

# OLD ISSUES IN NEW REGIONALISM

There has been a burst of interest in regional trading arrangements in the Asia Pacific region. Business pressures, frustration with the multilateral process, renewed interests in regional autonomy and domino effects have contributed to the interest in a preferential route. But the use of these arrangements leads to serious risks of new layers of discrimination in the regional trading system, and to a marked change in strategy for trade liberalisation in East Asia. Hopes that this route to reform will be successful may yet be disappointed. Even so, individual economies must design strategic responses to the change in the policy environment, with a long-run goal of returning liberalisation to the non-discriminatory track.

## Introduction

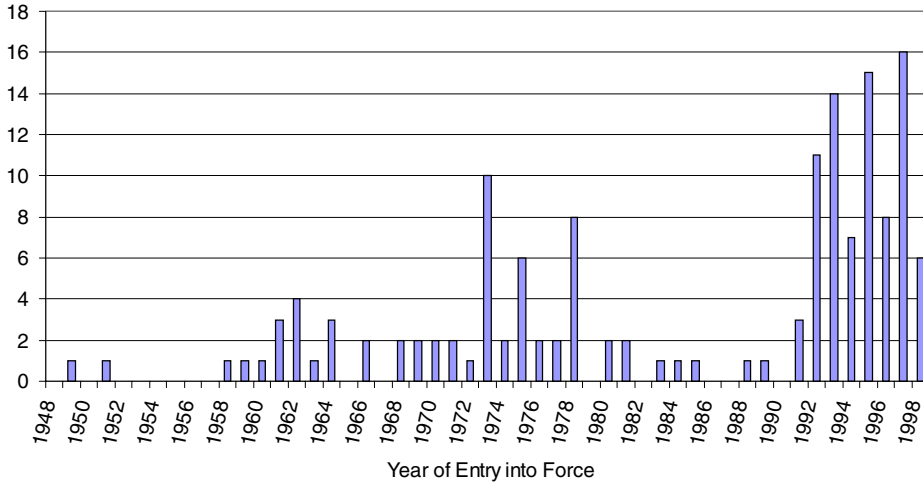
*Regional (preferential) trading arrangements are like street gangs: 'you may not like them, but if they are in your neighbourhood, it is safer to be in one'.<sup>2</sup>*

In the 1960s approximately two or three regional trade arrangements (as the World Trade Organisation calls them, whereas preferential trade arrangements is a better term) were being notified to the WTO every year.<sup>3</sup> The notifications occurred at an even lower rate in the 1980s and early 1990s. Then came the boom. Between 1992 and 1998, there were approximately 11 notifications a year (see Figure 1). As of August 1998:

- the WTO had been notified of 162 RTAs, and more than half the notifications had occurred in the previous eight years;
- a further 58 RTAs existed, or had existed, but had not been notified to the WTO (see Figure 2);
- the number of notified RTAs in force (estimated to be 87 at that time) was far fewer than the total number notified, but was still more than double the number that existed in 1991;<sup>4</sup> and
- 97 per cent of WTO members were participating in RTAs.

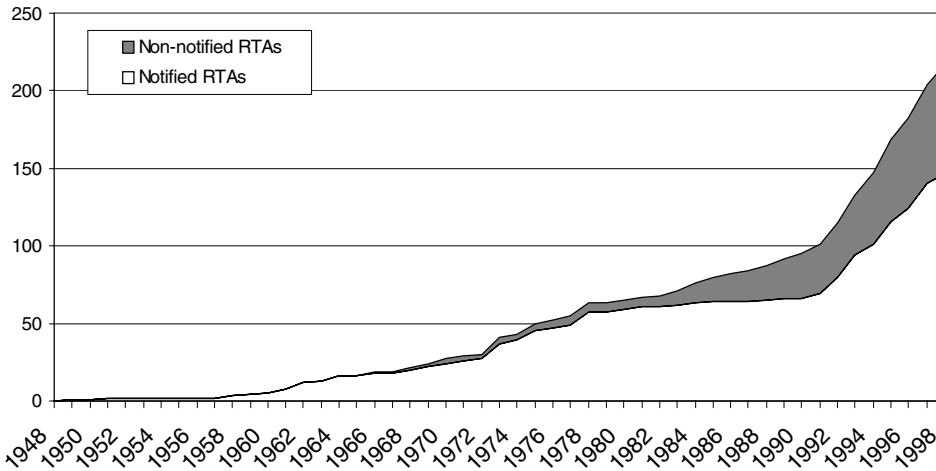
Crawford and Laird (2000) report that the European Union members and Mexico belong to more than 10 RTAs. Brazil, Colombia, Venezuela and Chile among others belong to between

**Figure 1 Number of RTAs notified annually to the GATT/WTO under Article XXIV and the enabling clause**



Source: WTO (1999).

**Figure 2 The evolution of notified and non-notified RTAs**



Source: WTO (1999).

5 and 10 arrangements. The WTO Secretariat (1998) reviewed 69 regional trading arrangements in force. Of these only 10 were customs unions, with the majority being free trade areas (FTAs).

Most members of the Asia Pacific Economic Cooperation Forum (APEC) also belong to RTAs. Long-standing arrangements in the Western Pacific include the ASEAN Free Trade Area (AFTA) and the Australia–New Zealand Closer Economic Relations Agreement (CER).<sup>5</sup> A large number of arrangements are also in place on the other side of the Pacific, including a string of bilateral agreements.<sup>6</sup> Another round of activity from APEC members has occurred recently, especially since the September 1999 APEC Leaders Meeting in Auckland, and has involved economies not usually noted for their participation in preferential approaches. The appendix provides further information on a sample of these initiatives.

It is important to stress that most of the recent activity has taken the form of proposals, studies or the continuing negotiation of arrangements. Some drafts of arrangements may never come to be signed since, as the material in the appendix illustrates, there are some serious constraints and sticking points. Some may become agreements to implement processes established in APEC (on standards, for example) or in the WTO (on services, for example). They may be divided into components, such as agreements on investment or on information technology. The label ‘free trade area’ could turn out to be an incorrect description. Even so, within the APEC region there has clearly been an increase in interest in preferential liberalisation.

The initiatives listed in the appendix to this paper have the following features:

- They involve economies that have not previously engaged actively in the preferential route to reform; for example, Japan.
- While some arrangements are between close neighbours, others involve some long-distance relationships; for example, across the Pacific, Mexico with Singapore, or Korea and Chile. Geographic proximity is not necessarily a feature.
- Only one considers combining two existing regional trading arrangements.
- There are examples of an individual member of an existing agreement signing with a member of another agreement, such as Singapore and Mexico, or Singapore and New Zealand.
- The coverage of these arrangements extends beyond traditional areas of trade policy to include investment, services and standards, for example.

- The discussions make reference to consistency with WTO rules, but also refer to other principles such as open access to new members.
- The arrangements mooted or under discussion are all free trade areas, not customs unions.

The purpose of this paper is to comment on these developments. Are they good news or bad news for the world economy?

## **Good news or bad?**

The answer to this question depends on whose perspective is being taken – that of members or of non-members – and even then can still depend on many other variables. Krueger (1999), Laird (1999), Crawford and Laird (2000) and Panagariya (2000) review the range of issues that RTAs generate. Both static and dynamic effects need to be considered.

### ***Static effects***

The static effects of preferential arrangements on member countries include both trade creation and trade diversion. Trade creation occurs when items purchased from another member of the preferential arrangement replace domestic production in a member economy. Trade is created because it is cheaper to import the products from the other member than to produce them at home. Trade diversion occurs when members replace imports from elsewhere in the world with higher-cost imports from other members. Trade creation increases welfare, and trade diversion generally decreases it.<sup>7</sup> The effects can vary considerably for several reasons.

The terms-of-trade effects need to be taken into account. Cooperative arrangements to liberalise trade among members can offset adverse terms-of-trade effects that might otherwise be associated with unilateral liberalisation. The presumption is that members' terms of trade will improve relative to the rest of the world.<sup>8</sup> This suggests a decrease in welfare for non-members.

Another issue to take into account is the relocation of rents (including away from non-members). A preferential arrangement might lead firms from other members to enter the imperfectly competitive market of a member, resulting in the ability of foreign firms to capture some of the profits. On the other hand, the rise in competition will bring benefits,

including opportunities to exploit economies of scale and an increase in welfare as a greater variety of goods becomes available. Foreign capital flows can also be affected; for example, if there is a diversion of capital to member economies from non-members.

Krueger (1999) stresses that when all these effects are combined, it is difficult to come up with a definite guide to when a preferential agreement will be good for members. There are a couple of critical parameters. One is the extent to which countries already trade extensively with each other. If trade is already high, trade diversion should be less. Another important parameter is the scale of the members' external tariffs at the time of establishment: lower external tariffs mean less chance of significant losses from trade diversion.

### *Dynamic effects*

With respect to the dynamic effects on the world trading system, there are a number of arguments for and against preferential arrangements. Krueger (1999) reviews these arguments, finding no strong support for the view that preferential arrangements are building blocks of the multilateral system, and indeed clear 'grounds for concern' that they will weaken it.

#### *Arguments for preferential arrangements*

It is argued that by building the momentum for further multilateral liberalisation, preferential arrangements have a positive effect on trade. Scollay (1996) found that this catalytic effect occurred with the CER, especially in New Zealand, where the enthusiasm producers had for greater access to the Australian market carried over to multilateral negotiations.

Andriamananjara (1999) identifies one set of circumstances in which a preferential path might lead to global free trade. In his model policymaking is driven by firm profits. There is only one good sold in oligopolistic and segmented markets in identical economies (with one firm in each economy). Global free trade emerges when there is one bloc, membership of which is considered sequentially, and where the rules of the bloc say that any country that wants to join has to be allowed to do so. In that case, outsiders will always want to join and the incumbents cannot stop them.

In other circumstances the outcome will not be free trade. Profits per firm reach a maximum before membership is universal. So if the incumbents are given discretion, they will deny further entry to the bloc after some point. This outcome is not the end of the game. The

countries excluded could then form their own arrangement. The further implication is that the first bloc would then have an incentive to increase the size of its membership. The emergence of the second bloc therefore makes the first bigger.

Andriamananjara also considers the incentives to merge smaller blocs. He starts with a situation in which each economy forms a bloc with one neighbour. In the next stage, the members of one agreement merge with those of one other agreement. And so on. Could this process of consolidation continue until free trade is reached, or are there circumstances in which it will stop before then? Andriamananjara finds that free trade is possible but only if inter-bloc tariffs are low enough (when tariffs are low, the oligopolistic firms in the model can make greater profits with unrestricted access to all markets).

Freund (2000a) provides another perspective on the process of consolidation by examining serial bilateralism. She uses the same model of segmented oligopolistic markets as Andriamananjara, but now governments maximise welfare; that is, the sum of producer and consumer surpluses, plus tariff revenue. The outcome of unilateral policymaking is that each government sets the optimal tariffs on imports from other countries, taking their tariffs as given. When bilateral agreements are possible, each country will want to sign an agreement with every other country. The benefits of a bilateral agreement include higher profits from preferential access to foreign markets, and higher consumer surplus at home. These gains always outweigh the loss of profits and tariff revenue in the home market from offering access to foreign suppliers at preferential rates. This is the case whatever agreements are already in place and whatever other countries have done. The consequence is that the best strategy for each country is to have a bilateral agreement with every other country. In this model, in the presence of uncoordinated bilateralism, the outcome is free trade.<sup>9</sup>

A number of other benefits have been identified:

- It has been argued that preferential arrangements help 'lock in' policy change. Policy change that is announced but is not credible will be ineffective. Commitments made in a preferential agreement can lend credibility to policy changes, since backsliding will be punished by the loss of the advantages provided by the agreement.
- Preferential arrangements may help producers in economies with high external tariffs to argue for lowering those tariffs, especially the ones applying to intermediate goods. Krueger (1999) refers to this effect in New Zealand and in Canada.
- It has also been argued that preferential arrangements can be used as a threat to push along multilateral liberalisation. They can help participants implement greater

liberalisation than has been agreed through the multilateral system. They can also help members deal with new policy issues and with emerging impediments to trade and investment. A preferential approach is said to help educate members about free trade and its benefits.

### *Arguments against preferential arrangements*

Many contrary views exist. Critics make the point that preferential arrangements are unnecessary because the same benefits would follow from unilateral liberalisation of trade, and would be larger in that case. Furthermore, members of preferential arrangements are more likely to raise barriers to non-members, even when external tariffs are low (further details on the mechanisms through which this could occur are offered below).

The second criticism of preferential arrangements could be termed the 'snouts in the trough' view. Export interests would normally be in favour of, or at least able to be mobilised to be in favour of, multilateral liberalisation. But once they get their snouts in the trough of rents created in a preferential structure, they do not want to give them up, or they cannot be compensated by the move to freer trade. This is the outcome of the Andriamananjara model when incumbents have discretion over the entry of new members. As a consequence, liberalisation gets suspended.<sup>10, 11</sup>

A third argument is that the negotiation of preferential arrangements uses up scarce policymaking and negotiating capacity. For example, in the lead-up to the Seattle WTO meeting, some countries normally expected to be stalwarts of the multilateral process were marketing regional initiatives at the cost of effort that might have gone into building the multilateral agenda. The reference in the appendix to the resources Korea is devoting to proposals on preferential arrangements illustrates this point.

Another criticism is that multilateral mechanisms are better at providing some of the specific benefits claimed for preferential arrangements. The WTO, for example, provides mechanisms for binding policy that avoid the disadvantages of trade diversion. The issue is whether the WTO is able to perform these roles over the range of policy areas that appear to be motivating the interest in preferential arrangements.

### **But why now?**

Despite the questionable benefits of preferential arrangements, there has clearly been a surge of interest in such arrangements in the 1990s and an apparent shift in opinion within some

East Asian economies. Supporters of preferential arrangements believe that they are the best method of addressing some impediments and that it would be more difficult to deal with them without discriminating against other countries. What factors might have contributed to this change?

One explanation is that private investors have lost confidence in the multilateral process. McLaren (1999) examines how a combination of conditions can contribute to an increase in demand for trade blocs. In his model investors make investments that are specific to one sector and are sunk. To make their investment choices, they have to establish expectations about future trade policy. The second condition is the presence of some sort of friction in trade negotiations. The two conditions interact in the following way. If investors expect the emergence of global free trade, they will invest in areas where they have a comparative advantage. If firms expect trade blocs to emerge, they will invest differently. These firms will invest more in sectors supplied by goods that non-members currently export. Firms within the bloc will also become more specialised relative to each other. The presence of these investments, which cannot be easily reversed, means that the actual gains from multilateral liberalisation are less than those from a preferential agreement. If there is a possibility of 'negotiating friction', which would add to the costs of multilateral liberalisation, firms may decide multilateralism is not worth the effort. The prediction of its failure creates a new set of investments and a new set of sensitive sectors. The expectation of a preferential outcome is then self-fulfilling. McLaren summarises this effect as 'a kind of "Say's law" for regionalism: because of the kinds of investment it generates, the anticipated supply of regionalism may induce its own demand'. The source of the change is that governments are perceived by investors to be not really committed to multilateralism.

A further factor is the reaction of non-members to the formation of a bloc by others. Baldwin (1997) provides an often-quoted analysis of how the establishment of a trade bloc can create a domino effect, as more and more members join.<sup>12</sup> More recently, Andriamananjara (1999), as discussed above, highlights how the growth of one existing large bloc prompts non-members to consider creating their own bloc.

The opportunity to address new policy issues has been a major factor behind the interest in preferential arrangements. In a recent survey by the Australian Department of Foreign Affairs and Trade (DFAT), firms rated measures to facilitate business relatively highly, particularly the harmonisation of standards. Japan's Minister of International Trade and Industry, Takeo Hiranuma, stated that the attraction of the Singapore–Japan FTA was its



coverage of items such as business mobility and a common cyberspace.<sup>13</sup> Business is increasing pressure for tariff reductions to achieve greater access to other markets and also for reductions in other barriers where multilateral approaches have been seen as not sufficient. There may be an advantage in trying to deal with non-tariff issues in a small group and, from the point of view of some countries, also an advantage in dealing with them in a discriminatory fashion.

Gandal and Shy (2001) consider the incentives for a preferential approach to the mutual recognition of standards. If the home government does not recognise a foreign standard, foreign suppliers bear a conversion cost to meet the home standard. They show, in a model with one industry, three countries and three different standards, that if governments (who maximise welfare according to both consumer and producer interests) have to choose between recognising all standards or none of them, they will recognise them all (total surplus is higher under recognition). The outcome is then universal mutual recognition of standards. Gandal and Shy then consider the option of a standards union and find that two countries will prefer to establish a union of just two members when conversion costs are moderate or very large. The home firms' profits in other member's market are higher and this effect dominates the loss of consumer surplus in the home market.<sup>14</sup> The profits increase with the size of the other member so the implication is that a union of the two largest countries generates the greatest surplus. There is a strong incentive, therefore, for larger countries to form a standards union.<sup>15</sup>

East Asian interest in preferential arrangements might also be prompted by the growth in intra-regional trade, leading to a re-evaluation of the costs and benefits of discrimination. The rise in intra-regional trade has not been driven by preferential arrangements, however, but has occurred as a consequence of liberalisation on a most-favoured-nation (MFN) basis. But Drysdale (2000) observes that the rate of growth of intra-regional trade has encouraged some in Japan and elsewhere in the region to think more critically about preferential arrangements. Interest in regionalism within East Asia also reflects discontent over the lack of progress being made by international economic institutions. The failure of the WTO ministerial meeting in Seattle to launch a new round of multilateral trade negotiations has prompted countries to look at regional approaches more favourably.<sup>16</sup> This situation would be expected to reinforce the McLaren conditions discussed above. Related developments, following the Asian financial crisis, include proposals for new currency arrangements in the region and for an Asian Monetary Fund.<sup>17</sup>

Hopes for new preferential arrangements may yet be disappointed. From the point of view of the bureaucracies involved, the negotiation of such arrangements may seem a quicker way of getting results than relying on multilateral organisations. However, this route is not as easy as it appears. Although the number of parties involved is often small, the issues under discussion are likely to be complicated. Further illustration of this point is offered below in relation to standards and services trade. Much time could be spent thrashing out a solution that suits all parties only to have the next set of negotiations lead to a different outcome, and for both outcomes to contradict principles established at the multilateral level.

The second difficulty is that negotiations can be easily derailed, especially when sensitive sectors are involved. Bilateral approaches usually cover less sectors than multilateral negotiations do. Protests by producers in sensitive sectors, such as winemakers in Korea anticipating a glut of Chilean wine or Japanese goldfish breeders concerned about imports of goldfish from Singapore, can halt negotiations since there are insufficient countervailing forces that can be mobilised from other sectors that gain from liberalisation. This problem is becoming more evident as the various talks proceed or, rather, as many fail to move as quickly as had been hoped.

## **Empirical evaluations**

What do empirical studies say about the influence of preferential arrangements on trade and welfare? This section provides some notes on selected studies.

Anderson and Norheim (1993) examine how preferential arrangements have affected the propensity to trade with countries outside the group. They found that, despite the greater number and coverage of preferential arrangements, global integration has deepened, but stress that the world might have been a better place without such arrangements.

More recently, Laird (1999) compared intra- and extra-bloc trade for preferential arrangements between 1990 and 1997. The picture is mixed. In many cases trade grew faster among members than with non-members, but in the case of the EU, the growth was similar. Trade with non-members tended to grow faster than world trade.

Table 1 extends Laird's findings to 1998, showing the value of intra- and extra-group imports for six preferential arrangements in 1998.<sup>18</sup> The table also looks at the share of these imports in the total imports of each group in 1990 and 1998 and the growth rates of intra- and extra-group imports over this period. Some key results include:

**Table 1 Merchandise imports of selected preferential trading arrangements, 1990–98**

Agreement	Imports	Value in 1998 (US\$ bn)	Share in total imports (per cent)		Growth rate 1990–98
			1990	1998	
EU	Intra-	1,233	63.2	60.0	2.9
	Extra-	822	36.8	40.0	4.7
NAFTA	Intra-	509	33.3	40.2	11.0
	Extra-	757	66.7	59.8	7.0
AFTA	Intra-	50	14.3	19.4	10.7
	Extra-	209	85.7	80.6	5.7
CER	Intra-	5	7.4	6.7	3.3
	Extra-	65	92.7	93.3	4.6
Mercosur	Intra-	21	14.5	21.2	22.0
	Extra-	78	85.5	78.8	15.2
Andean	Intra-	5	6.8	11.7	20.6
	Extra-	40	93.2	88.3	11.9
World Trade		5,600			6.2

*Source:* International Economic Data Bank, The Australian National University, updated from Laird (2000).

- import growth in the EU and CER over the period was slower than the growth of world imports, but imports from other countries grew faster than imports from other members;
- in each case except the EU, the group imported more from non-members than from members (for the EU the share imported from members was 60 per cent);<sup>19</sup>
- the next highest within-group import share in 1998 was 40 per cent for the North American Free Trade Agreement (NAFTA), followed by 21 per cent for Mercosur, 19 per cent for AFTA, 12 per cent for the Andean group and 7 per cent for CER;
- in all arrangements other than the EU and CER, import growth was faster within the group than with the rest of the world (by at least 45 per cent) and so the within-group import shares increased; and
- in all arrangements other than the EU and CER, imports from outside the group grew faster than world trade.

Could the relatively large growth of intra-group trade be explained by the preferential arrangements or by other factors? An idea of the forces at work can be gained from calculating trade intensity indices for trade within the group and with the rest of the world. These indices measure the extent of each group's trade with other members and with the rest of the world in relation to the group's share of world trade. A value greater than one indicates a bias. A significant rise in the index values for intra-group trade between 1990 and 1998 shows that trade within the group is growing much faster than the group's share in world trade would suggest. The key results (see Table 2) illustrate that:

- intensity values are greater than one for all forms of within-group trade;
- index values for the EU, NAFTA, AFTA and CER have been remarkably stable (except for the within-group export intensity for CER members, which shows that members are exporting much more to each other than their share in world trade would suggest); and
- very high and rising values in the indices for both import and export intensity are observed for the within-group trade of Mercosur and the Andean group.

**Table 2 Import and export intensity indexes, selected preferential trading arrangements 1990 and 1998**

Agreement	Trade flow	Import intensity		Export intensity	
		1990	1998	1990	1998
EU	Within group	1.38	1.49	1.45	1.67
	With ROW	0.68	0.67	0.63	0.61
NAFTA	Within group	2.09	2.23	2.19	2.29
	With ROW	0.79	0.73	0.72	0.62
AFTA	Within group	3.38	3.30	3.99	4.18
	With ROW	0.89	0.86	0.86	0.85
CER	Within group	5.35	5.95	5.20	6.74
	With ROW	0.94	0.94	0.94	0.93
Mercosur	Within group	10.23	14.10	10.49	14.26
	With ROW	0.87	0.80	0.92	0.76
Andean	Within group	7.01	16.44	8.32	17.91
	With ROW	0.94	0.89	0.96	0.86

*Note:* ROW = rest of the world.

*Source:* International Economic Data Bank, The Australian National University.

These results suggest that trade growth within the EU, NAFTA, AFTA and CER has generally been in line with the increase in each group's shares of world trade. This is not to say that these preferential arrangements had no influence – they could have contributed to a greater degree of overall openness which, in turn, could have led to their rising shares of world trade.

The pattern for Mercosur and the Andean members differed. Inter-bloc trade grew much faster than might have been expected – although more powerful tests are required to establish whether the results can be attributed to differences in these preferential arrangements.

There has been some more detailed work on Mercosur. Yeats (1998) finds that this arrangement has diverted rather than created trade over the period 1988–94. Trade growth within the bloc was greatest in sectors where members were not internationally competitive (p. 20). Pointing to the relatively high preference to trade with other members (p. 23), Yeats concludes that if 'the Mercosur countries had achieved an equivalent degree of liberalisation on a nondiscriminatory basis, they would have maintained a more efficient import structure ... and they would have purchased more from their trading partners outside the block' (p. 24).

A difficulty in studies of time trends (including those of events before and after the creation of an RTA) is the lack of a counterfactual. Yeats discusses this issue. An alternative track to liberalisation might have led to greater increases in trade, and in welfare, but these effects cannot be measured.<sup>20</sup> A further issue is the amount of time that should elapse before the preferential arrangement is evaluated.

A number of factors can affect the propensity of countries to trade with others, including those in formal preferential arrangements. A regression model can separate out the contribution of factors such as trade complementarity, distance and size to show how membership of a preferential agreement affects trade (see, for example, Greenaway 2000). This effect can then be examined over time, with dummy variables included to test for differing results for members and non-members. A fall in the value of the dummy variable would be consistent with trade diversion away from non-members. In studies completed so far, however, the effects have been difficult to isolate and the overall effect of preferential arrangements remains hard to assess.

Computable general equilibrium models have the advantage of providing more options for choosing base scenarios and are better able to capture the detail of preferential policies. The models are becoming increasingly sophisticated and able to incorporate scale effects, imperfect competition and capital accumulation. Srinivasan, Whalley and Wooton (1993)

reviewed the work in this field, concluding that the welfare effects of preferential arrangements have probably been positive but not necessarily very large. They suggest that both vigorous supporters and detractors of preferential arrangements are probably overstating the quantitative assessments in support of their case (p. 74).<sup>21</sup>

Krueger (1999) reports larger welfare effects from more recent studies, which are based on models that include more of the dynamic gains. Davis, McKibbin and Stoeckel (2000) simulate the effects of a free trade area involving AFTA and CER, using the APG-cubed model (18 countries and 6 sectors). They allow for allocative-efficiency effects, terms-of-trade changes, capital accumulation for goods and services, and endogenous productivity. They find that a joint AFTA–CER FTA is likely to increase GDP by US\$25.6 billion in the case of AFTA and by US\$22.5 billion for CER.<sup>22</sup> These gains are nearly three times larger than those estimated by an earlier study, which excluded services liberalisation and productivity effects.

An important conclusion of the study is that if APEC proceeds on schedule, the additional gains from an AFTA–CER arrangement are likely to be relatively small. The gain to AFTA members of an FTA with CER falls to just over US\$10 billion and the gain to CER members falls to just under US\$2 billion. This is because total AFTA–CER trade is much smaller than the total of each group's trade with APEC, and because APEC is not a discriminatory agreement.

The authors identify a number of implications from these results. One is that some of the APEC gains could in fact be attributable to the AFTA–CER proposal if it encourages further liberalisation in APEC (p. 40). However, as the literature suggests, this preferential arrangement could have the opposite effect of slowing down APEC.

## Issues

Empirical evaluations of regional trading arrangements usually focus on the effects of tariff reduction (the study by Davis, McKibbin and Stoeckel is an important breakthrough as it includes the services sector) by large blocs. Implementation of the arrangements is usually assumed to be relatively 'clean'. The analytical work reviewed above did not have the complications of a large number of sectors, a variety of instruments and the presence of rules of origin. The proposals under consideration in East Asia do not match these conditions: they generally involve a number of bilateral and overlapping FTAs. Countries appear to be considering signing more than one agreement and when they do sign, or plan to sign, the coverage is not just restricted to tariffs.

How do these extra issues affect the consideration of the costs and benefits of regional trading arrangements?

### ***Hubs and spokes***

The consistent role of some key countries in the discussions, and the use of bilateral structures, highlight the relevance of earlier work on hub-and-spoke arrangements (for example, Snape 1996a; Wonnacott 1996; Snape, Adams and Morgan 1993; and Anderson and Snape 1994). Suppose there are three countries, A, B and C. Country A concludes separate agreements with B and C but B and C do not have an agreement with each other. Country A is the hub and B and C are the spokes. Lloyd (1996), using this example, points out that country A could be a regional trading arrangement. He also notes that the hub-and-spoke approach is 'more common than is generally realised', giving examples associated with the EU and EFTA (the European Free Trade Association).

Hub-and-spoke agreements do not provide equal access to all participants. Even if each spoke country removes tariffs, the spokes will still not have free access to each other's markets – access is only to the hub. In fact, as explained below, the extent of access is also likely to vary along each spoke. The differential treatment of spoke members can be a source of friction among the participants.

Snape (1996a) explains that there is an incentive to create tailor-made agreements to deal with products regarded as 'difficult' by the hub country. He also notes that small countries have incentives to join, especially as more and more countries sign up with the hub. The hub-and-spoke system can 'spread like a rash' (p. 61), in a process similar to that stressed by Baldwin for membership of preferential arrangements. The spoke countries may or may not have arrangements with each other.<sup>23</sup>

Wonnacott (1996) stresses the benefits to the hub country. It gains from preferential access to markets in each spoke, compared with all the other spokes, and from being able to source duty-free inputs from each spoke.

Other ways in which the hub country can gain is if investment is diverted away from each of the spokes. The favoured position of the hub makes it sensible for foreign investors to locate there to get access to not just to hub markets but also those of the spoke countries. Furthermore, a firm based in the hub is more likely to be able to obtain inputs at low or zero tariffs than firms based in one of the spokes – it can source from the hub and any of the spokes.

Wonnacott (1996) explains how the result might be an inefficient pattern of investment that remains even if the hub-and-spoke system evolves into an FTA.

Spokes lose because they do not gain from free trade with other spokes and because their firms are likely to be discriminated against in other spoke markets and are likely to have less ability to compete in all markets against firms based in the hub (Wonnacott 1996). A spoke country could respond to some of these problems in the following ways. It could, in principle, organise equivalent agreements with other spoke countries. The cost of doing so may be high, and the risk is that a series of such agreements negotiated one after the other could simply add to the layers of discrimination, as each pair deals with their own set of difficult issues.

All the spokes could consider forming a trade bloc. But the identity of the spokes is likely to be determined by pressures from interest groups in the hub economy. There is no guarantee that a group defined in this way can agree on how to deal with a now larger set of difficult issues. Another response could be for a spoke country to unilaterally cut tariffs to the rest of the world. Depending on the extent of this cut, such an initiative could offset the diversion of investment to the hub. The earlier agreement with the hub would then be part of a transition to free trade, but a more expensive and less preferable one than a giant leap.

Snape (1996a) discusses how the growth of hub-and-spoke mechanisms could lead to greater resistance to multilateral liberalisation. He argues that spoke countries pay a price for preferential market access to the hub country, in that producers of sensitive products will resist further MFN tariff reductions that could erode the value of their special deal with the hub.

For the same reason, the current spokes are likely to resist, if they are able, the admission of new members to the arrangement, as these members would diminish the value of their preferential access. All members of an FTA are likely to be involved in negotiations over accession, but in a hub-and-spoke arrangement, spoke countries may have little say over admission. At the very least, the trade policy of the hub becomes a point of potential conflict among current and prospective members of the arrangement.

If spokes do have some influence, they may seek to restrict the benefits new members can receive. This resistance may come not only from domestic interests in the spoke countries, but also from foreign firms that might have invested in a spoke country for the purpose of access to the hub. Those investors might even be originally from the hub country and therefore will not be without influence.



In summary, the hub-and-spoke structure contains many dangers. Large economies have a strong incentive to try to capture the role of a hub in an attempt to dominate a group of complementary economies in their region. Hub-and-spoke structures lead to layers of discrimination and to potential conflict. As Wonnacott points out, such agreements can affect foreign policy. A hub economy that is economically dominant would be seen as trying to boost its power by biasing trade to its advantage.

### ***Rules of origin***

In a trading regime dominated by free trade areas, including hub-and-spoke systems, rules of origin have become a key issue. In the hub-and-spoke system, trade deflection can occur when goods are bought in the hub country from the spoke with the lowest tariff. The establishment of rules of origin avoids tariff hopping in preferential arrangements.<sup>24</sup>

Free trade areas, unlike customs unions, do not remove border-crossing barriers such as customs procedures (Krueger 1995, p. 13). Businesses place a high priority on addressing these issues through trade reform, but the FTA route will not help them.

Krueger (1995) shows there is great scope to manipulate rules of origin to achieve degrees of trade diversion. By reference to NAFTA's experience, Krueger illustrates the level of detail that is required to describe rules of origin. Rules of origin can also distort input choices. As Krueger explains, there may be an incentive to procure inputs from a high-cost trading partner, or to do more of the value adding in that country, in order to meet the rules of origin of that partner and gain market access for a finished product.

Stephenson (1997) and Scollay (1997) have reviewed the rules of origin that exist in the Asia Pacific region. Stephenson uses a PECC (Pacific Economic Cooperation Council) survey to show that such rules have significantly restricted business in the region. Scollay compares the effect on welfare of different rules of origin and argues that relaxing the rules will be welfare enhancing provided the relaxation is extensive enough.<sup>25</sup>

As noted above, a desire for greater market access for services has been one of the reasons behind the recent interest in preferential arrangements. A question is how these arrangements might apply rules of origin to services.

This issue has not been studied widely, but some options can be suggested. Article V of the General Agreement on Trade in Services (GATS) stresses that a 'juridical person' of a party to the agreement can access the benefits of a preferential agreement so long as the party

‘engages in substantive business operations in the territory of the parties to such agreement’. The definition of a juridical person (that is, any legal entity such as a company) suggests such a person would have residency in a partner economy, with either majority ownership of the firm providing the service or ‘effective control’ over the firm. Negotiators involved in setting up the Free Trade Area of the Americas agreement are considering concepts such as ownership, control, residency and ‘substantial business activities’ to define origin for services (the Singapore–NZ free trade agreement refers to the last of these). Clearly, as in the case of goods, there is considerable scope for variation and inconsistency in treatment and, therefore, discrimination in the application of rules of origin for services.<sup>26</sup>

The FTA approach might be driven by different business groups seeking market access and wanting to either avoid problems of trade facilitation or create a higher degree of certainty in trade. The consequence, however, can be greater complexity and, in the end, higher costs for business. Conflicting rules of origin in both goods and services are a good example of that problem.

### ***Standards***

There is plenty of evidence that business gives a high priority to coordinated policy action to deal with the impediments to international business associated with standards and conformance issues. The DFAT’s Survey of Business Needs for Trade Facilitation (August 1999) noted that:

Concerns about standards issues attracted the highest number of individual comments, particularly the need for mutual recognition of approval processes for new products. 67% of companies [that is, of all respondents] were concerned about harmonising or more closely aligning standards in export markets, with 56% [of those commenting on standards issues] indicating this as a top priority for further standards work. 53% [of all respondents] had problems with transparency and consistency of requirements, which was a top standards priority for 25% [of those commenting on standards issues]. Business was also concerned about the cost of testing procedures, delays in testing authorisation and the need for multiple testing.

Systems of standards can make markets work better. When operated efficiently, they can lower the cost of doing business. The issue is to find the most efficient systems. There is

a further risk that systems for the design and testing of standards will be abused in order to limit the access of products from other countries. A large number of decisions need to be made in any cooperative approach to setting standards. These include:

- whether standards should be harmonised, shown mutual recognition or some other option;
- the manner in which standards will be specified (for example, product characteristics compared with performance);
- whether international standards have set a benchmark and the relevance of this benchmark to all members of an arrangement;
- how conformance can be established; and
- which level of government will set and monitor the standards.

Clearly, reaching an agreement to resolve these and other issues will be a challenge, especially if one country belongs to other agreements that because of the character of their members have taken different paths to resolving these issues. An agreement between only industrialised countries might have different preferences to one that involves a more diverse membership.

Countries need to decide how to assess conformity of a standard that applies to imports, otherwise the product or the capacity to provide a service has to be reassessed each time it crosses a border. Some type of agreement between countries is required to deal with standards issues, and standards are difficult to reform unilaterally. The risk of discrimination arises in the way these issues are resolved. For instance, decisions on conformity could become a new means of discriminating between sources of supply. This already occurs at a sectoral level through bilateral mutual-recognition agreements (PECC 1999).

## ***Services***

A desire to reduce impediments to services business has been another motivation for the use of a regional track. The WTO has a built-in agenda on services but progress has been slow.<sup>27</sup>

Stephenson (2000) has reviewed the treatment of services in five regional preferential arrangements:

- the ASEAN Framework Agreement on Services (1995);
- the Closer Economic Relations Agreement between Australia and New Zealand (1989);
- the Free Trade Agreement between Chile and Canada (1997);

- the Free Trade Agreement between Chile and Mexico (1997); and
- the North American Free Trade Agreement between Canada, Mexico and the United States (1994).

A review of these agreements highlights some of the issues that will be confronted in the bilateral arrangements now under discussion, and in the proposal to join AFTA and CER.

Stephenson identified two broad approaches to services liberalisation in these agreements, all of which were entered into during the 1990s. ASEAN's approach is based on that of the GATS (a positive-list approach), while the other four use the system first adopted in the CER (a negative-list approach).

She notes that neither process guarantees the full liberalisation of trade in services since exemptions can be taken out in the CER-type arrangements and some sectors are not listed in ASEAN's GATS-type agreement. While each approach may show a commitment to liberalisation, that commitment does not mean much without a time frame.

Stephenson also reviews the information and reporting requirements of each system. She notes that the negative-list approach provides a great deal of information on barriers to trade, whereas positive lists provide less detail. Greater information might be helpful for business planning and could be used to pressure for further policy change. She also stresses, however, that such comprehensiveness comes at a cost. A full negative list requires a lot of specification when significant impediments to business exist in a number of services sectors. Countries that have relatively open services sectors will find it easier to adopt a negative-list approach. This approach also has the benefit of automatically covering new activities.

A more immediate issue is how these different methods might be fused, or how differences of approach could be resolved in a preferential agreement. One strategy would be to follow the approach of the GATS; that is, for the negotiators to agree on which sectors will be covered and then for all countries to prepare their own negative lists for those sectors. The risk is a proliferation of lists, which would divert access in all modes of supply and therefore allocate rents created by restrictions on other suppliers.

It used to be thought that multilateral progress to drive down tariffs would mitigate the risks of preferential arrangements by reducing the extent of discrimination and its costs. The problem is that many mechanisms other than tariffs, including standards, anti-dumping rules and rules of origin, can deliver discrimination.<sup>28</sup> The tendencies for regionalism to lead to fragmentation in the trading system might be reduced through multilateral liberalisation. However, given the current dissatisfaction about multilateral processes, multilateral rules

followed by unilateral action might not be enough. Some further regional cooperation could help contain the spread of potentially harmful preferential arrangements.

Are there any guidelines that could help preferential arrangements to target new interests and goals while constraining discrimination and reducing the chance of capture by particular interests? Are there some principles that could direct preferential arrangements toward liberalisation? The principles in existence in the General Agreement on Tariffs and Trade (GATT) and the GATS are inadequate.

Within the GATT, Article XXIV specifies that members of a customs union or free trade area (or any interim agreement leading to these arrangements) should not impose 'higher or more restrictive' duties and 'other regulations of commerce' on trade with non-members. Furthermore, the article requires that 'duties and other restrictive regulations of commerce ... are eliminated on substantially all trade'. A definite timetable for implementation is supposed to be provided.<sup>29</sup>

The WTO bases its assessment of preferential arrangements that are notified to it on Article XXIV, but so far has been unable to reach a consensus on most of the nearly 200 notified arrangements.<sup>30</sup> What are the reasons behind this lack of consensus?

Crawford and Laird (2000) provide a detailed discussion of the problems Article XXIV creates and of some of the background papers prepared by the WTO Secretariat (1998). Examples of the problems, to name just a few, are:

- the interpretation of the term 'substantially all trade' (for example, does this relate to the share of trade or the coverage of sectors?);
- the definition of the term 'other regulations of commerce' (what regulations are covered?);
- the special treatment of developing countries; and
- the allowance for transition periods and different time frames for implementation.

Concerning services trade, Article V of the GATS says that groups of members can enter into an agreement to liberalise trade in services between or among themselves as long as it:

- has substantial sectoral coverage; and
- provides for the absence or elimination of substantially all discrimination between or among the parties in the sectors covered.

There is also a requirement that the agreement should not raise the 'overall' level of barriers to trade in services with non-members. Developing countries that are members of an agreement are given a more flexible timetable to meet the condition on sectoral coverage.

Again, there are questions about what is meant by substantial coverage. A footnote to Article V says that this requirement should be interpreted in terms of the number of sectors, the volume of trade affected and the modes of supply, and stresses that arrangements should not provide for the a priori exclusion of any mode of supply. Even if potential members are able to agree on the parameters of an agreement on services, the lack of data on trade and investment in services will make it difficult to implement.

Snape (1996a) notes further that even if, for example, the conditions of the GATT are met, it could still be possible for a network of preferential arrangements to emerge that 'would harm the development of a truly multilateral and open trading system' (p. 60). These arrangements could set out to be discriminatory, he suggests. Even if formal barriers to trade do fall, the inclusion of administrative arrangements of the type discussed above could increase distortions.

There are therefore problems at two levels: first, the lack of clarity in the rules on preferential arrangements in the GATT and the GATS; and, second, the relevance these rules have to resolving the problems raised by the overlapping or hub-and-spoke structures of new or potential preferential arrangements.

There have been suggestions for guidelines to deal with these issues. For example, a proposal in Snape, Adams and Morgan (1993), and repeated in Snape (1996a), is that a regional preferential trade agreement would be more likely to promote multilateral liberalisation if it involved four conditions:

1. the full liberalisation of trade at least in all products if not also in all productive factors;
2. no raising of external barriers to trade and investment on or after formation, and a willingness and capacity to negotiate the reduction of barriers;
3. openness to new members on conditions similar to those faced by existing members; and
4. homogeneous rules of origin and dispute-settlement procedures.

The first of these conditions, if rewritten today, would probably refer to services as well as goods. The second condition on reducing external barriers is important to mitigate the diversion of trade and investment.

The results of Andriamananjara (1999) referred to above highlight the significance of the second and third items. In his model a binding to apply open membership, followed by sequential decision-making, can lead to free trade. In the presence of the simultaneous creation of trading blocs, there will be incentives to merge blocs and that process will continue

toward free trade as long as inter-bloc tariffs are low enough. As Andriamananjara points out, preferential integration can lead to free trade if it takes place alongside or after multilateral liberalisation so that the general level of MFN tariffs is low.<sup>31</sup> Although these results are based on a model with one industry, they highlight the value of these principles as a guide for preferential arrangements.

The fourth item on rules of origin is important in the light of the comments above. The authors did not define 'homogeneous'. Crawford and Laird (2000) stress that at present there are no WTO disciplines on rules of origin. A single set of such rules could be drawn up, which any preferential agreement could adopt and which non-members could refer to if they wished to make a complaint. The first step could be a review of existing rules of origin and their scope for abuse.

### ***APEC's contribution***

Preferential trade arrangements can build in mechanisms for peer review (that is, from non-members). Within the Asia Pacific, the APEC forum is the obvious location for such a process, and that work has begun. The APEC ministers meeting in Darwin in June 2000 stated: 'we believe that sub-regional trading arrangements should be consistent with WTO rules. We believe they should be in line with APEC architecture and supportive of APEC goals and principles'. They noted the proposal by APEC officials to survey existing arrangements.

The APEC architecture to which the ministers referred does have something to say about sub-regional arrangements. APEC's Osaka Action Agenda mentions accession to such arrangements. With respect to tariff and non-tariff barriers, it proposes that all members 'consider extending, on a voluntary basis, to all APEC economies the benefits of reductions and eliminations of measures derived from sub-regional arrangements'. APEC's long-term goal is free and open trade and investment by 2010 for industrialised economies and 2020 for developing economies. These long-term commitments across the wide scope of the APEC agenda would undo any discrimination by sub-regional arrangements. This effect is stressed in the new AFTA-CER study outlined above.

A more immediate opportunity for APEC is the scope to diminish the incentives for a preferential approach by increasing confidence in the prospects for multilateralism through its programs of liberalisation, trade facilitation and capacity building.

The consultations APEC promotes can help reduce concerns about preferential arrangements. It is a forum where discussion can be raised about the trade- and investment-diverting

effects of such arrangements. It could also provide a mechanism for members to review preferential arrangements and for encouraging members involved in preferential arrangements to apply APEC principles such as open accession and a commitment to MFN tariff reductions.

## **Conclusion**

Suppose a country's trading partners propose a new free trade area, or an extension of an existing area? What is the appropriate response? The net welfare effects on the country that is invited to join are uncertain because of the presence of offsetting costs and benefits. There are, however, powerful forces encouraging membership, especially in the context of the current lack of progress at the multilateral level.

A positive response to an invitation might also create other opportunities. Participation provides information on the proposal and allows new members to present views – for example, on the trade-diverting effects of existing or potential arrangements. In other words, rather than just lining up to join the 'neighbourhood street gang', it might be possible to influence it in a responsible way. Overall, it makes sense not to reject such an overture.

The problem is that tactical participation requires careful risk management and a clear purpose. As this paper illustrated, participation might be misinterpreted, or even captured, by domestic interests. The range of instruments available for discrimination includes not only tariffs but also rules of origin, standards and anti-dumping rules. Interest groups have an incentive to get involved in the negotiating process, in order to capture the rents that might become available, and can establish expectations that lead to particular investment decisions and to the proliferation of preferential arrangements. The signal those groups receive will depend on:

- a) whether the long-term policy goals are clearly and coherently presented and explained;
- b) whether the criteria adopted for evaluating proposed preferential arrangements (both domestically and internationally) is credible (criteria based on objectives of economic efficiency would be the most credible);
- c) whether there are mechanisms that will allow transparent reviews and reporting of initiatives within the group, so that the outcomes can be checked against the criteria; and



- d) the extent of global and regional international cooperation to reduce the risk of the narrow preferential arrangements that could stall the multilateral process.

In summary, the final outcome, and the likelihood of liberalisation in the long run, depends on the expectations that domestic policymakers establish for interest groups and investors. A clear framework for establishing those expectations is required, otherwise the surge of interest in regionalism will be insidious indeed.

## Notes

- 1 Earlier versions of this paper were presented at an international conference on The Trade and Monetary System in the Asia Pacific Region, held at Kobe University on 3–4 February 2001, and at the 2000 APEC Economic Outlook Symposium, held in Manila, the Philippines, on 24–25 July 2000.
- 2 Attributed by Crawford and Laird (2000) to a remark made by Alan Winters at a seminar in mid-1999.
- 3 Data on notifications are taken from WTO (1999).
- 4 Crawford and Laird (2000) report a higher number of 102 notified arrangements still in force at the end of 1998. They break this down into 78 goods agreements notified under Article XXIV, 13 goods agreements notified under the enabling clause and 11 agreements covering services trade notified under the General Agreement on Trade in Services (GATS).
- 5 In addition there are a number of sub-regional cooperative arrangements in the region. See Pomfret (1996).
- 6 Details are available at <<http://www.sice.oas.org>>.
- 7 Vousden (1990, section 10.2) reviews the literature on models with three goods. These studies highlight how the welfare effects depend on the level of tariffs before the union and on the degree of substitutability or complementarity between goods produced inside a customs union and those produced outside. The traditional notion of trade diversion assumes substitutability.
- 8 Vousden (1990) shows how a small member of a customs union can achieve a terms-of-trade gain by diverting its trade away from a large non-member country that is a price setter and imposes tariffs on its imports (or when exporting to that country incurs transport costs).
- 9 This result is derived in a model with only one good (a partial-equilibrium model). Each country treats the others in the same way and all the arrangements are the same; that is, a move to a zero tariff on imports from partners. The issue of sensitive sectors is ignored. And, as Freund (2000a) points out, there are costs associated with having a series of bilateral agreements, such as dealing with complex rules of origin.

- Another risk is that cooperation could impede the signing of new bilateral agreements and stop the process before free trade is reached.
- 10 Krishna (1998) reports the same result. Levy (1997) also finds a similar result, showing that the option of trade bloc can prevent a previously feasible multilateral agreement, but in a model in which policy is determined by the preferences of the median voter with a differentiated, monopolistically competitive good. The median voter blocks the interests of the average citizen. This outcome is more likely to be observed when the free trade agreement is between countries with similar factor endowments. Panagariya (2000) reviews this model in detail (pp. 319–22).
  - 11 This result also depends on the sequence of events. Freund (2000a) points out that models such as Krishna's consider the movement to free trade through either a multilateral reduction in tariffs or the expansion of an agreement among a smaller group. These agreements affect profits in a larger number of markets. In contrast, in her model the focus is on the gains from signing a new bilateral agreement.
  - 12 In Baldwin's model the outcome is global free trade, whereas Andriamananjara identifies how the interests of incumbents might stop the growth of membership before that point.
  - 13 Remarks by Takeo Hiranuma, 'Challenges of a new age', Singapore, 9 October 2000 (available from <http://www.meti.go.jp/english/report/data/gJ-SFTA1-1e.html>).
  - 14 Gandal and Shy find that the excluded country maximises consumer surplus by continuing to recognise all brands.
  - 15 There might also be network effects associated with products to which standards are applied. When direct network effects exist, the value of the product increases with the number of consumers who use a compatible product. Gandal and Shy also show that when these effects are significant, the incentive to form a standards union disappears.
  - 16 In some models, the success of multilateralism adds to the demand for a preferential approach. Freund (2000b) shows that by lowering tariffs multilateral rounds can increase incentives to pursue preferential reform.
  - 17 Noland (2000) provides more discussion of Japan's interest in these strategies.
  - 18 It was not possible to isolate entrepot trade in these data. In other words, one source of growth of within-group imports could be the provision of trading services by members of a group to other members (for example, Singapore to other AFTA members).
  - 19 If the EU is defined as including the EFTA members, this share rises to 65 per cent.
  - 20 Panagariya (2000) stresses that changes in aggregate trade flows are not sufficient to gauge the welfare effects of preferential arrangements.
  - 21 Panagariya (2000) identifies a number of problems in the modelling approaches. Appendix C of the Angkor Agenda (available from [http://www.aseansec.org/aem/angkor\\_agenda.pdf](http://www.aseansec.org/aem/angkor_agenda.pdf)) lists a number of other relevant empirical papers.
  - 22 The real consumption gain if the ability to shift spending through time is allowed is 1 per cent by 2005 for AFTA and 0.6 per cent for CER.

- 23 International air transport provides a simple one-sector illustration of this process by showing how the hub-and-spoke approach pursued by the United States puts spoke countries at a disadvantage. See Findlay (1997).
- 24 The WTO (1998) reviews the various types of rules of origin used in preferential arrangements, including a change in tariff heading, a value-added rule or a technical test (for example, concerning production processes).
- 25 As Scollay explains, it is possible that very tight rules will drive trade to zero so that no diversion occurs. From this point, relaxing the rules a little could induce trade and might actually reduce welfare. Further relaxation makes it more likely that the costs of diversion will be reduced. The exception is when the exporting industry is far from being internationally competitive.
- 26 More detail on the rules concerning the denial of benefits in services agreements in the Western Hemisphere is available from the trade unit of the Organisation of American States at <[http://www.sice.oas.org/cp\\_serv/english/sve1\\_21.asp](http://www.sice.oas.org/cp_serv/english/sve1_21.asp)>.
- 27 *Bridges Weekly Trade News Digest*, Vol. 4, No. 47, 12 December 2000.
- 28 Snape (1996b) has argued that far from being yesterday's problem, the question of discrimination in the trading system has considerable relevance.
- 29 There is also scope to apply tariff preferences on a much more limited range of products under GATT's so-called enabling clause. These agreements also do not require the elimination of duties, have no fixed timetables and are not subject to periodic reporting. See Laird (1999).
- 30 According to the GATT Analytical Index (1995), p. 817: 'the examination of agreements notified under Article XXIV:7 has almost never led to a unanimous conclusion or a specific endorsement by the CONTRACTING PARTIES that all the legal requirements of Article XXIV had been met and that the parties to the agreement in question could claim the benefits of Article XXIV. The exceptions are the customs union between the Czech Republic and the Slovak Republic; the Caribbean Community and Common Market (CARICOM); the Caribbean Free Trade Agreement; and the El Salvador–Nicaragua Free Trade Area and the Participation of Nicaragua in the Central American Free Trade Area. In the case of the Ireland–United Kingdom Free Trade Agreement the conclusions stated that no recommendations were being made under Article XXIV:7'.
- 31 Air transport was used above as a simple illustration of the consequences of the hub-and-spoke approach to reform. A solution of an 'open club' model has been proposed for that sector, whereby a preferential agreement would allow accession by any other country. Elek et al. (1999) present the details of that proposal, which was supported by the Australian Productivity Commission (1998). The same sorts of accession rules are being considered within APEC as a device for managing what might otherwise be the discriminatory effects of agreements on trade facilitation (for example, on customs clearance or business mobility).
- 32 The contents of this appendix do not cover all the work in progress on FTAs involving APEC members but only list the arrangements that have been completed or where commitments to negotiations have been made. Other bilateral arrangements are being discussed or are about to begin, including those between Australia and Japan,

Australia and Korea, Australia and the United States, and Singapore and Canada (see [http://www.mti.gov.sg/public/economgmt/public\\_docs/canada/canfta1.cfm](http://www.mti.gov.sg/public/economgmt/public_docs/canada/canfta1.cfm)). There also examples of FTAs involving an APEC member and a non-member such as the Mexico–Europe agreement, which appears to be having significant effect on strategy in other APEC members (for example, see Keidanren 2000).

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## **Appendix: Negotiations or studies into preferential trading arrangements involving APEC economies<sup>32</sup>**

**AFTA–CER:** The High Level Task Force was established in 1999 to look into the feasibility of a free trade area between AFTA and CER. The task force, which is chaired by Cesar Virata, a former prime minister of the Philippines, consists of a group of former senior political figures, academics and senior officials from ASEAN, Australia and New Zealand. The group made recommendations for consideration by government ministers in ASEAN and CER on whether and if so how to proceed with an AFTA–CER arrangement. The Angkor Agenda (available from <[http://www.aseansec.org/aem/angkor\\_agenda.pdf](http://www.aseansec.org/aem/angkor_agenda.pdf)>) was presented by the group to the ASEAN Economic Ministers and the Ministers from the CER countries at a meeting in Chiang Mai, Thailand, on 6 October 2000. The following decisions were made (taken from <[http://www.aseansec.org/aem/jps\\_aemcer.htm](http://www.aseansec.org/aem/jps_aemcer.htm)>):

6. The Ministers acknowledged that enhanced AFTA–CER relations would strengthen the international bargaining position of both regions and send a positive signal to investors of both regions' commitment to continuing liberalisation. The Ministers noted the emerging challenges posed by globalisation, the proliferation of regional trading arrangements around the world and competition from other countries and regions. The Ministers were of the view that there was a need to work on the recommendations of the Task Force to sustain the momentum that has been generated by its report.

7. In line with this objective, Ministers agreed to work towards a Closer Economic Partnership (CEP) which takes into account relevant recommendations of the Report and other issues relevant to the closer integration of ASEAN–CER countries.

8. They, therefore, agreed that:

- a) Senior Officials shall elaborate on the potentials and parameters of the CEP taking into account relevant recommendations of the Task Force, beginning next year;
- b) In their discussions, particular attention should be placed on development assistance in the form of technical assistance and capacity-building measures to ASEAN members in areas that have been proposed by the Task Force representatives from the New Members of ASEAN;



- c) Capacity-building initiatives be undertaken on a number of items of export interest to ASEAN Members given some current trade issues concerning non-tariff barriers such as SPS and technical barriers to trade;
- d) Senior Officials shall report on the outcome of their work to the 6th AEM-CER consultations in the year 2001;
- e) The ASEAN Secretariat be tasked to coordinate such work.

Therefore, according to this report, the work will be taken forward by APEC officials. The extent of the political commitment within ASEAN to the proposals remains uncertain, however, reflecting the sensitivity of some sectors including autos. A press release by Australian Trade Minister Mark Vaile, on 6 October 2000, stressed that the work had moved from a non-governmental process to the government-to-government level (available from <http://www.dfat.gov.au/media/releases/trade/2000/index.html>).

The task force proposed that:

- a new arrangement would be separate from either AFTA or CER, both of which would continue to exist;
- the new agreement would be comprehensive;
- its program of liberalisation would be not normally be faster than AFTA (which has committed to achieving zero tariffs by 2010 for the ASEAN-6 and by 2015 for the four newer members);
- the new agreement would have a faster program of liberalisation than APEC;
- the joint arrangement would be open to discussing new issues; for example, e-commerce, but in these cases members of either group could decide to exclude themselves temporarily;
- the timetable would be more flexible for newer ASEAN members; and
- the joint agreement would be open to accession by others.

**Australia-Singapore:** Australia and Singapore have agreed to begin negotiations on an FTA between the two countries. In a press conference with Singapore's prime minister, Goh Chok Tong, on 15 November 2000, Australia's prime minister, John Howard, said:

The Prime Minister of Singapore and I have just completed our discussions and we have agreed to immediately begin negotiations for a Free Trade Agreement between Australia and Singapore. We will aim to put everything in the agreement. We see it as an ambitious attempt to open trade between two countries that are very close economically, politically and



socially. It is worth remembering that there are more overseas students from Singapore in Australia than from any other source and the association between our two countries go back a very long way. We have set ourselves a deadline of completing it a year from now. We don't want the negotiations to be interminable and we think by the time of the next APEC meeting which will be in Beijing next year will be a timely opportunity, perhaps even to sign the agreement and we both take the view that although the ideal trade route is through the multilateral fora, the ideal trade route here in our part of the world is to make certain that the APEC countries continue to move towards the Bogor goals both in relation to 2010 and 2020. There is no reason why along the way if you have a free trade opportunity between two or more countries then you shouldn't take hold and Singapore and Australia have very similar views on this issue and the fact that we have been able to reach very quick agreement on this is evidence of the good relations that have always existed between our two countries. (From <<http://www.pm.gov.au/news/interviews/2000/interview543.htm>>)

**Japan–Canada:** Japan's Ministry of Trade and Industry has commissioned a study of the options for bilateral cooperation between Canada and Japan (Dobson, 1999). The Canada–Japan Trade Council also produced such a study (Holroyd 2000). Canada's relations with the United States, including the possibility of a common external tariff or common currency, motivated Japanese interest in a free trade agreement. Canada hopes that an FTA with Japan might maintain market access in East Asia if that region pursues its own bloc. Cooperation is also aimed at addressing issues related to sensitive sectors, such as the auto and machinery industries in Canada and fishing interests in Japan (see a column by John Wiebe in Toronto's *The Globe and Mail*, 19 April 2000). In a report on the relationship for the Canada Japan Business Conference, Hart (2000) argued that 'a conventional free trade agreement is not best suited to tackling the issues that stand in the way of increased bilateral trade and investment. Rather ... free trade makes more sense as the ultimate objective of a more focused and creative strategy that includes, as an important short-term goal, the development of greater confidence in the two business communities that freer trade can make a real and sustainable difference' (p. iii). Canadian business groups (see <[www.bcni.com/presentations/may15-00.pdf](http://www.bcni.com/presentations/may15-00.pdf)>) have made the same point.

**Korea–Chile:** Negotiations between Korea and Chile on a free trade agreement are in progress. Sensitive issues include Chilean exports of agricultural products. Cheong (1999) reviews Korea's position and identifies some sensitive sectors. 'In order to successfully

prepare for the signing of FTAs, the Ministry of Foreign Affairs and Trade [of Korea] has organised and is running five working groups and 14 sub-groups consisting of some 120 officials and experts from 15 ministries, 10 research centers, business firms and other organisations' (from a Ministry of Foreign Affairs and Trade press release, 12 April 2000, available at <<http://www.mofat.go.kr/main/etop.html>>. The fourth round of Korea–Chile negotiations was held in December 2000. There are four working groups on market access, services and investment, rules of origin and other issues including government procurement and competition policy.

**Korea–Japan:** During a visit in March 1999 by Japan's prime minister, Keizo Obuchi, to Korea, it was proposed to establish the Japan–Korea Economic Agenda 21, the coverage of which appeared to be a new investment treaty, a new tax treaty, cooperation in standards and conformance, an agreement to work on intellectual property issues and further talks leading up to the WTO ministerial meeting in Seattle. The broad goal of this program was to 'solidify [the] bilateral economic partnership'. This agenda was interpreted and extended, apparently on their own initiative, by research groups in Korea and Japan to include an examination of the feasibility of a bilateral FTA. The model studied by these groups is comprehensive, including not just tariffs but also rules and standards, investment, and other trade facilitation matters. The research completed so far is summarised in a collection of papers prepared by the Korean Institute for Economic Policy, Japan's Institute of Developing Economies and the Japan External Trade Organisation for a symposium entitled 'Toward a Korea–Japan FTA: Assessments and Prospects', held in Seoul on 24 May 2000 (also see <[www.kiep.go.kr](http://www.kiep.go.kr)>). In September 2000 the two countries adopted the South Korea–Japan IT Cooperation Initiative. The meeting in which that agreement was adopted also set up a Korea–Japan business forum to collect opinions on an FTA. There has also been some reporting of a separate 'investment pact' between Japan and Korea, which was originally planned for completion in 2000. The e-journal *Comparative Connections*, available at <<http://www.csis.org/pacfor/ccejournal.html>>, provides a history of bilateral relations.

**Singapore–Japan:** In December 1999 Prime Minister Goh Chok Tong made a proposal, which was accepted by Japan, to study and negotiate an agreement on trade facilitation and service-sector liberalisation. A report by a joint study group was released in September 2000 (the Japan–Singapore Economic Agreement for a New Age Partnership, available at <<http://>

[www.mofa.go.jp/region/asia-paci/singapore/index.html](http://www.mofa.go.jp/region/asia-paci/singapore/index.html)). The first round of negotiations started in January 2001 and is targeted for completion by the end of the year. The negotiations are reported to focus on goods, services, investment and the movement of people. Paragraph 9 of the report indicated that Japan 'was not prepared for further tariff reduction in [agricultural, forestry and fishery] sectors' and made reference to the issue of meeting the WTO condition that RTAs should cover substantially all trade. Hope was expressed that this issue could be resolved during any subsequent negotiations. Keidanren, the Japanese business group, issued a paper in October 2000 on 'Expectations for the Japan–Singapore Free Trade Agreement', in which it strongly supported the start of negotiations but stressed the importance of Japan making strong commitments to liberalisation and to other regulatory reforms (available from <http://www.keidanren.or.jp/english/policy/2000/049.html>).

**Singapore–Mexico:** Singapore and Mexico first discussed the idea of forming an FTA during the APEC Leaders Meeting in Auckland in September 1999. Negotiations for an FTA began in July 2000 and officials have met four times (see <http://www.gov.sg/sgip/Announce/mexico-sg.htm>). A joint declaration signed in November 2000 detailed what had been agreed so far and what still needed to be done. It had been hoped that the negotiations would have been completed by this time, but progress has been slower than expected. Prime Minister Goh and President Zedillo were quoted as saying that 'both countries said they had made progress in discussions focusing on the trade in goods, services, investment and government procurement'. It was planned that the accord would include a dispute-settlement mechanism, but the countries' leaders stated that because the free trade agreement (FTA) seeks to be comprehensive, 'it will be important to build consensus on these issues'. Both governments pledged to conclude the negotiations 'as soon as possible'.

**Singapore–New Zealand:** An FTA was agreed in September 1999. It is designed on the blueprint of the Australia–New Zealand Closer Economic Relations Agreement (CER), but the agreement is viewed as open for participation from other economies. The agreement was signed on 14 November 2000, just before the APEC Leaders Meeting in Brunei. The text of the agreement is available at <http://www.mft.govt.nz/foreign/regions/singapep.html>. The agreement covers goods (including tariffs and non-tariff barriers), services, investment, customs procedures, standards, government procurement, intellectual property and dispute settlement. The rule of origin for goods requires a 40 per cent ex-factory cost threshold for

goods partly manufactured in either economy, plus a requirement that the last manufacturing process is performed in the exporting economy. The rule for services refers to the presence of substantive business operations in either economy. Anti-dumping provisions are retained. There is, however, an explicit commitment to work toward adopting the APEC Principles to Enhance Competition and Regulatory Reform.

**Singapore–US:** The second round of negotiations on a Singapore–US FTA was held in January 2001. The first round in December was followed by a US fact-finding mission to Singapore in January. The visit covered competition policy, textiles, customs enforcement and labour market issues. The new US administration is to decide when the third round will start. The current commitment is to establish an FTA that covers substantially all trade, but issues that had previously been described as divisive, such as labour standards and the environment, might be treated differently by the new US government. For further information see: <<http://business-times.asia1.com.sg/5/news/nsing07.html>> and <[http://www.mti.gov.sg/public/infocentre/article\\_notif\\_index.cfm?ID=358](http://www.mti.gov.sg/public/infocentre/article_notif_index.cfm?ID=358)>.

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