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## The New Trend in Asia-Pacific Regional Trade Initiatives

In the last months of the old millennium and the opening months of the new, there was something of an explosion of new proposals for bilateral or plurilateral subregional trade agreements in the Asia-Pacific region<sup>1</sup> and Asia Pacific Economic Cooperation (APEC) forum.<sup>2</sup>

- A dramatic development early in this period was the decision by Japan and South Korea to study the implications of a free trade area (FTA) between the two countries as part of a wider program of deepening economic ties. This initiative resulted from meetings during the October 1998 visit to Japan of Korean President Kim Dae Jung, and received further impetus from the March 1999 visit to Korea by then-Prime

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1. The term “Asia-Pacific region” as used here is synonymous with “Pacific Rim.” In principle, it includes Australasia, East Asia, North America, and the Pacific seaboard of Latin America.

2. APEC (Asia Pacific Economic Cooperation) was established in 1989, and now includes 21 members: Australia, Brunei Darussalam, Canada, Chile, China, Hong Kong Special Administrative Region of China, Indonesia, Japan, South Korea, Malaysia, Mexico, New Zealand, Papua New Guinea, Peru, Philippines, Russia, Singapore, Taiwan, Thailand, United States, and Vietnam. In 1994, at a meeting of leaders in Bogor in Indonesia, APEC committed itself to establishing free trade and investment in the Asia-Pacific region, to be achieved through a process of voluntary liberalization, with a target date of 2010 for developed-country members and 2020 for developing-country members. APEC members’ liberalization commitments are recorded in individual action plans. APEC’s institutional structure includes an array of official committees and working groups, regular ministerial-level meetings, and (since 1993) an annual summit of economic leaders (who are also country presidents or prime ministers, for most APEC members).

Minister Keizo Obuchi of Japan. The results of the study were published in May 2000 (IDE 2000). Korea has suggested that it might be preferable to include China in any such arrangement (Yamazawa 2000), and studies are now underway on issues related to a three-way linkage between Japan, South Korea, and China.

- At the time of the APEC economic leaders' meeting in Auckland in September 1999, proposals were announced for negotiations or studies on FTAs between the following APEC members:

- Singapore and Japan
- Singapore and Chile
- Singapore and New Zealand
- South Korea and Chile
- Japan and Mexico

These proposals are at various stages of development. Singapore and New Zealand concluded their FTA in November 2000. Of the remainder, some are being actively negotiated, while others remain at the study stage. Subsequent to the Auckland leaders' meeting, it emerged that proposals have also been made for FTAs between

- Japan and Canada
- Japan and Chile
- South Korea and Mexico
- Singapore and Mexico
- Singapore and Canada

- Also at the time of the APEC economic leaders' meeting, proposals circulated informally for a so-called Pacific 5 (P5) FTA between Australia, Chile, New Zealand, Singapore, and the United States. Although this proposal never reached the stage of formal discussions, it is known that some prospective participants remain interested in taking it further.
- Other developments in 1999 were an attempt to revive an earlier proposal for an FTA between Chile and New Zealand, and the announcement by the South Korean and New Zealand governments of a joint study for an FTA between them. In early 2000, a similar announcement was made by the governments of Australia and Korea. Discussion on a Korea-Singapore FTA has also been reported.
- Discussions have been proceeding on further development of the linkage between the ASEAN<sup>3</sup> Free Trade Area (AFTA) and the Australia-New Zealand Closer Economic Relations Trade Agreement (ANZ-CERTA, usually shortened to CER). The AFTA-CER linkage has hitherto

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3. The members of the Association of Southeast Asian Nations (ASEAN) are Brunei Darussalam, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Vietnam.

focused on facilitation and information exchanges, but some participants on both sides of these discussions have expressed interest in elevating the connection to a full FTA.

- The APEC economic leaders' meeting in November 2000 was the occasion of still more announcements. Perhaps the most dramatic was the statement that study would begin on a free trade area between Singapore and the United States, marking the first time the United States has officially engaged in the new trend toward bilateral arrangements in the region. The prime minister of Singapore, Goh Chok Tong, forcefully put forward the view that new transpacific bilateral developments represent a fresh concept in regional integration, which he dubbed "Cross-Regional Free Trade Areas" (CRFTAs). He argued that, in present circumstances, CRFTAs offer the best defense against the evolution of a "three-bloc world." Other proposals for bilateral arrangements surfacing at this time included Australia-Singapore and Hong Kong-New Zealand, with some suggestions also of a possible Taiwan-New Zealand link. Informal discussions apparently also took place on possible reduced-form variations on the Pacific 5 formula, involving some combination of Australia, Chile, New Zealand, and Singapore. Just before the APEC economic leaders' meeting, the New Zealand-Singapore Closer Economic Partnership Agreement was signed by their prime ministers—the first of the new initiatives to reach the stage of formal agreement. More recently, Australia has proposed an FTA with the United States.
- There have also been further significant developments in East Asia. In November 2000 Premier Zhu Rongji is known to have suggested an FTA between China and ASEAN, and a study on this possibility is now being undertaken by an ASEAN/China Expert Group on Economic Cooperation. At the "ASEAN plus three" summit, also in November 2000, a study on a possible East Asia-wide free trade area was commissioned. More recently, a new expert group has been created to consider prospects of a Japan-ASEAN FTA.<sup>4</sup>
- In December 2000 an announcement was made that discussions would reopen on a possible free trade area between Chile and the United States.

This summary,<sup>5</sup> which is not exhaustive, lists 25 potential new SRTA<sup>6</sup> initiatives that have emerged in the APEC region since the end of 1998.

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4. This development was announced at the 2001 meeting of ASEAN-plus-three economic ministers in Cambodia.

5. Further details on a number of the proposals listed above can be found in Findlay (2001).

6. The terminology used to describe regional trade agreements has become somewhat confusing. The term "regional trade agreement" (RTA) continues to be used in the WTO and in much academic and official literature to describe any preferential trade agreement.

This contrasts with a period of 4 years following the Bogor Declaration in November 1994, during which the region saw very little activity directed at the formation of new SRTAs. During that post-Bogor period, only two new FTAs, between Chile and Mexico and between Chile and Canada, were added to the FTAs already existing in the region before Bogor, namely, the North American Free Trade Agreement or NAFTA (entered into force in January 1994), AFTA (entered into force in 1993), and ANZ-CERTA (entered into force in 1983).

Furthermore, the Chile-Mexico and Chile-Canada FTAs could reasonably be interpreted as by-products of NAFTA, serving as partial substitutes for the aborted earlier effort to bring Chile into NAFTA. The change in attitudes within the region since the end of 1998 has thus been sudden and dramatic, underlined by the historic shift represented by the involvement of Japan and South Korea in a number of the new initiatives. These two countries had hitherto eschewed preferential trade arrangements in favor of consistent adherence to the most-favored-nation (MFN) principle, and as such had formerly been counted among the last remaining “friends of GATT [General Agreement on Tariffs and Trade] Article 1.”<sup>7</sup>

It is tempting to link the lack of SRTA activity in the APEC region after 1994 to the notion that the Bogor Declaration, with its emphasis on “open regionalism,” reinforced the impact of the World Trade Organization’s (WTO) establishment in successfully countering what was then perceived as a growing threat that spreading regionalism would undermine the multilateral trading system. Any effect of this nature, however, clearly

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The term “subregional trade agreement” (SRTA) tends to be used within APEC circles to describe preferential trade arrangements involving subgroups of APEC members. The term “bilateral trade agreement” (BTA) has sometimes been applied to the new initiatives involving pairs of countries. Panagariya (1999) suggests that all such agreements should be described as “preferential trade agreements” (PTAs), because their preferential nature is their common characteristic. This would distinguish such arrangements from APEC, which has not pursued liberalization on a preferential basis, but might still be described as a regional trade arrangement. Trade arrangements involving large blocs of countries, such as APEC, the European Union, and the proposed Free Trade Area of the Americas (FTAA) in the western hemisphere, are sometimes described as “megaregional” trade arrangements, and the term “transregional trade arrangement” is also sometimes used to describe initiatives designed to link the megablocs, e.g., the proposed Transatlantic Partnership (TAP). The Asia-Europe Meeting (ASEM) might also be described as a transregional arrangement. In this book, the various regional trade arrangements will generally be described by the terms most commonly used in the particular context under discussion, recognizing that different terminology may be applied to the same agreement in different contexts.

7. The term “friends of Article 1” refers to the small (and diminishing) group of former GATT and now World Trade Organization members that have adhered strictly to the nondiscrimination principle and have resisted participation in any RTAs. Japan and South Korea were the two largest economies left in this group. The United States was previously a member of this group but began to engage in RTAs during the 1980s. China and Taiwan could potentially become important new members of this group when they accede to the WTO.

#### 4 NEW REGIONAL TRADING ARRANGEMENTS IN THE ASIA PACIFIC?

did not extend beyond the borders of the APEC region itself, because outside that region the spread of regionalism appears to have continued unabated throughout the 1990s. The WTO (1998) records that the number of notified regional trading agreements grew from 77 in 1990 to 162 in mid-1998, with an average of 11 new agreements notified annually since 1992. The rate of notification of new RTAs increased rather than decreased following the Bogor Declaration, and the inauguration of the WTO immediately afterward at the beginning of 1995. If the figures are adjusted for RTAs that have since gone out of existence, the number of notified agreements remaining in force grew from 42 in 1991 to 87 in 1998.<sup>8</sup>

In parallel with the increase in notified RTAs, there was an acceleration in the rate of establishing nonnotified agreements. WTO figures indicate 18 nonnotified RTAs in 1990, rising to 58 by 1998. Once again, the pace of new nonnotified agreements quickened in the years after 1995. A fresh survey in 2000 by WTO (2000a) counted a total of 172 RTAs currently in force, with a further 68 under negotiation.<sup>9</sup>

Thus, although the establishment of the WTO may have consolidated the status of the multilateral trading system, it does not appear to have seriously constrained the spread of regionalism in most parts of the world. Any effectiveness of the Bogor Declaration in restraining the proliferation of RTAs appears to have been limited to the APEC region itself, which managed to stay largely away from the trend elsewhere for 4 years. The appropriate question to be asked, therefore, is how far the recent apparent change of direction within the APEC region represents a turning away from APEC's own distinctive approach to liberalization. This invites further questions as to where this new direction might lead, and whether there are grounds for thinking that the economies of the region have found a new approach that promises greater economic benefits than an APEC-wide approach to liberalization. If not, and if the new departures simply reflect frustration with lack of progress within APEC, then the appropriate question might be why more effort is not being put into making APEC more effective.

A sharp edge to these questions is provided by the fact that the new developments have occurred at a time when fresh impetus appears to have developed toward establishing some form of East Asian economic grouping (Bergsten 2000). Although matters appear to be moving more quickly on the monetary and financial side than on the trade side, some

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8. The significance of the agreements that have remained in existence is of course highly variable. Baldwin (1999) points out that—despite the explosion in the number of RTAs in the 1990s—by far the largest share of world trade affected by RTAs is accounted for by just two RTAs, the European Union and NAFTA.

9. The WTO notes that a number of the new initiatives under negotiation are designed to replace existing arrangements. Thus the potential total of RTAs in force is less than the combined total of these two figures.

of the new SRTA proposals are clear evidence of a willingness in at least some East Asian official quarters to consider further subregional trade linkages in East Asia, beyond those already proposed. Establishing an East Asian economic bloc is once again being raised as a serious possibility, even though the form that such a bloc might take is far from clear.

The proposed FTA between Japan and South Korea could potentially be an important step toward an East Asian trade bloc. A Japan-Singapore FTA is also potentially a step in this direction, as is the recently floated suggestion of a China-ASEAN FTA. The commissioning of a study on a possible East Asia free trade agreement at the most recent ASEAN-plus-three summit may be a further very important development, signaling a willingness to at least consider extending the ASEAN-plus-three efforts at cooperation currently being developed in the monetary and financial sphere to embrace the possible formation of a preferential trade arrangement.

The reemergence of an East Asian economic bloc as a serious—if at this time perhaps somewhat distant—possibility raises once again the specter of a world economy divided into three major trade blocs, situated in Europe, the western hemisphere, and East Asia.<sup>10</sup> The European bloc already exists, and the western hemisphere bloc would be created by the formation of the Free Trade Area of the Americas. The prospect of such a three-bloc configuration was regarded with considerable apprehension in the early 1990s. Krugman (1991), for example, famously argued that such a configuration would be the worst possible outcome for the world as a whole.

The design of APEC and its approach to trade liberalization was explicitly intended, among other things, to avert this possibility, in two ways. First, inclusion of the key economies from both sides of the Pacific in APEC's membership was intended to preserve the benefits of transpacific interdependence and ensure that separate blocs would not be formed on each side of the ocean. Second, the APEC concept of open regionalism, based on encouragement for nondiscriminatory rather than preferential liberalization<sup>11</sup> by APEC members, was intended to offer the strongest possible support for the multilateral trading system. The commitment in the Bogor Declaration to free trade in the Asia-Pacific region on the basis of open regionalism seemed to satisfy both concerns. An ambiguity left conveniently unresolved in the concept of open regionalism allowed differing interpretations among the APEC membership to be accommodated.<sup>12</sup> It would appear, however, that APEC is no longer seen as provid-

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10. See Bergsten (2001) for a recent discussion of this possible development.

11. Voluntary liberalization on a nondiscriminatory basis is equivalent to unilateral liberalization. Hence the term "concerted unilateralism" was applied to the collective use of this approach by APEC members.

12. The United States has consistently insisted that it can undertake nondiscriminatory liberalization only if it is reciprocated by both members and nonmembers of APEC. The

ing adequate insurance against the evolution of a three-bloc world. This suggestion is implicit in the contention by Singapore's prime minister and others that CRFTAs now provide the best defense against this possibility.

The new crop of SRTAs thus appears as a likely focus for renewed concerns over questions that were thought to have been settled. Some of the new initiatives could contain the seeds of a future East Asian trade bloc, which would be an important step toward a three-bloc world. Conversely, others are being promoted in at least some quarters as a defense against the threat of this same potential development. The possible negative consequences of a fragmentation of the Asia-Pacific trading environment appear to have been given little consideration in the headlong rush to develop new SRTA initiatives.

Suggestions have also been made by some commentators that the launching of the fresh wave of SRTA proposals in the APEC region may be linked to disillusionment with the WTO process, particularly in the wake of the failed Seattle Ministerial meeting in December 1999. The chronology of the new initiatives does not support this view, however. Many of the new initiatives had been floated before the Seattle meeting.<sup>13</sup> Although no clear causal link has been established, the timing of the beginning of the new trend to SRTAs suggests that a more plausible hypothesis may be that the new wave of SRTAs reflects a reassessment of the prospects for successful liberalization within the APEC process following the disappointing outcome of the Early Voluntary Sector Liberalization (EVSL)<sup>14</sup> initiative at the end of 1998. To the extent that this hypothesis is correct,

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majority of members, however, have interpreted open regionalism as implying unconditional nondiscrimination, without any requirement for reciprocity.

13. Although signs of trouble in the WTO had appeared before the Seattle meeting—and are especially clear in retrospect—the failure of the Seattle meeting does not appear to have been widely anticipated.

14. EVSL was an attempt to accelerate the process of trade liberalization within APEC. In 1997, 15 sectors were targeted for early liberalization, and through 1998 negotiations were undertaken to establish commitments by APEC members to liberalize an initial 9 sectors. EVSL was welcomed by some trade officials as a way of introducing more rigorous liberalization commitments into the APEC process, but regarded by others as an unfortunate intrusion of the reciprocity-based WTO style of negotiation into a process that the members had earlier agreed would be based on voluntarism. In the event, it was not possible to reach consensus on an agreed-on set of liberalization commitments in the initial 9 sectors. The attractiveness of the overall “package” was greatly diminished when it became apparent that some members would not agree to the inclusion of some of the nominated sectors in their EVSL commitments (particularly the forestry and fishery sectors in the case of Japan), and that the United States would not undertake nondiscriminatory sectoral liberalization outside the WTO context. It was agreed that trade facilitation and economic and technical cooperation in relation to the 9 sectors would continue to be pursued within APEC, but that efforts to achieve liberalization in these sectors would be transferred to the WTO, where the APEC members would endeavor to secure participation in these sectoral initiatives by the full WTO membership. This latter effort has not so far been successful.

it adds a further dimension to the potential challenge posed to APEC by the new SRTA initiatives.

The EVSL experience may have affected the attitudes of APEC members to regional integration in several ways. Negotiators impatient with slow results from APEC's "voluntary" approach to liberalization may have taken the EVSL outcome as evidence that moving beyond voluntarism to binding commitments is unlikely to be feasible in the APEC context, and this in turn may have devalued APEC in their eyes as an instrument of regional liberalization. Japan and South Korea are likely to have felt uncomfortable with the position in which they found themselves during the EVSL debates, and this may have spurred interest in exploring alternative configurations in which they might be less likely to face pressures to liberalize sensitive sectors.<sup>15</sup>

Less obviously, but equally significantly, the EVSL experience signaled indirectly to the rest of the APEC membership that two of the three leading economic powers of the region, Japan and the United States, are unlikely to be willing or active participants in APEC's concerted unilateral approach to liberalization, and are likely instead to be willing to liberalize only within the context of the negotiated reciprocity of the WTO, and perhaps also of traditional preferential regional trade arrangements.<sup>16</sup> The difficulty, and perhaps undesirability, of introducing negotiated reciprocity into the APEC process itself was yet another lesson of EVSL.

It can, of course, be validly argued that continued pursuit of concerted unilateralism remains in the interests of the rest of the APEC membership. Standard economic analysis indicates that the smaller APEC members are likely to be the main beneficiaries of their own liberalization. Substantial benefits remain available from increased access to the APEC market, even with Japan and the United States excluded, particularly because that market would still include—in the shape of China—a third, rapidly growing economic giant, with an enormous distance still to travel in its external liberalization efforts.

However, it must also be acknowledged that increased access to the Japanese and US markets, which together account for about three-quarters

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15. While this may have been one of the effects of the EVSL episode, it is not suggested that this was the only, or even a major factor, in the decision by Japan and Korea to begin negotiating preferential trade agreements. Japanese officials, for example, have indicated a number of factors behind this decision, including concern over Japan's possible "isolation" in the light of developments in Europe and the Western Hemisphere, and a desire to offset any trade-diversionary effects arising from these developments.

16. A sober assessment—particularly one made with the benefit of hindsight—might well suggest that it was always unrealistic to expect US and Japanese participation in concerted unilateral liberalization. Even if this is the case, however, this reality was largely overlooked in the initial euphoria following the Bogor Declaration. Assessments of the benefits of APEC concerted unilateral liberalization generally assumed full participation of all members. See Scollay and Gilbert (2000) for a survey of quantitative assessments.

of the APEC membership's GNP,<sup>17</sup> is likely to have been viewed by many other APEC members as a major component of the economic benefit potentially obtainable from their participation in APEC. Thus the apparent unwillingness of Japan and the United States to participate seriously in concerted unilateralism removes a major incentive for continued commitment to the APEC process. This may have been a factor spurring other members to explore alternative modalities for liberalization.

Perceptions arising from the EVSL experience of a lack of engagement by two of APEC's economic giants with the APEC liberalization process led some commentators to add one more reason to the many already identified for emphasizing the need for a successful new WTO round: Japan and the United States (and perhaps some other APEC members as well) might deliver their part of the APEC bargain through commitments made in the WTO rather than within the APEC process itself. Although the importance of a successful WTO round has not diminished, the Seattle debacle and its aftermath have at least postponed the prospect for the time being. Thus, although the Seattle failure may not have triggered the beginning of the search for new modalities of trade liberalization in the APEC region, it is certainly likely to have been a reinforcing factor.

Conversely, a crucial issue raised by the new proliferation of SRTA proposals in the Asia-Pacific region is their potential impact on support for and confidence in the WTO-based multilateral system, and the prospects for eventually launching the next round of WTO negotiations. A new development of this kind naturally fuels fears that the WTO-based system is being further undermined. On the other hand, if negative consequences from the new SRTA developments begin to become apparent, this may prompt fresh efforts to reinvigorate the WTO process.

The positions of Japan and the United States are central to the evolution of Asia-Pacific trading relationships. Their importance stems not only from their dominant share of the region's output, but also from the fact that they are both major trading partners of virtually every economy in the region. By contrast, the region's other economic giant, China, is at this stage less fully integrated into its trade. Although it is a formidable competitor in regional trade in a number of sectors, it accounts for a significantly smaller share than either Japan or the United States in the trade of most economies in the region, even when its share is aggregated with that of Hong Kong.<sup>18</sup> Its potential future importance is enormous,

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17. This figure is based on GNP as measured in official national accounts. When GNP is measured on a purchasing power parity basis, the United States and Japan together account for just over half the combined GNP of all APEC members; see table 2.5a.

18. Detailed information on trade shares can be found in tables 2.1-2.3 and 2.5, which are discussed in chapter 2.

however, given the size of its economy,<sup>19</sup> its rate of economic growth, and the fact that the liberalization of its trade is relatively less advanced than in most other countries of the region.

In the absence of a clear indication of the strategy of these leading economic powers, the new developments in the region appear to be moving in a number of different directions at once. However, it is likely that other countries in the region will quickly adapt their own strategies to any clear indication of strategy that emerges from China, Japan, and the United States. In the meantime, the lack of a clearly defined strategy from those countries, particularly from the United States,<sup>20</sup> remains a source of uncertainty over the future development of the region's trading relationships.

### **“Building Blocks” versus “Stumbling Blocks” Once Again**

The renewed emphasis on SRTAs in the APEC region raises anew the familiar argument about whether RTAs and SRTAs are “building blocks” or “stumbling blocks” in the process of achieving a more open international trading system, and ultimately global free trade—or, more precisely, about the conditions under which they may become building blocks or stumbling blocks in this process.<sup>21</sup> The issue derives from the discrimination between members and nonmembers that is inherent in the preferential nature of RTAs. As is well known, this means that RTAs can give rise to trade diversion as well as trade creation. It follows from this “second-best” property of RTAs that they may be either welfare enhancing or welfare reducing, depending on the relative magnitude of trade creation and trade diversion effects. The outcome can depend on both the economic characteristics of the countries forming the RTA or SRTA, and on the design of the agreement itself.

The formation of RTAs and SRTAs may thus not necessarily lead in the direction of the enhanced global welfare expected to follow from global liberalization; it is possible that global welfare may instead actually be reduced. This will happen most obviously where RTAs and SRTAs

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19. Measured by official statistics, China is the 3rd largest economy in APEC, accounting for 3.2 percent of world GNP in 1998. Measurement on a purchasing power parity basis provides a more striking indication of China's regional and global economic significance. On this basis, the Chinese economy has already surpassed that of Japan in size, accounting for 10.9 percent of world GNP, as against 8 percent for Japan; see table 2.5a for details.

20. Although the recent decisions to open discussions with Chile and Singapore might be taken as the first indications of an emerging US strategy, it remains to be seen whether the new presidential administration of George W. Bush will continue in the directions indicated.

21. See Krueger (1999) and Panagariya (1999) for fuller recent treatments of this issue.

reduce the welfare of both members and nonmembers, which may occur if they have strong trade-diverting effects that outweigh any trade-creation effects, or if they are not accompanied by MFN liberalization by their members. Conversely, RTA and SRTA formation will unambiguously enhance global welfare if the new arrangements lead to enhanced welfare for members while also raising—or at least not lowering—the welfare of nonmembers, through a combination of strong trade creation effects and ongoing implementation of MFN liberalization by members.

The emphasis on MFN liberalization by the members of RTAs and SRTAs reflects a plausible inference drawn from the Kemp-Wan theorem (Kemp and Wan 1976). This theorem highlights the point that the issue of whether an RTA has damaging economic effects on nonmembers is essentially a question of the level at which its external barriers are set.<sup>22</sup> Trade economists—bolstered by the theorem—typically conclude that to minimize trade diversion and avoid negative welfare effects, members of SRTAs should continue to liberalize on an MFN basis while they eliminate barriers between themselves.

Nonmembers may well be damaged, and global welfare reduced, even by RTAs and SRTAs that enhance the welfare of members. Furthermore, even if global welfare is enhanced, the welfare of nonmembers may still be reduced. One danger to the international trading system arises from the possibility that disadvantaged nonmembers may then be provoked to take retaliatory or defensive action, by raising their own barriers or by forming RTAs or SRTAs of their own.

This is a scenario that the GATT system was explicitly designed to avoid. It also illustrates the more general point that the overall implications of RTA and SRTA formation for the international trading system depend not only on the resulting welfare effects but also on the way in which they affect the incentives for subsequent behavior by both members and nonmembers. The two issues are obviously connected, because the behavior of members (e.g., whether they continue to pursue MFN liberalization following the establishment of an RTA or SRTA) will clearly influence the overall welfare effects of a given RTA, and because the subsequent behavior of both members and nonmembers will determine whether the ultimate objective of a more open international trading system, with its attendant welfare benefits, is promoted or undermined.

One key question, therefore, is whether RTA membership is likely to encourage or inhibit further MFN liberalization, on either a multilateral or unilateral basis. An interesting literature has developed on the issues

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22. Although it highlights the importance of external barriers, the Kemp-Wan theorem does not itself offer any specific guidance as to how the external barriers should be selected in particular cases. Strictly speaking, the Kemp-Wan theorem refers only to customs unions, not FTAs. Panagariya (1999) reports a generalization of the Kemp-Wan conclusions to cover FTAs.

involved in this question.<sup>23</sup> A conclusive answer to the question has yet to emerge, and may not in fact be attainable, because a number of different scenarios are possible, and the outcome will typically depend on the political process at work in each case. At this stage, it appears that plausible models and arguments can be developed to suggest an answer in either direction.

Another question is whether the progressive expansion and amalgamation of RTAs and SRTAs could provide a route to the ultimate achievement of global free trade, which would be the outcome if the process continued until all RTAs have converged into a single global arrangement. The answer to this question depends on the incentives facing both members and nonmembers. One possible rationale for such a process is provided by Baldwin's (1999) domino theory of regionalism, in which the ongoing development of a leading RTA or SRTA sets up pressures that eventually lead excluded trading partners of the members of that agreement to take steps to secure membership.

Whether the expansion proceeds, and how far the process continues, depends also on whether the members of the "leading" RTA have incentives to encourage or block entry of new members, as pointed out by Panagariya (1999), who also cites a number of studies suggesting that the incentive for members to block further entry is likely to become dominant before the "bloc-building" process culminates in global free trade.<sup>24</sup> This in turn suggests the possibility that—if the bloc-building process becomes established in more than one region of the global economy—its ultimate result might be not global free trade but a global economy dominated by a small number of "megablocs," such as the three-bloc world hypothesized by Krugman (1991) and others.

There can be no *a priori* guarantee that the steps involved in the creation of such megablocs would not reduce global welfare, nor that the megablocs, once established, would not behave in ways that also reduce global—and ultimately possibly also their own—welfare. Krugman's hypothesis about the welfare-minimizing properties of a three-bloc world is essentially based on the argument that such large blocs may face particularly strong incentives to aggressively pursue the enhancement of their own welfare at the expense of the other two blocs, potentially leading to destructive trade wars.<sup>25</sup>

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23. See Panagariya (1999) for an overview of this literature.

24. The incentive to encourage or block entry of new members could be assessed in terms of the effects on aggregate welfare, and this is the approach followed in this book. The studies cited by Panagariya (1999), however, also include cases in which incentives are assessed on the basis of political-economy considerations, e.g., effects on profits. These effects need not coincide with effects on aggregate welfare. This qualification needs to be kept in mind when following the relevant discussion in chapter 3.

25. Another disturbing possibility is that there may be a constant incentive for two of the blocs to coalesce against the third, leading to a potentially destructive cycle.

At the other end of the scale from the bloc-building tendency is the prospect of a proliferation of SRTAs, leading to fragmentation of the regional (or international) economy. A proliferation of SRTAs might also occur as a response to the establishment of an initially significant SRTA, as affected countries scramble to protect themselves by negotiating preferential agreements of their own. The fragmentation of the regional economy may intensify if the SRTAs begin to overlap, and if they each also adopt complex, mutually inconsistent rules of origin, so that a particular product may be imported into or exported from a given country under a range of different rules, and even tariffs,<sup>26</sup> depending on its origin or destination. This is the “spaghetti bowl” phenomenon described by Bhagwati, Greenaway, and Panagariya (1998).<sup>27</sup>

The trade liberalization objectives of APEC and the process agreed to achieve them were designed as an alternative both to the spaghetti bowl and to the creation of a new preferential megabloc. APEC’s inclusiveness toward the economies of the Asia-Pacific region<sup>28</sup> offers a sharp contrast to the spaghetti bowl possibility, and its version of the principle of open regionalism seeks to rule out the formation of a preferential trade bloc. Successful achievement of APEC’s goals on the basis of open regionalism would provide economic benefits to all its members while enhancing global welfare and encouraging movement toward the ultimate objective of global free trade. APEC, in other words, was intended to serve unambiguously as a building block in the process of establishing global free trade.

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26. Variation in tariffs is likely during the transitional phase, in which tariffs between members of each agreement are being phased out toward zero according to different timetables.

27. The spaghetti bowl and bloc-building phenomena may not necessarily be wholly unrelated to each other. It is interesting that, in Baldwin’s model, initial steps by nonmembers toward joining the leading agreement may take the form of a series of preferential trade arrangements. The resulting apparent proliferation of SRTAs masks the underlying tendency toward amalgamation. Although Baldwin’s model is designed to be directly applicable to the European situation, it is suggestive of possible ways in which developments in the Asia-Pacific region might be interpreted, perhaps using a modified version of the model. Another possibility is that recognition of the inefficiency of the spaghetti bowl may lead to proposals to merge its constituent SRTAs into a single larger bloc. From a somewhat different perspective, Ethier (1998) also argues that the spread of SRTAs may reflect efforts by smaller countries, particularly developing ones, to ally themselves with larger industrial countries, with the aim of attracting investment and “locking in” their own trade reforms.

28. This inclusiveness is not, of course, absolute; APEC is not open to all comers. Moratoriums on the expansion of membership have been applied periodically, including at the present time. Some economies conventionally regarded as in the Asia-Pacific region have been denied membership (e.g., Colombia and Ecuador), and others have not applied (e.g., the island nations of the Pacific, with the exception of Papua New Guinea, and also Cambodia and Laos). With these exceptions, however, APEC can fairly claim to cover the entire Asia-Pacific region as conventionally defined, and the question of admission of new members essentially involves decisions as to whether the notional boundaries of the region should be extended.

From an analytical perspective, a path leading through achievement of APEC goals as an intermediate step may not necessarily be the only possible, or even the optimal,<sup>29</sup> route to global free trade. Nevertheless, from a practical policy perspective, as long as the members remain committed to it, the APEC objective of free trade in the Asia-Pacific region provides a convenient reference point for assessing the new SRTAs. Thus, for them to qualify as building blocks of global free trade, it would be sufficient (even if not strictly necessary) for them to function as building blocks toward APEC's own free trade objective, as an intermediate step toward global free trade. A standard justification for taking this indirect route to APEC-wide and global free trade is that, at least in some areas, it may be possible to make faster progress toward liberalization through negotiations between smaller groups of neighboring or likeminded countries.<sup>30</sup>

Singapore's Prime Minister Goh has been a strong advocate of the view that the new SRTAs may be "building blocks" toward the achievement of APEC's free trade objective. In announcing the signing of the New Zealand-Singapore Closer Economic Partnership Agreement, for example, he referred to an "intention to spin a web of interlocking free trade agreements between APEC members, which could help move the organization toward achieving free trade in the Asia Pacific."<sup>31</sup>

If the new Asia-Pacific SRTAs are indeed to function as "building blocks" for APEC, we would expect in future to see them gradually converge toward the APEC free trade goals, through the dual processes of elimination of barriers between members and the ongoing reduction of barriers against nonmembers on an MFN basis. The barriers between members would of course come down faster, but the preferences thereby created would gradually disappear as MFN barriers also approached zero. Expansions and amalgamations of some SRTAs could and probably would occur as intermediate steps along the road to full APEC liberalization.

For these additional intermediate steps to qualify as building blocks, it would be desirable that they both enhance regional and global welfare as well as the welfare of their members, and also leave open incentives for further progress toward APEC's goals. This appears to be very much what APEC's Eminent Persons' Group (EPG) had in mind in 1995 when

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29. Frankel (1997) develops a model in which the requirement for regional initiatives to achieve complete elimination of trade barriers does not provide for an optimal path toward free trade. This optimal path will generally involve partial liberalization at the regional level.

30. Many commentators, including Bergsten (1991), have pointed out, however, that regional negotiations have not been noticeably more successful than multilateral negotiations in dealing with contentious or sensitive issues. The negotiated reciprocity of the WTO continues to be indispensable to achieving progress in many of these areas.

31. See report at <http://www.mfat.govt.nz/help/file/nzsincep.html>.

it recommended (EPG 1995)<sup>32</sup> that “subregional trading arrangements (SRTAs) within APEC should accelerate their liberalization and forge linkages among themselves” on the basis of the principles of WTO consistency, ongoing commitment to MFN tariff reduction, and open accession.

The preceding discussion has identified two criteria for assessing whether RTAs and SRTAs qualify as building blocks or stumbling blocks for a more open international trading system.<sup>33</sup> The first criterion is that they should enhance both the economic welfare of their members and global economic welfare, while avoiding negative effects on the welfare of nonmembers. RTAs and SRTAs that meet this criterion can be regarded as steps toward the attainment of the benefits attainable from global free trade. The second criterion is that they should leave open scope for—and also leave open or even create incentives for—the negotiation of further arrangements satisfying the first criterion, as well as for further progress toward global free trade via multilateral liberalization.

Satisfaction of one of these criteria does not automatically guarantee satisfaction of the other. In particular, the establishment of an RTA or SRTA with widespread or significant negative effects on the trading partners of its members might well in some cases create pressures leading to proposals for alternative arrangements with more favorable welfare effects. The alternatives might involve inclusion of the previously excluded partners. In other words, this is one of the circumstances in which Baldwin’s domino effect might operate. Several potential examples of this are identified in the discussion of the simulation results in chapter 3. Conversely, an arrangement meeting the first criterion might fail to satisfy the second. An example might be the creation of megablocs that meet the first criterion but fail to leave open sufficient incentives to take the final step to global free trade.<sup>34</sup>

The two criteria could be synthesized to produce a “strong” criterion for building blocks. This strong criterion would recognize the importance of maintaining or creating incentives for further liberalization, but would also recognize the desirability of taking an unambiguous step toward realizing the benefits of free trade. An arrangement that imposed negative welfare effects on nonmembers might lead not to the adoption of more satisfactory agreements but to retaliatory action, giving rise to a further

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32. The commissioning of the EPG to “review the relationships between APEC and the existing sub-regional arrangements” reflected concern felt within APEC at the time over the implications of SRTAs. Subsequently, concern over SRTAs appeared to evaporate, and the issue was not seriously addressed again within APEC until its 2000 meetings.

33. Additional arguments are identified and discussed, e.g., in Krueger (1999).

34. It must, however, be admitted that creation of a megabloc without significant negative effects on nonmembers does seem unlikely. Yet if the negative effects on nonmembers created pressures to move to global free trade, the second criterion would be satisfied (but not the first).

round of negative effects. This danger would not arise from an arrangement that did not damage the welfare of nonmembers, but such an arrangement might still leave open incentives for the subsequent development of arrangements with still more favorable welfare effects, or for moves toward multilateral free trade.

As noted above, APEC is an example of an arrangement whose design is consistent with this strong criterion and therefore has the potential to serve unambiguously as a building block, although APEC is not a preferential arrangement, and its practical effectiveness has yet to be convincingly demonstrated. Few if any preferential arrangements are likely to fully comply with the strong criterion, because they will generally involve at least some negative welfare effects on nonmembers. Preferential arrangements might therefore be evaluated according to how closely they approach the standard embodied in the strong criterion.

One point highlighted in the discussion above is that MFN tariff reductions by the members of preferential arrangements are crucial to minimizing or, preferably, eliminating negative effects on the welfare of nonmembers. This suggests the possibility that RTAs and SRTAs that might otherwise be stumbling blocks can instead become building blocks, if sufficient MFN liberalization is undertaken by their members. This avenue has not been explored in the simulations undertaken for this book, but it is the authors' intention to fill this gap in future work.

## **Trade Facilitation, Services Trade, and the “Stumbling Block” Issue**

Much analytical discussion of SRTAs, including this study, tends to proceed as if tariff liberalization is, if not the only, certainly by far the most significant element in SRTA initiatives. In fact, modern SRTAs typically cover a wide range of issues besides tariffs. Many include elements of services trade and investment liberalization, as well as a range of measures that are often lumped together under “trade facilitation.”<sup>35</sup> Trade facilitation may conventionally include any or all of the following: harmonization or mutual recognition of standards and conformance arrangements, streamlining and harmonization of customs and quarantine procedures, harmonization of aspects of business law, and harmonization of value-added tax rates. More ambitious definitions may include liberalization of government procurement, and even agreement to replace antidumping procedures by harmonized and integrated elements of competition law.<sup>36</sup>

Inclusion of a selection of these measures in an SRTA allows the partners to take the liberalization of their bilateral trade well beyond the provisions

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35. For a recent treatment of some of the issues briefly mentioned here, see Findlay (2001).

36. These elements of trade facilitation are found, e.g., in ANZCERTA.

of WTO rules. Rules of origin are also relevant in this context. Although these rules are not usually considered under trade facilitation, trade nevertheless can be facilitated or inhibited by adopting permissive or restrictive rules. The increasing prominence given to trade facilitation in turn reflects the growing recognition that measures of this kind can often have at least as powerful an effect as removing tariffs on stimulating trade between SRTA partners.<sup>37</sup>

Effective liberalization of services trade can also require a range of trade facilitation measures, together with investment liberalization. Liberalization in some services sectors may require the harmonization or mutual recognition of occupational qualifications and other standards. Full liberalization will also often require facilitation measures providing for short-term mobility of businesspersons, along with right of establishment (the latter in turn implying a significant degree of investment liberalization).

All these measures can stimulate increased trade and economic integration, but they can also be used to discriminate against nonmembers, much like preferential elimination of tariffs. Adopting a recognized international standard, for example, will tend to facilitate trade with all countries, whereas adopting a common standard peculiar to SRTA members will tend to encourage trade between the partners at the expense of trade with nonmembers. The approach taken to trade facilitation and services trade is therefore also relevant to whether a given SRTA qualifies as a building block or stumbling block.

This consideration becomes even more important with proliferating overlapping agreements, as now appear to be occurring in the Asia-Pacific region. Consistency between the provisions of the agreements then becomes a critical factor in their effectiveness and efficiency in stimulating trade. Inconsistent provisions may mean that businesses must comply with a range of requirements, depending on the SRTA partner in whose market they are trying to do business. Inconsistent rules of origin and tariff-phasing provisions may cause the same product to be subject to quite different treatment, depending on its origin or destination.

There may even be uncertainty as to which provision or rule applies in cases where the same pair of countries is simultaneously a member of more than one agreement. As noted above, phenomena of this nature have been dubbed the spaghetti bowl effect by Bhagwati, Greenaway, and Panagariya (1998), who have pointed out that under these conditions trade is more likely to be discouraged than facilitated, and is certainly likely to be subject to avoidable additional costs and other inefficiencies.

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37. The famous but controversial Cecchini Report projecting the effects of the European Union's Single Market program was the pioneering effort to demonstrate quantitatively the importance of trade-facilitation measures relative to tariff elimination. For a summary, see Emerson et al. (1988). APEC Economic Committee (1997) endeavors to evaluate the benefits of trade facilitation in the APEC context.

It seems reasonable to hypothesize that—within groups of countries that trade extensively with each other—spaghetti bowl effects are much more likely to be found in a proliferation of bilateral agreements than in more inclusive arrangements covering most or all of each group. Another reasonable hypothesis is that the trade-inhibiting effect of the spaghetti bowl might be especially strong in agreements covering relatively small trade flows; the smaller the potential for business, the less inclined businesses may feel to invest time and money in working their way through inconsistencies between different trade agreements.

These considerations suggest another potential negative effect of the proliferation of SRTAs in the Asia-Pacific region, and a corresponding advantage of larger blocs or inclusive groupings such as APEC, where consistent provisions and rules can be developed across a number of countries, covering a large share of each country's trade. Little attention appears to have been given to these issues in commentaries on the recent upsurge of regionalism in the Asia-Pacific region, but they are potentially very significant.

## Summary

The recent proliferation of SRTAs in the Asia-Pacific region represents a significant new departure in the approach to trade integration in the region. It is occurring at the same time as fresh interest is being shown in the formation of an East Asian economic bloc, which in some formulations might also function as a trade bloc. These developments raise questions of APEC's future role in the evolution of trade liberalization, and also raise familiar questions regarding the conditions under which RTAs and SRTAs may function as stumbling blocks or building blocks in establishing a more open regional and international trading environment. They also raise once again the specter of a possible three-bloc world. If the Free Trade Area of the Americas is implemented on schedule, the subsequent establishment of an East Asian trade bloc would be the final step in the emergence of this scenario.

Asia-Pacific trade relations appear to be at a point from which they could move in several different directions. Further proliferation of SRTAs, the gradual emergence of an East Asian trade bloc, and a renewed commitment to APEC (either in its present form or a new variation) are all possibilities. The ultimate choice of direction will be heavily influenced by the region's major economic powers, and will also have to take into account the potential emergence of a unified trade bloc in the western hemisphere.

This book aims to contribute to an evaluation of these potential developments—of their costs and benefits, their wider implications for regional trade relations, and the economic incentives they create for the region's economies to pursue trade liberalization strategies. Before we address these issues, however, chapter 2 provides background on regional trade flows.