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in the Asia Pacific**

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TRADING WITH FAVOURITES: FREE TRADE AGREEMENTS IN THE ASIA PACIFIC

Even a year or two ago, observers could have been relatively sanguine about the boom of interest in free trade agreements (FTAs). Progress was much slower than people originally expected, and negotiations seemed to drag on without agreement being reached. That situation has now changed. The large economies – not just the United States but also China, Japan and South Korea – are pursuing FTAs. Motivations apparently include their contribution to domestic and international political targets, the mobilisation of reform and dealing with new types of impediments in order to intensify trade flows in the region. ASEAN members are also actively involved but there are doubts about ASEAN's capacity to reach a consensus on trade policy issues. While its members might hope otherwise, a hub-and-spoke outcome in which ASEAN members make up the spokes, and not the hub, is a plausible scenario, and one of the worst in terms of a regional trading regime. We therefore argue the case for the application of a new set of principles to provide a framework for risk management, including progress in the World Trade Organization (WTO) on liberalisation, new WTO rules on regional agreements, higher levels of transparency, and more work on other forms of agreement to facilitate trade. Overall, multilateralisation of preferential tariff reductions should be the main benchmark in any new set of principles for risk management in the tactic of trading with favourites.

Introduction

Bilateral and regional agreements – often referred to broadly as regional trading arrangements (RTAs) – have proliferated in East Asia in recent years. In this paper, we examine the motivations for countries to enter into such arrangements, identify the risks involved, analyse the significance of the risks and argue the case for the application of a new set of principles for risk management.

The arrangements for RTAs usually include two distinct elements. One concerns liberalisation – the traditional free trade agreement (FTA), in which parties to an agreement remove cross-border barriers to trade and investment on a preferential basis. The other concerns cooperation to facilitate trade and investment by removing various non-tariff and other administrative barriers. In this paper, we focus on liberalisation, because this is the area where

most of the risks or downsides of RTAs can be found. By definition, the FTA component of RTAs does not actually create free trade in terms of market access on most favoured nation (MFN) terms; instead, it provides a system of access on preferential terms. In essence, it promotes a regime of trading with favourites.

Recent proliferation of RTAs in the Asia Pacific region

In the East Asian region, interest in negotiating trading arrangements among small groups of economies has been led by shifts in attitude by some of the richer countries of the region. For example, Japan and Singapore have concluded an economic partnership agreement; Singapore has negotiated agreements with New Zealand and Australia; and Australia is currently negotiating an agreement with the United States. Hong Kong and Chinese Taipei have also examined options for FTAs.

More recently, there has been a surge of interest in FTAs among other members of ASEAN and by China. At the end of 2001, China and ASEAN reached agreement on a framework to establish an FTA and on a tariff elimination program which includes agricultural products in the so-called 'early harvest component' of the agreement, in which some products would be accepted under the agreement in advance of agreement on its whole coverage. This development is interesting not only because of the developing-economy character of the participants, but also because China initially began with ASEAN rather than pursuing bilateral arrangements and because the negotiators adopted a comprehensive approach from the outset. China has also signed an economic partnership agreement with Hong Kong.

Not to be outdone by China, the other major trading partners of ASEAN have also proposed initiatives for regional cooperation. For example, Japan has stepped up its expressions of interest in agreements with ASEAN members.¹ Japan is still pursuing an FTA with ASEAN as a whole, but is now giving higher priority to bilateral FTAs with individual ASEAN countries.

The United States is also showing interest in FTAs with ASEAN countries. In the APEC meetings in Los Cabos in 2002, President Bush announced the 'Enterprise for ASEAN' initiative, in which the United States and individual ASEAN members will together determine if they are ready to launch FTA negotiations. The United States expects a potential FTA partner to already be a member of the World Trade Organization (WTO) and to have concluded a trade and investment framework agreement (TIFA) with the United States (already in place for Indonesia, the Philippines, Brunei and Thailand). The United States reached agreement on an FTA with

Singapore on 19 November 2002 and with Chile on 11 December 2002.² The United States is likely to also pursue bilateral agreements with other individual ASEAN countries.

Other large countries and groups are also showing interest. India is currently negotiating a framework agreement for an FTA with ASEAN. This would be along the same lines as the agreement with China, although the sectoral coverage is expected to be less comprehensive. The European Union (EU) has approached ASEAN on the possibility of regional cooperation; it is not clear what form any agreement will take, but it is clear that the EU intends to deal with ASEAN as a group rather than with individual members bilaterally.

Individual ASEAN members are also negotiating bilaterally with trading partners. The initiatives of Singapore have been noted. Thailand is following Singapore's lead and is aggressively pursuing a parallel bilateral approach. Malaysia, in a significant shift in policy, has started talks with Japan. Many other countries in the Asia Pacific region are also involved or have just concluded agreements, including Mexico, Chile, Canada and South Korea.

Motivations for entering FTAs

Countries expect to gain from their participation in FTAs, although it is hard to determine empirically the net outcome of various effects on national economic welfare.³ Countries' motivations clearly have a considerable political component, including responding to domestic pressures and pursuing ambitions in international relationships. In particular, different decision makers may give different relative weights to overall national interest and the more specific political gains from accession.⁴

General considerations

When people analyse the gains of participation in FTAs, they often focus on gains and losses associated with the impact on import-competing sectors. Gains to a member's exporters from the application of a preferential tariff by a trading partner are also important. They can be predicted with more confidence than the net welfare effects, and exporters are important drivers in the domestic political economy of all the participants. As explained again below, their role in these agreements also affects the prospects for progress on the WTO agenda.

Non-members are affected via their terms of trade.⁵ Some empirical work suggests that such effects may be relatively small, especially when players are relatively small actors in the

relevant markets.⁶ However, there is a recent trend for small economies to sign FTAs. Whether non-members are large or small, they tend to react to FTAs by their larger trading partners. Either they want to join to ameliorate those effects or they want to sign their own agreements to try to generate their own terms of trade effects. 'We can't afford to stand still', they will say.

Proponents of the FTA route to reform might argue that the economies involved are not acting in a way which contradicts regional cooperation and that, in some special circumstances, the process might lead to free trade as more and more preferences are exchanged until the entire world is a member of the same agreement. Some proponents go further and seek to use preferential agreements in an offensive manner, hoping to stimulate non-members to develop their own proposals or accede to requests to negotiate in order to avoid the losses from discrimination. For example, Edmund L. Andrews⁷ commented on the US approach as follows:

Mr. Zoellick's strategy is based on what he calls 'competitive liberalization,' the idea that a bilateral trade agreement with one country puts pressure on others to seek their own deals with the United States.

Proponents of the FTA route might also say that the multilateral institutions are not delivering market access rapidly enough, and that the region should become – and in fact is already becoming – more self-reliant. This is especially important as the sources of growth that might be expected from developed economies in the rest of the world diminish. Furthermore, after its experience in the financial crisis, the region is seeking its own identity and greater self-reliance through a regional financial architecture. A new set of trading arrangements within East Asia can contribute to both objectives, it might be argued.

Political economy

We have already noted that elements of the domestic political economy and the role of export interests may motivate countries to pursue the FTA route to reform. FTAs are easier to sell at home than is MFN liberalisation.

The benefits of MFN reform are more diffuse than those of bilateral arrangements, which are more specific and concrete and whose political costs are easier to manage.⁸ This was always the case, but until recently politicians understood the risks in terms of longer-term interests (retaliation leading to a final position in which their economy could be worse off). Their choice on this trade-off appears to have shifted; perhaps the parameters have been forgotten by the current generation of policymakers or perhaps people are making a different assessment of the

costs of the outcome which is not preferred. In particular, people may make an assessment that the intensity of regional trade is increasing and that the growth of trade indicates not that impediments to intra-regional trade are diminishing but that more could be done locally to remove remaining impediments and let trade grow even faster. While the data may indicate that intra-regional trade is growing rapidly, the phenomenon may be the result of the growth of cross-border transactions along the supply chain rather than a shift away from the fundamental reliance on global markets.

Even if people believe that FTAs can contribute to important policy goals, is the preferential route the best way to obtain them? For example, some people see tariff impediments as important, but may also be motivated by the aim to fix elements of the so-called 'new age agreements', such as various types of non-tariff barriers. Some of these non-tariff barriers – systems of standards, rules on movement of people and payment of taxation on income from foreign investment, for example – require explicit cooperation between pairs of economies in order to introduce new arrangements. An FTA could include such negotiations but a trade and investment facilitation agreement or TIFA⁹ may also be proposed.

Especially important are the various forms of contingent protection. Policymakers hope that these will apply less vigorously to those with whom they have negotiated FTAs. It will be interesting to see whether such hopes will be fulfilled. Will such economies be less likely to apply those measures against trading partners with whom they have FTAs?

Mobilising domestic reform is another important factor for proponents of an FTA. This is particularly the case in Japan, where FTA proponents argue that international commitments are required to shift the most difficult issues on the domestic agenda. However, it is not clear that a preferential agreement generates enough 'grunt' to shift the resistance. Negotiations often appear to get stuck on issues which have relatively little impact on the whole economy but which matter in the domestic political economy.

Security

There are important two-way connections between deeper economic relationships and a lower risk of conflict. But will FTAs actually add to the stock of security-creating political assets in the region? And even if they do, could other forms of cooperation, including economic cooperation based on MFN principles, be more effective without the same risks? It is important to assess the alternatives. In any case, it is not clear that structures which embed favouritism and which

force economies to choose their partners make the region less likely to risk the sorts of disputes which could lead to conflicts.

A specific issue in the application of this route to reform is the treatment of Chinese Taipei. A multilateral approach to the design of trade policy provides a formula for the inclusion of Chinese Taipei for its own benefit as well as for the benefit of the rest of the region. But few economies would sign preferential trade arrangements with Chinese Taipei. The risk of the FTA route is therefore a higher degree of economic isolation of Chinese Taipei. What are the implications of that position? How would it affect the risks of conflict in the region?

Given the extent of activity on FTA-related agreements in East Asia, it was inevitable that the United States would start taking a stronger interest in the region. The United States has its own market access ambitions and will try to avoid suffering from discrimination. An example is its decisive move in Los Cabos to set up an initiative on ASEAN. The timing of this move might also have been prompted by the development of the US security agenda, which is another illustration of the linkages between economic and political motivations in the FTA agenda.

The design of the anti-terrorist agenda perhaps strengthens the US interest in the negotiation of FTAs with Southeast Asia. The implementation of that agenda is likely to be more demanding than current forms of cooperation over security, because of its domestic dimensions. It is not just a matter of defence cooperation on matters which apply between economies – sea-lane security, for instance, or joint defence exercises. Rather, cooperation demands joint activity within the border in ways which will affect the domestic community. FTAs can help tie commitments to economic cooperation with more stressful cooperation on security issues. At the same time, an FTA with a large economy offers substantial rents to the trading partner as a reward for cooperation.

The problem in this linkage is that, in an environment in which favourites have been selected, anti-terrorist programs could add new dimensions of discrimination to economic relationships. The extent of this discrimination – and its contribution to the perception of there being different clubs of economies divided by culture, religion or stage of development – has long run consequences that undermine the main security agenda. Facilitation arrangements that remain open and that include capacity-building components are valuable in order to avoid this consequence.

Risks

In this section, we examine some risks of entering into FTAs. A theme is that the tactic of favouritism appears to contradict the strategy of cooperation. Some commentators argue that cooperation will prevail in East Asia because of gains from consolidating bilateral agreements and having greater bargaining power with blocs in the rest of the world. This recognition of the value of work to consolidate the agreements will be intensified by progress on the Free Trade Area of the Americas (FTAA) negotiations, for example. We offer more comments on the hypothesis of consolidation below.

Resource allocation

The first risk concerns the effects of favouritism on the efficiency with which resources are allocated in the economy. Trade is diverted to trading partners in the agreement. The trade diversion effect is important for services as well as goods. Further, the diversion effect might be 'stickier' for services than for goods, given the nature of competition in markets for services, and the strong position acquired by 'first movers'.¹⁰ Participating economies might be locked in for longer with 'second-rate' suppliers because of this effect.¹¹

Retaliation

The second risk is that associated with retaliation by others. Unlike agreements in North America and Europe, where the regional market is significant, the rationale for a regional agreement in East Asia is to enhance complementarities and increase competitiveness to sell to major markets outside East Asia. Therefore, East Asia continues to depend on access to world markets. A series of agreements in East Asia feeds back into the momentum for preferential reform in the rest of the world, for the reasons just noted. In addition, there is a demonstration effect from economies like Japan and Korea appearing to sanction such an approach to reform. The risk is that East Asia will be discriminated against in other markets outside the region on which it still depends.

A related point is that creating a series of FTAs contradicts the patterns of commerce in the region. A key feature of the pattern of development in East Asia has been the relocation of industry as its host lost its comparative advantage in that sector. These shifts have occurred quite rapidly. They have been an important driver of East Asian investment in China. In recent

years, they have been evident in Korea and, even more, Japan. Until recently Hong Kong was managing the process of integration with southern China very successfully. Chinese Taipei is making a rapid adjustment to more capital and technology intensive production. This process works best in an MFN environment. A series of agreements with favourites impedes the process of relocation. Further, a lot of value adding, while based in a series of locations in East Asia, creates a final product which is sold outside the region: again, MFN rules facilitate the adjustment of market shares amongst the economies that take turns to host the final stages of production.

Political economy

The third effect concerns the political economy of reform. There has been some argument that the use of preferential agreements will, through the threat they impose, drive the world to make faster progress on the WTO negotiations and the application of MFN principles. However, it is more likely that the political economy effect will be to create a new set of interests who are opposed to further reform because it would remove their favoured positions in offshore markets. These are the very export interests whose commitments are so important in the domestic political economy processes for the adoption of WTO commitments. The extensive use of FTAs in this scenario does not accelerate the WTO process; it retards it. Therefore the final outcome is not independent of the path taken.¹²

A further effect on the political economy comes from the misnomer of 'free trade agreements'. In the context of bilateral negotiations, it is not likely that there will be capacity to mobilise sufficient political support to deal with very difficult and sensitive issues (areas in which tariffs are already high, for example).¹³ Groups hoping to gain better market access from the negotiations will be frustrated by the lack of effectiveness of the negotiation.

RTA architecture

The fourth risk concerns the architecture of RTAs. An argument in favour of RTAs is that their proliferation will lead to global free trade. However, it is not clear how this will occur. The political sensitivities in each bilateral arrangement will vary; excluded sectors from the agreements are therefore also likely to vary, and they will not naturally evolve to an MFN liberalisation. The specification of the rules of origin is another such issue (one among many). It is more likely that

a series of differentiated agreements will develop with different tariff schedules and rules, including rules of origin. The architecture could look like the famous spaghetti bowl, but with modern Asian characteristics.

Political considerations

The fifth set of risks is political. FTAs are often lauded for their contribution to the political relationship between two economies. Foreign ministers ask to be allowed to use all the instruments available to deepen a relationship. President Bush said that his East Asian initiative will 'enhance the already close U.S. ties with ASEAN'. But do FTAs necessarily lead to a net positive contribution to deeper political linkages? They are not without their own costs. The negotiating process can define new tensions – for example, on trade policy questions which would otherwise be dealt with in a multilateral setting and its institutions but which now are examined under the spotlight of the bilateral negotiations.

Once the agreement is established, direct conflicts arise over proposals to extend similar benefits to other trading partners. A rule of open accession might be used from the start, but it is more likely that accessions will not be automatically accepted (because of the presence of sensitive sectors and therefore the possibility of carve-outs). Accordingly, it is likely that every accession will need to be negotiated.

Finally, although FTAs are supposed to create political benefits within their own sphere, they can add to tension outside it. Others, by implication, are not favourites. In the MFN regime, they were equals, but now they are discriminated against. This signal risks diminishing the quality of the relationship with non-members, reduces the information flow, impedes the understanding of the motives of the FTA, and raises the ambitions in that field among the non-members, which accelerates the whole process.

ASEAN members: hub or spokes?

China, Japan, the United States and the EU are making offers to ASEAN, and in at least one case making explicit individual offers to ASEAN members. ASEAN is talking with India and the closer economic relationship (CER) members. This focus by big economies on the negotiation of FTAs with smaller economies is a new shock in the region. Is this situation a threat or an opportunity for ASEAN? Can ASEAN capitalise on this situation and become the hub of this

set of agreements? If it can, ASEAN might be able to go even further, consolidate the regional agreements into one and so lead the response in the Western Pacific to the FTAA development in the other hemisphere.

The problem is that, given the sensitivities in each ASEAN economy, any agreements actually signed might differ among the ASEAN members, who would then assemble around each hub in a series of spokes, rather than in a single agreement. The ASEAN members would become the spokes rather than ASEAN as a whole being the hub. There is already a sign of this outcome in the framework agreement between ASEAN and China, where each economy has the opportunity to list various exceptions, and in the individual initiatives of the member economies. It is also evident in the differences in the bilateral agreements that Singapore has signed with the major partners. For instance, the rules of origin range from simple in the case of the ASEAN Free Trade Area (AFTA) (40 per cent ASEAN content) to more complex in the US–Singapore bilateral agreement, where they run to 240 pages of text. This outcome also undermines the scenario of regional consolidation led by ASEAN that we have outlined above.

As bilateral agreements proliferate, the big economies in the Western Pacific would tussle to become the lead hub in the region, though China would be the favourite to win that particular race. Japan currently has less to offer in terms of long-term market growth potential or as a host for foreign direct investment (FDI) from relocating industry. Indeed, the United States may rank above Japan as a partner for ASEAN, particularly as some members have established security ties with the United States. Meanwhile, for now at least, there is a relatively small economic downside for China in its approach to ASEAN.

A hub-and-spoke structure has some important implications for ASEAN. Consider such a structure built around China. ASEAN members may be able to sign as a group, but there are sensitivities among them, as has been evident in the evolution of AFTA. Even if a framework agreement is signed, there may have to be variations for each member economy, for example, in the product coverage of the agreement as it applies to their trade with China.

What will be the effect of this architecture on the choices of foreign investors? The hub (China) would be a better choice than the spokes (the ASEAN economies), since market access and sourcing are guaranteed with each spoke. Being in a spoke provides less coverage, so one of ASEAN's original motivations for stepping into this process with China would not be met; further, China may be even more competitive than individual ASEAN members as a host for FDI.

Meanwhile, ASEAN could be fractured by the tensions which would emerge in this scenario. Further progress on AFTA would become even more difficult as the members shifted attention to accelerating their integration with their favourites in the rest of the world, rather than with each other. The tactic of the FTA route appears to offer large rewards, but only if ASEAN can emerge as a hub and subsequently establish a consolidated regional approach. If ASEAN breaks into a series of spokes of other competitive hubs, the scope for regional consolidation is much less and the ASEAN membership is unlikely to be better off than if it had not engaged the tactic of FTAs. The tactic also has implications for ASEAN as a whole and its capacity to deal with the other issues on its agenda, including other regional security matters. Overall, to use an analogy from business, ASEAN members are 'betting the firm' when they use this particular tactic.

How might this pressure on ASEAN be avoided? Ideally ASEAN should come to an agreement on a common framework of what constitutes a well designed RTA which will maximise the benefits for ASEAN and minimise downside risks already outlined. This framework should then be used for all negotiations – ASEAN-wide as well as bilateral.

Expectations of formal economic integration in the Americas and the value of responding to that development might be another important consideration in pushing for a common framework of the type just suggested, in order to increase ASEAN's bargaining position. But in the present environment in ASEAN it is not clear that it is possible to reach agreement on a common framework. Nor is it clear if there is the capacity to define and build a consensus on that solution in ASEAN right now.

Risk management

The scenario of the emergence of competitive hubs in East Asia challenges what might have been a more relaxed attitude to FTAs and supports the case for continuing to consider strategies for risk management. Prospects for significant progress in the WTO are important. The challenge is to demonstrate the capacity of the WTO to deliver on liberalisation.

Rules in the WTO process would help. The Doha Ministerial Declaration endorsed the idea of a new round of negotiations on rules on preferential agreements. Rules are important to set out the principles by which these agreements can be assessed. They serve to codify the principles. Even if the WTO rules are not enforced, they provide a reference point. The rules are necessary, given the risks, but they may not be sufficient.

Just like other forms of governance, black letter law is not usually sufficient to avoid a problem. It can never specify all the relevant circumstances. Also, the more it tries to do so, the more scope it creates for abuse, since the exceptions receive implicit endorsement by their failure to be listed. A commitment to work by the principles on which the rules are based is important, and that requires leadership, that is, choices which are designed to encourage others to act according to the principles, and which therefore cannot be interpreted as abuse of those principles. ASEAN's own capacity to reach a coordinated position on these issues is doubtful, given the recent experience in AFTA and given the moves by some of its members to negotiate their own agreements with non-members. But with further analysis, and with contributions from the research community, it may be possible to build a wider coalition in East Asia to take a common position on this issue.

APEC could have had a role in establishing this leadership, by reiterating its own Osaka Action Agenda principles and by engaging in dialogue on the motivation for the members' use of FTAs and how members see FTAs contributing to their progress to the Bogor goals. However, the experience of the individual action plan peer review processes, where apparently there has been little debate on the issue of the impact of FTAs, and the statements from the Los Cabos meetings, suggest that APEC will not be effective on this issue. Its wide membership and diverse interests appear to make it incapable of proceeding beyond the same gridlock that binds the review processes in the WTO. A subgroup may make better progress.

There is certainly value in transparency. Garnaut (2003) stresses the contribution of transparent and independent policy analysis to previous reform in Australia and suggests that trade policy initiatives with significant implications, including preferential agreements, should be subject to a public inquiry.

As noted earlier, the problem of perception can be an important driver of a response to the initiatives of others who negotiate FTAs. Non-members' concerns about new initiatives can be exacerbated by lack of information. The issue is whether information should be provided before or after agreement has been reached. The rationale for the ex ante provision of information is that non-members' concerns should be made clear before any agreement is concluded. However, it is more likely that the details of agreements will be distributed ex post.

Some people suggest that an important discipline is provided if FTAs are not made exclusive. This condition means that others can join on the same terms as original members. However, the building up of members by gradual accession is more likely to stall free trade than to lead to it (see the discussion on political economy effects above).

Ultimately, the key to managing the risks in the proliferation of FTAs is the commitment to MFN application of any agreements reached on preferential terms. This transfer of concessions to favourites into MFN treatment has been part of the ASEAN experience so far, and of the experience of the members. The economies involved have credibility on that score; between them, they could develop a position to take to the WTO. Such an approach would make a critical contribution to dealing with key risks in the FTA route to reform, including its efficiency effects, its domestic political economy problems and its proliferation tendencies.

One way to implement this approach is to include in each agreement a schedule by which the members promise to multilateralise the commitments. Margins of preference would diminish to zero over the time frame specified.

Rather than working from within the structure of the agreements, the same outcome could be imposed from outside the agreements. This is probably a more feasible route. Banks (2003) suggests that we should 'redouble our efforts to ensure progress in multilateral liberalisation within the WTO and APEC' (p. 17). Garnaut (2003) proposes that, in addition to a resumption of focus on multilateral negotiations, APEC leaders recommit to the Bogor goals and 'make these objectives operational by committing to multilateralise all preferential liberalisation by (the Bogor deadlines) in the context of a successful outcome of the Doha Round' (p. 31).

Conclusions

Even a year or two ago, observers could have been relatively sanguine about the boom of interest in FTAs. Progress was much slower than people originally expected, and negotiations seemed to drag on without agreement being reached. Readers may recall the anecdotes about the negotiations between South Korea and Chile which have only just concluded after four years. Some commentators in ASEAN have already questioned the likely progress on China–ASEAN talks. Slow progress of negotiations or even failure to reach FTAs with various major partners would undermine the credibility of FTAs and drive the participants back to the WTO, where at least they could mobilise sufficient forces to reach agreement. Also, business could be expected to realise that FTAs add to the cost of doing business and could therefore push for a different agenda.

Agreements which were reached but which imposed costs that were too high would be expected to collapse, as they have done before. Agreements which survived are more likely to be 'dirty', so they are not actually very effective and therefore not very costly, though they may create

some systemic problems along the way. In that case, the main costs of bilateralism are the waste of resources in the negotiating process.

Economies in the Western Pacific at that time were members of FTAs. But the perception of any risk was small. They were seen as facilitating reform programs leading to more open economies, and there was a track record of multilateralisation. Other large economies – Japan and Korea – were committed to the WTO. China had applied to enter the WTO. In effect, the architecture of the region had imposed on FTAs the disciplines discussed above.

That situation has now changed. The large economies – not just the United States but also China, Japan and South Korea – are pursuing FTAs. We have reviewed some of the motivations, including their contribution to domestic and international political targets, the mobilisation of reform and dealing with new types of impediments in order to intensify trade flows in the region. Meanwhile, there are doubts about ASEAN's capacity to reach a consensus on trade policy issues. The demonstration effect of the larger economies in the region has been significant, many people seeing China's initiative as the turning point. While its members might hope otherwise, a hub-and-spoke outcome in which ASEAN members make up the spokes, and not the hub, is a plausible scenario, and one of the worst in terms of a regional trading regime.

In this paper, we therefore argue the case for the application of a new set of principles to provide a framework for risk management. We suggest that, in the longer term, failure to do so could not only impose significant economic costs on participants but also diminish the stock of political assets in the region. The stock of such assets contributes to the reduction of risks of disputes and of more significant conflicts among economies there. The diminution of that stock makes it more difficult to respond to the new security agenda in a cooperative and therefore efficient manner.

The elements of a risk management strategy include progress in the WTO on liberalisation, new WTO rules on regional agreements, higher levels of transparency, and more work on TIFAs. Overall, multilateralisation of preferential tariff reductions should be the main benchmark in any new set of principles for risk management in the tactic of trading with favourites.

Notes

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- 1 See the press release of 5 November 2002, accessed at <<http://www.aseansec.org/13194.htm>>.
- 2 Also on the agenda for the United States are FTA negotiations with Central America and Morocco, an exploration with the South African Customs Union and negotiations with Australia. These small group negotiations are proceeding alongside the FTAA negotiations. At present, apart from NAFTA, Singapore and Chile, the United States only has FTAs with Israel and Jordan.
- 3 Following the presentation of these effects by Pomfret (1997), they include the welfare gains (triangles under both the demand curve and the domestic supply curve) from the lower price of the imported product, the loss from the higher expenditure on goods now imported from a high cost supplier, and the gain from lower expenditure on goods imported from non-members. The trading partner gains unambiguously from producer surplus on the new exports. One complication to this story is that the economy offering the tariff concessions to the favoured trading partner loses tariff revenue: the cost of replacing those funds should also be taken into account. Coincidentally, this issue is a matter of current debate in Chile, which has been vigorous in its efforts to sign preferential agreements.
- 4 The literature on the modelling of the adoption of trade agreements assumes governments are motivated by a combination of national welfare and political support – see for example, Maggi and Rodriguez-Clare (1998), Mitra (2002) and Ornelas (2002).
- 5 The terms of trade effects are reviewed by Pomfret (1997, ch. 9).
- 6 As Maggi and Rodriguez-Clare (1998) point out, an explanation of trade agreements which focuses on terms of trade effects may not be the whole story since many small countries tend to reduce tariffs as they enter trade agreements like the WTO.
- 7 Edmund L. Andrews, 'Singapore and US Near a Trade Deal', *New York Times*, 20 November 2002.
- 8 Gary Hufbauer has been quoted as saying, in the context of a presidential election in November 2002, that the Bush administration prefers FTAs since 'they don't give the same level of grief to the election strategy', contrasting that approach to the 'concessions' that might be required to settle the Doha Round or the FTAA (see Peter Hartcher, 'US trades principles of power', *Weekend Australian Financial Review*, 16–17 November 2002).
- 9 We now have two interpretations of this acronym: in the Western Pacific version, 'F' stands for 'facilitation'; in the US version, 'F' stands for 'framework', which is referred to as a first step to an FTA.
- 10 This argument is made by Mattoo and Fink (2002).

- 11 Some economies may have the capacity to manage all the tracks of trade policy (unilateral, bilateral and multilateral) to minimise the risk of welfare loss, and to manage the consequences of the other political economy effects noted below. This point is argued by policy commentators in Singapore for example. The difficulty is that not all may have that capacity, and actions by a significant member of a small group on the grounds of its own calculus may generate responses in other group members which ultimately diminish the welfare of the initiator.
- 12 Ornelas (2002) has a model in which signing a preferential agreement lowers the external tariff. This is because the rents generated by the external tariff are shared with foreign firms after the adoption of an FTA. The returns to lobbying for an external tariff are reduced and the political equilibrium shifts.

However foreign exporters (or investors in the case of services ‘exports’) would also be expected to join the domestic political process and argue against falls in the external tariffs. In the Ornelas model, political contributions are made only by domestic firms, so this effect is not taken into account.

Furthermore, profits made offshore might be affected by the domestic tariff (contrary to a condition in the Ornelas model). For example, home exporters lose from a reduction in the external tariff in the partner market once they have preferential access. They may enter the political economy process in that economy by offering to help resist the reduction in the home external tariff if their counterparts in the partner economy do likewise. In a non-preferential setting, the only way to gain access in the partner market is by a reduction in its external tariff. Exporters in the home economy in that case could offer to support a reduction in the home external tariff to help shift the political equilibrium in the partner economy.

- 13 If tariffs do not fall in these sensitive sectors, then there is no diversion and the cost associated with trade diversion in that sensitive sector is avoided. It is argued, for example, that agreements involving Korea or Japan will not lead to trade diversion in agricultural markets for this reason. However the overall dispersion of effective protection can still increase, with welfare consequences, and participation in the FTAs can contribute to the systemic effects which are the theme of this paper.

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