

# The Future of the World Trading System: Asian Perspectives

Edited by Richard Baldwin, Masahiro Kawai  
and Ganeshan Wignaraja



A VoxEU.org Book



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# Contents

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Foreword	vii
<b>1 Introduction</b>	<b>1</b>
Richard Baldwin, Masahiro Kawai and Ganeshan Wignaraja	
<b>2 The future of the world trade system: Asian perspectives</b>	<b>15</b>
Pascal Lamy	
<b>Section 1: Supply Chains and Production Networks</b>	
<b>3 WTO 2.0: Thinking ahead on global trade</b>	<b>23</b>
Richard Baldwin	
<b>4 Trade in value-added: An East Asian perspective</b>	<b>29</b>
Satoshi Inomata	
<b>5 Rethinking the impact of exchange rates on trade flows along global production networks</b>	<b>39</b>
Yuqing Xing	
<b>6 Do SMEs matter in Asian production networks?</b>	<b>45</b>
Ganeshan Wignaraja	
<b>Section 2: Commercial and Industrial Policies</b>	
<b>7 Increasing value from global value chain participation: What role for industrial policy?</b>	<b>55</b>
Patrick Low and Julia Tijaja	
<b>8 Is murky protectionism a real threat to Asian trade?</b>	<b>65</b>
Simon J. Evenett	
<b>9 Exchange rate policy and regional trade agreements</b>	<b>75</b>
Richard Pomfret and Victor Pontines	

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### **Section 3: Regional Trade Governance**

- 10 Policy challenges posed by Asian FTAs** 83  
Masahiro Kawai and Ganeshan Wignaraja
- 11 The ASEAN Economic Community: Progress, challenges and prospects** 91  
Siow Yue Chia
- 12 Construction of RCEP by consolidating ASEAN+1 FTAs** 99  
Shujiro Urata
- 13 ASEAN+, RCEP and TPP: A clash of integration concepts** 107  
Cédric Dupont

### **Section 4: Global Trade Governance**

- 14 The future of the World Trade Organization** 119  
Biswajit Dhar
- 15 A new perspective for the World Trade Organization** 125  
Tomochika Uyama
- 16 Plurilateral agreements: A viable alternative to the WTO?** 131  
Michitaka Nakatomi
- 17 The case for enhancing regional and global rules for investment** 141  
Zhang Yunling and Rongyan Wang
- 18 A multilateral agreement on investment: A brief reflection** 149  
Alejandro Jara
- 19 Multilateralisation of regional trade agreements** 155  
Rohini Acharya
- 20 WTO-ASEAN asymmetries: Calling for greater collaboration** 161  
Maika Oshikawa



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# Foreword

Governance of the world trading system is in limbo. The WTO's six-decade old *modus operandi* – large multilateral negotiations known as Rounds – is broken. WTO rules were last updated in 1994 and the current Round is mired after a dozen years of talks. In an unorganised manner, bilateral, plurilateral and regional trade agreements have taken the lead in bringing trade disciplines to the 21st century. Several mega-regionals and mega-cross regionals are striving to generalise the bilaterals and regionals into more coherent region-wide or cross-regional arrangements. The prognosis on the mega-regionals and cross regionals – especially the Trans-Pacific Partnership (TPP), the Regional Comprehensive Economic Partnership (RCEP) and the Trans-Atlantic Trade and Investment Partnership (TTIP) – is unclear.

It is in this state of flux that the Asian Development Bank Institute in Tokyo teamed up with the Centre for Trade and Economic Integration in Geneva to host a two-day conference, on the 11th and 12th March 2013, on *The Future of the World Trade System: Asian Perspectives*. The focus is on Asian perspectives since, as WTO Director-General Pascal Lamy put it, the problems facing Asian regionalism are a scaled-down model of the problems facing the world. Solutions that smooth out Asia's noodle bowl would also be likely to work at the global level.

In putting together this collection of short chapters based on the longer papers presented at the Geneva conference, Richard Baldwin, Masahiro Kawai and Ganeshan Wignaraja have brought the issues to the broader audience with speed and efficiency. They have been very ably supported by Team Vox, in particular by Anil Shamdasani. We are grateful to them all.

The topic of the eBook is especially timely given the change in leadership at the WTO. From September 2013 Roberto Azevêdo takes up the reins as Director-General. Contributors to this eBook provide abundant analysis and suggestions for how the new Director-General could address the new challenges.

Viv Davies

Chief Operating Officer, CEPR

Masahiro Kawai

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11 June 2013

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# 1 Introduction

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**Richard Baldwin, Masahiro Kawai and Ganeshan Wignaraja**

Graduate Institute, Geneva and CEPR; Asian Development Bank Institute, Tokyo;  
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## **What this eBook is about**

The world trading system is in a state of flux characterised by new developments and uncertainties about its governance. Fundamental changes are occurring because of the rise of emerging economies, such as the BRICS, and the expansion of their trade and foreign direct investment (FDI), and also the proliferation of free trade agreements (FTAs) globally. Over the last three decades, trade and FDI have grown rapidly in Asia and regional trade and investment integration has deepened, which has contributed to sustained growth and improvement in peoples livelihoods.

Trade and regional integration are likely to influence Asia's future growth, with some predicting that the region will account for over half of world GDP by 2050. With the continuing stalemate in the Doha Round trade talks, the credibility of rule-making on trade in the WTO is under intense scrutiny and FTAs appear to be emerging as the preferred alternative. The nature of these developments has prompted a debate on the future of the world trading system and the rules governing trade.

The essays in this VoxEU eBook, written by leading Asian and international trade experts, conduct a broad and comprehensive examination of key changes taking place in the world trading system and trace policy implications for Asia. The essays cover:

- Stylised patterns of, and participants in, global production networks and supply chains.
- The economic effects of commercial and industrial policies pursued by countries.
- The evolving architecture of regional trade governance characterised by the spread of FTAs and attempts at consolidation into large, region-wide agreements.
- The state of global trade governance centred on the WTO and proposals for reform.

How Asia thinks and acts on these issues will likely influence the world economy. As Pascal Lamy writes in his essay:

“Asia has been a successful model of development through trade, which has inspired many others around the world. There is no doubt that the region will continue to inspire the trade community in the decades to come.

With its significant economic and trade weight in the global economy, Asia is expected to shoulder more responsibilities and take the lead in the global trading system in the future. Their contribution to a successful WTO Ministerial Conference in Bali in December 2013 will be essential.”

The topic of this eBook is thus timely as Roberto Azevêdo takes over as Director-General of the WTO from September 2013 and leads the 9th WTO Ministerial Conference in Bali in December 2013. It is imperative that increasing recognition is given to the links between global production networks and supply chains, national commercial and industrial policies, and the governance of global and regional trade. Furthermore, critical decisions will need to be made at the WTO and regional forums about improvements in global and regional trade governance and greater coherence between global and regional trade rules.

The essays in this eBook arose from a conference on “The future of the world trading system” held at the WTO in Geneva on 11-12 March 2013, organised by the Asian Development Bank Institute and the Centre for Trade and Economic Integration at the Graduate Institute of International and Development Studies, in collaboration with the

WTO. Longer versions of many of these essays are being developed into full papers to be published in an edited book.

## **Global production networks and supply chains**

One important factor underlying the growth of trade and investment, and the resulting regional economic integration in Asia, is the formation of global production networks and supply chains, particularly the growth of vertical intra-industry trade in parts, components, other intermediate goods, and finished manufactured products. The increasing share of Asia's trade in intermediate goods has been aided by improvements in physical infrastructure and logistics services, rapid developments of information and communication technology, and falls in trade barriers and trade costs, all of which have helped expand trade and FDI.

As Richard Baldwin notes in his essay, the formation of global production networks and supply chains has changed the centre of gravity of the world economy. Globalisation since the 1990s has been accompanied by a steep rise in shares of world output and world trade of developing countries that have achieved industrialisation by joining supply chains. The major gainers were Asia's emerging economies – including the People's Republic of China (PRC), Korea, Thailand and Indonesia – that were part of US, German and Japanese supply chains.

The world trading system will have to take better account of the formation of global and regional supply chains, as this phenomenon alters how countries interact with each other through trade and FDI. In addition, the assembly of intermediate products into final products for export shipment means that imports matter as much as exports for trading nations, which implies a strong complementary relationship in economic activity among countries that are part of these value chains.

Better trade policymaking in this context requires more accurate data using innovative measurement of trade flows based on value-added, rather than gross commercial values

as recorded in conventional trade statistics, to measure the national content of imports and exports. In his essay, Satoshi Inomata argues that the recent Asian Input Output Table facilitates the mapping of patterns of trade in value-added between countries engaged in global production-sharing arrangements. Among other benefits, the trade in value-added approach avoids multiple counting of trade flows and allows a more realistic depiction of bilateral trade in the light of global production-sharing. The trade in value-added approach provides fresh insights into thorny international issues such as the size of the US trade deficit with the PRC. Under the trade in value-added approach, a lower US trade deficit with the PRC is observed compared with conventional trade statistics.

Yuqing Xing points out that movements in a single country's exchange rates do not fully determine the competitiveness of goods produced under production-sharing arrangements involving trade in value-added between many countries. A value-added real effective exchange rate is proposed instead to better represent the reality of value-added trade, particularly in Asia.

Furthermore, better trade policymaking also requires using micro-level data from enterprise surveys to understand the role of different firms in production networks. Firms are considered different in terms of efficiency, as well as fixed and variable costs, when involved in production networks. Accordingly, firm-specific characteristics (or firm heterogeneity) shape participation in production networks. Drawing on multi-country multi-enterprise surveys, Ganeshan Wignaraja suggests that firm size (reflecting economies of scale to overcome entry costs) matters for joining production networks, with large firms playing the dominant role in Asia. Nonetheless, higher SME participation rates are visible in more industrialised Asian economies like Malaysia and Thailand, indicating the potential role of SMEs as suppliers to large firms and direct exporters. Apart from size, other key influences on firm-level participation in production networks include investment in human capital, technological capabilities and access to credit. Governments can facilitate SMEs joining production networks

through a market-oriented strategy for SMEs, streamlined bureaucratic procedures and institutional support services.

## **Commercial and industrial policies**

Several factors have been critical in Asia's successful outward-oriented industrialisation and structural transformation. A favourable world economy – notably, a booming world economy that stimulated demand for labour-intensive imports from Asia and falling tariffs in developed country markets – provided the impetus. Developing Asian economies had ample supplies of low-cost, highly productive labour and were geographically close to an expanding developed Japanese economy. Efficient Japanese multinational corporations (MNCs) were actively seeking to relocate production to less costly locations in Asia. Through technology transfer and training, domestic firms acquired manufacturing capabilities to become suppliers and subcontractors to MNCs. These efforts were supported at individual economy levels by outward-oriented development strategies, high domestic savings rates, the creation of strong infrastructure, and investment in human capital. Outward-oriented development strategies often emphasised gradual import liberalisation and a strong export promotion (using various incentives for exports and export processing zones, among others).

As participation in global value chains became increasingly prevalent in Asia, there is growing interest in how the benefits from participation are distributed among countries and enterprises. At the national level, this is related to the pursuit of development objectives such as poverty reduction, job creation, better productivity, technological upgrading and economic diversification. Some economies have added industrial policies – with a plethora of incentives to encourage specific industrial sectors or particular geographical locations – to their outward-oriented policy framework. Patrick Low and Julia Tijaja, in their essay, examine a variety of approaches to industrial policy. He suggests that some are more promising than others in the context of global value chains. The size of domestic markets, resource endowments and country-specific

circumstances are crucial to determining opportunities. Furthermore, implementation of industrial policy carries the risk of government failure which may be mitigated by developing solid government capabilities (technical, analytical and operational) and forging close relations with the private sector and non-state actors.

In the wake of the global financial crisis of 2008, protectionist tendencies are on the rise in some economies, including within Asia. Simon Evenett argues that while there are many ways to implement protectionism, several governments have implemented what are called “murky forms of protection.” These do not involve a direct violation of WTO obligations, but represent an abuse of the policy discretion that discriminates against foreign goods, services, firms, and workers. Examples include the use of health and safety regulations to restrict imports, export taxes on native food and resources to keep them at home, clauses in stimulus packages that confine spending to domestically produced goods and services, and “green protectionism” that subsidises domestic firms only. The implications of these measures for trade policy are clear. As the world economy recovers, policymakers should resist temptations for protectionism and unwind these discriminatory measures. In the medium to long term, policymakers may wish to initiate negotiations on new rules on public procurement, export taxes and other less transparent forms of protection.

The multilateral trading system of the future will have to address important global issues that are not addressed under WTO rules. The blurring between trade policy and other policies, such as climate change and exchange rate policies, will require the attention of policymakers. For the efficiency gains from trade to translate into reduced greenhouse gas emissions, the right environmental context must be set for trade. Appropriate pricing is vital to bolster incentives to consume low-carbon products and use low-carbon technologies. For example, putting the right price on carbon will provide a clear market signal in reducing the consumption of fossil fuels and making low-carbon technologies commercially viable. If this is difficult, a subsidy may be provided for firms, whether domestic or foreign, that produce low-carbon goods and services or utilise low-carbon technologies.



The international monetary system needs to facilitate the free flow of international goods and services and cross-border investment. The system must be supported by stable exchange rates consistent with the underlying fundamental economic conditions. Policies to maintain undervalued exchange rates over an extended period can distort trade, like tariffs and trade subsidies, by making the country's exports artificially competitive and imports less attractive. Countries are advised to avoid such trade-distorting exchange rate policies as they have negative consequences not only for the trading partners, but ultimately for the countries concerned. Richard Pomfret and Victor Pontines argue that greater formation of FTAs in Asia means that trade policy is less effective than in the past and countries are tending to use exchange rate policy more. Within FTA blocs, countries are tending towards exchange rate stability. However, some countries, even within FTA blocs, are using exchange rate depreciation as a beggar-thy-neighbour form of exchange rate protectionism. This is harmful to others and implies the need for some coordination and monitoring mechanism within FTA blocs.

## **Regional trade governance**

Regional trade governance has become an increasingly important issue in the world trading system in recent years. Preferential or free trade agreements (PTAs or FTAs) are spreading globally, including in Asia. Many Asian economies have embarked on FTA negotiations with their trading partners, both within Asia and outside. The move towards FTAs in Asia is linked to the need to remove impediments to broadening the spread of global and regional supply chains, the intensification of FTA activity in Europe and the Americas, and the stalled WTO Doha Round trade talks.

In their essay, Kawai and Wignaraja argue that overlapping and complex FTA arrangements in Asia may pose several challenges for Asia's trade and investment. In particular, the presence of different, multiple rules of origin is one of the troublesome components of the Asian "noodle bowl", which also includes different, competing tariff schedules, exclusion lists, and rules and standards. The "noodle bowl" can make

Asian firms – particularly small and medium-sized enterprises (SMEs), which use FTA preferences – face costly business procedures and cumbersome requirements. Asia needs to consider measures to overcome the noodle bowl problem. Practical measures, such as encouraging rationalisation and flexibility of rules of origin, upgrading origin administration, improving business participation in FTA consultations and strengthening support systems for SMEs, can help in mitigating the Asian noodle bowl.

Furthermore, several economists in Asia argue for the consolidation of these multiple FTAs into a single Asia-wide FTA, like the Regional Comprehensive Economic Partnership (RCEP). A broad-based, region-wide FTA to be formed by 16 East Asian countries could help mitigate the harmful noodle bowl effects. It could simplify schedules for tariff reductions, exclusion lists, and the myriad rules, regulations and standards. Shujiro Urata examines the patterns of commitments in trade liberalisation in goods in ASEAN's FTAs with major regional economies and points out that the construction of RCEP may be difficult because of differences in patterns of tariff elimination and definitions of rules of origin adopted in such agreements. A practical way forward for trade liberalisation under RCEP is for a gradual approach in tariff elimination and a co-equal approach in rules of origin.

ASEAN – viewed as the driver of the process of regional economic integration in Asia – embarked on an ambitious project to form an ASEAN Economic Community (AEC) by 2015 including a single market and production base. Siow Yue Chia assesses progress towards AEC and future directions. Encouragingly, intra-ASEAN tariffs have been virtually eliminated and trade facilitation improved which has resulted in the growth of intra-ASEAN and extra-ASEAN trade. Furthermore, the ASEAN Comprehensive Investment Agreement was ratified in 2012 and may spur inward investment. Nonetheless, further progress is needed in other areas such as eliminating non-tariff barriers and liberalising restrictions on services trade. There is general acceptance in ASEAN policy circles that the achievement of the AEC project will extend beyond 2015 as residual measures will take time to implement.

Cédric Dupont questions whether ASEAN centrality in driving Asian regional integration will persist in a changing trade policy landscape in Asia. The emergence of an alternative mega-regional integration scheme, the Trans-Pacific Strategic Economic Partnership, seems to have raised issues about the future relevance of ASEAN centrality and also the prospect of a future clash between the TPP and RCEP.

It is possible, however, that a region-wide agreement in Asia could arise from a series of linked agreements covering various issues and participants. RCEP and TPP are key processes to create a larger Asia-Pacific FTA, which would require successfully addressing the difficult task of forging a US-PRC agreement. The two processes are not mutually exclusive and will likely prove to be complementary in the long run. Whichever path or paths maybe taken, it is important to accelerate regional liberalisation and domestic economic reforms. A harmonious Asia-Pacific would likely see a convergence of RCEP and TPP. This would be a win-win outcome for the Asia-Pacific community.

## **Global trade governance**

International trade rules and institutions can have profound and lasting effects on the shifts and redefinition of trade relationships in Asia and globally. The responsibility for global trade governance has rested with the WTO since its creation in 1995, and its membership had grown to 159 countries by March 2013. The WTO's central function is to provide a forum for international trade negotiations which results in WTO agreements. The WTO's other functions include administering WTO agreements, monitoring national trade policies, and providing technical assistance and training for developing countries. The slow progress in the WTO Doha Round trade talks means that new multilateral trading rules will take time to evolve amid calls for WTO reforms.

In his essay, Biswajit Dhar assesses prospects for the Doha Round and the future work program for the WTO. The focus of the negotiations, which commenced in November 2001, was lower trade barriers in agriculture and non-agricultural market access (NAMA). The talks stalled in 2008 largely over a divide on major issues such

as agriculture subsidies, industrial tariffs and non-tariff barriers. Furthermore, some key players seem to have been preoccupied with domestic economic issues since the economic downturn following the global financial crisis and have given less attention to the trade talks. One challenge faced by the global community is to assess the key developments in the Doha Round which have contributed to the present stalemate. Another is to develop a new program for the WTO to tackle behind-the-border issues relevant to fragmented production systems and supply chains, particularly trade facilitation, investment policy and non-tariff barriers. Richard Baldwin argues that the WTO has not kept up with the need for new rules governing the intertwining of trade, investment, intellectual property and services. Bringing these rules to the multilateral level needs the creation of a new international organization – a “WTO 2.0”.

The narrow negotiating agenda and slow progress of the WTO Doha Round may be partly due to the nature of the WTO’s decision-making mechanism and its underlying principles of consensus and single undertaking. Mitchitaka Nakatomi and Tomochika Uyama, in their essays, explore the role of plurilateral agreements which focus on rule-making and liberalisation on a single trade issue. An example is the Information Technology Agreement (ITA) with an open accession clause. Plurilateral agreements permit interested parties to freely choose the issue for an agreement and voluntarily participate in the negotiations. Well-designed, issue-based plurilateral agreements can serve the needs of like-minded developed and developing countries alike, enhance the spread of FDI-driven global supply chains, and complement rule-making in the WTO and FTAs. Services, trade facilitation and electronic commerce may be candidates for future issue-based plurilateral agreements.

How to make regional trade rules in FTAs including mega-regionals compatible with multilateral trade rules under the WTO has emerged as an important issue for the world trading system. Rohini Acharya examines whether FTAs have developed common standards and rules that could ultimately be multilateralised. WTO research on FTAs internationally suggests that, although FTAs discriminate against third parties and diverge from one another, they do have some common features. Thus, either FTA

rules do not differ significantly from multilateral rules (for instance, in anti-dumping or SPS and TBT), or common families of FTAs have formed in the same geographical area showing similarities within the family. Creating the same rules and liberalisation commitments within families of agreements is a next step. This is one of the aims of negotiations for TPP (following the NAFTA structure) and RCEP (following the ASEAN+1 structure). Eventually, common rules in mega-regionals may be harmonised multilaterally.

Maika Oshikawa, explores the potential for collaboration between the WTO and ASEAN based on different institutional strengths and weaknesses. ASEAN has relative strength in the legislative function, suggesting that gains may be achieved from extending ASEAN-based FTAs on a non-discriminatory basis to additional parties. Efforts to consolidate ASEAN+1 FTAs into RCEP are a move in that direction. The WTO has strengths in the judicial function with a strong dispute settlement mechanism and in monitoring trade policies. Accordingly, in an ideal scenario the WTO and ASEAN may collaborate on the judicial and monitoring functions to ensure greater coherence between global and regional rules. This also would help the WTO prepare for the eventual multilateralisation of ASEAN+1 FTAs.

FDI flows are fundamental to the spread of global production networks but, while trade barriers have typically fallen over past decades, barriers to FDI remain high, including in Asia. Apart from the usual issues relating to non-national treatment of foreign firms, protectionist tendencies and national security considerations seem to be driving new restrictions on FDI. Alejandro Jara, as well as Zhang Yunling and Wang Rongyan, in their respective essays, discuss the importance of FDI to sustaining global growth, the conditions generating new restrictiveness on FDI, and policy options. New Asian FTAs emphasise national treatment of FDI and more liberal FDI rules and international organisations have developed good practice guidelines for FDI, but this seems insufficient. A case emerges for an eventual multilateral agreement on investment covering transparency on investment rules and investor facilitation, ideally housed in the WTO.

## Conclusions

The world trading system has changed fundamentally over the past years with the expansion of production networks and supply chain trade, signs of new commercial and industrial policies, and the spread of FTA-led regionalism. These developments are all here to stay, but the WTO has not kept up with them. WTO centrality in global trade governance is eroding and is at risk of continuing to erode. The rise of Factory Asia through supply chain trade has placed it increasingly at the heart of the global economy. The region is also experimenting with new approaches to FTAs and economic policies to sustain economic growth amidst a fragile world economy.

Asia's experience of open trade-led development offers many valuable lessons for other regions. These include the importance of pursuing market-friendly trade and industrial policies to develop supply chain trade, improving surveillance of non-tariff measures, and consolidating FTAs into a large region-wide FTA. Using more accurate data to measure value added trade and participants in supply chain trade (e.g. SMEs) provide empirical insights for policy development.

In the longer term, better coherence is vital between Asia's regional trade rules and global trade governance. Improving the quality of large Asia-wide FTAs, a WTO agenda on supply chains and FTAs, and significant reforms of the WTO are necessary moves towards this end. Issue-based plurilateral agreements and an eventual multilateral agreement on investment can also play a role in facilitating coherence between regional and global rules on trade.

The debate on global and regional trade governance in the new era is a work in progress and we hope that this eBook will better inform the search for policy options. ADBI, Vox and CEPR look forward to hosting further policy commentary and analysis as they arise.

## About the Editors

**Richard Edward Baldwin** is Professor of International Economics at the Graduate Institute, Geneva since 1991, a part-time visiting research professor at the University of Oxford since 2012, Policy Director of CEPR since 2006, and Editor-in-Chief of *Vox* since he founded it in June 2007. He was Co-managing Editor of the journal *Economic Policy* from 2000 to 2005, and Programme Director of CEPR's International Trade programme from 1991 to 2001. Before that he was a Senior Staff Economist for the President's Council of Economic Advisors in the Bush Administration (1990-1991), on leave from Columbia University Business School where he was Associate Professor. He did his PhD in economics at MIT with Paul Krugman. He was visiting professor at MIT in 2002/03 and has taught at universities in Italy, Germany and Norway. He has also worked as consultant for the numerous governments, the European Commission, OECD, World Bank, EFTA, and USAID. The author of numerous books and articles, his research interests include international trade, globalisation, regionalism, and European integration. He is a CEPR Research Fellow.

**Masahiro Kawai** is Dean and CEO of the Asian Development Bank Institute. He was previously special advisor to the ADB president in charge of regional economic cooperation and integration. Before that he was in the academia, first as an associate professor of economics at The Johns Hopkins University and later as a professor of economics at the University of Tokyo. He also served as chief economist for the World Bank's East Asia and the Pacific Region and as deputy vice minister for international affairs of Japan's Ministry of Finance. His recent publications focus on economic regionalism. He holds a BA in economics from the University of Tokyo and a PhD in economics from Stanford University.

**Ganeshan Wignaraja** is Director of Research at the Asian Development Bank Institute. Previously, he was principal economist at the Asian Development Bank, chief programme officer at the Commonwealth Secretariat, a manager in a UK economics consulting firm and has held research positions at Oxford University, the OECD and the

United Nations Institute for New Technologies. Dr. Wignaraja has published 12 books on trade and competitiveness, regional economic integration, industrial technology, and development strategy. He is an executive editor of the *Journal of Asian Economics*. He has a D.Phil in economics from Oxford University and a BSc in economics from the London School of Economics.



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## 2 The future of the world trade system: Asian perspectives

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### **Pascal Lamy**

Director-General, World Trade Organisation

Asia is a vast continent with large heterogeneity – physically, culturally, linguistically, politically, and economically. The region includes some of the world’s most competitive and sophisticated economies, as well as large emerging ones which are fast becoming important global players. At the same time, they co-exist with numerous smaller, poorer and more vulnerable economies, including landlocked and island states. Despite its rapid economic growth, Asia still remains home to nearly half of the world’s poor. The region is facing numerous challenges, ranging from rising inequalities and disparities, limited natural resources and vulnerability to climate change to the risk of falling into the “middle income trap”, all of which have implications for the rest of the world.

The past few decades have witnessed the rapid economic take-off of the region. Asia’s share of world merchandise trade has grown from around 13% in 1960 to over 30% in 2011. Asia is projected to account for more than half of global GDP, trade, and investment and to enjoy widespread affluence by the middle of the 21st century.

Trade has played a key role in shaping the transformation of Asian economies in recent history; Asia is a living example of how trade can contribute to economic development. The trade share of GDP in Asia grew from 13% in 1960 to 70% by 2007. During the same period, hundreds of millions have been lifted out of poverty. It is my belief that trade will continue to play a defining role in Asia’s future prosperity.

## **Development of supply chains as the basis for Asian integration**

Integration – both regional and global – has been central to Asian prosperity. The share of intra-regional trade in Asia’s merchandise trade has grown from about 20% in 1960 to over 50% in 2011. Asia’s rapid economic growth owes much to the development of webs of supply chains and production networks, often known as “Factory Asia”. A joint study by the WTO and IDE-JETRO in 2011 highlighted a degree of complementarity among Asian industries, which is both a cause and a consequence of deepened economic interdependency between countries.

Today, nearly 60% of world merchandise trade is trade in components. In Asia, the figure is closer to two-thirds. This owes much to services, including transport, communications and other business services, that become key components in the operation of supply chains. The same can be said of relatively low tariffs on industrial products and little escalation in the tariff structures. FDI has also played a big role in the expansion of trade in intermediate goods in Asia.

There is a debate on the casualty between the growing supply chains and the number of free trade agreements (FTAs) in Asia. In fact, Asia is a relative latecomer to FTAs, only increasing its involvement over the last decade, albeit at a dramatic scale. The number of ratified FTAs grew from 36 in 2002 to 109 at the beginning of 2013, with an additional 148 at various stages of negotiation. The development of supply chains in Asia has been driven by businesses, and it is the FTAs that are catching up with the business reality of more trade and investment. The key driver of regional integration through FTAs is reducing the costs of trading, including the quantity and quality of infrastructure, the quality of logistics, the quality of institutions, and the competitiveness of the economy. As tariffs are generally not a significant barrier anymore, these agreements have increasingly focused on non-tariff trade facilitation measures, both at and behind borders.

## **The case for multilateralisation**

The co-existence between FTAs and the multilateral system is likely to continue for the foreseeable future. The key is how best to pursue coherence between them. In light of the growing supply chains as the basis for deepening Asia's regional and global integration, there is a need for a path towards gradual multilateralisation – the extension of existing arrangements, in a non-discriminatory manner, to additional parties. Some recent initiatives to consolidate intra-regional FTAs into a broader regional agreement, such as the Regional Comprehensive Economic Partnership (RCEP) by the ASEAN+6 members, or the Tripartite Free Trade Area among the members of COMESA, EAC and SADC, could be stepping stones in that direction. It is important, however, that such convergence efforts do not end up in an agreement of the lowest common denominators or a closed agreement.

The case for multilateralisation is particularly strong in Asia. First, the idea of “open regionalism” was originated in the APEC context in 1996, as an option to extend the benefits of the ASEAN FTA accords to non-members on an MFN basis. While this idea was not formally adopted, APEC members have embraced and practiced it on a range of products.

Second, Asia is increasingly focusing on inter-regional FTAs, outreaching other continents whether between economies on both sides of the Pacific or with Europe, in addition to the already existing inter-regional fora such level APEC and ASEM.

Third, recent Asian FTAs focus more on reducing non-tariff measures, involving standards, technical regulations, certification procedures, services regulations, prudential rules, and so on. While these measures are more complicated to negotiate than tariffs, once an agreement is reached their implementation would not only be easier, but also less costly and more efficient, if it is done in a non-discriminatory fashion.

Fourth, unilateral trade opening is one form of multilateralisation that has been widely practised as part of domestic reforms. According to a World Bank study, unilateral

actions constituted around 65% of trade opening worldwide between 1983 and 2003. This is especially true in Asia.

Finally, while multilateralisation itself does not automatically translate into multilateral accords, locking in these trade opening efforts in the WTO can provide credibility, transparency and predictability, which are central to the smooth operation of supply chains. Given the huge economic and systemic interests involved in the maintenance of an open, well-functioning trading system, Asia could proactively contribute to strengthening the global trading system by bringing their negotiating energies back to the WTO, ensuring greater coherence and synergies in their trade opening efforts at the regional and global levels.

## **Asia and the WTO**

While some Asian members might be frustrated at slow progress on the DDA negotiations, there are areas in which the WTO can complement and facilitate the integration efforts back home. For instance, a conclusion of the trade facilitation negotiations could help improve regional connectivity by halving logistical and other costs associated with border and customs procedures. Together with regional institutions, we can also ensure that Aid for Trade helps build trade capacity in poorer Asian countries, including capacity to implement a WTO trade facilitation deal. We can also work together to ensure availability and affordability of trade finance, in particular for SMEs.

Asia has been a successful model of development through trade, which has inspired many others around the world. There is no doubt that the region will continue to inspire the trade community in the decades to come.

With its significant economic and trade weight in the global economy, Asia is expected to shoulder more responsibilities and take the lead in the global trading system in the future. Its contribution to a successful WTO Ministerial Conference in Bali in December 2013 will be essential.

## **About the author**

**Pascal Lamy** began his career in the French civil service at the Inspection Générale des finances and at the Treasury. He then became an advisor to the Finance Minister Jacques Delors, and subsequently to Prime Minister Pierre Mauroy. In Brussels from 1985 to 1994, Pascal Lamy was Chief of staff for the President of the European Commission, Jacques Delors, and his representative as Sherpa in the G7. In November 1994, he joined the team in charge of rescuing Credit Lyonnais, and later became CEO of the bank until its privatisation in 1999. Between 1999 and 2004, Pascal Lamy was Commissioner for Trade at the European Commission under Romano Prodi. After his tenure in Brussels, Pascal Lamy spent a short sabbatical period as President of “Notre Europe”, a think tank working on European integration, as associate Professor at the l’Institut d’études politiques in Paris and as advisor to Poul Nyrup Rasmussen (President of the European Socialist Party). Mr. Lamy holds degrees from the Paris based Ecole des Hautes Études Commerciales (HEC), from the Institut d’Etudes Politiques (IEP) and from the Ecole Nationale d’Administration.



# Section 1

## Supply Chains and Production Networks





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# 3 WTO 2.0: Thinking ahead on global trade

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## **Richard Baldwin**

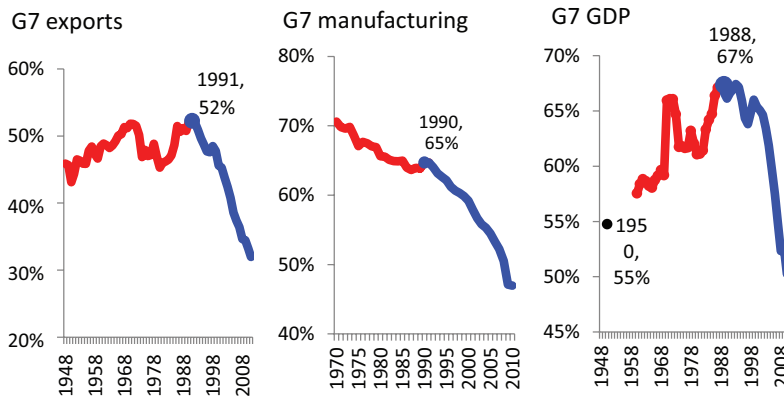
Graduate Institute and CEPR

The cross-border flows of goods, investment, services, know-how and people associated with international production networks – call it ‘supply-chain trade’ for short – has transformed the world (Gereffi and Lee 2012). The WTO has not kept pace. It is time to change that, as I argued in CEPR Policy Insight No 64 (Baldwin 2012). Before turning to the governance issue, consider the changes.

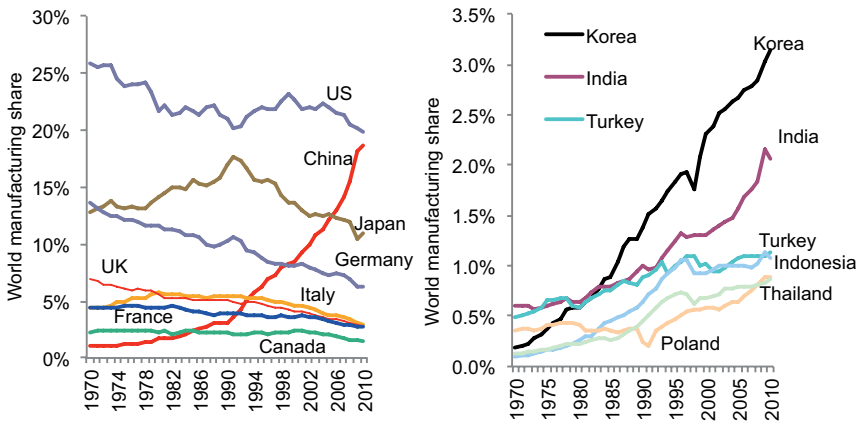
### **The world of trade has changed**

Since the 1990s, globalisation has been associated with a sharp drop in rich nations’ share of world income, world manufacturing and world exports (Figure 1). The big winners are developing nations that industrialised by joining, rather than by building, supply chains (Figure 2). The big share winners are all part of the supply chains of the US, Germany (Poland and Turkey), and Japan (People’s Republic of China (PRC), Republic of Korea, Indonesia and Thailand). India is the exception. This rapid industrialisation also pulled up a wide range of developing nation commodity exporters like Brazil, Russia, Australia and South Africa.

**Figure 1** G7 share of world exports, manufacturing and GDP



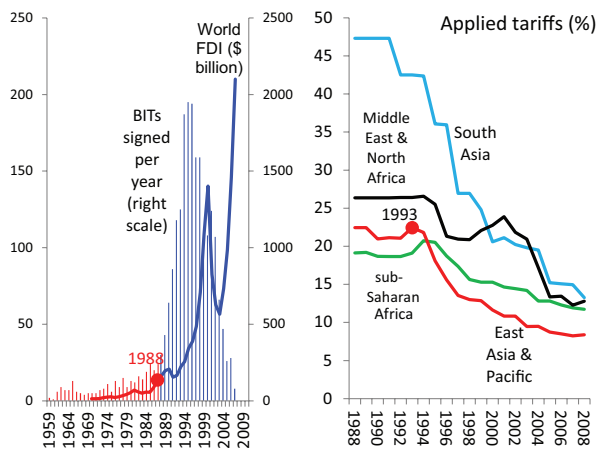
**Figure 2** Manufacturing shares: Seven gainers and the G7 losers



The world of trade politics and trade governance also changed. If a high-tech firm is to locate production stages in a developing nation, the nation's government must ensure the necessary free movement of goods, services, information and the protection of tangible and intangible property rights. Old fashioned protection, anti-FDI policies, or lax property rights almost guarantee that the offshored stages will go somewhere else. Developing nations that got the offshored factories became hyper-competitive and wiped out the exports of developing nations that clung to import-substitution industrialisation. In the world of supply-chain industrialisation, protectionism has become destructionism.

Having learned this lesson, developing nations unilaterally lowered tariffs and eagerly signed up for deep disciplines in regional trade agreements and bilateral investment treaties (Figure 3). It happened regionally, rather than multilaterally since most supply chains are regional (Baldwin and Lopez-Gonzales 2012). The fact that the WTO has been locked in a decade-long preoccupation with 20th century trade issues (tariffs and agriculture) in the Doha Round has merely exacerbated the regionalisation of supply-chain disciplines.

**Figure 3** Trade politics changed: Protectionism became destructionism



The latest erosion of WTO centrality comes with the mega-regionals – like the Trans-Pacific Partnership – that are being negotiated. On current trajectory, rules for supply chain trade will have been harmonised in these mega-regionals within a few years entirely outside the WTO’s ambit.

### Looking ahead on global trade governance: WTO 2.0 needed

The new rules and disciplines underpinning the rise of supply-chain trade have been and continue to be written outside the WTO – primarily in deep RTAs, BITs, and autonomous reforms by emerging economies. Efforts to harmonise these new disciplines are taking place in mega-regionals (Trans-Pacific Partnership, Trans-Atlantic Partnership, etc.)

and mega-bilaterals (e.g. EU-Japan) that are under negotiation or discussion. As the Doha Round is unlikely to conclude before 2020 and WTO engagement in supply-chain issues is unlikely before it does, world trade governance is headed for fragmentation. Specifically, supply-chain disciplines will be harmonised by mega-regionals and mega-bilaterals that will, on current trajectory, exclude the PRC and other large emerging economies.

Repairing the fragmentation and exclusion will require supply-chain disciplines to be multilateralised into a new organisation – call it WTO 2.0. A new organisation is needed since today's WTO is not suited to the task.

The GATT/WTO's success was based on win-win cooperation whose nature followed from the nature of traditional trade – i.e. goods crossing borders. With traditional trade, tariffs help the protecting nation while harming others, so the end result of individually rational protection is collective folly. The GATT/WTO flourished by solving this coordination problem – by disciplining selfish-but-harmful-to-others policies. The basic GATT/WTO bargain that underpinned the discipline was 'my market for your market'. Negative third-nation effects were global, so universal membership was the natural outcome. Given vast market-size and income differences, 'Special and Differential Treatment' for developing nations was a natural part of the package.

Supply-chain trade poses radically different coordination problems, so it is natural that the structure of the organisation that solves it would be radically different. The cross-border flows that trigger supply-chain trade tend to be one-way. Advanced-technology firms offshore tangible and intangible assets, combining them with low-wage labour in developing nations. The firms get higher returns on their firm-specific assets; the developing nations get fast-track industrialisation.

As such, the basic deal in supply-chain cooperation is not "I'll keep my market open if you keep yours open", as in WTO 1.0. It is "I'll offshore my factories and technologies if you assure my tangible and intangible assets are protected". The negative third-nation effects are limited, so the logic of universal membership in WTO 2.0 is weak.

The justification for SDT also disappears. The cooperation helps developing nations credibly commit to policies that are good for them. Allowing a poor nation to not assure protection of the assets that trigger supply-chain trade would harm rather than help. In the world of supply-chain trade, protectionism is destructionism as far as developing nations are concerned. Given that WTO 1.0 has universal membership and Special and Differential Treatment in its DNA, multilateralising supply-chain disciplines will require a new organisation – WTO 2.0, as it were.

## **Conclusions**

Much of my 2012 CEPR Policy Insight is based on judgements and conjectures that are debateable. One point that is not debateable, however. WTO centrality in global trade governance is eroding and will continue to erode. On current trajectory, multilateralism will continue to reign for traditional trade, but fragmentation and exclusion are the most likely outcomes when it comes to the most dynamic segment of international commerce – supply-chain trade.

This may well end up as the new normal. The PRC and other large emerging markets may be big enough to counter the exclusion. They may continue to attract offshored factories with a “my internal market for your factories and technology” deal instead of the “your factories for my reform” deal that most developing nations must make.

This new normal, however, would hardly be the best the world can do. Worse yet, a fragmented world dominated by Great-Power struggles could lead to the steady erosion of the WTO’s centrality that sooner or later brings the world to a tipping point – a point beyond which expectations become unmoored and nations feel justified in ignoring WTO 1.0 norms since everyone else does.

I am not sure that the solutions proposed in my Policy Insight are the right ones, but I am sure that solutions must be found if the world trade system is to avoid fragmentation and exclusion. It’s time to start thinking ahead on global trade governance.

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## About the author

**Richard Baldwin** is Professor of International Economics at the Graduate Institute. Professor Baldwin is also the Policy Director of CEPR since 2006, Editor-in-Chief of Vox since he founded it in June 2007, and an elected Member of the Council of the European Economic Association. He was a Senior Staff Economist for the President’s Council of Economic Advisors in the Bush Administration (1990-1991) following Uruguay Round, NAFTA and EAI negotiations as well as numerous US-Japan trade issues including the SII talks and the Semiconductor Agreement renewal. He was Co-managing Editor of the journal *Economic Policy* from 2000 to 2005, and Programme Director of CEPR’s International Trade programme from 1991 to 2001. Author of numerous books and articles, his research interests include international trade, globalization, regionalism, and European integration. He wrote his PhD at MIT under the guidance of Paul Krugman, His M.Sc. is from LSE, his B.A. from the University of Wisconsin-Madison; he was awarded an honorary doctorate by Turku School of Economics and Business in 2005.

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# 4 Trade in value-added: An East Asian perspective

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**Satoshi Inomata**

Institute of Developing Economies, JETRO

## 1. Introduction

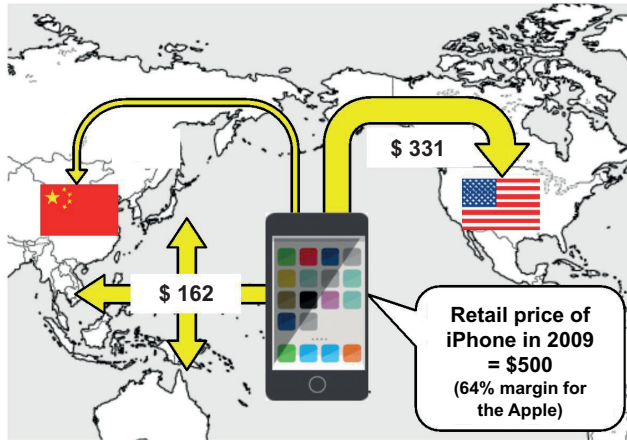
The Institute of Developing Economies conducted a joint research work with the WTO on the topic of global value chains, and published a report of the collaboration in June 2011 (WTO and IDE-JETRO 2011). The publication introduces the concept of “trade in value-added”, which addresses an important issue of measuring international trade in the face of growing production-sharing among different countries. The trade in value-added approach enables us to redefine the relationship between countries of origin and destination in international trade. In contrast to the orthodox concept of trade balances based on foreign trade statistics, it focuses on the value-added contents of a traded product, and considers each country’s contribution to value-added generation in its production process.

As such, this chapter aims to provide a non-technical explanation of the concept of trade in value-added, and in particular stresses the importance of the dataset called “International Input-Output Tables” for its measurement. The next section illustrates the idea of measuring trade in terms of value-added by referring to the example of the iPhone’s production networks. Section 3 introduces some analytical examples and the final section concludes with some policy implications.

## 2. What is measured by “trade in value-added”?

Figure 1 shows the international value distribution of an iPhone. It shows how much value accrues to the companies of the various countries that participate in the iPhone production networks. So, of US\$500 retail price of iPhones in 2009, the US received \$331 as a pay-back, Japan, Germany, and other major industrialised countries received \$162 in total, and the People’s Republic of China (PRC), which was the largest producer and exporter of iPhones, received only \$7.

**Figure 1** International value distribution of iPhones



Source: Drawn by the author, based on Xing and Detert (2010).

Why does this happen? Every component of an iPhone is produced by different production technologies, and hence has a different market value. Flash memories and touch screens, for example, are products of Toshiba, so the Japanese contribution to an iPhone is known to be around \$61 (Table 1).



**Table 1** Cost structure of parts for an iPhone3G

Manufacturer	Components	Unit price (US\$)
Toshiba (Japan)	Flash memory	24.00
	Display module	19.25
	Touch screen	16.00
Samsung (Rep. of Korea)	Application processor	14.46
	SDRAM-mobile DDR	8.50
Infineon (Germany)	Baseband	13.00
	Camera module	9.55
	RF Transceiver	2.80
	GPS receiver	2.25
	Power IC RF function	1.25
Broadcom (US)	Bluetooth/FM/WLAN	5.95
Numonyx (US)	Memory MCP	3.65
Murata (Japan)	FEM	1.35
Dialog Semiconductor (Germany)	Power IC application processor function	1.30
Cirrus Logic (US)	Audio codec	1.15
Others		48.00

Source: Xing and Detert (2010).

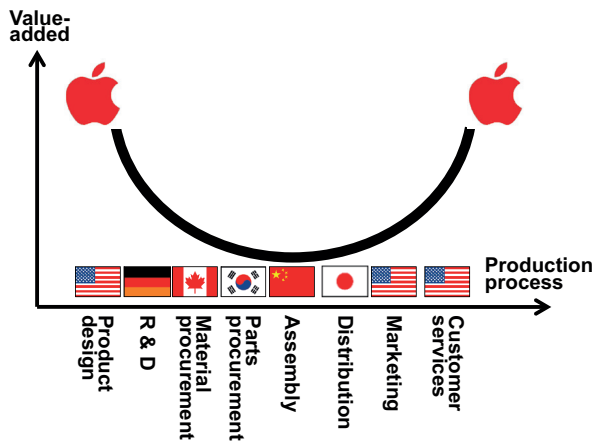
It is not surprising to see that market values differ depending on the type of component, but such a value gap can also emerge among the tasks in the production process. Suppose that the production of iPhones involves the following eight production stages:

- Product design
- Research & Development
- Material procurement
- Parts procurement
- Assembly
- Distribution
- Marketing
- Customer services

Also suppose that the tasks are carried out in different countries through international outsourcing. Here, if we align the production stages along the horizontal axis from

the upstream to downstream process, and if we take the vertical axis as the amount of value-added generated by each task/production stage, then the functional graph will be drawn as in Figure 2. Usually, it is at both peripheral sides along the task spectrum where the companies receive the higher values, for example from product design, R&D, marketing and customer support. Most of these accrue to advanced economies. On top of this, the highest values are captured, of course, by the lead firm, i.e. Apple. In contrast, the tasks in the middle range tend to require unskilled labour and thus have lower value-added, particularly the assembling stage which takes place predominantly in the PRC. Because of its shape, we usually call this diagram a “smile curve”, and it is the relative position of the countries along the smile curve that determines the international distribution of value-added.

**Figure 2** A “Smile Curve”



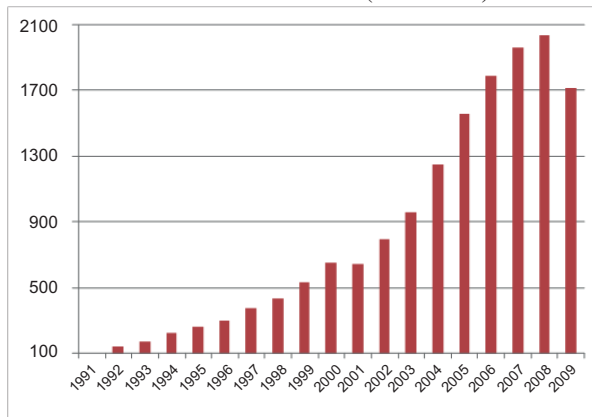
Source: Drawn by the author.

These observations pose a fundamental question about the way that we measure international trade today. iPhones are produced in the PRC and exported to the US, the main consumption market. Yet what Chinese producers do is indeed a very simple task of assembling parts and components, and hence the amount that they receive for the work is minimal. On the other hand, the iPhones exported from the PRC are finished products, with values of around \$180. This means that the current trade statistics, which only concern the physical transfer of goods and services from an immediate trading

partner, record a value of Chinese export that has no relevance to the real picture for Chinese manufacturers.

The way in which trade statistics are compiled underpins the supposed trade imbalance between the PRC and the US (Figure 3). We have just seen, however, that a significant part of the values embodied in Chinese exports has its origin in other countries, implying that the PRC's trade surplus – or the US's trade deficit – is significantly overestimated under the current measurement, as compared to the alternative method of measuring trade in terms of value-added.

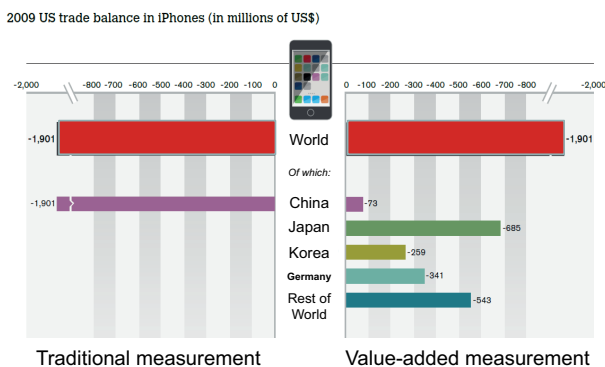
**Figure 3** The US trade deficits with the PRC (1991=100)



Source: Drawn by the author, based on the UN Comtrade

Using the value-added concept, we can redraw the bilateral trade balances of the iPhone. Figure 4 compares the US trade deficit of the iPhone in 2009 using the traditional measurement and the value-added measurement. In terms of value-added, the US deficit of \$1.9 billion against the PRC is reduced to only \$73 million, which can be broken down to the deficits vis-à-vis other countries such as Japan and Germany, the core parts suppliers for iPhones.

**Figure 4** The US trade balance of iPhones in 2009

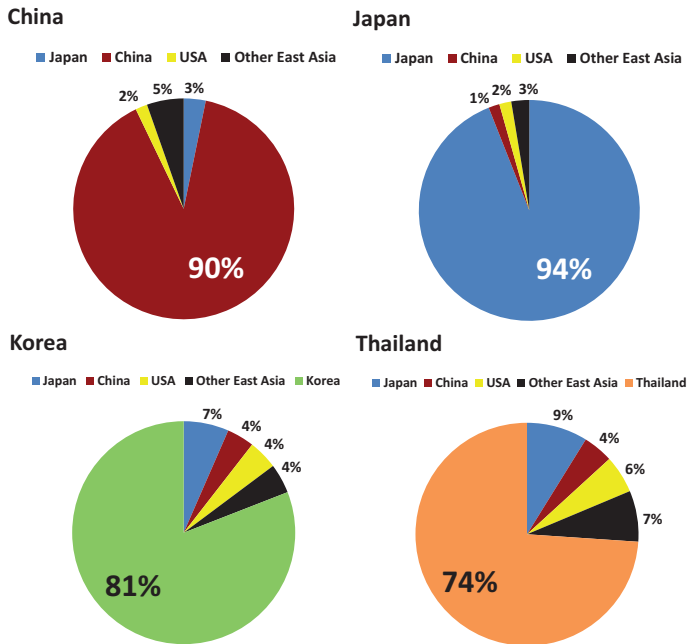


Source: WTO and IDE-JETRO (2011)

### 3. Some analytical results

Some analytical examples of the trade in value-added approach using the Asian International Input-Output Tables follow. The first chart in Figure 5 shows the country share of the origins of value-added embodied in the PRC’s exports to the US. Because the data refers to the PRC’s exports, it is quite evident that Chinese value-added is the largest, but at the same time it is also seen that other countries, especially Japan, contribute significantly to the value-added of Chinese exports. It is notable that the US itself, the export destination, is also shown as an origin of value-added. This is an interesting feature of the trade in value-added approach.

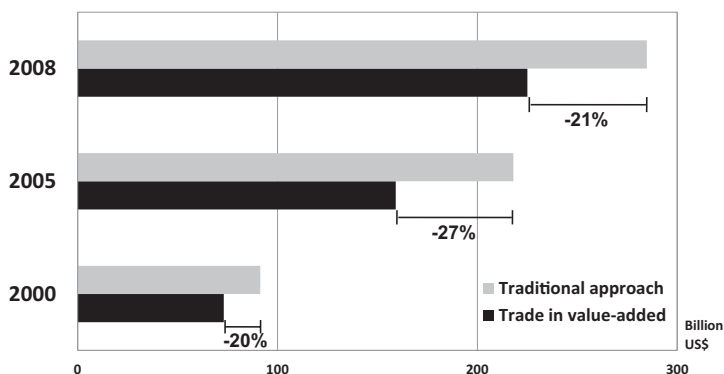
The results of decomposing value-added origins of exports can be compared for other East Asian countries. Even though we have repeatedly argued that a significant part of value-added in the PRC’s exports has its origin overseas, this cross-country comparison shows that even larger shares are attributable to foreign origins in the cases of Republic of Korea and Thailand. This is a rather generic observation about small open economies with a high degree of dependency on foreign markets for both demand and supply of goods and services.

**Figure 5** The origins of value-added embodied in domestic export to the US (2005)

Source: Calculated and drawn by the author.

Figure 6 shows the US trade deficits with the PRC for 2000, 2005, and 2008, with the grey bars indicating the trade deficits measured using the traditional approach, and the black bars showing the deficits measured in terms of value-added. (These are nationwide deficits, not of a particular product as we saw for the iPhone.) It is striking that in terms of value-added, the trade deficit is reduced by 20-30% compared to the traditional measurement. According to the WTO's estimate, the deficit would even be halved if we take into account the influence of export-processing zones in coastal areas of the PRC.

**Figure 6** The US trade deficit with the PRC



Source: WTO and IDE-JETRO (2011)

#### 4. Concluding remarks

Compared to the traditional method based on foreign trade statistics which only record the physical transfer of products between immediate trading countries, the trade in value-added approach measures international trade as a flow of values, rather than of goods and services. Its analytical benefits, especially from a policymaking perspective, are:

1. It provides a more realistic view of bilateral trade in the light of international production-sharing.
2. It avoids multiple counting of trade flows when goods are transferred across borders.
3. It univocally attributes the origins of imported products, which helps in designing specific trade policies such as tax schemes.

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# 5 Rethinking the impact of exchange rates on trade flows along global production networks

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**Yuqing Xing**

Asian Development Bank Institute

Conventional trade theory suggests that exchange rates play a critical role in determining the competitiveness of a country in the global market. If a country's currency appreciates, its exports become more expensive and thus foreign demand decreases, while imports become cheaper and demand for them increases. Consequently, the trade surplus shrinks. Following this simplistic view, much of the debate over global imbalances has focused on the exchange rate regime of the People's Republic of China (PRC). Despite an appreciation of more than 30% of the yuan's value against the US dollar, there is little evidence that this has helped mitigate the PRC's trade surplus. In fact, empirical evidence shows that variations in exchange rates have surprisingly small effects on prices of traded goods. This apparent disconnection is one of the central puzzles in international macroeconomics (Amiti et al. 2013).

The conventional view on the nexus between exchange rates and trade is based on outdated assumptions that the entire value-added of a country's exports is produced domestically, and all imports exclusively serve domestic consumption and investment. The fact is that international trade of manufactured products, in particular information communication technology products, is more sophisticated than during the time of the British economist David Ricardo. Proliferation of cross-country production fragmentation and global production networks has fundamentally changed the very nature of international trade. Integration of production processes, which involves sequential, vertical trading chains stretching across many countries, has transformed the trading of manufactured goods to essentially trading tasks (Grossman and Rossi-

Hansberg 2008). Therefore, value-added, embedded in products manufactured along global production networks, is not attributed to any single country, but to all countries involved in the process. Regardless of whether firms have the monopolistic power to engage in exchange rate pass-through, the currency appreciation of a single country would have a very limited effect on the cost of products designed, manufactured and distributed by global supply chains.

Taking the iPhone as an example, manufacturing iPhones involves nine companies located in the PRC, Germany, Japan, Republic of Korea and the US. All components produced by the suppliers on the iPhone global supply chain are shipped to Foxconn, a Taipei, China company located in Shenzhen, the PRC, for assembly into the final product and then exported to the US and the rest of the world. In 2009, iPhones contributed US\$1.9 billion to the US trade deficit, equivalent to about 0.8% of the total US trade deficit with the PRC (Xing and Detert 2010). Can we expect a 50% appreciation of the yuan against the US dollar to reduce the deficit associated with iPhone trade? This is highly unlikely. Chinese workers contribute a mere \$6.5, about 3.6%, of the total iPhone manufacturing cost of \$180. A 50% appreciation of the yuan would only affect the \$6.5 assembly cost materialised in the PRC, not the entire manufacturing cost \$180. The appreciation would, at most, raise the manufacturing cost of the iPhone by \$3.25, which is insignificant compared to the \$500 retail price. Hence, an appreciation of the yuan would not affect the price of the iPhone, and the US trade deficit due to iPhone trade would not shrink. In 2011, the PRC exported 34 million iPhones to the US, triple the volume of 2009, despite the steady appreciation of the yuan. This is unambiguous evidence supporting the disconnection between exchange rates and flows of goods produced along global production networks.

In addition, five different countries are involved in manufacturing iPhones, and currencies of these five countries may not move in the same direction. It is possible that other currencies might depreciate against the US dollar while the yuan appreciates. This simultaneous depreciation of other currencies would offset the potential negative impact of the yuan's appreciation on the manufacturing cost of the iPhone. Therefore,

to accurately examine the impact of exchange rates movements on the cost of manufacturing iPhone, the net effect of all currencies involved should be estimated instead of focusing on one single currency.

The iPhone is a typical example of a product manufactured along global production chains. The same logic can be applied to all exports which are made of imported parts and manufactured through global production networks. Costs of imports comprise a significant share of the costs of exports manufactured using imported components. Whether appreciation of the final exporting country's currency would raise the overall costs of its exports, and eventually undermine its global competitiveness, depends on the ratio between costs of imported components and the value added generated domestically. In East Asia, the production networks developed by multinational enterprises have created a PRC-centred triangle trade pattern: the PRC imports intermediate inputs from East Asian economies, assembles them into finished products, and exports them to the US and European markets (Athukorala 2011). The PRC's processing trade accounted for 100% of its trade surplus in 2008. 77% of its processing imports originated in East Asian economies such as Japan, Taipei, China, and Republic of Korea, while more than 70% of its processing exports were destined for markets outside of East Asia (Xing 2012). This implies that the competitiveness of Chinese processing exports depends not only on the exchange rate of the yuan, but also on the exchange rates of other East Asian currencies.

Considering that domestic content represents only a small portion of the total value of the PRC's processing trade, a unilateral appreciation of yuan may have limited impact on the PRC's processing exports. There is, in fact, empirical evidence to support this thesis; Thorbecke and Smith (2010) construct an integrated exchange rate – a weighted exchange rate between the yuan and the currencies of other East Asian economies – according to the importance of their trade with the PRC. They find that a joint appreciation of East Asian currencies is more effective in reducing the PRC's trade surplus than a unilateral appreciation of the yuan.

Furthermore, as conventional real effective exchange rates (REER), based on gross trade flows and consumer price indices, are not compatible with trade flows through vertical specialisations, Bems and Johnson (2012) propose a value-added REER, in which the weights of trading partners are given by bilateral trade in value-added. As value-added REER takes global value chains into account in assessing competitiveness, they suggest that the value-added REER can be used as an alternative to evaluate the impact of exchange rates on the comparative advantage of countries participating in global production networks.

Moreover, many countries along global production networks need to import a large quantity of parts and components to manufacture processing exports. As the global assembly centre, the PRC imported \$481 billion in parts and components, equivalent to 27% of its total imports in 2012. These kinds of imports do not respond to the movement of exchange rates in the traditional fashion; processing imports would decrease rather than increase if the appreciation of the yuan led to a decrease in its processing exports. Examining the elasticity of the PRC's processing trade to exchange rates, I found that the PRC's processing imports would fall by 5% for a 10% real appreciation of the yuan (Xing 2012). Similarly, using Belgian firm-level data, Amiti et al. (2013) show that exporters that import a large share of inputs pass on a much smaller share of the exchange rate shocks to exports prices. They argue that movements in the value of a country's currency are correlated across its trade partners, thus creating a natural hedge from exchange rate movements, and reducing the need for the exporter to adjust their export market prices.

A recent study by UNCTAD (2013) shows that foreign value-added accounted for 31% of the gross exports of developed economies, and 25% of developing economies. This suggests that many economies are now involved in global production networks and global supply chains. In a world driven by global supply chains, the standard textbook relationship between exchange rates and trade is outdated and no longer valid. The movement of a single country's currency cannot determine the competitiveness of globally produced exports.

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## 6 Do SMEs matter in Asian production networks?

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**Ganeshan Wignaraja**

Asian Development Bank Institute

### **A spotlight on SMEs**

SMEs are the backbone of economic development in Asian economies, accounting for the majority of firms and a large share of employment (Havic 2010). Facing an outlook of fragile world growth, the Association of South East Asian Economies (ASEAN) and East Asia Summits in 2011 emphasised the role of SMEs in increasing intra-regional trade and enhancing inclusive growth in Asia. The policy focus on SMEs will intensify with upcoming regional trade liberalisation under the ASEAN Economic Community (AEC) project, the Regional Comprehensive Economic Partnership (RCEP) and the Transpacific Partnership (TPP). Using firm-level data, this chapter examines whether SMEs matter in production networks in ASEAN economies, key factors affecting the role of SMEs, and what supporting policies are required.

### **.....but little research exists on SMEs in production networks**

A major feature of Asia's industrial success over recent decades has been growing global production networks and a regional division of labour (Baldwin 2011). Increasing returns and the advantages of specialisation of factors within firms have encouraged geographical fragmentation of production connected by service links. Components, rather than final goods, make up much of the region's trade between firms (Athukorala 2011). Greater SME participation in global production networks through closer supplier linkages with multinational corporations (MNCs) and direct exports can be a potent

means of accelerating technology transfer, skill upgrading, and economic development (Lim and Kimura 2010).

Empirical research on SMEs in production networks in Asia has been hitherto constrained by an absence of comparable published data at industry level. What little research exists is sometimes contentious due to different definitions used and timeliness (Tambunan 2009). To overcome these limitations, in a recent study I use micro-level data from 5,900 manufacturing enterprises from five ASEAN economies – Malaysia, Thailand, Indonesia, the Philippines, and Viet Nam – at different levels of economic development (Wignaraja 2012). Adopting the standard OECD definition, SMEs are defined in the study as enterprises having less than 100 employees. About 70% of sample are SMEs and the rest are large firms. The randomly selected enterprise-level data come from the World Bank's Enterprise Surveys and are for 2006 or 2008.

The main focus of the study is an econometric analysis of firm-level factors affecting participation in production networks drawing on recent empirical literature on international trade, industrial organisation, and technology. Highlighting the notion of heterogeneity of firms in international trade, this literature points to certain firm-level characteristics (such as size, foreign ownership, skills, and technological capabilities) as shaping firm-level participation in production networks (for a survey, see Wignaraja 2013). As the overall business environment impinges upon SME participation in production networks, the study also explored selected policy influences including a ranking by SMEs of the main obstacles to conducting business in ASEAN economies as well as SME perceptions of business and support services.

### **Variable SME role in production networks - evidence**

Three findings are noteworthy. First, large firms are the leading players in production networks in ASEAN economies, while SMEs are relatively minor players. About 22% of SMEs as a share of all SMEs in the sample participate in such networks (as direct



exporters or suppliers of intermediates to MNCs). Meanwhile, 72.1% of all large firms in the sample engage in production networks.

Second, higher SME participation rates are visible in more industrially developed ASEAN economies (e.g. Malaysia and Thailand) with more inward investment and a longer experience of production networks than other ASEAN economies. As much as 46.2% of all Malaysian SMEs and 30% of Thai SMEs engage in production networks. These figures compare with lower SME participation rates in other ASEAN economies (21.4% for Viet Nam, 20.1% in the Philippines, and 6.3% in Indonesia).

Third, SMEs do export directly to international markets, but less than large firms in the five ASEAN economies. SMEs account for 23% of direct exports from all ASEAN sample firms compared with 77% for large firms. Malaysia (28.1%) and Thailand (34.7%) are ASEAN's leaders in terms of SME shares of direct exports. Viet Nam has an SME export share of 16.8%, while Indonesia has 9.3%. If indirect exports from SMEs (through subcontracting or supplier relations) are also taken into account, the contribution of SMEs to exports in ASEAN economies is likely to be higher than the figures suggest. The available data also hints at a modest increase in the SME participation in exports since the late 1990s.

## **Firm heterogeneity shapes SME participation**

The econometric analysis underscored the notion of firm heterogeneity in production networks in ASEAN economies (i.e., that firms are considered different in terms of efficiency and fixed and variable costs when involved in production networks). The probability of SME participation in production networks was positively and significantly affected by several key factors:

- Larger firm size matters, indicating that economies of scale can help overcome the initial fixed costs and possibly variable costs of entering production networks.

- Foreign ownership facilitates access to the ownership advantages of parent firms (such as superior marketing know-how, technologies and management experience), which can improve efficiency in SMEs and hence participation in production networks.
- Better human capital (e.g. highly educated workers and experienced chief executives) increases the possibility that SMEs may enter production networks.
- SMEs which have invested significantly in building higher levels of technological capabilities are more likely to succeed in production networks.
- In the presence of capital market imperfections, well-organised SMEs with collateral and an established record with commercial banks are more likely to join production networks.

Interestingly, firm age was negative and significant. This unexpected finding suggests that younger firms were more likely to join production networks than older firms (or the older firms have become more integrated). Other enterprise characteristics are linked with age – the importance of educated, experienced entrepreneurs and building technological capabilities are underscored.

## **Importance of the business environment**

The exploration of policy influences on SME business activity in ASEAN economies provides additional insights. A high degree of trust among firms is increasingly regarded by MNCs as a critical ingredient for developing market-led production networks. Among other things, high levels of trust encourages positive collective behaviour among firms – such as sharing of sensitive information, pooling of technical knowledge, and joint production and marketing activities – which is critical in technologically intense, efficient production networks.

Supply-side factors – such as access to low cost finance, low electricity costs, efficient transport systems, and well educated workers – are also critical to SMEs. On the policy

and regulatory side, behind-the-border issues like low corporate tax rates and economic certainty additionally play their part.

Finally, limited evidence from Malaysia and Thailand suggests that affordable and high-quality business support services for SMEs are invaluable. These include a wide range of services produced by public and private institutions in the areas of engineering, marketing, accounting, legal and information technology services.

### **Policy implications**

Thus, SMEs do matter to some extent in Asian global production networks, particularly in more industrially developed ASEAN economies (like Malaysia and Thailand), thereby suggesting a large potential role for SMEs in global production networks. Nonetheless, it also seems that SMEs in several ASEAN economies are at a disadvantage for participation in production networks compared with large firms. SMEs face, to a greater extent than large firms, resource constraints (in terms of finance, information, management capacity, and technological capability). Moreover, SMEs suffer disproportionately from external barriers like market imperfections and regulations.

The quest for more inclusive Asian growth, coupled with the disadvantages of small firm size, justifies greater public policy support for involving SME in production networks in the region. Additionally, more intense competition is likely with upcoming regional trade liberalisation in Asia with implications for industrial adjustment in SMEs. In the main, support for Asian SMEs should be geared to ensuring a policy environment that opens access to markets and competition, reduces bureaucratic impediments against SMEs, and facilitates integrated SME institutional support services (e.g. information, technology, marketing, and finance). Investments to create world class infrastructure and industry-relevant skills through education and training are also important to support Asian SMEs.

Within a market-oriented strategy for SMEs, policies to promote industrial clusters in specific geographical locations or sectors may be justified under some circumstances. Such policies might range from industry-specific tax measures, to the provision of specialised institutional support for a particular cluster. Joint actions (e.g. the setting up of specialised training school) between a business association in the cluster and an aid donor or a government agency are also common. But cluster policies should not be applied in an ad hoc manner, as there is a risk of government failure. Instead, the use of cluster policies should be guided by near future comparative advantage, be strictly time-bound and be measured by clearly defined performance criteria.

In the absence of industry-level data on SMEs in many Asian countries, micro-level analysis provides useful insights on the characteristics of firms in production networks and policy influences. Further research is merited on this topic using time-series and panel data, and industry characteristics as well as a larger sample of Asian countries.

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## Section 2

# Commercial and Industrial Policies





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# 7 Increasing value from global value chain participation: What role for industrial policy?

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**Patrick Low** and **Julia Tijaja**

World Trade Organization; Fung Global Institute

As global value chain (GVC) participation becomes an increasingly commonplace form of insertion into the world economy, interest has grown among governments and firms in how the benefits from participation are distributed along the chains. To the extent that sources of value are geographically substitutable along value chains, seeking higher shares of value-added on existing chains through ‘upgrading’<sup>1</sup>, or through participating in new ones, is a perennial pursuit. Upgrading has been defined as “the shift in firms’ activity in the GVCs to sustain higher earnings” (Humphrey and Schmitz 2000).

Governments seek to maximise value capture at the national level in order to address developmental objectives such as better living standards, higher productivity, the deployment of new technologies, increased employment opportunities, and more diversified and resilient economies.

The key interest of firms is to maximise profits. Lead firms on vertically integrated value chains typically seek to locate activities where they yield the highest returns. This may or may not offer upgrading opportunities for particular countries and value chain participants within their borders. Domestic value chain participants will want to maximise their own value-added and will seek ways of doing so, including by engaging with other supply chains or seeking to become lead firms themselves.

<sup>1</sup> Upgrading is only one mechanism for adding additional value from supply chain participation. Gunter (2011) distinguishes between industrial diversification, industrial expansion and upgrading, and industrial deepening.

With different motivations, the optimal outcomes would differ between governments and firms. This is largely due to market failures (e.g. under-provision of public goods or externalities). Industrial policy is a tool for governments to maximise alignments with firms as value chain actors.

## **Two kinds of policies: Horizontal and industry-specific**

Policies can be broadly or narrowly focused. Broad-based or horizontal policies are targeted at inefficiencies and dead-weight losses, and seek ways of increasing competitiveness. Such policies may include streamlining administrative procedures, lowering the costs of doing business, strengthening institutions and developing infrastructure. The main point about horizontal policies is that they have economy-wide implications. These kinds of policies are less contentious than narrowly focused policies such as specifically targeted interventions that are typically referred to as industrial policy. Our focus is on industrial policy, although it should be noted that these two approaches are not mutually exclusive.

Industry-specific policies seek to change the incentive structure and stimulate activities in particular areas. A typical justification for such actions would be that market failures lead to resource misallocation, leading the economy to a suboptimal future. Different terms have been used to refer to variants of updated approaches to industrial policy, from strategic industrial policy (SIP) (Gunther 2011), to new industrial policy (Devlin and Moguillansky 2012), to global value chain-oriented industrial policy (Gereffi and Sturgeon 2013). Instead of proposing a new term, this chapter considers how old approaches might be updated. The advantage of this approach is to remind us that the industrial policy debate is a good deal older than the global value chain phenomenon that we witness today. The approach taken in the paper is first to identify what has changed or perhaps become more prominent in contemporary production arrangements and then to consider different industrial policy approaches.

Among major changes that have occurred in recent years are the fact that trade in intermediates has surpassed trade in final goods, services have become a more important part of the production process, trade in tasks is a rising phenomenon, tariffs have fallen while non-tariff measures including standards have increased in significance, and geographically dispersed production has placed additional emphasis on trade facilitation and connectivity. The emergence of the somewhat more complex world of global value chains calls for more effective strategic collaboration between governments and the private sector and accentuates the importance of government capabilities for policy effectiveness (Rodrik 2004).

## **Approaches to industrial policy**

In the long and varied debate on industrial policy over the last six decades or so, different approaches have emerged. They can be broadly characterised into five main genres. The typology is rough and the categories can overlap in terms of their respective policy or strategic emphases. Moreover, the approaches may not always be mutually exclusive. This chapter proposes how each could be updated to take account of global value chain proliferation.

### 1. Import substitution industrialisation (ISI)

ISI relies on the domestic market for economies of scale and diversification, and conventionally focuses on the production of final goods and services. This approach can be viable for a certain time in countries with sizable domestic markets and the ability to identify the sources of dynamic comparative advantage. Domestic enterprises typically receive low-priced (duty-free) imported inputs and are insulated from competing imports. These industries are expected to overcome their cost disadvantages through learning-by-doing and the realisation of economies of scale (if any), eventually becoming internationally competitive.

In global value chains, opportunities for upgrading and diversification may be present both upstream and downstream, in goods or services. A lesser anti-export bias than that frequently encountered under ISI policies – brought about by high-cost production and misaligned exchange rates – would help firms overcome the confines of domestic markets. Domestic market size is a crucial determinant of the potential success of ISI policies. International agreements sometimes constrain the use of policies aimed at protecting domestic production, including tariffs, subsidies, and local content requirements. A risk is that some policies are constrained while others are not, resulting in the use of less efficient policies or hidden protection.

For ISI to yield positive results for development, it should provide limited, time-bound protection. Industries that fail to become competitive should not be protected indefinitely. Effective consultation with the private sector, industry experts and research institutions would help to identify bottlenecks and opportunities while mitigating the influence of vested interests.

## 2. Export-oriented industrialisation (EOI)

EOI strategies rely on exports to diversify the domestic economy. This industry-specific incentive structure is typically designed to ensure that returns to exports are no less attractive than returns to domestic sales. The policy mix requires that where possible inputs are provided at world prices, and exports of the final product are subsidised to compensate for more costly inputs of domestic provenance. At the same time, the domestic market is not strongly protected from competing imports.

Support to the industry is removed within a specified time-frame, so the beneficiaries know that they have to compete internationally to survive. This approach was successfully followed by some South-East Asian economies in the second half of the 20th century. EOI may start with exporting processed resource-based products before graduating to manufacturing exports of increasing technological content. It is likely to

have more backward (and forward) linkages to domestic markets than export processing zones and buyer-driven assembly-oriented GVCs.

In global value chains, EOI can be targeted at intermediate products, allowing countries to focus on parts of production where they already have a comparative advantage. The available tools for EOI are now constrained by the prohibition of export performance-based subsidies under the WTO for many countries. Concerted efforts to improve firms' standard compliance capacity and general trade facilitation infrastructure are imperative.

### 3. Resource-based industrialisation (RBI)

RBI is a strategy that may be used if a country has an exportable raw material and the potential to elaborate that raw material into a manufactured good locally for export. The policy requirement is an export tax on the raw material that lowers its domestic price and subsidises downstream manufacturing. In the past, WTO rules have not constrained the use of export taxes, but this has changed for some countries that have joined the WTO in recent years. Some PTAs also have provisions on export taxes. Pressure is likely to increase on limiting the use of export taxes. This diversification strategy can have negative domestic distribution consequences, at least in the short term, if the producers are already poor or if domestic processing capacity is inadequate or commercially infeasible.

Downstream processing of natural resources may not be feasible for all countries/products. As noted by Kaplinsky (2011), other ways of increasing domestic participation in commodity supply chains involve the development of upstream and downstream linkages in complementary markets relevant to the commodity supply chain. These could be fiscal linkages, and production and consumption linkages, including services. Whether this approach is compatible with RBI will depend on whether the country concerned has terms-of-trade power in the export market.

#### 4. Export processing zones (EPZs)

EPZs can be viewed as the poor cousin of EOI, but may be one of the few viable options for economies with neither a sizable domestic market nor resource endowments. Zones are demarcated as extra-territorial for fiscal and regulatory purposes and are normally supplied with essential infrastructure for production. EPZs may often be little more than assembly or light manufacturing operations relying almost entirely on imported inputs.

They frequently come with the risks of footloose investment<sup>2</sup>, minimal backward linkages, and entrapment in a race to the bottom. Labour and environmental standards may also be compromised in EPZs. On the other hand, successful EPZs may develop into more than just job opportunities for unskilled workers. They could be the incubator for innovation and the gradual development of backward and forward linkages. A broader spectrum of ancillary goods and services may emerge over time with the promise of great shares of value.

#### 5. Industrialisation through innovation

Unlike the former approaches that focus on changing the external framing conditions in which firms operate, the emphasis here is upon change from within. Firms' upgrading potential can be enhanced by strengthening innovation systems and firm-level technological capabilities, including through networking and building mutually advantageous relationships with other firms, suppliers, consumers, governments and relevant non-state actors. Value chain upgrading, after all, means innovating better than competitors.

Global value chains raise awareness of firm networks. While global value chain participation provides firms with access to technology and upgrading assistance from their networks i.e. the lead firms and other sources, this approach also acknowledges

<sup>2</sup> That is, investments with low fixed costs that flee as soon as preferences end.

that technological learning is not costless. Technological capabilities differ among firms and allow learning opportunities from global value chain participation to be effectively seized by the firms for successful upgrading (Lall 1992, Morrison et al. 2006).

The outcomes of firms' technological learning and upgrading efforts are affected by the environment in which learning is taking place, i.e. the innovation systems (Tijaja 2012). Innovation systems are defined as the flow of technology and information among people, enterprises and institutions that facilitate innovation, and are key to firms' competitiveness. Firms located within an efficient innovation system cope better with the complexity of global value chain transactions.

Innovation systems can be strengthened through effective science and technology policy, and activities and initiatives such as industry-specific dialogues, science competitions, internships or work placements, tendering of research projects to universities/research institutes, R&D support, joint R&D, science parks, business incubators and personnel mobility . Many of these policies may seem horizontal in the first instance, but the peculiar nature of technology means that after a certain (low) threshold, effective intervention will become sector-specific (Lall 1992). Innovation systems are multi-layered at national, sub-national and sectoral levels. Frances Malerba (2002) defines a sectoral system of innovations as “a set of products and the set of agents carrying out market and non-market interactions for the creation, production and sale of those products.”

The conditions required to facilitate learning differ across sectors (Malerba and Nelson 2011). In some, technology might be embedded in capital goods, calling for close interactive relations with the suppliers for successful upgrading. In others, like agriculture, the low appropriability of innovations may require prompting by public institutions. Innovation-led industrialisation is complementary to other approaches, regardless of country characteristics.

## Conclusions

Some of the strategies reviewed above are more promising than others, both intrinsically and as a result of the influence of GVCs in production. Country or domestic market size can be a crucial determinant of opportunities, as can resource endowments. A key question underlying all this literature is how far policy can effectively shift resources to alternative, more desirable uses while ensuring competitiveness over time. The answer will obviously be context-specific.

The close involvement of governments in many variants of industrial policy may be a source of considerable risk. Good governance and integrity must be well developed. Technical, analytical and operational capabilities must be strong, and solid strategic relationships between governments, the private sector and other relevant non-state actors need to be in place.

Governments will not necessarily do better than the market in identifying winners and must be able to act decisively in dropping failures before they become burdens on the economy. All said, however, the risks of leaving matters entirely to the market will be even greater.

*Authors' note: The views expressed here are those of the authors and should not be attributed to the institutions with which they are associated.*

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## 8 Is murky protectionism a real threat to Asian trade?

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**Simon J. Evenett**

University of St Gallen and CEPR

Among certain policymakers and analysts, the following narrative concerning recent protectionism has developed: that governments have not resorted to across-the-board tariff increases shows they have learnt the lessons of the 1930s, eschewing beggar-thy-neighbour policies. On this view, domestic political restraint reinforced by international commitments – such as WTO trade rules and the G20 pledges on protectionism – kept trade more or less free. The system, then, worked and there are no new threats for trade ministers to worry about.

Are the governments of the Asia-Pacific region – the very region thought by many to have benefited the most over the past decades from integrating into the global economy – wise to accept such a reassuring narrative about contemporary protectionism? The purpose of this chapter is to pour cold water on this self-serving interpretation of apparently enlightened policymaking. The reality should give pause to any of the region's trade ministers, active as they are at the WTO, in various regional fora, and in negotiating free trade agreements.

The first mistake made by many is to focus almost exclusively on international trade in goods and, in so doing, effectively defining protectionism as government steps to restrict imports. In the 21st century, Asian firms and workers supply foreign markets through a variety of means: foreign direct investment, licensing, temporary and permanent movement of employees, to name just a few. This observation implies that any assessment of contemporary beggar-thy-neighbour policymaking should take account of as many modes of supply into foreign markets as possible.

Moreover, since the WTO's rules don't cover all the ways of supplying foreign customers – after all, those rules were last updated 20 years ago – the range of government policies used today to tilt the playing field in favour of domestic interests is broader than those subject to legally enforceable disciplines. Given that the WTO's rules set effectively defines the data that it collects or has submitted to it by governments, then no one should be surprised that reports from the international organisations understate 21st century protectionism, or that their easy-to-download datasets on trade policy stance miss some of what's going on.

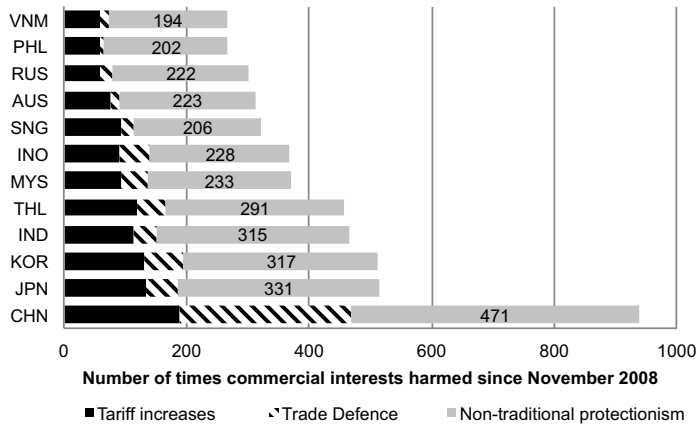
So much of what might be, just how relevant are non-traditional forms of protectionism for the economies of the Asia-Pacific region? To answer this question, on 20 May 2013 I extracted information from the Global Trade Alert database for 12 leading trading nations in the Asia-Pacific region on the frequency with which their commercial interests – broadly defined in the manner advocated above – have been harmed since the G20 countries first came together to publicly eschew protectionism in November 2008. I then sorted the instances of harm done between those where tariff increases were responsible, where trade defence instruments (antidumping, anti-subsidy and import surge or safeguard measures) were imposed, and where other forms of protectionism were employed. Richard Baldwin and I christened the latter “murky protectionism” because such measures are far less transparent than tariff hikes and trade defence investigations.

The 12 trading nations that I collected data on are Australia (denoted AUS in the figure that follows), the People's Republic of China (CHN), India (IND), Indonesia (INO), Japan (JPN), Republic of Korea (KOR), Malaysia (MYS), Philippines (PHL), Russia (RUS), Singapore (SNG), Thailand (THL) and Viet Nam (VNM). Despite the diversity of these countries, they share certain similarities at least as far as contemporary protectionism is concerned.

Figure 1 breaks down the total number of times each trading nation has seen its foreign commercial interests hurt since November 2008 into the number of times the harm can

be attributed to traditional forms of protectionism – tariff increases and trade defence measures – and other, non-traditional beggar-thy-neighbour acts. The frequency with which national commercial interests have been harmed should dispel any complacency: the PRC’s interests have been harmed the most, in total 939 times. Most of the other countries represented in Figure 1 have felt between 300 to 500 hits to their commercial interests since November 2008. Further investigation revealed that few of these protectionist measures have been unwound.

**Figure 1** Leading Asian traders hit more often by non-traditional beggar-thy-neighbour measures



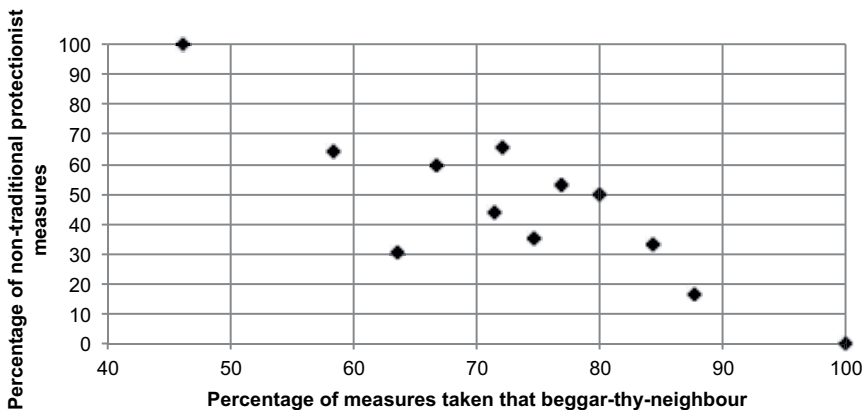
The number of non-traditional protectionist measures harming each trader is also reported in Figure 1. In every case, more than half of the hits to these nations’ commercial interests were by government policies that are in the spotlight far less often than tariff increases and trade defence actions. This is not to say that tariff increases and trade defence actions are unimportant, rather that something is missing in accounts of protectionism today that focus on the preferred protectionist instruments of yesteryear.

One policy implication immediately follows: even though (a) few governments have resorted to across-the-board tariff increases in recent years, and (b) other than certain recent EU antidumping investigations against the PRC, most trade defence investigations involve trivial amounts of trade, it does not follow that a level playing field has been

preserved in international commerce. Further investigation of the Global Trade Alert database, reports, and website ([www.globaltradealert.org](http://www.globaltradealert.org)) reveals many forms of export incentives being offered by industrialised and developing country governments in recent years, along with plenty of subsidies to keep underperforming firms afloat, so pushing the burden of adjustment to lower demand on to unsubsidised rivals.

Perhaps the most wide-ranging measures implemented by a large trading nation are the changes in rebates to exporters on VAT payments on imported inputs implemented by the PRC. As I have shown elsewhere with co-authors, the range of products covered by these rebate changes is so vast that it is tantamount to a system of broad-ranging and surgical export management (Evenett et al. 2012). Larger VAT rebates increase the incentive to export, allow firms located in the PRC to undercut rivals in foreign markets and thereby depress trading partners' exports. Rebate changes were ramped up in 2009, far beyond levels seen before the global economic crisis. Conservatively, we estimated that over US\$1.1 trillion of Chinese exports were in product lines affected by VAT rebate changes. More such studies of the export and other financial incentives that might have affected crisis-era trade are certainly needed. In the interim, it would be unwise for any policymaker to dismiss non-traditional forms of protectionism out of hand.

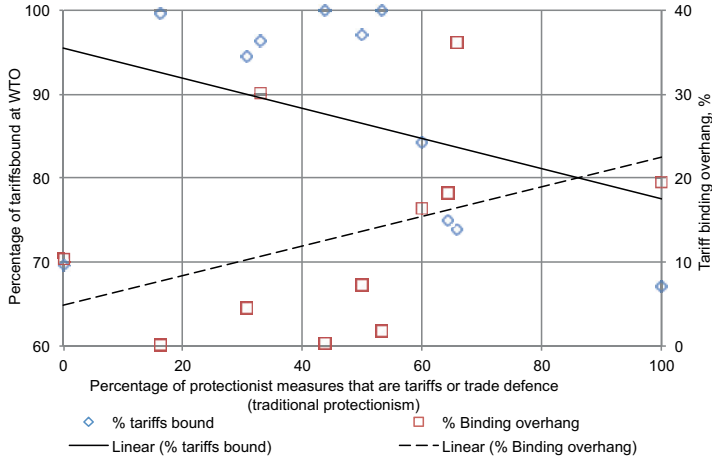
**Figure 2** The action isn't in tariffs and trade defence measures any more



Analysis of the beggar-thy-neighbour measures taken by our 12 leading Asian-Pacific traders is revealing too. Bearing in mind that governments can liberalise commerce as well, it is possible to calculate the proportion of all measures taken since November 2008 that implicate foreign commercial interests that also discriminate in favour of domestic firms. That proportion is plotted on the horizontal axis of Figure 2 against the percentage of non-traditional protectionist measures that a nation's government has implemented over the same time frame. The clear negative correlation in Figure 2 shows that the more determined a government was to tilt the playing field against foreign firms, the more often they used less well-known forms of protectionism. Once again a focus on more transparent forms of protectionism – about which information is easy to download – provides a woefully incomplete assessment of what governments in the Asia-Pacific region are doing and quite possibly what the negotiating and enforcement priorities of trade ministries should be in the 21st century.

But what of the WTO? Surely the binding rules there have kept governments in check. It is not well known that governments differ considerably in the extent to which even their tariffs – perhaps the most basic international trade obligation – are bound at the WTO. Countries that joined the WTO late, such as the PRC and Viet Nam, tend to have 100% of their tariff lines bound. Meanwhile, only 67% of the Philippines tariff lines contain any binding, meaning the government in Manila can raise tariffs on a third of its product lines to whatever level they like without breaking WTO rules.

**Figure 3** The tighter a WTO Member’s multilateral obligations, the less resort to traditional protectionism



Even those countries with many tariff lines bound at the WTO often have plenty of leeway to raise tariffs before reaching allowed maximums. Australia, for example, actually imposes on average tariffs of 2.8% on imports but it is allowed to raise its tariffs to 10% on average. The gap is known as the “binding overhang” and varies a lot across countries. So what? The size of these binding overhangs is large enough that more than half the WTO membership could impose an across-the-board tariff increase on the scale of Smoot-Hawley without breaking their legal commitments (Evenett 2011). For many countries, then, rather than ask how much the WTO has restrained protectionism, given the leeway in existing obligations it is better to ask how WTO rules could restrain many governments in the first place.

While the WTO’s restraining role has been oversold during recent years, it is going too far to suggest that it has had no impact. Data from Global Trade Alert on the resort to traditional protectionism was combined with information from the WTO’s Tariff Profiles database to produce Figure 3 for all of our 12 Asian-Pacific nations, except Russia for which some information in the latter database was missing. Figure 3 shows whether there is a relationship between resort to tariff hikes and trade defence measures



and the amount of wiggle room countries have in their WTO obligations, as measured by the percentage of their tariff lines bound and the size of the tariff binding overhang. To facilitate interpretation, regression lines are fitted through both plots as shown.

What does Figure 3 show? First, that countries with more tariff lines bound tended to resort to traditional forms of protectionism less. This could be taken as evidence that where the WTO rules bite on tariffs, they induce a substitution by other, less well-regulated forms of beggar-thy-neighbour policy. Second, countries that have greater binding overhangs tend to resort more frequently to traditional protectionism. Indeed, to the extent that such countries resort to tariff increases, then they may be using the leeway they have in their WTO commitments. Governments with little such leeway again resort more to non-traditional forms of protectionism. If anything, WTO rules are more likely to have altered the composition of protectionism than its level.

### **Implications for 21st century trade policymaking**

The saccharine narrative that some trade ministers and analysts present – lauding the apparent restraint on beggar-thy-neighbour policymaking during the recent global economic crisis – does not stand up to scrutiny. Trade ministries and their advisers in the Asia-Pacific region need to take note in particular, precisely because being able to sell into foreign markets has provided one important foundation for the region's prosperity.

While tariff hikes and trade defence measures are still possible and from time-to-time cause frictions between trading partners, for the most part they are not where the action has been since the onset of the global economic crisis. None of this will come as a surprise to historians of the world trading system as, once again, a sharp global economic downturn has resulted in a change in the most prominent form of protectionism. This time around it is the turn of murky protectionism – especially export incentives and numerous bailouts to the non-financial sector – that have greater trade coverage.

That data on such beggar-thy-neighbour policies is not so readily apparent, easy to download, or available going back for decades in no way diminishes the potential relevance of murky protectionism. In many respects, the data collectors, professors and other analysts need to catch up with the innovations of certain policymakers. For their part, trade ministers and advisers need to determine whether they are prepared to bind policies involving murky protectionism in trade agreements, what deals among trading partners on murky protectionism can be done, and how any such accords could be enforced. The Doha Round may be dead, but the 21st century trade policy agenda is very much alive.

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# 9 Exchange rate policy and regional trade agreements

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**Richard Pomfret** and **Victor Pontines**

University of Adelaide; Asian Development Bank Institute

## Introduction

Both the level and stability of exchange rates can impact trade flows. This chapter asks whether these connections are stronger when trading partners are members of a regional trading arrangement (RTA). Our evidence is based on analysis of trade flows among East Asian countries between 1990 and 2010, which includes the period when trade agreements proliferated in East Asia after 2000.

In the 1940s, the architects of the Bretton Woods system viewed exchange rate stability as an important condition for reducing the costs of international trade. After the move to generalised floating in the early 1970s, many researchers examined the connection between exchange rate volatility and trade, generally finding the expected statistically significant negative relationship, although the economic significance was often not large. A more recent literature on the impact of exchange rate valuation on trade or growth has found evidence of a negative relationship (i.e. depreciation is good for growth) but, given the popular perception that undervaluation is good for growth, the results have been surprisingly weak. In sum, exchange rate levels and volatility matter for trade. The relationships may not be as strong as expected because they are conditional relationships, e.g. financial development may reduce the cost of volatility by facilitating

hedging, sectoral composition of trade may affect the impact of depreciation because elasticities vary, and the state of the global economy may matter.<sup>1</sup>

## **The nexus between RTA membership and exchange rate policy**

How might membership of an RTA affect these relationships? Because an RTA restricts governments' autonomy in using trade policy instruments, RTA members may be more likely to use the exchange rate for trade policy ends. If protectionist pressures increase, then the government may help a threatened industry by depreciating the currency to make imports less competitive and to increase export competitiveness. On the other hand, if an RTA partner undertakes a large depreciation, its partners may respond with protectionist measures such as competitive devaluation or non-tariff barriers that threaten the integrity of the RTA, as for example happened in Mercosur after the 1999 depreciation of Brazil's real.

If the RTA is intended to promote regional integration, then exchange rate volatility is undesirable. Volatility undermines the working of price signals, as in the multilateral analysis described above. Furthermore, if RTA members introduce common policies, then exchange rate volatility can undermine fiscal agreements. The clearest example was the European countries' reintroduction of a fixed internal exchange rate regime in 1979, after the collapse of the Snake in 1976 had led to expensive ad hoc measures to maintain the common agricultural policy. After the 1992 European monetary system crisis, the majority of EU members decided they would rather give up all monetary autonomy than allow exchange rate volatility within the union, and over the next decade they created the Eurozone.

<sup>1</sup> The empirical literature has been reviewed by Aboin and Ruta (2011) and by Huchet-Bourdon and Korinek (2011).

## Our empirical evidence

Our study focuses on East Asia, the region where RTAs have flourished most over the past decade. In 2000, the only significant RTA was ASEAN, and that appeared to have a limited economic impact until the ASEAN Free Trade Area (AFTA) was strengthened in the early 2000s. By 2012, over 60 RTAs were operational in East Asia.<sup>2</sup> The process was in response to the emergence of regional value chains, creating “Factory Asia”. Such production networks in which processes are fragmented depend crucially on low costs in time and money of crossing borders, and many of the RTAs are aimed at reducing at- or behind-the-border trade costs.

We analyse the impact of the level and volatility of exchange rates on bilateral trade among 16 East Asian economies (ASEAN+3; Hong Kong, China; Macau and Mongolia) in 1990-2010. In a variety of gravity model specifications, bilateral exports are positively related to the rate of exchange rate depreciation and to RTA membership, and negatively related to exchange rate volatility. Interaction terms indicate that both exchange rate effects are magnified when the two economies have a trade agreement. Table 1 illustrates the results from representative country fixed effects regressions with real depreciation and volatility of real exchange rates as exogenous variables.<sup>3</sup>

2 The count is from the ADB database as reported by Kawai and Wignaraja (2013). Pomfret (2011) describes and analyzes East Asian regionalism.

3 The paper with more details of the data, regression analysis, and results with other specifications is available by email on request from [vpontines@adbi.org](mailto:vpontines@adbi.org).

**Table 1** Gravity model estimation results

Variables		
Log of GDP	1.35*** (0.07)	1.30*** (0.07)
RTA dummy	0.37** (0.07)	0.40*** (0.09)
Rate of exchange rate depreciation	0.54* (0.30)	
RTA*rate of ER depreciation	1.34** (.61)	
Exchange rate volatility		-0.37* (0.21)
RTA*exchange rate volatility		-0.89** (0.46)
No. of observations	3,875	3,869
Overall <i>R</i> -squared	0.33	0.34

Notes: \*\*\* statistically significant at the 1 percent level; \*\* statistically significant at the 5 percent level; \* statistically significant at the 10 percent level. Standard errors are in parentheses.

The novel finding is that interaction terms indicate that both exchange rate effects are magnified when the two economies have a trade agreement. We interpret the level result as indicating that, because a RTA restricts governments' trade policy instruments, members are more likely to use the exchange rate for trade policy ends. We interpret the volatility result as evidence that, because East Asian trade agreements are related to fragmentation and regional value chains, exchange rate volatility is especially harmful to trade flows within those RTAs.

## Conclusion

These results highlight the conflicting interests of countries — to stabilise exchange rates or to keep the option of exchange rate depreciation in order to maintain competitiveness of domestic tradable producers. With the deepening integration in East Asia, however, the desire for exchange rate stability will eventually outweigh the desire to maintain a protectionist tool. How extensive the pressures will be in East Asia will depend not only on how many countries seriously desire to be in the more integrated economic area



in which Factory Asia operates, but also on their institutional and political readiness to commit to such schemes at the cost of renouncing an important policy instrument.<sup>4</sup>

The policy implication is that RTAs among countries wishing to participate in RVCs can target desirable trade facilitation measures, including exchange rate stability. There is, however, a potential time-inconsistency problem. If a consequence of the RTA is intensified pressure on import-competing producers, then a member may resort to exchange rate depreciation for protection. Exchange rate depreciation is potentially harmful to other countries, implying the need for some monitoring mechanism within the RTA, comparable to avoiding the IMF-WTO policy gap at the global level.<sup>5</sup>

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4 Within the EU the members more committed to integration have adopted the euro and are in Schengenland, while the skeptics either do not use the euro or do not accept the border deregulation; the UK, notably, accepts neither the euro nor Schengen. Bulgaria, Cyprus and Romania are committed to joining Schengen, but have not yet done so, and ten EU members still use national currencies although eight of those are bound to adopt the euro in future. The numbers are not fixed; in 2013 Greece and Cyprus teeter on the edge of abandoning the euro, while Latvia applies for eurozone membership.

5 The IMF has priority on exchange rate matters, but does not have clear operational definitions of when exchange rate policies are detrimental to trade, and nor does it have effective sanctions. The WTO has sanctions, i.e. approved retaliation, but no mandate to act without an IMF finding. The gap is highlighted in the 2009 Independent Evaluation Office Report IMF Involvement in International Policy Issues – available at <http://www.ico-imf.org/ico/pages/CompletedEvaluation109.aspx>

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## Section 3

# Regional Trade Governance



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# 10 Policy challenges posed by Asian FTAs

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**Masahiro Kawai** and **Ganeshan Wignaraja**

Asian Development Bank Institute

## **The spread of Asian FTAs**

Asia's rise as the "global factory" over the past several decades was underpinned by outward-oriented development strategies and multilateralism. FTAs, as trade policy instruments in the region, were largely absent until the 1990s. The Asia-Pacific Trade Agreement (APTA) of 1976 was the region's first agreement and the Association of Southeast Asian Nations (ASEAN) Free Trade Agreement (1993) was another prominent one among a very small number of Asia's early FTAs. Today, Asia is a world leader. Between January 2000 and April 2013, the number of concluded FTAs increased from 3 to 76 and more are under development.

The region's largest economies (the People's Republic of China (PRC), India, and Japan) as well as a few advanced ASEAN economies (e.g., Singapore and Thailand) have become key players in FTA activity. Smaller neighbouring economies are now also actively involved in such efforts. Reflecting the growth of FTAs, the importance of FTAs to Asia's trade and investment has also increased.

The spread in FTAs is attributed to factors including the need to remove impediments to broadening the market-led integration of regional supply chains, the intensification of FTA activity in Europe and the Americas, and the stalled WTO Doha Round trade talks.

Concerns over such agreements have increased as FTAs have spread across Asia (e.g. Banda and Whalley 2005, Bhagwati 2008, Drysdale and Armstrong 2010, and Manchin

and Pelkmans-Balaoing 2007). Several key challenges associated with Asian FTAs are examined here, from a pragmatic perspective, with a view to providing better informed policy decisions.

## **Challenges of Asian FTAs**

### Raising FTA preference use

While well-designed FTAs can provide demonstrable benefits to FTA member economies, previous studies document that the historic use of FTAs in Asia has been relatively low. These studies, however, relied on data for the 1980s and early 1990s, before the major spurt in Asian FTAs. Using new data from certificates of origin, we computed average FTA preference use for four Asian countries (Republic of Korea, Thailand, Viet Nam, and Malaysia). A significant increase is visible in this figure from 24% to 37% of total exports between 2008 and 2011. Republic of Korea (49%) and Thailand (42%) had particularly high FTA use in 2011 compared to Viet Nam (33%) and Malaysia (24%).

The enterprise surveys conducted by the Asian Development Bank (ADB) and ADB Institute (ADBI) in the PRC, Japan, Republic of Korea, Malaysia, Philippines, Singapore, and Thailand also indicate higher-than-expected FTA use at the enterprise-level, with 32% of enterprises utilising FTAs and more planning to do so (see Kawai and Wignaraja 2011, Kawai and Wignaraja 2013). The surveys also reveal that FTA use entails fixed costs and that large enterprises are better able to muster the requisite financial and human resources than small- and medium-sized enterprises (SMEs).

A lack of information on FTAs is identified as the most significant reason for non-use of FTAs. Low margins of preference, administrative costs and delays associated with rules of origin (ROOs) and other export documentation, and non-tariff measures in partner economies were the other reasons cited for non-use of FTAs.

### Tackling multiple rules of origin

Existing literature suggests that multiple ROOs in overlapping FTAs constitute an Asian “noodle bowl” which raises transaction costs for SMEs. ADB-ADBI surveys indicate that multiple ROOs are a future risk to Asian enterprises rather than a present issue (Kawai and Wignaraja 2011). These surveys also reveal that, contrary to our usual expectations, larger enterprises in Asia have more negative perceptions of multiple ROOs than SMEs. Large established enterprises export to multiple markets and adapt their business strategies in response to FTAs. They are, therefore, more likely to express concerns regarding multiple ROOs. In contrast, SMEs tend to export to single markets and hence have little basis for complaint. However, as SMEs grow and start exporting to multiple markets, they will more likely express concerns about the Asian noodle bowl of complex, multiple, overlapping ROOs.

### Liberalising agricultural trade

The literature shows that the coverage of agricultural trade differs markedly among current Asian FTAs. Agricultural trade tended to be excluded from most of the early agreements due to pressure from powerful farm lobbies or social concerns regarding poverty in rural areas. A review of tariff-line coverage of agricultural products in current Asian FTAs shows that, over time, these agreements are becoming more comprehensive in their coverage of agricultural trade. Of the 69 FTAs for which data were available as of December 2012, 46% had comprehensive coverage, another 28% had some coverage, and 26% had little or no coverage of agricultural products.

### Reducing restrictions to services trade

FTAs can contribute to reducing the significant regulatory barriers to services trade currently present in the region. A review of criteria covering key sectors of the General Agreement on Trade in Services (GATS) similarly indicates a trend in Asian FTAs

towards progressively liberalising the services-trade sectors of participants and providing, again over time, for increased regulatory cooperation on services trade. Of the 69 FTAs reviewed, 41% had comprehensive coverage, another 36% had some coverage, and 23% had little or no coverage of services trade.

#### Increasing WTO-plus elements

Studies demonstrate that Asian FTAs vary considerably in scope in terms of coverage of issues going beyond the WTO framework. A review of criteria covering the four “Singapore issues” (competition, intellectual property, investment, and public procurement) shows that of the 69 FTAs reviewed, 23% had comprehensive “WTO-plus” coverage, another 54% had partial WTO-plus coverage, and 23% were goods-and-services agreements only.

### **Policy implications**

Several recommendations may be made for the future. These include strengthening national support systems for enterprises, especially SMEs, using or wishing to use FTAs; rationalising ROOs and improving their administration; ensuring better coverage of agricultural trade; facilitating services-trade liberalisation; forging comprehensive WTO-plus FTAs; and multilateralising regional FTAs. Reducing protectionism through enhanced international surveillance of non-tariff measures and concluding the WTO Doha Round trade talks would also be invaluable in boosting FTA use. In the medium term, a WTO agenda on supply chains and FTAs would be necessary to encourage convergence of regional and global trading rules (Baldwin 2011).

Multilateralisation of regional FTAs – through liberal cumulation rules and eventually a merger of various overlapping FTAs in Asia – would provide economic benefits such as greater market access for goods, services, skills, and technology; larger market size permitting increased specialisation and realisation of economies of scale; easier FDI and technology transfer by multinational corporations and SMEs; simpler trade and



investment rules; inclusion of small, low income economies in the region's wider trade agreement; and insurance against protectionist sentiments.

## **Convergence of RCEP and TPP?**

A region-wide FTA could arise from a series of linked agreements covering varied issues and participants (Kawai and Wignaraja 2013). Two competing processes are emerging as the future basis for a region-wide FTA: a Regional Comprehensive Economic Partnership (RCEP) among the ASEAN+6 countries (the ten ASEAN economies plus Australia, the PRC, India, Japan, Republic of Korea, and New Zealand); and the Trans-Pacific Strategic Economic Partnership (Trans-Pacific Partnership, or TPP) agreement among the 11 economies (Australia, Brunei Darussalam, Canada, Chile, Malaysia, Mexico, New Zealand, Peru, Singapore, the US, and Viet Nam) currently in negotiations as well as Japan, which is expected to join the negotiations as early as July 2013.

To realize the RCEP, a trilateral FTA among the PRC, Japan, and Republic of Korea should first be concluded and then be connected with the existing ASEAN+1 FTAs – that is, ASEAN's five FTAs with Australia-New Zealand, the PRC, India, Japan, and Republic of Korea. The TPP aims to achieve a high-quality agreement and includes four ASEAN members and Japan, from Asia. These two mega FTAs are key processes to create a larger Asia-Pacific FTA, which however would require successfully addressing the difficult task of forging a US-PRC agreement.

These two processes are not mutually exclusive and will likely prove to be complementary. The changing centre of global economic gravity – given the rapid economic rise of the PRC and India – suggests that an RCEP is attractive to many Asian economies, including developing ones. Countries that are ready to accept high standards required for the TPP and wish to strengthen existing ties with the US will likely join the TPP.

Whichever path or paths may be taken, it will be important to accelerate the liberalisation of goods and services trade and of investment, reduce behind-the-border barriers, and

pursue domestic reforms. A harmonious Asia-Pacific would likely see a convergence of the two processes being considered. This would be a win-win solution for the Asia-Pacific community.

Asia's next step would be to strengthen its trade relationships with other parts of the world, starting with Europe. A mega Asia-Europe FTA would be another important building block, along with the Asia-Pacific FTA, to connect Asia with the global economy and support global trade integration in a way to complement the WTO Doha Round trade talks.

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# 11 The ASEAN Economic Community: Progress, challenges and prospects

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## **Introduction**

ASEAN, established in 1967, embarked on formal economic integration only in the 1990s with the formation of the ASEAN Free Trade Area (AFTA) covering goods, the ASEAN Framework Agreement on Services (AFAS) and the ASEAN Investment Area (AIA). It became the first group in Asia to complement multilateralism under the GATT/WTO with regionalism, the latter characterised by various WTO-plus features. In the meantime, market-led integration was progressing through international production networks that make use of ASEAN's differences in cost structures, openness to international trade and investment, and efficient transportation and logistics to locate different parts of the value chain.

## **The ASEAN Economic Community: Rationale and scope**

Official reservations toward ASEAN regionalism prior to the 1990s were due to the wide differences in development and competitiveness levels and the pursuit of import-substituting industrialisation. The adoption of export-oriented industrialisation, the conclusion of the Uruguay Round and regionalism elsewhere manifested in the European Single Market and the North American Free Trade Area raised concerns about the international export and FDI competitiveness of ASEAN's small and medium-sized economies. The rise of the People's Republic of China (PRC) and India and the fallout

from the 1997-8 Asian financial crisis added further concerns and led to the 2003 decision to form the ASEAN Economic Community (AEC).

The AEC is an ambitious effort at deep integration. However, it falls short of a customs union or a common market. It has four pillars that aim to “transform ASEAN into a single market and production base, a highly competitive economic region, a region of equitable economic development, and a region fully integrated into the global economy” (ASEAN 2008). The creation of a single market and production base should allow ASEAN to benefit from economies of scale. ASEAN could also leverage on economies at different stages of economic development to provide complementary locations for production networks. An integrated market and production base would boost intra-regional trade and investment flows while a unified consumer market of over half a billion would be attractive to foreign investors.

The AEC Blueprint of November 2007 sets out the various measures and strategic schedules for implementation by 2015. It sought to accelerate existing economic integration agenda under AFTA, AFAS and AIA, laying down clear timelines for specific measures in tariffs, non-tariff measures, customs, standards, services, investments, intellectual property rights, and finance; designate priority sectors for accelerated integration and serve as a catalyst for expediting the integration process; and establish new institutional mechanisms such as compliance monitoring and dispute settlement mechanisms.

## **Measuring progress in ASEAN economic integration**

Output and process indicators that would measure progress include the following:

Tariff elimination and intra-ASEAN trade

Intra-ASEAN tariffs are almost completely eliminated. By January 2010, the older ASEAN members of Brunei, Indonesia, Malaysia, Philippines, Singapore and

Thailand (collectively known as ASEAN6) have eliminated tariffs representing 99% of ASEAN total tariff lines, with an average tariff of only 0.9%; for the newer members of Cambodia, Laos, Myanmar and Viet Nam (collectively known as CLMV), tariffs will be eliminated by 2015. There remain some products permanently excluded from liberalisation for reasons of national security, health and protection of animal and plant life, and historical-cultural artifacts, as well as a few sensitive products such as rice and sugar where tariffs are retained because of national food security concerns.

ASEAN's intra-ASEAN and extra-ASEAN trade grew rapidly in tandem with buoyant economic growth and increasing trade liberalisation. Intra-ASEAN trade share grew from 17% in 1990 to 25% in 2011, and ranged from over 60% for Laos to under 20% for Brunei and Viet Nam. Laos is landlocked and heavily dependent on trade with and through neighbouring Thailand; Viet Nam's dependence on trade with ASEAN declined since normalisation of trade with the US and accession to the WTO; Brunei's exports of oil and gas are increasingly to northeast Asia. Nearly 90% of intra-ASEAN trade is accounted for by Indonesia, Malaysia, Singapore and Thailand, with Singapore alone accounting for over one third. Cambodia, Indonesia and Laos are much more dependent on ASEAN sourcing, while Singapore and Thailand are more dependent on ASEAN as a market. Intra-ASEAN trade increasingly comprises trade in petroleum and petroleum products and parts and components of the electrical and machinery industries.

#### Utilisation of tariff preferences

A number of studies (e.g., Kawai and Wignaraja 2011) show that ASEAN tariff preferences have low utilisation rates, indicating that the growth of intra-ASEAN trade may not be directly attributable to tariff elimination and reduction. Reasons include the following: First, a low margin of preference (MOP) between MFN and preferential rates for many products, zero MOP for Singapore (the largest intra-ASEAN trade partner), and zero MOP for most electronic products and components (largest manufactures group in intra-ASEAN trade) under the WTO's Information Technology Agreement.

Second, disincentives posed by cumbersome and uncertain customs valuation and procedures and inability to conform to ASEAN rules of origin due to extensive outward processing trade. Third, disincentives posed by the high cost of logistics, transportation and telecommunications confronting some ASEAN countries, particularly CLMV. Fourth, many SMEs were unfamiliar with tariff preferences.

#### FDI inflows and intra-ASEAN FDI

ASEAN's share of global FDI has been declining in recent decades due to the rise of the PRC and the 1997-98 Asian Financial Crisis. However, the ERIA Mid-Term Review (ERIA 2012) found that the drive towards AEC 2015 is contributing to a surge in FDI to ASEAN, in part due to the AEC's tariff elimination and reduction, trade facilitation and investment liberalisation. Total FDI inflows reached US\$116 billion in 2011. There has also been sizeable growth in intra-ASEAN FDI from the more advanced ASEAN economies (particularly Singapore) to Indonesia and CLMV.

#### AEC Blueprint Scorecard

The Scorecard (ASEAN 2012) tracks the implementation of the various measures under the AEC Blueprint and its strategic schedules. For 2008-11, the implementation rates are 65.9% for the single market and production base, 67.9% for competitive economic region, 66.7% for equitable economic development, and 85.7% for integration into the global economy. The implementation rates are higher for Phase I (2008-09) than for Phase II (2010-11), indicating implementation slowdown even as 2015 draws nearer. The published aggregate scores fail to reveal the rates of implementation for individual countries and specific actions in the Blueprint. By not revealing the implementation record of individual countries, there is no "public" pressure for compliance, particularly when there is no penalty for non-compliance.

For the single market and production base, the weakest implementation in 2008-11 has been in the following:



- *Non-tariff barriers.* Problems include compiling the non-tariff measures (NTM) database, identifying those that are NTBs and undertaking the domestic regulatory reforms. On trade facilitation, progress has been made with customs reform (although corruption remains a serious problem) but the ASEAN Single Window is well behind schedule and streamlining of product standards has made limited progress.
- *Services liberalisation.* Difficulty in reaching consensus led to a flexible “ASEAN minus X” approach whereby two or more ASEAN countries can initiate negotiations on specific sectors/sub-sectors, while other members could join later. Service negotiators are cautious because of uncertainty about the impact of liberalisation, fear of the loss of regulatory control and/or because of domestic interest groups. The general reluctance to liberalise services under mode 3 (commercial presence) and Mode 4 (movement of natural persons) led to modifications in subsequent services negotiations, which resulted in liberalisation of all limitations for Mode 1 (cross-border supply) and Mode 2 (consumption abroad) but only progressive liberalisation for Mode 3 and Mode 4. Mode 3 liberalisation envisions only a maximum of 70% of ASEAN equity share, while Mode 4 liberalisation is confined to movement of professionals, with some MRAs completed.
- *Investment liberalisation.* The updated ASEAN Comprehensive Investment Agreement (ACIA) was signed in 2009 but ratified only in March 2012. While all ASEAN countries actively court inward FDI, the main problem is the large temporary exclusion and sensitive lists of some ASEAN countries which allow them to delay or opt out of implementing measures.

## **Realisation of the AEC by 2015?**

Realising the AEC by 2015 could mean full implementation of the AEC Blueprint measures and strategic actions, or realising the AEC objectives of a single market and production base, a competitive economic region, equitable economic development and

integration into the global economy. The Scorecard gives little indication of how far the AEC objectives are being realised.

There is general acceptance that not all of the AEC Blueprint can be fully implemented by December 2015, particularly as some measures require time to implement. Implementation obstacles include legislative and regulatory limitations and weak implementation coordination across national ministries and agencies. A better effort needs to be made to convince various FTA stakeholders, that is, policymakers, the business community, labour, and the general public, of the benefits of trade and investment liberalisation and the costs of non-action. Policymakers have the tough task of marketing the liberalisation idea, seeking consultations and dialogues with the private sector and workers to identify short-term losers, and finding mechanisms to “compensate” them through financial and technical assistance to enable firms to seek new businesses and job training to enable workers to find new jobs. There is a need to strengthen the monitoring capacity of the ASEAN Secretariat and to provide technical assistance to member states to enhance their implementation capacity. Greater private sector feedbacks should be undertaken to assess the impact and effectiveness of the policies and measures being implemented, so as to address the business impediments. In particular:

- *Goods liberalisation.* Utilisation rates of tariff preferences are low. Some problem areas are being addressed, but further efforts are needed in simplifying customs procedures and improving certainty of outcomes (including reducing corruption). To improve utilisation rates, more publicity and training programmes targeted at SMEs are called for. Removing NTBs has been slow, including those that impede supply chains such as the administrative-regulatory regime. Speedier harmonisation of standards and MRA for goods would facilitate realisation of ASEAN as a single production base.
- *Services sector liberalisation.* Liberalisations under Mode 3 and Mode 4 are slow. ASEAN needs to redouble efforts to ensure targets are met and the various

flexibilities and carve outs need re-examination. Some of the domestic constitutional and regulatory constraints on employment of foreigners should be re-examined. ASEAN professional associations should meet regularly to get better acquainted and explore common standards and exchanges.

- *Investment liberalisation.* Countries need to minimise their exclusion lists and avoid flip-flops in investment policies that create uncertainties for investors. Also, foreign investors often have difficulties accessing various factors of production. The highly successful Iskander region in southern Malaysia bears imitating.
- *A competitive economic region.* Competitive performance shows wide variations (as exemplified by the variations in the Doing Business Index) and there is ample scope for catching up by the laggards. Improvements in infrastructure and trade logistics will further reduce trade costs. ASEAN may also wish to explore liberalising government procurement (commonly found in other FTAs), as well as regional environmental standards in light of the impact of climate change and introducing basic labour standards to protect the lowly skilled. Corruption is anti-competitive and the Achilles heel of a number of ASEAN countries, and needs to be controlled.
- *Narrowing the development gap.* The development gap between ASEAN6 and CLMV is narrowing, but remains wide. SME development and Initiatives for ASEAN Integration (IAI) are inadequate. CLMV would be major beneficiaries of the ASEAN Connectivity Plan and ASEAN Infrastructure Fund. CLMV development would also benefit from increased ASEAN6 private-sector FDI inflows and financial and technical assistance and cooperation in public sector management, human resource development, urban development and agricultural development.

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# 12 Construction of RCEP by consolidating ASEAN+1 FTAs

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**Shujiro Urata**

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## 1. Introduction

The world has been witnessing a rapid expansion of regional trade agreements (RTAs), which include customs unions and free trade agreements (FTAs). RTAs began to increase in the early 1990s in many parts of the world, but it was not until the 21st century when East Asia started to catch up with the rest of the world in the RTA race. The number of bilateral and plurilateral FTAs increased sharply and rapidly in East Asia, giving rise to a concern over the emergence of a complicated trading system, or the spaghetti/noodle bowl effect, which may reduce trade by raising trade costs. Recognition of such concern by East Asian countries has resulted in the discussions over establishing a region-wide FTA. The members of the Association of Southeast Asian Nations (ASEAN), the People's Republic of China (PRC), Japan, Republic of Korea, India, Australia, and New Zealand (ASEAN+6 countries) have agreed to launch negotiations for a region-wide FTA under the name of the Regional Comprehensive Economic Partnership (RCEP). A natural foundation for the RCEP is five ASEAN+1 FTAs, ASEAN's FTAs each with the PRC, Japan, Republic of Korea, India and Australia-New Zealand, which have already been enacted. In light of these observations, this column examines the possibility of consolidating five ASEAN+1 FTAs for the establishment of the RCEP by investigating the similarities and differences among these five FTAs in terms of the commitments to tariff elimination and the definition of the rules of origin. The more similar these patterns are, the easier the consolidation of the ASEAN+1 FTAs is.

## 2. Tariff elimination in ASEAN+1 FTAs

The patterns of tariff elimination appear quite different for the five ASEAN+1 FTAs. Table 1 shows the tariff elimination rates, defined as the proportion of tariff lines (number of products) subject to tariff elimination in total number of tariff lines, for five ASEAN+1 FTAs. The last row of the table shows the average tariff elimination rates for the five ASEAN+1 FTAs. ASEAN-Australia/New Zealand FTA (ANZFTA) has the highest tariff elimination rate at 95.7%, while ASEAN-India FTA (AIFTA) has the lowest rate at 79.6%. Tariff elimination rate for AIFTA is exceptionally low compared to those for other ASEAN+1 FTAs, whose rates are greater than 90%.

**Table 1** Tariff elimination in ASEAN+1 FTAs (%)

	AANZFTA	ACFTA	AIFTA	AJCEP	AKFTA	Average
Brunei	99.2	98.3	85.3	97.7	99.2	95.9
Cambodia	89.1	89.9	88.4	85.7	97.1	90
Indonesia	93.7	92.3	48.7	91.2	91.2	83.4
Lao PDR	91.9	97.6	80.1	86.9	90	89.3
Malaysia	97.4	93.4	79.8	94.1	95.5	92
Myanmar	88.1	94.5	76.6	85.2	92.2	87.3
Philippines	95.1	93	80.9	97.4	99	93.1
Singapore	100	100	100	100	100	100
Thailand	98.9	93.5	78.1	96.8	95.6	92.6
Viet Nam	94.8	n.a.	79.5	94.4	89.4	89.5
Australia	100					
PRC		94.1				
India			78.8			
Japan				91.9		
Rep. of Korea					90.5	
New Zealand	100					
Average	95.7	94.7	79.6	92.8		

Notes: HS2007 version, HS6 digit base. Data for Viet Nam for the ASEAN-PRC FTA are missing. Data for the ASEAN-PRC FTA are missing for HS01-HS08. ACFTA: ASEAN-PRC FTA; AIFTA: ASEAN-India FTA; AJFTA: ASEAN-Japan FTA; AKFTA: ASEAN-Korea FTA. Figures indicate the proportion of tariff elimination in tariff lines.

Source: Kuno (forthcoming).

There are wide variations in tariff elimination rates among the countries in ASEAN+1 FTAs. Among the ASEAN countries, in terms of average tariff elimination rates shown on the extreme right column, Singapore has the highest tariff elimination rate

at 100%, indicating complete tariff elimination in all five ASEAN+1 FTAs. Indonesia has the lowest tariff elimination rate at 83.4%, reflecting the protective policy stance of the Indonesian government. The remaining ASEAN countries can be arranged in descending order in terms of tariff elimination rates as follows: Brunei (95.9%), Philippines (93.1%), Thailand (92.6%), Malaysia (92.0%), Cambodia (90.0%), Viet Nam (89.5%), Lao PDR (89.3%) and Myanmar (87.3%). Among ASEAN's FTA partners, Australia and New Zealand have the highest tariff elimination rate at 100%, as they eliminate tariffs on all their imports from ASEAN countries, while India has the lowest tariff elimination rate at 78.8%. Among the PRC, Japan and Republic of Korea, the PRC has the highest tariff elimination rate at 94.1%, followed by Japan (91.9%) and Republic of Korea (90.5%).

It is interesting to note that many ASEAN countries have different tariff elimination commitments depending on ASEAN's FTA partners. One noticeable pattern is very low tariff elimination rates committed to in the AIFTA. In particular, Indonesia registers a very low tariff elimination rate of 48.7% in the AIFTA. The low tariff elimination rate adopted by ASEAN countries in the AIFTA is largely attributable to two factors. One is strong competition in a large number of products between India and many ASEAN countries. One such example is apparel products, which are major export items of both India and many ASEAN countries. The other factor is the low tariff elimination rate committed to by India. The level of tariff elimination is negotiated bilaterally in ASEAN+1 FTAs. As such, reciprocity becomes an important element in determining the level of tariff elimination. Because India's level of tariff elimination is significantly lower compared to other ASEAN's FTA partners, many ASEAN countries' commitment to tariff elimination turned out low in their agreements with India.

The ease or difficulty of consolidation of FTAs depends on the similarities/differences in the sectoral pattern of tariff elimination. Tariff elimination for a product in the RCEP is not a problem if the tariff has been eliminated in all ASEAN+1 FTAs, while tariff elimination in the RCEP is difficult if the tariff has not been eliminated in all ASEAN+1 FTAs. With this observation in mind, the sectoral patterns of tariff elimination among

five ASEAN+1 FTAs are examined. The products at the level of HS 6 digit are classified into three groups depending on the tariff elimination commitment in five ASEAN+1 FTAs - “eliminated in all FTAs,” “eliminated in some FTAs,” and “not eliminated in any FTAs.” Those products that are subject to tariff elimination in all ASEAN+1 FTAs are classified under “eliminated in all FTAs,” while those products that are excluded from tariff elimination in all ASEAN+1 FTAs are classified under “not eliminated in any FTAs.” Those products that are subject to tariff elimination in some FTAs and excluded from tariff elimination in other FTAs are classified under “eliminated in some FTAs.”

The results of this exercise, which are shown in Table 2, indicate wide variations in terms of tariff elimination status among ASEAN countries. On average, 73.3% of the products fall under the “eliminated in all FTAs” category, while 0.9% are classified under the “not eliminated in any FTAs” category. The remaining 25.8% of the products fall under the “eliminated in some FTAs” category. Although the average rate of tariff elimination is low at 73.3%, it may be encouraging to observe that on average 99.1% (100-0.9) of the products have been liberalised under at least one ASEAN+1 FTA. If ASEAN countries can eliminate tariffs on those products that are liberalised in at least one of the ASEAN+1 FTAs in other ASEAN+1 FTAs, they can achieve a 99.1% tariff elimination rate, making the RCEP a highly liberalised FTA.

**Table 2** Tariff elimination in ASEAN+1 FTAs by product (%)

	Tariff elimination in all FTAs	Tariff elimination in some FTAs	No tariff elimination in any FTAs
Brunei	84.1	15.9	0.0
Cambodia	64.3	35.3	0.4
Indonesia	46.0	52.8	1.2
Lao PDR	68.0	31.6	0.4
Malaysia	76.0	22.9	1.1
Myanmar	66.6	31.8	1.6
Philippines	74.6	24.4	1.0
Singapore	100.0	0.0	0.0
Thailand	75.6	24.3	0.1
Viet Nam	78.1	19.1	2.8
Average	73.3	25.8	0.9

*Note:* The figure indicates the shares of the products that fall under the category in total number of products.



Source: Kuno (forthcoming).

A closer look at the tariff elimination status for individual ASEAN countries reveals the difficulties in establishing a region-wide FTA, which are masked in the average figures examined above. Specifically, it is only Singapore that does not have any problems in achieving a highly liberalised region-wide FTA. Other ASEAN member countries face difficulties in eliminating tariffs in a number of sectors. Indeed, the shares of “eliminated in all FTAs” are quite low for many countries (e.g. Indonesia (46.0%), Cambodia (64.3%), Myanmar (66.6%), and Lao PDR (68.0%)), indicating the possible presence of enormous obstacles in tariff elimination.

### **3. Rules of origin in ASEAN+1 FTAs**

In FTAs, the rules of origin (ROOs) play a very important role in ensuring that preferential treatment is accorded to FTA members by avoiding trade deflection. There are four major ROOs that are adopted by ASEAN+1 FTAs – wholly obtained or produced (WO); regional value content (RVC); change in tariff classification (CTC); and specific process rule (SPR). A general rule is applied to all the products except those products that are subject to product specific rules (PSRs). The general rule is provided in the main text of the agreement, while PSRs are attached as Annex.

An examination of the ROOs adopted in ASEAN+1 FTAs reveals a wide variety in the application of the types of ROOs among ASEAN+1 FTAs, as well as within ASEAN+1 FTAs<sup>1</sup>. Except for the ASEAN-PRC FTA and the ASEAN-India FTA, the basic rule is a co-equal rule, that is, either RVC(40) or a change in tariff heading (CTH). Co-equal rule is less restrictive compared to the single rule, because it gives the firm choices in the application of ROOs. RVC(40) requires a minimum 40% regional value content. CTH is equivalent to CTC at HS 4-digit level. For the ASEAN-PRC FTA, the general rule is RVC(40). In the case of the ASEAN-India FTA, the general rule is RVC(35) and CTSH

<sup>1</sup> See Meddala (2011) for the analysis.

(a change in tariff sub-heading). CTSH is equivalent to CTC at HS 6-digit, making it less restrictive than CTH. In other words, a regional content requirement at 35% is less restrictive compared to other ASEAN+1 FTAs, but it has an additional requirement of a change in tariff classification, albeit at a higher-6 digit level, making the ASEAN-India FTA most restrictive.

For the consolidation of FTAs, a common ROO for each product has to be established. To see the ease or difficulty of the consolidation from the point of view of ROOs, a comparison of ROOs adopted by five ASEAN+1 FTAs is conducted at HS 6-digit level. Table 3 shows the number of HS lines that have common ROOs. According to the results, all five ASEAN+1 FTAs have at least one common ROO in 64% of all HS lines. Moreover, for approximately 95% of the products, three or more ASEAN+1 FTAs share a common ROO. These findings seem to indicate that harmonisation of ROOs may not be a far-fetched idea among five ASEAN+1 FTAs.

**Table 3** Commonality of ROOs across ASEAN+1 FTAs

Degree of commonality	Frequency distribution of HS lines (6 digit HS2002)	
	No.	%
At least one common ROO in all 5 FTAs	3318	64.0
in only 4 FTAs	766	14.8
in only 3 FTAs	825	15.9
in only 2 FTAs	255	4.9
No common ROOs	23	0.4

Source: Meddala (2011).

## 5. The way forward

An examination of the patterns of commitments in trade liberalisation in goods for five ASEAN+1 FTAs reveals that the construction of the RCEP, or ASEAN+6 FTA, by consolidating five ASEAN+1 FTAs is difficult because of the differences in the patterns of tariff elimination and the definitions of ROOs adopted in five ASEAN+1 FTAs. In order to overcome the difficulties to establish RCEP, political leaders of ASEAN+6

countries need to show their strong determination for trade liberalisation under the RCEP. From a practical point of view, ASEAN+6 countries should adopt a gradual approach, which has been shown effective in the establishment of the ASEAN Free Trade Area (AFTA), in tariff elimination, and a co-equal approach in the definition of the rules of origin.

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## 13 ASEAN+, RCEP and TPP: A clash of integration concepts

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Trade and economic integration in Asia and the Pacific has been marked in the last decade by two complementary trends: states within the region have on the one hand increasingly embarked on bilateral preferential agreements with each other (and also with others beyond the region), while on the other they have attempted to come up with solutions to minimise the political and economic transaction costs of this so-called noodle bowl. This has been particularly true for members of the Association of South East Asian Nations (ASEAN) that have been as a group at the centre of a “widening complex” (Haggard 2011) since the early 2000s.

In addition to signing free trade agreements with individual non-member countries, such as the People’s Republic of China (PRC), India, Japan or Republic of Korea (ASEAN+1 agreements), ASEAN took the initiative to launch broader and deeper schemes beginning with the establishment in May 2000 of a regional financing arrangement with the PRC, Japan and Republic of Korea, referred to as ASEAN+3. Another regional dynamic launched by ASEAN has been the East Asia Summit, an ASEAN+6 (ASEAN+3+India, Australia and New Zealand) structure created in 2005. The idea here has been to build upon all the existing ASEAN+1 agreements to develop a regional comprehensive economic partnership (RCEP). ASEAN leaders adopted in 2011 the guiding principles and objectives of such a partnership, and recently refined it with a specific negotiation timetable (with a finishing time in 2015). A key principle behind this initiative is that negotiations “will recognise ASEAN centrality in the emerging regional economic architecture.” Such centrality would be the best response

that the organisation could give to a growing concern with its potential “irrelevance” (Ravenhill 2008).

There is, however, high uncertainty about whether such centrality will persist, in particular given the emergence since 2006 of an alternative dynamic toward mega-regional consolidation, namely, the Trans-Pacific Strategic Economic Partnership (TPP), launched initially by four small economies (Chile, New Zealand, and two ASEAN members, Singapore and Brunei) and now extended to twelve countries, including four big developed economies, (the US, Canada, Australia, and soon Japan). The emergence of the TPP process has not only raised questions about the future relevance of ASEAN, but also about a potential clash between mega-regional schemes. In contrast to those, mostly in Asia, who see a bright future for ASEAN centrality and/or see a harmonious way out of the consolidation of the two main mega-regional frameworks, we argue, based on what happened in Europe, that such a happy ending is unlikely given the difference of integration concepts behind the different proposals.

### **From diversity to harmony: Two main concepts toward integration consolidation**

Consolidation of integration within a context of multiple existing arrangements is a challenging task and it is useful to look for previous experiments to gain analytical traction. The dynamic that came the closest to the current situation in Asia and the Pacific took place in Europe between 1989 and 1997, when several combinations of bilateral and multilateral agreements were attempted to address the economic and political challenges after the fall of the Berlin Wall. Eventually, however, the situation was solved by the “solar” attraction of the EU that expanded from 12 to 27 members. Given that there is no equivalent to the EU in the Asia-Pacific region, the intriguing questions are whether the “widening complex” will reach a kind of equilibrium path and, if so, under which form. To address these questions, our discussion below builds upon our own earlier work on regional dynamics in Europe and Asia Pacific (Dupont 1998a, Dupont 1998b).

Simply put, one can consider two potential generic paths leading to equilibrium in the widening dynamic. Let's call them a nesting dynamic and an enlargement, or multilateralisation, dynamic. The two concepts aim at bringing harmony in regional economic integration but while nesting helps preserve diversity, the enlargement/multilateralisation dynamic tends to eliminate it. In a "Russian doll" nested arrangement, each institutional layer is a self-standing and sustainable grouping. In the multilateralisation dynamic, the institutional layer gradually shifts to expand to new members and possibly new issues. The smaller layer immediately or slowly wanes out.

Under which conditions can we expect each of the concepts to become enduring processes and not simply follow cyclical, if not erratic, patterns? Regarding the nesting dynamic, we consider two simple necessary conditions:

1. *Nesting static condition (NSC)*. Members of any institutional layer must be convinced of its specific value and have collective control over it.
2. *Nesting dynamic condition (NDC)*. The addition of a new larger unit should both preserve the value of existing layers and bring additional benefits to their members.

As for the multilateralisation dynamic, the basic necessary rules can be stated as follows:

1. *Multilateralisation static condition (MSC)*. Members must respond to one dominant, encompassing institutional layer.
2. *Multilateralisation dynamic condition (MDC)*. When modifying the boundaries of the layer, members must shift allegiance and priority to the newly bounded organisation while granting equal power of control to new members.

While the history of the EU is a textbook example of the multilateralisation dynamic, a successful example of the nesting dynamic is yet to be found. This can be explained by the fact that nested arrangements are particularly difficult to implement when the activity of different layers calls for clearly defined boundaries. This is the case when the benefits from club membership are subject to some rivalry of consumption and therefore call for strict rules. Obedience to strict rules at different institutional layers is

very likely to clash, pushing member states to give priority to one or a subset of layers, making the other(s) irrelevant thus negating the NSC rule.

### **RCEP and TPP: Examples of the two concepts of regional consolidation**

The two main efforts toward regional liberalisation consolidation in the Asia and the Pacific, RCEP and TPP, are clear examples of the two different concepts presented above. RCEP, within the ASEAN+ framework, fits the nesting logic. The aim is to come up with some harmonisation/consolidation but without imposing a clear priority among various agreements. This principle is explicitly embodied in the Guiding Principle and Objectives for Negotiating the Regional Comprehensive Economic Partnership adopted in late 2011:

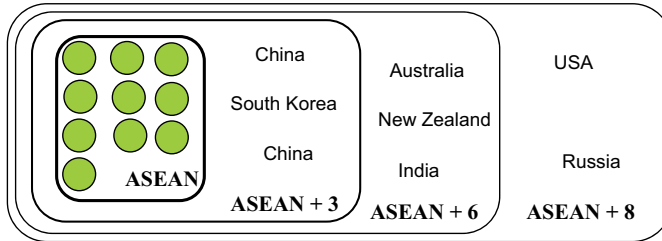
“The ASEAN+1 FTAs and the bilateral/plurilateral FTAs between and among participating countries will continue to exist and no provision in the RCEP agreement will detract from the terms and conditions in these bilateral/plurilateral FTAs between and among the participating countries.”

In contrast, TPP emerged from an agreement between four small countries in 2006 with a series of countries submitting their individual interest in, and being admitted to, the negotiation process. The intention has been to negotiate an agreement that would supersede existing agreements at the risk of making them less relevant. This has been particularly striking for NAFTA, with the US apparently keener to promote TPP than to worry about its potential impact on NAFTA, and Canada and Mexico more reluctantly and recently climbing on the bandwagon.

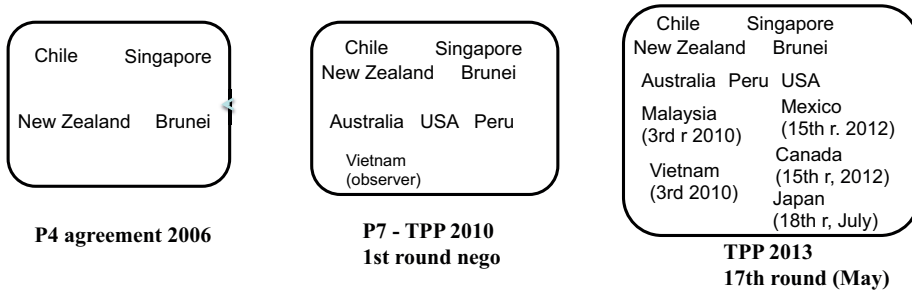


**Figure 1** Two concepts of widening in Asia and the Pacific

### ASEAN + Nesting dynamics



### TPP multilateralization dynamics



## Different concepts, different challenges

RCEP as an instrument recognising ASEAN centrality looks unlikely to succeed given the evolution of ASEAN+3 since its creation in the aftermath of the Asian financial crises in 1997. Key here is the willingness of ASEAN+3 members to durably embark on monetary cooperation. Indeed, in May 2000, they established a regional financing arrangement under the Chiang Mai Initiative. This initiative comprised of an expanded ASEAN swap arrangement (ASA) and a network of bilateral swap arrangements (BSAs) among ASEAN countries, the PRC, Japan and Republic of Korea.

While the objective of the initiative was to secure quick and deep lines of credit in case of crisis and to set up a monitoring facility and an early warning system, the bilateral pooling of resources raised doubts about any collective dimension of the initiative.

As a response, it was decided in Kyoto in May 2007 to multilateralise the reserve pooling arrangement with the adoption of the Chiang Mai Initiative Multilateralisation (CMIM). To ensure a full and sustainable implementation of this common pool resource exhibiting rivalry in consumption, they created stronger institutions, in particular an Independent Surveillance Unit (ISU). Given this development, ASEAN+3 stands out as the most natural focal point or “integrative centre” (Dent 2010) around which a multilateralisation of existing agreements could take place. It is unclear what this would mean for ASEAN. Whereas a role of “intermediary facilitator” (Dent 2010) sounds nice, it is hard to define it exactly and it is furthermore unlikely to survive the emergence of a multilateral free trade agreement in the broader region. In other words, either ASEAN+3 will emerge as the integration hub and ASEAN’s future will be grim, or ASEAN+3 will stagnate and with it the other layers, bringing an end to the ASEAN+ nesting dynamic. In the first case, the NDC condition (see above) would not be respected, in the second case it would be NSC condition.

As for TPP, its increasing attraction in the region constitutes its major challenge. Indeed, multilateralisation processes that start with smaller membership lead to deeper arrangements than those with large membership (Downs et al. 1998). Current negotiations that include seven, and soon eight, additional countries, some with significant reluctance and/or difficulties to agree on deep liberalisation and regulatory convergence, have generated significant concern about a loss of momentum and possible deadlock. Furthermore, the shift of allegiance toward TPP (the MDC condition described above) has yet to happen, in particular for countries such as Canada and Mexico, as well as for Malaysia and Viet Nam, the two ASEAN members forming part of the TPP process. For the latter two, shifting allegiance from ASEAN to TPP would signal a clear, and long-lasting, lack of respect for the “centrality of ASEAN in external, political, economic, social and cultural relations” mentioned as a core principle of the organisation (art. 2 ASEAN Charter).

## **Future of mega-regionalism in Asia-Pacific: Toward a clash of concepts**

Given the difficulties and uncertainties associated with each of the two processes, RCEP and TPP, one may wonder whether some kind of combination of the two into an hybrid solution could be the happy way out of the current liberalisation complex. Some have suggested that after some further progress, the two processes would somehow connect and merge into a free trade area of Asia and the Pacific (FTAAP) under the umbrella of APEC (Kawai and Wagnaraja 2013). But, as revealed by the example of APEC in the 1990s, it is very hard to envision any real progress without a significant shift of allegiance from ASEAN toward the broader framework. Given that its biggest economy, Indonesia, may want to preserve ASEAN as a tool in the larger forum of the G20 and that Laos, Cambodia and Myanmar may not want to jeopardise their current level of comfort within the group, it is hard to see how this could happen. Short of a quick and complete failure of the two processes, a clash between the two concepts is thus a real possibility. It could also be seen as a clash of power between the PRC and the US. By pushing for a very ambitious TPP, the US clearly aims at keeping the PRC out of the process, which could add a trade dimension to the existing tension on exchange rates between the declining top economy and its ambitious, and rising, challenger. From this perspective, the quest for mega-regional FTAs in the Asia and the Pacific may not be such a good idea in the end.

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## Section 4

# Global Trade Governance





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# 14 The future of the World Trade Organization

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**Biswajit Dhar**

Research and Information System for Developing Countries

The multilateral trading system, long considered as the first best option for liberalising global trade, faces the most serious crisis in its six and a half decades of existence. The inability of the World Trade Organization to deliver on the promise to deepen and widen trade liberalisation, an exercise that this forum had initiated nearly 12 years ago, has raised several questions about its continued relevance. And, yet, there is no escaping the reality that the WTO is the only organisation that can take a comprehensive view of the increasing complexities of the evolving economic engagements between countries. The challenges that the global community faces in this context are two-fold. In the first instance, there is a need to assess the key developments in the Doha Round, which have contributed to the present stalemate. At the same time, it is imperative to identify the options that the WTO could consider for defining its future work programme, given the new realities of global economic engagement. Since the Doha Round negotiations began, the drivers of economic integration have undergone significant changes. The most prominent of these is the recognition of global production networks as the harbinger of deepening economic integration between countries. The shift from localised to fragmented production systems requires new approaches that the WTO must take cognisance of.

This chapter addresses the two sets of issues indicated above. The first section focuses on the key developments in the Doha Round, encompassing some of the more critical negotiating areas. An exercise of this nature is important, in my view, since it helps in analysing the issues on which agreement has eluded the WTO Members. Thus, if

the Doha Round is to be brought to an early conclusion, as has been the consensus among the major economies, the disagreements between the key players involved in the negotiations must receive focused attention. There is no gain in saying that the global economic recovery, which is on a knife-edge, would need the backing of a resilient multilateral trading system to get onto a more sustainable path.

## **Prospects for the Doha Round**

Among the negotiating areas, agriculture and non-agricultural market access (NAMA) have been consistently in focus. More recently, the discussions in agriculture and NAMA have centred on the Draft Modalities Texts tabled by the respective Chairs of the Negotiating Groups on Agriculture and NAMA in December 2008. Services and intellectual property rights are two issues that are of considerable importance for several developing countries, for they bring with them several critical concerns. In both these areas, developed countries have traditionally been the demandeurs, but in more recent years, and particularly since the beginning of the past decade, developing countries have been quite active in bringing forth their agenda to the table.

Two sets of views can be expressed in response to the disciplines on farm support proposed in the framework text. The first is that the proposed discipline on domestic support and export competition would not be able to rein in the subsidies to a considerable extent on two counts. One, the proposed discipline on domestic support not only seeks substantial reduction in the AMS, but also extends the discipline to cover the “Blue Box” measures that were hitherto left outside the AoA discipline. Two, there has been an agreement on the need to eliminate export subsidies and some forms of export credit, which is a major step forward given that the EU has been refusing to do so thus far.

The second, which is the critical view on the proposed disciplines on farm support, is that the framework would not be effective in reining in the subsidies. The lack of discipline in respect of the “Green Box” measures, which contains several elements

that can distort markets, would render the proposed domestic support discipline largely ineffective. Latest figures show that “Green Box” measures accounted for nearly 90% of US domestic support spending, while in case of the EU, the corresponding figure is nearly 50%. Further, elimination of export subsidies is a small consolation given that the EU, the largest user of this form of subsidies, made minimal use of these subsidies.

In the area of market access, two issues are critical for developing countries: “Special Products” (SPs); and the “Special Safeguard Mechanism” (SSM). The former includes the proposal to allow developing countries to “self designate” 12% of agricultural tariff lines as SPs, guided by indicators based on the criteria of food security, livelihood security and rural development. As regards the SSM, the proposal is that either an import quantity trigger or a price trigger would trigger safeguard duties. The trigger for invoking the SSM determines when the safeguard duty can be imposed. It may be pointed out that if the import quantity trigger is set too high, the SSM would be rendered ineffective since the mechanism can be used only in the most exceptional circumstances. The same would hold true if the price trigger is set too low thresholds.

In the negotiations covering non-agricultural products (the so-called NAMA negotiations), one issue that could introduce a significant element of uncertainty is sectoral zero-for-zero. In its essentials, this issue involves identification of sectors in which tariff elimination can take place at an early date. In December 2008, WTO Members listed 14 sectors for inclusion in the sectoral initiative.

Proponents of the sectorals have justified the initiative on the ground that it would help realise the NAMA negotiating mandate that emphasises the need to “reduce or as appropriate eliminate tariffs”. On the other hand, several developing country members have opposed the move arguing that they would end up taking commitments for tariff cuts much more than their developed country partners. There does seem to be a justification in the point made by the developing countries, as the Doha mandate also indicated that these countries were to take commitments less than those taken by their developed country partners.

Negotiations in the Doha Round face formidable challenges going forward. The challenges, in our view, are two-fold. In the first instance, the negotiating process has considerable problems for it has not effectively taken on board several key issues in the negotiating mandate. Thus, while negotiations in agriculture and NAMA have been fast-tracked, critical areas like services and intellectual property rights have remained in the back burner.

The absence of parallel movement on the key areas in the negotiating mandate of the Doha Round is of considerable concern as this can cause an imbalance in the negotiating outcome. The architects of the Doha mandate had envisioned the “Doha Deal” as a “single undertaking”, which implies that the Doha Deal can be done only when there is agreement in all the areas included in the mandate.

The second challenge that the Doha Round faces is from the virtual non-participation of the largest economy, namely the US, particularly since the economic downturn. It was expected the US would get actively engaged in the negotiations after the Democrats assumed power in 2009. But engagement in the multilateral trade negotiations remained outside the list of priorities for first Obama Administration as it did not obtain the necessary mandate from the US Congress to negotiate trade deals. The US Congress has not yet considered the Trade Promotion Authority (TPA), without which the country’s trade negotiators would be unable to participate in the Doha Round. This implies that the position that the US would eventually take in the negotiations remains a matter of conjecture.

## **WTO for the future**

The proliferation of the global production networks (GPNs) poses a significant challenge to the multilateral trading system, for its basic construct is based on the existence of localised production within nation states. Production-sharing across national borders of the kind that has been spawned by the GPNs requires new instruments and institutions that are supportive of such networks. This, in our view, needs focus on three behind-the-

border areas: trade facilitation measures; investment policy; and non-tariff barriers for the adoption possible globally accepted frameworks/agreements.

From the point of view of the GPNs, justification for including trade facilitation in this group of issues is considerable. Enterprises figuring in the GPNs are required to meet the tight delivery schedules. A transparent set of rules and adequate infrastructure at the border are the necessary wherewithal that help them realise their objective. Reforms of the existing facilities offered in different jurisdictions with a view to harmonising them to the extent possible, given the resource constraints faced by the developing countries in particular, are therefore a desirable set of outcomes. In fact, the negotiations on trade facilitation in the WTO are aimed at making a forward movement in this direction.

Despite the progress made in the trade facilitation (TF) negotiations, there are obstacles in moving the negotiating process on TF towards an eventual agreement. Major developing countries like India and Brazil are not likely to favour a “stand alone” outcome, as TF is integral to the Doha package, which is to result as a part of the “single undertaking”. In other words, these countries will be reluctant to agree on a deal on TF without agreement on some of the key areas in the Doha negotiating mandate. Again, while there is no doubt that most of the lesser developed countries would benefit from an eventual deal on TF, since the benefits would not accrue to them in the absence of the technical assistance and capacity building commitments from the developed countries, it seems unlikely that a globally acceptable outcome can be realised soon.

Multilateral agreement on investment became a non-starter after the OECD-backed proposal for such an investment found resistance not only from the developing countries, but also from within the group of developed countries. Notwithstanding this development, there has been an unrelenting movement towards adoption of a de facto investment agreement at the global level through the bilateral investment treaties and the economic partnership agreements. However, in recent years, evidence is emerging on the nature of constraints that these agreements are imposing on the host countries. Not surprisingly, there has been a steep increase in the disputes involving

the foreign investors and their host states. This development could be detrimental to the GPNs, since they are dependent on cross-boundary movement of enterprises. There is therefore a need to better understand the contentious elements of the existing investment agreements, which could then trigger a move towards a more equitable global investment regime.

Since its establishment in 1948, the multilateral trading system was tasked with the elimination of border protection measures arising from the pursuit of discriminatory policies. The process of trade liberalisation that was thus initiated has since become almost synonymous with the lowering of tariffs. Yet, the critical issue of NTBs has remained largely unaddressed.

Non-tariff barriers (NTBs) have emerged as the insurmountable barriers that the multilateral trading system has had to cope with. However, nearly four decades after the initiation of negotiations for the reduction of NTBs, the world is now facing one of its most difficult and complex regimes. Since the establishment of the WTO in 1995, technical barriers have emerged as the fountainhead of NTBs. This was confirmed in course of the on-going negotiations on non-agricultural market access. The proliferation of these technical barriers or standards demands a global action to tame them.

## **About the Author**

Currently the Director General of the Research and Information System for Developing Countries (RIS), **Biswajit Dhar** has been intimately involved in the policy making process for more than a decade and a half. He has been a member of the official Indian delegations to WTO Ministerial Conferences, and the Ministry of Environment and Forests has nominated him as an expert in negotiations conducted under the aegis of the Convention on Biological Diversity. Dr. Dhar has also served on expert panels set up by the Ministry of Statistics, Department of Chemicals and Fertilizers, and Ministry of Environment and Forests.

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# 15 A new perspective for the World Trade Organization

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## **Tomochika Uyama**

Permanent Mission of Japan to WTO

When discussing the future of the global trading system, the Asian perspective could be relevant and useful. Although development is the most controversial issue in WTO trade negotiations, in most cases, it is discussed either in theories or political confrontations. What is useful about the Asian perspective is that discussions can derive from a number of successful cases on the ground and, from such concrete experiences, a desirable trading system can be explored.

So what is the core of Asian experiences?

Among various elements, the most important factor would be the emergence of international value chains through the diversification of production bases.

Many developing countries in Asia have achieved economic development through the expansion of production and trade, which has been broadly the result of becoming part of regional or global value chains for manufacturing.

In order to participate in the value chains, receiving investment is crucial. Such investment must be FDI, which can be used to make a production base, not merely a portfolio investment. Many developing countries in Asia have achieved success through making efforts to create an attractive investment climate.

Examples of efforts to create a better investment climate include building infrastructure, human development, and creating good regulatory institutions. These must be done by

developing countries themselves and, as necessary, by using assistance from outside, which is broadly called Aid for Trade.

Efforts to improve the investment climate also include building international frameworks, such as creating free trade agreements and investment agreements.

Since the essence of an investment climate is building trust for investors, various efforts must be aimed at a) liberalisation of trade and investment, b) ensuring transparent and fair implementation of rules, and, by doing so, c) enhancing predictability.

The emergence of international value chains has apparently changed the essence of trade policy and investment. Before the emergence of international value chains, the objective of trade policy was to expand exports of products the country concerned could already produce by lowering tariffs and other trade barriers of its trading partners, while maintaining its own tariffs.

Since the emergence of international value chains, participation in the value chains, and thereby participating in the production process, have become new targets. The most effective way of achieving such participation is to receive FDI. By receiving FDI, a country's production ability can increase dramatically. This is particularly important for developing countries whose exports depended only on primary products. By participating in international value chains, a country whose main export is bananas can become a major exporter of electronic products within a relatively short period of time.

The emergence of international value chains has also changed the products to be traded. The main products of export are no longer finished goods; more than half of products traded among Asian countries are materials, parts and components. Furthermore, various services - i.e. invisible products, including design, innovation of technologies, logistics, services to consumers, etc. – also form part of international value chains. With the development of information technologies, these various services can be done offshore and the opportunities to participate in international value chains have therefore expanded.



The emergence of international value chains, improvements in the investment climate to attract FDI, and the expansion of supply and export capacities as a result of the expanded FDI - these are the realities for Asia now. And the international value chains are expanding their networks and becoming more and more global.

Activities at the WTO need to take these realities into account. While Members of the WTO must do their best for negotiations of the Doha Round, there should also be discussions to explore the future of the world trading system with the initiative of researchers. Those discussions will eventually create new ideas that will benefit all countries and their people.

Recognising that participation in international value chains is a shortcut for development, the key is enhancing the investment climate. The WTO, with almost 160 Members, could play a role in the new global trend of expanding international value chains by assisting developing countries in improving their investment climate. While encouraging Aid for Trade will continue to be important for that purpose, the WTO can play a more important role by providing a new international framework within the multilateral trading system.

One such activity will be the promotion of negotiations to expand the product coverage of the Information Technology Agreement (ITA), aiming at the elimination of tariffs on a wider range of IT products by a number of interested Members. The ITA expansion negotiations take into full account the emergence of international value chains. The greatest benefit of introducing ITA expansion is not just eliminating tariffs on IT products, but also, by applying the elimination on a Most-Favoured Nation (MFN) basis to all WTO Members, freeing industries from the requirement of obtaining certificates of origin. While FTAs have eliminated a number of tariffs within certain countries, a certificate of origin is required to use preferential tariffs. This requirement is cumbersome and constitutes enormous cost for industries. The ITA can eliminate this cost. It should be recognised that the WTO framework can provide a higher level of benefits than FTAs. It should also be recognised that the elimination of costs in

expanding production networks increases opportunities for more developing countries to participate in international value chains.

Indeed, it is encouraging that a number of developing countries in Asia are participating in the ITA expansion negotiations.

If you are a traditional trade negotiator, you might consider not participating in the negotiations because, since the results of ITA negotiations will apply on an MFN basis to all Members of the WTO, you can still enjoy the elimination of your trading partners' tariffs if they participate in the ITA. In this case, you are in a position to enjoy the results of the negotiations without paying your share of the cost.

However, the reality is different; a number of developing countries are participating in the negotiations. I believe this is because these countries are interested in seeking FDI and therefore in providing a better investment climate. In the today's quickly changing world, what you are producing today might be obsolete in a few years. It is more important to look after the interests of businesses who will continue to invest in your country. Being a member of the ITA is useful status for attracting investment.

Therefore, a decision to participate in the ITA expansion negotiations must be the result of serious consideration by each government of the benefits, in particular of the increase of future investment to their countries. In this, other developing countries, including neighbours, could be your rivals. So if your rival is a member of the ITA, it is better for you to be a member as well. You cannot win the competition to get the next investment without continuous efforts to become more attractive than others for investors. These motivations will bring the ITA negotiations forward within the WTO framework.

ITA expansion negotiations could be a model for future activities of the WTO that is relevant to real business activities in the world. There will be a tremendous number of issues around the investment climate that can be addressed in the existing and future WTO framework. Academics are in a good position to explore various possibilities at this stage.

As has been seen above, the Asian perspective would be useful and could even be crucial for many countries, in particular developing countries, in providing a key solution for development. The seminar in March 2013 hosted by ADBI and the Graduate Institute, Geneva is a timely and extremely useful endeavour. Further development of discussion is expected in its future process.

*Author's note: The opinions contained in this paper are solely of the author and do not reflect the view of the organisations he belongs to.*

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Services for DDA as well as negotiators on EPAs with the Republic of Korea, the Philippines, Thailand and Indonesia.

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# 16 Plurilateral agreements: A viable alternative to the WTO?

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## **Michitaka Nakatomi**

Japan External Organization (JETRO)

The history of the WTO shows that major accords reached under the multilateral framework were based on issue-based plurilateral agreements. In this chapter, I will highlight the potential of well-designed issue-based plurilateral agreements in liberalisation and rulemaking.

Since its launch in 2001, the WTO's Doha Round of trade negotiations has been facing two serious problems. The first, and more serious, is the slow progress of the negotiations. The other serious problem is the narrow scope of issues covered by the WTO and the Doha Round.

The slowness and narrowness of the Doha Round are closely related to the decision-making mechanism of the WTO or, more specifically, its underlying principles of consensus and single undertaking. Against this backdrop, member states' confidence in the WTO as a vehicle for making global trade rules and promoting liberalisation has been undermined. With more governments and business communities looking to FTAs as a means to gain benefits, the "FTA competition" has intensified.

There is a clear danger that the proliferation of FTAs may undermine the multilateral trade rules embodied in the GATT/WTO. The "noodle bowl effect" is no longer limited to rules of origin, growing into a phenomenon encompassing global trade rules in general. A noodle bowl of rules of origin may be able to be swallowed, but a noodle bowl of global trade rules is not.

The emergence of “mega-FTAs or mega-RTAs” may also create “mega problems” unless rules are harmonised across them. Issue-based plurilateral agreements can remedy the situation and introduce consistent global rules while the WTO and the Doha Round are not in motion.

Developments since the establishment of the WTO show the importance of issue-based plurilateral agreements, which are key tools for both developed and developing countries to promote liberalisation and rulemaking. The Information Technology Agreement (ITA), the Financial Services and Basic Telecommunications Services Agreements, and the ACTA, stand as evidence of the effectiveness of the plurilateral approach (Nakatomi 2011). They also indicate that well-designed plurilateral agreements will be accessible and beneficial to developing countries.

Next, I would like to look at characteristics and advantages of issue-based plurilateral agreements. Issue-based plurilateral agreements have the following features.

First, they can pave the way for addressing specific issues and areas. Their most prominent feature is that participating parties can freely choose issues and areas upon which to establish an agreement. In the case of the WTO, it is difficult to promote an initiative for liberalisation or rulemaking in a specific area while the round is in process. In the case of FTAs, “substantially all trade” (GATT Art. 24) and “substantial sectoral coverage” (GATS Art. 5) provisions put constraints in flexibly dealing with specific issues and areas.

Second, they can allow flexibility in the choice of participants, unlike the case of FTAs, where the choice of participants comes first.

Third, they can get around the decision-making ordeal of the WTO. Decisions at the WTO are, in principle, taken by consensus, inhibiting its ability to respond with agility. An issue-based plurilateral agreement provides various options to get around this constraint.

Fourth, they can respond with agility to the changing needs of industries. Issue-based plurilateral frameworks, as well as FTAs, can respond to and address the changing needs of businesses and industries in a more practical timeframe than can the WTO.

Fifth, they can prepare for multilateral rulemaking in the future. An issue-based plurilateral agreement ensuring consistency with WTO rules can provide an important basis for improving these rules in the future. In view of the governance of the global trade system, it is critically important to define issue-based plurilateral agreements as a tool for governance and link them to the WTO. Regarding FTAs, their discriminatory nature against non-members may be hindering the creation of future WTO rules.

### **Examples of issue-based plurilateral agreements**

The GATT regime was founded on two types of rules: the GATT 1947, in which all member states participate; and “codes,” which refer to a series of non-MFN based agreements binding on limited groups of participating members. The Kennedy Round and the Tokyo Round produced a number of codes. The situation changed dramatically through the Uruguay Round, resulting in the launch of the WTO.

All members are bound, in principle, by the same set of rules under the WTO. The Tokyo Round Codes became universal rules (Annex 1 agreements) only with a few exceptions (Annex 4 agreements). Among them, only the Government Procurement Agreement and the Civil Aircraft Agreement remain as plurilateral agreements. But it is difficult to create a new Annex 4 agreement because consensus is needed for its creation.

In 1997, the ITA was concluded. Also concluded in that year were two services agreements – the Financial Services Agreement and the Basic Telecommunications Services Agreement – achieved by means of the participating members’ commitment to the relevant reference papers and changes to their schedules of concessions. The resulting benefits are extended to non-participating members on an MFN basis.

Together with the ITA, “critical mass plus MFN extension of the benefits to non-members” are the common features of these landmark plurilateral agreements in the history of the WTO.

In 2011, the ACTA was concluded based on the Japanese initiative.

Future plurilateral agreements should learn the lessons from the success of these precedents and their modalities. Especially, “critical mass plus MFN extension of the benefits to non-members” can be the initial starting point for a future issue-based plurilateral agreement.

### **Constraints on plurilateral agreements**

Incorporating a new plurilateral agreement into the WTO agreements (as an Annex 4 agreement) involves securing consensus among all of the WTO Members. Meanwhile, amendments to the existing WTO agreements without creating a new Annex 4 agreement lead to amendments to the Annex 1 agreements, which also require consensus among all WTO Members. The WTO is faced with the need to examine its “variable geometry,” and discussions to that effect are becoming essential.

Among the options to be discussed are: (i) critical mass plus MFN extension; (ii) reintroduction of codes (Annex 4 agreements); and (iii) modification of schedules of concessions and commitments.

As is the case for the ACTA, plurilateral agreements can be created to complement or reinforce the existing WTO rules. Or they can be created to set rules in areas not covered by WTO rules. Needless to say, any plurilateral agreement to which a WTO Member is a party must be WTO-consistent even if it is negotiated and concluded outside the WTO.

In principle, plurilateral agreements must not affect the rights and obligations of non-participating WTO Members. Including major WTO Members as signatories is the key



to success. Another key to concluding a successful plurilateral agreement is to strike the right balance of the following three factors: (1) level of discipline (ambition); (2) scope of participating countries; and (3) timing of realisation (see Nakatomi 2011).

## **Future plurilateral agreements**

Experiences with a series of plurilateral agreements hitherto concluded provided valuable lessons regarding their potential. At a time when the WTO and the Doha Round are stuck in a quagmire, they may be a light of hope as they have the potential to play a pivotal role to enhance the governance of the global trade system.

There is potential for concluding new plurilateral agreements in the following areas:

1. Tariff reduction and elimination
2. Services
3. Government procurement
4. Electronic commerce
5. Trade and investment
6. Trade and competition
7. Standards and conformance, and TBT
8. Rules of origin

The issues and areas are possible candidates to be dealt with by means of an issue-based plurilateral agreement.

They can be discussed separately, but it is also possible to bundle some mutually-related issues into one agreement. Businesses relying on global supply chains obviously want to see liberalisation and rulemaking in the broadest possible scope. For instance, one option worthwhile considering is to pursue, in collaboration with major economies as well as with business societies, a plurilateral agreement on an international supply

chain, a package of rules for standards and conformance, e-commerce, country of origin, investment, competition, and so forth.

It is too time consuming and dangerous to wait for the results of upcoming mega-RTAs. RTAs do not provide global solutions that the business community is pursuing. My concept paper of an International Supply Chain Agreement (Nakatomi 2012) responds to the requirements of the business community and deals with the challenges for the global trade system posed by mega RTAs.

This year's World Economic Forum Enabling Trade Report (WEF 2013) and a World Bank blog by Bernhard Hoeckman and Selina Jackson (Hoeckman and Jackson 2013) referred to the ISCA Concept Paper as an option to "holistically" deal with supply chain issues.

The areas discussed above are just examples; trade facilitation may be another possible area for plurilateral initiatives, that is, in the (hopefully, unlikely) event of failure of the ongoing efforts under the WTO. Governments should consider using issue-based plurilateral agreements more proactively in parallel with pursuing FTAs so that they can respond more quickly to new problems faced by their industries and challenges in global trade.

Since the Eighth Ministerial Conference, there has been moves toward plurilateral agreements. One is the discussion on the expansion of the product coverage and participants of the ITA. The other is a move toward launching negotiations on an International Services Agreement (ISA). These are welcome developments in plurilateral agreements involving certain WTO Members to meet the evolving needs of business.

Thus, issue-based plurilateral agreements have a great potential to facilitate rulemaking and liberalisation.

To sum up, I would like to answer two fundamental questions posed to issue-based plurilateral agreements:

*Are plurilateral agreements replacing the WTO?* The answer is “no.” They should and do complement the WTO, which is facing serious challenges posed by FTAs. Then, are they competing with FTAs? Again, the answer is “no.” They complement FTAs by offering global solutions, a task that cannot be accomplished by FTAs.

*Can plurilateral agreements address the needs of developing countries?* There are five factors that are likely to facilitate the participation of developing countries. First, as discussed, the proliferation of FTAs – especially the emergence of mega-FTAs – has put developing countries in a difficult situation. Issue-based plurilateral agreements may help their positions. Second, developing countries, which are increasingly diverse in their economic interests, would find clear merits in participating in plurilateral agreements designed to promote liberalisation and rulemaking in specific areas of interest. Third, plurilateral agreements should be designed to encourage the participation of like-minded developing countries. Fourth, technical assistance and capacity building should be an integral part of plurilateral agreements. Fifth, dispute settlement provisions should not be too stringent so as not to discourage developing countries from joining.

The answer to the question is “yes,” provided that they are designed to attract like-minded developing countries with due consideration given to the factors described above.

## **Conclusion**

The WTO, FTAs, and issue-based plurilateral agreements need to be considered collectively. Promoting issue-based plurilateral agreements helps understand the problems embedded in the WTO and find a direction for reform. In the face of globalisation and changes in the economic environment, governments will be required to have a good command of all of these various tools, applying the right one to the right need to deliver the best possible solution.

In a stalemate of the Doha Round, well-designed issue-based plurilateral agreements (single issue or multi-issues) can be a strong and efficient tool for global rulemaking and liberalisation, complementing the WTO regime.

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# 17 The case for enhancing regional and global rules for investment

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**Zhang Yunling and Rongyan Wang**

Chinese Academy of Social Sciences; Tianjin University

This chapter examines how foreign direct investment (FDI) has become more and more important to global economic growth. Over the last two decades, the growth in global FDI of 12.9% exceeded the growth in global GDP of 5.7% (World Bank Development Indicators). A striking characteristic of FDI over the same period has been the greater flow of FDI to developing economies (16.2%) than to developed economies (11.6%). After the 2008 global financial crisis, FDI to developed countries dropped and more FDI flowed to the developing economies. Among the developing economies, those in East Asia attracted more FDI than the others, though they were also affected by the global financial crisis. In East Asia, the People's Republic of China (PRC) attracted the largest share of FDI because of its high growth rate and large market.

FDI plays multiples roles for host economies. It generates economic dynamism by developing new industries, increasing trade, and introducing new technology and management. East Asia is a good example that illustrates FDI's positive role. East Asia has, over the past several decades, achieved an "economic miracle" and a key factor in this has been the FDI-friendly policies adopted by almost all of the economies in the region.

But compared with trade, there are more restrictions on FDI. The reasons for restrictions on FDI range from protectionism to national security. Protectionism often increases during times of economic crisis or as a way to deal with external competition. FDI restrictions include non-national treatment of FDI through different tax, financing,

standards and ownership; and special evaluations and approval processes for FDI acquisitions or mergers (UNCTAD 2012).

Although a seamless investment environment seems difficult, further liberalisation and a reduction of barriers to FDI are highly desirable because FDI can play a crucial role in accelerating economic recovery and generating a new dynamism of the global economy.

## **Facilitating FDI**

The WTO's Uruguay Round produced a well-rounded agreement on trade-related investment measures (TRIMs), providing disciplines for measures restricting foreign investment. The aim of TRIMs is to reduce the barriers on investments related to trade in goods. TRIMs rules apply to the domestic regulations a country applies to foreign investors. GATT 1947 prohibited investment measures that violated the principles of national treatment and the general elimination of quantitative restrictions, but the extent of the prohibitions was never clear. TRIMs provide an illustrative list that explicitly prohibits local content requirements, trade balancing requirements, foreign exchange restrictions and export restrictions (domestic sales requirements). However, TRIMs only apply to trade in goods, not to service trade that has a close relationship with FDI. Although the WTO opened the window for FDI liberalisation through TRIMs, it is not clear that the FDI issue could be fully handled by the WTO in the future.

The Declaration and Decisions on International Investment and Multinational Enterprises adopted by the OECD is aimed at creating a freer, more open, and more transparent investment environment to encourage FDI liberalisation. The OECD also completed the Investment Policy Framework, which sets an example that provides the most systematic permission conditions for investment covering 10 policies and 82 answers for investors to solve policy reform problems. The framework emphasises the principles to formulate policies, that is, the principle of a transparent, non-discriminatory environment and the protection of intellectual property, while still respecting the differences among countries.



The G20 is also tackling FDI related issues. It regularly publishes reports on trade and investment measures sponsored by UNCTAD, the WTO and the OECD in order to provide timely assessments and warnings on trade and cross-border investments, because it is crucial to avoid protectionism during a global economic crisis. According to the reports, G20 members continue to ensure an open market environment for trade and investment, but some protectionist measures have also been witnessed. For example, several new emergent policy measures have been taken that are related to national security, as well as emergency arrangements.

UNCTAD has done considerable work on the policy discussion and research of the trade and investment issues. The World Investment Report is the most authoritative analysis of global FDI trends and impacts. UNCTAD launched its Investment Policy Framework for Sustainable Development in 2012. The framework provides policymakers with concrete options for placing inclusive growth and sustainable development at the heart of efforts to attract and benefit from foreign investment. In so doing, the framework aims at creating synergies between investment policies and wider economic development goals; promoting the integration of investment policies into development strategies; fostering responsible investment and incorporating principles of corporate social responsibility; and ensuring policy effectiveness in the design and implementation of investment policies.

In sum, international organisations have made great efforts to promote FDI liberalisation and to provide guidelines for good policymaking, business behaviour and sustainable and inclusive development, though their roles appear to be limited in leading to a global investment agreement.

## **Investment liberalisation**

Investment liberalisation and facilitation are key parts of regional arrangements. The EU has realised full liberalisation by establishing the European single market. The North American Free Trade Agreement (NAFTA) guaranteed the principle of national

treatment, and prohibited investment-related performance requirements that forced foreign-owned companies to produce a certain amount of exports, use local contents, or transfer technology to local economies. The result was a far-reaching agreement that went considerably beyond the TRIMs.

ASEAN established the ASEAN Investment Area (AIA) to encourage and facilitate FDI in ASEAN. Under AIA, ASEAN members agreed to promote the area as a single investment region through joint investment promotion efforts that aim to increase the confidence of investors in investing in ASEAN. Under AIA, national treatment will be applied to both ASEAN investors and all other investors. With ASEAN as a centre, five “10+1” free trade agreements (FTAs) have been concluded in East Asia. All the agreements cover trade in goods, services, and investments. As for investment liberalisation and facilitation, the agreements include major issues such as national treatment, non-discriminate treatment, performance requirements, range of application, and transparency, among others.

ASEAN initiated the Regional Comprehensive Economic Partnership (RCEP), supported by six other countries (the PRC, Japan, Republic of Korea, India, Australia and New Zealand), in 2012. 16 countries agreed to start the negotiation for RCEP in 2013 and conclude it by 2015. RCEP aims to integrate five existing “10+1” FTAs (ASEAN with the PRC, Japan, Republic of Korea, India, Australia-New Zealand) as a basic foundation, and it also goes further to create a high standard regional agreement for liberalisation, facilitation, and cooperation. RCEP will include a comprehensive part on investment, which will certainly be beyond the AIA.

The key role for a RCEP investment arrangement is to help promote and restructure production networks and inclusive development. The PRC, Japan, and the Republic of Korea signed an investment promotion agreement (CJK IPA) in 2012. CJK IPA includes all the important principles, ranging from the definition of investment, scale of investment, most-favoured-nation treatment, and the national treatment to the dispute settlement. These three countries are committed to negotiate a trilateral FTA (CJK

FTA), and they plan to conduct further negotiations on investment liberalisation. As the three economies are highly integrated based on FDI networking, a high-quality investment agreement is demandable.

It is expected that some principles, like pre-national treatment to FDI, and the negative list liberalisation approach on services, will be negotiated. The CJK FTA has received strong support from business. A recent survey shows that 85.4% of Chinese companies, 78.7% of Japanese companies, and 70.9% of Korean companies have a positive attitude towards the CJK FTA. The key to its success is overcoming the political barriers among the three countries, which have seen ties strained over territorial disputes.

## **Policy implications**

Over half a century of work has seen trade barriers, especially tariffs, reduced significantly. However, FDI barriers remain very high. Compared to trade barriers, those for FDI are far more complex and invisible. Furthermore, the “noodle bowl” effect can also be found in FDI flows in all kinds of regional trade agreements because they adopted different principles and arrangements.

The global economy remains unstable, and the post crisis recovery has been uneven and weak. The challenge for the WTO, the G20 and other international organizations is how to cooperate seamlessly to create a new dynamism for the world economy. Therefore, along with trade facilitation efforts, the WTO should be encouraged to work on a new FDI framework to solve problems among member countries that cannot be dealt with easily or effectively by regional arrangements. This can be taken as the new initiative to recreate the economic dynamism for global economic development.

An FDI framework could be obtained by consolidating the work done by the G20, UNCTAD, and the OECD. But it should go further, to a higher level arrangement that could realise an integrated framework beyond TRIMs. Furthermore, as FDI regulations vary among regional arrangements, it is essential that a single agreement

on the multilateral level be adopted. Basic components should include transparency on investment policies, rules and regulations with a clear identification of agencies responsible for issuing relevant licenses, permits, and approvals. Foreign investors should also be required to commit to transparency in their labour and environmental standards and public scrutiny of their conformance with those standards.

Just as global trade has never been completely free, so it goes for investment. That is to say, there will always be two conflicting sides to investment policies; one side is promotion and facilitation, while the other is tending towards protecting domestic firms. In the current international environment, both investment promotion and protectionism need attention, including the process of bilateral, regional, and multilateral arrangements. On the multilateral level, considering the diversity of the economies, although a high-level liberalisation package appears difficult, high standard regulations, including transparent FDI policies, should be a priority.

It may be time for the WTO to initiate a global investment promotion and facilitation agreement.

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# 18 A multilateral agreement on investment: A brief reflection

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**Alejandro Jara**

World Trade Organisation

Since the Second World War, the international community has undertaken a vast effort to achieve and deepen international cooperation in the political, economic, social, environmental and other areas. In the field of trade, a multilateral trading system was first established under the GATT and was later improved and expanded through the establishment of the WTO in 1995.

Foreign investment has been an increasingly important element of international business. Most countries seeking to expand growth and employment, as well as transfer of technology, have done their best to attract new flows into their economies. It is surprising that important as it is, a few attempts to achieve wider international cooperation on investment, such as the Multilateral Agreement on Investment in the OECD, have failed. The WTO's General Agreement on Trade in Services (GATS) includes some disciplines that affect investment to the extent that it defines "trade" in services, inter alia, as Mode 3 of the supply of a service, i.e. by a service supplier of one member, through commercial presence in the territory of any other member. This presence will more often than not take the form of a foreign investment.

At the same time, the evidence shows that countries remain convinced that foreign investment needs to be regulated by rules embodied in international treaties. Most are directed to protect foreign investment after it is made, by providing the investor with the option of an international mandatory arbitration in cases of expropriation or measures of similar effect without the adequate compensation. These bilateral investment protection agreements form the bulk of the treaties.

A few, but nevertheless economically significant, countries have gone beyond and in addition provided for pre-establishment rights and made commitments to keep the market unrestricted to investors of the other party (unless a reservation has been made). Also, such agreements typically contain a list of measures that cannot be applied, such as performance requirements and other conditions. Some of these arrangements are embodied in free trade agreements (FTAs), along with provisions on trade in goods, cross-border trade in services, government procurement, intellectual property, etc.

All this growing body of international law-making points in the same direction: to keep markets open and to avoid arbitrary discrimination against foreign investment and investors. It is obvious that the resulting greater stability and certainty is supported by business and should correlate positively with an increase in investment flows.

In the past, many developing countries have been defensive with regards to foreign investment for several reasons that we will not go into here. This has changed over the last two decades, for at least three reasons. First, it has become increasingly clear that such binding commitments under international law do not limit the right of a host country to regulate investment horizontally or on a sectoral level, as long as there is no arbitrary discrimination. To liberalise is not the same as deregulation. In fact, in certain sectors increased regulation is very much of the essence to keep markets competitive and contestable, such as in the financial services sector as demonstrated by the 2008 financial crisis.

Second, many developing countries, such as the People's Republic of China (PRC), Republic of Korea, India, Singapore and the Gulf states, have become exporters of capital and thus have an interest in securing the best possible guarantees for their investors. After all, if a measure impacts a foreign investor in another jurisdiction, it is probable that the parent company's stock will take a hit.

Third, the increasing fragmentation of production creating regional and global supply chains is, to a large extent, made possible by foreign investment. Greater value-added and job creation has made a difference for thousands of people and firms, including



SMEs, especially in East and Southeast Asia, North America and Europe. Success translates into solid support for more open and transparent investment regimes.

While markets go global, the regulatory framework for foreign investment remains domestic or fragmented in many bilateral or sub-regional treaties. The poorer countries remain outside the mainstream of this treaty-making activity, which may discriminate against their markets as possible recipients of investment. This fragmentation poses an additional risk as the different models and approaches used by governments in investment treaties may become important obstacles to any future endeavour to converge international law into a multilateral arrangement.

The absence of effective rules and disciplines on investments has manifested itself in the past years. As capital has accumulated in emerging countries such as the PRC, the Gulf countries and India, their investors have at times faced insurmountable obstacles when attempting to invest in other markets, particularly in industrialised countries. The reasons are many, but often the denial of access is justified by “national security” considerations. Even within a tightly-knit regulatory framework such as the EU’s, there have been nationalistic/protectionist manifestations.

The case for multilateral rules on investment is stronger than ever. And more countries and businesses have an increasing vested interest in achieving such an agreement. However, two questions pose themselves. First, what should the scope be? Second, where should it be housed?

As for the scope, it must be acknowledged that there is increasing resistance to the provisions dealing with investment protection where investors are granted a right of action in an international jurisdiction against the host country. From a systemic and policy point of view, rules concerning pre-establishment and access rights are far more important, because they define potential markets and the constraints that governments have to apply measures that discriminate against foreign investors. The two are not inextricably linked, and indeed in certain agreements that contain both aspects in

the same chapter, they are dealt with separately, including in the dispute settlement mechanisms.

Investment protection agreements are numerous and roughly similar. One possibility is to establish a model agreement with its own Secretariat to administer an Arbitration Court (and perhaps an Appellate Body). Instead of having several dozen treaties to administrate, governments would find it more convenient to join a club that has a critical mass.

Different is the case of pre-establishment/access agreements, which ideally should be negotiated multilaterally. Despite all the shortcomings with the deadlocked Doha Round negotiations, the best house for such an exercise is the WTO. Not only does it already contain general principles on most-favoured nation, national treatment, general exceptions, and the right to regulate, among other key elements, but it also has the most effective system under international law to settle disputes between states. What the shape of such an agreement would be and what flexibilities would be available for some countries are matters that have to be discussed and settled in the negotiation.

Since a growing number of countries have negotiated or are negotiating FTAs with investment chapters, it should not be too difficult to find a critical mass of parties willing to undertake a multilateral exercise (or a plurilateral exercise in the multilateral context). Such chapters in most cases at least bind the existing level of liberalisation for both investments and cross-border trade in services, along with a ratcheting effect, i.e. any change to an existing restriction can only be in the direction of increasing the degree of liberalisation and not reducing it. All this provides a good basis to build on both in terms of the level of liberalisation commitments, and instruments and disciplines.

In addition, FTAs are by definition discriminatory since benefits and rights are available only for the signatories. However, from a public policy perspective in most sectors, it doesn't make sense or it is extremely difficult to provide preferential (discriminatory) access. Regulatory frameworks are usually applied to all investors and service suppliers across the board. Unlike trade in goods, there is very little actual "preferential" trade or

transactions. From this point of view, more FTAs with investment chapters mean that it could be easier to multilateralise later on.

Under the present circumstances, it is unrealistic to expect any serious engagement by WTO Members to begin talks of an investment agreement as suggested. First, the Doha Development Round must be completed. This means cracking the tough nut of a balanced result that will make agricultural reform politically possible, particularly in industrialised countries. The same can be said with regards to the elimination of harmful fisheries subsidies and other issues such as the improvements of the rules governing the application of anti-dumping measures. But the need for an investment agreement exists and is growing. For example, the report of a panel of 12 stakeholders on defining the future of trade convened by the WTO Director General Pascal Lamy in April 2013 states: “Like in the area of competition, we see the absence of multilateral rules on investment as a gap in cooperation. Current bilateral arrangements are not, in our view, a satisfactory substitute for a comprehensive international investment agreement.” Likewise, the World Economic Forum’s Global Agenda Council on Trade and Foreign Investment is issuing a report this year making the case to develop multilateral rules on investment.

There is little doubt that sooner or later, international cooperation will embrace a multilateral agreement on investment, ideally housed in the WTO. However, until that becomes politically possible, much work and research has to be done. It becomes crucial that the experiences of regions and countries be collected and examined, particular of those who, like most Asian countries, have developed global supply chains driven by foreign investment. The countries, think tanks and institutions such as the Asian Development Bank (ADB) not only can, but have the responsibility to, undertake the research, analysis and policy dialogue to enlighten the rest of the world.

*Author’s note: The article represents the opinions of the author and does not represent the positions or options of the WTO or its Members, not the official position of any staff member.*

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# 19 Multilateralisation of regional trade agreements

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**Rohini Acharya**

World Trade Organisation

Since the formation of the WTO and especially since the late 1990s, there has been a rapid rise in regional trade agreements (RTAs) among the Members of the WTO (Baldwin and Thornton 2008).<sup>1</sup> As at end March 2013, there were 241 RTAs in force that had been notified to the WTO and the GATT.<sup>2</sup> Of these, 133 are RTAs that provide preferences in goods only, and 107 included both goods and services; one agreement had been notified as a services only agreement. That increase is expected to continue as negotiations to sign new RTAs continue. Most of the agreements in force today (81%) are bilateral involving two parties, rather than plurilateral. In addition, the same parties may have more than one bilateral relationship through different agreements with the same party. In the Asia-Pacific, for example, Japan, in addition to its overall agreement with ASEAN, has individual bilateral agreements with the ASEAN members, thus providing exporters with a choice (or confusion) of rules under which to trade. Such overlapping relationships contribute to what has been called the “spaghetti or noodle bowl” effect of RTAs. It would make sense to try and consolidate these relationships, if only to harmonise rules of origin and other RTA rules where feasible.

In this regard it will be interesting to see the outcome of negotiations on three RTAs. Two of these, the Trans-Pacific Partnership (TPP) and the Regional Comprehensive

1 All WTO Members, except Mongolia, are currently party to at least one RTA.

2 WTO RTA Database ([rtais.wto.org](http://rtais.wto.org)). WTO figures on RTAs are based on notifications as Members are required to notify the goods aspects of their RTAs under GATT Article XXIV or the Enabling Clause if between developing countries and the services aspects under GATS Article V. The figures presented in this paragraph however reflect complete or physical RTAs (which in many cases include goods and services notifications together). The corresponding figures on notifications are 363 notifications of RTAs in force.

Economic Partnership (RCEP), bring together partners in the Asia-Pacific and the third, the Tripartite Free Trade Agreement, aims to consolidate existing RTAs in Africa. The TPP, currently with 12 partners, is an enlargement of an existing RTA between four partners.<sup>3</sup> Most of those negotiating the TPP also have existing bilateral RTAs with each other. The RCEP aims to consolidate existing relationships between the ASEAN members and six other nations (Australia, the People's Republic of China (PRC), India, Japan, Republic of Korea and New Zealand) who likewise have existing bilateral and plurilateral RTAs with each other, while the Tripartite Agreement aims to bring together the current members of the Common Market for Eastern and Southern Africa (COMESA), the East African Community (EAC) and the Southern African Development Community (SADC).<sup>4</sup>

Although these negotiations would be an opportunity to consolidate existing bilateral and plurilateral relationships in the region into these agreements, it is not clear that this will happen.<sup>5</sup> Nevertheless, they raise an interesting question about whether in general there is any discernible trend among RTAs to develop common standards that could ultimately be plurilateralised/multilateralised.

The RTA phenomena has given rise to concerns that the different sets of rules and preferences created by RTAs have made modern trading relationships more complex and ultimately has negative systemic implications for the multilateral trading system (see, for instance, Bhagwati 2008). A recent WTO report (WTO 2013) notes that RTAs add to trade costs, they can be exclusionary especially for smaller countries, and may also lead to regulatory divergence resulting in segmentation of the world economy.<sup>6</sup> While these fears may be legitimate, there is very little knowledge on whether the rules

3 The Transpacific Strategic Economic Partnership is an agreement between Brunei Darussalam, Chile, New Zealand and Singapore. The TPP is being negotiated between the existing members and Australia, Canada, Japan, Malaysia, Mexico, Peru, United States, and Viet Nam.

4 This will imply a combined membership of 26 countries and harmonized rules and tariffs between them.

5 In the case of the RCEP for instance, the Declaration states "The ASEAN plus one FTAs and the bilateral/plurilateral FTAs will continue to exist and no provision in the RCEP Agreement will detract from the terms and conditions in these bilateral/plurilateral RTAs between and among the participating countries." The Tripartite Agreement is likely to be a real consolidation of the three existing plurilateral agreements once it is completed.

6 The report, however, also notes that some regulatory reform under RTAs may be intrinsically non-discriminatory, leading to a de facto MFN dividend.

of RTAs actually diverge from those of the multilateral trading system, thereby having a negative impact on the latter.

RTAs clearly discriminate in favour of their parties and therefore against third parties. In goods and services, RTAs improve market access for their parties by liberalising tariffs and improving services commitments. However, even in areas such as tariff liberalisation, the WTO World Trade Report in 2011 suggested that only around 16% of the world's merchandise trade took place under preferences (WTO 2011). A WTO Staff Working Paper based on 192 RTAs in force suggests that RTAs have also been relatively unsuccessful in significantly reducing tariff peaks in certain sensitive sectors and products such as agriculture (Crawford 2012).

The emphasis of RTAs has therefore shifted beyond liberalisation of trade in goods to increasingly include commitments in services, investment, intellectual property rights and other issues such as government procurement, competition, and also to some extent agreeing to common standards on environment and labour. These behind the border issues and barriers are harder to quantify and little is known about the liberalising effect of RTAs in reducing these barriers.

Recent research by the WTO on market access in goods, services rules, anti-dumping provisions, intellectual property rights and rules of origin suggests that while there is divergence, there are also areas where RTA rules are similar either to rules in other RTAs or to the WTO Agreements. In a survey of over 190 RTAs for instance, a WTO Staff Working Paper on anti-dumping rules in RTAs found that 68% of RTAs reaffirm or substantially replicate the language in the WTO Agreements, while a further 21% of RTAs do not explicitly refer to anti-dumping; thus for them the status quo is their WTO rights and obligations (Rey 2012). In IPRs, a number of RTAs (45%) reaffirm existing commitments under the TRIPS Agreement although with regional variations (Valdes and Tavengwa 2012). Moreover, while the GATT (through Article XXIV) and the GATS (Article V) allow members to take an exception to MFN treatment,

the TRIPS Agreement does not have a similar general provision.<sup>7</sup> The assumption is therefore that RTA parties that are Members of the WTO would have to provide national and MFN treatment to nationals of other Members even where this might result in higher protection than is currently provided under the TRIPS Agreement, including through RTAs. A number of RTAs also exhibit similarities relating to “families” of RTAs which use similar approaches (such as negative or positive list approaches in services commitments and rules) or “templates” used by certain parties. In rules of origin, 50 out of 192 agreements use the EU model while 21 use the NAFTA model (Donner Abreu 2013). The EU agreements also permit diagonal cumulation across an area covering 42 parties.<sup>8</sup>

Thus, while RTAs discriminate against third parties and diverge from each other, to some extent they appear to have common features. These features either mean that the rules do not diverge significantly from the multilateral rules, such as in anti-dumping and to some extent in SPS and TBT, or that certain common frameworks or “families” of RTAs have developed that show considerable similarities within that family. The families are often found in the same geographical areas (for instance the EU family which is based around the EU and EFTA agreements, or the NAFTA family which is found in the agreements signed by countries in the Americas). While in the former case (rules which are the same as WTO rules) the rules are already harmonised, the latter shows that, subject to variations, RTAs within the families seem also to have a degree of harmonisation between each other. The obvious next step may be to examine how to plurilateralise RTAs within families of RTAs so that RTAs that already share a common structure also share the same rules and liberalisation commitments. Negotiations for the TPP and the RCEP are likely to do so, with the former likely to follow the NAFTA structure and the RCEP the existing structure of the ASEAN+1 agreements. These agreements and the TTIP will also change the current RTA landscape by further cross-

7 Articles 3 and 4 respectively of the TRIPS Agreement require each member to provide each other national and MFN treatment, subject to the exceptions indicated in these Articles.

8 The parties are EU(27) and soon to include Croatia as the 28th Member State of the EU, Algeria, Egypt, EFTA, the Faeroe Islands, Israel, Jordan, Morocco, Tunisia, Turkey, the Lebanon, the Palestinian Authority and Syria; the last three participants have yet to complete procedures required to join the area of cumulation (Donner Abreu 2013).



regionalising RTA relationships. The longer-term goal would be to harmonise these rules multilaterally.

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## 20 WTO-ASEAN asymmetries: Calling for greater collaboration

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For many observers, the WTO and ASEAN are at the opposite ends of the spectrum. The WTO, on one hand, is characterised by its inability to make progress in its 12 year-old Doha Round, but equipped with a super powerful dispute settlement mechanism. ASEAN, on the other hand, can be described as a frenzy of FTAs, busy announcing or concluding new agreements almost on a weekly basis – collectively or individually – but with an untested dispute settlement mechanism. Carrying out a busy calendar of FTA negotiations, while being frustrated with the WTO, is a typical reality for many trade ministers and ministries around the world.

Despite the centrality and supremacy of the WTO in the hierarchy of trade regimes, judging from ideological, theoretical or practical points of view, the period of co-existence between a dormant multilateral trading system and rapidly increasing, expanding and deepening FTAs is likely to continue for some time to come. However, many would also agree that ultimately, it is in everyone's interest to bring these agreements back into the multilateral trading system as long as every nation trades beyond its FTA partners. Therefore, coherence and synergies between the different trade regimes need to be promoted until such time when all converge. The question that needs to be asked is how best such coherence and synergies could be pursued in practice during the period of co-existence.

## WTO-ASEAN asymmetries on the core functions of the trade regime

A trade regime, whether preferential (bilateral, regional and plurilateral) or multilateral, performs three major functions – legislative, judicial and monitoring – that interact with each other to reinforce the credibility of the given regime. The legislative function refers to a platform for negotiations on a trade agreement encompassing market access or/and rules, while the judicial function is performed by a dispute settlement system. The monitoring function refers to transparency activities often linked to the implementation of a trade agreement. Table 1 shows asymmetries that are often observed in the strength of the three functions between the WTO and ASEAN.

**Table 1** WTO-ASEAN asymmetries: Room for collaboration?

Function	WTO	ASEAN
Legislative (negotiations)	Weak	Strong
Judicial (dispute settlement)	Strong	Weak
Monitoring (transparency & notifications)	Strong	Weak

*Note:* Strictly personal views

The literature on the WTO’s legislative and judicial functions is vast and growing. Since the conclusion of the Uruguay Round of negotiations in 1994 which resulted in the creation of the WTO as an institution, its legislative function has delivered only limited results, such as in the areas of information technology, financial services, basic telecommunication, intellectual property rights, government procurement and accessions of new WTO Members.<sup>1</sup> An ambitious Doha Round of negotiations, launched in 2001 on a range of issues, is currently in its 12th year and its conclusion is not foreseen in the near future, except in a few areas. On the other hand, the WTO’s judicial function has flourished since its establishment and the number of cases that

<sup>1</sup> These include the Agreement on Information Technology (1997), the Agreement on Financial Services (1997), the Agreement on Basic Telecommunications (1997), the Amendment of the TRIPS Agreement (2005), the revision of the Government Procurement Agreement (2011), as well as the Protocols of Accession of 31 Members which joined the WTO since its establishment in 1995.

have been to the Dispute Settlement Mechanism to date - 457 by April 2013 - is a testimony to the well-functioning part of the multilateral trade regime.

The literature has not said as much about the WTO's monitoring function as the other two, more visible functions. There are several mechanisms in the WTO to promote transparency in trade policymaking and implementation, including regular notifications of trade laws and measures applied or intended to be applied under the covered agreements, the periodic Trade Policy Reviews, as well as more recent Transparency on Regional Trade Agreements adopted in 2006 and the Trade Monitoring Reports on protectionism, launched in the wake of the 2008 global financial crisis. While no direct penalties are involved in these mechanisms (other than "name and shame"), they exert certain peer pressure on Members' behaviours within the parameters defined by the multilateral trade regime, which is equipped with a strong dispute resolution mechanism.

When it comes to ASEAN, which started as a five-member regional grouping to foster peace and security in 1967, its integration efforts, often dubbed as the "ASEAN way", have been based on the ideals of non-interference, informality, minimal institutionalisation, consultation and consensus, non-use of force and non-confrontation. Over the last few decades, however, ASEAN has managed to promote itself as a regional economic platform of its ten member states driven by the development of production networks and supply chains, with the share of intra-regional trade growing from 17% in 1990 to 25% in 2011. It has also become a hub of an Asian noodle bowl of FTAs, connecting to other parts of the world. Its vibrant legislative function is reflected in its goal of achieving the ASEAN Economic Community (AEC) in 2015 as well as the number of FTAs in which its member states are involved, based on the ASEAN+ format. By the beginning of 2013, according to the data from the Asian Development Bank, the number of ASEAN+6 FTAs has reached 179, including those under negotiation.

ASEAN's judicial function, however, is yet to be tested. In 2004, the ASEAN members adopted the Protocol of Enhanced Dispute Settlement Mechanism, which is a replication

of the WTO Dispute Settlement Understanding except for a few wordings to reflect the ASEAN bodies and shorter time frames for dispute resolutions. To date, no case has been brought to the ASEAN system. Reasons for the non-usage range from inadequate resources, the lack of confidence and credibility in the system, to simply the “ASEAN way” of preferring non-confrontation.

As for its monitoring function, the AEC Scorecard was developed to track the implementation of necessary economic measures and policy actions as outlined in the AEC Blueprint for the 2008-11 period. While its efforts were commended, the Scorecard fell short of its expectations to serve as a compliance tool of “name and shame” as it only provided aggregated scores, revealing neither the rates of implementation for individual members nor the policy actions in the Blueprint (see the contribution by Siow Yue Chia in this volume). In other words, like its judiciary, its monitoring function remains the “ASEAN way”.

### **Translating asymmetries to complementarity**

Can we take advantage of the apparent asymmetries of strengths and weaknesses between the WTO and the ASEAN regimes? On the legislative function where ASEAN has a relative strength, there is a strong case for the multilateralisation or extension of ASEAN-based FTAs on a non-discriminatory basis to additional parties, given the expanding business reality of production-sharing centred around ASEAN (see the contribution by Pascal Lamy in this volume). In this regard, the recent efforts to consolidate the ASEAN+6 FTAs into the Regional Comprehensive Economic Partnership (RCEP) could be a stepping stone in that direction. Such efforts can go a step further toward convergence if the need for multilateralisation is explicitly referred to in future PTAs in which ASEAN will be engaged.

Concerning the judicial and monitoring functions where the WTO has a relative strength, there is room for collaboration between both Secretariats, either by sharing resources or even through the outsourcing of certain functions. These functions

generally involve a wide range of activities which require more support and resources from a Secretariat in the form of consistent report writing and information compilation, than the legislative function which is largely driven by member states. In other words, some of the ASEAN's judicial and monitoring functions may be performed and assisted by the WTO.

There are three obvious benefits for collaboration between the two systems. One is resource saving and information/knowledge sharing, especially as the ASEAN Secretariat is thinly staffed with 260 officials and a small budget of US\$15.8 million in 2012. The WTO Secretariat, in contrast, has 620 staff with a 2012 budget of US\$215 million, although it compares itself to other multilateral institutions such as the International Monetary Fund or the World Bank. If ASEAN members bring a case to its dispute settlement system, not only does the Secretariat have a very small team of five legal officers who are available to support the panel and appeal processes in addition to other legal work, but there is also only a small number of panellists to draw from the pool, especially if the case involves more than two members or has third-country participation. Given the wealth of expertise which the WTO system has acquired, consideration may be given to resource sharing, such as in the form of training of ASEAN legal officers or the provision of support to the panel and appeal processes, as appropriate. On the monitoring side, the two Secretariats can share information from their respective monitoring and transparency exercises.

The second benefit is de-politicisation. The WTO can provide a more neutral platform which can defuse regional sensitivity among ASEAN neighbours. For instance, a joint undertaking of the AEC Scorecard by the two Secretariats or even outsourcing to the WTO (including the venue) may strengthen its role as a "name and shame" compliance tool of ASEAN integration. As for dispute settlement cases, which are more confrontational by nature, ASEAN members have already utilised the WTO system, rather than their system, in two cases involving its members.

Third and finally, collaboration between the two systems on the judicial and monitoring functions would help the WTO to prepare for the eventual multilateralization of ASEAN+ FTAs. While such collaboration has implications for resources and operations especially for the WTO Secretariat, regular information flows and contacts would better equip the multilateral regime and can even accelerate multilateralisation efforts. Some scholars have argued for the use of WTO Dispute Settlement Mechanism as a venue for resolving FTA disputes, so that WTO Members can develop a body for common law on PTAs, which would then form the basis for harmonisation of FTAs (Gao and Lim 2008). Collaboration on both the judicial and monitoring functions can help minimise the potentially negative effects of FTAs, especially in the areas of non-tariff measures such as standards and regulations, and indeed promote their convergence with the WTO, thus ensuring the centrality of the multilateral trading system.

*Author's note: The article represents the options of the author and does not represent the positions or opinions of the WTO or its Members, not the official position of any staff member. Any errors are the fault of the author.*

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## About the author

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What future for the world trading system? The system has radically altered over the past years with new developments bringing uncertainty about its governance, and its future is one of today's most pressing international economic issues. Several changes – production networks and supply chains, industrial and commercial policies, and mega regional trade agreements – are posing challenges to the WTO-led multilateral trading system. Economically important Asia is at the centre of these developments, and how the region evolves policy solutions will influence the global economy in future decades. The election of a new WTO Director-General, the 9th WTO Ministerial Conference in Bali during 3-6 December 2013, and regional fora offer opportunities for action on improving global and regional trade governance.

This eBook, containing 19 essays from leading Asian and international trade experts, dissects important changes taking place in the world trading system and explores policy implications for Asia. It also offers lessons for other regions.

Key policy recommendations from the eBook include:

- pursuing market-friendly trade and industrial policies to develop supply-chain trade;
- improving surveillance of non-tariff measures;
- consolidating bilateral FTAs into a large, high-quality region-wide FTA;
- a WTO agenda on supply chains and FTAs,
- significant reforms of the WTO ;
- a case for issue-based plurilateral agreements and a multilateral agreement on investment; and
- using more accurate data to measure value-added trade and participants in supply-chain trade (e.g. SMEs).

With contributions from Rohini Acharya, Richard Baldwin, Siow Yue Chia, Biswajit Dhar, Cedric Dupont, Simon Evenett, Satoshi Imomata, Alejandro Jara, Masahiro Kawai, Pascal Lamy, Patrick Low, Mitchitaka Nakatomi, Maika Oshikawa, Richard Pomfret, Victor Pontines, Wang Rongyan, Julia Tijaja, Shujiro Urata, Ganeshan Wignaraja, Yuqing Xing and Zhang Yunling.