



*US President Barack Obama and US Trade Representative Ron Kirk during a meeting with Trans-Pacific Partnership (TPP) leaders.*

## Trade pacts in a ‘second best’ world

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**I**n the world of free trade, a multilateral trade agreement (MTA) supported by unilateral liberalization is “first best.” But we don’t live in a first best world. While recognizing the benefits of trade liberalization, countries usually resist measures that limit sovereignty.

This means a middle path prevails: liberalization using bilateral trade agreements (BTAs). There are 189 such agreements in Asia, more than twice the number of multicountry, or plurilateral, trade agreements (PTAs). For East Asia, the comparison is even more striking: 118 BTAs versus 41 PTAs. Combined, the number of free trade agreements in Asia has more than tripled during the past decade, reaching more than 250. The failure of the World Trade Organization’s (WTO) Doha Round has no doubt played a major role. Closer to home, the emergence of plurilateral trade agreements involving the Association of Southeast Asian Nations — the ASEAN+1 FTAs, and the ASEAN–Australia–New Zealand FTA (AANZFTA) — underscores the regional grouping’s role as a hub for East Asia’s free trade agreements.

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But to say East Asia is region-centric is far from the truth. Strong supply chain and production networks born out of the marriage between foreign direct investment and free trade means Asia has to remain open globally. Indeed, the pattern where trade in intermediate goods is largely intra-Asian and final goods are exported mostly to the United States and Europe continues despite the recent fall in demand from these advanced economies. Thus, it is no surprise that there are more extra-regional free trade agreements than intraregional ones in East Asia. While this pattern has helped spur trade in the region, relying on existing supply chains that serve advanced countries could undermine Asia's competitiveness in producing final goods. This should have strengthened the incentive for unilateral liberalization by marginally lowering final goods tariffs. Yet, the global financial crisis and the rise of China, along with new geopolitical developments, leave us with today's three emerging mega-blocs: the Trans-Atlantic Trade and Investment Partnership (TTIP), the Trans-Pacific Partnership (TPP) and the Regional Comprehensive Economic Partnership (RCEP). The last two are Asia-linked.

Evolving from the 2005 PTA between New Zealand, Chile, Singapore and Brunei, the Trans-Pacific Partnership was adopted and subsequently championed by the US because of its strategic and political importance rather than the promise of any dramatic expansion of trade (the US already has bilateral agreements with many TPP members). This

also jives with the Obama administration's renewed US "pivot" toward Asia. A TPP agreement, presumably to be finalized by the end of this year, is a gold standard aimed at dealing with emerging 21st century issues including intellectual property rights, procurement, labor standards and dispute settlements (known as WTO-plus). Aside from criticism about a lack of transparency in the negotiations, and discontent over too much leverage given to corporate interests, TPP proposals are both too expansive and too restrictive for some members.

Then there is the Regional Comprehensive Economic Partnership, a compromise between Japan's proposed ASEAN+6 Comprehensive Economic Partnership in East Asia and the China-proposed ASEAN+3 East Asia FTA. The agreement to launch RCEP negotiations was formally declared by leaders at the East Asia Summit (EAS) in November 2012, and talks are expected to be concluded in 2015. It would become the largest free trade bloc in the world, comprising all 10 ASEAN nations plus China, India, Japan, South Korea, Australia and New Zealand. No matter how officials spin it, it is no secret that RCEP is a rival to and competes with the TPP. RCEP, like the TPP, is also meant to be high quality, although flexibility for weaker members is allowed. RCEP coverage is also broad — it includes investment; transfer of technology; and institutional, physical and people-to-people connectivity — in order to address expanding production networks and other new trade issues.



While Trans-Pacific Partnership members account for nearly 40 percent of global gross domestic product, RCEP covers more than 45 percent of the world's population and one-third of its GDP. The distinction in membership between the two cannot be more stark: the United States is in the TPP but not RCEP, while China is in RCEP but not the TPP. To some, the TPP is seen as a political response to China's new aggressiveness, though they are vague as to whether it represents containment or cooperation. With ASEAN's centrality in RCEP, it is seen as more Asia-driven and increasingly championed by Beijing. But ASEAN also is worried about being marginalized, as members Brunei, Malaysia, Singapore and Vietnam are also in the TPP. (Thailand expressed an interest in joining in 2012 but has not joined the negotiations). Clearly, there is a perceived risk of fragmentation of ASEAN's efforts at integration. Japan's enthusiasm toward the TPP only reinforced ASEAN's push toward

RCEP. There is no doubt that competition between the two blocs could shape the nature and speed of regional integration in this part of the world. At the same time, it can also prompt a major rethink of what to do about the WTO's drive to deepen the multilateral system.

#### **APEC's relevance**

This brings us to the question over the relevance of the Asia-Pacific Economic Cooperation (APEC) forum. It is not entirely accurate to compare RCEP and TPP with APEC, because the latter is a nonbinding and non-negotiating forum that is purely voluntary in character. This leaves APEC with nothing concrete, and as such it is taken less seriously. But it also makes APEC the only effective forum to exchange ideas and discuss issues that would otherwise not be taken up by its members. Before the TPP, APEC was the only multilateral economic

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forum connecting the US with a select group of East Asian economies. To its proponents, the 24-year-old APEC is a unique incubator of ideas, able to provide useful input for any regional trade agreements, including the TPP and RCEP. Proposals discussed in APEC can be used by negotiators in both blocs. But pursuing negotiations with binding agreements through RCEP and the TPP would continue with or without APEC. As a consultative forum, APEC is not and will not become a regional free trade agreement. At one point, there were some discussions on using APEC as a building block for the Free Trade Area of the Asia Pacific, involving 21 economies, but this was misguided. While the idea of expanding regional coverage is good, it makes more sense to debate the possibility of enlargement through a forum with binding agreements like RCEP and TPP.

Still, no matter how ideal enlarging these pacts would be, what really matters is implementation. This is where Asian cooperation does not have a good track record. Even after free trade agreements have been ratified, actual implementation is often limited. This has been the case with most Asian FTAs, where the actual utilization rate is low. Attempting the gold standard of cooperation, the Trans-Pacific Partnership is rather ambitious. Even if its proposals are successfully negotiated, they will not be easy to implement. It is difficult to imagine, for example, how officials in Asia can seriously adopt a special tribunal to allow corporations to sue governments, which is the TPP version of dispute settlement. Enforcing conditions on

procurement and state-owned enterprises, and complying with strict rules on labor standards and intellectual property rights are equally challenging. It is also difficult to imagine how the TPP requirement to ban capital controls can be enforced, given the vulnerabilities that can easily arise under the current system of capital flows. Even the International Monetary Fund now acknowledges the merits of capital controls under certain circumstances.

On the US side, obstacles also abound. Washington will likely push for free trade in manufacturing and services, but not in agriculture. The Republican-controlled House of Representatives and business lobbies continue to pressure US negotiators to protect American farmers, making it difficult to reach a deal under the TPP. Access to generic medicines is another thorny issue, as the Office of the US Trade Representative remains reluctant to lay out its negotiating stance, even after Congress included access in other trade agreements.

**Why regional and not multilateral?**

Meeting all the goals of the Regional Comprehensive Economic Partnership is equally doubtful. To have a modern and comprehensive trade agreement among 16 diverse countries covering not only trade in goods, but also services, investment, economic and technical cooperation, as well as dispute settlement is quixotic. Making those things compatible with WTO rules, as stressed by all parties involved, is

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ideal but even more challenging. Thus, while everything on paper seems fine, given the difficulty in implementation, it is almost impossible to evaluate which of the two blocs offer more for individual members. Only theoretical assessments can be made.

If enlarging market size is the goal of a regional free trade agreement, there are several relevant questions to ask. What is the “optimal” size of the bloc to make the agreement effective and consistent with WTO multilateral principles? Why limit coverage to only countries with geographical proximity? Isn’t it more logical to integrate the economy globally rather than regionally? All these boil down to one fundamental question: why regionalism and not multilateralism?

Close proximity does have some merits, as one can see in the North American Free Trade Agreement, the European Union (EU), the Mercado Común del Cono Sur and the Southern African Customs Union. The inverse relationships between distance and membership in most free trade pacts relates to the so-called coordination problem. As each country has the option to select partners when constructing an FTA, coordination failure can easily arise — especially without effective communication and when transaction costs are not large enough to hinder trade. This can lead to several possible combinations of FTA membership (multiple equilibria). So countries generally prefer to join regional trade agreements with geographical proximity because it is easier to resolve coordination issues. From this perspective, RCEP would be better able to

minimize coordination failure.

But like other agreements, RCEP remains a trade bloc and is unlikely to be more welfare-enhancing than a multilateral system, regardless of its relatively large membership (16 economies versus 12 so far in the TPP). One clear case regards removing subsidies. If, for example, RCEP members agree to dismantle export subsidies, the process could remain distorted through production subsidies. Indeed, this is one of the stumbling blocks in the contentious agriculture debate in the Doha negotiations. Even if, subsequently, RCEP members also agreed to reduce production subsidies, it is utterly impossible to make these measures reciprocal only to other RCEP members. In this sense, there is no difference between RCEP and the TPP. Only a multilateral agreement would work. And that remains the ideal.

However, policies must be realistic and the reality is simple: Doha has stalled and free trade agreements proliferate. So we have to deal with a “second best” world. This does not mean that FTAs like RCEP and the TPP do not offer benefits. Proponents argue that the desire to prevent future conflicts is among the strategic reasons for forging regional agreements just as the geopolitical motivation to counter Communist influence during the Cold War played a prominent role in the 1967 formation of ASEAN itself. Indeed, countries may wish to cooperate and integrate not purely for economic reasons. The objective may ultimately be to maintain geopolitical stability, although that in itself can help foster economic prosperity. By being more regionally integrated, economic



*Agriculture has been a stumbling block to trade negotiations.*

interdependence deepens and interaction among countries increases, from which mutual trust can arise. It is no secret that regional cooperation in Asia is clouded by a lack of trust. Several studies have also shown the “peace dividend” of free trade — increased trade between countries — reduces the risk of conflict between them.

Countries also pursue regional arrangements because it is relatively easier to manage negotiations and concessions during the process. It is also true that a successfully negotiated trade agreement provides a thumbs up for the negotiators and officials in charge, boosting their reputation while strengthening their leverage in global discussions. In most cases, a country’s bargaining power is enhanced when officials from the respective country are seen as representing a region rather than any single country.

### **Reform still needed**

**A**nother argument favoring regional agreements is that they can be useful

in working through or avoiding turmoil or potential crises. For example, in the 1980s external and peer pressure from regional agreements was applied to help counter protectionist forces coming from powerful domestic lobbies. At that time, many Asian countries were trying to intensify efforts to liberalize their economies. Today, similar pressure — in fact, more pressure — is needed. It is abundantly clear that the core problem behind the recent market turmoil in Asia is the region’s delay in pushing serious structural reform. When growth was strong, exports were rising steadily and financial markets attracted lots of capital, the impetus for reform faded and economic restructuring languished. No matter how weak the production and export structure is, as long as demand is strong, growth will persist.

Indonesia is a clear example. With no serious trade reform during the last decade, the share of primary goods exports failed to decline, and exports of high- and medium-tech products failed to increase. High com-

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modity prices and strong demand, particularly from China, allowed the country to enjoy trade and current account surpluses. But when growth in China slowed, demand fell and commodity prices plummeted and the current account surpluses turned into deficits. All of a sudden, the economy became vulnerable to external shocks. When the US Federal Reserve announced just the possibility of a tapering of quantitative easing, the rupiah depreciated sharply and capital markets plunged. Combined with slowing growth and mounting inflationary pressures, largely due to the effect of removing government fuel subsidies, the policy dilemma intensified. Had existing free trade pacts and other regional agreements been able to exert pressure to tackle domestic structural reform earlier, boosting economic fundamentals, the effect would have been less severe. Thus, “yes,” FTAs can potentially help push domestic reform, but “no,” there is no guarantee it will happen unless policymakers make deliberate efforts. It remains to be seen whether or how RCEP and TPP could support domestic structural reform.

Like with most FTAs, there is the fear that RCEP and TPP could drift toward the lowest common denominator. How do we prevent that from happening, and, more importantly, how can we insure the agreements that emerge remain consistent with multilateral principles? Arguably, this can happen if, for example, external tariffs imposed by members are not above those agreed to under RCEP and TPP. That way, there is no incentive for trade diversion and no dis-

crimination against nonmembers. As trade diversion cuts into the profits of exporters in nonmember countries, there should be greater incentive to boost trade liberalization preferentially, implying the trade agreement will enlarge. In the long run, this is good for the multilateral system. But that is only possible under the principle of “open regionalism,” where nonmembers are allowed to join. Aside from their many agenda items, RCEP and TPP should always keep this in mind, as the opposite could happen instead.

What are the signals so far? The empirical evidence is not conclusive, although more studies are showing there is limited trade diversion given all the free trade agreements out there. But that is probably because of low FTA utilization. To the extent that RCEP and TPP members wish to have their blocs fully utilized, the risk of the “second best” scenario drifting away from multilateral principles could be high. To prevent this, consolidating existing FTAs is a prerequisite. This will also be necessary if larger interregional trade agreements are used to move toward multilateralization. But these consolidated, expanded FTAs should replace rather than add to the existing, convoluted free trade agreement structure. Thus, RCEP should ideally replace all the ASEAN+1s, not add to them. To disentangle the noodle bowl and the notoriously complex procedures for determining rules of origin, a more rational approach may be needed. Given, for example, the intricate and convoluted details of rules of origin, it may help to have a separate forum led by an independent regional insti-



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tution. This can avoid delays due to politically and bureaucratically constrained working groups established under FTAs.

The welfare impact of this “second best” world will likely be less than a “first best” solution. But more critical for Asia is how the welfare is distributed. Given the signs of growing economic and social inequality and rising polarization across the region, a major challenge is how to make free trade agreements more accommodating to small and medium enterprises. While there are concerns whether continuing to join the supply chains of advanced economies’ is either

sustainable or optimal, Asian policymakers should also be concerned with unequal participation in industries dominated by large and multinational firms. On this front, however, it is hard to be optimistic.

The way existing free trade agreements were negotiated, commercial interests always seem to be placed ahead of broader national interests. Will RCEP and TPP negotiations be any different? It is doubtful, for example, that a TPP agreement will benefit the millions of small-food industries across Asia, knowing that they have been excluded in negotiations involving big industrial farms, agrochemical companies and large agricultural traders. Extending patents and expanding WTO rules on intellectual property rights as proposed under the TPP will only benefit “Big Pharma” and cut into the access that millions of low-income Asian households have to far more affordable generic medicines.

Living in a “second best” world of trade does not have to be bad. But its potential welfare gains may not be widely enjoyed or equally distributed. At the very least, RCEP and TPP negotiators must be sensitive to the potential welfare benefits for the many and not just the commercial few.