

# The Role of Preferential Trading Arrangements in Asia

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Recently, there has been renewed interest in the formation of Preferential Trading Arrangements (PTAs) in the Asian and Pacific region. Japan and Singapore signed an Economic Partnership Agreement in February 2002. The previous year, Singapore signed a bilateral trade agreement with New Zealand. Japanese policymakers have proposed a Japan-ASEAN Comprehensive Economic Partnership, and an ASEAN-China Free Trade Area was proposed by the People's Republic of China and endorsed by ASEAN's ten leaders in the organization's ministerial meeting in Brunei in October 2001. Also in February 2002, government representatives of 14 Pacific Island nations met and agreed to form a PTA. Most recently, during an Asian tour of the US Trade Representative, several new proposals for bilateral trade agreements emerged from talks with policymakers in the region.

These developments have brought to the fore the question of participation in PTAs by Asian economies and once again raised the question of whether regionally based trading arrangements are beneficial to the region's economies. These developments make it important for policymakers to consider: how the economic effects of PTAs compare with the effects of broader multilateral trading arrangements, and how developments in PTAs influence the current operation of and future progress to expand the membership and coverage of the World Trade Organization (WTO).

### **Pros and Cons of PTAs**

Recent discussions in the financial press concerning trade policy developments and new proposals for PTAs in Asia have raised several of these points as well as other issues. Much of the earlier discussion has tended to emphasize the dangers and negative economic effects of PTAs, but has neglected some potentially beneficial effects that PTAs can have when properly focused and structured. Economic theory provides various rationale for why PTAs may be beneficial or detrimental to the long-term economic interests of members and nonmembers (see, for example, Baldwin and Venables 1995). While empirical estimates are not conclusive, they do tend to show that PTA membership is generally associated with

greater trade flows, both between PTA members and between members and nonmembers (Frankel and Wei 1998, Robinson and Thierfelder 1999, Soloaga and Winters 2001). Estimates also indicate that the effects of PTAs depend crucially upon their particular characteristics.

While much of the academic debate over PTAs refers to PTA archetypes, it is important for policy purposes to look more carefully at the details of the existing arrangements before making general recommendations. Whether PTAs are stumbling blocks or constructive steps to eventual achievement of global free trade depends on the content and background conditions surrounding the formation of PTAs. The *Asian Development Outlook 2002* report (ADB 2002) contributes to this debate by taking an in-depth look at PTAs in the region.<sup>1</sup>

In general, PTAs are not necessarily beneficial or harmful. It is important to consider PTAs both in terms of their narrow economic effects on trade as well as their effects as broader multilateral arrangements capable of addressing a range of cross-border issues. The economic advantages of PTAs stem from the greater ease of dealing with complex issues of trade and regional cooperation among a smaller group of usually neighboring countries (Fruend 2000). For example, the Closer Economic Relations (CER) agreement between Australia and New Zealand was path-breaking in addressing services trade liberalization. Like other forms of trade liberalization, PTAs offer increasing competition in domestic industries that can spur productive efficiency gains among domestic producers and improve the quality or quantity of inputs and goods available in the economy. Producers also benefit from the greater market size created through the PTA, which can expand opportunities for exporting products and lead to employment growth.

PTAs can provide an institutional vehicle for fostering regional cooperation in developing infrastructure and addressing cross-border externalities. Through negotiation of PTAs, developing countries can

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<sup>1</sup>The *Asian Development Outlook 2002* is available on-line through <http://www.adb.org/Documents/Books/ADO/2002/default.asp>

gain experience and experiment with trade liberalization on a limited scale. The commitments to liberalize trade contained in PTAs can provide policymakers an opportunity to commit to future policy reforms or to cement past policy reforms. PTAs can be a forum for improved diplomatic relations and increased nontrade economic integration to foster peace and stability.

Counterbalancing the potential benefits of PTAs are a host of possible negative consequences. There are fears that PTAs provide policymakers reluctant to undertake serious trade liberalization with an easy way out. By entering a PTA without substance in reducing trade barriers, such policymakers can appease domestic pressures pushing for liberalization without significantly liberalizing their trade. There are also dangers that PTAs may augment intra-bloc trade by diverting trade away from nonmember economies. Overlapping international and regional trading arrangements can create a *spaghetti bowl* of complex trade regulations and commitments that are difficult to disentangle and make it difficult to proceed to broader trade liberalization. In a similar vein, PTAs can create complex bureaucratic procedures that generate incentives for rent seeking. This is particularly the case with complex rules of origin that underpin PTAs in which member countries maintain independent external tariffs.

### **PTAs and the Global Multilateral Trading System**

While economists' opinions regarding the effects of PTAs in practice differ sharply, there is consensus in the profession that a global free trading arrangement offers the greatest economic benefits to economies worldwide and that PTAs offer—at best—a less advantageous arrangement. The narrow economic benefits related to the increased trade brought about through PTAs are generally less than the benefits that can be achieved from broader multilateral trading arrangements. Economists point out that nonoptimal patterns of specialization can emerge from PTAs, especially when the composition of country members produce a set of goods that differ greatly from the set of goods available globally. The patterns of specialization in PTAs are not necessarily those that would occur if the country had opened its borders to the world economy, and thus are only *second best*. PTAs generally yield less competition to domestic producers and lower efficiency gains than would be

achieved through broader multilateral trade liberalization. The extent to which a PTA falls short of broader multilateral trade liberalization in enhancing the efficiency of resource use across economies depends crucially upon the composition of member economies and the degree of trade liberalization agreed to in the PTA (Bhagwati and Panagariya 1996). In general, the greater the difference in the comparative advantages of member economies in a PTA and the closer the agreement approaches open trade across members, the greater the economic benefits of the agreement.

### **PTAs, the WTO, or Both?**

Asian nations have historically placed greater emphasis on the pursuit of trade liberalization through the global multilateral trading arrangement rather than through PTAs. While there are a number of PTAs in the Asian and Pacific region (e.g., ASEAN's Asian Free Trade Area or AFTA, and the South Asian Association for Regional Cooperation's South Asian Preferential Trading Arrangement or SAPTA), most of these have political roots and have tended to emphasize broader issues of regional cooperation over concrete actions in trade liberalization (WTO 1995). Japan, until only recently, has favored continued expansion and deepening of the existing multilateral trade arrangement to development of regional trading arrangements. In general, PTAs in the region are less institutionalized than PTAs in other regions, and their tangible efforts in liberalizing member's trade barriers have been more muted—although this is changing, for example, as in current efforts to transform AFTA into a true free trade area. Dispute settlement mechanisms tend to be based on bilateral negotiations, and agreements include few provisions for resolution of disagreements. Much of the implementation of the PTA agreements, such as application of rules of origin, takes place according to commonly agreed standards negotiated between members.

This stance has served the region well and its export-based economies have been able to achieve robust growth and to reduce poverty substantially. Asian economies have been able to take advantage of the positive aspects of PTAs in fostering regional cooperation and addressing shared concerns while avoiding many of the drawbacks. In considering future PTAs in the Asian region, policymakers should remember this experience and focus efforts on

more limited regional or bilateral trading arrangements in areas where they can complement rather than compete with the WTO. In particular, countries should emphasize action in areas where the broader multilateral arrangement has proven slow or ineffective, and in activities to further international or regional cooperation in nontrade areas.

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