

## ADB Working Paper Series on Regional Economic Integration



### Institutional Parameters of a Region-Wide Economic Agreement in Asia: Examination of Trans-Pacific Partnership and ASEAN+ FTA Approaches

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Shintaro Hamanaka

No. 67 | November 2010





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## **Abstract**

The future creation of a region-wide economic agreement in Asia has become the hot issue among trade policymakers in the region. The APEC 2010 Summit Statement clearly states that the members should pursue a Free Trade Area of the Asia-Pacific (FTAAP), building on various ongoing regional cooperation formworks including ASEAN+3 or +6 and the Trans-Pacific Partnership (TPP). This paper considers the path or sequencing towards a future region-wide economic agreement in Asia, both theoretically and empirically. It attempts to streamline the policy arguments on the sequencing issues by clarifying the pros and cons of various approaches. The paper first presents two possible approaches to a region-wide economic agreement: the consolidation approach and the expansion approach. It then reviews political economy theories on the evolution of economic agreements with regard to four key issues to highlight the differences between the two approaches: (i) negotiation timing, (ii) negotiation format, (iii) broader–deeper trade-off, and (iv) the participation process. The final section of the paper analyzes and considers three existing economic agreements—ASEAN+*a* free trade agreements, the TPP, and the Asia–Pacific Trade Agreement—that have the potential to be the basis of a future region-wide economic agreement.

*Keywords:* Trans-Pacific Partnership Agreement (TPP), Free Trade Area of the Asia-Pacific (FTAAP), ASEAN+3 FTA, ASEAN+6 FTA, Consolidation Approach, Expansion Approach

*JEL Classification:* F15, F53, F55, F59

## 1. Introduction

There have been active policy debates on the future of economic agreements in Asia. Some authors argue that the current Asian Noodle Bowl status of economic agreements is not economically beneficial, usually by focusing on the issues relating to rules of origin (ROO). Some of these arguments insist that an economic agreement with a larger number of participants will bring larger benefits to the participating economies, usually by relying on the result of computable general equilibrium (CGE) analysis. They then jump to the conclusion that a region-wide economic agreement is a desirable way to solve various problems and therefore should be pursued by the countries in the region. Meanwhile, others emphasize the difficulty of reaching consensus on the modality of such an agreement among the major powers in the region.<sup>1</sup>

The important issue left insufficiently explored with regard to economic agreements in Asia is the path or sequencing towards a future region-wide economic agreement.<sup>2</sup> The essential questions to be considered include: In which region should a region-wide economic agreement be pursued? Which economic issues should be covered by such a region-wide economic agreement? Another set of important questions relating to the evolution of regional agreements are: Which existing arrangement can serve as the platform of a future region-wide agreement? What kind of path is possible? In other words, we need to seriously consider the two issues at hand: (i) critical institutional parameters that affect the evolution of economic agreements; and (ii) an assessment of the existing agreements in terms of their future evolution into region-wide cooperation.

This paper does not intend to find a single answer to these highly contested questions. Rather, the purpose of this paper is to streamline the complicated policy arguments by clarifying the pros and cons of various approaches to a region-wide economic agreement in Asia. For example, the confusion over the argument is partly because the key terms such as “consolidation” are used in various ways by various authors without a clear definition. The paper attempts to provide the common basis for the policy debates on the path to a regional economic agreement in Asia. Both theoretical investigation into the path to a region-wide agreement and empirical examination of existing economic agreements in Asia are necessary to have a solid and concrete policy discussions on the future of Asia’s economic agreements.

The structure of the paper is as follows. The next section presents two approaches to a future region-wide economic or trade agreement: the consolidation approach and the expansion approach. It then reviews useful political economy theories relating to the path or sequencing towards a geographically wider economic agreement.<sup>3</sup> It covers

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<sup>1</sup> For a comprehensive review covering various views on regional economic agreements, see Chia (2010).

<sup>2</sup> One of the important contributions on this issue is Menon (2009). He points out that there are four possible solutions to the Asian Noodle Bowl problem: consolidation, harmonization, dilution and multilateralization.

<sup>3</sup> This paper mainly focuses on political economy issues of the evolution of economic agreements. An analysis on sequencing issues of Asian trade and financial cooperation using economic theories can be found in Pomfret (2005).

issues relating to negotiation timing, negotiation format, broader-deeper trade-off and participation process. The third section examines three actual possible paths to a region-wide economic agreement, using the potential tools explained in the first half of the paper. The paths of ASEAN+3 or ASEAN+6 and the Trans-Pacific Partnership (TPP), which are mentioned in the APEC 2010 Summit Statement as possible building blocks of a future Free Trade Area of the Asia-Pacific (FTAAP) are each worth closer examination to clarify their strengths and weakness.

## 2. Necessity and Possibility of Re-Alignment of Existing Economic Agreements

This section analyzes the necessity and possibility of re-aligning several economic agreements. We first consider problems that resulted from “nested” agreements and “overlapped” agreements. The second half of this section considers various approaches to a region-wide economic agreement in the future.

### 2.1. Multiple Ruling Problems: Nested and Overlapped Agreements

Multiple ruling problems exist when economic or trade relations between two or more countries are governed by different rules. There are two kinds of multiple ruling problems (Figure 1). The strong multiple ruling problem is the situation where one bilateral relation is governed by different (two or more) agreements and thus rules. This usually happens when the small and large agreements in terms of membership are “nested”.<sup>4</sup> Suppose a situation where Country A and Country X signed both a bilateral agreement and a regional agreement that covers the two countries as well as others (Case 1). Trade between Country A and X becomes tariff free for so long as the traded goods between the two countries satisfy rules in either the bilateral agreement or the regional agreement.

The weak multiple ruling problem is the situation where different bilateral relations are governed by different agreements. In particular, weak multiple ruling becomes serious when one country has different rules with multiple partners (this can be called overlapping agreements). Suppose the situation where Country A has a bilateral agreement with both Country X and Y (Case 2). The rules for preferential trade between Country A and X may be different from preferential rules applicable to trade between Country A and Y.

It is not easy to conclude the argument on which kind of multiple ruling problems is more problematic. Some may argue that the situation where different (bilateral) relations (e.g., A–X relation and A–Y relation) are governed by different bilateral agreements/rules (e.g., A–X agreement/rule and A–Y agreement/rule) is unavoidable and that what should be avoided is the situation where one bilateral relation is governed by several agreements because traders need to compare several agreements. Others may argue that the strong

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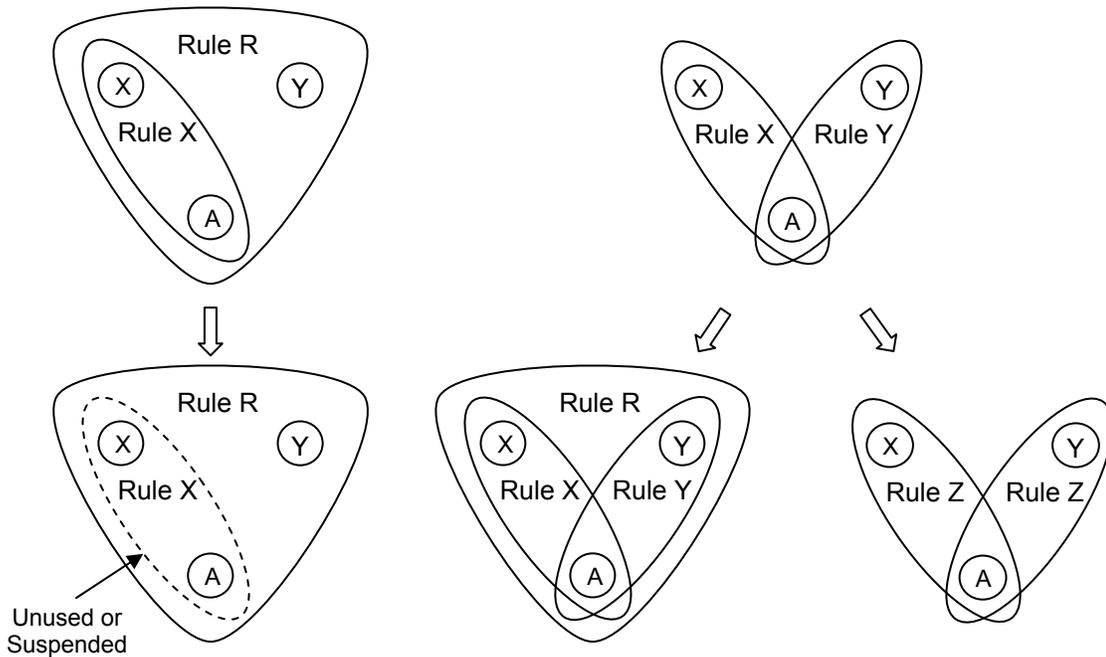
<sup>4</sup> The term “overlapping” is sometimes used to refer to this situation (for example, see Busch 2007), but this paper uses “nested” for the strong case while “overlapped” is used to refer to the weak case.

multiple ruling problem is not that serious because it simply offers more options to traders and traders can choose the most beneficial rule.

**Figure 1: Two Kinds of Multiple Ruling Problems**

Case 1: Strong Multiple Ruling (Nested)

Case 2: Weak Multiple Ruling (Overlapped)



Source: Author's illustration.

How to solve strong multiple ruling problems? First of all, one should note that the most beneficial agreement/rule is chosen by traders and less favorable agreements/rules become unused. It should be recognized that the strong multiple ruling problem already exists in Asia. For example, trade relations between Japan and Southeast Asian countries are doubly governed by the bilateral agreements between Japan and individual ASEAN countries (e.g., Japan–Thailand Economic Partnership Agreement [EPA]), as well as by a wider regional agreement (e.g., Japan–ASEAN EPA), but this does not seem to have caused serious confusion. Likewise, trade between New Zealand and Singapore is doubly governed by the bilateral agreement between the two and by the TPP Agreement, which includes the two countries as well as Brunei Darussalam and Chile. Concerned governments consider such a situation where traders have more options as being beneficial for traders.<sup>5</sup>

However, if traders consider such a situation as confusing and costly, the only way to completely eliminate the strong ruling problem is to abolish or suspend the smaller

<sup>5</sup> New Zealand Ministry of Foreign Affairs and Trade (2005).

agreements in terms of membership. In the real world, the suspension of an economic agreement is rare, but there is some precedent. For example, when the North American Free Trade Agreement (NAFTA) was launched in 1994, the pre-existing US–Canada FTA was suspended (United States General Accounting Office, 2004). However, suspension of agreements could result in the violation of GATT IVXX 5 (b) if the suspended (bilateral) agreement is less restrictive than a new (geographically wider) agreement.<sup>6</sup>

How to solve weak multiple ruling problems? One way to solve the weak multiple ruling problem is to create a new economic agreement covering all concerned countries (e.g., an agreement covering Country A, X, and Y; the left-hand scenario in Figure 1, Case 2). Then, a new common rule among concerned parties is created in addition to bilateral rules. If traders consider that the strong multiple ruling is not that problematic (or at least not as problematic as the weak case), this becomes a viable option. In this case, to a degree, a weak problem is replaced by a strong problem.

Another solution is harmonization (the right-hand scenario in Figure 1, Case 2). However, harmonizing only two agreements would simply make the situation more complicated because further harmonization with other FTAs becomes even more difficult in the future. Moreover, the new harmonized rule (e.g., rule Z in Figure 1, Case 2) may become more restrictive than the old rules (e.g., rule X and Y).<sup>7</sup> Furthermore, harmonization may be difficult in reality.<sup>8</sup> In Southeast Europe, the “spaghetti bowl” situation, in which a web of 28 bilateral FTAs existed among eight countries ( $8 \times 7/2 = 28$ ), became an issue in the early 2000s. Scholars and international institutions insisted upon the necessity of harmonizing bilateral FTAs to eventually form a region-wide FTA in Southeast Europe called the Southeast Europe Free Trade Area (SEEFTA) (World Bank, 2000; Mersserlin and Miroudot, 2004). Leaders of the countries in Southeast Europe, however, finally decided to join the then-existing Central Europe Free Trade Area (CEFTA), rather than harmonize 28 FTAs because the former move was deemed to be a more feasible option. The experience of Southeast Europe seems to suggest that creating a new agreement or participating in an old existing agreement is an easier way to achieve a region-wide agreement than harmonizing a number of FTAs.<sup>9</sup>

<sup>6</sup> The ROO in the US–Canada FTA was less restrictive than the ROO in NAFTA (Brenton and Imagawa 2005). For example, Under the US–Canada FTA, textile products satisfy the origin rule if the fabrics originate in the region. Under NAFTA, however, products must be produced from yarns originating in the region in order to meet North American rules of origin. For the details, see METI (2003). Likewise there is an argument that India–Sri Lanka FTA is superior to South Asia Free Trade Area (SAFTA), which includes both India and Sri Lanka. See Menon (2009).

<sup>7</sup> Cadot et al. (2002) argue that the harmonization of external quota rules among FTA members will lead to more restrictive quota vis-à-vis others. This implies that harmonization of quota rules between FTAs have a similar effect. Also see footnote 6.

<sup>8</sup> For a contrasting view, see Trejos (2005).

<sup>9</sup> The consequence of the spaghetti bowl situation in Southeast Europe deserves attention from policymakers and researches on Asian trade integration because it has a significant implication on how to realign the network of bilateral FTAs in Asia. For studies on the Southeast European spaghetti bowl, see Reka (2006), Elezi (2010), and Bartlett (2008).

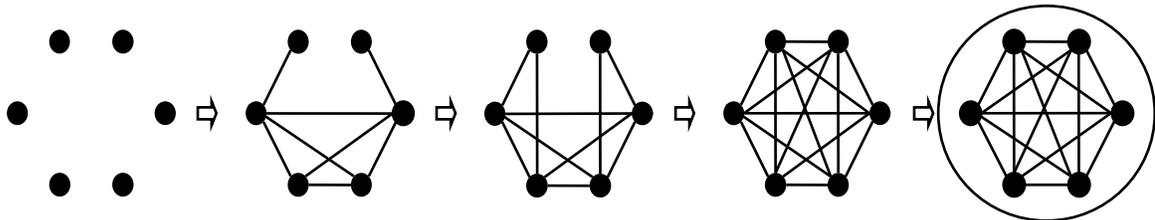
## 2.2. Possible Approaches to a Region-Wide Economic Agreement

If a region-wide economic agreement is to be achieved in Asia in the future, which sequencing or path does it follow? There are two possible approaches to a region-wide economic agreement as suggested by many policymakers and scholars in the region: the consolidation approach and the expansion approach (Figure 2). The two approaches can be summarized as follows:

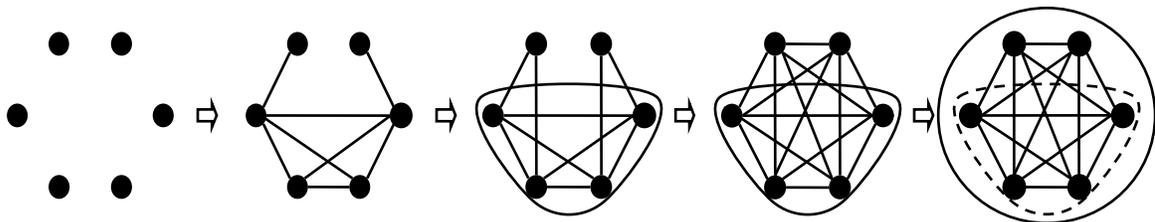
- (i) **The consolidation approach.** Concluding several bilateral agreements between major concerned parties, harmonizing them, and then creating one region-wide agreement covering all concerned parties, which may be followed by the suspension of old bilateral agreements.
- (ii) **The expansion approach.** Starting from a small economic agreement among plurilateral parties (more than three), and accepting new regional members that are ready to participate in the agreement.

**Figure 2: Possible Approaches to a Region-Wide Economic Agreement**

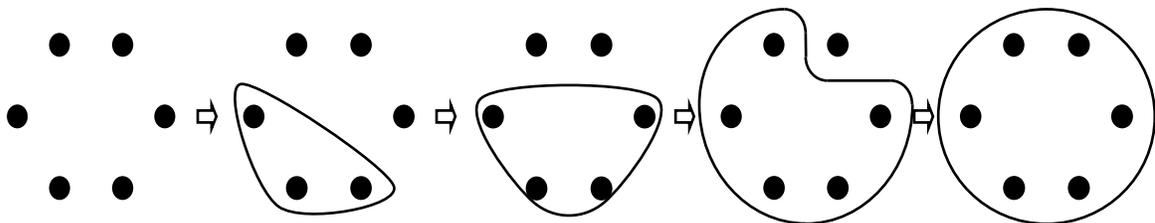
### Consolidation Approach



### Hybrid Approach



### Expansion Approach



Source: Author's illustration.

The two approaches are theoretical models and in reality there are various hybrid models between them. For example, countries may chose to form a (sub-)regional economic agreement including some plurilateral parties in the (sub-)region after having a complete network of bilateral agreements among themselves, but before having a complete network of all possible bilateral agreements in the entire region. However, comparing the two contrasting approaches is useful to understand their strengths and weaknesses.

The two approaches differ in the critical institutional or negotiation parameters, including the timing and scope of and participants in negotiations. Should the final region-wide economic agreement start from a small group at an early stage or should it be negotiated by all major concerned parties only when the majority is ready for it? Which issues (trade only or investment/services as well) should be covered in the agreement? Which countries should be involved in the negotiation? Those critical institutional or negotiation parameters will be discussed in detail in section 3.

Another important difference between the two approaches is about the degree of freedom that the negotiating parties have: are the concerned parties free to decide the content of the new region-wide economic agreement or they are constrained by existing agreements to a considerable degree? In the case of the consolidation approach, once several FTAs are harmonized, a newly created region-wide FTA would be based on the harmonized rules. Thus, the harmonization process is critical in this approach.<sup>10</sup>

### **2.3. Driving Force of the Two Approaches: Domino Effects**

Why countries engage in FTAs is an interesting question. In particular, the question of why FTAs are contagious draws attention. Two kinds of domino effects have been pointed out by scholars. First is the economic domino effect (Boldwin, 1993) in which the firms in one country put pressure on their government to establish an FTA in order for them to secure a level playing field, especially if their exporting interests are disadvantaged by an agreement signed by the country in which their competitors are located. In this case, firms play a critical role in FTA policymaking.

The second type of domino effect is more political or diplomatic. Ravenhill (2010) argues that the primary driving force that makes governments sign FTAs is not business interests, but concerns of being excluded from a new dimension of regional economic diplomacy.<sup>11</sup> He considers that strengthening and demonstrating a diplomatic tie with a partner country vis-à-vis rival countries is the purpose of signing an FTA—a process he refers to as “political domino effects.”

The two domino effect theories explain the incentives in getting involved in FTAs. The contagion of FTAs triggered by the two kinds of domino effects can be a driving force of

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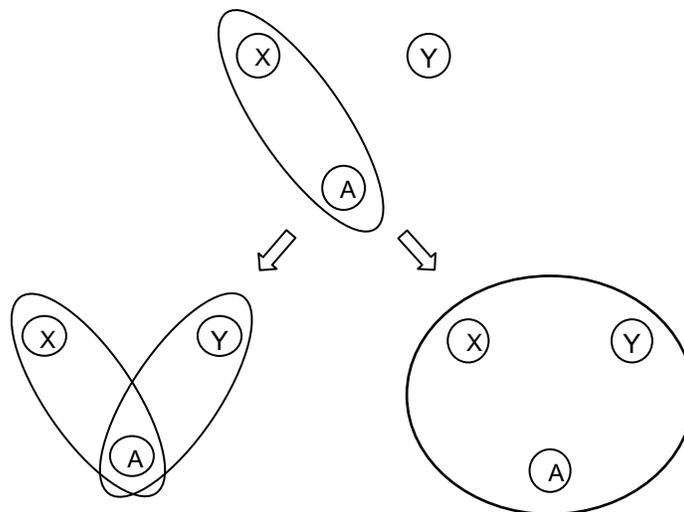
<sup>10</sup> A detailed examination of harmonization procedure is beyond the scope of this paper. The amount of literature that extensively discusses this issue is very limited. For a comprehensive analysis on this topic, see APEC (2008).

<sup>11</sup> For more on the incentives for a country to join an agreement that currently excludes it, see Hamanaka (2010).

the evolution of FTAs towards a region-wide agreement in the two approaches mentioned above. If Country A and X agree to forge an FTA, such an agreement may drive Country Y to set up an FTA with Country A to avoid a disadvantageous situation towards Country A vis-à-vis Country X. Likewise, if Country A and X create a bilateral FTA, Country Y may try to join such an FTA to secure equal footing with Country X.

However, the critical weakness of the domino theories is that they are silent about the form of FTA(s) resulting from economic or political domino effects. Suppose that Country A and X have an FTA, while Country Y does not have an FTA with Country A (Figure 3). Then, Country Y is in a disadvantageous position vis-à-vis Country X economically and diplomatically. Under such a situation, it is unclear which policy is adopted by Country Y to compete with Country X: forming an agreement between Country Y and A, or joining the existing Country X–A agreement to make it a trilateral FTA comprising Country A, X, and Y. In short, domino effect theories provide a post-hoc explanation on the driving force of the evolution of agreement(s) in both consolidation and expansion approaches, but these cannot predict which kind of evolution will actually take in place.

**Figure 3: Create New or Participate**



Source: Author's illustration.

### 3. Political Economy Issues on the Evolution of Economic Agreements

In order to highlight the differences between the two approaches explained in the previous section, this section reviews the political economy theories associated with critical institutional parameters of economic agreements. Four key issues regarding the evolution of economic agreements will be discussed: (i) negotiation timing, (ii) negotiation format, (iii) broader–deeper trade-off, and (iv) the participation process.

### 3.1. Negotiation Timing: Intersection of Rising Power and Declining Power

There has long been a debate on the relation between the distribution of power and the development of cooperation and institutions. A power shift (change in power distribution) brings to various countries both incentives and disincentives for creating agreements. Generally speaking, a country with relatively declining power (hereafter referred to as a declining power) may attempt to use regional agreements to contain or socialize rising powers (Johnston and Ross, 2002).

It is said that a declining power attempts to sign a (regional) agreement when it recognizes that its power is declining yet it is still strong enough to establish a favorable agreement (Hurrell, 1995). A declining country expects that the agreement embeds its current share of power. US interest in institutionalizing APEC (Crone, 1993) and France's effort to establish a European Central Bank (ECB) and strengthen European monetary integration (Grieco, 1995) are often-cited examples of this.<sup>12</sup> But once a declining power finds that its power has declined too much, it may become cautious in signing an agreement because the agreement may become advantageous only to a rising dominant power.

In contrast, a rising power attempts to delay the establishment of regional agreements. It may not oppose the proposals because the agreement may become beneficial for it someday, but it may delay the negotiations on agreements while they have less power. Rising powers need to avoid signing unfavorable agreements at an early stage when they have less power because they may have more bargaining power in the future.

Thus, the timing of signing an agreement that includes both rising and declining powers is very limited and constrained by the interests of both declining and rising powers. It should occur at the stage after a dominant but declining power realizes its declining position and a regional agreement would embed its still-significant power, but before the declining power becomes afraid of a situation where the agreement negotiations could be dominated by a rising power. It should also be after a rising power has become confident in securing an agreement beneficial enough for itself.

Perhaps, in the context of ongoing regionalism projects in Asia, most agree that the position of the People's Republic of China (PRC) is a typical case of a rising power. Many countries have attempted to create regional arrangements that include the PRC before it becomes very strong, and the PRC is attempting to delay the conclusion of negotiations until it becomes confident enough in its capability to conclude favorable agreements. Both Japan and the US are declining in power vis-à-vis the PRC, but the time when these countries each find regional agreements most useful may not be identical.

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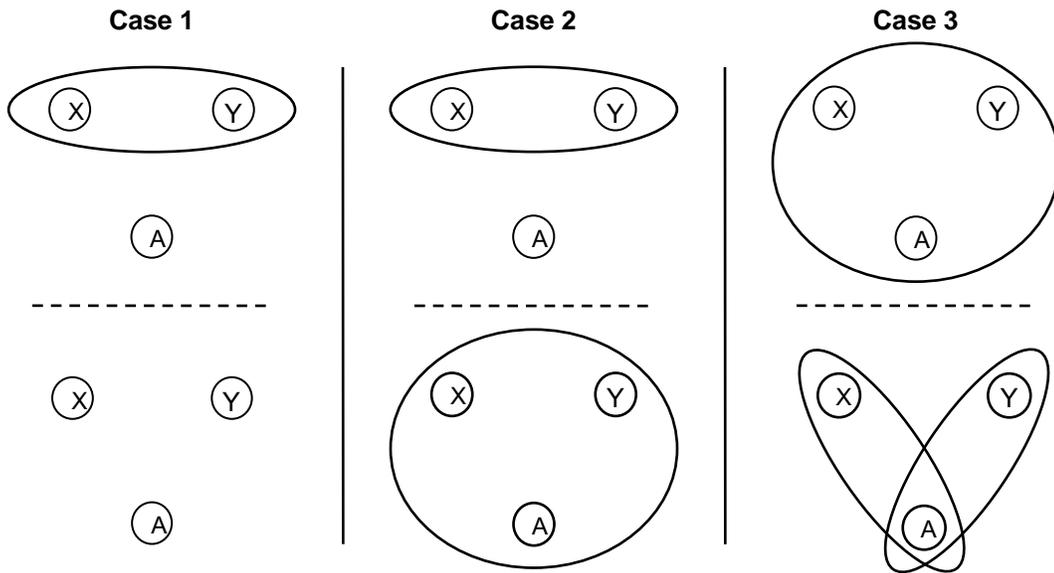
<sup>12</sup> For a similar argument in the Latin American context, see Hurrell (1992).

### 3.2. Negotiation Format: Divide-and-Rule

In order to have bargaining power in both strategic security issues and international economic issues, countries need to increase their relative positions vis-à-vis others. One often-used way to achieve this is the policy of “divide-and-rule.” It is a resort employed by a country to try to make or keep its competitors weak by dividing them or keeping them divided (Morgenthau, 1978). An historical case is the former Soviet Union’s policy toward European cooperation—it consistently opposed all plans of European unification on the ground that the pooling of the divided strength of European nations would make the Soviet Union’s situation worse.

The policy of divide-and-rule takes various forms in the case of international economic cooperation. In all three sets of examples in Figure 4, the lower situation is better than the upper situation from the stand point of Country A. The first case is a typical situation of divide-and-rule, particularly in—but not limited to—the security field. For Country A, the non-existence of an agreement between Country X and Country Y is better than when there is such an agreement. However, in the economic field, a direct method to prevent other countries from having an agreement is limited.

**Figure 4: Negotiation Format**



Source: Author’s illustration.

Thus, the more frequent case is the second case. For country A, being a part of an agreement is better than a situation in which it is excluded from an existing agreement. It is widely argued that economic agreements contribute to the negotiating power of the group vis-à-vis others. This is exactly the reason why external parties try to enter into an agreement that excludes them. In this case, Country A simply needs to join the agreement (or proposed agreement) between Country X and Y.

The third case is another form of divide-and-rule, which is usually called a hub-and-spoke system. In the upper scenario in the third case, Country X and Y may form an alliance within a large trilateral grouping so that the two countries can keep bargaining power vis-à-vis Country A. Thus, for Country A, having a separate bilateral agreement with Country X and Y is more beneficial (the lower scenario). In this case, Country A may need to achieve a hub-and-spoke system of bilateral agreements before a regional plurilateral agreement is signed.

The parties that use the divide-and-rule policy in the economic field require special attention. While it is assumed that small countries are divided and ruled by major powers in the security field, small countries can divide-and-rule major powers in the economic field. Making the country's negotiating position relatively better, irrespective of its absolute size, by dividing others instead of allowing a situation where others form a cooperation framework, can be referred to as the exercise of the divide-and-rule policy in the economic field.

### **3.3. Broader–Deeper Trade-off: Rationale for Starting from Small**

It is widely believed by policymakers that the larger the group, the lower the level of ambition with regard to an economic agreement. This is mainly because the negotiation and monitoring costs of agreements increase as the number of participants grows and, in particular, when heterogeneous countries are included in the membership (Olson 1965 and Keohane 1984 for the theoretical argument; Funabashi 1995 for the empirical argument). Meanwhile, Kahler (1992) argues that the proper institutional design, such as an effective voting mechanism, can solve the large number problem.<sup>13</sup> Kelly (2010) suggests that the critical factor is heterogeneity in terms of policy preferences among participating countries, rather than numbers.

An interesting recent finding on this issue in political economy literature is that the path of membership expansion itself affects the depth of the agreement, even if the final participants are the same. Downs, Rocke, and Barsoom (1998) argue that many institutions start out with substantially smaller memberships compared with their eventual composition and gradually expand over time, rather than form an inclusive agreement at inception that covers nearly all of the states that its designers eventually hope to include. Such a strategy contributes to a deeper agreement as the final product. In contrast, Gilligan (2004) argued that the analysis by Downs, Rocke, and Barsoom is relevant only when members of the agreement set their policies at identical levels of ambition. When members are allowed to set the levels of their policy at different levels,

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<sup>13</sup> Further discussion of this issue can be found in Ravenhill (2001).

the broader–deeper trade-off will be diminished. In short, the Downs–Rocke–Barsoom model assumes members agree upon on one level that all members should follow, while the Gilligan model assumes that different levels of policy in terms of ambitions are adopted by members as a result of negotiations.

It is reasonable to consider that the assumption employed by Downs, Rocke, and Barsoom, which is the proposition that all members adopt roughly identically ambitious levels of policy, seems to be relevant for the negotiation of economic and trade liberalization agreements. In fact, the issue covered by their literature is FTAs.<sup>14</sup> Moreover, legally speaking, in the case of FTAs, it is expected that “substantially all tariffs” should be eliminated. Basically, FTA members cannot negotiate how much of a percentage of trade is to be freed by each country.

### **3.4. Participation Process: Who Accepts Whom and Who Socializes Whom?**

The participation process of an economic agreement can be a source of influence from the perspective of incumbents. In particular, three questions should be considered in analyzing influence associated with participation. The first question is: who are the original members or incumbents? Clearly, incumbent status is beneficial because applicants need to accommodate the requests by incumbents so that their participation is allowed. The membership conditionality is one of the most effective ways to influence the applicants (Kelly, 2010). It is also possible for incumbents to socialize the new entrants after the accession, although there is the possibility in which a new entrant socializes the old members.<sup>15</sup>

The second point is whether incumbents have veto power over the accession process. Some economic agreements require consensus among incumbents on accepting a new member. Other economic agreements accept a new member so long as a certain portion of the incumbents agree with it, while specific concessions are not applicable between the acceding party and the existing members that do not support the accession.

The third question is the level of precision with regard to the participation rules.<sup>16</sup> The larger the discretion incumbents have with regard to the decision over accepting participants, the larger their influence becomes. This is because incumbents can request more and more. The room of discretion becomes small when there are transparent and established processes of participation. For example, an economic agreement that stipulates clear accession criteria and procedures contributes to transparency and possibly reduces—if not eliminates—the discretion of acceptance or rejection by incumbents. In contrast, the discretion reaches maximum when participation is limited to an “invitation only” process. Incumbents have the freedom to decide whether or not to send an invitation and countries seeking participation need to behave accordingly in

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<sup>14</sup> Negotiations on CO<sub>2</sub> emission levels are a good example that follows the Gilligan model.

<sup>15</sup> There is a lot of literature on this question. For example, Bearce and Bondanella (2007), and Bayers (2005).

<sup>16</sup> On the precision of agreements, see Abbott et al. (2000).

order to be offered an invitation. The establishment of partnership is usually a diplomatic process and thus invitation-based. If the determination of membership is conducted in a discretionary manner, this may make the agreement less effective to serve as a platform for encompassing regional cooperation.

### 3.5. Consolidation and Expansion Approaches Compared

The consolidation and expansion approaches significantly differ in critical institutional parameters mentioned above, namely the negotiation timing, negotiation format, the depth of the agreement, and accession criteria of new members. From those angles, it is now possible to consider which country prefers which approach (see Table 1).

**Table 1: Comparison of Consolidation and Expansion Approaches**

Negotiation timing	Declining countries favor creating an agreement in the short-run (expansion approach), rather than wait for the conclusion of several bilateral agreements among concerned parties (consolidation approach). Rising countries wish to delay the conclusion of multilateral agreement in a region and therefore prefer the consolidation approach.
Negotiation format	Smaller countries prefer to have bilateral agreements first (consolidation approach) rather than negotiate a multilateral agreement in a region (expansion approach), because they are often marginalized in the later scenario.
Broader-deeper trade-off	Developed countries prefer to start from a small-member agreement and invite others at a later stage in order to achieve a deeper agreement (expansion approach), while developing countries attempt to achieve a shallow agreement by avoiding the expansion approach (thus, in relative terms, developing countries prefer the consolidation approach).
Participation process	Incumbents are at an advantage because they can compel applicants to follow what has already been agreed upon by incumbents and set applicants' membership criteria.

Source: Author's compilation.

Because the creation of a new region-wide agreement is the final stage of the consolidation approach after some harmonization processes, the inception of negotiations on a region-wide FTA is delayed in the consolidation approach. This implies that countries that would like to delay the completion of a region-wide agreement support the consolidation approach, not the expansion approach.

If a region-wide agreement starts from a small group, this has two important implications. First, starting from a small agreement is helpful in achieving deeper integration. Thus, developed countries most likely prefer the expansion approach. Second, starting from a small group implies the future accession of other countries. From this perspective, it is safe to consider it is more beneficial for incumbents than late comers because it is the incumbents who set the accession criteria and decide whether or not to accept applicants. Naturally, most countries attempt to be one of the pioneers of a regional framework, rather remain an outsider or spectator that would be compelled to follow rules and conditions set by incumbents.

Having a favorable negotiation format where countries' negotiation positions are maximized is important for all countries. From this perspective, smaller countries may prefer negotiating a web of bilateral agreements rather than wider-membership agreements from the outset because their voice is often marginalized in a multilateral setting.

## 4. Examination of Possible Paths

The APEC 2010 Summit Statement clearly states members should pursue a Free Trade Area of the Asia-Pacific (FTAAP) and spells out the ASEAN+ $\alpha$  and Trans-Pacific Partnership (TPP) among others as possible paths towards a future region-wide agreement. Using the tools explained in the first half of the paper, this section examines the prospects of three possible paths to a region-wide economic agreement: (i) the ASEAN+ $\alpha$  FTA path; (ii) the TPP path, and (iii) the Asia-Pacific Trade Agreement (APTA) path.

### 4.1. ASEAN+1, ASEAN+3, ASEAN+4, ASEAN+6 Path

In 2001, the PRC proposed to start negotiations on an FTA with ASEAN and sought the enforcement of the agreement within 10 years. In fact, the ASEAN–PRC FTA (ACFTA) came into effect in January 2010. Japan and ASEAN also agreed to negotiate the Comprehensive Economic Partnership (CEP) in 2002 and the ASEAN–Japan CEP was signed in 2008. Meanwhile in 2002, the US proposed the Enterprise for ASEAN Initiative (EAI) that offered the prospect of an FTA between the US and ASEAN countries. ASEAN also has an FTA with its other dialogue partners such as Australia, India, and the Republic of Korea (Korea), and an FTA with the European Union (EU) has been negotiated. Meanwhile, there has been little political momentum to realize an FTA among all of the ASEAN+3 countries.<sup>17</sup>

The proliferation of ASEAN+1 FTAs can be explained by the motivations of both ASEAN and its dialogue partners. First, such a situation can be considered the result of a divide-and-rule policy as implemented by ASEAN. ASEAN would not have a strong bargaining position if an ASEAN+ $\alpha$  FTA, as opposed to a series of ASEAN+1 FTAs, was negotiated from the outset and, in particular, if  $\alpha$  were a large number. It is beneficial for ASEAN if each dialogue partner competes with each other by offering better concessions to ASEAN than others. Moreover, the selection of FTA partners is under ASEAN's discretion and partnership is forged on an invitation basis. Second, the surge of ASEAN+1 FTAs is widely considered as a typical case of domino effects of FTAs (Ravenhill, 2010). In this scenario, ASEAN's dialogue partners that do not have an FTA with ASEAN attempt to sign an FTA in order to avoid an unfavorable economic as well as diplomatic situation vis-à-vis other dialogue partners of ASEAN that have already signed an FTA. As a result of the motivations of both sides, the situation of ASEAN+1 FTAs becomes extremely complicated and politicized. While ASEAN appears to be holding the hub position of FTAs in Asia because of the proliferation of ASEAN+1 FTAs,

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<sup>17</sup> ASEAN+3 comprises the 10 member states of ASEAN plus the PRC, Japan, and Korea.

this is a result of the divide-and-rule policies of ASEAN as well as other countries' policies being affected by economic and political domino effects.

There is an argument that the harmonization of ASEAN+1 FTAs is the first step in the consolidation processes (Batra, 2007). However, consolidation may not be an easy task for three reasons. First, it is extremely difficult to decide which ASEAN+1 FTAs should be consolidated. There is not much logic behind the existing ASEAN+1 FTAs. If ASEAN+Country A and ASEAN+Country B, but not ASEAN+Country C, are chosen as ASEAN+1 FTAs to be consolidated at the first stage, Country C may feel uncomfortable.<sup>18</sup>

Second, there is no driving force of consolidation, at least, from the ASEAN side—the hub of these FTAs. As mentioned above, the proliferation of ASEAN+1 FTAs is comfortable for ASEAN because such a negotiation format and agreement brings relatively large bargaining power to ASEAN compared with the situation where ASEAN needs to deal with many dialogue partners at once.

Third, ASEAN's dialogue partners may not want to have an economic agreement between them. Japan and the PRC is an often cited case of difficult bilateral relations, while other critical bilateral economic agreement such as a PRC–US FTA is also very unlikely at this stage. The difficulty of having a PRC–Japan economic agreement can be explained by two factors. First, political problems and rivalries between the two countries are the significant impediment. Each country has strong aspirations for leadership in the region and they attempt to create a favorable regional framework in which they can easily assume (exclusive) influence (Dent, 2008; Hamanaka, 2008).<sup>19</sup>

The second equally important point is that the two countries are heterogeneous in terms of key policy preference including the depth of discipline: Japan prefers strong discipline, in particular, in investment-related areas as soon as possible, while the PRC does not seek this. For example, based on Japan's request, a trilateral investment treaty has been under negotiation among the three Northeast Asian countries—the PRC, Japan, and Korea—since 2005. While Japan wants to conclude it as soon as possible, the negotiations have been prolonged partly because of the PRC's cautious stand towards investment protection. For the PRC, it may be beneficial not to subject itself to strong investment discipline so that the country maintains a free-hand to adopt discretionary investment policies. This is a good illustration of the difficulty of having a PRC–Japan economic agreement because of different policy preferences, and not only political issues. In this context, it is important to note why PRC pursues East Asia Free Trade

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<sup>18</sup> Batra (2007) develops an interesting argument on this issue. He argues that not just three ASEAN+1 FTAs (the PRC, Japan, and Korea), but four ASEAN+1 FTAs (including India), should be consolidated first. Given the size and prospects of the Indian economy, his suggestion seems to be reasonable. However, such a proposal may not be acceptable for countries other than the four, such as Australia.

<sup>19</sup> In particular, it seems that the PRC carefully chooses its FTA partners so that it can maximize its negotiation bargaining power. The PRC generally prefers to choose smaller FTA partners in terms of the PRC's trade share, with the exception of ASEAN and Australia. However, the PRC is always one of the top five trade partners from the perspective of its FTA partners. Due to such an asymmetrical relationship, the PRC has more bargaining power in FTA negotiations than at the WTO. See Gao (2008).

Area (EAFTA) while Japan made a counter-proposal on the Comprehensive Economic Partnership in East Asia (CEPEA). Although commentators tend to focus on the membership issue arguing that PRC prefers ASEAN+3 cooperation framework where PRC can hold a dominant position while Japan is attempting to dilute the Chinese influence by including Australia and India, one should not overlook the fact that the emphasis of the two proposals is different. The Chinese proposal on EAFTA is a free trade agreement, with a natural emphasis on trade in goods, whereas the Japanese proposal on CEPEA emphasizes the significance of issues that go beyond trade in goods such as investment and services.<sup>20</sup>

It seems that proponents of the ASEAN+ $\alpha$  FTA model as a platform for a future region-wide economic agreement suggest a hybrid approach, as explained in Section 2. It is expected that several ASEAN+1 FTAs would be consolidated first and then others would join later. However, the hybrid approach seems to be unrealistic if the late comers are an economic giant such as the US or India. This is because it is difficult for the second stage participants to just accept what was agreed upon by the first stage participants. Thus, if a region-wide economic agreement is realized through this path, there is a possibility that a small ASEAN+ $\alpha$  FTA (the first stage consolidation) and a large ASEAN+ $\beta$  FTA (the second stage consolidation) would continue to co-exist.<sup>21</sup>

## 4.2. Trans-Pacific Partnership (TPP) Path

The genesis of the TPP Agreement can be found in the proposed FTA between Chile and New Zealand in the 1990s.<sup>22</sup> While the two parties decided not to pursue an FTA after two rounds of negotiations, the idea of Pacific Three (P3)—comprising Chile, New Zealand, and Singapore—gained momentum when the latter two signed the Closer Economic Partnership (CEP) in 2000. Brunei Darussalam participated in the negotiations as an observer in the second round. In June 2005, four countries, including Brunei Darussalam (Pacific Four: P4), concluded the negotiations and the agreement known as TPP came into force in 2006.

The US manifested its interests in TPP membership when the P4 countries began to work on outstanding chapters on financial services and investment in 2008. It formally announced in November 2009 in Tokyo that the Obama Administration was ready for TPP membership negotiations. Some consider that the US is utilizing TPP to have an agreement with Asian countries that is economically meaningful as well as politically important, and in doing so avoiding the evolution of Asian economic cooperation that excludes the US (Gao, 2010). In other words, it can be said that US participation in TPP can be interpreted as a kind of divide-and-rule policy by the US towards Asian

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<sup>20</sup> On Japan's Agenda for regional economic integration, see Hatch (2004). He argues that Japan's agenda is not trade liberalization but standards setting.

<sup>21</sup> ASEAN+ $\alpha$  FTA (the first stage consolidation) and ASEAN+ $\beta$  FTA can be either nested or overlapped. For more on nested FTAs and overlapped FTAs, see section 2.

<sup>22</sup> For a more comprehensive review of the background of TPP, see Gao (2010) and the website of New Zealand Department of Foreign Affairs and Trade. Available at: <http://www.mfat.govt.nz/Trade-and-Economic-Relations/Trade-Agreements/Trans-Pacific/index.php>.

regionalism. TPP also serves US interests because it may start from relatively small groups with relatively deep levels of integration.

The first negotiations were held in Melbourne in March 2010 with the participation of P4 countries, the US, Australia, Peru, and Viet Nam. Authorities in Malaysia; Taipei,China; Korea; Canada; and Colombia expressed their interest in possible participation in the future. The recent remarkable development in the TPP negotiations is that Japan manifested its interests in participating in TPP, despite the fact that the country has considerable sensitivity in liberalizing agricultural sectors, especially rice.

The significant interest in having membership in TPP is partly because of domino effects. In 2009, the US decided not to pursue bilateral FTAs with Asian countries and instead allocated resources to negotiate TPP. This means that Asian countries that did not have an FTA with the US needed to join TPP. Malaysia is a typical case because its neighbor, Singapore, signed an FTA with the US. The situation of Taipei,China may also be similar to Malaysia's. Likewise, it is widely said that Japan only realized the significance of TPP membership because of the possibility of a leveling the playing field in the US markets once the Korea-US FTA is signed. The domino of proposing bilateral FTAs between the US and individual Asian countries before 2009 was replaced by a domino of Asian countries' participation in TPP negotiations when the US stopped negotiating bilateral agreements.

The preamble to TPP clearly states that the purpose of TPP is to promote common frameworks within the Asia-Pacific region and affirm members' commitment to encourage the accession of other economies to TPP.<sup>23</sup> However, the accession procedures are unclear. First, it is unclear if an incumbent has a veto and what would happen if one incumbent does not approve accession. Second, accession criteria are uncertain. Article 20.6 simply says

This Agreement is open to accession on terms to be agreed among the Parties, by any APEC Economy or other State. The terms of such accession shall take into account the circumstances of that APEC Economy or other State, in particular with respect to timetables for liberalization.

Unclear procedures with regard to accession may produce an incentive for incumbents to exercise influence during the accession process. There is even a possibility that incumbents utilize a veto threat during the accession negotiations of new members to exploit such benefits. Such uncertainty is risky because it may result in the frustration of applicants that believe incumbents have misused the accession process to exercise their influence. In particular, given the possibility that some Asian countries might feel the US is attempting to rule Asia through TPP, accession criteria should be made clear, particularly after the US formally joins. Otherwise, applicants may become frustrated that the US requests too much from new applicants. It should be also recognized that the developmental level of original members and current applicants are relatively high. Thus,

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<sup>23</sup> Non-APEC members still have a chance at membership.

whether the same accession criteria are used for developed and developing applicants in the future should be openly discussed.<sup>24</sup>

It should be also recognized that the TPP has some elements of the consolidation approach. In fact, most potential members of the TPP already have bilateral FTAs. Thus, it is possible to regard the TPP as a consolidation of bilateral FTAs among its potential members. If existing bilateral FTAs among potential members affect the modality of TPP in favor of those who already have FTA, such a situation may not be acceptable to other parties, especially new applicants that do not have bilateral with existing members. More concretely, for example, because sugar is exempted in Australia-US FTA, the US may not be required to open the sugar market under the TPP regime despite the “no *a priori* exclusion rule”.<sup>25</sup> If this is the case, new applicants which are required to follow the “no *a priori* exclusion rule” stringently may feel frustration. Equal treatment between countries which already have bilateral FTAs and those which do not have should be maintained.

TPP has already experienced strong multiple ruling problems. First, the Singapore–New Zealand FTA has not been suspended and thus a firm can choose between the better treatment afforded under either the Singapore–New Zealand FTA or TPP. This is designed to ensure that that no firms are left worse off. The trade between Singapore and Brunei Darussalam is also governed by both TPP and the ASEAN Free Trade Agreement (AFTA). This implies that TPP can serve as a platform for region-wide economic agreement at the same time that other bilateral agreements between TPP members co-exist.

Thus, for as long as the transparency of accession procedures and criteria are secured, a situation in which late-comers are not required to concede more than incumbents, and developed country incumbents are generous in accepting developing country applicants with a relatively low-level of concessions, TPP has a chance to form the basis of a future region-wide economic agreement that covers both sides of the Pacific. It may eventually grow into a possible Free Trade Area of the Asia Pacific (FTAAP).

### 4.3. Asia-Pacific Trade Agreement (APTA) Path

While there is a view that a region-wide economic agreement is necessary, there is in fact already a quasi region-wide economic agreement in Asia: Asia-Pacific Trade Agreement (APTA). It was originally called the Bangkok Agreement but changed its

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<sup>24</sup> In this context, services agreement under TPP could pose another issue for developing countries if TPP adopts the negative list approach, because the majority of developing countries in the region have not been ready to go beyond the positive list services commitments, which is the scheduling methodology adopted by the General Agreement on Trade in Services (GATS). Most services agreements in Asia, such as the ASEAN Framework Agreement on Services (AFAS), adopt a positive list approach. For more detail, see Hamanaka (2009).

<sup>25</sup> In fact, it is reported that the US insisted that the TPP talks should not re-open market access schedules in existing bilateral agreements (*Inside U.S. Trade* 18 June 2010. Available at: <http://insidetrade.com/Inside-US-Trade/Inside-U.S.-Trade-06/18/2010/tpp-negotiators-unable-to-reach-consensus-on-key-structural-issues/menu-id-710.html>).

name in 2005. APTA covers two of the giant economies in Asia: the PRC and India. Also, it is important to note that the trade agreement includes both the PRC and Korea.

APTA was inaugurated in July 1975 with five original members: India, Bangladesh, Sri Lanka, Korea, and the Lao People's Democratic Republic (Lao PDR). While Thailand and the Philippines originally signed the agreement, they did not ratify it mainly because the two countries considered their participation in ASEAN Preferential Trade Agreements would have been complicated if they had signed the Bangkok Agreement.<sup>26</sup> The PRC joined the agreement in 2001, the same year it joined the World Trade Organization (WTO) and proposed the ASEAN-PRC FTA.

As the history of membership expansion of the group indicates, APTA has an accession clause (Article 30) and accepts new members to the agreement. Thus, APTA may be able to serve as a platform for a region-wide economic agreement in the future. Its relatively liberal accession procedures may also contribute to its membership expansion in the future. An applicant obtains membership if at least two-thirds of participating states recommended its accession. If any of the member countries objects to such accession, the provisions of the agreement will not apply between that country and the acceding country. This means that a single country cannot block the participation of new members.

The problem of the membership criteria of APTA is that the membership is open only to the developing member countries of the United Nations (UN) Economic and Social Commission for Asia and the Pacific (ESCAP). Thus, developed countries such as Japan and Australia are unable to join. Unless accession criteria are changed, APTA will become a region-wide trade agreement for developing countries at best, not a true region-wide agreement. The related issue to this is that APTA is an FTA notified under the Enabling Clause (formally called the Decision on Differential and More Favorable Treatment, Reciprocity, and Fuller Participation of Developing Countries) agreed upon at the Tokyo Round, not GATT Article XXIV.<sup>27</sup> It is also difficult for APTA to develop as a region-wide trade agreement that extends beyond Asia and the Pacific as defined by the UN.

APTA adopts round negotiations to reduce tariffs. This approach is possible because APTA is based on the Enabling Clause, not GATT XXIV. To date, three rounds of tariff negotiations have been conducted (1979, 1990, and 2006) and the fourth round of negotiations was launched in 2007. However, the level of preferential tariffs is still insignificant. So far, only goods are covered by the agreement.

In summary, APTA is a remarkable trade agreement covering both the PRC and India. It has the potential to develop as a region-wide FTA for developing countries in Asia and

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<sup>26</sup> See Kelegama (2001).

<sup>27</sup> An FTA that includes developed members of WTO should satisfy three conditions set by GATT Article XXIV. These are (i) tariffs on substantially all trade between FTA members should be removed (GATT IVXX-8 (a)); (ii) an FTA should be completed within 10 years (GATT XXIV-5 (c)); and (iii) barriers to the trade with non-members should not be raised (GATT XXIV-4). In contrast, developing countries are allowed to form an FTA consisting only of developing members based on the Enabling Clause, which does not impose any condition upon the formation of an FTA.

the Pacific. Rather than starting negotiations on a new bilateral trade agreement between developing countries in Asia and the Pacific (the so-called South–South FTA, especially one based on the Enabling Clause, not GATT Article XXIV)<sup>28</sup>, joining APTA seems to be a reasonable option in order not to intensify the Asian Noodle Bowl problem of overlapping FTAs. Given that APTA is based on the Enabling Clause, concessions under the agreement can be tailor-made to suit the unique situations of individual developing countries.

## 5. Conclusion

This paper has considered the path or sequencing towards a future region-wide economic agreement in Asia. The paper first presented two possible approaches to a region-wide economic agreement: the consolidation approach and the expansion approach. The differences between the two approaches center on the timing and the participants of negotiations of the future region-wide economic agreement, and the level of freedom that the negotiating parties have. In the expansion approach, the negotiations are started by a small group of countries at an early stage and they have relatively high-level of freedom to design the economic agreement. In contrast, in the consolidation approach, negotiations can be started only after all concerned parties get ready for negotiations and the negotiations are considerably influenced by (harmonized) existing bilateral agreements that should be the basis of a region-wide economic agreement.

There are some useful political economy theories for comparing the two approaches mentioned above. The relative power shift theory suggests that a rising power sometimes has an incentive to delay the timing of signing an agreement until it becomes powerful enough to dominate the negotiations. The divide-and-rule policy is also helpful in understanding the negotiation format preferred by each country, depending on the situation. The broader–deeper trade-off theorem also provides the rationale for starting from a small agreement and accepting others later to achieve a broader agreement. The participation process is critical for incumbents to exercise influence on new members.

Against those theoretical backgrounds, the paper also examined the future prospects of three existing economic agreements. The proliferation of ASEAN+1 FTAs is the result of various political forces, including the divide-and-rule policy and domino effects. If policymakers in the region opt for this path, they need to answer which ASEAN+1 FTAs should be harmonized and how they should be organized in the harmonization process. If policymakers fail to manage the process, there is a risk of having two region-wide economic agreements in Asia: a small ASEAN+ $\alpha$  FTA and a large ASEAN+ $\beta$  FTA, which would be nested or significantly overlapped. While APTA is a significant agreement covering both the PRC and India, it can grow, at best, as a region-wide economic agreement for developing countries only since the participation of developed countries is prohibited by its accession rules. For developing countries in Asia, joining APTA seems to be a better option than starting negotiations on a new South–South economic

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<sup>28</sup> On the negative sides of FTA based on Enabling Clause, see Rajapatirana (1994), Baldwin (2006) and Park (2009).

agreement. The newly-created TPP has a chance to form the basis of a future region-wide economic agreement that covers both sides of the Pacific so long as the transparency of accession procedures and criteria are secured, and late-comers are not required to concede more than incumbents. The developed incumbents of TPP should be generous in accepting developing applicants, even if they cannot offer a comparable level of concessions to incumbents.

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## **Institutional Parameters of a Region-Wide Economic Agreement in Asia: Examination of Trans-Pacific Partnership and ASEAN+ FTA Approaches**

The APEC 2010 Summit Statement clearly states that members should pursue a Free Trade Area of the Asia-Pacific (FTAAP), building on various ongoing regional cooperation frameworks including ASEAN+3, ASEAN+6 and the Trans-Pacific Partnership (TPP). This paper analyzes the future prospects of those paths towards a region-wide agreement from the perspective of four critical institutional parameters: negotiation timing, negotiation format, broader–deeper trade-off, and the participation process.

### **About the Asian Development Bank**

ADB's vision is an Asia and Pacific region free of poverty. Its mission is to help its developing member countries substantially reduce poverty and improve the quality of life of their people. Despite the region's many successes, it remains home to two-thirds of the world's poor: 1.8 billion people who live on less than \$2 a day, with 903 million struggling on less than \$1.25 a day. ADB is committed to reducing poverty through inclusive economic growth, environmentally sustainable growth, and regional integration.

Based in Manila, ADB is owned by 67 members, including 48 from the region. Its main instruments for helping its developing member countries are policy dialogue, loans, equity investments, guarantees, grants, and technical assistance.