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Background Paper

**Asia-Pacific RTAs as Avenues to Achieving
the Bogor Goals: Analysis and Ways Forward**

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ASIA-PACIFIC RTAs AS AVENUES TO ACHIEVING THE BOGOR GOALS: ANALYSIS AND WAYS FORWARD

Basic Concepts

APEC Commitments and the Regional Approach to Liberalisation

APEC's 1994 Bogor Declaration sets out a commitment by APEC members to realisation of the vision of free trade and investment in the Asia-Pacific region, with the liberalisation and facilitation measures required to achieve this vision to be implemented by 2010 in the case of developed APEC economies and by 2020 in the case of developing APEC economies.

There were a number of important features underlying the commitments of APEC members in the Bogor Declaration:

- Achievement of the Bogor goals is to be achieved by a process of “open regionalism”, the key feature of which is non-discrimination¹. “Open regionalism” was explicitly intended to contrast with the discrimination inherent in conventional regional trading arrangements (RTAs). Thus APEC was not intended to be a conventional regional trading bloc
- The Bogor goals are to be pursued in such a way as to strengthen the multilateral trading system and contribute to its increasing openness
- APEC was explicitly conceived as a trans-Pacific regional grouping, embracing both sides of the Pacific.
- In elaborating on the modalities for implementing the Bogor Declaration, the 1995 Osaka Action Agenda (OAA) committed APEC members to adherence to nine basic APEC principles.

¹ In this context there was an ambiguity in the interpretation of non-discrimination, as to whether non-discrimination was to be unconditional or conditional, the latter version meaning that the principle would apply only to economies that were prepared to reciprocate. This ambiguity was left conveniently unresolved, allowing APEC members supporting either interpretation to subscribe to APEC's “open regionalism”

APEC members recognised the problem of inconsistency between APEC's "open regionalism" and the discrimination inherent in preferential RTAs, three of which were already in existence among APEC members at the time of the Bogor Declaration: NAFTA, AFTA and CER. In 1995 the APEC Eminent Persons' Group (EPG) set out some guiding principles under which RTAs might be considered compatible with "open regionalism". These recommendations of the EPG were not formally adopted by APEC members, and the issue was left essentially unresolved. In practice APEC members largely refrained from pursuing new RTAs between 1994 and 1999. Two new free trade agreements between Canada and Chile and between Mexico and Chile could be regarded realistically as extensions of NAFTA, partly substituting for the earlier failed effort to bring Chile into NAFTA.

The Logic and Benefits of the APEC Approach to Regional Liberalisation

The commitment of APEC members to the Bogor goals was underpinned by the recognition that their successful growth and development was based on openness and stability of global and regional markets. The APEC commitments were also firmly based on a foundation of strong business linkages and intense trade and investment relations already established throughout the APEC region, including across the Pacific (trans-Pacific dimension), within the western Pacific APEC economies (intra-western Pacific dimension) and among APEC members in the Americas (intra-American dimension).

Commitment to the APEC goals also reflected an understanding that the economic benefits of trade and investment liberalisation accrue primarily to the liberalising economies themselves. This is especially true of small economies, and provides the economic rationale for unilateral liberalisation. APEC members also understood that the economic gains from liberalisation are greater if trading partners liberalise at the same time, and indeed this simultaneous liberalisation may be essential in the case of larger economies to ensure that the potential gains from liberalisation are fully realised. One of APEC's original contributions was to provide for this through a process envisaged as

simultaneous unilateral liberalisation by APEC members. The term “concerted unilateralism” was coined to describe this process.

At the same time it was also clearly recognised that realisation of the gains from liberalisation by developing economies requires building the capacity of human and institutional resources, to ensure that liberalisation truly contributes to development goals. For this reason developing APEC members have always insisted that economic and technical cooperation should be given equal status with liberalisation and facilitation in APEC’s agenda. It was recognised too that realisation of the potential gains from liberalisation and facilitation requires as well that economies undertake key economic reforms in the areas of market structure and public and corporate governance. This importance of these issues received some recognition in the inclusion of competition policy and deregulation as items on the OAA, and they have received much greater emphasis and prominence following the experiences of the East Asian economic crisis of 1997-98.

The Distinctive Features of the Preferential Route to Trade Liberalisation

There are essentially three routes to trade liberalisation

- Unilateral liberalisation, where economies reduce their trade barriers without expecting or requiring reciprocity from trading partners (APEC’s “concerted unilateralism” can be interpreted as a variation on this approach, where parallel liberalisation by trading partners is anticipated, but there is no formal requirement for reciprocity). WTO rules require that in general unilateral liberalisation should be undertaken on an MFN basis.
- Multilateral liberalisation, where economies reach agreement on simultaneous reduction of trade barriers on the basis of negotiated reciprocal concessions. Multilateral liberalisation also takes place on an MFN basis.
- Preferential liberalisation, where barriers to trade are removed between pairs of countries (bilateral trade agreements or BTAs), subregional groupings (subregional trade agreements or SRTAs) or regional groupings (regional trade

agreements or RTAs). The term RTA is often used to cover all three types of regional agreement. The common characteristic of all three however is that they are preferential in nature, and it therefore seems better to use the term preferential trade agreement, or PTA, as the generic term covering all such agreements. This term will be used for the remainder of this paper.

In practice economies typically pursue all three forms of liberalisation simultaneously. For countries that profess a commitment both to achieving the full potential gains from trade for themselves and also to eventual achievement of APEC-wide or even global free trade, a key question is whether and to what extent each form of liberalisation contributes to and is consistent with these objectives. Notwithstanding some technical issues relating to multilateral liberalisation, it is generally agreed that unilateral and multilateral liberalisation do so contribute and are consistent with the objectives. The controversial issue has always been whether and under what conditions preferential liberalisation can also contribute to and be consistent with the objectives.

The fundamental characteristic of PTAs is that they are indeed preferential and therefore discriminatory. By favouring the members of the agreement with preferential treatment they necessarily discriminate against the countries that are excluded. In doing so they violate the most basic principle of the WTO, the non-discrimination or MFN principle enshrined in Article I of the GATT, and they also contravene one of the nine principles of APEC's OAA, thereby calling into question the APEC commitment to "open regionalism". In the WTO legal cover for the violation of the WTO's MFN principle is of course provided by GATT Article XXIV and GATS Article V, and this is discussed later in the paper.

This discriminatory property of PTAs has a number of consequences that have long been well understood:

- In addition to the gains from trade creation that normally flow from trade liberalisation, there will also be trade diversion. Trade diversion negatively affects the welfare of the members of the PTA and the whether the overall effect

on members is positive or negative depends on whether trade creation effects exceed trade diversion effects or vice versa.

- Trade diversion is also unambiguously harmful for economies excluded from the PTA
- In addition to trade diversion there is also likely to be investment diversion, with analogous and quite possibly larger consequences for the welfare of members and non-members.
- Preferential liberalisation of services trade, like preferential liberalisation of goods trade, cuts across the objective of trade liberalisation, of securing the widest possible access to the best products at the lowest cost.
- The existence of trade and investment diversion creates the potential for conflict and division between members and non-members.

Despite their well-known disadvantages PTAs have proved extremely popular, as illustrated by the number of PTAs that have been notified to the WTO. From the perspective of economic analysis PTAs represent a “second-best approach to liberalisation. From the perspective of policymakers they represent a “pragmatic” approach, to be pursued when unilateral or multilateral liberalisation cannot make progress to the extent desired, due to factors such as market imperfections and political and strategic considerations. The “pragmatic” approach tends to proceed on the assumption that some liberalisation is better than none at all. Economic analysis shows that this is not always or necessarily true, and its contribution is to identify the conditions under which PTAs can indeed be relied upon to contribute to national and global welfare, and towards a more open multilateral trading system.

The Attractions of PTAs

The attractions of the preferential approach to liberalisation are also well-known. They include the following:

- It is likely to be possible to proceed further and faster with a small group of trading partners than in the multilateral negotiations
- Political economy factors: the more readily identifiable increases in export opportunities arising from PTAs make them easier to “sell” politically.
- In contrast to APEC, PTAs allow the establishment of binding commitments through the negotiation of reciprocal concessions.
- PTAs may provide a context for discussing and resolving difficult bilateral trade and investment issues.
- PTAs can serve as “training grounds” for unilateral and multilateral liberalisation, where governments and business learn how to adapt to increased competition resulting from liberalisation.
- PTAs can contribute to economic development by providing vehicles for the production and delivery of regional public goods
- Negotiation of PTAs can be linked to foreign policy and security objectives.

Modern bilateral and regional agreements also extend well beyond the traditional liberalisation in goods and even services, to include a wide range of trade facilitation measures in areas such as customs procedures, standards and conformance, quarantine measures, government procurement and harmonisation of business law and tax practices, as well as provisions in areas such as competition policy, investment, intellectual property, digital commerce and trade-related labour and environmental measures. The term “Closer Economic Partnership”, or CEP has come to be commonly used to describe such wide-ranging agreements, and they are also often justified and promoted on the grounds that they are “WTO-Plus”. A number of new agreements in the Americas effectively represent the upgrading of earlier inward-looking or “WTO-minus” agreements to the standards of the new CEPs. Even some very progressive CEPs may however be “WTO-minus” in certain respects, most notably in the treatment of agriculture. It may prove useful to consider separating the “PTA” and “non-PTA” components of CEPs, and this issue is discussed later in the paper.

Modern PTAs may be North-North, North-South, and South-South, and different motivations may apply in each case. An important motivation for North-North agreements may be to capture the dynamic gains potentially available from economies of scale and increased competition through intra-industry trade in technologically dynamic markets. Similar motivations may apply in North-South agreements, but North-South agreements are also much more likely to offer potential for the conventional gains from inter-industry trade based on differences in comparative advantage. Developing countries are also likely to pursue agreements with developed partners to safeguard vital export markets that they perceive to be vulnerable. South-South agreements may be pursued by developing countries as a way of developing potential export markets for value-added products in situations where they face difficulty in penetrating developed country markets for these products due to the well-known phenomena of peak tariffs and tariff escalation.

PTAs as “Building Blocks” or “Stumbling Blocks” to More Open Regional and Global Trade

There is by now a well-developed literature on whether PTAs may act as “building blocks” or “stumbling blocks” to the objective of free trade on a global basis and (by implication if not explicitly) on an APEC-wide basis. As is well-known, one conclusion that can be drawn from this literature is that PTAs may in fact be either “building blocks” or “stumbling blocks”, depending on their characteristics in each case. An important task is to identify the conditions under which each outcome is likely, thus allowing proposals to be developed for increasing the likelihood that they will act as “building blocks” and for reducing the risk that they will act as “stumbling blocks”.

The purpose of reviewing this set of issues is not to argue against the involvement in RTAs of APEC members. It is rather to point out that while PTAs can be potentially act as “building blocks” for APEC-wide and global free trade, they cannot be relied upon to

perform this role of their own accord. Strong leadership and enlightened policy choices on RTA issues will be needed if the “building block” potential of RTAs is to prevail.

From Proliferating PTAs to APEC-wide or Global Free Trade: Possible Routes

There are four main routes that could lead from a proliferation of PTAs to eventual APEC-wide or global free trade, none of them mutually exclusive:

- Creation of a comprehensive “web” of bilateral PTAs covering all pairwise relationships. While some APEC economies, such as Chile, Mexico and Singapore appear to have a strategy of concluding PTAs with all their significant trading partners, it is to be doubted whether this is a realistic or efficient route towards free trade at the region-wide or global level. Peter Lloyd points out that to achieve the equivalent of multilateral free trade via bilateral PTAs in a world of n countries would require $[n(n-1)/2]$ bilateral PTAs. Thus to achieve free trade among the 21 APEC members would require 210 bilateral PTAs. To achieve free trade in a world of 200 economies would require 19,900 bilaterals. It is hard to believe that this would be a feasible way to proceed, nor is it likely to be efficient, especially if there are many inconsistencies among the provisions of the multiple PTAs.
- Gradual expansion of existing PTAs offers in some ways a more practical and efficient way to proceed, since as Lloyd points out adding a new member to an existing PTA is equivalent to establishing separate bilateral PTAs between the new member and each member of the existing PTA. This allows for much greater economy in the number of PTAs required and also reduces though it does not eliminate the likely incidence of inconsistent provisions among the various PTAs.
- Amalgamation or convergence of existing PTAs will have to occur in a world of multiple PTAs, if the transition is to be eventually made from these multiple PTAs to APEC-wide or global free trade.

- MFN liberalisation on either a multilateral or unilateral basis, proceeding in parallel with PTA liberalisation but at a slower pace will eventually see all existing PTAs converge on APEC-wide or global free trade, even if the PTAs themselves do not converge.

It is therefore important to establish how far each of these routes can be relied upon. It will be apparent that each of the first three routes faces significant difficulties. This of course only serves to highlight the importance of parallel MFN liberalisation as the guarantee that ultimate the objective will eventually be reached, regardless of what happens within the PTA processes, and the crucial importance also of the question as to whether the PTA process can be expected to have positive or negative effects on MFN liberalisation at the multilateral and unilateral levels, as well on the achievement of the Bogor goals.

Incentives for Proliferation, Expansion or Amalgamation of PTAs: Competitive Liberalisation

The U.S. has recently adopted the doctrine of “competitive liberalisation” promoted by Fred Bergsten and others. According to this doctrine the establishment of new PTAs, particularly by an economic superpower like the United States, creates incentives for other countries to seek PTAs of their own, including with the United States, either by establishing new PTAs or obtaining membership of existing PTAs. One possible explanation is the “domino effect” identified by Baldwin, whereby the establishment of a new trading bloc, or a significant advance in integration within an existing bloc, creates incentives for non-members to seek membership of the bloc, in order to capture the benefits of bloc membership and to avoid the costs of being excluded from the bloc. A similar motivation could lead members of separate PTAs to seek their amalgamation into a single PTA. In another possible variant of the “domino effect”, economies react to the success of their competitors in securing a PTA with one of the major economies such as the U.S. by seeking an RTA of their own with the same major partner. The motivation

for doing so is to defend their markets in the major trading partner from discrimination arising from RTAs with that partner secured by their competitors.

“Competitive liberalisation” thus explicitly seeks to exploit the negative effects of PTAs, by using them to place pressure on other economies to enter into the preferential liberalisation arena, and in the process to create additional pressure for multilateral liberalisation.

If this effect is important it would be expected that more and more economies would be seeking PTAs with a large trading partner such as the United States that has shown itself open to the establishment of new PTAs, and this does indeed appear to be occurring in the Asia-Pacific region. Proposed amalgamation of existing PTAs could begin to emerge, such as the proposal to merge AFTA and CER into a single PTA. There has been little sign to date of APEC economies seeking to join existing PTAs, perhaps with the exception of Chile’s unsuccessful attempt to join NAFTA in the mid-1990s, but there is little doubt that if an East Asian FTA were to be formed by the “ASEAN Plus Three” group, other western Pacific economies such as Chinese Taipei, Australia and New Zealand would be very anxious to join if possible.

Competitive liberalisation does therefore put pressure on economies excluded from particular PTA developments to seek PTA arrangements of their own. It is less clear that the same incentive exists for the incumbents to admit new members. Andriamananjara points out that for the existing members of a PTA there are two opposing factors affecting their incentive to admit new members. On the one hand they benefit from the expansion of the size of the market when new members are admitted. On the other hand the entry of new members also affects them negatively by diluting their preferences in the PTA market. Andriamananjara’s analysis shows that the market expansion effect tends to dominate in the early stages of the expansion of the PTA, but that eventually the preference dilution effect will take over, so that the incentive to expand the PTA peters out well before global free trade (or perhaps even APEC-wide free trade) is achieved. In the western Pacific one notes the opposition of some ASEAN members to the

amalgamation of AFTA and CER into a single PTA, and to possible Australian and New Zealand membership of an East Asian PTA, although this opposition may be based more on political than economic grounds. This latter example illustrates the point that in addition to economic incentive effects there may also be significant political obstacles to the expansion, amalgamation or convergence of PTAs, and these obstacles may be difficult to overcome. Furthermore the process of PTA proliferation itself may create divisions and conflicts that add to these obstacles.

In the case where “competitive liberalisation” operates through a major economic “hub” such as the United States negotiating separate bilateral PTAs with individual partners, the structure of incentives is somewhat different. On the basis of an overall economic welfare calculus the “hub” ought to have an incentive to conclude PTAs with all its significant trading partners. On the other hand special interest groups in sensitive sectors will oppose each new PTA, especially in cases where several prospective partners are potentially competitive exporters within the PTA of the same sensitive products. For the incumbents who initially secure PTAs with the major partner however the conclusion by that partner of new PTAs with additional partners is likely to have unambiguously negative effects, since the new PTAs do not provide them with any additional market access but do dilute their preferences in the market of the major partner. These incumbents will thus have an incentive at the very least not to encourage the negotiation by the “hub” of new PTAs with their competitors, and may well have an incentive to actively obstruct such developments. There are again apparent examples of this behaviour in the Asia-Pacific region.

One issue that regularly comes up in the context of the expansion of existing PTAs is whether each PTA should contain an “open accession” clause, providing for the automatic acceptance of a membership application from any economy willing to join the PTA on the same terms and conditions. While this is an attractive notion in principle it is clear that it will be a difficult one to operationalise. The terms and conditions of bilateral PTAs tend to contain at least some provisions that are specific to relations between the two partners, and that would not be easy to apply to the relationship with the new partner.

Certain conditions that are acceptable in an agreement with one partner may not be acceptable in an agreement with a different partner, with whom there may be a different balance of strengths and weaknesses, and advantages and disadvantages. More pessimistically the PTA option may in some cases be chosen precisely because the benefits of the PTA do not have to be extended to other parties, particularly those with strengths in sectors considered sensitive by the original members.

Nevertheless if APEC members remain committed to the objective of free trade and investment in the Asia-Pacific region, on a non-discriminatory basis at least among each other, and if PTAs are going to be an important avenue leading to the eventual achievement of this objective, then it seems reasonable to suggest that some form of credible commitment will need to be devised to assure that all members who wish to do so can participate in the developing pattern of RTAs, and that no member will be permanently excluded.

Effects of RTAs on the Incentives for Multilateral Liberalisation

Economic analysis has not come to definite conclusions on whether RTAs increase or decrease the incentives for multilateral liberalisation. In part the answer depends on whether the incentives are viewed from the perspective of the community as a whole, or from the perspective of the profits of domestic firms. If PTAs produce a lower level of overall economic welfare than multilateral liberalisation, then the community in at least one potential PTA member is likely to have an incentive to prefer multilateral liberalisation and thus reject the PTA option. On other hand trade diversionary PTAs may yield very sizeable economic rents to some domestic firms, even if their overall economic welfare effect is negative, and these rents may be larger, the greater is the trade diversionary effect of the PTA. Once the PTA is in place these firms are likely to have an incentive to resist any multilateral liberalisation that would dilute their preferences and thus reduce their economic rents. PTAs may also provide an additional rallying point for opponents of trade liberalisation and globalisation, thus indirectly boosting the forces ranged against multilateral liberalisation.

On the other hand there have been clear cases in the APEC region, for example the CER example of Australia and New Zealand, where a PTA has helped to attune the business community to the requirement of adjusting to a liberalising trade environment, and in so doing has helped to pave the way for extensive subsequent MFN liberalisation, in the case of Australia and New Zealand on a unilateral basis.

It has also been argued by advocates of “competitive liberalisation” that the emergence or threatened emergence of significant PTAs may increase the pressure on economies elsewhere to participate effectively in the multilateral negotiations. For example it was argued by Fred Bergsten - and denied by Jagdish Bhagwati - that the potential emergence of APEC as a serious liberalising force was instrumental in persuading the EU that it needed to move constructively towards the successful conclusion of the Uruguay Round. This argument been inconclusive.

One concern that is frequently expressed is that PTA negotiations absorb large quantities of scarce negotiating resources in trade bureaucracies, as well as using up scarce political capital in many cases. The focusing of substantial negotiating resources and deployment of political capital in the pursuit of PTAs may leave some economies in a weak position to play their full part in the multilateral process, which may suffer accordingly.

Another possible issue relates to the apparent intention of some APEC economies, notably Chile, Mexico and Singapore to negotiate PTAs with all their significant trading partners. There could be some concern that once an economy has been successful in this objective it may have little remaining incentive to participate actively in WTO negotiations. On the other hand, it is likely that there will be trade issues of vital interest to these economies that can best be pursued, or in some cases can only be pursued through the WTO, and this may ensure their continuing commitment to engagement with the multilateral process.

Likelihood and Implications of “Hub and Spoke” Patterns

“Hub and spoke” patterns of RTAs are the likely consequence of the variant of “competitive liberalisation” in which the negotiations of PTAs by a major economy with selected partners places pressure on those partners’ neighbours to seek PTAs of their own with same major economy. In this case the major economy serve will as the “hub” and the separate RTAs with its various trading partners will form the “spokes”.²

The disadvantages for the spoke economies in “hub and spoke” patterns of PTA development are well-known. These patterns tend to reinforce the unequal bargaining strength of the parties, since the “hub” can exploit competition among the “spoke” economies, and use precedents established in PTAs with one “spoke” to strengthen the case for inclusion of similar provisions in agreement with other “spokes”. There are further inequalities in that the “hub” gains access to all the “spoke” markets whereas the “spokes” gain access to the “hub” alone unless they negotiate separate PTAs with each other. The greater size of market to which access is available from the “hub” also gives the “hub” an advantage over the “spokes” in attracting investment.

One of the strategies for the “spoke” economies to compensate for their disadvantaged position in the “hub and spoke” configuration is to seek PTAs with each other. In fact, the pattern that has been observed recently is that leading “spoke” economies seek to establish themselves as “secondary hubs” by negotiating PTAs with a number of their minor trading partners. In this way they may be able to not only offset the disadvantage of being a “spoke” attached to a major “hub” but also to capture the benefits of being the hub within their own secondary “hub and spoke” configuration. The patterns of “hub and spoke” arrangements that are likely to emerge are thus very complex. In the Asia-Pacific region further potential complexity is added by the ambitions of ASEAN, a group of ten smaller APEC economies, to present itself as an alternative “hub”, while at least some of

² In practice there may be more complex patterns in which “spoke” economies having PTAs with major economies in turn act as “minor hubs” or “sub-hubs” in “hub and spoke” patterns of RTAs with their own neighbours. For simplicity however the discussion here is restricted to single “hub and spoke” patterns.

its major trading partners, notably the U.S. and Japan appear more interested in treating the individual APEC economies as “spokes”.

Economies that find themselves in the position of “spokes” in several “hub and spoke” configurations may find that there are significant inconsistencies between their agreements with the different “hubs”. For example the U.S. and E.U. tend to promote distinct RTA “models”, and it is possible that other large economies such as Japan and China will also develop their own distinct “models”.

By concentrating on their own “hub and spoke” configurations, major “hubs” may forego the benefits of preferential liberalisation with each other, unless steps are taken to pursue this avenue as well as the “hub and spoke” arrangements. Trade flows between “hubs” are generally large, and the potential gains from bilateral liberalisation may be correspondingly significant.

Inclusion and Exclusion: “Ins” and “Outs”

Successful “spokes” (“ins”) may derive almost all available gains from trade by securing PTAs with every major “hub”, perhaps supplemented by PTAs with other “spokes” with whom they have a significant trading relationship. The trade-off is with the risk of increased business transaction costs if the various PTAs contain inconsistent provisions.

Economies that are unable to secure PTAs with hubs, for whatever reason (“outs”) face significant economic damage. However, the logic of “competitive liberalisation” as propounded by its advocates requires that there should be no permanent “outs”, but that “hubs” should be prepared to negotiate PTAs with all prospective partners that display a desire and readiness to do so and are prepared to conclude agreements on acceptable terms and conditions. Permanent exclusion of some potential partners would contradict one of the fundamental purposes of the WTO’s non-discrimination principle and one of the most basic arguments for WTO membership, namely that it ensures that small

economies cannot be discriminated against by large economies for reasons that have nothing to do with trade. Permanent exclusion of some APEC members is also clearly a violation of APEC's own principle of non-discrimination and is inconsistent with APEC's paradigm of "open regionalism".

Rules of Origin

Rules of origin are required in PTAs to prevent unwanted trade deflection and thereby ensure that preferences are available only to those for whom they are intended and to the extent intended. They are one of the most important parts of any PTA, but also one of the most under-emphasised. Rules of origin serve a range of purposes besides assuring the integrity of the preferences under the RTA. At one end of the spectrum they can be designed to facilitate trade. At the other end of the spectrum they can have an explicitly protectionist purpose, being designed to offset the reduction of protection for sensitive products that would otherwise occur as a result of the tariff reduction provisions of the FTA.

Compliance with rules of origin requirements typically involve significant costs for businesses. Estevadeordal and Suominen quote one estimate of the costs of complying with rules of origin at between three and five percent of the f.o.b. value of the exported goods. These costs are likely to escalate for exporters from economies that are involved in multiple PTAs, each with their own separate and mutually inconsistent rules of origin. The burden of compliance costs is likely to fall disproportionately heavily on small and medium-sized exporters.

Rules of origin may also impose efficiency costs on the members of an RTA, though these effects are as yet poorly understood. One clear conclusion is that provision of full cumulation of origin in PTAs with multiple membership is important in order to facilitate the efficient development of regional production networks.

Rules of origin in PTAs among APEC economies range from the highly complex to the apparently very simple. Very complex rules of origin are likely to add to the compliance costs of business and increase the likelihood of costly disputes. Ideally rules of origin should be as straightforward as possible consistent with the objective of preventing unwanted trade deflection. However even apparently straightforward rules of origin, such as those based on a percentage of area content, can create significant difficulties for exporters and can have perverse effects on economic efficiency. Perhaps the most unequivocal criteria that can be stated for rules of origin is that they should be transparent, clear and consistent.

The Spaghetti Bowl: Potential Costs of Inconsistent Provisions in Multiple RTAs

As economies become involved in multiple RTAs the likelihood increases that there will be inconsistencies between the provisions of the different RTAs. Rules of origin are the most obvious and perhaps the most important potential source of these inconsistencies, but they inconsistencies can also arise in other areas as well such as standards and conformance, customs procedures and quarantine procedures.

Jagdish Bhagwati has suggested that as individual economies become involved in a growing number of PTAs, a “spaghetti bowl” of inconsistent provisions will develop, imposing increased transactions costs on businesses involved in exporting and importing. The extent of these increased transaction costs is an empirical matter and no reliable estimates are yet available. In the APEC region economies that are already involved in multiple PTAs, such as Chile, Mexico and Singapore may prove to be useful “laboratories” for the investigation of this issue.

Facilitation Measures: the “non-PTA” Components of Closer Economic Partnerships

It is well understood that a comprehensive package of trade and facilitation measures can

provide benefits to PTA members at least as great as the traditional PTA elements of trade liberalisation. These facilitation measures should be designed with due regard to the possibility that facilitation measures, like liberalisation measures can sometimes be discriminatory in effect, and that some types of measures may be challenged in the WTO.

To maximise the contribution of PTAs to APEC-wide progress in these areas, member-specific facilitation measures should be applied only where it is not possible to use international standards or APEC-wide agreements including mutual recognition agreements.

Inconsistencies Between “Models” and Other Potential Difficulties

As noted above, the evolution of multiple “hub and spoke” configurations is likely to result in competition between different PTA “models” favoured by the respective hubs. Distinctive E.U. and U.S. “models” can already be observed, and distinctive Japanese, Chinese and Korean “models” may also emerge. Differences between the U.S. and E.U. models can be found on issues where the U.S. and E.U. are competing to have their approaches accepted within the multilateral trading system, and inclusion of these approaches in their respective RTAs is bound to reflect this “competition”. The most obvious differences relate to rules of origin, but differences can also be observed on many other issues as well, including contentious area such as environmental and labour standards. The possibility of convergence of the “models” is likely to depend on whether convergence on the issues in question is achieved within the multilateral process.

For the smaller “spoke” economies negotiating PTAs with the “hubs”, the result is to increase the likelihood of inconsistencies between the various PTAs in which they are involved. This will reinforce the “spaghetti bowl” effect and its attendant transaction costs.

The propagation of “models” containing features that may not be acceptable at the multilateral level is not likely to be a positive development for the multilateral trading system. It also becomes important to identify whether there are any undesirable features in these “models”, viewed in the light of the intention that these PTAs should be “building blocks” for eventual APEC-wide and global free trade. Restrictive and highly complex rules of origin, such as the “NAFTA type rules” appearing in PTAs negotiated by the U.S. clearly fall into the category of undesirable features. Other potentially controversial features, including the treatment of sensitive sectors and provisions on labour and environment need to be reviewed from the same perspective.

Conclusions from Empirical Studies

The appendix to this paper provides a survey summarising the results of 40 separate computable general equilibrium (CGE analyses) of Asia Pacific PTAs. When considering the impact of different RTA configurations on economic welfare there are a number of propositions that receive reasonably consistent support from these results:

- Unsurprisingly, the largest welfare gains tend to come from large groupings
- APEC members generally derive their largest gains in economic welfare from APEC-wide liberalisation, regardless of whether this is undertaken on a non-discriminatory or preferential basis.
- East Asian economies generally derive larger welfare gains from an ‘ASEAN Plus Three’ PTA rather than ‘ASEAN Plus One’ configurations.
- Bilateral PTAs yield the smallest gains in economic welfare, although small economies do tend derive substantial economic welfare gains from PTAs with large “hubs”.
- Expansion of existing PTAs to include new members often erodes benefits of the existing members (especially small members)
- Economic welfare gains for members (“ins”) from PTAs are generally (though not always) accompanied by losses for excluded countries (“outs”)
- The welfare losses from PTAs tend to be concentrated on “outs” that trade

intensively with “ins”

- While larger blocs yield larger economic welfare gains for members they also impose larger economic welfare losses on these “outs”. The welfare losses of economies outside the APEC region, that trade less intensively with APEC economies, tend to be proportionately much lower.
- Studies of individual PTAs can produce widely differing (sometimes contradictory) results

A recent set of simulations of some thirteen potential FTAs involving the U.S., carried out by Gilbert for the IIE conference on U.S. FTAs also produced the following telling results:

- When the FTAs are simulated individually, the welfare gains accrue disproportionately to be the smaller prospective partners of the U.S.
- In a simulation of the thirteen FTAs implemented simultaneously however, relatively large gains accrue to the U.S., whereas the gains to the smaller partners are much smaller than when the FTAs are simulated individually.

The conclusions to be drawn in relation to this evidence include the following:

- The variant of the “domino” effect arising from “competitive liberalisation”, whereby small economies are strongly motivated to seek PTAs with potential “hubs”, is likely to be strong in the APEC region. Successful achievement by some small economies of PTAs with a major “hub” economy will increase the pressure on their competitors and neighbours to do likewise.
- On the other hand there are mixed incentives for the expansion and consolidation of PTAs. While PTAs involving larger groups of economies do generally larger economic gains for their members, it also often the case that expansion of an existing PTA to include a new member may erode the benefits of some existing members, who may therefore have an incentive to oppose the admission of the new member. Similarly, smaller economies that negotiate an

initial “spoke” agreement with a potential “hub” may have an incentive to obstruct the establishment of additional “spoke” agreements.

- Some of the larger prospective PTAs face well-known political obstacles to their achievement. It may not be an exaggeration to say that the most economically beneficial PTAs may be the most difficult to achieve in political terms.
- The keys to East Asia-wide and trans-Pacific integration are respectively the linkages between the Northeast Asian economies and the linkages between these Northeast Asian economies and the U.S. These are largest economies in the APEC region, and the trade flows between them are the region’s largest and among its most important. In order for PTAs to serve as building blocks for APEC-wide and global free trade, it will be essential that they embrace these linkages, as well as comprehensive linkages between these major economic powers and the smaller economies of the region.

Further Design Issues

The discussion so far in this paper has identified a number of important issues in the design of RTAs. This section discusses some further important design issues that need to be considered.

WTO- and APEC-Consistency

Economies announcing new PTAs routinely emphasise that the new agreement will be WTO-consistency. It is of course important that PTAs should be WTO-consistent, but it is also important to recognise that WTO disciplines on PTAs, while not wholly lacking in effect, are relatively weak, due to the well-known imprecision and ambiguity of GATT Article XXIV in particular and GATS Article V, and the inability of WTO members to reach agreement on the interpretation of these articles. As a result there is no universally accepted definition of a number of important provisions in the Articles, including but by

no means limited to the interpretation of the requirement that PTAs should cover “substantially all trade” between the parties. As a result the WTO’s Committee on Regional Trade Agreements (CRTA) has failed to reach consensus on the WTO-compatibility of all but one of the over 100 PTAs that have been referred to it for examination, and is unlikely to reach consensus on any further PTAs in the near future. The effect is that members are in practice left free within quite a large range to unilaterally adopt their own interpretations of the disputed provisions.

This is not quite to say that “anything goes” in relation to WTO-consistency of PTAs. Some common understandings on the meaning of parts of GATT Article XXIV and GATS Article V do exist, and have the effect of ruling out some modes of dealing with PTA issues. For example non-reciprocal PTAs involving developed economies are ruled out. This counts against the suggestion of the APEC EPG that APEC members of PTAs should consider extending to other APEC members on a voluntary basis the same preferences that they provide to their partners within the PTA. Arrangements involving developed economies for the granting of partial preferences are also ruled out, except for schemes like GSP that are available to all developing economies, and consequently fit criteria set out in the Enabling Clause.

Clarification and improvement of the WTO rules on trade would certainly be desirable and this question is on the negotiating agenda for the Doha Development Agenda. Prospects for significant change are not however encouraging.

For APEC members it is also important that PTAs among APEC members should be APEC-consistent as well as WTO-consistent. At a minimum this should mean that:

- PTAs conform to the APEC Principles set out in the OAA.
- The timetable for liberalisation within PTAs should be consistent with the Bogor dates i.e. it should not extend beyond 2010 in PTAs involving developed APEC economies and beyond 2020 in other PTAs.

Treatment of Sensitive Items

The treatment of sensitive products and sectors within PTAs is a longstanding issue that has not been able to be conclusively resolved, largely because of the lack of an agreed interpretation of the provision in Article XXIV regarding coverage of “substantially all trade”. WTO members have debated endlessly whether this provision allows the exclusion of an entire sensitive sector such as agriculture.

One view is that “substantially all trade” should be defined in purely quantitative terms, such as 90% or 80% of trade between the parties, and that agriculture can be excluded provided the required proportion of trade is nevertheless covered. Another view is that the provision should be interpreted among other things to mean that no major sector should be wholly excluded. Support for this interpretation is provided in the preamble but not the legally-binding sections of the WTO’s 1994 “Understanding” on the interpretation of Article XXIV.

Economic analysis has identified the following relevant considerations:

- In a PTA that contains a competitive producer in the “sensitive sector”, the “sensitive sector” is a potential source of trade creation, and its exclusion lowers the welfare gains that members can expect from the PTA.
- In a PTA that includes only uncompetitive producers in the “sensitive sector”, the sensitive sector is a potential source of trade diversion, and its exclusion may have a positive effect on both members and non-members.
- Inclusion of sensitive sectors in PTAs may prepare the way for multilateral liberalisation.
- An ability to exclude “sensitive sectors” from PTAs may encourage economies with highly sensitive sectors (such as agriculture) to increasingly focus on PTAs at the expense of commitment to multilateralism. PTAs with “sensitive sectors” excluded may then become one of the “models” of Asia-Pacific PTAs, and it may be difficult for this model to converge with other models.
- At the same time in the case of agriculture there are three key issues: market

access, domestic support and export subsidies. Of these only market access can be adequately addressed within PTAs, while progress on domestic support and export subsidies almost certainly depends on action at the WTO. This suggests that liberalisation in agriculture will need to proceed along parallel but linked tracks in both PTAs and the WTO.

On balance it is suggested that the arguments against exclusion of sensitive sectors clearly carry greater weight.

APEC members should have regard to APEC principles as well as WTO rules. In particular the principle of “comprehensiveness” indicates that all major sectors should be included, while the principle of “flexibility” indicates that liberalisation in sensitive sectors can proceed on a slower timetable and with due regard for the sensitivities of member economies in that sector.

Trade in Services

There are two distinct approaches to liberalisation:

- The GATS approach, in which MFN treatment is applied as comprehensively as possible, but the choice of sectors to be liberalised is made on a positive list basis
- The NAFTA approach, in which a “negative list” approach is taken to the liberalisation of services.

There is also an important question as to whether preferential liberalisation is desirable in certain sectors, particularly key infrastructure sectors such as transport, telecommunications and financial services. In these sectors in particular the aim should be to attract internationally competitive suppliers of the services into the domestic market.. Preferential liberalisation that discriminates against internationally competitive suppliers could have severe negative consequences.

Conclusions: Towards PTAs as “Building Blocks” for Achievement of the Bogor Goals

Based on the discussion above, the following are suggested as requirements for PTAs that will contribute to the achievement by APEC members of their Bogor goals.

Commitment to the Bogor Goals

In the context of PTAs it is important to re-affirm that APEC members remain committed to the Bogor goals and that pursuit of PTAs does not detract from that commitment.

WTO Consistency

Adherence to WTO provisions on RTAs is of course essential, but it must be acknowledged that this is not a sufficient condition for PTAs to serve as “building blocks” towards achievement of the Bogor goals.

Consistency with APEC Commitments

PTAs among APEC members should also be consistent with their APEC commitments, including the Principles that APEC members have adopted. In particular this means that the PTAs should conform to the Principles set out in the Osaka Action Agenda, and the implications of this include the following:

- The principle of Comprehensiveness indicates that PTAs should cover trade in both goods and services
- The principle of Comprehensiveness also indicates that all sectors should be included, while the principle of Flexibility indicates that sensitive sectors may be liberalised on a slower timetable with due regard to the sensitivities of member economies.

- The principle of Non-Discrimination indicates that no APEC member should be permanently excluded from the pattern of PTAs being developed in the region. If “open accession” clauses are not practical, APEC members should nevertheless devise a credible form of commitment that each member is prepared to entertain the possibility of a PTA relationship with every other member, whether through negotiation of a bilateral PTA or through membership of a larger PTA grouping, and that no APEC member will be permanently excluded from larger PTA groupings that may develop among APEC economies.

The timetable for liberalisation within PTA should not extend beyond the target date for achievement of the Bogor goals.

Closer economic partnership (CEP) agreements, including both traditional PTA elements and facilitation elements (sometimes referred to as “non-PTA” or “WTO-Plus” elements are clearly in the spirit of members’ APEC commitments, since they allow all items on the Osaka Action Agenda to be covered.

Where relevant, provisions in PTAs among APEC members should be linked to the specific sets of Principles that APEC members have adopted such as the Principles on Competition and Regulatory Reform, the Non-Binding Investment Principles, the Principles on Government Procurement, and the Principles on Trade Facilitation.

Expansion, Amalgamation and Convergence of PTAs: Allowing for Differential Progress

If PTAs are to lead to the achievement of the Bogor goals, expansion, amalgamation or convergence of PTAs, or some combination of these processes, will have to occur. It should be recognised that these processes will not necessarily occur of their own accord. Strong leadership and guidance from APEC leaders will be needed, including but not limited to the commitment suggested above that no APEC member will be permanently excluded from these developments.

In relation to these processes of expansion, amalgamation or convergence, different considerations apply to the “PTA elements” and “non-PTA” or facilitation elements of CEPs. It is likely that there is potential for these processes to be moved forward at different speeds for the two types of elements. To ensure that the processes move forward as quickly as they are able, it may be useful to design CEPs so that the “PTA elements” and “non-PTA” or facilitation elements can be separated from each other if necessary, to allow the processes of expansion, amalgamation or convergence to move forward in one set of elements but not the other.

MFN Liberalisation and Multilateralisation

Progressive MFN liberalisation in parallel with liberalisation within PTAs provides the ultimate assurance that the negative effects of preferential liberalisation will be minimised and that the ultimate goal of APEC-wide or even global free trade will be attained. In order to minimise negative effects it is important that all MFN barriers be reduced to moderate levels as soon as possible, thereby limiting margins of preference in PTAs and so reducing the scope for trade diversion. Elimination of peak tariffs and tariff escalation must be a priority.

Achievement of the Bogor goals effectively implies multilateralisation of the liberalisation commitments undertaken by APEC members within PTAs. Confidence that APEC members are serious in their intention to use PTAs as “building blocks” towards the achievement of Bogor goals will be strengthened by a credible up-front commitment on the part of APEC members to eventually multilateralise the concessions that they make to PTA partners. It is suggested that APEC members give consideration to the form that such a commitment might take. The experience of PTAs where partial or full multilateralisation has already taken place, such as AFTA and CER, may provide useful guidance.

Liberalisation Modalities

APEC members should endeavour to ensure that the liberalisation of both goods and services within PTAs is progressive and automatic.

In the case of services trade, binding of the status quo should be regarded as acceptable. Where liberalisation is undertaken, MFN liberalisation should be regarded as the norm, especially in key infrastructure sectors. APEC members should not insist on preferential liberalisation by their PTA partners in these key sectors. To facilitate liberalisation of trade in services, relevant domestic regulations should be subject to a necessity test, and should be applied in the least trade restrictive manner possible.

In cases where liberalisation cannot commence immediately “negative lists” should be employed, with provision for regular reviews aimed at removing all remaining trade restrictions. This should apply to both goods and services trade, including “sensitive sectors”. The “negative lists” should be subject to “sunset clauses” and there should be no permanent exclusions.

Rules of Origin

The crucial importance of rules of origin must be recognised. Rules of origin are not an appropriate mechanism for protecting “sensitive sectors” or for facilitating adjustment to liberalisation. Complex rules with protectionist purposes should be avoided. Ideally rules of origin should as far as possible be neutral in their impacts on trade flows. Rules of origin should be as straightforward as possible, and should be transparent, clear and consistent, and should not impose unnecessary compliance costs. It is important to allow full cumulation in PTAs with multiple members. The development by APEC members of “best practice guidelines” for rules of origin would be a very useful contribution.

Facilitation Measures

In regard to facilitation, to ensure maximum contribution to achievement of the Bogor

goals, use should be made wherever possible of international standards and APEC-wide agreements and processes, including mutual recognition agreements.

Development Dimension

APEC members should carry over into their PTAs and CEPs their recognition that trade and investment liberalisation and facilitation must be accompanied by capacity building for developing economies in order for the full benefits to be realised. CEPs between APEC economies should allow for assistance in capacity building to be provided to developing economy members by their developed economy partners. The potential for CEPs to serve as vehicles for the provision of regional public goods should be recognised and exploited.

Transparency

Transparency in PTAs among APEC members is essential if confidence is to be maintained that they will serve as “building blocks” towards achievement of the Bogor goals. There is merit in the suggestion that a review process similar to the TPRM should be introduced in the WTO for PTAs, and APEC members should consider promoting this suggestion.

In the meantime, in the interests of transparency, APEC members should institute their own process of peer review of PTAs involving APEC members. To be fully effective, peer review should occur before the PTAs are finally concluded. It is also important that provision be made for the inclusion of PTAs in the IAPs of APEC members. This would formally bring IAPs within the scope of the IAP peer review process.

Also in the interests of transparency, the texts of PTAs should be made publicly available as soon as possible after agreements are concluded. APEC members might also consider following the example of Canada, in releasing the negotiating texts of PTAs into the public domain, thereby facilitating meaningful input by business and civil society into the

negotiating process.