A World Trade Organization for the 21st Century

This unique compilation of essays addresses a core political economy question: how do market forces and trade regulation interact? Its fresh Asian perspective offers a much-needed contribution to our understanding of how treaty-based regional and bilateral economic integration is driven by the Factory Asia phenomenon. The authors also compellingly show where the World Trade Organization could fit in. An informative read for scholars and experts alike.

Manfred Elsig, University of Bern, Switzerland

The global financial crisis exposed great shortcomings in the global economic architecture, generating extensive international debate about possible remedies for these deficiencies. Postwar global architecture was guided by major developed economies, centered around the IMF, the GATT, and the World Bank. Today, the balance of economic power is shifting toward emerging economies. Global governance and economic policy must reflect this shift.

The world trading system, led by the World Trade Organization (WTO), is under pressure to evolve and address 21st-century trade issues. Meanwhile, economically salient Asia has built deep supply chains over decades, whilst experimenting with mega-regional trade agreements and economic policies to sustain growth amid a fragile economy. The Asia-led Regional Comprehensive Economic Partnership (RCEP) and the United States-led Trans-Pacific Strategic Economic Partnership (TPP) are competing to set standards for Asia’s trade and supply chains. With contributions from prominent Asian and international trade experts, this book critically examines key changes occurring in the world trading system and explores policy implications for Asia. Lessons from the Asian experience offer new approaches and economic policies to sustain growth, presenting the WTO as forum for action to improve global and regional trade governance in the 21st century.

Policy makers will benefit from the expert knowledge and policy lessons presented in this book, and development economists and researchers will profit from its critical examination of the world trading system. Undergraduate and postgraduate students interested in development, development economics, international development, and related fields will find this essential supplementary reading.

Richard Baldwin is Professor of International Economics at the Graduate Institute of International and Development Studies, Geneva, Switzerland, Masahiro Kawai is Project Professor at the Graduate School of Public Policy, University of Tokyo, Japan and Ganeshan Wignaraja is Director of Research at the Asian Development Bank Institute, Tokyo, Japan.

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A World Trade Organization for the 21st Century
The Asian Perspective
Edited by Richard Baldwin, Masahiro Kawai and Ganeshan Wignaraja

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A World Trade Organization for the 21st Century
The Asian Perspective

Edited by

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Foreword

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

The past few decades witnessed the rapid economic take-off of the region. Asia’s share in world merchandise trade has grown from around 13 percent in 1960 to over 32 percent in 2012. Asia is projected to grow and account for more than half of global gross domestic product (GDP), trade, and investment, and enjoy widespread affluence by the middle of the 21st century.

Trade has played a key role in shaping the transformation of Asian economies in the recent history. Asia is a living example of how trade can contribute to economic development. The trade share of GDP in Asia has grown from 13 percent in 1960 to 60 percent by 2012. During the same period, hundreds of millions of people have been lifted out of poverty. It is my belief that trade will continue to play a defining role for Asia’s future prosperity.

Integration – both regional and global – has been central to Asian prosperity. The share of intra-regional trade in Asia’s merchandise trade has grown from about 20 percent in 1960 to over 50 percent in 2012. Asia’s rapid economic growth owes much to the development of webs of supply chains and production networks, often known as ‘Factory Asia’.

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

There is a debate on the causality between the growing supply chains and the number of free trade agreements (FTAs) in Asia. In fact, Asia is a relative latecomer to FTAs, only increasing its involvement over the past decade, albeit at a dramatic scale. The number of ratified FTAs grew from 36 in 2002 to 113 in the beginning of 2014. The development of supply chains in Asia has been driven by businesses, and it is the FTAs that are catching up with business reality of more trade and investment. The key driver of regional integration through FTAs is to reduce the costs of trading, through the improvement of quantity and quality of infrastructure, the quality of logistics, the quality of institutions and the competitiveness of the economy. As tariffs are generally not a significant barrier anymore, these agreements have increasingly focused on non-tariff trade facilitation measures, both at and behind borders.

The coexistence between FTAs and the multilateral trading system is likely to continue for the foreseeable future. The key is how best to pursue coherence between them. In light of the growing supply chains as the basis for deepening Asia’s regional and global integration, there is a need for a path toward gradual multilateralization: the extension of existing arrangements in a non-discriminatory manner to additional parties. Some recent initiatives to consolidate intra-regional FTAs into a broader regional agreement – such as the Regional Comprehensive Economic Partnership (RCEP) by the Association of Southeast Asian Nations (ASEAN) plus Australia, the People’s Republic of China, India, Japan, the Republic of Korea, and New Zealand (ASEAN+6) members or the tripartite FTA among the People’s Republic of China, Japan, and the Republic of Korea – could be a stepping stone in that direction. It is important, however, that such convergence efforts should not end up in an agreement of the lowest common denominators or a closed agreement.

The case for multilateralization is particularly strong in Asia. First, the idea of ‘open regionalism’ originated in the Asia-Pacific Economic Cooperation (APEC) context in 1996, as an option to extend the benefits of the ASEAN FTA accords to non-members on a most-favored-nation (MFN) basis. While this idea was not formally adopted, APEC economies have embraced it and practice it on a range of products.

Second, Asia is increasingly focusing on inter-regional FTAs, outreach- ing other continents, whether between economies on both sides of the Pacific Ocean or with Europe, in addition to the already existing inter-regional fora such as APEC and the Asia–Europe Meeting (ASEM).

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

Fourth, unilateral trade opening is one form of multilateralization that has been practiced widely as part of domestic reforms. This is especially true in Asia.

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

While some Asian members might be frustrated at slow progress on the Doha Development Agenda negotiations, the adoption of the ‘Bali Package’ at the WTO Ministerial Meeting in December 2013 offers hope for multilateralism. Indeed, there are areas in which the WTO can complement and facilitate the integration efforts back home. For instance, the conclusion of the Trade Facilitation negotiations helps improve regional connectivity by halving logistical and other costs associated with border and customs procedures. Together with regional institutions, the WTO can also ensure that Aid for Trade helps build trade capacity in poorer Asian countries, including capacity to implement a WTO trade facilitation deal. The WTO can also work together with regional institutions to ensure availability and affordability of trade finance, in particular for small and medium-sized enterprises (SMEs).

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

With its significant economic and trade weight in the global economy, Asia is expected to shoulder more responsibilities and take the lead in the global trading system in the future. Its contribution to formulating a post-Bali agenda will be essential. Asia’s successful experience of facilitating Factory Asia can also contribute to the challenges of developing better regulatory convergence in services trade markets, investment rules, and government procurement regimes.
This book, edited by Richard Baldwin, Masahiro Kawai, and Ganeshan Wignaraja, provides a timely analysis of the evolving 21st-century world trading system and the role of the WTO. The chapters in the book examine key changes relating to supply chains and the rules governing trade from an Asian perspective. I believe that they will make a valuable contribution to the debate about how to reform the world trading system and to develop more coherence between multilateral and regional trade rules.

Pascal Lamy
Preface

This study was motivated by uncertainty in the governance of the world trading system and its economic implications for Asia. The negotiating function of the World Trade Organization appears to be malfunctioning and there is little end in sight for the current Doha Development Round after several years of talks. Following the Great Recession, murky non-tariff protectionism remains a risk to trade-led growth. In an uncoordinated manner, a plethora of bilateral free trade agreements are setting new rules for international trade. Large mega-regional arrangements – such as the Regional Comprehensive Economic Partnership and the Trans-Pacific Partnership – are attempting to consolidate and shape such rules into 21st-century trade disciplines. However, the future direction of mega-regional negotiations and their relationship with WTO multilateral trade rules are unclear.

Against this backdrop, the Asian Development Bank Institute in Tokyo and the Centre for Trade and Economic Integration in Geneva jointly organized a conference on 11–12 March 2013 on the Future of the World Trading System: Asian Perspectives. With its successful model of outward-oriented development, Asia has increasingly emerged at the center of gravity of the world economy. The solutions developed in Asia to the ‘noodle bowl’ problem will be of interest to other regions and likely influence the future course of the world trading system.

We gratefully acknowledge valuable comments on the papers provided by session chairs, discussants, and participants at the Geneva conference. Thanks are also due to several individuals who contributed to the preparation of this study: Victor Pontines, Theresa Carpenter, and Maika Oshikawa organized the Geneva conference. Victor Pontines coordinated the preparation of the papers. Robert Davis and Grant Stillman organized publication of the book. Menaka Arudchelvan and Xiaoming Pan provided research assistance.

The opinions expressed in this book are those of the authors and do not represent the views of the Asian Development Bank Institute or the Centre for Trade and Economic Integration.

Richard Baldwin, Masahiro Kawai, and Ganeshan Wignaraja
## Abbreviations

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<th>Full Form</th>
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<td>ASEAN–Australia/New Zealand Free Trade Agreement</td>
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<td>ABMI</td>
<td>Asian Bond Markets Initiative</td>
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<td>ACCSQ</td>
<td>ASEAN Consultative Committee on Standards and Quality</td>
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<td>ACIA</td>
<td>ASEAN Comprehensive Investment Agreement</td>
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<td>ACFTA</td>
<td>ASEAN–PRC Free Trade Agreement</td>
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<td>ACTA</td>
<td>Anti-Counterfeiting Trade Agreement</td>
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<td>ADB</td>
<td>Asian Development Bank</td>
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<td>AEC</td>
<td>ASEAN Economic Community</td>
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<td>AFAS</td>
<td>ASEAN Framework Agreement on Services</td>
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<td>AFTA</td>
<td>ASEAN Free Trade Area</td>
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<td>AHTN</td>
<td>ASEAN Harmonized Tariff Nomenclature</td>
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<td>AIA</td>
<td>ASEAN Investment Area</td>
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<td>AICO</td>
<td>ASEAN Industrial Cooperation</td>
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<td>AIF</td>
<td>ASEAN Infrastructure Fund</td>
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<td>AIFTA</td>
<td>ASEAN–India Free Trade Agreement</td>
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<td>AIOT</td>
<td>Asian International Input–Output Table</td>
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<td>AJCEP</td>
<td>ASEAN–Japan Comprehensive Economic Partnership</td>
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<td>AKFTA</td>
<td>ASEAN–Republic of Korea Free Trade Agreement</td>
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<td>AMRO</td>
<td>ASEAN+3 Macroeconomic Research Office</td>
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<td>AMS</td>
<td>Aggregate Measurement of Support</td>
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<td>AoA</td>
<td>Agreement on Agriculture</td>
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<td>APAEC</td>
<td>ASEAN Plan of Action for Energy Cooperation</td>
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<td>APEC</td>
<td>Asia-Pacific Economic Cooperation</td>
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<td>APL</td>
<td>average propagation length</td>
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<td>APTA</td>
<td>Asia-Pacific Trade Agreement</td>
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<td>ARIC</td>
<td>Asia Regional Integration Center</td>
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<td>ASEAN</td>
<td>Association of Southeast Asian Nations</td>
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<td>ASEAN6</td>
<td>Indonesia, Malaysia, Philippines, Singapore, Thailand, and Viet Nam</td>
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<tr>
<td>ASEAN+3</td>
<td>ASEAN plus the PRC, Japan, and the Republic of Korea</td>
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<tr>
<td>ASEAN+6</td>
<td>ASEAN plus Australia, the PRC, India, Japan, the Republic of Korea, and New Zealand</td>
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<td>ASEM</td>
<td>Asia–Europe Meeting</td>
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<td>Abbreviation</td>
<td>Full Form</td>
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<td>EU</td>
<td>European Union</td>
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<td>FDI</td>
<td>foreign direct investment</td>
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<td>FOB</td>
<td>free on board</td>
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<td>FTA</td>
<td>free trade agreement</td>
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<td>FTAA</td>
<td>Free Trade Area of the Americas</td>
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<td>FTAAE</td>
<td>Free Trade Area of Asia and Europe</td>
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<td>FTAAP</td>
<td>Free Trade Area of the Asia-Pacific</td>
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<td>G20</td>
<td>Group of Twenty</td>
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<td>G33</td>
<td>Group of Thirty-Three</td>
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<td>GATS</td>
<td>General Agreement on Trade in Services</td>
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<td>GATT</td>
<td>General Agreement on Tariffs and Trade</td>
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<td>GCC</td>
<td>Gulf Cooperation Council</td>
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<td>GDP</td>
<td>gross domestic product</td>
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<td>General Exclusion List</td>
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<td>GFC</td>
<td>global financial crisis</td>
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<td>GM</td>
<td>General Motors</td>
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<td>GMS</td>
<td>Greater Mekong Subregion</td>
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<td>GPA</td>
<td>Government Procurement Agreement</td>
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<td>GPN</td>
<td>global production network</td>
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<td>GTA</td>
<td>Global Trade Alert</td>
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<td>GTAP</td>
<td>Global Trade Analysis Project</td>
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<td>GVC</td>
<td>global value chain</td>
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<td>HS</td>
<td>harmonized system</td>
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<td>IADB</td>
<td>Inter-American Development Bank</td>
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<td>IAI</td>
<td>Initiative for ASEAN Integration</td>
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<td>ICSID</td>
<td>International Centre for Settlement of Investment Disputes</td>
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<td>ICTSD</td>
<td>International Centre for Trade and Sustainable Development</td>
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<td>IDE</td>
<td>Institute of Developing Economies</td>
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<td>IDEA</td>
<td>International Digital Economy Agreement</td>
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<td>IIOT</td>
<td>international input–output table</td>
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<td>IL</td>
<td>Inclusion List</td>
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<td>IMF</td>
<td>International Monetary Fund</td>
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<td>IP</td>
<td>intellectual property</td>
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<td>IPFSD</td>
<td>Investment Policy Framework for Sustainable Development</td>
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<td>IPR</td>
<td>intellectual property rights</td>
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<td>ISA</td>
<td>international services agreement</td>
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<td>ISCA</td>
<td>international supply chain agreement</td>
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<td>ISDS</td>
<td>investor–state dispute settlement</td>
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<td>ISI</td>
<td>import-substituting industrialization</td>
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<td>ISO</td>
<td>International Organization for Standardization</td>
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<td>IT</td>
<td>information technology</td>
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<td>ITA</td>
<td>Information Technology Agreement</td>
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<td>ITI</td>
<td>industrialization through innovation</td>
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<td>JETRO</td>
<td>Japan External Trade Organization</td>
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<td>KORUS</td>
<td>Republic of Korea–US Free Trade Agreement</td>
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<td>Lao PDR</td>
<td>Lao People’s Democratic Republic</td>
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<td>LDC</td>
<td>least developed country</td>
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<td>LRP</td>
<td>licensing requirements and procedures</td>
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<td>MA</td>
<td>market access</td>
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<td>MAI</td>
<td>multilateral agreement on investment</td>
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<td>MEA</td>
<td>multilateral environmental agreements</td>
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<td>Mercosur</td>
<td>Southern (American) Common Market</td>
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<td>MFN</td>
<td>most favored nation</td>
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<td>MNC</td>
<td>multinational corporation</td>
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<td>margin of preference</td>
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<td>MRA</td>
<td>mutual recognition arrangement</td>
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<td>NAFTA</td>
<td>North American Free Trade Agreement</td>
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<td>NAMA</td>
<td>non-agricultural market access</td>
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<td>NFTC</td>
<td>National Foreign Trade Council</td>
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<td>NGMA</td>
<td>Negotiating Group on Market Access</td>
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<td>NIE</td>
<td>newly industrialized economy</td>
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<td>NSW</td>
<td>national single window</td>
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<td>NT</td>
<td>national treatment</td>
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<td>NTB</td>
<td>non-tariff barrier</td>
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<td>NTM</td>
<td>non-tariff measures</td>
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<td>OA</td>
<td>office automation</td>
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<td>OECD</td>
<td>Organisation for Economic Co-operation and Development</td>
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<td>OTDS</td>
<td>overall trade distorting domestic support</td>
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<td>P3-CEP</td>
<td>Pacific Three Closer Economic Partnership</td>
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<td>P4</td>
<td>Pacific 4</td>
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<td>PECC</td>
<td>Pacific Economic Cooperation Council</td>
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<td>PFI</td>
<td>Policy Framework for Investment</td>
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<td>PN</td>
<td>production network</td>
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<td>PPP</td>
<td>purchasing power parity</td>
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<td>PRC</td>
<td>People’s Republic of China</td>
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<td>PSR</td>
<td>product specific rule</td>
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<td>PTA</td>
<td>preferential trade agreement</td>
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<td>QRP</td>
<td>qualification requirements and procedures</td>
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<td>R&amp;D</td>
<td>research and development</td>
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<td>RBI</td>
<td>resource-based industrialization</td>
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<td>Abbreviation</td>
<td>Description</td>
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<td>RCEP</td>
<td>Regional Comprehensive Economic Partnership</td>
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<td>ROO</td>
<td>rule of origin</td>
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<td>ROW</td>
<td>rest of the world</td>
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<td>RPT</td>
<td>reasonable period of time</td>
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<td>RTA</td>
<td>regional trade agreement</td>
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<td>RVC</td>
<td>regional value content</td>
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<tr>
<td>S&amp;DT</td>
<td>special and differential treatment</td>
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<td>SAFTA</td>
<td>South Asian Free Trade Agreement</td>
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<tr>
<td>SCM</td>
<td>Agreement on Subsidies and Countervailing Measures</td>
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<tr>
<td>SDT</td>
<td>special and differential treatment</td>
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<tr>
<td>SL</td>
<td>Sensitive List</td>
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<tr>
<td>SMEs</td>
<td>small and medium-sized enterprises</td>
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<tr>
<td>SOE</td>
<td>state-owned enterprise</td>
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<tr>
<td>SPR</td>
<td>specific process rule</td>
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<td>SPS</td>
<td>sanitary and phytosanitary standards</td>
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<td>SSM</td>
<td>special safeguard mechanism</td>
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<td>TAP</td>
<td>Trans-Atlantic Partnership</td>
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<td>TBT</td>
<td>technical barriers to trade</td>
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<td>TEL</td>
<td>Temporary Exclusion List</td>
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<td>TPP</td>
<td>Trans-Pacific Strategic Economic Partnership</td>
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<td>TPPA</td>
<td>Trans-Pacific Partnership Agreement</td>
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<td>TRIMs</td>
<td>trade-related investment measures</td>
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<td>TRIPs</td>
<td>trade-related intellectual property rights</td>
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<td>TS</td>
<td>technical standards</td>
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<td>TTIP</td>
<td>Transatlantic Trade and Investment Partnership</td>
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<td>UN</td>
<td>United Nations</td>
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<td>UNCITRAL</td>
<td>United Nations Commission on International Trade Law</td>
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<td>UNCTAD</td>
<td>United Nations Conference on Trade and Development</td>
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<tr>
<td>UN ESCAP</td>
<td>United Nations Economic and Social Commission for Asia and the Pacific</td>
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<td>US</td>
<td>United States</td>
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<tr>
<td>VAX</td>
<td>value-added export</td>
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<td>VS</td>
<td>vertical specialization</td>
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<tr>
<td>WGTI</td>
<td>Working Group on the Relationship between Trade and Investment</td>
</tr>
<tr>
<td>WIOD</td>
<td>World Input–Output Database</td>
</tr>
<tr>
<td>WO</td>
<td>wholly obtained or produced</td>
</tr>
<tr>
<td>WTO</td>
<td>World Trade Organization</td>
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1. Introduction and overview

Richard Baldwin, Masahiro Kawai and Ganeshan Wignaraja

1.1 AIM OF THE BOOK

The 1995 creation of the World Trade Organization – as an institutional extension of the General Agreement on Tariffs and Trade (GATT) – held out the promise of an effective, rules-based world trading system where all countries were treated alike. In addition to establishing a global judiciary for trade disputes, the WTO was expected to provide a forum for trade negotiations and undertake other related functions. Progress on the judiciary side has been brilliant, but the negotiation promise is largely unfulfilled (Hoekman and Kostewei 2010).

The world trading system is in a state of flux characterized by new developments and uncertainties about global trade governance under the WTO. Fundamental changes are occurring because of the rise of emerging economies (such as Brazil, Russian Federation, India, People’s Republic of China, and South Africa – the BRICS), the expansion of international production networks and supply chains, signs of new commercial and industrial policies, and the proliferation of free trade agreements globally. These developments are all here to stay but the WTO has not kept up with them. Furthermore, the WTO Doha Round has been going on for more than a decade. Despite being the longest multilateral trade talks in history, it shows little sign of concluding comprehensively anytime soon. The WTO’s centricity in global trade governance is eroding and risks continuing to erode.

The profound nature of these developments has prompted a debate on the future shape of the world trading system and the rules governing trade (Hufbauer and Cimino 2013; Trebilcock 2014; WTO 2013). The chapters in this book, written by leading Asian and international trade experts, conduct a broad and comprehensive examination of key changes taking place in the world trading system and traces policy implications for Asia. The links among global production networks and supply chains, national commercial and industrial policies, and the governance of global and
regional trade are also explored in the book. Also, the book offers lessons for other regions.

The chapters cover several specific issues:

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

Given Asia’s economic importance in the world economy, how it thinks and acts on these issues will likely influence the future shape of the global trading system. As the former Director-General of the WTO, Pascal Lamy, writes in the Foreword to this book:

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

With its significant economic and trade weight in the global economy, Asia is expected to shoulder more responsibilities and take the lead in the global trading system in the future.

This book is timely. Roberto Azevedo became the new Director-General of the WTO in May 2013 and began to facilitate intense negotiations among WTO members on the Doha agenda. At the 9th WTO Ministerial Conference in Bali, in December 2013, WTO members agreed on a set of issues covering trade facilitation, agricultural subsidies, and cotton, as well as development and least developed country issues. The so-called ‘Bali package’ is the first tangible result from the Doha Round since it was launched in December 2001 and has given multilateralism a small boost. However, uncertainties remain in multilateral trade negotiations on wider issues under the WTO. The Bali package is only distantly related to the core of the 2001 Doha negotiating agenda. Furthermore, what little of the original Doha agenda that could be done was done in Bali. This suggests that the WTO risks drifting for the foreseeable future, and WTO centricity in world trade governance may continue to erode.

The chapters in this book arose from a conference on the future of the world trading system held at the WTO in Geneva in March 2013 organized by the Asian Development Bank Institute and the Centre for Trade
and Economic Integration at the Graduate Institute of International and Development Studies, in collaboration with the WTO. Summaries of these chapters, along with pieces by other trade experts, were published in a VoxEU e-book (Baldwin et al. 2013).

1.2 GLOBAL PRODUCTION NETWORKS AND SUPPLY CHAINS

One important factor underlying the growth of trade and investment, and the resulting regional economic integration in Asia, is the formation of global production networks and supply chains, particularly the growth of vertical intra-industry trade in parts, components, other intermediate goods, and finished manufactured products (OECD, WTO, and UNCTAD 2013). The increasing share of Asia’s trade in intermediate goods has been aided with improvements in physical infrastructure and logistics services, rapid developments of information and communication technology, and falls in trade barriers and trade costs, all of which have helped expand trade and foreign direct investment.

As Richard Baldwin notes in Chapter 2 entitled ‘WTO 2.0: governance of global supply-chain trade’, the formation of global production networks and supply chains has changed the center of gravity of the world economy. Globalization since the 1990s has been accompanied by a steep rise in shares of world output and world trade of developing countries that have achieved industrialization by joining supply chains. The major gainers were Asia’s emerging economies – including the People’s Republic of China (PRC), Indonesia, the Republic of Korea, and Thailand – which were part of supply chains of the United States, Germany, and Japan. The chapter argues that the WTO has not kept up with the need for new rules governing the intertwining of trade, investment, intellectual property, and services. Bringing these rules to the multilateral level needs the creation of a new international organization: a ‘WTO 2.0’.

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

Better trade policy-making in this context requires more accurate data, using innovative measurement of trade flows based on value added, rather than gross commercial values as recorded in conventional trade statistics,
to identify the national content of imports and exports. Recent work (e.g., Koopman et al. 2014) suggests an accounting framework that decomposes national gross exports into various value-added components by source and additional double-counted terms. In Chapter 3, entitled ‘Trade in value added: concept, development, and an East Asian perspective’, Satoshi Inomata argues that the recent Asian International Input–Output Table facilitates the mapping of patterns of trade in value added between countries engaged in global production sharing arrangements. Among other benefits, the trade in value added approach avoids multiple counting of trade flows and allows a more realistic depiction of bilateral trade in the light of global production sharing. The trade in value added approach provides fresh insights on thorny international issues like the size of the United States’ trade deficit with the PRC. The chapter points out that using the trade in value added approach, the United States’ trade deficit with PRC is lower than conventional trade statistics show.

Furthermore, better trade policy-making also requires the use of micro-level data from enterprise surveys to understand the role of different firms in production networks. Firms are considered different in terms of efficiency as well as fixed and variable costs when involved in production networks. Accordingly, firm heterogeneity (or firm-specific characteristics) shapes the participation in production networks. In Chapter 4, entitled ‘Joining the supply chain: a firm-level perspective’, Ganeshan Wignaraja undertakes a comparative, firm-level analysis of joining the supply chain in five Southeast Asian economies to improve our understanding of fragmentation of manufacturing across borders in Asia. He suggests that firm size (reflecting economies of scale to overcome entry costs) matters for joining supply chains, with large firms playing the dominant role in Asia. Meanwhile, small and medium-sized enterprises make a small contribution to supply-chain activity relative to the sector’s employment or GDP contribution in Southeast Asian economies. However, firm size is not the whole story. Efficiency – particularly investment in building technological capabilities and skills – and access to commercial bank credit also influence joining supply chains. The chapter suggests that governments can facilitate SMEs joining supply chains through a market-oriented strategy for SMEs, modern physical infrastructure, streamlined bureaucratic procedures, and good quality business support services.

1.3 COMMERCIAL AND INDUSTRIAL POLICIES

Several factors have been critical in Asia’s successful outward-oriented industrialization and structural transformation. A favorable world
Introduction and overview

5

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

As participation in global value chains is increasingly prevalent in Asia, there is growing interest in how the benefits from participation are distributed among countries and enterprises. At the national level this is related to the pursuit of development objectives such as poverty reduction, job creation, better productivity, technological upgrading, and economic diversification. Some economies have added industrial policies – with a plethora of incentives to encourage specific industrial sectors or particular geographical locations – to their outward-oriented policy framework. Patrick Low and Julia Tijaja, in Chapter 5 entitled ‘Effective industrial policies and global value chains’, examine a variety of approaches to industrial policy. They suggest that some are more promising than others in the context of global value chains. The size of domestic markets, resource endowments and country-specific circumstances are crucial to determining opportunities. Furthermore, the chapter argues that implementation of industrial policy carries the risk of government failure which may be mitigated by developing solid government capabilities (technical, analytical, and operational) and forging close relations with the private sector and non-state actors.

Since the global financial crisis of 2008, protectionist tendencies have been on the rise in some economies including within Asia. In Chapter 6, entitled ‘Mapping crisis-era protectionism in the Asia and Pacific region’, Simon J. Evenett argues that while there are many ways to implement protectionism, several governments have implemented what are called ‘murky forms of protection’. These do not involve a direct violation of WTO obligations, but represent an abuse of the policy discretion that discriminates against foreign goods, services, firms, and workers. Examples include the use of health and safety regulations to restrict imports, export taxes on
native food and resources to keep them at home, clauses in stimulus packages that confine spending to domestically produced goods and services, and ‘green protectionism’ that subsidizes domestic firms only. The implications of these measures for trade policy are clear. As the world economy recovers, policy makers should resist temptations for protectionism and unwind these discriminatory measures. In the medium to long term, the chapter argues that policy makers may wish to initiate negotiations on new rules on public procurement, export taxes, and other less-transparent forms of protection.

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

The international monetary system needs to facilitate the free flow of international goods and services and cross-border investment. The system must be supported by stable exchange rates consistent with the underlying fundamental economic conditions. Policies to maintain undervalued exchange rates over an extended period can, like tariffs and trade subsidies, distort trade by making the country’s exports artificially competitive and imports less attractive. Countries are advised to avoid such trade-distorting exchange rate policies as they have negative consequences not only for the trading partners but ultimately for the countries concerned. In Chapter 7, entitled ‘Exchange rate policy and regional trade agreements: a case of conflicted interests?’, Victor Pontines and Richard Pomfret argue that formation of a large number of FTAs in Asia means that trade policy is less effective than in the past and countries are tending to use exchange rate policy more. Within FTA blocs, countries are tending toward exchange rate stability. However, some countries even within FTA blocs are using exchange rate depreciation as a beggar-thy-neighbor form of exchange rate protectionism. The chapter suggests that this is harmful to others and implies the need for some coordination and monitoring mechanism within FTA blocs.
1.4 REGIONAL TRADE GOVERNANCE

Regional trade governance has become an increasingly important issue in the world trading system in recent years. Free trade agreements are spreading globally, including in Asia. Many Asian economies have embarked on FTA negotiations with their trading partners, both within Asia and outside. The move toward FTAs in Asia is linked to the need to remove impediments to broadening the spread of global and regional supply chains, the intensification of FTA activity in Europe and the Americas, and slow progress in the WTO Doha Round trade talks. Today, Asia is a world leader in FTAs. This has sparked concerns (for example, Bhagwati 2008) about the erosion of the WTO trading system and the Asian ‘noodle bowl’ (multiple and possibly conflicting FTAs).

In Chapter 8, entitled ‘Policy challenges posed by Asian free trade agreements: a review of the evidence’, Masahiro Kawai and Ganeshan Wignaraja review patterns of FTAs in Asia and examine key policy challenges faced by Asian economies. They argue that maximizing the benefits of Asian FTAs while minimizing their costs would be highly pragmatic as FTAs seem here to stay. These challenges include their use, scope, and impact on regionalization trends. This analysis supports strengthening business support for FTAs, rationalizing rules of origin and upgrading their administration, expanding coverage of agricultural and services trade, forging comprehensive ‘WTO-plus’ agreements, and encouraging a region-wide FTA. The chapter suggests a bottom–up approach to global trade liberalization as a complement to WTO processes. Kawai and Wignaraja argue for the consolidation of multiple FTAs into a single Asia-wide FTA starting with the Regional Comprehensive Economic Partnership. A broad-based, region-wide FTA to be formed by 16 East Asian countries could help mitigate the harmful noodle bowl effects. It could simplify schedules for tariff reductions, exclusion lists, and the myriad rules, regulations, and standards.

Shujiro Urata, in Chapter 9 entitled ‘Constructing and multilateralizing the Regional Comprehensive Economic Partnership: an Asian perspective’, examines the patterns of commitments in trade liberalization in goods in ASEAN’s FTAs with major regional economies and points out that the construction of the RCEP within a short period of time may be difficult because of differences in patterns of tariff elimination and definitions of rules of origin adopted in such agreements. The chapter argues that a practical way forward for trade liberalization under the RCEP is for a gradual approach in tariff elimination and a co-equal approach in rules of origin.

ASEAN – viewed as the driver of the process of regional economic
integration in Asia – embarked on an ambitious project to form an ASEAN Economic Community (AEC) by 2015 including a single market and production base. In Chapter 10, entitled ‘The ASEAN Economic Community: progress, challenges, and prospects’, Siow Yue Chia assesses ASEAN’s efforts at achieving an ASEAN Economic Community by the desired target of 2015. Encouragingly, intra-ASEAN tariffs have been virtually eliminated and trade facilitation improved which have resulted in the growth of intra-ASEAN and extra-ASEAN trade. Furthermore, the ASEAN Comprehensive Investment Agreement was ratified in 2012 and may spur inward investment. Nonetheless, further progress is needed in other areas such as eliminating non-tariff barriers and liberalizing restrictions on services trade. The chapter concludes that there is general acceptance in ASEAN policy circles that the achievement of the AEC project will extend beyond 2015 as residual measures will take time to implement.

Some question whether ASEAN centrality in driving Asian regional integration will persist in the future in a changing trade policy landscape in Asia. The emergence of an alternative mega regional integration scheme, the Trans-Pacific Strategic Economic Partnership (TPP), may have raised concerns, at least among some experts, about the future relevance of ASEAN centrality and also the prospect of a future clash between the TPP and the RCEP.

However, those concerns can be addressed squarely. By focusing on the creation of the AEC and undertaking the needed domestic structural reforms, ASEAN can retain its centrality. Countries which are negotiating members of both the RCEP and the TPP – such as Japan, Singapore, and Malaysia – can ensure that the two initiatives are consistent with each other and are open to new membership. The RCEP and the TPP are key processes to create a larger Asia-Pacific FTA, which would require successfully addressing the difficult task of forging a US–PRC agreement in the future. The two processes are not mutually exclusive and will likely prove to be complementary. A harmonious Asia-Pacific would likely see a convergence of the RCEP and the TPP. This would be a win–win outcome for the Asia-Pacific community.

1.5 GLOBAL TRADE GOVERNANCE

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

Biswajit Dhar, in Chapter 11 entitled ‘The future of the World Trade Organization’, assesses prospects for the Doha Round and the future work program for the WTO. The focus of the negotiations, which commenced in November 2001, was lower trade barriers in agriculture and non-agricultural market access (NAMA). The talks stalled in 2008 largely over a divide on major issues such as agricultural subsidies, industrial tariffs and non-tariff barriers. Furthermore, some key players seem to have been preoccupied with domestic economic issues since the economic downturn after the global financial crisis and have given less attention to the trade talks. The chapter points to two challenges for the future. One challenge faced by the global community is to assess the key developments in the Doha Round which have contributed to the present stalemate. Another is to develop a new program for the WTO to tackle behind-the-border issues relevant to fragmented production systems and supply chains particularly, trade facilitation, investment policy, and non-tariff barriers.

The narrow negotiating agenda and slow progress of the WTO Doha Round may be partly due to the nature of the WTO’s decision-making mechanism and its underlying principles of consensus and single undertaking. Michitaka Nakatomi, in Chapter 12 entitled ‘Plurilateral agreements: a viable alternative to the World Trade Organization?’, explores the role of plurilateral agreements which focus on rule making and liberalization on single trade issues. An example is the Information Technology Agreement (ITA) with an open accession clause. Plurilateral agreements permit interested parties to freely choose the issue for an agreement and voluntarily participate in the negotiations. The chapter argues that well-designed issue-based plurilateral agreements can serve the needs of like-minded developed and developing countries alike, enhance the spread of FDI-driven global supply chains, and complement rule-making in the WTO and FTAs. Services, trade facilitation, and electronic commerce may be candidates for future issue-based plurilateral agreements.

Foreign direct investment flows are fundamental to the spread of global production networks but, while barriers to goods trade have typically fallen over past decades, barriers to FDI remain high including in Asia. Apart from the usual issues relating to non-national treatment of foreign firms, protectionist tendencies and national security considerations seem
to be driving new restrictions on FDI. Yunling Zhang and Rongyan Wang, in Chapter 13 entitled ‘The role of foreign direct investment flows and a possible multilateral agreement’, discuss the importance of FDI to sustaining global growth, the conditions generating new restrictiveness on FDI, and policy options. New Asian FTAs emphasize national treatment of FDI and more liberal FDI rules, and international organizations have developed good practice guidelines for FDI, but this seems insufficient. According to the analysis in the chapter, a case emerges for an eventual multilateral agreement on investment covering transparency on investment rules and investor facilitation, ideally housed in the WTO.

1.6 CONCLUSIONS

The world trading system has changed fundamentally over past years with the expansion of production network and supply-chain trade, adoption of new commercial and industrial policies, and the spread of FTA-led regionalism. These developments are all likely to stay but the WTO has not adjusted to cope with them. The WTO’s centricity in global trade governance is eroding and risks continuing to erode. The rise of Factory Asia through supply-chain trade has placed it increasingly at the heart of the global economy. The region is also experimenting with new approaches to FTAs and economic policies to sustain economic growth amid a fragile world economy.

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

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

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


2. WTO 2.0: governance of global supply-chain trade

Richard Baldwin

2.1 INTRODUCTION

The cross-border flows of goods, investment, services, know-how, and people associated with international production networks – call it ‘supply-chain trade’ for short – has transformed the world. The WTO has not kept pace. This chapter argues that adapting world trade governance to the realities of supply-chain trade will require a new organization: a WTO 2.0 as it were.

The argument for a new organization boils down to profound differences between supply-chain trade and traditional trade:

Traditional trade means selling into one nation goods that were made in another nation; traditional trade is thus mostly about selling things internationally.

Supply-chain trade is much more complex and much more asymmetric.

Supply-chain trade arises when high-tech firms combine their know-how with low-wage labor in developing nations; supply-chain is thus mostly about making things internationally, although international selling is also important.

Today’s WTO is crafted to facilitate traditional trade – its nature, membership, and rules are designed to support international selling. Supply-chain trade, by contrast, enjoys little or no global regulation. This ‘21st century international commerce’ is currently underpinned by an ad hoc combination of regional trade agreements (RTAs), bilateral investment treaties (BITs), and unilateral reforms by developing nations. But supply-chain governance is evolving rapidly.

Advanced-technology nations, especially the US, are leading efforts to knit together the ad hoc governance into ‘mega-regionals’, such as the TPP
and the Trans-Atlantic Partnership (TAP), and mega-bilaterals, such as EU–Canada, Japan–EU, and so on.

- The mega-regionals and mega-bilaterals may be in place within a few years – at which point global trade governance will be marked by fragmentation and exclusion.
- On current trajectory, the new trade giants – the PRC, India, and Brazil – will end up outside this governance superstructure.

The most natural means of avoiding the emergent fragmentation and exclusion would be to multilateralize regional supply-chain disciplines into the WTO. This chapter argues that the WTO does not seem well suited to the task. First, the WTO seems incapable of getting beyond the Doha negotiations, and incapable of addressing supply-chain governance until it does. Second, the nature of the supply-chain governance calls for a very different organization. It seems impossible to re-craft the existing WTO in a way that would allow it to facilitate cooperation on both traditional trade and supply-chain trade.

2.1.1 Thinking Ahead on International Trade

Much of this chapter is based on judgments over which reasonable people can disagree. One point is clear, however, the WTO’s centricity in global trade governance is eroding and will continue to erode. Multilateralism will continue to reign when it comes to traditional trade. Fragmentation and exclusion, however, are the most likely outcomes when it comes to the most dynamic segment of international commerce – supply-chain trade.

This two-pillar system may well end up as the ‘new normal’ – with (1) a coherent WTO 1.0 governing traditional trade, and (2) a fragmented and exclusionary system of mega-regionals governing supply-chain trade. The PRC and other large emerging markets may be big enough to counter the exclusion – using the size of their internal markets as a lever to force high-technology firms to offshore factories and technology even without embracing the disciplines smaller developing nations have adopted in the mega-regionals.

This new normal, however, would hardly be the best the world can do. Worse yet, a fragmented world dominated by Great-Power struggles could lead to the steady erosion of the WTO’s centricity with respect to traditional trade. That erosion sooner or later would bring the system to a tipping point – beyond which expectations become unmoored and nations feel justified in ignoring WTO rules on traditional trade since everyone else does.
The chapter is organized in six sections. The next two sections discuss, in sequence, how globalization’s second unbundling transformed globalization and the political economy of trade liberalization, but the WTO failed to respond. Sections 2.4 and 2.5, the heart of the chapter, use the new logic of supply-chain trade to suggest what WTO 2.0 should look like in terms of areas covered, membership, and special and differential treatment. The final section presents the concluding remarks.

2.2 GLOBALIZATION CHANGED

Today’s globalization really is different. This section presents the prima facie case (see Baldwin 2013).

Up to the end of the 1980s, globalization was associated with rising G7 shares of world trade and income, and a gentle slide in its manufacturing share. Afterwards, globalization worked very differently. As supply-chain trade took off between high-technology and low-wage nations in the 1980s and 1990s, G7 world shares of income and exports plummeted while declines in G7 manufacturing shares accelerated (despite steady manufacturing growth globally) (see Figure 2.1). At about the same time, a handful of developing nations saw their share of global manufacturing output soar.

2.2.1 International Commerce Changed

At about the same time, international commerce changed. While supply-chain trade among rich nations has long been important (US–Canada and intra-EU), from the late 1980s it boomed between high-technology and low-wage nations. Figure 2.2 illustrates the timing with two proxies for supply-chain trade – a ‘vertical specialization’ index and partner-wise intra-industry trade indices. These changes have been widely noted.3

The precise measure we use is the share of, say, Canadian exports to the US that are made up of intermediates that Canada previously imported from the US. This percentage measures the share of the bilateral flow from Canada to the US that is actually the US reimporting its own intermediates. United States re-exports are the share of US exports to Canada made up of Canadian intermediates that the US had previously imported.

Figure 2.3 shows how North American re-exporting/reimporting relationships changed between 1995 and 2008. United States–Canada supply-chain trade had been common since the 1965 US–Canada Auto Pact, so little changed here between 1995 and 2008. The radical change involved Mexico. This North–South offshoring, and the reimporting/re-exporting it sparked, increased enormously. The US started reimporting its own
Sources: WTO, World Bank and Maddison, UNstats.

Figure 2.1 G7 post-war shares of world income, trade and manufacturing
intermediaries from a much wider range of partners including the PRC and Indonesia. The changes for Mexico are even starker. In 1995, Mexico’s re-exports to the US were a minor story; re-exports to others were non-existent. By 2008, re-exports had boomed with the US and Mexico joined the supply chains of the PRC, the Republic of Korea, Germany, and Japan.

The offshoring revolution has also created what could be called Factory Europe – mostly around Germany. The pattern of reimporting/re-exporting among a high-technology hub and low-wage spoke nations is similar to that of North America. In 1995, Germany was doing a lot of reimporting but mostly with other advanced technology nations. By 2009, the two-way flows had blossomed between Germany and its low-wage neighbors, especially Poland and the Czech Republic.

The change for the PRC has been even more spectacular. In 1995, the PRC did a little reimporting and re-exporting for Japan. By 2008, Chinese-based manufacturers were deeply involved in the supply chains of a wide range of partners, including several natural resource exporters and other emerging economies.

This global trend toward greater internationalization of supply chains cuts across all industries but is far more advanced in some sectors (Figure 2.4). The bars show final goods’ share of world production in the

Figure 2.3 Reimports and re-exports in Factory North America: United States, Canada, and Mexico
Figure 2.3 (continued)
Governance of global supply-chain trade

listed sectors (the rest being produced for intermediate goods). For some product categories, like food or footwear, almost 70 percent of production is for final consumption; these are the traditional trade sectors. At the other extreme, classic raw materials such as fuel and mining products are mostly sold as intermediates but there is nothing new here. What is new is the big supply-chain trade flows in sectors such as transport equipment, electrical and optical equipment, and chemicals. Figure 2.4 also shows that the final-good shares have retreated in all sectors as supply chains have internationalized. Note that if every stage of production is done in a single factory, the final share would be 100 percent; as the production process unbundles, the final share falls whether the unbundled stages are offshored or not.

2.2.2 Supply-chain Trade is More Regionalized

All trade is quite regionalized, but supply-chain trade even more so. The key points are that (1) supply-chain trade is not global – it is regional, and (2) the global production network is marked by regional blocs, that could be called Factory Asia, Factory North America, and Factory Europe. Supply-chain trade is also marked by a hub-and-spoke pattern around the four manufacturing giants – the PRC, Germany, Japan, and the US. This can be most easily seen in North America where the sales and sourcing


Figure 2.4 Final-good share of production and world export shares by sector
flows with the US are all large, but those between Mexico and Canada are small (Figure 2.5). The same holds for Germany (its row and column are rather full especially in Europe).

A key distinction that we return to repeatedly below is the technological asymmetry in international production networks, namely ‘headquarter economies’ and ‘factory economies’. Firms in headquarter economies (basically the US, Japan, and Germany, with the possible inclusion of Taipei, China and the Republic of Korea) orchestrate the production networks directly or indirectly, while factory economies seek to attract the offshored jobs and investment. The Republic of Korea seems to have transitioned between the two categories in the last decade or so.

2.2.2.1 Why the changes? Globalization’s second unbundling
How are all these changes connected? The basic idea is simple. The rise of international production networks from 1985 or so (sometimes called globalization’s second unbundling) involved North–South production sharing. To ensure North and South production stages jived seamlessly, rich-nation firms brought all the missing know-how when moving production stages to developing nations. This combination of high-technology and low wages benefited rich-nation firms because it boosted the value of their firm-specific assets. It benefited developing nations because it removed many bottlenecks that had previously stymied industrialization in all but a handful of developing nations.

In short, globalization’s second unbundling is as much a story of heightened international mobility of know-how as it is a story of heightened trade in parts and components. No wonder its impact on global income shares is so different and so momentous.

2.3 INTERNATIONAL TRADE POLITICS CHANGED

At about the same time, say the late 1980s, the political economy of trade liberalization was turned on its head – and global trade governance started to shift. The internationalization of supply chains transformed policy in two fundamental ways:

- It created new political-economy ‘supply’ and ‘demand’ for openness.
- It created a bond among various strands of policy – some of which had previously been viewed as purely domestic; trade policy, in a nutshell, became a ‘package’.

Consider the two transformations in turn.
Notes: Bilateral purchases of intermediates by row economy from column economy as percentage of all I2P flows in World Input-Output Database (WIOD); flows under 0.3 percent set to zero.

Source: Adapted from Baldwin and Lopez-Gonzales (2012).

Figure 2.5 The global supply-chain matrix, 2009
A World Trade Organization for the 21st century

2.3.1 Domestic Trade Politics Changed: Joining a Supply Chain

From the late 1980s, openness that facilitated international production sharing was suddenly embraced by developing nations – including many who had eschewed all liberalization for decades. As Figure 2.6 shows, they:

- slashed tariffs unilaterally (left panel);
- signed BITs, which are mostly unilateral concessions to rich-nation firms seeking to invest (middle panel); and
- signed a massive wave of RTAs with ‘deep’ provisions that are pro-supply-chain, for example, assurances for intellectual property, capital movements, competition policy, business visas, and so on (right panel).

Importantly, this is not the 1970s and 1980s view of trade openness embraced by Singapore, Taipei, China, and Hong Kong, China (lower tariffs, fewer quotas, and so on). This liberalization wave included many...
measures traditionally viewed as purely domestic since joining a supply chain meant a much more thorough integration of the developing nation’s economy with that of the headquarter nation directing the supply chain. International supply chains are at the heart of this transformation of developing nation domestic politics.

- The new ‘supply’ of reform came from developing nation governments seeking to industrialize by joining international supply chains.
- The new ‘demand’ for reform came from headquarter-economy firms seeking to raise the return on their firm specific know-how by combining high-technology with low wages in developing nations.

In short, production unbundling created a new type of win–win situation in international commerce. The old type was ‘my market for yours’. The new type is ‘my factories for your reform’.

2.3.2 Trade Governance Changed

The regionalization, complexity, and interconnectedness of supply-chain trade naturally shifted world trade governance toward regionalism. There was nothing new in this.

Supply-chain trade first boomed in the 1960s but then it was North–North. The simple GATT 1947 rules that were designed to underpin international selling were not sufficient to underpin the complex cross-border flows linked to the supply chains that arose among rich nations in the 1960s and 1970s. Since the trade was regional rather than multilateral and focused on autos, the deeper disciplines underpinning US-centered production sharing were negotiated in the 1965 US–Canada Auto Pact. The deeper rules underpinning European production sharing were placed in the European Economic Community’s (EEC’s) Common Market. The only other manufacturing giant at the time, Japan, did very little production sharing and so it had no need for deeper disciplines.

The history lessons are twofold. First, complex cross-border flows demand complex rules. Since most supply-chain trade is regional, there is a strong tendency to establish the necessary rules regionally rather multilaterally. Second, while multilateral rules would almost surely have been more efficient, negotiating them in the GATT would have been too cumbersome and slow because most GATT members at the time were not involved in this type of international commerce.

Moving forward to the rise of North–South production sharing, the same reaction is seen but with a twist. Since property rights of all sorts
tend to be more precarious in developing nations, the necessary disciplines focus heavily on tangible and intangible property rights. Specifically, North–South supply-chain trade creates a need for two types of disciplines corresponding to the two elements of supply-chain trade:

- producing abroad; and
- coordinating internationally dispersed production facilities.

The former requires heightened tangible and intangible property assurances. The latter requires assurances of unhindered two-way flow of goods, services, people, and capital. In the world of supply-chain trade these assurances are a package. For example, any threat to property rights or cross-border flows is, de facto, a barrier to supply-chain trade. A developing nation that cannot commit to the whole package is unlikely to see supply-chain trade take-off. (The PRC and India with their enormous internal markets are in a somewhat special class.) Section 2.5 enumerates the items in a typical ‘package’.

2.3.3 The WTO Did Not Change

How did the WTO change while globalization changed, trade changed, trade politics changed, and trade governance changed? The answer is simple: it changed very little. The last time multilateral trade rules were updated, Bill Clinton was in his first term of office, e-mail was for computer scientists only, cell phones looked like bricks, and calling costs were measured in dollars per minute. Apart from a few useful initiatives in 1997 (for example, the ITA), the WTO has made only very limited progress toward adjusting to the new world of supply-chain trade. The ongoing multilateral talks (Doha Round) have focused almost exclusively on 20th century trade issues – tariffs, agricultural subsidies, and so on.

It seems clear that the Doha Round will not finish in this decade. The mini-package agreed at the Bali Ministerial in 2013 was in no way a conclusion since it avoided that vast majority of issues that are in the 2001 Doha agenda.

Without a conclusion to the Doha Round, it seems politically impossible for the WTO to move on to new issues, that is, to address the deeper disciplines needed to underpin supply-chain trade. The reason is that few WTO members have a significant stake in supply-chain trade and many have a stake in settling market access and agriculture issues. The latter fear that talk of ‘new issues’ is another way for rich nations to (once again) avoid opening their markets to the goods in which developing nations have their comparative advantage.
Instead, these supply-chain trade rules have been and continue to be written outside the WTO. The supply-chain governance gap is being filled by uncoordinated developments in deep regional trade agreements, bilateral investment treaties, and autonomous reforms in emerging economies. In particular, the existing deep RTAs signed by the big outsourcing nations – especially the US, Japan, and the EU – have set a template for the sort of disciplines that seem necessary. Mega-regionals like TPP and Trans-Atlantic Trade and Investment Partnership (TTIP) are trying to harmonize the rules across a broad range of nations. Even if TPP ultimately fails or slips into limbo, the TPP negotiations have already strongly conditioned the shape of harmonized rules that will eventually emerge.

In a nutshell, this reasoning suggests that:

- harmonized rules on deeper disciplines linked to supply-chain trade are likely to be written by the end of this decade;
- the rules are likely to be harmonized in mega-regionals; and
- the WTO will have no part in this rule-writing.

So what is the future of the WTO?

2.4 THE WTO’S FUTURE

Looking forward, two background facts are important to keep in mind.

1. When it comes to traditional trade, that is, the international selling of goods, the WTO is in excellent health.

The basic WTO rules for this sort of ‘20th century trade’ are almost universally respected. The WTO’s court decisions are almost universally complied with in letter (if not always in spirit). Nations – even big nations like the Russian Federation – seem willing to pay a high political price to join the organization. Where the WTO’s future seems cloudy is on the supply-chain trade front.

2. The status quo that is comfortable for key WTO members will, on current trajectory, be gone in a few years; mega-regionals will have transformed world trade governance.

The mega-regionals will have established global trade governance on the most dynamic segment of world trade – the segment that is most critical to today’s industrialization of developing nations, that is, supply-chain trade.
As such, these mega-regionals will, de facto, become major pillars of world trade governance.

This prospective ‘second-pillar’ of trade governance is likely to exclude the largest emerging markets, most importantly, the world’s largest exporter, the PRC. In response, Asian nations have launched their own mega-regional initiatives, but the political landing zone for these initiatives is seriously narrowed by well-known industrial and political tensions. At the very least, the future of mega-Asian arrangements is much less clear than it is for the TPP, the TTIP, and the mega-bilaterals (EU–Canada, Japan–EU, and Japan–Canada). In any case, the global trade governance system is on a course for fragmentation by the end of the decade. The successful conclusion of other mega-regionals that include the Asian giants will diminish exclusions but magnify fragmentation.

The implications are clear:

The WTO’s future will either be to stay on the 20th century trade sidetrack on to which it has been shunted, or to engage constructively and creatively in the new range of disciplines necessary to underpin supply-chain trade.

The only way to avoid this governance fragmentation would be to move the deeper disciplines into the WTO. This, however, would require a new structure – a WTO 2.0 as it were. The reason has to do with politics and broken status quos.

### 2.4.1 WTO 2.0

If the mega-regionals and mega-bilaterals being negotiated among the old GATT Quad (US, EU, Canada, and Japan) do go through, three of the four hubs in the world’s hub-and-spoke supply-chain system will find global governance to be reasonable coherent. Japanese, German, and the US firms will find global supply-chain governance to be rather well organized. Chinese firms will not (along with Indian, Brazilian, Russian, and South African firms).

This awkward state of affairs may well become the ‘new normal’. It may prove impossible to bring supply-chain-trade rules to the multilateral level in any event. The old GATT Quad may have only weak incentives to compromise once the new status quo is in place. Likewise, the PRC and India may not find it too inconvenient since they may have the influence needed to deal with the fragmented system without joining it. However, if the PRC and the other BRICS want a say in which of the TPP-like rules will be raised to the multilateral level, the rules must be negotiated into a multilateral institution. The natural candidate for this – the WTO – does
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not seem to be a suitable vehicle. The reasons are mostly political but also partly practical.

First, the multilateralization process would be extremely difficult to start in the WTO before the 20th century issues raised by the Doha Round are settled, that is, probably not before 2020. However, by this time it is quite likely that the old GATT Quad will have completed mega-regionals and mega-bilaterals. This means that the old Quad would be in a position where the status quo was relatively comfortable while the emerging economic giants would be the demanders. For political reasons, the US and perhaps other Quad members are likely to want to negotiate multilateralization in an organization where all large exporters were treated equally, that is, no special and differential treatment for manufacturing giants like the PRC and India.7

Second, while eliminating special and differential treatment (SDT) for brand new disciplines in the WTO – say capital movement – could be envisioned, eliminating it for matters currently covered by the Enabling Clause’s treatment of developing nation preferential trade agreements would be almost impossible. As Figure 2.9 (p. 32) shows, these provisos would apply to many disciplines that seem to be core to supply-chain governance.

Third, the vast majority of WTO members are only tangentially involved in supply-chain trade. Given this, the near-universal membership and consensus decision-making procedures of WTO 1.0 would make the multilateralization negotiations very problematic, to say the least. The parties that would really have to agree would be the old Quad and the new manufacturing giants, particularly the PRC.

This logical thread leads to a rather strange conclusion – one that is a long way from where I started when I began writing about the multilateralization of deep regionalism in 2009 (Baldwin et al. 2009). The world will need two organizations to reunify global trade governance – WTO 1.0 (the current one) for issues and members where spillovers are universal and SDT is important, and WTO 2.0 where spillovers are mostly limited to major supply-chain traders and where the SDT concept is harmful rather than helpful to developing nations.

2.5 THE SHAPE OF WTO 2.0

Successful international organizations facilitate win–win outcomes in situations that would otherwise produce lose–lose outcomes. The nature of an international organization must respond to the type of cooperation it hopes to facilitate. Disciplining wars required a Security-Council type structure in the United Nations (UN). Lending money required a weighted
voting structure as in the World Bank. This section considers the type of institution that would best help the WTO 2.0 accomplish its task of multilateralizing rules on supply-chain trade.

The key institutional questions include: should all members be treated equally? Who should join? What issues should be covered? Before addressing these, it is instructive to review the economic and political economic logic underpinning the answers to these questions as far as the GATT/WTO is concerned.

### 2.5.1 WTO 1.0 Institutions and the Nature of Cooperation Fostered

The GATT’s issue coverage followed a very strong logic. Traditional trade refers to goods made in one nation and sold in another. Thus the natural issues for the GATT were border barriers (tariffs, and so on) and policies that could directly offset the effects of removing them (subsidies, unfair competition, and so on).

The logic of universal GATT membership follows directly from the political economy of how tariffs and other border barriers work. Before the second unbundling, tariffs shifted production to the protecting nation while simultaneously improving its terms of trade. Since one nation’s terms-of-trade gain is another nation’s terms-of-trade loss, tariff policy is a giant prisoners’ dilemma. The GATT can be thought of as turning the 1930s lose–lose outcome into a postwar win–win outcome (Figure 2.7). This gain from cooperation is the touchstone of GATT/WTO cooperation.8

The connection to universal membership is quite direct. As Figure 2.7 shows, each nation would like to exploit other nations by protecting while

![Figure 2.7 The political economy gains from GATT](source: Author's elaboration.)
others liberalize, but all prefer global openness to global protectionism. Thus:

The GATT was set up to discipline selfish behavior that harmed others with the negative effects coming via world prices (that is, terms of trade).

While many WTO scholars think in terms of ‘market access’ instead of ‘terms of trade’, these are two sides of the same coin. A terms-of-trade loss is the ‘price symptom’ of restricting market access. Tariffs reduce market access and exporters naturally react by some combination of reduced sales and lower border prices – in effect, exporters find it optimal to absorb some of the tariff by lowering border prices.

Because the negative spillovers of the selfish behavior (protection) work through world prices, spillovers are intrinsically global. It therefore makes perfect economic sense to agree disciplines of this selfish-but-harmful-to-others policy at the global level. Moreover, if nations try to settle this bilaterally or in small groups, they automatically spread negative effects to non-members via trade diversion. Thus something like a political economy domino effect supports the logic of universal membership. As more nations join, WTO membership becomes more important for outsiders.

Finally, SDT follows straight on from this reasoning. Thinking of the GATT as a way of disciplining selfish-but-harmful-to-others policies makes SDT a gift; it allows developing countries to shift the me-versus-them balance toward their own needs (more on this below). As we shall see, the nature of many supply-chain barriers is fundamentally different. Many of them are not of the selfish-but-harmful-to-others type. This matters hugely when thinking about the nature of WTO 2.0. The first task, however, is to think about which issues should be covered.

2.5.2 Issues to be Covered by WTO 2.0

When it comes to tariffs, the global negative spillovers make global governance the natural solution. When it comes to the deeper disciplines needed to underpin supply-chain trade, the most efficient level of governance is less clear. There is a good analogy with what goes on in the EU where the question is, what policies should be decided at the national level and which at the EU level? The answer in the EU is guided by a general principle – the subsidiarity principle that says policy should be set at the lowest level that is efficient. Policies that have important EU-wide spillovers (positive or negative) tend to get regulated at the EU level.

Future research should probably apply this subsidiarity logic to
supply-chain trade issues to see what can be said. It seems plain, however, that clear-cut answers will not be found owing to the lack of clear information on the trade-offs involved. An alternative approach is to look at the sorts of issues that have been widely included in deep RTAs signed by the advanced technology hubs – the US, Japan, and Germany (EU). The PRC has not signed any deep agreements of note.

2.5.2.1 Revealed preference evidence
The idea here is that the firms of these ‘headquarter economies’ – the high-technology firms that organize most international supply chains – have already identified the disciplines necessary to underpin supply-chain trade and have implemented them via bilaterals where possible. The nature of such bilaterals should therefore help us identify the core disciplines that a WTO 2.0 should address.

Before turning to the nature of the RTAs, it is worth looking at the global distribution of supply-chain exports to identify the big players. As Figure 2.8 shows, the trio on whose RTAs we focus – the US, EU, and Japan – account for about half of global supply-chain industrial exports. This is a large share but hardly dominant. The PRC is a huge player and the Republic of Korea, Taipei, China, Canada, and Mexico are important players. This confirms the point that relatively few economies are heavily involved in supply-chain trade.

Figure 2.8 National shares of global supply-chain exports, 2009
Turning to the content of the key deep RTAs that currently set the rules for supply-chain trade, we rely on an excellent dataset assembled by the WTO Secretariat as part of its 2011 World Trade Report. A team of trade lawyers read through the text of about 120 agreements and noted the issues mentioned in each. The lawyers used a checklist of measures that was drawn up by Horn et al. (2009). This checklist includes 52 measures, 38 of which are ‘beyond WTO’ disciplines, that is, they involve disciplines that do not exist in WTO agreements today (for example, prohibition of capital controls). The other 14 measures touch on disciplines that are covered by existing WTO agreements, but where the RTA goes beyond the disciplines in the WTO (for example, tariffs reduced below the WTO-bound MFN rate). For each measure, the lawyers noted whether the RTA text covering the various provisions involved legally enforceable language or simply mentioned intentions in the area covered.

The goal here is to find a consistent pattern of provisions. If a pattern does emerge from existing RTAs, revealed preference reasoning suggests that these provisions are likely to be the core issues included in WTO 2.0 – should such an organization ever arise.

To this end, consider the share of US bilaterals that include each of the 52 provisions (Figure 2.9 left panel). The provisions are listed in reverse alphabetical order with the beyond-WTO issues coming first (up to agriculture) and then the existing WTO provision at the bottom, again in reverse alphabetical order. The dark bars show the share of all US agreements in the WTO database that mention each provision; the light bars show the share where the provision enters with legally enforceable language. Two points stand out:

- the US is remarkably consistent in the provision-coverage of its RTAs; that is, there is something like a US template; and
- most provisions that enter US agreements enter with legally binding language.

Only 12 of the 52 provisions enter into 80 percent or more of US RTAs (that is, RTAs where the US is a signatory). Setting the threshold lower to two-thirds, the number rises only to 17. The bulk of these involve disciplines that are already covered by the WTO, but where the RTA goes further – the most notable as far as supply-chains are concerned are the deeper commitments in services, trade-related aspects of intellectual property rights (TRIPs), trade-related investment measures (TRIMs), customs cooperation, and procurement. Only five beyond-WTO provisions make it into at least two-thirds of the RTAs: three measures are clearly aimed at underpinning internationalized production (intellectual property rights,
Source: WTO RTA database, 2011.

Figure 2.9  Share of US and Japanese agreements with deeper provisions
investment restrictions and assurances, and the free movement of capital),
and two that reflect deeply entrenched US domestic concerns (labor and
environment).

The right panel of Figure 2.9 shows the same facts for Japan’s RTAs.
The basic pattern is not too dissimilar to that of the US. Most of the legally
binding provisions are extensions of existing WTO disciplines (bottom of
the chart). Again, those that are supply-chain relevant are TRIPs, TRIMs,
services and customs cooperation. Among the beyond-WTO provisions,
those that appear most frequently in Japanese RTAs are movement
of capital, intellectual property rights (IPR), investment, and visa and
asylum (mostly dealing with business mobility issues). Competition policy
is almost always mentioned but almost never legally binding.

The facts for the EU’s RTAs are much less clear (Figure 2.10, left panel).
This may have to do with the fact that most of ‘Factory Europe’ is inside
the EU itself – and the EU is the ultimate deep RTA. As such, the EU itself
is the guarantor of supply-chain disciplines for European high-technology
firms.11 It may also be related to the fact that the EU has a much longer
and richer history with RTAs. The WTO database has information on
10 US RTAs, 11 Japanese RTAs, and 58 EU RTAs. The earliest US and
Japanese arrangements come from the 1990s while Europe’s date back to
the 1960s.

Only a handful of provisions appear in at least two-thirds of the EU
agreements, two of which are the classic, 20th century trade provisions
namely tariffs on industrial and agricultural goods and export taxes. The
only near-universal supply-chain linked provisions are customs coopera-
tion and competition policy as far as legally binding provisions are con-
cerned. The key deeper provisions seen in US and Japanese arrangements
also appear in EU agreements, but without legally binding language, spe-
cifically movement of capital, IPR, and investment.

Facts for the remainder of agreements in the database are shown in the
right panel of Figure 2.10. Here we see that these RTAs are much more
diverse and much shallower on average. Only 60 percent of them include
deeper than MFN tariff cuts, to say nothing of more forward-leaning dis-
ciplines. There is, however, some comfort in the pattern of beyond-WTO
provisions that are included. The spikes in frequency occur in movement
of capital, IPR, investment, and competition policy – all supply-chain
related provisions. In this sense, the shape of these other agreements is not
radically at odds with the shape of US and Japanese agreements.

2.5.2.2 Summary: what issues for WTO 2.0?
Pulling all this together, we see that the disciplines necessary for supply-
chain trade to flourish include deeper disciplines on the WTO-covered
Source: WTO RTA database, 2011.

Figure 2.10 Share of EU and Rest of World agreements with deeper provisions
areas of services, TRIPs, TRIMs, and customs cooperation, and beyond-WTO disciplines on IPR, investment assurances, and the free movement of capital. Think of these as two categories:

- disciplines that assure the two-way flows of goods, information, capital, and people that are necessary to run an international production network; and
- disciplines that guarantee tangible and intangible property rights, and a favorable business climate.

The former include liberalization of infrastructure services, some financial services, capital flows, and barriers to trade in parts and components. The latter include assurances on movement of capital, IPR, investor rights, and competition policy or some other policies that guard against ill treatment of foreign-owned firms.

Other measures that are sure to be raised but less likely to be included due to differences among the outsourcing giants are: visa issues, procurement, labor issues, and environmental issues. Of course many new issues might also arise including state-owned enterprises, and standing committees to address business concerns that arise continually in this fast-developing world.

Important issues concerning the interaction between WTO 1.0 and WTO 2.0 would arise if WTO 2.0 addressed issues that are already covered by WTO agreements. This might argue for limiting WTO 2.0 to issues that involve beyond-WTO disciplines. Further legal and political economy research is needed on this issue.

### 2.5.2.3 Basis of cooperation

When it comes to tariffs, mega-regional and mega-bilaterals pose no new challenges. When it comes to the new, beyond-WTO issues, a sweeping rethink is necessary. I shall argue that the intrinsic nature of these barriers is radically different from tariffs as far as the gains from cooperation are concerned.

The fundamental difference between tariffs and supply-chain disciplines are illustrated schematically by the comparison of Figure 2.11 – which shows the basis for supply-chain trade cooperation – and Figure 2.7, which does the same for traditional trade cooperation.

The point of departure is a fundamental asymmetry of supply-chain trade relations. While supply-chain trade is very much two-way, the linchpin flows that trigger it are not. The key is the application of an advanced-technology firm’s know-how inside a developing nation. The choices and actors are not symmetric as in GATT cooperation.
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(Figure 2.7). Firms from a headquarter economy decide whether to invest in a particular developing nation. The developing-nation government decides whether to provide strict or lax supply-chain disciplines.

Two choices by two actors yield four outcomes. The government provides strict disciplines and (1) the high-technology firm engages, or (2) not, and government provides lax disciplines and (3) the high-technology firm engages, or (4) not. The win–win outcome is (1); engage with strict disciplines. The worst outcome for the high-technology firm is the rip-off scenario (3), that is, engage with lax disciplines. Outcome (4) maintains the pre-offshoring status quo.

Since the high-technology firm will never invest in a nation with lax disciplines, the best strategy for the developing-nation government is to adopt strict disciplines – regardless of what the advanced technology firm decides to do. If the investment happens, the government wins rapid industrialization. If no engagement happens, the government loses little. Thus a simple analysis suggests that there is no gain from cooperation. Both parties have an incentive to do the right thing with or without a WTO 2.0 or mega-regional agreement. But then why do we observe so many deep RTAs signed despite their high political price (for example, US–Republic of Korea FTA)?

2.5.2.4 The ‘holdup problem’ and WTO 2.0 cooperation

The problem arises from what economists call the hold-up problem. Once the offshoring investment is made, the developing nation government has an incentive to backslide toward lax disciplines since this would allow its citizens to directly or indirectly expropriate some of the high-technology firm’s tangible and intangible assets. In anticipation of this, the firm may not engage, or engage too little, or offshore only simple processes that

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<thead>
<tr>
<th>Developing nation government choices</th>
<th>Advanced-technology firm choices</th>
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<tr>
<td>High</td>
<td>Engage</td>
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<td>Smoot–Hawley</td>
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<td>Low</td>
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Source: Author’s elaboration.

(Figure 2.11) The gains from cooperation on supply-chain policies

(Figure 2.7). Firms from a headquarter economy decide whether to invest in a particular developing nation. The developing-nation government decides whether to provide strict or lax supply-chain disciplines.

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involve low technology. This is an inferior outcome for both the firm and the government concerned. Thus a slightly more forward-looking analysis suggests that assuring the win–win outcome will require some agreement that makes backsliding unlikely. This is the critical difference.

- The gain from supply-chain disciplines is based on a hold-up problem, not a prisoners’ dilemma.
- What this means is that the optimal form for the WTO 2.0 might be very different than that of WTO 1.0.

2.5.3 Who Should Join?

If WTO 2.0 is successful, it could well eventually attract all nations. But what would be the minimum members for a viable WTO 2.0?

One way to approach this is to think about the institution’s goal. Since the world already has a great deal of supply-chain governance, the goal of WTO 2.0 should be to make supply-chain trade governance more harmonious by multilateralizing deep regionalism. Therefore membership must be cross-regional if the organization is not to be redundant to existing bilaterals and mega-regionals under discussion.

This leads us to ask what sort of trade flows should come under a new WTO 2.0? We start by looking at the global pattern of supply-chain dependency. The data show the dominant role of three of the four manufacturing giants (Germany, the PRC, the US, and Japan). Some of these supply-chain dependencies are already covered by deep RTAs. The largest is the EU itself (the customs union with Turkey is also shown). The next largest is the North American Free Trade Area. Apart from these, there are only two RTAs that cover substantial amounts of supply-chain trade, namely, the PRC’s agreement with ASEAN and the US–Republic of Korea RTA, and the proposed Trans-Atlantic Partnership.

Roughly speaking, the gains from a WTO 2.0 that multilateralized supply-chain trade disciplines would be to include the flows that are not or will not be covered by deep RTAs. The most obvious omissions are the PRC and the Russian Federation. Russian participation in supply-chain trade is largely that of a natural resource exporter where supply-chain disciplines are less important.

This thinking suggests two key points:

1. If a WTO 2.0 is to be a step beyond the mega-regionals, it must include the PRC. If it does not include the PRC, it will change relatively little.
2. Many nations are largely uninvolved in supply-chain trade.
World Trade Organization 2.0 membership for such nations could be considered a luxury rather than a necessity – a luxury that would be worth having if it did not come at the price of overly sluggish decision-making.

2.5.3.1 Bilateral rather than global spillovers and WTO 2.0 membership
More directly, the argument for limited membership is based on the nature of the spillovers that WTO 2.0 would be designed to prevent. For instance, the intense supply-chain trade between Canada and the US is organized almost entirely by large corporations – not competitive markets. The international exchanges involved are a bundle of cross-border flows of goods, services, investment, know-how, and people. This is why most supply chains are regional rather than global and why the spread of supply-chain trade is so tightly concentrated around the world’s four manufacturing giants – the US, the PRC, Japan, and Germany.

This suggests that the economic logic for universal membership is weak. Put simply, the direct spillovers are not global, so the membership of WTO 2.0 need not be global. For WTO 2.0, the issues are much more bilateral – an issue that primarily concerns the firms that are potentially expropriated and the people tempted to expropriate. This suggests that the main players in supply-chain trade should be members, but does not argue for membership beyond that as a matter of first-order importance. This reasoning for limited membership, however, begs the question: ‘If the spillovers are mostly regional, why have a global institution at all?’

The answer lies in network externalities. While most offshoring relationships are primarily bilateral – typically organized by US, German, or Japanese firms – the industries and firms involved are global. The US automobile company GM, for instance, runs an elaborate supply-chain trade network in and around Factory Europe, another one in and around Factory Asia, and yet another in Factory North America. There would be synergies for the high-technology companies to have similar supply-chain disciplines in all three zones. Moreover, network externalities work two ways.

Developing nations who have already joined supply chains would find the bargaining power of high-technology firms mitigated by a standardization of supply-chain trade disciplines. If US, Japanese, and German firms were all set up for a global standard, firms from these three headquarters economies would be more substitutable as a source of offshored industrial jobs in any given developing nation. Or to put it differently, the existence of US-centric disciplines in North American Free Trade Agreement-like RTAs that differ from, say, Japan-centric disciplines in economic partnership agreement-like RTAs, tends to tie particular developing nations to particular high-technology partners. A multilateralization of the rules
would make it easier to play off US firms against, say, Japanese firms. For the same reason, multilateralization would make it easier for new nations to jump on the supply-chain industrialization path.

2.5.3.2 Summary: why the WTO 1.0 and WTO 2.0 membership differences?

As noted above, GATT was set up to discipline selfish behavior that harmed others with the negative effects coming via world prices. As world prices are global, the ‘spillovers’ are global, so membership should be global. World Trade Organization 2.0 would be set up to solve bilateral hold-up problems that operate through the expropriation of property. As these are intrinsically more bilateral than terms-of-trade effects, the logic for universal membership in WTO 2.0 is much weaker. The economic argument for multilateralizing the existing supply-chain disciplines turns on network effects – that is, the gains from having a single set of rules globally. The political argument is that multilateralization would be necessary to prevent or remove the exclusion that is emerging with mega-regionals and mega-bilaterals.

2.5.4 Special and Differential Treatment

A cornerstone of WTO 1.0 is special treatment of developing country members.18 Should it also be part of WTO 2.0?

The economic and political economic rationales for SDT in the GATT and WTO are many, varied and sometimes contradictory (Page and Kleen 2005). They fall into three categories. Developing nations need different and special policies to become developed nations, or they need more time and assistance to implement the same policies, or they deserve special treatment as compensation for current or past injustices.

Over-layering these intellectual rationales is what might be called the negotiators’ instinct. In an organization whose DNA is structured on what Krugman (1991) calls ‘enlightened mercantilism’, disciplines and rules are instinctively viewed as preventing members from doing things that are good for them but bad for others. In this mindset, avoiding discipline is a gift. Or as Page and Kleen (2005) put it, GATT/WTO rules are designed to allow members to grow without impeding the progress of others; SDT allows developing countries to shift the me-versus-them balance toward their own needs.

2.5.4.1 Protectionism becomes destruction-ism

These justifications for SDT were logically consistent in the world that the GATT and WTO 1.0 were designed to govern – one where most
production was bundled so trade involved goods made in one nation being sold in another. In this world, the primary barriers to trade were border measures, especially tariffs, and border-barriers protected industry. Allowing poor nations to keep tariffs while rich nations liberalized was one way of fostering production in poor nations. Globalization’s second unbundling – the internationalization of supply chains – changed this. As I have argued elsewhere, in a world where production unbundling is pervasive, protection does not protect industry, it destroys it (Baldwin 2011).

Of course, the protection still protects at the very last stage of the supply chain – final consumer goods like shoes, clothes, and food – and reverse protection (export taxes) still protects at the very beginning of the supply chain. But for most industrial goods, the rise of supply-chain trade flipped the logic that underpins SDT in WTO 1.0.

This is not an intellectual point. It has been fully embraced by developing country policy makers as the rush to unilateral tariff-cutting plainly shows (Figure 2.6). Nevertheless, it is worth contemplating the elementary economics that turned protectionism into destructionism.

The basic economic logic is ancient. Cheaper imported intermediates foster downstream production; for example, producing industrial chemicals is more attractive where the costs of imported precursors are lower; making cars is more profitable when imported components are cheaper, and so on. In such situations, protection of intermediates destroys rather than protects downstream industry. This is the political economy reason for the tariff escalation that has so long been a feature of global trade policy. In a world of bundled production, low tariffs on raw materials and high tariffs on final goods promoted local industry.

The new part of the logic lies in the massive increase in the range of imported intermediates. As production unbundled internationally, many inputs that previously had to be made locally can now be sourced from abroad. Naturally, this massively increased the range of goods where higher tariffs were bad for industry. Even more directly, the rise of supply-chain trade means that nations must import components from the most competitive sources if their own output is to be globally competitive since everyone else is sourcing internationally.

In sectors where international supply-chains are important, protecting local, inefficient producers of the component may save a few jobs in the upstream sector. However, the inefficient upstream sector can only sell in the domestic market and thus creates few jobs. The downstream industry, by contrast, can sell to the world, and so entails many more jobs. In other words, tariffs on intermediates destroy more jobs downstream than they create upstream. Protectionism became destructionism.
2.5.4.2 SDT when barriers to trade and industry involve property rights

The second big change concerns the nature of the relevant barriers. To understand the point, it helps to rethink goods. Think about a 1982 Toyota Land Cruiser not as a vehicle but rather as a bundle of Japanese labor, Japanese capital, Japanese innovation, and Japanese managerial, marketing, engineering, and production know-how. In 1982, the Land Cruiser could be exported to any nation without regard to the destination’s property rights since it was basically impossible to unbundle the inputs. Toyota’s intangible property rights were protected by law in Japan, and by physics abroad. In 2012, things are quite different.

Today, Toyota assembles Land Cruisers in several nations and sources the parts and components from factories around the world, including many developing nations. Since the parts have to all fit together seamlessly, Toyota does not rely only on local know-how. It combines Japanese capital, Japanese innovation, and Japanese know-how with local labor when producing parts for its international supply chain. As such, physics provides much less protection for Toyota’s intangible property. Production unbundling, in other words, creates new vulnerabilities to intangible property.

Deeper disciplines are necessary to assure Toyota’s property rights are respected in the developing nations that get the Toyota factories. Economists can argue about the impact of such property rights on the poor nation’s development prospects, but no one can argue with the simple reality of offshoring. There are dozens of nations that would love to have the factory and are thus willing to sign up to tough property right disciplines to make it happen. Nations that do not provide such assurances in the form of BITs, deep RTAs, and unilateral, pro-business reforms will not get the supply-chain industrialization and spectacular manufacturing growth that it has produced in a handful of developing nations.

In this world, granting SDT in the form of slower implementation or weaker property right assurances will destroy rather than protect industry. In short, supply-chain trade with its trade-investment-services-intellectual-property (IP) nexus has flipped the primary logic underpinning SDT in the WTO.

2.6 CONCLUSIONS

The complex international flows of goods, investment, services, know-how, and people associated with international production networks – call it ‘supply-chain trade’ for short – has transformed the world. The WTO has not kept pace.
The new rules and disciplines underpinning the rise of supply-chain trade have been and continue to be written outside the WTO – primarily in deep RTAs, BITs, and autonomous reforms by emerging economies. Efforts to harmonize these new disciplines are taking place in mega-regionals (TPP, TAP, and so on) and mega-bilaterals that are under negotiation or discussion. As the Doha Round is unlikely to conclude before 2020 and WTO engagement in supply-chain issues is unlikely before it does, world trade governance is headed for fragmentation. Specifically, supply-chain disciplines will be harmonized by mega-regionals and mega-bilaterals that will, on current trajectory, exclude the PRC and other large emerging economies.

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

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

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

As such, the basic deal in supply-chain cooperation is not ‘I’ll keep my market open if you keep yours open’, as in WTO 1.0, but ‘I’ll offshore my factories and technologies if you assure my tangible and intangible assets are protected’. The negative third-nation effects are limited, so the logic of universal membership in WTO 2.0 is weak. The justification for SDT also disappears. The cooperation helps developing nations credibly commit to policies that are good for them. Allowing a poor nation to not assure protection of the assets that trigger supply-chain trade would harm rather than help. In the world of supply-chain trade, protectionism is destructionism as far as developing nations are concerned. Given that WTO 1.0
has universal membership and SDT in its DNA, multilateralizing supply-chain disciplines will require a new organization – WTO 2.0 as it were.

2.6.1 The Way Forward

World Trade Organization centricity is eroding. If today’s mega-regional agreements succeed, fragmentation and exclusion are the most likely outcomes when it comes to the governance of the supply-chain trade. This situation works in one sense. Large emerging markets may be big enough to thrive outside the formal disciplines that may arise from the mega-regionals. These nations may continue to attract offshored factories with a ‘my internal market for your factories and technology’ deal instead of the ‘your factories for my reform’ deal that most developing nations must make.

This situation would be worrying. Great-Power struggles further erode the WTO’s centricity and this might bring the world to a tipping point – a point beyond which expectations become unmoored and nations feel justified in ignoring WTO 1.0 norms since everyone else does.

The WTO 2.0 idea might not be the right one, but the world will need a solution if fragmentation and exclusion is to be avoided. In short, it is time to start thinking ahead on global trade governance.

NOTES

1. I wish to thank Bernard Hoekman, Gary Hufbauer, Simon Evenett, Patrick Low, Peter Draper, Miguel Rodriguez, members of the World Economic Forum’s Global Agenda Council on Trade, participants at the September 2012 World Trade Forum session ‘21st century trade and global trade governance’, and participants at the November 2012 E15 meeting at ICSTD for insights and suggestions. I thank Yuan Zi for excellent proof reading. This chapter draws heavily on the author’s earlier work and includes some verbatim passages. It is not to be viewed as freestanding, original research but rather as a policy-oriented development of already published papers by the author. A more academic version of the core idea in this chapter was published in the Review of International Organisations, as Baldwin (2014).


3. The mid-1980s structural break has been shown by many (Federal Reserve Bank of Dallas 2002; Feenstra and Hanson 1996; Ando and Kimura 2005; Fukao et al. 2003) and the trade changes by many others (Hummels et al. 2001; Yi 2003; Bems et al. 2010; Koopman et al. 2011; Johnson and Noguera 2012a, 2012b).

4. Note that reimports here include the full supply chain so US capital good exports are counted in the reimports if the PRC uses US capital goods to produce, say, mobile phones exports to the US.

5. As Cooper (1971, p. 41) puts it: ‘The principle of reciprocity is designed to hold out the promise of export gains to certain sectors of the economy, and thereby to establish a counterweight to those who will be hurt by increased imports. Reciprocity attempts
to build pluralistic support for tariff reduction. Well known to trade negotiators, this point was surely not novel to Cooper and many have made it subsequently including Roesseler (1978), Blackhurst (1979), and Baldwin (1980). For an early formal treatment see Moser (1990), or Hillman et al. (1995); the basic logic of these early papers were brought to the attention of the broader community of trade academics by Grossman and Helpman (1995).

6. For details see Baldwin (2010) on the link with supply-chain trade. Other theories on unilateralism include Coates and Ludema (2001), Krishna and Mitra (2008), Ludema et al. (2010), and Conconi and Perroni (2009).

7. More profoundly, the US, inter alia, views the asymmetric, developing-nation status of the PRC as unacceptable. As the US seems to perceive things, the PRC is a poor nation, but it does not look like a developing nation in the GATT sense of the word – not the sort of country diplomats had in mind when special and differential treatment was introduced in the 1950s and renewed and strengthened in the 1960s, 1970s, and 1980s.

8. The basic point that international agreements can switch lose–lose outcomes into win–win outcomes by encouraging self-restraint is an ancient insight. It was brought into modern economics by Mayer (1985), Moser (1990), Krugman (1991), Hoekman (1993), and, more recently, by Bagwell and Staiger (1999).

9. It should be noted however, that most of the EU’s supply chain is inside the Single Market and so is governed by a regional trade agreement that is a quantum leap deeper than others. For instance it embraces the free intra-EU movement of goods, services, labor and capital, and common policies on competition, subsidies, and so on. All of these are enforced by a supranational court whose authority exceeds that of national courts on Single Market issues.

10. The list includes standard border measures such as tariffs on industrial and agricultural goods, standard measures that could offset the lowering of border measures (subsidies, unfair competition, biased public procurement, onerous customs procedures), and a few behind-the-border barriers such as investment restrictions, trade-related intellectual property rights, and technical barriers to trade (basically standards for industrial goods).

11. Note that the list of 52 provisions does not include the large number of extremely deep integration provisions in the EU’s Treaties since Horn et al. (2009) considered EU RTAs with a third nation.


13. This may explain why Washington Consensus policies have been so widely adopted, even by nations who have not received offshored manufacturing jobs.

14. Technically, strict disciplines is the dominant play for the government and, given this, invest is the dominant strategy for the firm, so offshoring industrialization is the iterative dominant strategy in a one-shot game.

15. For early thinking on the multilateralization of deep regionalism, see Baldwin et al. (2009).

16. It is important to note, however, that this information is severely incomplete when it comes to East Asia where supply-chain trade is rampant, RTAs are abundant, but participation in the WIOD project is scarce (only Japan, the PRC, Republic of Korea, Indonesia, and Taipei,China). All the major ASEAN nations have RTAs with the Republic of Korea, Japan, and the PRC, as well as with themselves. The lack of information on Latin American and African nations is less problematic since they have many RTAs but engage in relatively little supply-chain trade.

17. See Baldwin et al. (2009) for an analysis of why many supply-chain trade disciplines are not discriminatory per se.

18. The WTO classifies SDT measures into six categories: granting better market access to developing countries, safeguarding interests of developing countries, flexibilities, longer transitions, technical assistance, and flexibilities for least developed countries (LDCs).

19. Technically, this is just the effective rate of protection argument.
REFERENCES


3. Trade in value added: concept, development, and an East Asian perspective

Satoshi Inomata

3.1 INTRODUCTION

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

The next section provides a non-technical explanation of the concept of trade in value added, with particular reference to East Asia. The basic motivation for focusing on East Asia stems from the general observation that the region has successfully fostered very sophisticated production networks across countries, and came to form what Richard Baldwin called ‘Factory Asia’ (Baldwin 2007). An increasing number of segments in the production process were rapidly and extensively relocated to different places in different countries within the region, yet what really characterizes the production system of East Asia is the diversity and complementarity of its constituent countries, where each country specializes in a different stage of a production process according to its own comparative advantage. Such a vertical structure of production sharing among countries is highly relevant in considering the significance of the trade in value added approach.

This chapter illustrates the basic idea behind the concept of trade in value added by referring to the example of Apple’s iPhone production
networks. In Section 3.3, the literature review traces the development of relevant studies and argues for the importance of the dataset called international input–output tables in measuring trade in value added. Section 3.4 introduces the input–output analysis and the basic feature of Asian International Input–Output Tables that are used in identifying the vertical structure of the production system in East Asia (Section 3.5), and in some analytical examples of the trade in value added approach (Section 3.6). Section 3.7 concludes with policy implications and future prospects of the study.

3.2 WHAT IS MEASURED BY TRADE IN VALUE ADDED?

Figure 3.1 shows the international value distribution of an iPhone. It presents the value that accrued to the companies in various countries that participated in the production networks of iPhones. Out of US$500, which was the retail price of the iPhone in 2009, the US received US$331 as a payback. Japan, Germany, and other major industrialized economies received US$162 in total, and the PRC, which was the largest producer and exporter of iPhones, received only US$7.

![Figure 3.1: International value distribution of iPhones](image)

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

Figure 3.1 International value distribution of iPhones
Why does this happen? Every component of an iPhone is produced by different production technologies, and hence has different market values. Flash memories and touch screens, for example, are the products of Toshiba, so the Japanese contribution to one iPhone is known to be around US$61 (Table 3.1).

It is not surprising to see that market values differ depending on the types of components, but such a value-gap can also emerge among the ‘tasks’ in the production process. Suppose the production of an iPhone involves eight production stages: product design, research and development (R&D), materials procurement, parts procurement, assembly, distribution, marketing, and customer services. Also suppose that the tasks are carried out in different countries through offshoring. Here, if the production stages are aligned along the horizontal axis from the upstream to the downstream process, and if the vertical axis is taken for the amount of value added generated by each production stage, then the functional graph will be drawn as in Figure 3.2. Usually, it is at both the peripheral sides along the task spectrum where the companies receive the higher values: such as product designs, R&D, marketing and customer support – most of them accrue to developed economies. On top of this,
the highest values are captured, of course, by the lead firm, that is, Apple. In contrast, the tasks in the middle range tend to require unskilled labor, and thus have lower value added, particularly the assembly stage which predominantly takes place in the PRC. Because of this shape, the diagram is called a ‘smile curve’, and it is the relative position of the countries along the smile curve that determines the international distribution of value added.

These observations pose a fundamental question to the way that international trade is measured. iPhones are produced in the PRC and exported to the US, the main consumption market. Yet what the PRC producers do is just a very simple task of assembling parts and components, and hence the amount that they receive for the work is minimal. On the other hand, the iPhones exported from the PRC are finished products, with values of around US$180. This means that the current trade statistics that only concern the physical transfer of goods and services from an immediate trading partner, record the value of the PRC export that has no relevance to the real picture of manufacturers in the country.

Such an unwarranted nature of trade statistics has brought on the chronic issue that is faced today – the trade imbalance between the PRC and the

Source: Drawn by the author.

Figure 3.2 A ‘smile curve’
A World Trade Organization for the 21st century

It is considered that the significant part of the value embodied in the PRC’s exports has its origin in other countries, the implication of which is that the PRC’s trade surplus, or the US trade deficit, is significantly overestimated based on the current measurement, as compared to the alternative method of measuring trade in terms of value added.

3.3 LITERATURE REVIEW

The value added approach to international trade is neither new nor surprising. It has been widely discussed at venues such as the WTO. In practice, however, the idea was hardly realized due to the lack of an appropriate methodology or database.

The conventional approach to tracing cross-border value chains can be found in the studies that use firms’ micro-level data. As seen in the case
of the iPhone, the approach generally aims to identify the structure of the production process and/or the sales networks of a particular product, based on the information provided by manufacturers.

The pioneering work of this kind includes Dedrick et al. (2008). They conducted an analysis of the value-added structure of four representative products: Apple’s iPod and video iPod, a laptop PC of Hewlett Packard, and one of Lenovo, utilizing the information from business reports. The study reveals, for example, that in 2006 a video iPod with a retail price of US$299 is associated with a cost of US$80 for profit and/or operating surplus of the lead firm (Apple), US$144 as the ex-factory price (before distribution margins) of the product, and US$3.86 for the product assembly in the PRC. The original motivation of the study was to investigate how firms benefit from technological innovation through production sharing, but it came to elucidate a separate, and even more alarming, question about the validity of conventional trade statistics.

Xing and Detert (2010) probe the issue of US–PRC trade imbalances. Their research results on the iPhone’s production network are presented below. In 2009, it was known that iPhones were not sold in the PRC, which implies that the PRC’s exports of iPhones to the US is equivalent to the US trade deficit of the product in relation to the PRC. The study shows that the US deficit of US$1.9 billion for iPhone trade is reduced to US$73 million if viewed in terms of value added, and broken down to the deficits with other countries such as Japan and Germany, the core parts suppliers (Figure 3.4). On this ground, the authors question the efficacy of exchange rate adjustment of the PRC’s yuan for the purpose of trade rebalancing.

These ‘firm-level’ approaches are useful in drawing the actual structure of supply chains since they utilize the data directly provided by individual firms rather than resorting to any forms of statistical inference. The weakness, however, is also apparent in its flipside.

First, their applicability is limited in considering macroeconomic issues like trade policy, since the analytical focus is cast only to a particular product and/or activity of a few firms. It is far from being sufficient to capture the entire value flows at the national context.

Second, as pointed out by Dedrick et al. (2008), the majority of firm-level data does not explicitly present ‘compensation of employees’ as an important component of value-added items in the national account framework, but merges it with other types of production costs. The value added analysis based on a firm’s micro-data, therefore, is bound to be an approximation by the information on a firm’s operating surplus (profit).

Finally, since values are generated at every point of the production process, the value added analysis should be able to trace all the production stages along the entire supply chain. The firm-level approach, however,
<table>
<thead>
<tr>
<th></th>
<th>Traditional measurement</th>
<th>Value-added measurement</th>
</tr>
</thead>
<tbody>
<tr>
<td>World</td>
<td>-1,901</td>
<td>-1,901</td>
</tr>
<tr>
<td>PRC</td>
<td>-73</td>
<td>-685</td>
</tr>
<tr>
<td>Japan</td>
<td></td>
<td>-685</td>
</tr>
<tr>
<td>Rep. of Korea</td>
<td>-259</td>
<td></td>
</tr>
<tr>
<td>Germany</td>
<td>-341</td>
<td></td>
</tr>
<tr>
<td>Rest of the world</td>
<td>-543</td>
<td></td>
</tr>
</tbody>
</table>


*Figure 3.4 US trade balance of iPhones, 2009*
only considers the value-added structure of direct input suppliers (the first tier), but leaves all the rest of the value-added stream untracked. Toshiba’s hard-disk drives or Broadcom’s multimedia processors contain various sub-parts produced in different countries, and thereby require further decomposition and investigation of the value-added sources.\(^2\)

Given these limitations of the conventional approach, increasing attention is directed to a new strand of studies that use statistical tables called international input–output tables (IIOTs). An IIOT provides a comprehensive mapping of international transactions of goods and services. This massive dataset combines national input–output tables of various countries at a given point of time. Since the tables contain information on supply–use relations between industries across countries, which is totally absent in conventional trade statistics, it is possible to identify the vertical structure of international production sharing. Unlike the firm-level approach, the input–output analysis covers an entire set of industries that comprises an economic system, and thereby enables the capture of cross-border value flows at the level of a country or a region. Theoretically, it has the capacity to track the value-added generation process of every commodity in every country at every production stage.

The studies on trade in value added using input–output tables became increasingly visible in the last decade, yet its origin can be traced back even to the beginning of the century, when Hummels et al. (2001) introduced the concept of vertical specialization (VS). The VS metric is defined as the ‘amount of imported intermediate inputs used for the production of an exported good’, or, put differently, the import contents of exports presented as a measurement of international production sharing.

The idea was brought into the value-added context by the study of Chen et al. (2004) that for the first time investigated the statistical distortion of ignoring the presence of processing trade in measuring international trade in terms of value added. Here, the long-debated issue of US–PRC trade imbalances, as referred to in the iPhone example, was fully considered in the value-added perspective. The approach was further developed and methodologically formalized in Koopman et al. (2008), in which separate input–output matrices for export processing sectors were estimated for the tables of the PRC and Mexico, where processing trade is most prevalent.

While the empirical exercises of these seminal works rely on individual countries’ national input–output tables, Daudin et al. (2006) rallied the database of the Global Trade Analysis Project (GTAP) and constructed multi-regional input–output tables of 70 countries and composite regions for the calculation of domestic value-added contents of export, alongside the indices of vertical specialization and regionalization. This was followed by the Johnson and Noguera (2009) study that calculated the ratio
of value-added exports to gross exports (VAX ratio) as a metric of international production sharing, again using the GTAP database. In this study, the impact of production sharing on the scale of bilateral trade balances was extensively discussed with respect to myriads of countries and regions, not to mention US–PRC trade relations.

One of the latest developments is the Koopman et al. (2010) study that devised a full decomposition method of export value into various sources of value added, and presented a complete picture of the ‘anatomy’ of the value-added generation process. In this work, various preceding methods of measuring value added trade are systematically integrated into a single scheme of estimation formulae.

In the next section, the basic feature of an input–output table is presented, with an extension to the international version.

### 3.4 DATA

The input–output table is a map of an economy, which compactly depicts all the flows of goods and services for a given period of time (usually one year) using recorded transaction values between industries. Its image is like a piece of textile woven from warps and woofs. In the input–output framework, warps represent demand sectors of goods and services while woofs are supply sectors, and the intersection gives the value of transactions made between these two industries. Figure 3.5 shows a schematic image of an input–output table with three industrial sectors: agriculture and mining, manufacturing, and services.

In particular, the intermediate transaction segment provides a core apparatus of the input–output analysis. In the modern production system, goods and services are processed through progressive commitment of various industries, in which a product of one industry is used as an intermediate input of others, and this is neatly given by the intermediate transaction matrix of an input–output table. The strength of an input–output table, and what makes it special, is indeed its information of production linkages that are derived from supply–use relations between industries.

Suppose that there is an increase in the demand for cars by ¥10 billion (Figure 3.6). The output expansion of cars brings about the secondary repercussion on the production of other products. It increases the demand for car parts and accessories such as chassis, engines, front glass, and tires. The increase in production of these goods, however, further induces the demand for, and hence the supply of, their sub-parts and materials: steel, paint, rubber, and so on. At each production stage, value is generated,
Trade in value added

In today’s globalized world, such production propagation often crosses national borders. An increase in the output of Japanese cars increases the demand for tires made in Thailand, which further increases import demand in the country for rubber made in Malaysia. Value is transferred across borders, embodied in traded products. So, the international context has to be considered.

The Asian International Input–Output Table (AIOT) constructed by IDE–JETRO is an international version of an input–output table. It covers ten economies: Indonesia (I), Malaysia (M), the Philippines (P), Singapore (S), Thailand (T), the PRC (C), Taipei, China (N), Republic of Korea (K), Japan (J), and the US (U), for the reference years of 1985, 1990, 1995, 2000, and 2005. Industrial sector classification is 76 sectors for the most detailed nomenclatures. Figure 3.7 presents its schematic image. Each cell of $A^{**}$ represents transactions among 76 industrial sectors,

Figure 3.5  *Schematic image of an input–output table*

which can be captured by an input–output table throughout the entire supply chain.


Source:  Drawn by the author.

![Input-Output Table Image](image-url)

<table>
<thead>
<tr>
<th></th>
<th>Agri. and mining</th>
<th>Manuf.</th>
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Source:  Drawn by the author.
Figure 3.6  Image of production propagation and value-added generation (car industry)
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**Note:** EU = European Union; PRC = People’s Republic of China; ROW = Rest of World.

**Source:** IDE–JETRO (2006).

**Figure 3.7** The Asian International Input–Output Table (for the reference year 2000)
namely, it is a square matrix of 76 dimensions. The AIOT is valued at the producer price, except for the import matrices from Hong Kong, China; the European Union (EU); and the rest of the world, which are valued at cost, insurance, and freight (CIF).

The AIOT is simply a patchwork of the pieces taken from each national input–output table, and hence they can be read exactly in the same manner as for national tables. Each cell in the columns of the table shows the input composition of industries of the respective country. \( A^{II} \), for example, shows the input composition of Indonesian industries in relation to domestically produced goods and services, that is, the domestic transactions of Indonesia. \( A^{MI} \) in contrast shows the input composition of Indonesian industries for the imported goods and services from Malaysia. Cells \( A^{PI}, A^{SI}, A^{TI}, A^{Cl}, A^{NI}, A^{KI}, A^{JI}, A^{UI}, A^{HI}, A^{OI}, \) and \( A^{WI} \) indicate the imports from other countries. \( BA^{*} \) and \( DA^{*} \) give the international freight and insurance and taxes levied on these import transactions.

The 11th column from the left side shows the composition of goods and services that have gone to the final demand sectors of Indonesia. \( F^{II} \) and \( F^{MI} \), for example, show respectively the goods and services produced domestically and those imported from Malaysia that flow into Indonesian final demand sectors. The rest of the column is read in the same manner as for the first column.

\( L^{*H}, L^{*O}, L^{*W} \) are exports (vectors) to Hong Kong, China; the EU; and the rest of the world, respectively. \( V^{*} \) and \( X^{*} \) are value added and total input or total output, as seen in the conventional national input–output table. \( Q^{*} \) represents the statistical discrepancies in each row.

3.5 THE PRODUCTION SYSTEM OF EAST ASIA

As stated at the beginning of this chapter, the production system in East Asia, or ‘Factory Asia’, is highly characterized by its vertical structure of production sharing and fine division of labor among constituent countries, which makes the region an ideal analytical target for the study of trade in value added. In brevity, the structure is reduced to the form of a triangular product flow as such that:

1. East Asian economies other than the PRC supply intermediate products to the PRC.
2. The PRC assembles them into final consumption goods.
3. The final goods are exported to big markets like the US and the EU.
That is, the competitiveness of the PRC exports is not only attributable to its cheap labor force, but also stems from the high value-added intermediate products that it receives from other East Asian countries, as embedded in goods labeled ‘Made in China’.

Given this, what follows shall identify the above-mentioned vertical structure of production sharing in East Asia since, as shown in the iPhone example, the relative position of the countries along a ‘smile curve’ is what determines the international distribution of value added.

How do we evaluate a country’s relative position? The approach is simple. If the country’s overall supply chains toward final products are found to be longer than those toward primary products, then it can be said that the country operates in a relatively upstream position (Figure 3.8).

Then, how are the lengths of supply chains measured? For this end, the following analysis employs the input–output model of average propagation length, or APL, developed in Dietzenbacher et al. (2005). As an illustrative example, consider the hypothetical supply chains in Figure 3.9. In order to measure the length of the supply chains between Industry A and Industry E, the number of production stages of every branch of the supply chain should be looked at: the top branch has a two-step path, the second branch has a four-step path, the third has a three-step path, and so forth. Also, the relative importance of each path can be calculated by

\[ \text{APL} = \sum \frac{d_i}{S_i} \]

where \( d_i \) is the demand of the product at stage \( i \), and \( S_i \) is the supply of the product at stage \( i \).

Source: Drawn by the author.

Figure 3.8 How to position economies in regional supply chains
the information from the input–output tables, as given at the end of each branch (in percentages).

In this example, the APL between Industry A and Industry E is derived as:

$$\text{APL}_{AE} = 1 \times 0\% + 2 \times 50\% + 3 \times 30\% + 4 \times (10 + 10)\% + 5 \times 0\% + \ldots = 2.7.$$ 

That is, the APL is formulated as a weighted average of the number of production stages from one industry to another, using the relative importance of each path as a weight.

The APL can be measured both in forward-looking and backward-looking directions in the production process, so the relative position of a country in a regional production system can be identified by comparing the lengths between the two, as schematized in Figure 3.9.

Figure 3.10 is a plot diagram of all-industries averages of forward APL (the vertical axis) and backward APL (the horizontal axis), showing movement from 1985 to 2005. Looking at the figure along the
northeast–southwest diagonal, it presents the entire length of supply chains that each economy participates in. It is observed that most economies have increased the length of supply chains from 1985 to 2005 (with exceptions of the US and Taipei, China). Among the ten economies in the region, the PRC demonstrates outstanding length of supply chains. It is considered that interlinking of its domestic supply chains with overseas...
production networks was accelerated by the country’s accession to the WTO in 2001, as suggested by the big leap of value from 1985 to 2005.

On the other hand, if the figure is looked at along the northwest–southeast diagonal, it draws the relative position of each economy within the regional supply chains, as determined by the ratio of forward and backward APL. Japan and the US, the most developed economies in the region, are located in the upstream position, though they moved downward during the period and the US in particular swapped its position with the Republic of Korea. The PRC stays in the downstream segment of the regional supply chains, which reflects the country’s dominant position as a ‘final assembler’ of the regional products. The other economies more or less remain in the middle-range spectrum, though the notable change is that Taipei, China moved up into the middle cluster and Thailand went downstream to a large extent. This change clearly reflects the development of the roles of these two economies in the region. Taipei, China significantly increased its electronics manufacturing service and became a major parts supplier to big computer multinationals, while Thailand invited and accommodated the massive inflow of Japanese car assembly plants, and later received the name of the ‘Asian Detroit’.

Figure 3.11 maps the previous diagram into a one-dimensional schematization of the relative position of countries within the regional supply chains. From 1985 to 2005, upstream economies were more or less clustered, while the PRC and Thailand became downstream standalones. Bipolarization between parts suppliers and final assemblers can be observed during this period. As such, ‘Factory Asia’ demonstrates a high degree of vertical division of labor among member economies, where the role of each economy is clearly reflected in its relative position within the regional production system.

3.6 ANALYTICAL EXAMPLES OF THE TRADE IN VALUE ADDED APPROACH

The fragmented production networks and strong vertical relations among the economies rendered East Asia a highly relevant region for the analysis of trade in value added, since the multiple counting of intermediate values, and the implicit distortion of the measurement of bilateral trade based on conventional statistics, become particularly salient as the vertical sequence of a production process increases.

Figure 3.12 compares the results of decomposing value-added origins of export in 2009 among several countries. Even though it is repeatedly argued that the significant part of value added in the PRC’s exports has
Trade in value added

its origin overseas, the cross-country comparison reveals that even larger shares are attributable to foreign sources in the case of the Republic of Korea. This is a rather generic observation about small open economies, with a high degree of dependency on foreign markets for both demand and supply of goods and services.

Figure 3.13 shows the US trade deficits with the PRC for 2000, 2005, and 2008, with the gray bars indicating the trade deficits measured in the traditional approach, and the black ones being the deficits measured in terms of value added; these are nationwide deficits, not of a particular product like the one for iPhones. It is striking to see that in the value-added term the trade deficit is reduced by 20 percent to 30 percent as compared to the traditional measurement. According to the WTO’s estimate, the deficit would be even halved if we take into account the effect of export-processing zones in coastal areas of the PRC.

Finally, indicators of trade performance, such as the revealed comparative advantage, can be also reformulated in terms of value added. Comparative advantage indicates international competitiveness in export performance of a certain commodity, but with a new index, it shows competitiveness in the international value distribution. Table 3.2 is calculated

Source: Drawn by the author.
from a preliminary hybrid data of the Organisation for Economic Co-operation and Development (OECD) and IDE–JETRO’s input–output tables, and compares both indices of comparative advantage for the ‘computer and office automation (OA) equipment’ industry. There are three main findings from the study:
1. If the traditional index and value-added index are compared, Japan does not show a significant difference, while the case of the PRC presents a big gap, especially in 1995. This is because the PRC’s export of computer and OA equipment is dominated by final consumption products, and its production activities are skewed toward the final assembly stages with lower value added compensation.

2. This gap, however, is reduced in 2005, from −56 percent to −33 percent. It seems to reflect a rapid technological catch-up of the PRC manufacturers during the decade, stepping up the value-added ladder from a mere assembler of ready-made components to a parts supplier with advanced production skills.

3. As a result, from 1995 to 2005, the PRC enhanced its competitiveness of the industry, and in 2005 it surpassed Japan in both forms of the index.

3.7 CONCLUDING REMARKS

Compared with the traditional method based on foreign trade statistics, which only records the physical transfer of products between immediate trading partners, the trade in value added approach measures international trade as a flow of values, rather than a gross transfer of goods and
Table 3.2  Revealed comparative advantage for computers and OA equipment, 1995 and 2005

<table>
<thead>
<tr>
<th>Traditional index</th>
<th>Value-added index</th>
<th>Traditional index</th>
<th>Value-added index</th>
</tr>
</thead>
<tbody>
<tr>
<td>Singapore 6.80</td>
<td>Ireland 9.55</td>
<td>Mexico 5.48</td>
<td>Singapore 7.93</td>
</tr>
<tr>
<td>Ireland 5.27</td>
<td>Singapore 6.50</td>
<td>Singapore 4.49</td>
<td>Thailand 5.81</td>
</tr>
<tr>
<td>Taipei,China 3.60</td>
<td>Taipei,China 3.21</td>
<td>Ireland 4.03</td>
<td>Mexico 4.84</td>
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<tr>
<td>Mexico 3.16</td>
<td>Mexico 2.86</td>
<td>PRC 4.01</td>
<td>Hong Kong, China 4.65</td>
</tr>
<tr>
<td>Japan 2.13</td>
<td>Poland 1.95</td>
<td>Thailand 3.88</td>
<td>Ireland 3.81</td>
</tr>
<tr>
<td>United States 1.59</td>
<td>Japan 1.81</td>
<td>Hong Kong, China 3.71</td>
<td>PRC 2.66</td>
</tr>
<tr>
<td>Hong Kong, China 1.49</td>
<td>United Kingdom 1.52</td>
<td>Czech Republic 1.91</td>
<td>Hungary 2.24</td>
</tr>
<tr>
<td>United Kingdom 1.47</td>
<td>United States 1.52</td>
<td>Hungary 1.72</td>
<td>Philippines 1.92</td>
</tr>
<tr>
<td>PRC 1.06</td>
<td>Hong Kong, China 1.47</td>
<td>Japan 1.26</td>
<td>Japan 1.24</td>
</tr>
<tr>
<td>Poland 0.92</td>
<td>Rest of World 1.03</td>
<td>Philippines 1.04</td>
<td>United States 0.86</td>
</tr>
<tr>
<td>Korea, Rep. of 0.83</td>
<td>France 0.97</td>
<td>Taipei,China 0.83</td>
<td>United Kingdom 0.67</td>
</tr>
<tr>
<td>France 0.80</td>
<td>Korea, Rep. of 0.53</td>
<td>United States 0.69</td>
<td>Korea, Rep. of 0.55</td>
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<td>Canada 0.57</td>
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<td>Germany 0.48</td>
</tr>
<tr>
<td>Australia 0.46</td>
<td>Spain 0.47</td>
<td>United Kingdom 0.41</td>
<td>Taipei,China 0.48</td>
</tr>
<tr>
<td>Spain 0.39</td>
<td>PRC 0.47</td>
<td>Germany 0.30</td>
<td>Rest of World 0.46</td>
</tr>
<tr>
<td>Finland 0.33</td>
<td>Germany 0.42</td>
<td>India 0.30</td>
<td>India 0.39</td>
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<tr>
<td>Netherlands 0.32</td>
<td>Netherlands 0.34</td>
<td>Netherlands 0.26</td>
<td>Czech Republic 0.35</td>
</tr>
<tr>
<td>Italy 0.31</td>
<td>Romania 0.33</td>
<td>France 0.25</td>
<td>Sweden 0.31</td>
</tr>
</tbody>
</table>

Note: PRC = People’s Republic of China.

Source: Meng et al. (2012).
services. Its analytical benefits, especially from a policy-making perspective, are as follows:

1. The trade in value added approach offers a better measurement of bilateral trade in the world of increasing production sharing among countries. As shown in the chronic example of the US–PRC trade imbalances, the traditional statistics often lead to a distorted picture of international trade, due to the prevalence of multiple counting of the values per intermediate inputs as they cross national borders. This may result in misguided policies with wrong targets. The improved information on the generation and exchange of values helps to tailor appropriate schemes in the policy-making process.

2. Trade in value added analysis can be a core apparatus for linking trade policies to cross-cutting economic and social issues, such as job creation, poverty alleviation, and energy and environmental planning. This is because the input–output table, with which value-added trade is measured, is complemented by various satellite accounts, such as employment tables, energy consumption accounts, and greenhouse gas emissions matrices. The value chain is a concept that views industrial organization as a continuous process of generating value (which can be negative as in the case of environmental stress), and hence the trade in value added approach should be able to draw a comprehensive roadmap for international trade as a main driver of economic development.

NOTES

1. If we include ‘non-academic’ literature, Tempest (1996) on the Barbie doll is one of the earliest.

2. Monge-Arino (2011) presents a rare research example that successfully overcomes these analytical limitations. By conducting an extensive survey on the supply–use relations of leading companies in Costa Rica, the study identifies the value-added structure of the country’s core economic system. Though insightful, it is difficult to envisage the approach being applied to other countries, since its feasibility is fundamentally attributable to the idiosyncratic feature of Costa Rica that a few multinational corporations (such as Intel) are assumed to ‘sufficiently represent’ the national economy.

REFERENCES


World Trade Organization (WTO) and Institute of Developing Economies – Japan External Trade Organization (IDE-JETRO) (2011), Trade Patterns and Global Value Chains in East Asia: From Trade in Goods to Trade in Tasks, Geneva: IDE–JETRO and WTO.

4. Joining the supply chain: a firm-level perspective

Ganeshan Wignaraja

4.1 INTRODUCTION

Global production networks and supply chains (hereafter, supply chains) have transformed Asia in recent decades (Baldwin 2013). Joining supply chains has been a fast-track route for some Asian economies to industrialize and achieve unprecedented prosperity. Adopting outward-oriented policy reforms have facilitated entry into supply chains. Rising inequality is a problem in Asia and greater participation of SMEs in supply chains supports more inclusive growth (Lim and Kimura 2010). Increasing attention has focused on measuring the magnitude of supply chain trade through trade in parts and components and trade in value added (for example, Ng and Yeats 2003; Koopman et al. 2010; Athukorala 2011; WTO and IDE-JETRO 2011). However, little micro-level work exists on supply chains in Asia.¹ The behavior of large firms and SMEs in supply chains in Asia thus largely remains a mystery.

This chapter studies the supply chain from the unique micro-level perspective of the firm. It undertakes a comparative and firm-level analysis of factors influencing joining supply chains in Southeast Asian economies. The research aims to improve our understanding of the micro-level behavior of firms in supply chains and contribute to the handful of empirical studies on Asia. The main focus of the research is a firm-level econometric investigation of why some firms have been better able to join supply chains than others. This investigation draws on recent literature emphasizing the notion of heterogeneity of firms and highlights key enterprise characteristics (for example, firm size, technological capabilities, skills, and access to finance) underlying success. The research also maps supply chains in Southeast Asian economies by firm size at the national and enterprise levels and explores the role of the business environment in shaping enterprise behavior.

The absence of cross-country firm-level data was previously a binding constraint on micro-level research on supply chains in Asia. This research
benefited from access to a large cross-sectional enterprise dataset from the World Bank. It covers 5900 firms in five economically important outward-oriented Southeast Asian economies (Indonesia, Malaysia, the Philippines, Thailand, and Viet Nam).

The chapter is organized as follows. Section 4.2 reviews the literature and formulates hypotheses for empirical testing. Section 4.3 sets out the empirical methodology. Section 4.4 maps supply chains by firm size. Section 4.5 presents econometric results. Section 4.6 explores the role of the business environment. Section 4.7 concludes. The enterprise dataset is described in the appendices to the chapter.

4.2 LITERATURE REVIEW

An established body of trade, industrial organization, and technology literature points to the overwhelming importance of firm-specific factors, on which competitive advantages are built. As background to this research of the role of firms in supply chains, key aspects of the theoretical and empirical literature are discussed here.

4.2.1 Theory

Several strands of literature can explain trade and supply chain activity of firms, which is the focus of this chapter. The so-called fragmentation of production approach – found in seminal work by Jones and Kierzkowski (1990) and Arndt and Kierzkowski (2001) – has become the standard framework for international economists to study supply chains. It shows how increasing returns and the advantages of specialization of factors within firms encouraged the location of different stages of manufacturing production across geographical space connected by service links. Products traded between firms in different countries are components rather than final goods. Papers by Kimura and Ando (2005) and Baldwin (2013) are among those that develop conceptual explanations as to why fragmentation trade occurs. Meanwhile, Low (2013) points out that the role of services in production and trade has been understated and that this has become a greater problem with the growth of supply chains.

Competing methods have been used to quantify the magnitude of fragmentation trade. One uses national trade data obtained from the United Nations trade data reporting system to identify trade in parts and components (for example, Ng and Yeats 2003; Athukorala 2011) which are used as a proxy for supply chain trade. It shows that East Asia’s trade is increasingly made up of parts and components trade, which suggests
that global supply chains are growing in importance in Asia. Within East Asia, the PRC has been the major driving force but Southeast Asian economies have grown faster than the regional average.\(^2\) More industrially developed economies such as Malaysia and Thailand are more prominent in supply chain trade than other Southeast Asian economies. Another more innovative method – relying on input–output tables to trace value added in production networks – suggests that value added seems a more accurate means of capturing supply chain activity in Asia than trade data (for example, Koopman et al. 2010; WTO and IDE-JETRO 2011). Both methods are widely used to chart trends in supply chain trade, but their findings require careful interpretation. However, neither method highlights factors affecting firms joining supply chains. Case studies show that micro-level factors matter in supply chains. In particular, case studies suggest that large multinational corporations, which use the region as an international production base, drive the process of production fragmentation (Kuroiwa and Heng 2008; Kuroiwa 2009).

Other theoretical approaches have focused on the role of firms in international trade. The neo-Heckscher–Ohlin model and Vernon’s concept of the product cycle provided the early rationale for studies highlighting the importance of firm-specific advantages (that is, differences in skills, technologies, and tastes) in the operation of industry-level determinants of comparative advantage (for example, Lall 1986; Wilmore 1992; Wakelin 1998). More recently, the ‘new new’ trade theory of Melitz (2003) and Helpman et al. (2004) emphasized firm heterogeneity in international trade (that is, that firms are considered different in terms of efficiency and fixed and variable costs when involved in trade). Accordingly, only a few highly efficient firms are able to export and invest overseas as they are able to make sufficient profit to cover the large trade costs required for overseas operations.

The technological capability and national innovation systems approach reveals a different channel through which firm behavior affects export performance. Focusing on innovation and learning processes in developing countries, studies emphasize the acquisition of technological capabilities as a major source of export advantage at the firm level (Bell and Pavitt 1993; Lall 1992; Wignaraja 2002; Iammarino et al. 2008). The underlying evolutionary theory of technical change emphasizes that difficult firm-specific processes and complex interactions with institutions are needed to absorb imported technologies efficiently (Nelson and Winter 1992).

Combining the fragmentation of production approach with firm-level approaches to international trade provides additional insights for supply chains. Technology and know-how are key enablers of supply chains. Furthermore, firm heterogeneity (or firm-specific advantages) is
important to explaining successful entry into supply chains. In essence, the self-selection hypothesis applies whereby the better firms are more able to join supply chains than other firms. Firm size is an important aspect of being a better firm but not the whole story. Implicit in most of the above theories is the notion that SMEs are at a disadvantage in participation in supply chains compared with large firms. Small and medium-sized enterprises face, to a higher extent than large firms, resource constraints (in terms of finance, information, management capacity, and technological capability). In addition, SMEs suffer disproportionately from external barriers such as market imperfections and regulations. Accordingly, the probability of SMEs joining supply chains (as direct exporters or indirect exporters) is lower than that of large firms. Thus, justification exists for public policies to support the entry of SMEs in supply chains and exports. In the main, such support should be geared toward an enabling environment that opens access to markets, reduces bureaucratic impediments against SMEs, and provides appropriate SME institutional support services (for example, technological, marketing, and financial support).

4.2.2 Empirical Studies and Hypotheses

There is a growing econometric literature on the relationship between firm size and exports at the enterprise level (see, for example, Kumar and Siddharthan 1994; Zhao and Li 1997; Wignaraja 2002, 2012; Hollenstein 2005; Srinivasan and Archana 2011). There have also been econometric studies of SMEs and exports (for example, Lefebvre and Lefebvre 2001). A very few recent econometric studies have begun to explicitly look at the link between firm size and supply chains (for example, Harvie 2010; Harvie et al. 2010; Kyophilavong 2010; Rasiah et al. 2010; Tranh et al. 2010). The notion of firm heterogeneity receives broad support from empirical work. Several studies report that the characteristics of firms vary widely within industries and across countries. Firms that are involved in exports or supply chains are larger, more efficient, and have higher levels of skills than other firms.

However, this empirical literature has some limitations. First, scant coverage of countries and sectors was attempted. Typically, studies have looked at a single country and a specific sector within manufacturing (for example, electronics) rather than multiple countries and multiple sectors. Second, with the exception of van Dijk (2002), most work uses small samples of fewer than 1000 firms. It is thus difficult to generalize their findings. Third, two studies deal exclusively with SMEs in supply chains, but no studies compare the characteristics of large exporters with SME exporters or SME exporters with indirect SME exporters.
Our study attempts to remedy these gaps in the empirical literature. It covers five Southeast Asian economies (Indonesia, Malaysia, the Philippines, Thailand, and Viet Nam) and a wide range of industrial sectors. Second, the dataset used here is large, comprising 5900 manufacturing enterprises (including 70 percent SMEs), which were randomly selected using a comprehensive questionnaire (see Appendix 4.1). Third, the analysis is based on two alternative econometric models: one for all firms in supply chains (direct and indirect exporters) and one for sustained exporters only. Each model was estimated separately for all manufacturing firms and SMEs.

Relevant studies are mentioned below to formulate hypotheses for empirical testing in this study.

4.2.2.1 Firm size
Most studies are based on the conventional assumption that large firms are more competitive than SMEs in international markets (see Zhao and Li 1997; van Dijk 2002; and Srinivasan and Archana 2011). A positive relationship between size and exports has thus been reported. Similar arguments can be made about participation in supply chains through direct and indirect exporting. Owing to scale economies, larger firms may have lower average and marginal costs, which would increase the probability of participation in supply chains. Furthermore, large firms have more resources to meet the fixed costs of entry into supply chains (for example, information, marketing, and technology expenses). A few studies, however, report no relationship or a negative one. This conflicting result can be partly attributed to the nonlinear nature of this relationship (Kumar and Siddharthan 1994; Lefebvre and Lefebvre 2001). It may be that economies of scale and fixed costs are significant in the early stages of joining production networks but less relevant in the longer term. For instance, SMEs may join together in industrial clusters and collectively overcome the disadvantage of firm size. Alternatively, some SMEs might concentrate on niche markets and emerge as leading enterprises with branded products.

As a result of the above discussion, the following hypothesis is proposed:

**Hypothesis 1:** Firm size is expected to have a positive effect on participation in supply chains up to a given threshold, but may not matter later on.

4.2.2.2 Technological capabilities
Empirical studies indicate that firm-level technological capabilities contribute to export performance (Zhao and Li 1997; Hobday 2001; Rasiah
Building technological capabilities in developing country firms, particularly SMEs, is not just a simple function of years of production experience. Rather, it requires conscious investments in creating skills and information to operate imported technology efficiently. Such investments involve a spectrum of technological activities, such as technology search, quality management, engineering, and research and development (R&D) activities (Kumar and Siddharthan 1994; Lefebvre and Lefebvre 2001). Importing technology through foreign licenses is an important mechanism for transfer of new technologies and internal capability building. Furthermore, foreign buyers and subcontractors view internal quality standards (for example, International Organization for Standardization – ISO – certification) as increasingly compulsory for enterprises to qualify as potential suppliers. Developing new products (or modifying existing products) and taking out patents to protect intellectual property rights also facilitate export competitiveness at the firm level.

These considerations suggest:

Hypothesis 2: Firms that have acquired high levels of technological capabilities are more likely to succeed in supply chains.

4.2.2.3 Human capital

Within a given activity, a higher level of human capital contributes to a firm’s export performance. Higher levels of human capital are generally linked with development of more effective business strategies and more rapid technological learning that can provide a competitive edge at the enterprise level (van Dijk 2002; Dueñas-Caparas 2006). Enterprises with a stock of high-quality human capital are expected to be more likely to perform well in supply chains as this is essential for forging close supplier relationships with large exporters, effective technology transfer, and efficient production of orders (Harvie et al. 2010). Although human capital at all levels is important, workers’ education and that of the chief executive officer (CEO) and his or her experience are particularly significant for participation in supply chains. A literate workforce made up of high school graduates is more productive and adaptive to new technology than one that is not. Furthermore, a CEO with a college degree or vocational training as well as work experience may have a better business attitude (that is, in terms of risk taking or willingness to implement new business ideas). In SMEs, with few high school educated workers, much of the firm’s human capital may be reflected in the quality of the CEO’s education and experience.

Accordingly, the following could be said:
Hypothesis 3: Higher levels of human capital, in terms of secondary level educated workers or well-educated and experienced CEOs, are positively correlated with joining supply chains.

4.2.2.4 Age
A learning-by-doing effect may be at work, the older the firm, the more accumulated experience in production and tacit knowledge, which is likely to facilitate participation in supply chains. Alternatively, mature firms may become complacent with an overreliance on accumulated experience and set in past ways. Meanwhile, younger firms may be at an advantage in joining supply chains for two reasons. First, younger enterprises may use relatively modern technology, which increases productivity and product quality (van Dijk 2002). Second, they may be more proactive in learning about business and technological opportunities in supply chains. For instance, younger firms may be more nimble in seeking out new sources of information and external knowledge, such as market information from buyers of output or technical know-how from equipment suppliers. Younger firms may be more flexible in combining external and internal information to realize opportunities in supply chains.

Bearing in mind these different possibilities, the following hypothesis is put forward:

Hypothesis 4: Firm age needs to be controlled for when looking for relationships between factors affecting firm-level participation in supply chains.

4.2.2.5 Foreign ownership
A joint venture with a foreign partner (or 100 percent foreign equity) facilitates participation in supply chains, as it enables firms to reap the ownership advantages of parent companies (Wilmore 1992; Nguyen and Nishijima 2009; Srinivasan and Archana 2011). First, access to the superior marketing connections and know-how of parent companies enables direct and indirect exporting. Second, access to parent companies' accumulated learning experience of export production as well as access to sophisticated technologies and management experience improves technical efficiency. The transfer of such ownership-specific advantages depends on whether the foreign firm has a controlling interest in the domestic venture. A controlling interest typically can occur with minority foreign equity in a project rather than total foreign equity. In most of the previous literature on firm-level exporting and participation in supply chains, it has been consistently observed that foreign ownership matters.

These arguments lead to the following proposition:
Hypothesis 5: Foreign ownership is positively related to participation in supply chains because it provides access to superior marketing, technology, and management expertise.

4.2.2.6 Access to credit

Access to credit for working capital and investment is typically a binding constraint on the involvement of firms in supply chains (Harvie et al. 2010). Capital markets in developing countries are highly segmented into a formal bank sector and informal sources owing to various market imperfections associated with underdevelopment. Credit from commercial banks is usually cheaper than finance from informal credit sources but requires substantial information about balance sheets and collateral. Many firms (including SMEs) find it difficult to provide the requisite financial information and collateral and instead rely on internally generated funds or more expensive informal sources. This puts them at a cost disadvantage compared to well-organized firms with an established record with commercial banks.

The following hypothesis emerges:

Hypothesis 6: Enterprises with access to bank credit are more likely to join supply chains than other firms.

4.3 EMPIRICAL METHODOLOGY

In order to examine the firm-level characteristics shaping all manufacturing firms’ and SMEs’ joining supply chains, the following general equation is estimated:

$$Y = \beta X + \varepsilon,$$

where $Y$ is the vector denoting joining supply chains at the firm level, $X$ is the matrix of explanatory variables, $\beta$ is the matrix of coefficients, and $\varepsilon$ is the matrix of error terms.

Joining supply chains is captured by a binary variable reflecting different activities by firms in such networks, particularly SMEs. The probit model in two alternative forms was used here. In the first, the dependent variable takes a value of 1 if a firm undertakes any form of activity in a supply chain (that is, as an exporter, an indirect exporter, or some combination of the two) and 0 for a wholly domestic market-oriented firm. In the second, the dependent variable is 1 if the firm’s primary mission is to export (defined as more than 40 percent of sales being exported globally) and 0 otherwise.
The first captures all involvement of firms in supply chains regardless of the intensity of exporting or indirect exporting behavior (subcontracting or input supply) of a given firm. While this definition is inclusive, it encompasses a range of participation in supply chains from occasional and limited involvement of firms to more sustained involvement. Accordingly, the second was formulated to represent a more focused mission of sustained involvement in supply chains through exports. It is interesting to examine whether the determinants are the same for both models. Our approach refines previous work which did not distinguish between different activities undertaken by SMEs in production networks.

The hypotheses were described in section 4.2. The explanatory variables in $X$ in equation (4.1) are described in the following, and Table 4.1 includes a summary.

**Firm size** is represented by the number of employees. This is commonly used in empirical work as other measures such as value added or output are more susceptible to variations in macroeconomic conditions. To provide additional insights, a size-squared variable was also added to some of the models.

**Technological capabilities** are represented by several variables: (a) a dummy variable which is 1 if a firm has a technology license; (b) a dummy variable which is 1 if a firm has a form of internationally agreed quality certification (for example, ISO 9000 or 9002); and (c) a dummy variable which is 1 if a firm has registered a patent. The three chosen variables were the only technology variables included in the dataset for Indonesia, the Philippines, and Viet Nam. Accordingly, these were included individually in the regressions and a composite technology index could not be constructed.

**Age** is represented by the number of years in operation of the firm. This is more accurate than number of years since establishment as there can be a lag between the legal incorporation of a firm and the start-up of plant operations.

**Human capital** is proxied by the following variables: (a) a dummy variable which is 1 if the average production worker has high school education; (b) four dummy variables to capture different levels of educational attainment of the CEO from primary schooling to college education; and (c) the number of years of work experience of the CEO. In line with the hypothesis on human capital, these variables attempt to capture the average quality of education of workers and the CEO. In addition, the CEO’s experience is included.

**Foreign ownership** is captured by a dummy variable which takes a value of 1 if the firm has any foreign equity. The standard
### Table 4.1 Description of variables

<table>
<thead>
<tr>
<th>Variable</th>
<th>Description</th>
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<tbody>
<tr>
<td><strong>Independent</strong></td>
<td></td>
</tr>
<tr>
<td>Size</td>
<td>No. of permanent workers</td>
</tr>
<tr>
<td>Size squared</td>
<td>Square of the no. of permanent workers</td>
</tr>
<tr>
<td>SME</td>
<td>Firm has fewer than 100 employees (1–99)</td>
</tr>
<tr>
<td>Foreign license</td>
<td>1 if firm uses technology licensed from foreign-owned company (excluding software); 0 otherwise</td>
</tr>
<tr>
<td>ISO</td>
<td>1 if firm has a form of internationally-agreed certification (e.g., ISO 9000, ISO 9002); 0 otherwise</td>
</tr>
<tr>
<td>Patent</td>
<td>1 if firm has registered a patent; 0 otherwise</td>
</tr>
<tr>
<td>Age</td>
<td>No. of years in operation</td>
</tr>
<tr>
<td>Workers HS</td>
<td>1 if average production worker has HS education; 0 otherwise</td>
</tr>
<tr>
<td>GM primary</td>
<td>1 if GM/CEO’s highest level of education is primary school; 0 otherwise</td>
</tr>
<tr>
<td>GM secondary</td>
<td>1 if GM/CEO’s highest level of education is HS; 0 otherwise</td>
</tr>
<tr>
<td>GM vocational</td>
<td>1 if GM/CEO’s highest level of education is vocational; 0 otherwise</td>
</tr>
<tr>
<td>GM college</td>
<td>1 if GM/CEO’s highest level of education is college; 0 otherwise</td>
</tr>
<tr>
<td>GM experience</td>
<td>No. of years of work experience of the GM/CEO</td>
</tr>
<tr>
<td>Foreign ownership</td>
<td>1 if firm has foreign ownership; 0 otherwise</td>
</tr>
<tr>
<td>Access to credit</td>
<td>1 if firm has credit line/loan from financial institution; 0 otherwise</td>
</tr>
<tr>
<td>Indonesia</td>
<td>1 if firm is located in Indonesia; 0 otherwise</td>
</tr>
<tr>
<td>Malaysia</td>
<td>1 if firm is located in Malaysia; 0 otherwise</td>
</tr>
<tr>
<td>Philippines</td>
<td>1 if firm is located in the Philippines; 0 otherwise</td>
</tr>
<tr>
<td>Thailand</td>
<td>1 if firm is located in Thailand, 0 otherwise</td>
</tr>
<tr>
<td>Viet Nam</td>
<td>1 if firm is located in Viet Nam; 0 otherwise</td>
</tr>
<tr>
<td><strong>Dependent</strong></td>
<td></td>
</tr>
<tr>
<td>1. All firms in supply chains</td>
<td>1 if more than 0% of sales are exported (directly or indirectly); 0 otherwise</td>
</tr>
<tr>
<td>2. Sustained exporter</td>
<td>1 if more than 40% of sales are directly exported; 0 otherwise</td>
</tr>
</tbody>
</table>

*Note: CEO = chief executive officer, GM = general manager, HS = high school, ISO = International Organization for Standardization, SMEs = small and medium-sized enterprises.*
measure – share of foreign equity – seems to suffer from some noise and may be correlated with number of employees. Access to credit is proxied by a dummy variable which is 1 if a firm has a credit line or loan from a formal financial institution.

In addition, four country dummy variables were included to capture country-specific effects of the five Southeast Asian economies.

4.4 MAPPING SUPPLY CHAINS BY FIRM SIZE

4.4.1 Insights from National Data and Problems

Research on firm size in Southeast Asian economies is scarce and sometimes contentious. A major problem facing such research is the dearth of data at the sectoral level and the use of different definitions of SMEs (for example, turnover, employment, assets, and so on). Appendix 4.2 shows the definitions of SMEs in Southeast Asia and other economies. In Thailand and Viet Nam, SMEs are defined by broad economic sectors and assets or employees. Malaysia defines SMEs by broad economic sectors and turnover or employees. Indonesia uses only assets or turnover, while the Philippines relies only on assets. A further problem is that assets or turnover are expressed in national currencies and the firm size thresholds are not comparable when converted into US dollars. These problems make it difficult to reliably compare the role of SMEs across Southeast Asian economies over time. As a crude approximation, studies (for example, Harvie and Lee 2002; Tambunan 2009; Lim and Kimura 2010) have typically used national SME definitions to compute the share of SMEs in employment, GDP, and exports in Southeast Asian economies for the most recent year. The balance shares of economic aggregates are attributed to large firms. The SME shares of exports can be used as an indication of the sector’s involvement in supply chains.

Following this approach, Table 4.2 provides most recent estimates of economic activity by firm size for the five Southeast Asian economies in this study and for other selected economies (the PRC, Germany, the Republic of Korea, Japan, and the US). Several interesting findings emerge.

First, on average, SMEs account for the majority of national employment in Southeast Asian economies (74.4 percent) and a notable share of GDP (40.8 percent). Meanwhile, large firms account for the remainder (25.6 percent of employment and 59.2 percent of GDP). Inter-country variations are visible in these figures. Indonesia seems an outlier in Southeast
Table 4.2  Contribution of large firms and SMEs in economic activity, most recent estimates (national data, percentage)

<table>
<thead>
<tr>
<th></th>
<th>Large firms</th>
<th></th>
<th>SMEs</th>
<th></th>
<th>Yeara</th>
<th>Definition of SMEs</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Share of total employment</td>
<td>Contribution to GDP</td>
<td>Share of total employment</td>
<td>Contribution to GDP</td>
<td>Share of total employment</td>
<td></td>
</tr>
<tr>
<td><strong>Southeast Asian economies</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Malaysia</td>
<td>41.1</td>
<td>68.1</td>
<td>81.0</td>
<td>58.9</td>
<td>31.9</td>
<td>19.0 Emp 2008, GDP 2010, Exp 2005</td>
</tr>
<tr>
<td>Thailand</td>
<td>22.1</td>
<td>61.3</td>
<td>70.5</td>
<td>77.9</td>
<td>38.7</td>
<td>29.5 Based on industry, number of employees, and total assets</td>
</tr>
<tr>
<td>Philippines</td>
<td>39.0</td>
<td>64.3</td>
<td>80.0</td>
<td>61.0</td>
<td>35.7</td>
<td>20.0 Emp/GDP 2011, Exp 2001</td>
</tr>
<tr>
<td>Indonesia</td>
<td>2.8</td>
<td>42.2</td>
<td>84.2</td>
<td>97.2</td>
<td>57.8</td>
<td>15.8 Based on total assets and turnover</td>
</tr>
<tr>
<td>Viet Nam</td>
<td>23.0</td>
<td>60.0</td>
<td>80.0</td>
<td>77.0</td>
<td>40.0</td>
<td>20.0 Emp/GDP 2011, Exp 2009</td>
</tr>
<tr>
<td>Average</td>
<td>25.6</td>
<td>59.2</td>
<td>79.1</td>
<td>74.4</td>
<td>40.8</td>
<td>20.9</td>
</tr>
<tr>
<td><strong>Comparator economies</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>People’s Republic of China</td>
<td>20.0</td>
<td>41.5</td>
<td>32.0</td>
<td>80.0</td>
<td>58.5</td>
<td>68.0 2009 Based on industry, number of employees, total assets, and turnover</td>
</tr>
</tbody>
</table>

*Note: GDP stands for Gross Domestic Product, Exp for Exports.*
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Republic of Korea</td>
<td>12.5 50.6 69.1 87.5 49.4 30.9</td>
<td>Based on industry, number of employees, capital, and turnover</td>
<td>Based on industry, number of employees, capital and turnover</td>
</tr>
<tr>
<td>Japan</td>
<td>29.8 50.0 46.2 70.2 50.0 53.8</td>
<td>Emp/GDP 2010, Exp 2009</td>
<td>Emp/GDP 2010, Exp 2009</td>
</tr>
<tr>
<td>Germany</td>
<td>21.0 46.2 44.1 79.0 53.8 55.9</td>
<td>Emp/GDP 2010, Exp 2009</td>
<td>Based on the number of employees, turnover, and assets</td>
</tr>
<tr>
<td>United States</td>
<td>50.6 54.0b 66.3 49.4 46.0b 33.7</td>
<td>Emp/Exp 2010, GDP 2008</td>
<td>Based on number of employees</td>
</tr>
</tbody>
</table>

Notes: GDP = gross domestic product, SMEs = small and medium-sized enterprises.

Asia with SMEs accounting for as much as 97.2 percent of employment and 57.8 percent of GDP. The figures for the Southeast Asian economies are generally in line with international trends. Small and medium-sized enterprises make up the majority of employment and about half of GDP in the comparator economies. The US has a much lower SME share of employment than other comparator economies.

Second, SMEs in Southeast Asian economies make relatively little contribution to exports relative to the sector’s size or employment contribution. On average, SMEs account for only 20.9 percent of exports compared with 79.1 percent for large firms. A comparison with an earlier study by Harvie and Lee (2002) suggests that the figure for SME exports in Southeast Asian economies may have risen modestly over time. It thus appears that SMEs in Southeast Asia play a limited role in supply chains as direct exporters. It is possible, however, that SME export shares in Southeast Asian economies may be understated if indirect exports through subcontracting or input supply are included (Tambunan 2009). Data gaps, however, make it hard to estimate the indirect contribution of SMEs to national exports.

Third, Thailand seems an outlier among the five Southeast Asian economies with a relatively high share of its exports (29.5 percent) originating from SMEs. The other Southeast Asian economies have notably lower SME export shares. In Indonesia, the figure is particularly low (15.8 percent).

Fourth, SMEs in more industrialized East Asian economies and other developed economies are more involved in supply chains as direct exporters than in Southeast Asian economies. The data show that as much as 68 percent of the PRC’s exports, 53.8 percent of Japan’s exports, and 30.9 percent of the Republic of Korea’s exports come from SMEs. It seems that room exists for the advancement of SMEs in Southeast Asian economies’ exports through supply chains.

National-level data, however, suffer from some important drawbacks from the perspective of this study on enterprise behavior in supply chains. As discussed earlier, no standard definition of firm size exists for national data collection in Southeast Asian economies, which makes cross-country comparisons problematic. Furthermore, national sources on Southeast Asian economies lack data on indirect SME exports (for small firms as input suppliers or subcontractors) and explanatory variables for micro-level econometric analysis of supply chains or exports. To remedy these problems with national data sources, our study was based on information from multi-country, multi-firm surveys collected by the World Bank’s Enterprise Surveys. Appendix 4.1 describes the cross-section dataset of 5900 enterprises in the five Southeast Asian economies, which was
collected in the late-2000s. The absence of cross-country firm-level data has been up to now a binding constraint on such research.

### 4.4.2 Findings on Firm Size in Supply Chains

Table 4.3 provides data on aspects of the sample firms’ overall participation in supply chains for each Southeast Asian economy sample and across the five countries. These include the number of firms in supply chains (that is, both direct and indirect exporters), large firms in supply chains as a percentage of all large firms, and SMEs in supply chains as a percentage of all SMEs. Table 4.3 also provides data on export behavior by firm size, including the percentage of exports from large firms and SMEs in total export value as well as the share of the top 25 percent of SME exporters in terms of export value.

The following can be observed:

- A minority of the sample firms (37.3 percent of the total) are in supply chains. More developed Southeast Asian economies such as Malaysia and Thailand have particularly high representation in supply chains (nearly 60 percent of their firms participate). Viet Nam (36.4 percent) follows. The Philippines (26.9 percent) and Indonesia (14.5 percent) have relatively low participation in supply chains.

- Large firms are the major players in supply chains with 72.1 percent of all large firms participating. Most of the large firms in Malaysia and Thailand are involved in supply chains and over half the large firms in the remaining three countries.

- SMEs are minor players in supply chains as only 22.0 percent of all SMEs participate. Small and medium-sized enterprise participation rates vary considerably across Southeast Asian economies. As much as 46.2 percent of all SMEs in Malaysia and 29.6 percent of all SMEs in Thailand are involved in supply chains. In Viet Nam, the figure is 21.4 percent and in the Philippines 20.1 percent. Indonesia seems an outlier with only 6.3 percent of all SMEs involved in supply chains.

- A small fraction of SMEs in supply chains are 100 percent global exporters. The vast majority of such SMEs engage in either a mix of global exports and indirect exporting, or purely indirect exports. Accordingly, only 18.2 percent of SMEs in supply chains in all the countries are 100 percent global exporters. The figures by country are: Malaysia (14.1 percent), Thailand (16.4 percent), Philippines (27.2 percent), Indonesia (15.0 percent), and Viet Nam (19.2 percent).
<table>
<thead>
<tr>
<th></th>
<th>All sample countries</th>
<th>Malaysia</th>
<th>Thailand</th>
<th>Philippines</th>
<th>Indonesia</th>
<th>Viet Nam</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) Number of firms in supply chains&lt;sup&gt;c&lt;/sup&gt;</td>
<td>2203</td>
<td>646</td>
<td>619</td>
<td>352</td>
<td>206</td>
<td>380</td>
</tr>
<tr>
<td>(2) Supply chain firms as a percentage of all firms, %</td>
<td>37.3</td>
<td>59.7</td>
<td>59.3</td>
<td>26.9</td>
<td>14.5</td>
<td>36.4</td>
</tr>
<tr>
<td>(3) Large firms in supply chains as a percentage of all large firms, %</td>
<td>72.1</td>
<td>82.4</td>
<td>91.1</td>
<td>51.1</td>
<td>52.0</td>
<td>64.6</td>
</tr>
<tr>
<td>(4) SMEs in supply chains as a percentage of all SMEs, %</td>
<td>22.0</td>
<td>46.2</td>
<td>29.6</td>
<td>20.1</td>
<td>6.3</td>
<td>21.4</td>
</tr>
<tr>
<td>(5) Share of large firms in total exports, %</td>
<td>77.0</td>
<td>71.9</td>
<td>65.3</td>
<td>66.6</td>
<td>90.7</td>
<td>83.2</td>
</tr>
<tr>
<td>(6) Share of SMEs in total exports, %</td>
<td>23.0</td>
<td>28.1</td>
<td>34.7</td>
<td>33.4</td>
<td>9.3</td>
<td>16.8</td>
</tr>
<tr>
<td>(7) Share of top 25% SME exporters in terms of export value, %</td>
<td>85.8</td>
<td>69.9</td>
<td>85.0</td>
<td>78.9</td>
<td>96.3</td>
<td>76.2</td>
</tr>
<tr>
<td>(8) Share of SMEs that are 100% exporters&lt;sup&gt;d&lt;/sup&gt;</td>
<td>18.2</td>
<td>14.1</td>
<td>16.4</td>
<td>27.2</td>
<td>15.0</td>
<td>19.2</td>
</tr>
</tbody>
</table>

Notes: SMEs = small and medium-sized enterprises.
- Large firms are defined as firms with 100 or more employees.
- SMEs are defined as firms with 1–99 employees.
- Number of firms in supply chain includes direct and indirect exporters.
- SMEs that do not serve the domestic market.

Source: Author’s calculations based on World Bank Enterprise Surveys.
Large firms (77 percent) make a larger contribution to exports in all countries compared with SMEs (23 percent). The country-level pattern of SME export shares is broadly reflective of the picture of SME participation in supply chains. Malaysia (28.1 percent) and Thailand (34.7 percent) are among the leaders in terms of SME export shares. The Philippines, unexpectedly, has a similarly high SME export share (33.4 percent), which may partly reflect the high proportion of SME numbers in the country sample. Viet Nam’s SME export share is 16.8 percent, while Indonesia’s is 9.3 percent.

Small and medium-sized enterprise exports are highly concentrated in a relatively few firms in the Southeast Asian economies. The top 25 percent of SMEs account for 85.8 percent of SME exports in all countries. Concentration in the top 25 percent of SME exporters is highest in Indonesia (96.3 percent). This is followed by Thailand (85.0 percent), the Philippines (78.9 percent), Viet Nam (76.2 percent), and Malaysia (69.9 percent).

4.5 ECONOMETRIC RESULTS

This section examines factors influencing the engagement of firms in supply chains in the five Southeast Asian economies. A probit model was used to estimate equation (4.1) specified in section 4.3 using the two alternative dependent variables but with the same set of determinants. The results of the probit regressions are shown in Table 4.4. Column 1 shows the results of the model for all manufacturing firms in supply chains, while the results of sustained exporters are in column 2. The results for SMEs are in columns 3 and 4.

Following diagnostic testing, we first consider the results for all manufacturing firms and then for SMEs. As shown by a higher $R^2$, the ‘all manufacturing firms in supply chains’ model better fits the outcome data than the ‘sustained exporters’ model. Many of the firm-specific variables are significant, as hypothesized. The coefficient of firm size is positive and significant, as expected, in both models. Adding a size-squared variable in the all manufacturing firms model was useful in clarifying the size effect. The coefficient on size-squared is negative and significant, implying a non-linear relationship. Thus, it seems that economies of scale and fixed costs are important in the early stages of joining production networks, but less relevant over time as SMEs become important players in their own niche markets or form industrial clusters.

The coefficient on internationally agreed quality certification is positive and significant in both models. Having an internationally agreed quality
### Table 4.4 Probit estimates

<table>
<thead>
<tr>
<th></th>
<th>All manufacturing firms</th>
<th></th>
<th>SMEs only</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>All firms in supply chain</td>
<td>Sustained exporter</td>
<td>All firms in supply chain</td>
</tr>
<tr>
<td>Firm size</td>
<td>0.002*** (0.000)</td>
<td>0.001*** (0.000)</td>
<td>0.012*** (0.001)</td>
</tr>
<tr>
<td>Firm size squared</td>
<td>−0.000*** (0.000)</td>
<td>−0.000*** (0.000)</td>
<td></td>
</tr>
<tr>
<td>Firm uses foreign licenses</td>
<td>0.169*** (0.055)</td>
<td>0.027 (0.061)</td>
<td>0.196*** (0.073)</td>
</tr>
<tr>
<td>Firm is ISO-certified</td>
<td>0.403*** (0.049)</td>
<td>0.100* (0.053)</td>
<td>0.311*** (0.071)</td>
</tr>
<tr>
<td>Firm has registered patents</td>
<td>0.331*** (0.056)</td>
<td>0.063 (0.062)</td>
<td>0.218*** (0.073)</td>
</tr>
<tr>
<td>Firm age</td>
<td>−0.004* (0.002)</td>
<td>−0.009*** (0.002)</td>
<td>−0.004* (0.003)</td>
</tr>
<tr>
<td>Workers have HS education</td>
<td>0.181*** (0.045)</td>
<td>0.053 (0.050)</td>
<td>0.255*** (0.059)</td>
</tr>
<tr>
<td>GM has primary education</td>
<td>0.167 (0.285)</td>
<td>0.131 (0.365)</td>
<td>0.329 (0.415)</td>
</tr>
<tr>
<td>GM has secondary education</td>
<td>0.372 (0.273)</td>
<td>0.256 (0.351)</td>
<td>0.482 (0.404)</td>
</tr>
<tr>
<td>GM has vocational degree</td>
<td>0.516* (0.276)</td>
<td>0.387 (0.354)</td>
<td>0.538 (0.407)</td>
</tr>
<tr>
<td>Variable</td>
<td>GM has college degree</td>
<td>GM’s experience</td>
<td>Foreign ownership</td>
</tr>
<tr>
<td>---------------------------</td>
<td>----------------------</td>
<td>-----------------</td>
<td>-------------------</td>
</tr>
<tr>
<td></td>
<td>0.595** (0.272)</td>
<td>0.003 (0.002)</td>
<td>0.566*** (0.050)</td>
</tr>
<tr>
<td></td>
<td>0.564 (0.349)</td>
<td>0.005** (0.002)</td>
<td>0.533*** (0.053)</td>
</tr>
<tr>
<td></td>
<td>0.515 (0.403)</td>
<td>0.003 (0.003)</td>
<td>0.547*** (0.071)</td>
</tr>
<tr>
<td></td>
<td>0.159 (0.484)</td>
<td>0.007** (0.003)</td>
<td>0.500*** (0.081)</td>
</tr>
<tr>
<td>N</td>
<td>5641</td>
<td>5641</td>
<td>3903</td>
</tr>
</tbody>
</table>

**Notes:**
GM = general manger, HS = high school, ISO = International Organization for Standardization, PN = production network, SMEs = small and medium-sized enterprises.
* p<0.1, ** p<0.05, *** p<0.01.
Binary variable: 1 if part of a production network; 0 otherwise.
Robust standard errors in parentheses.
Thailand was used as reference.
All firms in PN: 1 if more than 0 percent of sales are exported (directly or indirectly); 0 otherwise.
Sustained exporter: 1 if more than 40 percent of sales are directly exported; 0 otherwise.

**Source:** Author’s calculations based on World Bank Enterprise Surveys.
A World Trade Organization for the 21st century

certificate (such as ISO) increases the probability of a firm joining a supply chain. Foreign licenses and registered patents are also significant with the correct sign in the all manufacturing firms model. Accordingly, firms that have acquired higher levels of technological capabilities are more likely to succeed in supply chains. This requires firms to undertake conscious investments in skills and information to operate imported technologies rather than simply learning by doing. Capability building involves a range of technological activities, including actively acquiring new technologies through foreign licenses, implementing international quality standards, and developing new products supported by patent protection.

The firm age variable is negative and significant in both models, thereby contradicting the hypothesized positive sign. While age may be a proxy for many influences, this result suggests that younger firms are likely to be more nimble in learning new market and technological information and more flexible in combining internal and external knowledge in an efficient manner. Both of these traits are likely to facilitate younger firms joining production networks.

The coefficient on workers' high school education is positive and significant in the all manufacturing firms model. Having a high school educated workforce increases the probability of a firm joining a supply chain. Furthermore, the CEO having a college degree or vocational degree is positive and significant in the all manufacturing firms model. Meanwhile, the CEO's experience is positive and significant in the sustained exporters model. These results suggest that higher levels of human capital, particularly literate secondary-level educated workers, college and vocational educated CEOs, and experienced CEOs, increase the probability of a manufacturing firm joining a supply chain. The foreign ownership variable has a positive and significant effect on the probability of joining supply chains in both models. Access to the superior marketing connections and know-how of parent companies enables direct and indirect exporting by firms. Furthermore, access to parent companies’ accumulated learning experience of export production as well as access to sophisticated technologies and management experience improves technical efficiency in firms.

Access to commercial bank credit is positive and significant in the all manufacturing firms model. This suggests that, in the presence of capital market imperfections, well-organized firms with collateral and an established record with commercial banks are more likely to join production networks.

The significance of the coefficients on the country dummies suggests that some differences exist between the Southeast Asian countries. Indonesia, Malaysia, and the Philippines are significant in both models. Viet Nam is significant in the all manufacturing firms model.
The two all manufacturing firms models provide a somewhat better fit than the two SME models (compare the R² in columns 1 and 2 with columns 3 and 4). The all-SMEs model (column 3) is a better fit to the outcome data than the sustained SME exporters model (column 4). Interestingly, several variables (firm size, international quality certification, firm age, workers high school education and foreign ownership) turn out as significant with the correct sign in both SME models. Hence, the key determinants of firm-level participation in supply chains are remarkably stable across the four models, suggesting that the pattern for all manufacturing firms broadly holds for SMEs.

There are also some differences between the all-manufacturing-firms models (columns 1 and 2) and the SME models (columns 3 and 4). The size-squared variable was not significant in either SME model. In addition, the CEO’s characteristics are less pronounced in the SME models, with only CEO’s experience being significant in the sustained-SME-exporters model. Finally, country characteristics matter but differ somewhat between the different models.

It is interesting to examine some predicted probabilities of the size variable holding all other variables at their means. In the all-SMEs model (column 3) the probability of an SME participating in a supply chain for a firm with 1 to 25 workers is 10 percent, compared with 35 percent for one that has 75 to 100 workers. Having an internationally agreed quality certificate (such as ISO) increases the probability of an SME joining a supply chain from 16 percent to 25 percent in the all-SMEs model (column 3). Having a high school-educated workforce increases the probability of an SME joining a production network from 14 percent to 21 percent in the all-SMEs model (column 3).

### 4.6 EXPLORING THE BUSINESS ENVIRONMENT

#### 4.6.1 Incentive and Supply-side Policies

The overall business environment in Southeast Asian economies is an important influence on firms joining supply chains. A myriad of reform policies, factor markets, and targeted policies are involved. These range from trade policies and customs regulations to business start-up regulations, export promotion initiatives, special financing schemes, and technology support measures. It is hard to portray the overall business environment in Southeast Asian economies and disentangle the different effects on firms. One practical method is to use available data on enterprise perceptions to examine the supportive nature of the business
environment facing SMEs in their quest to participate in supply chains. Small and medium-sized enterprise-level analysis of the business environment is useful to formulate policy implications for SMEs, which are less present in supply chains or exports than large firms in Southeast Asian economies.

Table 4.5 lists the main obstacles identified by the SMEs in conducting business in the Southeast Asian economies using information from the World Bank’s Enterprise Surveys. These are grouped under three headings: incentive framework, supply-side factors, and other. The discussion that follows highlights SMEs’ views of major obstacles facing them for all five Southeast Asian economies and for individual economies. The data for Thailand should be interpreted with caution as the survey was conducted in the late-2000s during a period of political turbulence and uncertainty.

Contrary to expectations, the leading obstacle facing SMEs in all Southeast Asian economies falls under the heading of ‘other’ and relates to the practices of competitors in the informal sector. Cited by 38.6 percent of all SMEs in Southeast Asian economies, such practices refer to a variety of negative activities including smuggling of goods and inputs, price fixing and other anticompetitive practices, and poaching of skilled workers. A high degree of trust among firms is increasingly regarded by multinational corporations as a critical ingredient for developing market-led production networks. Among other things, high levels of trust encourage positive collective behavior among firms (for example, sharing of sensitive information, pooling of technical knowledge, and joint production and marketing activities), which is critical in technologically intense, efficient production networks. However, the data are suggestive of a general trust deficit among SMEs in Southeast Asian economies which impedes the development of production networks with greater SME involvement. Interestingly, Malaysian SMEs (20.7 percent) seem to view the practices of competitors much less seriously than those of the other Southeast Asian economies, suggesting that higher levels of trust exist among its enterprises.

A variety of supply-side factors are viewed as an obstacle by SMEs. The usual constraint in most studies of SMEs – access to finance (34.6 percent) – follows closely as the second most important obstacle in Southeast Asian economies. This issue seems least severe in Malaysia (22.1 percent) and most severe in Viet Nam (39.4 percent) and Indonesia (38.6 percent). Both the high cost of borrowing and the availability of financing from commercial banks fall under this heading. Inter-country differences in access to finance partly reflect the influence of monetary policies and the development of capital markets. A lack of financing is a deterrent to some
Table 4.5  Main obstacles to conducting business, SMEs (percentage of all SMEs)

<table>
<thead>
<tr>
<th></th>
<th>All sample countries</th>
<th>Malaysia</th>
<th>Thailand</th>
<th>Philippines</th>
<th>Indonesia</th>
<th>Viet Nam</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Incentives</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tax rates</td>
<td>31.9</td>
<td>31.1</td>
<td>54.8</td>
<td>42.9</td>
<td>14.3</td>
<td>16.5</td>
</tr>
<tr>
<td>Tax administration</td>
<td>26.7</td>
<td>24.0</td>
<td>49.6</td>
<td>34.2</td>
<td>13.3</td>
<td>12.4</td>
</tr>
<tr>
<td>Customs and trade regulations</td>
<td>20.0</td>
<td>20.1</td>
<td>41.0</td>
<td>18.0</td>
<td>12.5</td>
<td>8.7</td>
</tr>
<tr>
<td>Business licensing and permits</td>
<td>16.7</td>
<td>16.4</td>
<td>25.4</td>
<td>22.1</td>
<td>16.5</td>
<td>2.8</td>
</tr>
<tr>
<td>Political instability/economic uncertainty</td>
<td>34.7</td>
<td>28.8</td>
<td>84.0</td>
<td>28.9</td>
<td>29.5</td>
<td>2.3</td>
</tr>
<tr>
<td><strong>Supply-side factors</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Transport</td>
<td>23.8</td>
<td>11.3</td>
<td>33.6</td>
<td>26.5</td>
<td>23.2</td>
<td>24.2</td>
</tr>
<tr>
<td>Electricity</td>
<td>29.6</td>
<td>17.9</td>
<td>42.4</td>
<td>30.6</td>
<td>30.2</td>
<td>26.7</td>
</tr>
<tr>
<td>Telecommunication</td>
<td>10.4</td>
<td>9.3</td>
<td>24.5</td>
<td>7.6</td>
<td>6.6</td>
<td>3.8</td>
</tr>
<tr>
<td>Access to finance/credit</td>
<td>34.6</td>
<td>22.1</td>
<td>44.3</td>
<td>28.5</td>
<td>38.6</td>
<td>39.4</td>
</tr>
<tr>
<td>Inadequately educated labor force</td>
<td>28.0</td>
<td>24.1</td>
<td>60.2</td>
<td>16.8</td>
<td>15.4</td>
<td>23.7</td>
</tr>
<tr>
<td>Labor regulations</td>
<td>17.4</td>
<td>17.2</td>
<td>35.2</td>
<td>15.5</td>
<td>11.3</td>
<td>8.0</td>
</tr>
<tr>
<td>Access to land</td>
<td>16.0</td>
<td>11.1</td>
<td>11.7</td>
<td>9.6</td>
<td>19.2</td>
<td>28.3</td>
</tr>
<tr>
<td><strong>Other</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Crime, theft, and disorder</td>
<td>24.5</td>
<td>25.3</td>
<td>53.7</td>
<td>16.5</td>
<td>21.4</td>
<td>5.8</td>
</tr>
<tr>
<td>Corruption</td>
<td>30.1</td>
<td>20.6</td>
<td>59.7</td>
<td>37.4</td>
<td>23.4</td>
<td>9.5</td>
</tr>
<tr>
<td>Practices of competitors in the informal sector</td>
<td>38.6</td>
<td>20.7</td>
<td>55.9</td>
<td>44.5</td>
<td>36.6</td>
<td>35.3</td>
</tr>
</tbody>
</table>

Source: Author’s calculations based on World Bank Enterprise Surveys.
firms investing in new equipment, technologies, and marketing methods which are needed to participate in production networks.

Bottlenecks pertaining to physical infrastructure and worker skills also show up as impediments to SMEs joining production networks in Southeast Asian economies. Electricity costs (and some fluctuations in supply) were cited by 29.6 percent of SMEs in all Southeast Asian economies and the quality of transport systems (roads, rail, and ports) by another 23.8 percent. High electricity costs and the quality of transport systems appear to be less of a problem in energy-producing economies (for example, Malaysia and Indonesia) than in the three energy-importing economies. Relative infrastructure gaps in energy-importing Southeast Asian economies was reflected in poorer connectivity and higher trade costs compared with energy-producing economies.

An inadequately educated labor force was mentioned as a problem by 28.0 percent of SMEs in all Southeast Asian economies, but Thailand, Malaysia, and Viet Nam report higher figures than the other economies. This pattern may reflect skill shortages and rising wage costs in part associated with moves in the direction of full employment. Amid a tightening labor market, labor regulations were perceived to be more of a problem for SMEs in Malaysia and Thailand than in the other Southeast Asian economies.

In contrast, access to land is generally not seen as an obstacle, with only 16 percent of SMEs in all Southeast Asian economies highlighting this issue. Within this overall picture, however, SMEs in Viet Nam (28.3 percent) may have some concerns in relation to access to land.

On the policy and incentive front, regulatory issues at the border seem to be of limited concern. For instance, only 20.0 percent of SMEs in all Southeast Asian economies cited customs and trade regulations as a concern. This may reflect the fact that tariffs are quite low in Southeast Asian economies and that customs administrations have been improved due to decades of gradual trade reforms. Thailand may be somewhat of an outlier, and the issue may relate to customs administration rather than trade regulations per se. Thus, customs and trade regulations generally do not seem to be an important impediment to SMEs participating in production networks.

There are mixed views about some behind-the-border regulatory issues. Business licensing and permits are not a widespread problem in Southeast Asian economies, with only 16.7 percent of firms pointing to this issue. Meanwhile, tax policy issues do matter. In this vein, high corporate tax rates were cited by 31.9 percent of SMEs and gaps in tax administration by 26.7 percent. Tax policy issues directly affect enterprise profitability and the incentive to participate in production networks. These issues appear to
be of particular concern in the Philippines and Thailand and, to a lesser extent, in Malaysia.

According to 34.7 percent of SMEs in all Southeast Asian economies, economic uncertainty is also a notable impediment. However, a closer look at the data indicates that this figure is partly attributed to Thailand (84 percent) being an outlier for an unusually long period of domestic political turbulence. With the exception of Viet Nam (2.3 percent), some concerns about economic uncertainty were also expressed in the other ASEAN economies.

Finally, corruption was mentioned by 30.1 percent of SMEs in all Southeast Asian economies, and crime, theft, and disorder by 24.5 percent, indicating that these are significant issues for SMEs.

### 4.6.2 Business Support Services

Thus far, the availability of enterprise-level data on the five Southeast Asian economies has limited further exploration of supply-side factors influencing SME participation in supply chains. The important area of business services markets and business service providers for SMEs has not been discussed. Fortunately, some data for Malaysia and Thailand only on SMEs’ ranking of the affordability and quality of business services in the country could be obtained from the World Bank’s Enterprise Surveys. These are provided in Table 4.6 for six kinds of business services.

<table>
<thead>
<tr>
<th></th>
<th>Malaysia</th>
<th></th>
<th>Thailand</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Affordable</td>
<td>Quality</td>
<td>Affordable</td>
<td>Quality</td>
</tr>
<tr>
<td>Business services available in the</td>
<td>score</td>
<td>score</td>
<td>score</td>
<td>score</td>
</tr>
<tr>
<td>country – quality (average)</td>
<td>69.4%</td>
<td>3.2</td>
<td>42.6%</td>
<td>2.8</td>
</tr>
<tr>
<td>Engineering and design</td>
<td>57.4%</td>
<td>3.1</td>
<td>15.4%</td>
<td>2.8</td>
</tr>
<tr>
<td>Management and marketing</td>
<td>69.8%</td>
<td>3.1</td>
<td>8.4%</td>
<td>2.6</td>
</tr>
<tr>
<td>Accounting</td>
<td>81.9%</td>
<td>3.3</td>
<td>84.2%</td>
<td>3.0</td>
</tr>
<tr>
<td>Legal services</td>
<td>69.3%</td>
<td>3.1</td>
<td>35.1%</td>
<td>2.8</td>
</tr>
<tr>
<td>Insurance</td>
<td>78.6%</td>
<td>3.2</td>
<td>81.2%</td>
<td>3.0</td>
</tr>
<tr>
<td>Information technology services</td>
<td>59.4%</td>
<td>3.1</td>
<td>31.2%</td>
<td>2.8</td>
</tr>
</tbody>
</table>

*Source:* Author’s calculations based on World Bank Enterprise Surveys.
The following are the main findings:

- On average, Malaysia seems to have more affordable and higher-quality business services than Thailand. Thus, 69.4 percent of SMEs in Malaysia said that business services were affordable, compared with only 42.6 percent in Thailand. Likewise, the quality of business services in Malaysia was scored as 3.2 and in Thailand as 2.8 (where 4 is very good).
- Looking at individual services, there is little variation in the good quality of individual business services in Malaysia. Technology services (engineering and design as well as information technology services), however, are somewhat less affordable compared with other services.
- Meanwhile, Thailand shows notable variation in terms of affordability and quality of business services. Strikingly, engineering and design (15.4 percent), management and marketing (8.4 percent), and information technology services (31.2 percent) are considered less affordable than other business services. In terms of service quality, marketing and management services (with a score of 2.6) are rated lower than other business services.

4.7 CONCLUSIONS

This chapter conducted a comparative, firm-level analysis of joining the supply chain in five Southeast Asian economies to improve our understanding of fragmentation of manufacturing across borders in Asia. It mapped supply chains by firm size at the national and firm levels, undertook econometric analysis of factors influencing supply chain participation, and discussed enterprises’ perceptions of the influence of the business environment. This difficult and painstaking research was facilitated by access to a large and comprehensive dataset of manufacturing enterprises from the World Bank.

Analysis of national data indicates that SMEs play an important role in economic activity in Southeast Asia. Not only are SMEs the major source of employment in Southeast Asian economies, but they also contribute notably to GDP. Large firms are a minor source of employment and significant contributor to GDP. However, SMEs in Southeast Asian economies make relatively little contribution to exports relative to the sector’s employment or GDP contribution. Furthermore, even more industrially developed Southeast Asian economies (for example, Thailand and Malaysia) lag behind the SME export shares of advanced
East Asian economies such as the PRC, Japan, and the Republic of Korea. Accordingly, national export data hint at the underperformance of SMEs in supply chains relative to large firms in Southeast Asia and SMEs in advanced East Asian economies.

Complementary and more detailed insights show up in the analysis of firm-level data (which include both direct and indirect exporters). A minority of firms in Southeast Asian economies are involved in supply chains through exports, input supply, and subcontracting. More developed economies (such as Thailand and Malaysia) have a higher share of their firms in supply chains than other Southeast Asian economies. Turning to firm size, the dominance of large firms in supply chains and the minor role of SMEs is confirmed by firm-level data. Small and medium-sized enterprise participation varies across Southeast Asia with Malaysia and Thailand having a higher proportion of their SMEs in supply chains than in other economies. Small and medium-sized enterprise exports are highly concentrated in relatively few firms in the Southeast Asian economies – the top 25 percent of SMEs account for the bulk of SME exports in Southeast Asia.

The results of the micro-econometric analysis, conducted separately on all manufacturing firms and on SMEs in Southeast Asian economies, underscore the notion of firm heterogeneity in supply chains. The findings indicate that some firms are better at joining supply chains than others and that these differences are linked to various factors. Firm size shows up as an important influence on the probability of joining supply chains but exhibits a nonlinear form. It seems that economies of scale and fixed costs are significant in the early stages of joining production networks but less relevant in the longer term. Small and medium-sized enterprises may form clusters or embark on niche market strategies to overcome the disadvantages of firm size.

However, econometric analysis further suggests that firm size is not the whole story. Efficiency, particularly investment in technological capabilities and skills, and access to commercial banks also affect the probability of supply chain participation. The controls on firm age and ownership are also revealing. Unexpectedly, the econometric results further indicate that younger firms are likely to be more nimble in joining supply chains than older firms as they more easily use information and knowledge. In addition, foreign ownership facilitates participation in supply chains through access to marketing and technological know-how.

The exploration of SME perceptions of the business environment provides additional policy insights. A trust deficit seems to hamper the requisite intra-firm cooperation needed for effective SME participation in supply chains. Supply-side factors – such as lack of access to finance, high
electricity costs, variable quality of transport systems, and inadequately educated workers – are an additional hindrance to SMEs. On the policy and incentive side, behind-the-border issues like high corporate tax rates as well as economic uncertainty also play their part. Finally, the limited evidence from Malaysia and Thailand suggests that the affordability and quality of business support services are an issue.

Some limitations in the methodology employed in this study may be addressed in future research. First, several factors that may also affect the participation of firms in supply chains (for example, trade policies, domestic regulations, infrastructure, and business support services) were considered in the descriptive part but not in the econometric exercise. Attempting to include such factors in future econometric work may provide additional insights. Second, the supply chain functions estimated are static as only cross-section data were available from the World Bank surveys. Panel data analysis would be invaluable to highlight changes over time when the requisite data are available. Third, the research was unable to examine the issue of foreign direct investment by large firms and SMEs in Southeast Asia due to data gaps. Fourth, as larger enterprise samples become available in the future, it would be useful to explore whether the characteristics of joining the supply chain of one industry subsector differ from those of another. Thus, the findings need to be interpreted with caution.

Three policy implications may be drawn from the research. First, policy and incentive reforms are necessary but not sufficient to promote the participation of firms in supply chains. The myriad of supply-side obstacles and other issues identified by firms in Southeast Asia suggests that transparent and comprehensive national policies (which integrate supply side and incentive interventions) are crucial to support the participation of firms in supply chains. Specific policies to support SMEs (for example, to form industrial clusters) could be useful, but further research is required on what works as there is a risk of government failure. Second, private sector representatives such as business associations should be involved in formulating policies for supply chains in Southeast Asia as they have firsthand knowledge and experience of rapidly evolving supply chains. Third, to facilitate effective policy development for supply chains, national statistics need to take better account of trends in supply chains and firm size. Noteworthy initiatives include using a consistent definition of firm size across countries to enable better mapping of exports by firm size, attempting to incorporate the contribution of indirect exports into gross export data, and, ultimately, measuring value-added trade.
NOTES

1. The very few micro-level studies of supply chains in Asia include Harvie et al. (2010), Kyophilavong (2010), Rasiah et al. (2010), and Lim and Kimura (2010). See also some papers in Kuroiwa and Heng (2008) and Kuroiwa (2009).

2. Athukorala (2011) presents data on world trade based on network trade or supply chain trade. His data show that Southeast Asian economies, with the exception of Singapore, have increased their world share of network trade between 1992–93 and 2006–07. Thus, Malaysia’s world share of network trade increased from 1.8 percent to 2.6 percent, Thailand’s from 0.8 percent to 1.6 percent, the Philippines’ from 0.4 percent to 1.2 percent, Indonesia’s from 0.1 percent to 0.5 percent, and Viet Nam’s from 0.0 percent to 0.1 percent.

3. For further discussion of resource constraints and external barriers faced by SMEs as well as appropriate policy interventions, see Levy et al. (1999), Hallberg (2000), Wignaraja (2002), Fischer and Reuber (2003), and Tambunan (2009).

4. There are a few multi-country, multi-sector studies (Harvie et al. 2010; Wignaraja 2011) and one multi-country single sector study (Rasiah 2004).

5. See Harvie et al. (2010) and Rasiah et al. (2010).

6. For instance, Harvie et al. (2010) simply define SME participation in supply chains according to whether it is a supplier, importer of intermediate goods, or exporter of some of its products.

7. Technological capabilities are hard to measure and empirical work has either used aspects of technological activity (for example, quality certification, patents, and so on) or a composite index of technological capability made up of many different technical functions performed by enterprises to assimilate imported technologies.

8. Most unfortunately, data were not available from the World Bank Enterprise Surveys on the share of engineers and technicians in employment to more accurately capture technical-level skills at the firm level.

9. Unfortunately, time series data on exports by firm size are not readily available from national sources. Methodological difficulties notwithstanding, a rough indication may be obtained by comparing the share of SME exports (largely for the late-2000s) in Table 4.2 with the estimate by Harvie and Lee (2002) for the late-1990s. This crude comparison suggests that the percentage of SME exports in Southeast Asian economies rose from 14.3 percent to 20.9 percent between the late 1990s and the late 2000s.

10. Wignaraja et al. (2013) further explore this insight for a sample of Malaysian and Thai firms using a technology index (consisting of eight technical functions) based on the taxonomy of technological capabilities developed by Lall (1992). The results show that participation in production networks and supply chains is positively correlated with technology upgrading at the firm level.

11. The same assumption is made for all the probabilities given in the text. A complete set of results on predicted probabilities is available on request.

12. It is recognized that the developing industrial clusters involving SMEs and large firms are also an important means to promote SME entry into production networks. However, a lack of data on this aspect meant that clustering and cluster promotion could not be examined in this chapter (see Fischer and Reuber 2003).

REFERENCES


Kuroiwa, I. and T.M. Heng (eds) (2008), Production Networks and Industrial


APPENDIX 4.1 ENTERPRISE DATA AND SAMPLE CHARACTERISTICS

The dataset and sampling methodology used in this study are briefly described here. Our firm-level study on five Southeast Asian economies was based on cross-section data collected in the late 2000s from the World Bank’s Enterprise Surveys dataset. The World Bank surveys are conducted at infrequent intervals in the given countries – the data for Malaysia and Thailand were gathered in 2007 and those for the other three economies in 2009. This is the only relatively detailed and recent firm-level dataset currently available for Southeast Asian economies. The data are not publicly available, but it is possible to apply to the World Bank for access for research purposes.

Stratified random sampling with replacement was the sampling methodology used by the World Bank Enterprise Surveys.1 This means that all population units are grouped within a homogenous group and simple random samples are selected within each group. This method allows computing estimates for each of the strata with a specific level of precision, while population estimates can also be estimated by properly weighting individual observations. The strata for Enterprise Surveys are firm size, business sector, and geographic region within a country. In most developing countries, SMEs form the bulk of the enterprises. Large firms are oversampled in the firm surveys as they tend to be engines of job creation.

Face-to-face interviews using a common questionnaire were conducted with business owners and senior managers of firms. The surveys provide cross-section firm-level information on direct and indirect exports, employment, ownership, human capital, technology, access to credit, and aspects of the policy regime. Table 4A.1 provides a snapshot of the enterprise dataset for the five ASEAN economies according to firm size, ownership, and sector. The dataset largely consists of a total of 5900 manufacturing firms with reasonable samples of over 1000 firms for each ASEAN country.

Following the standard Organisation for Economic Co-operation and Development (OECD) definition, large firms are defined in our study as enterprises with more than 100 employees and SMEs those with fewer than 100 employees.2 Large firms constitute 30.7 percent of the total sample and the remaining 69.3 percent consists of SMEs. The figure for SMEs as a percentage of total number of firms varies by country: Malaysia (62.7 percent), Thailand (51.6 percent), the Philippines (78.2 percent), Indonesia (82.1 percent), and Viet Nam (65.3 percent). About a quarter of the total sample has some proportion of foreign equity. The share of firms
<table>
<thead>
<tr>
<th></th>
<th>All firms</th>
<th>Malaysia</th>
<th>Thailand</th>
<th>Philippines</th>
<th>Indonesia</th>
<th>Viet Nam</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of firms</td>
<td>5900</td>
<td>1082</td>
<td>1043</td>
<td>1310</td>
<td>1422</td>
<td>1043</td>
</tr>
<tr>
<td>By sector, % of distribution</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Garment</td>
<td>11.4</td>
<td>8.2</td>
<td>15.2</td>
<td>10.8</td>
<td>11.6</td>
<td>11.2</td>
</tr>
<tr>
<td>Textile</td>
<td>7.6</td>
<td>3.5</td>
<td>12.8</td>
<td>0.2</td>
<td>12.5</td>
<td>9.6</td>
</tr>
<tr>
<td>Machinery and equipment</td>
<td>3.6</td>
<td>8.5</td>
<td>8.0</td>
<td>0.2</td>
<td>0.5</td>
<td>2.7</td>
</tr>
<tr>
<td>Electronics/electrical appliances</td>
<td>2.3</td>
<td>8.9</td>
<td>8.7</td>
<td>9.6</td>
<td>0.4</td>
<td>1.8</td>
</tr>
<tr>
<td>Rubber and plastic</td>
<td>15.0</td>
<td>25.3</td>
<td>24.7</td>
<td>13.4</td>
<td>10.5</td>
<td>3.0</td>
</tr>
<tr>
<td>By size, % of distribution:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>SMEs</td>
<td>69.3</td>
<td>62.7</td>
<td>51.6</td>
<td>78.2</td>
<td>82.1</td>
<td>65.3</td>
</tr>
<tr>
<td>Large</td>
<td>30.7</td>
<td>37.3</td>
<td>48.4</td>
<td>21.8</td>
<td>17.9</td>
<td>34.7</td>
</tr>
<tr>
<td>By ownership, % of distribution:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foreign</td>
<td>25.5</td>
<td>30.5</td>
<td>59.9</td>
<td>23.3</td>
<td>6.8</td>
<td>14.0</td>
</tr>
<tr>
<td>Domestic</td>
<td>74.5</td>
<td>69.5</td>
<td>40.1</td>
<td>76.7</td>
<td>93.2</td>
<td>86.0</td>
</tr>
</tbody>
</table>

*Note:* SMEs = small and medium-sized enterprises.

*Source:* Author’s calculations based on World Bank Enterprise Surveys.
Joining the supply chain

with foreign equity as a percentage of total number of firms is highest in
Thailand and Malaysia and lowest in Indonesia.

Notes

1. For details of the sampling methodology in the World Bank surveys, see www.enter-
prisesurveys.org/methodology.
APPENDIX 4.2  DEFINITION OF SMALL AND MEDIUM-SIZED ENTERPRISES ACROSS VARIOUS ASEAN MEMBER STATES AND OTHER COUNTRIES

Table 4A.2  Definition of small and medium-sized enterprises across various ASEAN member states and other countries

<table>
<thead>
<tr>
<th>Economy</th>
<th>Category of industry</th>
<th>Criteria/country’s official definition</th>
<th>Source</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Wholesale industry</td>
<td>≤ 200 employees or assets ≤100 million baht</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Retailing industry</td>
<td>≤ 150 employees or assets ≤ 60 million baht</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Service industry</td>
<td>≤ 200 employees or assets ≤ 200 million baht</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Industry and construction</td>
<td>≤ 300 employees or assets ≤ 100 billion dong</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Commerce and services</td>
<td>≤ 100 employees or assets ≤ 50 billion dong</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Services</td>
<td>Sales turnover ≤ 5 million ringgit or full-time employees ≤ 50</td>
<td></td>
</tr>
<tr>
<td>Country</td>
<td>Industry/Region</td>
<td>Definition</td>
<td>Source</td>
</tr>
<tr>
<td>-----------------------</td>
<td>---------------------------------------------</td>
<td>---------------------------------------------------------------------------</td>
<td>------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Philippines</td>
<td>Total assets less than 100 million pesos</td>
<td>ASEAN SME data and statistics, available at <a href="http://www.asean.org">http://www.asean.org</a></td>
<td></td>
</tr>
<tr>
<td>United States</td>
<td>≤ 500 employees</td>
<td>United States Small Business Administration, available at <a href="http://www.sba.gov/">http://www.sba.gov/</a></td>
<td></td>
</tr>
<tr>
<td></td>
<td>≤ 100 employees or assets ≤ 100 million yen</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>≤ 50 employees or assets ≤ 50 million yen</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Republic of Korea</td>
<td>≤ 300 employees, capital or sales ≤ 8 billion won</td>
<td>Small and Medium Business Administration, available at <a href="http://eng.smba.go.kr/">http://eng.smba.go.kr/</a></td>
<td></td>
</tr>
<tr>
<td></td>
<td>≤ 300 employees, capital or sales ≤ 3 billion won</td>
<td></td>
<td>index.do</td>
</tr>
<tr>
<td></td>
<td>≤ 300 employees, capital or sales ≤ 30 billion won</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Table 4A.2  (continued)

<table>
<thead>
<tr>
<th>Economy</th>
<th>Category of industry</th>
<th>Criteria/country’s official definition</th>
<th>Source</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>support service activities; human health and social work activities; professional scientific and technical activities</td>
<td>≤ 300 employees, capital or sales ≤ 20 billion won</td>
<td></td>
</tr>
<tr>
<td>Agricultural, forestry, and fishery; electricity, gas, steam, and waterworks business; wholesale and retail trade; accommodation; food services activities; financial and insurance activities; arts, entertainment, and recreation</td>
<td>Sewerage, waste management, and remediation activities; education; repair and other services</td>
<td>≤ 300 employees, capital or sales ≤ 10 billion won</td>
<td></td>
</tr>
<tr>
<td>Real estate, rental, and leasing activities</td>
<td></td>
<td>≤ 300 employees, capital or sales ≤ 5 billion won</td>
<td></td>
</tr>
<tr>
<td>Sector</td>
<td>Employees/Assets/Sales Limits</td>
<td>Source</td>
<td></td>
</tr>
<tr>
<td>-------------------------------</td>
<td>------------------------------------------------------------------</td>
<td>-----------------------------------------------------------------------</td>
<td></td>
</tr>
<tr>
<td>People’s Republic of China</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Industry</td>
<td>( \leq 300 ) employees, total assets ( \leq 40 ) million yuan, or business sales ( \leq 30 ) million yuan</td>
<td>Economic Research Institute for ASEAN and East Asia, available at <a href="http://www.eria.org/SME%20Development%20in%20China_A%20Policy%20Perspective%20on%20SME%20Industrial%20Clustering.pdf">http://www.eria.org/SME%20Development%20in%20China_A%20Policy%20Perspective%20on%20SME%20Industrial%20Clustering.pdf</a></td>
<td></td>
</tr>
<tr>
<td>Construction</td>
<td>( \leq 600 ) employees, total assets ( \leq 40 ) million yuan, or business sales ( \leq 30 ) million yuan</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Wholesale</td>
<td>( \leq 100 ) employees, or business sales ( \leq 30 ) million yuan</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Retail</td>
<td>( \leq 100 ) employees, or business sales ( \leq 10 ) million yuan</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Transport</td>
<td>( \leq 500 ) employees, or business sales ( \leq 30 ) million yuan</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Post</td>
<td>( \leq 400 ) employees, or business sales ( \leq 30 ) million yuan</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hotel and restaurant</td>
<td>( \leq 400 ) employees, or business sales ( \leq 30 ) million yuan</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Note:** ASEAN = Association of Southeast Asian Nations, SMEs = small and medium-sized enterprises.

**Sources:** All sources in the final column were accessed 10 December 2013.
5. Effective industrial policies and global value chains

Patrick Low and Julia Tijaja

5.1 INTRODUCTION

In a world of increasingly fragmented international production structures, the decision by the lead firms on where to locate various production activities is a key factor influencing a country’s development and diversification outcomes. The returns to different production activities vary and are reduced over time by the entry of new competitors and the erosion of entry barriers. The speed with which this occurs is affected by a number of factors, both external and internal to value chains. Among the external factors is policy, including industrial policy.

From a development perspective, policy makers attach importance to more than just generating income by being part of a global value chain (GVC). Considerations include the type of activity, the scope of participation, indirect returns from forward and backward linkages, the quantity and quality of employment, the degree of knowledge creation, and more generally the contribution to economic diversification and resilience.

In many ways, these questions about how to add domestic value through GVC participation is a new take on an old question. Since the beginnings of the process of industrialization, manufacturing has been seen as a vehicle for economic deepening and diversification, and a source of growth and prosperity (Agenor and Dinh 2013). Trade has always figured in this story, as has the role of government in shaping economic structures. The current terms of the debate have been largely fashioned since the second half of the 20th century by the emergence of development as a branch of economic, social, and political analysis.

The term ‘industrial policy’ can be defined as ‘a non-neutral governmental intervention aimed at altering market signals in order to steer investment in desired directions’ (Fortin 2012, p. 1). In a world of GVCs, these directions can be seen in terms of modularized value chain activities instead of the entire sectors or industries. The influence of ideological preferences as to whether governments should have any role at all in shaping
economic incentives has sometimes obstructed a much more relevant debate over the efficacy of different options. If governments are to intervene, the important dialogue revolves around when and how governments should intervene (Lin and Chang 2009).

Two important developments in recent years have influenced the nature and content of the debate over industrial policy. Both of them are largely the result of technological advances, predominantly in the fields of transport, communications, and production technology. First, increased efficiency in transportation and communication technology has led to the shrinkage of distance and acceleration of transactional speed. As firms become more interconnected, the opportunities to gain from trade increase, as do the costs of poorly conceived or designed government policies. Second, advances in production technology and the development of standards have facilitated the fragmentation of production processes, fostering the rise of GVCs and broadening opportunities for participation in international production sharing. Firms now have more opportunities to participate in parts of a value chain instead of having to possess the competitiveness to produce from start to finish. The capacity to participate depends not only on the capabilities and competitiveness of firms but also on the environment in which they operate. Here, too, there is a role for government policy in promoting a conducive environment.

The nature and configuration of GVCs permit a degree of geographically substitutable value creation along supply chains. This is where industrial policy comes in. Governments may seek higher shares of value added on existing chains through ‘upgrading’ or through participating in new production sharing activities. To upgrade means ‘to make products more efficiently, and to increase value adding activities by making more sophisticated products and taking on more sophisticated processes’ (Humphrey and Schmitz 2000, p. 3).

Governments and firms do not necessarily share the same objectives. Governments seek to maximize value capture at the national level in order to promote objectives such as better living standards, higher productivity, the deployment of new technologies, more and better jobs, diversification in production, and economic resilience. Part of this effort must focus on managing market failures, including a range of positive and negative spillovers. Whatever interventions are chosen, these will not have proportionate effects across an economy, making sound decision-making even more challenging, especially in the face of limited resources and capacity.

The key interest of firms, on the other hand, is to maximize profits. Lead firms on vertically integrated value chains typically seek to locate activities where they yield the highest returns. This may or may not offer participatory or upgrading opportunities for particular economies and value chain
participants. Domestic value chain participants will want to maximize their own value added and will seek ways of doing so, including by engaging with other supply chains or seeking to become lead firms themselves. Different motivations and objectives may reasonably be expected to result in varying perceptions of the most desirable outcomes. In a world of constrained optimization, the challenge is to seek mutually accommodating outcomes between markets and the state. In the final analysis, however, it is the responsibility of governments to do whatever is required to maximize social welfare. The conception and design of industrial policy is fundamental to the successful pursuit of this objective, where governments seek to maximize alignments with firms as value chain actors. In general, the longer the time period, the greater the prospects of alignment of interests between markets and the state.

5.2 SCOPING POLICY OPTIONS

5.2.1 Two Kinds of Policies: Horizontal and Industry-specific

Policies can be broadly or narrowly focused. Broad-based or horizontal policies are targeted at removing inefficiencies and deadweight losses, thereby increasing competitiveness. Such policies may include streamlining administrative procedures, lowering the costs of doing business, strengthening institutions, investing in human capital, and developing infrastructure. The main point about horizontal policies is that they have economy-wide implications rather than being specific to sectors, industries, or firms. They are not intended to affect prevailing relative prices in narrowly defined markets. These types of policies are less contentious than more market-specific approaches and carry considerably less risk in terms of the unforeseen consequences of policy-induced relative price relationships.

The fact that horizontal policies can affect many different aspects of the operating environment means that they may be more or less affordable, and may yield tangible results over quite different time frames. Administrative or regulatory reform and various measures of trade facilitation can be relatively costless and yield rapid results. Institutional reform is of a more basic character, will be harder to achieve, and may take longer to yield dividends, but in some cases is imperative. Investment in human capital through training and education and physical infrastructure investment may be costly and take some time to produce results, but will be high-yielding and have potentially trajectory-shifting results.

In effect, these kinds of horizontal reforms and investments would not
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be regarded by some as industrial policy. This taxonomical approach typically reserves the definition of industrial policy to interventions specifically targeted at industries or even firms. In reality, however, owing to resource constraints and geographical realities, even interventions that are intended to be largely price-neutral may affect resource allocation decisions in a narrow sense.

Industry-specific policies, on the other hand, seek to change the incentive structure and stimulate activities, in particular industries, sectors, or activities. A typical justification for such actions would be that market failures result in resource misallocation, leading the economy toward a suboptimal future. A major argument of those opposing industry-specific policies is that government failures more often than not substitute for market failures. The capacity of individual governments to avoid or minimize such failures is therefore key in justifying the case for narrowly drawn industrial policy.

Renewed interest in industrial policy has emerged recently in the context of major changes in the global trade landscape. These changes include economic rebalancing where the centers of growth and consumption are increasingly shifting to the emerging economies, changing the pattern of global trade. At the same time, the fact that trade in intermediates has surpassed trade in final goods (at least by some definitions of intermediates) is a reflection of greater fragmentation of production processes. Services have also become a more important part of the production process. Tariffs have fallen while non-tariff measures including standards have increased in significance. Geographically dispersed production has placed additional emphasis on trade facilitation and connectivity in an increasingly complex setting of overlapping regional and multilateral trading arrangements. The emergence of GVCs calls for more effective strategic collaboration between governments and the private sector, and accentuates the importance of government capabilities for policy effectiveness (Rodrik 2004).

In this evolving environment, a new perspective is called for in looking at industrial policy. This view conforms with the approach of other writers who have used different terms to refer to variants of updated approaches to industrial policy, from strategic industrial policy (Gunther and Alcorta 2011) to new industrial policy (Devlin and Moguillansky 2012) and global value chain-oriented industrial policy (Gereffi and Sturgeon 2013). Instead of proposing new terms, this chapter focuses on how old approaches could be updated. An advantage of this focus is to remind us that the industrial policy debate is a good deal older than the GVC phenomenon we witness today.
5.2.2 Approaches to Industrial Policy

In the long debate on industrial policy over the last six decades or so, different approaches have emerged. They can be broadly placed in the five main categories outlined in what follows. The typology is rough and the categories can overlap in terms of their respective policy or strategic emphases. Moreover, the approaches may not always be mutually exclusive, particularly for sufficiently big and diversified economies.

5.2.2.1 Import-substituting industrialization

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

Identifying the right industries that have the highest potential to be competitive in a sustainable way is a key challenge in this approach. An even greater challenge is letting go of mistakes. Complex domestic political economy and vested interests often leave governments propping up inefficient industries longer than they should. In an environment where resources are scarce, the opportunity costs could be considerable. Rodrik (2010) famously said ‘what determines success in industrial policy is not the ability to pick winners, but the capacity to let the losers go’.

In an updated, GVC-sensitive approach to ISI, the opportunities for upgrading and diversification may exist for goods and services both upstream and downstream. A lesser anti-export bias than that frequently encountered under ISI policies – brought about by high-cost production and misaligned exchange rates – would help firms overcome the confines of domestic markets by tapping into external markets, including in the case of domestic intermediate goods. The structure of intermediate goods industries varies across sectors, and some sectors may source from the same intermediate goods industry with greater potential for the realization of economies of scale within the home market. There remains, however, the challenge of breaking out of reliance on a protected domestic market to become internationally competitive.

Domestic market size is a crucial determinant of the potential success of ISI policies. The most obvious policy tool for ISI is tariffs, although some
countries have resorted to quantitative restrictions in the past. The scope for using tariffs for this purpose is broadly defined for WTO members by their tariff commitments (bound tariffs). The scope for flexibility in this context is greater for older GATT/WTO members than for those who have acceded more recently. Tariff levels are also likely to be constrained by commitments under preferential trade agreements (PTAs).

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

5.2.2.2 Export-oriented industrialization

On the other hand, export-oriented industrialization (EOI) strategies rely on external markets to diversify the domestic economy. This industry-specific incentive structure is typically designed to ensure that returns to exports are no less attractive than returns to domestic sales. The policy mix requires that, where possible, inputs are provided at world prices, free of domestic taxes or import restrictions. At the same time, exports of the final product are subsidized to compensate for more costly inputs of domestic provenance. These are the essential ingredients of a policy mix designed to equalize returns between domestic and export sales. A further requirement is that the domestic market is not strongly protected from competing imports in other sectors, as this could draw resources away from export growth industries.

Support to the industry is removed within a specified time frame, so the beneficiaries know that they have to compete internationally to survive. This approach was successfully followed by some Southeast Asian economies in the second half of the 20th century and resembles the People's Republic of China's approach in the early 21st century. Export-oriented industrialization may start with exporting processed resource-based products, or simply the product of low-wage unskilled labor, before graduating to manufacturing exports of increasing technological content. Export-oriented industrialization is likely to have more backward (and forward) linkages to domestic markets than export processing zones and buyer-driven assembly-oriented GVCs, as the latter two are in general highly import-dependent. One key advantage of EOI is that its outward orientation allows domestic production to leapfrog spending and technological demand levels in the domestic market.

In GVCs, EOI can also be targeted at intermediate products, allowing countries to focus on parts of production where they already have a
comparative advantage or can develop one with relative ease. This would allow the economy to engage in the production of products of higher value, technology, and knowledge, even if just in parts. The available tools for EOI are now constrained by the prohibition of export performance-based subsidies under the WTO for many countries, except for least developed countries and members with a gross national product per capita of less than US$1000 per year listed in Annex VII of the Agreement on Subsidies and Countervailing Measures (see WTO 1995). In practice, a range of developing countries have been providing subsidies for years unchallenged. There are also other policy tools beyond export subsidies that can be used to promote EOI. For example, as standards increasingly play a role in coordinating international production sharing, concerted efforts to improve the standards compliance capacity of firms and general trade facilitation infrastructure are crucial for competitiveness.

5.2.2.3 Resource-based industrialization

Resource-based industrialization (RBI) is a strategy that may be used if a country has an exportable raw material and the potential to elaborate that raw material into a manufactured good locally for export. The key policy instrument is an export tax on the raw material that lowers its domestic price, effectively subsidizing domestic downstream manufacturing. As with ISI, the objective behind this arrangement is to enable producers to become internationally competitive over time through the realization of economies of scale and learning by doing. A key risk with this strategy arises from the inability and/or unwillingness to wean manufacturers off their dependence on the subsidies on raw material implicitly granted through export taxes or restrictions. Furthermore, this diversification strategy may have negative domestic distributional consequences, at least in the short term, if producers of raw materials are already poor or if domestic processing capacity is inadequate or commercially infeasible.

Downstream processing of natural resources may not be feasible for all countries or products. For example, the next step in production or processing may require a large leap in technological or skill requirements compared with those deployed in the extraction process, and may be beyond the reach of an economy’s existing capacity. As noted by Kaplinsky (2011), there are other ways of increasing domestic participation in commodity supply chains involving the development of upstream and downstream linkages in complementary markets relevant to the commodity supply chain. These could be fiscal, production, and consumption linkages.

In the past, WTO rules have not constrained the use of export taxes, but this has changed for some countries that have joined the WTO in recent
years. Some PTAs also have provisions on export taxes. More generally, pressure is mounting to reduce or eliminate the use of export taxes or restrictions, as can be seen in both multilateral and preferential trade negotiations.

5.2.2.4 Export processing zones
Export processing zones (EPZs) can be viewed as the poor cousin of EOI, but may be one of the few viable options for economies with neither a sizeable domestic market nor resource endowments. Zones are demarcated as extra-territorial for fiscal and regulatory purposes and are normally supplied with essential hard and soft infrastructure for production and exports.

One downside of EPZs is that they may often be little more than assembly or light manufacturing operations, relying almost entirely on imported inputs with minimal backward linkages. They also frequently come with the risks of footloose investments, which involve modest levels of sunk capital and can easily move elsewhere if conditions change, including the loss of preferences. Labor and environmental standards may also be compromised in EPZs as host countries compete for a limited pool of investment projects.

On the other hand, successful EPZs may develop into more than just job opportunities for unskilled workers. Through learning by doing, they could be an incubator for indigenous innovation and the gradual development of backward and forward linkages. A broader spectrum of ancillary goods and services may also emerge over time with the promise of capturing a greater share of value added. Nevertheless, these benefits do not arise automatically without the right infrastructure and institutions in place. There may also be a place for capacity building and temporary financial support.

5.2.2.5 Industrialization through innovation
Unlike the former approaches that focus on changing the external framing conditions in which firms operate to promote industrial upgrading, the emphasis of the industrialization through innovation (ItI) approach is upon change from within; both within individual firms and collectively. Firms’ upgrading potential can be enhanced by strengthening national/local innovation systems and firm-level technological capabilities. Successful value-chain upgrading, after all, means innovating better than competitors. This can be achieved through effective networking and building mutually advantageous relationships with other firms, suppliers, consumers, governments, and relevant non-state actors, such as research institutions and technical organizations.
GVC participation provides firms with access to technology and upgrading assistance from their networks, including from the lead firms as well as other sources. Participating in GVCs also provides firms with an opportunity for incremental upgrading through modularization. This allows firms to innovate in specific production activities, for example design and distribution, instead of along the entire chain. This updated approach to industrial policy acknowledges that technological learning is not costless, and that the outcomes of such learning depend, among other things, on firm-level technological capabilities. Technological capabilities differ among firms and allow those that possess them to better seize the learning opportunities from GVC participation for successful upgrading (Lall 1992; Morrison et al. 2006). Among the roles of industrial policy is the promotion of successful technological learning by providing a conducive environment and supporting the development of firm-level technological capabilities.

The outcomes of firms’ technological learning and upgrading efforts are also affected by the environment in which learning is taking place, that is, the innovation systems (Tijaja 2012). Innovation systems are defined as the flow of technology and information among people, enterprises, and institutions that facilitate innovation, and are key to firms’ competitiveness. Firms located within an efficient innovation system can cope better with the complexity of GVC transactions and undertake technological learning at relatively lower costs. Beyond the capabilities of individual firms, well-functioning innovation systems also strengthen chain-wide efficiency.

Innovation systems can be strengthened through effective science and technology policy, and targeted activities and initiatives such as industry-specific dialogues, science competitions, internships or work placements, collaboration with universities/research institutes, R&D support, joint R&D, science parks, business incubators, and personnel mobility. Many of these policies may seem horizontal in the first instance, but the peculiar nature of technology means that after a certain (low) threshold, effective intervention will necessarily become sector specific (Lall 1992). For most governments, resources are limited, and trade-offs are inevitable when deciding to which sectors, industries, or activities resources should be allocated in order to maximize the benefits from innovation.

Innovation systems are also multilayered at national, subnational, and sectoral levels, and this will call for different combinations of science and technology policy and targeted initiatives. Malerba (2002, p. 250) defines the sectoral systems of innovation and production as ‘a set of new and established products for specific uses and the set of agents carrying out market and non-market interactions for the creation, production and sale...’
of those products’. The conditions required to facilitate learning differ across sectors (Malerba and Nelson 2011). In some, technology might be embedded in capital goods, calling for close interactive relations with suppliers for successful upgrading. In others, like agriculture, the low appropriability of innovations may require prompting by public institutions.

The versatility of ItI over other forms of industrial policy comes from the fact that innovation-led industrialization is complementary to other approaches, regardless of country characteristics. It will be difficult for any country to participate effectively in GVCs, let alone to upgrade its participation, if the economy does not have enough innovation capabilities and/or its domestic GVC participants do not possess sufficient technological capabilities.

5.3 WORLD TRADE ORGANIZATION RULES

This chapter does not enter into all the subtleties surrounding the interpretation of the legal permissibility of trade policies required for the pursuit of different kinds of industrial policy. Many of these have been highlighted, if not fully resolved, through WTO dispute settlement. In other cases, ambiguity or uncertainty remains because governments either have chosen not to mount legal challenges, or lack the capacity to do so.

The chapter does not cover departures from the WTO rules in PTAs or in the context of government procurement contracts. Preferential trade agreements may well be more important than the WTO for some developing countries in defining the degree of flexibility they enjoy in pursuing industry-specific policies. Even within the WTO, the degree of policy flexibility will almost certainly be different for any economy that has acceded to the WTO since it came into force in 1995. This is because acceding members have typically been obliged in negotiations to agree to conditions in their protocols of accession that have gone beyond the template legal obligations contained in the WTO. World Trade Organization obligations will also vary among members at different levels of development due to special and differential treatment provisions.

As noted earlier, some approaches to industrial policy require measures that encourage domestic production, including tariffs, subsidies, and local content requirements, but their use is sometimes constrained by international agreements such as the WTO or various PTAs. The fact that some measures are constrained while others are not can result in the use of less efficient policies or opportunities for hidden protection.

In what follows, we take each of the policy areas identified along the horizontal axis of Table 5.1 and consider the extent to which WTO rules
do, or are likely to, constrain the ability of countries to apply the policies in question. This will provide us with a first take on the degree to which WTO obligations may constrain the pursuit of industrial policies. It should be noted that these constraints will turn out to be real only when one WTO member mounts a successful legal challenge against another for the use of a particular policy. In legal terms, government measures are presumed to be WTO-consistent until the Dispute Settlement Body concludes otherwise. One should not underestimate, however, the fact that the possibility of a legal challenge introduces uncertainty, which bears a cost.

In Table 5.1, we have distinguished between those policies judged to be essential to the pursuit of a particular industrial policy and those that could be additionally used to attain or reinforce the same end, but in a strict sense could be considered nonessential. This implies a degree of subjectivity in the assessment of how essential particular interventions are to the attainment of the objective. On the other hand, the distinction is useful in helping to sharpen the focus on the nature of WTO-imposed constraints on policy flexibility.

Underlying this distinction between essential and nonessential interventions, there are also efficiency issues upon which disagreements are likely to arise. It would be argued by many, for example, that quantitative restrictions are generally more costly than tariffs because of their particular incentive- and price-distorting effects. Quantitative restrictions deny revenue to governments that would be collected under tariffs, introduce administrative allocation mechanisms that may not conform to efficiency considerations, encourage rent-seeking activities, and force adjustments...
only through price rather than quantity and price when market conditions change. If tariffs can achieve the same end as quantitative restrictions, then WTO strictures on the use of the latter may be a welcome constraint on policy flexibility. Provisos to this argument are that the price effect of tariffs will act with a time lag and that it can be difficult to determine the appropriate tariff rate to achieve a particular result. These considerations would need to be weighed against the costly features of quantitative restrictions. A similar set of arguments in relation to price versus quantity interventions might be made in relation to domestic content requirements.

Traditional economic analysis also establishes the welfare superiority of subsidies over tariffs. This argument is based upon the fact that tariffs create distortions in consumption that are avoided by subsidies. This is a reason why RBI might be considered superior to ISI. One drawback with this argument, however, is that it assumes the revenue required for paying out subsidies can be collected in a relative-price-neutral manner. An additional consideration is that developing countries will find it easier to tax than to subsidize on account of a sparse revenue base. These debates are not entered into in any detail in this chapter.

5.3.1 Tariffs

Individual WTO members have consolidated their tariffs on goods under the WTO Agreement (Article II, GATT 1994) to differing degrees and at different levels. Except for some customs unions, no two members have identical maximum tariff obligations (bindings). Nor do members generally share identical applied tariff rates. This is a reflection of several factors, including levels of development, the degree of participation in rounds of negotiations, and the conditions under which countries joined the GATT (accession or succession under Article XXVI, GATT 1947).

With the exception of RBI and ItI, the industrial policy approaches listed in Table 5.1 depend to some degree on differentiated tariff levels, typically ranging from high tariffs on competing imports and low or zero tariffs on inputs. For ISI, this kind of structure is essential. The picture becomes more complicated if a domestic input industry is also being protected. For EOI, levels of protection in the domestic market may be less pronounced because of the export orientation of the strategy and the objective of equalizing returns to domestic and export sales. However, the policy generally seeks to ensure that imported inputs can be acquired at world prices. For RBI, high tariffs are not essential because the source of support is lower production costs resulting from taxes or restrictions on exports of manufacturing inputs. In the case of EPZs, imported inputs attract zero tariffs.
Although the experiences of individual countries may vary in terms of the factors determining bound tariff levels, it remains the case that many developing countries still maintain applied tariffs below their bound rates. This suggests that for those countries with this gap between bound and applied rates, tariffs are not likely to be among the most significant constraining policy instruments in terms of industrial policy design. Moreover, the provisions of Article XXVIII, GATT 1994 allow for the renegotiation of tariff bindings.

### 5.3.2 Export Taxes

For historical reasons, export taxes have never received the same attention as import taxes. This is reflected in the absence of systematic bindings of export taxes, as well as any flanking policies dealing with valuation for tax purposes and with licensing (both elements of the WTO regime for imports). Resource-based industrialization is the only industrial policy that relies on export taxes, given the source of protection applied for this kind of diversification or industrialization policy. It is precisely because RBI typically applies in cases where domestic (agricultural and non-agricultural) raw materials can be restricted on world markets that some countries are pressing for negotiations on new disciplines in this area. For the time being, however, apart from the case of some economies that have acceded under the WTO, the possibility of freely deploying export taxes remains open.

### 5.3.3 Quantitative Import and Export Restrictions

Quantitative trade restrictions are generally frowned upon in economic analysis because of their distortionary and cost-raising impact in comparison to price-based measures. These arguments may be modified over long periods under uncertainty, as recent literature dealing with climate change policies has demonstrated. The essential point is that if a policy error is committed, then the costs of the error will be greater in the short term if quantities are restricted rather than a tax being applied, but the reverse is true over a longer period. This is explained by the different properties of the two instruments (Weitzman 1974; Hepburn 2006; Stern 2006).

The general prohibition of quantitative trade measures, save in carefully specified exceptional circumstances (including for public policy reasons under Article XX, GATT 1994), does not appear to have been especially contentious. If anything, emphasis has been placed on ensuring that the legitimate use of quantitative limitations on trade is not compromised by hidden protection. It may be noted that in Table 5.1, all the listed
industrial policy options except it could deploy quantitative restrictions instead of, or as well as, price-based measures. We have argued, however, that constraints here are not a strong restraint on flexibility, precisely because of available alternatives.

5.3.4 Trade-related Investment Measures

The WTO strictures on the use of trade-related investment measures are perhaps more contentious than those applying to quantitative trade restrictions. The WTO Agreement on Trade-Related Investment Measures prohibits the use of any measures linked to investment that infringe the national treatment provisions of Article III (GATT 1994), as well as the general prohibition on quantitative restrictions under Article XI (GATT 1994). Trade-related investment measures place a range of regulatory requirements upon the purchasing or marketing behavior of investors. These requirements will in one way or another favor domestic production over imports. Investors are expected to accept these constraints in exchange for cost-offsetting advantages such as privileged market access (protection against competing imports) or subsidization (for example, corporate tax breaks). Both the obligation imposed upon an investor and the reward offered in exchange may in some cases fall foul of WTO law.

While these WTO provisions restrict the use of industrial policy in different ways, a question arises as to whether alternative approaches might be available to achieve the same objectives, possibly at a lower efficiency cost. This is a similar argument to the one made in relation to quantitative trade restrictions in terms of efficiency costs. A possible objection to the comparison is that TRIMS may be less susceptible to the kinds of distortions that plague quantitative restrictions. On the other hand, the nature of the investment incentives granted in exchange for accepting sourcing restrictions must also be factored into the efficiency calculus. The basic issue is whether the objective of securing favorable market conditions for domestic products in relation to competing imports could be better achieved through the tariff structure or through subsidies. This kind of argument has not prevented the fairly widespread use of TRIMS.

5.3.5 Subsidies

The Agreement on Subsidies and Countervailing Measures (SCM) deems a subsidy to exist if there is a financial contribution (including revenue foregone) or any form of government-sanctioned income or price support, and a benefit is thereby conferred. An important additional element of the definition is specificity. A subsidy is considered specific if access to it is
explicitly limited in some way (including to specific sectors, industries, or firms), either in terms of design or possibly outcome. In addition, Article 3 of the SCM prohibits subsidies that are contingent upon exports or the use of domestic over imported goods. Both of these are presumed to be specific subsidies. In practice, this is the key difference in the treatment of production and export subsidies, where the former are not ruled prima facie illegal, although they may turn out to be so in cases where adverse effects are established through a dispute settlement finding.

Potentially important exceptions to this framework arise in the case of agriculture and for some developing countries. The Agreement on Agriculture (AoA) contains provisions permitting the continued use of export (and production) subsidies at negotiated levels, but this only applies to countries that were using such subsidies at the time the AoA was negotiated, and most developing countries have not negotiated such flexibility for the use of subsidies. It is notable that the definition of agricultural products includes processed foodstuffs.

In addition, Article 27 of the AoA allows least-developed developing countries to continue to use export subsidies on manufactures, and other developing countries to do so provided their income per capita is below US$1000 per annum. Under Article 27.2 (b), developing countries were granted an eight-year period following the entry into force of the agreement, during which they were permitted to use export subsidies. This provision was subsequently renewed for certain developing countries on a set of specified products. Absent further action to extend these exemptions, those that remain will soon expire.

Whether or not subsidies are considered illegal, they may be subject to countervailing or antidumping duties. This possibility clearly reduces any security that countries might otherwise enjoy in terms of legally sanctioned access to certain subsidy practices. As far as the use of subsidies for industrial policy is concerned, the WTO provisions are both constraining and a source of uncertainty. Production subsidies would seem to be an essential ingredient of ItI policies. Export subsidies are also a key ingredient of EOI and EPZs. Ultimately, the exposure to risk from WTO-sanctioned actions against countries using subsidies as a development tool depends on whether trading partners wish to take action. The likelihood that they would generally increases with country size and competitiveness.

In analytical terms, it is straightforward to distinguish between good and bad subsidies from a social welfare perspective. In practice, however, such distinctions are complex and contentious. Nevertheless, a case could be made for refining the legal approach to subsidization on sustainability and developmental grounds, as well as perhaps technological grounds (for example, R&D subsidies), while at the same time exploring ways of
softening the competitiveness consequences of subsidies in the marketplace. It is worth recalling that Article 8 of the SCM provided for such partial flexibilities, but there was no consensus to continue its application at the end of the transition period in 2000.

5.4 GOVERNMENT CAPABILITIES

A crucial ingredient for effective industrial policy is government capabilities. They are imperative for the policy process, from design to execution, and the lack of them is a cause of industrial policy failure in many countries. Government capabilities become more important for (specific) industrial policy as the effect of changing relative prices is amplified due to the interdependencies and trade-offs among activities.

Altenburg (2013) elaborated on four dimensions of industrial policy management capability: (1) strategic, (2) rules for market-based competition, (3) avoidance of political capture, and (4) effective delivery of services.

The first dimension of government capabilities requires governments to be strategic in identifying ways of achieving inclusive growth, generating buy-in and societal consensus, ensuring coherence at all levels of policy (micro, meso, and macro), and forging collaboration. Strategic capability also includes the capability to maximize forward and backward linkages, and building economic resilience through diversification. All these capabilities need to be considered in the context of GVCs – that is, of trade in intermediates, trade in tasks, and the growing importance of services. Another important element of strategic capability is coordination, which includes the appointment of an effective lead agency and coordination with external agencies, such as other governments and relevant international organizations.

The second dimension is more embedded and of an institutional nature as it seeks to form a rules-based, participatory, and transparent environment. Its importance is emphasized by the fact that policy and regulatory uncertainties are often a greater concern than policy and regulatory density. This concerns not only process development and execution but also publication and information dissemination strategy. The aim should be to minimize ambiguity, and hence the scope for discretion. As it is impossible for a single agency to devise an all-encompassing process, a participatory approach to policy formulation and implementation with feedback mechanisms is needed.

The third dimension involves both the strategic creation and removal of measures underpinning an industrial policy. It requires close collaboration
with the private sector and other stakeholders, as well as clearly defined timelines and exit options. The involvement of a broad base of stakeholders can help minimize the risk of capture by vested interests, as can co-financing with beneficiaries. Strict criteria for extensions, exit options, and accountable decision-making processes will reduce the risk of policy capture.

Altenburg’s final dimension concerns efficient service delivery involving the technical and operational aspects of public service providers. When internal capabilities are lacking or resources limited, public services may be best delivered by market-based entities. Often, a catalyst in the form of initial support is more effective than prolonged, suboptimal service delivery by governments. Governments should nevertheless ensure that services are generally accessible and affordable. This could include training opportunities for the less skilled, and targeted support for small and medium-sized enterprises.

While well-designed and executed industrial policy can doubtless contribute to a country’s development efforts, the need for appropriate government capabilities is an underlying precondition.

5.5 CONCLUSIONS

Some of the strategies reviewed above are more promising than others, both intrinsically and as a result of the influence of GVCs on production. Domestic market size can be a crucial determinant of opportunities, as can resource endowments. A key question is how far policy can effectively shift resources to alternative, more desirable uses while ensuring competitiveness over time. The answer will obviously be context-specific, and depend to a considerable extent on government capabilities. Quite a few industrial policy experiments have foundered over the years.

The close involvement of governments in many variants of industrial policy can be a source of considerable risk. To minimize this risk good governance and integrity must be well developed. Strategic, technical, analytical, and operational capabilities must also be strong. Solid strategic relationships and communication channels between governments, the private sector, and other relevant non-state actors need to be in place. In the absence of a certain level of attainment of these underlying conditions for the successful application of industrial policy, the pursuit of these policies could leave a country no better off than it would be without any industrial policy.

Moreover, the extent to which a government convincingly pursues what are commonly described as horizontal policies, the greater is the likelihood that conditions will exist for the successful application of industrial
Effective industrial policies and global value chains

policy. Most horizontal policies are less subject to constraining external influences that trading partners could deploy through the exercise of their WTO rights. On the contrary, aid-dependent countries may be able, with relative ease, to convince their major trading partners to provide financial and technical assistance to pursue horizontal reforms and build development infrastructure, including through such initiatives as Aid for Trade.

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

As to the question of policy flexibility afforded by the WTO to pursue industrial policy, and the degree to which this may be considered a worthwhile issue for negotiation in the future, the chapter has laid out the issues without offering a systematic prescription. We have not entirely refrained, however, from offering views as to the direction in which one might look to address these issues. One of the stronger economic cases for seeking to negotiate modifications in WTO rules appears to be in the field of subsidies.

NOTES

1. Patrick Low works with the Fung Global Institute. Julia Tijaja worked with the Fung Global Institute and now works with the ASEAN Secretariat. The views expressed here are those of the authors and should not in any way be attributed to the institutions with which they are associated. The authors wish to thank Gabrielle Marceau for her useful comments on an earlier draft. This piece is based heavily on a note entitled ‘Increasing value from global value chain participation: what role for industrial policy?’ that appears in a VoxEU e-book edited by Richard Baldwin, Masahiro Kawai, and Ganeshan Wignaraja, titled The Future of the World Trading System: Asian Perspectives, and also on a think piece prepared for the International Centre for Trade and Sustainable Development’s e15 Initiative expert group on global value chains titled ‘Global value chains and industrial policies’. A version of this piece has also been published as a Fung Global Institute Working Paper, titled ‘Effective Industrial Policies and Global Value Chains’.
2. Upgrading is only one mechanism for adding additional value from supply chain participation. Gunther and Alcorta (2011) distinguishes between industrial diversification, industrial expansion and upgrading, and industrial deepening.
3. These are also referred to as soft-meso industrial policy (Wade 2012).
4. Products, of course, apply equally to goods and services.

REFERENCES


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6. Mapping crisis-era protectionism in the Asia and Pacific region

Simon J. Evenett

6.1 INTRODUCTION

During the past 30 years many governments in the Asia and Pacific region sought to integrate their national markets into the global economy. One consequence is that cross-border trade in goods is lessening as the principal mode for supplying foreign customers. Cross-border flows of services, investment, intellectual property, and employees have grown in prominence, potentially adding to the gains from international commerce.

The dependence of living standards in the Asia and Pacific region on international commerce is widely acknowledged, in particular in discussions about ‘export-led’ development strategies, rebalancing of national economies, or the fallout from economic crises. The Asia and Pacific region has a substantial stake in the proper functioning of an open world economy. In addition to supporting the multilateral trading system, governments in Asia and the Pacific have been active in promoting regional integration, as witnessed by the number of regional trade agreements signed or under negotiation (ADB 2013a, 2013b). Still, sizeable cross-border price differentials remain, suggesting that integration has some way to go (for recent evidence from East Asia see Moon 2013).

The commitment of governments to open borders was tested during the global financial crisis (GFC) that began in 2007 and spread quickly throughout the world economy. Although not every country witnessed contractions in GDP, almost all were knocked off their previous growth paths. Many countries in the Asia and Pacific region witnessed sharp falls in their exports (for evidence from four East Asian economies see Hsieh 2011). Some countries appear to have revisited their development strategies, as discussed in one recent account of developments in Indonesia (Wignaraja 2013).

Compared to a typical recession, the impact of the GFC was deeper, more synchronized, and longer lasting. It is well understood that governments have tended to adjust trade policies during recessions, but to
what extent have these three features of the GFC affected the resort to protectionism in recent years? Answering this question, making particular reference to developments in the Asia and Pacific region, is one goal of this chapter.

Given that tariff hikes and import quotas have had a bad name ever since the 1930s,¹ that there are many policy instruments available to states whose implementation can harm foreign commercial interests, and that during economic crises governments come under considerable pressure to go beyond macroeconomic policy measures and to intervene in specific markets, crisis-era protectionism need not take the same form. This observation has important implications for the monitoring of protectionism, for the analysis of protectionism during systemic economic crises and, ultimately, for the design of international rules relating to discrimination against foreign commercial interests. The case will be made here that it is unwise, if not misleading, to have a historically determined, instrument-based definition of protectionism. A treatment-based definition of protectionism is preferable and, seen from this perspective, the record of government policy choice in recent years is less promising.

While analysts and policy makers may be more confident of the conclusions that they can draw if they have data on policy choices before and during crises, during a severe downturn the reality is that governments may start employing policy instruments for which there is a sparse, prior empirical base. Inevitably, analysts and decision makers are going to have to make the most of the data that is available. Here the perfect should not become the enemy of the good. Moreover, analysts and decision makers should be aware that there may be some – who for whatever reason wish to deny the extent of protectionism – that deliberately exploit the paucity of data.

That the form of cross-border discrimination can change also has implications for assessing whether international initiatives concerning protectionism have altered state behavior. International initiatives and rules that are form-based, such as those found in many WTO accords, create incentives for policy ‘innovation’ (a euphemism for circumvention) when economies experience severe, prolonged setbacks.

It is argued here that these considerations are relevant when assessing the G20’s public commitments to eschew protectionism and the impact of the existing, incomplete set of binding multilateral trade rules. On this logic, expectations of the extent to which international initiatives constrain national policy choice during systemic economic crises should be tempered. As a result, the primary focus of efforts to restrain protectionism should remain at the national level.

The remainder of this chapter is organized as follows. The next section
explores the notion of protectionism that is relevant for the early 21st century, rejecting many previous notions in favor of a treatment-based definition. The latter approach has weaknesses, and these are discussed as well. The third section describes the dataset used (compiled from the Global Trade Alert monitoring initiative) to map crisis-era protectionism. The main findings that relate to developments in the Asia and Pacific region are summarized in section 6.4 and an explanation offered for them in section 6.5. Concluding observations can be found in section 6.6.

6.2 WHAT NOTION OF PROTECTIONISM IS RELEVANT FOR THE EARLY 21ST CENTURY?

Before protectionism can be mapped it must be defined. But what are the characteristics of a useful definition? One desirable feature of a meaningful definition is that it can be readily applied to the diverse forms of international commerce in the 21st century, not just cross-border trade in goods. In a world with considerable cross-border foreign investment and movement of persons, as well as cross-border provision of services, definitions of protectionism must keep up with the new ways in which customer needs are met by the private sector. Care must also be taken not to define the ‘problem’ away by too restrictive a notion of protectionism. Moreover, there are significant interests – both commercial and official – at stake and it would be unwise to take at face value every claim made about crisis-era protectionism. Other desirable features are that the definition be objective and implemented independently and expeditiously. Are these characteristics reflected in the definitions of protectionism used in recent years?

Since the onset of the GFC notions of contemporary protectionism have been advanced based on the following five elements:

1. Specific policy instruments, such as import tariffs and quotas.
2. Policy instruments covered by WTO accords.
3. Intent of the policy maker.
4. Effects-based criteria based on estimates of harm done.

The first two definitions of protectionism are form-based. The first is typically based on readings of history as they relate to prior outbreaks of protectionism. A leading example is the association of protectionism with across-the-board tariff increases and import quotas in the 1930s. The second is based on the policy instruments covered by existing multilateral trade disciplines. Given disagreements between experts as to which
policies are covered by the general disciplines of WTO membership (in particular, those relating to national treatment), the second definition is not quite as unambiguous as some observers might think.

For the purposes of monitoring contemporary protectionism during a systemic economic crisis, the principal drawback, however, of the first two definitions is that they create incentives for desperate governments to choose forms of beggar-thy-neighbor policy instruments that fall outside the set of policies deemed to be protectionist. History shows that governments have often altered the mix of protectionism employed from crisis to crisis, so a backward-looking, form-based definition could miss such ‘innovation’ on the part of policy makers. For example, had the 1930s experience led analysts to define protectionism as the resort to tariffs and quotas then the application of that definition to the sharp global economic downturn in the early 1980s would have missed the substantial resort to voluntary export restraints during that era.

Definitions of protectionism based on intent are difficult to implement in an uncontroversial manner because what (little) is known about the motives of a policy maker may not be accurate. Using intent to identify policies that are protectionist also has the drawback of encouraging policy makers to misrepresent their rationale for intervening.

Defining a measure as protectionist if the quantum of harm done to foreign commercial interests exceeds a certain \textit{de minimus} level has, at a conceptual level, some appeal. After all, why trawl for minnows? Arguably, given the small volume of trade involved in many trade defense investigations, having a \textit{de minimus} standard for effects might focus deliberations in policy circles on the state measures ‘that really matter’. But there are problems with this approach, not least concerning which effects are to be considered – trade-related, investment-related, or, as many economists would no doubt prefer, welfare effects?

Moreover, there are practical objections. Analysts will squabble over how to conduct empirical analyses of such effects. Plus, there is simply not enough analyst time available to conduct evaluations of all of the potentially important measures introduced since the GFC began.\textsuperscript{2} Demanding that the impact of crisis-era policy interventions be estimated before possibly classifying them as protectionist sets too high a bar, given constraints on analyst time. None of this is to discourage empirical studies of crisis-era commerce-related policy interventions; rather, the reality is that there probably will not be enough of those studies to generate a comprehensive account of protectionism.

This leaves differential treatment as a basis for defining protectionism. Here a government measure is deemed protectionist if de facto or de jure the measure worsens the relative treatment of a foreign commercial
interest vis-à-vis a like domestic interest or a like, rival foreign commercial interest. Discrimination against rival suppliers on the basis of their nationality can be introduced or increased; both constitute protectionism on this definition. An increase in the tariff charged on an imported good, for example, worsens the treatment of suppliers from abroad as compared to suppliers in the jurisdiction responsible for the tariff increase. Export subsidies, tax breaks, and other incentives benefit domestic firms that ship goods to third markets at the expense of rival foreign firms that are not eligible for the same financial inducements. State measures that treat the profits on foreign greenfield investments better than the profits of domestic, rival firms do not involve worse treatment of foreign commercial entities and, therefore, do not constitute protectionism on this definition.

There are pros and cons to a treatment-based definition of protectionism. The pros are, first, that the definition is not tied to any predetermined set of policy instruments or to any mode of supplying foreign customers and, second, that its implementation requires typically less resources than conducting an empirical analysis of a measure’s effects. The fact that a differential treatment standard can be implemented without reference to specific policy instruments and modes of supply is a major advantage given the history of ‘policy innovation’ during crises and the varied nature of 21st-century international commerce. Innovations on the part of policy makers that result in the use of new policy tools to discriminate against foreign commercial interests – or greater use of existing, previously lower profile tools to discriminate – will be picked up by this definition of protectionism. Moreover, given that economies differ markedly in their commercial interests and in the modes of supply to foreign markets, a differential treatment standard is going to be relevant to more jurisdictions than a standard based on a predetermined set of policy instruments.

The principal con is that certain government measures that worsen the treatment of some foreign commercial parties may be deemed to have a legitimate public policy purpose, such as promoting financial stability or protecting consumers against unsafe food or manufactured goods. State measures such as regional trade agreements, sanitary and phytosanitary standards (SPS), and technical barriers to trade (TBT) would fall foul of an unqualified differential treatment standard. One, perhaps inelegant, way to address this concern is to exclude regional trade agreements from any list of protectionist measures drawn up on a differential treatment standard and to include only those SPS and TBT measures imposed for which there is no evident scientific basis.

Proper implementation of a differential treatment standard, however, requires monitoring and investigating measures that fall outside the remit of many trade ministries. Industrial policy, public procurement, visa and
migration initiatives – to name just a few – need to be monitored and this adds to implementation costs. Given the focus of this chapter is on the Asia and Pacific region, the prominence attached to a plethora of industrial policies requires careful monitoring to obtain as complete a picture as possible about contemporary protectionism.

There are two other important implications of adopting a differential treatment standard for classifying contemporary protectionism. First, measures that discriminate against foreign commercial interests need not be trade-restricting, like tariffs and quotas. It may have been appropriate to associate protectionism with declining world trade in the 1930s but, on a differential treatment standard, it is possible that some discriminatory policy interventions increase trade, such as export subsidies and other incentives. Therefore, the fact that world trade did not collapse in recent years as much as it did in the 1930s should not be taken as evidence of the absence of differential treatment or protectionism. Indeed, the considerable resort to subsidization, more generous trade finance schemes, and export incentives by leading economic powers early in the GFC may well have helped stabilize, and possibly increased, trade in 2010 and after.

Second, a differential treatment standard could apply to government initiatives that involve policy instruments not covered by existing WTO agreements or that are governed by weak WTO rules. If patterns of circumvention or evasion of the WTO’s rules are detected then this may be useful in deliberations over whether and how to strengthen the WTO accords.

In sum, before monitoring protectionism or commenting on the data presented by others, it is worth considering the pros and cons of different approaches to classifying policy instruments as protectionist, not least because the term ‘protectionist’ has such bad connotations. In this section a case has been made for the differential treatment standard over four alternative approaches. Having said that, the differential treatment standard is not perfect, yet many of its pitfalls can be avoided during implementation. The remainder of this chapter refers to the data assembled by the Global Trade Alert (GTA), an independent monitoring initiative that has sought to implement the differential treatment standard.

6.3 MAPPING PROTECTIONISM IN THE ASIA AND PACIFIC REGION USING THE GLOBAL TRADE ALERT DATABASE

It would be wrong to give the impression that there was no data available on the trade policy stance of Asian and Pacific governments before
the GFC. Selected indicators of trade policy stance – principally associated with average tariff rates and measures taken against dumped and subsidized imports⁴ – were available in the online databases of the World Bank and the International Monetary Fund. The WTO’s *World Tariff Profiles*, an annual publication containing information on many territories, contains useful data on the distribution as well as the average tariff levels for agricultural and non-agricultural goods. In principle, the United Nations Conference on Trade and Development’s TRAINS database contains information on non-tariff measures (NTMs), but there are concerns about this dataset’s coverage and whether the data reported is up to date. A useful overview of the latest research and data on NTMs can be found in the WTO (2012a). In addition, the relevance of NTMs to the ASEAN region and associated reforms has been described recently by Pasadilla (2013).

Given discrimination against foreign commercial interests is possible using a wide range of policy instruments, the reality was that analysts and government officials were not well placed to monitor the full range of potentially relevant policy developments at the start of the recent crisis. The inadequacy of data became a greater concern in the first half of 2009 when fears multiplied⁵ that governments might resort to protectionism on a scale not seen since the 1930s.

The GTA was launched in June 2009 to provide independent, freely and readily available information online⁶ about policy developments likely to alter the relative treatment of foreign commercial interests. From the beginning it was understood that improvements in the relative treatment of foreign commercial interests would be reported as well as the converse. Information on government measures that were announced but were pending implementation were reported also, so as to alert users about measures that might soon affect foreign commercial interests. The GTA’s reporting of measures went back to those announced on or after the first crisis-era G20 summit in Washington, DC, on 14–15 November 2008, partly to facilitate monitoring of the adherence of the G20 members to their pledges to eschew protectionism.

Consistent with being an independent initiative, the GTA team comprised trade policy experts from around the world that were not affiliated with a government, international organization, or with a directly government-sponsored research institution. To avoid double counting, the unit of analysis in the GTA monitoring is the announcement of a government initiative. An initiative could involve a decree that changes the tariff on a single item – while in other cases the initiative could be an official budget speech containing dozens of policy changes affecting foreign commercial interests. It is for this reason that each report includes
information on the tariff lines, sectors, \(^7\) and trade partners likely affected by a measure – so counts of measures undertaken by governments are not the only proxies for potential impact that can be constructed from the GTA database. Subsequent analysis revealed a high positive rank correlation coefficient between listings of countries on the basis of the number of protectionist measures imposed, number of tariff lines affected, number of sectors affected, and number of trading partners affected.

Each measure in the GTA database was classified according to the impact of its implementation on the relative treatment of domestic and like foreign commercial interests. Measures that improve the relative treatment of the latter or improve the transparency of trade-relevant regulations were coded green. Measures that are almost certainly discriminatory – that is, whose implementation almost certainly worsen the relative treatment of foreign commercial interests – were coded red. An amber coding was given to \textit{announced} measures that, if implemented, would almost certainly discriminate against foreign commercial interests and to those \textit{implemented} measures that are likely\(^8\) to discriminate against foreign commercial interests. The date a measure came into force is also reported. Furthermore, implementation of measures is monitored so that those measures still in force and those that have lapsed could be distinguished.

With information on the identity of the implementing jurisdiction, type of government policy intervention, tariff lines, sectors, and trading partners affected, color coding on the basis of likely differential treatment, the date a measure came into force, and implementation status, users of the GTA database can recover immediately summary statistics concerning all, and combinations of, these variables. The advanced search page of the GTA has been configured so as to enable users to undertake detailed searches across products, sectors, countries, trading partners, and time. Searches by certain groups of countries (G8, G20, European Union members, and least developed countries) are possible, too. No alternative source of data on contemporary trade policy choice, covering nearly 4000 reports on government acts, can be accessed so easily. Consequently, it may not be surprising to learn that, at the time of writing, the phrase ‘Global Trade Alert’ can be found in over 525 studies and reports on Google Scholar after less than four and a half years of operation.

The GTA is, however, not the only initiative to monitor protectionism since the onset of the GFC. The WTO and the European Commission on a regular basis have released useful reports. These official sources tend to use a form-based definition of protectionism, although it has been argued that the scope of their reporting has improved over time. Moreover, their reporting tends to focus on the larger trading economies (the European Commission’s reports state as much). In effect, the GTA’s coverage of
policies and countries is wider than these official sources. Still, when apples-to-apples comparisons have been made in recent years between the GTA and European Commission reports the number of protectionist measures found are similar. This finding is reassuring, but also not terribly surprising – the GTA website is updated frequently (typically at least weekly) and the European Commission officials can access the reported protectionist measures on the GTA website, just like anyone else.

Over time acceptance of the information collected by the GTA has grown. Reports by the World Bank and by United Nations Economic and Social Commission for Asia and the Pacific (UNESCAP) frequently make reference to the GTA’s data (see for example UNESCAP 2012a, 2012b, 2013). Leading public officials including, amongst others, the President of the World Bank and the Secretary-General of the United Nations Conference on Trade and Development (UNCTAD), have referred to GTA data in their speeches. Likewise, ambassadors to the WTO have referred to GTA findings in deliberations at the WTO. Finally, as of June 2013, 505 media reports made reference to the GTA’s reports and findings, including reports in major newspapers and business magazines.

In principle, the GTA covers measures taken by national and subnational governments as well as other state bodies – such as state-owned enterprises – in any customs territory. For the purpose of this chapter, the group ‘Asia-Pacific’ refers to all of the regional members of the Asian Development Bank, including industrialized members, plus the Russian Federation. The grouping ‘developing Asia-Pacific’ includes all of the Asia-Pacific customs territories except: Australia; Hong Kong, China; Japan; New Zealand; Russian Federation; and Singapore. The latter six are referred to below as the ‘high income Asia-Pacific’ economies.

6.4 RESORT TO DISCRIMINATION IN THE ASIA AND PACIFIC REGION: A COMPARATIVE ANALYSIS

To what extent, if at all, does the resort to discrimination against foreign commercial interests in the Asia and Pacific region differ from patterns observed worldwide? Furthermore, does resort to protectionism differ among nations in Asia and the Pacific according to level of economic development? The purpose of this section is to answer these questions, making reference to the charts and tables reported at the end of this chapter and assembled from the GTA database on 6 October 2013. That is, the statistics refer to state measures announced or implemented
between 14 November 2008 (the start of the first crisis-era G20 summit) and 6 October 2013, a period covering almost five years.

Table 6.1 reports the totals for measures that benefit and harm foreign commercial interests, with and without the traditional protectionist instruments of tariffs and trade defense.10 Worldwide, 3228 state measures were reported in the GTA database as having been implemented, of which 832 and 591 measures relate to measures implemented by governments in developing Asia-Pacific and high income Asia-Pacific economies, respectively. Therefore, the Asia and Pacific region accounts for 44 percent of the measures implemented worldwide.

There are clear differences between countries in their tendency to resort to protectionism as measured by the ratio of the total number of protectionist measures imposed to the total number of liberalizing measures implemented (which can be derived from data reported in Table 6.1). Worldwide this ratio is 3.1. In the developing Asia-Pacific group this ratio is 2.45 and the comparable ratio for the high income Asia-Pacific group is 3.58. To the extent that counting measures makes sense and assuming that there are no biases in undercounting, these ratios indicate a differential willingness to engage in beggar-thy-neighbor behavior in the Asia and Pacific region, with the richer countries engaging in proportionally more discriminatory actions during the crisis. Perhaps some developing country governments in Asia took the view that implementing protectionist measures would scare off foreign investors. Policy makers in high income Asia-Pacific jurisdictions may have reasoned that the longer standing advantages of their economies might offset any tarnishing of their reputation that could follow from implementing beggar-thy-neighbor policies during the GFC.

There also appears to be differences between Asian and Pacific economies in the resort to non-traditional forms of protectionism. Comparing the total number of protectionist measures implemented with the total that involve the use of tariffs or trade defense, half of the measures implemented by the developing Asia-Pacific economies were of the latter types (Table 6.1). In contrast, traditional forms of protectionism accounted for just 28.4 percent of the protectionist measures taken by governments of the high income Asia-Pacific economies, a percentage well below the comparable statistic for the world. Part of the difference is due to the resort to bailouts and subsidies by the richer countries in the Asia and Pacific region, whose governments presumably have deeper pockets. Together, the six high income Asia-Pacific economies have implemented 244 schemes that provide financial support to national firms operating at home or abroad.

An alternative explanation may be that, with the exception of the
<table>
<thead>
<tr>
<th>Group of countries</th>
<th>Measures imposed from November 2008 to September 2013</th>
<th>Measures still in force on 6 October 2013</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total number of liberalizing measures</td>
<td>Total number of protectionist measures</td>
</tr>
<tr>
<td>Developing Asia Pacific</td>
<td>241</td>
<td>591</td>
</tr>
<tr>
<td>High Income Asia Pacific</td>
<td>129</td>
<td>462</td>
</tr>
<tr>
<td>World</td>
<td>787</td>
<td>2441</td>
</tr>
</tbody>
</table>

*Source:* Data extracted 6 October 2013 from Global Trade Alert database.
recently acceded developing countries of Asia, the jurisdictions with lower per capita incomes had larger tariff binding overhangs and thus had more leeway to raise their tariffs significantly during the GFC without violating their WTO obligations. This hypothesis is explored further in the next section of this chapter.

Comparing the total numbers of protectionist measures that have been removed with those still in force sheds light on the extent to which crisis-era protectionism has been unwound by October 2013 – and how much further unwinding is needed to restore commercial conditions to the pre-crisis status quo. Worldwide, 14.3 percent of all discriminatory measures implemented since November 2008 had been unwound by October 2013. That percentage falls to 11.9 percent for the higher income Asia-Pacific countries and to 9.6 percent for the developing countries in the region. In sum, while the lower per-capita income countries in the Asia and Pacific region have implemented proportionally fewer protectionist measures than their richer counterparts, the former have unwound approximately the same percentage of those measures as the latter (Table 6.1).

The annual variation in the resort to protectionism in the Asia and Pacific region and elsewhere is revealing and is portrayed in Figure 6.1. To facilitate comparison, the raw data for 2008 and (year to date) 2013 were annualized. Worldwide, a spike in protectionism was recorded in 2009, with the number of protectionist measures implemented in that year rising more than 40 percent above the annualized rate for 2008. Although the annual totals since 2009 have fallen, they have yet to fall below levels seen in 2008.

Interpreting these annual totals requires care, however. The very nature of less transparent – or murky – forms of protectionism is that they are more difficult to document. Consequently, there can be substantial reporting lags. These reporting lags can create the impression that the resort to protectionism was lower in more recent years when, in fact, as more evidence becomes available, the totals for later years are revised upwards. The matter of reporting lags was explored in the 14th report of the GTA, where it was shown that, evaluated at comparable stages in the reporting cycle, the reported worldwide totals for protectionism in 2012 were higher than those observed in 2009 (Evenett 2013a).

Figure 6.1 also reveals interesting differences in the annual resort to protectionism by the high income and developing economies of the Asia and Pacific region. The former’s annual resort spiked in 2009, fell in 2010 and 2011, and picked up subsequently. In contrast, the developing nations economies the region increased their resort to protectionism in 2009 and 2010 and then the rate plateaued, with between 110 and 130 protectionist measures being implemented in every year since. Similar differences
between the higher and lower per capita income members of the G20 have been observed (Evenett 2013a).

As information on tariff changes and investigations into dumped imports, subsidized imports, and import surcharges is easier to come by, many observers have paid greater attention to these forms of protectionism. This is unfortunate, as Figure 6.2 shows. In no year since 2008 has resort to these traditional forms of protectionism accounted for more than half of the protectionist measures implemented by the high income Asia-Pacific economies and by the rest of the world. Even in the developing Asia-Pacific group, resort to tariff increases and trade defense measures accounts for just over half of all measures taken. This finding is significant as some have sought to downplay crisis-era protectionism by reporting small totals for the amount of trade affected by traditional protectionism, overlooking the fact that other forms of protectionism were implemented as well.11

Figure 6.1 Annual totals of protectionist measures implemented by economies in the Asia and Pacific region and the rest of the world

Source: Author’s calculations.
There are also differences in the annual variation in the propensity to remove (‘unwind’ in trade policy parlance) protectionist measures taken since 2008 (see Figure 6.3). The high income Asia-Pacific economies unwound a higher percentage of the measures that they imposed in the early years of the crisis than developing countries from the same region. However, of the protectionist measures implemented since the beginning of 2011, both groups have unwound roughly the same, small percentage (in the range of 5 percent to 10 percent). One implication of these findings is that the stock of crisis-era protectionism implemented in the Asia and Pacific region (and, for that matter, in the rest of the world) is rising over time, supporting the concern that the crisis-era has witnessed a growing fragmentation of regional and world markets.

Asian and Pacific economies have seen their diverse commercial interests adversely affected by state measures taken by trading partners. Table 6.2 identifies the ten nations in the Asia and Pacific region harmed most often by foreign protectionism. The PRC stands out in two respects. Most obviously, because the PRC has seen its commercial interests harmed over 1100 times since November 2008. Since the onset of the
GFC no other nation has been hit so often by foreign protectionism. The second reason is that half of the foreign protectionism harming Chinese interests is due to tariff hikes and trade defense measures – whereas, for the other countries listed in Table 6.2, traditional protectionism accounts for between 25 percent and 40 percent of the total number of times that their commercial interests have been hit. Even in the PRC’s case, if steps taken to remove crisis-era protectionism were confined to more traditional forms of protectionism, then half of the hits to Chinese commercial interests would remain in place. Much of the protectionism harming these ten country’s commercial interests has yet to be unwound. One policy implication immediately follows for these countries: they should have an interest in initiatives that seek to remove protectionism imposed during the crisis era.

Source: Author’s calculations.

Figure 6.3 Percentage of each year’s protectionist measures unwound by 1 October 2013 for the Asia and Pacific region and the rest of the world
Table 6.2  The ten jurisdictions in the Asia and Pacific region most frequently harmed by other nations’ protectionism, sorted in descending order by the number of red (almost discriminatory) measures imposed on a target jurisdiction since November 2008

<table>
<thead>
<tr>
<th>Rank</th>
<th>Jurisdiction affected</th>
<th>Number of times commercial interests harmed by foreign protectionism implemented since November 2008</th>
<th>Number of foreign protectionist measures unwound before 1 October 2013</th>
<th>Number of times commercial interests harmed by foreign tariffs and trade defense measures</th>
<th>Percentage of total number of foreign protectionist measures that . . . have been unwound by 1 October 2013</th>
<th>Percentage of total number of foreign protectionist measures that . . . are tariff increases or trade defense measures</th>
</tr>
</thead>
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<td>1</td>
<td>People’s Republic of China</td>
<td>1103</td>
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<td>549</td>
<td>11.9</td>
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<tr>
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<td>53</td>
<td>89</td>
<td>15.4</td>
<td>25.9</td>
</tr>
</tbody>
</table>

Source:  Extracted 6 October 2013 from Global Trade Alert data.
6.5 INTERPRETING THE EVIDENCE

In interpreting the resort to discrimination against foreign commercial interests in recent years, it is not surprising that many analysts have made reference to the longstanding literature on the relationship between trade protectionism and the business cycle and to the role that protectionism played in the Great Depression of the 1930s. The former literature often predicts that protectionism is counter-cyclical, with governments offering respite to import-competing firms during downturns, often through the use of trade defense measures. The latter literature showed that the resort to across-the-board protectionism in the 1930s was influenced by macro-economic policy options (Eichengreen and Irwin 2009). Those countries that left the Gold Standard and devalued their currencies to a greater degree tended to raise their average tariff rates by less, indicating a degree of substitutability across policies (Irwin 2012).

Ultimately, the question that arises is how useful are these perspectives for understanding the decisions taken by governments since the onset of the GFC? It is important to bear in mind that the crisis had three features: the crisis simultaneously affected many nations; saw financial markets seize up with the immediate consequence that firms had to scramble to find working capital, else they would have to start laying off workers and defaulting on their debts and payments to suppliers; and the initial downturn in many economies was more severe than in a typical recession. To what extent does our understanding of the determinants of protectionism need to be altered in the light of these circumstances?

On the face of it, the fact that governments reacted to the sharp economic downturn of 2009–10 with expansionary fiscal and monetary policy raises the question of whether these steps might have substituted – in whole or in part – for protectionism. There may be something to this but, as argued below the substitutability hypothesis needs to be qualified so as to account for contemporary circumstances.

While Smoot Hawley-style tariff increases have been avoided in the early years of the GFC, this does not imply the absence of a considerable amount of discrimination against foreign commercial interests – some of it directly associated with the macroeconomic stimulus policies undertaken. Worldwide, 50 countries – including 18 in the Asia and Pacific region – instituted or expanded ‘buy national’ or other measures that channeled additional government spending to domestic firms. In some jurisdictions local and state governments joined central governments in implementing discriminatory public procurement policies. It would be wrong, then, to think that this time around ‘clean’ fiscal stimulus plans substituted for ‘dirty’ protectionism. The way fiscal stimulus plans were implemented in
many countries during 2009 and 2010 actually contributed to discrimination against foreign commercial interests.

Even greater prominence has been given to the adverse knock-on effects for trading partners of expansionary monetary policies, as the discussion of the so-called currency wars shows (Evenett 2013b). To the extent that expanding a central bank’s balance sheet leads ultimately to a depreciation of its national currency, this will shift expenditure toward domestically produced goods and away from foreign goods. Concerns that such depreciations might trigger reactions by trading partners are real – in recent years currency depreciation by one major trading nation has been emulated.\textsuperscript{12} Such concerns persist – witness the reaction of Japan’s trading partners to the implementation of its policy of monetary easing in 2013.

In the case of monetary policy under a floating exchange rate regime, there appears to be a policy dilemma. One of the accepted lessons of the 1930s is that the central bank should make whatever liquidity is necessary to stabilize the national banking system. Yet doing so creates a by-product – a depreciation of the national currency, which hurts trading partners. However, had governments combined a non-discriminatory fiscal policy stimulus with a lax monetary policy then some of the adverse cross-border effects would have been reduced (Evenett 2013b). Instead, as governments turned to fiscal austerity measures, trading partners were faced with currency devaluations and reduced prospects for benefiting from public procurement contracts. Under these circumstances, it is not surprising that trade tensions have risen as the effects of the austerity programs were felt.

The dependence of modern capitalism on working capital\textsuperscript{13} and the freezing up of financial markets witnessed during the early phase of the GFC poses another question for governments: which tool to use to help firms that could not obtain credit from banks and other financial institutions?\textsuperscript{14} Without such credit, widespread layoffs and defaults would soon follow, adding to the economic downturn. Governments could raise import barriers hoping this will switch expenditures to domestic firms that were in financial trouble. However, during a sharp economic downturn customers may rein in their spending, implying there is less buying power to shift in the first place. An alternative policy intervention, that can be targeted more effectively and its impact felt more quickly, is to offer the firms in question subsidies or bailouts, either directly from the public treasury or through the banking system. Such selective bailouts discriminate in favor of recipients against both domestic and foreign rivals. The GTA has documented 545 such bailouts worldwide, 424 of which do not involve recipients in the financial sector. State-led relaxation of corporate budget constraints is an alternative to Smoot Hawley-like tariff increases
and, like the latter, the former can be designed to favor domestic over foreign commercial interests.

Some might object that during financial crises the resort to bailouts is inevitable. Even if true, it is not clear that the resort to selective bailouts was necessary. Governments could have ensured that bailouts and the like were offered on the same terms to all firms within a jurisdiction. While that would have still involved discrimination against firms located abroad, foreign subsidiaries based in the subsidy-granting jurisdiction would not have been discriminated against. Moreover, to the extent that subsidies were in fact not motivated by providing emergency infusions of working capital but by the desire to limit capacity reductions by local firms, then the latter have a stronger beggar-thy-neighbor character as these subventions seek to shift the burden of adjustment on to rival firms located in trading partners. In addition, it may well be the case that some of the subsidies that began as working capital injections evolved over time into measures to slow or put off capacity reductions and associated job losses. Therefore, what may have started as a response to market failure (the freezing up of financial markets) could have morphed into another, potentially longer-lasting, form of discrimination against foreign commercial interests.

In light of this, what should one make of the contemporary relevance of the 1930s-motivated substitutability argument? At best, it is incomplete – contemporary relevance requires adding softening budget constraints as a viable policy alternative. At worst, it overlooks the fact that many of the macroeconomic policy alternatives to tariffs and traditional protectionism implemented in recent years have also involved discrimination against foreign commercial interests. A modified, less sanguine, version of the substitutability hypothesis is called for if it is to account in part for the resort to protectionism since the onset of the GFC.

While the above accounts for the resort to bailouts and subsidies, recall from section 6.4 that developing countries in the Asia and Pacific region employed proportionally more traditional forms of protectionism during the crisis era, such as tariff increases and trade defense measures. It may be that countries with lower per capita incomes cannot afford to offer subsidies from the public treasury, or lack the banking systems necessary to direct credit to favored firms.

Another consideration, however, is that developing countries tend to have more leeway under existing WTO commitments to raise tariffs. Here, Figures 6.4–6.6 are relevant, although the relatively small sample sizes necessarily qualify the conclusions drawn. Data was collected from the WTO publication *World Tariff Profiles 2012* (WTO 2012b) on the severity of their WTO obligations, in particular toward tariffs on trade in goods (for which continuous measures of the tightness of WTO obligations can
be constructed). Perhaps it is not that widely known just how much variation there is across WTO members in the extent to which governments are free to raise their tariffs without breaking their WTO commitments. Asian and Pacific countries differ markedly in the percentage of their tariff lines that are subject to legal maximums (bindings in WTO parlance) in the first place, in the difference between the maximum tariff allowed and the tariff actually set (the so-called tariff binding overhang), and the percentage of a nation’s tariff lines (import product categories) where the right to set tariffs has been given up entirely. It will be interesting to see if countries more constrained by WTO rules in their use of tariffs resort more frequently to non-traditional forms of protectionism.

First, however, it will be helpful to check whether governments that resorted relatively more often to protectionism did so by making greater use of traditional forms of protectionism. As Figure 6.4 shows, for the Asian and Pacific economies this is not the case. Governments that have skewed their treatment of foreign commercial interests more toward discrimination have tended to use less traditional means of doing so. That the traditional forms of protectionism are subject to the toughest WTO

![Image of Figure 6.4](image-url)

*Source:* Author’s calculations.

**Figure 6.4** Where the protectionist impulse in the Asia and Pacific region is stronger the less is the resort to traditional forms of protectionism
A World Trade Organization for the 21st century

rules is important as this finding suggests those governments more desperate to protect domestic interests have resorted to policy instruments less constrained by WTO rules.

Apart from the developing countries that acceded to the WTO since 1995 (such as the PRC and Viet Nam), others in the Asia and Pacific region have plenty of room to raise their most-favored-nation tariff rates before reaching their bindings. That leeway appears to have been a factor conditioning policy choice in recent years, as shown in Figure 6.5. Asian and Pacific economies with more room to raise tariffs altered the mix of measures taken toward more traditional forms of protectionism.

The extent to which WTO members have given up the right to charge tariffs at all on imports differs a lot. In the sample of Asian and Pacific countries employed here the percentage of tariff lines that WTO members have agreed to forgo tariffs entirely varies from zero to 53 percent. As Figure 6.6 shows, there is a negative correlation between the extent to which a WTO member has given up the right to use tariffs and their resort

Source: Author’s calculations.

Figure 6.5 Among Asian and Pacific members of the WTO resort to traditional protectionism is greater where tariff binding overhangs are larger
to traditional forms of protectionism. In the light of this evidence it would be naive to conclude that just because a WTO member has given up certain rights to use tariffs that it could not – and therefore did not – resort to protectionism since the onset of the GFC.

High-income countries in the Asia and Pacific region and the PRC\textsuperscript{16} do not have the option of raising their tariffs legally and so have substituted policy instruments for which there are transparent WTO rules for those state measures for which the rules are either less transparent, weaker, or do not exist in the first place. What do we learn, then, about the effectiveness of WTO rules during a crisis? The incomplete nature of the WTO’s agreements – that do not prevent substitution between policy instruments – limits the extent to which multilateral trade rules restrain the resort to protectionism during systemic economic crises. Consequently, such incompleteness implies that current WTO rules more likely affected the composition rather than the amount of crisis-era protectionism. To argue that the WTO rules have failed entirely would be going too far. Likewise,
as long as the sizeable tariff binding overhangs in many developing countries and the incompleteness of the architecture of WTO rules persist, the expectation that during systemic economic crises the WTO alone could prevent substantial resort to protectionism represents a triumph of hope over experience.

In other writings I have added a further factor that limits the effectiveness of the WTO during systemic economic crises – namely, the fact that the simultaneous pressures on governments to engage in discrimination against foreign commercial interests creates a ‘glass houses syndrome’ (Evenett 2011). According to the saying ‘people who live in glass houses should not throw stones’; in this instance it means that governments will be reluctant to bring cases to the WTO’s dispute settlement body about crisis-era violations of WTO rules precisely because those governments too have been breaking multilateral trade rules. In this regard, it is worth noting that the number of dispute settlement cases brought to the WTO from 2009 to 2011 was below the trend seen before the GFC began (Evenett 2012). There was an increase of cases in 2012 and, interestingly, this produced threats of retaliation from the governments of those jurisdictions named in the suits. In sum, then, the experience of recent years should temper what is to be expected from binding multilateral rules during systemic economic crises.

6.6 CONCLUSIONS

One goal of this chapter is to better understand the resort to protectionism in the Asia and Pacific region since the onset of the GFC. Interesting differences were found between countries in the region and between the region and the global totals. Not surprisingly, then, no single explanation is likely to fit all of the facts. However, there were enough commonalities upon which to formulate possible explanations for the differential resort to protectionism.

Before analyzing the evidence it was necessary to reflect on which notion of protectionism is relevant for the 21st century, given the many modes available to supply foreign markets. The case was made here for a ‘differential treatment’ standard to classify crisis-era policy initiatives. One advantage of this standard is that it can be applied to initiatives that improve the treatment of foreign commercial interests, not only measures that disadvantage foreign interests. Another attraction of this approach is that it captures new forms of discrimination against foreign commercial interests, which is important as the GFC and its predecessors saw changes
in the mix of policies used by desperate governments keen on favoring local firms and industries.

High-income economies in the Asia and Pacific region were found to resort to bailouts often. Many developing countries in the Asia and Pacific region tended to employ more traditional forms of protectionism during the crisis, such as raising tariffs and imposing trade defense measures. The substantial tariff binding overhang that many developing countries have affords them the leeway to raise tariffs considerably without breaking their WTO obligations. The simultaneous, deep, and financial nature of the GFC accounts for the richer countries resorting more to discriminatory bailouts and subsidies, measures that are less constrained by WTO rules than tariffs.

In interpreting this evidence it was argued that our understanding of the factors responsible for protectionism during systemic economic crises needs to be updated from the standard account of beggar-thy-neighbor policy in the 1930s. Moreover, the incomplete nature of the WTO’s rules, and the glass house syndrome induced by the simultaneous nature of the deep economic slump, both limit the bite that can be realistically expected of WTO rules during systemic economic crises. Even if the set of WTO rules were filled out and circumvention became impossible, then the glass houses syndrome could still limit the enforcement of those rules. The appointment of an independent legal ‘guardian of the treaties’ (to borrow a well-known phrase from European Union parlance) willing and able to bring offending governments to the WTO Dispute Settlement Mechanism might banish the glass house syndrome. Unfortunately, there is little to suggest that governments (that are the members of the WTO) are keen on such a reform.

In conclusion, the GFC revealed some of the limitations of current multilateral trade rules and enforcement. This is not to imply that such rules are completely useless. Rather, analysts and officials should temper their expectations of the WTO accordingly. Another implication is that the case for open borders will be won and lost in national capitals. To the extent that WTO membership helps frame national debates on protectionism during crises, then multilateral rules may play an indirect and potentially constructive role. It would be wrong, however, to expect a white knight from Geneva to come over the horizon and save the day.
NOTES

1. This stigma has remained even though protectionism is not viewed by leading macroeconomists and historians as being the cause of the Great Depression. During systemic crises, then, a policy can be widely condemned without being the cause of the crisis.

2. As described in section 6.4 of this chapter, nearly 4000 implemented or announced government measures have been identified since November 2008 that could have implications for cross-border commerce.

3. This is very close to the approach taken by the Global Trade Alert. The GTA does include steps taken by governments to renego on previously agreed obligations under regional trade agreements on the grounds that the legitimate expectations of the affected commercial parties have not been met. Even so, there are only a few such measures, relating to Argentina and Brazil. As a percentage of the nearly 4000 measures included in the GTA database, few relate to SPS and TBT. It was decided early on by the GTA team to include only reports on major changes in SPS and TBT legislation and regulations. There is no assumption that any change in legislation or regulation must be classified as protectionist in the GTA. For example, a state measure that reduced the administrative burden on foreign firms during SPS and TBT compliance might be classified as liberalizing in the GTA database.

4. In this regard the creation of the Temporary Trade Barriers Database by the World Bank early in the GFC was a welcome advance.

5. Many references to protectionism were made by national premiers and heads of state in the run up to the April 2009 G20 Leaders Summit in London.


7. Including information on the sectors affected is important for measures – such as those relating to investment and services – where the impact is unlikely to be felt in cross-border imports and exports.

8. Notice the difference between ‘likely’ and ‘almost certainly’. To be classified red, a measure must meet the latter standard, which is usually met when the official description of the measure involves de jure discrimination against a foreign commercial interest. (In such cases the official document used by the GTA team to make the determination is referred to on the GTA website.) The GTA team has insisted on a higher evidential standard to classify as red a measure involving de facto discrimination.

9. For a list, see www.adb.org/about/members (accessed 6 October 2013). In total, data on 49 jurisdictions was used to compile the statistics presented in this chapter.

10. Trade defense is a European term covering state measures taken against dumped imports, subsidized imports, and import surges. Some refer to measures taken against dumped and subsidized imports as unfair trade measures.

11. The evidential base on the amount of trade affected by non-traditional forms of protectionism is growing. For example, over a trillion US dollars of Chinese exports are eligible for trade-related incentives that have been changed since the GTA began reporting (Evenett et al. 2012). Other estimates of the trade affected by ‘jumbo’ protectionist measures can be found in Evenett and Fritz (2011).

12. A good example is the depreciation of the Brazilian real after its Finance Minister publicly criticized the US for starting a currency war in 2010.

13. Many firms must pay their staff and suppliers before being paid by customers.

14. This argument was developed at greater length in Evenett (2011).

15. In another study with colleagues, I found that a national government’s pre-crisis credit rating was positively correlated with the resort to bailouts during the crisis, suggesting that deep pockets matter.

16. Only nine of the 112 protectionist measures taken by the PRC involve tariff increases.

17. Recall that in the WTO a member government must bring a case against another member government. There is no legal authority independent of the member states who can bring cases, as there is in the European Court of Justice.
18. Not dissimilar reasons can be advanced for doubting the restraint induced by the non-binding G20 pledges on protectionism, first made in November 2008 and repeated often since. For evidence casting doubt on the effectiveness of the G20 accords see Evenett (2013a).

REFERENCES


United Nations Economic and Social Commission for Asia and the Pacific


7. Exchange rate policy and regional trade agreements: a case of conflicted interests?

Victor Pontines and Richard Pomfret

7.1 INTRODUCTION

The relationship between exchange rates and trade has long been controversial. The fixed exchange rates of the pre-1914 gold standard were viewed as essential for efficient trade. In the period of 1919–39, exchange rate flexibility was positively correlated with growth, and too rigid adherence to the gold standard was negatively correlated with growth (Eichengreen 1992). However, beggar-thy-neighbor policies of devaluing in order to reduce unemployment in the 1930s came to be seen as a zero-sum strategy that exacerbated the breakdown of the global economy.\(^1\)

In the Bretton Woods era the International Monetary Fund (IMF) was responsible for ensuring that countries maintained fixed exchange rates and that any devaluation or revaluation was orderly.

Since the advent of generalized floating in the 1970s, no multilateral organization has been responsible for the global exchange rate system. There have been recurring charges of countries using exchange rate protectionism or promoting exports by exchange rate undervaluation. At the same time, the global trading system is increasingly characterized by proliferation of regional trade agreements which, together with World Trade Organization commitments, limit governments’ ability to use traditional trade policy measures (WTO 2011), and may increase the attractiveness of using the exchange rate as a trade policy instrument.

The aim of this chapter is to examine the relationship between the exchange rate regime and exchange rate volatility and trade among countries in an RTA.\(^2\) Exchange rate policy can be a substitute for trade policy, because the trade impact of any change in the exchange rate is (roughly) equivalent to that of some combination of changes in import taxes and export subsidies. The temptation to use exchange rate depreciation as a substitute for traditional trade measures may be greater within an RTA.
if a country has partially dismantled its trade barriers and cannot re-erect them within the RTA. On the other hand, exchange rate policy may be a complement to a liberal trade policy. If an RTA is signed to facilitate trade and promote regional value chains, exchange rate stability is complementary because, even if the cost of hedging against exchange rate risk is small, exchange rate volatility still imposes an added trade cost.

These questions are especially relevant to the Asian trading system, which has been characterized by burgeoning RTAs since the turn of the 21st century and by increasingly complex value chains based on reduced trade costs. After the 1997–98 crisis, several proposals for financial regionalism in East Asia were floated, but actual progress through the Chiang Mai Initiative, Asian bond market coordination, and macroeconomic monitoring have made slow and limited progress. The flourishing of bilateral and plurilateral agreements in East Asia since 2000 have been trade driven, and associated with reducing tariff and especially non-tariff barriers to the smooth functioning of regional value chains (Pomfret 2011). Exchange rate fluctuations are inimical to the operation of supply chains based on locating each individual segment of the chain in the least-cost location.³ Many observers have identified the desirability of maintaining bilateral exchange rate stability, preferably by a means other than generalized pegs to the US dollar.⁴

The next section reviews the literature on the relationships between exchange rates and trade flows. Section 7.3 summarizes trends on trade, RTAs, and exchange rate policy choices in East Asia. Section 7.4 discusses the divergence between using the exchange rate as a protectionist tool as opposed to exchange rates acting as a complement to facilitating trade. In section 7.5 the empirical results from a gravity model that examines the relationship between exchange rates and trade are presented. Section 7.6 discusses the competencies of the IMF and WTO, the two multilateral institutions with primary responsibility for exchange rate policies and international trade, concluding that the link between exchange rate and trade policies has fallen into a gap since the gold exchange standard ended in 1971–73. The final section draws conclusions and discusses policy implications.

### 7.2 EXCHANGE RATES AND TRADE

The modern econometric literature on exchange rates and trade dates from the end of the gold exchange system of fixed exchange rates in the early 1970s. From the 1970s until the early 2000s, coming out of the fixed versus flexible exchange rate debates, the focus was on whether and to
what extent exchange rate volatility was harmful to trade. Since the turn of the 21st century, attention has also turned to connections between exchange rate undervaluation or depreciation and trade.\textsuperscript{5}

Theoretical models can produce either positive or negative effects of exchange rate volatility on trade depending on assumptions about elasticities, attitudes toward risk, and so forth (de Grauwe 1988; McKenzie 1999; Baccheta and Van Wincoop 2000). Hedging can reduce risk, but involves extra costs (Caporale and Doroodian 1994; Obstfeld and Rogoff 1998). The theoretical literature is reviewed by Auboin and Ruta (2011).

The empirical literature on exchange rate volatility and the volume of trade is also inconclusive. Typical is the IMF (2004) study of the time path of exchange rate volatility and trade from 1970 to 2004 that found a weak negative relationship that was not robust to changes in specification; a cross-sectional analysis using a gravity model found a stronger negative relationship, but again one that was not robust. More recent papers have similar results (for example, Bahmani-Oskooee and Hegerty 2007a; Arize et al. 2008) find a significant negative relationship between exchange rate volatility and export flows of eight Latin American countries, while Tenreyro (2007), using a global sample of 87 countries, concludes that exchange rate volatility has no significant effect on trade flows. The consensus appears to be that there may be a negative relationship between volatility and trade, but if it exists it is of minor importance (Coric and Pugh 2010; Auboin and Ruta 2011, annex 1).\textsuperscript{6}

These are aggregate results and, as Maskus (1986) points out, the impact may vary by sector depending on openness to trade, concentration levels, prevalence of long-term contracts, and so on. It may also be a conditional relationship: Aghion et al. (2009) find that exchange rate volatility has a negative effect on productivity growth when the financial sector is underdeveloped, but not otherwise. A smaller number of studies finds a positive relationship from trade to exchange rate volatility (for example, Broda and Romalis 2003), suggesting a two-way relationship.

Empirical research on exchange rate levels and trade has been more limited. Changes in the real exchange rate can affect trade in many direct and indirect ways, altering incentives to allocate inputs between tradable and non-tradable activities, changing the output mix, and providing an indicator of relative competitiveness. In theoretical models the effects of exchange rate changes in the long-run, when by definition all prices have adjusted, will normally be zero, while the short-run effects are assumption-specific, depending in large part on the assignment of invoice currencies (Staiger and Sykes 2010). The growth impact of undervaluation is generally thought to be positive, but this rests on the presumed existence of distortions, for example, greater learning externalities in the traded goods
sectors, and is mostly supported by anecdotal evidence (most commonly from East Asia).

The econometric literature is surprisingly inconclusive given the general presumption that depreciation/undervaluation is good for growth. The relationships may be non-linear and sensitive to the choice of time horizon (due, for example, to J-curve effects). Auboin and Ruta (2011) conclude that the results are inconclusive because the exchange rate is just one of many influences on the trade balance.

The most interesting recent contributions have disaggregated the data by individual firms, by product level, or by time period. Berman et al. (2009) argued, theoretically and with French firm-level data, that the most productive firms export and depreciation encourages less productive firms to export; the former are more likely to absorb exchange rate fluctuations in their markups, while the less productive firms respond by changes in export quantity, so that trade flows do not generally respond greatly to exchange rate volatility, but exchange rate depreciation can increase the responsiveness. Bahmani-Oskooee and Wang (2007b) examined trade flows at the two- and three-digit industry level between the US and selected Asian economies and found large variations in responsiveness to exchange rate changes both across industries and between countries. For example, appreciation of the US dollar against the renminbi decreased US exports in 18 of the 88 industries and increased US imports in 40 of the industries, a result attributed to demand from the PRC for imports from the US being less price elastic than US demand for imports from the PRC. Finally, Auboin and Ruta (2011, pp. 15–16) point out that ‘the relationship between exchange rates and trade varies over time, as changes in the world economy materialize’, which is intuitively appealing in a world of increased outsourcing and more complex supply chains, although they are not able to cite much empirical evidence. These three considerations may be interconnected insofar as more dynamic outward-oriented firms in particular industries (for example, electronics) participate to a greater degree in global value chains.

All in all, there is an extensive literature on exchange rates and trade with some theoretical presumptions and empirical support for the intuitive results that depreciation favors trade and volatility deters trade, although the empirical evidence is modest. There are, however, suggestions that these relationships are uneven and conditional, perhaps in systematic ways. Of particular relevance to East Asian trade is the recurring implication of exchange rate protection and export promotion by countries in the region and the growing importance of regional value chains in what has become known as ‘Factory Asia’.

With respect to trade flows in East Asia, time series analysis of exchange
rate volatility and trade has produced mixed results. Poon et al. (2005) found a negative relationship between volatility and trade for Japan, the Republic of Korea, and Singapore, but a positive relationship for Thailand and Indonesia. More recent studies using panel data have found a negative relationship between exchange rate volatility and trade, for example, Chit et al. (2010) for ASEAN countries and the PRC, and a conditional relationship where volatility is harmful for trade when the financial sector is underdeveloped (Chit and Judge 2011).7

Thorbecke (2008), using data from the five largest ASEAN economies; the PRC; Japan; the Republic of Korea; and Taipei, China, found a negative relationship between exchange rate volatility and export of electronic components, and Hayakawa and Kimura (2009) found similar evidence for machinery goods and parts. Tang (2012) links these results to the strengthening of regional value chains, finding that the link between volatility and trade is strongest within a grouping of the five largest ASEAN economies; the PRC; Hong Kong, China; Japan; the Republic of Korea; and Taipei, China, and stronger for trade in intermediate and equipment goods than for trade in primary products or consumption goods. This argument suggests that the relationship may be time-sensitive, becoming stronger as regional value chains have become more prevalent.

7.3 TRADE, RTAS, AND EXCHANGE RATE POLICIES IN EAST ASIA

East Asia’s strategy of export-led growth has resulted in the rapid expansion of its share of world trade. As presented in Table 7.1, the region’s share of global exports rose from 14 percent in 1980 to 21 percent in 1990 and 26 percent in 2000. Its share of global imports also rose from 14 percent in 1980 to 23 percent in 2000. However, the rapid rise in both the region’s global share of exports and imports slowed sometime in the 2000s with the region’s global share of exports and imports in 2005 at 27 percent and 23 percent, respectively. Recent figures show that the post-2007 financial crisis had an effect on the region’s share of global exports and imports; the former dropped to 29.5 percent in 2011 from a global share of 30 percent in 2010, while the latter increased to 27.5 percent in 2011 from a global share of 27 percent in 2010.

Particularly striking is the rapid and consistent growth of the PRC’s shares of total world exports and imports from 1980 to 2010, only slowing down in 2011. Rapid growth in its exports and imports led in the early 21st century to the PRC overtaking Japan as East Asia’s leading trading nation, which is especially striking noting that in 1980 the PRC’s shares
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East Asian economies have been active in negotiating and completing regional trade agreements, particularly since the turn of the 21st century. Within East Asian economies alone, a number of bilateral and plurilateral trade agreements have entered into force since the ASEAN Free Trade Area (AFTA) came into effect in 1992 (Table 7.2). The East Asian region’s largest economies, that is, the PRC, Japan, and the Republic of Korea,

Table 7.1  East Asia’s global trade share, 1980–2011

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<td>12.1</td>
<td>8.7</td>
<td>8.6</td>
</tr>
<tr>
<td>European Union</td>
<td>43.1</td>
<td>45.0</td>
<td>38.0</td>
<td>39.2</td>
<td>33.5</td>
</tr>
<tr>
<td>Others</td>
<td>30.8</td>
<td>22.3</td>
<td>23.7</td>
<td>25.3</td>
<td>27.6</td>
</tr>
<tr>
<td>Total (World)</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Economy or region</th>
<th>Imports</th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Hong Kong, China</td>
<td>1.2</td>
<td>2.3</td>
<td>3.2</td>
<td>2.8</td>
<td>2.8</td>
</tr>
<tr>
<td>Japan</td>
<td>7.4</td>
<td>6.7</td>
<td>5.8</td>
<td>4.8</td>
<td>4.5</td>
</tr>
<tr>
<td>Republic of Korea</td>
<td>1.1</td>
<td>2.1</td>
<td>2.4</td>
<td>2.4</td>
<td>2.8</td>
</tr>
<tr>
<td>Taipei, China</td>
<td>0.0</td>
<td>1.6</td>
<td>2.1</td>
<td>1.7</td>
<td>1.6</td>
</tr>
<tr>
<td>PRC</td>
<td>1.0</td>
<td>1.5</td>
<td>3.4</td>
<td>6.1</td>
<td>9.1</td>
</tr>
<tr>
<td>ASEAN</td>
<td>3.4</td>
<td>4.6</td>
<td>5.6</td>
<td>5.4</td>
<td>6.2</td>
</tr>
<tr>
<td>Sub-total (East Asia)</td>
<td>14.1</td>
<td>18.9</td>
<td>22.6</td>
<td>23.2</td>
<td>27.0</td>
</tr>
<tr>
<td>United States</td>
<td>13.4</td>
<td>14.7</td>
<td>18.8</td>
<td>16.1</td>
<td>12.8</td>
</tr>
<tr>
<td>European Union</td>
<td>46.4</td>
<td>44.8</td>
<td>37.5</td>
<td>38.4</td>
<td>33.8</td>
</tr>
<tr>
<td>Others</td>
<td>26.1</td>
<td>21.6</td>
<td>21.2</td>
<td>22.3</td>
<td>26.3</td>
</tr>
<tr>
<td>Total (World)</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Source: IMF, World Economic Outlook; Direction of Trade Statistics.

of global world exports and imports were only 1 percent compared with Japan’s 7 percent.
have been players in the formation of these agreements within East Asia and in partnership with an ASEAN member state.8

In tandem with the active negotiation and completion of regional trade agreements with their East Asian neighbors, perhaps another contributing factor to the rapid growth in East Asia’s trade is that before the 1997–98 East Asian crisis, most Asian countries maintained de facto dollar pegs,9 which worked to stabilize exchange rates within the region. With the adoption of more flexible exchange rates following the 1997–98 East Asian crisis, intraregional exchange rate volatility has risen significantly. Table 7.3 depicts the evolution of East Asian exchange rate arrangements on 30 April 2013 according to the de facto IMF exchange rate classification.

The striking observation from Table 7.3 is that East Asian exchange rate arrangements cover a wide spectrum of regimes of varying degrees of flexibility ranging from the crawl-like arrangement of Singapore to floating regimes in the Republic of Korea, Japan, the Philippines, and Thailand. The only exceptions are Hong Kong, China; Brunei Darussalam; Cambodia; Viet Nam; and the Lao PDR, all five of which operate varieties of fixed exchange rate arrangements. One contributing factor for the

### Table 7.2 Major trade agreements for East Asian economies, 1992–present

<table>
<thead>
<tr>
<th>Agreement</th>
<th>Status</th>
<th>Year enforced</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Bilateral RTAs</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Japan–Singapore</td>
<td>Effective</td>
<td>2002</td>
</tr>
<tr>
<td>PRC–Macau, China</td>
<td>Effective</td>
<td>2003</td>
</tr>
<tr>
<td>PRC–Hong Kong, China</td>
<td>Effective</td>
<td>2003</td>
</tr>
<tr>
<td>Rep. of Korea–Singapore</td>
<td>Effective</td>
<td>2006</td>
</tr>
<tr>
<td>Japan–Malaysia</td>
<td>Effective</td>
<td>2006</td>
</tr>
<tr>
<td>Japan–Thailand</td>
<td>Effective</td>
<td>2007</td>
</tr>
<tr>
<td>Japan–Indonesia</td>
<td>Effective</td>
<td>2008</td>
</tr>
<tr>
<td>Japan–Philippines</td>
<td>Effective</td>
<td>2008</td>
</tr>
<tr>
<td>PRC–Singapore</td>
<td>Effective</td>
<td>2009</td>
</tr>
<tr>
<td>Japan–Viet Nam</td>
<td>Effective</td>
<td>2009</td>
</tr>
<tr>
<td><strong>Plurilateral RTAs</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>AFTA</td>
<td>Effective</td>
<td>1992</td>
</tr>
<tr>
<td>ASEAN–PRC</td>
<td>Effective</td>
<td>2005</td>
</tr>
<tr>
<td>ASEAN–Rep. of Korea</td>
<td>Effective</td>
<td>2007</td>
</tr>
<tr>
<td>ASEAN–Japan</td>
<td>Effective</td>
<td>2008</td>
</tr>
</tbody>
</table>

*Source: Compiled from WTO database.*
Table 7.3  De facto East Asian exchange rate regimes according to IMF exchange rate classification

<table>
<thead>
<tr>
<th>Exchange rate arrangements</th>
<th>Currency board</th>
<th>Stabilized arrangement</th>
<th>Crawl-like arrangement</th>
<th>Other managed arrangement</th>
<th>Floating</th>
</tr>
</thead>
<tbody>
<tr>
<td>Monetary policy framework</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Exchange rate anchor</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>US dollar</td>
<td></td>
<td>Hong Kong, China</td>
<td>Cambodia</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Composite Others</td>
<td></td>
<td>Brunei, Darussalam</td>
<td>Viet Nam</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Others</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Monetary target</td>
<td></td>
<td></td>
<td></td>
<td>People’s Republic of China</td>
<td></td>
</tr>
<tr>
<td>Inflation targeting</td>
<td></td>
<td></td>
<td>Indonesia</td>
<td>Rep. of Korea, Philippines, Thailand, Japan</td>
<td></td>
</tr>
<tr>
<td>Others</td>
<td></td>
<td></td>
<td>Lao PDR</td>
<td>Malaysia, Myanmar</td>
<td></td>
</tr>
</tbody>
</table>

Source: IMF (2013, table 1: De Facto Classification of Exchange Rate Regimes and Monetary Framework, 30 April 2013).
move toward more flexible exchange rate arrangements in these East Asian economies is that after the Asian financial crisis, almost all of the crisis-affected countries, that is, Indonesia, the Republic of Korea, Philippines, and Thailand, chose to abandon a conventional pegged exchange rate regime in favor of flexible exchange rates, while Malaysia implemented a conventional pegged arrangement until 2005 but has since shifted to a managed flexible exchange rate regime (ADB 2010).

In other words, most East Asian monetary authorities have not willingly assumed the responsibilities that come with operating a rigid peg, let alone the alternative of a clean float. By and large, the middle has not really become hollow for the exchange rate policies of these East Asian economies, and more of them have the desired preference of managing exchange rates that are edged toward flexible exchange rates albeit not free floating.

The implication of the above analysis is that moving forward with deeper integration in the region requires solving the exchange rate problem. This task is made more complex by a current understated nuance of East Asian middle-ground exchange rate management of less willingness to tolerate exchange rate appreciations. Part of the reason for the unwillingness has to do with the potential of losing competitiveness against other East Asian neighboring economies that compete with each other in markets within and outside the region. As a consequence, the scenario of a beggar-thy-neighbor competitive depreciation strategy, which can be costly to the region in terms of a large and unnecessary reallocation of resources across the region, always looms large on the horizon (Kawai and Takagi 2012).

7.4 THE TENSION BETWEEN DEPRECIATED OR STABLE EXCHANGE RATES: CONFLICTING DOMESTIC ASPIRATIONS IN AN RTA

Proliferation of RTAs is a salient feature of the international trading system. In view of their expressed purpose of at least partially lowering restrictions to trade, RTAs generally commit participants to freer-trade by 'tying their hands' or make it difficult for members to alter their terms-of-trade through traditional trade policy measures. In this vein, RTAs enhance trade between member countries. If the effect of exchange rate volatility on trade is significant, then the traditional case for exchange rate stability in encouraging trade and investment applies to a country’s motivation of being a part of an RTA. Greater exchange rate instability among members of an RTA can work against the goal of trade creation.

On the other hand, RTAs also increase international competition, and
governments may face protectionist pressures from those most negatively affected. Given their RTA commitments and the consequent inability to pursue traditional trade measures to offset the adverse consequences of greater import competition, protectionist pressures can take the form of a desire to increase the level of the country’s international competitiveness via the pursuit of a competitive exchange rate policy, in particular, in the form of a competitive devaluation. Exchange rate protection can serve as a substitute to trade policies, since the trade impact of a depreciated or weak currency is equivalent to that of some combination of changes in import taxes and export subsidies.

A depreciated or weak currency increases the domestic currency prices of imported goods, which raises the cost of living for domestic consumers. In a domestic political economy sense, however, it is relatively easier for governments to trade off the welfare of exporters and import-competitors, on the one hand, for that of consumers, on the other, since domestic producers represent a more coherent and better organized political lobby. In addition, consumers are probably ill-informed about the effects of protectionism and are, in any case, poorly organized (Bird and Rajan 2006; Frieden et al. 2012).

Exporters are, nonetheless, likely to be torn between a concern for currency stability, on the one hand, and a concern for a competitive, hence a depreciated exchange rate, on the other. However, when these two conflicting concerns and divergent interests – to stabilize exchange rates or to maintain the competitiveness of domestic tradable producers – are brought to bear in the national macroeconomic policy arena, it is the latter which poses the bigger danger of a conflict among countries. The underlying reason is that the adverse consequence of the volatility between two countries’ currencies are entirely internalized in both countries’ domestic actors (for example, exporters and import-competitors), whereas a weakened national currency imposes a negative externality on other countries by transferring the competitive pressure to the country’s trading partners, which can stimulate protectionist sentiments abroad. So much so that when partner countries engage in the same policy of weakening their own currency, the competitive devaluations cancel each other out with no observable gain in output, but result in a significant strain in bilateral relations between the countries in question, which can also even endanger trade agreements (Frieden and Broz 2012; Frieden et al. 2012).

The implication of the above analysis is that international coordination between governments and among international institutions can help to avoid the problems that can arise as a result of artificially weak currencies. In the remainder of this chapter, we first verify in the quantitative section
that follows the existence of the conflicting interest of whether to stabilize exchange rates or to maintain the competitiveness of domestic producers in an RTA using data for East Asian economies. The next step, addressed in Section 7.6, is to consider to what extent international policy coordination might help address the problems that arise when countries decide to pursue artificially weak currencies in order to gain competitive advantage at the expense of other countries.

7.5 EMPIRICAL METHODOLOGY AND ANALYSIS OF RESULTS

In this section we revisit the relationships between exchange rate depreciations and trade, and between exchange rate volatility and trade. In contrast to previous studies, however, we focus on these relationships in the context of RTA membership. We estimate a conventional gravity model of trade, including dummies for RTA membership and variables capturing exchange rate depreciation and volatility, and are interested not just in the direct relationships between these variable and bilateral trade, but also in the interaction between the exchange rate variables and RTA membership.

The dependent variable in all of our estimating equations is the log volume of merchandise trade flows from country $i$ to country $j$. The data cover 16 East Asian economies over the period 1990 to 2010. We create a binary variable for plurilateral and bilateral RTAs involving the 16 East Asian economies using information provided by the WTO. We also create a measure of the rate of exchange rate depreciation of country $i$ relative to country $j$ by calculating the annual average daily changes in exchange rates for each pair of East Asian economies (an increase denotes an exchange rate depreciation). A measure of exchange rate volatility was created by calculating the standard deviation of the daily changes in exchange rates in each year for each pair of East Asian economies.

The estimating equations are:

$$\ln(X_{ijt}) = \beta_0 + \beta_1 \ln(Y_i Y_j)_t + \beta_2 \ln D_{ij} + \beta_3 \ln(Area_i Area_j) + \beta_4 \text{Cont}_{ij} + \beta_5 \text{Lang}_{ij} + \beta_6 \text{RTA}_{ij} + \beta_7 \text{EXRDep}_{ij} + \beta_8 \text{RTA}_{ij} \times \text{EXRDep}_{ij} + \varepsilon_{ijt}$$ (7.1)

$$\ln(X_{ijt}) = \beta_0 + \beta_1 \ln(Y_i Y_j)_t + \beta_2 \ln D_{ij} + \beta_3 \ln(Area_i Area_j) + \beta_4 \text{Cont}_{ij} + \beta_5 \text{Lang}_{ij} + \beta_6 \text{RTA}_{ij} + \beta_7 \text{EXRVol}_{ij} + \beta_8 \text{RTA}_{ij} \times \text{EXRVol}_{ij} + \varepsilon_{ijt}$$ (7.2)

where $i$ and $j$ denote countries, $t$ denotes time, and the variables are defined as:
● $X_{ijt}$ denotes the average value of bilateral trade flows from country $i$ to country $j$ at time $t$;
● $Y$ is GDP and GDP per capita, respectively;
● $D$ is the distance between $i$ and $j$;
● $\text{Area}$ is the land mass of the country;
● $\text{Cont}$ is a binary variable which is unity if $i$ and $j$ share a land border;
● $\text{Lang}$ is a binary variable which is unity if $i$ and $j$ share a common language;
● $\text{RTA}$ is a binary variable which is unity if $i$ and $j$ belong to the same regional trade agreement at time $t$;
● $\text{EXRDep}$ is the rate of currency depreciation of country $i$ to country $j$ at time $t$;
● $\text{RTA}_{ijt} \times \text{EXRDep}_{ijt}$ is the interaction between the RTA binary variable and $\text{EXRDep}$;
● $\text{EXRVol}$ is the volatility in the exchange rate of country $i$ to country $j$ at time $t$;
● $\text{RTA}_{ijt} \times \text{EXRVol}_{ijt}$ is the interaction between the RTA binary variable and $\text{EXRVol}$; and
● $\varepsilon$ represents other influences on bilateral exports, assumed to be well behaved.

We estimate equations (7.1) and (7.2) with random effects and country fixed effects. The random effects estimates use a generalized least-squares estimator assuming Gaussian disturbances that are uncorrelated with the random (country-pair specific) effects, while the fixed-effects ‘within’ estimator essentially adds a set of country-pair specific intercepts to the equation, and thus exploits the time-series dimension of the dataset around country-pair averages.

Table 7.4 presents the random-effects and fixed-effects estimation results. Columns (1) to (4) show the random-effects estimates, while columns (5) to (8) presents those estimated on the basis of fixed effects. The size and distance variables are the basic gravity model terms, expected to have positive and negative coefficients respectively. The contiguity and common language dummies are standard control variables, and the fixed effects estimation is intended to capture the multilateral resistance terms (Anderson and Van Wincoop 2003).\textsuperscript{13}

The coefficient on the RTA variable, $\beta_6$, is expected to be positive, implying that an RTA increases trade between partner countries. The coefficient $\beta_7$ captures the relationship between exchange rate depreciations and trade in equation (7.1), while in equation (7.2), the $\beta_7$ coefficient captures the relationship between exchange rate volatility and trade. We expect the coefficient $\beta_7$ to be positive in equation (1) and negative in
<table>
<thead>
<tr>
<th>Variables</th>
<th>Random effects</th>
<th>Fixed effects</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(1)</td>
<td>(2)</td>
</tr>
<tr>
<td>Log of GDP in pair</td>
<td>1.38***</td>
<td>1.34***</td>
</tr>
<tr>
<td></td>
<td>(0.07)</td>
<td>(0.07)</td>
</tr>
<tr>
<td>Log of per capita GDP in pair</td>
<td>0.60</td>
<td>0.58</td>
</tr>
<tr>
<td></td>
<td>(0.53)</td>
<td>(0.54)</td>
</tr>
<tr>
<td>Log of distance</td>
<td>-0.07</td>
<td>-0.38***</td>
</tr>
<tr>
<td></td>
<td>(0.10)</td>
<td>(0.12)</td>
</tr>
<tr>
<td>Log of area in pair</td>
<td>0.96*</td>
<td>2.10***</td>
</tr>
<tr>
<td></td>
<td>(0.53)</td>
<td>(0.54)</td>
</tr>
<tr>
<td>Common land border</td>
<td>2.59***</td>
<td>2.44***</td>
</tr>
<tr>
<td></td>
<td>(0.47)</td>
<td>(0.56)</td>
</tr>
<tr>
<td>Common language</td>
<td></td>
<td></td>
</tr>
<tr>
<td>RTA</td>
<td>0.36***</td>
<td>0.28**</td>
</tr>
<tr>
<td></td>
<td>(0.09)</td>
<td>(0.13)</td>
</tr>
</tbody>
</table>
Table 7.4  (continued)

<table>
<thead>
<tr>
<th>Variables</th>
<th>Random effects</th>
<th>Fixed effects</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(1)</td>
<td>(2)</td>
</tr>
<tr>
<td>Rate of exchange rate depreciation</td>
<td>0.53*</td>
<td>0.52*</td>
</tr>
<tr>
<td></td>
<td>(0.30)</td>
<td>(0.30)</td>
</tr>
<tr>
<td>RTA*rate of ER depreciation</td>
<td>1.35**</td>
<td>1.11*</td>
</tr>
<tr>
<td></td>
<td>(0.61)</td>
<td>(0.62)</td>
</tr>
<tr>
<td>Exchange rate volatility</td>
<td></td>
<td>-0.34*</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(0.21)</td>
</tr>
<tr>
<td>RTA*exchange rate volatility</td>
<td>-0.86*</td>
<td>-1.22**</td>
</tr>
<tr>
<td></td>
<td>(0.46)</td>
<td>(0.47)</td>
</tr>
<tr>
<td>No. of observations</td>
<td>3875</td>
<td>3877</td>
</tr>
<tr>
<td>Overall $R^2$ squared</td>
<td>0.41</td>
<td>0.20</td>
</tr>
</tbody>
</table>

Notes:  
The dependent variable is the log of bilateral trade flows. In columns (1) to (8), panel data estimation techniques are applied to all annual observations over the period from 1990 to 2010. Intercept and year dummy variables are included (not reported). Robust standard errors are reported in parentheses.  
*** Estimated coefficients are statistically significant at the 1 percent level.  
** Estimated coefficients are statistically significant at the 5 percent level.  
* Estimated coefficients are statistically significant at the 10 percent level.  
Source: Authors’ calculations.
equation (7.2). The coefficient of most interest to us is $b_8$. Specifically, $b_8$ in equation (7.1) captures the effect of whether exchange rate depreciations reinforce the expected positive impact of membership in RTAs on trade, while in equation (7.2) it accounts for the effect of whether exchange rate volatility neutralizes the expected positive impact of RTAs on trade.

The gravity model explains the bilateral trade data reasonably well. As predicted by the model, the log of GDP, the log of per capita GDP, the common land border dummy, and the common language dummy all have a positive and statistically significant relationship with the volume of bilateral trade between East Asian economies. The log of area coefficient is negative, as expected, and statistically significant in two (columns (2) and (4) in Table 7.4) of the four random effect estimates. The coefficient on the distance variable is negative but statistically not different from zero.

The coefficients on the RTA binary variable coming from both the random effect estimates in columns (1) to (4) and the fixed-effect estimates reported in columns (5) to (8) robustly indicate that membership in an RTA increases trade between the partner countries. They are mostly statistically significant at the 1 percent level.

Exchange rate depreciations are associated with greater bilateral trade between East Asian economies. The estimated coefficients of the rate of exchange rate depreciation are, according to both the random effect estimates in columns (1) and (2) and the fixed-effect estimates in columns (5) and (6) statistically different from zero, albeit only at the 10 percent significance level. While currency depreciations directly increase trade, the regression results suggest that exchange rate depreciations have a further indirect effect of augmenting the positive impact of RTAs. This is shown by the coefficient on the interaction term of the RTA binary variable and the rate of exchange rate depreciation which is positive and statistically significantly different from zero in both the random effect estimates in columns (1) and (2) and the fixed-effect estimates in columns (5) and (6).

Exchange rate volatility is associated with less bilateral trade between East Asian economies. The estimated coefficients on exchange rate volatility are statistically significant and negative in both the random effect estimates in columns (3) and (4) and the fixed-effect estimates in columns (7) and (8), which suggest that exchange rate volatility directly reduces trade. Reducing exchange rate volatility then is beneficial for bilateral trade. Moreover, the negative and statistically significant coefficients on the interaction term between exchange rate volatility and the RTA binary variable in both the random effect estimates (columns (3) and (4)) and the fixed effect estimates (columns (7) and (8)) indicate that exchange rate stability is especially beneficial for increasing trade among RTA members. In other words, not only does exchange rate volatility have a direct negative
impact on trade flows, it also has a further indirect effect of mitigating the positive impact of RTAs in East Asia.

7.6 ARGUMENTS FOR AND AGAINST INTERNATIONAL POLICY COORDINATION

The architects of the post-1945 global economic institutions were influenced by the experience of the 1930s, and by the prevalent interpretations of that decade (for example, Nurkse 1944). These interpretations saw floating exchange rates and ‘competitive devaluations’ as destabilizing to the global economy, and the IMF’s Articles of Agreement required members to ‘avoid manipulating exchange rate or the international monetary system to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other countries’. The GATT set rules for trade policy that were designed to limit protection. However, Article XII allowed any contracting party to impose quantitative restrictions on trade in order to safeguard its balance of payments position.

During the Bretton Woods period, countries resorted to import surcharges when faced with balance of payments deficits. These became less common during the 1960s, when they were typically short-term measures that were precursors to eventual devaluation. The most prominent examples were Britain’s 15 percent import surcharge in October 1964 reduced to 10 percent in 1965 and eliminated in November 1966 before the 1967 devaluation of the pound sterling, and the August 1971 ‘Nixon shock’ when the US imposed a 10 percent surcharge on imports that was removed before the devaluation of the dollar under the December 1971 Smithsonian Agreement.

Following the adoption of generalized floating in 1973, the major economies renounced exchange rate stability in favor of independent monetary policies. Recurring trade disputes were resolved by temporary measures contrary to the spirit, if not the letter, of GATT, for example, the ‘voluntary’ export restraint agreements of the 1980s most notably imposed by the US on Japanese car imports in a period of rapid US dollar appreciation. The direct and indirect consequences of such gray area protectionist measures were at least as harmful as – and typically much more harmful than – those from tariff protection (Pomfret 1989), and one of the achievements of the Uruguay Round was to outlaw them.

Since the establishment of the WTO in 1995, the connection between exchange rates and trade policies has fallen between the competencies of the IMF and WTO. International Monetary Fund agreements condemn ‘protracted large-scale intervention in one direction in exchange markets’,
but IMF surveillance is weak (Mussa 2008, p.288), and even if violation were found the IMF has no means of compelling a country to change its policy (Irwin 2011). The WTO has an enforcement mechanism, that is, sanctified trade retaliation, but none of the GATT Articles or other WTO agreements provide clear legal conditions under which exchange rate polices might be actionable. The lacuna creates pressure for unilateral measures, most notably discussed in US political debates about the PRC’s purportedly undervalued currency. Copelovitch and Pevehouse (2010) provide evidence that currency undervaluation increases the likelihood of WTO disputes.

The difficulty in assigning competencies for exchange rate policies is, of course, that exchange rates may be responding to legitimate macroeconomic policy decisions or they may be manipulated to achieve a competitive edge in international markets. A country faced with unemployment or slow growth may respond with expansionary policies that lead to exchange rate depreciation, which *inter alia* will have the desirable consequence of strengthening the stimulus via increased net exports, but this may appear to the country’s trading partners as obtaining an unfair advantage in international trade through currency manipulation. The IMF formulation denouncing ‘protracted’ intervention in one direction is an attempt to discriminate between these two motivations, but ‘protracted’ is difficult to define and ‘intervention’ may be indirect. Even in a pure floating exchange rate environment with no intervention, macroeconomic policies may be perceived as beggar-thy-neighbor stimuli to trade – as in, for example, Japan’s expansionary macro policies in 2010 – or as beneficial stimuli to global demand. Similarly, accumulation of reserves accompanied by sterilization may be driven by precautionary motives, but will result in exchange rate protectionism and provide an export stimulus relative to a fixed exchange rate regime without reserve accumulation. A recent survey of exchange rate regimes in emerging Asia (Rajan 2011) refers to a widespread apparent ‘fear of appreciation’.14

Concerns about the trade consequences of undervaluation interact with concerns that currency volatility increases the costs of international trade. The tension is evident in the evolution of exchange arrangements among European countries since the establishment of the customs union in the 1960s. After some European countries adopted the ‘Snake’ in 1972, they quickly dropped the arrangement because it posed too much restriction on domestic macropolicy in an era of generalized floating and stagflation. However, bilateral exchange rate volatility was harmful for trade within the customs union and especially costly for countries with a common agricultural policy that each year set farm prices in an attempt to balance producer and consumer interests. Within a year of the Snake’s definitive
demise in 1976, the leaders of France and Germany and the Chairman of the European Commission negotiated a new European Monetary System that limited bilateral exchange rate volatility and became the precursor to the euro.\textsuperscript{15}

In contrast to the long-term EU experience leading to the eurozone, Copelovitch and Pevehouse (2013) contend that countries are less likely to adopt or sustain a fixed exchange rate when they have signed an RTA with the country in relation to which they have traditionally fixed the currency or the major industrial country with which they have the most extensive trade ties. Using data on 99 countries from 1975 to 2004, they find strong support for the hypothesis that countries which have signed an RTA also tend to have more depreciated currencies. Protectionism has been greatest at the regional level during periods of sharp intra-regional exchange rate fluctuations, such as the 1992–93 European Monetary System crisis and the 1999 Brazilian real devaluation within the Southern (American) Common Market (MERCOSUR).

Asian countries face similar tensions. While there has been little enthusiasm for currency union and renunciation of monetary policy independence, bilateral exchange rate movements have been reduced by many Asian countries following a de facto dollar standard. Subramanian (2011) argues that the dollar standard is being replaced by a renminbi zone as the PRC becomes a crucial player in regional value chains.\textsuperscript{16} In 2012, the PRC made arrangements with the Republic of Korea and Taipei, China to increase the use of the renminbi in international transactions, although similar proposals with Japan were negatively affected by territorial disputes, reflecting the often political nature of such developments (Chin 2013). Given concerns about renminbi undervaluation, this could result in a broader assessment of East Asia as a zone of currency manipulation.

7.7 CONCLUSION

The connections between exchange rate regimes and trade flows are complex. Studies find systematic positive relationships between exchange rate undervaluation or depreciation and exports, and as depreciation is a zero-sum game this is a potential source of disputes between countries. Since the end of the Bretton Woods fixed exchange rate regime in 1973, however, there has been no multilateral agency tasked with monitoring exchange rates or resolving disputes over the use of exchange-rates for trade policy purposes. It is a gray area falling between the competencies of the IMF and WTO.

The econometric literature offers some cause for relief insofar as the
impact of both the level and the volatility of exchange rates on trade appears to be small. However, this may reflect a twentieth century perspective, as more and more countries adopt export-oriented development strategies and become involved in value changes where predictability of prices and costs are important. These developments are especially pronounced in East Asia where countries are outward-oriented and participate in regional value chains often referred to as ‘Factory Asia’.

Another salient feature of the twenty-first century East Asian economy has been the proliferation of trade agreements. Participation in an RTA places constraints on a country’s ability to pursue independent trade policies; even a free trade agreement in which countries retain trade policy autonomy vis-à-vis non-members, restricts introduction of protectionist measures on trade with members. In this setting member countries may be tempted to use currency depreciation as an alternative to protectionist trade policies, or to gain a competitive edge as an exporter. At the same time, if RTA formation is driven by a desire to facilitate trade among countries involved in regional value chains, exchange rate stability will be desirable.

This chapter analyzes the impact of the level and volatility of exchange rates on bilateral trade in 1990–2010 among 16 East Asian economies (ASEAN+3; Hong Kong, China; Macau, China; and Mongolia), many of which have shifted from not being part of any RTAs in 1990 to having a range of RTA partners in the region. In a variety of standard gravity model specifications, exports are positively related to the rate of exchange rate depreciation and to RTA membership and negatively related to exchange rate volatility. The novel finding is that interaction terms indicate that both exchange rate effects are magnified when the two economies have a trade agreement. We interpret the level result as indicating that, because an RTA restricts governments’ trade policy instruments, they are more likely to use the exchange rate for trade policy ends. We interpret the volatility result as evidence that, because East Asian trade agreements are related to fragmentation and regional value chains, exchange rate volatility is especially harmful to trade flows within RTAs.

The policy implications favor formation of RTAs among countries wishing to participate in regional value chains, because such agreements can target desirable trade facilitation measures, including exchange rate stability. There is, however, a potential time-inconsistency problem. If a consequence of the RTA is intensified pressure on import-competing producers, a member may resort to exchange rate depreciation as an instrument for protection. However, depreciation is potentially harmful to other countries, implying the need for some monitoring mechanism within the RTA, comparable to avoiding the IMF-WTO policy gap at the global
level. With deepening integration, the desire for exchange rate stability will eventually outweigh the desire to maintain a protectionist tool. This has been the evolutionary path in the European Union. Within ASEAN there has been a similar time path, although not so clearly focused on exchange rates.\textsuperscript{17} How extensive such pressures will be in East Asia will depend not only upon how many countries seriously desire to be in this more integrated economic area, but also on their institutional and political readiness to commit to such grander schemes.

NOTES

1. A recent revisionist argument is that fixed exchange rates were more harmful than competitive devaluations because governments striving to maintain the gold standard were more likely to adopt protectionist measures than countries that had abandoned the gold standard in favor of a more flexible exchange rate. Eichengreen and Irwin (2010) and Irwin (2012) argue that during the 1930s exchange rate policy was even more important than falling output or rising unemployment in determining national protectionist measures.

2. Non-trade-related policy incentives for responding to exchange rate levels and volatility, surveyed in Weber and Wyplosz (2009), are not addressed in this chapter. See also Huchet-Bourdon and Korinek (2011) for a literature review and further evidence.

3. Baldwin (2011) and Sourdin and Pomfret (2012) highlight the role of fragmentation and supply chains in facilitating export-oriented development. Johnson and Noguera, extending an idea of Hummels et al. (2001) with more extensive data, combine input-output and bilateral trade data to compute the value-added component of international trade. The value-added share of trade (VAX) within East Asia fell from 75 percent in 1995 to 61 percent in 2005 (Johnson and Noguera 2012c), the largest decadal change in any of the three regions covered. National data show the ratio declining from the late 1980s in Thailand, and with a less clear break in the PRC (Johnson and Noguera 2012a). For Singapore, the VAX ratio for manufactures in 2004 was 25 percent (Johnson and Noguera 2012b).

4. Volz (2012) provides a recent statement of the argument, and references to the literature. Using daily data from 1999 to 2012, Click (2013) estimates an implicit currency basket for the major ASEAN countries that is dominated (with almost 90 percent weight) by the US dollar, but concludes from the individual country variation that the region is not close to having a common currency basket. Pontines (2012) analyzes the usefulness of an agreed Asian Currency Unit index for surveillance in East Asia.

5. We use ‘depreciation’ as a general term to cover a fall in a currency’s value relative to another currency or basket of currencies, without regard to whether the currency was previously pegged or not. This section draws on the more detailed surveys by Coric and Pugh (2010), Huchet-Bourdon and Korinek (2011), and Auboin and Ruta (2011).

6. Jochen and Lazarov (2012), updating Coric and Pugh (2010), report a meta-analysis of 67 studies from 1980 to 2012, of which 39 found a negative effect, 20 found no effect or inconclusive results, and 6 found a positive effect. They test and reject hypotheses of publication bias. However, they make no attempt to control for the quality of the studies.

7. Chit and Judge (2011) also find that using currency depreciation to promote exports is only successful when the exchange rate is stable.

8. East Asian economies have also signed RTAs in the broader region outside of the economies examined in this chapter as well as cross-regions (ADB 2008).

10. For evidence on this phenomenon, see, for instance, Pontines and Rajan (2011), who examine India, Indonesia, the Republic of Korea, the Philippines, Singapore, and Thailand. Pontines and Siregar (2012a) and Pontines and Siregar (2012b) deal with the issue in the context of an announced pursuit of inflation targeting regimes by Indonesia, the Republic of Korea, the Philippines, and Thailand.

11. Countries can put in place non-tariff trade barriers (NTBs), but governments when faced with greater import competition do not limit their options to trade policies, which will be constrained to a greater or lesser degree in an RTA but also consider a competitive exchange rate policy, which is more likely to remain a matter of national competence.

12. The 16 economies are Brunei Darussalam; Cambodia; PRC; Hong Kong, China; Indonesia; Japan; the Republic of Korea; Lao PDR; Macau, China; Malaysia; Mongolia; Myanmar; Philippines; Singapore; Thailand; and Viet Nam.

13. We recognize the possibility of RTA formation being influenced by the level of bilateral trade or that both variables may have a common determinant (Baier and Bergstrand 2007). The problem of endogeneity though is likely to be less of an issue for the number of Asian economies that have formed RTAs between them as opposed to deep integration projects like the European Union (EU), the North American Free Trade Agreement (NAFTA), or Closer Economic Relations (CER), a free trade agreement between the governments of New Zealand and Australia.

14. Also refer to note 10 above for other evidence on this fear of appreciation in the region.

15. The role of community fiscal policies, and especially the common agricultural policy, in the rapid emergence of a rebranded Snake in 1977–78 is analyzed in Basevi and Grassi (1993) and Pomfret (1991).

16. Frankel (2011) compares prospects for the internationalization of the yuan (RMB) with that of the US dollar in 1913–45, the German mark in 1973–90, and the Japanese yen in 1978–91 and emphasizes three factors: economic size, confidence in the currency, and depth of financial markets. The RMB satisfies the first two but the latter will hold back its internationalization.

17. Despite AFTA entering into effect in 1992, its impact during the 1990s was limited by the extensive list of exceptions for politically important activities; Malaysia’s car industry was the most high-profile example, but there were many others. In the 21st century such exceptions have been abandoned in favor of creating a more integrated intra-ASEAN market en route to an ASEAN Economic Community. The pressures for exchange rate stability within the AEC will be similar to those that built up in the EU after completion of the customs union and then the Single Market (EC92) program.

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8. Policy challenges posed by Asian free trade agreements: a review of the evidence

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8.1 INTRODUCTION

Asian economies face important policy challenges regarding the use of free trade agreements – primarily their scope and their impact on regionalization trends. These topics are at the forefront of contemporary negotiations and of great interest to policy makers. This chapter reviews existing literature, provides new data on the use of FTA preferences from certificates of origin and enterprise surveys, uses new analytical tools to examine the contents of existing FTAs, and shows the results of computable general equilibrium (CGE) modeling exercises to highlight economic impacts.

There is an emerging literature on policy issues concerning Asian FTAs. Issues and concerns highlighted in the new literature include low FTA preference utilization, a ‘noodle bowl’ problem of criss-crossing agreements that potentially distort trade toward bilateral channels, excessive exclusions and special treatment in FTAs, limited liberalization of agriculture and services, and the possibility that the multilateral trading system may be progressively eroded (Banda and Whalley 2005; Baldwin 2006; Tumbarello 2007; World Bank 2007; Bhagwati 2008; Drysdale and Armstrong 2010; Ravenhill 2010; Hoekman and Mattoo 2011). Free trade agreements are a relatively new phenomenon in Asia, and a dearth of empirical evidence, particularly with respect to patterns of Asian FTAs and business impacts, has made it difficult to verify the validity of these concerns. With the availability of new data, the time is ripe for an evidence-based assessment of Asian FTAs.

Asia – a relative latecomer to using FTAs as a trade policy instrument – is now at the forefront of global FTA activity (Fiorentino et al. 2009; WTO 2011). Free trade agreement-led regionalism seems here to stay in Asia for three reasons. First, the large economies of Northeast Asia – the PRC, Japan, and the Republic of Korea – and ASEAN are leading
Policy challenges posed by Asian free trade agreements

Efforts to use FTAs to pursue international trade strategies and to increase participation in global production networks (Chia 2013; Kawai and Wignaraja 2008, 2011a). There is a growing momentum for the Asia-led Regional Comprehensive Economic Partnership (RCEP) and the competing US-led Trans-Pacific Partnership (TPP) process (Gordon 2012; Kawai and Wignaraja 2013; Lim et al. 2012; Zhang and Shen 2011).

Second, slow and limited progress in the World Trade Organization Doha Development Agenda of trade negotiations means that FTAs are a vehicle to support the deepening of production networks through trade and investment liberalization. Finally, even if a comprehensive Doha Round were to be concluded in the future, FTA activity would continue as many of the ‘new age’ agreements go well beyond what is on the negotiating table and deal with investment, competition, intellectual property, and public procurement (the so-called Singapore issues). Accordingly, business will need to learn to export more effectively under a regional trade regime anchored on FTAs. The focus for policy makers is how best to minimize the costs of Asian FTAs (for example, transactions and administrative costs) while maximizing their benefits (for example, preferential tariffs, better market access, and new business opportunities).

Adopting a pragmatic perspective, this chapter examines trends and challenges in Asian FTAs with a view to providing policy implications. Section 8.2 maps major trends in Asian FTAs since 2000, including growth, activity intensity, cross-regional orientation, and trade coverage. Section 8.3 analyzes six key challenges posed by Asian FTAs: (1) improving use of FTA preferences, (2) tackling the Asian ‘noodle bowl’ problem, (3) promoting comprehensive coverage of agricultural trade, (4) facilitating services trade liberalization, (5) including of new issues (for example Singapore issues) that go beyond the WTO framework, and (6) forming a region-wide FTA. New evidence from analysis of FTAs, firm surveys, and CGE models is used to address these challenges. The discussion includes indicative results of an RCEP scenario for Asian countries and economic sectors. In response to increasing interest in forming a region-wide agreement, section 8.4 explores political economy issues as they relate to FTA consolidation in Asia and its potential connection with North America and Europe. In conclusion, section 8.5 advocates strengthening the support system for regional production networks, forging comprehensive WTO-plus agreements, and encouraging an East Asia-wide FTA. A bottom-up approach to a WTO Doha Round Agreement emerges from the analysis.2
8.2 GROWTH OF ASIAN FTAS

8.2.1 Patterns and Drivers of FTAs

Free trade agreements were largely absent in Asia until recently. The Asia-Pacific Trade Agreement (APTA), which took effect in 1976, was the region’s first agreement. It was followed by the Thailand-Lao People’s Democratic Republic (Lao PDR) PTA in 1991 and the AFTA in 1992. Alongside multilateralism, Asia began emphasizing FTAs as a trade policy instrument in the 1990s and the region is today at the forefront of world FTA activity (Feridhanusetyawan 2005; ADB 2008, 2010; Fiorentino et al. 2009). A comprehensive review of the evolution of the FTA landscape internationally, WTO (2011, p. 57) notes that:

the countries of Asia have only recently become active in signing preferential trade agreements (PTAs). Over the last ten years, countries in East and West Asia, as well as Oceania have participated in almost half the PTAs concluded over that period (more than, for instance, European and CIS countries, which participated in one-third of agreements), while their participation in PTA activities in the 1990s barely reached 5% (only 6 out of 106 agreements).

ADB’s Asia Regional Integration Center (ARIC) FTA Database (www.aric.adb.org) provides information on the number of concluded FTAs in Asia (at December 2013). The main expansion of FTAs in Asia occurred in the 2000s. As Figure 8.1 shows, the number of concluded FTAs in Asia as a group increased from only three to 22 between 2000 and 2005 and still further to 77 in 2013. Of these, 70 FTAs are currently in effect. This figure compares with around 379 FTAs worldwide according to WTO (2013). The proliferation of FTAs in Asia is likely to be sustained: another 51 are either under negotiation or proposed. On the whole, Asia seems to be opting for bilateral agreements rather than more complex plurilateral ones because bilateral agreements may be easier to negotiate. Bilateral FTAs comprise 76 percent of Asia’s concluded FTAs, while plurilateral FTAs comprise the remainder.

Four main factors underlie the recent spread of FTA initiatives in Asia: (1) deepening market-driven economic integration in Asia, (2) European and North American economic integration, (3) the 1997–98 Asian financial crisis, and (4) slow progress in the WTO Doha negotiations.4

First among these is market-driven economic integration through trade, FDI, and the formation of Asian production networks and supply chains.5 Market-driven economic integration has begun to require further liberalization of trade and FDI and harmonization of policies, rules, and standards governing trade and FDI, including the protection of investment and
intellectual property rights. Asia’s policy makers are increasingly of the view that FTAs, if given wide scope, can support expanding trade and FDI activities through further elimination of cross-border impediments, facilitation of trade and FDI, and other such harmonization efforts. Thus, FTAs can be regarded as part of a supporting policy framework for deepening production networks and supply chains formed by global multinational corporations (MNCs) and emerging Asian firms.

Second, European and North American economic regionalism – including EU expansion into central and eastern Europe, a monetary union in the eurozone, the success of NAFTA, and incipient moves toward a Free Trade Area of the Americas (FTAA) – motivated Asian countries to adopt FTAs. Governments fear that the two giant trading blocs of Europe and North America might dominate rule-setting in the global trading system, thereby marginalizing Asia. Increasingly, policy makers have realized the need for stepping up the pace of integration to improve international competitiveness by exploiting economies of scale and strengthening their bargaining power through a collective voice on global trade issues. Free trade agreements can help insure against the periodic difficulties of multilateral

Notes:
* Concluded FTAs include those that are in effect and those that have been signed but are not yet in effect.
** Asia includes the ten ASEAN member states; PRC; Hong Kong, China; India; Japan; Republic of Korea; and Taipei, China.

Source: ARIC FTA Database (www.aric.adb.org), data as at December 2013.

Figure 8.1 Growth of concluded* free trade agreements in Asia,** 1976–2013 (number of FTAs)
trade liberalization, such as the recent slow progress in the WTO Doha negotiations and a perceived loss of steam in the voluntary APEC process.

Third, the 1997–98 Asian financial crisis made it clear that Asian economies needed to work together in the area of trade and investment in order to sustain growth and stability by addressing common challenges. This need has not yet been fully met by either regional initiatives to strengthen the international economic system or by national efforts to strengthen individual economies’ fundamentals, both of which will take time to bear fruit. With the proliferation of FTA initiatives in the region, a number of countries have begun to jump on the bandwagon of these initiatives out of fear of exclusion.

Fourth, slow progress in the WTO Doha negotiations encouraged countries to consider FTAs as an alternative. Hailed as a development round to promote trade-led growth in poor countries, the WTO Doha Development Round began in November 2001. The talks have largely focused on liberalization in two key areas: agricultural and non-agricultural goods market access. In essence, developed countries were being asked to accelerate the pace and scope of reductions in agricultural tariffs and subsidies, and developing countries were being asked to reduce tariffs for industrial goods and liberalize services trade. Seven years of formal negotiations eventually stalled in mid-2008 over concerns in developing countries about safeguard measures to protect poor farmers from rising food and oil prices. However, discussions continued behind the scenes and these efforts were eventually rewarded. In December 2013, the 9th WTO Ministerial Meeting adopted a small Bali package made up of agreements in trade facilitation, agriculture, cotton and development. The Bali package represents only a part of the ambitious Doha Development Agenda and the future direction of trade negotiations at the WTO seems unclear at the time of writing. As prospects for an early deal diminished over time, pro-business Asian countries emphasized bilateral and plurilateral FTAs for the continued liberalization of trade in goods and services, as well as the adoption of the Singapore issues (that is, trade facilitation, investment, government procurement, and competition policy), which are currently beyond the scope of the WTO.

8.2.2 Intensity of FTA Activity in Asia

In spite of the surge in FTAs in Asia since 2000, the region has fewer FTAs per country relative to international levels – Asia has an average of nine FTAs per country compared with a global average of 13 FTAs that a WTO member is a party to (Appendix Table 8A.1; WTO 2011). Free trade agreement activity in Asia over the past decade has given rise to varying
degrees of intensity in terms of the number of agreements. As Figure 8.2 shows, the region’s three largest economies and ASEAN’s more developed countries have become key players of FTA activity, while smaller neighbors have also jumped on this bandwagon, with less intensity. The number of concluded FTAs includes Singapore (21), Japan (13), India (13), PRC (14), Malaysia (13), and Thailand (12), with many more FTAs under negotiation. By comparison, the world’s leader in the global spread of FTAs, the EU has 31 concluded FTAs while the US has 20 FTAs (see Appendix Table 8A.1).

It is worth noting that ASEAN – with one of the oldest trade agreements in Asia – is emerging as the major regional hub linking ASEAN members with the region’s larger economies. Having enacted FTAs with the PRC, Japan, and the Republic of Korea, ASEAN recently implemented regional agreements with India and with Australia and New Zealand jointly, and has had FTA discussions with the EU. The varying degrees of intensity of FTA activity across economies in Asia can be related to several factors, including economic size, per capita income, levels of protection, economic geography, and the production network strategies of MNCs (see Appendix Table 8A.1).
Singapore is by far the most active Asian economy in terms of the number and geographic coverage of FTAs. With its strategic location, one of the region’s most open economies and world-class infrastructure and logistics, the country is the regional headquarters for many leading MNCs and regional cooperation organizations – for example, the APEC Secretariat, the Pacific Economic Cooperation Council (PECC) Secretariat, and the ASEAN+3 Macroeconomic Research Office (AMRO). Singapore is seeking access to new overseas markets, particularly for services and investments. The country is a founding member of the AFTA and has implemented bilateral agreements with the largest Asian economies – the PRC, India, Japan, and the Republic of Korea – as well as economies outside the region, including the US and Australia. The US–Singapore FTA, which has been in effect since 2004, was the first such agreement made by the US in Asia and is reputed to be a model agreement in terms of scope (Koh and Lin 2004). Interestingly, the US approach to FTAs with ASEAN countries under the ‘Enterprise for ASEAN Initiative’ expressly used the US–Singapore FTA as a model.

As a supporter of multilateralism, Japan was a latecomer to FTAs (Urata 2004; Kawai and Urata 2012). The region’s first developed economy has the strongest base of giant MNCs involved in production networks and supply chains throughout Asia. One motivation for Japan’s engagement in FTAs is to provide a market-friendly and predictable regional business environment for its MNCs. Japan has rapidly implemented bilateral economic partnership agreements (EPAs) with 11 countries6 and a regional agreement with ASEAN, and signed an EPA with Peru in 2011. More FTAs are expected in the future. In March 2013, Japan and the EU officially launched negotiations for an FTA and in July 2013, Japan joined the ongoing TPP negotiations. Japan is also negotiating agreements with Australia and the Gulf Cooperation Council economies, and has recently (May 2012) agreed to negotiations on a trilateral agreement with the PRC and Republic of Korea.

The two Asian giant developing economies, the PRC and India, are forming FTAs to ensure market access for goods and expand regional coverage for outward investment (Wignaraja 2011, 2012). To this end, the PRC implemented separate FTAs on goods and services with ASEAN and is now finalizing its negotiations on an investment agreement. The PRC has also forged bilateral comprehensive economic partnership agreements (CEPA) with Hong Kong, China and with Macau, China; and an economic cooperation framework agreement with Taipei, China. The PRC has FTAs with Chile, Pakistan, New Zealand, Singapore, Peru, Costa Rica, Switzerland, and Iceland; and is a member of APTA. India is a member of APTA and, as a part of its Look East Policy, has implemented
several comprehensive agreements with East Asian economies since 2005 (including Singapore, ASEAN, Republic of Korea, Malaysia, and Japan). It also has agreements with its South Asian neighbors.

Middle-income countries such as Malaysia and Thailand have emerged as regional production hubs for the electronics and auto industries, respectively. As one of the founding members of ASEAN, Thailand has entered into bilateral agreements with the PRC, India, Japan, Australia, and New Zealand. It also concluded an FTA with Peru in 2011. Likewise, Malaysia is a member of ASEAN’s FTAs and has separate agreements with Japan, Pakistan, New Zealand, and Chile.

Though the Republic of Korea does not have as many FTAs as do other large economies in the region, it has strategically forged FTAs with the world’s major traders (the US and Europe) as well as ASEAN. The Republic of Korea has agreements with members of the APTA and ASEAN, and Singapore within Asia; and with Chile, Peru, the EU, and the European Free Trade Area (EFTA) countries outside Asia. The EU–Republic of Korea FTA was signed in October 2010 and has been in force since July 2011. The US–Republic of Korea FTA was signed in June 2007 and took effect on 15 March 2012. The Republic of Korea is also negotiating with a number of economies including Australia, Canada, GCC, Mexico, Viet Nam, New Zealand, the PRC, and trilaterally with the PRC and Japan, and is a party to the RCEP Agreement.

With some exceptions, the region’s lower-income economies – Cambodia, Indonesia, Lao PDR, Philippines, and Viet Nam – have tended to rely on ASEAN for concluding FTAs with the region’s larger economies. This may reflect weak institutional capacity, lack of human and technical resources, and limited leverage to undertake FTA negotiations in poorer economies. The ASEAN framework offers the possibility of pooling scarce capacity and resources.

The geographical orientation of Asian FTAs is summarized in Figure 8.3. A high degree of cross-regional orientation among some of the region’s stronger economies is visible – notably for the PRC, the Republic of Korea, India, and Singapore. The trend toward cross-regional FTAs is even more evident in Asia’s proposed FTAs and those under negotiation. It appears that Asia has a strong preference to maintain open trading relations with the rest of the world rather than becoming inward-looking (Kawai 2005).

A recent area of cross-regional expansion is Asia–Latin America economic ties which have grown rapidly since 2000, driven by differences in demand conditions, factor endowments, trade policy, and the rise of giant emerging economies (ADB, ADBI and IDB 2012). The slowdown in industrial economies since the global financial crisis may have also contributed
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to growing South–South trade and investment. Market-led integration has been followed by FTAs. Since the first Asia–Latin America FTA emerged in 2004, an average of two FTAs have taken effect every year between countries of the two regions, bringing the total number in effect to 22 in 2013 (Wignaraja et al. 2013). This figure is projected to rise to 30 FTAs by 2020. The FTA growth led by major trading partners in the two regions and key agreements include the Republic of Korea–Chile FTA, the Japan–Mexico FTA, the PRC–Costa Rica FTA and the India–Chile FTA. The ASEAN and South Asian economies do not trade much with Latin America and have not participated much in inter-regional FTAs. The future policy agenda for sustaining Asia–Latin America economic ties includes expanding the number of economies involved, promoting inter-regional investment, emphasizing deep integration FTAs, and pursuing domestic structural reforms. Strong partnerships between government, business, and regional institutions can facilitate implementation of this ambitious agenda.

Note: FTAs within Asia cover FTAs where all partners are in Asia. Here Asia includes the 16 economies listed in the figure.

Source: ADB ARIC FTA Database (www.aric.adb.org), data as at December 2013.

Figure 8.3 Geographical orientation and share of concluded free trade agreements in Asia – within Asia and cross-regionally, 2013 (number of FTAs by economy)
8.2.3 Trade Coverage of FTAs

The numbers of FTAs are relatively easy to track over time, but by themselves the numbers do not indicate the importance of FTAs to economic activity or trade at the national level. It is informative to get an idea of how much of a country’s world trade is covered by FTA provisions, but this is difficult to measure because of exceptions and exclusions contained in many agreements. Furthermore, official statistics on utilization rates of FTA preferences in Asia are hard to come by and published data on the direction of services trade do not exist. Nevertheless, by making the bold assumption that all goods trade is covered by concluded FTAs, indicative estimates can be obtained. Accordingly, Figure 8.4 and Appendix Table 8A.1 show the share of an economy’s bilateral trade with its FTA partners in its total trade with the world for 2000 and 2012. Figures for the EU and the US are also reported. Two observations can be made:

Note: Covers all concluded FTAs at December 2013; trade figures relate to the 2012 calendar year; and Japan and Hong Kong, China had no FTA partners in 2000.

Sources: ADB staff estimates based on Direction of Trade Statistics, International Monetary Fund and UN Comtrade, data at December 2013, and ADB ARIC FTA Database (www.aric.adb.org), data as at December 2013.

Figure 8.4 Share of an economy’s trade with its free trade agreement partners relative to the economy’s trade with the world, 2000 and 2012 (percentage of total trade)
The region’s larger economies have smaller shares in 2012 than ASEAN members, highlighting the latter’s greater reliance on FTAs, especially AFTA. The shares for the larger economies are: Republic of Korea (56 percent), the PRC (31 percent), India (20 percent), and Japan (19 percent). There is some diversity within ASEAN, with Brunei Darussalam, Myanmar, and the Lao PDR having shares in excess of 80 percent, Singapore and Indonesia over 65 percent, while others range between 45 percent and 65 percent. Meanwhile, Japan has the lowest trade coverage by FTAs at 19 percent.

All Asian economies experienced a significant increase in reliance on FTAs between 2000 and 2012, reflecting the spread of FTAs throughout the region. Asia’s largest economies – Japan, the Republic of Korea, the PRC, and India – have experienced at least a quadrupling of the ratio of trade covered by FTAs to total trade over the period. Notable increases are also visible in most ASEAN countries. It is interesting to compare the current trade coverage of Asia’s largest FTA players with the EU (71 percent) and the US (39 percent).

### 8.3 CHALLENGES POSED BY ASIAN FTAS

As FTAs have spread across Asia, concerns over such agreements have increased (see Banda and Whalley 2005; Baldwin 2006; Tumbarello 2007; World Bank 2007; Bhagwati 2008; Drysdale and Armstrong 2010; Ravenhill 2010; Hoekman and Mattoo 2011). A cursory analysis of the growing number of political debates, media stories, policy studies, and conference reports on Asian FTAs indicates that a host of challenges exist for regional integration. It is not possible in this chapter to address all the economic, political, and legal issues arising from the subject of integration. From a pragmatic perspective and with a view to making suggestions, six key challenges associated with Asian FTAs merit further examination: (1) improving firm-level use of FTAs, (2) tackling the Asian ‘noodle bowl’ problem, (3) promoting comprehensive coverage of agricultural trade, (4) facilitating services-trade liberalization, (5) increasing WTO-plus elements, and (6) forming a region-wide FTA. New evidence from firm surveys, analysis of agreements, and CGE models can be useful in addressing some of these challenges and indicating the way forward.

### 8.3.1 Challenge 1: Improving Use of FTA Preferences

Improving preference use at the firm level is probably the most important challenge associated with Asian FTAs. Well-designed and comprehensive
FTAs provide numerous benefits, including preferential tariffs, market access, and new business opportunities. One might assume that firms would desire to avail themselves of such benefits once a given FTA is in effect. Previous studies at the country and industry levels, however, suggest that FTA preference utilization rates – based on shares of export value enjoying preferences – are low in Asian countries and that FTAs are underutilized (Baldwin 2006; World Bank 2007; Drysdale and Armstrong 2010; Ravenhill 2010). A study of Australia’s FTAs also reported that half of Australia’s imports from New Zealand, the Pacific Island Forum economies, Thailand and Chile claimed preferences in 2000 but all had lower utilization rates by 2009 (Pomfret et al. 2010). This is mainly due to the increasing number of zero MFN tariff lines. Accordingly, Asian FTAs are often viewed as discriminatory and a drain on scarce trade negotiation capacity in developing countries (Bhagwati 2008).

Information on certificates of origin, based on databases of customs authorities or business associations, cover all the users of FTA preferences in a given country. One of the difficulties in investigating the evolution of FTA preferences is that most Asian countries do not publish official information. Fortunately, Thailand is an exception and publishes official FTA-use information in the Thai language which was obtained from secondary sources (JETRO 2010, 2012). Data for the Republic of Korea, Malaysia, and Viet Nam are not published and were obtained from secondary or official sources. Table 8.1 shows annual FTA use data for 2008–11 for the four countries and a four-country average.

Several findings are worth highlighting. First, average FTA use in the four countries is higher than expected from previous studies. Strikingly the four-country average FTA use rose markedly from 24 percent to 39 percent between 2008 and 2009. After a modest decline between 2009 and 2010, this figure reached a respectable 37 percent in 2011.

Table 8.1  Share of export value with free trade agreement preferences, 2008–11 (percentage)

<table>
<thead>
<tr>
<th></th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Republic of Korea</td>
<td>48.3</td>
<td>53.2</td>
<td>51.1</td>
<td>49.4</td>
</tr>
<tr>
<td>Thailand</td>
<td>26.8</td>
<td>37.5</td>
<td>37.2</td>
<td>42.2</td>
</tr>
<tr>
<td>Malaysia</td>
<td>10.3</td>
<td>28.3</td>
<td>22.7</td>
<td>23.5</td>
</tr>
<tr>
<td>Viet Nam</td>
<td>11.3</td>
<td>35.0</td>
<td>24.3</td>
<td>32.7</td>
</tr>
<tr>
<td>4-country average</td>
<td>24.2</td>
<td>38.5</td>
<td>33.8</td>
<td>37.0</td>
</tr>
</tbody>
</table>

Sources: Republic of Korea (Republic of Korea Customs Services), Malaysia and Thailand (JETRO 2010, 2012), and Viet Nam (Tran Ba Cuong 2012).
Second, all countries show notable levels of FTA use since 2008 but the pattern varies by country. The Republic of Korea is an outlier for having achieved particularly high FTA use of 48 percent in 2008 which increased slightly to 49 percent in 2011. Other countries show significant increases in FTA use over the same period – Thailand’s FTA use rates rose from 27 percent to 42 percent, Malaysia’s more than doubled from 10 percent to 24 percent, and Viet Nam’s trebled from 11 percent to 33 percent.

Third, country-level FTA use varies by trading partner. Some examples are useful. In the case of the Republic of Korea, the most used were the US–Republic of Korea FTA (69 percent), the EU–Republic of Korea FTA (79 percent), and the Republic of Korea–Chile FTA (99 percent). Meanwhile, other agreements like the Republic of Korea–India FTA (16 percent) and the ASEAN–Republic of Korea FTA (33 percent) were used less. In Thailand’s case, the agreements with high use include the ASEAN–Republic of Korea FTA (49 percent), the Thailand–Australia FTA (59 percent), and the ASEAN–India FTA (80 percent) while the less used ones were the ASEAN–PRC FTA (35 percent), AFTA (28 percent), and the Japan–Thailand FTA (25 percent). In Viet Nam, the ASEAN–Republic of Korea FTA had the highest use (91 percent), while the ASEAN–India FTA had the lowest use (7 percent). In Malaysia, the ASEAN–Republic of Korea FTA (51 percent) had highest use, the ASEAN–Japan FTA reasonable use (31 percent), and the ASEAN–Australia and New Zealand FTA the lowest use (14 percent). Underlining the role of FTAs in facilitating market access, some agreements with major markets appear to have higher FTA use (for example the US–Republic of Korea FTA and EU–Republic of Korea FTA) than others. More attractive tariff preferences for key products and more simplified rules of origin may help explain why bilateral FTAs are often more attractive to firms than plurilateral agreements.

How do the FTA-use data for the four countries compare with other regions? By comparison, about 54 percent of all Canadian exports to the US used NAFTA preferences between 1998 and 2003 (Kunimoto and Sawchuk 2005). Encouragingly, the figures for many major Asian FTAs (including the Republic of Korea–EU FTA, the Republic of Korea–US FTA, the ASEAN–Republic of Korea FTA, and the Thailand–Australia FTA) are well above the Canadian figure for NAFTA. These figures seem reasonable given the low applied MFN tariffs (averaging 7.4 percent in 2010). While these findings are encouraging, room for improvement exists in FTA preference use in Asia. Another important future priority for research on Asian regionalism is to assemble and maintain a comprehensive dataset on FTA use for individual Asian countries.

While certificate of origin data comprehensively cover FTA users, they do not highlight the characteristics of FTA users nor impediments to
using FTAs. Accordingly, more micro-level analysis using firm surveys in several countries are required to highlight these issues. Multi-country firm survey studies are a time consuming and expensive venture but well-managed surveys provide unique insights to make them worthwhile. Six comprehensive surveys of manufacturing exporting firms conducted in 2007–08 by ADB, ADBI and several partner researchers in Japan, the PRC, the Republic of Korea, Singapore, Thailand, and the Philippines shed light on the use of FTA preferences (see Kawai and Wignaraja 2011b; Wignaraja 2010). In addition, a survey of Malaysia was conducted by ADB and ADBI in 2012 (see Wignaraja 2013b). The surveys yielded a sample of 1075 Asian sample firms and the details of the firm survey methodology are provided in Kawai and Wignaraja (2011b).

The ADB/ADBI firm surveys confirm that Asian exporting firms tend to use FTA preferences more frequently than previously thought and may even be increasing their utilization rate. Around 32 percent of the sample firms use FTA preferences. When plans for using FTA preferences are also factored in, 52 percent of all Asian firms either use or plan to use FTA preferences. PRC and Japanese firms are the highest users of FTA preferences.

The ADB/ADBI firm surveys shed light on the characteristics of FTA users and non-users (see Kawai and Wignaraja 2011b). T-tests indicate that a striking difference between FTA preference users and non-users in Asian countries is found in firm size. Japan stands out for its base of large multinational corporations. The average number of employees among Japanese firms using FTA preferences is 30,104, while this number is 3,542 in the PRC, 1,098 in Singapore, 591 in Thailand, 404 in Malaysia, and 395 in the Philippines. The average number of employees among non-users is 7020 in Japan, 2,226 in the PRC, 291 in Thailand, 269 in the Philippines, 142 in Singapore, and 86 in Malaysia. Accordingly, a classic firm size effect seems to underlie the pattern of FTA preference use in the Asian sample. The results suggest that using FTAs entails large fixed costs – for example, learning about FTA provisions, tailoring business plans to complex tariff schedules, and obtaining certificates of origin – and larger firms are better able to muster the requisite financial and human resources than SMEs.

The reasons that the majority of Asian sample firms do not currently use FTA preferences are not widely known. The ADB/ADBI surveys also generated responses from 717 Asian sample firms on the reasons for non-use of FTA preferences. Surprisingly, a lack of information on FTAs was the most significant reason for non-use of preferences as reported by 39 percent of firms surveyed. Low margins of preference (15 percent) and delays and administrative costs associated with rules of origin (13 percent) were the second and third most common reasons cited. Other reasons for
non-use included: use of other schemes such as export processing zones and the Information Technology Agreement for exporters, which also provide incentives for exporters (7 percent), and non-tariff measures in partner countries (5 percent) that inhibit exports and, hence, use of FTA preferences.

Accordingly, use of FTA preferences can be encouraged by raising awareness of (1) FTA provisions, including the phasing out of tariff schedules; (2) margins of preference at the product level; and (3) administrative procedures for rules of origin (ROOs). Business associations and governments could make information on how to use FTAs more transparent, particularly for SMEs. Practical ideas include frequent seminars with SMEs, television programs directed at businesses, and dedicated websites and telephone helplines. More generally, institutional support systems for businesses, particularly for SMEs, need to be improved. Existing support systems for exporting under FTAs are of varying quality and take-up rates. Significant public and private investment is required in Asia to improve coverage of support services, upgrade service quality, and reduce bureaucratic impediments to service use. Business and industry associations will have to play a greater role in providing members with support services for exporting under FTAs. Upgrading SME technical standards, quality and productivity could be useful so that they can participate more fully in regional production networks driven by large firms. Furthermore, a region-wide database on FTA use needs to be established and maintained so that FTA use can be tracked over time.

8.3.2 Challenge 2: Tackling the Asian ‘Noodle Bowl’

Rules of origin are another potentially challenging aspect of Asian FTAs. These are devices to determine which goods will enjoy preferential tariffs in order to prevent trade deflection among FTA members. For manufactured goods, ROOs comprise three types: (1) a change in tariff classification rule defined at a detailed harmonized system level; (2) a local (or regional) value content rule, which requires a product to satisfy a minimum local (or regional) value in the country (or region) of an FTA; and (3) a specific process rule, which requires a specific production process for an item (Estevadeordal and Suominen 2006). An influential strand of literature argues that Asian FTAs have complicated ROOs, sparking concerns about what the attendant rules and administrative procedures would imply for the cost of doing business (Manchin and Pelkmans-Balaoing 2007; Tumbarello 2007). This literature claims that restrictive ROOs in Asian FTAs deter the use of FTA preferences, while complex ROOs raise
transaction costs for firms. With the rapid spread of FTAs throughout Asia, this literature further suggests that multiple ROOs in overlapping FTAs pose a severe burden on SMEs, which have less ability to meet such costs. Originally termed a ‘spaghetti bowl’ of trade deals (Bhagwati 1995), this phenomenon has become widely known as the ‘noodle bowl’ effect in Asia.\textsuperscript{13}

To what extent are multiple ROOs perceived as a problem by businesses in Asia? The ADB firm surveys provide interesting insights into this issue (see Kawai and Wignaraja 2011b). Specifically, the surveys provide enterprise perceptions of whether dealing with multiple ROOs in the region’s FTAs would significantly add to business costs. The main findings suggested by the surveys are given below.

First, at the present level of concluded FTAs in the region, the evidence suggests that multiple ROOs impose a limited burden on firms in Asia. Of the 922 firms that responded to the question on this issue, 197 firms (21.4 percent) said that multiple ROOs do significantly add to business costs. Meanwhile, the bulk of the sample firms did not think that they were a problem at present. However, the aggregate figure masks interesting country-level variations in perceptions. Singaporean firms had the most negative perceptions regarding multiple ROOs (38 percent), while PRC firms had the least negative perceptions (6 percent). In between these two extremes were Japanese, Philippine, Thai, Malaysian, and Korean firms with negative responses of 31 percent, 28 percent, 26 percent, 25 percent, and 15 percent, respectively. National FTA strategies, industrial structures, and the quality of institutional support may underlie differences in perceptions of ROOs across Asian countries.

Second, the surveys suggest that larger firms in Asia have more negative perceptions of multiple ROOs than SMEs, which was an unexpected finding (Figure 8.5). The relationship between firm size and concerns about multiple ROOs presents an interesting puzzle for research. Econometric analysis to resolve the puzzle shows that large established firms tend to export to multiple markets and change their business plans in response to FTAs. Therefore, they are more likely to complain about issues of multiple ROOs (Kawai and Wignaraja 2009b). In contrast, smaller firms tend to export to a single market and hence do not have much basis for complaining. While inter-country and intra-firm size variations exist, there does not seem to be much variation in perceptions across sectors.

Third, most firms want to be able to choose between ROOs included in FTAs. The surveys suggest that firms are supportive of having alternative ROOs for the same product for several reasons: (1) if they cannot reach the value content requirement, having another ROO could enable firms to still use FTA preferences; (2) as the application for the value content rule
A World Trade Organization for the 21st century may require confidential information on costs, suppliers and many firms are often reluctant to divulge such information; and (3) some ROOs may be better aligned with the technology and production process of particular industries.

The finding of a limited burden imposed by multiple ROOs does not mean that policymakers should be complacent about the issue. As the number of concluded agreements increases, it is possible that multiple ROOs may become more of a problem for firms. Supportive measures — such as encouraging rationalization of ROOs and upgrading their administration — are needed to mitigate the negative effects of the Asian noodle bowl in the future. Widespread gains are possible from pursuing a simplified approach to ROOs in Asia involving harmonized ROOs, cumulation of value contents, and coequality of ROOs. Likewise, it would be useful to adopt international best practices in ROO administration. These may include introducing a trusted trader program, as with NAFTA, that would allow successful applicants to self-certify their own certificates of origin, switching to business associations issuing certificates of origin for a fee, increasing use of information technology-based systems of ROO administration, and training SMEs to enhance their capacity to use FTAs.

**Figure 8.5** Burden imposed by multiple rules of origin in free trade agreements (percentage of respondents by firm size)

Note: SME = 100 or fewer employees, Large = 101 to 1000 employees, Giant = more than 1000 employees.

Source: Kawai and Wignaraja (2011b).
Policy challenges posed by Asian free trade agreements

8.3.3 Challenge 3: Promoting Comprehensive Coverage of Agricultural Trade

A third potential challenge for Asian FTAs may be the extent of coverage of agricultural goods trade. Some suggest that the coverage of agricultural goods trade differs markedly among Asian FTAs, with agricultural products largely excluded due to pressures from powerful farm lobbies or social concerns over the rural sector, where poverty is predominant in developing countries (Feridhanusetyawan 2005). Furthermore, the big push in Asian FTAs since 2000 relates to production networks in manufacturing. As production networks are not particularly active in agriculture, this may also be another reason for the exclusion of agriculture. As a result, there is a suboptimal level of liberalization in agricultural products and even conflict with the spirit of GATT Article XXIV, which provides exemption to the WTO’s most favored nation clause, or nondiscriminatory treatment. Consistency with GATT Article XXIV requires FTAs to eliminate trade barriers on ‘substantially all trade’ in originating goods from members within a reasonable period of time, which is sometimes referred to as the ‘substantially all trade’ rule.

Two problems have hampered empirical research on the coverage of agricultural goods trade in Asian FTAs. First, little systematic data and analysis are available on the treatment of agricultural products across Asian FTAs. Second, clear criteria for the ‘substantially all trade’ rule do not seem to exist. With the development of new databases on Asian FTAs – for example, ADB’s Asia Regional Integration Center database – new sources of FTA data are now available. Furthermore, tariff lines for agricultural products can be used as a basis to gauge the criteria of substantially all trade.

A simple threefold classification system was used to categorize Asian FTAs according to tariff line coverage of agricultural products. Given the complexity of provisions for agriculture in many agreements, and the availability of tariff schedules and exclusion lists at the product level, a combination of coverage of product lines and exclusions was used to assess each agreement. The classifications are as follows:

Comprehensive coverage – at least 85 percent of all agricultural product lines in a given agreement are covered, or not more than 150 product lines are excluded. FTAs with these features for agricultural products are taken as covering substantially all trade.

No, or limited, coverage – agricultural products are completely excluded in the agreement, or fewer than 100 product lines are included.
Some coverage – more agricultural products are included in FTAs than ‘no or limited coverage’, but fewer products are covered than ‘comprehensive coverage’. Agreements with such coverage typically include more than 100 agricultural product lines, but less than 85 percent of agricultural product lines. These agreements may also exclude over 150 agricultural product lines.

It was possible to apply this classification system to examine the agricultural coverage of concluded Asian FTAs during 2000–2013 and the results are provided in Figure 8.6. The data suggest Asian FTAs have become more comprehensive in their coverage of agricultural products over time. AFTA, for instance, was originally proposed as only ten manufacturing sectors, and only latterly included agriculture. The three concluded

![Agricultural coverage of Asian free trade agreements, 2000–2013 (number of FTAs)](image)

**Notes:**

1. The data cover 77 FTAs in Asia. Agricultural products and chapters are classified according to WTO classification.
2. ‘Comprehensive’ means agriculture is substantially covered (at least 85 percent of agricultural product lines) or not more than 150 product lines are excluded. ‘Excluded/limited’ means agriculture is completely excluded or fewer than 100 product lines or 5 percent of the total tariff lines. ‘Some coverage’ refers to those in between excluded/limited and comprehensive.

**Source:** Legal annexes of FTAs (www.aric.adb.org) and WTO reports; data as at December 2013.
FTAs in 2000 had no or limited coverage of agriculture. Concluded FTA numbers grew to 22 in 2005. Of these, eight (36 percent) were regarded as comprehensive in coverage of agriculture, five (23 percent) had some coverage, and nine (41 percent) had no or limited coverage. Further expansion of FTAs occurred thereafter. Of the 77 agreements for which texts were available in December 2013, 40 (52 percent) are comprehensive coverage of agriculture while another 19 (25 percent) have some coverage of these items. The remaining 18 (23 percent) have limited or no coverage.

The Republic of Korea has the most comprehensive coverage of agriculture in its FTAs. For instance, under the Republic of Korea–United States FTA (KORUS), it will eliminate tariffs on almost two-thirds of current US agricultural exports upon entry into force, including wheat, corn, and cotton. Tariffs and import quotas on most other agricultural goods will be phased out within ten years. The Republic of Korea even agreed to eliminate its 40 percent tariff on beef muscle meats over a 15-year period. Furthermore, the Republic of Korea–Chile FTA is taken as a comprehensive agreement for agricultural goods as the Republic of Korea excludes only 21 agricultural products from the agreement, such as rice, apples, and pears. These exclusions are likely due to a lack of seasonal competition.

Three of Japan’s agreements (with the Philippines, Viet Nam, and India) have comprehensive coverage of agriculture while the rest have some coverage. Under the Japan–Viet Nam FTA that took effect in 2009, Japan immediately eliminated 784 out of 2020 tariff lines on farm products, or 67.6 percent of Viet Nam’s total export value to Japan. Overall, Japan committed to cut tariffs on 86 percent of agricultural, aquatic, and forestry exports from Viet Nam within ten years from the agreement taking effect.

The AFTA is also regarded as a comprehensive agreement as members exclude only 20 agricultural products on average. The ASEAN–Australia and New Zealand FTA follows the AFTA model where most tariffs on agricultural products are bound at 0 percent upon the FTA’s entry into force or phased to 0 percent by 2020. Exclusions from tariff commitments have been kept to a minimum including rice, sugar, and maize. The ASEAN countries in particular have liberalized key export sectors for Australia including meat, dairy, fish, and grains. A case in point, most meat tariff lines are eliminated upon entry in force or phased out and only a few meat tariff lines remain untouched in a few countries.

While the PRC’s early agreements tended to have little coverage of agriculture, more recent agreements have placed more emphasis on this sector. Today, the PRC has five FTAs with comprehensive coverage of agriculture and another two with some coverage. The PRC–New Zealand is a benchmark FTA with comprehensive coverage as tariffs on most key New Zealand agricultural products are phased out by 2019, including tariffs on
all dairy products (by 2019) sheep and beef (2016) apple (2012), kiwifruit (2016), and seafood (2012). A special safeguard measure is made available to the PRC with regard to certain dairy products. Likewise, India under-emphasized the coverage of agricultural products until recently. India’s three FTAs with comprehensive coverage of agriculture (with ASEAN, the Republic of Korea, and Japan) were concluded after 2009.

Additional work is needed to refine the criteria for assessing the coverage of agricultural products in Asian FTAs according to the ‘substantially all trade’ rule and to develop new criteria based on the value of total trade. Nonetheless, better coverage of agricultural trade in Asian FTAs is needed and a gradual approach to liberalization seems optimal for developing economies. This is a key element of the continuation of the liberalization agenda for trade in goods. An important future step would be to include provisions on agricultural products in all prospective agreements. This would serve as a signal for producers to adjust to competition and improve productivity. A next step would be meeting the benchmark for comprehensiveness by ensuring coverage of at least 85 percent of all agricultural product lines in a given agreement and minimizing exclusions to not more than 150 product lines. This can be done by adopting a negative list approach\(^\text{18}\) to agricultural products with a few sensitive items. Issues for the future would include a realistic tariff elimination schedule, a transparent sanitary and phytosanitary regime, and subsidy reform.

**8.3.4 Challenge 4: Facilitating Services-trade Liberalization**

A fourth challenge is for Asian FTAs to facilitate services-trade liberalization. Services account for more than half the GDP of most Asian countries and trade in services has grown rapidly (Hoekman and Mattoo 2011). Studies suggest that impediments to trade in services, particularly regulatory restrictions on foreign services and service providers, exist across Asia (Findlay et al. 2009). Such impediments may occur in ownership rules, technical regulations, licensing, and qualification requirements. Meanwhile, WTO negotiations in trade in services at the multilateral level have not made much progress due to diminished interest among governments and the private sector (Hoekman and Mattoo 2011). Services-trade liberalization remains desirable to support growing services trade and the operation of production networks which increasingly depend on efficient logistics and trade facilitation services.

Many of today’s comprehensive FTAs seek to remove regulatory restrictions on services trade and the operation of services providers. Conformity with Article V of the General Agreement on Trade in Services (GATS) requires WTO members to conclude FTAs that meet three requirements:
(1) substantial sectoral coverage, (2) elimination of substantially all discrimination in the sense of national treatment, and (3) no raising of barriers against non-members as a result of a given FTA. All three conditions need to be satisfied for strict GATS conformity. However, in practice it is difficult to assess conformity of an FTA with GATS Article V. A lack of data on trade in services makes it hard to estimate the value of the services trade covered by an FTA. There also seems to be limited consensus on the meaning of ‘substantial sectoral coverage’ in the services trade and an assessment of ‘national treatment’ requires detailed sub-sectoral analysis. Furthermore, varying liberalization approaches to services (for example, positive, negative, or hybrid approaches to GATS negotiations) and an absence of disaggregated data on trade in services makes it difficult to quantify substantial sector coverage.

A practical way forward is to focus on requirement (1) of the GATS and to interpret ‘substantial sectoral coverage’ to mean that a high-quality FTA should cover key services sectors. This approach, which draws on Wignaraja and Lazaro (2010) and Wignaraja et al. (2013), can be readily applied to a large proportion of Asian FTAs. The GATS classification list of 12 services sectors is a useful input for creating a simple threefold classification of Asian FTAs as follows:

1. Comprehensive coverage of services: FTA covers the five key sectors of the GATS – business and professional services, communications services, financial services, transport services, and labor mobility/entry of business persons. Coverage of other sectors may also be included. The five sectors were chosen as the yardstick because they are the main sectors in terms of the value of services trade in Asia and also subject to multiple regulatory barriers on foreign services and service providers.

2. Excluded or limited coverage of services: FTA either excludes services trade liberalization or provides only general provisions thereof, or covers only one of the five key sectors in addition to some other sectors.

3. Some coverage of services: FTA is not otherwise classified as comprehensive, excluded, or limited. Such an FTA would typically cover between two and four key sectors of the GATS and some minor sectors.

A sector is considered as covered if at least one party includes its GATS and GATS-plus commitments, regardless of the number of subsectors, volume of trade affected, or the four modes of supply. This classification system was applied to Asian FTAs during 2000–2013 (see Figure 8.7).
A World Trade Organization for the 21st century

Evidence indicates a trend in Asian FTAs toward progressively liberalizing the services sectors of participants and providing for deeper regulatory cooperation in services over time. In the early 2000s, the majority of FTAs had limited or some coverage of services. By 2005, ten FTAs (45 percent) were deemed to be comprehensive in covering at least five key sectors, five (23 percent) provided coverage of between two and four key sectors, and seven (32 percent) had little or no coverage. Thereafter, most new FTAs typically incorporated either comprehensive or some coverage of services. Of the 77 FTAs in 2013, 35 (45 percent) were comprehensive and another 25 (32 percent) had some coverage. Only 17 (22 percent) had no or limited coverage.

Many Asian FTAs adhere to key GATS principles such as market access (quota elimination); national treatment (equal treatment of local and foreign service providers); MFN treatment (service suppliers of an FTA member will automatically receive benefits given to other future

Notes:
1. The data cover 77 FTAs in Asia.
2. ‘Comprehensive’ means covers the five key sectors of the GATS – business and professional services, communications services, financial services, transport services, and labor mobility/entry of business persons. ‘Excluded/limited’ means FTA either excludes services trade liberalization or provides only general provisions thereof, or covers only one of the five key sectors in addition to some other sectors. Coverage of other sectors may also be included. ‘Some coverage’ refers to those in between excluded/limited and comprehensive.

Source: Legal annexes of FTAs (www.aric.adb.org) and WTO reports; data as at December 2013.

Figure 8.7 Services coverage of Asian free trade agreements, 2000–2013 (number of FTAs)
FTA parties); reasonable, impartial, and objective domestic regulations; transparency; and mutual recognition agreements (MRAs). Mutual recognition agreements enable the qualifications of professional services suppliers to be mutually recognized by signatory member states, thereby facilitating the easier movement of professional services providers among the member countries.

Several Asian FTAs also provide for GATS-plus commitments meaning that the FTA liberalization goes beyond WTO commitments in relation to subsectors or regulations. The Japan–Singapore agreement is particularly comprehensive with each side expanding its commitments in more than 130 sectors focusing on national treatment (that is, treating service suppliers from the FTA partner country as nationals). Additional comprehensive disciplines for financial and telecommunications services are imposed through two separate annexes. In the EU–Republic of Korea FTA, the Republic of Korea commits to liberalize more than 100 sectors, including telecommunications, environmental, transport, construction, financial, postal and express delivery, and professional services such as legal, accounting, engineering, and architectural services. For example, in telecommunications, the Republic of Korea will relax foreign ownership requirements, allowing 100 percent indirect ownership within two years of entry into force. Further, EU shipping firms will gain full market access and the right of establishment in the Republic of Korea, in addition to non-discriminatory treatment in the use of port services and infrastructure. Further, European law firms will be allowed to open law firms in the Republic of Korea to advise both foreign and domestic clients on non-Korean law and lawyers will be allowed to use their domestic job titles for example, solicitor or advocate. Finally, in the ASEAN–Australia/New Zealand Free Trade Agreement (AANZFTA), the six original ASEAN members expanded the liberalization of their telecommunication services to additional subsectors, while four others (Indonesia, Malaysia, Philippines, and Singapore) went even further with their commitments in financial services. Australia and New Zealand have also made GATS-plus commitments covering modes 1–3 (see note 20) in a number of sectors, including business and financial services.

Notable comprehensive coverage of services among other Asian FTAs include the ASEAN FTA, India–Singapore CECA, and PRC–Singapore FTA. The ASEAN countries began to negotiate trade in services in 1995 through the ASEAN Framework Agreement on Services (AFAS). To date, ASEAN has concluded at least seven packages of commitment, agreed on five priority services sectors (air transport, e-ASEAN, health-care, tourism, and logistics) and seven MRAs. They include engineering, nursing, architectural, surveying, medical and dental, and accounting
services. ASEAN is continuously negotiating all other sectors and modes of supply to achieve the free flow of services by 2015 in line with its blueprint for an ASEAN Economic Community. Under the India–Singapore CECA, preferential treatment is given for all five of the major services sectors as well as for construction and related engineering, tourism and travel-related services, distribution, education, and environmental services. Meanwhile, the services coverage of the PRC–Singapore FTA goes beyond the GATS to incorporate commitments under the ASEAN–PRC FTA and also includes a chapter on the movement of natural persons.

Although there is variation across Asian FTAs in terms of coverage of services, more emphasis is being placed on services-trade liberalization than before. Newer agreements, particularly those between developed and developing countries, typically encompass the five key sectors of the GATS (business and professional services, communications services, financial services, transport services, and labor mobility/entry of business persons). Radical liberalization of trade in services via the WTO or Asian FTAs seems unlikely for political economy reasons. With limited appetite for multilateral service trade liberalization, a modest way forward is for all future Asian FTAs to cover the five key sectors of the GATS. Furthermore, such coverage should adhere at least to GATS principles (such as market access, national treatment, transparency, and mutual recognition agreements) and contain only limited exemptions. Over time, sectoral coverage can be extended and further GATS-plus commitments can be considered particularly in agreements encompassing more developed economies.

8.3.5 Challenge 5: Increasing WTO-plus Elements

A fifth challenge relates to expanding the coverage of Asian FTAs to new issues which go beyond the WTO framework. The WTO system that emerged from the Uruguay Round in the mid-1990s consisted of substantive agreements on goods and services. The subsequent WTO Doha Development Round initiated in 2001 has focused on liberalization in agricultural and non-agricultural market access. The four Singapore issues (competition policy, investment, trade facilitation, and government procurement) were conditionally included in the work program for the Doha Round, but were dropped at the WTO Ministerial Conference in Cancun in 2004. World Trade Organization-plus agreements and 'new age' FTAs, which are comprehensive and address the Singapore issues, are becoming more common globally (Fiorentino et al. 2009; Freund and Ornelas 2010). An increase in WTO-plus elements in the landscape of Asian FTAs has been identified as a pressing challenge for economies. Studies suggest
that Asian FTAs vary considerably in their scope with some sophisticated agreements alongside limited FTAs (Banda and Whalley 2005; Plummer 2007).22 Yet, systematic cross-country evidence on the scope of Asian FTAs is lacking, particularly with regard to more recent agreements.

Figure 8.8 shows the scope of all concluded Asian FTAs between 2000 and 2013 and Figure 8.9 by economy for 2013 according to (1) narrow agreements that deal with goods and/or services; (2) somewhat broader agreements covering goods, services, and some Singapore issues (partial WTO plus); and (3) comprehensive agreements covering goods, services, and all four Singapore issues (comprehensive WTO plus). Those covered by (2) and (3) can be considered WTO plus FTAs. The scope of concluded agreements reflects a combination of economic interests, economic strength, and negotiation capacity. The pattern is striking. The early Asian FTAs seemed to be concerned largely with goods and services. From the mid-2000s onwards, however, significantly more emphasis was given to broad agreements with many WTO-plus elements (see Figure 8.8). By 2013, 20 (26 percent) were goods and/or services only FTAs, 39 (51 percent) were partial WTO plus FTAs, and 18 (23 percent) were comprehensive WTO plus FTAs.

Three leading participants in Asian FTAs – Japan, Singapore, and the Republic of Korea – strongly favor a WTO-plus approach to FTAs
and are increasingly emphasizing comprehensive agreements (see Figure 8.9). Appendix Table 8A.2 summarizes coverage of selected FTAs by participant. All of Japan’s agreements and most of Singapore’s and the Republic of Korea’s are WTO-plus. Likewise, Thailand, Malaysia, Brunei Darussalam, Indonesia, Philippines, and Viet Nam largely follow a WTO-plus format.

Historically, the PRC and India have been relatively cautious on scope, preferring agreements focusing on goods and services elements. More recently, however, both have begun to experiment by incorporating some WTO-plus provisions such as in the India–Singapore Comprehensive Economic Cooperation Agreement (CECA), the Japan–India EPA, and the PRC–New Zealand FTA. Thus, with a few exceptions, Asian economies are increasingly favoring WTO-plus agreements rather than narrowly limited agreements.

Some additional points are worth noting about WTO-plus provisions in Asian FTAs (Kawai and Wignaraja 2009a). First, agreements between developed countries and developing and emerging economies generally take a WTO-plus format. Examples include the ASEAN–Japan
FTA, US–Singapore FTA, US–Republic of Korea FTA, EU–Republic of Korea FTA, and PRC–New Zealand FTA. Second, the Republic of Korea and Singapore tend to behave like developed countries in their agreements with many developing countries. This behavior is visible in the Trans-Pacific Strategic EPA, Singapore–PRC FTA, and Republic of Korea–Chile FTA. Third, some existing FTAs are gradually being expanded to have WTO-plus coverage. Examples include the ASEAN–Republic of Korea CEPA and the India–Sri Lanka CEPA. Fourth, the trend toward increasing WTO-plus elements in Asian FTAs means that the region’s FTA activity is likely to continue even if a Doha deal (focusing on liberalization in agricultural and non-agricultural market access) were to be concluded in the future.

The inclusion of WTO-plus provisions – particularly the four Singapore issues – would be desirable in all future Asian FTAs. For example, competition policy and investment provisions are integral ingredients in facilitating FDI inflows and the development of production networks. Inclusion of provisions on trade facilitation and logistics development would help lower transaction costs in conducting trade. Cooperation provisions – along the lines of the APEC economic and technical cooperation (ECOTECH) agenda – would stimulate technology transfer and industrial competitiveness. In their FTA negotiations, the US and EU prefer a single undertaking and the inclusion of these WTO-plus provisions. The US–Singapore, US–Republic of Korea, and EU–Republic of Korea agreements are cases in point. ASEAN is also considering an ASEAN Comprehensive Agreement on Investment as a part of the process of moving toward an ASEAN Economic Community by 2015.

8.3.6 Challenge 6: Forming a Region-wide FTA

Finally, there is increasing recognition in Asia of the merits in forming a region-wide FTA as a means to consolidate the plethora of bilateral and plurilateral agreements. Such an FTA would confer various economic benefits: (1) increase market access to goods, services, skills, and technology; (2) increase market size to permit specialization and realization of economies of scale; (3) facilitate the FDI activities and technology transfer of MNCs; and (4) permit simplification of tariff schedules, rules, and standards (see Chia 2013; Gordon 2012).

ASEAN – with the region’s oldest FTA – has established itself as an integration hub for FTAs in Asia. All major dialogue partners in East Asia – Australia, PRC, India, Japan, Republic of Korea, and New Zealand – have implemented their respective FTAs with ASEAN. With key ASEAN+1 agreements in place, an earlier policy discussion in Asia
focused on competing region-wide FTA proposals – an East Asia Free Trade Area (EAFTA) among ASEAN+3 countries and a Comprehensive Economic Partnership for East Asia (CEPEA) among ASEAN+6 countries – that would guide future policy-led integration in the region. The EAFTA was an attempt to bridge ASEAN and its Northeast Asian neighbors, while the CEPEA emerged through the realization that synergies could be gained by linking ASEAN+3 countries with India, Australia, and New Zealand. The PRC had been a strong supporter of EAFTA while Japan had put more emphasis on CEPEA. Political rivalry over FTA leadership in Asia could hinder any such joint venture. However, in late 2012, the PRC agreed to begin negotiations of an RCEP among the ASEAN+6 countries. After a period of intense political discussions involving ASEAN and its ASEAN+1 FTA partners, efforts to form a region-wide FTA in Asia are now focusing on achieving an RCEP by the end of 2015. Although under the new label of RCEP, this is essentially a CEPEA among ASEAN+6 countries. Political economy considerations relating to RCEP and possible developments are discussed in the next section.

Based on earlier studies on the impact of prospective FTAs on Asian economies, we report results of our region-wide FTA study, covering not only goods but also other aspects of Asian FTA coverage – such as services and trade facilitation. Figure 8.10 shows the results of a CGE exercise for economies in Asia. The EAFTA scenario provides for free trade among the ASEAN+3 countries, while the CEPEA scenario broadens the EAFTA scenario to include India, Australia, and New Zealand. Thus, the simulation results of the CEPEA scenario are indicative of the economic effects of the RCEP scenario. Four model features are worth noting: (1) strong microeconomic foundations and detailed interactions among industries, consumers, and governments across the global economy; (2) medium- to long-run investment effects by allowing for trade to affect capital stocks through investment activities; (3) use of the GTAP database (version 6.3) through to 2017, which projects trade and production patterns to represent a post-Uruguay Round world using the phase out of the Agreement on Textiles and Clothing, the implementation of the remaining WTO commitments under the Doha Round, and enlargement of the EU to 27 members; and (4) a stylized FTA that includes goods, services, and some aspects of trade cost reduction. The model’s baseline is 2017 and the simulations show changes from this baseline.

Three overall results can be highlighted from the CGE exercise in terms of percentage change from 2017 baseline income: (1) a region-wide FTA, whether an EAFTA or CEPEA, offers larger gains to world income than the current wave of bilateral and plurilateral FTAs; (2) the CEPEA scenario, which is broader in terms of country coverage, offers larger gains
Policy challenges posed by Asian free trade agreements

Some interesting national level results in terms of percentage change from 2017 baseline income emerge from this exercise:

- For ASEAN’s dynamic members, projected gains are significant under the CEPEA scenario: Thailand (12.8 percent), Viet Nam (7.6 percent), Malaysia (6.3 percent), and Singapore (5.4 percent). For the rest of ASEAN – Cambodia, Indonesia, the Philippines, and the remaining economies – the gains are less than 3.0 percent.
- Among Northeast Asian countries, the Republic of Korea experiences the largest gain under the EAFTA (6.2 percent) and CEPEA (6.4 percent) scenarios.
- India, Australia, and New Zealand experience losses under the EAFTA scenario and gains under the CEPEA scenario. The losses

Figure 8.10  Income effects of alternative scenarios compared to 2017 baseline (percentage change in GDP by economy)
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under an EAFTA are less than 0.5 percent for each, while under a CEPEA, gains are 2.4 percent for India, 3.9 percent for Australia, and 5.2 percent for New Zealand.

- Third parties like Taipei, China and Hong Kong, China experience small losses from being excluded from both EAFTA and CEPEA.

For the CEPEA scenario, Appendix Table 8A.3 contains output effects across broad sectors compared to 2017 baseline. The implementation of the CEPEA scenario is likely to result in significant structural changes toward manufactures and services (and away from agriculture and other primary products) in Asia. There are also shifts within manufacturing. Among ASEAN’s dynamic members, Thailand witnesses projected gains in electrical machinery and electronics, motor vehicles, and services; Viet Nam in textiles and clothing; and Malaysia in metals and metal products. In the rest of ASEAN, Cambodia sees losses in a key sector (textiles and clothing) and the Philippines in motor vehicles. Meanwhile, the PRC has gains in electrical machinery and electronics and India in services and metals. Japan and the Republic of Korea see gains in most manufacturing sectors. Strikingly, seven countries see declines in agriculture and the others negligible gains.

The CGE analysis indicates that a region-wide agreement in East Asia – particularly a CEPEA or RCEP – provides larger welfare gains than the present wave of ASEAN+1 FTAs. The gains to members of such an agreement are notable, while losses to non-members are relatively small. Accordingly, arguments for and moves toward CEPEA or RCEP are supported by economic modeling. The CGE analysis also reveals that some members gain more than others and this issue may need to be addressed in policy discussions. There is a case for further narrowing development gaps by providing financial and technical support for low-income countries, particularly with respect to trade-related infrastructure, governance reforms, customs modernization, enhancing SME development, and capacity building.

8.4 POLITICAL ECONOMY CONSIDERATIONS OF FTA CONSOLIDATION IN ASIA

8.4.1 Consolidation in Asia

Even if the consolidation of FTAs into a region-wide agreement – particularly in the form of RCEP among the ASEAN+6 economies – demonstrably yields large economic gains to Asia, the future remains
unclear. Political-economy considerations may significantly affect the process on the ground.

Given the role in Asia of the US as a security anchor for many regional economies, one may argue that excluding the US from the Asian integration process is not politically desirable. Large, mature European markets also suggest that many Asian economies should work more closely with Europe to expand investment and trade.

We consider three competing scenarios for consolidation of various Asian FTAs into a larger FTA: (1) an East Asia-wide FTA in the form of an RCEP; (2) a Free Trade Area of the Asia-Pacific (FTAAP) among APEC economies; and (3) a Free Trade Area of Asia and Europe (FTAAE) among the ASEM economies.

An East Asia-wide FTA – in the form of an RCEP – addresses the noodle bowl concern among East Asia’s production network economies while FTAAP and FTAAE take into account external markets as well. The idea of forming an ASEAN+ FTA had been on the official agenda of the earlier East Asia Summit meetings, and the RCEP was launched at the ASEAN Summit in Cambodia in November 2012 among the ASEAN member states and ASEAN’s FTA partners. Negotiations among the 16 parties began in May 2013 and are scheduled to conclude by the end of 2015. In the same vein, FTAAP has also been officially considered in the APEC leaders’ process. However the idea of establishing FTAAE has not yet attracted much political attention.

To discuss these scenarios and their feasibilities, some political-economic considerations have to be addressed with regard to RCEP and an FTAAP.

### 8.4.2 Building Blocks for Wider Agreements

With the rise in the number of participants officially negotiating FTAs, creating an all-encompassing FTA for Asia and beyond could become exceedingly complicated. This suggests that reaching agreement on RCEP would be more complex than forming ASEAN+1 FTAs and that forming FTAAP would be even more complex.

A first step toward the establishment of a trans-regional FTA (such as FTAAP and/or FTAAE) would create an RCEP. Creation of an RCEP in turn requires its building blocks, that is bilateral and multilateral agreements among the ASEAN+6 countries. Its challenge is how to make meaningful progress in the absence of a dominant hegemon in the region. The PRC and Japan are natural candidates to act as a hegemon who can lead the RCEP process, but it is politically difficult for either to act as the sole hegemon.

ASEAN has been acting as Asia’s integration hub or convener in
forming an Asia-wide FTA and the ‘plus-six’ economies – Australia, PRC, India, Japan, Republic of Korea, and New Zealand – would then need to coordinate their trade and FDI regimes. India, which has only recently moved away from its former protectionist stance, would also need to coordinate deeper structural and regulatory reforms addressing both tariff issues and ‘behind-the-border’ red tape issues.

An RCEP would be based on existing ASEAN+1 FTAs with the ‘plus-six’ economies as well as networks of bilateral and/or plurilateral FTAs among these ‘plus’ economies. Five ASEAN+1 FTAs have been implemented, but not all FTAs among the ‘plus’ economies have been completed.

For example, several bilateral and/or plurilateral FTAs are patchy and important components – such as a trilateral FTA among the PRC, Japan, and the Republic of Korea or three bilateral FTAs among these three economies – are still missing (Table 8.2). Such FTAs would facilitate, as important building blocks, for concluding an RCEP. From this perspective the successful formation of an RCEP requires not only the completion of ASEAN+1 FTAs but also a series of agreements among the ‘plus’ economies, particularly among the PRC, Japan, and the Republic of Korea (see Kawai and Wignaraja 2008). The ASEAN+6 economies began RCEP negotiations without all these building blocks in place, with the expectation that such agreements will be created as elements of the RCEP.

Given that bilateral negotiations between the PRC and Japan will likely take significant time, setting the time frame for an RCEP, to be concluded by 2015, would facilitate such laborious discussions. Similarly, during the official negotiation for an RCEP, India needs to conclude negotiations with the PRC. India, however, is perceived as being slow to liberalize trade policies so it might take collective pressure to encourage India to further open its economy and produce a region-wide FTA including India.

If all building blocks were to be successfully achieved by 2015, RCEP negotiations could lead to the formation of a single, larger Asian FTA through consolidation and harmonization of existing FTAs. An argument for supporting an RCEP is that Asia’s production network has already developed beyond the ASEAN+3 economies and already encompassed both Australia and India so harmonizing ROOs among these economies would produce immediate benefits.

Even though the ASEAN+6 countries began to negotiate on an RCEP, the actual process might proceed faster among countries other than India. An RCEP focuses not only on trade and investment liberalization and facilitation, but also on technical cooperation to help build capacities of low-income ASEAN countries.
Table 8.2  Bilateral and multilateral free trade agreements (status by economy)

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Notes:
(1) ◎ = FTA in place or FTA negotiation signed; ◎ = official negotiations under way; □ = official study of FTA under way; and × = no official move taken.
(2) Although Japan and the Republic of Korea launched an official negotiation in December 2003 it was suspended in November 2004 because of continuing significant differences in views. A new official study on a PRC–Japan–Republic of Korea FTA was introduced in May 2010. An official consultation between Japan and the Republic of Korea is expected to be held seeking possible resumption of bilateral FTA negotiations. Late in 2012, the PRC, Japan, and the Republic of Korea agreed to begin trilateral negotiations and the first official talks were held in March 2013.

Source: ADB ARIC FTA database (www.aric.adb.org); data as at December 2013.
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8.4.3 A PRC–Japan–Republic of Korea FTA

One of the most important building blocks of RCEP would be the creation of a PRC–Japan–Republic of Korea (CJK) FTA either as a trilateral FTA among these economies or as three bilateral FTAs between pairs of these economies. There are, however, significant differences in enthusiasm for FTAs among these three economies. Japan and the Republic of Korea launched official EPA negotiations in December 2003 but suspended these negotiations in November 2004 because of significant continuing differences in views. In May 2012 negotiations began on a PRC–Republic of Korea FTA and discussions on a CJK FTA. The decision to begin these negotiations was encouraged, in part, by the advent of the TPP promoted by the US. In November 2013, the PRC, Japan, and the Republic of Korea had the third round of negotiations in Tokyo.

Japan is concerned with the rising competitiveness of the PRC’s agricultural and manufacturing sectors. Japan wishes to treat the PRC as a non-market economy to allow Japan’s use of safeguard measures protecting against a rapid increase of Chinese products entering Japanese markets. The PRC, however, insists upon being recognized as a market economy. Japan also argues that the PRC has yet to demonstrate significant progress in implementing WTO entry commitments such as equitable treatment of Japanese firms in PRC, transparency of enterprise regulations and rules, and protection of intellectual property rights. Food-safety issues in the PRC are also of concern to Japan.

Japan had insisted that an investment treaty be a first condition before beginning broader EPA negotiations. The PRC, Japan, and the Republic of Korea, in fact, began to negotiate a trilateral investment treaty in March 2007, reached final agreement and signed the investment treaty in May 2012. As the treaty addresses investment promotion, protection and facilitation, CJK FTA negotiations include investment liberalization measures.

The Republic of Korea was also concerned about the PRC’s agricultural competitiveness, the excessive dependence on the Chinese market, and the lack of an overall policy on investment and trade with the PRC. But the Republic of Korea decided to negotiate a bilateral FTA with the PRC, hoping to capture important market segments in the PRC. Given the participation in the increasing momentum of the TPP process and Japan’s TPP negotiations, the PRC aggressively approached the Republic of Korea to convince the latter to begin trilateral FTA negotiations with Japan, and the Republic of Korea agreed.

Although Japan and the Republic of Korea are also interested in concluding an EPA with each other, each economy has concerns. Japan’s
primary concern regarding a Japan–Republic of Korea EPA is the competitiveness of the Republic of Korea’s agricultural and fishery sectors. In contrast, the Republic of Korea’s primary concerns regarding Japan’s competitiveness are manufactured products (intermediate inputs), relative weakness of manufacturing SMEs, large tariff concessions required from the Republic of Korea to address existing high most-favored-nation tariffs, and the risk of a greater Korean bilateral trade deficit with Japan.

A major challenge for a CJK FTA is whether the three parties can seriously negotiate with each other given the concerns noted above and recent political conflict among the three countries. The three economies can negotiate mutually agreeable FTAs if they could provide a strong foundation for a possible RCEP. This would require substantial political commitments from the governments of all three economies.

8.4.4 TPP

The US has advocated strengthening economic ties among APEC members through the formation of an APEC-wide free trade area (that is, the FTAAP). The FTAAP would increase two-way trade of partner economies in a significant manner. Some argue that it could also serve as a useful step in reinvigorating the Doha Round trade talks or offer an alternative ‘Plan B’ solution should the Doha Round trade talks fail (Bergsten 2007; Hufbauer and Schott 2009). Creation of the FTAAP would likely take many years and assuredly involve multiple studies, evaluations, and negotiations among all 21 member economies. Given the large number of APEC members, a smaller group might more successfully initiate the process.31

The TPP is often viewed as a key element in a strategic US pivot to Asia. Participation in the TPP is projected to add billions to the US economy and solidify US military and political links with the Asia-Pacific economies for future decades (Gordon 2012). Given its substantial potential benefits, the TPP would appear to have a better chance of overcoming US domestic opposition (from trade unions and the US automotive industry) to trade liberalization than would the Doha Round trade talks or new bilateral FTAs.

The goal of an expanded TPP would be to achieve a comprehensive 21st-century FTA covering not only tariff reductions and services-trade liberalization but also a large number of WTO-plus issues such as investment, competition, environmental and labor standards, intellectual property, public procurement, sanitary and phytosanitary measures, and technical barriers to trade.

Regarding market access, in principle all tariffs are eliminated.
Non-tariff barriers to trade will be substantially reduced and behind-the-border regulatory reforms would be pursued to guarantee domestic markets are open and transparent. The TPP’s broad framework was unveiled at the APEC summit in Hawaii in November 2011. As of March 2014, 12 APEC members – Australia, Brunei Darussalam, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, the US, and Viet Nam – are in the middle of negotiations.

The TPP has the potential to include many other economies under the agreement’s accession clause. Thus, the TPP could help expand and strengthen economic and strategic ties among select APEC members and could provide the foundation for a wider FTAAP.

8.4.5 FTAAP

The Asia-Pacific Economic Cooperation remains important for both Asia and the US because it is the only multilateral economic forum that bridges the two entities. The US provides the most open market for Asian products as well as a security umbrella for key Asian economies. The US has advocated forming an APEC-wide free trade area (FTAAP) and promoted this cause in APEC forums.

The 2010 APEC Leaders’ Summit in Yokohama ended with a promise of further steps toward forming an APEC-wide free trade area. That summit also suggested that such a comprehensive FTAAP should be pursued by building on ongoing regional initiatives – notably ASEAN+6 and the TPP.

The US has also pursued bilateral FTAs with some Asian economies and has concluded bilateral FTAs with such economies as Australia, Singapore, and the Republic of Korea. However, despite serious attempts, the US has not been able to reach agreements with other economies such as Malaysia and Thailand. Questions remain as to whether the US is able to agree to an FTA with the whole of Asia – one that includes the PRC – given the current US domestic political environment.

There are presently two alternative paths under consideration for creating the FTAAP: using an expanded TPP and using a prospective RCEP.32 A number of impediments exist in pursuing either the TPP or the RCEP alternative.

The TPP faces the following issues. While APEC is a voluntary, non-binding organization, forming FTAs requires binding commitments to trade and investment liberalization from the participating economies. Unless the mandate of APEC is to change, this would indicate that an expanded TPP would need to be pursued outside of the formal APEC process.33 Also the TPP alternative would reduce the importance of
ASEAN centrality to Asian integration, given that not all ASEAN economies are APEC members. Currently, Brunei Darussalam, Malaysia, Singapore, and Viet Nam are the ASEAN members actively involved in negotiating the TPP. It appears unlikely that all other ASEAN economies participating in APEC – particularly Indonesia – would be able to join the TPP within a reasonable time frame as the TPP aims for high-standard and comprehensive liberalization measures. The extent of this problem would, of course, depend on the conclusions of TPP12, that is, the 12 negotiating countries. Further, any TPP, while strongly trans-regional, would likely exclude the PRC – the most dynamic economy in the region – and thus will fail to generate a fully inclusive FTAAP. Finally, India is not an APEC member and would, therefore, require significant additional time to participate in any TPP.34

While an RCEP clearly recognizes the importance of ASEAN centrality, it also faces significant issues. An RCEP is unlikely to adopt high-standard and comprehensive liberalization measures because participants include large developing economies – such as the PRC, India, and Indonesia – not yet ready to accept significant investment and trade liberalization as well as open transparent rules and regulations. Also, by excluding the US – still the most important economy in the Asia and Pacific region from both economic and security perspectives – an RCEP cannot become a full-fledged regional agreement directly leading to the formation of an FTAAP.

These issues suggest that both alternatives – TPP and RCEP – must, at some point, converge to form an effective FTAAP. If the US were to successfully conclude an FTA with ASEAN as an ASEAN+1 partner,35 the convergence process could well be substantially accelerated. But more importantly, convergence requires the PRC to be ready to accept high-level liberalization of, and transparent rules over, trade and investment. It will also require the US to accept the PRC as a responsible trade and investment partner.

8.4.6 Links with Europe

In recent years economic ties between Asia and the EU have rapidly expanded. Two-way trade has doubled over the last 5 years and the EU economies are among the most significant foreign investors in Asia. When compared, however, to APEC’s efforts in investment and trade facilitation and liberalization, the ASEM has been much less active addressing trans-regional trade and investment liberalization. Only since 2007 has the EU initiated negotiations on trade agreements with Asia. The EU and the Republic of Korea implemented the EU’s first Asian FTA in July 2011.
The EU has also been negotiating FTAs with ASEAN and India and launched EPA negotiations with Japan in April 2013.

The Republic of Korea–EU FTA is one of the most comprehensive and high-level agreements ever negotiated with an Asian economy, going much further than WTO commitments and eliminating 97 percent of all tariff barriers within three years. Initially the EU attempted to generate a single FTA with ASEAN but later changed its strategy to negotiating separate FTAs with individual ASEAN members. This shift in approach reflected the economic diversity and heterogeneity among ASEAN economies.

EU–India FTA negotiations are slowing in the face of a number of challenges: the EU wants India to liberalize investment, public procurement, and services-trade policies while India wants the EU to relax its stringent food-safety criteria and immigration policy with regard to Indian professionals.

After lengthy consultations regarding Japan’s non-tariff barriers to investment and trade, the EU and Japan began official FTA negotiations. The EU focuses on public procurement, standards and regulations, and tariff elimination on certain dairy products and others. Japan wants to see elimination of tariffs on automobiles and other machinery products in the EU.

Though connecting Asia with the EU is a relatively recent effort, should the EU decide to negotiate an FTA with the PRC – building on its FTAs with the Republic of Korea and, possibly, ASEAN economies, India, and Japan – a solid foundation for FTAs linking Asia with Europe could be developed.

Unfortunately, given the Eurozone economic crisis, this process may take considerable time. The EU presently appears preoccupied with resolving multiple sovereign-debt and banking-sector crises and shoring up the euro rather than focusing on external trade policies. Nonetheless the EU has agreed to launch FTA negotiations with the US and is expected to substantially connect it with the growing Asian region.

8.4.7 A Likely Scenario: Sequencing of FTA Consolidation

Free trade agreement consolidation in Asia may proceed along the lines of an Asia-based RCEP and US-led TPP. The following consolidation sequence might be a likely scenario:

- the acceleration of an ASEAN Economic Community (AEC) to be created by 2015;
- the creation of a PRC–Japan–Republic of Korea FTA either directly through a PRC–Japan–Republic of Korea trilateral agreement or through bilateral agreements among the three economies;
the formation of an RCEP among the ASEAN+6 economies through mechanisms connecting the existing ASEAN+1 FTAs, a new PRC–Japan–Republic of Korea FTA, and other bilateral FTAs among the ‘plus six’ countries by allowing the harmonizing, cumulation, and simplifying of ROO;\textsuperscript{36}

- the formation of the TPP and expansion of its membership within the Asia and Pacific region;
- the convergence of an RCEP with the TPP to form an FTAAP; and
- the connection of an RCEP with the EU to form an FTAAE.

The dynamics of this ‘likely scenario’ would evolve over time with each step creating incentives and momentum for the next. The completion of an AEC is vital to FTA consolidation in Asia. This would strengthen the ability of ASEAN to serve as the region’s integration hub and maintain ASEAN centrality. Once the AEC is in place, ASEAN economic integration would be further promoted and ASEAN would become a more coherent entity. Building on this strength, an AEC would be expected to improve substantially in quality.

Transforming the AEC into a full customs union would likely be difficult as it would require all members agreeing to a common external tariff where members presently use quite different tariffs (Appendix Table 8A.1). Some economies (for example, Singapore) could be required to raise import tariffs while others (for example, Cambodia and Thailand) could be required to lower such barriers. Nonetheless, a full customs union is a desired direction for ASEAN after the completion of an AEC.

The creation of a CJK FTA is needed for the formation of RCEP because it would be otherwise impossible to formally integrate the ASEAN+6 economies. A political decision by the PRC, Japan, and the Republic of Korea to form a trilateral FTA or bilateral FTAs would be the required cornerstone agreement. ASEAN may play a key role in encouraging these three economies to agree to a CJK FTA. Once a PRC–Japan–Republic of Korea FTA (or bilateral FTAs among the three countries) is formed it could be connected with ASEAN+1 FTAs through coordinating various provisions and ROOs. The conclusion of an RCEP would also require, among other factors, a bilateral FTA between the PRC and India, which is a challenge.

Formation of an FTAAP (through convergence between an RCEP and the TPP) or an FTAAE may take time as many developing countries cannot liberalize their trade and investment regimes and behind-the-border measures within a short period of time. Step-by-step liberalization is a realistic approach for these economies and joining an RCEP would be the next step for them. After significant domestic structural reforms
are undertaken, some of these economies may be ready to join the TPP or form a future FTAAP.

Separate from the RCEP and TPP sequencing discussed above, it would be easier to eventually connect the whole of Asia with the EU (possibly through FTAAE) once the EU has concluded FTAs with several key Asian economies.

Such sequenced approaches are important and would potentially accelerate the process of Asia’s intra-regional economic integration as well as its trans-regional economic integration with North America and Europe.

8.5 CONCLUSION

This study has addressed trends, challenges, and prospects, associated with the spread of Asian FTAs. It has offered new evidence on the impacts of Asian FTAs through the analysis of such agreements, CGE results, certificate of origin data, and enterprise-level surveys as well as considered political-economy issues and various competing proposals.

The evidence demonstrates a shift in Asian trade policy occurring since 2000. With 77 concluded agreements, FTAs are assuming ever-greater importance as tools of Asian commercial policy. Singapore and the region’s three largest economies are identified as key to the growing Asian FTA activity while ASEAN, as an organization, is emerging as an integration hub for such efforts. Asian FTAs have maintained strong cross-regional orientations, their trade coverage has increased, and broader issues than simply trade liberalization – including competition, intellectual property, investment, labor standards and mobility, and public procurement – have been addressed.

Successful conclusion of comprehensive global trade talks would be an invaluable contribution to global, including Asian, prosperity. The small Bali package agreed in December 2013 is a useful step toward restoring the credibility of the WTO as a trade rule-making institution. However, the outcome of the current Doha Round trade talks remains uncertain and the eventual result may be a significantly limited agreement. Additional key actions for the WTO include enhancing surveillance of non-tariff measures to reduce protectionism and a WTO agenda on supply chains to encourage convergence of global and regional trading rules (see Baldwin et al. 2013).

With the large number of FTAs concluded, under negotiation, or proposed, Asian FTAs are here to stay. Maximizing the benefits of these Asian FTAs while minimizing their costs would be highly pragmatic. Given the observations of this study, key elements of pragmatic responses to Asian FTAs at the national and regional levels might include:
● increasing the use of FTAs through improved awareness and strengthened institutional support, particularly for SMEs, and creating a regional database on FTA use;
● addressing the Asian noodle bowl through greater rationalization of ROO and upgrading ROO administration to best-practice levels;
● encouraging greater coverage of agricultural products in Asian FTAs and supporting gradual increases in liberalizing agricultural-trade policies;
● facilitating gradual increases in liberalizing services-trade policies through emphasis on key GATS sectors;
● including WTO-plus provisions – particularly the four Singapore issues – in all future Asian FTAs; and
● facilitating the creation of a region-wide agreement in Asia – particularly RCEP – with appropriate sub-sequencing and support for development gaps among members.

While the economic case for a region-wide agreement such as RCEP is clearly supported by CGE analysis, political-economy considerations will continue to heavily influence any outcome. With key ASEAN+1 FTAs currently in place, a realistic consolidation sequence of discrete steps within Asia would include strengthening ASEAN economic integration, generating a CJK FTA and a PRC–India FTA, and combining ASEAN+1 FTAs with a CJK FTA. These steps would be followed by forging an RCEP and then connecting RCEP with Europe and North America.

To connect Asia with Europe, a series of bilateral FTAs with the EU would be useful. To connect Asia with North America, TPP and a series of bilateral FTAs with the US would be similarly useful. This has already started by overlapping countries that negotiate both an RCEP and a TPP – Japan, Singapore, Brunei Darussalam, Malaysia, and Viet Nam – and this process can be accelerated if more Asian economies join TPP negotiations. The Republic of Korea has already concluded an FTA with the EU, and Japan and India have been negotiating FTAs with the EU. For this to be possible, every Asian economy must pursue domestic structural reform so that it can liberalize trade and investment regimes and reduce behind-the-border barriers.

Actual developments may well not be as orderly, neat, or rational as those described above. The reality could easily become substantially more complex. Once Asia succeeds in integrating itself and connecting with various parts of the world, it can concentrate on global trade and investment integration. Asia can encourage major economies in the rest of the world to connect with each other and with Asia. This study thus suggests
that a bottom–up approach to global trade and investment integration, complementing the existing top–down process, be adopted.

NOTES

1. For reviews of the theoretical and empirical literature on FTAs see Freund and Ornelas (2010), WTO (2011), and Baldwin (2012). Discussions on Asian FTAs can be found in Chia (2010, 2013), Baldwin and Kawai (2013), Kawai and Wignaraja (2013), and Wignaraja (2013b).
2. For the purposes of this paper, the term ‘Asia’ is narrowly used to describe 16 economies in East Asia and India, while the term ‘developing Asia’ excludes Japan. More specifically, ‘Asia’ includes: the ten ASEAN member states (Brunei Darussalam, Cambodia, Indonesia, Lao People’s Democratic Republic, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Viet Nam); the Asian newly industrialized economies (NIEs) other than Singapore (that is, Hong Kong, China; Republic of Korea; and Taipei, China); PRC; Japan; and India.
3. The members are Bangladesh, PRC, India, Republic of Korea, Lao PDR, Sri Lanka, Nepal, and the Philippines.
6. Brunei Darussalam, Chile, India, Indonesia, Malaysia, Mexico, Philippines, Singapore, Thailand, Switzerland, and Viet Nam.
7. On this point, see Fiorentino et al. (2009).
8. We are grateful to Richard Baldwin for this suggestion.
9. In Singapore’s case, the high ratio reflects a proactive strategy of concluding a large number of bilateral and ASEAN FTAs. In Brunei Darussalam, the Lao PDR, and Myanmar, this ratio may suggest high commodity dependence and market concentration in a limited export base.
10. Intra-EU trade is included in this figure.
12. In essence, experienced teams of researchers used a common questionnaire and random sampling methods to collect the firm-level data. The firm surveys of each country contained a mix of firms of different ownership (foreign and local) and size classes (large firms and SMEs), which were broadly representative of national industrial structures. The firms were drawn from the region’s largest industries (such as electronics, automotives, textiles, and garments) as well as an industry of national importance in each country (such as metals and machinery in Republic of Korea and food in the Philippines).
13. Others suggest that the depiction of Asian FTAs as a complicated noodle bowl is misleading. On the contrary, it has been argued that Asian FTAs may be creating an order of a different sort by building the foundation for a stronger regional trading system (Petri 2008; Chia 2010).
14. Harmonized ROOs means the same ROO is applied across FTAs. Co-equal ROOs means alternative ROOs for the same product are available in an FTA and firms are free to choose between them. Cumulation allows the use of non-domestic inputs from a specific country or group of countries (with such inputs taken as originating in the FTA partner country claiming origin) as determining the product’s origin. See Kawai and Wignaraja (2011b).
15. The data excludes FTAs involving Pakistan–Indonesia and Viet Nam–Chile for which texts were not available.
16. However, rice (a key sensitive sector) was excluded from the KORUS agreement.
17. Lao PDR excludes 5 items, Viet Nam 7, Malaysia 16, Philippines 17, Indonesia 24, and Cambodia and Myanmar 36 each. In contrast, Brunei Darussalam and Singapore eliminated tariffs on all agricultural products.
18. Positive and negative list approaches facilitate the identification of products/services for inclusion in FTAs and the extent of their coverage. A negative list approach liberalizes all sectors/products (in a phased manner), unless otherwise specified. A positive list approach is the stipulation of a specific number of products/sectors for preferential treatment with details of the extent of liberalization given to each item.
19. Future research can extend Fink and Molinuevo (2008)’s more detailed review of key architectural choices in East Asian FTAs with a services component (for example, scheduling commitments, treatment of investment, movement of natural persons, and dispute settlement) to analyzing the 69 Asian FTAs.
20. Namely, cross-border trade in services (Mode 1), consumption abroad (Mode 2), commercial presence (Mode 3), and temporary movement of natural persons (Mode 4).
21. Six FTAs involved Singapore, which typically covers the five key services in its FTAs. A similar approach was followed in the Taipei-China–Panama FTA, the Japan–Mexico FTA, and the Thailand–Australia FTA. The ASEAN Framework Agreement on Services was signed in 1995/96 and the protocol to amend AFAS was launched in 2003. Thereafter, several rounds of negotiations have aimed at deepening AFAS.
22. An early review of 11 Asian agreements concluded that ‘modern FTAs in Asia, some of which are the most sophisticated in the world, have tended to be more comprehensive in terms of coverage and of the building block rather than the stumbling block type, though there are some (minor) exceptions in terms of certain components’ (Plummer 2007, p. 1795). The study suggested a set of best practices to guide future FTAs.
23. The members are Brunei Darussalam, Chile, New Zealand, and Singapore.
24. ECOTECH is the APEC schedule of programs designed to build capacity and skills in APEC member economies to enable them to participate more fully in the regional economy and the liberalization process. See http://www.apec.org for more information (accessed 7 January 2014).
25. See Gilbert et al. (2004), Bchir and Fouquin (2006), Plummer and Wignaraja (2006), and Kawai and Zhai (2010). Computable general equilibrium models have the advantage of being based on consistent structural equations that describe economic activity in each economy.
26. More recent work by Petri et al. (2011) provides CGE estimates for an Asian track scenario (EAFTA) and a TPP scenario leading to FTAAP. Cheong and Tongzon (2013) provide CGE estimates for a TPP scenario and an RCEP scenario.
27. Our overall findings broadly echo those of Lee et al. (2009), whose sophisticated CGE exercise incorporates tariff reduction, trade cost reduction, and endogenously determined productivity levels. These authors also suggested that the CEPEA scenario (US$201 billion) yields larger gains than the EAFTA scenario (US$177 billion), and that insiders gain while losses to outsiders are negligible.
28. As Lee et al. (2009) observed, a worthwhile but difficult extension of CGE models on region-wide Asian FTAs would be to endogenize FDI flows involving Asian countries. Consistent data on bilateral FDI flows in Asia, however, are lacking.
29. Although the initial negotiation members of an RCEP have not been made explicit, they are generally understood to be ASEAN+6 countries, including the ten ASEAN member states plus Australia, PRC, India, Japan, New Zealand, and Republic of Korea.
30. Interestingly, farmers in the Republic of Korea do not seem overly threatened by the Republic of Korea–US FTA but express concerns over agriculture with regard to a Republic of Korea–PRC FTA.
31. A recently emerging smaller FTA, the TPP, is attracting a growing number of economies sympathetic to its goal of high-standard liberalization (Markheim 2008). The TPP, previously known as the Pacific Three Closer Economic Partnership (P3-CEP), among
Chile, New Zealand, and Singapore, launched its first negotiations at the 2002 APEC Leaders’ Summit. In April 2005, Brunei Darussalam joined, and the original agreement was signed by the four countries in June 2005 and came into force in May 2006. Then the trade bloc became known as the Pacific-4. The agreement eliminated 90 percent of all tariffs among member economies upon entry into force and will completely eliminate all trade tariffs by 2015. In September 2008 the US announced its intent to begin comprehensive negotiations with the P4 economies to join the agreement. Negotiations to expand P4 membership began in March 2010 with Australia, Peru, the US, and Viet Nam. With the subsequent addition of four more economies (Malaysia, Mexico, Canada, and Japan), 12 parties are in the TPP talks.

Petri et al.’s (2011) CGE model includes the possibilities for increasing varieties of goods and service’s and for shifting resources among firms with heterogeneous productivity within each sector. They report welfare gains for the TPP track of US$104 billion, US$303 billion for both the Asian and TPP tracks and US$862 billion with FTAAP. The dynamic CGE model estimates in Cheong and Tongzon (2013) suggest a weak economic impact of TPP because many TPP members have FTAs which are being implemented. Accordingly, Cheong and Tongzon argue that early TPP studies may have overstated its economic impact.

Changing APEC’s mandate into a prospective FTA organization would, however, likely encounter strong opposition from the PRC and a few other middle-income ASEAN economies.

TPP lacks clarity concerning the extent of expansion of its membership but there is a presumption that it is open to APEC members willing to accept the TPP-negotiated text and ready to undertake its ambitious liberalization goals.

The US signed ASEAN’s Treaty of Amity and Cooperation in July 2009. This was a significant political step in strengthening this bilateral relationship. This provides a strong foundation for the US becoming a legitimate ASEAN+1 partner.

A significant challenge is whether India can complete FTAs individually with all the ‘plus’ economies.

For recent restatements of this case, see Hoekman et al. (2009), Bhagwati and Sutherland (2011), and WTO (2011).

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Wignaraja, G. (2010), ‘Are ASEAN FTAs used for exporting?’, in P. Gugler and J. Chaisse (eds), *Competitiveness of the ASEAN Countries: Corporate and


### Table 8A.1 Per capita income and trade policy in Asia

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<th>GDP per capita (current international dollars)</th>
<th>Share of world GDP, PPP (%)</th>
<th>Simple mean, MFN tariff rate (%)&lt;sup&gt;a&lt;/sup&gt;</th>
<th>Concluded FTAs (no. of FTAs)</th>
<th>Trade coverage of FTAs (% of total trade)</th>
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<th>Country</th>
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Sources: World Bank, World Development Indicators; ADB, Asia Regional Integration Center; IMF, Direction of Trade Statistics; IMF, World Economic Outlook Database; US Trade Representative (http://www.ustr.gov); EU Trade (http://ec.europa.eu).
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A. GOODS
- Tariff Elimination
- ROOs
- Trade Remedies–Anti-Dumping
- Trade Remedies–Subsidies and Countervailing
- Trade Remedies–Bilateral Safeguards
- Agriculture
- Textiles and Apparel
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Quarantine and SPS Measures
Other Non-Tariff Measures
Technical Barriers to Trade Standards and Conformance, MRAs
Customs Administration and Procedures
B. SERVICES
Telecommunications
Financial Services
Professional Services
Labor Mobility/
Entry of Business Persons

C. SINGAPORE ISSUES
Trade Facilitation
(Paperless Trading/ Transit)
Investment
Government Procurement
Competition Policy

D. COOPERATION ENHANCEMENT
Intellectual Property
ICT and E-Commerce
Labor Standards/
Movement of Natural Persons
Environment
ECOTECH
Capacity Building
Information Exchange
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<td></td>
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</tr>
<tr>
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<td>Rep. of Korea–Chile FTA (2006)</td>
<td></td>
</tr>
<tr>
<td>SINGAPORE</td>
<td>ASEAN–Japen EPA (2007)</td>
<td></td>
</tr>
<tr>
<td>JAPAN</td>
<td>India–Japan EPA (2011)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>ASEAN–Japan CEPA (2008)</td>
<td></td>
</tr>
<tr>
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<td>Japan–Mexico EPA (2005)</td>
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<td>India–Rep. of Korea FTA (2010)</td>
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<td>South Asia FTA (2006)</td>
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<td>India–Micron FTA (2004)</td>
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<td>PRC–Pakistan FTA (2007)</td>
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<td></td>
<td>ASEAN–PRC CECA (2005)</td>
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</tr>
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<td>ASEAN FTA (1992)</td>
<td></td>
</tr>
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<td>REPUBLIC OF</td>
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</tr>
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<td></td>
</tr>
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<td>OF</td>
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<tr>
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<td>India–Japan EPA (2011)</td>
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<td></td>
<td>Japan–Philippines EPA (2008)</td>
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Table 8.4.2 (continued)
<table>
<thead>
<tr>
<th>Dispute Settlement</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>% of goods and services provisions covered (A+B)</td>
<td>44 81 56 63 94 38 31 63 50 94 75 56 88 69 69 69 56 75 81 88 100 63 81 56 75</td>
</tr>
<tr>
<td>% of WTO-plus provisions covered (C+D)</td>
<td>5 5 37 11 42 20 5 5 5 90 53 47 32 58 58 85 5 26 63 85 58 37 26 47 47</td>
</tr>
</tbody>
</table>

**Note:** ADB = Asian Development Bank; ASEAN = Association of Southeast Asian Nations; CECA = Comprehensive Economic Cooperation Agreement; CEP = comprehensive economic partnership; CEPA = comprehensive economic partnership agreement; ECOTECH = economic and technical cooperation; EFTA = European Free Trade Area; EPA = economic partnership agreement; FTA = free trade agreement; ICT = information and communications technology; Mercosur = Common Market of the South; MRA = mutual recognition agreement; PRC = People's Republic of China; ROOs = rules of origin; SME = small and medium-sized enterprise; SPS = sanitary and phytosanitary standards; US = United States; WTO = World Trade Organization.

**Source:** FTA legal texts available at ADB’s Asia Regional Integration Center (ARIC) FTA Database (www.aric.adb.org). Data as at 3 April 2012.
<table>
<thead>
<tr>
<th>Sector</th>
<th>Thailand</th>
<th>Viet Nam</th>
<th>Rep. of Korea</th>
<th>Malaysia</th>
<th>Singapore</th>
<th>Philippines</th>
<th>Indonesia</th>
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<tbody>
<tr>
<td>Agriculture &amp; food</td>
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<td>0.7</td>
<td>0.6</td>
<td>0.3</td>
<td>0.5</td>
<td>0.4</td>
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<td>Manufactures</td>
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<td>49.9</td>
<td>5.5</td>
<td>5.7</td>
<td>1.5</td>
<td>10.6</td>
<td>2.4</td>
</tr>
<tr>
<td>Textiles &amp; clothing</td>
<td>3.2</td>
<td>63.1</td>
<td>26.3</td>
<td>2.6</td>
<td>−14.3</td>
<td>12.4</td>
<td>1.9</td>
</tr>
<tr>
<td>Metals</td>
<td>22.0</td>
<td>12.1</td>
<td>11.8</td>
<td>24.4</td>
<td>16.7</td>
<td>−2.3</td>
<td>−1.2</td>
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<tr>
<td>Electrical machinery</td>
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<td>11.5</td>
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<td>1.2</td>
<td>2.0</td>
<td>7.1</td>
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<tr>
<td>Motor vehicles</td>
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<td>−28.4</td>
<td>−18.2</td>
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<td>5.8</td>
<td>4.7</td>
<td>4.5</td>
<td>4.0</td>
<td>2.9</td>
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<table>
<thead>
<tr>
<th>Sector</th>
<th>India</th>
<th>Japan</th>
<th>PRC</th>
<th>Cambodia</th>
<th>Other ASEAN</th>
<th>Hong Kong, China</th>
<th>Taipei, China</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture &amp; food</td>
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<td>−4.1</td>
<td>0.9</td>
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<td>0.7</td>
</tr>
<tr>
<td>Other primary</td>
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<td>0.2</td>
<td>0.1</td>
<td>0.3</td>
<td>0.4</td>
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<td>−2.4</td>
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<td>Textiles &amp; clothing</td>
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<td>5.8</td>
<td>2.7</td>
<td>−2.1</td>
<td>−3.5</td>
<td>−13.1</td>
<td>−17.5</td>
</tr>
<tr>
<td>Metals</td>
<td>15.6</td>
<td>6.5</td>
<td>−1.4</td>
<td>69.4</td>
<td>−8</td>
<td>−6.1</td>
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</tr>
<tr>
<td>Electrical machinery</td>
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<td>−8.8</td>
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<td>−17.4</td>
<td>5.5</td>
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<td>−4.5</td>
</tr>
<tr>
<td>Motor vehicles</td>
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<td>−5.6</td>
<td>−7.7</td>
<td>−2.1</td>
<td>1.8</td>
<td>0</td>
</tr>
<tr>
<td>Services</td>
<td>4.2</td>
<td>1.1</td>
<td>2.4</td>
<td>3.1</td>
<td>0.2</td>
<td>0.2</td>
<td>−1.6</td>
</tr>
</tbody>
</table>

*Note:* CEPEA = Comprehensive Economic Partnership for East Asia.

*Source:* Estimates based on the CGE model used in Francois and Wignaraja (2008).
9. Constructing and multilateralizing the Regional Comprehensive Economic Partnership: an Asian perspective
Shujiro Urata

9.1 INTRODUCTION

Asia began to witness the emergence of free trade agreements (FTAs) in the 21st century. Asia was a latecomer in the FTA race that started in the early 1990s in the rest of the world. The number of bilateral and plurilateral FTAs increased sharply and rapidly, giving rise to a concern over the emergence of a complicated trade system, or the spaghetti or noodle bowl effect, which could reduce trade by raising trade cost. Recognition of such concern by Asian countries has resulted in the discussions of establishing a region-wide FTA. Two major frameworks were proposed, one consisting of the member countries of ASEAN, the PRC, Japan, and the Republic of Korea (ASEAN+3), and the other consisting of ASEAN+3, plus India, Australia, and New Zealand (ASEAN+6). After several years of discussions on the desirability and feasibility of these two frameworks, East Asian countries led by the ASEAN member countries have decided to establish a region-wide FTA with the ASEAN+6 countries under the name of the Regional Comprehensive Economic Partnership (RCEP). The ASEAN+6 countries began the RCEP negotiations in May 2013.

Free trade agreements have been theoretically shown to be second best in terms of global welfare, while the first best is global or multilateral trade liberalization. Recognizing this point, policy makers and researchers are keen to investigate whether the recent expansion of FTAs and the rise of regionalism in terms of trade policy would lead to a free multilateral trade system. In other words, the issue is whether regionalism in the form of FTAs is a building block for multilateralism or whether it is a stumbling block.

In light of these discussions and the recent FTA developments in
East Asia, this chapter examines multilateralization of FTAs from an Asian perspective. To achieve this objective, the chapter takes a two-step approach. First, the chapter analyzes the feasibility of constructing a region-wide FTA, or RCEP, and then examines the way to multilateralize the RCEP. Section 9.2 reviews FTA developments in East Asia and section 9.3 discusses the characteristics and motives of FTAs in East Asia. Section 9.4 analyzes the five ASEAN+1 FTAs, that is ASEAN’s FTAs each with the PRC, Japan, the Republic of Korea, India, and Australia/New Zealand, which are considered as a base for a region-wide FTA. Section 9.5 examines the feasibility of the RCEP by consolidating the ASEAN+1 FTAs. Section 9.6 discusses the possible ways to multilateralize the RCEP. Section 9.7 presents concluding remarks.

9.2 PROLIFERATION OF FREE TRADE AGREEMENTS IN EAST ASIA

East Asia was not active in the formation of regional trade agreements (RTAs) until the end of the 1990s (Table 9.1). Indeed, the ASEAN Free Trade Area established in 1992, was the only major FTA until the 21st century, when the number of FTAs started to increase rapidly. Many countries in East Asia began to form FTAs with countries not only in the region but also outside the region.

Faced with increasing competitive pressure from the PRC and with a growing regionalism trend in Europe and other parts of the world, the members of ASEAN began the AFTA process in 1992 to make ASEAN a competitive region for exports and an attractive region for foreign direct investment. The 1992 agreement provided for the liberalization of tariff measures under common effective preferential tariffs (CEPT). The target year for achieving tariff liberalization was originally set for 2008, but was later moved forward to 2002. The AFTA process was completed among the original six AFTA members – Brunei Darussalam, Indonesia, Malaysia, the Philippines, Singapore, and Thailand – in January 2002 when their tariff rates on intra-AFTA trade were reduced to 0–5 percent, though the exclusion list from tariff reduction and/or elimination was long and individual country circumstances varied. The AFTA process further proceeded and all the tariffs for intra-AFTA trade for the original members were removed with some exceptions by January 2010. New AFTA members Cambodia, Lao People’s Democratic Republic (Lao PDR), Myanmar, and Viet Nam have lowered tariff rates for their intra-ASEAN trade and are expected to complete tariff removal by 2015.
<table>
<thead>
<tr>
<th>Year</th>
<th>Proposed</th>
<th>Under negotiation</th>
<th>Negotiation</th>
<th>Signed</th>
<th>In Effect</th>
<th>Total</th>
<th>Types</th>
<th>Bilateral</th>
<th>Plurilateral</th>
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<td>0</td>
<td>12</td>
<td>19</td>
<td>32</td>
<td></td>
<td>28</td>
<td>4</td>
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<tr>
<td>2000</td>
<td>3</td>
<td>0</td>
<td>6</td>
<td>16</td>
<td>30</td>
<td>55</td>
<td></td>
<td>48</td>
<td>7</td>
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<td>56</td>
<td>169</td>
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<td>132</td>
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<tr>
<td>2010</td>
<td>57</td>
<td>17</td>
<td>47</td>
<td>23</td>
<td>97</td>
<td>241</td>
<td></td>
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<td>50</td>
<td>14</td>
<td>61</td>
<td>23</td>
<td>109</td>
<td>257</td>
<td></td>
<td>189</td>
<td>68</td>
</tr>
</tbody>
</table>

**Note:** Asia in this table refers to Asian Development Bank members; FTA = free trade agreement.

Compared to tariff liberalization, non-tariff barriers, including both border barriers such as import quotas and anti-dumping actions as well as behind-the-border measures such as technical, administrative, and safety regulations, are more difficult to deal with. In order to minimize trade costs arising from these regulations, ASEAN countries have attempted to either harmonize or mutually recognize standards and other regulations. Although some progress has been made in this area, substantial non-tariff barriers still remain.

ASEAN has pursued the liberalization of trade in services under the 1995 ASEAN Framework Agreement on Services. The agreement aims to go beyond commitments in the General Agreement on Trade in Services, in order to improve the efficiency and competitiveness of ASEAN service providers. Services trade liberalization has proceeded through several rounds of negotiations, but there still remain substantial barriers to services trade. Among the four modes of supply of services trade, (1) cross-border supply, (2) consumption abroad, (3) commercial presence, and (4) movement of natural persons, modes 3 and 4 are most sensitive. ASEAN adopted a flexible approach of ‘ASEAN minus X’ to accommodate ASEAN member countries that are unable to move at the same pace.

Foreign direct investment liberalization in ASEAN has been under way through the 1998 ASEAN Investment Area (AIA) and 2009 ASEAN Comprehensive Investment Area (ACIA) that provide coordinated investment cooperation and facilitation programs, market access, and national treatment of all industries. The AIA was criticized for its long exclusion lists, but there have been improvements. As with services liberalization, the ‘ASEAN minus X’ formula has been introduced in AIA. Under the ACIA, in addition to the AIA provisions, including investment liberalization and facilitation, investment protection that has provisions on the investor–state dispute settlement mechanisms, transfer and repatriation of capital and others was included.

In 2003 the ASEAN leaders agreed to set the target year of 2020 for the establishment of an ASEAN Community that is composed of the ASEAN Political-Security Community (APSC), the ASEAN Economic Community (AEC), and the ASEAN Socio-Cultural Community (ASCC). Under the AEC, free flow of goods, services, investment, and capital is to be established to make ASEAN a single market and production base. Specifically, the AEC includes trade (goods and services) liberalization and facilitation, FDI liberalization and facilitation, and economic cooperation. The target date for the establishment of an ASEAN Community was later moved forward to 2015. ASEAN countries introduced the AEC Blueprint in 2007 to achieve the AEC. The AEC Blueprint sets out the measures to be taken and the schedule for their implementation. In order
The Regional Comprehensive Economic Partnership

to monitor the progress by the ASEAN members for the AEC Blueprint, ASEAN ministers and officials adopted a ‘scorecard’ to assess the progress. According to the scorecard for 2008–09, 82 percent of the goals have been achieved for the objective of a single market and production base (Chia 2011).

Besides AFTA, ASEAN as a group as well as its members individually have become active in FTA discussions with other countries. ASEAN has enacted five ASEAN+1 FTAs (with the PRC, the Republic of Korea, Japan, India, and Australia/New Zealand), making ASEAN an FTA hub for East Asia. ASEAN and the PRC enacted an FTA (ACFTA) in goods trade in July 2005 and completed the liberalization process in January 2010. ASEAN and the PRC enacted an FTA in services trade in July 2007 and signed an ASEAN–PRC Investment Treaty in August 2009. ASEAN enacted an FTA in goods trade with the Republic of Korea (AKFTA) in January 2010 and an FTA in services in May 2009. ASEAN and the Republic of Korea signed an Investment Treaty in June 2009. ASEAN and Japan enacted an FTA (ASEAN–Japan Comprehensive Economic Partnership – AJCEP) in goods in December 2008. ASEAN enacted FTAs with India (AIFTA) and Australia/New Zealand (AANZFTA) in January 2010. The ASEAN–Australia/New Zealand FTA includes trade in services and investment, while the ASEAN–India FTA does not. ASEAN and India are discussing agreements on trade in services and investment.

All the ASEAN members have become active in establishing bilateral FTAs. ASEAN members as a total have enacted 91 FTAs (Table 9.2). Among the ASEAN members, Singapore has the largest number of FTAs at 18. It is important to note that Singapore established an FTA called P4 (later changed to the Trans-Pacific Partnership (TPP)) with Brunei Darussalam, New Zealand, and Chile in 2006. Malaysia and Thailand have enacted as many as 12 FTAs each. Cambodia and Myanmar, which have the smallest number of FTAs among ASEAN members, have enacted six FTAs each.

Compared to the ASEAN countries in Southeast Asia, the economies in Northeast Asia including the PRC, Japan, the Republic of Korea, and Taipei, China had not been active in establishing FTAs until the end of the 1990s. The PRC, Japan, and the Republic of Korea have since become very active in establishing FTAs. Among them Japan has the largest number of FTAs at 13, while the PRC has enacted 12 FTAs. The Republic of Korea, which has enacted FTAs with large trading partners including the EU and the US, has nine FTAs. Taipei, China is very keen on having FTAs with many countries but political problems with the PRC have precluded them from achieving this objective. However, the situation is likely
Table 9.2  Free trade agreements for selected Asian economies (as at January 2013)

<table>
<thead>
<tr>
<th>Economy</th>
<th>Proposed Under negotiation</th>
<th>Conclusion</th>
<th>Total</th>
</tr>
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<td>B</td>
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<td>Sri Lanka</td>
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</tr>
</tbody>
</table>

**Note:** A = Framework Agreement; B = FTA; FTA = free trade agreement.

to change as Taipei, China enacted an FTA with the PRC in 2010. In addition to the PRC, Taipei, China has enacted four FTAs with small countries in Central America including Nicaragua and El Salvador.

India has enacted 13 FTAs, including the South Asian Free Trade Agreement (SAFTA), whose membership includes Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka. It is currently negotiating a number of FTAs including with the Bay of Bengal Initiative for Multisectoral Technical and Economic Cooperation (BIMSTEC)\(^6\) and the EU.

As a result of the increasing number of FTAs in Asia, the share of trade that is covered by FTAs in overall trade (FTA coverage ratio) has increased for Asian countries. Among the Asian countries, ASEAN registers the highest FTA coverage ratio amounting to 60.0 percent in 2011 (JETRO 2012). The FTA coverage ratios for the PRC (16.2 percent), Japan (18.6 percent), and the Republic of Korea (34.0 percent) are significantly lower compared to those for ASEAN countries.\(^7\) These values indicate that there is room for further FTA expansion for Asian countries, especially for those in Northeast Asia. The FTA coverage ratio for ASEAN+6 countries would become 44.8 percent if an FTA covering the ASEAN+6 countries is established.\(^8\)

Unlike Europe or the US, both of which have established region-wide FTAs, East Asia so far has established a number of bilateral and minilateral FTAs and not a region-wide FTA. Recognizing the economic benefits of region-wide FTAs such as a large unified market, several ideas have been floated for establishing region-wide FTAs. However, due to differences in opinion among East Asian economies about region-wide FTAs, it took a number of years before reaching a decision in 2012 to establish an FTA covering ASEAN member countries, the PRC, Japan, Republic of Korea, India, Australia, and New Zealand, or the ASEAN+6 countries, under the framework of the RCEP.

Regional economic cooperation in East Asia began to intensify in order to deal with the currency crisis in 1997, as the first leaders’ summit meeting of ASEAN+3 was held to discuss the serious situation and ways to overcome the problems. At the leaders’ summit meeting in 1998 the leaders decided to set up the East Asia Vision Group, at a proposal of the Republic of Korea’s President Kim Dae-Jung, to study a long-term vision for economic cooperation. The group presented the leaders with recommendations including the establishment of an East Asia free trade area (EAFTA), consisting of the ASEAN+3 countries. An expert group, that was set up at the recommendation of the ASEAN+3 economic ministers, presented recommendations to the economic ministers in 2006 to start the process in 2007 toward the establishment of an East Asia FTA. The recommendations by the expert group were not adopted and the expert group
A World Trade Organization for the 21st century was asked to conduct further study. The expert group undertook phase two of the project and recommended to start the process toward the establishment of an EAFTA in 2009. Responding to those recommendations, the leaders ordered the government officials to set up four working groups (Rules of Origin (ROOs), tariff nomenclature, customs procedure, and economic cooperation) as steps toward achieving an EAFTA (EAFTA 2009).

At the 2006 ASEAN+6 economic ministers’ meeting, Japan proposed the Comprehensive Economic Partnership in East Asia (CEPEA), which is an agreement including an FTA covering the ASEAN+6. The ASEAN+6 members are also the members of the East Asian Summit that began in 2005. It has been argued that behind the CEPEA idea lies Japan’s strategy of taking a leadership role in setting up a regional institution in East Asia, as it was the PRC that took the initiative in the EAFTA discussions. A similar course of events to those for EAFTA evolved for CEPEA. As was the case for EAFTA, government officials were engaged in the discussions under the four working groups.

After the EAFTA and CEPEA working groups completed reports on the four issue areas, the PRC and Japan jointly proposed to set up three working groups (trade in goods and services and investment) in August 2011. Behind this surprising joint action by the PRC and Japan, who competed to take leadership in the establishment of region-wide FTAs under EAFTA and CEPEA, was their interest in speeding up the process of regional economic integration in East Asia. This motivation was particularly strong for the PRC, as it observed the increasing influence of the US in the formation of a regional economic framework in the Asia–Pacific region under the TPP. Faced with the threat of losing ASEAN centrality, or the driver’s seat, in East Asian regional integration, ASEAN proposed the RCEP involving ASEAN and its FTA partners in November 2011. To follow up the move on the RCEP, ASEAN announced the guiding principles for the negotiation of the RCEP that include WTO consistency, transparency, and open accession to ASEAN’s FTA partners and others. The ASEAN+6 leaders agreed to launch the negotiation of RCEP in November 2012 to begin in 2013 (ASEAN Secretariat 2012).

The PRC, Japan, and the Republic of Korea began a joint study on their FTA involving government officials, academics, and business persons in 2010. A feasibility study of a tripartite FTA by the private sector involving government-related research institutes began in 2003. The study continued by changing the focus of research topics over time. The joint study completed the discussions in December 2011 and released its report in March 2012. Responding to the recommendation of the joint study that proposed
to begin the negotiations, economic ministers of the three countries agreed to launch negotiations in 2013.

Since these three Northeast Asian countries account for a dominant share of GDP in East Asia, the successful establishment of the RCEP crucially depends on the establishment of a CJK FTA. In addition to economic issues such as increased competition, non-economic issues including historical and social problems have made it difficult to discuss tripartite cooperation such as a CJK FTA. Although non-economic relations involving Japan on the one hand, and the PRC and the Republic of Korea on the other hand improved, resulting in positive discussions on the formation of a CJK FTA, the situation changed dramatically and negatively after the territorial dispute between the PRC and Japan in September 2012. Under these unstable political relations the prospects of the negotiations are not clear.

One FTA that has attracted attention recently is the TPP. Brunei Darussalam, Chile, New Zealand, and Singapore originally established the TPP in 2006 under the name of Pacific 4 (P4). The TPP started to draw attention when the US along with Australia, Peru, and Viet Nam joined negotiations in March 2010 on the expanded TPP. Since then, Malaysia, Canada, and Mexico have also joined the negotiations. The TPP, the ASEAN+3, and the ASEAN+6 FTAs (ASEAN+3 and ASEAN+6 FTAs are considered to have been merged into the RCEP) were recognized by APEC leaders in their summit in 2010, as pathways toward a Free Trade Area of the Asia-Pacific (FTAAP), covering 21 APEC member economies. It was the US that proposed an FTAAP in 2006. Behind the US proposal of an FTAAP is a concern that the US would be excluded from East Asia resulting in a decline in its economic activities in East Asia. It should be noted that differences in the members of the RCEP and APEC give rise to important implications of the groups. Taipei, China and the Russian Federation, important economic players, are included in an FTAAP, while India, a member of RCEP, is excluded. Besides, Cambodia, Lao PDR, and Myanmar are ASEAN members and thus included in RCEP, but they are not included in APEC. Because of this, APEC and more significantly the TPP are regarded as frameworks that may weaken ASEAN cohesiveness. Another important characteristic of the TPP is its high liberalization requirement in that practically all the tariffs on intra-FTA members’ trade are to be removed within ten years. Furthermore, the TPP has comprehensive coverage including not only trade (goods and services) and investment liberalization and facilitation, but also competition policy, intellectual property rights, government procurement, labor, environment and others.

It is important to point out that the US does not seem interested in
promoting regional trade integration with ASEAN countries as a group. Unlike the PRC, Japan, the Republic of Korea, Australia/New Zealand, and India, which enacted FTAs with ASEAN, and the EU, which is negotiating an FTA with ASEAN, the US has not discussed the possibility of a US–ASEAN FTA. Instead, the US has enacted bilateral FTAs with Singapore and begun discussions with selected ASEAN countries within the framework of the TPP. This reflects the US view that the US is interested in a high-level FTA with comprehensive coverage. In the eyes of the US, some ASEAN countries are not ready to participate in such a high-level FTA. It should be noted that the TPP has had significant impacts on the formation of regional economic integration frameworks such as the RCEP and CJKFTA. The process of these frameworks has been sped up by the progress of the TPP negotiations. Indeed, there is the US and the PRC rivalry in establishing a regional economic integration framework. The US is eager to set up a high-level and comprehensive, or 21st-century type, FTA, while the PRC, being unable to join a high-level and comprehensive TPP, would like to establish a framework based on communal spirit with an emphasis on cooperation.

9.3  CHARACTERISTICS AND MOTIVES OF FREE TRADE AGREEMENTS IN EAST ASIA

One notable characteristic of FTAs in East Asia is their comprehensive coverage. As such, some of the FTAs established in East Asia are named as economic partnership agreements (for example, between Japan and Singapore) or closer economic partnership arrangements (for example, between the PRC and Hong Kong, China), and others. These new types of FTAs typically include facilitation of foreign trade, liberalization and facilitation of FDI, and economic and technical cooperation, in addition to trade liberalization, which is included in traditional FTAs. It is worth noting that the contents of these new types of FTAs are similar to those of the APEC forum, whose three pillars are trade and investment liberalization, trade and investment facilitation, and economic and technical cooperation.

The economic and technical cooperation pillar is given special attention in the FTAs established in Asia because narrowing the development gap between the high-income and low-income countries is important for achieving economic prosperity and social and political stability in the region. One of the programs in many FTAs in Asia is the promotion of SMEs, which would contribute to the construction of a competitive and resilient economic structure and also to the improvement of livelihood of
people. These objectives may be achieved because SMEs have important positions in many economies in terms of production and employment. It is important to note that the PRC and Japan (who are eager to play a leadership role in regional integration) have used economic assistance to gain support for FTAs from FTA partners. Having noted a common characteristic of comprehensiveness of FTAs in Asia, specific content differs among the FTAs, reflecting different motives of the countries concerned. Japan emphasizes the importance of liberalization and facilitation of investment and services trade, as such measures would provide a free, transparent, and stable business environment for Japanese firms that have invested heavily in production networks in Asia. In particular, Japan is interested in setting up a well-functioning intellectual property rights protection system. By contrast, developing countries such as ASEAN members and the PRC have a less strong interest in these measures. Indeed, ASEAN and the PRC have adopted a gradual and sequential approach by dealing with trade in goods and services and investment separately with different timing, as liberalization in trade in goods is followed by liberalization in services trade and investment. India is interested in the liberalization of services trade such as information technology (IT) software, legal, financial, and medical services, while it is less keen on opening up goods trade.

Let us turn to the discussions on the motives of East Asian countries behind their FTA strategies. Various common motives, despite the differences in their importance among the countries, can be identified. First, rapid expansion of FTAs in other parts of the world has made Asian economies realize the importance of establishing FTAs to maintain and expand their export opportunities. Free trade agreements with this kind of market-seeking objective are largely of a defensive nature. An example is Japan’s FTA with Mexico. Japanese firms were in a disadvantageous position vis-à-vis US firms and EU firms in the Mexican market because the US and the EU had FTAs, under which their firms had duty-free access to Mexico. In order to overcome this disadvantage, Japanese firms put pressure on their government to negotiate an FTA with Mexico. It should be noted that a stalemate of the Doha Development Agenda negotiations under the auspices of the WTO turned the attention of the WTO members with an interest in trade liberalization to FTAs. The market-seeking motive has played a role in FTAs between and among Asian economies, as trade barriers are still substantial for many sectors in Asian economies.

Second, countries interested in promoting structural domestic reform to achieve economic growth use FTAs as external pressure on the opposition to structural reform, in order to implement domestic structural reform. The motive of promoting domestic reform was important for the Republic of Korea in pursuing an FTA with the US. Being sandwiched between the
PRC, a rapidly growing economic giant, and Japan, a highly competitive economic giant, the Republic of Korea needed to carry out structural reforms to maintain and improve competitiveness.

Third, rivalry among Asian economies over gaining a leadership role in the region has activated their FTA strategies. Both the PRC and Japan, which are competing to become a ‘leader’ in the region, are keen on using FTAs to strengthen their relationships with ASEAN, the Republic of Korea, and other countries. In November 2002, Japan proposed an economic partnership framework to ASEAN one day after the PRC agreed to start FTA negotiations with the ASEAN. It should also be noted that ASEAN, the Republic of Korea, and other countries consider FTAs as a means to maintain and increase their influence in Asia. ASEAN has been rigorously pursuing FTAs with major countries in order for them to take a ‘driver’s seat’ in regional integration in Asia, while the Republic of Korea is moving ahead of other countries such as Japan and the PRC to take a lead in the FTA race.

Fourth, countries with active outward foreign direct investment would like to use FTAs to improve the business environment in FDI recipient countries, so that multinational corporations (MNCs) can perform efficiently. This motive is sought by including FDI liberalization and facilitation in FTAs. As pointed out earlier, this is one of the most important motives for Japan as many Japanese MNCs have invested in East Asia. This motive is likely to be more important for other Asian countries in the future, as the number of countries in East Asia with active outward FDI is likely to rise.

So far, this chapter has discussed the motives behind bilateral and plurilateral FTAs. The discussion now turns to the motives behind region-wide FTAs such as EAFTA and CEPEA. Many countries in the region realize the importance of establishing a large region-wide, unified market to promote economic growth and reduce development gaps as firms can expect benefits from exploiting scale economies. Besides, economic and technical cooperation may be provided efficiently under one region-wide framework by consolidating separate programs provided by individual countries.

The crises contributed to the discussions on the promotion of region-wide FTAs. The financial crisis in East Asia in the late 1990s increased the awareness among East Asian countries of the need for regional cooperation such as a region-wide FTA to avoid another crisis and to promote regional economic growth. The immediate concern about financial problems resulted in regional cooperation in financial areas. Specifically in 2000, the ASEAN+3 countries set up bilateral currency swap arrangements to deal with the shortage in foreign exchange under the name of the
Chiang Mai Initiative (CMI). This was expanded to become a multilateral currency swap arrangement in 2009 under the CMI Multilateralization (CMIM). Furthermore, the ASEAN+3 countries are developing the Asian Bond Market to establish efficient and liquid bond markets in East Asia, with a view to better utilize East Asian savings for East Asian investments. It is also expected to contribute to the mitigation of currency and maturity mismatches in financing, which was one of the factors that led to the Asian financial crisis.

The 2008–09 global financial crisis also increased interest among East Asian countries to establish a region-wide FTA. Unlike the case of the Asian financial crisis for which financial links with the US and Europe were a problem, it was East Asia’s dependence on the US and Europe for its exports that caused a sharp decline in East Asia’s economic activities. The decline in import demand caused a decline in East Asia’s exports to the US and EU, triggering a downward spiral. In order to avoid such negative impacts caused by factors outside the region, East Asian countries started to argue for the need to increase intra-regional dependence by establishing a region-wide FTA.

9.4 COMPARISON AND EVALUATION OF ASEAN+1 FREE TRADE AGREEMENTS FROM THE GATT/WTO PERSPECTIVE

This section evaluates the quality of ASEAN+1 FTAs from the point of view of the GATT/WTO rules on regional trade agreements. Specifically, the chapter examines them regarding transparency and the level of liberalization in terms of trade in goods and services. In addition, ASEAN+1 FTAs concerning their ROOs in trade in goods and the contents of agreements on investment are compared.

An important element for providing a predictable and stable trading environment is to make trade rules as clear and public (‘transparent’) as possible. Without transparency, trade rules cannot be implemented or enforced appropriately, discouraging firms’ trading activities, thereby preventing economies from maximizing the benefits from trading opportunities. With this in mind, the Committee on Regional Trade Agreements introduced a new transparency mechanism on RTAs in December 2006 (WTO 2006). Under the new transparency mechanism the members of a newly established RTA are expected to notify the WTO as early as possible, in general no later than the member’s ratification of the RTA. To enhance transparency, the parties to an RTA shall make data available to the WTO secretariat as soon as possible, but normally within a period
of ten weeks (or 20 weeks in the case of RTAs involving only developing countries) after the date of notification of the agreement.

Five ASEAN+1 FTAs are evaluated on the basis of the transparency mechanism explained above, specifically, the notification date and the submission of the data. Table 9.3 provides the information concerning these two issues. As for the notification, all the FTAs did not meet the ‘requirement’ as the notification was conducted after the date of entry into force. The shortest lag was four months (ASEAN–ANZ FTA), while the longest lag was 13 months (ASEAN–Republic of Korea FTA in services). Concerning the submission of the data, only the ASEAN–PRC FTA in goods has submitted the data in the form of factual abstract. These observations indicate the need for improving transparency in the notification of FTAs in East Asia.

Let us turn to the level of trade liberalization for ASEAN+1 FTAs. According to GATT Article XXIV: 8, a free trade area shall be understood to mean a group of two or more customs territories, in which the duties and other restrictive regulations of commerce are eliminated on substantially all the trade between the constituent territories in products originating in such territories (WTO 1994). Although there is not yet any agreement on the definition of ‘substantially all the trade’ among the GATT/WTO members, it is important to evaluate the quality of FTAs in terms of trade liberalization. Table 9.4 shows trade liberalization rate,

### Table 9.3 Translucency in ASEAN+1 free trade agreements

<table>
<thead>
<tr>
<th>Free trade agreement</th>
<th>Date of notification</th>
<th>Date of entry into force</th>
<th>End of implementation period</th>
<th>Factual abstract</th>
</tr>
</thead>
<tbody>
<tr>
<td>ASEAN–PRC (G)</td>
<td>21 Sep 2005</td>
<td>1 Jan 2005</td>
<td>2020</td>
<td>Yes</td>
</tr>
<tr>
<td>(S) 26 Jun 2008</td>
<td>1 Jul 2007</td>
<td></td>
<td></td>
<td>No</td>
</tr>
<tr>
<td>ASEAN–Republic of Korea (G)</td>
<td>15 Jun 2010</td>
<td>1 Jan 2010</td>
<td>2024</td>
<td>No</td>
</tr>
<tr>
<td>(S) 15 Jun 2010</td>
<td>1 May 2009</td>
<td></td>
<td></td>
<td>No</td>
</tr>
<tr>
<td>ASEAN–Japan</td>
<td>23 Nov 2009</td>
<td>1 Dec 2008</td>
<td>2026</td>
<td>No</td>
</tr>
<tr>
<td>ASEAN–India</td>
<td>19 Aug 2010</td>
<td>1 Jan 2010</td>
<td>Not specified</td>
<td>No</td>
</tr>
<tr>
<td>ASEAN–ANZ</td>
<td>8 Apr 2010</td>
<td>1 Jan 2010</td>
<td>2025</td>
<td>No</td>
</tr>
</tbody>
</table>

**Note:** ANZ = Australia/New Zealand; ASEAN = Association of Southeast Asian Nations; G = goods; PRC = People’s Republic of China; S = services.

### Table 9.4 Tariff concessions in ASEAN+1 free trade agreements (percentage)

<table>
<thead>
<tr>
<th>Country</th>
<th>AANZFTA</th>
<th>ACFTA</th>
<th>AIFTA</th>
<th>AJCEP</th>
<th>AKFTA</th>
<th>Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brunei Darussalam</td>
<td>99.2</td>
<td>98.3</td>
<td>85.3</td>
<td>97.7</td>
<td>99.2</td>
<td>95.9</td>
</tr>
<tr>
<td>Cambodia</td>
<td>89.1</td>
<td>89.9</td>
<td>88.4</td>
<td>85.7</td>
<td>97.1</td>
<td>90.0</td>
</tr>
<tr>
<td>Indonesia</td>
<td>93.7</td>
<td>92.3</td>
<td>48.7</td>
<td>91.2</td>
<td>91.2</td>
<td>83.4</td>
</tr>
<tr>
<td>Lao People’s Democratic Rep.</td>
<td>91.9</td>
<td>97.6</td>
<td>80.1</td>
<td>86.9</td>
<td>90.0</td>
<td>89.3</td>
</tr>
<tr>
<td>Malaysia</td>
<td>97.4</td>
<td>93.4</td>
<td>79.8</td>
<td>94.1</td>
<td>95.5</td>
<td>92.0</td>
</tr>
<tr>
<td>Myanmar</td>
<td>88.1</td>
<td>94.5</td>
<td>76.6</td>
<td>85.2</td>
<td>92.2</td>
<td>87.3</td>
</tr>
<tr>
<td>Philippines</td>
<td>95.1</td>
<td>93.0</td>
<td>80.9</td>
<td>97.4</td>
<td>99.0</td>
<td>93.1</td>
</tr>
<tr>
<td>Singapore</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
<tr>
<td>Thailand</td>
<td>98.9</td>
<td>93.5</td>
<td>78.1</td>
<td>96.8</td>
<td>95.6</td>
<td>92.6</td>
</tr>
<tr>
<td>Viet Nam</td>
<td>94.8</td>
<td>NA</td>
<td>79.5</td>
<td>94.4</td>
<td>89.4</td>
<td>89.5</td>
</tr>
<tr>
<td>Australia</td>
<td>100.0</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>People’s Republic of China</td>
<td></td>
<td></td>
<td>94.1</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>India</td>
<td></td>
<td></td>
<td>78.8</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Japan</td>
<td></td>
<td></td>
<td></td>
<td>91.9</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Republic of Korea</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>90.5</td>
<td></td>
</tr>
<tr>
<td>New Zealand</td>
<td>100.0</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Average</td>
<td>95.7</td>
<td>94.7</td>
<td>79.6</td>
<td>92.8</td>
<td>94.5</td>
<td></td>
</tr>
</tbody>
</table>

**Notes:**
- AANZFTA = ASEAN–Australia/New Zealand FTA; ACFTA = ASEAN–PRC FTA; AIFTA = ASEAN–India FTA; AJCEP = ASEAN–Japan Comprehensive Economic Partnership; AKFTA = ASEAN–Republic of Korea FTA; FTA = free trade agreement.
- HS 2007 version, HS 6-digit base.
- Data for Viet Nam for the ASEAN–PRC FTA are missing.
- Data for Myanmar for the ASEAN–PRC FTA are missing for HS01–HS08.
- Figures indicate the proportion of tariff elimination in terms of tariff lines.

**Source:** Kuno (forthcoming).
defined as the proportion of tariff lines (number of products) subject to tariff elimination in total number of tariff lines for five ASEAN+1 FTAs. The last row of Table 9.4 shows the average trade liberalization rates for the five ASEAN+1 FTAs. The AANZFTA has the highest trade liberalization rate at 95.7 percent, while the AIFTA has the lowest rate at 79.6 percent. Indeed, the trade liberalization rate for AIFTA is exceptionally low compared to those for other ASEAN+1 FTAs, whose rates are greater than 90 percent.

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

It is interesting to note that many ASEAN countries have quite different trade liberalization commitments depending on their FTA partners. One noticeable pattern is very low trade liberalization rates committed in the AIFTA. In particular, Indonesia registers a very low trade liberalization rate of 48.7 percent in the AIFTA. The low trade liberalization rate adopted by ASEAN countries in the AIFTA is largely attributable to two factors. One is strong competition in a large number of products between India and many ASEAN countries. One such example is apparel products, which are major export items of India and many ASEAN countries. The other factor is the low trade liberalization rate committed by India. The level of trade liberalization is negotiated bilaterally in ASEAN+1 FTAs. As such, reciprocity becomes an important element in determining the level of trade liberalization. Because India’s level of trade liberalization is significantly lower compared to other ASEAN’s FTA partners, many ASEAN countries’ commitments in trade liberalization turn low in their agreements with India.
Another condition that GATT Article XXIV imposes on RTAs is the length of time for the implementation of the agreement. According to GATT Article XXIV: 5, an interim agreement necessary for the formation of a free-trade area shall include a plan and schedule for the formation of such a customs union or of such a free-trade area within a reasonable length of time (WTO 1994). Understanding on the interpretation of GATT Article XXIV in 1994 indicates that the reasonable length of time should exceed ten years only in exceptional cases. In cases where members believe that ten years would be insufficient they shall provide a full explanation to the Council for Trade in Goods of the need for a longer period.

Table 9.5 shows the schedule of tariff elimination for the five ASEAN+1 FTAs. For the ASEAN FTA partners, tariff elimination is scheduled to take place within ten years from the year of ratification. However, this is not the case for ASEAN countries. Cambodia, Lao PDR, Myanmar, and Viet Nam (CLMV), or the new ASEAN members, are given extra time for the implementation of the agreement. The maximum additional time of eight years, in total 18 years, is given for the completion of tariff elimination and/or reduction under the ASEAN–Japan CEP. The original AFTA members (Brunei Darussalam, Indonesia, Malaysia, the Philippines, Singapore, and Thailand), are also given additional time in the cases of the ASEAN–Australia/New Zealand FTA, ASEAN–PRC FTA, and ASEAN–Japan CEP. The findings about the length of the period for the completion of ASEAN+1 FTAs reveal that they are not consistent with the GATT/WTO rules.

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

Table 9.6 shows the ROOs adopted in the ASEAN+1 FTAs. The figure indicates the number of products subject to the ROO type shown in the left column. The table reveals a wide variety in the application of the types of ROOs among ASEAN+1 FTAs as well as within ASEAN+1 FTAs. Except for the ASEAN–PRC FTA and the ASEAN–India FTA, the basic rule is a co-equal rule: RVC(40) or a change in tariff heading (CTH). The co-equal rule is less restrictive compared to the single rule, because it gives the firm choices in the application of ROOs. Regional value content (40) requires a minimum 40 percent regional value content. Change in tariff heading is equivalent to CTC at the HS 4-digit level. CTSH is equivalent to CTC at the HS 6-digit level, making
<table>
<thead>
<tr>
<th>FTA</th>
<th>Year of enactment</th>
<th>ASEAN6 Elimination (Normal Track or SL)</th>
<th>Other Reduction (SL or HSL)</th>
<th>CLMV countries Elimination (Normal Track or SL)</th>
<th>Other reduction (SL or HSL)</th>
<th>FTA partners Elimination (Normal Track or SL)</th>
<th>Other reduction (SL or HSL)</th>
</tr>
</thead>
<tbody>
<tr>
<td>ACFTA</td>
<td>2005</td>
<td>2012*1</td>
<td>2018</td>
<td>2018*1</td>
<td>2018</td>
<td>2012*1</td>
<td>2018</td>
</tr>
</tbody>
</table>

Notes:
AANZFTA = ASEAN–Australia/New Zealand FTA; ACFTA = ASEAN–PRC FTA; AIFTA = ASEAN–India FTA; AJCEP = ASEAN–Japan Comprehensive Economic Partnership; AKFTA = ASEAN–Republic of Korea FTA; ASEAN6 = Brunei Darussalam, Indonesia, Malaysia, Philippines, Singapore, Thailand; CLMV = Cambodia, Lao PDR, Myanmar, Viet Nam; FTA = free trade agreement; SL = sensitive list; HSL = highly sensitive list.

*1. Including Normal Track 2 (new AFTA members: Cambodia, Lao PDR, Myanmar, and Viet Nam). Normal Track 1 (six original AFTA members: Brunei Darussalam, Indonesia, Malaysia, the Philippines, Singapore, and Thailand) for ASEAN6 and the PRC has completed in 2010.

*2. In AIFTA, each year corresponds to 31 December of the previous year. For example, 2014 means 31 December 2013.

*3. Including Normal Track 2.

*4. To the Philippines.

*5. Including Normal Track 2. Normal Track 1 for ASEAN5 has completed in 2010.

*6. Thailand.

Source: Modified table 2 of Fukunaga and Isono (2013).
Table 9.6  Frequency by type of rules of origin used in ASEAN+1 free trade agreements

<table>
<thead>
<tr>
<th>ROO type</th>
<th>AANZFTA</th>
<th>ACFTA</th>
<th>AIFTA</th>
<th>AJCEP</th>
<th>AKFTA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single Rule or stricter</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>WO</td>
<td>294</td>
<td>8</td>
<td>3</td>
<td>458</td>
<td></td>
</tr>
<tr>
<td>CC</td>
<td>248</td>
<td>1</td>
<td>735</td>
<td>61</td>
<td></td>
</tr>
<tr>
<td>CTH</td>
<td>107</td>
<td></td>
<td>137</td>
<td>4</td>
<td></td>
</tr>
<tr>
<td>CTSH</td>
<td></td>
<td></td>
<td></td>
<td>8</td>
<td></td>
</tr>
<tr>
<td>RVC(&lt;40)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>36</td>
</tr>
<tr>
<td>RVC(40)</td>
<td>68</td>
<td>4659</td>
<td>219</td>
<td>22</td>
<td></td>
</tr>
<tr>
<td>RVC(&gt;40)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>6</td>
</tr>
<tr>
<td>RVC(35)+CTSH</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>5224</td>
</tr>
<tr>
<td>CC with exception*</td>
<td>3</td>
<td></td>
<td>258</td>
<td></td>
<td></td>
</tr>
<tr>
<td>CTH with exception*</td>
<td>10</td>
<td></td>
<td>20</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Various**</td>
<td>43</td>
<td></td>
<td>3</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sub-total</td>
<td>773</td>
<td>4668</td>
<td>5224</td>
<td>1380</td>
<td>590</td>
</tr>
<tr>
<td>% share in total</td>
<td>14.80</td>
<td>89.40</td>
<td>100.00</td>
<td>26.40</td>
<td>11.30</td>
</tr>
<tr>
<td>‘RVC(40) or CTH’ or more flexible</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>RVC(40) or CTH</td>
<td>2204</td>
<td>122</td>
<td>3057</td>
<td>4076</td>
<td></td>
</tr>
<tr>
<td>RVC(40) or CTH or Specific Process Rule</td>
<td>24</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>RVC(40) or CTH or [RVC(35)+CTSH]</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sub-total</td>
<td>3501</td>
<td>122</td>
<td>0</td>
<td>3090</td>
<td>4137</td>
</tr>
<tr>
<td>% share in total</td>
<td>67.00</td>
<td>2.30</td>
<td>0.00</td>
<td>59.20</td>
<td>79.20</td>
</tr>
<tr>
<td>Other ‘or’ rules</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>RVC(40) or CC or Textile Rule</td>
<td>583</td>
<td>7</td>
<td>126</td>
<td>487</td>
<td></td>
</tr>
<tr>
<td>Various***</td>
<td>367</td>
<td>427</td>
<td>628</td>
<td>10</td>
<td></td>
</tr>
<tr>
<td>Sub-total</td>
<td>950</td>
<td>434</td>
<td>0</td>
<td>754</td>
<td>497</td>
</tr>
<tr>
<td>% share in total</td>
<td>18.20</td>
<td>8.30</td>
<td>0.00</td>
<td>14.40</td>
<td>9.30</td>
</tr>
<tr>
<td>Total number of 6-digit HS 2002 lines</td>
<td>5224</td>
<td>5224</td>
<td>5224</td>
<td>5224</td>
<td>5224</td>
</tr>
</tbody>
</table>

Notes:
AANZFTA = ASEAN–Australia/New Zealand FTA; ACFTA = ASEAN–PRC FTA; AIFTA = ASEAN–India FTA; AJCEP = ASEAN–Japan Comprehensive Economic Partnership; AKFTA = ASEAN–Republic of Korea FTA; CC = change in commodity classification; CTH = change in tariff heading; CTSH = change in tariff subheading; FTA = free trade agreement; GR = General ROO; PRC = People’s Republic of China; ROO = rules of origin; RVC = regional value content; WO = wholly obtained.
* Exception varies, from sourcing of materials to process.
** For example, CTH + RVC(40), CC + RVC(40), CC + Textile Rule.
*** For example, (RVC(40)+Textile Rule) or CC, RVC(>40) or CTH.

Source: Medalla (forthcoming).
It less restrictive than CTC. For the ASEAN–PRC FTA, the general rule is RVC(40). In the case of the ASEAN–India FTA, the general rule is RVC(35) and CTSH (a change in tariff sub-heading). In other words, regional content requirement at 35 percent is less restrictive compared to other ASEAN+1 FTAs, but it has an additional requirement of a change in tariff classification, albeit at a higher 6-digit level, making the ASEAN–India FTA the most restrictive.

Let us turn to trade in services. Among the five ASEAN+1 FTAs, the ASEAN–PRC, the ASEAN–Republic of Korea, and the ASEAN–Australia/New Zealand FTAs contain commitments in trade in services. The service chapters of these three FTAs adopt GATS-style reporting, enabling direct comparison among GATS commitments and ASEAN+1 FTAs. In order to evaluate the liberalization commitment for the GATS-style reporting, Hoekman (1995) proposes a scoring method. This method assigns scores to each of 8 cells, comprising 4 modes and 2 aspects – market access (MA) and national treatment (NT), as follows: assign the value 1 when the sector at issue is ‘fully liberalized’; 0.5 when ‘limited (but bound)’; 0 when ‘unbound’ (government has not committed to liberalize) by sector, by mode, and by aspect (market access and national treatment), and take the simple average for aggregation; then calculate the average value for the country. The higher the score, the more liberal are the country’s services trade commitments to its FTA partners.

Ishido (forthcoming) computed the Hoekman Index for the ASEAN–Australia/New Zealand, ASEAN–PRC, and ASEAN–Republic of Korea FTAs (Table 9.7). ‘Total’ means the score based on the simple average of the Hoekman Index derived from 155 subsectors. ‘WTO Plus’ is the difference between commitments under FTAs and those under the GATS, meaning ‘additional commitment’ to the WTO commitment. As is shown, most countries have commitment levels of less than 0.5, meaning that the ‘unbound (no commitment)’ is dominant overall. This observation may indicate that the level of commitments under ASEAN+1 FTAs does not meet the requirement under the GATS Article V that stipulates that the agreement has substantial sectoral coverage and provides for the absence or elimination of substantially all discrimination (WTO GATS website).

Among the ASEAN FTA partners, Australia and New Zealand committed most, as their respective scores are 0.52 and 0.51, respectively. It should be noted that both Australia and New Zealand made substantially large additional commitments in their FTA with ASEAN beyond their GATS commitments. The Republic of Korea’s and the PRC’s commitments are significantly lower compared to those by Australia and New Zealand, as their respective Hoekman scores are 0.31 and 0.28. Compared
to the commitments by Australia and New Zealand, the Republic of Korea and the PRC have much smaller additional commitments under their ASEAN+1 FTAs.

Turning to the ASEAN countries, an interesting pattern emerges in that their additional commitments are high for AANZFTA while they are low for AKFTA and ACFTA. These patterns reflect the reciprocal approach adopted in FTA negotiations. There exist wide variations in the level of commitment among the ASEAN countries. Cambodia has the highest level of commitment at 0.42 (average), while Brunei Darussalam has the lowest level of commitment at 0.10. Indeed, one can classify the ASEAN countries into three groups in terms of the level of commitment. The high group consists of Cambodia, Viet Nam, and Singapore. The middle group includes Malaysia, Indonesia, and the Philippines. The low group includes Myanmar, Lao PDR, and Brunei Darussalam. Thailand, whose information for AKFTA is not readily available and thus not reported,
seems to be placed between high and middle groups based on its score for AANZFTA and ACFTA.

9.5 MOVES TOWARD THE ESTABLISHMENT OF A REGION-WIDE FREE TRADE AGREEMENT

Asia has seen a rapid increase in the number of FTAs since the beginning of the 21st century. Many of these FTAs are bilateral or plurilateral and unlike the situations in North America or Europe, a region-wide FTA has not been established yet in Asia. Recognizing the benefits of a region-wide FTA with a larger market, Asian countries have been examining ways to establish a region-wide FTA as was discussed in section 9.2. Two region-wide FTA initiatives, EAFTA and CEPEA were discussed. These two initiatives have been merged to form the RCEP. According to the CEPEA Phase II Report, which conducted a simulation exercise using a computable general equilibrium model, the impact of CEPEA (ASEAN+6 FTA with the same membership as RCEP) on economic growth was found to be substantial and larger compared to ASEAN+3 FTA. If the full effect of liberalization in combination with cooperation and facilitation is taken into account under the framework of the CEPEA, the overall impact on GDP will be substantial, ranging from 0.64 percent for Japan to double-digit figures for Malaysia, Brunei Darussalam, Viet Nam and Thailand (CEPEA 2009). Kawai and Wignaraja (2009) also found similar impacts using a CGE model. In light of the benefit from the establishment of a region-wide FTA under the ASEAN+6 framework, this section examines the possibility of consolidating five ASEAN+1 FTAs by investigating the similarities and differences among these five FTAs.

Let us begin with the agreements on trade in goods. Kuno (forthcoming) analyzed ASEAN countries’ commitments in tariff elimination in five ASEAN+1 FTAs. He classified the products in terms of HS 6-digit classification into three categories, ‘eliminated to all’, ‘depends on FTA’, and ‘protected to all’ based on their trade liberalization status in five ASEAN+1 FTAs. Those products that are subject to tariff elimination in all ASEAN+1 FTAs are classified under ‘eliminated to all’, while those products that are excluded from tariff elimination in all ASEAN+1 FTAs are classified under ‘protected to all’. Those products that do not fall under either ‘eliminated to all’ or ‘protected to all’ are classified under ‘depends on FTA’. In other words, those products that are subject to tariff elimination in some FTAs and are excluded from tariff elimination in other FTAs are classified under ‘depends on FTA’.

The results of this exercise (Table 9.8) indicate wide variations in the
The Regional Comprehensive Economic Partnership

liberalization status among ASEAN countries. On average 73.3 percent of the products fall under the ‘eliminated to all’ category, while 0.9 percent of the products are classified under the ‘protected to all’ category. The remaining 25.8 percent of the products fall under the ‘depends on FTA’ category. Although the average rate of trade liberalization is quite low at 73.3 percent, it is encouraging to observe that on average 99.1 percent of the products have been liberalized under at least one ASEAN FTA. If ASEAN countries can liberalize the products that are liberalized at least to one FTA partner to other FTA partners, they can achieve 99.1 percent liberalization rate.

A closer look at the liberalization status for individual ASEAN countries reveals difficulties in establishing a region-wide FTA, which are masked in the average values examined above. Specifically, it is only Singapore that does not have any problems in achieving a high level region-wide FTA. Other ASEAN member countries face difficulty in liberalizing a number of sectors. Indeed, the shares of ‘eliminated to all’ in all products are low for many countries, Indonesia (46.0 percent), Cambodia (64.3 percent), Myanmar (66.6 percent), and Lao PDR (68.0 percent), indicating the possible presence of enormous obstacles in tariff elimination. In order to promote trade liberalization in the RCEP, the members may take a sequential approach by setting an explicit schedule in a similar fashion as was done under the AFTA.

Section 9.4 showed that five ASEAN+1 FTAs have adopted different rules of origin (ROOs), making it difficult to establish a region-wide FTA.

<table>
<thead>
<tr>
<th>Country</th>
<th>% of ‘Eliminated to All’ products</th>
<th>% of ‘Depends on FTA’ products</th>
<th>% of ‘Protected to All’ products</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brunei Darussalam</td>
<td>84.1</td>
<td>15.9</td>
<td>0.0</td>
</tr>
<tr>
<td>Cambodia</td>
<td>64.3</td>
<td>35.3</td>
<td>0.4</td>
</tr>
<tr>
<td>Indonesia</td>
<td>46.0</td>
<td>52.8</td>
<td>1.2</td>
</tr>
<tr>
<td>Lao PDR</td>
<td>68.0</td>
<td>31.6</td>
<td>0.4</td>
</tr>
<tr>
<td>Malaysia</td>
<td>76.0</td>
<td>22.9</td>
<td>1.1</td>
</tr>
<tr>
<td>Myanmar</td>
<td>66.6</td>
<td>31.8</td>
<td>1.6</td>
</tr>
<tr>
<td>Philippines</td>
<td>74.6</td>
<td>24.4</td>
<td>1.0</td>
</tr>
<tr>
<td>Singapore</td>
<td>100.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Thailand</td>
<td>75.6</td>
<td>24.3</td>
<td>0.1</td>
</tr>
<tr>
<td>Viet Nam</td>
<td>78.1</td>
<td>19.1</td>
<td>2.8</td>
</tr>
<tr>
<td>Average</td>
<td>73.3</td>
<td>25.8</td>
<td>0.9</td>
</tr>
</tbody>
</table>

Source: Kuno (forthcoming).

Table 9.8 Distribution of tariff lines by liberalization status
A World Trade Organization for the 21st century  

Medalla (2011) compared ROOs adopted by five ASEAN FTAs at 6-digit HS lines. Table 9.9 shows the number of HS lines that have common ROOs. According to Medalla’s computation, all five FTAs have at least one common ROO in 64 percent of all HS lines. Moreover, 90 percent of the time, three or more FTAs share a common ROO. These findings seem to indicate that harmonization of ROOs may not be a far-fetched idea among five ASEAN FTAs.

Turning to trade in services, agreements are included in the ASEAN–Australia/New Zealand FTA, the ASEAN–PRC FTA, and the ASEAN–Republic of Korea FTA. Ishido (2011) investigated the liberalization levels of the commitments by sectors under these three ASEAN FTAs and the AFAS. He found similarities in the level of liberalization commitments among them, as correlation coefficients, which are computed using country-average liberalization levels by sector, between the pair of FTAs are greater than 0.615 (Table 9.10). Indeed, the correlation coefficient between the ASEAN–Australia/New Zealand FTA and the ASEAN–Republic of Korea FTA is as high as 0.870. These findings indicate that the sectoral patterns of liberalization and/or protection for trade in services under the ASEAN+1 FTAs are similar and thus consolidating these FTAs into one FTA may be possible. However, it is important to note that consolidation of FTAs does not necessarily mean liberalization of trade in services.

Table 9.9 Commonality of rules of origin across 5 ASEAN+1 free trade agreements

<table>
<thead>
<tr>
<th>Degree of commonality</th>
<th>Frequency distribution of HS lines (6-digit HS 2002)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number</td>
</tr>
<tr>
<td>At least one common ROO in all 5 FTAs</td>
<td>3318</td>
</tr>
<tr>
<td>in only 4 FTAs</td>
<td>766</td>
</tr>
<tr>
<td>in only 3 FTAs</td>
<td>825</td>
</tr>
<tr>
<td>in only 2 FTAs</td>
<td>255</td>
</tr>
<tr>
<td>No common ROOs</td>
<td>23</td>
</tr>
</tbody>
</table>

Note: ASEAN = Association of Southeast Asian Nations; FTA = free trade agreement; ROO = rules of origin.

MULTILATERALIZATION OF FREE TRADE AGREEMENTS

According to Baldwin and Low (2009), multilateralization of regionalism or region-wide FTAs is promoted through the non-discriminatory extension of preferential trading arrangements to non-FTA members. They argue that such extensions can occur in two ways – either through the inclusion of new members in existing agreements or by replacing existing agreements with new ones that extend to new members. One may add that ultimate multilateralization at the global level may be achieved when such extension is applied to all the countries/economies in the world. With these observations in mind, let me discuss the possible ways to multilateralize East Asian regionalism in the form of RCEP.

In order to extend the RCEP to new members, the RCEP needs to have an explicit rule on accession. The general principles state that the RCEP shall have an open accession clause to enable participation of any of the ASEAN FTA partners, should they not be ready to participate at the outset as well as any other external economic partners (ASEAN Secretariat 2012). This is conditional open accession in that only the ASEAN FTA partners may be considered for accession. Although such treatment is necessary for ASEAN to maintain its centrality in regionalism in East Asia, the RCEP needs to have unconditional open accession for its multilateralization. Considering unconditional open accession, the TPP provides useful lessons as it is open to accession on terms to be agreed among the parties, by any APEC economy or other state (TPP 2005).

Focusing on trade in goods, which is a main component of the RCEP, the RCEP needs to establish a very high level of trade liberalization for

Table 9.10  Correlation coefficients of service trade liberalization commitments among ASEAN+1 free trade agreements

<table>
<thead>
<tr>
<th>FTA</th>
<th>AFAS</th>
<th>AANZFTA</th>
<th>ACFTA</th>
<th>AKFTA</th>
</tr>
</thead>
<tbody>
<tr>
<td>AFAS</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>AANZFTA</td>
<td>0.718</td>
<td>1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>ACFTA</td>
<td>0.615</td>
<td>0.826</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>AKFTA</td>
<td>0.704</td>
<td>0.870</td>
<td>0.830</td>
<td>1</td>
</tr>
</tbody>
</table>

Note: AFAS: ASEAN Framework Agreement on Services; AANZAFTA: ASEAN–Australia/New Zealand FTA; ACFTA: = ASEAN–PRC FTA; AKFTA = ASEAN–Republic of Korea FTA; PRC = People’s Republic of China.

its multilateralization and to contribute to the promotion of multilateralism. The opposition against liberalizing trade with non-RCEP members, or multilateralizing RCEP, is small and weak, when a high level of trade liberalization is already achieved in RCEP. Two additional comments are in order here. It is important to have an efficient producer country as a member, in order to minimize the negative impacts from multilateralization. If RCEP members are inefficient producers, then the impacts of extending trade liberalization to non-members would incur substantial costs. Another point is the importance of broadening membership before achieving multilateralization completely, as larger membership increases the probability of having efficient producers as members.

Rules of origin play a crucial role in FTAs such as the RCEP; ROOs ensure the benefits of free trade to FTA members. However, ROOs may unnecessarily constrain trade flows because of the spaghetti or noodle bowl effect resulting from the adoption of different ROOs by different FTAs. In order to avoid the spaghetti or noodle bowl effect, one common ROO should be defined for a specific product and applied to any FTA. Such ROOs have to be created at the WTO. It is important to establish less restrictive ROOs in order to avoid constraining trade flows. If the establishment of such common ROOs is not possible, then a co-equal system, under which choices of ROOs are given for the FTA users, should be adopted. For a region-wide FTA such as RCEP, lenient rules on cumulation, such as full or total cumulation, should be adopted.

The discussion thus far has focused on trade in goods. A similar approach may be applied to trade in services, which is subject to existing rules under the GATS, in order to achieve multilateralization of the services chapter in the RCEP.

So far, discussions have been confined to the RCEP or a region-wide FTA in East Asia. FTA developments in other parts of the world need to be considered in order to achieve multilateralization of regionalism such as the RCEP. In particular, the TPP agreement that has been in negotiation under the APEC framework is an important FTA to consider, as membership overlaps to some extent.

Although the contents of the RCEP and the TPP will not be finalized until negotiations are concluded, discussions indicate that these two frameworks are likely to be quite different. Compared to the RCEP, the TPP is more comprehensive in the coverage of issues and has a higher level in terms of trade and FDI liberalization. One of the important features of the RCEP is to provide developing members with economic cooperation, while the TPP places less importance on economic cooperation. Because of these differences, the RCEP and the TPP should complement each other rather than substitute one another. Indeed, these two frameworks may be
considered as two different stages. Developing countries that cannot meet high requirements for the TPP membership may achieve economic development under the RCEP, and then may later join the TPP when they can pass the membership requirements.

Although the contents of the RCEP and the TPP are likely to be quite different, it is important to ‘coordinate’ the two, especially to promote multilateralization. Coordination may be effectively conducted if a common guiding principle is adopted. For such guiding principles, APEC’s best practice for RTAs and FTAs, that include comprehensive aspects including trade in goods and services, ROOs, cooperation, and open accession, should be adopted (APEC 2004).

9.7 CONCLUDING COMMENTS

This chapter analyzed developments concerning FTAs in East Asia and pointed out a recent move toward the establishment of a region-wide FTA under the RCEP possibly by consolidating the existing five ASEAN+1 FTAs. An examination of the contents of agreements in trade in goods and services revealed wide variation in the level of trade liberalization and the definitions of ROOs. Given these starting points, a gradual approach of sequential trade liberalization with an explicit liberalization schedule may be realistic. To successfully complete trade liberalization, monitoring is necessary. On ROOs, the RCEP should try to establish one ROO per product. If this is difficult, then a co-equal approach should first be applied to all the products, followed by a gradual move to a one ROO–one product framework. It is also important to introduce a lenient cumulation rule in order to promote intra-RCEP trade. For the multilateralization of the RCEP, the RCEP needs to achieve a high level of trade liberalization and also needs open accession.

One possible impediment to the RCEP negotiations is political tension among the negotiating countries. The most worrisome cases are the territorial and political tensions between the PRC and the Republic of Korea on the one hand, and the PRC and Japan on the other hand. Indeed, Japan’s political relations with these two countries have worsened recently because of disputes over territorial and historical issues. It is encouraging to observe that the PRC, Japan, and the Republic of Korea began trilateral FTA (CJK FTA) negotiations in March 2013 with a second round of negotiations in July–August 2013, despite heightened political tensions. Having noted optimism, it is very important for the leaders to avoid aggravating the situation and to improve political relations in order to make progress on and to conclude the RCEP and the CJK FTA negotiations.
NOTES

1. In the GATT/WTO, RTAs, which violate one of its basic principles of non-discrimination, are permitted under GATT Article XXIV with several conditions, including liberalization of substantially all the trade of members, not increasing trade barriers on non-members, and completing the RTA process within ten years. For developing members, more lenient conditions are applied under the enabling clause. RTAs include FTAs and customs unions. An FTA is considered to be a shallow form of regional integration, because it only removes tariff and non-tariff barriers among the members, while a customs union is a deeper integration, as it adopts common external tariffs on non-members, in addition to the removal of tariff and non-tariff barriers on trade among the members. All the RTAs established so far in Asia are FTAs.

2. For discussions on FTAs in East Asia, see for example, Aggarwal and Urata (2006), Pangestu and Gooptu (2004), Soesastro (2006), Sally (2006), and Kawai and Wignaraja (2011).

3. Chia (2011) gives a detailed account of ASEAN’s programs for promoting its economic integration including those related to trade in goods and services and foreign direct investment.

4. By 2010, eight packages had agreed to implement the commitments under the AFAS.

5. See also ERIA (2012) for a review of the progress of AEC.

6. BIMSTEC members are Bangladesh, Bhutan, India, Myanmar, Nepal, Sri Lanka, and Thailand.

7. For comparison, the FTA coverage ratios are 38 percent for the US and 74.8 percent for the EU.


9. This section draws on Urata (2010b).

10. See Urata (2010a) for the discussions on this point.

11. The discussions on ROOs draw on Medalla (2011).

12. An agreement on trade in services is included in a chapter in Japan’s bilateral FTAs with Brunei Darussalam, Indonesia, Malaysia, the Philippines, Singapore, Thailand, and Viet Nam.

13. See Gasiorek et al. (2009) and Estevadeordal et al. (2009) for detailed discussions on the issues of ROOs.

14. Schott et al. (2013) provide an overview of the TPP, while Guiding Principles and Objectives for Negotiating the Regional Comprehensive Economic Partnership prepared by ASEAN trade ministers in August 2012 indicates important features of the RCEP (ASEAN Secretariat 2012).

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10. The ASEAN Economic Community: progress, challenges, and prospects

Siow Yue Chia

10.1 INTRODUCTION

The Association of Southeast Asian Nations (ASEAN) was formed by Indonesia, Malaysia, Philippines, Singapore, and Thailand in 1967 mainly to foster regional peace and security. Brunei Darussalam joined in 1984, and Cambodia, Lao People’s Democratic Republic, Myanmar, and Viet Nam joined between 1995 and 1999. Economic cooperation and integration began modestly in 1977 with the PTA and a number of industrial cooperation schemes. Economic integration began with the 1992 AFTA that covers trade in goods, complemented by the 1995 AFAS and the 1998 AIA agreement. In 2003 it was agreed to deepen economic integration with the formation of the AEC, to create a unified market and production base via a free flow of goods, services, foreign direct investment, skilled labor, and a freer flow of capital.1

In assessing the success or shortfall of the AEC to date, benchmarks are important. The ‘cup is half-full’ when the achievements are measured against the backdrop of 1992. The ‘cup is half-empty’ when the shortfalls are measured against what is promised in the AEC Blueprint of objectives and strategic actions and measures. In going forward, a SWOT analysis of ASEAN’s current strengths, weaknesses, opportunities, and threats are shown below.

10.1.1 ASEAN’s Strengths

Strategically located in dynamic Asian region; generally robust economic growth; good macroeconomic fundamentals (especially among Brunei Darussalam, Indonesia, Malaysia, Philippines, Singapore, and Thailand, known as the ASEAN6); market of 600 million people; abundance of natural resources and biodiversity; wide-ranging productive
capabilities (in agriculture, manufacturing, and services); diversified exports by destination and product; mostly young, growing populations and expanding middle class; strong FDI with strong production networks; progressive open trade and investment regimes; strong track record of regional cooperation.

10.1.2 ASEAN’s Weaknesses

Development gaps between and within members in income, human capital, institutions, and infrastructure and the absence of regional distributive mechanisms; disparities in good governance and the rule of law; disparities in population growth and population aging, that together with disparities in economic growth lead to large labor deficits and surpluses among countries that spurred cross-border illegal migration; slow decision-making and even slower implementation of AEC commitments due to need for consensus building and slow progress in domestic reforms; weak ASEAN Secretariat with inadequate human and financial resources; weak links between ASEAN and subregional programs such as the Greater Mekong Subregion (GMS) and ASEAN growth triangles.

10.1.3 ASEAN’s Opportunities

Central strategic location, with high market potential in the PRC and India; strong historical, cultural links throughout Asia; strong economic links with ASEAN+1 FTA markets in Australia, New Zealand, the PRC, India, Japan, and the Republic of Korea; potential development of region-wide FTA with the PRC, Japan, the Republic of Korea, India, Australia, and New Zealand (RCEP); rapidly rising middle class; deep manufacturing and technology links with Northeast Asia; financial cooperation with PRC–Japan–Republic of Korea in reserve pooling through the CMIM; and surveillance through AMRO.

10.1.4 ASEAN’s Threats

Political–security conflicts in Asian region arising from unresolved intra- and extra-regional territorial disputes; vulnerability of export-dependent economies to external shocks from the US and Europe; rise of the PRC and India overshadow ASEAN relevance; lack of effective regional cooperation on climate change, water–energy–food security, and disaster management (drought, floods, earthquakes, volcanic eruptions).
10.2 ASEAN ECONOMIC INTEGRATION IN THE 1980S–1990S

The economic literature lists several benefits of economic integration, including an enlarged market with economies of scale and scope, improved resource allocation with free movement of factors of production, improved resource pools with inflows of capital, investment and labor, and increased competition leading to improved efficiency and innovation.

10.2.1 Factors Pushing or Impeding ASEAN Economic Integration

Economic integration in ASEAN, as elsewhere, has both political and economic objectives.

10.2.1.1 Geopolitical factors favoring regional cooperation

The political–security environment in Southeast Asia in the 1960s and 1970s led to the desire to cooperate for regional peace and security: there were territorial disputes among several Southeast Asian countries; the Cold War united the ASEAN founding market economies (Indonesia, Malaysia, Philippines, Singapore, and Thailand) against communism, while the rest of Southeast Asia was under different political and economic systems. Brunei Darussalam joined after gaining political independence, while Cambodia, Lao PDR, Myanmar, and Viet Nam joined following the end of the Cold War. ASEAN provided the security backdrop for individual countries to pursue their national economic development goals.

The so-called ‘ASEAN Way’ contributed to the early success of the regional grouping, as it focused heavily on building confidence and trust among neighbors rather than legalistic structures and styles. There was a policy of non-intervention in domestic affairs, there was no hegemony, the ASEAN Secretariat was kept small so that there was minimal discomfort with supranationality, and cooperation and integration was pursued not according to any pre-decided blueprint but at a pace that all members would be comfortable with.

10.2.1.2 Initial economic diversity an impediment to regional integration

As shown in Table 10.1, ASEAN members show wide diversity in land and population size, level of economic development and per capita income, and openness to international trade and investment. This diversity gave rise to differing perceptions of benefits and costs of economic integration. Larger economies (particularly Indonesia) felt less need to achieve economies of scale through trade openness, while perceiving that the more
<table>
<thead>
<tr>
<th></th>
<th>Brunei Darussalam</th>
<th>Indonesia</th>
<th>Malaysia</th>
<th>Philippines</th>
<th>Singapore</th>
<th>Thailand</th>
<th>Cambodia</th>
<th>Lao PDR</th>
<th>Myanmar</th>
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<td>Population, million</td>
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<td>95.8</td>
<td>5.2</td>
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<td>14.5</td>
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<td>287.9</td>
<td>224.3</td>
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<td>GDP per capita, US$</td>
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<td>3 563</td>
<td>9 941</td>
<td>2 341</td>
<td>5 0130</td>
<td>5 116</td>
<td>879</td>
<td>1 279</td>
<td>875</td>
<td>1 403</td>
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<td>GDP per capita, PPP-adjusted</td>
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<td>4 736</td>
<td>15 955</td>
<td>4 289</td>
<td>60 744</td>
<td>8 907</td>
<td>2 287</td>
<td>2 825</td>
<td>1 393</td>
<td>3 440</td>
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<td>111.8</td>
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<td>4.0</td>
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<td>49.8</td>
<td>298.3</td>
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<td>48.8</td>
<td>28.2</td>
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<td>27.6</td>
<td>518.6</td>
<td>139.7</td>
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<td>32.2</td>
<td>16.9</td>
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</table>

**Note:** ASEAN = Association of Southeast Asian Nations, FDI = foreign direct investment, GDP = gross domestic product, Lao PDR = Lao People’s Democratic Republic, PPP = purchasing power parity.

**Source:** Compiled from ASEAN (2013) and UNCTAD (2012).
competitive smaller ASEAN economies (particularly Singapore) would gain more with free entry into an integrated regional market.

10.2.1.3 Initial similar production and export structures an impediment to regional integration
Economies that are complementary at the outset of economic integration face less resistance since there would be limited competition among them, while economies that are in competition at the outset would face more resistance, as economic restructuring would be painful. However, the gains from economic integration would also be larger with improved economic efficiency from reforms and resource reallocations. Likewise, economies that are already open and globalized will benefit less from economic integration while economies that are closed will face painful adjustments from trade and investment liberalization but will enjoy efficiency gains.

Initially there was limited trade among the Southeast Asian countries (except with Singapore which functions as the regional entrepôt), since they exported similar natural resource products (such as rubber, palm oil, and metals) owing to having similar natural endowments and labor-intensive manufactures due to similar low technological capability. Hence they competed with each other for markets in the developed countries. With the rise of production networks in the region since the late 1980s and consequent rapid growth in intra-industry trade in parts and components, economic complementarity in manufactures developed among the ASEAN economies.

10.2.1.4 Pressure to be competitive with transition to outward-looking development strategies
The pursuit of import substituting industrialization from the 1960s to the 1980s by the ASEAN economies (except Singapore which maintained a free trade regime because of its entrepôt role) discouraged trade and investment liberalization to build a regional market. However, a rapidly globalizing world and realization of the limits of import substitution led to the adoption of outward-looking development strategies through unilateral economic reforms. As such, regional economic integration became a more acceptable idea by the end of the 1980s.

10.2.1.5 External pressures toward economic integration
From the late 1980s, external developments were pressuring ASEAN to move toward regional economic integration to compete effectively for global markets and investments. First, regional competition prepared ASEAN industries for the more liberal global trading regime following the conclusion of the Uruguay Round in December 1991 and the
reorganization of the GATT into the WTO. Second, an ASEAN regional market overcame the threat to market access and FDI from the emerging European Single Market and the NAFTA. ASEAN had an integrated market size of 360 million to attract investments, and with economies of scale also led to a rational allocation of resources and increased efficiency in production. These led to the decision to establish the AFTA, the AFAS, and the AIA in the 1990s.

A subsequent perceived external ‘threat’ from the economic rise of the PRC and to a lesser extent of India, led to the decision to form the AEC in 2003. Both the PRC and India are large countries with huge domestic markets, while ASEAN comprises ten small fragmented markets, unless an ASEAN regional market could be developed. An integrated ASEAN market as well as integration with the rest of East Asia and beyond, would enable ASEAN to respond more effectively to both the challenges and opportunities of the PRC and India.

ASEAN centrality is traditionally premised on ASEAN being a neutral platform for the major powers to meet so as to avoid the dominance of a single power within the East Asia region. In the 1990s, with the rise of the PRC and India, the idea of ASEAN centrality took hold, with the notion of an ASEAN-led regional architecture in which the region’s economic (and political–security) relations with the wider world are conducted with the interest of the ASEAN community in mind.

10.2.2 Market-driven Integration through Production Networks

International and regional production networks are market-driven and involve the breaking up of production processes into fragmented segments that can be carried out in different cross-border locations and eventually coordinated for assembly into final products. Production networks make use of each location’s advantages to boost productivity and cut costs, while bolstering investment and technological transfer. The development of production networks has been facilitated by FTAs that encourage inward FDI by MNCs. Factors in the rapid growth of production networks in East Asia include the following: first, wide regional differences in wage and labor productivity levels, resulting in different competitive cost locations for different parts of the value chain; second, ASEAN countries increasingly adopted outward oriented development strategies resulting in trade and investment liberalization unilaterally and regionally under the FTAs; and third, cross-border trade flows were facilitated by improvements in customs administration and availability of efficient trade infrastructure and logistics that result in lower production and logistics costs. Production networks are usually found in industries with long value
The ASEAN Economic Community

chains, such as electronics and electrical machinery, automotives, and textiles and garments.

The East Asian fragmentation of manufacturing production and export appears as follows: the PRC, Japan, and the Republic of Korea are home countries for production networks, with the PRC increasingly functioning as the major assembly base (factory of the world). The ASEAN countries of Malaysia, Philippines, Singapore, and Thailand encourage inflows of MNC investments, successfully absorb new production technologies and develop local supporting industries, and became major exporters of machinery parts and components. The success of these ASEAN economies led to a second wave of production networks to Indonesia and CLMV, as they are able to absorb the relocation of labor-intensive segments and enter international markets requiring only a limited range of skills.

Table 10.2 shows the growth in production network trade in parts and components and final assembled products between 1992–93 and 2006–07, accounting for 66.1 percent of ASEAN exports and 64.0 percent of ASEAN imports, with wide variations among ASEAN countries.

The Asian Development Bank (ADB 2007)\textsuperscript{5} finds over 70 percent of intra-East Asian trade comprises trade in parts and components which are then assembled into final goods and exported to the rest of the world, particularly the US and the EU. This highlights the vulnerability of ASEAN exports to external shocks such as the US and EU crises.

Although production networks are essentially market-driven, FTA trade and investment liberalization and facilitation have encouraged MNCs to locate multi-plants in the ASEAN region, the most apparent being in the electronics and automotive sectors. While studies have shown that the utilization of ASEAN preferential tariffs has been low, improvements in ASEAN customs, standards harmonization, transport and logistics, and investment liberalization, facilitation, and protection have facilitated trade and FDI flows. More particularly, regional trade and investment liberalization and facilitation programs have also resulted in the spread of production networks from the more developed ASEAN countries to the less developed CLMV.

10.2.3 FTA-driven Economic Integration in the 1990s

The AFTA entails intra-ASEAN tariff liberalization and elimination under the Common Effective Preferential Tariff (CEPT) scheme. A customs union with common external tariffs was ruled out in view of the marked differences in MFN tariff levels among ASEAN economies, particularly between Singapore and the rest. Initially, tariffs were to be
### Table 10.2  Share of production network manufacturing trade in East Asia, 1992–93 and 2006–07 (percentage)

<table>
<thead>
<tr>
<th></th>
<th>Part and components</th>
<th>Final assembly</th>
<th>Total network products</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Exports</strong></td>
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<td></td>
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</tr>
<tr>
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<td>20.2</td>
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<td>31.6</td>
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<tr>
<td>Japan</td>
<td>23.9</td>
<td>34.4</td>
<td>44.5</td>
</tr>
<tr>
<td>Developing East Asia</td>
<td>17.3</td>
<td>34.0</td>
<td>21.8</td>
</tr>
<tr>
<td>PRC</td>
<td>7.4</td>
<td>25.6</td>
<td>13.7</td>
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<tr>
<td>Hong Kong, China</td>
<td>15.8</td>
<td>33.3</td>
<td>18.0</td>
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<td>Taipei, China</td>
<td>24.7</td>
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<td>17.6</td>
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<tr>
<td>Korea, Rep. of ASEAN</td>
<td>18.1</td>
<td>44.2</td>
<td>22.2</td>
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<tr>
<td>Indonesia</td>
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<td>5.6</td>
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<td>Malaysia</td>
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<td>40.7</td>
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<td>Philippines</td>
<td>32.9</td>
<td>71.7</td>
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<td><strong>Imports</strong></td>
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<td>Developing East Asia</td>
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<td>Viet Nam</td>
<td>19.1</td>
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</table>

**Note:** ASEAN = Association of Southeast Asian Nations, PRC = People’s Republic of China.

**Source:** Athukorala (2010).
The ASEAN Economic Community brought down to the 0–5 percent range within 15 years. Following economic integration trends elsewhere, where free trade in goods was accompanied by free trade in services and investment liberalization, the AFTA was complemented by the 1995 AFAS and the 1998 AIA agreement. The implementation of the AFTA, the AFAS, and the AIA are discussed in later sections.

In 1996 the ASEAN Industrial Cooperation (AICO) scheme was introduced to promote joint manufacturing between ASEAN-based companies. The scheme requires the participation of at least two companies in two ASEAN countries and at least 30 percent national equity. The AICO’s products enjoy immediate AFTA end-tariff rates of 0–5 percent as well as local content accreditation and investment incentives offered by ASEAN national authorities. The AICO has successfully promoted production networks in automotive and electronics industries.

10.3 THE AEC – RATIONALE, PROGRESS, AND SHORTFALLS

10.3.1 Rationale and Process toward the AEC

In October 2003, ASEAN decided to establish the AEC by 2020 but advance it to 2015 in January 2007 (with a longer timeline of 2018–20 for CLMV). The AEC is a highly ambitious effort at deep integration which includes factors of production as well as a dispute settlement mechanism. It draws on the 1997 ASEAN Vision 2020 and the recommendations of the ASEAN High Level Task Force. In November 2004 the Vientiane Action Program laid down the goals and strategies for making the ASEAN Community a reality. In November 2007, the AEC Blueprint outlining various measures and strategic schedules for implementation was adopted. In April 2009 the Declaration on the Roadmap for the ASEAN Community (2009–15) agreed to an accelerated timetable for the realization of the AEC. In April 2012 ASEAN agreed to redouble efforts and set priority activities and concrete key actions to realize the AEC by 2015.

The AEC has four pillars that aim to ‘transform ASEAN into a single market and production base, a highly competitive economic region, a region of equitable economic development, and a region fully integrated into the global economy’ (ASEAN Secretariat 2008, p. 2). It has often been inappropriately compared to the EU Single Market. But the AEC is neither a customs union (with common external commercial policy) nor
a full common market (with free mobility of capital and labor and some policy harmonization).

The creation of a single market and production base should allow ASEAN to benefit from economies of scale and efficiency in production network processes. ASEAN could leverage on economies at different levels of economic development to provide complementary locations for production networks. An integrated market and production base would clearly boost intra-regional trade and investment flows while an ASEAN consumer market of over half a billion would be attractive for investors. The ASEAN High Level Task Force recommended the following for the AEC:

1. Accelerate current ASEAN economic integration programs, laying down clear timelines for specific measures in the areas of tariffs, non-tariff measures, customs, standards, services, investments, intellectual property rights, and finance.

2. Designate 12 priority sectors for accelerated integration with the coverage of each sector broad enough to account for a substantial portion of intra-ASEAN trade and potential to maximize the complementarities among ASEAN economies and serve as a catalyst for expediting the integration process. Priority sectors identified are agro-based products, fisheries, rubber-based products, wood-based products, textiles and apparel, automotives, electronics, e-ASEAN, air transport, healthcare, logistics, and tourism.

3. Adopt an ‘ASEAN minus X’ formula in integrating the priority sectors. That is, two or more ASEAN members may initiate and participate in intra-ASEAN economic arrangements, while other ASEAN members may join when they are ready to do so.

4. Improve the CEPT ROO, including making the ROO more transparent, predictable and standardized. Ensure transparency on NTMs, eliminate NTMs that are barriers to trade, establish an ASEAN database on NTMs, set clear and definitive work program for removal of NTBs, adopt the WTO agreements on Technical Barriers to Trade, Sanitary and Phytosanitary and Import Licensing Procedures and develop implementation guidelines appropriate for ASEAN.

5. Establish new institutional mechanisms, including a legal unit on trade disputes in the ASEAN Secretariat, a compliance monitoring body for peer adjudication, and an impartial dispute settlement mechanism.

10.3.2 Quantifying the Expected Benefits of the AEC

A CGE model of the AEC by Plummer and Chia (2009) incorporates assumptions on the complete elimination of tariffs and NTBs, the
liberalization of five service sectors, AEC-induced changes in FDI, and a 5 percent reduction in trade costs (Table 10.3). First, ASEAN economic welfare under the AEC should rise by 5.3 percent relative to the baseline. All ASEAN countries benefit, although some benefit more than others, either absolutely or relative to GDP size. Second, to estimate the direct effects of behind-the-border measures and best practices spread by means of the AEC, the projections suggest that competition policy alone could raise per capita GDP by 26–38 percent in the ASEAN6. And by creating opportunities for production networks and spreading best practices that boost productivity, the AEC should help the CLMV converge with the ASEAN6. Third, the net benefits of the AEC would be larger than the estimated 5.3 percent increase in ASEAN economic welfare, due to gains that have not been quantified by the CGE model. These include lower cost of capital due to freer movement of capital and improved financial systems; efficiency gains from freer movement of skilled labor; and greater macroeconomic stability due to the conservative macroeconomic policies necessary to support the AEC.

An alternative simulation by the ERIA (2012)13 assumes all tariffs are eliminated, there is a 20 percent reduction in tariff equivalent of service trade barriers, and also a 20 percent reduction in time cost to export and

<table>
<thead>
<tr>
<th></th>
<th>AFTA $ billion, 2004 price</th>
<th>AFTA % of baseline GDP</th>
<th>AEC $ billion, 2004 price</th>
<th>AEC % of baseline GDP</th>
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<td>2.8</td>
</tr>
<tr>
<td><strong>ASEAN total</strong></td>
<td><strong>10.1</strong></td>
<td><strong>0.8</strong></td>
<td><strong>69.4</strong></td>
<td><strong>5.3</strong></td>
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Note: AEC = ASEAN Economic Community; AFTA = ASEAN Free Trade Area; ASEAN = Association of Southeast Asian Nations; GDP = gross domestic product; Lao PDR = Lao People’s Democratic Republic.

Source: Plummer and Chia (2009).
import (improved trade facilitation). The cumulative impact of the policy change on GDP, exports, imports relative to baseline over the 2011–15 period as measured by 2015 shows the following: first, the impact on GDP of complete tariff elimination is largely marginal for most ASEAN states except Cambodia and to a lesser extent Viet Nam and Lao PDR, as CEPT tariffs were already very low in the other ASEAN states; second, the biggest jump in GDP growth rates for Indonesia, Malaysia, Philippines, Singapore, Thailand, and Viet Nam are from service trade liberalization; and third, reduction in time costs due to improved trade facilitation, infrastructure, and logistics has significant positive impact on GDP, especially for Lao PDR, Cambodia, and Viet Nam. Finally, the CGE model underestimates economic effects as it fails to fully capture the effects of productive efficiency, technology improvements, and even possibly the extent of improvement in investor expectations as a result of reform efforts for economic integration.

10.3.3 The AEC Blueprint and Progress

The AEC’s four pillars and core elements are shown in Table 10.4. The AEC Blueprint sets out the measures to be taken and the schedule for implementation.

10.3.3.1 The AEC as single market and production base

The EU single market is an area with free movement of goods, services, labor, and capital. However, cross-border freedoms are not sufficient to ensure foreign suppliers have access equal to that of domestic suppliers and national treatment behind the border is necessary. However, even full national treatment is inadequate to remove all measures that inhibit cross-border trade or factor movements. Hence the need for harmonization of the relevant laws, including competition law and intellectual property rights, and mutual recognition of product standards and labor market qualifications.

In the AEC, the single market is committed to free flow of goods, services, and skilled labor and freer flow of capital for priority sectors by 2010 ‘to the extent feasible and agreeable to all member countries’ and a goal of national treatment for all service sectors is in the Roadmap for Integration of ASEAN. On the harmonization of standards and technical regulations, working groups have been established in some priority sectors to implement standard-related measures while steps have been taken to set up a common intellectual property regime.

*Progress in goods trade liberalization* The AFTA was implemented in 1993 and succeeded by the ATIGA (ASEAN Trade in Goods Agreement)
The ASEAN Economic Community

in May 2010, the latter to consolidate and synergize various provisions on trade in goods into a single document. The AFTA’s CEPT scheme for tariff reduction has an Inclusion List (IL), Temporary Exclusion List (TEL), Sensitive List (SL), and General Exclusion List (GEL). The TEL would be eliminated through five annual transfers to the IL, completed by 2000 for the ASEAN6 and by 2003 for CLMV. The SL comprises unprocessed agricultural products with tariff liberalization delayed to 2010 for the ASEAN6 and 2013–17 for CLMV. The GEL permanently excludes certain products from liberalization for reasons of national security, protection of human, animal, or plant life and health, and articles of artistic, historic, and archaeological value.

Several changes have been made to the initial CEPT tariff reduction/elimination schedule. First, the time frame to reach the 0–5 percent target

Table 10.4  AEC Blueprint – four pillars and core elements

<table>
<thead>
<tr>
<th>Pillars</th>
<th>Core elements</th>
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<tbody>
<tr>
<td>A. Single market and production base</td>
<td>A1. Free flow of goods: 9 strategic approaches</td>
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<td></td>
<td>A2. Free flow of services: 3 strategic approaches</td>
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<td></td>
<td>A3. Free flow of investment: 5 strategic approaches</td>
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<td>A4. Freer flow of capital: 7 strategic approaches</td>
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<td></td>
<td>A5. Free flow of skilled labor</td>
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<td></td>
<td>A6. Priority integration sectors</td>
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<td></td>
<td>A7. Food, agriculture, and forestry</td>
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<tr>
<td>B. Competitive economic region</td>
<td>B1. Competition policy</td>
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<tr>
<td></td>
<td>B2. Consumer protection</td>
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<td></td>
<td>B3. Intellectual property rights</td>
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<td></td>
<td>B4. Infrastructure development: 10 strategic approaches</td>
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<td></td>
<td>B5. Taxation</td>
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<td></td>
<td>B6. E-commerce</td>
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<tr>
<td>C. Equitable economic development</td>
<td>C1. SME development</td>
</tr>
<tr>
<td>D. Integration into global economy</td>
<td>C2. Initiative for ASEAN Integration</td>
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<td></td>
<td>D1. Coherent approach toward external economic relations</td>
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<td></td>
<td>D2. Enhanced participation in global supply networks</td>
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Note:  AEC = ASEAN Economic Community; ASEAN = Association of Southeast Asian Nations; SMEs = small and medium-sized enterprises.

Source:  ASEAN (2008).
was shortened. Second, it was agreed to further reduce tariffs from 0–5 percent level to zero level. Third, for priority sectors, the target dates for eliminating tariffs were advanced. Table 10.5 shows that from January 2010, all tariffs for CEPT ILs of the ASEAN6 have been eliminated, representing 99 percent of ASEAN total tariff lines and the average tariff brought down to 0.9 percent. For the CLMV countries, tariff levels were down to 0–5 percent level by 2010 and to be eliminated by 2015. The CEPT IL coverage ranges from a high of 98.3 percent for Cambodia to a low of 78.4 percent for Indonesia.15 There is difficulty in eliminating tariffs on the SL products, particularly rice and sugar, because of national food security concerns in some ASEAN countries.

*Rules of origin.* Initially AFTA had a simple ROO criterion of a 40 percent RVC. But in response to feedback highlighting difficulties in qualifying under the existing ROO, the AFTA introduced additional ROO options using the CTC and the product specific process rule; abolished the free on board (FOB) value in the ASEAN Certificate of Origin (CO) Form D; and implemented the Pilot Project for a Regional Self Certification System by Brunei Darussalam, Malaysia, Singapore, and Thailand. The ROO has also been made more user-friendly with back-to-back CO and third party invoicing. Remaining issues with ROOs include arbitrary classification of origin resulting from differences in tariff classification among countries caused by slow adoption of ASEAN harmonized tariff classification and the ‘noodle bowl’ effect in the absence of a common template for the numerous ASEAN+16 and bilateral FTAs of ASEAN countries.

*Removal of NTBs.* With the elimination of most tariffs, NTBs emerge as a serious trade impediment. In reality, removal of NTBs has been slow in ASEAN, partly because it took considerable time for ASEAN to compile and update its NTB database.17 As shown in Table 10.5, NTBs were supposed to be eliminated by 2010, except for the Philippines (by 2012) and for CLMV (by 2015 with flexibility to 2018 for some products). While Myanmar, Indonesia, and Philippines were countries applying most of the NTBs, Cambodia and Thailand were the least NTB-restrictive countries.

*Progress in goods trade facilitation* ASEAN is not a customs union, and border procedures and inspections are necessary and pervasive. The ASEAN Trade Facilitation Framework and its work program have been adopted to address issues such as integrating customs procedures, establishing the ASEAN single window (ASW) program, enhancing
Table 10.5  ASEAN Economic Community – tariff and NTB reduction and/or elimination schedule

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<tr>
<td>Complete tariff reduction to 0–5% for all IL products for Lao PDR and Myanmar (2008)</td>
<td>Complete tariff reduction to 0–5% for all IL products for Cambodia (2010)</td>
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<tr>
<td>Integrate products outside CEPT Scheme according to CEPT Agreement (2008)</td>
<td>Eliminate import duties on 60% of all IL products except for those phased in from SL and HSL for Lao PDR and Myanmar (2008)</td>
<td>Eliminate import duties on 60% of all IL products except for those phased in from SL and HSL for Cambodia (2010)</td>
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Table 10.5 (continued)

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<th>Tariff elimination (continued)</th>
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<tr>
<td><strong>2008–09</strong></td>
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<tr>
<td>Eliminate import duties on 80% of all IL products except for those phased in from SL and HSL for ASEAN6 (2007)</td>
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<td>Eliminate import duties on products in the PIS for ASEAN6 (2007)</td>
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<td><strong>2010–11</strong></td>
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<tr>
<td>Eliminate import duties on 80% of all IL products except for those phased in from SL and HSL for Viet Nam (2010)</td>
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<td>Eliminate tariffs on all products, except for those phased in from the SL and HSL for ASEAN6 (2010)</td>
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<tr>
<td>Eliminate import duties on products in the PIS for ASEAN6 (2007)</td>
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<td><strong>2012–13</strong></td>
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<tr>
<td>Eliminate import duties on 80% of all IL products except for those phased in from SL and HSL for Lao PDR and Myanmar (2012)</td>
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<tr>
<td>Eliminate tariffs on all products, except for those phased in from the SL and HSL for ASEAN6 (2010)</td>
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<tr>
<td>Eliminate import duties on products in the PIS for CLMV (2012)</td>
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<tr>
<td><strong>2014–15</strong></td>
</tr>
<tr>
<td>Eliminate import duties on 80% of all IL products except for those phased in from SL and HSL for Lao PDR and Myanmar (2012)</td>
</tr>
<tr>
<td>Eliminate tariffs on all products, except for those phased in from the SL and HSL for CLMV 2015 with flexibility on some sensitive products up to 2018</td>
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<td>Eliminate import duties on products in the PIS for CLMV (2012)</td>
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Eliminate duties for 3rd tranche ICT products for CLMV according to Framework Agreement on e-ASEAN (2010)

Reduce tariffs on SL products to 0–5% for ASEAN6 (2010)

Reduce tariffs on SL products to 0–5% for Viet Nam (2013). For sugar, Viet Nam shall reduce tariffs to 0–5% by 2010

Complete phase in of remaining products in SL into CEPT Scheme and reduce tariffs on them to 0–5% (2015 Lao PDR and Myanmar, 2017 Cambodia)

Complete phase in of remaining products in SL into CEPT Scheme and reduce tariffs on them to 0–5% (2015 Lao PDR and Myanmar, 2017 Cambodia)

Eliminate duties for 1st and 2nd tranche of ICT products for CLMV according to the Framework Agreement on e-ASEAN (2008 for 1st tranche and 2009 for 2nd tranche)

Reduce tariffs on SL products to 0–5% for Viet Nam (2013). For sugar, Viet Nam shall reduce tariffs to 0–5% by 2010

Complete phase in of remaining products in SL into CEPT Scheme and reduce tariffs on them to 0–5% (2015 Lao PDR and Myanmar, 2017 Cambodia)

Complete phase in of remaining products in SL into CEPT Scheme and reduce tariffs on them to 0–5% (2015 Lao PDR and Myanmar, 2017 Cambodia)

Complete phase in of remaining products in SL into CEPT Scheme and reduce tariffs on them to 0–5% (2015 Lao PDR and Myanmar, 2017 Cambodia)

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Complete phase in of remaining products in SL into CEPT Scheme and reduce tariffs on them to 0–5% (2015 Lao PDR and Myanmar, 2017 Cambodia)
Table 10.5 (continued)

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<tr>
<td>Enhance transparency</td>
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<td>by abiding by the Protocol</td>
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<td>on Notification Procedure</td>
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<td>and setting-up an effective</td>
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<td>surveillance mechanism</td>
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<td>Eliminate NTBs for ASEAN5 (2010)</td>
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<td>Eliminate NTBs for Philippines (2012)</td>
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<tr>
<td>Eliminate NTBs for CLMV (2015) with flexibility to 2018 for some sensitive products</td>
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</table>

Note: AEC = ASEAN Economic Community; ASEAN = Association of Southeast Asian Nations; CEPT = Common Effective Preferential Tariff; CLMV = Cambodia, Lao PDR, Myanmar, Viet Nam; HSL = Highly Sensitive List; ICT = information and communication technology; IL = Inclusion List; Lao PDR = Lao People’s Democratic Republic; NTB = non-tariff barriers; PIS = priority integration sector; SL = Sensitive List.

Source: ASEAN (2012).
preferential tariff certification procedures, harmonizing standards, and conformance procedures.

**Customs improvements.** Customs regulations and procedures give rise to arbitrary and sometimes corrupt application in ASEAN countries and add to business transaction costs. Improvements are via the 1983 ASEAN Code of Conduct on Customs, the 1997 ASEAN Agreement on Customs,\(^{18}\) the 2003 ASEAN Customs Valuation Guide (modeled after the WTO customs valuation agreement), the 2003 ASEAN Post-Clearance Audit Manual, the Green Lane system for customs clearance of goods from ASEAN, and the ASEAN Harmonized Tariff Nomenclature (AHTN) system to provide a common system to classify and designate all goods for customs purposes. The ASW program, requiring prior establishment of national single windows (NSW) aims to reduce transaction costs by speeding up clearance of shipments and release of goods by customs authorities. However, the ASW program has fallen behind its 2008 deadline, as several countries have not fully established their NSWs.\(^{19}\) The technical and legal foundations of the ASW program are being set up for modest implementation by 2015.

**Technical barriers, product standards, and mutual recognition.** To minimize business transaction costs, national standards and technical regulations on products are either harmonized across ASEAN or MRAs adopted. ASEAN’s wide development gap poses an impediment. The 1992 ASEAN Consultative Committee on Standards and Quality (ACCSQ) focused on four main activities of harmonizing national standards, mandatory technical requirements, conformity assessment procedures, and technical regulations. In 1997 ASEAN designated some 20 priority products for standards harmonization (using international standards); in 1999 it agreed to align safety standards for 71 electrical appliances for commercial and household use and electromagnetic compatibility standards for ten categories of scientific and other equipment. In 1998 ASEAN adopted a framework agreement on MRAs that would obviate duplicative product testing and other forms of product compliance and thus reduce delays and costs. Mutual recognition arrangements have been reached in the electrical and electronics, cosmetics, and pharmaceutical sectors.

**Transportation and trade logistics.** Both the physical transport infrastructure and the administrative regulatory system are crucial for efficient delivery of physical goods. Interstate land and air transport are subject to bilateral agreements, and regional agreements are
badly needed. In 1995 ASEAN adopted the Singapore–Kunming rail link. In 1998 ASEAN moved to remove administrative regulatory obstacles to the free movement of goods, agreeing that inspection certificates issued by one country for commercial vehicles be valid in the other countries. Also in 1998 ASEAN concluded a framework agreement to facilitate transit passage of goods, that is, to ensure that goods being transported from one ASEAN country to another through a third would not be subject to unnecessary delays, restrictions, taxation, or customs inspection in the transit country. In 1999 the ASEAN Highway Network was formalized. The 1998 Hanoi Plan of Action called for a framework and modalities by 2000 for the development of a Competitive Air Services Policy as a prelude to an ASEAN Open Sky Policy; the rapid growth of budget airlines in the region was already breaking up the monopolies of ASEAN national airlines. In November 2005 an agreement on multimodal transport was concluded.

Logistics encompasses activities from transport, warehousing, cargo consolidation, and border clearance to domestic distribution and payment systems. According to the Logistics Performance Index (World Bank 2012), there is a wide gap in logistics performance among ASEAN countries, with Singapore and Myanmar at two ends of the spectrum.

Progress in services trade liberalization The AFAS helps lock in the unilateral liberalization measures already undertaken by ASEAN member states, and prepare them for further services liberalization in the WTO and other FTAs. The AFAS requires negotiations to be conducted sector by sector, with negotiations originally based on the GATS approach of request and offer. However, difficulty in reaching consensus led ASEAN to adopt the flexible ‘ASEAN minus X’ approach in 2004 whereby two or more ASEAN countries can start to negotiate services trade liberalization for specific sectors and/or subsectors, while other members are able to join later.

Liberalization is to be achieved through consecutive biennial rounds of negotiations, so that by 2015 substantially all restrictions would be removed. Each round of negotiations resulted in a package of commitments in each agreed sector and/or subsector and mode of supply. The general reluctance to liberalize services under Mode 3 (commercial presence) and Mode 4 (movement of natural persons) led to modifications in subsequent services negotiations, which resulted in liberalization of all limitations for Mode 1 (cross-border supply) and Mode 2 (consumption abroad) but only progressive liberalization for Modes 3 and 4. For Mode
4, MRAs or MRA frameworks for professional qualifications have been completed in architecture, accountancy, surveying, engineering, medical practitioners, dental practitioners, and nursing. Other MRAs for professional services are to be identified and negotiations completed by 2015.

There have been five rounds of negotiations involving eight packages that cover business services, professional services, construction, distribution, education, environmental services, healthcare, maritime transport, telecommunications, and tourism. Criticisms of slow progress in services liberalization include the following: the AFAS has resulted only in marginal liberalization when compared to GATS commitments; service negotiators are extremely cautious either because of their uncertainty about the impact of liberalization and fear of the loss of regulatory control in some service sectors (such as financial services) or because of the power of domestic interests; Mode 3 liberalization envisions only a maximum of 70 percent of ASEAN equity share; Mode 4 liberalization is confined to movement of professionals only; and the pre-agreed flexibilities cover subsectors totally excluded from liberalization and subsectors without agreed liberalization on all the four modes of supply. In September 2005, ASEAN ministers declared 2015 as the end-date for liberalization of all services sectors.

Progress in investment liberalization, facilitation, promotion, and protection  The 1998 AIA agreement aims to facilitate FDI inflows and participation in global and regional production networks. It grants national treatment to ASEAN investors by 2010 and to non-ASEAN investors by 2020, with some exceptions specified in the TEL, SL, and GEL. In 2001 the date for full realization of the AIA was advanced to 2010 for the ASEAN6 and 2015 for CLMV, and differential treatment of ASEAN and non-ASEAN investors was removed. Sectoral coverage includes manufacturing, agriculture, fisheries, forestry, and mining, and services incidental to those sectors. In 2003 this was expanded to include other services such as education, healthcare, telecommunications, tourism, banking and finance, insurance, trading, e-commerce, distribution and logistics, transportation and warehousing, and professional services such as accounting, engineering, and advertising.

The extent and type of investment barriers are indicated by the TEL, SL, and GEL. The deadlines for phasing out the TELs in manufacturing were advanced to January 2003 for the ASEAN6 and Myanmar, and to January 2010 for Cambodia, Lao PDR and Viet Nam. The deadlines for phasing out TELs in agriculture, fishery, forestry, mining, and related services were 2010 for the ASEAN6 and Cambodia, 2013 for Viet Nam, and 2015 for Lao PDR and Myanmar. As with services liberalization, the
‘ASEAN minus X’ formula was introduced. The GEL comprises industries and investment measures closed to FDI for reasons of national security, public morals, public health, and environmental protection.

The ACIA superseded the AIA, with the additional feature of investment protection. Although signed in 2009 it was ratified only in March 2012, due to delays by Thailand and Indonesia. The ASEAN countries also delayed submission of their reservations lists even though they are required to submit within six months after their signing. In particular, the ACIA offers:

- **Investment liberalization.** Free and open investment by 2015 with MFN and national treatment for investors (with limited exceptions); reduce and/or remove restrictions to entry for investments in the priority integration sectors; and reduce and/or remove restrictive investment measures and other impediments, including performance requirements. While all ASEAN countries welcome FDI, some countries such as Indonesia and Thailand have long TELs and SLs on right of establishment and national treatment. ASEAN countries have started to consider amending regulatory regimes to support changes in rules.

- **Investment facilitation.** This entails more transparent, consistent, and predictable investment rules, regulations, policies and procedures; harmonize, where possible, investment policies to achieve industrial complementation and economic integration; streamline and simplify procedures for investment applications and approvals; promote dissemination of investment information, rules, regulations, policies and procedures; strengthen databases on investment to facilitate policy formulation; strengthen coordination among the government ministries and agencies concerned; and consult with ASEAN private sectors to facilitate investment and identify and work toward areas of complementation.

- **Investment protection.** Updated a 1987 protection agreement to provide enhanced protection to all investors and their investments; provisions on the investor–state dispute settlement mechanism; and transfer and repatriation of capital, profits, dividends, among others; provide transparent coverage of expropriation and compensation, full protection and security, and treatment of compensation for losses resulting from strife.

- **Investment promotion.** Promote ASEAN as an integrated investment area; intra-ASEAN investments, especially from the ASEAN6 to CLMV; growth and development of SMEs as well as MNCs; promote industrial complementation and production networks
among MNCs in ASEAN; joint investment missions that focus on regional clusters and production networks; and an effective network of bilateral agreements on avoidance of double taxation among ASEAN countries. ASEAN has intensified efforts through such initiatives as the linking of investment agencies’ websites, development and dissemination of investment publications, and investment road shows and seminars.

**Progress with freer flow of capital** Efforts to liberalize and integrate the financial markets through initiatives such as financial services liberalization, capital market development, and capital account liberalization have been further strengthened to support trade integration. On financial services liberalization, based on a new approach of pre-agreed flexibilities, the sixth round of negotiations was launched in May 2011. On capital market development, efforts to deepen equities markets were strengthened and new working committees on dispute resolution and enforcement, and taxation were established. The marketing and branding campaign for the ASEAN Exchanges initiative that promotes ASEAN as an asset class was launched in May 2011 and an ASEAN Bond Market Development Scorecard was developed. In line with the development of local currency bond markets, the Credit Guarantee and Investment Facility (CGIF) was established in October 2011, while the agreement for the ASEAN Infrastructure Fund (AIF) was signed in September 2011. The CMIM was finalized in December 2009, providing for an enlarged US$120 billion swap arrangement.

**Progress with free flow of skilled labor** Factors driving skilled labor mobility in ASEAN include large disparities in wages and employment opportunities, geographic proximity and sociocultural-linguistic environment, and disparities in educational developments. As more ASEAN countries move up the technological ladder, liberalizing trade in goods and services and in FDI would not be enough, and a larger pool of professional and skilled labor becomes necessary. Until such time when domestic educational and training institutions are able to supply the necessary high level manpower, and domestic economic growth is able to absorb this high level manpower, countries will still have to depend on foreign talent or export talent. However, even with adequate domestic supply there is still need for foreign talent to provide competition, stimulation, and synergy to improve the quality and productivity of domestic talent. Some countries, such as Singapore, and to a lesser extent Malaysia, regard foreign talent as an upgrading and competitive tool and have active policies to promote their inflows. Most ASEAN countries, however, have yet to move away
from protecting domestic professionals and skilled workers through constitutional provisions, policies, regulations, and practices.

In the AEC Blueprint, strategic actions on free flow of skilled labor include facilitating the issuance of visas and employment passes, MRAs for major professional services, core concordance of services skills and qualifications. Enhanced cooperation for the movement of natural persons was finalized in late 2012.

**Mutual recognition arrangements.** Mutual recognition arrangements are major instruments for skilled labor mobility in ASEAN. Through MRAs, ASEAN countries may recognize the education or experience obtained, requirements met, and licensing or certification granted by other ASEAN countries. However, negotiating for recognition is a complex and time consuming process given the wide differences in development levels and educational and professional standards among ASEAN countries and the role of national professional bodies. Mutual recognition arrangements for professional qualifications have been completed in accountancy, engineering, medicine, dentistry, and nursing. MRA frameworks in architecture and surveying and other MRAs are expected to be identified and negotiated by the 2015 deadline.

Chia (2013) notes that effective implementation of these MRAs poses problems as market access (permission to work) is subject to domestic rules and regulations. Rules and regulatory frameworks that constrain and impede skilled labor mobility include requirements and procedures for employment visas and employment passes, constitutional and legal provisions reserving jobs for nationals, policies that impose numerical caps on foreign professionals and skills in sectors and occupations, economic and labor market tests that constrain employment of foreigners and require them to be replaced by locals within a stipulated period, language proficiency requirements, and licensing regulations of professional bodies. National sensitivities to the migration issue have prevented much effective cooperation to date.

### 10.3.3.2 AEC as a competitive economic region

This AEC pillar has several behind-the-border action areas to reinforce ASEAN competitiveness. These cover:

**Competition policy.** Several initiatives have been undertaken, including the formation of an ASEAN experts’ group on competition, ASEAN regional guidelines on competition policy, and a handbook
on competition policy and laws for business in ASEAN. The guidelines provide a reference on country experiences and best practices at the international level, while the handbook provides basic notions of substantive and procedural competition law applicable in ASEAN countries.

*Intellectual property rights.* The ASEAN countries' position is primarily that of developing country users, although Singapore has significant interest in IP protection for its high technology and biomedical sectors, while other ASEAN countries are concerned with the protection of their traditional and indigenous cultures, medicines, and plants. The development of IP and IPR is crucial to build ASEAN as an innovative and competitive economic region. Hence in August 2011, ASEAN endorsed its IPR Action Plan 2011–2015. ASEAN also collaborated with dialogue partners and international organizations to enhance capacity building in IP. Conflicts of interest among ASEAN countries are rare and the main conflicts are enforcing the IPR of developed countries and foreign MNCs in regard to manufactured branded products, patented medicines, IT software, and online music and movies.

*Infrastructure development.* Transportation and IT infrastructure are essential for the movement of goods, capital, labor, people, and ideas among ASEAN countries. The Brunei Action Plan adopted in 2010 contains strategic actions to be implemented in 2011–15 toward the realization of the AEC as well as new priorities under the Master Plan on ASEAN Connectivity. The signing of the ASEAN Multilateral Agreement on the Full Liberalization of Passenger Air Services and its protocol provided a framework for the full realization of ASEAN Open Skies. To facilitate ASEAN shipping services, the Strategy Toward the Integration of an ASEAN Single Shipping Market was developed. The stock-taking of road inventory of all national route components of the ASEAN Highway Network to strengthen the ASEAN regional infrastructure was completed. The ASEAN ICT Master Plan 2015 was adopted in January 2011, and a study on the adoption of an ASEAN Technical Architecture Framework for e-commerce interoperability was completed. The ASEAN Plan of Action for Energy Cooperation (APAEC) 2010–2015 consists of seven key areas of cooperation to enhance energy security, accessibility, and sustainability for ASEAN: ASEAN Power Grid, Trans-ASEAN Gas Pipeline, Coal and Clean Technology, Renewable Energy, Energy Efficiency and Conservation, Regional Energy Policy and Planning, and Civilian Nuclear Energy. The necessary domestic legislation
has yet to be enacted for the ASEAN Framework Agreement on Multilateral Transport, the ASEAN Framework Agreement on Inter-State Transport, the ASEAN Multilateral Agreement on Full Liberalization of Passenger Air Services, the ASEAN Single Shipping Market, and the ASEAN Interconnection Projects. In 2010 the Master Plan on ASEAN Connectivity was adopted, with an estimated US$60 billion annual infrastructure investment needed for the 2010–20 period. The ASEAN Infrastructure Fund commenced operation in May 2012.

A major challenge in ASEAN infrastructure development is coordinating the various national needs with the regional vision and plans so as to obviate costly overlaps and missing links, harmonizing various national infrastructure standards, and effective monitoring of implementation of infrastructure projects so as to facilitate the flows of goods and people. As infrastructure financing needs are huge, ASEAN needs to explore various funding mechanisms and sources.

10.3.3.3 AEC with equitable economic development

The AEC Blueprint lists only two measures: SME development targeted to narrow intra-country development gaps; and the Initiative for ASEAN Integration (IAI) targeted at narrowing the development gap between the ASEAN6 and CLMV. The 19th ASEAN Summit in November 2011 endorsed the ASEAN Framework on Equitable Economic Development (EED) as a new initiative.

Development of small and medium-sized enterprises  This is necessary for equitable development through mitigating market dominance by foreign MNCs and large state-owned enterprises (SOEs) and fostering local entrepreneurship, innovation, and employment creation. Small and medium-sized enterprises in ASEAN face several challenges, including limited access to finance and technology, severe competition from SOEs and MNCs as well as SMEs from the PRC, Japan, and the Republic of Korea, weak entrepreneurial and management skills, and difficulties in coping with AEC market standards. ASEAN endorsed the Strategic Action Plan for the ASEAN SME Development (2010–2015) in August 2010. The ASEAN SME Advisory Board provides strategic policy input on SME development to the ministers and guidance on high priority matters to the ASEAN SME Working Group. Work started on the Conceptual Framework for Regional SME Development Fund. Two projects under the Strategic Action Plan have been completed. The Directory of Outstanding ASEAN SMEs seeks to promote
links of SMEs to the regional and global supply chains and production networks.

Initiative for ASEAN Integration  The IAI serves as a platform for identifying and implementing technical assistance and capacity-building programs targeted at CLMV. The ASEAN6, ASEAN dialogue partners, and the Asian Development Bank are involved in the IAI programs. The new IAI Strategic Framework and Work Plans I and II were endorsed to facilitate implementation of CLMV projects. The scope of priority areas has expanded beyond the initial focus on infrastructure, human resource development, ICT, and capacity building for regional integration to include tourism, poverty, and quality of life.

Vo (2013) surveyed responses on the effectiveness of the IAI and came to the following conclusions. First, CLMV countries have positive perception of the IAI programs and projects, as they are relevant to development needs and priorities of CLMV. However, better outcomes would have been realized if the IAI work plans had been better designed and implemented and there had been better financial adequacy. Second, the IAI program areas and/or projects contribute either moderately or substantially to narrowing development gaps. Criticisms of the IAI programs focus on the inappropriateness of using a common template for CLMV while also noting that: some projects are too ambitious in terms of financial resources and time available; the role of the World Bank and ADB as donors would be necessary; and the IAI needs to pay more attention to institution building.

10.3.4 Measuring Progress in ASEAN Economic Integration

Growth in intra-regional trade is a common measure of the extent of trade integration achieved. However, unlike economic integration efforts elsewhere where the focus is on increasing intra-regional trade and investment shares, ASEAN’s focus is on reducing barriers to intra-regional trade and investment so as to compete more effectively in the global arena.

10.3.4.1 Intra-ASEAN trade

As shown in Table 10.6, intra-ASEAN trade share grew from 17.0 percent in 1990 (pre-AFTA) to 25.0 percent in 2011, representing a significant improvement. However, this trade share is still significantly lower than that of NAFTA and the EU. Also, the improved intra-ASEAN trade needs qualification. It may not necessarily be attributable to the implementation of the AFTA and the ATIGA, as tariff preference utilization rates have been consistently low in a number of studies. On the other hand, it could be argued that the removal of some NTBs and improvements in
customs and trade logistics as a result of the FTA and the ATIGA have improved intra-ASEAN trade.

At the country level, the intra-ASEAN trade share between 1990 and 2011 has declined for Brunei Darussalam and Cambodia, remained stable for Malaysia, Lao PDR, and Viet Nam, and increased for the other ASEAN countries. By 2011, dependence on intra-ASEAN trade is highest for Lao PDR and lowest for Viet Nam. The Lao PDR is a landlocked country and heavily dependent on trade with neighboring Thailand, while Viet Nam’s dependence on trade with ASEAN has declined since normalization of trade with the US and accession to the WTO. Cambodia’s dependence on ASEAN trade declined with increased exports of garments to the US and EU markets.

As shown in Table 10.7, countries show asymmetric dependence on trade with ASEAN. Brunei Darussalam, Cambodia, Indonesia, and Lao PDR are much more dependent on ASEAN sourcing than ASEAN as a market, while the reverse is true of Singapore and Thailand. The bulk of intra-ASEAN trade (87.7 percent in 2011) is accounted for by Indonesia, Malaysia, Singapore, and Thailand, with Singapore alone accounting for 34.4 percent.

Since the inception of AFTA in 1993 intra-ASEAN trade had grown from US$82 billion to reach US$598 billion by 2011. At the outset,
<table>
<thead>
<tr>
<th>Country</th>
<th>Intra-ASEAN imports</th>
<th></th>
<th></th>
<th>Intra-ASEAN exports</th>
<th></th>
<th></th>
<th>Total intra-ASEAN trade</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$ million</td>
<td>%</td>
<td>% of country</td>
<td>$ million</td>
<td>%</td>
<td>% of country</td>
<td>$ million</td>
<td>%</td>
<td>% of country</td>
</tr>
<tr>
<td></td>
<td>distribution imports</td>
<td></td>
<td></td>
<td>distribution exports</td>
<td></td>
<td></td>
<td>distribution trade</td>
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<td></td>
</tr>
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<td>0.4</td>
<td>48.4</td>
<td>1721</td>
<td>0.5</td>
<td>13.9</td>
<td>2912</td>
<td>0.5</td>
<td>19.6</td>
</tr>
<tr>
<td>Indonesia</td>
<td>57254</td>
<td>21.1</td>
<td>32.3</td>
<td>42099</td>
<td>12.9</td>
<td>20.7</td>
<td>99353</td>
<td>16.6</td>
<td>26.1</td>
</tr>
<tr>
<td>Malaysia</td>
<td>52090</td>
<td>19.2</td>
<td>27.8</td>
<td>56050</td>
<td>17.1</td>
<td>24.6</td>
<td>108140</td>
<td>18.1</td>
<td>26.0</td>
</tr>
<tr>
<td>Philippines</td>
<td>15040</td>
<td>5.6</td>
<td>23.6</td>
<td>8635</td>
<td>2.6</td>
<td>18.0</td>
<td>23676</td>
<td>4.0</td>
<td>21.2</td>
</tr>
<tr>
<td>Singapore</td>
<td>78126</td>
<td>28.9</td>
<td>21.4</td>
<td>127545</td>
<td>38.9</td>
<td>31.2</td>
<td>205671</td>
<td>34.4</td>
<td>26.5</td>
</tr>
<tr>
<td>Thailand</td>
<td>39224</td>
<td>14.5</td>
<td>17.0</td>
<td>72227</td>
<td>22.1</td>
<td>31.6</td>
<td>111450</td>
<td>18.6</td>
<td>24.3</td>
</tr>
<tr>
<td>Cambodia</td>
<td>2170</td>
<td>0.8</td>
<td>35.4</td>
<td>834</td>
<td>0.3</td>
<td>12.4</td>
<td>3004</td>
<td>0.5</td>
<td>23.4</td>
</tr>
<tr>
<td>Lao PDR</td>
<td>1571</td>
<td>0.6</td>
<td>71.1</td>
<td>960</td>
<td>0.3</td>
<td>55.0</td>
<td>2530</td>
<td>0.4</td>
<td>64.0</td>
</tr>
<tr>
<td>Myanmar</td>
<td>3250</td>
<td>1.2</td>
<td>47.8</td>
<td>3957</td>
<td>1.2</td>
<td>48.7</td>
<td>7208</td>
<td>1.2</td>
<td>48.3</td>
</tr>
<tr>
<td>Viet Nam</td>
<td>20793</td>
<td>7.7</td>
<td>20.0</td>
<td>13505</td>
<td>4.1</td>
<td>14.2</td>
<td>34298</td>
<td>5.7</td>
<td>17.2</td>
</tr>
<tr>
<td>ASEAN10</td>
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<td>327532</td>
<td>100.0</td>
<td>26.4</td>
<td>598242</td>
<td>100.0</td>
<td>25.0</td>
</tr>
</tbody>
</table>

Note: ASEAN = Association of Southeast Asian Nations; Lao PDR = Lao People's Democratic Republic.

Source: Compiled from ASEAN Secretariat trade statistics (ASEAN 2013).
the intra-ASEAN trade centered on Singapore, largely the Singapore–Malaysia bilateral trade, and to a lesser extent the Singapore–Indonesia and Singapore–Thailand bilateral trade. The Singapore entrepôt was importing for re-export the primary commodities of neighboring countries and exporting to them the manufactures from industrialized countries and increasing intra-ASEAN trade in parts and components. However, with the growing importance of oil and gas production and as ASEAN countries industrialize and participate in production networks, trade among ASEAN countries other than Singapore grew, and the intra-ASEAN trade increasingly comprises trade in petroleum and petroleum products and manufactures, particularly parts and components of the electrical and machinery industries (Table 10.8).

10.3.4.2 Utilization of CEPT tariff preferences
A number of studies showed that the CEPT had a low utilization rate (for example, Dennis and Yusof, 2003; Kawai and Wignaraja 2011). Reasons include the following. First, the low margin of preference (MOP) between MFN and CEPT rates, with zero MOP for Singapore, and for some products in other ASEAN countries. For the latter, most electronic products and components enjoy zero MFN tariffs under the WTO’s Information Technology Agreement as well as under duty-drawback schemes in ASEAN export processing zones. Second, problems with customs valuation and rules of origin. Apart from problems with customs authorities, some exporters find it difficult to qualify under the value added ROO because of the prevalence of outward processing in production networks. Third is the high cost of logistics, transportation, and telecommunications. Fourth, many SMEs were unfamiliar with applying for tariff preferences under the CEPT.

10.3.4.3 FDI inflows and intra-ASEAN FDI
The main basis of ASEAN economic integration is not regional market pooling and increasing the intra-ASEAN trade share, but rather that of increasing competitiveness in the global market. In this, attracting FDI and integrating into production networks plays a crucial role. It is difficult to determine the impact of the AFTA, the AFAS, and the AIA on FDI inflows. ASEAN’s share of global FDI destined for the developing world has been declining in recent decades for two major reasons: the rise of the PRC and its growing attraction for foreign investors, and the negative effect of the 1997–98 Asian financial crisis. FDI inflows to several ASEAN countries dropped sharply in the aftermath of the crisis. However, without the attractions of ASEAN economic integration, FDI inflows could have fared worse.
Table 10.8  Intra-ASEAN trade at HS 2-digit, 2011

<table>
<thead>
<tr>
<th>HS 2-digit</th>
<th>Intra-ASEAN</th>
<th>Intra-ASEAN</th>
<th>Intra-ASEAN</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Exports</td>
<td>Imports</td>
<td>Total</td>
</tr>
<tr>
<td></td>
<td>$ million</td>
<td>% distribution</td>
<td></td>
</tr>
<tr>
<td>01–05 Animal &amp; animal products</td>
<td>2,808.7</td>
<td>2,462.9</td>
<td>5,271.6</td>
</tr>
<tr>
<td>06–15 Vegetable products</td>
<td>15,290.5</td>
<td>12,206.8</td>
<td>27,497.3</td>
</tr>
<tr>
<td>16–24 Foodstuffs</td>
<td>13,186.0</td>
<td>8,664.7</td>
<td>21,850.7</td>
</tr>
<tr>
<td>25–27 Mineral products</td>
<td>83,597.8</td>
<td>81,215.1</td>
<td>164,812.9</td>
</tr>
<tr>
<td>28–38 Chemical and chemical products</td>
<td>19,695.2</td>
<td>15,250.8</td>
<td>34,946.0</td>
</tr>
<tr>
<td>39–40 Plastics and rubbers</td>
<td>24,494.6</td>
<td>15,163.6</td>
<td>39,658.2</td>
</tr>
<tr>
<td>41–43 Raw hides, skins, leather, furs</td>
<td>633.8</td>
<td>505.0</td>
<td>1,138.8</td>
</tr>
<tr>
<td>44–49 Wood and wood products</td>
<td>5,799.2</td>
<td>6,068.4</td>
<td>11,867.6</td>
</tr>
<tr>
<td>50–60 Textiles</td>
<td>3,523.0</td>
<td>2,711.3</td>
<td>6,234.3</td>
</tr>
<tr>
<td>61–63 Apparel</td>
<td>1,316.0</td>
<td>1,145.6</td>
<td>2,461.6</td>
</tr>
<tr>
<td>64–67 Footwear and headgear</td>
<td>599.1</td>
<td>462.5</td>
<td>1,061.6</td>
</tr>
<tr>
<td>68–71 Stone and glass</td>
<td>5,655.0</td>
<td>6,223.0</td>
<td>11,878.0</td>
</tr>
<tr>
<td>72–83 Metals</td>
<td>20,580.4</td>
<td>17,557.1</td>
<td>38,137.5</td>
</tr>
<tr>
<td>84 Machinery</td>
<td>42,606.5</td>
<td>27,099.6</td>
<td>69,706.1</td>
</tr>
<tr>
<td>85 Electrical machinery</td>
<td>58,800.9</td>
<td>53,058.5</td>
<td>111,859.4</td>
</tr>
<tr>
<td>86–89 Transportation</td>
<td>17,879.0</td>
<td>14,010.6</td>
<td>31,889.6</td>
</tr>
<tr>
<td>90–92 Precision instruments</td>
<td>6,689.1</td>
<td>4,364.6</td>
<td>11,053.7</td>
</tr>
<tr>
<td>93–97 Miscellaneous</td>
<td>2,012.3</td>
<td>1,546.2</td>
<td>3,558.5</td>
</tr>
<tr>
<td>98–99 Others</td>
<td>2,364.9</td>
<td>994.7</td>
<td>3,359.6</td>
</tr>
<tr>
<td>Total</td>
<td>327,531.8</td>
<td>270,710.4</td>
<td>598,242.2</td>
</tr>
</tbody>
</table>

**Note:** ASEAN = Association of Southeast Asian Nations; HS = harmonized system.

**Source:** Compiled from ASEAN Secretariat trade statistics (ASEAN, 2013).
Unlike the EU and NAFTA, intra-regional investments have been limited in ASEAN as all member countries are net recipients of FDI. Intra-ASEAN investments are dominated by investments among Singapore, Malaysia, and Thailand. In recent years, CLMV as well as Indonesia have attracted sizeable investments from the more developed ASEAN countries, with regional economic integration playing a significant role in improving the investment climate in CLMV. Table 10.9 shows that the bulk of intra-ASEAN investments from 1995–2006 was received by Thailand, Singapore, and Malaysia, and to a lesser extent by Indonesia and Viet Nam. More recent evidence shows that Singapore is a major investor in Indonesia, Malaysia, Cambodia, Myanmar, and Viet Nam.

10.3.4.4 Implementation issues of AFTA, AFAS, and AIA

The Mid-Term Review of the Hanoi Plan of Action (ASEAN 2001) highlighted the following implementation problems. First, weak commitments to some of the decisions to promote liberalization and cooperation programs, possibly due to poor awareness of the benefits of liberalization with inadequate or late submission of necessary information. Weak commitment was also reflected in the low level of representation at negotiations and meetings, resulting in inability to make critical decisions at such meetings. Second, slowness in implementing decisions reflects the need to consider and consult diverse national, sectional, and private sector interests that could be time consuming, particularly where there are perceived conflicts between ASEAN commitments and the various interests. Third, new national legislation and changes to existing national legislation to accommodate the ASEAN commitments are often time consuming. Fourth, at times, delays in implementation are also due to lack of appropriate and sufficient technical capacity for implementation and/or inadequate financial resources (ASEAN 2001).

Severino (2006), a former ASEAN Secretary-General, candidly assessed the reasons why ASEAN had fallen short on implementation. First, a fundamental problem is that most ASEAN governments do not feel a sufficient identification of the national interest with regional economic integration and most ASEAN firms do not see how their businesses benefit from such integration. Most national governments and firms place more value on extra-ASEAN markets, and national governments feel no pressure from their business sectors to move faster on regional economic integration. Second, NTBs are largely opaque and hard to identify and even more difficult to remove. Streamlining customs operations and coordinating them regionally may require the overhaul of entire cultures at some national customs’ authorities. Regulatory bodies may have to give up a measure of their authority in order to harmonize product standards
Table 10.9 *Intra-ASEAN foreign direct investment flows by ASEAN host country*

<table>
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<tr>
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<td>$ million</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Brunei Darussalam</td>
<td>311</td>
<td>21</td>
<td>37</td>
<td>25</td>
<td>19</td>
<td>10</td>
<td>1434</td>
<td>3.6</td>
</tr>
<tr>
<td>Indonesia</td>
<td>609</td>
<td>1337</td>
<td>384</td>
<td>32</td>
<td>883</td>
<td>1524</td>
<td>4295</td>
<td>10.7</td>
</tr>
<tr>
<td>Malaysia</td>
<td>1677</td>
<td>0</td>
<td>251</td>
<td>980</td>
<td>573</td>
<td>468</td>
<td>9030</td>
<td>22.4</td>
</tr>
<tr>
<td>Philippines</td>
<td>242</td>
<td>38</td>
<td>175</td>
<td>116</td>
<td>13</td>
<td>−96</td>
<td>1272</td>
<td>3.2</td>
</tr>
<tr>
<td>Singapore</td>
<td>1165</td>
<td>774</td>
<td>637</td>
<td>649</td>
<td>1176</td>
<td>1138</td>
<td>9459</td>
<td>23.5</td>
</tr>
<tr>
<td>Thailand</td>
<td>161</td>
<td>1223</td>
<td>670</td>
<td>336</td>
<td>762</td>
<td>2822</td>
<td>9760</td>
<td>24.2</td>
</tr>
<tr>
<td>Cambodia</td>
<td>0</td>
<td>9</td>
<td>20</td>
<td>32</td>
<td>129</td>
<td>156</td>
<td>383</td>
<td>0.9</td>
</tr>
<tr>
<td>Lao PDR</td>
<td>7</td>
<td>8</td>
<td>3</td>
<td>8</td>
<td>7</td>
<td>11</td>
<td>287</td>
<td>0.7</td>
</tr>
<tr>
<td>Myanmar</td>
<td>97</td>
<td>25</td>
<td>24</td>
<td>12</td>
<td>38</td>
<td>28</td>
<td>1113</td>
<td>2.8</td>
</tr>
<tr>
<td>Viet Nam</td>
<td>387</td>
<td>200</td>
<td>100</td>
<td>243</td>
<td>165</td>
<td>182</td>
<td>3286</td>
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<td>2433</td>
<td>3765</td>
<td>6242</td>
<td>40316</td>
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</tr>
</tbody>
</table>

*Note:* ASEAN = Association of Southeast Asian Nations; Lao PDR = Lao People’s Democratic Republic.

*Source:* Chia (2011).
with other ASEAN countries and give recognition to those countries’ certificates of compliance with regulations. Governments will have to ensure that firms adjust to ASEAN norms and abandon the standards that they have adhered to for years. Third, services are even more sensitive than trade in goods. Liberalizing transportation services would expose to greater competition national airlines, shipping lines, and land transport companies, many of which are state-owned or crony-owned and used to state protection. Trans-boundary transport arrangements can also be held hostage to political disputes or pressures. Fourth, ASEAN has no compliance or enforcement mechanisms and failure to implement carries no sanctions. The ASEAN Secretariat has no power to enforce agreements or the authority to make transparent the cases of non-compliance.

10.3.5 AEC Scorecard for 2008–2011

The AEC Blueprint provides a roadmap with a timeline for implementing the necessary economic measures and actions and the ASEAN Scorecard was developed to track implementation. The implementation rate for 2008–11 was 67.5 percent. Table 10.10 shows the scorecard reporting measures that were fully implemented or not fully implemented for the AEC’s four pillars and components. Highlights are as follows:

- Implementation rates are highest for the fourth pillar (integration into the global economy), but less than 70 percent for the other three pillars. Implementation rates are also higher for Phase I (2008–09) than for Phase II (2010–11). Thus, instead of accelerating implementation as the target date of 2015 draws nearer, ASEAN countries seem to be slackening. Alternatively it could mean that as ‘the low hanging fruits are first plucked, the fruits further up the tree are more difficult to reach’.

- For the single market and production base, implementation in services is the most problematic, followed by investment. The main problem with investments is enforceability, as the TEL and SL lists allow ASEAN countries to delay or opt out of implementing measures. Many of the outstanding measures are in trade facilitation. For the competitive economic region, measures not fully implemented are primarily in transport, with delays in ratification of regional agreements and translating them into respective national laws. For equitable economic development, non-full implementation is mainly in SME development.

- At the national level, all ASEAN countries have fully implemented freer flow of capital (except Myanmar), free flow of skilled labor,
<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td></td>
<td>Fully implemented</td>
<td>Not fully implemented</td>
<td>Fully implemented</td>
</tr>
<tr>
<td>Single market and production</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>base</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Free flow of goods</td>
<td>9</td>
<td>0</td>
<td>23</td>
</tr>
<tr>
<td>Free flow of services</td>
<td>10</td>
<td>3</td>
<td>13</td>
</tr>
<tr>
<td>Free flow of investment</td>
<td>5</td>
<td>1</td>
<td>5</td>
</tr>
<tr>
<td>Freer flow of capital</td>
<td>1</td>
<td>0</td>
<td>5</td>
</tr>
<tr>
<td>Free flow of skilled labor</td>
<td>–</td>
<td>–</td>
<td>1</td>
</tr>
<tr>
<td>Priority integration sectors</td>
<td>28</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>Food, agriculture, and forestry</td>
<td>8</td>
<td>0</td>
<td>5</td>
</tr>
<tr>
<td>Total number of measures</td>
<td>61</td>
<td>4</td>
<td>53</td>
</tr>
<tr>
<td>Implementation rate</td>
<td>93.8%</td>
<td></td>
<td>49.1%</td>
</tr>
<tr>
<td>Competitive economic region</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Competition policy</td>
<td>2</td>
<td>0</td>
<td>2</td>
</tr>
<tr>
<td>Consumer protection</td>
<td>2</td>
<td>0</td>
<td>5</td>
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Table 10.10  (continued)

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<td>Implementation rate</td>
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<td>78%</td>
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Note: AEC = ASEAN Economic Community; IAI = Initiative for ASEAN Integration; ICT = information and communication technology; SMEs = small and medium-sized enterprises.

Source: ASEAN (2012).
priority integration sectors, competition policy, mineral, ICT, taxation (except Cambodia), and e-commerce. They have also more than half implemented the free flow of goods, services and investments, food–agriculture–forestry, consumer protection, transport, energy, IAI, and external economic relations. In IPR, the compliance record is mixed, with full implementation by Malaysia, Philippines, Singapore, Thailand, and Viet Nam. The record is also mixed in SME development with full implementation

- The aggregate scores fail to reveal the rates of implementation for individual countries and for different parts of a country (for example, the capital city versus other provinces and areas) and on each of the policy actions in the blueprint. By not making public the compliance record of individual countries, there is no ‘public’ pressure for compliance. The lack of sanctions for non-compliance reflects the club-like nature of ASEAN and the downplay of legalism among club members. On the other hand, if a more legalistic stance with sanctions for non-compliance had been adopted, then ASEAN leaders would be more reluctant to commit to so many liberalization and facilitation measures.

10.4 THE AEC BY 2015 AND BEYOND

Realizing the AEC by 2015 could be interpreted in two ways. First, it would mean full implementation of all the actions and measures listed in the AEC Blueprint. Second, it would mean realizing the AEC objectives of a single market and production base, a competitive economic region, equitable economic development, and integration into the global economy. The scorecard only monitors compliance in implementing the specific actions and measures indicated in the AEC Blueprint. It gives no indication of how far the AEC objectives are being realized.

10.4.1 Implementing the AEC Blueprint by 2015

The immediate priority is to improve the implementation of AEC Blueprint’s strategic actions so that the 2015 timelines can be met as far as possible. Problematic areas are measures pertaining to services liberalization, trade facilitation, and free flow of skilled labor. It is crucial that efforts are intensified both at regional and country levels to close the implementation gaps. As discussed earlier, obstacles to implementation include legislative and regulatory limitations and effective coordination of implementation across various national ministries and agencies. A better
effort needs to be made to gain the acceptance of legislators, government officials, business leaders, and the general public of the benefits of trade and investment liberalization and of the costs of non-action. In any FTA, there are winners and losers. Winners are businesses, investors, workers, and consumers that gain directly from liberalization and integration, while losers are those businesses and workers that face intensified competition from foreign suppliers, investors, and professionals. There should be greater understanding of the political economy of FTAs. Policy makers have the tough task of marketing the liberalization idea, commissioning and disseminating studies on the benefits of economic integration, seeking consultations with the private sector and workers to identify short-term losers, and finding mechanisms to ‘compensate’ losers through financial and/or technical assistance to enable firms to seek new businesses and workers to undertake training for new jobs. Some ASEAN countries such as Singapore have been more successful than others in achieving this objective.

Monitoring the progress of the AEC should be strengthened. There is a need to strengthen the monitoring capacity of the ASEAN Secretariat and provide technical assistance to member states to enhance their implementation capacity. Greater private sector feedback should be undertaken to assess the impact and effectiveness of the policies and measures being implemented, so as to address the business impediments to the free flow of goods, services, investments, capital, and skilled labor.

There is growing consensus that it would not be possible to fully implement the AEC Blueprint by the end of 2015, particularly as some measures, such as the removal of NTBs and investment in infrastructure, have long gestation periods. The important thing is to set in motion the process, even if full implementation extends beyond 2015.

The *Mid-Term Review of the Implementation of the AEC Blueprint* (ERIA 2012) notes that the drive toward AEC 2015 is already contributing to a surge in FDI to the ASEAN region, in part due to substantive achievements in AEC measures. Reduction and elimination of tariffs has resulted in a rise in ASEAN import sourcing of individual countries and a geographic diffusion beyond the earlier Singapore–Malaysia trade concentration. On trade facilitation, the private sector in ASEAN has noted favorably the improvements in customs and import and/or export clearance in many ASEAN countries in recent years. On investment liberalization, commitments in the goods sector under ACIA are remarkably liberal in most ASEAN countries, using as a yardstick a minimum of 70 percent allowable foreign equity. However, there remains room for further liberalization through a reduction in the number of industries in the ACIA Reservations List.
10.4.2 Realizing the AEC objectives

Promoting trade and investment liberalization and facilitation in the AEC has a caveat: it should be accompanied by efforts to improve governance and the rule of law and to improve the capabilities and capacities of local businesses and local workers to compete regionally and internationally. The action plans outlined in the AEC Blueprint for 2008–15 are inadequate to realize the objectives of the AEC. More needs to be done.

10.4.2.1 AEC with equitable economic development

Goods sector liberalization  Tariff elimination has largely been on schedule and even brought forward. However, utilization rates of FTA tariff preferences are low. Some of the problem areas such as ROO and certification and customs procedures are being addressed. Further efforts are needed in simplifying customs procedures and improving certainty of customs outcomes (including removing corruption). A customs union would remove the problems associated with ROO, but it has problems of its own as discussed later. To improve tariff preference utilization rates, more publicity, enhanced website information, and training programs targeted at SMEs are called for. The removal of NTBs has been slow, including those that impede supply chains such as the administrative-regulatory regime and inefficient trade logistics. Some of these barriers are indicated in the components of the World Bank Ease of Doing Business Index (World Bank 2013) and the Logistics Performance Index (World Bank 2012) and further action is called for.

Services sector liberalization  The services sector will play an increasing role in ASEAN economies to support the growth of services in consumption and services inputs in production, as well as the development of service sectors such as telecommunications, transportation and logistics, education and healthcare. The ERIA Mid-Term Review found that the benefits of services liberalization exceed those from tariff elimination. So far, services liberalization commitments from ASEAN countries range from moderate to high. Liberalization under Mode 3 (right of establishment) and Mode 4 (movement of natural persons) are low. ASEAN needs to redouble efforts to ensure AFAS targets are met and the various flexibilities and carve outs minimized.

Investment liberalization, facilitation, and protection  Countries need to re-examine their exclusion lists and avoid changes in direction in investment policies that create uncertainties for investors. Also, foreign
investors often have difficulties accessing various factors of production such as land, finance, and skilled workers. Creating special economic zones would help create an investment-friendly environment for FDI. One such example is the highly successful Iskandar region in southern Malaysia that is attracting investments from neighboring Singapore where businesses face rising land and wage costs and severe labor shortages. At the same time, ASEAN countries need to redouble efforts to develop local SMEs so that they can compete with the foreign investors and suppliers and enter into joint ventures to exploit new business opportunities.

*Mobility of ASEAN skilled professionals* Some of the domestic regulatory constraints on employment of foreigners should be re-examined, including constitutional constraints. ASEAN professional bodies should meet regularly to get better acquainted and explore common visions and exchanges. Professional education and training at the national level should be strengthened, including English language proficiency, so that while inviting inflows of foreign professionals, local professionals will also likewise be able to access other ASEAN markets.

10.4.2.2 Competitive economic region

This entails reduction and/or elimination of various behind-the-border measures that impede free flow of goods, services, investment, capital, and skilled labor and national treatment of foreign suppliers, investors, and professionals. The effective implementation of competition policy would help ensure a level playing field for domestic (private and state-owned enterprises) and foreign investors. So far the AEC has no provisions for opening up government procurement, due to sensitivities in a number of ASEAN countries. However, opening up government procurement is now standard in most FTAs, including the TPP agreement that some ASEAN countries are now negotiating – a compromise would be to agree on certain thresholds that would be open to foreign bidders. The AEC may also need to adopt regional environmental standards in the light of the impact of climate change and introducing basic labor standards to protect the low skilled. Corruption is anti-competitive behavior, and the weakness in a number of ASEAN countries and needs to be controlled on efficiency and equity, if not ethical, grounds.

10.4.2.3 Equitable economic development

The AEC Blueprint strategic actions for SME development and IAIs are inadequate to narrow the development gap within and between countries. Promoting the accelerated and equitable development of CLMV is the
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surest way to narrow the development gap between them and ASEAN6. ASEAN could explore how the ASEAN6 can render more assistance to CLM (that is excluding Viet Nam, which has reached the status of a low middle-income country) to reach middle-income status. Assistance could include studying their best practices, encouraging investment flows from their private sectors, and providing more technical assistance in public sector management, human resource development, urban and transport development and agricultural development. Cambodia, Lao PDR, Myanmar, and Viet Nam would be major beneficiaries of the ASEAN Connectivity Plan and the ASEAN Infrastructure Fund, and actions and measures under the Asian Development Bank’s GMS.

There has been discussion, in some circles, of ASEAN adopting the structural and cohesion funds of the EU (for example, ADBI 2012). However, issues on the sources of such funding and the likely beneficiaries have to be resolved. Unlike the EU, where the biggest economies are also the richest, in ASEAN the highest per capita incomes are in the small economies of Singapore and Brunei Darussalam. A stronger case can be made for such a fund if there is consensus on the funding formula, such as based on deviation from the weighted mean per capita income of all ten ASEAN countries, or if funding is purely on a voluntary basis.

10.4.2.4 Full integration into the global economy

The AEC Scorecard had a perfect score for implementation of this fourth pillar. ASEAN has a market of 600 million people, exceeding the NAFTA and the EU in population size but only a fraction of their economic size. Hence the need for ASEAN to practice open regionalism and widen its economic networking through various ASEAN-wide FTAs, integrate further into global production networks and supply chains, and play a more active role in the WTO.

In November 2012, ASEAN initiated the RCEP with the six FTA partners of the PRC, Japan, Republic of Korea, India, Australia, and New Zealand. Negotiations began early in 2013 and are expected to be concluded by 2015. The RCEP is an attempt to reinforce ASEAN centrality, as there is some concern that ASEAN centrality would be undermined as the economic gravity shifts to PRC–Japan–India. With only some ASEAN members being part of the TPP negotiations, the RCEP will serve to unite ASEAN under the Asian-FTA track. With ASEAN united under the AEC, it should be able to pursue its goals on the international and regional stage much more forcefully and effectively.
10.5 CONCLUSION – MOVING BEYOND 2015

In summary, the AEC has come a long way, but it has fallen short of the high standard and time frame it has set for itself. With the completion of the AEC by the end of 2015, ASEAN would have achieved a level of deep economic integration not commonly found in the developing world. Much remains to be addressed, and some of these issues are discussed below.

10.5.1 An ASEAN Customs Union?

A customs union with a common commercial policy would ensure a single market as goods would not be subject to certification of rules of origin and non-tariff barriers. There are good reasons why there are very few customs unions in the global economy, as compared to the proliferation of FTAs. First, countries have to pool sovereignty over their commercial policies, thus reducing the national policy space. Second, it is difficult to reach agreement on a common external tariff (CET) for ASEAN in view of the wide dispersion of tariff rates across ASEAN countries, with Singapore and Brunei Darussalam having essentially zero MFN applied tariffs and CLMV having relatively higher tariffs. With its role as an entrepôt and its heavy dependence on imports for consumption and inputs into production, a positive CET would undermine Singapore’s cost competitiveness and cost of living, as well as subjecting it to WTO sanctions. A customs union would become more feasible if overall ASEAN’s MFN applied tariffs are reduced to zero or near zero. However, as commercial policy covers not only tariffs but also the removal and harmonization of NTBs (including natural resource subsidies, and preferential treatment of state-owned enterprises), many ASEAN countries would find it difficult to surrender national sovereignty for a customs union. Businesses surveyed are not so much concerned with tariffs inhibiting trade and investment, as with obstacles posed by various NTBs and institutional practices.

10.5.2 Free Movement of Labor and Capital?

ASEAN might consider completing the common market by including other aspects that have hitherto been excluded from the AEC Blueprint. For example, the blueprint only envisions the free movement of skilled labor and the freer movement of capital. Implementing free movement of unskilled labor across ASEAN will be at least as politically difficult as the creation of a customs union, as countries with very large populations, high numbers of unemployed, and low-skilled workforces are also the low-income and low-wage countries, while high-income Singapore
and Brunei Darussalam have limited land and populations and would face severe spatial and social constraints. What is more politically acceptable would be effective regional cooperation in managing the large legal and illegal intra-regional flows of low-skilled workers. Such cooperation could include sharing information on the demand for and supply of such workers, policing common borders to prevent illegal flows and human trafficking, greater transparency on the terms of employment for low-skilled workers, and better protection of the rights of such workers from abuse by recruiting agencies in home countries and placement agencies and unscrupulous employers in host countries.

With greater volatility in global financial markets in recent years, ASEAN governments are understandably reluctant to commit to free flow of capital, with the threat to domestic financial volatility. Further, proposals for financial integration have taken a back-seat since the outbreak of the eurozone crisis. What are progressing are the ASEAN+3 cooperative arrangements of regional financial surveillance (AMRO), the CMIM, and the Asian Bond Markets Initiative (ABMI).

10.5.3 Strengthening the ASEAN Secretariat?

There have been calls to enlarge and strengthen the ASEAN Secretariat to meet the growing needs of ASEAN as an economic, political–security, and sociocultural community. There are two issues being debated: one is the work scope and responsibility of the secretariat, and the other is the funding for an enlarged secretariat.30 On the economic front, the ASEAN Secretariat has to effectively perform, among other things, the functions of coordinating and monitoring ASEAN economic integration as well as integration with ASEAN+1 FTA partners. The issue of delegation of authority to a supranational authority meets with resistance from several ASEAN governments. At the same time, an enlarged secretariat needs more funding resources. The existing formula of equal payment by all ten ASEAN countries is unsustainable and an alternative formula has to be found, with some ASEAN countries paying more than others. The funding formula adopted by the CMIM could be looked at. Additionally, the ERIA Mid-Term Review recommended strengthening the secretariat’s monitoring function through outsourcing: first, introduce third party technical resource and monitoring by the secretariat with support from regional research institutions (including ERIA); and second, establish a supplementary monitoring system at regional and national levels and use academic and business insights to supplement the AEC Scorecard.
10.5.4 ASEAN and the WTO

Some ASEAN members are of the view that regionalism (whether AEC, RCEP, or TPP) should be seen as stepping stones to the bigger goal of trade and investment liberalization through the WTO. As Singapore’s Trade and Industry Minister Lim Hng Kiang observed:

Even with progress made on RCEP and TPP, they should not be seen as ends in and of themselves. Rather success on these fronts should be seen as building momentum toward a longer-term goal of reforming the multilateral trading system. Ongoing WTO talks in Doha Round should not be abandoned or allowed to falter. The WTO remains the best insurance against protectionism and predictability for traders and businesses from all countries, small and large, developed and developing. (Lim 2013)

Additionally, the WTO has successfully launched its ‘aid for trade’ initiative. ASEAN could apply for technical assistance to implement its capacity-building programs, such as the development of its SMEs.

NOTES

1. The AEC was complemented by the ASEAN Political–Security Community and the ASEAN Sociocultural Community.
2. See Jovanovic (2011) for an overview.
3. ASEAN commissioned the 2003 McKinsey Competitiveness Study that found that ASEAN had lost to the PRC its competitive edge in labor costs and premier location for foreign direct investment.
4. As the PRC develops and experiences rising incomes, it provides a huge market for ASEAN exports of goods and services, particularly for natural resource products and tourism. Also, as the PRC experiences rising wages (particularly on the east coast) and moves up the technology ladder, lower-cost ASEAN countries (including Indonesia, Philippines, Thailand, and CLMV) have become major beneficiaries of FDI spillovers.
5. See ADB (2007) for detailed discussions.
6. The CEPT scheme for AFTA was agreed for implementation without the exhaustive feasibility studies and public debate that characterized the formation of the NAFTA, and while the NAFTA document contained almost 400 pages, the AFTA document contained only six pages.
7. ASEAN had experimented with several industrial cooperation schemes in the 1970s and 1980s without much success.
8. This national equity requirement was waived following the outbreak of the Asian financial crisis and the waiver remained until the end of 2005.
9. ASEAN Vision 2020 was agreed by ASEAN Heads of State in Kuala Lumpur on 15 December 1997.
10. Two months before the November 2002 Phnom Penh Summit, ASEAN economic ministers had agreed to form a High Level Task Force on ASEAN Economic Integration to recommend measures for deepening the region’s economic integration beyond AFTA. This was in response to the McKinsey study commissioned by ASEAN, which had concluded that ASEAN had great economic promise and potentially large market but was losing out to others as an investment destination because of its market fragmentation.
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11. The 12th priority sector, logistics, was added only in 2007.
12. Empirical studies estimating the effects of FTAs usually focused on tariff liberalization as it is the easiest trade barrier to identify. However, the AEC also includes liberalization of non-tariff barriers and behind-the-border measures affecting goods trade, as well as liberalization of services trade and investment.
13. The full report has not been released by ERIA, due to some sensitivities.
14. See Lloyd (2007) for detailed explanation. Under the WTO, national treatment has been applied to a wide range of government taxes, charges and product standards that provide discrimination against foreign goods. Exceptions to national treatment in the WTO include subsidies and government procurement of goods.
15. Inclusion lists for other ASEAN countries are 97.5 percent for Singapore, 94 percent for Thailand, 92.89 percent for Brunei Darussalam, 87.39 percent for Malaysia, 79.61 percent for the Philippines, 99.3 percent for Myanmar, 96.6 percent for Viet Nam, 95.2 percent for Lao PDR, and 98.3 percent for Cambodia.
16. ASEAN+1 FTAs have been signed between ASEAN and the PRC, Japan, Republic of Korea, India, and Australia and New Zealand. Negotiations are under way on FTAs with the EU and the Gulf Cooperation Council. There is no common template in the various ASEAN+1 FTAs.
17. It is a difficult process to identify all the NTMs in each country and at sub-country level, especially as not all NTMs are barriers to intra-ASEAN trade.
18. The code aims to establish a common system for the valuation of traded goods for customs purposes, customs classifications and tariff nomenclatures; simplify and harmonize customs procedures; and provide for the right of affected persons to appeal decisions by customs authorities.
19. The ASEAN6 countries are at various stages of operating their respective NSWs, but still face challenges regarding their effectiveness. For example, Indonesia needs to improve coordination among offices involved in the NSW, human resource capacity in its customs office and related agencies, and new regulations made to implement the NSW; Thailand has a coordination problem among agencies involved in the NSW; and the Philippines has problems of data standardization and business process simplification. The CLMV had until 2012 to set up their NSWs and need a huge effort to meet the 2015 AEC completion deadline.
20. Among the index’s components, Malaysia and Thailand ranked poorly for customs process, Philippines and Viet Nam ranked poorly for quality of infrastructure, Indonesia ranked poorly for both customs process and quality of infrastructure and competence and quality of its logistics services. Cambodia, Lao PDR, and Myanmar have problems in all components – border control efficiency, infrastructure quality, ease of arranging competitively priced shipments, competence of logistics services, ability to track and trace consignment, timeliness in shipments of reaching destinations.
21. For Mode 3, the allowed foreign equity should be not less than 52 percent by 2008, and 70 percent by 2010 for the four priority service sectors; not less than 49 percent by 2008, 51 percent by 2010, and 70 percent by 2013 for logistics services; and not less than 49 percent by 2008, 51 percent by 2010 and 70 percent by 2015 for other services sectors. For Mode 3, the parameters of liberalization for national treatment limitations, and limitations in the horizontal commitments for each round are set by 2009 and schedule commitments according to agreed parameters. All ASEAN countries (except Singapore) have fallen behind the liberalization goals in terms of foreign equity participation. Domestic restrictions on equity and landholdings, and licensing requirements continue to pose significant barriers to intra-regional investment in services. Since the AEC does not reach into behind-the-border issues, it is likely that these barriers will persist in the foreseeable future.
22. See Deunden (2013) for a more detailed critique.
23. For a more detailed discussion, see Chia (2013).
24. These include lack of consistency in treatment by customs authorities of the Form D Certificate of Origin, uncertainty on the authorized issuer of the forms, lengthy time for
the forms to be issued, uncertainty on the status of tariffs, and complicated payments arrangements.

25. The initial CEPT Agreement contains only one sentence pertaining to rules of origin: ‘A product shall be deemed to be originating from ASEAN Member States, if at least 40 percent of its content originates from any Member State.’ This simple statement gave rise to different customs interpretations and disputes.

26. The World Bank’s Ease of Doing Business Index shows wide variations in these costs in ASEAN countries.

27. The AIA includes the goal of joint investment promotion by ASEAN countries in missions to Japan, Europe, and the US, but these have not been an unqualified success as officials were more interested in promoting national interests.

28. The AEC Blueprint’s table 8 lists the outstanding measures not implemented in the 2008–11 period.

29. Current political and economic reforms underway in Myanmar are attracting large inflows of FDI and will herald a new era of high economic growth.

30. Critics usually point to the huge bureaucracy and budget of the European Commission as bad lessons of supranationality.

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11. The future of the World Trade Organization

Biswajit Dhar

11.1 INTRODUCTION

The multilateral trading system, long considered to be the first best option for liberalizing global trade, faces the most serious challenge in its six and a half decades of existence. The inability of the WTO to deliver its promise to deepen and widen trade liberalization, an exercise this forum had initiated nearly 12 years ago, has raised questions about its continued relevance. Yet, the reality remains that the WTO is the only organization that can take a comprehensive view of the increasing complexities of the evolving economic engagements between countries. The challenges the global community faces in this context are twofold. First, there is a need to identify and assess the key developments in the Doha Round that have contributed to the present stalemate. Secondly, it is imperative to identify the options that the organization could consider for defining its future work program, given the new realities of global economic engagement. Since the start of the Doha Round negotiations, the drivers of economic integration have undergone significant changes. The most prominent of these is the emergence of global production networks (GPNs) as drivers of economic integration between countries. The most compelling evidence in this regard is provided by Southeast Asia, the most integrated of all the regions. The shift from localized to fragmented production systems requires new approaches that the WTO must take cognizance of.

This chapter addresses the two sets of issues indicated above and is divided into three sections. The first section of the chapter focuses on the key developments in the Doha Round encompassing some of the more critical negotiating areas. An exercise of this nature is important, in our view, since it helps in analyzing the issues on which agreement has eluded the WTO members. Thus, if the Doha Round is to be brought to an early conclusion, an objective shared by the major economies, the disagreements between the key players involved in the negotiations must receive focused attention. There is no gain in saying that the global economic
recovery, which is on a knife-edge, would need the backing of a resilient multilateral trading system to get on to a more sustainable path.

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

In the second section, we discuss the functioning of the dispute settlement mechanism of the WTO, one of the most prominent elements of the organization. The Dispute Settlement Understanding (DSU) adopted at the end of the Uruguay Round negotiations established rules for the settlement of disputes between WTO Members. The Dispute Settlement Body (DSB) established by the DSU distinguishes the WTO from other multilateral institutions as it provides the organization with the necessary powers to resolve disputes between member states. However, despite having included these features, architects of the WTO felt that the dispute settlement rules needed an early review.\(^1\) The review process was initiated in 1997 through informal consultations conducted by the Chairperson of the DSB.\(^2\) This process was unable to yield results and therefore review of the DSU was included in the mandate of the Doha Round (WTO 2001a, para. 30). This review process provided the WTO members with an opportunity to reflect on the problems they have encountered while using the dispute settlement rules.

In the final section, we dwell on the proposition that a possible way forward for the WTO is to reflect on the manner in which the rules of the organization might accommodate and support the new reality of GPNs, and assess the possibility of including new disciplines covering areas that can help the growth of these drivers of global economic integration. Such an initiative could include three sets of issues – trade facilitation measures, an equitable investment regime, and effective disciplines for curbing NTBs.

11.2 KEY DEVELOPMENTS IN THE DOHA ROUND

The time that has elapsed since the start of these negotiations is testimony to the fact that the Doha Round has been the most vexatious of all the
negotiating rounds the multilateral trading system has witnessed since its establishment in 1948. Hindsight would perhaps suggest that this state of impasse was not entirely unexpected since developing and developed countries had widely differing perceptions on the future agenda of the WTO, which was primarily responsible for the failed Ministerial Conference in Seattle in 1999. The developing countries essentially focused on two sets of issues: rebalancing the Uruguay Round Agreements to make them more development-friendly, and ensuring that these agreements were effectively implemented.\(^3\) On the other hand, the developed countries led by the US and the EU, were keen to launch a new round of negotiations and expand the scope of the WTO by introducing issues like labor standards (House of Representatives 1999; WTO 2002a).

The agreement among the WTO members to launch the Doha Round was a compromise between the positions held by the developing countries and the developed countries. This was reflected in the negotiating mandate that had the following dimensions: (1) comprehensive review of the Uruguay Round Agreements; (2) review of implementation of the Uruguay Round Agreements;\(^4\) and (3) expansion of the negotiating mandate of the WTO. The review of the existing agreements had, in turn, two components: deepening the level of commitments of WTO members to the unshackling of their domestic markets, and rebalancing the agreements keeping in view the needs of the developing countries.

A fourth crucial outcome of the Doha Ministerial Conference was the Declaration on the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) and Public Health (WTO 2001c). This Declaration was a response to the submissions made by the developing countries that provided evidence to show that the implementation of the Agreement on TRIPS was adversely affecting access to medicines. The Declaration introduced several flexibilities that could be used by WTO members to address the problem of access to medicines.\(^5\)

For the best part of the Doha Round, the focus of the negotiations has been on three sectoral issues – agriculture, NAMA, and services. The impetus to focus on these areas was market access ambitions across groups of countries. Thus, while developed countries have been seeking enhanced access to the markets of their developing country partners in both agriculture and NAMA, some developing countries, such as India, have long maintained that they have a substantial interest in services trade liberalization.
11.2.1 Doha Negotiations on Agriculture: Rebalancing the Agreement on Agriculture

Agriculture negotiations in the Doha Round are being guided by two sets of mandates. The first set, provided in Article 20 of the WTO AoA, has three clear guidelines. First, members are expected to take into account their experience of implementing the reduction commitments (made at the end of the Uruguay Round), which spanned the three ‘pillars’ of the AoA. Second, members are to consider the effects of the reduction commitments on world trade in agriculture. Finally, members are expected to take note of ‘non-trade concerns, special and differential treatment to developing country Members, and the objective to establish a fair and market oriented agricultural trading system’. The above-mentioned mandate was reinforced by the Doha Ministerial Declaration, wherein it was agreed that the negotiations should be aimed at: (1) substantial improvements in market access; (2) reductions of, with a view to phasing out, all forms of export subsidies; and (3) substantial reductions in trade-distorting domestic support (WTO 2001a, para. 13). It was further stipulated that special and differential treatment for developing countries would be an integral part of all elements of the negotiations and would be embodied in the schedules of concessions and commitments and as appropriate in the rules and disciplines to be negotiated, so as to be operationally effective and to enable developing countries to effectively take account of their development needs, including food security and rural development.

Although the mandate for the review of the AoA seems quite comprehensive, there are two sets of lacunae that ought to be pointed out. First, the review of the subsidies discipline spoke of ‘substantial reductions in trade-distorting domestic support’ (WTO 2001a, para. 13). This meant that the negotiations were to focus on only two forms of agricultural subsidies that were deemed to be ‘trade distorting’ – price support and input subsidies. All other forms of domestic support, which the AoA had labeled as ‘Green Box’ payments were excluded from the purview of the negotiations. Thus, the Doha mandate legitimized the false distinction that the AoA had made between agricultural subsidies by categorizing them as ‘trade distorting’ or otherwise, even when the latter category included several forms of subsidies, which created distortions in agricultural markets. The impact of this categorization of subsidies introduced by the AoA was that the large providers of agricultural subsidies in the developed countries shifted their subsidies onto the ‘Green Box’, thereby insulating their domestic support policies from the subsidies disciplines.

The second lacuna in the mandate relates to market access, which does not take on board the problem of the growing incidence of NTBs in
agricultural trade. This lacuna is particularly galling in light of the fact that the Doha mandate provides that negotiations on market access for non-agricultural products would include NTBs. How critical this omission can be from the point of view of reforming agricultural markets is indicated in a later section.

11.2.1.1 Role of developing country coalitions in the agriculture negotiations

One of the features of the negotiations on agriculture has been the strong coalition building between the developing countries. Faced with a situation where the two dominant players in the global agricultural markets, namely the US and the EU, were reluctant to reform their domestic policies, especially their subsidies regime to their farm sector, major developing countries led by Brazil and India formed the Group of Twenty (G20) coalition that played a determining role in the negotiating dynamics. The base paper, which marked the emergence of the G20 (WTO 2003a), emphasized the point that the negotiations in the Doha Round should establish a fair and market-oriented trading system through fundamental reform in agriculture. The interventions made by this group have had two substantive dimensions: (1) domestic support, including capping and/or reducing ‘Green Box’ agricultural subsidies granted by some of the more prominent members of the WTO, has to be substantially reduced and eventually removed, and (2) special and differential treatment for developing countries should be an integral part of the negotiations, and that non-trade concerns should be taken into account.

The latter element, in the view of the G20, was to be addressed in the revised AoA through two mechanisms. First, products that are critical for realizing the objectives of food security, rural livelihoods, and rural development, the so-called ‘special products’, would not be subjected to any tariff cuts. Secondly, introduction of a special safeguard mechanism (SSM) aimed at allowing developing countries to counter anticipated or actual import surges. The developing countries saw the special products and the SSM as measures that would help them in addressing the twin problems of food security and livelihood concerns in the face of mounting pressures to lower agricultural tariffs.

Support for special products and SSM was lent by another group of developing countries, the Group of Thirty-Three (G33), which has focused solely on the need to include these two mechanisms in the AoA (WTO 2003b). The G33 argued that developing countries must have the right to designate as special products ‘at least 20% of its agricultural tariff lines’ guided by an ‘illustrative, non-exhaustive, non-prescriptive, and non-cumulative list of indicators’ (WTO 2005c, p.1). The treatment of
the special products was spelled out as follows: (1) at least 50 percent of the tariff lines designated as special products by any developing country member would not be subject to any tariff reduction commitment; (2) 25 percent of the tariff lines designated as special products would be subjected to a 5 percent reduction on bound import tariff rates; and (3) the remaining tariff lines would be subjected to reduction on bound import tariff rates of no more than 10 percent. As regards SSM, G33 argued that additional duty for guarding against actual or potential surges in imports could be imposed in respect of any agricultural product (WTO 2005a).

The proposals of the G20 aimed at reforming the structure of disciplines in the AoA stand to reason on account of the fact that the tariff reductions of the kind that the US and the EU have been demanding are possible only after distortions caused by the subsidies are substantially reduced in the markets for agricultural commodities. The large doses of subsidies provided by the US and the EU in particular, gave rise to uncertainties in the markets, as international prices have become more volatile as a result. At the same time, the G20/G33 proposals for inclusion of concrete mechanisms such as lower tariff cuts, special products, and SSM had to be provided for in the revised AoA, so that some of the key concerns of the developing countries, in particular those related to food security and livelihoods, are addressed effectively.

The two coalitions of developing countries mentioned above have had a substantial impact on the negotiating dynamics. Their key proposals, particularly in respect of the special products and SSM, have become an integral part of the negotiations, although there is considerable disagreement among WTO members as to how the SSM is to be designed.

Agriculture negotiations have made very slow progress given the wide range of differences between the major protagonists. However, the successive Chairs of the Committee on Agriculture have tried to steer the negotiations so as to broker a deal. The latest in this process was the draft modalities that were tabled by then Chairman of the Committee on Agriculture, Crawford Falconer in July 2008. A revised version of these modalities is currently being considered by the WTO members for sealing a deal on agriculture (WTO 2008a).

11.2.1.2 Key elements of the Falconer modalities
The Falconer modalities provide a comprehensive framework for revising the AoA. However, the modalities seem to be falling short of realizing the overall objectives of the agriculture negotiations, as set out in the negotiating mandate in the Doha Ministerial Conference, as we indicate below.

In the case of domestic support, a tiered approach to reducing the levels of support was adopted, aimed at targeting countries granting higher
levels of ‘trade distorting subsidies’. Accordingly, the reduction in domestic support was proposed at several levels. First, reduction in ‘overall trade distorting domestic support’ was proposed. The term ‘overall trade distorting domestic support’ or OTDS was used to expand the ambit of ‘trade distorting support’ so as to include a production limiting form of domestic support or so-called ‘Blue Box’ support (WTO 2008a, p. 4). Secondly, it was proposed that trade distorting support or ‘Amber Box’ support would be reduced substantially, using a tiered approach. This approach would ensure that countries providing higher levels of subsidies would make greater reductions. Thirdly, product-specific support was proposed to be capped at their respective average levels.

The proposed discipline on export competition includes elimination of export subsidies and export credits (with repayment periods beyond 180 days) by an end date to be decided during the negotiations. Operationally effective disciplines on food aid are also proposed to be established at the end of the negotiations.

Two sets of views can be expressed in response to the disciplines on farm support proposed in the framework text. The first is that the proposed discipline on domestic support and export competition would be able to reduce subsidies to a considerable extent on two counts: (1) the proposed discipline on domestic support not only seeks substantial reduction in the Aggregate Measurement of Support (AMS), but also extends the discipline to cover the ‘Blue Box’ measures that were hitherto left outside the AoA discipline; and (2) there has been an agreement on the need to eliminate export subsidies and some forms of export credit, which is a major step forward given that the EU has been refusing to do so thus far.

The second set of views, which is the critical view on the proposed disciplines on farm support, is that the framework would not be effective in reining in the subsidies. The lack of discipline in respect of the ‘Green Box’ measures, which contains several elements that can distort markets, would render the proposed domestic support discipline largely ineffective. We had indicated above that the ‘Green Box’ measures account for nearly 90 percent of US domestic support spending, while in case of the EU the corresponding figure was nearly 50 percent. Again, the agreement to eliminate export subsidies is a small consolation given that the EU, the largest user of this form of subsidies, made minimal use of them.

In the area of market access, Falconer has proposed that developed countries would have to reduce their bound tariffs in equal annual installments over five years with an overall minimum average cut of 54 percent, while developing countries would have to reduce their bound tariffs by 36 percent over a ten-year period.

Both developed and developing members would have the flexibility to
designate an appropriate number of tariff lines as sensitive products, on which they would undertake lower tariff cuts. However, for these products, there has to be ‘substantial improvement’ in market access, and so the smaller cuts would have to be compensated by tariff quotas for improving market access prospects. Developed countries would therefore have an opportunity to protect their commercially sensitive tariff lines.

According to the Falconer proposals, developing countries would be able to ‘self-designate’ 12 percent of agricultural tariff lines as special products guided by indicators based on the criteria of food security, livelihood security, and rural development. The proposed average tariff cut on special products is 11 percent, including 5 percent of total tariff lines at zero cuts. This proposal falls short of the expectations of the major developing country groupings like the G33, which had insisted that they should be able to ‘self-designate’ a minimum of 20 percent of tariff lines as special products, with at least half of these being subjected to zero tariff cuts.

As regards the SSM, Falconer has proposed that either an import quantity trigger or a price trigger would trigger safeguard duties. The trigger for invoking the SSM determines when the safeguard duty can be imposed. It may be pointed out that if the import quantity trigger is set too high, the SSM would be rendered ineffective since the mechanism can be used only in the most exceptional circumstances. The same would hold true if the price trigger is set at too low a threshold.

Discussions on the design of an SSM have focused on three issues: (1) the trigger, that is, when the mechanism would be applicable; (2) the size of the remedy, that is, the magnitude of safeguard duties to be allowed; and (3) duration of the remedy and whether safeguard duties could be applied in consecutive years.

Discussions on SSM have been deeply divided largely because exporting countries have argued for very high initial triggers. For instance, one proposal was that the initial trigger should be fixed at 40 percent, in other words, imports have to be at least 140 percent of the imports in the previous period before safeguard duties can be imposed. The G33 (and India) has argued that this would be far too high a trigger, effectively denying them recourse to the SSM.

11.2.1.3 Recent state of play
In the run-up to the Bali Ministerial, both G33 and G20 have identified areas in which they are looking for changes in the AoA. The former grouping has pushed for early agreement to address food security issues, while the latter is seeking clear directions for introducing new disciplines in the export competition pillar of the AoA, which includes the issues of export subsidies, export credits, and international food aid.
G33 proposal on food security  Toward the end of 2012, G33 tabled a proposal for the inclusion of specific elements in the Draft Modalities, which could address the problem of food insecurity (WTO 2012a) through three amendments in the ‘Green Box’ (Annex 2 of the AoA). These proposals are not new, having been included in the Draft Modalities of 2008. By tabling the proposals now, G33 is aiming at an early decision at the Bali Ministerial.

The first of the proposed amendments is aimed at allowing developing countries to make payments for specific activities to promote rural development and poverty alleviation without being subjected to any disciplines introduced by the AoA. The proposal is to amend paragraph 2 of Annex 2 of the AoA by including payments by developing countries for farmer settlement, land reforms, rural development, and rural livelihood security, such as provision of infrastructural services, land rehabilitation, soil conservation and resource management, drought management and flood control, rural employment programs, nutritional food security, issuance of property titles, and settlement programs.

Secondly, G33 proposed that the existing provisions relating to public stockholding for food security purposes should be amended to allow developing countries to spend on acquisition of stocks of foodstuffs for supporting low-income or resource-poor producers and the cost of so doing will not be accounted for in their subsidies’ bills. Two textual amendments that these countries have proposed would therefore allow developing countries to implement food security programs ‘with the objective of fighting hunger and rural poverty’ by procuring foodstuffs from the poorer farmers without being subjected to the AoA disciplines.

G20 proposal on export competition  One of the major decisions taken in the 6th Ministerial Conference held in Hong Kong, China in 2006 was that there would be ‘parallel elimination of all forms of export subsidies and disciplines on all export measures with equivalent effect . . . by the end of 2013’ (WTO 2005b, p. 2). However, even as recently as in 2010–11, the EU and its member states, which have been the largest user of export subsidies, had continued to use such subsidies.11

In view of the non-implementation of the commitment made by members, the G20 has proposed that a Ministerial Decision on Export Competition be adopted, which would include both export subsidies and export credits (WTO 2013b).

According to this proposal, by the end of 2013, developed country members shall reduce their export subsidy commitments both in terms of outlay and quantity commitments as follows: (1) budgetary outlays shall
be reduced by 50 percent, and (2) export quantity commitments shall be reduced to the actual average of quantity levels in the 2003–05 base period.

As regards export credit, G20 has proposed that the maximum repayment term for developed countries shall not be more than 540 days from the ‘starting point of credit’¹² and end on the contractual date of the final payment.

The proposed Ministerial Declaration includes ‘special and differential treatment’ (S&DT) for developing countries. In case of export subsidies, developing countries would continue to benefit from the provisions of Article 9.4 of the AoA¹³ for five years after the end of all forms of export subsidies. Furthermore, the limit for repayments of export credit proposed for developed countries will be applicable to the developing countries three years after the former begin implementing it.

11.2.2 Non-agricultural Market Access

The negotiations in the area of NAMA are being conducted with the mandate to ‘reduce or as appropriate eliminate tariffs, including the reduction or elimination of tariff peaks, high tariffs, and tariff escalation, as well as NTBs, in particular on products of export interest to developing countries’ (WTO 2001a, para. 16). Furthermore, WTO members had agreed that the negotiations would ‘take fully into account the special needs and interests of developing and least-developed country participants, including through less than full reciprocity in reduction commitments’ (WTO 2001a, para. 16).

Although the NAMA mandate gave direction to the WTO membership to rein in NTBs, the focus of the negotiations in this area has been on reducing tariffs. In the initial phase of the negotiations, India, along with several other developing countries, favored only a moderate reduction in non-agricultural tariffs, which was more in keeping with the Uruguay Round approach (WTO 2003c). In contrast, the US, the EU, and Canada set very high goals for tariff reduction across all countries, with the exception of the LDCs (WTO 2003d). The approach of these countries (also called the ‘tariff’ harmonization’ approach) was to ensure that tariffs on non-agricultural products are brought below a particular threshold (better known as the ‘coefficient’) using the ‘Swiss formula’. In addition, they had argued for reducing the flexibilities available for developing countries.

The US–EU–Canada paper was significant because it changed the dynamics of the NAMA negotiations. The developing countries, which were opposed to tariff harmonization, accepted this approach after they were allowed to keep some sensitive tariff lines unbound. In other words, developing countries agreed to deep cuts in non-agricultural tariffs across
the board, except for sensitive products, on which relatively high tariffs could be imposed.

One important issue the NAMA negotiations have been dealing with is the use of NTBs. Most developed countries, but also some advanced developing countries, have been increasingly relying on NTBs, often as a border protection measure. An indication of the increase in NTBs can be obtained from the manner in which TBTs have increased. In 1995, the year in which WTO was established, fewer than 400 notifications were issued, but by 2012 this number had increased to more than 2100. This trend seems to suggest that WTO member countries have increased their reliance on NTBs during a phase when tariff protection levels have been falling.

In 2008, the Chairman of NAMA, Luzius Wasescha, made a series of proposals for the lowering of tariffs on non-agricultural products (WTO 2008b). Three coefficients – 20, 22, and 25 – were offered to developing countries, and the coefficient 8 was offered to developed countries. Importantly, for developing countries, a link between tariff reductions and flexibilities to keep tariff lines unbound was established.

The implications of the tariff cuts proposed by the NAMA Chairman on India and Brazil are provided in Table 11.1. The table shows that if the lowest coefficient were adopted, the overall decrease in the bound tariffs of both countries would be relatively steep. In the case of India, the reduction of bound duties by 65 percent would bring average bound tariffs to 12 percent from about 34 percent at present. It may be argued that India can absorb this level of reduction given that the average of India’s applied tariffs is currently around 11 percent.

One issue that could introduce a significant element of uncertainty in the NAMA negotiations is that of sectoral zero-for-zero. This issue was included in the negotiating process through the so-called ‘July Framework’ that helped to put the Doha Round on track in 2004 after the failed Ministerial Conference in Cancun (WTO 2004a, p.B-2). Essentially, the sectoral initiative has involved WTO members identifying sectors in which they are pushing for elimination of tariffs by a certain date. In

<table>
<thead>
<tr>
<th>Range of coefficients</th>
<th>India</th>
<th>Brazil</th>
</tr>
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<tbody>
<tr>
<td>Coeff. = 20</td>
<td>64.9</td>
<td>60.8</td>
</tr>
<tr>
<td>Coeff. = 22</td>
<td>60.4</td>
<td>58.6</td>
</tr>
<tr>
<td>Coeff. = 25</td>
<td>57.3</td>
<td>55.5</td>
</tr>
</tbody>
</table>

Source: Author’s calculations (figures in percent).
December 2008, WTO members listed 14 sectors for inclusion in the sectoral initiative (Appendix Table 11A.1).

Proponents of the sectoral zero-for-zero have justified the initiative on the grounds that it would help realize the NAMA negotiating mandate that emphasizes the need to ‘reduce or as appropriate eliminate tariffs’. However, several developing country members have opposed the initiative arguing that they would end up taking more commitments for tariff cuts than their developed country partners. Their opposition would seem justified, as the Doha mandate stipulates that the commitments of developed country members should be greater than those of their developing country partners.

11.2.3 Services

Trade in services was brought under the purview of multilateral trade negotiations during the Uruguay Round which established a kind of framework agreement, called the General Agreement on Trade in Services, covering the entire gamut of services trade. But the achievement of the Uruguay Round in terms of the actual liberalization of services trade was rather modest.

Nevertheless, the GATS provides a ‘built-in agenda’ requiring the members to enter into successive rounds of negotiations aimed at progressive liberalization, with the first such round to begin no later than five years after the entry into force of the WTO agreement (that is, 1 January 1995). Accordingly, GATS negotiations were re-launched in January 2000 and this new round of negotiations came to be known as the GATS 2000 negotiations. The ‘Guidelines’ for this negotiation had two mandates: (1) market access and (2) rule-making. The GATS 2000 negotiations were subsequently subsumed under the Doha Development Agenda in November 2001 (WTO 2001a, para. 15). Since then the GATS 2000 negotiations have been proceeding as part of the Doha Round.

11.2.3.1 GATS negotiations on market access

In March 2001, WTO members adopted the modalities for the services negotiations, referred to as the ‘negotiating guidelines and procedures’ (WTO 2001d). The guidelines stipulated the ‘request-offer’ approach as the main method of negotiating new ‘specific commitments’. Importantly, the guidelines also recognized the need to provide an appropriate degree of flexibility to developing countries.

Initially negotiations adopted the bilateral request-offer approach. Under this approach, one country requests other countries to undertake commitments in particular sectors and modes of commercial interest. Revised requests and subsequent offers by all members continue to be
submitted until the commitments entered into can be adopted as final schedules. In other words, the bilateral request-offer approach involves a process of repeated reiteration – offer, negotiation, revision, re-submission, and so on. The Doha Declaration also set out two important timelines for the negotiations: submission of initial requests by the members by 30 June 2002, and ‘initial offers’ by 31 March 2003. Subsequently, the July 2004 Framework Agreement (WTO 2004a, p. C-1) set May 2005 as the deadline for the submission of the ‘revised offers’, while urging the members to submit the outstanding ‘initial offers’ as soon as possible.

For various reasons, some technical and some political, the bilateral approach failed to generate sufficient momentum as less than half of the WTO membership came forward with their offers for liberalizing their services sectors. Against this backdrop, the Ministerial Declaration of the WTO Conference in Hong Kong, China in December 2005 mandated the adoption of a plurilateral ‘request-offer’ approach as a complementary method of negotiations with the aim of expediting the market access negotiations on services (WTO 2005b, p. C-3). The Declaration called for plurilateral requests to be submitted by 28 February 2006. Accordingly, around 20 plurilateral groups had been formed in 2006, with the involvement of only around 35 countries out of the then 149 member countries of the WTO. This clearly reflects the fact that only the major players in services trade have come forward to participate in the plurilateral negotiations on services. As per the Ministerial Declaration, a recipient country of a plurilateral request is obliged to accept the request; it is only obliged to ‘consider’ that request while submitting a new round of ‘revised offers’. However, the offer emanating from a plurilateral request is to be granted on an MFN basis to all WTO members, not only to the demandeurs of that particular request.

11.2.3.2 GATS negotiations on rule making
At the end of the Uruguay Round, the set of rules comprising the GATS remained incomplete with regard to certain important aspects, such as emergency safeguard measures, government procurement, subsidies, and domestic regulation. The future shape of the GATS will be determined by these rules to a great extent. Rules also assume significance in determining the effectiveness of the market access commitments undertaken by a member country. A member’s choice of domestic reforms is also likely to be influenced by rules. The negotiations on rules, however, have progressed quite slowly so far. This is due in part to the divergent views of the Members in different areas of rules and in part to technical and conceptual difficulties involved in each aspect of rules.

The Disciplining Domestic Regulation comprises one of the most critical
areas of the rules negotiations under the GATS. The GATS explicitly recognizes the right of members to regulate and introduce new regulations on the supply of services within their territories in order to meet their national policy objectives. Article VI: 4 of the GATS mandates members to develop disciplines aimed at ensuring that domestic regulatory measures do not constitute unnecessary barriers to trade in services. This mandate covers the following issues: (1) qualification requirements and procedures (QRP); (2) licensing requirements and procedures (LRP); and (3) technical standards (TS). Given the relatively advanced level of discussions on this issue, the Declaration of the WTO Ministerial Conference in Hong Kong, China instructed the members to finalize the disciplines on domestic regulation before the end of the Doha Round and as part of the single undertaking.

The Disciplining Domestic Regulation can go a long way in complementing market access particularly in the areas of interest to developing countries (including India). Challenges for enhancing market access in the developed countries under both cross-border services trade (Mode 1) and movement of natural persons (Mode 4) lie in the range of state-imposed regulatory barriers, including burdensome visa formalities, registration and licensing requirements, fee structure, stringent quotas and qualification requirements, discriminatory taxes, levies, and standards faced by service providers from developing countries. However, a counter concern of many member countries, including in particular developing countries, relates to the issue of regulatory autonomy. It is widely apprehended that disciplines on domestic regulation under the GATS may encroach upon the sovereignty of member countries by requiring trade considerations to supersede legitimate domestic policy objectives. Against this backdrop, all submissions stress the need to strike a balance between respecting a member’s right to regulate, and curbing regulatory measures that could potentially undermine market access.

Prior to the start of the Doha negotiations, WTO members had agreed to domestic regulation in the accounting sector (WTO 1998). Subsequently, members agreed to establish ‘horizontal’ disciplines, which are not sector-specific and are applicable to all measures affecting trade in services. As in the case of market access negotiations, negotiations on domestic regulation remained mired in differences between the major protagonists despite the fact that several members had underlined the importance of a satisfactory outcome on domestic regulation as a means of ensuring the effectiveness of scheduled commitments (WTO 2011, para. 76). At the same time, however, members also observed that progress on domestic regulation disciplines had to be balanced with advances on the market access side of the services negotiations, and more broadly with progress in other areas of the Doha negotiations.
11.3 FUNCTIONING OF THE DISPUTE SETTLEMENT MECHANISM AND ITS REFORM AGENDA

One of the major achievements of the Uruguay Round negotiations was the adoption of the DSU, which provided rules for the settlement of disputes between WTO members. The rules provided by the DSU were distinct improvements over those that existed under the GATT. Among the new rules was the so-called ‘reverse consensus’ voting rule at key milestones in the dispute settlement process, legal review of panel reports by a permanent appellate body, establishment of deadlines for various phases of the dispute settlement process, and improved multilateral oversight of compliance. The general rules of the DSU apply to all the covered agreements.

The introduction of the ‘reverse consensus’ rule addresses one of the major weaknesses of the GATT dispute resolution system. In keeping with practice, reports of the dispute settlement panels were adopted by consensus. This practice effectively meant that the GATT panel reports could never be adopted. The ‘reverse consensus’ rule, included in the dispute settlement understanding, provides that unless it decides by consensus not to do so, the dispute settlement body will (1) consider requests to establish panels, (2) adopt panel and appellate body reports, and (3) if requested by the prevailing member in a dispute, authorize the member to impose a retaliatory measure in case the defendant has not complied with the rulings of the panels and appellate body.

The speed of the whole process is controlled by the principal disputing governments, the complainant, and the respondent, with the complainant in the driving seat, and takes about 15 months from filing the complaint to the final ruling.

The setting of timelines for the settlement of disputes was another significant feature of the WTO DSU. According to Article 15 of the DSU, the duration from the filing of a complaint to the appellate body stage should be about 14 months (Table 11.2), with the panel stage taking up more than three-quarters of this period. In practice, however, the time taken by the panels is substantially longer. The details are discussed in the following section.

11.3.1 Implementation of the DSU: An Appraisal

The use of the WTO dispute settlement mechanism would provide an indication as to its usefulness for the membership, particularly the developing and the least developed countries. The following discussion will provide
the details of the use that the WTO membership has made of the dispute settlement rules.

Until February 2013, 456 disputes had been referred to the DSB.¹⁴ These disputes had been notified by 485 complainants, meaning there were several disputes involving multiple complainants. The trend of notification of disputes shows that after the initial enthusiasm, which saw 50 notifications recorded in 1997, there was a secular decline until 2011. In fact, of the total disputes between 1995 and 2012, almost 50 percent were notified in the first six years (Figure 11.1). This is one of the clearest indications that WTO members were skeptical about the ability of the DSB to resolve their disputes.

The use of the DSB was quite skewed, with the OECD members (primarily developed countries) emerging as the largest users of the DSB (Table 11.3). In almost 65 percent of the dispute cases, the complainant was a member of the OECD. Only once did an LDC approach the DSB as a complainant (Bangladesh versus India). This group of countries had an even larger share among the respondents, with the share exceeding two-thirds of the total. While no complaint was brought against any of the LDC members of the WTO, this group of countries participated in several disputes as third parties. This seems to be a positive development, for it would enable the LDC members to prepare themselves for using the dispute settlement rules.

The US and the EU were the largest users of the dispute settlement rules (Table 11.4). About 40 percent of the all disputes brought before the DSB included one of these countries as a complainant. Brazil and India led the emerging economies in the use of the DSB, a list that also includes

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### Table 11.2  Main stages in the dispute settlement system (with respective time periods)

<table>
<thead>
<tr>
<th>Stage</th>
<th>Description</th>
<th>Timeline</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stage 1</td>
<td>Bilateral consultations between the complainant and the respondent</td>
<td>2 months</td>
</tr>
<tr>
<td>Stage 2</td>
<td>Legal examination: a panel of three legal experts approved by the disputing governments</td>
<td>6–9 months</td>
</tr>
<tr>
<td>Stage 3</td>
<td>An appellate stage</td>
<td>2–3 months</td>
</tr>
<tr>
<td>Stage 4</td>
<td>Implementation of the rulings</td>
<td>Subject to negotiation between the parties</td>
</tr>
</tbody>
</table>

*Source: Author’s calculations based on WTO (2010).*
Argentina and Thailand. The PRC, currently the largest trading nation, does not figure on this list.

An important aspect of the countries invoking the dispute settlement rules is that the African continent has not initiated any disputes. Several countries in the region have faced severe trade discrimination, which has prevented some of the poorest countries from benefiting from the opening of markets since the conclusion of the Uruguay Round. The major constraining factor for these countries had been their lack of capacity to participate in the proceedings of the DSU, an issue that has

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**Figure 11.1  Trend in the initiation of World Trade Organization disputes**

**Table 11.3  Participation of groups of countries in WTO trade disputes**

<table>
<thead>
<tr>
<th>Country groups</th>
<th>As complainant</th>
<th>As respondent</th>
<th>As third party</th>
</tr>
</thead>
<tbody>
<tr>
<td>OECD members</td>
<td>313 (64.7%)</td>
<td>311 (66.3%)</td>
<td>829 (48.4%)</td>
</tr>
<tr>
<td>Non-OECD members</td>
<td>170 (35.1%)</td>
<td>158 (33.7%)</td>
<td>869 (50.7%)</td>
</tr>
<tr>
<td>Least developed country</td>
<td>1 (0.2%)</td>
<td>0</td>
<td>15 (0.9%)</td>
</tr>
<tr>
<td>Total</td>
<td>484</td>
<td>469</td>
<td>1713</td>
</tr>
</tbody>
</table>

Source: Author’s calculations based on WTO (2013c).
figured prominently in the ongoing negotiations for the strengthening of the mechanism.

In terms of the covered agreements in which the disputes were notified, more than a third of these involved adjudication based on the GATT articles. If the other areas that were included in the GATT framework prior to the establishment of the WTO are considered, including anti-dumping and safeguards, the share of the traditional GATT areas increases to nearly two-thirds. Of the GATT articles referred to in the disputes, the three key articles — Articles I (General Most-Favoured-Nation Treatment), Article II (Schedules of Concessions), and Article III (National Treatment on Internal Taxation and Regulation) — were used the most (nearly 40 percent). This is not entirely unexpected since the commitments entered into by WTO members under the various Uruguay Round agreements were built on the premise of non-discrimination vis-à-vis goods, service providers, and intellectual property owners, which is a major departure from the practices they had followed prior to their WTO accession.

Less than a sixth of the notified disputes covered the four new areas included in the multilateral trading system — agriculture, intellectual property, services, and investment (Table 11.5). These results are somewhat surprising since this set of areas includes some of the more contentious agreements, like agriculture and intellectual property. A possible reason could be that the agreements covering all these areas (except investment) are included in the Doha Round, and could therefore be a greater focus on the part of the WTO members to address their contending objectives through re-negotiating the existing texts rather than to get an interpretation by the dispute settlement panels on which they have no influence.

<table>
<thead>
<tr>
<th>Complainant</th>
<th>Number of disputes</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>105</td>
</tr>
<tr>
<td>European Union</td>
<td>87</td>
</tr>
<tr>
<td>Canada</td>
<td>33</td>
</tr>
<tr>
<td>Brazil</td>
<td>26</td>
</tr>
<tr>
<td>Mexico</td>
<td>23</td>
</tr>
<tr>
<td>India</td>
<td>21</td>
</tr>
<tr>
<td>Argentina</td>
<td>18</td>
</tr>
<tr>
<td>Japan</td>
<td>17</td>
</tr>
<tr>
<td>Republic of Korea</td>
<td>15</td>
</tr>
<tr>
<td>Thailand</td>
<td>13</td>
</tr>
</tbody>
</table>

Source: Author's calculations based on WTO (2013c).
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Table 11.5 Broad areas covered in the disputes

<table>
<thead>
<tr>
<th>Covered area</th>
<th>Share of total (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agreement establishing the World Trade Organization</td>
<td>4.7</td>
</tr>
<tr>
<td>Agriculture</td>
<td>7.0</td>
</tr>
<tr>
<td>Anti-dumping (Article VI of GATT 1994)</td>
<td>9.3</td>
</tr>
<tr>
<td>Customs valuation</td>
<td>1.5</td>
</tr>
<tr>
<td>Dispute settlement understanding</td>
<td>1.5</td>
</tr>
<tr>
<td>GATT 1947</td>
<td>0.1</td>
</tr>
<tr>
<td>GATT 1994</td>
<td>36.0</td>
</tr>
<tr>
<td>Government procurement</td>
<td>0.4</td>
</tr>
<tr>
<td>Import licensing</td>
<td>3.8</td>
</tr>
<tr>
<td>Intellectual property</td>
<td>3.1</td>
</tr>
<tr>
<td>Protocol of accession</td>
<td>2.6</td>
</tr>
<tr>
<td>Rules of origin</td>
<td>0.7</td>
</tr>
<tr>
<td>Safeguards</td>
<td>4.2</td>
</tr>
<tr>
<td>Sanitary and phytosanitary measures</td>
<td>3.9</td>
</tr>
<tr>
<td>Services</td>
<td>2.3</td>
</tr>
<tr>
<td>Subsidies and countervailing measures</td>
<td>9.5</td>
</tr>
<tr>
<td>Technical barriers to trade</td>
<td>4.4</td>
</tr>
<tr>
<td>Textiles and clothing</td>
<td>1.6</td>
</tr>
<tr>
<td>Trade-related investment measures</td>
<td>3.4</td>
</tr>
</tbody>
</table>

Source: Author’s calculations based on WTO (2013c).

Next we provide some facts regarding the use of dispute settlement rules by WTO members, to get an indication about the ability of the DSB to efficiently settle disputes between member states.

As indicated above, 456 disputes had been referred to the DSB by February 2013. Of these, 452 took longer than the two months the DSU has provided for consultations between parties. In other words, either these disputes should have been settled by mutual consent, or requests for the setting up of panels should have been put forth.

Available data on these 452 disputes shows that panels were set up in 235 cases, which roughly corresponds to 52 percent of total cases. In 43 of the total number of disputes, the parties found a mutually agreeable solution before the establishment of the panel. Thus, in less than 10 percent of the disputes notified, the parties involved found an acceptable solution at the consultation stage. A further 19 cases were decided by mutual consent after the establishment of a panel. This shows that in about one-seventh of the total notified disputes, the parties found a solution before going through the panel proceedings. However, there were two cases, the
Japan–US dispute on ‘Measures Affecting Agricultural Products’ and the Turkey–India dispute on ‘Restrictions on Imports of Textile and Clothing Products’, in which the parties found a mutually acceptable solution only after the appellate body had adjudicated.

Of the complaints filed by non-OECD countries, mutually agreed solutions were found in only in 9 percent of the cases, which is nearly half of the corresponding figure in cases of disputes initiated by OECD countries. In terms of the advancement of the dispute settlement process through the panel process, the OECD countries fared much better. While the panels had submitted their reports in 54 percent of the disputes they had initiated, only 45 percent of non-OECD country members’ dispute panels had submitted their reports. These figures clearly indicate that OECD members of the WTO were able to get a better return on their efforts to resolve disputes with their partner countries. Once again, this may be due to developing countries being less well prepared for their involvement in the WTO dispute settlement process.

Although panels were established in 235 cases, the latest available information shows that panel reports were circulated in 185 cases. This relatively low number of panel reports circulated to Members is due in large part to inordinate delays in the process of adjudication.

The timelines for the 185 cases in which the panels had submitted reports, gives the impression of a rather indifferent WTO DSB. In only four of the 185 disputes did the panels submit their reports within 11 months of the filing of the complaint as stipulated by the DSU. At the other end of the spectrum are 53 cases where the panels took more than two years to submit their reports. In three of these disputes, all of which involve the US and the EU, the panels took nearly five years to submit their reports.

According to the DSU, the appellate body should be completing its proceedings within 14 months of the initiation of the complaint. This time frame could be observed in four of the 124 disputes that went to the appellate stage. In about half of these disputes, the appellate body reports were submitted more than two years after the initiation of the complaint. In the two ‘Large Civil Aircraft’ disputes involving the US and the EU, the appellate body reports took nearly seven months from the date of filing the complaint to be released.

The functioning of the WTO DSU provides some telling insights into the nature of participation by developing countries. Not only was their level of participation much lower than that of their developed country counterparts, but Africa, which has suffered trade discrimination over long periods, has not been able to use the dispute settlement rules. Participation in the proceedings of the DSB has also been relatively expensive for
developing countries. One indicator of this is that only a relatively small proportion of their complaints were resolved through mutually agreed solutions. Again, compared with the OECD countries, a larger proportion of the disputes initiated by the developing countries have not progressed up to the panel stage.

11.3.2 Issues in the DSU Review

Not surprisingly, therefore, developing countries have raised several problems regarding the DSU in the ongoing review of the mechanism. One of the most comprehensive proposals in this respect was presented by the African Group (WTO 2002b). The group pointed out that the major problems countries from this region face in seeking to use the dispute settlement rules include the following: (1) rules are complicated and using them is overly expensive; (2) injury suffered has not been satisfactorily compensated in situations where the offending measures are withdrawn before or after the commencement of proceedings; (3) the means provided for enforcement of findings and recommendations (trade retaliation) are skewed against and disadvantage African members; (4) special procedures for developing country members have not addressed the core difficulties African members face in seeking to use the rules; (5) in their interpretation and application of the provisions, the panels and the appellate body have in several instances exceeded their mandate and fundamentally prejudiced the interests and rights of developing-country members as enshrined in the WTO Agreement; (6) the panel and appellate body composition and operation have not been conducive to ensuring the achievement of the development objectives of the WTO and of equity in geographical distribution; and (7) any assessment and improvement of the DSU should be primarily based on the development objectives set out in the WTO Agreement.

Elaborating on some of the issues, the African Group argued that in order to participate effectively in the proceedings of the DSB, developing countries members 'will need supplementary resources and means to be provided to develop both the institutional and human capacity' (WTO 2002b, p. 2). The group further pointed out that the ‘Advisory Centre on WTO Law should not be considered as a panacea for all institutional and human capacity constraints of developing countries’ since its ‘terms of reference are equivocal in certain instances, and it does not cover all developing countries’.

Other prominent developing countries have raised a number of issues, including the following: (1) a limit on the cases against developing countries each year (the PRC’s view is no more than two per year); (2) reimbursing the costs of litigation to developing countries, especially in a case
where they have won a favorable judgment (proposal from like-minded group of countries); (3) increased reasonable period of time (RPT) to developing countries for implementing the decisions of the panel and/or the appellate body; and (4) invoking of automatic cross retaliation in any sector by developing countries (Kaushik 2008, p. 28).

The last-mentioned issue is important for developing countries that have not been able to retaliate, even if they obtained an authorization from the DSB. Ecuador obtained a right to retaliate in the EC–Bananas case, but could not exercise its right. Likewise, India, the Republic of Korea, Chile, and Brazil did not retaliate in the US–Byrd case after having obtained the authorization to do so.

Apart from the issues concerning developing countries, discussions on the reform of the DSU have focused on two key issues. The first is the so-called ‘sequencing’ issue, provided in Article 21.5 of the DSU. This article authorizes the setting up of a compliance panel in the event of a disagreement between the parties as regards compliance by the responding party, but does not specify the time when action to set up the compliance panel will be triggered. On the other hand, Article 22.2 provides that if there is no agreement on satisfactory compensation between the parties within 20 days of the expiry of the RPT granted to the responding party, the complaining party may request authorization to retaliate. These provisions could result in situations where the setting up of compliance panels has not been sought within 20 days of expiry of the RPT while the complaining party is obliged to request authorization to retaliate in order to preserve its right to retaliate. In other words, the sequencing between the establishment of a compliance panel to the disagreement between the parties in a dispute and the right to retaliate is not provided in the existing discipline.

The second lacuna is the lack of remand procedures in the DSU. The DSU provides a division of responsibility between the panel and the appellate body – while the panel establishes the facts and makes legal findings, the appellate body can only consider matters of law and its interpretation. Thus, any change in the legal interpretation when this is considering a dispute requiring new facts, which may facilitate resolution of the dispute, cannot be sought by the appellate body. Several countries have proposed textual amendments to rectify this lacuna.

11.4  SUPPORTING THE GLOBAL PRODUCTION NETWORK: A PROACTIVE AGENDA

Over the past two decades, global production networks have emerged as a strong integrating force in the global economy. Not only have GPNs
played a determining role in bringing economies closer together by stimulating the flows of goods and capital across countries, but they have also contributed to knowledge diffusion, and have provided opportunities for local capabilities to emerge in countries that are part of the networks. This dimension has received relatively less attention in the literature on GPNs, which has discussed this new organizational form largely from the point of view of trade integration.

Global production networks have been seen both as products of the process of liberalization of trade and financial flows as well as the catalysts for ensuring a greater degree of openness in the global economy. Proponents of this thinking have argued that the unshackling of economies has triggered a change in transnational corporations, converting them from ‘tariff-hopping’ investors to ‘global network flagships’ that have integrated their dispersed supply, knowledge, and customer basis into the GPNs. Fragmentation of production caused by the ‘network flagships’ is assisted by the existence of a plethora of specialized suppliers, usually spread over a large geographical spectrum (Ernst and Kim 2002, pp. 1417–29).

The logic of GPNs demands a high degree of competence all along the supply chain. The suppliers to the network flagship, which is usually the point of assembly of the final product, are not only required to meet the exacting quality standards and the price of the intermediates they are responsible for; they would also have to meet this rigid ‘just-in-time’ schedule. But in order to ensure that the suppliers’ performances meet expectations, the network flagships need to transfer technical and managerial knowledge to them. There is therefore a need to upgrade the suppliers’ technical and managerial skills on a continuous basis. The increasing rate of product obsolescence seen in a large number of industries, in particular those producing products that use information and communications technology, put pressure on the network flagships to upgrade the technologies of their suppliers (Bernhardt and Milberg 2011).

Network flagships transfer knowledge across borders using a slew of mechanisms. First, the transfer of knowledge may be mediated through market mechanisms, using licensing contracts and outright purchases of technology and plant equipment, among others, that may or may not involve FDI. Secondly, the network flagship may transfer technologies through the supply chain and in doing so would be exercising control over the manner in which the knowledge is disseminated to and used by the supplier. The type of control over the supply chain can be seen by the manner in which the operation of original equipment manufacturers, or the so-called ‘tier I’ suppliers, are managed by the network flagships.

Irrespective of the nature of GPNs, that is, whether they are producer
driven or buyer driven, network flagships are able to control the production process of their suppliers by actively transferring knowledge in the form of blueprints and technical specifications. The objective is to ensure that the suppliers meet the technical standards of the final products. Branded marketers like Nike and Reebok, managing the ‘buyer driven’ networks, maintain close control over their suppliers by setting standards, sourcing raw materials, distributing them, and finally importing the finished products. Global production networks are also able to encourage firms figuring in the networks to access knowledge indirectly through indirect mechanisms, as for instance import of sophisticated equipment to improve their production capabilities.

With the maturing of production networks, the pattern of knowledge acquisition has also been undergoing changes. Along with this has come the phenomenon of firms in the GPNs engaging in innovations that take them across value chains thereby giving the innovating firms more scope to operate independently.

The existence of successful GPNs, however, presupposes the existence of local suppliers that have the capabilities to absorb the knowledge disseminated by the networks. Furthermore, to remain in the GPN, local suppliers must constantly upgrade their absorptive capacity. Participation in GPNs cannot, therefore, be ensured unless the local suppliers are able to develop their technological capabilities and prepare themselves for inclusion in these networks.

The proliferation of GPNs poses a significant challenge to the multilateral trading system for its basic construct is based on the existence of localized production within nation states. Production sharing across national borders of the kind that has been spawned by GPNs requires new instruments and institutions that are supportive of such networks. This, in our view, requires a focus on three behind-the-border areas – trade facilitation measures, investment policy, and NTBs for the adoption of possible globally accepted frameworks and agreements.

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

A multilateral agreement on investment became a non-starter after
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the OECD-backed proposal for such an investment agreement met with resistance not only in developing countries, but from within the group of developed countries. Notwithstanding this development, there has been an unrelenting movement toward adoption of a de facto investment agreement at the global level through bilateral investment treaties and economic partnership agreements. However, in recent years, it has become evident that such agreements are imposing a variety of constraints on host countries. Not surprisingly, there has been a steep increase in disputes involving foreign investors and their host states. This development could be detrimental to GPNs since they are dependent on cross-boundary movements of enterprises. A better understanding of the contentious elements of the existing investment agreements could trigger a move toward a more equitable global investment regime.

Non-tariff barriers have been the insurmountable barrier the multilateral trading system has had to cope with since its establishment. In more recent years, technical barriers have emerged as the fountainhead of NTBs. This was confirmed in the course of the ongoing negotiations on non-agricultural market access. Taming the proliferation of these technical barriers or standards requires global action.

Below we discuss the elements of each of these four areas, which could help in taking the GPNs to the regions that have as yet been untouched.

11.4.1 Trade Facilitation

Although several of its elements form part of the GATT, trade facilitation was unveiled as an integrated framework to address customs related issues, including that of transit, at the first WTO Ministerial Conference in Singapore in 1996. The issue thus became one of the ‘Singapore Issues’, along with investment, competition, and government procurement. After much discussion, the issue was included in the WTO work program in the Doha Ministerial Conference. While the other ‘Singapore Issues’ were taken off the table in the Doha Round for want of consensus,18 trade facilitation was included in the negotiations as a part of the ‘July package’ in 2004.

Trade facilitations are mandated to produce an appropriate set of rules both from a technical point of view and from the perspective of the development imperatives of developing countries. In more precise terms, the negotiations ‘aim to clarify and improve relevant aspects of Articles V, VIII and X of the GATT 1994 with a view to further expediting the movement, release and clearance of goods, including goods in transit’ (WTO 2004a, p. D-1). The negotiations are also aimed at enhancing ‘technical assistance and support for capacity building’ and to develop ‘provisions for effective
cooperation between customs or any other appropriate authorities on trade facilitation and customs compliance issues’. The negotiations are expected to ‘take fully into account the principle of special and differential treatment for developing and least-developed countries’ and, in keeping with this spirit, the mandate clarifies that the countries in question are not expected ‘to undertake investments in infrastructure projects beyond their means’ (WTO 2004a, p. D-1).

Developing countries were initially opposed to the expansion of the remit of the WTO by including trade facilitation in the Doha agenda if adequate efforts were not made to address issues arising from the implementation of the Uruguay Round commitments. They questioned the developmental impact of trade facilitation, besides arguing that they did not have the resources to implement the commitments the proposed agreement would impose on them.

However, despite the initial skepticism there seems to be an emerging consensus that developing countries would benefit from a WTO Agreement on trade facilitation. A widely accepted view is that in developing countries customs procedures and the supporting infrastructure are generally not very efficient, and that this results in higher transaction costs. ‘Doing Business’, the annual survey of the World Bank, provides endorsement of this point.

Given the weight of evidence emerging in favor of the various elements of trade facilitation, including simplification and harmonization of customs procedures and improvement of border infrastructure and management systems, there is no doubt that the introduction of these measures would not only increase developing countries’ capacity to trade, but businesses in these countries will also be able to integrate into global supply chains. Better coordination among the customs authorities would increase operating efficiency of the agency, and this in turn will enable the system to generate more revenue through a transparent mechanism. A recent study conducted by the OECD Secretariat using data on ‘trade facilitation indicators’ from 106 non-OECD countries, which include 95 WTO members and 11 WTO observers, showed that the benefits accruing to developing countries, both as importers and exporters, could be substantial if appropriate reforms are undertaken (OECD 2012).

The negotiations on trade facilitation have been dealing with a plethora of issues that could eventually form a part of the agreement. These include issues relating to transparency, such as publication and availability of information through publication, Internet and enquiry points, operational issues such as the release and clearance of cargo, introduction of risk management and post-clearance audit and disciplines on expedited shipments,
and institutional issues like establishing a single window for clearance of goods, elimination of pre-shipment and post-shipment inspections, and uniform forms and documentation requirements for clearance of goods. Besides, the above-mentioned freedom of transit and customs cooperation are key elements of the discussions.

While the broad contours of an agreement on trade facilitation seem clear, several contentious issues continue to engage WTO members. Developing countries have been insisting that there should be firm commitments on capacity building and technical assistance, which will enable them to tackle the challenges posed by the proposed agreement.

Despite the progress made in the trade facilitation negotiations, several obstacles stand in the way of an eventual agreement. Major developing countries like India and Brazil are not likely to favor a ‘stand-alone’ outcome, as trade facilitation is integral to the Doha package, and thus part of the ‘single undertaking’. In other words, these countries will be reluctant to agree on a deal on trade facilitation without agreement on some of the key areas in the Doha negotiating mandate. Again, while there are doubts that most of the lesser developed countries would benefit from an eventual deal on trade facilitation (Mohamadieh 2013, p. 1), since the benefits would not accrue to them in the absence of the technical assistance and capacity-building commitments from the developed countries, it seems unlikely that a globally acceptable outcome can be realized soon.

11.4.2 Toward a Balanced and Equitable Investment Regime

As with trade facilitation, a multilateral agreement on investment has also been on the fringes of the discussions in the WTO since the Singapore Ministerial Conference. The Doha Ministerial Conference in 2001 included trade and investment issues in the post-Doha work program with the following mandate:

Recognizing the case for a multilateral framework to secure transparent, stable, and predictable conditions for long-term cross-border investment, particularly foreign direct investment, that will contribute to the expansion of trade, and the need for enhanced technical assistance and capacity-building in this area... and hence agreed that negotiations will take place after the Fifth Session of the Ministerial Conference on the basis of a decision to be taken, by ‘explicit consensus’, at that session on modalities of negotiations. (WTO 2001a, p. 4)

The Doha Ministerial Declaration also provided some indications regarding the nature of work the Working Group on the Relationship between Trade and Investment (WGTI) was to undertake as follows:
In the period until the Fifth Session, further work in the Working Group on the relationship between trade and investment will focus on the clarification of: scope and definition; transparency; non-discrimination; modalities for pre-establishment commitments based on a GATS-type, positive list approach; development provisions; exceptions and balance-of-payments safeguards; consultation and the settlement of disputes between members. Any framework should reflect in a balanced manner the interests of home and host countries, and take due account of the development policies and objectives of host governments as well as their right to regulate in the public interest. (WTO 2001a, pp. 4–5)

It was agreed that special development, trade, and financial needs of developing and least-developed countries should be taken into account as an integral part of any framework, which should enable members to undertake obligations and commitments commensurate with their individual needs and circumstances, with due regard to other relevant WTO provisions. It was also agreed that account should be taken, as appropriate, of existing bilateral and regional arrangements on investment.

In the post-Doha discussions on a possible multilateral regime on investment, India, along with other developing countries, argued strongly in favor of the ‘need [for] policy flexibility to determine the form of investment that would lead to highest growth’. India made the point that the definition of investment would itself have important implications for the development prospects of developing countries (WTO 2002d). It was pointed out that greenfield investments would be more conducive to furthering the development goals than mergers and acquisitions, as investments of the former kind could result in better economy-wide linkages. According to India, any inflows of capital that are inimical to the domestic industry, particularly small and medium-sized enterprises, and have adverse effects on employment would need to be carefully regulated. And, finally, India stated that developing countries need to retain the ability to screen and channel foreign investment so as to meet their domestic interests and priorities.

Arguments made against a multilateral regime on investment by developing countries led by India resulted in the eventual exclusion of the investment issue from the Doha Round negotiations. A decision was taken by WTO Members in July 2004 that this issue ‘will not form part of the [Doha] Work Programme . . . and therefore no work towards negotiations . . . will take place within the WTO during the Doha Round’ (WTO 2004a, para. (g)).

The position that India and other developing countries took in the discussions in the WGTI needs to be considered in the context of the initiative taken by the OECD countries to formalize a ‘multilateral agreement on investment’ (MAI). The MAI, a draft of which was discussed by OECD
members during 1998–2000, contained far-reaching proposals aimed at bringing about significant changes to the foreign investment regime. It should be pointed out that the proponents of the MAI themselves found it difficult to support the initiative at a later stage, and consequently efforts to formalize the agreement were abandoned.

Any progress on investment issues at the multilateral level should therefore be mindful of problems that were encountered while negotiating the OECD MAI. The major roadblock faced in these negotiations stemmed from the sweeping rights that were promised to foreign investors. At least three areas were prominent in this regard – definition of investment, expropriation of investment, and investor–state dispute settlement. Our view is that these three areas need to be revisited in light of the growing evidence that is informing a better understanding of the issues involved for both the home and the host states. This would help in developing a multilateral regime on investment, which besides providing adequate protection to the foreign investor, provides the necessary policy options to the host countries to further their development objectives.

11.4.2.1 Definition
What constitutes an investment is a key element of an investment treaty for it lays down the extent to which foreign investors can get protection against direct and/or indirect expropriation in their host countries. Most bilateral investment protection agreements (BIPAs) that are currently in operation include a broad definition of investment. These treaties usually cover ‘every kind of asset’, which is typically followed by a non-exhaustive list of covered assets.

Three observations regarding the definition of investment included in the BIPAs should be made here. The first is that by agreeing to include forms of investment such as ‘rights to money or to any performance under contract having a financial value’ in the definition, host countries have often left the door open for an expansive interpretation of what should constitute ‘investment’. This issue was brought up by the United Nations Commission on International Trade Law (UNCITRAL) tribunal adjudicating White Industries versus Republic of India, which is discussed below.

While host countries in the developing world, including India, have encountered problems with foreign investors over the ambiguous definition of investments that are included in their BIPAs, the capital exporting countries have taken steps to overcome this problem. These countries have subjected their BIPAs to periodic reviews; the best example of which is the US. The US initiated its BIT program in 1981 and has reviewed its model BIT twice in a period of eight years.

The first review resulting in the 2004 model BIT was triggered by the
Trade Act of 2002, which stated, the ‘principal negotiating objectives of the United States regarding foreign investment are to reduce or eliminate artificial or trade-distorting barriers to foreign investment, while ensuring that foreign investors in the United States are not accorded greater substantive rights with respect to investment protections than United States investors in the United States’ (emphasis added).

The second review, the outcome of which is the 2012 US model BIT, resulted from President Obama’s Trade Policy Agenda of 2009 that called for a ‘review [of] the implementation of our FTAs and BITs to ensure that they advance the public interest’ (USTR 2009). This review was driven by yet another set of concerns:

whether [US] FTAs and BITs give foreign investors in the United States greater rights than U.S. investors have under U.S. law; whether the FTAs and BITs give governments the ‘regulatory and policy space’ needed to protect the environment and the public welfare; and whether an investor should have the right to submit to arbitration a claim that a host government has breached its investment obligations under an FTA or a BIT.22

The definition of investment appearing in the US model BIT was comprehensively amended in the review undertaken in 2004 and this definition was adopted in the 2012 BIT as well. The preambular language was changed from ‘every kind of investment owned or controlled directly or indirectly, including equity, debt; and service and investment contracts’ to ‘every asset that an investor owns or controls, directly or indirectly, that has the characteristics of an investment, including such characteristics as the commitment of capital or other resources, the expectation of gain or profit, or assumption of risk’ (emphasis added). At the same time, the forms of involvement of foreign enterprises that can receive protection under the BITs were narrowed down and, importantly, these bore a direct relationship with the long-term forms of participation.

An appropriate definition of investment will also help to protect a country’s interest in the arbitration process. The majority of investment treaty disputes are filed at the ICSID.23 The ICSID Convention does not define investment and its interpretation is left to the tribunals (IISD 2008, p. 21). Providing a broad definition of investment bestows the tribunal with considerable discretion in determining whether a particular asset meets the criteria of investment, which otherwise may not qualify for investment as per the domestic law.24

11.4.2.2 Expropriation
Although in common parlance, expropriation of investment is equated with nationalization, in the world of BITs this term is used in several
different situations. An indication of the complexity involving the term ‘expropriation’ (the other term commonly used is ‘takings’) can be gauged from the fact that this term is used by investors whenever they find hindrances in their operations in their host countries. The UNCTAD points out that there can be three broad categories of expropriations: (1) direct expropriations include nationalizations and/or outright physical seizure of the property; (2) indirect expropriations which permanently destroy the economic value of the investment or deprive the owner of the ability to manage, use or control the property in a meaningful way; and (3) regulatory measures, that is, acts taken by States in the exercise of their right to protect the public interest, which may have the same effects as an indirect expropriation (UNCTAD 2012a, p. 6).

All investment treaties provide for expropriation under certain circumstances. Investment treaties such as the NAFTA, US–Australia BIT, the ASEAN–Australia–New Zealand FTA, and India’s BIPAs provide that expropriation of investment is not allowed except for public purposes, in a non-discriminatory manner and on payment of fair and equitable compensation. It may be pointed out that the definition of investment holds the key to the determination of expropriation. Thus, in countries, which have a more precise definition of investment (as in the case of the US, discussed above), claims of expropriations may be far fewer compared with India.

The investment protection agreements the US has entered into with advanced countries, for example, the NAFTA and the US–Australia BIT, have a significant set of exclusions from expropriation, and these relate to intellectual property rights. This exclusion is also included in the US model BIT. The relevant article states that provisions on expropriation do not ‘apply to the issuance of compulsory licenses granted in relation to intellectual property rights in accordance with the TRIPS Agreement, or to the revocation, limitation, or creation of intellectual property rights, to the extent that such issuance, revocation, limitation, or creation is consistent with the TRIPS Agreement’.25 Interestingly, this exclusion is absent in the BITs concluded with the developing countries. Particularly important in the list of exclusions from appropriation is compulsory license, an instrument that can be used by countries to counter excessive use of monopoly rights by patent holders.

The customary international law and most of the investment treaties provide for three conditions to make the expropriation lawful: it must be for a public purpose, it must be non-discriminatory, and compensation must be paid. Some investment treaties such as the NAFTA, US–Australia FTA, and ASEAN–Australia–New Zealand FTA, provide for a fourth parameter, ‘due process’ (Tienhaara 2010). The indirect expropriation,
However, is very controversial, as no parameter has been prescribed to judge whether an expropriation has taken place. The model BITs of the US provide for certain criteria to decide whether an act amounts to indirect expropriation. They are (among other factors) the economic impact of the government action, the extent to which the act interferes with the reasonable expectations of the investor, and the character of government action.26

11.4.2.3 Investor–state dispute

Several commentators have written critically about a number of aspects of the investor–state dispute mechanism. They have alluded to the ‘pro-investor’ bias of the BITs and the process of the investor–state arbitration, including the ability of the courts in the host countries to deal with the rulings of the arbitration panels.

A key feature of the investor–state dispute process is that it gives investors superior bargaining power vis-à-vis their host countries. This dimension manifests itself in several forms. The first is that the consent of the investor is essential for initiating an investor–state dispute under the BITs. Commentators have suggested that this element introduces ‘an inherent pro-investor bias in the system’ (Tienhaara 2009, p. 5) since investors will participate only if it is in their interest to participate in the dispute. The ICSID arbitration process introduces a second ‘pro-investor’ bias. The ICSID Convention does not require an investor to exhaust local administrative or judicial remedies as a condition to arbitration, whereas a contracting state may require the exhaustion of such remedies. Interestingly, some commentators have justified this dimension of the ‘pro-investor bias’ thus: ‘A foreign investor, justifiably in many instances, will not have confidence in the impartiality of the local tribunals and courts in settling any disputes that may arise between him and the host state’ (Dodge 2006, p. 11).

Commentators have pointed out that the arbitration tribunals are often insulated from control by the judicial authorities of the host countries since ‘investment treaties provide that investor–state disputes are to be treated as commercial disputes for the purposes of the New York Convention. This restricts the degree to which domestic courts can refuse to enforce an investor–state award on the grounds that it goes beyond the bounds of commercial arbitration’ (Van Harten 2005, p. 622).27 The Supreme Court has recently overturned a decade old ruling, which had allowed Indian companies to approach Indian courts against unfavorable awards by foreign arbitration panels.28 This will give a further boost to foreign investors in their disputes with Indian companies and the Government of India. What seems more egregious is that the arbitration
rules allow judicial review of the decisions of the panels based solely on the laws of the country where the arbitration is held. Furthermore, in their attempts to create business for the arbitration industry, many countries have revised their national laws to provide for less vigorous judicial review of foreign arbitration awards. As mentioned above, BITs give investors the right to initiate disputes against their host states, so when deciding on a jurisdiction investors often opt for locations that limit the judicial review of international arbitration. Belgium went as far as removing any kind of judicial oversight by Belgian courts on international arbitration awards (Van Harten 2005).

Controversies over investor–state dispute mechanisms have spilled over into the negotiations on the Trans-Pacific Partnership Agreement (TPPA), which has been described as the 21st-century trade agreement by its most prominent protagonist, the US. Among the issues figuring in the TPPA negotiations is an investment agreement that would have ‘provisions for expeditious, fair, and transparent investor–state dispute settlement’ (USTR 2011). The negotiations on the investment chapter of the TPPA have met with strong opposition from Australia, which has rejected the inclusion of investor–state mechanisms. In its trade policy statement of 2011, the Gillard Government was against ‘provisions that would confer greater legal rights on foreign businesses than those available to domestic businesses’. At the same time, the government also announced that it would no longer seek ‘inclusion of investor–state dispute resolution procedures in trade agreements with developing countries at the behest of Australian businesses’. The Gillard Government declared that it ‘will discontinue this practice’.31

This turnaround in Australia’s position was not without reason. The Gillard Government had been involved in a dispute over packaging of cigarettes, which it was trying to regulate through the Tobacco Plain Packaging Act 2011. The bill was brought to regulate the retail packaging and appearance of tobacco products among others, ‘to increase the effectiveness of health warnings on the retail packaging of tobacco products’. The tobacco giant, Philip Morris Asia Limited, which controlled the operation of its subsidiary in Australia, challenged this legislation. The firm used the investor–state dispute provisions of the Australia–Hong Kong, China BIT to challenge the Australian Government’s legislation on plain packaging of tobacco products. The reverberations of this dispute were heard in the trade policy statement of 2011. The government declared that it ‘has not and will not accept provisions that limit its capacity to put health warnings or plain packaging requirements on tobacco products’. 33
11.4.3 Taming the Non-tariff Barriers

Since its establishment in 1948, the multilateral trading system has been tasked with the elimination of border protection measures arising from the pursuit of discriminatory policies. The process of trade liberalization that was thus initiated has since become almost synonymous with the lowering of tariffs. Yet, the critical issue of NTBs has remained largely unaddressed. The consideration given to this issue appeared to be just enough to protect the protagonists of trade liberalization against criticism that they were reluctant to ensure distortion-free markets were put in place. The results were along expected lines. For a number of decades, GATT had to face the criticism that it had established a regime that had worked for the lowering of tariffs while ignoring the growing incidence of NTBs.

The WTO could scarcely do any better. Disciplining NTBs was included as a part of the negotiations on non-agricultural products. More importantly, the two agreements that were explicitly included in the Uruguay Round package for monitoring the growth of standards in recent decades have been questioned regarding their effectiveness, and were substantially left outside the purview of the current round.

The Doha Ministerial Declaration was a major departure from the past when it mandated the market access negotiations to address the problem of ‘non-tariff barriers’ instead of the more ubiquitous ‘non-tariff measures’ that had been included in previous mandates. This change in nomenclature had two significant dimensions. First, the focus on NTBs could be considered a step toward clarifying the scope of the negotiations. As discussed above, the focus of the Uruguay Round market negotiations on NTBs created the problem in that several of the ‘non-tariff measures’ were being discussed in other negotiating groups, and this created jurisdictional overlaps. The second dimension, and one which caused a new set of problems, was that the Doha Ministerial Declaration gave no guidance as to how NTBs would be identified. In fact, much of the negotiating capital has been devoted to defining the scope of the negotiating mandate on NTBs.

11.4.3.1 Defining the scope of NTBs

In one of the early submissions to the Negotiating Group on Market Access (NGMA), New Zealand focused on this issue in a systematic manner, pointing out that the top seven of the so-called NTBs identified by its exporters included those that could, on examination, be found to be ‘WTO-legal’ (WTO 2002e). They included standards and certification, customs procedures, food safety and health requirements. To obviate this problem, New Zealand suggested the scope of the negotiations on NTBs could be defined using the following classifications: (a) issues that might
be addressed in negotiations elsewhere under the Doha mandate; (b) issues or proposals involving substantial change to existing WTO agreements; (c) proposals involving clarification of existing rules; (d) issues involving disputed interpretation of rules; (e) issues open to bilateral resolution; (f) products of interest to developing countries; (g) capacity issues; (h) implementation issues; and (i) special and differential provisions.

Canada provided similar guidance on defining the scope of the negotiations on NTBs, based on the views expressed by the country’s exporters (WTO 2002f). Canada identified four sets of so-called NTBs. These were: (a) quotas; (b) import licensing, rules of origin, customs valuation, SPSs, and TBTs; (c) tariff classification; (d) border-related measures including customs procedures, fees and administration. Of these four categories, Canada’s view was that the NTB negotiations could take up only the first set of issues, since all the other sets included issues that either were a part of existing WTO agreements or were being negotiated in other negotiating groups.

India made yet another suggestion, which addressed a more specific issue concerning the developing countries (WTO 2002g). In India’s view, legitimate instruments that developing countries might use under the various WTO agreements for development of their industries should not be included as NTBs. For example, export tariffs or levies are generally used to generate resources to develop an industry by diversification in the product profile and development of value-added products for export. India, therefore, suggested that ‘export duties be negotiated . . . outside the Doha mandate’ (WTO 2002g, p. 3).

A parallel process for identifying NTBs was initiated by the NGMA chairman in 2002. This process resulted in the submission of a large number of notifications in which WTO members identified the NTBs their exporters were facing.34

In their submissions, members identified three sets of NTBs that, in their view, were outside the purview of the NTB negotiations being conducted by the NGMA. These were: (1) NTBs related to existing WTO agreements (for example, customs valuation, import licensing, SPS, and TBT) that are not subject to a specific negotiating mandate; (2) NTBs related to other WTO agreements that are also the subject of a negotiating mandate (for example, Anti-Dumping and Countervailing Duties); (3) NTBs that are already part of the Doha Declaration (for example, trade facilitation, transparency in government procurement, and services).

Members identified the relevant GATT/WTO Articles/Agreements that could be applied to the NTBs thus identified. The NTB categories with the highest incidence of notifications were TBTs (530 NTB entries, almost half the total), customs and administrative procedures (380 entries), and
SPSs (137 entries). Quantitative restrictions, trade remedies, government participation in trade, charges on imports and barriers falling under the other groups accounted for less than 5 percent of total NTB entries. Interestingly, SPS measures were also identified as NTBs.

Nearly four decades after the initiation of a multilateral negotiation on the reduction of NTMs for free global trade and enhancing market access, the world is now facing one of its most difficult and complex regimes. Since the establishment of the WTO in 1995, both the number of TBTs and the spread of such measures across the member countries are fast outstripping and undermining the trade liberalization achieved by way of tariff reduction and elimination. As Table 11.6 clearly shows, the use of TBTs by WTO member countries has been on the rise, especially under the WTO regime. In 1995, 389 TBT notifications were issued, which went up to nearly 2200 in 2012.

Table 11.6 shows that the number of TBT notifications issued has increased consistently except in the years affected by the downturn at the end of the 1990s and 2000s. A more noteworthy feature of TBT

<table>
<thead>
<tr>
<th>Years</th>
<th>OECD countries</th>
<th>Non-OECD countries</th>
<th>Total notifications</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995</td>
<td>348</td>
<td>41</td>
<td>389</td>
</tr>
<tr>
<td>1996</td>
<td>395</td>
<td>105</td>
<td>500</td>
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<tr>
<td>1997</td>
<td>305</td>
<td>195</td>
<td>500</td>
</tr>
<tr>
<td>1998</td>
<td>491</td>
<td>189</td>
<td>680</td>
</tr>
<tr>
<td>1999</td>
<td>436</td>
<td>260</td>
<td>696</td>
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<tr>
<td>2000</td>
<td>428</td>
<td>202</td>
<td>630</td>
</tr>
<tr>
<td>2001</td>
<td>294</td>
<td>278</td>
<td>572</td>
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<td>2002</td>
<td>325</td>
<td>295</td>
<td>620</td>
</tr>
<tr>
<td>2003</td>
<td>380</td>
<td>513</td>
<td>893</td>
</tr>
<tr>
<td>2004</td>
<td>341</td>
<td>377</td>
<td>718</td>
</tr>
<tr>
<td>2005</td>
<td>381</td>
<td>519</td>
<td>900</td>
</tr>
<tr>
<td>2006</td>
<td>391</td>
<td>643</td>
<td>1034</td>
</tr>
<tr>
<td>2007</td>
<td>498</td>
<td>737</td>
<td>1235</td>
</tr>
<tr>
<td>2008</td>
<td>621</td>
<td>959</td>
<td>1580</td>
</tr>
<tr>
<td>2009</td>
<td>740</td>
<td>1160</td>
<td>1900</td>
</tr>
<tr>
<td>2010</td>
<td>708</td>
<td>1172</td>
<td>1880</td>
</tr>
<tr>
<td>2011</td>
<td>735</td>
<td>1032</td>
<td>1767</td>
</tr>
<tr>
<td>2012</td>
<td>832</td>
<td>1346</td>
<td>2178</td>
</tr>
</tbody>
</table>

Source: Compiled by the author from the notifications submitted by members of the WTO.
notifications is the steep increase in the number of countries that have been involved in issuing notifications. In 1995, only 26 of the 123 WTO members issued TBT notifications, but by 2012, 74 members were active in issuing TBT notifications. Quite obviously, the increase in the number of countries active in terms of issuing TBT notifications was due to increased interest shown by non-OECD countries, a large proportion of which are developing countries. Again, the number of these countries that issued TBT notifications far outstripped the OECD countries. This phenomenon is illustrated by Figure 11.2 showing trends in TBT notifications. In 1995, the share in the total notifications issued by non-OECD countries was below 10 percent. But by 2012 the share of those same countries had increased to more than 60 percent. The emergence of non-OECD countries as new players in the application of TBTs is reflected in the increased number of notifications made by them – from 41 in 1995 to almost 1350 in 2012.

11.5 CONCLUSION

Negotiations in the Doha Round face formidable challenges primarily because the negotiating process has been beset with problems. As
indicated in this chapter, negotiations in agriculture and NAMA had been fast-tracked, while critical areas like services and intellectual property rights remained on the back burner. Although agriculture and NAMA negotiations have shown some progress, the impetus for concluding the negotiations seems to be eluding the negotiators since the major players are still in disagreement over some of the most critical issues.

Services negotiations have made the least progress both in the area of market access and rules. The complexities of negotiating market access possibilities across the 12 services sectors together with the framing of an array of rules, have contributed to the slow progress. At various points in the negotiating process, attempts were made to initiate plurilateral negotiations involving the principal demandeurs of services trade liberalization. However, a wide gulf in the expectations of these countries prevented any forward movement.

The Doha Round has unequivocally shown that there are inherent risks in conducting comprehensive trade deals at the multilateral level, arising at two levels. First, the architects of the Doha Round provided a mandate for arriving at a balanced outcome, taking into consideration the results of all the negotiating areas. The second problem was that the WTO was called upon to address a number of behind-the-border issues as well as non-trade concerns while redesigning a number of key Uruguay Round agreements. These problems would suggest that the Doha Round could be suffering from a design flaw, which needs to be rectified to be able to advance.

Another significant issue which is part of this thinking on the way forward should be the new dynamics of trade that have been set in motion by the emergence of global production networks. It has been argued that these networks have helped markets to integrate in an efficient manner and that there is a need on the part of policy makers to find ways of supporting them. In this chapter, we have indicated a few areas which need careful policy intervention for the strengthening of global production networks. This is a task the WTO Members could set themselves as they prepare for the Bali Ministerial Conference.

NOTES

1. The decision was taken ‘to complete a full review of dispute settlement rules and procedures under the World Trade Organization within four years after the entry into force of the Agreement Establishing the World Trade Organization’. In other words, the review was to have been completed by 1 January 1999. See GATT (1994).
2. Informal consultations were held by the Chairman of the DSB in 1997, signaling the commencement of DSU review. For details, see WTO (1998).
According to Robert Wolfe (2004, p. 587), “implementation” in WTO jargon means both that developing countries find it too hard to meet their Uruguay Round commitments quickly, despite the Special and Differential treatment provisions; and that developed countries have been too slow in meeting their obligations to developing countries. The preamble to the Doha Ministerial Decision on ‘Implementation-Related Issues and Concerns’, states that the Decision was adopted as a ‘concrete action to address issues and concerns that have been raised by many developing-country Members regarding the implementation of some WTO Agreements and Decisions, including the difficulties and resource constraints that have been encountered in the implementation of obligations in various areas’ (WTO 2001b).


The ministers agreed that the ‘TRIPS Agreement does not and should not prevent Members from taking measures to protect public health’. They added that ‘the Agreement can and should be interpreted and implemented in a manner supportive of WTO Members’ right to protect public health and, in particular, to promote access to medicines for all’ (WTO 2001c, para. 4).

Principal among these is direct income support to agricultural producers. This handout from the government enabled the producers to drive a wedge between the costs and prices, thus enabling them to sell their products below economic costs.

The changed character of US subsidies’ regime is the best illustration of the phenomenon of ‘box-shifting’. The notifications submitted by the US to the WTO show that in 1995, ‘Green Box’ subsidies accounted for 46 percent of its total domestic support; in 2010, the corresponding figure was 93 percent.

The rise in non-tariff barriers can be gauged from the fact that while in 1995, the WTO members had issued fewer than 200 notifications on sanitary and phytosanitary measures, in 2013, this figure had exceeded 1200.

Current membership of G20: Argentina, Bolivia, Brazil, Chile, the PRC, Cuba, Ecuador, Egypt, Guatemala, India, Indonesia, Mexico, Nigeria, Pakistan, Paraguay, Peru, Philippines, South Africa, Tanzania, Thailand, Uruguay, Venezuela, and Zimbabwe.

Current membership of G33: Antigua and Barbuda, Barbados, Belize, Benin, Bolivia, Botswana, the PRC, Congo, Côte d’Ivoire, Cuba, Dominica, Dominican Republic, El Salvador, Grenada, Guatemala, Guyana, Haiti, Honduras, India, Indonesia, Jamaica, Kenya, the Republic of Korea, Madagascar, Mauritius, Mongolia, Mozambique, Nicaragua, Nigeria, Pakistan, Panama, Peru, Philippines, St Kitts and Nevis, St Lucia, St Vincent and the Grenadines, Senegal, Sri Lanka, Suriname, Tanzania, Trinidad and Tobago, Turkey, Uganda, Venezuela, Zambia, and Zimbabwe.

The outlay on export subsidies was about €177 million, while the quantity of subsidized products was nearly 2 million tonnes. As compared to 2009–11, there was a halving of its outlay on export subsidies, but quantity of subsidized exports had declined by a modest amount: from 2.5 million tonnes to 2 million tonnes. For details, see WTO (2013a) and WTO (2012b, table ES.1).

The ‘starting point of a credit’ shall be no later than the weighted mean date or actual date of the arrival of the goods in the recipient country for a contract under which shipments are made in any consecutive six-month period.

These include provisions for subsidies to reduce the costs of marketing exports of agricultural products and internal transport and freight charges on export shipments, provided or mandated by governments, on terms more favorable than for domestic shipments.

In February 2013, the US notified the 456th dispute against India.

The dispute was initiated in 1996 with Ecuador and four other countries, including the US, bringing a complaint against EU’s regime for the importation, sale and distribution of bananas. After the EU had failed to comply with the decision of the panel and the appellate body, the arbitrators allowed Ecuador to initiate trade retaliation proceedings in the year 2000. However, a mutually agreed solution was found between the parties in 2001. For details see WTO (1996, 2000, 2001e).
16. The dispute was initiated in 2001 (WTO 2001f) with Australia, Brazil, Chile, the EU, India, Indonesia, Japan, the Republic of Korea, Thailand, Canada, and Mexico bringing a complaint against the Continued Dumping and Subsidy Offset Act of the US (Byrd Amendment). After the panel and appellate body ruled against the US, arbitration proceedings were initiated with six complainants (India, Japan, the EU, the Republic of Korea, Brazil, and Chile). However, only two of these complainants, Japan and the EU, took retaliatory actions against the US. For details, see WTO (2013d).

17. See for instance, the joint proposal by Argentina, Brazil, Canada, India, New Zealand, and Norway (WTO 2007).

18. In respect of each of the ‘Singapore Issues’, the Doha Ministerial Declaration had stated ‘that the negotiations will take place after the Fifth Session of the Ministerial Conference on the basis of a decision to be taken, by explicit consensus, at that Session on modalities of negotiations’. See WTO (2001a, paras 20–27).

19. For the most recent version, see WTO (2013e).


22. For details, see the report of the House of Representatives (2009).

23. 27 out of 35 disputes in 2007 were filed in ICSID. For details, see IISD (2008).

24. So far, 279 cases have been registered with ICSID whereas 126 cases have come up in UNCITRAL. Out of the 46 new disputes registered in 2011, 34 were with ICSID. For details, see UNCTAD (2012a).


27. The New York Convention, officially known as the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards, was concluded in 1958. This treaty offers greater scope for the enforcement of international arbitration awards primarily because the Convention dropped the requirement that an arbitration award had to comply with the laws of the state in which it was enforced. Instead, the Convention maintained that in order to be enforceable, the award had to comply only with the laws of the state in which the arbitration was held. This implies that state parties to the Convention ‘relinquished national judicial control over awards made in other jurisdictions’. For details, see Van Harten (2005, p. 605).


29. Countries currently engaged in the TPPA negotiations are Australia, Brunei Darussalam, Chile, Malaysia, New Zealand, Peru, Singapore, the US, and Viet Nam.


31. This development is interesting because developed countries have always maintained double standards with respect to investor–state disputes. While they have insisted on including this provision in their BITs with the developing countries, in the very few BITs they have signed amongst themselves this form of dispute is either excluded or has not been used in recent years. For details, see Dodge (2006).


34. Between 2003 and 2006, 24 notifications were issued under the series TN/MA/W/46.
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APPENDIX

Table 11A.1  List of tariff sectoral initiatives proposed

<table>
<thead>
<tr>
<th>Sectoral initiative</th>
<th>Participants</th>
</tr>
</thead>
<tbody>
<tr>
<td>Automotives and related parts</td>
<td>Japan</td>
</tr>
<tr>
<td>Bicycle and related parts</td>
<td>Singapore; Switzerland; Taipei, China; Thailand</td>
</tr>
<tr>
<td>Chemicals</td>
<td>Canada; the European Communities; Japan; Norway; Singapore; Switzerland; Taipei, China; United States</td>
</tr>
<tr>
<td>Electronics/electrical products</td>
<td>Hong Kong, China; Japan; Republic of Korea; Singapore; Thailand; United States</td>
</tr>
<tr>
<td>Fish and fish products</td>
<td>Canada; Hong Kong, China; Iceland; New Zealand; Norway; Oman; Singapore; Thailand; Uruguay</td>
</tr>
<tr>
<td>Forest products</td>
<td>Canada; Hong Kong, China; New Zealand; Singapore; Switzerland; Thailand; United States</td>
</tr>
<tr>
<td>Gems and jewellery</td>
<td>Canada; the European Communities; Hong Kong, China; Japan; Norway; Singapore; Switzerland; Taipei, China; Thailand; United States</td>
</tr>
<tr>
<td>Hand tools</td>
<td>Taipei, China</td>
</tr>
<tr>
<td>Open access to enhanced healthcare</td>
<td>Singapore; Switzerland; Taipei, China; United States</td>
</tr>
<tr>
<td>Raw materials</td>
<td>United Arab Emirates</td>
</tr>
<tr>
<td>Industrial machinery</td>
<td>Canada; the European Communities; Japan; Norway; Singapore; Switzerland; Taipei, China; United States</td>
</tr>
<tr>
<td>Sports equipment</td>
<td>Norway; Singapore; Switzerland; Taipei, China; United States</td>
</tr>
<tr>
<td>Textiles, clothing, and footwear</td>
<td>European Communities</td>
</tr>
<tr>
<td>Toys</td>
<td>Hong Kong, China; Taipei, China</td>
</tr>
</tbody>
</table>

12. Plurilateral agreements: a viable alternative to the World Trade Organization?

Michitaka Nakatomi

12.1 INTRODUCTION: WHY PLURILATERAL AGREEMENTS?

This chapter deals with issue-based ‘plurilateral’ agreements, presents an approach to trade liberalization and rulemaking in specific areas, and analyzes their necessity and contribution to the global trade system.

A recent achievement of this plurilateral approach is the conclusion of the Anti-Counterfeiting Trade Agreement (ACTA), for which Japan has been an advocate and took the initiative in the negotiation. The signing ceremony was held in October 2011 in Tokyo, and Japan ratified the agreement in September 2012.

Looking back at the history of the WTO, major accords reached under the multilateral framework—such as the Information Technology Agreement, the Financial Services Agreement, and the Basic Telecommunications Services Agreement—were actually based on issue-based plurilateral agreements.

This chapter analyzes issue-based plurilateral agreements as an additional framework complementary to the WTO and free trade agreements, assessing their roles in rulemaking and liberalization in the area of international trade, with the aim of exploring the future prospects and possibilities of the plurilateral approach. It also illustrates that developing countries can join and utilize such agreements to improve their positions in the global trade regime.

12.1.1 Definition and Precedents

12.1.1.1 Definition

The scope of discussion on plurilateral agreements in this chapter is confined to trade-related issues within the scope directly or indirectly
associated with rulemaking and liberalization under the WTO. In this chapter, the term ‘plurilateral’ is defined as the involvement of three or more countries, with a view to their contribution to rulemaking and liberalization in trade. It is hoped that suggestions resulting from this analysis will lead to an enhanced international trade system and improved governance with the WTO as its center.

The relationship between multilateral and plurilateral agreements on trade-related issues is shown in Appendix 12.1, Table 12A.1. This chapter examines plurilateral agreements (shaded area in Table 12A.1) from various points of view.¹

Regional trade agreements and FTAs are country-based plurilateral agreements that are, in principle, required to liberalize ‘substantially all trade’² and have ‘substantial sectoral coverage’.³ In contrast, the plurilateral agreements assessed in this chapter are issue based (or issue oriented).

12.1.1.2 Precedents

Plurilateral agreements in the GATT/WTO⁴

Tokyo Round Codes. The General Agreement on Tariffs and Trade (GATT) regime was founded on two types of rules: the GATT 1947, in which all member states participate, and codes, which refer to a series of non-MFN-based agreements binding limited groups of participating member states. The Kennedy Round (1964–67) and the Tokyo Round (1973–79) produced a number of codes – the Agreement on Subsidies and Countervailing Measures, the Anti-dumping Agreement, the Agreement on Technical Barriers to Trade, the Agreement on Import Licensing Procedures, the Customs Valuation Agreement, the Agreement on Trade in Civil Aircraft, the Agreement on Government Procurement, the International Dairy Agreement, and the International Bovine Meat Agreement. Up until the establishment of the WTO, these codes had functioned fairly well. However, the number of subscribing countries was not large, even for key agreements, and generally ranged from 10 to 40 out of the 128 member states.⁵ The situation changed dramatically during the Uruguay Round, resulting in the launch of the WTO.

The Uruguay Round concluded at the end of 1993 and the WTO came into existence in 1995. The single undertaking principle (that is, nothing is agreed until everything is agreed), adopted at the conclusion of the Uruguay Round, greatly strengthened the rules regarding the rights and obligations of WTO member states and enhanced the
Plurilateral agreements: a viable alternative to the WTO? 363

stability and predictability of the global trade order in comparison to the pre-WTO period (that is, the GATT 1947 era). However, from the viewpoint of at least some of the developing countries, this meant making commitments beyond their capacity and accepting the enforcement of rulings of the WTO Dispute Settlement Body.

Unlike in the GATT regime, all members are bound, in principle, by the same set of rules under the WTO. The Tokyo Round Codes became universal rules (Annex 1 agreements) with only few exceptions (Annex 4 agreements as analyzed below).

**WTO Annex 4 agreements.** Among the Tokyo Round Codes, only the Government Procurement Agreement and the Civil Aircraft Agreement remain as plurilateral agreements.6 They are categorized as Annex 4 agreements in which participating members are limited in number, and obligations are imposed only on them.

**Other important plurilateral agreements**

1. **ITA (1997).** In 1997, two years after the establishment of the WTO, three important plurilateral agreements were concluded. In the area of industrial tariffs, the Quad group of major economies – the US, the EU, Japan, and Canada – began to negotiate the elimination of tariffs on computers, telecommunication equipment, semiconductors, and semiconductor manufacturing machines in 1996, with support from their electronics industries. After tough negotiations that subsequently involved some non-Quad countries, a framework agreement was concluded at the first WTO Ministerial Meeting in Singapore in December 1996. In the form of the Ministerial Declaration on Trade in Information Technology Products (ITA Declaration), 29 economies (including 15 EU countries) agreed to remove tariffs on IT products by 2000. Under the terms of this accord, it was to be decided before 1 April 1997 whether the ITA should be brought into force.8

The criteria for the entry into force of the ITA were:

(a) Participants representing approximately 90 percent of world trade in IT products have notified their acceptance of the agreement (critical mass criteria); and

(b) Staging of tariff reductions has been agreed upon to the participants’ satisfaction.

Covered products include: semiconductors, computers, telecommunication apparatus, and semiconductor manufacturing equipment. Their definitions were provided in the form of two attachments: Attachment A (list of products defined by harmonized system – HS – codes) and
Attachment B (list of products defined by words and covered by the ITA regardless of tariff classification). At a technical meeting held in Geneva in January 1997, it was decided that the Singapore Ministerial Declaration’s version of the list of products were to be upheld, and exceptions to (or flexibility on) the staging of tariff reductions were discussed and adjusted.

In February 1997, the staging issues of Thailand and Malaysia were settled. At the subsequent review meeting held on 26 March 1997, the participation of 40 economies – together accounting for more than 92 percent of world trade in IT products – was confirmed, fulfilling the approximately 90 percent trade coverage criteria, resulting in an official decision that the ITA would be entered into force.

2. Financial Services and Basic Telecommunications Services Agreements (1997). Also concluded in 1997 were two landmark services agreements – the Financial Services Agreement and the Basic Telecommunications Services Agreement – achieved by means of the participating members’ commitment to the relevant reference papers and changes to their schedules of concessions. The resulting benefits are extended to non-participating members on an MFN basis, just as tariff bindings in ITA signatories benefit not only themselves but also non-signatory WTO members.

3. ACTA (2011). The WTO Agreement on Trade-Related Intellectual Property Rights imposes a degree of discipline on trade in counterfeit and pirated goods. However, TRIPS provisions to this effect are neither sufficient nor clear enough in themselves. Furthermore, the TRIPS Agreement has not been implemented comprehensively, particularly in developing countries, and, as a result, trade in counterfeit and pirated goods remains rampant, causing damage in various forms.

This means that legitimate rights holders are being deprived of profits, which may suppress the incentive of businesses to innovate and create. This ongoing situation also poses a serious problem to the general public because counterfeit products can be hazardous to the health and safety of consumers, and illicit trading can become a source of revenue for criminal organizations. This gave rise to the notion that more effective and stringent international discipline must be put in place to address the damage and risks associated with trade in counterfeit and pirated goods.

Against this backdrop, Japan proposed to create a plurilateral agreement to deal with counterfeiting and piracy in 2005, a move that culminated in the conclusion of the ACTA. It was signed by like-minded countries in 2011, and Japan was the first to ratify it in 2012. Although negotiated and concluded outside the WTO, the ACTA is intended to supplement the TRIPS Agreement.
Japan played an important role in terms of the realization of the ITA and the ACTA. In particular, in the case of the ACTA, Japan was the initiator and took the lead throughout the negotiations.

With respect to the history and legal consideration of the ITA and the ACTA, it is hoped my paper on the ITA and the ACTA can serve as a reference point to better understand the background and reality of plurilateral negotiations.

12.1.2 Necessity of Plurilateral Agreements

12.1.2.1 Stalemate of the WTO and the Doha Round
Multilateralism embodied in the GATT and the WTO has been the backbone of the global trade system since the end of World War II. Countries across the world, including Japan, have benefited from free trade underpinned by the multilateral trade system. The GATT/WTO has been and should continue to be the cornerstone of the global trade regime.

However, the WTO has been facing serious difficulties, a situation pointing to the need to pursue issue-based plurilateral agreements.

Slowness and narrowness of the Doha Round Ever since its launch in 2001, the Doha Round of trade negotiations has faced two serious problems. The first and more serious problem has been the slow progress of the negotiations. Rulemaking for the multilateral trade system is adrift as the Doha Round continues to drag on without making much headway. Twenty-one years after the conclusion of the Uruguay Round in 1993 and 13 years after the launch of the Doha Round, the prospect for its conclusion remains remote. Although the WTO has played a useful role as a judicial system, as a forum for global trade rulemaking and liberalization, it is in a state of serious confusion.

The other serious problem is the narrow scope of issues covered by the WTO and the Doha Round. With negotiations focused on market access for industrial goods (that is, non-agricultural market access), agriculture, and services, other important issues, such as investment and competition, were dropped from the agenda at the WTO Cancun Ministerial Meeting in 2003. The scope of the current WTO negotiating agenda is too narrow to meet the demands and challenges of industries and businesses operating on a global scale. Simply dealing with border measures does not serve the needs of evolving business activities across borders.

Decision-making by consensus (160 vetoes) and single undertaking The slowness and narrowness of the Doha Round are closely related to the
decision-making mechanism of the WTO, or more specifically its underly-
ing principles of consensus and single undertaking that makes decisions in
the WTO extremely difficult and time-consuming.

12.1.2.2 Accelerating FTA proliferation
Against this backdrop, member states’ confidence in the WTO as a vehicle
for making global trade rules and promoting liberalization has been
undermined. With more governments and business communities looking
to FTAs as a means of gaining benefits, FTA competition has intensified.
The number of RTAs in force reported to the WTO had reached 379 by
early 2013.12

Twenty-one years after the completion of the Uruguay Round, the
WTO remains unable to make tangible progress in liberalization and rule-
making. It is only natural for those in the business community to feel that
they cannot afford to continue to rely solely on the WTO.

12.1.2.3 Conclusion of ACTA negotiations
A recent achievement of the plurilateral approach is the conclusion of the
ACTA in 2011. At a time when the Doha Round continues to face a dif-
ficult situation, the successful conclusion of the ACTA suggests the pos-
sibility of promoting rulemaking and liberalization under an issue-based
plurilateral framework as an additional channel, complementary to the
multilateral WTO approach and efforts through FTAs.

12.1.2.4 Polarized global trade regime and global governance
As long as the Doha Round remains adrift, FTAs will inevitably dominate
the global trade regime. Free trade agreements are a necessary tool for lib-
eralization and rulemaking in trade. At the same time, however, the pro-
liferation of FTAs will lead to the polarization of the global trade regime,
introducing differing and mutually inconsistent rules. The problem is
especially serious with FTAs involving the US and the EU as well as with
regional FTAs.13

There is a clear danger that the proliferation of FTAs may undermine
the multilateral trade rules embodied in the GATT/WTO. The spaghetti
bowl effect, a term that initially referred to the complexity of rules of
origin incorporated into FTAs, is no longer limited to that realm and
has been growing into a phenomenon encompassing global trade rules
in general. The concern over such disturbing developments should be
shared by all economies around the world as the fragmentation of global
trade rules endangers the smooth and efficient operation of global supply
chains. A spaghetti bowl of rules of origin could possibly be tolerated, but
a spaghetti bowl of global trade rules is intolerable.
The emergence of mega-FTAs or RTAs may also create mega-problems unless rules are harmonized across them. They would pose an especially serious challenge to developing countries that are not members and are left outside such mega-FTAs/RTAs. Even for those that choose to participate, adjusting to different rules would be an extremely difficult task.

Issue-based plurilateral agreements could remedy the situation and introduce consistent global rules while the WTO and the Doha Round are not in motion.

12.1.2.5 An important tool for both developed and developing countries to promote liberalization and rulemaking

Together with FTAs, issue-based plurilateral agreements can serve as an effective driver of liberalization and rulemaking in trade. Perceiving the current situation as a choice between just two options – the WTO and FTAs – is an erroneous approach. It is necessary to always consider the possibility of issue-based plurilateral agreements.

Developments since the establishment of the WTO have clearly shown the importance of issue-based plurilateral agreements. The ITA (liberalization), the ACTA (rulemaking), the Financial Services and Basic Telecommunications Services Agreements (liberalization and rulemaking) are evidence of the effectiveness of the plurilateral approach in achieving progress in the trade area.

These agreements, but above all the ITA, also suggest that well-designed plurilateral agreements would be accessible and beneficial to developing countries, that is, if they are established in a manner accommodating the economic interests of developing countries and their technical capacity constraints. Transparency in the negotiation process, technical assistance, and capacity building are essential to facilitating greater participation of developing countries. Indeed, it is no exaggeration to say that most of the important trade agreements concluded after the establishment of the WTO are plurilateral ones. As such, they can be a viable third choice in the dichotomy of the WTO and FTAs.

12.2 CHARACTERISTICS OF PLURILATERAL AGREEMENTS

This chapter looks at the characteristics of issue-based plurilateral agreements compared with the WTO. It also discusses how issue-based plurilateral agreements differ from sector-specific initiatives under the framework of FTAs. Although both issue-based plurilateral agreements and FTAs are complementary to the WTO and can potentially provide a basis for
multilateral rulemaking in the future, they differ with regard to the following points.

12.2.1 Paving the Way for Addressing Specific Issues and Areas

The most prominent feature of issue-based plurilateral agreements is that participating parties can freely choose issues and areas in which to try to come to an agreement. This may not sound like anything special. However, in the case of the WTO, a succession of negotiations is treated as a round, meaning their outcomes must be accepted in a single undertaking. This makes it difficult to promote an initiative for liberalization or rulemaking in a specific area while the round is in process.

Furthermore, adding a new initiative to an already weighty agenda is virtually impossible. Indeed, in reality, a trend to the contrary can be observed, with the scope of issues on the agenda for the Doha Round shrinking rather than expanding. In particular, the outcome of the WTO Ministerial Conference in Cancun in 2003, in which two issues of the utmost importance for industries – ‘trade and investment’ and ‘trade and competition’ – were dropped, seriously undermined the credibility of the WTO. In contrast, the plurilateral approach enables the launch of discussions on issues in a specific area – whether liberalization or rulemaking – among countries concerned with a good chance of reaching a meaningful conclusion that can impact the participating countries and their industries.

With respect to FTAs, in cases where two or more WTO members negotiate and conclude any agreement discriminatory against other members, they must initially satisfy conditions provided for in GATT Article XXIV:5 and the GATS Article V. In other words, FTAs can be defined as country-based plurilateral agreements.

Furthermore, GATT Article XXIV requires that an FTA covers ‘substantially all of the trade’ – which is construed to mean about 90 percent or more of the existing trade – between the signatories to the FTA. Therefore, FTAs are, by nature, not suitable as vehicles for issue-specific or sector-specific negotiations.

Indeed, WTO members may form a service sector FTA, a deal specifically on trade in services. Yet, such an agreement is required to have ‘substantial sectoral coverage’ (GATS Article V), and liberalizing just a specific service sector is not permitted under the GATS.

Members of the WTO may negotiate measures for addressing sector-specific problems in the course of discussing overall bilateral trade issues under the framework of FTAs. However, the aforementioned requirements would, in many cases, impose significant constraints on attempts to address sector-specific problems. Needless to say, discussing rules
and liberalization measures for various areas comprehensively under the framework of multinational, regional FTAs such as the TPP Agreement and the Japan–EU Economic Integration Agreement (EIA) is possible and offers some significant benefits.

12.2.2 Allowing Flexibility in the Choice of Participants

Another distinctive feature is flexibility in the choice of participants. Whereas negotiations under the multilateral framework of the WTO must, in principle, involve all members (160 economies), this is not the case under a plurilateral framework. It is therefore possible to discuss specific issues among specific countries in preparation for discussions under a broader framework in the future.

In the case of issue-based plurilateral agreements, any group of like-minded countries can discuss specific areas or issues of their choice. In contrast, FTAs are country based, whereby a specific pair or group of countries would first determine whether or not to pursue trade liberalization between or among them.

12.2.3 Getting around the Decision-making Ordeal of the WTO

Decisions at the WTO are, in principle, taken by consensus of all of the members, inhibiting its ability to respond speedily. An issue-based plurilateral agreement and FTA provide various options to get around this constraint.

12.2.4 Responding to the Changing Needs of Industries with Agility

In developing global value chains, businesses and industries around the world are engaged in trade and investment activities by making tough and difficult decisions on a daily basis. It is no exaggeration to say that the WTO is a world apart from those working in the fast-changing world of business. As a result, businesses and industries are showing increasingly less interest in the WTO apart from its dispute settlement mechanism.

In contrast, FTAs and issue-based plurilateral frameworks can respond to and address the changing needs of businesses and industries in a more practical time frame.

12.2.5 Preparing for Multilateral Rulemaking in the Future

Plurilateral agreements may not include any provision contradictory to WTO rules, to the extent that participants are WTO members. However,
an issue-based plurilateral agreement struck by a group of countries – each of which is firmly committed to the improvement of the WTO system – in a specific area of their concern in a manner ensuring consistency with WTO rules can provide an important basis for improving these rules in the future (this holds true, to some extent, for provisions under major FTAs). In view of the governance of the global trade system, it is critically important to define issue-based plurilateral agreements as a tool for governance and link them to the WTO.

In the case of FTAs, GATT Article XXIV and GATS Article V provide for exceptions to the WTO principle, allowing for discriminatory application of FTA rules. As such, FTAs are in principle applied on a non-MFN basis. (As the TRIPS Agreement does not provide for such provisions, IPR-related arrangements agreed to as part of a FTA must be applied on an MFN basis.)

Issue-based plurilateral agreements are not necessarily of such a discriminatory nature. Rather, as is the case under the ITA, the Basic Telecommunications Services Agreement, and the Financial Services Agreement, liberalization commitments made under plurilateral agreements are, in many cases, applied to non-party members on an MFN basis.

There exist no general provisions setting forth requirements for plurilateral agreements to be regarded as WTO-consistent, those that are equivalent to GATT Article XXIV for FTAs. This means that no deviation from the WTO principles is permitted for plurilateral agreements in general, and, in this regard, it may be necessary to take a more cautious approach in pursuing one.

The GATT Council’s decision in 1979 (L/4905), made at the time of adopting the Tokyo Round Codes, stipulates that ‘existing rights and benefits under the GATT of contracting parties not being parties to [plurilateral agreements], including those derived from Article I [that is, the right to MFN treatment], are not affected by these agreements’.

It has been argued that RTAs, particularly mega-RTAs, can make up for the two major defects of the WTO system – that is, slowness and narrowness – and, by further expanding and deepening RTAs, it is possible without relying on issue-based plurilateral agreements to build a foundation for making future rules on global trade. How should we evaluate this argument? There is no doubt that RTAs – particularly mega-RTAs – will be the driving force for trade liberalization and rulemaking. However, can they serve as an autonomous mechanism for making future rules governing global trade?

Professor Richard Baldwin has put forward a WTO 2.0 scenario in which mega-RTAs will set trade rules to deal with the new issues of the 21st century. However, I cannot help but question the automaticity of the scenario for the following reasons:
1. Emergence of a spaghetti bowl of rules. Since mega-RTAs are negotiated by different sets of countries under varying time schedules, there is no guaranteeing that the resulting agreements will be in harmony with one another as I analyzed in section 12.1.2.4 above. It is quite predictable that different RTAs will come up with their own solutions not only in the area of rules of origin but also regarding trade rules in general. In order to prevent this, it is necessary for all countries concerned to cooperate closely and make harmonization efforts. There is no guarantee that such cooperation and efforts will be made simultaneously.

2. Cost of ex post harmonization. Of course, it is technically possible to disentangle the spaghetti bowl in an ex post facto manner. However, it would take a long time and be very costly. Harmonizing rules across a series of mega-RTAs that will be established and put into effect may take as long and cost as much as completing a new round of trade negotiations.

3. Regionality of RTAs. Regional trade agreements are, by nature, region-based agreements aimed at finding regional, not global, solutions. The scope of membership is limited in number, resulting in the application of different solutions between member and non-member economies. Therefore, although mega-RTAs certainly help build a foundation for making future rules on trade and are an indispensable vehicle to promote liberalization and rulemaking, they would inevitably cause spaghetti bowl problems unless rules are harmonized across them on an issue-by-issue basis. Also, adjusting differences in applicable rules between member and non-member economies is essential in light of the need to make rules on a global level.

Issue-based plurilateral agreements, which can prevent the fragmentation of rules that would otherwise result from the emergence of mega-RTAs, are an important tool for making future trade rules. It is expected that they will continue to play a complementary role to the WTO and mega-RTAs.

12.3 CONSTRAINTS ON PLURILATERAL AGREEMENTS

Plurilateral agreements have various constraints, however. This chapter examines constraints on plurilateral agreements from legal and substantive points of view.
12.3.1 Legal Constraints\textsuperscript{16}

Legal constraints on realizing plurilateral agreements involve different issues depending on whether they constitute part of the WTO agreements or those outside it.

12.3.1.1 Agreements within the WTO

Incorporating a new plurilateral agreement into the WTO agreements (as an Annex 4 agreement) involves securing consensus among all of the WTO members. Amendments to the existing WTO agreements without creating a new Annex 4 agreement lead to amendments to the Annex 1 agreements, which also require consensus among all of the WTO members.\textsuperscript{17}

There are strong calls for maintaining decision-making by consensus, which is also part of the tradition of the GATT/WTO. However, continuing to focus solely on consensus at a time when the WTO has lost its nature as a club poses the serious risk of undermining its \textit{raison d’être} by further accelerating the FTA race. The WTO as the main architect supporting the global trade system is faced with the need to examine its variable geometry, and discussions to that effect are now becoming essential.\textsuperscript{18, 19}

Presented below are two ways of thinking derived from the above viewpoint and some discussion on the possible revival of the code approach.

\textit{Critical mass plus MFN extension} Successful precedents for this approach of critical mass plus MFN extension have been set by the ITA, the Financial Services Agreement, and the Basic Telecommunications Services Agreement. As a matter of legislative theory, there is an argument that a departure from the principle of decision by consensus should be allowed under certain circumstances, where there exists an agreement among a critical mass of the WTO members, on the premise that all of the benefits resulting from such plurilateral agreements be applied to non-participating WTO members on an MFN basis.\textsuperscript{20} This argument should be studied further.\textsuperscript{21}

Referring to precedents set by the ITA, the Basic Telecommunications Services Agreement, and the Financial Services Agreement, the Report of the First Warwick Commission points to the need to introduce critical mass decision-making under the WTO based on the condition that benefits resulting from a new critical mass agreement be extended to all WTO members. The report also discusses criteria that must be fulfilled to protect the rights of WTO members, specifying seven conditions including the following:

1. New rules are required to protect or refine the existing balance of rights and obligations under the WTO and/or the extension of
cooperation into new regulatory areas will impart a discernible positive global welfare benefit.\textsuperscript{22}

2. The disciplines are binding and justifiable so as to attain the objectives laid out in the first criterion above.

3. The rights acquired by the signatories to an agreement shall be extended to all WTO members on a non-discriminatory basis, with the obligations falling only on signatories.

4. WTO members shall consider any distributional consequences arising among members from cooperation in new regulatory areas and shall consider the means of addressing any such adverse consequences that they anticipate.

\textit{Codes (Annex 4 agreements)} It is technically possible to create a new, non-MFN-based Annex 4 agreement by consensus. However, achieving consensus on such an agreement that would enforce differentiated treatment across WTO members is nearly (if not completely) impossible in reality. Further consideration and discussion should be made to alleviate voting conditions for Annex 4 agreements as a way to implement ‘variable geometry’ within the WTO.

\textit{Modification of schedules of concessions and commitments} As a legislative theory concerning a procedure for incorporating plurilateral agreements into WTO agreements, there are calls for introducing schedules of concessions and commitments as a means to promote liberalization in broader areas. This approach is currently adopted under WTO agreements on tariffs and trade in services (including the Agreement on Government Procurement as an example of Annex 4 agreements). It is argued that WTO members should utilize this approach as a tool to expand their respective obligations under the WTO to promote liberalization in areas other than tariffs and trade in services.

Concessions and commitments listed in respective members’ schedules are defined as their obligations under the WTO. Such schedules of concessions and commitments can be utilized as a means to check voluntary promises made by respective members. Also, as a way of incorporating agreements reached under a plurilateral framework into WTO-binding commitments, an approach using schedules of concessions or commitments is an interesting idea meriting further debate.\textsuperscript{23}

Some people argue that the WTO already has a full-fledged framework for negotiating and making necessary agreements by consensus of its members, but that they have been unable to utilize this framework due to insufficient effort. I do not agree with this argument.

The existing decision-making framework that assumes the same rights
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and obligations applicable to the 160 member economies and consensus among them has been paralyzing rulemaking in the WTO and the Doha Round. It is time to take a hard look at this system that has been unable to deliver results – except for some plurilateral agreements – despite 21 years of trial and error after the conclusion of the Uruguay Round, and to start discussing ways to rebuild it. Failing this, the WTO would lose its relevance, and there would be no stopping the ongoing move toward it being replaced with mega-FTAs.

Reforming the procedure and other matters relating to plurilateral agreements indicated above is indispensable in order to accommodate the increasing diversity of WTO members and their changing needs. This is also a challenge we must confront if we are to save the WTO.

12.3.1.2 Agreements outside the WTO

As is the case for the ACTA, plurilateral agreements can be created to complement or reinforce the existing WTO rules (TRIPS-plus rules in the case of the ACTA). Or they can be created to set rules in areas not covered by WTO rules. A plurilateral agreement on competition rules is a case in point.

Any plurilateral agreement to which a WTO member is a party must be WTO consistent, even if it is negotiated and concluded outside the WTO. For example, had it been TRIPS-minus in substance, the ACTA would have been in violation of the WTO TRIPS Agreement. In contrast, a plurilateral agreement on competition would, in principle, not violate any WTO agreement because competition issues are not covered by the existing WTO rules.

12.3.2 Substantive Constraints

This section looks at constraints or critical factors affecting the formation of issue-based plurilateral agreements. The selection of participants is the most critical factor in determining the substance and also the success of plurilateral agreements.

In principle, plurilateral agreements must not affect the existing rights and obligations of non-participating WTO members, including the right to MFN treatment under GATT Article I. At the same time, the MFN principle (under GATT Article I, and so on) mandates the non-discriminatory distribution of benefits derived from such agreements.

In the case of the ITA, it was agreed that signatories must represent at least approximately 90 percent of world trade in products covered by the agreement as a prerequisite to its entry into force. The minimum threshold for the coverage of participants was set in order to avoid free riding by non-participating WTO members, a problem arising from the MFN application of benefits. This is a standard criterion used in plurilateral agreements.
initiatives for tariff reduction and elimination, an area in which the free riding concern is particularly strong. The threshold value does not have to be, but is typically set at, 90 percent to deal effectively with this problem.

As such, even though agreements are concluded under a plurilateral framework, the relationship with non-participating WTO members is always taken into account in decision-making.

Including major WTO members as signatories is the key to success. Without the participation of major players, plurilateral agreements cannot materialize because they would distort competition among businesses. The distribution of benefits on an MFN basis would not be a problem insofar as major WTO members participate. However, in the case where the coverage of participants is less than satisfactory (such as when not all of the major countries participate), whether signatories can agree to extend benefits on an MFN basis poses a critical question. As such, critical mass and MFN-based benefit distribution are closely interrelated.

Another key to concluding a successful plurilateral agreement is to strike the right balance between the following three factors: (1) level of discipline (ambition), (2) scope of participating countries, and (3) timing of realization. Japan always gives consideration to this point and had sought the support of other countries in promoting the ACTA initiative.

Consider that these three factors are measured by the yardsticks of $X$, $Y$, and $Z$, respectively. Then, countries negotiating a certain agreement must seek to achieve the optimal mix of these three factors, that is, maximizing the value of $F = \alpha X \times \beta Y \times \gamma Z$. It is possible to add more yardsticks or factors to consider. However, a simple model such as this tends to work better when considering a plurilateral agreement involving a large number of players, and the above model worked well for the ACTA negotiations.

This is no easy task, as the three factors are in conflict with each other. For example, raising the level of ambition decreases the number of participants and prolongs the process of negotiations. Yet, no matter how difficult it may be, balancing the three conflicting factors is crucial to achieving a meaningful plurilateral agreement. The successful conclusion of the ACTA in 2011 was made possible as the participating members managed to strike a balance and maximized $F = \alpha X \times \beta Y \times \gamma Z$.

12.4 POTENTIAL AREAS FOR FUTURE PLURILATERAL AGREEMENTS

12.4.1 Overview

Experiences with a series of plurilateral agreements hitherto concluded – that is, the ITA, the Financial Services Agreement, the Basic
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Telecommunications Services Agreement, and the ACTA – have not only revealed the nature and difficulty of such agreements but also provided many valuable lessons regarding their potential. At a time when the WTO and the Doha Round are stuck in a quagmire, issue-based plurilateral agreements may be a ray of hope as they have the potential to play the pivotal role of enhancing the governance of the entire global trade system.

This chapter looks into the possibility of concluding new plurilateral agreements.

12.4.2 Specific Possibilities

12.4.2.1 Tariff reduction and elimination

First, possible plurilateral or sectoral agreements in the area of tariff reduction and elimination include those on the expansion of the ITA and the elimination of tariffs on environmental goods. The key points at issue and approaches in this regard have been discussed in this chapter, including in the section that analyzed the ITA.

It is necessary, in principle, to develop a negotiation package by always considering the combination of the three yardsticks measuring the realizability of agreements – the level of ambition, the timing of realization, and the scope of participants.

Regarding the scope of participants, the coverage of countries is usually too small if the membership comprises only developed countries, and such an agreement is prone to exploitation by free riders. To avoid this, it is vitally important to involve major developing economies, and the success of this task hinges on the formulation of a mutually beneficial negotiation package that is enticing enough to attract them. For instance, lowering the level of ambition by narrowing down the coverage of products is one way to achieve this.

Furthermore, as was the case with the ITA, some consideration needs to be given to responses to non-tariff issues and a possible linkage to tariff reduction and elimination packages in other areas. In doing so, it should be kept in mind that trying to deal with non-tariff issues will naturally cause negotiations to drag on and tend to reduce the number of participants.

12.4.2.2 Services

The Financial Services Agreement and the Basic Telecommunications Services Agreement can be cited as pioneering cases of plurilateral agreements in the area of trade in services, and approaches employed for their realization are well known.

Although much depends on how services negotiations under the Doha Round will turn out, it will be necessary hereafter to explore the
possibility of concluding plurilateral agreements on specific service sectors (for example, agreement on environment services) or issue-specific plurilateral agreements (for example, agreement on domestic regulations). As the global economy becomes more service sector-oriented and increasingly more service companies move into the global market, there will be a wide range of potential areas for plurilateral initiatives.²⁶

12.4.2.3 Government procurement
To begin with, the successful conclusion at the 2011 WTO Ministerial Conference of the renegotiation of the Government Procurement Agreement (GPA) should be welcomed. In this area, a very high level of discipline imposed by the GPA, a non-MFN-based plurilateral agreement, has long hampered the expansion of its membership. However, it is worth noting that a range of non-signatory economies, including the PRC, are now showing interest in joining the agreement, attracted by the government procurement market of signatory economies.

If the recent conclusion of the GPA renegotiation serves as an impetus and drives membership expansion in the future, interest in plurilateral initiatives in general will likely increase as well. Now that the renegotiation has ended successfully, it is necessary to shift the focus on to increasing the number of participants.

12.4.2.4 Electronic commerce
Electronic commerce, or e-commerce, is another potentially promising area for plurilateral initiatives. Discussions on a moratorium on customs duties on electronic transmissions took place more than a decade ago along with those on the question of whether e-commerce should be dealt with under the GATS or the GATT (regarding which Japan took the initiative in advocating application of the latter).

Subsequently, the US has incorporated various provisions related to e-commerce including those for a moratorium on customs duties and tariffs on e-commerce into its FTAs with such countries as the Republic of Korea and Australia. Japan has also introduced its first set of such e-commerce provisions – including those for a moratorium on customs duties and tariffs, MFN and NT, and market access – in its EPA with Switzerland.

In fact, e-commerce provisions under existing FTAs are far from satisfactory, and discussions should be deepened toward introducing additional provisions. A possible approach in this regard would be to pursue further development of rules for e-commerce through various opportunities such as the TPP and the Japan–EU EIA, while at the same time exploring the possibility of bringing them all under a plurilateral framework.
12.4.2.5 Trade and investment
Following a failed attempt to conclude the MAI at the OECD, the relationship between trade and investment was included in the initial agenda for the Doha Round negotiations, but was subsequently dropped at the WTO Ministerial Conference in Cancun in 2003. This turn of events has been greatly affecting overseas investment not only by Japanese companies, but also those from the US, Europe, and many other countries. Lack of satisfactory international rules on investment is critically detrimental to international business activity, particularly in countries that grant national treatment only after the establishment of a local subsidiary while continuing to demand technology transfers.

Bilateral investment treaties are definitely important, but not enough. Discussing plurilateral rules on investment is necessary not only for investing countries – that is, Japan and other developed economies – but also for developing countries where FDI is essential for economic growth. Indeed, all countries and regions around the world need this discussion because it is anticipated that South–South and South–North investment will expand in the coming years. It is also expected that developing economies’ attitude toward initiatives for creating international rules on investment will change over the course of time and it will become necessary to deepen discussions on procedures for settling investment-related disputes, including investor-state dispute settlement (ISDS) provisions.

12.4.2.6 Trade and competition
Interaction between trade and competition policy was put on the agenda of the Doha Round in response to a strong request from the European Commission (which was supported by Japan). However, as with the issue of trade and investment, it was dropped at the WTO Ministerial Conference in Cancun.

The loss of venue for discussing competition-restrictive trade measures and their treatment under the WTO has been making it extremely difficult to discuss export restrictions imposed by certain countries and companies at a time when natural resources markets are becoming increasingly oligopolistic (for example, export restrictions of natural resources and mergers between natural resources giants). Disciplines on SOEs cannot holistically be discussed in the WTO, either.

The competition authorities of some economies are already engaged in policy dialogue. However, it is also necessary to launch international discussions on competition-restrictive situations and measures from the viewpoints of both trade and competition.
12.4.2.7 Standards and conformance, and technical barriers to trade
At the launch of the Doha Round, Japan attempted but failed to put TBT on the agenda due to a lack of sufficient support from other WTO members. Today, however, while the Doha Round remains gripped by deadlock, non-tariff issues and behind the border measures are drawing much attention. Establishing a set of effective rules for such issues is critical in view of the need to create an environment that can respond properly to the globalization of business.

Discussions in this area are expected to make progress at the APEC forum and in the course of negotiations for interregional FTAs. The OECD also has a repository of relevant knowledge and expertise accumulated over the years. Since this area is extremely broad in scope and involves various treaties and agreements, it will be necessary to clarify the scope of issues to be discussed. However, despite such odds, this area deserves active efforts and commitments in view of the need to create business-friendly rules and build global value chains.

Issues are wide-ranging, including the definition of international standards, best regulatory practices, MRAs, and certification rules. This is an area in which soft law has traditionally played an important role, and the WTO relies significantly on external institutions. The fact that cooperation between the WTO and external specialized agencies is highly valued can be seen as an indication that the former lacks sufficient knowledge and expertise in this area.

It is considered quite possible to enhance TBT provisions through a plurilateral initiative. Given the highly specialized and technical nature of TBT issues, an in-depth discussion is warranted. At the same time, however, it must be remembered that developed and developing economies are still divided over rulemaking for TBT as well as for standards and conformance. Thus, starting with like-minded countries would be a reasonable approach to a plurilateral initiative.

12.4.2.8 Rules of origin
Efforts to harmonize non-preferential rules of origin have made little headway due to difficulties imposed by their multi-purpose and often protectionist nature (rules of origin are used for statistical purposes, enforcement of anti-dumping and countervailing duties, quota management, and so on). As for preferential rules, different countries have different rules, creating a situation often referred to as the spaghetti bowl effect phenomenon. The chaotic presence of many different rules and their arbitrary nature are, no doubt, hindering global trade. Indeed, various plurilateral forums should be utilized to propose and take steps to improve rules of origin, particularly those of preferential terms.
12.4.3 International Supply Chain Agreement

The issues and areas above are possible candidates to be dealt with by means of an issue-based plurilateral agreement. They can be discussed separately, but it is also possible to bundle some mutually related issues into one agreement.28

Businesses relying on global supply chains obviously want to see liberalization and rulemaking of the broadest possible scope. For instance, one option worth considering is to pursue, in collaboration with major economies and business societies, a plurilateral agreement on an international supply chain, a package of rules for standards and conformance, e-commerce, country of origin, investment, competition, and so forth. Or rather, these types of proactive proposals are crucially needed for the further enhancement of global supply chains and the development of the international trade system.29

It goes without saying that such initiatives must be intended to support the multilateral trade regime under the WTO and are designed to provide a basis for multilateral rulemaking in the future. Thus, they must be consistent with WTO rules.

It is too time-consuming and risky to wait for the results of upcoming mega-RTAs such as the TPP, the Transatlantic Trade and Investment Partnership (TTIP), the Japan–EU EIA, and the RCEP, not only for non-participants but also for participants. As analyzed in section 12.2, RTAs do not provide the global solutions business societies are pursuing. Mega-RTAs can facilitate and improve value chains. However, they could also create mega-problems if the disciplines they contain are not harmonized across them.

Appendix 12.2 comprises the concept paper of an international supply chain agreement (ISCA) based on the draft circulated by the author, originally to the International Centre for Trade and Sustainable Development (ICTSD) and the Inter-American Development Bank (IADB) Expert Group Meeting on Global Supply Chains in Geneva in November 2012, to respond to the requirements of business societies and to deal with the challenges for the global trade system posed by mega-RTAs.30

In 2013, the World Economic Forum Enabling Trade report31 and World Bank blog by Bernhard Hoeckman and Selina Jackson32 referred to the ISCA concept paper as an option to ‘holistically’ deal with supply chain issues.33

12.4.4 Summary

In terms of the possible legal form of agreements, the areas discussed above can be broadly classified into the following three groups: (1) those in
which the incorporation of rules into WTO agreements is assumed (tariffs, services, government procurement); (2) those in which immediate incorporation into WTO agreements is not assumed (investment, competition); and (3) those in which specific policies have not been set and will depend on future developments (e-commerce, standards and conformance/TBT, rules of origin).

However, as seen in the case studies on the ITA and the ACTA, discussions on the legal form of agreements are inseparable from the type of forum, participants, and the intended content of agreements. In this sense, a conclusion can be drawn only by examining all of these factors on an area-by-area basis.

The areas discussed in sections 12.2 and 12.3 above are intended to be examples and have been selected from those closely related to trade and the WTO. Thus, there are many more potential areas for plurilateral agreements, if not limited to those related to the WTO.

For instance, in the area of trade and the environment, there may be more items – other than the liberalization of environmental goods and services – that should be dealt with under a plurilateral framework, depending on future developments in the relationship between multilateral environmental agreements (MEAs) and the WTO. Trade facilitation may be another possible area for plurilateral initiatives, that is, in the (unlikely) event of failure of the ongoing efforts under the WTO. Indeed, further globalization and the changing needs of industries will certainly generate various new demands and requirements. Furthermore, it may become necessary to discuss some of those issues together as a combined package as in the case of issues related to global supply chains.

At the moment, FTAs and RTAs are serving as essentially the sole channel for promoting trade liberalization and rulemaking because of the stalemate in the WTO negotiations under the Doha Round. Continuing this trend could result in the fragmentation and inefficiency of the global trade regime.34

The sense of speed permeating the WTO and its round of trade negotiations is not acceptable, given the pace at which globalization is taking place and business environments are changing. While firmly supporting the WTO as the bedrock of the global trade system, governments around the world should consider utilizing issue-based plurilateral agreements more proactively in parallel with pursuing FTAs so that they can respond more quickly to new problems faced by their industries and challenges in global trade.
12.4.5 Recent Developments toward Plurilateral Agreements

Since the 8th Ministerial Conference, there has been active movement toward plurilateral agreements, as exemplified by the following two developments.

One is the negotiation on the expansion of product coverage and participants of the ITA. Since there is an agreement among existing signatories not to discuss non-tariff barriers at this juncture, the focus is on the expansion of product coverage. The other is a move toward a Trade in Services Agreement (TISA), for which plurilateral negotiation is going on. One crucial issue is its legal framework – whether it should take the form of a GATS Article V agreement (FTA) and hence keep the resulting benefits only to its signatories. It is still too early to judge the eventual outcome of this discussion. As such, WTO members are increasingly turning to a plurilateral approach in seeking progress in both trade liberalization and rulemaking. These have been welcoming recent developments in plurilateral agreements involving certain WTO members to meet the evolving needs of business societies.

12.5 CONCLUSION: GOVERNANCE OF THE GLOBAL TRADE SYSTEM AND PLURILATERAL AGREEMENTS

I have looked at issue-based plurilateral agreements from various angles, for instance, in the light of precedents as well as their legal and practical constraints. I have also identified possible areas where such agreements can be utilized as a vehicle for promoting trade liberalization and rulemaking in the future. Developing an appropriate understanding of the nature of issue-based plurilateral agreements would enable us to pursue not only single-issue agreements but also multi-issue agreements such as an ISCA.

In concluding this chapter, I answer two fundamental questions posed regarding issue-based plurilateral agreements.

12.5.1 Are Plurilateral Agreements Replacing the WTO?

Today, as the stagnation and problems plaguing the WTO have become all too clear, it is imperative to prepare and establish a mechanism for making full use of issue-based plurilateral agreements along with FTAs. The WTO, which operates on the principles of a single undertaking and decision-making by consensus, is groaning under its own weight, with its membership growing in size and diversity and a large number of issues
Plurilateral agreements: a viable alternative to the WTO?

listed on its agenda. On the other hand, FTAs are proliferating. There is a high possibility that they may replace the WTO as the primary rulemaker and promoter of trade liberalization.

Plurilateral agreements can and must present solutions and provide much needed impetus to the WTO, thereby enabling it to cope properly with global issues in reality. The issue-oriented approach of plurilateral initiatives is instrumental in supporting the free trade regime and the WTO that are vital not only for Japan but also for all of the WTO member economies.

Are plurilateral agreements replacing the WTO? The answer is ‘no’, as I have extensively discussed in this chapter. They should and do complement the WTO, which is facing serious challenges posed by FTAs.

Are plurilateral agreements competing with FTAs? Again, the answer is ‘no’. They complement FTAs by offering global solutions, a task that cannot be accomplished by FTAs.

12.5.2 Can Plurilateral Agreements Address the Needs of Developing Countries?

The second question is whether plurilateral agreements can properly address the needs of developing countries. I have already looked at this issue in various parts of this chapter. However, I would like to supplement my earlier discussion since developing countries’ participation is of vital importance.

The success of the ITA as well as of the financial and telecommunication agreements, each with a wide participation of developing countries, demonstrates how plurilateral agreements can accommodate the demands and concerns of developing countries. As discussed earlier, once a critical mass has been reached, plurilateral agreements will be readily accepted by non-members (including developing countries), provided that the benefits of such agreements are to be extended to non-members on an MFN basis.

The crucial question that needs to be asked here is whether plurilateral agreements can be realized with the willing participation – not just acquiescence – of a broad scope of developing countries. This relates to the question of whether a critical mass can be created with the participation of developing countries.

Here I would like to point to five factors that are likely to facilitate the participation of developing countries.

First, as already discussed, the proliferation of FTAs – especially the emergence of mega-FTAs – has put developing countries in a difficult situation. Above all, those left outside of the mega-FTAs would face a high risk of seeing their presence in the global economy undermined. Issue-based plurilateral agreements may help their positions. Should the
Doha Round continue to fail to make progress, those developing countries not invited to join any mega-FTA would naturally turn their attention to plurilateral initiatives as a way of protecting their national interests.

Second, developing countries, which are increasingly diverse in their economic interests, would find that there is much merit in participating in plurilateral agreements designed to promote liberalization and rulemaking in specific areas of interest. Since areas or issues of interest differ from one country to another, treating all developing countries as a group may not be an efficient approach. Even though the WTO and Doha Round may be the best forum for setting global trade rules, they are not functioning as expected. Given this reality, the plurilateral approach may be an attractive alternative for both developing and developed countries seeking changes to the trade regime.

Third, plurilateral agreements should be designed to encourage the participation of like-minded developing countries. In this regard, ensuring transparency in the negotiation and implementation of agreements is key to widening participation. It is also critically important to disseminate information on the economic merits of the plurilateral approach. The success of the ITA would not have been possible without the shared understanding of the economic importance of the agreement.

Fourth, technical assistance and capacity building should be an integral part of plurilateral agreements. This is crucial to ensuring the participation of a large number of developing countries, as many of them lack the technical capabilities necessary to accommodate new rules and procedures.

Fifth, dispute settlement provisions should not be too stringent, so as not to discourage developing countries from joining.

Can plurilateral agreements properly address the needs of developing countries? The answer is ‘yes’, provided they are designed to attract like-minded developing countries with due consideration given to the factors described above. Indeed, as evidenced by the ongoing efforts to expand the product coverage of the ITA, the participation of like-minded developing countries is becoming a crucial factor to the successful conclusion of plurilateral agreements of almost any kind.

More active discussions should take place about how we can create an environment that will facilitate the participation of like-minded developing countries in issue-based plurilateral agreements.

12.5.3 Global Governance and Plurilateral Agreements

The WTO, FTAs, and issue-based plurilateral agreements need to be considered collectively from the viewpoints of trade liberalization and rulemaking. Promoting issue-based plurilateral agreements contributes to
an understanding of the problems embedded in the WTO and finding a direction for reform.

Setting a framework for an issue-based plurilateral agreement involves the selection of both issues and members, hence, requiring a more strategic approach than would be the case in pursuing multilateral agreements or FTAs.

In the face of progressive globalization and continuous changes in the economic environment, governments will be required to have a good command of all of these various tools, applying the right one to the right need to deliver the best possible solution. It is hoped that this chapter will provide useful insights to governments and businesses in pursuing issue-based plurilateral agreements and implementing trade policies in the future.

NOTES

1. For further detailed analyses, see Appendix 12.1, Table 12A.2.
2. GATT Article XXIV.
3. GATS Article V.
4. On historical developments, see Appendix 12.1, Table 12A.3.
5. Among the 128 contracting parties (as of 1 June 1995), 18 subscribed to the Agreement on Subsidies, 24 to the Anti-dumping Agreement, 38 to the Agreement on Technical Barriers to Trade, 26 to the Agreement on Import Licensing Procedures, 18 to Customs Valuation Agreement, 18 to the Agreement on Trade in Civil Aircraft, and 13 to the Agreement on Government Procurement (quoted from ‘GATT Analytical Index’).
6. The International Dairy Agreement and the International Bovine Meat Agreement, originally included in Annex 4, are no longer in force.
7. The author was Japan’s negotiator for the ITA and the ACTA (until 2008). For case studies and lessons of the negotiations, see Nakatomi (2011a).
8. The ITA Declaration has no legal binding force despite its name.
10. See Nakatomi (2011a). The paper explains some of the important checkpoints to realize plurilateral agreements.
12. As of 10 January 2013. The number includes customs unions and enabling clauses.
13. One example is the case of the Republic of Korea–EU FTA and the Republic of Korea–US FTA. The Republic of Korea accepted different sets of rules vis-à-vis the US and the EU in such areas as international standards, which are apparently not consistent with each other.
14. They differ depending on the nature of each agreement.
16. See Appendix 12.1, Table 12A.2.
17. On the legal constraints of plurilateral agreements, see the National Foreign Trade Council (NFTC) report, Harbinson and De Meester (2012).
18. The principle of variable geometry is being discussed in relation to the diversity of the WTO members from the viewpoint of promoting the further development of the WTO system. While such discussion looks at variable geometry in the forms of plurilateral agreements, S&DT including the ‘graduation’ of developing countries, and RTAs, this chapter focuses solely on variable geometry in the form of plurilateral agreements.
19. Lawrence (2004) and the Global Agenda Council on Trade (World Economic Forum 2010) discuss the necessity of ‘protocols’ under which plurilateral rulemaking is systematically incorporated into the WTO.


21. The scope of application of this proposal is not clear but definitely includes the establishment of new Annex 4 agreements. In addition, an amendment to Annex 1 agreements may be included.

22. Low (2011) argues that a plurilateral agreement which boosts the welfare of one group at the expense of another without improving economic welfare as a whole should not be allowed, whereas a plurilateral agreement that is welfare-improving globally is desirable even if it involves compensation to be lowered.

23. Cottier (2006) discusses the possibility of introducing schedules of concessions or commitments, similar to those annexed to the GATT and the GATS, in the areas of TRIPS, TBT, SPS, import licensing, customs valuation, agriculture, dumping, and industrial subsidies.


25. See Appendix 12.1, Figure 12A.1, which was actually used in the ACTA negotiation.

26. Lee-Makiyama (2011). In this paper, Lee-Makiyama calls for establishing the International Digital Economy Agreement (IDEA), an expanded version of the ITA, which includes not only tariff reduction and elimination but also services liberalization commitments.

27. Footer (2010).

28. In the area of ‘Sustainable Energy Trade’, ‘Fostering low carbon growth: the case for a sustainable energy trade agreement’ (ICTSD 2011) is a trial designed to deal with various issues in a plurilateral agreement. In the IT areas, see Lee-Makiyama (2011).


30. See Nakatomi (2013b, 2013c) for the details and necessity of ISCA.


32. ‘Shifting focus in trade agreements – from market access to value-chain barriers’, by Hoeckman and Jackson (2013).

33. See also Sweden National Board of Trade (2013).

34. The US and the EU differ in their trade regimes and legal systems. Seeking to harmonize various systems in a bits-and-pieces manner in this situation would definitely cause inefficiency and give rise to new problems. A spaghetti bowl of rules must be avoided by all means.

35. See Nakatomi (2011a). At the time of negotiating the original ITA, the Quad members accounted for about 80 percent of global IT trade, enabling the successful conclusion of the agreement under their initiative.

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**APPENDIX 12.1**

*Table 12A.1 Multilateral agreements and plurilateral agreements on trade-related issues*

<table>
<thead>
<tr>
<th>Multilateral agreements</th>
<th>Plurilateral agreements</th>
<th>WTO rule: Yes</th>
<th>WTO rule: No</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Country-based plurilateral agreements</strong></td>
<td><strong>Issue-based plurilateral agreements</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>WTO Annex 1, 2 &amp; 3 to GATT 1994</td>
<td>GATT Article XXIV GATS Article V RTAs/FTAs</td>
<td>Annex 4 Agreements on:</td>
<td>Financial Service Agreement, Basic Telecommunications Agreement, ITA, ACTA, etc.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Government Procurement</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Trade in Civil Aircraft</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>In the future, plurilateral agreements may be concluded in the areas of services, electronic commerce, standards and conformance (TBT), country of origin, etc.</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>In the future, plurilateral agreements may be concluded in the areas of competition, investment, etc. (In the area of investment, TRIM is already in place)</td>
</tr>
</tbody>
</table>
**Table 12A.2** Comparison of trade-related multilateral and plurilateral agreements

<table>
<thead>
<tr>
<th>Participants (countries/regions)</th>
<th>160</th>
<th>Two or more</th>
<th>Two or more</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basic rules</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Annex 1 to Agreement Establishing WTO (WTO Agreement)</td>
<td>GATT Article XXIV (Substantially all trade) GATS Article V (Substantial sectoral coverage)</td>
<td>Annex 4 to WTO Agreement</td>
<td></td>
</tr>
<tr>
<td>Establishment of a new agreement</td>
<td>N.A.</td>
<td>Participants</td>
<td>Consensus of all WTO members No voting provision</td>
</tr>
<tr>
<td>Amendments to existing agreements</td>
<td>Consensus of all WTO members No voting provision</td>
<td>Participants</td>
<td>Participants</td>
</tr>
<tr>
<td>Plurilateral agreements</td>
<td>Issue-based plurilateral agreements*</td>
<td></td>
<td></td>
</tr>
<tr>
<td>------------------------</td>
<td>--------------------------------------</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Service-sector agreements (Financial Services Agreement/Basic Telecommunications Agreement)</td>
<td>Tariff reduction/elimination agreement (ITA)</td>
<td>ACTA</td>
<td>Others</td>
</tr>
<tr>
<td>Critical mass</td>
<td>Current membership:</td>
<td>Financial Services Agreement (70) / Basic Telecommunications Agreement (69)</td>
<td>Critical mass (ITA): approx. 90% of world trade (currently, ITA covers 97% of world trade or 73 countries.)</td>
</tr>
<tr>
<td>Protocols to GATS concerning financial services / basic telecommunications services</td>
<td>GATT</td>
<td>TRIPS</td>
<td>?</td>
</tr>
<tr>
<td>Protocols to GATS concerning financial services/basic telecommunications services (by consensus of all WTO members) &gt;&gt; Participants' schedules of commitments and lists of exemptions from GATS Article II (MFN treatment) amended and attached</td>
<td>Ministerial declaration by participating countries &gt;&gt; Participants' schedules of concessions amended</td>
<td>Participants</td>
<td>? (Separate consideration for each negotiation area)</td>
</tr>
<tr>
<td>Modification of schedules under GATS Article XXI</td>
<td>Participants (in terms of each participant amending its schedule of concessions)</td>
<td>Participants</td>
<td>Participants</td>
</tr>
</tbody>
</table>

WTO rule: No
Table 12A.2 (continued)

<table>
<thead>
<tr>
<th>WTO (Multilateral)</th>
<th>RTAs/FTAs (Country-based plurilateral agreements)</th>
<th>WTO Rule: Yes</th>
<th>Annex 4 agreements</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Obligations under WTO rules</strong></td>
<td>YES</td>
<td>NO</td>
<td>YES</td>
</tr>
<tr>
<td><strong>Application of benefits on MFN basis</strong></td>
<td>YES (in principle)</td>
<td>NO</td>
<td>NO (for Agreement on Trade in Civil Aircraft and Agreement on Government Procurement) * YES is possible for future agreements.</td>
</tr>
<tr>
<td><strong>Others</strong></td>
<td>Doha Round launched in 2001 and ongoing on basis of consensus of all WTO members</td>
<td>In principle, no selectivity for negotiation areas * Service-sector agreements possible under GATS Article V (505 agreements reported to date)</td>
<td>Only two agreements are in force now. (Agreement on Trade in Civil Aircraft and Agreement on Government Procurement)</td>
</tr>
</tbody>
</table>

| Establishment | 1995 | ? | 1995 |

*Note:* For the purpose of the chapter, issue-based plurilateral agreements signed by three or more countries are considered from the aspect of contribution to rulemaking and liberalization in the field of international trade. N.A. = not applicable.
### Plurilateral agreements

#### Issue-based plurilateral agreements*

<table>
<thead>
<tr>
<th>Service-sector agreements (Financial Services Agreement/Basic Telecommunications Agreement)</th>
<th>Tariff reduction/elimination agreement (ITA)</th>
<th>ACTA</th>
<th>Others</th>
</tr>
</thead>
<tbody>
<tr>
<td>YES (subsequent to amendments to schedules of commitments)</td>
<td>YES (subsequent to amendments to schedules of concessions)</td>
<td>NO</td>
<td>? (Depends on content of agreement)</td>
</tr>
<tr>
<td>YES</td>
<td>YES</td>
<td>TRIPs has no provision for MFN exceptions.</td>
<td>YES in principle? (L/4905) Depends on relevant WTO provisions and content of agreement</td>
</tr>
<tr>
<td>Regarded as a precedent-setting plurilateral agreement on trade in services</td>
<td>Regarded as precedent-setting plurilateral agreements for tariff reduction and elimination</td>
<td>Standalone agreement supplementary to TRIPs Agreement</td>
<td>Negotiation areas may be selected * Must be WTO-consistent, in principle (Separate consideration for each negotiation area)</td>
</tr>
</tbody>
</table>

Plurilateral agreements on trade and competition, etc. fall into this category

| 1997 | 1997 | 2011 | ? | ? |
### Table 12A.3 GATT/WTO and Changes in the Treatment of Plurilateral Agreements

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>GATT</strong></td>
<td>GATT 1947 Participation of all members</td>
<td>GATT 1947 Participation of all members</td>
<td>GATT 1994 Participation of all members</td>
<td>N.A.</td>
</tr>
<tr>
<td><strong>Codes</strong></td>
<td>N.A.</td>
<td>Agreement on Subsidies and Countervailing Measures, Anti-dumping Agreement, TBT Agreement, Agreement on Import Licensing Procedures, Customs Valuation Agreement, Agreement on Trade in Civil Aircraft, Agreement on Government Procurement, International Dairy Agreement, International Bovine Meat Agreement &gt;&gt; Non-MFN-based agreements Participation of some members</td>
<td>Agreement on Subsidies and Countervailing Measures, Anti-dumping Agreement, TBT Agreement, Agreement on Import Licensing Procedures, and Customs Valuation Agreement were turned into Annex 1A agreements under the WTO (participated by all members). &gt;&gt; Participation of all members</td>
<td>N.A.</td>
</tr>
<tr>
<td><strong>WTO Annex</strong></td>
<td>N.A.</td>
<td>N.A.</td>
<td>Participation of all members</td>
<td>?? Introduction of schedules of concessions approach? Amendments by critical mass plus MFN-based distribution of benefits?</td>
</tr>
<tr>
<td><strong>IA agreements</strong></td>
<td>N.A.</td>
<td>N.A.</td>
<td>Participation of all members</td>
<td>?? Introduction of schedules of concessions approach? Amendments by critical mass plus MFN-based distribution of benefits?</td>
</tr>
<tr>
<td>WTO Annex 4 agreements</td>
<td>N.A.</td>
<td>N.A.</td>
<td>Agreement on Trade in Civil Aircraft, Agreement on Government Procurement, International Dairy Agreement International Bovine Meat Agreement (Only first two agreements are effective today.)</td>
<td>?? Easing procedural requirements for establishing new agreements? (e.g., Critical mass + MFN-based distribution of benefits)</td>
</tr>
<tr>
<td>------------------------</td>
<td>------</td>
<td>------</td>
<td>--------------------------------------------------------------------------------------------------</td>
<td>--------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>WTO Annex 1B agreements on trade in services</td>
<td>N.A.</td>
<td>N.A.</td>
<td>Participation of all members Introduction of schedules of commitments approach</td>
<td>Additional sectoral agreements by same approach as those used for Financial Services Agreement and Basic Telecommunication Agreement? (Amendments to schedules of commitments)</td>
</tr>
<tr>
<td>WTO Annex 1C agreements on trade-related aspects of intellectual property rights</td>
<td>N.A.</td>
<td>N.A.</td>
<td>Participation of all members</td>
<td>?? Introduction of schedule of concessions/commitments approach? Amendments by critical mass plus MFN-based distribution of benefits?</td>
</tr>
</tbody>
</table>

*Note: Issue-based plurilateral agreements between three or more countries are considered here with a view to their contribution to rulemaking and liberalization in the field of international trade. N.A. = not applicable.*
Members should maximize:

\[ F = \alpha X \times \beta Y \times \gamma Z \]

Ambition Level, Number of Participants, and Schedule for Conclusion should be considered as essential parameters to achieve ACTA.

Figure 12A.1 Basic parameters for ACTA
APPENDIX 12.2

Concept Paper for an International Supply Chain Agreement (ISCA)

2012/10/29

Improving global supply chains by an issues-based plurilateral approach

NAKATOMI Michitaka

Research Institute of Economy, Trade and Industry

1. Necessity and Background

Need to accommodate the globalization of business activities
Lack of progress in the World Trade Organization (WTO) Doha Round (slowness)
Narrow scope of the Doha Round (narrowness)
Proliferation of regional trade agreements (RTAs) and resulting “spaghetti bowls” of rules of origin as well as of trade rules and disciplines
   - Fragmentation of rules across different RTAs involving big players poses by far the most serious problem.
   - Big RTAs are indispensable for international trade liberalization and rulemaking but do not provide a global solution.

2. A Possible Tool for Reform

1) Accelerating WTO negotiations where applicable
   Potential areas include non-agricultural market access (NAMA), services, trade facilitation, the expansion of the International Technology Agreement (ITA), etc.
   Progress, however, is not necessarily forthcoming.

2) Big RTAs
   Big (cross-regional) RTAs – e.g., the Trans-Pacific Partnership Agreement (TPP), a free trade agreement (FTA) between the United States and the European Union (EU), and one between Japan and the EU – can facilitate the development and efficient operation of global supply chains if, and only if, there is strong coordination among the members concerned and others toward the development of uniform global rules.
   An international supply chain agreement (ISCA) is a possible mechanism for coordination among the members concerned, thereby
enabling them to untangle the spaghetti bowl effect of multiple sets of rules of origin and trade rules.

3) ISCA
To improve global supply chains in certain priority areas, the possibility of launching plurilateral negotiations should be studied, following such successful precedents as the ITA, the Basic Telecommunication Services Agreement, the Financial Services Agreement concluded in 1997, and the Anti-Counterfeiting Trade Agreement (ACTA) in 2011.

3. Basic Principles to Underlie the ISCA

1) A plurilateral agreement covering multiple areas

2) Complementary to and consistent with WTO agreements, thereby creating the basis for future multilateral rules
   a) Complementary where relevant WTO agreements exist (cf. ACTA approach as a trade-related aspects of intellectual property rights (TRIPs)-plus agreement)
      e.g., Agreement on Technical Barriers to Trade (TBT Agreement)
   b) Creating new disciplines/rules where relevant WTO agreements do not exist
      e.g., competition, investment, e-commerce, preferential rules of origin

3) ISCA negotiations should neither delay nor undermine the Doha Round
   Areas to be covered by the ISCA should not overlap with the Doha Development Agenda (DDA)
   e.g., trade facilitation should be pursued in the DDA negotiations unless it becomes clear that progress is not expected.

4) Promotion and participation by like-minded members (critical mass)
   The United States, the EU, Japan, and other leading developed members
   Like-minded developing members

5) An agreement outside the WTO

6) Most favored nation (MFN) extension to provide the basis for future rules
Benefits resulting from the agreement should be extended to non-participants in general to create de facto international standards in the targeted areas to provide the basis for future WTO rules.
The free riding issue has been exaggerated in many circumstances.
Exceptions to MFN can be discussed further.
In areas where relevant WTO rules exist, MFN extension is generally required by the WTO agreement concerned.

7) Avoiding the fragmentation of trade rules and the spaghetti bowl phenomenon
In the course of negotiations, participating members should seek to address the fragmentation of trade rules that either has been or may be created by big regional RTAs.

8) Timeframe and targets for negotiations
Conclusion within a maximum of three years
Business requires speed.
Speed is also crucial to prevent the creation of an “unswallowable” spaghetti bowl of big RTAs.
The level of ambition should be carefully controlled by participating members.
The harmonization of existing business practices and rules should be the primary goal of the negotiations.
Big members must not engage in a fight for hegemony.

9) Dispute settlement
To avoid protracting the negotiations and enable wider participation in the future, dispute settlement provisions should not be too stringent.
cf. ACTA

10) Sufficient consultation with the business community
As in the case of the ITA, the full involvement of the business community is essential to picking up its needs and bringing the negotiations to a successful end.

11) Transparency
To enable the ISCA to serve as the basis for future multilateral rules, the transparency of the negotiations should be open and visible to the governments of non-participating members as well as to the business community.
4. Possible Areas to be Covered by the ISCA

1) Defining the agenda in close collaboration with the business community
   The views and opinions of the business community should be respected and taken into account in selecting areas subject to negotiation.

2) Setting a focused agenda to enable the negotiations to be concluded within a designated, short time period
   Almost all of the WTO agreements are somehow relevant to global supply chains.
   The level of ambition, scope of participating members, and negotiation speed are correlated (see the attached chart used in the ACTA negotiations).
   Overburdening the agenda is tantamount to stifling and killing the negotiations from the outset.

3) Potential areas for consideration
   The following are some of the potential areas and issues that should or may be considered for inclusion in the agenda for the ISCA negotiations to stimulate discussion. Other areas and issues can also be considered.

3.1) Areas already covered by WTO agreements
   a) Technical barriers to trade (TBT) and sanitary and phytosanitary (SPS) measures
      TBT measures are unquestionably the area of interest to the business community.
      Many behind-the-border measures and non-tariff barriers are related to TBT measures.
      By introducing further clarity, transparency, good practices, and so forth, the ISCA can complement the TBT Agreement and hence facilitate cross-border business activities.
      Likewise, the ISCA may complement certain elements of the Agreement on Sanitary and Phytosanitary Measures (SPS Agreement).

   b) Trade facilitation
      This should be added to the ISCA agenda if, and only if, trade facilitation negotiations in DDA fail to move forward.
c) Export restrictions
Although the WTO rules impose disciplines on export restrictions, they are much weaker than those on import restrictions. To facilitate the development and efficient operation of global supply chains, discussions should take place to set out rules to discipline export restrictions as explicitly as those governing import restrictions.

3.2) Areas not covered by WTO agreements

a) Investment
The issue of trade and investment was dropped from the DDA at the Cancun Ministerial.
It is becoming clear that not only investment protection but also investment liberalization is necessary.
No single country can persuade the governments of other countries to fix the problems in their investment regimes.
Establishing a common position on investment rules is essential.
Investment rules benefit not only developed members but also developing countries in need of inward foreign direct investment (FDI) and investment opportunities abroad (North–South, South–South, South–North investment).

b) Competition
Trade and competition was also dropped from the DDA at the Cancun Ministerial.
Competition rules are useful, for example, in disciplining the anti-competitive practices of state-owned enterprises (SOEs) and oligopolistic suppliers in certain areas as well as dealing with discriminatory export controls.
Regarding SOEs, serious discussion should take place first on their definition and the disciplines governing them.

c) E-commerce
Issues related to MFN, national treatment (NT), market access (MA), and intellectual property right (IPR) protection in e-commerce are undoubtedly the area where collaboration among the like-minded countries can produce meaningful results for business around the world.

d) Preferential rules of origin
The harmonization of non-preferential rules of origin is covered by the DDA but is not progressing well because of their multi-faceted nature (e.g., statistics, trade remedies, quota management, etc.). Preferential rules of origin are not covered by the DDA. As the first step toward eliminating the spaghetti bowl effect of preferential rules of origin, collaboration should take place within the ISCA framework to lessen the burden on business.

3.3) Others

a) Capacity building and technical assistance

In order to enable wider participation, collaboration for capacity building and technical assistance is essential.

b) Collaboration in analyzing global supply chains

As in the case of the WTO/Institute of Developing Economies–Japan External Trade Organization (IDE–JETRO) study on global value chains, participating members must collaborate to deepen their common understanding of changes in value chains and trade in tasks.

Note

1. Original version of the concept paper was submitted to ICTSD/IADB E-15 Expert Group Meetings on Global Value Chains and RTAs in Geneva, November 2012.
13. The role of foreign direct investment flows and a possible multilateral agreement

Yunling Zhang and Rongyan Wang

13.1 INTRODUCTION

Foreign direct investment flows play a key role in globalization. The size of FDI flows has increased dramatically since the 1990s, albeit with some ups and downs. Foreign direct investment brings capital, technology, and management to the host economies; rationalizes industrial allocation; and creates supply–demand chains both on the regional and the global level. On the other hand, FDI could increase cross-border trade since industrial reallocation and supply–demand chains create multiple routes of exchange of goods and services.

As a cross-border activity, FDI is supported by business incentives, business strategies, the host market environment, and in particular by FDI-friendly policy. In general, all economies have now adopted an FDI-friendly policy and welcome inflow of FDI, since it not only meets the gap in investment, but also encourages competition and improves economic efficiency. This is why FDI flows have complex incentives and directions. The incentives include those for production networks, for market access, or for lowering business costs, while the direction could be either among developed economies, from developed to developing economies, among developing economies, or even from developing to developed economies.

Foreign direct investment is an integrated part, and the most active factor, of global economic activities. Given that the global economy is in a period of post-financial/economic crisis recovery and restructuring, it is crucial to improve the environment for FDI so to facilitate FDI flows.

However, there are still many barriers that hamper FDI flows, the major barrier being policy restrictions. Governments often exercise control over key or sensitive sectors, the reasons ranging from vulnerability of domestic industries to national security. This is true not only for developing countries, but also for developed countries. Efforts to liberalize and facilitate
FDI flows have been made by the multilateral process and also by the bilateral and plurilateral process (regional arrangements). To renew the global economic dynamism, it may be timely for the WTO to initiate a new agenda on investment promotion and facilitation.

13.2 ROLE OF FOREIGN DIRECT INVESTMENT FLOWS

Foreign direct investment flows have become increasingly important in supporting global economic growth, and the growth rate of FDI has actually exceeded that of GDP since the 1990s. There have been many theoretical studies that examine the relationship between trade and FDI either as substitutes or as complements (Mundell 1957; Helpman 1984; Markusen 1984; Markusen and Venables 1998), but they have still not come up with an unambiguous conclusion because of the complexity of the issue. Recently, FDI has played an increasingly important role in developing countries, especially those in East Asia developed under the framework of production networks. Mora and Singh (2012) examine the cases of ten Asian economies with respect to economic growth, trade, and FDI connections, and find that FDI is often positively correlated with higher productivity levels in exports and imports. Kumar (2012) has shown empirically that FDI has a positive impact on India’s export boom and its effects are much greater than those of domestic capital.

Although there were some fluctuations in the annual FDI flows in the decades after World War II, the size of FDI flows increased significantly. One of the striking characteristics of the FDI flows is that FDI into the developing economies increased faster than that to developed economies. By 2010, the size of FDI flows into the developing economies was close to that of the developed economies (Figure 13.1). In the 1990s, as globalization and regional integration spread rapidly, FDI began to show a steady upward trend from 1990 to 2000 (Figure 13.2).

The developed economies are the major source of FDI flows. Figure 13.3 shows that from 1990 to 2011, except in 2002, the EU has been in position of net FDI outflows, while Figure 13.4 shows that the US has had stable net FDI outflows since 2003.

Although East Asian economies have gradually become an important source of FDI outflows, inward FDI to the region is still much larger than outward FDI (Figure 13.5). Following the global financial crisis in 2008, the level of FDI flowing into the developed economies fell. As a result, more FDI flowed into the developing economies. Among the developing economies, those in East Asia attracted more FDI than those in other
regions although they too were affected by the crisis. In particular, the PRC attracted the largest share of FDI due to its high growth rate and large market size.

Foreign direct investment flows play multiple roles for the host economies. They generate economic dynamism by developing the new industries, increasing trade, and introducing new technology and management. East Asia provides a good example to illustrate the positive
role of FDI flows. The region achieved the ‘economic miracle’ in the 1970s and 1990s and continues to remain dynamic in the 21st century. One of the key success factors is the FDI-friendly policy adopted by almost all economies in the region. Carkovic and Levine (2005) show that aside from an FDI-friendly policy, the ability and skills of the labor force play a crucial role in FDI having a positive effect and generating economic growth.

At the same time, many East Asian economies are also concerned about the negative role of FDI from the point of view of their own economy’s
The role of foreign direct investment flows

Some are worried about their domestic industries being vulnerable to competition from MNCs. They therefore tend to take many restrictive FDI inflow measures to ensure the benefits from introducing FDI are greater than the negative effects.

As shown in Figure 13.6, Japan’s FDI inflow has been relatively low, primarily because Japan did not adopt a policy conducive to FDI inflows during its economic high growth period. However, Japan has played a

**Note:** FDI = foreign direct investment.

**Source:** Authors’ calculation based on UNCTAD Statistics, deflated by price index in terms of current US dollars based on year 2000 = 100.

**Figure 13.5** Inward and outward foreign direct investment, East Asia (US$ billion)

**Figure 13.6** Inward and outward foreign direct investment, Japan (US$ billion)
crucial role as a major source of FDI outflows to East Asia after the late 1980s. Since 1990, Japan has invested large amounts across the world, and even with the global financial crisis, Japan has still kept this investment trend after 2008.

The economies of the ‘four Asian dragons’ benefited largely from the FDI flows originating from the US and Japan. With more and more economies adopting an open development policy, opportunities for FDI to extend the business network increased, and thus the regional production network was formulated and FDI flows became multi-oriented. As the production network is based on the (multiple) reprocessing–assembly structure, cross-border transactions of goods and services in the region increased significantly. Free trade agreements in particular help increase intra-FDI inflows in East Asia (Kim and Oh 2007). The data show that from 1990 to 2000, East Asia experienced a high FDI growth rate, and since 2001 the rate of FDI has been relatively stable in the region (Figure 13.7).

In the case of the ‘four Asian dragons’ and other NIEs, FDI played an unprecedented role to achieve the fast growth that enabled these economies to realize their rapid ascent. The NIEs adopted an FDI-friendly policy and an export-oriented strategy that led to a fast inflow of FDI into those markets (Figure 13.8). In fact, these NIEs consider FDI to be an easy instrument through which they can integrate their economies into the global market with high levels of capital, technology, managerial

\[\text{FDI} = \text{foreign direct investment.}\]

East Asia includes the ten member states of ASEAN; the PRC; Hong Kong, China; Japan; the Republic of Korea; and Taipei, China.

\[\text{Source: Authors' calculation based on UNCTAD Statistics, deflated by price index in terms of current US dollars based on year } 2000 = 100.\]

**Figure 13.7** Trade and foreign direct investment, East Asia (US$ billion)
The role of foreign direct investment flows

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capacities, and skills. Foreign direct investments found the comparative advantage in cheap labor force and open market environment in those emerging economies. The four Asian dragons and other NIEs quickly became the reprocessing–assembly and export centers.

While drawing in external FDI, the ASEAN as an economic area also made efforts to promote intra-regional FDI. In 1995, the ASEAN initiated an AIA. The AIA Framework Agreement, which was officially approved in 1998, stipulated that national treatment apply to all investors and sectors of member states by 2010 and be extended to all investors by 2020.

The PRC presents a special case for the positive role of FDI in generating export and economic growth. Figure 13.9 shows that there is a positive relationship between export growth and FDI inflow in the PRC. Based on its sizeable FDI inflows, the PRC has become the ‘world’s factory’ and processing–assembly and export center (Guo and Luo 2009). The PRC’s FDI-friendly policy has two major characteristics: one is to provide open and preferential treatment for FDI into labor-intensive and reprocessing export-oriented sectors, while another is to give priority of the policy incentives to the coastal areas. Owing to the special advantage of its cheap and abundant labor force and the great size of its potential market, the PRC has become the second largest market for FDI inflows, trailing only the US.

Notes:
FDI = foreign direct investment.
East Asia includes the ten member states of ASEAN; the PRC; Hong Kong, China; Japan; the Republic of Korea; and Taipei, China.

Source: UNCTAD, COMTRADE Database.

Figure 13.8  Comparison of growth rate of exports and foreign direct investment inflows, East Asia (percentage)
However, compared with trade, there are more restrictions on FDI (including the outflow and inflow). The reasons for setting restrictions are various, ranging from protection of infant sectors to national security. Such protectionism generally becomes more evident during times of economic crisis or in the face of external competition. The following are examples of some of the restrictions:

- prevention of FDI involvement in restricted sectors considered to be sensitive to national security;
- high-level regulation of FDI activities in those sectors that are considered to be in their infancy or less competitive;
- non-national treatment given to FDI through different taxation, financing, standards, and ownership; or
- special evaluation and approval process for FDI (acquisition or merger) (UNCTAD 2012a).

Although a seamless investment environment appears difficult to achieve, further liberalization and reduction of barriers for FDI flows are highly desirable since FDI flows play a crucial role in speeding up economic recovery and generating the new dynamism of the global economy.
13.3 EFFORTS TO FACILITATE FOREIGN DIRECT INVESTMENT

13.3.1 International Efforts

Most WTO efforts have focused on trade liberalization, including TRIMs. Before WTO negotiations began, governments imposed TRIMs to either encourage or compel investments to achieve certain national priorities, which could have an obvious effect on countries’ trade patterns. However, since having TRIMs did not guarantee higher economic growth, and they possibly even generated negative impacts for the host economies, the WTO members during the Uruguay Round negotiated a multilateral agreement on TRIMs.

The Uruguay Round negotiations of the WTO produced a well-rounded agreement on TRIMs, providing disciplines for measures restricting foreign investment. The nature of the TRIMs Agreement is to reduce the barriers on the investments that relate to trade in goods. TRIMs Agreement rules apply to the domestic regulations a country employs with respect to foreign investors. The 1947 GATT prohibited investment measures that violated the principles of national treatment and the general elimination of quantitative restrictions, but the extent of the prohibitions was never clear. The TRIMs Agreement provides an illustrative list that explicitly prohibits local content requirements, trade balancing requirements, foreign exchange restrictions, and export restrictions (domestic sales requirements). The related investment measures prohibited by the TRIMs Agreement include those that are mandatory or enforceable under domestic law or administrative rulings, or those with which compliance is necessary to obtain an advantage (such as subsidies or tax breaks). Prohibited examples include local content requirements, trade balancing requirements, foreign exchange restrictions, export restrictions (domestic sales requirements). The TRIMs Agreement sets up an evaluation process to determine how the treaty is being implemented and can be supplemented with additional investment and competition clauses, suggestions for which can be put forward in the multilateral negotiations concerning FDI (WTO 1994). However, the TRIMs Agreement covers limited areas and only applies to trade in goods, not to service trade which is closely related to FDI flows. Although the WTO opened the window for FDI liberalization through TRIMs, it is not clear whether the FDI issue can be fully handled by the WTO in the future.

The number of bilateral investment agreements increased rapidly during the 1990s as countries and investors sought more regulations to protect and facilitate their investments after it became clear that the
Uruguay Round’s Agreement on TRIMs addressed only part of the investment-related concerns and did not provide enough security for investors or strong controls on host governments to regulate MNCs. As an organization whose membership comprises developed countries, the Ministerial Council of the OECD aimed to reach a broad multilateral framework for international investment with high standards for the liberalization of investment regimes and investment protection and with effective dispute settlement procedures. Although the agreement was to be negotiated between the member states, the intention was to have an open agreement to which non-OECD members could accede on a negotiated basis.

In May 1995, the OECD Ministerial Council formally launched the negotiations on MAI (Witherell 1995). Little was known about the content of the agreement until a leaked draft made it to the public in March 1997 (Smythe 1998). The leaked material drew severe criticism from various non-government organizations globally and on 3 December 1998 the OECD announced that the MAI negotiations would no longer take place (Neumayer 1999).

There were three key criticisms of the MAI. First, it was seen as a threat to national sovereignty and democracy (Sklair 2001, p. 90). Second, it was believed that it would result in the participating nations collapsing to a ‘race to the bottom’ in environmental and labor standards. Finally, the MAI was criticized for giving corporations excessive powers to buy, sell, and undertake financial operations while severely weakening national laws on environmental protection, regulation of labor standards, and human rights in developed countries.

On the other hand, proponents claimed that the MAI would restrict the government’s ability to limit foreign MNCs engagement in sectors considered to be important for developmental, environmental, or other reasons. Furthermore, they argued that the MAI would establish the principle of ‘national treatment’ as the norm for international investment, whereby governments must treat foreign companies as they would domestic companies. This would eliminate policies such as requiring investors to form a partnership with a local company and requiring a minimum number of local employees. Finally, it was maintained that the MAI would provide a framework in which the rules can be enforced. For example, if an investor believes the country in which they have invested is violating the MAI, they can either complain to their own government, which can then take the host country to a binding international arbitration; alternatively, they can challenge the host country directly. In either case, the arbitration is closed – neither the government nor the communities that have been affected can challenge the behavior of the investor. The lack of a binding
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obligation on corporate investors is the fundamental flaw of the MAI (Vallianatos 1997).

The US, Canada, and several EU economies, all proponents of the MAI, continue to promote investment provisions similar to the MAI through regional trade agreements, bilateral investment treaties, and bilateral free trade agreements. The OECD has also continued to promote the Declaration on International Investment and Multinational Enterprises and the OECD Guidelines for Multinational Enterprises in 2000. From May 2006, the OECD has promoted a non-binding set of ‘good practices’ for attracting investment, known as the Policy Framework for Investment (PFI). Substantial increases in FDI flows from developed and developing countries alike and growth in MNCs from all parts of the world have increased the need for an MAI. Furthermore, the numerous bilateral investment treaties warrant a standardized set of rules for FDI (OECD 2006). With investment now clearly identified with MNCs and integrated with trade, the WTO has emerged as a natural home of an MAI.

The Group of Twenty (G20) also deal with FDI-related issues. The G20 regularly publishes the reports on trade and investment measures sponsored by the UNCTAD, the WTO, and the OECD, which intend to provide timely assessments and warning signals on international trade and cross-border investments since it is crucial to avoid protectionism in times of global financial/economic crises. According to the reports, G20 members generally continue to ensure an open market environment for trade and investment, but some protectionist measures have also been observed. For example, there are some new emergent policy measures that have been undertaken relating to national security, as well as the emergency arrangements.

The UNCTAD has participated intensively in policy discussions and research in trade and investment issues. The World Investment Report is the most authoritative analysis of global FDI trends and impacts (UNCTAD 2012b). Its findings are extensively employed by national and international policy units, statistical offices, and government institutions. On 12 June 2012, UNCTAD launched its Investment Policy Framework for Sustainable Development (IPFSD). The framework provides policy makers with concrete options for placing inclusive growth and sustainable development at the heart of efforts to attract and benefit from foreign investment. The IPFSD aims to create synergies between investment policies and wider economic development goals, promote the integration of investment policies into development strategies, foster responsible investment and incorporate principles of corporate social responsibility (CSR), and ensure policy effectiveness in the design and implementation of investment policies.
In sum, the international organizations have made great efforts to promote FDI liberalization and to provide guidelines for good policy-making, business behavior, and sustainable and inclusive development, though their roles in leading to a global investment agreement seem limited.

13.3.2 Regional Efforts in East Asia

Investment liberalization and facilitation are key parts of regional arrangements. The EU has realized full liberalization by establishing the European single market. The NAFTA guaranteed the principle of national treatment and prohibited investment-related performance requirements that forced foreign-owned companies to produce a certain amount of exports, use local contents, or transfer technology to local economies. The result was a far-reaching agreement that went considerably beyond the TRIMs (Okamoto 2003).

The ASEAN established the AIA, which helps to encourage and facilitate FDI in the ASEAN region. Members of the ASEAN agreed to promote the area as a single investment region through joint investment promotion efforts that seek to increase the confidence of investors in investing in the ASEAN region. Under the AIA, national treatment will be given both to ASEAN investors and all other investors (Thanadsillapakul 2013).

With the ASEAN at the center, five ‘10+1’ FTAs have been concluded in East Asia. All agreements cover the areas of trade in goods, services, and investment. As for investment liberalization and facilitation, the agreements include major issues such as national treatment, non-discriminatory treatment, performance requirements, range of application, and transparency (see Table 13.1).

Table 13.1 shows that all the FTAs include clauses on investment liberalization and investment protection. The main difference is that the ASEAN–PRC FTA did not assign investors the right of national treatment before accession. The FTAs all include the transparency requirement and the relationship with other treaties. In addition, the FTA between ASEAN and the PRC also incorporates clauses promoting and facilitating investment.

The ASEAN initiated the RCEP, supported by six other countries (Australia, the PRC, India, Japan, the Republic of Korea, and New Zealand) in 2012. Sixteen countries agreed to start the negotiations for the RCEP in 2013 and conclude it by 2015. The RCEP intends to integrate the five existing ‘10+1’ FTAs (ASEAN with Australia–New Zealand, the PRC, India, Japan, and the Republic of Korea) as a basic foundation, and
Table 13.1  Comparison of investment clauses in free trade agreements in East Asia

<table>
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<tr>
<th></th>
<th>ASEAN–PRC FTA</th>
<th>ASEAN–Republic of Korea FTA</th>
<th>ASEAN+6-Japan EPA</th>
<th>ASEAN–Australia FTA</th>
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<td><strong>Investment liberalization clause</strong></td>
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<td>1. National treatment before investment</td>
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<td>2. MFN treatment before investment</td>
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<td>3. Performance requirement</td>
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<td><strong>Investment protection clause</strong></td>
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<td>1. National treatment after investment</td>
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<td>2. MFN after investment</td>
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<td>3. Integrity treatment</td>
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<td>4. Compensation for expropriation and nationalization</td>
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<td>5. Compensation for war damage</td>
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<td>6. Capital transfer</td>
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<td>7. Subrogation</td>
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<td>8. Contracting party dispute settlement</td>
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<td>9. Contracting party and investors dispute settlement</td>
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<td><strong>Other clauses</strong></td>
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<td>1. Investment promotion</td>
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<td>2. Investment facilitation</td>
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<td>3. Transparency</td>
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<td>4. Relationship with other clauses</td>
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<td>5. Investment environment</td>
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<td>6. Senior management and board of directors</td>
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*Notes:*  
EPA = economic partnership agreement; FTA = free trade agreement; MFN = most favored nation; PRC = People’s Republic of China.  
○ implies ‘included’ and – implies ‘not included’.  

*Source:*  
Based on related FTAs.
goes further to create a high standard for a regional agreement for liberalization, facilitation, and cooperation. The RCEP will include a comprehensive part of investment which will surely extend beyond the scope of the AIA. The key role for the RCEP investment arrangement is to help promote inclusive development and restructure the production network.

The PRC, Japan, and the Republic of Korea signed an investment promotion agreement (CJK IPA) in 2012. The CJK IPA includes all the important principles ranging from the definition of investment to scale of investment, MFN treatment, national treatment, and dispute settlement. The three countries have committed to negotiating a trilateral FTA (CJK FTA). They plan to conduct further negotiations on investment liberalization. As the three economies are highly integrated based on their FDI networks, a high-quality investment agreement is called for. It is expected that some principles, such as pre-national treatment for FDI, and a negative list approach to the liberation of trade in services will be negotiated. The CJK FTA has received high support from the business community. As a recent survey shows, 85.4 percent of companies in the PRC, 78.7 percent of companies in Japan, and 70.9 percent of companies in the Republic of Korea, have positive attitudes toward the CJK FTA (Jiang 2012).

All bilateral FTAs have made efforts to further investment liberalization and facilitation (Shen 2010). Table 13.2 shows how the four selected bilateral FTAs include, among others, comprehensive commitments toward investment promotion, facilitation, and transparency. As for the interaction among different FTAs, only the FTA between the PRC and Singapore has clauses about the relationship with other agreements, the reason being that both sides are party to the ASEAN–PRC FTA.

Although great efforts have been made on investment liberalization and facilitation, visible and invisible barriers to FDI are still intensifying. While such barriers may be not a major reason for the high capital flows to non-real sectors for speculation, an environment conducive to FDI will surely encourage more capital investment in the real economic sectors. In the aftermath of the global financial crisis, it is important to make further efforts to encourage capital flow to real sectors, especially to the green and innovative sectors.

13.4 CONCLUSIONS

Foreign direct investment plays a key role in the development of the global economy. Efforts spanning over half a century have significantly reduced the barriers to international trade, especially tariff barriers. However, the barriers to FDI are still very high. Compared with trade barriers, those
Table 13.2 Comparison of bilateral free trade agreement investment clauses in East Asia

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<td><strong>Investment liberalization clause</strong></td>
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<td>1. National treatment before investment</td>
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<td>2. MFN treatment before investment</td>
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<td>3. Performance requirement</td>
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<td><strong>Investment protection clause</strong></td>
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<td>2. MFN after investment</td>
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<td>3. Integrity treatment</td>
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<td>4. Compensation for expropriation and nationalization</td>
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<td>5. Compensation for war damage</td>
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<td>6. Capital transfer</td>
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<td>7. Subrogation</td>
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<td>8. Contracting party dispute settlement</td>
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<td><strong>Other clauses</strong></td>
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<td>3. Transparency</td>
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<td>4. Relationship with other clause</td>
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<td>5. Investment environment</td>
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<tr>
<td>6. Senior management and board of directors</td>
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**Notes:**
EPA = economic partnership agreement, FTA = free trade agreement, MFN = most favored nation, PRC = People’s Republic of China.
○ implies ‘included’ and – implies ‘not included’.

**Source:** Based on related FTAs.
to FDI are far more complex and invisible. Furthermore, the adoption of different principles and arrangements in all kinds of regional trade agreements has also brought about a ‘noodle bowl’ effect for the FDI flows.

As FDI has become increasingly important in generating economic dynamism and moving toward a sustainable and inclusive development structure, more efforts should be made on a global level by multilateral institutions. The global economy is currently still not stable, and the post crisis recovery is uneven and not strong. The challenge for the WTO, the G20, and other international organizations is how to cooperate seamlessly to create a new dynamism for the world economy. Therefore, the WTO should be encouraged to work on a new FDI framework to solve the existing problems among member countries that cannot be dealt with easily or effectively by the regional arrangements and to promote FDI flows as a new initiative to recreate the dynamism for global economic development. The framework can be obtained by consolidating the work done by the G20, the UNCTAD, and the OECD, and it should go further to a higher level so as to establish an integrated agreement beyond TRIMs. Furthermore, as regulations on FDI in the regional arrangements vary, it is essential to adopt a single agreement at the multilateral level. Basic components would include transparency about investment rules and regulations, with clear identification of agencies responsible for issuing relevant licenses, permits, and approvals. Foreign investors could also commit to transparency in their labor and environmental standards and public scrutiny of their conformance with those standards.

As for Asia, the regional production network which has been formed has connected countries in the whole region more closely with each other. However the global financial crisis has brought great challenges to the Asian export-oriented model of development. Faced with the changes in the international market, Asia should make the RCEP the new model to take on the new economic situation. At the same time, the new dynamism of the economy in this region should also be strengthened by coordinating the policies in the regional agreements, including the arrangements concerning FDI flows; and investment promotion and liberalization should be one of the key elements of the RCEP. The future of an Asia-wide FTA should then be able to not only increase the regional demand but also create a new development model (Zhang 2010).

Further removing the restrictions on FDI flows and lowering the business operation costs will provide firms with more opportunities to move into the region and restructure their production activities. As a result, the resources in the entire Asian region will be fully and efficiently used to become a more energetic economic region.

A global movement that aims to encourage businesses to pay closer
attention to their social responsibility has gained momentum in recent years. The United Nations Global Compact asks companies to embrace, support, and enact, within their sphere of influence, a set of core values in the areas of human rights, labor standards, the environment, and anticorruption. To reinforce good behavior and take action when investors misbehave is rather important for host countries who want to absorb FDI. Regulation of the social responsibility requirements of MNCs by international organizations will alleviate the concerns of host countries, which will bring about a reduction of FDI restriction policies, making liberalization of FDI flows much easier to realize.

Just as world trade has never realized completely free trade, neither has investment. That is, there will always be two conflicting sides with regard to investment policy: one is facilitation and the other is protection. The better way to solve this problem is to try to balance the two, instead of avoiding them. As far as the current international environment is concerned, both investment promotion and protection should be given attention, including bilateral, regional, and multilateral arrangements. On the multilateral level, considering the diversity of types of economies, although coming up with a high-level liberalization package seems very difficult, priority should be on the high-level standard regulations, including transparency of FDI policies, minimal red tape, and true national treatment.

Considering all of the above factors, it may be time for the WTO to initiate a global investment promotion and facilitation agreement.

NOTES

1. It is not clear whether the RCEP will adopt the pre-national treatment principle.
2. In the past, FDI flows mainly came from Japan and the Republic of Korea to the PRC. In the future, FDI from the PRC to Japan and the Republic of Korea is expected to surely increase. Thus, it is also in the interest of the PRC to negotiate a high-level agreement on investment liberalization.
3. Herein, the protection refers more to environmental protection and social responsibility of the investors.

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