs sent to other countries for further processing and exporting through various value chains. This is the “seller” perspective or the supply side of GVCs. Total GVC participation is the sum of backward and forward participation.

Figure 11.5 shows GVC participation rates for ASEAN countries, China, Japan, and Korea (ASEAN+3 countries) in 1980 and 2018. Many countries increased the level of GVC participation, although there are some countries that experienced a decline in GVC participation. Singapore, Malaysia, and the Philippines show very high GVC participation rate, while Cambodia, Lao PDR, and Myanmar exhibit low GVC participation rate. Magnitude of backward and forward GVC participation rates reveals interesting patterns of GVC participation of a country. Countries with relatively high share of backward participation such as Singapore and Malaysia engage in assembling final products by importing intermediate goods. We may divide countries with relatively high share of forward participation into two groups. One group of countries includes Brunei, Indonesia, Lao PDR, and Myanmar, while the other group consists of China and Japan (1980). Countries in the first group mainly export raw materials, while those in the second group mainly export manufactured or processed intermediate goods such as parts and components. One cannot make judgment a priori as to which type of participation, high share of backward participation or forward participation, contributes more to economic growth. Having said this, one may observe that countries with high share of manufacturing tend to grow fast compared to those with high share of raw materials sector.

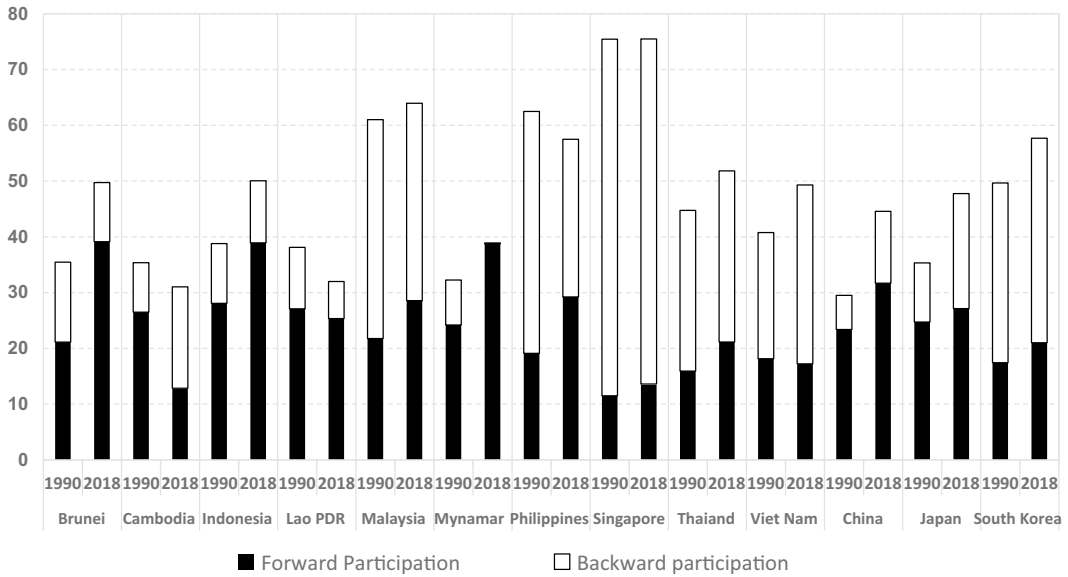
### 11.2.3 Benefits of GVC Participation

In the early stages, GVCs were formed by MNCs to involve their foreign subsidiaries; over time, they expanded to include local companies. GVCs

have brought many benefits to their participating companies and the countries in which they operate.<sup>8</sup> By participating in GVCs, local firms are able to import high-quality raw materials and components, which they use to produce and export their products. This export expansion not only increases production and employment, but also improves production efficiency and strengthens competitiveness. It is particularly important that superior technologies and management know-how owned by MNCs are transferred to the participating local companies through these GVCs. To make this technology transfer possible, it is essential that local companies that participate in GVCs have capable employees with technological knowledge and managers who understand the importance of technology.

Another benefit of participating in GVCs is that their robustness and resilience limits damage to the production system that may be caused by various factors. Crises caused by natural disasters, such as the Great East Japan Earthquake and the floods in Thailand in 2011, and the COVID-19 pandemic in 2020–2021, disrupted GVCs and suspended the production of parts and final products, causing economic damage to many companies and countries. In such situations, GVCs’ vulnerability and the way in which these negative effects propagate were considered problematic. However, experience shows that most GVCs were not greatly damaged and in fact are quite robust. Furthermore, when GVCs were seriously damaged, they recovered rapidly and rebuilt, and their resilience was recognized. To contend with the risk of GVC fragmentation, rather than retreating to integrated production, system diversification is considered to be an effective countermeasure. As deepening and expanding GVCs are seen as important for promoting future economic growth in East Asia and Japan, this issue will be discussed later.

<sup>8</sup> On the benefits of GVC participation, see, for example, World Bank (2020) and Urata and Baek (2021).



**Fig. 11.5** GVC participation in selected East Asian countries. *Source* UNCTAD, GVC Database

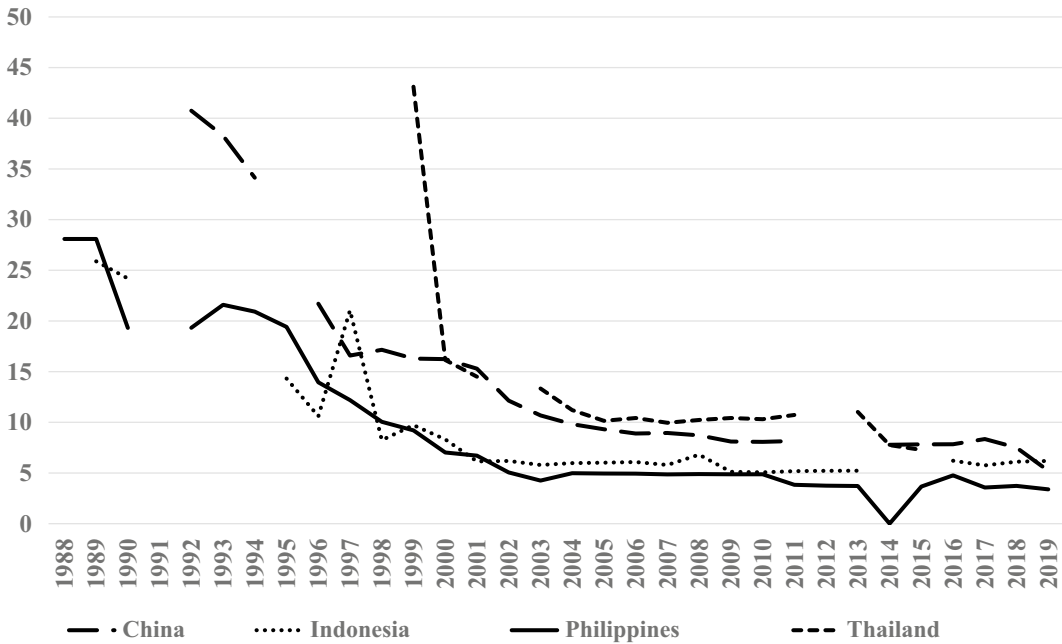
#### 11.2.4 Factors Leading to the Formation of GVCs

The factors that led to the formation of many GVCs by MNCs in East Asia may be classified into two groups. The first group consists of supply-side factors from the perspective of MNCs, and the other contains demand-side factors from the standpoint of the East Asian countries that hosted them. As noted above, a major realignment in foreign exchange rates encouraged MNCs to relocate production from their home countries (e.g., Japan and South Korea) to developing countries in East Asia, to achieve low-cost production. Accumulated international business experience in exporting and importing businesses contributed to MNCs' ability to create and manage GVCs. In addition, major reductions in the cost of communication and transportation services, attributable to technological innovations such as the development and the propagation of the Internet in the telecommunications arena and the development of large ships for transportation, as well as deregulation in both of those sectors, played an important role.

Turning to demand-side factors, we consider two types: those pertaining to local firms participating in

GVCs and those originating in GVCs' host countries. Starting with the factors related to local firms, the number of local firms with technical and managerial capabilities in East Asia has been increasing. In their study of GVC participation by firms in Asia, Urata and Baek (2020) find that competitive local firms can successfully participate in GVCs. However, many firms are not able to handle the processes or complete the tasks within the GVC network needed to produce the products to be exported to foreign countries. Competitiveness among local firms reflects various factors such as the high labor productivity, uniqueness or high quality of their product or task, low-cost production capabilities, and others. To possess competitiveness, firms need educated, trained, and high-skilled workers; capable and ambitious managers; high-quality technology; and imported inputs. Having links to MNCs, access to technology, capital, and information about foreign markets helps firms to improve their competitiveness. Local firms' competitiveness is reflected by international certifications such as ISO. As such, possessing international certifications facilitates firms' participation in GVCs.

Regarding the factors concerning the GVCs' host countries, Urata (2021) found that compared to other developing countries, many East Asian



**Fig. 11.6** Changes in tariff rates (%). *Source* World Bank, World Development Indicators online

countries have established a business environment that is open to trade and FDI inflows, with an abundance of educated and disciplined workers, financial resources, technology and information with respect to foreign markets, and a well-developed infrastructure. Figure 11.6 shows tariff rates on manufacturers have declined for selected East Asian countries, reflecting the trade liberalization policies they have adopted. Infrastructure, which plays an important role in promoting economic activity, is a rather broad concept that may be divided into soft and hard infrastructures. Soft infrastructure includes educational, regulatory, and legal systems, while hard infrastructure includes transportation and communication systems. Having an efficient public sector refers to government and business associations that facilitate firms' participation in GVCs.

These findings reinforce the importance of government policies in promoting GVC participation. Governments can help local firms participate in GVCs in various ways, including technical and financial support that helps firms upgrade their technology and marketing support that disseminates information on foreign markets to the firms. Governments are also advised to

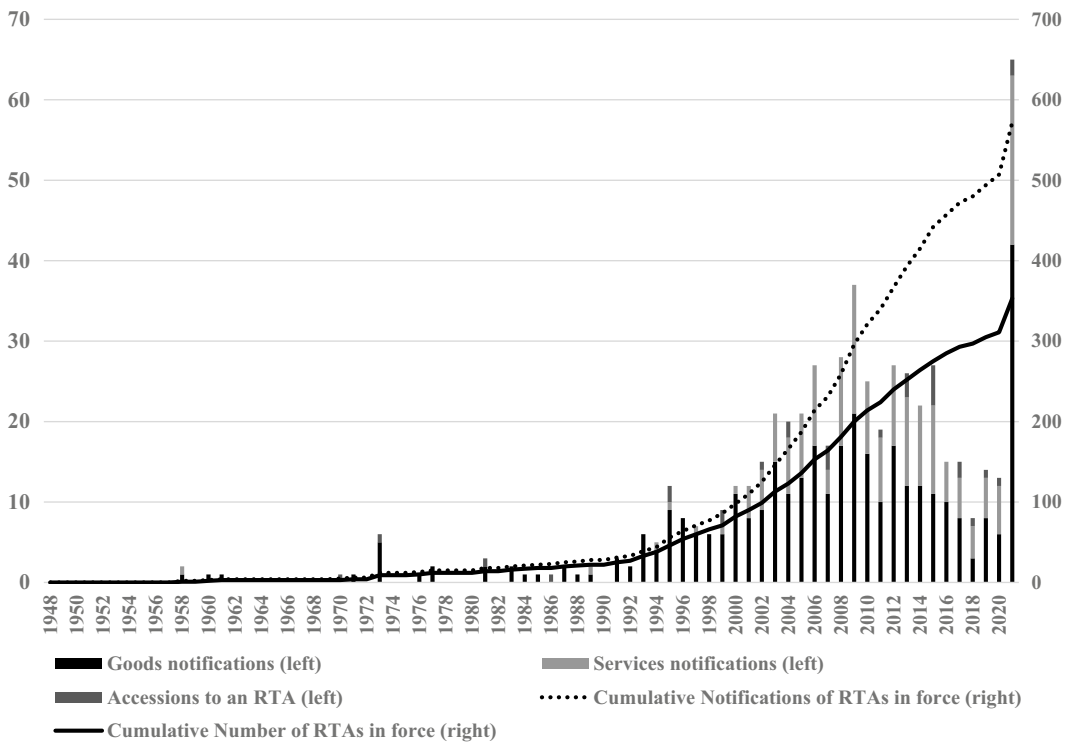
establish a business-friendly environment, characterized as open, fair, transparent, and rules-based with respect to trade and FDI. One effective way for governments to achieve this objective is to join FTAs, which we discuss in the next section. Governments can also play an important role in building soft and hard infrastructure that can contribute not only to attracting MNCs to involve local firms in their GVCs, but also to provide the building blocks that are fundamental to achieving economic growth. To the extent possible, governments should leverage economic assistance provided by foreign donor countries, international organizations, and other sources to supplement their own efforts.

### 11.3 Regional Economic Integration in East Asia<sup>9</sup>

East Asia witnessed a rapid expansion of intra-regional trade during the late 1980s and 1990s, resulting in de facto regional economic integration.

<sup>9</sup>This section updates and modifies Urata (2019, 2022). See also Urata (2014) on regional integration in East Asia.





**Fig. 11.7** Regional trade agreements (RTAs) in the world.<sup>12</sup> Source World Trade Organization, RTA database

As discussed in the previous section, the formation of regional production networks or GVCs by MNCs drove this integration. The development of GVCs contributed to economic growth, which in turn further liberalized trade and FDI policies, resulting in greater and deeper regional economic integration. Because of the increased importance of market forces in forming regional economic integration, which results from allowing more open trade and FDI policies, such integration is characterized as market-driven regional economic integration.<sup>10</sup>

In the latter half of the 1980s, the movement toward institutionalized regional economic integration (institution-driven regional economic integration) gained momentum in various regions of the world (Fig. 11.7). In Europe, the movement that started in the 1950s accelerated: The European Single Market was established in 1992, the EU in 1993, the European Central Bank in

1998, and the single currency, the euro, was introduced in 1999. In North America, the US-Canada Free Trade Agreement came into effect in 1989, followed by the North American Free Trade Agreement between the US, Canada, and Mexico in 1994. One important reason for this institution-driven economic integration was the slow progress in trade liberalization negotiations that were part of the General Agreement on Tariffs and Trade (GATT) under the so-called Uruguay Round, which began in 1986.<sup>11</sup> Faced with stalled negotiations for GATT, countries interested in trade liberalization to promote economic growth opted to sign FTA with like-minded countries, which promoted regional economic integration.

<sup>10</sup> See Urata (2004) for discussions on market-driven and institution-driven regional economic integration in East Asia.

<sup>11</sup> The Uruguay Round began in 1986 with the goal of completing negotiations in four years. However, the negotiations involved many difficult issues and agreement was not reached until 1994.

<sup>12</sup> Regional trade agreements (RTAs) include FTAs and customs unions.

Compared to other regions of the world, East Asia has been slow to develop institution-driven regional economic integration.<sup>13</sup> The first major regional economic integration in East Asia was the ASEAN Free Trade Area (AFTA), created by the ASEAN member countries (Brunei, Indonesia, Malaysia, the Philippines, Singapore, and Thailand) in 1993. Two external factors prompted AFTA's formation: the development of regional economic integration in other parts of the world and the rise of China. These forces had reduced ASEAN's importance as an investment destination and were negatively impacting its economic development. The ASEAN countries sought to improve the region's attractiveness as an investment destination by integrating their markets through AFTA, which was completed by 2015. ASEAN then created the ASEAN Economic Community to deepen economic integration in the region.<sup>14</sup>

In the latter half of the 1990s, support for regional economic integration on an institutional level that would encompass the countries of the East Asia region emerged. This movement developed along two tracks: one by the East Asian countries and the other by the Asia-Pacific countries. In the remaining sections, we present an overview of the developments along each track and examine the possible impacts of regional economic integration on an institutional level on economic growth in East Asian countries.

### 11.3.1 East Asia Track

In the early 1990s, then Malaysian Prime Minister Mahathir proposed the formation of a regional economic integration that would encompass the countries of East Asia. The idea was inspired by movements toward regional economic integration in Europe and North

America, but it was not until the beginning of the twenty-first century that the effort began in earnest. Here, we review the development of bilateral or plurilateral FTAs in East Asia and then analyze the trends in regional FTAs in the region.

At the start of the twenty-first century, a number of bilateral FTAs were established by East Asian countries, starting with the Japan-Singapore FTA that came into effect in 2002. Singapore, Japan, and South Korea began to actively engage in FTAs but China showed no interest in participating. After China joined the World Trade Organization (WTO) in 2001 and secured access to the world market, it began to use FTAs to advance its regional presence in Asia. China's FTA policy was different from those of other countries. First, while Japan and South Korea began their FTA participation through bilateral FTAs, China chose all ASEAN countries as its first FTA partners. Second, the China-ASEAN FTA included content that was not included in other FTAs. For example, China offered preferential treatment, including economic cooperation, to the new member countries of ASEAN, namely Cambodia, Lao PDR, Myanmar, and Vietnam, which were lagging in their economic development compared to the original AFTA members. China's FTA strategy included both economic objectives, such as expanded trade, and political objectives such as building friendly relations with neighboring countries. The China-ASEAN FTA came into effect in 2005, generating a domino effect; by 2010, Japan, South Korea, Australia, New Zealand, and India had individually ratified FTAs with ASEAN (the so-called ASEAN+1 FTA).

The movement toward forming regional economic integration within the East Asian region was triggered by the Asian currency crisis that occurred in 1997 and 1998. East Asian countries that suffered serious economic consequences from the currency crisis recognized the need for regional economic cooperation to recover and to avoid a recurrence and considered an East Asia FTA (EAFTA) with ASEAN, China, Japan, and South Korea (ASEAN+3) as one form of regional economic cooperation. The idea of regional

<sup>12</sup> Regional trade agreements (RTAs) include FTAs and customs unions.

<sup>13</sup> See Urata (2014, 2016) on regional economic integration in East Asia.

<sup>14</sup> See ERIA (2014) for a detailed analysis of ASEAN's economic integration.

economic integration in East Asia was accelerated by the growth of regional economic integration in the rest of the world. The plans for EAFTA began in 2005, with China taking the lead. In 2006, Japan proposed the Comprehensive Economic Partnership in East Asia (CEPEA), which would consist of ASEAN+6, namely ASEAN+3 countries, Australia, New Zealand, and India. It was clear that the backdrop to EAFTA and CEPEA was the rivalry between Japan and China for regional economic integration in East Asia.

The feasibility studies for EAFTA and CEPEA were conducted in parallel until 2011, when Japan and China proposed establishing a joint working group to accelerate the discussions. Underlying the proposal to establish the joint working group made by Japan and China, which had been battling for leadership in establishing a regional FTA, was China's desire to create an East Asian regional FTA that excluded the US without being bogged down in debates about EAFTA versus CEPEA while the Trans-Pacific Partnership (TPP) negotiations, as discussed in the next section, progressed. The joint proposal from China and Japan created a sense of crisis for the ASEAN countries, which had a strong interest in playing a central role in regional integration in East Asia. ASEAN proposed the Regional Comprehensive Economic Partnership (RCEP) in 2011 to counter the move by Japan and China. RCEP is an ASEAN-centered framework, in which any country that has concluded an FTA with ASEAN can participate, rather than a framework that fixes the member countries as in EAFTA and CEPEA.

Although ASEAN+6 declared the start of RCEP negotiations in November 2012, the actual negotiations did not begin until May 2013. RCEP members realized the need to start their negotiations after Japan formally announced it would join the TPP negotiations in March 2013. The RCEP negotiations were contentious, and the target date for agreement was repeatedly pushed back. India withdrew from the final stage, and the agreement was reached in November 2020. Several reasons for India's withdrawal have been offered. One is that India feared that

trade liberalization through RCEP would not only increase its trade deficit with China, but it would also be a major blow to India's manufacturing sector, given the country's large trade deficit due to its large volume of Chinese manufactured product imports. Another is the concern about a negative impact on India's agriculture sector, as low-priced agricultural products from Australia and New Zealand would increase substantially. RCEP is scheduled to enter into force on January 1, 2022, now that the requirements for enactment have been fulfilled. RCEP faces several challenges, including monitoring to ensure that the members comply with the agreement and their commitments. Another is to improve the quality of the agreement, as discussed in Sect. 11.3.3.

### 11.3.2 Asia-Pacific Track

Discussions on the formation of a framework for economic integration that would encompass the Asia-Pacific region began in the 1990s with some countries participating in the Asia-Pacific Economic Cooperation forum (APEC). Established in 1989 by the economies<sup>15</sup> located in the Asia-Pacific region, its main objective is to achieve economic growth by promoting regional economic integration through trade and investment liberalization. Due to differences in the approaches and priorities of the various economies involved, movement toward liberalization of trade and investment did not progress as hoped. Therefore, Chile, Singapore, New Zealand, and Brunei, all of whom were interested in a high degree of trade and investment liberalization, established the Trans-Pacific Strategic Economic Partnership Agreement (P4) in 2006. The purpose of P4 is to create a free and open business environment and to help realize APEC's goal of achieving a free and open environment for trade and FDI. The founding members hoped

<sup>15</sup> The word "economies" is used to describe APEC members because the APEC cooperative process is predominantly concerned with trade and economic issues, with members engaging with one another as economic entities.

that by accepting new members, P4 would become the basis for a larger regional FTA.

In March 2008, the P4 members began negotiations to expand the scope of the agreement to include financial services. P4 was described as a living agreement because it was open to amendments based on the demands and wishes of businesses in its member countries even after it entered into force. The US, which had a strong interest in liberalizing cross-border activities in the financial services sector, decided to participate in the expanded P4 negotiations in September 2009. Following the announcement by the US, Australia, Peru, and Vietnam also announced their intention to participate in the negotiations. During this period, P4 was renamed as the TPP. It has been said that the US participated in TPP negotiations to avoid being excluded from East Asia, whose economies were projected to grow rapidly and were increasingly moving toward regional integration on an institutional level.

In the 2010s, the move toward regional economic integration on the institutional level gained momentum. Negotiations for an expanded TPP that included eight countries—Brunei, Chile, New Zealand, Singapore, Australia, Peru, the US, and Vietnam—began in March 2010. Four more countries joined after the start of negotiations: Malaysia (in October 2010), Canada and Mexico (in 2012), and Japan (in 2013). It is unusual for new countries to join after negotiations have begun, and this indicated the importance of the TPP. The negotiations took five years and seven months, culminating in an agreement in October 2015. The TPP agreement was signed by the negotiating parties in February 2016, and the 12 countries involved began the process of ratifying the agreement. However, the conditions for the agreement to enter into force were abrogated when US President Trump took office in 2017 and withdrew from the TPP. As a result, the agreement is no longer in effect.

Although the US withdrew from the TPP, the remaining TPP countries decided to establish TPP11 without the US. Negotiations were completed in a short period of time, and the agreement was signed in March 2018. TPP11 entered

into force in December 2018 as the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP). To date (December 2021), the agreement has been ratified by all signatories except Malaysia, Brunei, and Chile. There are a number of possible reasons the TPP11 members promoted the agreement. First, as a continuation of the original TPP (see the next section), the CPTPP includes comprehensive sectoral rule-building and a high degree of trade and investment liberalization, and its members expect it to stimulate economic activity that will promote economic growth. Second, the CPTPP is a high-level, comprehensive FTA that will serve as a model for future FTAs. Third, the CPTPP is expected to curb and reverse the protectionism that has emerged since the 2007–2008 global financial crisis. Fourth, as there is a possibility that the US will seek to return to the TPP in the future, the CPTPP must be brought into force to prepare for such a situation. The CPTPP is attracting considerable attention, as evidenced by the UK's application for membership in February 2021, followed by applications from China and Taiwan in September 2021.

### 11.3.3 CPTPP and RCEP

Both the CPTPP and RCEP contain comprehensive content aimed at promoting regional integration and achieving economic growth through increased trade and investment, with a particular emphasis on expanding GVCs. An important benefit of both agreements is that common rules will be applied to trade and investment for many of the participating countries, thereby avoiding the “spaghetti bowl” effect of restraining trade that results from a mix of FTAs between two countries that have different rules, or have a small number of participating countries. This emphasizes that RCEP is much more than just a combination of four ASEAN+1 FTAs and ASEAN's FTAs with China, Japan, South Korea, and Australia-New Zealand, in one framework.

While the CPTPP and RCEP share a common goal of economic growth, there are important

differences: The RCEP focuses on economic development, not just economic growth; the CPTPP emphasizes the importance of active private sector involvement in achieving economic growth, while the RCEP emphasizes the importance of economic cooperation in achieving equitable and inclusive economic development. The RCEP includes countries in the early stages of development, such as Cambodia, Lao PDR, and Myanmar, and emphasizes economic cooperation because economic development in these countries is important for the region's sustainable development and social stability. Specifically, the RCEP allows for preferential treatment of countries in the early stages of development, while the CPTPP treats all members equally and does not allow for special treatment.

Both the CPTPP and RCEP are more comprehensive than the WTO (Table 11.1); however, they differ in the items they cover. The agreements cover many common issues, such as market access for trade in goods and services, trade facilitation, and intellectual property rights, but they differ on important issues. Important items addressed in the CPTPP but not the RCEP are state-owned enterprises and designated monopolies, labor, environment, regulatory coherence, transparency, and anti-corruption. While these aspects of the CPTPP are important to developed countries such as Japan and Australia in order to maintain a level playing field across firms and achieve sustainable economic growth, developing countries find them difficult to accept. For example, the regulations do not allow preferential policies for state-owned enterprises, which is difficult for developing countries where government involvement in the economy is significant. Importantly, the CPTPP includes rules that protect and promote workers' rights: requiring freedom of association and collective bargaining, forbidding child labor, forced or compulsory labor, and discrimination in employment and occupations, helping to achieve some of the goals of SDG 8, namely to promote productive employment and decent work.

Some items are common to both agreements but differ in content and degree of discipline. One

clear example of this is in the liberalization of trade in goods (market access), where the CPTPP eliminates almost all tariffs on all products (100% tariff elimination rate), with a few exceptions. In the RCEP, tariff elimination varies among countries and the average rate is roughly 90%, lower than in the CPTPP. There is also a major difference in the area of e-commerce, which is attracting attention as it regulates the international movement of data that is becoming increasingly important in the global economy. The CPTPP includes the following three principles of the TPP: (1) ensuring freedom of cross-border transfer of information by electronic means, (2) prohibiting requests to install and/or use computer-related equipment, and (3) prohibiting the transfer of and requests for access to source code, with the aim of ensuring the free movement of data. In contrast, items (1) and (2) are included in the RCEP, but (3) is excluded. In addition, the content of (1) and (2) is less rigid in the RCEP, not only because exceptions are allowed for national security and other reasons, but also because they are not subject to dispute settlement procedures.

Some believe that the CPTPP and RCEP are competitors because the US took the lead in negotiating the CPTPP's predecessor, the TPP, and showed a strong desire to exclude China, while the RCEP includes China but not the US. However, as there are considerable differences between the two agreements in content and the degree of discipline, they are considered to be complementary, rather than conflicting or competing. The two agreements can be viewed as presenting a phased opportunity for countries that cannot join the CPTPP due to its high level of discipline to first join the RCEP and then join the CPTPP when the higher level of discipline imposed by the CPTPP becomes acceptable. Beyond the RCEP and CPTPP, the Free Trade Area of the Asia-Pacific (FTAAP), which encompasses the Asia-Pacific region, was agreed upon at the APEC summit in Yokohama, Japan, in 2010 as the ultimate goal of regional integration in the Asia-Pacific region.

**Table 11.1** CPTPP, RCEP, and WTO

|   | CPTPP | RCEP | WTO |
|---|-------|------|-----|
| Market access for goods                           | ●     | ●    | ●   |
| Rules of origin and origin procedures             | ●     | ●    | ●   |
| Textiles and apparel                              | ●     | ●    | ●   |
| Customs administration and trade facilitation     | ●     | ●    | ●   |
| Trade remedies                                    | ●     | ●    | ●   |
| Sanitary and phytosanitary measures               | ●     | ●    | ●   |
| Technical barriers to trade                       | ●     | ●    | ●   |
| Investment  | ●     | ●    | ▲   |
| Cross-border trade in services                    | ●     | ●    | ●   |
| Financial services                                | ●     | ●    | ●   |
| Temporary entry for business persons              | ●     | ●    | ▲   |
| Telecommunications                                | ●     | ●    | ●   |
| Electronic commerce                               | ●     | ●    |     |
| Government procurement                            | ●     | ●    | ▲   |
| Competition policy                                | ●     | ●    |     |
| State-owned enterprises and designated monopolies | ●     |      |     |
| Intellectual property                             | ●     | ●    | ●   |
| Labor   | ●     |      |     |
| Environment                                       | ●     |      |     |
| Cooperation and capacity building                 | ●     | ●    |     |
| Competitiveness and business facilitation         | ●     |      |     |
| Development                                       | ●     |      |     |
| Small and medium-sized enterprises                | ●     | ●    |     |
| Regulatory coherence                              | ●     |      |     |
| Transparency and anti-corruption                  | ●     |      |     |
| Administrative and institutional provisions       | ●     | ●    |     |
| Dispute settlement                                | ●     | ●    | ●   |

*Note* ● indicates the issue is covered, and ▲ is partially covered

*Sources* CPTPP and RCEP texts

### 11.3.4 Economic Impacts of Regional Economic Integration

Regional economic integration in the form of FTAs affects economic activity for both member and nonmember countries, mainly through its impacts on trade and investment. Here, we examine the economic impacts of FTAs, first from a theoretical perspective and then based on empirical analyses.

We can think of the effects of FTAs as static and dynamic.<sup>16</sup> Beginning with static effects, FTAs promote trade among FTA members (the trade creation effect), as tariffs on bilateral trade decline, and tend to reduce trade between members and nonmembers (the trade diversion effect), as some of their bilateral trade activities are likely to be replaced by trade among FTA members. FTAs give rise to these trade creation and

<sup>16</sup> For more detailed explanation, see textbooks on international economics such as Appleyard and Field (2017).

diversion effects because they give preferential access to the FTA partners' markets. A non-member's economic welfare will decline because of the reduction in exports, while it is not known a priori whether the member country's economy will gain or lose. The member country gains from an expansion of trade, but loses from the reduction in tariff revenue. If the gain exceeds the loss, a member gains overall, but loses otherwise.

Turning to dynamic effects, FTAs may promote economic growth because expanded trade is likely to increase productivity through economies of scale and greater competition. An FTA member could gain from increased investment that may occur because the member country's future economic prospects are expected to improve. An FTA member may also expect an increase in FDI because many FTAs, including the CPTPP and RCEP, liberalize FDI policies. Expanded FDI inflows would lead to economic growth for FDI recipient countries.

With this theoretical understanding of the economic impacts of FTAs, we turn to an empirical analysis. Researchers conduct an ex-ante analysis of FTAs before they are enacted using a simulation based on economic models. The most popular model for analyzing FTAs is the computable general economic (CGE) model, which mimics a real economy based on market mechanisms by considering consumers, producers, and governments. A typical CGE model covers all sectors of an economy (typically represented by 15–30 sectors) and the world (generally represented by 20–50 countries and regions). An ex-post analysis is conducted after FTAs are enacted to examine their impact on trade. A typical approach is to apply the gravity model, which attempts to explain the magnitude of bilateral trade using the economic size of two countries and the geographical distance between them. The name comes from physics, specifically Newton's Law of Gravity, which states that the gravitational force between two bodies is directly proportional to the product of their masses and inversely proportional to the square of the distance between them. We first consider studies that examine the economic impacts of the CPTPP and RCEP using a CGE model and then review

studies that examine the trade creation and diversion effects of AFTA using a gravity model.

Petri and Plummer (2020) simulate the economic impacts of the CPTPP and RCEP by projecting economic conditions in 2030 that reflect commitments required by those agreements, such as tariff reductions. The results of their analysis with respect to national income are shown in Table 11.2, with the figures for member countries shown in bold. Consistent with theoretical expectations, national income for members of the CPTPP and RCEP increases but declines for many nonmembers. The increases in national income are mainly due to the trade creation effect, while decline is primarily caused by the trade diversion effect. In the case of the CPTPP, Japan gains the most in absolute terms and China loses the most. With the RCEP, China gains the most while India (not shown in the table) loses the most. These opposite impacts for China clearly indicate that a country benefits from being a member of an FTA. Impacts on the US are very small.

The impacts are quite different when we consider the percentage change in national income, rather than the absolute change. With the CPTPP, Malaysia gains the most, and Japan and South Korea gain the most with the RCEP. One important factor that determines the gain for a given country is the tariff reduction that the country experiences for its exports, i.e., tariff reductions in its export destination countries. For example, the large gain that Japan obtains from membership in the RCEP is mainly due to a reduction of tariffs on its exports to China and South Korea, with whom free trade is established under the RCEP. For the same reason, ASEAN members see relatively small gains because they have already established free trade with other RCEP members such as China, Japan, and Korea under the ASEAN+1 FTA frameworks. It should be noted that the world as a whole gains from both the CPTPP and RCEP.

Turning to studies on the impacts of FTAs on trade using the gravity model estimation method, there are no comparable studies to those reviewed above that use the CGE model because the gravity model applies to ex-post data,

**Table 11.2** Effects on real income, 2030 (USD billion, %)

|               | Incremental change |           | Incremental percent change |            |
|---------------|--------------------|-----------|----------------------------|------------|
|               | CPTPP              | RCEP      | CPTPP                      | RCEP       |
| Asia          | 69                 | 164       | 0.1                        | 0.3        |
| Brunei        | <b>1</b>           | <b>0</b>  | 2.6                        | <b>0.5</b> |
| China         | -10                | <b>85</b> | 0.0                        | <b>0.3</b> |
| Indonesia     | -1                 | <b>3</b>  | -0.1                       | <b>0.1</b> |
| Japan         | <b>46</b>          | <b>48</b> | <b>0.9</b>                 | <b>1.0</b> |
| South Korea   | -3                 | <b>23</b> | -0.1                       | <b>1.0</b> |
| Malaysia      | <b>21</b>          | <b>4</b>  | <b>3.1</b>                 | <b>0.6</b> |
| Philippines   | 0                  | <b>2</b>  | 0.0                        | <b>0.3</b> |
| Singapore     | <b>13</b>          | <b>0</b>  | <b>2.7</b>                 | <b>0.0</b> |
| Taiwan        | 0                  | -3        | 0.0                        | -0.4       |
| Thailand      | -5                 | <b>4</b>  | -0.6                       | <b>0.5</b> |
| Vietnam       | <b>11</b>          | <b>3</b>  | <b>2.2</b>                 | <b>0.5</b> |
| Oceania       | <b>15</b>          | <b>1</b>  | <b>0.5</b>                 | <b>0.0</b> |
| America       | 49                 | 2         | 0.1                        | 0.0        |
| United States | -2                 | 1         | 0.0                        | 0.0        |
| Europe        | 12                 | 13        | 0.0                        | 0.1        |
| World         | 147                | 186       | 0.1                        | 0.1        |

Note Figures of the CPTPP/RCEP members are shown in bold letters

Source Petri and Plummer (2020)

whereas the CGE model is used in ex-ante studies. The CPTPP entered into force in December 2018, and the RCEP has yet to be enacted; therefore, there is not yet sufficient data for a gravity model analysis of these FTAs. As a result, our discussion of gravity model studies is rather general. A large number of studies that use the gravity model have analyzed the impacts of FTAs on trade. The results are mixed in that some studies found positive impacts, i.e., the trade creation effect, while others did not.

Bair and Bergstrand (2007) conducted a rigorous analysis by addressing econometric problems encountered in earlier studies and found that on average the bilateral trade between two members under an FTA approximately doubles after 10 years. Okabe and Urata (2014) conducted one of the few studies on FTAs in Asia by analyzing the impact of the AFTA. They found the trade creation effect for a wide range of products and that such trade creation effects are relatively small for the newer ASEAN members

compared to the original members. Based on these results, they claim that AFTA was successful in promoting intra-ASEAN trade. In their study of the trade creation and trade diversion effects of FTAs covering 20 products, Urata and Okabe (2013) found that FTAs among developed countries generate trade creation effects for many products, while the trade diversion effect was not found except for medical and pharmaceutical products. In contrast, FTAs among developing countries generate trade creation effects in fewer products but give rise to trade diversion for many more products when compared with FTAs among developed countries. They also found that plurilateral FTAs give rise to trade creation for many more products compared to bilateral FTAs.

Empirical studies of the economic impacts of FTAs have shown that FTA members tend to benefit in terms of increased trade and economic growth, while nonmembers are likely to lose in both respects. These findings indicate that countries should join FTAs to help them achieve



economic growth; however, this is not an optimal situation for the world economy as a whole, because FTAs give rise to trade diversion. The optimal situation would be free trade among all countries. Since achieving free trade around the world is unlikely in the current environment where the WTO is not functioning effectively to liberalize trade, the second-best policy may be to expand the membership of existing mega-FTAs such as the CPTPP and RCEP, with the goal of eventually covering all countries, thereby achieving global free trade.

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### 11.4 Conclusions: Achieving Inclusive Economic Growth

This chapter examined the roles of foreign trade and FDI in achieving high economic growth in East Asia, in order to draw lessons for achieving sustainable economic growth (SDG 8). We noted the formation of GVCs through FDI by multinational corporations (MNCs) as a special characteristic of rapid economic growth in East Asia. Participation in GVCs has provided opportunities for East Asian countries to expand their foreign trade and obtain new technology, helping them to increase productivity and achieve strong economic growth. We emphasized the importance to East Asian countries of pursuing trade and FDI liberalization and constructing and managing hard and soft infrastructure to realize economic growth based upon participation in GVCs. To promote further economic growth and achieve higher levels of economic development, East Asian countries are advised to participate in mega-FTAs such as the CPTPP and RCEP to improve their business environment, which would expand and intensify GVCs.

Although East Asian countries have been successful in achieving rapid economic growth and improving the standard of living for their people, they face a number of challenges, including growing inequality, a deteriorating environment due to climate change, worsening relations between the US and China, a growing probability of infectious disease, and others. Here, we focus on the issue of inequality because

it has been argued that the rapid expansion of trade and FDI—in other words, the globalization of economic activity—has significantly increased inequality. It is important to realize that greater inequality would deter economic growth as it would likely lead to political and social instability.

In discussing globalization and inequality, we need to differentiate between developed and developing countries, and this section takes the perspective of developing countries.<sup>17</sup> For many East Asian countries, growing income/asset inequality is a rather recent phenomenon. Indeed, for many decades expanding trade and FDI helped to reduce inequality in East Asia. From the 1980s through the early 2000s, East Asian countries increased exports of unskilled labor-intensive products such as clothing in large quantities, which generated a high demand for unskilled labor. This in turn led to a rise in wages for these workers, reducing the wage inequality between unskilled and skilled labor. The situation changed when MNCs began to undertake FDI in sectors such as electric and electronic machinery and transport equipment. MNCs brought technologies that require skilled labor, and introducing such technologies increased demand and therefore raising wages for skilled labor, widening the wage and income gap in East Asia.

Large FDI inflows resulted in a different kind of inequality problem, namely inequality between large firms and small and medium-sized enterprises (SMEs). MNCs are typically large firms that tend to have advantage over SMEs in terms of financial and human resources. This resource gap between large firms and SMEs not only leads to differences in their performance, but it also increases the wage/income gap between those working for large firms and those working for SMEs.

This growing income inequality must be addressed, and inclusive growth has to be achieved to realize the political and social stabilities necessary for sustainable economic

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<sup>17</sup> See, for example, Urata and Narjoko (2017) for a detailed discussion on this issue.

growth (SDG 10, reducing inequality). This will require SMEs to improve the capabilities of their unskilled workers to stay competitive, which calls for more education and training. Public institutions/governments should provide education and training with respect to general skills and knowledge, while specialized skills and knowledge should be developed by specialized institutions or through on-the-job training. To improve SMEs' competitiveness, public institutions/governments should provide technical, financial, and marketing assistance. Furthermore, a policy to promote competitiveness for SMEs to address the risk of dominance of large firms over SMEs should be considered, to level the playing field. We emphasize that governments, as providers of assistance, must have capable personnel to identify the need of those who seek to benefit from that assistance and to apply appropriate measures so that various forms of assistance can be effective. It should be noted that assistance can be effective if it is provided in cooperation with the private sector. Finally, governments' own efforts are of utmost importance, but they should seek international cooperation with donors and international organizations.

Finally, we would like to reiterate the importance of constructing, maintaining, and managing soft and hard infrastructure (SDG 9), not only for the developing countries to participate in GVCs, but also for building the foundations for economic growth, more specifically, inclusive and sustainable economic growth.

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