

The Move to Preferential Trade in the Western Pacific Rim

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I S S U E S

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S U M M A R Y Western Pacific Rim states have been slow to participate in preferential trade agreements (PTAs). In the past four years, however, more than 40 PTAs involving these economies have been proposed or are being implemented. For the first time, Japan and China have either signed or are negotiating bilateral or plurilateral agreements. The new interest in PTAs reflects the perception that they have been successful in other parts of the world, and is reinforced by dissatisfaction with the region's existing trade groupings. Although arguments can be made in favor of PTAs, they amplify political considerations in trade agreements, may adversely affect the political balance in participating countries, impose costs on nonparticipants, and deplete scarce negotiating resources. Nevertheless, the number of western Pacific Rim states participating in PTAs continues to climb. Northeast Asian countries have been following Europe in exploiting loopholes in WTO rules on PTAs to protect their noncompetitive sectors, thereby strengthening their political positions, which will likely make global liberalization more difficult.

Economists suggest that the welfare gains from trade liberalization can be maximized either through unilateral liberalization or through negotiating non-discriminatory agreements at the global level through the World Trade Organization (WTO). In recent years, however, many countries have turned to preferential trade arrangements (PTAs) as a significant component of their liberalization strategy. More than a hundred such agreements have been notified to the WTO since its establishment in 1995, the vast majority of these involving only two parties.

Countries of the western Pacific Rim were slow to jump on the PTA bandwagon: Throughout the post-war period, they were strong adherents of multilateralism in trade negotiations. Beyond the negotiated commitments they undertook in the General Agreement on Tariffs and Trade (GATT) and the WTO, they preferred to reduce their trade barriers on a unilateral and nondiscriminatory basis. The region's preferential trade groupings (the Association of Southeast Asian Nations [ASEAN] and the Australia–New Zealand Closer Economic Relations Trade Agreement) were only partial exceptions to the rule: Their members continued to engage in significant unilateral and nondiscriminatory tariff reductions from the mid-1980s onward, an approach that made sound economic sense given the relative unimportance of their regional partners in their overall exports.

At the end of 2001, only China, Hong Kong, Japan, Korea, Mongolia, and Taiwan, among the 144 members of the WTO, were not parties to preferential trade agreements. By this date, however, all the northeast Asian economies had been included in one or more proposals for bilateral or plurilateral PTAs. In the last four years, more than 40 such arrangements involving western Pacific economies have been proposed or are under negotiation, or have been agreed on and are being implemented (see Table 1). For the first time, Japan and China, the world's second and third largest economies, have either signed or are negotiating PTAs. These agreements will have significance for not only the participants and regional nonparticipants, but also the multilateral trading system as a whole.

Is the move to preferential trade by western Pacific Rim countries cause for concern? Why have they

changed the direction of their trade policies? What are the likely effects of PTAs on the economies of participants and nonparticipants? How will the agreements affect the balance of pro- and antiliberalization forces within the participating countries? How will they affect liberalization in regional and global forums? These are the principal questions addressed below.

The Pros and Cons of Preferential Trade Agreements

PTAs (especially bilateral agreements) have been the dominant form of trade agreement since the Industrial Revolution. Although economic historians have often identified the preferential agreements of the interwar period as a major contributory factor to the global depression of the 1930s, no evidence exists to date that the current wave of PTAs is responsible for an increase in global trade barriers; in fact, overall tariff levels have fallen substantially thanks to the successful conclusion of the GATT's Uruguay Round. PTAs certainly have not produced the breakdown of the global system into rival blocs that was predicted by some at the end of the 1980s. Other positive arguments can be made in favor of the new bilateralism:

- PTAs are being negotiated more speedily than global trade agreements now that the WTO membership is approaching 150 economies.
- PTAs present opportunities for exposing protected sectors gradually to international competition, thus paving the way for an eventual full liberalization. Although PTAs are often labeled “second best” by economists, they may represent an improvement on the status quo.
- Provisions may be included in preferential agreements that go beyond commitments previously made in the WTO. They can produce deeper economic integration and serve as testing grounds for collaboration, which can later be extended through global agreements.
- Exporting interests may be strengthened by the new agreements. When incomes rise because of increased market access, exporters will have both

Countries of the western Pacific Rim have been slow to jump on the PTA bandwagon

Table 1. Preferential Trade Agreement Participation in East Asia

Country/ Grouping	Partners	Status of Agreement, April 2003	Country/ Grouping	Partners	Status of Agreement, April 2003
ASEAN	China	Under Negotiation	Malaysia	China	Proposed
	EU	Proposed		Japan	Proposed
	Japan	Proposed		USA	Proposed
China	ASEAN	Under Negotiation	Philippines	Japan	Proposed
	Hong Kong	Proposed		USA	Proposed
	Macau	Proposed	Singapore	Australia	Agreement Signed
	Malaysia	Proposed		Canada	Under Negotiation
Hong Kong	China	Proposed	EFTA	Agreement Signed	
	Macau	Proposed	EU	Proposed (rejected by EU)	
	New Zealand	Under Negotiation	India	Under Negotiation	
Japan	ASEAN	Proposed	Japan	Agreement Signed	
	Canada	Proposed	Korea	Under Study	
	Chile	Under Study	Mexico	Under Negotiation	
	Korea	Under Study	New Zealand	Agreement Signed	
	Malaysia	Proposed	Taiwan	Proposed	
	Mexico	Under Negotiation	USA	Agreement Signed	
	Philippines	Proposed	Taiwan	Costa Rica	Proposed
	Singapore	Agreement Signed		Japan	Proposed
	Thailand	Proposed		New Zealand	NZ withdrew from negotiations
	Korea	Australia	Under Study	Panama	Under Negotiation
Chile		Agreement Signed	Singapore	Proposed	
Japan		Under Study	USA	Proposed	
Mexico		Under Negotiation	Thailand	Australia	Under Negotiation
New Zealand		Under Study		Japan	Proposed
Peru		Proposed		Korea	Under Study
Singapore		Under Study		New Zealand	Under Study
Thailand		Under Study			
USA		Under Study			

Note: "Proposed" refers to agreements that have been officially proposed with varying degrees of formality by one government to another. (Numerous other proposals have been made, primarily by business groups.) Most proposals are then referred for study to either national think tanks or consultants and/or joint working parties established by the partners. Negotiations usually do not begin until governments have received these studies.

Source: Government websites and various newspapers.

Smaller, less developed countries may be excluded from PTAs because others regard them as insignificant markets

the means and the incentive to lobby governments for further liberalization.¹

Despite these positive influences, preferential agreements are cause for concern:

- By definition, PTAs discriminate against non-members and their exporters. Some suppliers may find trade diverted away from them because of the tariff-free access to markets enjoyed only by members of the PTA. When it is the more competitive suppliers who are unable to participate, global welfare suffers. Some East Asian textile exporters could not compete with Mexican producers in the U.S. market after the signing of the North American Free Trade Agreement (NAFTA) even though many of them were more efficient suppliers.

- Smaller, less developed countries may be excluded from PTAs because others regard them as insufficiently important markets. Similarly, countries deemed unreliable because of the nature of their political systems are likely to be shunned. The coverage of existing and proposed PTAs in East Asia is far from uniform; the principal players are the larger and/or more developed economies (see Table 1). (Although the lowest income ASEAN countries may be nonparticipants in their own right, they are of course included in proposed agreements between ASEAN and other countries.)
- Political factors may play a significant role in the choice of potential partners and in determining the outcome of negotiations. In some instances,

this may be regarded as desirable. The European Union's requirement that new members be established democracies has been credited with helping consolidate democracies in southern and eastern Europe. On the other hand, political factors have led to the exclusion of Taiwan from the ASEAN Plus Three grouping (and Beijing has also warned other governments against negotiating bilateral trade agreements with Taiwan). Negotiations with a limited number of partners have also allowed more powerful countries to dictate the terms of agreements. In its agreement with Singapore, the Japanese government was able to exclude liberalization of trade in sectors that it considers politically sensitive.

- PTAs may adversely affect the political balance in participating countries. By creating new preferences in partners' markets for domestic exporters, PTAs generate income beyond that which investments otherwise would earn (what economists call "rents"). Exporters may have an incentive to lobby to maintain preferential access rather than work toward a broader liberalization of international markets. Moreover, if the product coverage of these liberalization agreements is incomplete, PTAs will encourage resources to be diverted to those sectors that continue to receive protection (for instance, rice production in Korea). Finally, in an effect similar to that noted by Aggarwal and Ravenhill in sectoral liberalization, if PTAs give exporters the market access they desire, they may lose interest in lobbying for global trade liberalization.ⁱⁱ
- Negotiating multiple bilateral agreements is less efficient than negotiating at the global level; few governments have the resources to sustain talks with more than three countries simultaneously. The deployment of resources necessitates choice, which is unlikely to favor smaller economies. The preferential treaties themselves are often lengthy, complex documents, especially regarding what is needed for a product to qualify as having been manufactured in a partner country. These "rules of origin" are intended to prevent the transshipment of products, which would take advantage of

the preferred access created by the agreements. In the Japan-Singapore economic partnership agreement, the rules of origin account for 200 of its 360 pages.

- A proliferation of PTAs, many with different rules of origin, complicates life for businesses and adds to the transactions costs they face in international trade.

Why PTAs?

Governments' decisions to invest scarce resources in negotiating bilateral arrangements that are likely to generate inferior results when compared with unilateral or multilateral liberalization, therefore poses a puzzle. For countries in the western Pacific Rim, the puzzle also has a temporal dimension: Why was there a sudden interest in negotiating PTAs in the last years of the previous century?

Commentators have suggested a plethora of answers. With an issue as complex as this, it would be naive to think that one factor provides a universally valid explanation. Some purported explanations, however, can easily be ruled out. Arguments that the move to PTAs reflected the resentment many Asian governments felt at Western reactions to the financial crises of 1997–98, coupled with a desire to forge a new sense of regional identity, seem incompatible with the fact that many of the proposed PTAs were made with countries outside of East Asia. Similarly, the argument that the move to PTAs was driven by the "debacle in Seattle" and the failure of the WTO ministerial meeting to make any significant progress is implausible because the timing is all wrong. The Seattle meeting was held at the beginning of December 1999; by then, numerous proposals for bilateral agreements had already been made and, in some instances, negotiations begun.

The most persuasive explanation for the new bilateralism is that governments of the western Pacific Rim were increasingly concerned with the effects of regionalism elsewhere and feared that their economies would be adversely affected should they fail to negotiate parallel arrangements. In some instances (particularly in Japan and Korea), an impetus for the

A proliferation of PTAs complicates life for business and adds to the transaction costs of international trade

negotiation of PTAs came from the private sector, which worried that the new agreements would give its competitors an advantage. The Japanese Federation of Economic Organizations (Keidanren) noted, for example, that both European and American exporters enjoyed duty-free access to the Mexican market—courtesy of preferential trade agreements—while its members faced tariff barriers averaging 16 percent.

The timing of the move to PTAs can be explained by not only the implementation of agreements in other parts of the world, but also disappointment with the results of collaboration in existing regional institutions, most notably ASEAN and the Asia-Pacific Economic Cooperation grouping (APEC). Although it would be unreasonable to blame either for failing to bring a quick resolution to the financial crises of the late 1990s, neither grouping enhanced its reputation in the aftermath. In addition, momentum toward trade liberalization in both regional bodies appeared to be stalled: ASEAN members sought to exclude key industries from their upcoming free trade agreement, the implementation of which was proceeding at a tortuous pace, while the failure of APEC's efforts to accelerate trade liberalization through sectoral agreements was a political and public relations disaster.

Some governments saw the negotiation of preferential agreements as an opportunity to enhance their influence in multilateral talks as well as in the region (a possibility mentioned, for example, in Japanese government documents advocating PTAs). Others, primarily proliberalization ministries within governments, saw PTAs as a chance to move their agendas forward, in some instances by taking advantage of the lack of specificity in WTO requirements to exclude the discussion of politically sensitive sectors that might derail negotiations (see box on p. 6).

Proprotection ministries took advantage of the opportunity for partial liberalization afforded by PTAs. The European Union set a precedent in bilateral agreements when it excluded most agricultural products from its PTAs with Mexico and South Africa. (It claimed that these agreements met WTO requirements because not all agricultural products were excluded and the PTAs covered more than 90 percent of existing trade.) Keidanren seized upon this

precedent in its lobbying for the negotiation of PTAs, arguing that although it was desirable “to liberalize as much trade as possible,” the ambiguities in WTO requirements made it possible to exclude “sensitive” items from the liberalization schedule and thus minimize the domestic political costs of the new regionalism.ⁱⁱⁱ

The Japanese government followed the European precedent when it negotiated its economic partnership agreement with Singapore: The few products that Singapore exported in the ultrasensitive agricultural sector, principally cut flowers and goldfish, were not included in the liberalization provisions. The Japan-Singapore agreement consequently liberalized only 50 percent of Singapore's dutiable exports to Japan. Korea has since indicated that it will not expose its agricultural sector to additional competition from Mexico and Chile by lowering barriers as part of preferential agreements. For its part the Taiwanese government is reported to have excluded 800 products, mainly textiles and clothing, from its proposed free trade agreement with Singapore to protect its domestic textiles industry.^{iv}

The vagueness of the GATT's Article XXIV.8 enables the negotiation of proliberalization agreements that avoid imposing adjustment costs on the least efficient domestic sectors; in other words, it permits liberalization without political pain. In turn, the political position of protected sectors is reinforced, as is their incentive to continue lobbying for exclusion from trade liberalization. Meanwhile, pressure from exporters for domestic trade liberalization is reduced because the PTAs provide them improved access to foreign markets.

The Economic Effects of the New PTAs

The economic effects of trade agreements are usually estimated by applying sophisticated economic modeling. Models, however, are only as good as the conjectures on which they rest. In the case of PTAs, these include controversial assumptions about the competitive structure of economic sectors and how consumers will respond to changes in the relative prices of goods. Furthermore, models often fail to capture

The move to PTAs reflects, in part, disappointment with the results of collaboration in existing regional institutions

The World Trade Organization and Preferential Trade Agreements

The fundamental principle of the international trade regime that has prevailed since 1947 (initially the GATT and subsequently the WTO) requires that exports of member countries receive the same treatment as those of the most-favored nation (Article I.1). Exceptions to this principle have always been allowed, however. The most important of these is contained in Article XXIV of the GATT, which permits closer integration of economies that choose to implement free trade areas or customs unions.

Article XXIV also lays down the criteria that such arrangements must meet to be regarded as legitimate by the WTO. Customs duties under the new agreement must not be higher or more restrictive than those previously imposed by the individual countries. The preferential agreement, according to Article XXIV.8, must also eliminate duties and other restrictions on "substantially all the trade" between participants.

These provisions have generated enormous controversy over the years. In particular, members have failed to reach agreement on defining and applying the phrase "substantially all the trade." The WTO notes "there exists neither an agreed definition of the percentage of trade to be covered by a WTO-consistent

agreement nor common criteria against which the exclusion of a particular sector from the agreement could be assessed." The European Union, a pioneer in negotiating PTAs, has argued that the Article XXIV.8 requirement has both a quantitative and a qualitative element, with at least 90 percent of the trade between parties being covered and no major sector excluded. But other members have contested this interpretation, which raises its own problems of definition: How is the 90 percent of trade to be measured? (Does it refer only to existing trade or to that which might take place should restrictions be removed?) And how does one define a "major" sector?

The lack of agreement on Article XXIV.8 has stymied the work of the WTO's Committee on Regional Trade Agreements, created in February 1996 to examine PTAs and their implications for the multilateral trading system. Members have simply failed to determine whether or not any of the large number of PTAs notified to the Committee in the past seven years is fully compatible with the relevant rules. An agreed interpretation of Article XXIV.8 is one of the items on the agenda in the current Doha Round of multilateral negotiations.

the dynamic effects that regional collaboration may set in train by, for example, stimulating inflows of foreign direct investment. Because of differences in the assumptions made, the modeling of the likely effects of PTAs involving western Pacific Rim countries has produced results that differ substantially.^v

On one thing, however, the models are in agreement: Many of the proposed PTAs will generate very small benefits in terms of trade creation and welfare gains. This is to be expected because the parties are often minor trade partners for one another and any removal of tariffs will take place in a context where for many countries such barriers for most manufactured products are already low. A study of the likely effects of a free trade agreement between Australia and Singapore predicted that it would increase Australian exports by a mere \$37 million, or less than 0.1 percent of current exports.^{vi} Even an agreement with the world's largest economy would have limited welfare benefits for most western Pacific partners: The U.S. International Trade Commission calculated

that the proposed Korea–U.S. Free Trade Agreement would provide a one-off increase of Korean gross domestic product of 0.7 percent, a relatively small figure in the context of the Korean economy's annual average growth rates.^{vii}

Nonparticipants can take comfort in knowing that they themselves will suffer only small aggregate losses from these agreements. But, as noted above, individual sectors in some countries may incur substantial losses when exporters face significantly poorer terms of access to markets than those enjoyed by their principal competitors.

How Will the New Agreements Affect the Balance of Domestic Interests?

A short answer to this question is that it is too early to tell. Only a few agreements have been signed and none have been fully implemented. Some worrying trends in terms of political economy effects have already emerged, however, because of the selective approach

Many of the agreements will generate very small benefits in terms of trade creation and welfare gains

to liberalization adopted by northeast Asian governments. Exporting interests are securing access to the foreign markets they desire without having to pressure their own governments to liberalize protected domestic sectors. Although some potential partners continue to push for full liberalization, here, too, there have been disturbing developments. The Australian government, during Prime Minister Koizumi's visit to Canberra in May 2002, ruled out negotiation of a free trade agreement with Japan because of Tokyo's unwillingness to discuss agricultural issues. Subsequently, Australia has showed interest in reaching an "economic framework agreement" with Japan that would cover liberalization of trade in noncontroversial sectors.^{viii} Such an agreement might satisfy Australian manufacturing and service sectors and remove them from the forces lobbying the government to pressure Japan for complete liberalization. The overall result is a fractured proliberalization lobby and reduced external pressure on Japan to open up sensitive sectors.

How Will the New PTAs Affect Regional and Global Institutions?

Again, the recent origin of PTAs involving countries of the western Pacific Rim necessitates caution when addressing such questions. It is certainly too early to demonstrate, as some proponents have suggested, that the agreements are proving to be successful testing beds for initiatives subsequently adopted at the global level. What is clear, however, is that the agreements signed to date are noncumulative: Each has been negotiated individually, leading to a proliferation of different rules for the conduct of preferential trade.

Moreover, the energy diverted into negotiating the agreements has had a negative impact on the Pacific's major trade institution, APEC. The move to PTAs coincided with the disappearance of trade liberalization issues from APEC's agenda (especially at its summit meetings, which have been dominated since 1999 by discussions on security issues). Meanwhile, the

capacity to exclude sensitive sectors from PTAs has reinforced the recalcitrance of some governments in the WTO. This is evident, for instance, in Japan and Korea's stance on agricultural liberalization in the current Doha Round of multilateral negotiations.

The one regional institution that appears to have benefited, at least in the short term, from the move to negotiate PTAs is ASEAN. Although Singapore's early enthusiasm for preferential agreements caused tensions with its ASEAN partners, the recent negotiations between ASEAN as a single entity and China, and the possibility of similar negotiations with Japan, gave the institution a new prominence at a time when its credibility was increasingly being called into question.

Conclusion

Throughout the postwar era, the foreign commercial policies of western Pacific Rim states have frequently been defensive in nature—created in response to developments elsewhere, whether at the regional level (the formation of a European trading bloc, the emergence of NAFTA) or at the global level. The recent turn to preferential trade agreements is no exception, with western Pacific countries scrambling to defend their interests in an environment in which the proliferation of PTAs in other parts of the world has threatened to place them at a competitive disadvantage.

Western Pacific countries can scarcely be criticized for looking to PTAs, especially when they have been successful elsewhere in the global economy. What is disappointing, however, from the perspective of those attempting to fashion a rational trade policy, is the determination of northeast Asian countries to follow Europe in exploiting WTO loopholes to protect their noncompetitive sectors. Such action is likely to stiffen the resistance of these sectors and make global liberalization more difficult. In the end, western Pacific countries might be better off devoting the considerable amount of resources and energy needed to negotiate bilateral agreements to promoting trade liberalization through the WTO.

The move to PTAs coincided with the disappearance of trade liberalization from APEC's agenda

Notes

ⁱ See, for example, Baldwin, Richard E. 1977. "The Causes of Regionalism." *World Economy* 20, no. 7, pp. 865–88.

ⁱⁱ Aggarwal, Vinod K. and John Ravenhill. 2001. "Undermining the WTO: The Case Against 'Open Sectoralism'." *AsiaPacific Issues* 50.

ⁱⁱⁱ Keidanren. 2000. "Urgent Call for Active Promotion of Free Trade Agreements: Toward a New Dimension in Trade Policy." <http://www.keidanren.or.jp/english/policy/2000/033/proposal.html>.

^{iv} Agence France-Presse. April 21, 2002. "Some 800 items on Taiwan protected list in FTA with Singapore: Report." <http://asia.news.yahoo.com/020421/afp/020421050556singapore.html>

^v The most comprehensive survey to date is found in Scollay, Robert and John Gilbert. 2001. *New Regional Trading Arrangements in the Asia Pacific?* Washington, D.C.: Institute for International Economics.

^{vi} Access Economics. 2001. *Access Economics, The Costs and Benefits of a Free Trade Agreement with Singapore*. Canberra: Access Economics Pty Ltd.

^{vii} United States International Trade Commission (USITC). 2001. *U.S.-Korea FTA: The Economic Impact of Establishing a Free Trade Agreement (FTA) Between the United States and the Republic of Korea*. Washington, D.C.: USITC.

^{viii} Department of Foreign Affairs and Trade, Commonwealth of Australia. 2003. "Proposed Trade and Economic Agreement with Japan." <http://www.dfat.gov.au/trade/negotiations/japan.html>.

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