

TRADING WITH FAVOURITES:
RISKS, MOTIVES AND IMPLICATIONS OF FTAs IN THE
ASIA PACIFIC¹

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Recent Events

Efforts to negotiate trading arrangements among small groups of economies have proliferated in the last few years in the East Asian region.

The more extensive interest in this effort in East Asia is evident in the shift in attitude in Japan and Singapore which led to their Economic Partnership Agreement in January 2002. Singapore's agreement with New Zealand in November 2001 was also an important prompt for action by others. Having now reached agreement with the US, Singapore has turned its attention to the other NAFTA members. It has also begun talks with Korea. Australia too is an active participant, and has just concluded an FTA with Singapore and is now in negotiation with the US. In its early stages, the richer countries –, Singapore, New Zealand, Australia, Japan, and Korea – dominated the negotiating activity. There have also been reports of Hong Kong and Chinese Taipei looking at options. A more recent development has been a surge of interest among the other members of ASEAN as well as in China.

China and ASEAN reached an agreement on a framework to establish a free trade area. This development is interesting not only because of the character of the participants, but also because of the membership of the proposed agreement. Other proposals so far have been bilateral.

Japan too has stepped up its expressions of interests in agreements with ASEAN members. According to the press release of November 5:²

ASEAN and Japan today signed a Joint Declaration on the Comprehensive Economic Partnership (CEP) at the ASEAN-Japan Summit in Cambodia. The implementation of measures for the realization of the economic cooperation, including elements of a

² <http://www.aseansec.org/13194.htm>

possible Free Trade Area (FTA), is to be completed as soon as possible and within ten years, taking into account the economic levels and sensitive sectors of each country.

Special and differential treatment would be provided to the developing members of ASEAN in accordance with the World Trade Organisation agreements with flexibility accorded to the new members of ASEAN.

The leaders agreed that the CEP would open up new opportunities for their countries with the creation of larger and newer markets, enabling businesses to enjoy economies of scale. They expressed confidence that this partnership would bring about greater stability and prosperity to the region, besides promoting a sense of community between ASEAN and Japan. Both sides noted the need for cooperation in trade and investment liberalization, customs procedures, standards and conformance, non-tariff measures and cooperation in financial services, information and communications technology, human resource development, small and medium enterprises, tourism, transport, energy and food security.

Individual ASEAN members are also negotiating with trading partners. The initiatives of Singapore have been noted. Thailand has stepped out to establish separate negotiations with China. It has conducted a joint study with Korea into the feasibility of an FTA and has set up a joint task force to study how to promote closer economic relations with Japan. It has signed an MOU with Australia to negotiate an FTA by 2005. Malaysia, in a significant shift in policy, has started talks with Japan. In November 2002, India proposed talks with ASEAN.

In the APEC meetings in Los Cabos in 2002, President Bush announced the Enterprise for ASEAN initiative. In this Initiative, the US and individual ASEAN members (emphasis added) will together determine if they are ready to launch FTA negotiations. The US expects a potential FTA partner to already be a member of the WTO (which excludes Cambodia, Laos and Vietnam) and to have concluded a Trade and Investment Framework Agreement (TIFA) with the US (already in place for Indonesia, the Philippines and Thailand). On November 19,

2002, the US reached agreement with Singapore and on December 11 concluded negotiations with Chile.³

Many other countries are also involved or have just concluded agreements including Mexico, Chile, Canada and Korea.

These types of arrangements are often referred to broadly as regional trading arrangements or RTAs. Their agendas are wide, and their coverage of issues is often beyond that of the WTO.

The main concern in this paper is with the preferential component of the agreements, that is, the traditional Free Trade Area elements. These parts are where most of, though not all, the risks are to be found.

Despite its title, the FTA component of these agreements does not actually create free trade in terms of market access without discrimination. It provides instead a system of access on preferential terms. It involves a tactic of trading with favourites.

The question is what are the risks in the FTA tactic, how significant are the risks and how might they be managed?

While clearly FTA members expect to gain from their participation in an agreement, the net outcome of the various effects on national economic welfare⁴

³ The Chile agreement is not yet signed. Negotiations with Central America and Morocco, an exploration with the South African Customs Union and negotiations with Australia are also on the agenda. These small group negotiations are proceeding alongside the FTAA negotiations. The US already has FTAs with Israel and Jordan.

⁴ Following Pomfret's (1997) presentation of these effects, they include the welfare gains (triangles on under both the demand curve and domestic supply curve) from a lower price of the imported product, the loss from the higher expenditure on goods now imported from a high cost supplier, and the gain from the lower expenditure on goods imported from non-members. The trading partner gains unambiguously from producer surplus on the new exports. One complication to this story is that the economy offering the tariff concessions to the favoured trading partner loses tariff revenue: the cost of replacing those funds should also be taken into account. Coincidentally, this issue is a matter of current debate in Chile which has been vigorous in its effects to sign preferential agreements.

is actually an empirical issue.⁵ However, gains to a member's exporters from the application of a preferential tariff by a trading partner can be predicted with more confidence. Exporters are therefore important drivers of the domestic political process that supports their economy's participation. As explained again below, the role of exporters in providing this political support also affects the prospects for progress in the WTO agenda.

Non-members' trade may be diverted away from the FTA member economies but the main effects on non-member economic welfare occur via changes in their terms of trade.⁶ Some of the empirical work suggests that while such effects exist, they may also be relatively small, especially so when the players are relatively small actors in the relevant markets. But the interesting recent development is the trend among small economies to sign FTAs. Whether actually large or small, therefore, non-members still tend to react to FTAs initiated by their trading partners. They want to join to ameliorate those effects, or they want to sign new agreements of their own – “we can't afford to stand still”, they'll say. The consequence is the proliferation we now observe.

Proponents of the FTA route to reform might argue that the economies involved are not acting in a way that contradicts regional cooperation. In some special circumstances, the process might actually end up at free trade, as more and more preferences are exchanged until the entire world is a member of the same agreement. Some proponents of the process seek to use preferential agreements in an offensive manner, hoping to stimulate the non-members to make their own proposals or accede to requests to negotiate in order to avoid the losses from discrimination. For example, in a comment on the US approach it was reported that

⁵ The relative weight in decision making on national interest and political gain from accession is a matter for speculation. The literature on the modelling of the adoption of trade agreements assumes governments are motivated by a combination of national welfare and political support – see for example, Maggi and Rodriguez-Clare (1998), Mitra (2002) and Ornelas (2002).

⁶ The terms of trade effects are reviewed by Pomfret (1997), ch. 9. Findlay (2002) notes issues in empirical work on the impact of FTAs.

Mr. Zoellick's strategy is based on what he calls "competitive liberalization," the idea that a bilateral trade agreement with one country puts pressure on others to seek their own deals with the United States (Singapore and US Near a Trade Deal, by Edmund L. Andrews, *New York Times*, 20 November 2002)

Proponents of the FTA route might also say that the multilateral institutions are not delivering market access rapidly enough, and that the region should, and in fact is already becoming, more self-reliant, partly as a consequence of the growth in demand for final goods and services in China. The region, furthermore, is seeking its own identity and greater self-reliance in terms of a regional financial architecture after its experience in the financial crisis. A new set of trading arrangements within East Asia can contribute to both objectives, it might be argued.

The various motivations for these agreements are considered in more detail in a later section. Clearly, the motivations involve a significant political component, and not just that of responding to domestic pressures for market access. The motivation also includes that of pursuing ambitions in or cementing linkages within various international relationships.

A framework in which to examine the risks involved in this tactic is presented in later sections. A theme of the observations derived from that framework is that a tactic of favouritism is at odds with an overall strategy of cooperation. There is another and apparently contradictory view that in fact 'East Asian regionalism has never been stronger'. We also offer more comments on these positions below.

Risks

The first of five types of risk examined in this section is the effects of favouritism on the efficiency with which resources are allocated in the economy. Trade is diverted to trading partners in the agreement. The trade diversion effect is important for services as well as goods. Further, the diversion effect might also be “stickier” for services than for goods, given the nature of competition in markets for services, and the strong position acquired by ‘first movers’.⁷ Participating economies might be locked in for longer with ‘second rate’ suppliers because of this effect. The diversion effects also mean that the competitiveness of their exports to non-member markets which remain open is likely to be reduced.⁸

The second risk is that associated with retaliation by others. East Asia in particular continues to depend on access to world markets. A series of agreements in East Asia feeds back into the momentum for preferential reform in the rest of the world, for reasons just noted. In addition there is a demonstration effect of economies like Japan and Korea appearing to sanction such an approach to reform. The risk is that East Asia will be discriminated against in other markets outside the region on which it still depends.⁹ There is a further risk of fragmentation in trade within East Asia.

A series of FTAs contradicts the patterns of commerce in the region. A key feature of the patterns of development in East Asia has been the relocation of industry as its host lost its comparative advantage in that sector. These shifts have occurred quite rapidly and have been an important driver of East Asian investment in China. It has been evident in Korea and more so in Japan in recent years. Hong Kong until recently was managing the process of integration

⁷ Mattoo and Fink (2002) make this argument.

⁸ It is sometimes claimed that FTAs have important dynamic effects, for example, by increasing market size and adding to the extent of competition in a market. Competition leads to lower costs and greater capacity to compete in markets not included in the FTA. The strength of this offsetting effect to the cost-increasing impact of trade diversion has been asserted in some modelling work to be important but remains an empirical question.

with southern China very successfully. Chinese Taipei is making a rapid adjustment to more capital and technology intensive production. This process works best in an MFN environment. A series of agreements with favourites impedes the process of relocation. Further, a lot of value adding, while based in a series of locations in East Asia, creates a final product which is sold outside the region: again, MFN rules facilitate the adjustment of market shares amongst the economies who take turns to host the final stages of production.

The third risk is in the architecture of the FTAs. The hope is that proliferation will lead to global free trade. It is not clear how this will occur. The political sensitivities in members of each bilateral arrangement will vary so excluded sectors from the agreements are also likely to vary and the agreements will not naturally evolve to MFN liberalisation. The specification of the rules of origin is another (among many) such issues. A series of differentiated agreements will develop, which will increase the cost of doing business and add to the demand on bureaucracies to confirm that the rules of origin are met etc. The architecture could look like the famous spaghetti bowl, but with modern Asian characteristics.¹⁰

The fourth effect is that on the political economy of reform. There has been some argument that the tactic of the use of preferential agreements will, through the threat it imposes, drive the world to make faster progress on the WTO negotiations and the application of MFN principles. More likely, though, the political economy effect will be to create a new set of interests who are opposed to further reform, because it removes their favoured positions in offshore markets. These are the very export interests whose commitments are so important in the domestic political economy processes for the adoption of WTO commitments. The extensive use of FTAs in this scenario retards the WTO process, and does

⁹ At the same time, and as just implied by comments on the impact of trade diversion, economies participating in FTAs not involving East Asian economies run the risk of cutting themselves off from trade growth in East Asia.

not accelerate it. The final outcome therefore is not independent of the path taken.¹¹

A further effect on the political economy comes from the misnomer of ‘free trade agreements’. In the context of bilateral negotiations, there is not likely to be capacity to mobilise sufficient political support to deal with the very difficult and sensitive issues (areas in which tariffs are already high for example¹²). Groups hoping to gain better market access from the negotiations will be frustrated by the lack of effectiveness of the negotiating process.¹³ Other groups opposed to free trade may then try to use this situation to illustrate an argument that a ‘free trade’ strategy is not effective.

The fifth set of risks is also political. FTAs are often lauded for their contribution to the political relationship between two economies. Foreign Ministers ask to be allowed to use all the instruments available to deepen a relationship. President Bush said his EAI will ‘enhance the already close U.S. ties with ASEAN’. But do FTAs necessarily make a net positive contribution to deeper political linkages?

¹⁰ Measuring the contribution of new agreements to the spaghetti bowl effect is a useful addition to the research agenda in this field.

¹¹ Ornelas (2002) has a model in which signing a preferential agreement lowers the external tariff. This is because the rents generated by the external tariff are shared with foreign firms after the adoption of an FTA. The returns to lobbying for an external tariff are reduced and the political equilibrium shifts.

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

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

¹² If tariffs do not fall in these sensitive sectors, then there is no diversion and the cost associated with trade diversion in that sensitive sector is avoided. It is argued for example that agreements involving Korea or Japan will not lead to trade diversion in agricultural markets for this reason. However the overall dispersion of effective protection can still increase, with welfare consequences, and the participation in the FTAs can contribute to the systemic effects which are the theme of this paper.

¹³ ‘The sacrifice of live sheep on the steps of Parliament House’, as disgruntled Australian farmers protest the lack of success in arranging access to US markets under the FTA negotiations, is one such scenario. This situation might appear to be protest against free trade, rather than against the inadequacy of negotiating with favourites! (Thanks to a business sector colleague for this scenario).

They have their own costs. The negotiating process can define new tensions, for example, on trade policy questions which would otherwise be dealt with in a multilateral setting but which now are examined under the spotlight of the bilateral negotiations.

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

Finally, FTAs, while they are supposed to create political benefits within their own sphere, can add to tension outside it. Non-members, by implication, are not favourites. This signal risks diminishing the quality of the relationship with non-members.

The consequences of FTA can therefore be considered in a various categories, including the impacts of trade diversion, the effects of retaliation, and the costs of the spaghetti bowl effects. Consequences include both domestic and international political effects. Progress in the WTO can be impeded as a result of their application. Overall, the tactic of favouritism contradicts the strategy of cooperation.

Some commentators argue that, despite these concerns, cooperation will eventually prevail in East Asia. This occurs mainly because economies in the region recognise the gains from the consolidation of the bilateral agreements and value the stronger bargaining position which a larger group will have in relation to the blocs, existing or emerging, in the rest of the world. Recognition of the value of consolidating bilateral agreements in East Asia will be intensified by progress on the FTAA negotiations, according to this argument. We offer more comments on the hypothesis of consolidation below.

Motivations

What are the motivations for the FTA route to reform, given these risks. The elements of the domestic political economy and the role of export interests in promoting their use have already been noted.

FTAs are easier to sell at home than MFN liberalisation. The benefits of MFN are more diffuse and those of the bilateral more specific, while its political costs are easier to manage.¹⁴ This was always the case: but politicians understood the risks in terms of their longer-term interests (retaliation leading to a final position in which their economy could be worse off). Their choice on this trade off appears to have shifted (its parameters having been forgotten by the current generation of policy makers, or the assessment of the costs of the outcome which is not preferred having shifted).

The assessment may be made that the intensity of regional trade is increasing. The relatively rapid growth of trade with others in the region may be taken to indicate not that impediments to intra-regional trade are diminishing but that more could be done on a local basis to remove remaining impediments and to let trade grow even faster. Recall President Bush on the 'already close ties' mentioned earlier.

The issue is that, while the data may indicate that intra-regional trade is growing rapidly, the phenomenon may be the result of the growth of cross-border transactions along the supply chain, as noted above, rather than a shift away from the fundamental reliance on global markets.

¹⁴ Gary Hufbauer has also been quoted to say that in the context of a Presidential election in November 2004, the Bush administration prefers FTAs since "they don't give the same level of grief to the election strategy", contrasting that approach to the 'concessions' that might be required to settle the Doha Round or the FTAA (in Peter Hartcher, 'US trades principles of power', *The Weekend Australian Financial Review*, November 16-17, 2002).

FTAs can be identified to be contributing to valuable policy goals. But the question is whether the preferential route is the best way to obtain them?

For example, one motivation for an agreement seems to be to fix elements of the so-called “new age agreements”, such as various types of non-tariff barriers. Some of these non-tariff barriers, such as systems of standards, rules on movement of people and payment of taxation on income from foreign investment, for example, require explicit cooperation between pairs of economies in order to introduce new arrangements. These items could be included in FTA negotiations but there is an alternative, called a trade and investment facilitation agreement (TIFA), which need not trigger the same concerns about the effects of discrimination.¹⁵

Especially important are the various forms of contingent protection. It is hoped that these will apply less vigorously to those with whom FTAs have been negotiated. It is an interesting question for further work to see if, for example, those economies are less likely to apply say anti-dumping measures against trading partners with whom they have FTAs.

A special factor among the ASEAN economies is to respond to the ‘China challenge’, mainly in terms of the capacity to continue to attract foreign direct investment from third countries. Access to China without trade impediments increases the attractiveness of ASEAN compared to China as an investment location. But there are risks in this strategy which we discuss below.

Mobilising domestic reform is an important factor, especially in Japan where proponents of this route to reform argue that the international commitments are required to shift the most difficult issues in the domestic agenda. However it is

¹⁵ There are now two interpretations of this acronym – the Western Pacific version refers to F for Facilitation and the U.S. version refers to F for Framework and refers to it as a first step to an FTA

not clear that a preferential agreement generates enough 'grunt' to shift the resistance. As already noted, negotiations quite often appear to get stuck on issues which are relatively small in terms of its impact on the whole economy but which matter in the domestic political economy.

Links to the security agenda

A motivation of the use of a preferential agreement in Europe was its contribution to security. Does the same argument apply in the Pacific? How do they add to the stock of political assets in the region?

There are important two-way connections between deeper economic relationships and a lower risk of conflict. But will FTAs actually add to the stock of security-creating political assets in the region? Even if that contribution was positive, the question remains of whether other forms of cooperation, including economic cooperation based on MFN principles, is even more effective without the same risks.

Some assessment relative to alternatives is important and it is not clear that structures which embed favouritism and which force economies to choose their partners make the region as a whole less subject to risk of the sorts of disputes which could lead to conflicts.

A specific issue in the application of this route to reform is the treatment of Chinese Taipei. A multilateral approach to the design of trade policy provides a formula for the inclusion of Chinese Taipei to not only its benefit but also to the benefit of the rest of the region. But which economies would sign preferential trade arrangements with Chinese Taipei? If the answer is 'hardly any', then there is a risk of a higher degree of economic isolation of Chinese Taipei. What are the implications of that position? Further thought is required on how that outcome would affect the risks of conflict in the region.

Given the extent of activity on FTA related agreements in East Asia, it was inevitable that the US would start taking a stronger interest in this development. It too has its own market access ambitions, and would seek to avoid losses from discrimination. As already reported, the US did make a decisive move in Los Cabos in its initiative on ASEAN.

The timing of this move might also have been prompted by the development of its security agenda, which is another illustration of the linkages between economic and political motivations in the FTA agenda.

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

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

Hub or spokes: the ASEAN challenge

A new shock in the region is the focus by all three big economies on the negotiation of FTAs with smaller economies. For example, China, Japan and the US are now all making offers to ASEAN, and in at least one case, making explicit individual offers to ASEAN members. ASEAN is talking with India and the CER members.

It would appear therefore that ASEAN is building a hub position for itself with respect to East Asia. Is this situation a threat or opportunity for ASEAN? Can ASEAN capitalise on this situation? In that case, ASEAN might be able to go even further and, it might be hoped, consolidate the regional agreements into one and so lead the cooperative response in the Western Pacific to the FTAA development in the other hemisphere.

ASEAN finds itself in this position by default rather than through the exercise of its own strategy. No single Northeast Asia position could take on that role of a hub and it is not likely that a Northeast Asian regional structure will emerge in the short term. But ASEAN still faces a number of factors which limit its capacity to benefit from this situation.

As a consequence of the sensitivities in each ASEAN economy, any agreements actually signed might differ among the members. If so, the ASEAN economies would then assemble around the partner economy in a series of spokes, rather than in a single agreement. The ASEAN members instead become spokes to another economy's hub.

There is already sign of this outcome in the framework agreement between ASEAN and China, where each economy has the opportunity to list various exceptions, and in the individual initiatives of the member economies. This outcome also undermines the scenario of regional consolidation led by ASEAN

already outlined. While this is a matter of concern for ASEAN, the economic downside for China in its approach to ASEAN is relatively small.

The big economies in the Western Pacific may then compete to become the lead hub in the region, although China would be favoured to win that particular race.¹⁶ Japan currently has less to offer in terms of long term market growth potential or as a host for FDI from relocating industry. The US, indeed, may rank above Japan as a partner for ASEAN, particular as some members have established security ties with the US.¹⁷

A hub and spoke structure has some important implications for ASEAN. Consider such a structure built around China. What will be the effect of this architecture on the choices of foreign investors? Apart from any considerations of market size, China (the hub) is a better choice than the spokes, since market access and unrestricted procurement of intermediate products is guaranteed with each spoke. Location in a spoke provides less coverage. So one of the ASEAN's original motivations for stepping into this process with China would not be met, and China's competitiveness as a host for FDI might actually be even higher!

ASEAN may be involved in a series of agreements which are very different from each other. This would create serious problems for ASEAN to manage its external relations, particularly in East Asia, and will only add to the cost of doing business, as investors have to deal with differences in scope and speed of tariff reductions, and different rules and regulations.

¹⁶ On the other side of the Pacific, US leadership, it is argued, avoids the scenario of hub competition and leads to a larger integrated market to which East Asia will have to respond. This scenario is the foundation of the argument for that economic cooperation will eventually emerge between the hubs in the Western Pacific. The complications in this scenario introduced by individual security relationships with the US are a topic for further work.

¹⁷ For example, Thailand, Singapore and the Philippines, whose US links would be less affected by US-led war in Iraq.

The co-existence of FTAs between ASEAN and three Northeast Asian economies side-by-side with the increasing number of bilateral FTAs between individual ASEAN members and non-ASEAN economies may increase the chance of conflicting, costly and sometime irreconcilable outcomes in ASEAN.

This situation of the co-existence of regional and bilateral FTAs may be viewed as a sign of ASEAN's disintegration. This situation may be exploited by ASEAN's trading partners in their negotiations of bilateral FTAs. This situation also has implications for ASEAN's capacity to deal with the other issues on its agenda, including other regional security matters.

Therefore while the tactic of the FTA route appears to offer large rewards, those rewards are only captured if ASEAN can emerge as a hub and subsequently establish a consolidated regional approach. The agreements in which ASEAN members were involved would have to be carefully designed, negotiated, coordinated and sequenced. A Common Framework Agreement would be a starting point. The design of this Agreement depends on answers the questions of whether ASEAN is seeking an FTA or closer economic cooperation? If an FTA is chosen, what is the coverage (ideally complete) and what are the mechanics of the removal of impediments? The expectation is that any model agreement would have to go beyond removing impediments related to goods trade and include also various trade facilitation measures. The process of multilateralising the Agreement would also have to be considered, so that it does become a building block for the multilateral system. An important criterion is to also to avoid protracted negotiations, not only because of reasons of the resource constraints but also because of the skepticism about free trade that might follow from a delay.

Responding to these questions and constraints is clearly a challenge. One tactic, now that there is a commitment to a series of negotiations, is to a) start with facilitation measures where agreement is likely in a short period and b) if and

when trade liberalisation negotiations are undertaken, work for an ‘early harvest’ of reductions of impediments of mutual interest to all the parties, but also make available those reductions to all other trading partners.¹⁸

Risk Management

The scenario of the emergence of competitive hubs in East Asia challenges what might have been a more relaxed attitude to FTAs and it supports the case for continuing to consider strategies for risk management. Some options for ASEAN have already been noted.

Prospects of significant progress in the WTO are important. The challenge is to demonstrate the capacity of the WTO to deliver more open markets.

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

Just like other forms of governance, black letter law is not usually sufficient to avoid a problem. It can never specify all the relevant circumstances. Also the more it tries to do so, the more scope it creates for abuse, since the exceptions receive implicit endorsement by their failure to be listed. A commitment to work by the principles on which the rules are based is important and that requires leadership, that is, choices which are designed to encourage others to act according to the principles, and choices which therefore cannot be interpreted as abuse of those principles.

¹⁸ Multilateralised commitments do not trigger formal WTO requirements on coverage and could also be introduced according to different schedules in each economy, if such variation was required to

As noted the three largest economies in the region appear to be more deeply involved in the FTA strategy in East Asia. It is not clear therefore that they will provide this type of leadership. ASEAN's own capacity to reach a coordinated position on these issues is doubtful, as noted already. But with further analysis, and with contributions from the research community, it may be possible to build a wider coalition in East Asia to take a common position on this issue.

APEC could have had a role in establishing regional leadership, by reiterating its own OAA principles and by engaging in dialogue on the motivation for the members' use of FTAs and how members see the use of FTAs contributing to their progress to the Bogor goals. APEC additional and special feature of value in this context was its wide membership, including the US.

However, the experience of the IAP peer review processes in APEC, where apparently there has been little debate on the issue of the impact of FTAs, and the statements from the Los Cabos meetings suggest that APEC has not yet been effective on this issue. Its wide membership and diverse interests appear to make it difficult to escape the same gridlock that binds the review processes in the WTO. A sub-group may make better progress. APEC's progress on the issue will depend on how effectively it makes use of its second track processes that take in business and research community analysis and suggestions.¹⁹

Valuable work remains to be done on the specification of trade and investment facilitation agreements. They can focus on the new areas which currently are bundled up with FTAs. It is important these arrangements be designed to be consistent with open regionalism and the specification of their accession clauses, as well as their original design, are good topics for the APEC work program. Properly specified, and with explicit business sector support and with good

reach an agreement.

¹⁹ The Pacific Economic Cooperation Council is working on a set of principles for the design of regional trading arrangements to be tabled in a dialogue with officials in June this year.

capacity building programs, these agreements can also satisfy the demand for increments to the stock of political assets in bilateral relationships.

An important discipline is provided if FTAs are not made exclusive (alongside a commitment for 'no carve outs'). This condition means that others can join on the same terms as original members. But the discussion of the political economy effects above suggests that building up members by gradual accession is more likely to stall with a small group than to lead to free trade. Where carve-outs are possible, existing members will still want to negotiate with new ones.

Ultimately, the best tool for risk management is the commitment to MFN application of any agreements reached on preferential terms.²⁰ This transfer of concessions to favourites into MFN treatment has been part of the ASEAN experience so far, and of the CER members. These economies have credibility on that score and between them, they could develop a position to take the WTO. Such an approach makes a critical contribution to dealing with key risks in the FTA route to reform, including its efficiency effects, its domestic political economy problems and its proliferation tendencies.

Conclusion

Even as little as a year or two ago, observers could have been relatively sanguine about the boom of interest in FTAs.

Progress was much slower than people originally expected, and negotiations seemed to drag on without agreement being reached – recall the anecdotes about the Korea-Chile negotiations which only just concluded after 4 years. Some commentators in ASEAN have already questioned the likely progress on China-ASEAN talks. Slow progress in, or failures of, bilateralism would, it might

²⁰ In terms of an accession clause, MFN treatment is equivalent to a commitment in advance to extend membership automatically to all other trading partners.

be expected, undermine the credibility of FTAs and drive the participants back to the WTO where at least they could mobilise sufficient forces to reach an agreement. Also business could be expected to wake up to the fact that FTAs add to the cost of doing business, and could therefore push for a different agenda.

Agreements which were reached but which imposed costs that were too high would be expected to collapse, as they have done before. Agreements which survived are more likely to be 'dirty', therefore not actually very effective and therefore not very costly, though they may create some systemic problems in along the way. In that case, the main costs of bilateralism are the waste of resources in the negotiating process.

Economies in the Western Pacific were members of FTAs. But the perception of any risk was small. They were seen as facilitating reform programs leading to more open economies. Leadership as strong in those areas where FTAs applied was strong, and there was a track record of multilateralisation. Other large economies – Japan and Korea – were committed to the WTO. China had applied to enter the WTO. So the architecture of the region had in effect put in place the disciplines on FTAs which were discussed above.

That situation has now changed. The large economies, not just the US but also China and Japan as well as Korea, Singapore, Australian and New Zealand, are pursuing FTAs. Some of the motivations were reviewed above, including their contribution to domestic and international political targets, the mobilisation of reform and dealing with new types of impediments in order to intensify the trade flows in the region. Meanwhile, the situation in ASEAN in terms of its capacity to reach a consensus on trade policy issues has become problematic. The demonstration effect of the larger economies in the region has been significant, China's initiative being regarded by many as the turning point. While its members might hope otherwise, a hub and spoke outcome in which ASEAN

members make up the spokes, and not the hub, is a plausible scenario, and one of the worst in terms of a regional trading regime.

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

The elements of a risk management strategy include progress in the WTO on liberalisation, new WTO rules on regional agreements, higher levels of transparency, and more work on TIFAs. But, overall, multilateralisation of preferential tariff reductions is the most valuable benchmark in any new set of principles for managing the risks arising from the tactic of trading favours

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