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Toward Win-Win Regionalism in Asia: Issues and Challenges in Forming Efficient Trade Agreements

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Toward Win-Win Regionalism in Asia: Issues and Challenges in Forming Efficient Trade Agreements

by Michael G. Plummer

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Toward Win-Win Regionalism in Asia: Issues and Challenges in Forming Efficient Trade Agreements

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Abstract:
Many economists tend to be skeptical of the merits of Free-Trade Areas (FTAs) due to their second-best nature, while others support them under certain conditions, particularly as they allow for a more comprehensive treatment of trade- and investment-related issues than is currently possible under the 149-member WTO. This paper endeavors to bridge this analytical chasm by developing a blueprint for “first-best“ regionalism based on “best practices.“ It then applies the associated set of rules to existing FTAs in Asia (both intra- and extra-regional) to guage the degree to which they approach best practices. In summary, we find that most accords receive high marks in most areas, with the exception of “rules of origin“ and certain service sectors.

Toward Win-Win Regionalism in Asia: Issues and Challenges in Forming Efficient Trade Agreements

I. Introduction

The World Trade Organization (WTO) projected that at the end of 2005, regional trade agreements between WTO members would approach 300, up from 130 as of 1 January 1995.[1] Regionalism came late to Asia; apart from the ASEAN Free-Trade Area (AFTA) in 1992, no Asian country had a significant bilateral or plurilateral[2] accord in place prior to 2000, whereas today there exist at least a dozen major free-trade areas (FTAs) and many more in the works. Given the uncertain outcome of negotiations at the multilateral negotiations under the Doha Development Agenda, the regionalism movement currently constitutes the most significant trend in international commercial policy. Unlike multilateral liberalization, regionalism tends to be controversial in economic and policy circles for a variety of reasons, most of which are linked to the fact that preferential trading arrangements, such as FTAs and customs unions, are by their very nature, discriminatory. Why adopt "second-best" policies such as free-trade areas when the first-best policy can be obtained through multilateral negotiations? Others would argue that regionalism and multilateralism are consistent, even perhaps reinforcing. They cite the fact that the vast majority of regional trading arrangements have been negotiated over the past decade, when international trade and investment have boomed and globalization has intensified. This is not to say necessarily that regionalism caused this expansion in trade, but it does give prima facie evidence that they are compatible.

The disagreement among mainstream economists over this issue pertains to means rather than ends. Each school advocates global free trade (and investment) as an ultimate goal, but they differ in opinion as to whether or not regionalism is a stepping-stone or a bottleneck,. This split is arguably the first major policy difference that has emerged among international trade economists since the "new international economic order" debate of the 1960s.

Could there be a synthesis? Yes. In fact, the basic idea of "open regionalism," which emerged in the context of the Asia Pacific Economic Cooperation (APEC) forum, is explicitly to unite the region through nondiscriminatory means. The idea found its theoretical origin in the Kemp-Wan Existence Theorem (Kemp and Wan 1976), which stipulated the conditions of a Pareto-optimal customs union,—one in which all countries would be better off.[3] By liberalizing unilaterally—but in a concerted fashion among countries producing the majority of world output—"open regionalism" under APEC was advocated as a first-best approach to regionalism and became enshrined in APEC's "Bogor Vision" of open trade and investment in the region by 2010 (2020 for developing countries). However, while the economics of such an approach would be generally applauded by both the pro- and anti-regionalism camps, the politics were clearly second-best (at most): "value-added" in trade liberalization toward the Bogor goals has been marginal, and the first deadline is only 4 years away. The vagueness of the

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[1] WTO website, http://www.wto.org/english/tratop_e/region_e/region_e.htm, accessed 6 October 2006.

[2] Defined here as between one or more countries and one regional group, or between two regional groups.

[3] In short, this would be possible if the customs union were to (i) set the common external tariff such that trade with the outside world is not affected (thereby setting trade diversion to zero); (ii) impose free trade within the customs union, such that efficiency gains would be generated; and (iii) provide a compensation mechanism for any country that would be a net loser.

commitment (for example, what "open trade and investment" means, the question of whether or not "open regionalism" should be nonreciprocal for non-partners in order to reap the benefits), and its "voluntary" nature have taken away any political urgency. While the countdown to 2010 may create some momentum, the political obstacles will be daunting. Evidence of private sector disappointment with the lack of progress in meeting the Bogor goals is perhaps evidenced by the recent (January 2006) decision by the APEC Business Advisory Committee (ABAC) and the Pacific Economic Cooperation Council (PECC) to launch a study on the political economy of a Free Trade Area of the Asia Pacific (FTAAP), which would ostensibly be an extension of the "reciprocal open regionalism" option. Also, even in applying the APEC agenda, it has been difficult to avoid discriminatory components however unintended, for example, in terms of sector selection,[4] sequencing, and even institution building.

Instead bilateral and plurilateral accords ostensibly have emerged to fill the gap left by APEC in "uniting" the region. Practically all countries in Asia have at least one bilateral agreement in place—with more on the way—when very few had any before 2002, the exception being AFTA.[5] As will be noted below, Asia has been extremely active in cementing regional accords over the past 3 years, both with partner and non-partner countries.

In this paper we attempt to take stock of these new initiatives in the context of the "building blocs versus stumbling blocs" debate, evaluate them in terms of their meeting various efficiency-related and "openness" criteria (which we will argue is necessary for the accords to be consistent with WTO goals and economic efficiency), and suggest how the negative ramifications of these many accords—the "spaghetti bowl" effect—can be minimized. Given that regionalism will inevitably have "second best" aspects, our goal is to develop a concrete approach to "open regionalism" that can be used as a general best-practices guide to FTAs in Asia—one that approximates a first-best solution to the greatest extent possible in practical terms. It is hoped that such a guide will also be applicable to FTAs in other regions as well.

We approach this topic first by surveying the various bilateral and regional accords in Asia and their constituent parts (Section II). Section III develops a taxonomy of the problems that are associated with having such a wide variety of agreements, and what can be done to minimize them. This is followed in Section IV by an evaluation of existing accords in Asia with respect to how well they meet criteria associated with efficiency and "open regionalism," as well as their consistency with structural policy reform at the national level. Section V gives some concluding remarks and recommendations for future work. The rest of this Section I is devoted to setting the stage for the analysis of Asian regionalism in a global context. We begin with a brief review of the contemporary global trade framework in which the regionalism trend has developed, followed by an analysis of the difficulties involved in estimating the economic implications of global and regional integration in the context of developing countries.

a. The WTO, Doha, and the Regionalism Zeitgeist

Relative to previous negotiating rounds, Doha has been characterized by far greater participation of developing countries, raising expectations as to what they hope to receive from developed countries

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[4] For instance, the APEC Ministerial meeting in 1996 suggested the identification of sectors that might be slated for early liberalization in APEC, which was eventually to be known as "Early Voluntary Sectoral Liberalization" (EVSL). In 1997, they delineated 15 sectors for priority liberalization. However, in 1998 these negotiations broke down and the idea was shelved. In fact, economists tended to be skeptical of this approach, as the limited number of sectors and sequencing issues could have led to important negative effects on effective rates of protection and other potential (indirect) efficiency problems.

[5] Moreover, AFTA is far from complete: some exclusion lists are still in the process of being phased out, and the ASEAN Member Countries that acceded in the 1990s—Cambodia, Lao PDR, Myanmar, and Viet Nam (or CLMV)—will be fully integrated only in 2008 at the earliest.

in terms of liberalization of hitherto sacrosanct sectors—particularly labor-intensive products and agriculture, including market access but especially export subsidies—if the ambitious Doha agenda is to move forward. This has given the impression of "North-South" tension at this round of negotiations, something in evidence since the Seattle WTO Ministerial meeting in 1999. In reality the situation is far more complex. Developing countries have become more active at Doha because the vast majority of countries now embrace outward-oriented policies and they now count on the international marketplace for continued and enhanced growth and development. In the past, these countries were not active at GATT rounds, as they generally "free-rided" on commitments between developed countries from which they also received most-favored nation (MFN) benefits. The cost of this approach became evident in time; the sectors that were being liberalized were of principal interest to developed, rather than developing, countries. In order to include comparative-advantage sectors of the developing countries, a proactive stance at WTO was, of course, necessary. The G-20 group of developing countries[6] is one expression of this new approach. However, much of its agenda can be considered "global" rather than merely "North-South," as various developed countries can be listed among the supporters of many of their causes, and *vice versa*.

Disillusionment with progress at Doha may be one reason for the proliferation of regional agreements in Asia and the rest of the world, particularly accords between developed and developing countries. The ambitious agenda of Doha, from both developed- and developing-country viewpoints, could be more easily managed bilaterally or between a small group of countries than in an organization of 149 highly-divergent economies. Hence, it is no mystery as to why many of the new bilateral/plurilateral agreements are between developed and developing countries: what is needed to integrate global markets further, from nontariff barriers to non-border issues, may be too much to handle at the WTO. In some ways, the supposed "North-South" conflict at the WTO is really a sign of maturity. During 1950s–1970s, most trading arrangements were between countries at similar levels of economic development. North-South accords were mainly in the form of nonreciprocal preferences extended by developed countries to developing countries (through the Generalized System of Preferences, or GSP), association agreements, and/or extension of colonial preferences.[7] The North American Free Trade Area (NAFTA), which began implementation in 1994, was the first significant preferential trading arrangement between developed countries and a major developing economy. Since then, many such agreements have been negotiated and implemented. Indeed, most new agreements are between developed and developing countries or developing countries themselves.[8]

The WTO is cognizant of the regionalism trend and understands the problems that it could potentially entail for the global trading system. It is not in an easy situation; fundamentally it must see regionalism as a threat, but as almost all of its member-states are now part of the trend, it cannot seriously advocate setting back the clock. Thus, it has vowed to adopt policies that ensure that these agreements do not contradict its goal of open global trade and investment and keep regionalism as consistent with multilateralism as possible. Indeed, while Article XXIV of the GATT/WTO does put some restrictions on what can be done in regional trading agreements involving developed countries, these rules are broad, relatively vague, and loose, such that no major agreement has ever been vetoed by the GATT or WTO,

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[6] The G-20 actually has 21 members: five from Africa (Egypt, Nigeria, South Africa, Tanzania, and Zimbabwe), six from Asia (PRC, India, Indonesia, Pakistan, Philippines, and Thailand), and 10 from Latin America (Argentina, Bolivia, Brazil, Chile, Cuba, Guatemala, Mexico, Paraguay, Uruguay, and Venezuela).

[7] The EU generally grew out of the donor-recipient approach in its relationship with developing Asian countries, at least officially, with its 1994 paper on the "Partnership of Equals with Asia."

[8] This will also be true in the future, for the simple reason that developed (Organisation for Economic Co-operation and Development—OECD) countries are either already integrated through preferential trading arrangements (for example, the EU and the European Economic Area, the United States [US] and Canada) or are unlikely to reach any accords in the near future due to political and political-economy reasons (for example, a "Transatlantic Free Trade Area" and US-Japan free-trade area have been proposed at various times but have never been seriously negotiated due to various political-economy problems).

regardless of any infringements of limits spelled out in Article XXIV.[9] Besides, developing countries, by virtue of the "Enabling Clause," are not even bound by the mild exigencies of Article XXIV. [10]

The challenges of regionalism to the WTO are many, but two in particular stand out. First, the GATT/WTO was created with MFN treatment as its overriding principle, and Article XXIV was to be a conditional exception to this rule. With nearly 300 accords in place and every major economy participating in at least one FTA (and most in many), what happens when the exception becomes the rule? How valid is the coveted MFN, a birthright of WTO membership, when regional trading arrangements erode it and, in essence, force countries into regional trading arrangements to *get back* MFN status? Second, as we will argue below, regionalism is not necessarily in conflict with multilateralism, subject to the principle of openness and minimization of the inefficiencies and potential discrimination inherent in regional agreements. But if regionalism *is* taking the lead, the fundamental role of the WTO in the global economy would have to change, if it is not to be become redundant.

Recognizing these challenges, members of the WTO have been discussing the need to revamp the organization's policies toward regionalism. The 1994 Understanding on the Interpretation of Article XXIV of GATT was an attempt to enhance the compatibility of regionalism with multilateralism at a time when the regionalism trend was beginning to grow. It had several functions, including agreement to (i) reaffirm the requirement that regional groupings should not raise barriers to trade on nonmembers; (ii) define a "reasonable length of time" within which a regional agreement should be completed to be greater than 10 years "only in exceptional cases;" (iii) note that especially in the cases of difficult-to-quantify measures the GATT may find it necessary to consider "individual measures, regulations, products covered, and trade flows affected;" and (iv) underscore that the WTO dispute settlement provisions are relevant to any matters related to regionalism under Article XXIV ((Herzstein and Whitlock 2005, pp. 225–226).

Under the Doha Development Agenda, further revisions of interpretations of Article XXIV are slated to be an important area of focus. Recommendations as to how to improve Article XXIV are to be part of its "single undertaking," which was due to be completed by 1 January 2005 (but has obviously been delayed).[11] Stock-taking of progress in this regard was to be made at the WTO Ministerial in Cancun, Mexico in 2003, but Cancun ended without any agreement. In fact, it is not at all clear how the WTO should approach this issue, as the dimensions are many. As the WTO notes:

> WTO rules say regional trade agreements have to meet certain conditions. But interpreting the wording of these rules has proved controversial, and has been a central element in the work of the Regional Trade Agreements Committee. As a result, since 1995 the committee has failed to complete its assessments of whether individual trade agreements conform with WTO provisions.
>
> This is now an important challenge, particularly when nearly all member governments are parties to regional agreements, are negotiating them, or are considering negotiating them. In the Doha Declaration, members agreed to negotiate a solution, giving due regard to the role that these agreements can play in fostering development.

[9] For example, the EEC-EFTA Free Trade Area, created in the 1960s, included only manufactured goods, in clear violation of the "substantially all goods" principle in Article XXIV. The US-Canada Auto Pact of 1965 was restricted to one (albeit major) industrial sector.

[10] It will be argued that the flexibility allowed by the Enabling Clause has been detrimental to developing countries over the years, as it prompted a "piecemeal," positive-list approach that had little effect on trade and yet created distortions.

[11] As of June 2006, no formal Doha package had been forthcoming, despite the earlier self-imposed deadline of April 2006. At the December 2005 Hong Kong Ministerial, the WTO member-states committed themselves to an agreement with respect to regional trade agreements under the "rules" negotiations, but the goals were quite modest. In particular, the main objective was to inject greater "transparency" in bilateral and regional trading agreements. According to the WTO webpage as of May 2006 (www.wto.org), an agreement in this area was highly probable, but again, the focus would merely be on "transparency."

> The declaration mandates negotiations aimed at "*clarifying and improving disciplines and procedures under the existing WTO provisions* applying to regional trade agreements. The negotiations shall take into account the *developmental aspects of regional trade agreements*." (par 29, emphasis added).[12]

Two important issues are especially worthy of note here. First is the recognition that the current state of WTO provisions relative to regionalism are inadequate. Further, the Regional Trade Agreements Committee has not been able to accept (or reject) the proposition that current trade agreements conform with WTO provisions, no doubt due to the subjective nature of any such assessment (and political resistence against criticism by some of the contracting parties). Second, there is a clear emphasis on assessing the implications of these regional trade agreements for developing countries, which would only seem natural under the Doha *Development* Agenda.

Below, we give a critique of the existing *academic* literature focused on regional trading agreements, and consider what special significance they may have for developing countries.

b. Problems with Economic Models of Contemporary Trade Agreements

Most of the policy-related literature dealing with various aspects of global economic integration developed over the past half-century has focused on the tariff-liberalization aspects of commercial policy reform, rather than nontariff, non-border, and dynamic effects. This is true of both theoretical and empirical models, with the possible exception of certain *ex-post* empirical approaches.[13] Such a bias was arguably more relevant at a time when tariffs constituted the main weapons of commercial policy. However, this is no longer the case; contemporary trade negotiations at all levels are often dominated by nontariff and behind-the-border issues. Given the complicated nature of modern trade and the activities of multinational corporations, this is an important shortcoming, especially since economists agree that these latter effects are far more influential on future growth than mere tariff liberalization could possibly be. Today, average tariff levels in the largest economies have fallen considerably. Average tariffs in EU, Japan, and US are currently below 5%. True, there are tariff peaks, and liberalization within the context of a formal regional accord could have important sector effects. Still, when policymakers look to models for guidance as to what effects a trade pact will have, they usually focus on aggregate effects. And these are inevitably going to be small. Therefore, empirical models of modern trade liberalization could seriously underestimate the benefits of economic integration if they exclude these areas.

Of course, it is extremely difficult to model and measure accurately nontariff, non-border/policy-related, and dynamic effects of economic integration, which is obviously why so few empirical models include them (we review certain exceptions later). But their exclusion may in fact be misleading in ways that could be detrimental to policymaking, including during negotiations for regional and bilateral FTAs. An example might illustrate the point. In one fairly-frequently cited study using a standard applied Computation General Equilibrium (CGE) model, Gilbert (2003) estimates that a US-Malaysia Free-Trade Area would generate an increase in welfare (estimated using the equivalent variation technique) of $392 million (0.03% of GDP) and $248 million (0.46% of GDP) in the US and Malaysian economies, respectively. If these were, indeed, the excepted results, why would either country bother to push for

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[12] WTO homepage, http://www.wto.org/english/tratop_e/dda_e/dohaexplained_e.htm#regional, cited 11 September 2005.

[13] For example, the most popular, traditional technique is the applied Computational General Equilibrium (CGE) approach, discussed below, which is mainly (though not always) exclusively tariff- and tariff-equivalent nontariff-barrier driven and ex ante in nature. However, as is discussed below, dynamic features have been included in CGE models and they do incorporate certain ex post elements, such as calculating potential productivity spillovers. Certain applications of econometric gravity models and "import growth approaches" do include (implicitly) nontariff/non-border effects (see Kreinin and Plummer 2002). Nevertheless, as these are not structural models, the nontariff/non-border effects are generally intractable.

an FTA? The answer, of course, lies in the nontariff and non-border issues that the US would like to put on the table, and the potential dynamic effects and structural change that Malaysia would like to see. But these effects are completely excluded from the formal analysis. Hence, the accord may be important to both, while the numbers would suggest otherwise. Moreover, Scollay and Gilbert (2002), using the same type of standard Global Trade Analysis Project (GTAP)-based CGE model, estimate that complete *global free trade* would generate an increase in GDP in Indonesia by a one-time 1.31%, hardly politically attractive to policymakers who would have to move the sky and earth to arrive at free trade. In sum, rather than making the case for free trade (or FTAs), these models risk doing the opposite.

In addition, most of this economic literature on regionalism has been developed for—and generally applied to—developed countries. The same positive and normative analysis that derives from that literature generally applies to developing countries as well. But the exclusion of dynamic and non-border effects in particular could be more problematic in the case of developing countries. For example, in addition to the standard allocative effects of regional integration, key areas that are less relevant to developed countries but could be extremely important to developing countries include the following:

1. Macroeconomic Stability. There is general consensus in economics that macroeconomic stability is critical to the continued success of any development strategy. Even short-term bouts of instability can haunt an economy for many years to come; Latin America's long struggle with inflation is only now beginning to be won, and this has been accomplished with considerable economic cost (through unemployment and foregone output) and social tension. Promoting macroeconomic stability tends to be difficult in developing countries, and external means to support this process are often a necessary part of the stabilization process.

In particular, exchange-rate stability is a vital area for the smooth functioning of an economy, particularly in the tradable sector. Developing countries tend to rely on variations of fixed exchange-rate regimes for a number of reasons, including vulnerability to inflation. What became clear during the Asian financial crisis is that the internationalization of these economies, though having many benefits, also expose them more to "external shocks" originating abroad (particularly for countries with fixed-exchange rates). Combined with growing intraregional interdependence, as well as the perception that Asia is increasingly performing as a group,[14] suggest that there exist strong policy externalities in the region. That is, macroeconomic instability created, say, by an asset bubble in one market, could have an important effect on the other markets. Hence, closer integration at the real and policy levels imply the need for greater cooperation at the macroeconomic level as well.

Preferential trading arrangements can help encourage macroeconomic stability in a number of ways. In particular, real-financial links endemic to preferential trading agreements require stable macroeconomic policies if the agreement is to function smoothly. In order to ensure a stable partnership, countries must share information, cooperate in advocating stable fiscal and monetary policies, and engage in strong "peer pressure" against unstable policies. In advanced ("modern") regional agreements, countries find that they must focus on nontraditional areas affecting trade and investment if they are to advance economic integration, including competition policy and government procurement. These "non-border" measures force a stronger market orientation, inject greater microeconomic competition by reducing the power of domestic monopolies and "rent seeking," and put constraints on government spending through, say, the abolition of export subsidies and restrictions on industrial policies. Thus, such "forced macroeconomic stability" could be highly beneficial to the economic development strategies of participating countries.

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[14] For example, as ASEAN cooperation deepens, markets begin to view it as one entity. Besides, business cycles in the ASEAN countries have become more correlated (see, for example, Bayoumi and Eichengreen 1999 and Kim, Kose, and Plummer 2003).

Box 1: Examples of Dynamic Modeling in Computation General Equilibrium (CGE) Models

Empirical evidence shows that an outward-oriented regime is the most effective development strategy. This result emanates not only from the static (allocative) effects of international policy change in the direction of liberalization, but especially from dynamics spillovers of closer economic interaction with the global economy through increased trade and investment. Static changes in international prices generate a one-time shock to resource allocation. But if trade is linked to changes in productivity, far greater gains can be realized.

Through the importation of capital equipment, countries are able to gain from "embodied" technological progress. As developing countries do most of their trade with developed countries, spillovers can be large, albeit a function of the type of inputs, specific industry, and the ability of the country to absorb new technologies. Moreover, with respect to exports, firms have an increased incentive to adopt new technologies because of the marginal increases in the profitability of such investments (Pissarides 1997). A related effect is that freer international markets force exporting firms to become more efficient as they face greater competition. As noted by Dollar (1992; pp. 523– 524), "Outward orientation also generally results in more rapid growth of exports, and there may be externalities associated with exporting that cause open economies to grow more rapidly over long periods of time. There is considerable evidence that the process of exporting, combined with easy availability of imported inputs and machinery, accelerates technological advance in developing countries." The importance of trade-productivity links is being increasingly appreciated in the endogenous growth literature (see, for example, Grossman and Helpman 1993).

One of the more ambitious models in this regard is that of Lewis, Robinson, and Wang (1995), who assess the implications of an Asia-Pacific wide free-trade area, including estimates with and without trade-productivity links.[15] These links take three forms: (i) sectoral productivity links to imports of capital goods, with the productivity link determined by (fixed) intermediate inputs; (ii) an externality associated with sectoral export growth; and (iii) an aggregate productivity effect in which exports increase productivity of the capital stock. Hence, any policy shock that affects trade will also affect total factor productivity. These links are embodied in the following three equations (we drop country-based script for simplicity):

(1) Imported-input Link: $IMi = (TOTMt/TOTM0)^{\eta m} * ai + (1-ai)$

(2) Sectoral Export Link: $SEi = (Ei,t/Ei,0)^{\eta e}$

(3) Aggregate Export Link: $AE= (TOTEt/TOTE0)^{\eta}$

where ai is the share of intermediate inputs in production; ηm, ηe, and η correspond to the relevant "productivity elasticities", E and M refer to exports and imports, respectively; and subscripts t and 0 represent the experiment and base periods, respectively. For the productivity-linked simulations, Equations 1-3 are fed into sector production functions and the aggregate capital stock according to Equations 4 and 5, respectively:

(4) Sectoral Production Function: $Xi = IMi * SEi [\Sigma f \alpha i,f Fi,f -\gamma i,f] -1/\gamma i,f$

(5) Aggregate Capital Stock: $FSt = FS0 * AE$

where Fi,f, Xi, and FS denote sectoral factor inputs, sectoral output, and the economy-wide capital stock, respectively. Hence, it is apparent from Equation 5 that the externality associated with aggregate exports is "embodied" as an increase in the base-period capital stock.

While in all simulations Lewis, et al estimate fairly small gains from an Asia-Pacific free-trade area, the productivity-linked results tend to be much higher than the de-linked simulations, especially for developing countries (for example, productivity links increase the gains by over eight-fold in the case of the resource-rich ASEAN countries, whereas Japan and Asia's newly industrialized countries (NIEs) experience less than doubling of their gains).

For foreign direct investment (FDI), existing CGE models that attempt to include foreign investment do so by fashioning it as an additional factor of production responding to relative changes in rates of return, either between countries or between countries and sectors. Brown (1994) uses an imperfect competition model with investment flows in which returns to both labor and capital can change in the same direction with an economic policy shock. Hence, a labor-abundant country applying a tariff in a differentiated-products model generates an increase in the rate of return to both scarce and abundant factors of production (this is contrary to the Stolper-Samuelson prediction). Inflow of capital to this country could render it more similar to its trading partner in terms of relative factor abundance, suggesting that factor flows and trade may become complementary. A tariff will attract capital flows, but it will actually harm the tariff-imposing country, as the repatriation of profits forces deterioration in the terms of trade. The investing country actually gains.

This result follows from the fact that growth is not endogenous in the model so the rise in capital flows does not create a new steady-state growth path for the economy, from which the tariff-imposing country could gain. Baldwin and Seghezza (1996b) incorporate an endogenous growth in their analysis. In a static (competitive) model with foreign investment, an increase in tariffs on capital-intensive goods in a labor abundant country will raise the return to capital. This leads to a "trade-induced, investment-led" permanent shock to steady-state growth, which would generate support for the import-substitution paradigm for developing countries. However, given the abundance of stylized facts contradicting this approach, alternative variants yield conflicting results.

Policymakers and academics agree that FDI is instrumental in boosting the economic development process by fostering human capital development, introducing new management systems, bringing in "embodied" technologies, providing ready-made

[15] Lewis, et al base their model on information available through GTAP, with the exception of additional information on factor inputs and supplementary information on nontariff barriers in Japan. Their model is benchmarked to 1992 data.

external markets, and other positive influences. One such model, developed by Haddad and Harrison (1993), uses panel data for Morocco's manufacturing sector to check for positive FDI spillovers. Foreign firms are found to exhibit higher levels of total factor productivity than domestic firms, but a slower rate of productivity growth. Their study offers insight into how one might go about modeling the effects of FDI.

First, in order to gauge the importance of foreign presence for productivity, they estimate the following general form equation:

(6) uij = f (FDI_Firmij, FDI_Sectorj, SIZEij),

where uij denotes productivity of firm in sector j; FDI_Firmij refers to the share of foreign assets in firm i in sector j; FDI_Sectorj is the importance of FDI in sector j; and SIZEij is a measure of the size of the firm. Positive estimated coefficients for FDI_Firmij suggest that joint ventures exhibit less deviation from best practice relative to domestic firms, and the same results for SIZEij suggests that larger firms achieve higher levels of productivity. Finally, a positive coefficient of the sector variable suggests that a larger foreign presence in the sector corresponds to higher levels of productivity, for example, because of greater competition. Haddad and Harrison (1994) estimate positive (and statistically significant) signs for each of these variables.

Next, they use an aggregate production function to gauge the implications of foreign investment for productivity growth:

(7) d log Yijt = a FDI_Firmijt+ b FDI_Sectorjt+ c Cj + d Dj + al d log Lijt + ak d logKijt,

where Cj and Dj are sector and time binary variables, respectively. Productivity growth varies across sectors and time, as well as being a function of the level of foreign investment in firms and sectors. Statistical results from estimation of Equation 7 are poor; the independent variables explain only about 40% of the variance in output, and the FDI variables are each statistically insignificant. The coefficient on foreign investment at the firm level is negative but statistically insignificant.

Finally, led in part by the seminal work of Paul Romer (1986), there has been a resurgence of interest in economic growth theory, especially in endogenous growth models. Endogenous growth theory lends itself to the type of analysis put forth in CGE models. The links between trade- and FDI-related productivity growth were examined above; but applications of endogenous growth theory would provide a better idea of how to link productivity changes to economic growth over time.

Recognizing the importance but great difficulties associated with incorporating endogenous growth into CGE models, Kehoe (1992) notes that differences in capital/labor ratios cannot explain large differences in output per worker, say, between Canada, Mexico, and US. In trying to explain these differences, he develops a model

in which learning by doing (through increases in specialization in manufacturing) influences growth of output-per-worker, as does the ability to trade in specialized products. In the endogenous growth tradition, he develops and estimates a model of the following form:

(8) gj=α + β1logYj + β2log(Xj1/Xj)2 + β3log GLj + β4logyj + β5PRIMj + ej,

where gj is average annual growth of manufacturing output per worker; Yj is base-period manufacturing output; the sum over all (Xj1/Xj)2 is a specialization index (he uses exports at the 3-digit SITC level; this is the proxy for "learning by doing" through specialization); GLj is the Grubel-Lloyd index of intra-industry trade (proxying the ability of a country to trade in highly-differentiated products); and yj and PRIMj are base-period per capita income and primary-school enrolment rates, respectively (each a typical explanatory variable in endogenous growth models). Results from a cross-section of countries over the period 1970–1985 period yields statistically-significant and expected signs for all estimated coefficients. The size of β3 is high and lead Kehoe to conclude that Mexico could increase its growth in output per worker by 1.656% annually through greater specialization. He then calculates that after 25 years Mexico's output per worker would be over 50% higher than otherwise would have been the case.

2. Technology Transfer and FDI. The link between FDI and technology transfer has been firmly established (see Box 1 for a formal example of this link). It is one of the primary reasons why countries in Asia and elsewhere have consistently sought ways to lure FDI inflows—including through unilateral and concerted trade liberalization. Regional integration is one means to attract such long-term investment flows by creating a more integrated marketplace within which multinationals can exploit product-level economies of scale and enjoy a regional division of labor with low transactions costs. It is often said that AFTA itself is more of an investment agreement than a trade agreement, in that it is designed to enhance inward FDI more than intraregional trade flows. The Asian Development Bank Institute (ADBI) Executive Summary Series No. S58/52 (ADBI 2002) identifies FDI as a prominent motivation for FTAs, noting that it constitutes a key "dynamic effect."

> In the implementation of regional integration agreements, large locational advantages and environmental change could result in substantial impacts on the regional distribution of FDIs. In particular, technological change and other efficiencies should strengthen the positive linkages between regional agreements and intraregional FDI flows. (p.1)

The relationship between trade and technology transfer (also see Box 1) is less well known than that of FDI and technology transfer, or at least less well appreciated. Through trade liberalization, countries are also able to stimulate technological development. For example, trade leads to the adaptations of new technologies from abroad by increasing the potential for success in using these technologies to crack foreign markets; in addition, increased competition forces domestic firms to place a higher priority on creating their own or importing new technologies (Pissarides 1997). This implies a strong incentive for developing countries emphasizing technology transfer (such as ASEAN) to liberalize even unilaterally.

Mai (et al) estimate the potential effects of an Australia-PRC FTA, combining both ex ante (liberalization of trade in goods and services) and FDI, in which changes in FDI and its implications on productivity are in part derived from ex post estimates using PRC data. Relative to a "business as usual" benchmark, the study estimates an increase in GDP of 3.3% and 6.7% for Australia and the PRC, respectively. These are obviously not large results but are impressive if one considers the sectoral trading patterns of the two countries and the relative size of their bilateral trade and investment.

Moreover, to best take advantage of these new technologies, countries find that they must establish strong intellectual property protection laws and the means to enforce them. Without an attractive, protective environment in which multinationals can operate and in which domestic firms can invest in new innovations, the process of technology transfer is significantly inhibited. Formal free-trade areas can help in creating a strong underlying framework for the protection of intellectual property and "peer pressure" in the implementation of associated laws.

When developing countries team up with developed countries in an FTA, they are also specifically able to encourage technology transfer, either through internal promotional means (in terms of training facilities, regional research and academic institutes, and research consortia for example) or in jointly devising means to bring in appropriate technologies from abroad. The US-Singapore FTA, for example, tries to remove barriers to greater cooperation in higher education and the establishment of foreign universities.

3. Structural Policy Change and Reform. Related to points 1 and 2 above are various reforms in developing countries that are not directly pertinent to trade or even investment/financial flows per se, but are essential to the modernization and competitiveness of an economic system. While often advocated by economists and technocrats, these reforms often do not find special interest groups within the body politic that are able to push them. And as they tend to be controversial (with clear losers), they are difficult to promote, even if the economic gains from increased competitiveness are clear. Examples include the need for better laws related to corporate (and public) governance; competitions policy, including reform of state-owned enterprises, financial and other services; and other "sensitive sectors" with important links to the rest of the economy.

Regional integration can help promote reforms in these areas by providing the rigor of a formal accord. Because developing countries need these reforms more than most developed countries, regional integration can therefore generate greater gains. For example, the creation of the European Economic Community (EEC) and the US-Canada Free Trade Area arguably made relatively little progress in promoting structural reforms, as these agreements were between developed countries. However, when the EEC took on Greece, Portugal, and Spain in the 1980s, these countries—which were really "newly industrialized" rather than developed—made significant gains in terms of structural reforms, leading to greater competitiveness and productivity (outside agriculture, in any case). The same can be said of Mexico in NAFTA; while it has a long way to go before becoming a truly "developed" economy, Mexico has made great progress in providing a more stable economic framework, modernizing and liberalizing previously undeveloped sectors (such as financial services, which now has significant foreign penetration), and increasing productivity.

This eventual necessity of "teeth" in formal regional accords will be difficult in the Asian context, which has demonstrated a revealed preference for loose, informal accords. However, progress in this area will be essential to promote "deep" integration. As will be discussed at length below, developing Asian countries are being forced to accept "hard" formal bilateral OECD-country accords anyway. In partial recognition of this exigency, ASEAN itself is moving in the direction of greater formality, including the

Kuala Lumpur Declaration on the ASEAN Charter (12 December 2005), which articulates the desire of ASEAN Member Countries to make ASEAN a legal entity and support its institutional framework.[16]

4. Harmonization Issues. The largest effects of the Single Market program in the EU were gauged to be in many of the "non-border areas" mentioned above, but, perhaps one of the most important areas of cooperation can be classified under the rubric of "harmonization issues," such as product testing, professional certification, standards conformance, customs and transit, and so forth. Gains in all of these areas would be maximized by adopting global harmonization standards. Nevertheless, doing so at the global level is much more difficult, particularly for developing countries, which often feel threatened by such programs. By conforming as a group to some global standards, the agreement clearly reinforces the global system. But even when they do not, such agreements will reduce the "stock of divergencies," making global agreements that much more feasible.

5. Political-Economy and Policy Issues. Most existing preferential trading arrangements were either created as economic arrangements in support of political goals or at least were consistent with the diplomatic strategy of the founding countries. Economic cooperation in these arrangements is seen as an important vehicle through which political goals can be pursued (which in themselves have important economic ramifications). The EU has been effective in using preferential trading arrangements as diplomatic tools over the past 40 years, in part out of necessity: commercial policy was the only unified policy at the regional level (Messerlin 2001).

To the extent that these regional accords add to the political stability of the region, they do service to economic development in general and the goal of policy reform in particular, even if they are gener ally weak in substance. This, of course, is an important part of the early success story of ASEAN. Although most ASEAN countries had only recently achieved independence and were struggling to create nation states (complete with resolving territorial disputes), the arrangement established an important dialogue process that prevented overt hostilities to break out. To say that the (intentionally) weak economic cooperation initiatives in ASEAN had nothing to do with the subsequent dynamic growth in the region is to seriously understate its role.[17]

Today, Asia is developing its own identity in terms of strategic economic policy and diplomatic relations. It is unwise to compare the emerging reality of economic cooperation in Asia with the process in Europe: Asia today is in a far different subjective historical context. However, Europe has always provided an "economic cooperation guide" to ASEAN and Asia in general. Asian countries have (wisely) not copied the European experience, but rather have adapted it within their own special context and at their own pace. But the pace is quickening; as we will note at length below, regional accords in Asia have been booming in terms of numbers and membership ("horizontal integration") as well as in terms of product, sector, and policy coverage. The decision to create an "ASEAN Economic Community" (AEC) by the ASEAN leaders was a conscious attempt to signal the fact that ASEAN intended to pursue a single market along the lines of the EU, albeit with ASEAN characteristics. For example, while

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[16] The Declaration states that: "The ASEAN Charter will codify all ASEAN norms, rules, and values and reaffirm that ASEAN agreements signed and other instruments adopted before the establishment of the ASEAN Charter shall continue to apply and be legally binding where appropriate.....The ASEAN Charter will reaffirm principles, goals and ideals contained in ASEAN's milestone agreements, in particular the ASEAN Declaration (1967), the Treaty of Amity and Cooperation in Southeast Asia (1976), the Treaty on Southeast Asia Nuclear Weapon Free Zone (1995), the ASEAN Vision 2020 (1997) and the Declaration of ASEAN Concord II (2003) as well as the principles of inter-state relations in accordance with the UN Charter and established international law that promote and protect ASEAN community interests as well as inter-state relations and the national interests of the individual ASEAN Member Countries... the ASEAN Charter will confer a legal personality to ASEAN and determine the functions, develop areas of competence of key ASEAN bodies and their relationship with one another in the overall ASEAN structure." http://www.aseansec.org/18030.htm.

[17] Naya and Plummer (1991).

the Single Market in Europe set out to create a common market in which goods, services, capital, and labor would flow, the AEC's goals are less ambitious; especially with respect to the free flow of labor (even the most ambitious proposals exclude unskilled labor).

In sum, while regionalism is a second-best policy, there is reason to believe that bilateral and plurilateral accords could potentially generate far greater gains than standard models would suggest, given the critical importance of dynamic and non-border/policy changes that are inherent in such accords. Moreover, developing countries in Asia stand to gain relatively more from these "deep" policies than developed countries, provided that the region's FTAs are open; trade creating rather than trade diverting (the regional division of labor that emerges from the accord is consistent with comparative advantage); and other regulatory and non-border conditions, discussed below, are met.

II. Bilateral and Regional Accords in Asia

a. **A Brief Review of Economic Integration in Asia**

There have been many excellent surveys of regional economic integration in Asia (for example, Kawai 2005, Naya 2002, ADB 2002). Hence, we give a brief review of the evolution of regional accords in Asia, leaving more detailed reviews to these authoritative sources. We will instead concentrate on the analysis of the components of existing accords in the next subsection.

We might begin by considering what lies behind the contemporary regionalism trend in East Asia, which has been by far the most active area in Asia and the Pacific. We do not include in this survey economic cooperation among the Pacific Islands, which tends to be a very special case of regional cooperation (for analysis of Pacific economic cooperation and recommendations for the future, see the October 2005 Asian Development Bank/Commonwealth Secretariat Joint Report to the Pacific Islands Forum Secretariat, Towards a New Pacific Regionalism), but we do consider South Asia and Central Asia.

Briefly, we would first suggest several factors influencing the regionalism trend in East Asia that stem directly from the Asian financial crisis, including: (i) the obvious contagion relationships, which demonstrated the policy externalities across countries in ASEAN and the NIEs; (ii) major disappointment with respect to the US reaction to the crisis, leaving the feeling of "being in it alone together," (iii) disappointing progress in APEC in achieving closer trade and financial cooperation, as well as development assistance cooperation ("ECOTECH"); (iv) Japan's offer to create an Asian Monetary Fund during the crisis—opposed by the IMF and the US—gave the impression that Japan wanted to be proactive in the region; (v) arguably, the PRC decision not to devalue during this period also created a sense of solidarity; (vi) the "New Miyazawa Plan," launched in October 1998 which dedicated $30 billion to help spur recovery in East Asia (and deemed highly successful),[18] and (vii) the policies promulgated by the IMF to solve the crisis were deemed inappropriate, giving greater credibility to the "Asian approach."

Hence, the crisis itself set the stage for serious and durable East Asian regionalism. There are many other internal and external forces at work that have expedited the process, such as the rise of regionalism globally and its potential negative effects on the region; the successful example of the Single Market Program in Europe and, eventually, monetary union; general pessimism regarding what can be achieved at the WTO in light of failure to move forward at the Seattle and Cancun WTO Ministerials; and the potential inherent benefits of FTAs.

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[18] Kawai (2005).

Table 1 gives a chronology of arguably the most important Asian initiatives in terms of preferential trading arrangements,[19] financial cooperation, and plans for widening and deepening economic integration. ASEAN economic cooperation features as the most prominent of the regional accords, constituting by far the most important initiatives prior to the Asian crisis, but East-Asia-wide initiatives, such as the "ASEAN Plus Three" (ASEAN+3) accords, are taking on greater importance over time.

Despite the many early agreements in ASEAN's history that were mainly political and token in nature,[20] its first major initiative was AFTA (1992). With the exception of the Japan-Singapore FTA ("Japan-Singapore Economic Partnership Agreement", or JSEPA), which began implementation over 10 years later, AFTA is the only example of cooperation in Asia that is similar in concept to NAFTA. However, in true ASEAN fashion, rather than overly commit to regional integration in sensitive areas, the specifics of AFTA were purposefully left somewhat ambiguous, with the agreement basically committing the ASEAN members to free trade in a 15-year timeframe. Also, the definition of "free trade" was somewhat loose, as it included tariffs in the range of 0–5%, rather than the traditional 0%t.[21] After the original agreement, ASEAN broadened the scope of goods covered by AFTA and the period of implementation shortened such that AFTA was technically in full effect at the beginning of 2004 for the original five ASEAN countries and Brunei Darussalam, though there are transitional periods for products on the temporary exclusion lists (for example, sensitive products such as rice and automobiles in some cases) and some country-specific implementation problems in certain areas. The original target for full implementation was 2006 for Viet Nam, 2008 for Lao PDR and Myanmar, and 2010 for Cambodia. Recently, ASEAN decided to speed up the process to complete AFTA fully in 2007. ASEAN has also made important strides in investment cooperation—in the form of ASEAN "one-stop investment centers" and the ASEAN Investment Area (AIA).[22] These efforts at industrial cooperation have been designed with essentially the same goal in mind as AFTA: reduce transactions costs associated with intraregional economic interaction.

In November 2002, the ASEAN Heads of Government—meeting in Phnom Penh—proposed that the region should consider the possible creation of an "ASEAN Economic Community" (AEC) by 2020. At the 11th ASEAN Summit in Kuala Lumpur, December 2005, ASEAN leaders discussed the possibility of expediting the AEC process, to complete it in 2015 (with flexibility for new member countries).

The name of the AEC is significant, for an "Economic Community" brings to mind the European experience. In fact, when APEC was "re-inventing" itself, it was proposed that the words behind the acronym for "Asia-Pacific Economic Cooperation" should be replaced with "Asia-Pacific Economic Community." This idea was rejected explicitly because it would give the impression that APEC was intending to move in the direction of the EC model, which was thought to be too controversial. The ASEAN leaders actually agreed, at the Bali ASEAN Summit in October 2003, to create a region in which goods, services, capital, and skilled labor would flow freely, though the details remain to be worked out.

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[19] This review is based in part on material in Naya and Plummer (2005).

[20] For example, the Preferential Trading Agreement (PTA), was a positive-list approach to trade liberalization with small margins of preference and limited product coverage, expanded somewhat during the 1980s, but with no real impact on trade. Industrial cooperation, such as the ASEAN Industrial Project (AIP) system, never really got off the ground.

[21] In fact, this range of tariffs probably contradicts the requirements spelled out in Article XXIV of the GATT/WTO, but, as was noted earlier, ASEAN benefits from the Enabling Clause, which has always freed it from these constraints.

[22] A salient component of the AIA is the ASEAN Industrial Cooperation (AICO) Scheme, which offers more in terms of tariff (0–5%) and nontariff incentives than the traditional industrial cooperation programs. Moreover, the ASEAN countries created the ASEAN Agreement for the Promotion and Protection of Investments (September 1996), which includes simplification of investment procedures and approval processes, as well as enhanced transparency and predictability of FDI laws.

The reasons behind the decision to create the AEC are many, including the (i) desire to create a comprehensive post-AFTA agenda; (ii) a perceived need to deepen economic integration in ASEAN in light of the new international commercial environment, especially the dominance of FTAs; (iii) given (ii), the possibility that bilateral FTAs could actually jeopardize ASEAN integration as all member-states are free to pursue their own commercial-policy agenda; and (iv) the recognition since the Asian financial crisis that cooperation in the real and financial sectors must be extended concomitantly, and that free flows of skilled labor will be necessary to do this.[23]

The effective design and implementation of the AEC pose major challenges to ASEAN. While the European experience would suggest that considerable gains can be made from the creation of a single market,[24] the diversity and level of economic development of the ASEAN members render even the creation of a customs union—an essential feature of any single market—extremely complex, at least in terms of political-economy-related issues. For example, most transitional ASEAN members continue to have relatively protected markets, whereas Singapore is the one of the most open economies in the world, having an average tariff of essentially zero.[25] How can one erect an ASEAN Common External Tariff with such great dispersion in tariff rates across countries? Perhaps the end-game will be free trade—a Common External Tariff of zero—which would be applauded by economists and, in fact, would not be foreign to ASEAN thinking on issues related to economic integration.[26] Moreover, the transition period is, in effect, relatively long: 9 years (at a minimum, assuming the 2015 date for the completion of the AEC is accepted) for the more developed ASEAN countries should be a sufficient amount of time to allow for the necessary structural adjustment and the maturing of any "infant industries," assuming they exist.[27] However, embracing pure "open regionalism" and a tariff-free zone will be a politically difficult albeit noble fight. In any event, the ASEAN leaders are serious about creating the AEC and, in fact, are currently studying options as to how a customs union in ASEAN might best be formed.

As noted above, despite the progress under APEC, there is a general impression that APEC lags far behind the implementation of its ambitious agenda. Given the new international and Asian zeal for regionalism, it would appear that most countries have put APEC on the back burner and are considering other options. Indirectly, the idea of creating an East-Asia only economic grouping seems to be gaining new interest in the form of the ASEAN+3-related initiatives. The first East Asian Summit in December 2005 testifies to this trend.

In addition to the "APEC ebb," there were several events that shifted the focus to East Asia. First, even with the successful APEC Summits at Blake Island and Bogor, the East Asian Economic Grouping (EAEG) concept never faded away. On the contrary, it began to grow in substance. Strangely, the initiative came from ASEAN's effort to expand economic cooperation with the EU, but the EU's desire to deal with all of East Asia led to ASEAN's asking PRC, Japan, and Korea to participate. The first

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[23] The free flow of all labor, including unskilled labor, was deemed too politically difficult to consider in the AEC.

[24] For in-depth analysis of the lessons of the EU's Single Market Program for ASEAN, see Plummer (forthcoming 2006)..

[25] The only real exception relates to positive tariffs on beverages. Also, we might note that Singapore's bound tariffs are greater than zero.

[26] For example, there was a proposal prior to the Asian financial crisis, sponsored by the Philippines with support of some other ASEAN countries, to multilateralize tariff cuts within AFTA, which would have precluded trade diversion and, in fact, would have eventually made ASEAN a free-trade zone. This proposal was dropped during the Asian financial crisis and has not been taken up again, but will no doubt naturally surface as plans for the AEC begin to materialize.

[27] From a practical point of view, it should be noted that a deadline of 2015 (or 2020, for that matter) will not be etched in stone: no doubt flexibility in the more delicate sectors will be permitted. The European Single Market Program had 1992 as a deadline (hence the sobriquet, "EC 1992"); however, it was not until 1994 that the lion's share of the relevant directives had been implemented among EU member. Further, some of the sectors continue to defy integration, especially in finance and energy.

Asia-Europe Meeting (ASEM) was held in Bangkok in March 1996, which was to initiate a process of informal economic, political, and cultural cooperation. ASEM includes a Heads of State Summit every 2 years, with the Fifth Summit being held in Viet Nam in October 2004. Membership in ASEM includes the 25 members of the EU and ASEAN+3. Even though the initial impetus for these meetings was economic cooperation with the EU, the significance for East Asian regionalism lies in that these meetings brought officials from ASEAN, PRC, Japan, and Korea together to discuss issues of economic cooperation.

The original "Miyazawa Plan" was initiated by Japan during the Asian financial crisis to create an Asian Monetary Fund to supplement the IMF. It was opposed by the IMF and the US, but eventually led to the establishment of currency swap arrangements among East Asian countries (basically bilateral swaps between Japan and individual countries— the Chiang Mai Agreement) during the 2000 ADB annual meeting.

However, financial integration in general is a complicated process. Usually it occurs well into the process of regional integration, as suggested by the experiences of the EU and the creation of the euro, which was only possible after decades of a customs union and a common market. Because the benefits of monetary cooperation are less clear—particularly in the Asian case, as exchange rate stability among Asian countries is of limited value for the many countries that trade heavily outside the region—and the political benefits are far less obvious than in the EU case, countries have begun to focus more on FTAs, at least as a first step.

APEC's lack of influence in the Asian financial crisis has served to solidify East Asia's move in favor of an ASEAN+3 approach. The current spate of agreements, however, has not been extended to all ASEAN+3, but rather has come more from ASEAN to individual countries. For example, the completion of the PRC-ASEAN joint FTA study in the summer of 2001 prompted Japan to quickly initiate a study of its own with ASEAN. One month later, at the 2001 ASEAN+3 meeting in November, ASEAN and the PRC announced the intention to negotiate a free trade area within 10 years (the agreement was formalized in a Framework Agreement in December 2004, discussed below).

In short, regional integration in East Asia began with ASEAN economic cooperation, and recent initiatives have involved ASEAN countries but in a wider context. We might call this the ASEAN+3 approach but, in effect, actual accords have actually been more in the form of "ASEAN+1." Moreover, while there may be grand designs for integrating East Asia, bilateral accords with nonregional partners have been flourishing since 2002. Some have seen this in a negative light; however, as will be discussed below, in a way it merely underscores the "openness" of the regional movement in East Asia. An Asia-only bloc akin to the EU is not in the cards. In this, the region may be able to avoid the shortcomings of the European experience, and Asia countries will be freer to focus rather on the gains from economic integration.

Regional cooperation in South Asia and Central Asia has been modest at best, at least relative to East Asia. The reasons for this are many but from the economic standpoint relate mainly to the time-path and direction of industrialization policy. East Asia became an early convert of outward-oriented industrialization and has been a leader in the developing world with respect to trade and investment liberalization. South Asia has been a reluctant disciple of the "liberal" model; in fact, it can be argued that up until this past decade South Asian countries have generally been reluctant reformers, though the record differs by country. It has only been recently that India, whose commercial policy position is critical to the region's policy path, has embraced sustained outward-oriented reforms (though even today this process has been a difficult one in the world's largest democracy). Central Asia, on the other hand, frozen until 1991 in the Second World of the USSR, only in the past decade has been fitfully carrying out its transition agenda, with highly-divergent approaches (and success) across the region. Kyrgyz Republic, for example, is a member of the WTO and has a relatively open economy, whereas Tajikistan and Uzbekistan continue to be notoriously closed.

It comes as no wonder, then, that the South Asian Association for Regional Cooperation (SAARC)[28] and the Economic Cooperation Organization (ECO)[29] have made little progress traditionally in real economic cooperation. Their piecemeal "positive list" approaches have been geared more at strengthening confidence and supporting political dialogue, rather than genuine efforts at regional integration. This may change in the near future, at least in South Asia, with the peace process opening up many possibilities at the same time outward-oriented policy change is taking root. The ECO region is far more complex in terms of its matrix of national economic policies and will likely require considerable time before any effective integration takes place. After all, the priority for these countries is first WTO accession (only a few—Pakistan, Turkey, and, as noted above, Kyrgyz Republic—are already WTO members but all have applied to join and are at various phases in the accession process) and they have a long way to go in terms of commercial policy liberalization (particularly in terms of nontariff and non-border areas). Moreover, their factor endowments are similar and geared toward inter-industry trade, leaving little prospect of boosting intraregional trade effectively.[30]

Table 1: **Chronology of Asian Integration: ASEAN and ASEAN+3**

Main Points: ASEAN	ASEAN Summit	Year		Main Points: ASEAN+3
ASEAN CONCORD 1. Established ASEAN Secretariat 2. Treaty of Amity: Mutual Respect for independence, sovereignty, equality, territorial integrity and identity of nations, i.e. non interference 3. Establishment of Zone of Peace, Freedom, And Neutrality	1st-Bali	1976		
1. ASEAN Industrial Projects agreed 2. Preferential Trading Agreement (PTA)	2nd-Kuala Lumpur	1977		
1. Accelerate PTA 2. Accelerate and make more flexible ASEAN Industrial Joint Venture (AIJV)	3rd-Manila	1987		
1. ASEAN Free Trade Area (AFTA) 2. Common Effective Preferential Tariff (CEPT)	4th-Singapore	1992		

[28] SAARC member-states include: Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka.
[29] ECO members include Afghanistan, Azerbaijan, Iran, Kazakhstan, Kyrgyz Republic, Pakistan, Tajikistan, Turkey, Turkmenistan, and Uzbekistan.
[30] Intraregional trade in the ECO region comes to about 7%.

	5th-Bangkok	1995		
1. Proposal for ASEAN Vision 2020	1st-informal-Jakarta	1996		
2. ASEAN 2020 presented, a broad long-term vision for ASEAN in 2020 (with ASEAN Economic Community in mind)	2nd-informal-Kuala Lumpur	1997	1st-Kuala Lumpur	1st ASEAN+3 (ChinaPRC, Japan, and Korea)
Hanoi Plan of Action adopted to move towards Vision 2020: 1. Advance AFTA to 2002, 90% intra-trade subject to 0-5% tariff 2. ASEAN Investment Area (AIA)-goal investment liberalization within by ASEAN 2010, outside ASEAN by 2020 3. ASEAN Surveillance Process 4. Eminent Persons Group (EPG) proposed to come up with plan for ASEAN Vision 2020	6th- Hanoi	1998	2nd-Hanoi	-East Asian Vision Group (EAVG) proposed by Kim Dae Jung, President of Korea to look into East Asian Integration
EPG develops plan for Vision 2020: 1. Concern that ASEAN not effective in responding to Asian financial crisis, so proposed financial cooperation. 2. Speed up AFTA 3. Accelerate AIA 4. To respond to surge of PRC, need to become more competitive, attract investment, faster integration, and promote information technology	3rd-informal-Manila	1999	3rd-Manila	

Adopted Initiative for ASEAN Integration (IAI): 1. Framework for more developed ASEAN members to assist those less-developed members in need 2. Focus on factors to enhance competitiveness for new economy: education, skills development, and work training	4th-informal-Singapore	2000	4th-Singapore	-East Asian Study Group (EASG) to consider EAFTA and agree to hold East Asian Summit -Two major ideas: 1) Development of institutional link between Southeast Asia and East Asia 2) Study group for merit of an East Asian Free Trade Area (EAFTA) and investment area -Begin financial cooperation, ex. Chiang Mai Initiative (CMI) May 2000. By March 2006, bilateral swap arrangements under the CMI came to $71.5 billion. -Propose Expert Group Study on ASEAN-PRC FTA
- Challenges facing ASEAN: Declining FDI, erosion of competitiveness. - Road map for Integration for ASEAN to achieve 2020 - Go beyond AFTA and AIA by deepening market liberalization for both trade and investment	7th-Brunei	2001	5th-Brunei	-Endorse EAVG recommendation for EAFTA but overshadowed by PRC-ASEAN Free Trade Agreement proposal within 10 years, with the adoption Early Harvest Provision to speed up FTA -Prompted by PRC-ASEAN FTA proposal, Prime Minister Koizumi proposed Japan-ASEAN Economic Partnership in reaction to PRC-ASEAN proposal -Japan-Singapore Agreement for a New Age Partnership singed January 2002 and enforced Summer 2002
-AEC end goal of Vision 2020	8th-Phnom Penh	2002	6th-Phnom Penh	Adopt EASG recommendations of deepening and broadening of East Asian integration. ASEAN+3 Asian Bond Markets Initiative (ABMI) endorsed by ASEAN+3 Deputies meeting in December 2002 in Chiang Mai
	9th-Bali	2003	9th-Bali	
-Vientiane Action Plan -Australia attends for 1st time	10th-Vietianne	2004	10th-Vietianne	PRC speeds up FTA with ASEAN from 2015 to 2010

Notes:1. In 1998, 1999, and 2000 PRC speeches always contained the idea of advising ASEAN. It is difficult to imagine this from leaders of other countries, like Japan and Korea.
Source: Adopted from Naya and Plummer (2005).

b. Existing Accords: A Survey

In this subsection, we give a brief review of the various FTAs and related framework agreements that have been established in Asia. The flurry of negotiations makes it quite difficult to keep up with *proposed* FTAs, which tend to start off with a bilateral trade agreement and/or a formal framework agreement. Given that our ultimate goal will be to see to what degree these agreements conform to a "building bloc" or "outward-oriented" approach to commercial policy, we do not include these in this study, as the results are not yet known. For a July 2005 survey of various accords in the Asia-Pacific region, see Feridhanusetyawan 2005.[31]

The texts of modern Asian FTAs are complicated and can be quite diverse, though there tends to be considerable overlap in terms of topics addressed. To simplify the task of reviewing these accords, we group them into three different types, Full FTAs; Limited FTAs; and Framework Agreements, and summarize their salient components in Table 2. There can be significant variation within each of these groupings, but we will get more into a taxonomical review of their coverage and depth in Section IV.

Full FTAs tend to be highly comprehensive, covering both goods and services, and usually investment. A good benchmark for Full FTAs are Singapore's bilateral agreements with developed countries, which are all advanced, as is clear from Table 2 (and discussed below). Limited FTAs usually contain a positive list of goods and/or services that are accorded tariff preferences, to be expanded gradually. They tend to be a first step toward stronger integration. As far as Framework Agreements are concerned, those that involve ASEAN stipulate objectives to strengthen and enhance cooperation on economic, trade, and investment matters, to liberalize progressively and promote trade and to facilitate the more effective integration of newer ASEAN members. In general, they lay the foundation for negotiations in future FTAs.

There appears to be general conformity on issues undertaken in negotiations under Full FTAs. Hence, in Table 2 we do not detail all possible features of these agreements (in order to save space). Other components that emerge in these agreements include (i) abolition of tariffs and nontariff barriers on included projects[32]; (ii) anti-dumping provisions; (iii) customs procedures, essentially modeled on "best practices," (iv) professional services (either with details included specifically in the agreements or as a framework for future negotiation); (v) dispute-settlement mechanisms (of various degrees of detail); and (vi) balance of payments safeguards, generally referring to IMF protocols and the GATT 1994 "Understanding on Balance of Payments Provisions."

Some salient observations regarding the components of these agreements follows:

- 1. As the only major subregional initiative in East Asia, AFTA is unique in many ways. We have classified it here as a "Full FTA," but this might be controversial. AFTA continues to be a fairly "loose" agreement, with extensive coverage of goods but limited *real* coverage of anything aside from investment, and investment is covered under the AIA/AIC agreements—outside of, but obviously related to, AFTA. There is an ASEAN Framework on Services (AFS), but its coverage continues to be relatively limited. In fact, creating essentially a free market in services under the AEC would merely be a matter of building on the AFS. AFTA's protection of

[31]An adequate summary of the results of the various empirical models examining the economic effects of these arrangements is beyond the scope of this study, though we do include references to specific, pertinent studies. For a summary of the effects of various initiatives, see Feridhanusetyawan 2005, Naya and Plummer 2005, and Scollay and Gilbert 2002.

[32] With the exception of AFTA, this implies an abolition of tariffs and nontariff barriers for included projects, which in the case of Full FTAs tends to be fairly comprehensive. AFTA is an exception in that it defines free trade to be tariffs of 0-5%.

intellectual property rights (IPR) essentially refers to WTO trade-related aspects of intellectual property rights (TRIPS). The monitoring and enforcement mechanisms still need to be worked out properly before true "deep integration" emerges; settlements within AFTA at present tend to be *ad hoc*. However, the region does have a liberal approach to rules of origin, generally with an across-the-board 40% minimum. Further, deepening other areas of cooperation, including financial areas and skilled labor, are slated to be included in the AEC blueprint, in ASEAN+3 and even APEC initiatives. The history of ASEAN, the complicated nature of its membership, the dominance of its trade and investment partners situated outside the subregion, and its position at the heart of East Asia will ensure that additional deepening within the context of AFTA and the AEC will be colored by developments at the ASEAN+3, APEC, and ASEM levels.

Table 2: **Asian Bilateral and Plurilateral Accords**

Year	Partners	Type	Main Features
1992	ASEAN (AFTA)	Full FTA	Not fully comprehensive; fairly simple ROO; separate framework agreements on services and FDI as well as on IPRs (builds on TRIPS).
2000	ANZSCEP (SGP/NZ)	Full FTA	Comprehensive; ROO: general VA rule (40%); "negative list" in services; FDI essentially fully covered; IPR included: TRIPS; general commitments on competition; only APEC non-binding rules on government procurement
2000	EFTA-SGP	Full FTA	Comprehensive; complicated product specific ROO; FDI essentially fully covered; IPP included: TRIPS; refers to WTO Government Procurement Agreement
2002	JSEPA (J/SGP)	Full FTA	Comprehensive; complicated, product specific ROO; "negative list" in services; separate financial-services and capital market development measures; FDI essentially fully covered; IPR included, doesn't refer to TRIPS; builds on WTO Government Procurement
2003	USSFTA (US/SGP)	Full FTA	Highly Comprehensive; 10 year implementation; restrictive mainly in textiles and apparel; complicated, product specific rules of origin (ROO), including "Integrated Sourcing Initiative"; generous "negative list" in services; capital controls only as safeguard; FDI essentially fully covered; extends WTO TRIPS; limits on SOE competition; builds on WTO Government Procurement.
2003	SAFTA (SGP/Australia)	Full FTA	Comprehensive; simple general ROO: 30% or 50% local value content; "negative list" in services, no safeguard measures except for BoP purposes; FDI covered; separate, additional commitments for financial services to ensure transparent market access; measures on movement of persons included; builds on TRIPS; Australia not signatory to WTO GPA, but government procurement covered

2003	ECOTA (Afghanistan/Iran/ Azerbaijan/ Kazakhstan/ Kyrgyz Republic Pakistan/Turkey/ Tajikistan/ Turkmenistan/ Uzbekistan)	Limited FTA (Parties recently agreed to sign FTA in 2006)	Covers trade in goods: positive list to be gradually expanded so as to cover at least 80% of the goods on tariff lines; IPRs included: protection shall be gradually improved in order to be of a level corresponding to the standards of multilateral agreements within 8 years
2003	Korea/Chile	Full FTA	Comprehensive; restrictive in agriculture; complicated product specific ROO; “negative list” in services, financial services not included; FDI covered; builds on TRIPS; Chile not signatory to WTO GPA but government procurement covered .
2004	India/MERCOSUR	Limited PTA	Positive list of goods with tariff preferences; general 40% ROO
2004	SJFTA (Jordan/SGP)	Full FTA	Comprehensive; complicated product specific ROO, separate provisions for textiles and apparel; investment governed by separate bilateral treaty (2004); IPR refers to WTO commitments;
2004	Japan/Mexico	Full FTA	Comprehensive; fairly complicated and diverse ROO; services and FDI broadly included; IPRs not extensively covered, but commitment to multilateral agreements; Mexico not signatory to WTO GPA, but government procurement is covered
2005	Thailand/Australia	Full FTA	Comprehensive; complicated product specific ROO; special safeguard measures for sensitive agricultural goods; services broadly included and full coverage of FDI; builds on TRIPS; government procurement not covered, but commitment to add as soon as possible
2005	CECA (India/SGP)	Full FTA	Comprehensive; ROO: generally 40%, but includes product-specific rules as well; services and FDI broadly covered; “negative list” in services; measures on movement of persons included; commitment to develop IPR co-operation, no mention of TRIPS; does not cover Government Procurement, India not signatory to WTO GPA;
2005	KSFTA (Korea/SGP)	Full FTA	Comprehensive; 10 year implementation; complicated ROO, product specific rules that apply only to non-originating materials; “negative list” in services; FDI and financial services broadly included, some sector specific commitments for financial services; provisions on movement of persons; builds on TRIPS; parties signatories to WTO GPA

2005	Trans-Pacific SEP (Brunei Darussalam/ Chile/NZ/ SGP)	Full FTA	Not fully comprehensive; complicated and product specific ROO; "negative list" in services that excludes financial services, but Parties commit to commence negotiations on financial services chapter in 2 years; FDI not covered; builds on TRIPS; parties not signatories to WTO GPA but government procurement extensively covered
2006	SAFTA (Bangladesh/Bhutan /India/Maldives/ Nepal/Pakistan/ Sri Lanka)	Limited FTA	Not comprehensive; tariff reduction to 20% (non-LDC) or 30% (LDC) in 2 years and to 0-5% in 5 years; sensitive goods are exempt (positive list); generally reserves favorable treatment to LDCs
2005	Korea/EFTA	Full FTA	No text available yet; comprehensive agreement that provides for liberalization of trade in goods, services and public procurement and protection of IPRs. Negotiations on separate agreements on agriculture and investment were also concluded.
2001	ASEAN-CER (ASEAN/Aus/NZ)	Framework Agreement for CEP	Goal is to double trade and investment between the regions by 2010; negotiations for FTA started in 2005
2003	ASEAN/Japan	Framework Agreement for CEP	Parties agree to negotiate in order to progressively liberalize trade in goods and services and create a liberal and transparent investment regime. The implementation of measures leading to the Closer Economic partnership (CEP), including elements of a possible FTA, should be completed by 2012
2004	ASEAN/India	Framework Agreement for RTIA	Parties agree to negotiate in order to establish a Regional Trade and Investment Area (RTIA) which includes a FTA in goods, services and investment. Negotiations are to be finalized by 2005 (FTA and ROO) and 2007 (trade in service and investment)
2002	ASEAN/PRC	Framework Agreement for FTA	Parties agree to negotiate in order to establish a full FTA by 2012. Newer ASEAN members are allowed a longer timeframe (2015)

- As was noted above, the other subregional groupings in Asia—SAARC's SAPTA, and the ECO's ECOTA—tend to be far less advanced than ASEAN. We include these as "Limited FTAs," but in effect they are just preferential trading arrangements, similar in approach to ASEAN's earliest Preferential Trading Agreement (PTA) of the 1970s. While SAPTA does allow for special treatment of its least-developed member-states, coverage is unlikely to stimulate trade. They offer relatively limited positive lists and unimpressive margins of preference (as was the case with the original ASEAN agreement), though some items are accorded a higher margin of preference for least-developed member-states in SAPTA. Rules of origin in these agreements tend to be relatively simple, but as the margins of preference are so limited, there apparently would be no need even in theory for a more complicated rules-of-origin approach. Enforcement mechanisms are weak. Investment is not dealt with in these agreements, though the ECO has been working on an investment framework (similar in approach to "Bilateral Investment Treaties"). In sum, these agreements could almost as easily have been classified

as “Framework Agreements” as they are merely first steps in what will be a long process.[33] They are mainly political in nature; as such, they are perhaps paving the way for deeper cooperation in the future, as the earlier PTA did. But at present they are superficial at best.

- With respect to plurilarteral accords, that is, between a region and a country or another region, no Full or Limited FTA currently exists, though ASEAN has Framework Agreements toward this end with Australia and New Zealand, PRC, India, and Japan. No doubt this reflects the difficult nature of negotiating a bilateral accord in the context of an *FTA*, rather than a *customs union*. Indeed, the EU, which from its beginning as the EEC, has been able to negotiate myriad agreements with countries and even regions with relative ease due to the fact that it has a united commercial policy. No such united policy exists in the context of an FTA, and ASEAN commercial policies, though relatively liberal compared with other developing countries, tend to be highly diverse. Singapore is essentially a free-trade country and one of the most advanced economies in the world; the CLMV transitional economies are far less open and sophisticated. Still, ASEAN has always had a preference to negotiate with partners as a group, in part out of fear that separate trade deals could hurt the process of economic integration within ASEAN itself. At first, ASEAN was even against any deepening of integration within the context of APEC beyond mere consultation (the “Kuching Consensus”). This is why Singapore’s first bilateral FTAs with Japan and the US were so controversial. ASEAN has now accepted the reality of the bilateral FTAs that its members are now negotiating, choosing to avoid any diminishing of the ASEAN integration process by pushing forward under the AEC and in other cooperative areas. *This is one example of how regionalism can actually foster greater integration and liberalization through a process of reinforcement and competition* (discussed in the next section). Nevertheless, ASEAN does appreciate the potential benefits of developing plurilateral accords wherever possible, commensurately with bilateral accords. For example, soon after the ASEAN-China Framework agreement in December 2001, Japan decided to begin its own negotiation process with ASEAN, culminating in the 2003 Framework Agreement. It is doing this while at the same time negotiating FTAs and bilateral trade agreements with individual ASEAN countries. On the other hand, through its “Enterprise for ASEAN Initiative,” the US has implicitly demonstrated that it is not interested in an agreement with ASEAN but rather with its component members.[34]

  With respect to the Framework Agreements themselves, ASEAN and Australia and New Zealand (through their “Closer Economic Partnership,” or CEP, which is an advanced FTA) finally followed up on its Framework Agreement intentions in March 2005 with negotiations toward the creation of an FTA. ASEAN and CEP ministers completed their 10th consultations in September 2005. The PRC has moved much more quickly; after its “early harvest” program with ASEAN in January 2004, it finalized a deal on trade in goods and a blueprint for FTA negotiations by the end of that year. The agreement on trade in goods began implementation in July 2005 and PRC and ASEAN are currently working on services and investment; the fourth consultations between PRC and ASEAN senior officials began in September 2005.[35] Still, it is important not to exaggerate how much the trade and goods agreement itself covers; to date, tariff lines enjoying zero tariffs only constitute 4.8% of the total.[36] The services agreement is expected to be signed at the 11th ASEAN Summit in Malaysia in December.[37] The ASEAN-India

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[33] We label them as “Limited FTAs” only because they are written up as actual accords, rather than a framework for future negotiations..

[34] There are a number of reasons for this, including the diversity of ASEAN, the difficulty of dealing with transitional economies that are not yet members of the WTO, and, of course, the Myanmar issue.

[35] http://www.shanghaidaily.com/art/2005/09/26/191989/China_and_ASEAN_focus_on_FTA_talks.htm

[36] http://english.people.com.cn/200509/29/eng20050929_211656.html

[37] http://english.people.com.cn/200509/29/eng20050929_211656.html

Framework Agreement stipulates that the first phase of negotiations on an FTA (and the rules of origin) should be complete by the end of 2005, leaving the agreement on services and investment for 2007.

- Bilateral accords with key nonregional OECD members, in particular Australia, EU, Japan, and US are in many ways quite similar. These tend to be "Full FTAs" with extensive product coverage for goods and services, especially for the agreements involving Singapore (Singapore has FTAs with Australia, Japan, New Zealand, and US),[38] and include the many areas cited above under Full FTAs. In fact, the US has said explicitly that it would like the US-Singapore FTA to be a "model" for bilateral FTAs with all qualifying ASEAN countries,[39] and at the time of writing it had recently finished its fifth round of bilateral negotiations with Thailand. The US and Japan are both signatories to the WTO Government Procurement Protocol, and their bilateral FTAs tend to build on these, even with partners that are not signatories. Australia is not a signatory to the WTO Government Procurement protocol but it does tend to include government procurement in its arrangements. New Zealand explicitly includes the APEC Non-binding Principles on Government Procurement in its FTA with Singapore (ANZSCEP).

  All OECD partners include IPR chapters that extend and/or reinforce WTO TRIPs, and investment provisions tend to be fully covered. Indeed, in these agreements the WTO "Singapore Issues," which it was said "doomed" the WTO Cancun Ministerial, are addressed essentially in full. The agreements with the US tend to be the deepest and include such sensitive sectors as financial services, capital controls, and competition policy, including competition by state-owned enterprises.

  It would appear that many of these US accords are not only "modern" in the sense that we've used in this paper but also are being emulated by other developed countries in their respective bilateral FTAs. Hence, in many ways, they are becoming a blueprint or at least a benchmark for the other accords. Interestingly, the smaller developed countries are negotiating their agreements keeping in mind that larger developed countries, such as the US, will also be negotiating deep agreements with Asian developing countries. Hence, in anticipation of this they are including certain MFN-like clauses, which would give them maximum access if and when future accords are made. For example, let's assume that Australia is negotiating an FTA with Thailand, and it would like to include liberal coverage of the financial services sector. This sector is highly sensitive in Thailand, and Australia knows that it would be extremely difficult to include it, as it does not have the negotiating clout (or the political opportunity cost would be too high). Hence, rather than squander resources in such a difficult and uncertain area, it would seek an MFN clause, knowing that the US will insist on maximum coverage of this area and, once a US-Thailand agreement is complete, Australia would naturally gain access. Indeed, the US has been trying to include a comprehensive treatment of financial services in its negotiations with Thailand, based on a "negative list" approach, but thus far it has not made any progress (*The Nation*, September 27, 2005).

  Interestingly, this sort of approach was known as "unconditional MFN" of pre-GATT trade accords, when trade agreements were basically bilateral. The GATT was intended to multilateralize "unconditional MFN," as is clear in Article I of the GATT/WTO.

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[38] EFTA also has an FTA with Singapore, but the EU does not. However, the EU did launch the Trans-regional EU-ASEAN Trade Initiative (TREATI) talks in April 2003 to improve economic relations between the EU and ASEAN regions. Its practical emphasis was on health and hygiene standards and the protection of intellectual property rights, with trade barriers and other issues left to be handled at the Doha Development Agenda talks. As is discussed below, in April 2005, the EU Trade Commissioner, Peter Mandelson, and the ASEAN Trade Ministers agreed to set up a "Vision Group" to consider such new cooperative initiatives, including a possible EU-ASEAN Free-trade Area.

[39] There are two conditions: (i) the ASEAN member state must be a member of the WTO; and (ii) it must have a Trade and Investment Facilitation and Liberalization (TIFL) accord in place, meaning it must have normal trade relations with the US.

- Japan's first FTA was its agreement with Singapore in 2002. The agreement is comprehensive, but somewhat less so than the US-Singapore agreement. Since then, it has reached FTA accords several ASEAN countries, including Thailand (August 2005). Details are either unavailable at present regarding these agreements or are still being worked out,[40] such as in the case of Japan-Thailand. This FTA was slated to be signed in April 2006 with a goal of implementation 5 months later. It would appear, however, that while there will be substantial coverage of the auto sector (an area which proved to be extremely difficult in the negotiations) included agricultural goods will be fairly limited (for example, rice and sugar are excluded). Rules of origin considerations still need to be worked out.

- The EU has not yet negotiated an FTA with any Asian country. It may appear odd that this economic grouping, which more than any other has led the regionalism movement and has often served as a model for ASEAN and others, has not joined other OECD countries in forming FTAs in the region. As Asia is the most dynamic region in the world, such neglect obviously comes with considerable risk. In part, this neglect is due to the fact that the EU's attention has been focused elsewhere: in May 2004, it enlarged to include 10 additional Central and Eastern European members; it has been preoccupied with the EU Constitution and associated referenda, which eventually ended in failure (for the time being); it has been focusing on internal growth problems and debates surrounding its commitment to become the most competitive knowledge-based economy in the world by 2010 (the "Lisbon Agenda"); and its primary trade initiatives in Asia have focused on dealing with the PRC in the wake of the expiry of the Agreement on Textiles and Apparel in January 2005. However, the EU has always kept a close watch on these trends in Asia. Its response to APEC was to create ASEM, but it has done little with ASEM (as APEC itself has done little in terms of deeds) outside of basic consultations and studies as to how to improve bilateral relations. Moreover, the EU is now rising to the challenge: In April 2005, the EU and ASEAN trade ministers agreed to set up a "Vision Group" to consider such new cooperative initiatives, including a possible EU-ASEAN Free-trade Area.

- We do not include APEC in the table, as it is not only a mere Framework Agreement with ambiguous goals but also includes a wide variety of members outside Asia. Still, it is worth mentioning, as just about all East Asian countries are members of APEC. The most salient economic initiative within APEC is the "Bogor Vision," which dedicates the region to "open trade and investment" by 2010 (2020 for developing countries). APEC has always embraced "open regionalism," but it has never been clear exactly what is meant by this term. As noted in Section I, there are two competing schools of thought: one would argue that any concerted regional liberalization should be nondiscriminatory (i.e., non-member countries should automatically benefit from trade and investment liberalization), while another would suggest that it would be non-discriminatory in that all APEC accords would be open to non-members *provided* that they reciprocate. It is also unclear as to what "open trade and investment" means.

  Achieving the Bogor Vision, however defined, was always going to be an extremely difficult process, and the ambiguities surrounding it only complicate the process, as does its "voluntary" nature. While a nondiscrminatory accord would be applauded by economists, political scientists marvel at its political naiveté. On the other hand, a reciprocal accord, which might be supported by those in the pro-regionalism camp, would create the possibility of a split in the global marketplace, given the fact that APEC is so large. In the meantime, as noted above, the process itself has ebbed. Nevertheless, APEC does play a role in trade and investment facilitation in the region by providing a forum for discussions, urging trade and investment liberalization, and developing region-wide practical ways of reducing transactions costs. For

[40] Bilateral trade agreements have been worked out with Malaysia and the Philippines.

example, extensive work is being undertaken by APEC working groups on improving customs clearance procedures, including the creation of a businessperson's "smart card," APEC investment agreements, exploration of means to facilitate technology transfer, cooperation in infrastructure, standards and conformance, harmonization of product standards, enhanced dialogue on trade and investment facilitation and development cooperation (ECOTECH), and means toward improving other areas generally classified under "deep integration."[41]

Following the Asian financial crisis, APEC was compelled to deal with financial issues. APEC cooperation was not initially intended to include finance as a principal area of cooperation; the emphasis has been on facilitating and liberalizing trade and FDI, as well as ancillary "nuts-and-bolts" issues that are useful for improving business interaction and lowering transactions costs in the region. Because of the 1997/98 crisis, APEC officials now agree that the region should be actively involved in supporting regional financial stability, but there does not yet seem to be a consensus on what should be done. Moreover, the work that has been done within APEC regarding financial stability concerns is not well known and, hence, APEC has thus far had little effect to date in promoting financial cooperation (Feinberg and Ye Zhao 2001).

In sum, Asia has been successful in negotiating a number of bilateral and regional FTAs, and has plans for several plurilateral agreements. This process is very recent; outside of AFTA (1992), the first bilateral FTA in the region, between Singapore and New Zealand, was signed only in 2000. If one includes all of the proposed agreements at various levels of discussion and negotiation, as well as the others that will emerge in response to these, it is easy to forecast a complicated web of formal relationships, of various degrees of depth, binding the region together. It is not difficult to understand and appreciate the anti-regionalism camp's concern that such a "spaghetti bowl" of regional accords could be potentially damaging to the global trading system. The EU has had to live with such a system for decades, and it has created considerable complications in certain areas (Messerlin 2001).[42] We now tackle this debate in some detail.

III. Turning Stumbling Blocs into Building Blocs: How to Minimize Spaghetti-bowl Effects

The "spaghetti bowl" effect refers to the Italian pasta dish famous for being highly intertwined. The term is used generally in a derogatory manner by critics of regionalism to underscore problems in terms of coverage diversity, overlap, and "contradictions" associated with an economy having many different preferential trading agreements. As was noted above, this is potentially a real problem in the global marketplace. A strong advantage of MFN in the WTO framework is that it generally (but not totally) avoids this problem.

Exactly how big is this problem, and how might countries minimize the associated effects? We address these issues in this section, beginning with a conceptual/analytical approach to the problem. This is followed by a brief review of the debate regarding whether or not policy reform within the context of a regional trading arrangement can actually support global trade and investment liberalization, meaning regional trading accords are "building blocs," or whether they detract from it —they are "stumbling blocs." Finally, we develop a framework that might be used to minimize the negative implications of preferential trading arrangements in general and "spaghetti bowl" effects in particular. Given that

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[41] Naya and Plummer (2005).

[42] For example, bilateral agreements with Mediterranean countries eventually led to the new to create a plurilateral "Global Mediterranean Policy." A variety of influences has led the EU to abandon its Lomé Agreements in favor of the Contonou Agreements, which essentially creates a series of FTAs with former colonies (ACP countries). Presently over 80% of EU total trade takes place under its "pyramid of preferences," rather than WTO-MFN.

regionalism in Asia is gaining momentum and will likely continue to do so for some time, such guidelines are important to keep the agreements efficient, open, and supportive of global trade and investment.

a. Introductory Comments Regarding Regionalism versus Multilateralism

It is important to note first of all that, while WTO accords do impose a certain symmetry, they do not guarantee it. For example, the WTO sets out rules of behavior in terms of anti-dumping that are no doubt superior to a system void of rules. But they do not harmonize all anti-dumping practices. Member-states continue to have a great deal of flexibility in this regard (and probably always will have, at least in the context of the WTO). The existence of a WTO Valuation Agreement on customs is extremely useful, but there continues to be considerable variation in terms of adopted practices across WTO member-states. The same can generally be true of the Singapore Issues, IPR protection, and the like, in which the WTO often has little or incomplete jurisdiction (and likely will not have much more for the foreseeable future).[43] A salient disadvantage of the multilateral approach under the WTO is that harmonization of such rules and policies has proven to be extremely difficult, and progress highly limited—due to the diversity of its membership as well as disagreements as to how comprehensive the mission of the WTO should be.

The usefulness of regional agreements—and certainly one reason for their popularity (see World Bank 2005, ADB 2002, Kreinin and Plummer 2002, Frankel 1998)—lies in their ability to drive integration and cooperation in areas that have hitherto been neglected by the WTO, such as in tariff, nontariff, and non-border measures. Thus, while it is true that a multilateral approach would dominate a bilateral/regional strategy if all the same measures are included and harmonized/liberalized to the same extent, it is not a dominant strategy once we relax this (unrealistic) assumption of symmetry in liberalization.

In fact, when critics of regionalism demonstrate the inferiority of preferential treatment relative to free trade, frequently the analysis falls into "straw man" analysis. For example, the rules of origin constraints under NAFTA, discussed below, in automobiles (62.5%) and certain textile products (effectively 100%) do not fit the criteria for "open regionalism" under any definition of this term. However, these are probably among the most obvious out of relatively few such divergences in what is in reality a liberal agreement. Besides, for NAFTA, the effective benchmark should be the *status quo*, not *free trade*. Would auto and textile imports to the US have been much less restrictive without NAFTA? Not necessarily. In fact, admitting that associated trade diversion does have costs, we cannot say that NAFTA closed those markets, since failure to meet NAFTA rules of origin meant recourse to the *status quo*. The *status quo* did not become more protective; in textiles and apparel, the US market has become *more* open with the expiration of global import quotas on 1 January 2005 (under Uruguay Round commitments). Again, Mexican textiles receive preferential treatment and, hence, trade diversion is a cost to be borne by non-partners and US consumers, but there still is an associated trade creation effect that would have not occurred had there been no NAFTA.

Many American economists supported NAFTA not for love of regionalism or their belief that it would have great effects on allocative efficiency in North America through the liberalization of tariff and nontariff barriers, which after all, were low in the aggregate.[44] Effects on the US and, especially, Canada, were estimated to be small. Rather, it was supported in the main because it would lock in the Mexican economic reforms leading up to NAFTA and would set the stage for further liberalization. Given the history of economic volatility in Mexico, NAFTA as a "policy anchor" was deemed to be extremely

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[43] Indeed, one reason for the failed WTO Ministerial at Cancun is related to the rejection of reform under the rubric of the Singapore Issues, in particular investment policy, by developing countries.

[44] These were higher in the case of Mexico, but as Mexico is a small economy compared to the US and Canada, the net effects could not be large.

useful. Once NAFTA began to be implemented in full force—after the Mexican crisis in December 1994, which had little or nothing to do with NAFTA directly—the net effect on macro performance in Mexico has been very positive (Kose and Rebucci 2005). In 2005, the US government gave a high priority to an FTA with Central America ("CAFTA") in hopes that it would have the same stabilizing effect.[45] And while the percentage of total Mexican trade has risen to somewhat over three-fourths (from two-thirds) in the wake of NAFTA, a result of both trade creation and diversion, one cannot say that Mexico has been "captive" in NAFTA. In fact, Mexico now has negotiated some 39 FTAs. Moreover, openness of the Mexican economy has allowed non-partner countries to benefit; the financial sector in Mexico, for example, is characterized by a considerable European presence.

Again, this is not to argue that restrictive rules of origin and other inward-looking clauses in regional trading arrangements do not constitute a problematic aspect of preferential trading arrangements. As is argued below, a consistent, liberal, across-the-board rules-of-origin policy carries the least distortion in a second-best world. But we should not exaggerate its absolute importance in the regionalism debate. Moreover, it is inconsistent to focus merely on the problem of discrimination across *countries*, which is the key problem in an FTA, to the complete exclusion of the problems associated with discrimination across *sectors*, which results from piecemeal multilateral liberalization.[46]

A related point was underscored analytically in Wonnecott and Wonnecott (1981) in terms of tariff liberalization. Early advocates of a purely nondiscriminatory approach to tariff liberalization (in the tradition of Cooper and Massell 1965 and Berglas 1979) maintained that such a strategy was always superior to a regional approach. Every country has within its own powers the ability to unilaterally liberalize its commercial policy regime, and if this is done on a nondiscriminatory basis, there will be only trade creation and no trade diversion. Hence, unilateral trade liberalization "dominates" FTAs and customs unions, as the latter generate trade diversion as well as trade creation. Wonnecott and Wonnecott (1981) pointed out that these "unilateralists" missed the obvious point that countries engage in regional trade negotiations in order to open up their partner(s)'s market, rather than merely to extract gains through greater domestic liberalization. Thus, while trade diversion is eliminated under a nondiscriminatory approach, the fact that foreign markets are left untouched without negotiation would suggest that the welfare gains would be limited. Indeed, an FTA could be superior to unilateral liberalization if the gains in terms of increased national welfare due to foreign reductions in tariff barriers (for example, through gains to domestic exporters and improvements in terms of trade) were greater than the losses due to trade diversion.

Moreover, time *and* depth matter. Many protagonists of a purely multilateral approach to economic cooperation tend to present arguments without a well-defined time horizon. But time is important when considering the present discounted value to national welfare of a regional trading accord compared with multilateral free trade. A heuristic example may help underscore this point. Suppose, say, Indonesia, has an option to create an FTA with Japan, but its leaders know that this will have some costs in terms of trade diversion. The "first-best" (global free trade) policy, its leaders might reckon, would ultimately be the best deal for Indonesia, as nondiscriminatory free trade would have no trade diversion and could maximize trade creation. But timing would be crucial as to whether or not Indonesia should agree to the accord from an economic perspective. Suppose that global free trade were an option immediately. *Ceteris paribus*, free trade would be better than the deal with Japan. But what if the FTA with Japan were possible today, and yet global free trade would take 5 more years? Which would be

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[45] It is interesting to note that CAFTA was passed in the US only after personal lobbying by the President himself, and then the pact passed by only a two vote margin in the House of Representatives. But congressional opposition was not due to a dislike of regionalism per se but rather a dislike of trade liberalization, that is, it was generally opposed on traditional protectionist grounds.

[46] In other words, while trade diversion (due to discrimination across countries) certainly does come at a cost, so does discrimination across sectors (due to lopsided sector liberalization under the GATT/WTO), through, for example, changes in effective rates of protection.

better? It would depend on what the Indonesia-Japan deal would look like (relative to the global deal); nevertheless, it could be that free trade would still be worth the wait. But what if free trade were to take more like 20, 30, or 40 years? After all, the GATT/WTO has existed for almost a half-century, and global free trade is nowhere in sight. Of course, this type of analysis will be a function of the type of regional accord, in particular if it is inward-looking or outward-looking. If it were the former, the deal with Japan could end up being very much to the detriment of Indonesia. As we shall see in terms of the "building bloc versus stumbling bloc" debate, the type of agreement is of the essence. But it would also be important to know what the multilateral deal would be. If a regional accord entailed far more reforms vis-à-vis market-friendly, efficient policies at macro and micro levels whereas global free trade meant merely the abolition of tariff and nontariff barriers, the former could still potentially be as good as or better than the latter.

Indeed, the point expressed above in terms of the Wonnecott and Wonnecott framework is even more important when applied to modern FTAs, which include nontariff and non-border policies that the WTO does not yet touch (and may never, in some cases), and for which a unilateral approach would have limited benefits. The extensive tariff liberalization over the past two decades in East Asia, and more recently in parts of South Asia, would suggest that countries have *increasingly less* incentive to engage in the WTO should it continue to focus on tariffs and mostly on manufactured products and limited agricultural goods. While progress was made at the Uruguay Round, further integration of the international marketplace will be more difficult at the margin, for the remaining areas that now have the greatest potential for improving international interchange tend to be the most delicate, in terms of their traditional political sensitivity (for example, various agricultural products and areas in which a country has comparative disadvantage), national-sovereignty questions (such as those with respect to IPR, labor, and environmental protection), and the power over domestic regulation (like the Singapore issues). Progress in these areas at the WTO has always proven to be exceedingly difficult, and they continue to be so today. The Seattle Ministerial; Cancun Ministerial; and Hong Kong, China WTO Ministerial in December 2005 testify to this.

Herein lies the attraction and, in many ways, advantage that regionalism holds over multilateralism: it allows like-minded countries to address far more issues and in a shorter period of time. By choosing one or several like-minded partners, countries are able to make more progress in terms of deep integration than they could in the extremely-diverse WTO context. Recent interest in regionalism on the part of OECD countries that have traditionally shunned them (Australia and New Zealand, Japan, South Korea, US,, and so on) derives from their desire to address these many issues and their understanding that they cannot accomplish them in the context of the WTO, or at least not in the short/medium run. A successful conclusion to Doha would, perhaps, have an impact on the momentum behind the regionalism movement, but this is not guaranteed: the incentives for new bilateral/plurilateral accords, as well as for deepening existing ones, would remain.

But what is guaranteed through a successful Doha Development Agenda is a reduction in the potential negative effects of these regional agreements and overall less risk to the integrity of the international trading system. Moreover, to the extent that Doha can, indeed, make Article XXIV more effective in ensuring that these new regional agreements will be outward-looking and consistent with a WTO approach, the risks associated with regionalism could be significantly mitigated.

Such important steps forward would be cheered by all pro-globalization economists, regardless of whether they are in the pro- or anti-regionalism camp. Nevertheless, the challenges are great, perhaps overwhelming, at least for Doha. Success, assuming it arrives in the current WTO negotiations, would be defined at a much more modest level. In the meantime, it is a good working assumption that the current regionalism trend will continue—indeed, intensify—in the short- and medium run.

Hence, the obvious question emerges as to how regional agreements themselves can work in favor of global free trade. We approach this question from two perspectives. First, there is the more "macro

policy" perspective relative to the "building blocs versus stumbling blocs" debate. Next, we look at the nuts and bolts of regional agreements and ask how their very components can be made to minimize any associated policy distortions, and how they may be harmonized in order to avoid the "spaghetti-bowl" effect discussed above. In other words, we ask the question: given that regionalism is a second-best policy, to what degree and how can it be made to resemble the first-best as much as possible? Kemp and Wan (1976) were the first to show that a customs union could be made Pareto Optimal (first best) focusing on tariff adjustments.[47] We will try to revisit this approach in the broader context of policy formation in terms of non-border issues.

b. Building Blocs versus Stumbling Blocs: Theoretical Considerations

Does regionalism support unilateral/multilateral reform goals, or does the discrimination inherent in a trade bloc lead to a "second best" outcome at best, or an inward-looking one at worst? This is the essence of the "building blocs" versus "stumbling blocs" debate. The literature would suggest that several possible negative policy consequences could emerge from an FTA—inherent "stumbling bloc" tendencies—while either tendencies would be consistent with multilateral goals and market-friendly domestic liberalization. Briefly, these would include the following:[48]:

i. Stumbling blocs*:*

- **Maximizing terms of trade.** Regional integration, particularly customs unions, increases the size of an economic zone and, as such, increases market power. The potential benefits of exploiting such an advantage by imposing an "optimal tariff"—maximizing the difference between the terms of trade gains from a tariff regime against its costs in terms of efficiency—are familiar from the international trade literature. Moreover, FTAs and customs unions, by "virtue" of the trade diversion effect, improve their terms of trade relative to the rest of the world; the larger the grouping, the larger the potential improvement in the terms of trade.

  In reality, the first effect is probably not particularly relevant, as even in tariff regimes in the context of a customs union are not erected according to optimum tariff rules.[49] Moreover, in the cases of both customs unions and FTAs, changes in the external tariff regime cannot on average be more protective than the pre-integration *status quo*, according to Article XXIV. This does not mean that there will not be any potentially negative sector effects, but in this case GATT/WTO members are able to sue for compensation. The most famous case in this regard is the "Turkey: Restrictions on Imports of Textile Products," in which India initiated a GATT panel against Turkey in the wake of the harmonization of its external tariff with the EU when it formed a customs union in manufactures (Herzstein and Whitlock 2005).[50] Of course, this effect would be even less important with improved rules within the context of Article XXIV.

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[47] As noted in FN 2, essentially this is an Existence Theorem. For the customs union to be Pareto Optimal, it must: (i) set its common external tariff such that trade with non-partners does not change (thereby eliminating any trade diversion costs); (ii) allow for internal free trade, leading to gains from a more efficient regional division of labor; and (iii) have a compensation mechanism in which countries that lose within the region will be sufficiently compensated so as to make them at least as well off as they were before the customs union (efficiency generated from internal free trade would guarantee that this would be feasible).

[48] See Frankel 1997, from which some of these topics are adopted.

[49] Nor are they at the country-level. While the optimum tariff argument is one of the three classic economic arguments in favor of protection (the others being the infant-industry argument and strategic trade policy), it is well recognized as a theoretical argument. Tariffs are generally implemented for political and political-economy-related reason, not as a means of trying to extract terms of trade gains.

[50] The Turkey case may be the most famous but there are others. For example, while Spain's external tariff regime became more liberal after it joined the EC, the country did raise protection on agriculture imports in order to harmonize its policies with the EC's Common Agricultural Policy. The US was able to extract compensation from the EC in the feed-grains sectors in compensation for the associated trade diversion.

With respect to the terms of trade effect, since trade diversion undeniably results from preferential trading arrangements, it is certainly a concern. But trade diversion is actually a one-time price effect and, hence, static in nature. In fact, it is *the* static cost of preferential trading accords.

- **Manipulation of the contents and scope of the agreement by special interests.** This concern obviously also manifests itself in the context of domestic policy formation. Deardorff (2004) stresses that this is especially a problem in the context of developed-developing country accords, in which the former obviously have the upper hand, as special interests tend to be far better organized and funded. The lack of rigor and coverage in Article XXIV makes this a particular problem, as the flexibility allowed in an FTA tends to give considerable liberty to special-interest influences. Of course, this could also have a positive effect: special interest groups in developed countries no doubt push for better IPR protection, competition policy, treatment of FDI, and better trade and investment facilitation, but these could have important positive effects on efficiency and policy formation in developing countries.

- **Waste of scarce negotiating resources.** Particularly (but not exclusively) in the case of developing countries, the scarcity of well-trained and well-experienced experts on trade negotiations imply that the opportunity cost of resources devoted to regional agreements is the allocation of less talent to multilateral deals. Critics of regionalism suggest that such a capacity constraint can only be detrimental to multilateral liberalization, and even well-developed domestic policy reform. For example, after Viet Nam joined ASEAN in 1995, it worked not only to enter into AFTA (due for completion in 2006) but also to implement a number of other accords, including an extensive Bilateral Trade Agreement (BTA) with the US in 2001. On top of that, it was working on APT initiatives and, eventually, the ASEAN Economic Community (AEC). Given its human-capital capacity constraints, this could very well have delayed its drive to join the WTO. In the worst-case scenario, as articulated in the colorful words of Peter Drysdale, regionalism can "suck oxygen" out of the reform movement.[51]

  Or perhaps not. A counter-argument would be that Viet Nam has been able to ready its economy for the WTO through the outward-oriented policies of ASEAN, and the BTA itself is essentially a means of preparing Viet Nam for WTO entry, including legal and administrative reforms that would in any event be necessary (Lao PDR and the US began to implement this year the same type of BTA with the same goals). The agreement is replete with reference to WTO protocols and WTO-consistent reforms, from services liberalization to TRIPs-Plus. These negotiations have also sharpened the expertise of Viet Nam's negotiating authorities. The US also allocated a relatively large project (the "STAR Project") to assist Viet Nam in reforming its legal system to be more compatible with international norms, as well as train officials

ii. Building Blocs.

- **Lock in policy change.** We have referred to this effect fairly frequently in previous sections, using in particular the case of Mexico in NAFTA. But there are many others, including the case of Viet Nam mentioned above, which has been able to use regional integration as a blueprint for market-friendly reform to become more competitive in the international marketplace. Without ASEAN (and eventually the BTA), one can easily argue that Viet Nam would have not made as much progress (and its joining the WTO would no doubt have been further delayed, instead of probable accession in the near future). This effect also applies to industrialized regions: as was noted in Section Ib, when Greece (1981), and Spain and Portugal (1986), joined the EU, they were essentially "newly-industrialized economies", each having had political instability/

[51] Discussant's comments on this paper at the ADB "Brainstorming Session on FTAs," 20 March, 2006.

transition only a few years before. They each made significant strides in modernizing their policies and economies—as a result of EU accession—and today have significantly closed the gap with advanced industrial economies, featuring a relatively-standardized set of modern economic policies.

- **Improve negotiating power for smaller units.** Traditionally, the possibility of small countries joining together and working as one cohesive unit in trade negotiations has always been recognized: even Harry Johnson, who was an avid critic of regionalism, acknowledged this potential benefit. This would apply both to smaller countries as well as larger units, such as the EU (discussed below). Hence, in theory, ASEAN should be able to have much more power in influencing WTO negotiations, or bilateral/regional/plurilateral deals in general, as a group: the whole could be greater than the sum of its parts.

  The EU has certainly been effective in this regard from its beginning as the European Economic Community. But it began as a customs union, not merely an FTA, in which national commercial policy vis-à-vis third countries can differ (oft-times, substantially). ASEAN, for example, has never been very effective in projecting its power as a unified group, even after AFTA. The region is just too diverse and the interests of individual countries diverge too much. Most resource-rich ASEAN countries were part of the Cairns group at the Uruguay Round, but they essentially acted more as individual member-states rather than as a group. Joint action in APEC and even in the context of APT, though existent, has been widely considered disappointing. Thus, we could probably conclude that this potential "building bloc" is theoretically a possibility, but in practice can be somewhat difficult, being a function of the type of accord (FTA or customs union) and the interests of the component states. Size within the group also matters; Brazil, for example, has been effective in using MERCOSUR, a customs union comprised of Argentina, Brazil, Paraguay, and Uruguay, in international negotiations, such as the Free Trade Area of the Americas (FTAA). But rather than acting as group, Brazil was essentially able to use the region to project its own approach to the FTAA, which has resulted in no progress at all. This was not necessarily in the interest of other MERCOSUR countries, particularly the small ones, as suggested by the fact that many Latin American countries are now negotiating bilateral/regional FTAs directly with the US.

- **A Dynamic weeding process as a first step toward free trade.** It could very well be that the process of structural adjustment unleashed by a regional trading arrangement through trade creation could, in effect, make multilateral accords easier. As the weakest (and, hence, more resistant to any international competition) are weeded out due to, say, an FTA, the stock of opposition to trade falls in importance, thereby making multilateral initiatives easier.

  Perhaps an example would illustrate the point. Suppose that the trade policies of a country (let's call it "home") are determined by domestic firms, and "home" trades with two other countries: "partner" (the country that would ultimately form an FTA with "home") and "rest of world." Furthermore, assume that, in autarky, there are six industries, with linear cost structures of the firms in the home country being such that two are globally competitive (goods A and B), two (goods C and D) are competitive only regionally (in a potential FTA with "partner"), and two would never be competitive with trade (goods E and F). Now, assume that the "home" government puts to vote whether or not the country should move to free trade. Firms producing A and B will vote yes, as they would benefit from a larger market, but the other four firms would vote against it, as they would be put out of business. We remain in an autarkic equilibrium. But suppose now that the home country votes on whether or not it should have an FTA with "partner". Goods A, B, C, and D will vote in favor, and E and F against. The FTA would pass. Eventually, competition from the partner country will force out production of goods E and F in the home country (trade creation), and there will be no trade diversion (as we began in autarky). The remaining firms in the home country will, therefore, eventually only produce A, B, C, and

D. Next, assume that the home country votes once again on whether or not it should have free trade. The votes will now be two in favor (A and B) and two against (C and D); assuming that consumers have even a little say would be sufficient to usher in free trade, and this would be due to the FTA "stepping stone" process.

- **Competitive liberalization to attract international capital, as well as a positive "threat."** Regional integration can be used as a means of rendering the component economies more efficient, competitive, and market friendly. While a grouping may or may not adopt global "best practices" in regulatory, legal, and other issues, it can reduce the stock of divergences across countries (thereby making it easier to integrate globally). By reducing transactions costs across countries, an FTA can enhance its attractiveness to multinationals. As policy externalities become increasingly important as an FTA "deepens," the incentive to internalize them through monitoring, sharing information, closer cooperation, increases. Because trade and financial links are becoming increasingly appreciated, countries within an FTA soon find it useful—or even necessary—to further financial and macroeconomic cooperation.

  It may also be true that regional agreements can be used as implicit and explicit "threats," particularly since FTAs seem to have a tendency to grow over time. An obvious example was the boost that President Bill Clinton gave to APEC in 1993, when it invited leaders to Blake Island, Washington, for the first APEC Heads of State Summit. Strengthening the organization was supported at Blake Island, and the political will to move forward on economic cooperation, especially in trade, was obviously in evidence (the next year in Indonesia this would manifest itself in the "Bogor Vision" goals of open trade and investment). Now, prior to Blake Island, the Uruguay Round had failed to be approved twice (in 2000 and again in 2002) essentially because the EU and the US, backed by the Cairns Group, could not reach an agreement on agriculture. After the Blake Island Summit, the Europeans decided to sign the agreement, which was also ultimately ratified in the US (but only with strong support by Clinton). Many experts have stressed that Clinton deliberately used APEC as a "threat" to Europe—if the Uruguay Round didn't go through, the US was perfectly willing to move forward on free trade with Asia. Rather than face trade diversion in the world's most rapidly growing market by far, the EU opted for the GATT.

Each of these arguments has *theoretical* merits. But in practice, the inclination of the regional accord tends to be extremely important. Clearly, if the group is being formed as a means of enhancing inward-looking development strategies or as a way of isolating the region from global competition, this initial policy thrust would set in motion many of the problems discussed above. In fact, this approach led to the downfall of many regional trading agreements in the past, especially in Latin American (for example, the Latin American Free Trade Area). Yet, if outward-looking economies form a regional grouping, it is likely that regionalism will serve to promote the goals of domestic policy reform and multilateral liberalization. This is due to at least four factors: (i) it is unlikely that a country wishing to promote outward-looking policies, including extensive unilateral liberalization and active participation at the WTO, would contradict this stance in favor of a regionally-closed system; (ii) reductions in trade barriers within a preferential trading arrangement make it more attractive for a country to reduce external barriers, in effect "MFN-izing" regional concessions, because the most important cost of regionalism is trade diversion and lower external barriers will reduce associated costs; (iii) the "weeding out" of least competitive industries discussed above, and making the political economy of trade liberalization more favorable over time, seems to have been important empirically,[52] and (iv) the membership of preferential trading arrangements tends to expand and to become more diverse over time,

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[52] Perhaps it would be more accurate to say "anecdotally," as the empirical literature on this subject is not well developed. Given its importance, we suggest in the last section that this should be an important area of future research.

thereby reducing regional sources of support for protectionism in a particular country and industry, as well as reducing the overall potential for trade diversion. One might add to this the list of nontraditional benefits for developing countries in regional trading agreements noted in Section I—macroeconomic stability, FDI and technology transfer, structural policy change and reform, state-of-the-art harmonization, political and political economy aspects of regionalism.

In sum, while the risk of regionalism is real and, as with any real-world second-best policies, costs exist, it would appear that what is driving the regionalism movement in the 2000s is based on an outward-looking approach to integration. AFTA and other expressions of ASEAN integration are exemplary of this aproach. Still, minimizing costs is of the essence. Below, we attempt to develop a blueprint as to how countries might minimize costs (and maximize benefits).

c. A Taxonomy of Relevant Policies and Approaching First-Best

The desirability of preferential trading agreements in general and "stumbling bloc versus building bloc" considerations in particular constitute the most divisive debate among mainstream international trade economists. But while there is no consensus, essentially all would agree that the relationship between regionalism and overall policy reform is of the essence. To the extent that regionalism is open and supports a market-friendly economic reform process, it would be welcomed by all. The debate outlined above centers around this question.

Even though a great deal has been written on this and related issues, little has been done focusing on specific components of regional trade groupings themselves and how they influence the debate. True, there are many anecdotes, with rules of origin being a favorite example as to how FTAs embody a good deal of hidden protectionism. However, we have argued that focusing on such anecdotes may not be productive; what matters is the entire picture and how it compares to the *status quo*. In this subsection, we endeavor to highlight some of these component policies and suggest how they might be developed in order to minimize distortions and favor an outward-oriented approach—in other words, how the "*spaghetti-bowl* effect" might be minimized and turned into a "*lasagna* effect".[53]

APEC and the Pacific Economic Cooperation Council (PECC) have also taken up the issue of best practices in FTAs, and they have articulated key general principles and guidelines that the Asia-Pacific region needs to embrace in order to reduce business-related transactions costs.[54] They stress that FTAs should embrace nondiscrimination (presumably where possible, as FTAs by their very nature are discriminatory), comprehensiveness, flexibility, WTO-consistency, transparency, and cooperation. However, as noted by Scollay (2004), the language of related statements does not go far beyond that of the relevant clauses in the 1994 WTO Understanding on Interpretation of GATT Article XXIV.

In its Trade Facilitation Action Plan (October 2002), subsequently formalized in the 2003 "Shanghai Declaration," APEC leaders dedicated themselves to a 5% reduction in transactions costs due to red tape and other costly barriers to doing business by 2006 through trade facilitation measures. The Action Plan articulates over 50 reforms to be undertaken in the general areas of movement of goods (including expediting customs clearance), standards (such as harmonization of procedures and rules in goods and services trade), business mobility, and e-commerce.[55] In June 2006, the APEC Ministers

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[52] Perhaps it would be more accurate to say "anecdotally," as the empirical literature on this subject is not well developed. Given its importance, we suggest in the last section that this should be an important area of future research.
[53] While both belong to the Italian food group known as "pasta," lasagna is made using a straight, wide, and flat noodle and is multilayered.
[54] See, for example, PECC Trade Policy Forum 2004 and summaries in Scollay 2004.
[55] http://www.whitehouse.gov/news/releases/2002/10/20021027.html, accessed June 20, 2006.

Responsible for Trade considered the idea of reducing such costs by an additional 5% by 2010, though the modalities to achieve this were somewhat unclear.[56] Interestingly, they also committed themselves to work on "high quality" regional and bilateral free-trade areas. In short, APEC does give a high priority to the adoption of "best practices," though the road to efficiency will be a long one (and full of potholes).

APEC and PECC have also been active in trying to estimate the potential benefits that might accrue from trade facilitation measures. For example, the APEC Economic Committee report *2004: Trade Facilitation and Trade Liberalization: From Shanghai to Bogor* (APEC 2004), offers a methodology developing proxies for the measurement of various trade facilitation policies, followed by some empirical estimation comparing trade facilitation improvements with reductions in tariffs.[57] The report finds that the trade creation effect of tariff liberalization is greater than that of trade facilitation: when APEC economies liberalize tariffs by 10%, intraregional imports rise by about 2%, whereas they only rise by about 1% in the case of trade facilitation. However, it also suggests that trade facilitation can be an excellent complement to tariff reduction.

In this section, we consider some of the more salient components of "high quality" FTAs that require close attention and analysis in the development of outward-oriented, efficient FTAs.

- **Product coverage: Goods**. *Comprehensive coverage is best, to be included within a reasonable period of time (defined as 10 years by the GATT/WTO)*. Article XXIV of the GATT/WTO stipulates that, in an FTA or customs, product coverage should include "substantially all goods." However, few FTAs cover all goods. Even NAFTA, which is comprehensive by most measures, does not effectively include all goods; tomatoes, for example, remain *de facto* outside of the FTA. The US-Australia FTA, negotiated in 2004, is between two advanced countries, each actively involved in global liberalization of manufactured goods, agriculture, and services. Yet, sugar is excluded from the US-Australia FTA, and beef has a 17 year implementation period. The EU-EFTA FTA in the 1970s excluded agricultural goods, and, actually, the US-Canada Auto Pact of 1965 only included *one* sector.. Clearly, the rigors of Article XXIV have not been very binding in this regard.

  Exclusions of individual products can be problematic in terms of efficiency, particularly when they involve products that are used as inputs in the productive chain. For example, duty free inputs on steel will cause exaggerated protection of value added (the "effective rate of protection") in the automotive sector. Exclusion of tariffs on imported lumber will do the same in the furniture industry if the latter is excluded from liberalization. "Positive list" approaches tend to be the worst possible mechanisms in this regard, as items that would generate trade creation are excluded and those that would generate trade diversion (that promote intraregional trade at the expense of non-partners) would be included.

  Thus, to the greatest political extent possible, the FTA should include all goods. Some will no doubt be excluded either temporarily or permanently, but such exemptions should be as few as possible and should take into account the important effects that they might have on the effective rate of protection, as well as on trade diversion.

- **Product coverage: Services**. Again, *comprehensive coverage and a reasonable time period for implementation are best* from an economic perspective, and transparency is important in some areas. Services present some special and important challenges. Certain services are

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[56] http://www.acnnewswire.net/press/en/32057/APEC.html, accessed June 20, 2006.

[57] The model used, however, is a gravity model, which has a lot of shortcomings in analyzing the effects of regionalism. See, for example, Frankel (1997) and Kreinin and Plummer (2002).

fairly easy to liberalize—for example, in terms of allowing for the movement of professional persons, tourist-related services (the most important in terms of exports for the ASEAN countries, for example), and even high-tech/knowledge-based services. Others are extremely difficult. Educational services tend to be highly protected. Financial services are often the most difficult to include in any liberalization package. Even the EU, which has been a regional trading organization for almost a half-century and technically completed its "Single Market" over 10 years ago, has a long way to go before incorporating financial services at the EU level, despite commitments to do so.[58] The same is true about postal services, which continue to be protected within the EU based on their "universal service obligations" but in reality due to heavy unionization. Within the framework of General Agreement on Trade in Services (GATS), some financial services will be included but education and postal services will be excluded due to their politically-sensitive nature.

Hence, if such opposition to full inclusion of services exists in advanced developed-country agreements, it is obvious that certain sectors will be controversial in developed-developing country accords. Nevertheless, they should be included as much as possible. In fact, in many Asian developing countries, this could be one of the best policies for "forced" structural policy change in the region. Telecommunications and financial services might even be highest on the list of the most productive in this sense. Development of the telecommunications is extremely important in the functioning of a modern economy, as it serves as a key input to knowledge-based products and services. Financial-services development is essential in modernizing the financial sector, increasing opportunities for savers and investors, and enhancing the integrity of the financial system. And given the importance of education in the modernization of instruction and preparing populations for a highly-competitive global economy, greater competition in this sector is critical in achieving the development goals of many developing (and developed) Asian economies. Already liberalization is taking place; the process can be enhanced through FTAs. For example, Singapore has long sought to increase competitiveness of its higher education in order to be a global competitor. Provisions laid out in the US-Singapore FTA, for example, are expediting this process.

- **Rules of Origin**. *Rules of origin should be as low as possible as well as symmetrical*. "Abuses" of rules of origin in FTAs is the most common criticism of regional agreements by economists. In our discussion of existing FTAs in Asia above, we noted that developed-country agreements tend to be more comprehensive and "deeper." They also have their dark sides—the darkest arguably the rules of origin provisions (see Table 2). Research as to how much compliance with rules of origin taxes efficiency is difficult to find. One estimate (Estevadeordal and Suominen 2003) calculates the cost to be in the range of 3–5% of the free-on-board value of the exported goods.[59]

  Table 3 generalizes the various approaches to determining rules of origin and their advantages and disadvantages (Brenton and Imagawa 2005). In contrast to developing-country accords such as AFTA, which tend to have simple rules of origin (usually at about 40%), the developed-country accords tend to be extremely complicated and often very high. The US—and often the EU—especially insists on generally product-specific rules of origin, yielding highly-divergent rates. These can be used to protect domestic industry inappropriately, rather than merely making sure that a product is mainly produced within the region. In NAFTA, for example, the

[58] Foreign control—especially of retail banking is taboo in many European countries. Foreign competition in retail banking essentially do not exist in the biggest continental European countries—France, Germany, and Italy. Recently (2005), a scandal broke out in Italy when the Bank of Italy seemingly used illegal means to thwart the takeover of an Italian bank (Antonveneta) by a Dutch bank (ABN Ambro). Antonio Fazio, the Italian central bank governor, was eventually forced to resign.

[59] This study is available on the PECC website: http://www.pecc.net/trade_washington.htm.

rules of origin come to 62.5% in automobiles and essentially 100% in many textile products (under the "yarn forward" rule). There is also the famous (and strange) case of EU imports of fish: one would think that rules of origin of fish, which obviously do not have component imports, would be simple. But to receive access to the EU's GSP, a developing country must satisfy the following conditions: (i) the vessel has to be registered in the beneficiary country or any EU member-state and must sail under the flag of a beneficiary/EU member; (ii) the vessel must be at least 60% owned by nations of the beneficiary or EU country, or by companies with a head office in the beneficiary of EU country, of which the chairperson and a majority of the board members are nationals; and (iii) the master and officers of the ship must be nationals of the beneficiary or EU member country, and 70% the crew must be nationals of the beneficiary country or the EU (Brenton and Imagawa 2005).

Stringent rules could have important trade diversion and investment diversion effects, with a potentially high cost to non-partners. For example, the boom in FDI in Mexico in the automotive industry was no doubt due to NAFTA and no doubt came at the expensive of more efficient investment elsewhere in Asia. To keep these effects to a minimum and avoid the complicated web knit by the rules of origin codes, Singapore worked out with the US the "integrated sourcing initiative," in which selected products that are not made in Singapore, but exported through Singapore, are deemed as of Singapore origin and entitled to preferential treatment when exported to the US.

- **Customs Procedures**. *To the greatest extent possible, customs procedures should follow global best practices and GATT/WTO-consistent protocols*. Customs and related procedures are at the heart of "trade facilitation," a key priority in the Doha Development Agenda. They are obviously closely related to rules of origin, as one of the key challenges of customs officials is to clear countries-of-origin of imports. The extent of globalization of production combines with the need for rules of origin in the context of FTAs (and, sometimes, customs unions, if the issue relates to nonreciprocal agreements such as the GSP or the EU's "everything but arms" initiative for Least Developed Countries) to ensure that customs procedures and related regulations form an essential component of any regional accord. A key issue in the customs negotiations pertains to transparency and "risk management".[60] "Best practices" under WTO relate to the Agreement on Customs Valuation, which provides private-sector access to a review and appeal mechanism. Some agreements go further than the WTO Agreement on Customs Valuation; for example, in the context of the US-Singapore FTA, the US import declaration is the only document necessary to prove origin.[61]

[60] That is, "a systematic framework to assess the risk on goods imported which target limited resources on high risk goods and high risk traders while facilitating the clearance of legitimate cargoes through the checkpoints" (Chia 2005).
[61] Chia (2005).

Table 3: **Various Approaches to Rules of Origin**

Rule	Advantages	Disadvantages	Key Issues
Change of tariff classification in the Harmonized System	- Consistent with nonpreferential rules of origin - Once defined, unambiguous and easy to learn - Relatively straightforward to implement	- Harmonized System not designed for conferring origin: there are often many individual product-specific rules, that can be influenced by domestic industries - Documentary requirements may be difficult for compliance - Conflicts over classification of goods can introduce uncertainty over market areas	- Level of classification at which change required: the higher the level, the more restrictive - Can be positive (which imported inputs allowed) or negative (cases in which change of classification won't confer origin) test: negative test more restrictive
Value -added	- Simple to specify and unambiguous - Allows for general rather than product-specific rules	- Complex to apply: requires firms to have sophisticated accounting systems - Uncertainty due to sensitivity to changes in exchange rates, wages, commodity prices, etc.	- The level of value-added required to confer origin - The valuation method for imported materials: methods that assign a higher value (e.g., CIF) will be more restrictive on the use of imported inputs
Specific manufacturing process	- Once defined, unambiguous - If rules can be complied with, provides certainty	- Documentary requirements can be burdensome and difficult for compliance - Leads to product-specific rules - Can quickly become obsolete due to technological progress and require frequent modification	- The formulation of the specific processes required: the more procedures required, the more restrictive - Should test be negative (processes or inputs that can't be used) or positive (what can be used)?

Sources: Brenton, Paul and Hiroshi Imagawa, "Rules of Origin, Trade and Customs," Chapter 9 in–De Wulf, Luc and José B. Sokol, *Customs Modernization Handbook* (Washington, DC: The World Bank, 2005), Annex 9.A.

Regional trading agreements can be used as instruments to modernize customs laws, regulations, administrative guidelines, and procedures. The most basic questions being asked are (McLinden 2005, pp. 76–77)): (i) has a process of continuous review been created?; (ii) has an official process of the review and rationalization of exemptions and concessions been developed?; (ii) is there in place an efficient cross-agency process in applying regulatory requirements?; (iv) have internationally-accepted conventions and standards, including those

found under the WTO Valuation Agreement, been implemented? (v) do regional trading groups adopt internationally accepted standards and work toward regionalization of best practices?; and (vi) are the laws, regulations, procedures, and administrative guidelines transparent?

If "best practices" are developed, progress in this area could be an important advantage of FTAs, especially if, as part of the agreement, developed countries help modernize these procedures, build capacity, transfer related technology, and train administrators. One does see this happening in such agreements, such as in the (non-preferential) US-Viet Nam Bilateral Trade Agreement and Japan's New Miyazawa Plan.

- **Intellectual Property Protection (IPR)**: *IPR guidelines should be nondiscriminatory and consistent with TRIPS, TRIPS Plus, and related international conventions*. The protection of intellectual property is one of the most sensitive issues in negotiating FTAs. Developed countries, having a strong comparative advantage in IPR-intensive products, want to make sure that IPR is taken seriously both *de facto* and *de jure*. In fact, many developing countries, including those that often find themselves on the US "special 301 watch list" of IPR offenders, have appropriate laws on the books, but lack implementation as well as enforcement. Developed countries have included IPR as essentially a *sine qua non* in bilateral FTAs.

  Developing countries often criticize the IPR stance of developed countries as being too severe and too favorable to innovators—for example, granting patent monopolies for an exaggerated amount of time, or being too insensitive in areas such as pharmaceuticals. On the other hand, it may be that stronger, more serious IPR protection can actually be positive for the development of a country's own innovative and artistic sectors. Moreover, a new literature in the international investment area gives credence to the view that FDI is not only a function of IPR protection, but also influences the sector distribution of FDI and the degree of technology transfer. Countries with stronger IPR protection tend to receive more FDI in sectors in which technology transfer is more likely.

  In any event, the extent to which IPR-related clauses within an FTA reinforce international conventions, the more likely the accord will support multilateralism, provided, of course, that the clauses are nondiscriminatory across countries.

- **Foreign direct investment**. *Investment-related provisions should embrace national treatment, nondiscrimination, shun performance requirements, and have a highly-inclusive negative list, as well as provide the usual protection necessary for foreign investors*. As was noted above, Asian countries generally place a strong emphasis on FDI, and having liberal, nondiscriminatory provisions tend to be less controversial than in the case of other developing regions. Exceptions might exist with respect to FDI in state-owned enterprises and "sensitive" sectors. This is true not only for developing Asia but also developed countries: state-owned enterprises have traditionally restricted significantly FDI penetration in areas such as defense, public morals, the media, and certain other sectors of high "national security" or "national sovereignty" importance. The US, for example, is only now considering allowing significant FDI in its airline industry. Hence, every country will have "negative lists" with respect to FDI. This will always be true with or without FTAs. For our purposes, we would stress that pacts should keep them to a minimum.

  Also, it is important that the accords embrace national treatment, thereby not giving preferential treatment to local relative to foreign firms. This has important implications for creating a competitive environment. Further, with respect to the "outward orientation" of the agreement, nondiscrimination *vis-à-vis* non-partners is also essential in creating a level playing field. For

example, in the US-Thai Treaty of Amity, Thailand gives certain preferences to US firms that are not accorded to multinational affiliates of other countries. This part of the agreement has expired; it will no doubt be an area of discussion in the ongoing US-Thai FTA negotiations.

- **Anti-dumping**. *Anti-dumping procedures and dispute resolution need to be transparent and fair, and the process needs to be well specified and effective*. Anti-dumping and countervailing duties, also known as "administrative actions," have been condemned as an important weapon in the arsenal of the "new protectionism." Anti-dumping duties have mainly been used by developed countries but some developing countries have begun to use them as well. Anti-dumping measures may or may not be stipulated directly in an agreement; sometimes, the references may be exclusively directed to the WTO dispute resolution. Anti-dumping clauses in an FTA might be used as a means to tighten anti-dumping evaluations procedures, promote transparency, and expedite any processes. But it also important that dispute settlement procedures be clearly identified and respected. Otherwise, confusion can follow. The most obvious example of this problem is the ongoing dispute between the US and Canada regarding softwood lumber exports from the latter to the former. The US claims that Canadian loggers have been given unfair subsidies (mainly in the form of subsidies stumping fees in state-owned forests), whereas the Canadians argue that the Americans are exaggerating this effect and, in effect, the US also subsidies their lumber industry. A NAFTA panel ruled in favor of Canada; a recent WTO panel has now (2005) ruled in favor of the US. There continues to be uncertainly as to what the next step will be in the process. In the meantime, US-Canadian trade relations are arguably at an all-time low, despite having an FTA since 1989.

- **Government procurement**. *Government procurement should be open and as nondiscriminatory as possible, and procedures should be clear and as open as possible*.

- **Competition**. *Policies related to competition should create a "level playing field" for both residents and partners, and they should not put non-partner competition at a disadvantage*.

- **Technical Barriers to Trade**. *These should be kept to a minimum, with clear and transparent mechanisms for determination of standards*. The WTO Agreement on Technical Barriers to Trade (TBT) attempts to "ensure that technical negotiations and standards, as well as testing and certification procedures, do not create unnecessary obstacles to trade." TBT takes on particular significance at the global level, as many of its aspects, including harmonizing standards, "mutual recognition," defining what are legitimate means of protecting, such as animal and plant life and the environment, among others, should have global rules of conduct. International standards, however, are bound to be general; FTAs, as they only involve a few or several countries, can potentially achieve far deeper means of integration and progress in this area. What would be critical for efficiency and outward-orientation, therefore, would be that any TBT clauses in FTAs should be based on international standards, have high levels of transparency, embrace best practices, and eschew discrimination against outsiders as much as possible.[62] The Uruguay Round created a "Code of Good Practice for the Preparation, Adoption and Application of Standards" by standardizing bodies; FTAs should build on these, or at least not contradict them.

In sum, by adopting best-practices, Asian FTAs could generate significant gains in terms of economic efficiency, well-beyond the effects of traditional FTAs (which can potentially be welfare-inhibiting) and,

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[62] As one would essentially always have trade diversion in an FTA (one way or another), the same is true of harmonization of standards within a regional group. When the EU launched its Single Market Program beginning in 1986, for example, one major aspect was the harmonization of standards and professional qualifications, thereby making a truly regional market. A European standard, however, cannot be completely a global one.

arguably, beyond what any realistic multilateral approach could possibly hope to generate. How much is "significant"? This would be difficult, indeed, to model. However, the EC's Single Market Programme, which did not focus entirely on best practices but is largely devoted to improving efficiency through the harmonization of the types of policies including in this section, was estimated (Cecchini 1988) to increase EC GDP by up to 6.5%. Moreover, in order to compare traditional estimates—induced by liberalization of tariff and tariff-equivalent nontariff barriers—of gains due to trade liberalization in Asia (Scenario 1) and more general trade-cost reduction effects such as improving customs clearance, lower transaction costs, and facilitation of international market access (Scenario 2), Brooks, Roland-Holst and Zhai (2005) run simulations to compare the aggregate impact on real income, exports, and terms of trade.[63] They assume that non-policy-related trade costs are around 120% and are cut by half over a 20-year period for East Asia, Southeast Asia, and South Asia.[64] The results are illuminating. Under Scenario 1, real income rises in the range of 0.9–2.9% for East Asia, 1.9– 6.6% for Southeast Asia, and 0.3–0.6% for South Asia. Under Scenario 2, the gains are many times as large, that is, 8.1–53.8%, 35.5–116.6%, and 10.4–22.4%, respectively.

Hertel, Walmsley, and Itakura (2001) go even further in their analysis of the potential gains from the Japan-Singapore FTA. They essentially develop a dynamic Global Trade Analysis Project (GTAP)-based model using an *ex ante* simulation but with some *ex post* features in estimating what we've defined above as dynamic and policy relationships in the model. Thus, they add to traditional trade barrier effects the harmonization of e-commerce standards, liberalizing rules in trade in services, automating customs services in Japan (to be consistent with Singapore), and investment flows. Interestingly, given the nature of this "new age" agreement, *all* regions of the world gain, including, of course, Japan and Singapore. Fully 70% of the gains accrue to Japan (a good share of which due to improved customs services). Hertel, et. al. stress that it is precisely the "new age features" which drive the positive results for all—and these are just a few of the possible areas we delineate above, as well as being between two advanced countries with less to gain from "best practices".

IV. To What Degree Are Existing Arrangements in Asia Consistent with Minimizing the Spaghetti-Bowl Effect?

To what degree do the regional accords listed in Table 2 conform with the "best-practices" outlined in Section III? In this section, we address this question by evaluating the existing accords, delineated in Table 2, and then "rating" them according to the areas analyzed in Section III. In gauging how well a specific agreement meets our "best practices" definition, we assign "letter grades", in which

- —"A" deems that the agreement generally conforms to our criteria and does not contradict GATT/WTO principles;
- "B" signifies that the agreement is an approximation of best-practices, but there is room for improvement;
- "C" would suggest that the agreement has many "holes" in it; is possibly "inward-looking"; and/or has certain potentially problematic features;
- "D" implies that the agreement is, indeed, inward-looking and potentially disruptive to international trade; and
- —"I" (for "incomplete") denotes that the area is basically excluded from the agreement.

[63] Brooks, Roland-Holst and Zhai (2005) model the Scenario 2 liberalization as an "iceberg effect," in which a fraction of goods and services"melt away in transit due to the trade costs" (p. 4, fn 4).
[64] It is important to note that this value is a guesstimate and is not derived systematically or empirically.

Of course, such a rating scheme will have to be somewhat subjective; each agreement is sufficiently nuanced as to preclude confident generalizations and uniformity of evaluation. However, it is hoped that such a rating scale will give an idea as to how closely the various agreements come to minimizing the costs of discrimination inherent in FTA and maximize the benefits of regional cooperation. Nevertheless, we *do not* calculate a "grade point average" for each accord; this would require a far too subjective rating scale. An example might illustrate the problem. We can compare AFTA and the US-Singapore in terms of their respective (i) product coverage in services; and (ii) rules of origin. As will be seen below, we would give respectively to AFTA and US-Singapore a C and an A for category (i), and a A- and a C for category (ii). We are bold enough to do this, as services in the US-Singapore agreement are covered extensively, whereas in AFTA they do not appear in specific terms except in a limited manner in the ASEAN Framework on Services (AFS), which has a long way to go; the US-Singapore agreement has complicated rules of origin provisions, whereas the AFTA agreement is far more transparent (it receives an "A-" only because its 40% rules of origin is not as "low as possible"). But how would we calculate an average grade for the two? We could impose symmetry, and assign a 50% weight to each. But who is to say that services are as important as rules of origin in an FTA? Services would tend to expand the potential benefits of the FTA, in terms of trade creation and trade facilitation and other means of enhanced efficiency, but rules of origin could be highly significant if they lead to greater trade diversion. They are apples and oranges; hence, we choose not to mix them.

It is apparent from this analysis that most FTAs involving developed countries tend to receive high marks with the exception of one category—rules of origin. Comparative analysis of the agreements in this area is extremely difficult due to the complicated nature of the subject and the product-by-product approach of the various agreements. Estevadeordal and Suominen (2005) attempt to do this for several of the pacts we discussed, including AFTA, Japan-Singapore, US-Singapore, and Singapore-New Zealand (as well as others).[65] Their analysis supports our conclusions below, that is, these accords do have restrictive rules of origin clauses, with the exception of AFTA.

As a final introductory consideration, it behooves us to consider why these agreements tend to exhibit so much diversity. Several points are relevant here. First, we should not exaggerate too much the differences. On the whole, by global standards we would judge most of these agreements to be generally outward-looking. This reflects the commercial policy stance of governments in the region,—in the direction of greater openness. It certainly would make little sense if, say, the ASEAN countries were pursuing economic reform and unilateral liberalization at the national level but, for some unexplained reason, they would opt to contradict this stance in AFTA by creating a "fortress." Given that the technical personnel and high-level policy makers in the trade and trade-related ministries tend to be the same people, such a schizophrenic approach would be hard to contemplate. This is not say that protectionist forces do not exert their interests; they do, and this is present in all agreements, be they regional or multilateral. But the thrust of these agreements is outward-looking, particularly when compared to other regions.

Second, the comparative advantage of large developed countries has changed such that their export interests are increasingly in the services sectors, which can account for over three-fourths of GDP and over one-third of exports. This ensures that behind-the-border measures, such as IPR protection, liberalization and protection of foreign investment and related mode 3 measures, and sensitive services sectors such as telecommunications, financial services, and even education, will be included in FTAs with developed countries, especially the US, but also Japan. Foreign direct investment in general is also another important topic for these countries, as their multinationals see FTAs as an important way to acquire a competitive edge in the globalization process. Moreover, large developed countries in the region (Japan) and outside the region (especially the US and EU) will continue to try to resist

[65] Estevadeordal and Suominen (2005), Annex 9.B.

the inclusion of certain products in which they have lost comparative advantage, especially highly-sensitive agricultural products.

Third, the smaller developed countries in the region—Australia and New Zealand—certainly have the same incentives as the other developed countries to include the behind-the-border sectors as well, but given their size may not have the clout to impose inclusion of such sectors. Moreover, they differ from the other developed countries in that they have a strong comparative advantage in agriculture and, hence, are in favor of more comprehensive product coverage in goods, something that is not always reciprocated, however, in their negotiations with other countries.

Fourth, most developing-country ("South-South") accords tend to be far less "legalistic" and more informal than trade agreements in which developed countries are included. This has much to do with weaker formal institutions in some of the developing countries and, often, the overriding importance of the political aspects of integration (discussed below). This is why there appears to be a tendency on the part of multinational firms and other players to discount the value of accords between developing countries. However, increasingly developing countries are accepting the reality that more structure, transparency, firm rules, and "depth" will be necessary if the goals of trade pacts are to be realized. The evolution of ASEAN integration is an excellent case in point.

Fifth, as was noted above, the noneconomic motivations for these agreements have an important bearing on the number and scope of the agreements. An in-depth analysis of the political and strategic motivations of these accords is beyond the scope of this paper. Suffice it to note that the motivations may be part of a strategic regional vision (such as the developed countries and the PRC), a strategic global vision (the US, Mexico, and Singapore), fear of being left behind (the "defensive" FTAs of the ASEAN countries and, arguably, Australia and New Zealand), or could be *sui generis* in nature.

Table 4 presents the grades that we would assign to each sector/issue and each agreement. In addition, we give some evaluating comments on the more significant agreements.

1. AFTA (multiple protocols: January 1992–January 2003). We reviewed the evolution of ASEAN economic cooperation extensively above. It should be noted, however, that relative to all "Full FTAs," AFTA is the most difficult to track and evaluation, as it really does manifest itself in pieces. While many of the other Full FTAs are hundreds of pages long, the AFTA agreement, signed 28 January 1992, comes to approximately four pages, supplemented by an additional six pages outlining the workings of the Common Accepted Preferential Tariff (CEPT)—the means by which tariff demobilization would take place. The agreement has several additional protocols and amendments, including those necessary to include the accessions of the transitional ASEAN countries in the mid-late-1990s. These have broadened the coverage of AFTA significantly over the years, defining "temporary exclusions lists" and means for their inclusion over time,[66] expedite the integration process; deepen CEPT tariff cuts within the AFTA framework from 0–5% to 0% (as of the "Protocol on the CEPT" signed 31 January 2003); and eventually foster other areas of cooperation under the AFS, AIA/AIC, and so on. In this sense it is the least "transparent" of the Full FTAs; however, it does demonstrate an evolutionary drive toward closer integration, which is consistent with the ASEAN approach to economic integration. Moreover, as noted above, a main goal of the ASEAN Charter, supported at the Kuala Lumpur Heads of State Summit in December 2005, will likely be to integrate these many documents.

It is also noteworthy that, in Article I of AFTA, the agreement specifies explicitly that "Member States shall endeavor to strengthen their economic cooperation through an outward-looking attitude so that

[66] According to the "Protocol on the Special Arrangement for Sensitive and Highly Sensitive Products," signed in Singapore, 30 September 1999, all products on the temporary exclusion lists should be included by 2010 for the ASEAN-6, and up to 2017 for the transitional ASEAN countries.

their cooperation contributes to the promotion of global trade liberalization." No other agreement has such a clear statement in favor of open regionalism as its absolute first priority. In fact, ASEAN members have been lowering their external barriers at the same time that they have been liberalizing intraregional barriers through CEPT, thereby reducing any potential marginal-of-preference that could lead to trade diversion. This is also true for investment flows; FDI is largely being liberalized on a nondiscriminatory basis.

Table 4: Grading Existing FTAs in Asia

Accord	Goods	Serv.	ROO	GovPro	Comp	Inv.	IPR	Mon	TBT
1. AFTA	A	C	A-	I	I	A-	I	C	I
2. SGP-NZ	A	B	A-	B+	A	A	A	A	A
3. EFTA-SGP	C	A	C	B+	B	A	A	A	B
4. JPN-SGP	A	A	C	A	B	A	A	A	B
5. US-SGP	A	A	C	A	A	A	A	A	A
6. AUS-SGP	A	A	C	A	A	A	A	A	A
7. KOR-CHLE	B	B	C	A	A	A	A	A	A
8. JPN-MEX	A	B	C	A	A	A	A	A	A
9. THAI-AUS	A	B	C	B-	A	A	A	A	A
10. INDIA-SGP	B	B	C	C	C	B+	C	A	A
11. KOR-SGP	B	B+	C	A	A	A	A	A	A

Notes:
1. Goods=Trade in Goods; Serv=Trade in Services; ROO=Rules of Origin; GovPro=Government Procurement (chapter/clauses); Comp=Competition (chapter/clauses); Inv.=FDI provisions; IPR=Intellectual Property Protection (WTO TRIPs plus related conventions); Mon=Monitoring and dispute settlement provisions; TBT=Technical Barriers to Trade.
2. Grading is based on: consistency with WTO and outward-orientation; best-practices; scope.

2. Singapore-New Zealand (ANZSCEP; 182 pages, including annexes; November 2000). New Zealand has evolved substantially over the past 20 years, from one of the most inward-looking economies in the OECD to one of the most outward-oriented. Hence, this accord is between two sophisticated, developed economies. And this is demonstrated in the high marks for the accord. It is outward-oriented and comprehensive, in terms of both goods and services. Even the rules of origin, which is based on either tariff transformation or a simple 40% rule, is liberal relative to other accords involving developed countries. It is interesting that the agreement actually refers to APEC commitments (under national treatment and coverage in services) in anticipation of the 2010 "deadline" (Article 20:4); they also refer to APEC nonbinding rules under government procurement, rather than the relevant WTO protocol. In terms of transparency, the agreement is fairly straightforward, with the exception of services, which leaves quite a bit open. "MFN status" is explicitly included in the investment section. The "technical barriers" section is particularly advanced (and takes up a relatively large part of the agreement). The part on "intellectual property" merely refers to WTO protocols.

3. EFTA-Singapore (590 pages, 545 of which comprise annexes; entered into force January 2003). This is a plurilateral agreement, in that the European Free Trade Area has had a FTA for over 30 years, and is between developed, sophisticated economies. The agreement essentially only covers manufactured products (Chapters 25–97 of the HS system) and, as such, is fairly restrictive in terms of goods. This comes as no surprise; one of the main reasons the remaining EFTA countries have not joined the EU relates to agriculture, which is even more protected in EFTA than it is in the EU. It is, therefore, no coincidence that city-state Singapore is unique as an FTA partner of EFTA in Asia. Sanitary

and Phytosanitary measures are simple and insist on nondiscrimination, but do nothing in terms of attempted harmonization of further cooperation. Competition-related clauses, including anti-dumping and those affecting state-owned enterprises, refer to WTO protocols, with a commitment (Article 50) to eschew any anti-competitive practices. By far the largest part of the actual text refers to trade in services; scope, as defined in Annex VII, includes considerable detail on professional (and business-related) services and tends to be quite liberal in this regard, consistent with other Singapore FTAs. Postal services are included, as are telecommunications—that is, those outside the purview of the Singapore Broadcasting Authority Act—and market access considerations for broadband multimedia (no doubt, a high priority for Nokia) to be reviewed in the future, leaving ambiguity (but EFTA is protected in the Singapore market by its MFN clause in the agreement's text). Limited progress appears to have been made on educational services in terms of mutual recognition, and university education is excluded (though secondary and post-secondary technical and vocational education are included). Coverage of financial services is broad. The investment agreement is fairly standard, with a strong emphasis not only on national treatment but also MFN (also the case with services and IPR protection). Government procurement provisions are strictly WTO-related.

4. Japan-Singapore FTA (JSEPA; January 2002; 512 pages, of which 432 annexes). Many of the same provisions found in the EFTA-Singapore FTA are found in this one as well, though coverage, particularly in the goods sector, is more comprehensive. Interestingly, earlier on in the agreement (Article 6), Japan and Singapore anticipate any potential "spaghetti bowl" problems, noting that any apparent contradiction between this and any other agreement shall be immediately addressed. Anti-dumping is not included in the agreement but rather relegated to WTO rules. Rules of origin tend to be product-specific and fairly complicated, which is actually the only drawback in a liberal, straightforward agreement. On the other hand, the emphasis on "paper trading" in this agreement (Chapter 5) suggests an advanced approach to trade facilitation. Services coverage is generally extensive (and, as in other accords, includes MNF clauses, though the language tends to be less direct). However, business practices (Article 66) are less explicitly detailed than in the case of the EFTA-Singapore FTA. It is noteworthy, however, that the parties agree to cooperate on the building of "capital markets," which would appear to be manifesting itself not only on a bilateral level but within the APT process. Joint human-resource development is also a priority. Investment is fully covered, and dispute settlement is transparent and clear (Article 82). IPR protection is relegated to the WTO TRIPs agreement (Article 86) but is expanded at length in Chapter 10. In fact, the IPR provisions in the Japanese and US FTAs with Singapore are highly advanced in this respect. Mutual recognition of professional persons is spelled out in detail, as is (short-term) movement of "natural" persons. Government procurement is WTO-based, and includes a liberal threshold of SDR100,000. The parties vow to avoid anti-competitive behavior (Articles 103–104), but resolutions of related disputes are not clear from the agreement (they are to wait for the "Implementing Agreement").

5. US-Singapore FTA (USSFTA; 240 pages plus annexes; May 2003). As noted above, the USSFTA is thought to be one of the most modern FTAs in the world. The US has explicitly expressed its intentions to use it as a model for accords with other ASEAN countries (under the "Enterprise for ASEAN Initiative") and is no doubt a benchmark for other accords is either negotiating or contemplating in the region. Hence, its "efficiency" and "openness" are of the essence, given the importance of the US in the global economy. Coverage of goods is comprehensive, though it devotes an entire chapter (Chapter 5) to textiles and apparel; with a view to ensuring that "trade deflection" will not take place through Singapore. Singapore, for its part, was able to negotiate a waiver on rules of origin for about two-dozen products under its "Integrated sourcing Initiative."[67] Services coverage is also comprehensive, going somewhat beyond the other Singapore accords noted above (especially in terms of banking services and capital controls). As is the case with all US FTAs, the rules of origin tend to be complicated. The

[67] Even "chewing gum" found its way into the agreement by way of compromise. Chewing gum had been banned in Singapore, but the US claimed this was a sort of technical barrier to trade. An agreement was struck whereby US chewing gum can be sold in Singapore…in pharmacies.

anti-competition clause is better developed than in the case of the other accords, as is IPR protection. An entire Chapter is devoted to Technical Barriers to Trade, with references especially to the WTO but also APEC. Controversially, labor and the environment each have Chapters in this agreement, a result of political realities in the US. However, the compromise agreement turned out to be fairly uncontroversial (and will be a model for other accords, no doubt): Singapore agrees merely to serious implementation of its *own* laws *vis-à-vis* labor and the environment. They also vow not to increase competitiveness by lowering standards in any of these areas.

6. Australia-Singapore (SAFTA; 117 pages plus annexes; 2003). Our final Singapore-based bilateral agreement with a developed country, Australia, exhibits many of the same features as the agreements above, particularly ANZSCEP. This is no doubt a result of the "Closer Economic Relations" FTA between Australia and New Zealand, which is highly-comprehensive and has been effective in linking the two countries' economies. Symmetry in the agreements was, therefore, important in order not to cause any trade deflection or other "spaghetti-bowl" effects. Coverage of goods and services is comprehensive; in fact, services, such as financial services and telecommunications services, are arguably even better developed in this agreement. Anti-dumping is essentially WTO-based, as are safeguards. Rules of origin are complicated, but somewhat less so than in the US case; various rules apply, and percentage of value added is generally defined either as 30% (for selected goods) or 50% (for all other goods). Rules on government procurement are fairly elaborate, but references to WTO protocol somewhat vague and noncommittal (Article 18). Investment, competition, TBT, and dispute settlement are fairly standard and well-developed in this agreement. IPR protection builds on WTO TRIPS.

7. Korea-Chile (130 pages; signed February 2003). While Chile has many FTAs in place, this accord was the very first FTA for Korea. It may appear strange that Korea would choose Chile as its first preferential partner, particularly since Chile's share of Korean trade and investment is so small. But in the main this was more of "starter agreement" for Korea, a means to begin the process of incorporating FTAs in its commercial policy with an "easy country," to which sensitive sectors in Korea would be minimally exposed. While manufactured goods are essentially covered, agriculture products are restricted. Rules of origin are complicated. The agreement does build on many WTO protocols, including in the areas of anti-dumping, sanitary, and phytosanitary measures, IPR protection, trade-related investment measures, and technical barriers to trade. The investment agreement, with replaces an earlier "BIT," takes up a more than commensurate share of the agreement (relative to the others) and is fairly exhaustive in its coverage of investment issues. Services liberalization, however, is incomplete and somewhat piecemeal. Quantitative restrictions are allowed, and financial services are excluded. Telecommunications are included, but mainly only ensure guaranteed access to local services.

8. Japan-Mexico FTA (135 pages; signed September 2004). Bilateral trade and investment between Mexico and Japan is small for each as a percent of their respective totals. However, each counts the US as its most important economic partner, at least at the signing of the agreement.[68] Given NAFTA, the usefulness of this agreement to Japan is clear, and Japan, being the second largest economy in the world and a major source of FDI, was an attractive partner for Mexico. In addition, Mexico has been seeking to diversify its trade and investment partners (currently the US is dominant, particularly in trade, for which the US market accounts for approximately 80% of total Mexican trade). NAFTA also made an FTA with Japan easier; many of the same components manifest themselves in this agreement. Coverage is similar to the Japan-Singapore FTA and other modern FTAs mentioned above. Financial services are included but are geared more to cross-border trade in financial services, rather than a "deep" approach to integration of the sector. Telecommunications are excluded altogether. Government procurement is covered extensively, including the creation of a "sub-committee" to monitor and ensure that the provisions of the agreement are respected. There is little written with respect to trade-labor concerns (especially relative to NAFTA and other US accords) but there is an explicit commitment to

[68] Shortly afterwards, the PRC became Japan's most important trading partner

not use environmental measures in order to attract FDI (Article 74). Monitoring and dispute settlement are clear and receive attention throughout the Agreement. “Competition” is included (Chapter 12) but the Agreement only outlines general guidelines of comportment.

9. Thailand-Australia FTA (118 pages, excluding annexes; 2004). As both Thailand and Australia are major exporters of agricultural goods, this side of the agreement was easier to reach than was the case for many of the other accords (except, of course, the Singapore agreements). Services liberalization, however, is not comprehensive. Sanitary and phytosanitary measures, as well as technical barriers to trade, are dealt with in-depth. Investment and competition policies are included as separate chapters (Chapter 9 and Chapter 12, respectively). Government procurement is included, but its provisions are not clear: it establishes the creation of a working group with a general mandate to give recommendations. IPR protection focuses on WTO protocols, with additional general commitments to protection.

Limited and Emerging Agreements: **ECOTA, the Proposed SAFTA (January 2004), and the Proposed Transpacific Strategic Economic Partnership (June 2005)**. The main goal of ECOTA was to (i) reduce barriers to international trade, particularly in the areas of nontariff and technical barriers; (ii) integrate the Economic Cooperation Organization (ECO) such that the region would become more competitive internationally; and (iii) boost intraregional trade, which was only at approximately 7% of total trade at the time the agreement was signed. The agreement itself was not easy to reach, given the extreme diversity of the organization, from countries with highly-developed commercial policies such as Turkey (which has a customs union with the EU) to those with emerging policies in Central Asia (and Afghanistan, which is a member of ECO). The low intraregional trade share was a reflection both of barriers to trade, especially high and unpredictable border fees and other nontariff barriers, and the fact that the region has comparative advantage in many of the same industries, which in turn are characterized by inter-industry trade. Hence, in practice the goal of increasing intraregional trade should have been secondary; defining “boosting intraregional trade” as a goal in the Treaty of Izmir (establishing ECO) could potentially be problematic if it were to take place through trade diversion. And while there is a good deal of market-friendly and outward-looking aspects to ECOTA, it remains an incomplete agreement in many aspects. Agriculture is essentially excluded, as are all sensitive manufacturing goods (in fact, the agreement appears to take a “positive list” approach to integration, similar to the ASEAN PTA). Rules of origin still need to be worked out, as well as the tariff demobilization component. In sum, listing ECOTA in Table 4 would have required a number of Ds, Is, and question marks, so we deemed it best to exclude it until it is better developed.

The SAFTA agreement came into force 1 July 2006, after “completion of formalities” and various ratification measures are completed in the member states (although Pakistan decided not to immediately implement the accord). This suggests that, if sufficient political will is mustered, the agreement will eventually emerge; but, at present, it is essentially a framework agreement that would lead up to an FTA. For example, rules of origin are not specified; the agreement just mentions that they are to be negotiated (Article 18). Product coverage remains unclear, though the tariff demobilization process is specified. One prominent feature of the agreement regards “special and differential treatment” for the Least Developed Countries of SARRC, which are among the poorest in the world.

In addition to the South Asian Preferential Trading Agreement (SAPTA), which is a highly-limited regional trading accord that was negotiated a decade ago, India also has like agreements with MERCOSUR (January 2004; 12 pages) and Nepal (December 1991; 9 pages). We exclude these from the table given their lack of significant content in terms of actual liberalization.

The Transpacific Strategic Economic Partnership, comprising Brunei Darussalam, Chile, New Zealand, and Singapore, would appear to be modern FTA, replete with references to WTO and APEC protocols.

This FTA would have to be extensive given the member-states; Singapore, for example, already has an FTA with each of these countries. But like SAFTA, the Agreement has left much to be worked out, and its date of implementation is unclear (the Parties have 6 months from 15 June 2005 to sign the Agreement). However, the text as it now stands would suggest an outward-oriented, comprehensive agreement between these four small countries.

IV. Conclusions and Recommendations for Future Research

In a controversial academic piece in the *American Economic Review* (but widely circulated beforehand), Andrew Rose tests the hypothesis of whether or not the WTO has really made a difference in stimulating world trade (Rose 2004). Using a gravity model of international trade, he rejects this hypothesis. In other words, over the 1948–2000 period, being a member of the WTO had no statistically-significant effect on influencing bilateral trade, when one controls for other relatively standard variables. Now, while few would doubt the analytical robustness of the article (the *American Economic Review* has arguably the most rigorous academic review process in the US), the piece has been criticized from a variety of angles, including the fact that it focuses on overall bilateral trade, rather than trade by sectors. One certainly wouldn't expect a significant WTO effect in agriculture, textiles, and clothing, and other protected sectors that have basically remained outside of the GATT/WTO liberalization process. Still, that is his point: the GATT/WTO has not done enough.

On the other hand, Rose 2004 does find strong effects in terms of the importance of regional trade agreements such as FTAs and customs unions, and especially monetary union. His results in this sense are consistent with the by now huge stock of empirical research on the determinants of trade and even investment flows using gravity models. These models generally do not tell us whether or not the effects of regional integration are due to trade creation or trade diversion, though the impressive internationalization of the world economy would certainly suggest that the former dominates the latter.[69] No doubt this is due to the fact that these regional trading agreements promote far deeper integration between countries, including not only many sensitive sectors hitherto unaffected by the WTO but also nontariff, non-border, regulatory, and other trade- and investment-related policies.

In fact, the economics literature, as well as the GATT/WTO Rounds themselves, placed far too much emphasis on tariffs. It is true that they are easiest to analyze (for economic models) and negotiate (for policy markers) but they are no longer the most important obstacles to international trade. In fact they have become increasingly irrelevant, and with them much of the standard "trade creation and trade diversion" approach to estimating the worthiness of a regional trading agreement. According to the World Bank (2005, p. 66), the average tariff of NAFTA countries comes to approximately 3% and that of AFTA, slightly less than 5%. Obviously, the effects of these FTAs, for better or worse, will ultimately not be decided by the usual net efficiency calculations. The economics of FTAs have become far too complicated and, generally speaking, economic analysis and negotiators have often failed to keep pace.

In any event, the regionalism trend is here to stay. Regardless of the argumentative merits of the pro- and anti-regionalism camp, it is a "fact on the ground" that preferential trading agreements, in particular FTAs, have been flourishing. There are myriad reasons behind this movement, with convincing economic, political-economy, and strictly political arguments. But this does not mean that evaluating regionalism is the economic equivalent of counting how many angles can dance on the head of a pin. An inward-approach to regional economic cooperation could pose serious risks to the

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[69] While the type of agreement obviously matters, empirical models of just about all modern regional trading arrangements, be they ex ante or ex post, tend to generate net trade creation. See Frankel (1997) and Kreinin and Plummer (2002) for surveys.

countries espousing them as well as to the international marketplace. Given that all major countries now subscribe to regional trading accords to various degrees, this suggests a threat that must be evaluated with continued vigilance.

A successful conclusion to the Doha Development Agenda, we have argued, would be very favorable to the global economy. With respect to the regionalism movement, not only would it, perhaps, strengthen openness rules on Article XXIV beyond the 1994 GATT Understanding, but it would also mitigate the effects of discrimination inherent in regionalism. We believe that Doha should receive the highest possible priority from its member-states. Unfortunately, talks were suspended in July 2006.

However, not even a successful Doha would have likely turned back the clock on bilateral and regional FTAs. Even if we leave aside the diplomatic and political-economy aspects of regionalism that tend to support the movement, there will remain salient economic influences that will continue to make bilateral, regional and plurilateral FTAs and other forms of regional economic cooperation attractive. Hence, it behooves economists to accept regionalism as a reality, and proscribe means to ensure that the trend be consistent with global market integration as well as being as efficient as possible in terms of minimizing costs associated with this second-best commercial policy.

This has been the main goal of this paper. In addition to evaluating regionalism itself in light of its relative merits and sustainability, we developed a general blueprint to gauge to what degree FTAs meet efficiency criteria and applied them to the case of Asian FTAs, both intraregional and with partners outside the region.

Our main conclusions from our review of the agreements themselves were several:

- "Full FTAs" in Asia have tended to be of the "building bloc" rather than the "stumbling bloc" type, though there are some (minor) exceptions in the terms of certain components;
- many of the FTAs that Asian countries have negotiated tend to be "modern" and among the most sophisticated in the world, including a wide set of sectors, integration mechanisms, and non-border policies;
- the agreements themselves, particularly those between Singapore and developed countries (such as Japan and the US), are liberal, with the exception of rules of origin. In fact, outside of rules of origin, we would argue that these accords generally unequivocally support the WTO system in most of their provisions, rather than conflict with it; with respect to the more limited FTAs, however, the restricted scope and selectivity of non-border areas can be problematic; and
- while Asian countries score better than most other FTAs in the international marketplace in terms of their matching a "blueprint" minimizing the costs associated with overlapping accords and consistency (the "spaghetti bowl effect"), progress could be made in this area.

This paper is merely a first step in trying to chart effective strategies to minimize the "spaghetti-bowl" effects of regionalism and ensure that Asia becomes an exemplary region in terms of its embrace of outward-oriented regionalism. Several additional lines of research would include:

- *Better ex-post modeling* of existing trade agreements in Asia, particularly ASEAN. While there is an abundance of *ex ante* models, which in this piece we argue can be sometimes counter-productive, little has been done using *ex post* modeling, outside of gravity models which are limited in their applicability. Studies along these lines would include: (i) a general survey of the static and dynamic modeling, both *ex ante* and *ex post*, to date in the Asia-Pacific literature, with a clear methodological comparison and analytical scrutiny (perhaps to include *ex post* validation of *ex ante* estimation); (ii) given the relatively paucity of *ex post* models, the development of a comprehensive, common *ex post* approach to modeling the effects of Asian bilateral accords (for which there exist sufficient data); and (iii) at the sector level, a study testing the hypothesis

as to whether or not FTAs have actually led to the "weeding out" process discussed above in the context of the "building blocs" versus "stumbling blocs" debate.

- *Better empirical modeling* of the costs of certain components of FTAs that tend to be "stumbling blocs." We noted above that there are many critics of regionalism that assume the costs of the spaghetti-bowl effect are large, without any actual formal estimates. One study cited in this paper suggests that compliance with rules of origin in FTAs can cost 3–5% of the fob value of exports; more such studies need to be done, including simple interviewing. During the course of this study, the author interviewed European customs officials regarding the costs of the EU "pyramid of preferences," a spaghetti-bowl if there ever was one. No official believed that the costs were high, given the organization of customs clearance in Europe. Studies of this nature could include partial equilibrium estimates as well as general equilibrium approaches, such as expanded approaches to the Hertel et. al. (2005) model.

- *More research on investment issues in FTAs*. In contrast to the large theoretical and empirical literature on the trade effects of FTAs, very little has been done in the area of investment. Given the empirically-verified importance of trade-FDI links and its importance to economy-wide growth and development, such research could pay rich dividends, particularly for developing countries. In addition to expanding on such models as those surveyed above (and in Box 1) and applying them to specific Asian cases, scholars could focus on the issue of investment diversion, in terms of both potential investment diversion due to emerging bilateral and regional accords *and ex post* estimates as to whether major agreements outside the region (such as NAFTA and the expansion of the EU) have resulted in investment diversion.

- *More research on FDI and technology spillovers in the context of FTAs*. We noted in our "taxonomy of FTA best practices" that certain policies within FTAs, for example, with respect to IPR protection or "Singapore Issues"-related areas such as investment codes, could enhance not only FDI inflows but also technology transfer. Useful studies in this regard would include: (i) An integrated review of the related theoretical literature; and (ii) empirical research as to technology transfer and productivity spillovers in the context of FTAs.

- *Comprehensive approaches to reforming the WTO to ensure that regional integration complements, rather than contradicts, multilateral goals*. It was noted above that the Doha Development Agenda is slated with the task of reforming Article XXIV such that it has more "teeth." However, not much progress was made in this regard, as the single-undertaking has not proceeded effectively. This is unfortunate; we have argued that the regionalism trend is here to stay, regardless of what eventually happens to Doha. Hence, ensuring compatibility is of the essence. But how could this be done in practical terms? An economist's immediate response would be fairly easy to construct; require them to embrace open regionalism (suxh as include a clause that states no barriers to trade can rise on non-partners exports to the region, rather just saying that no average increase would suffice). But is this politically feasible? Unlikely. Hence, development of a practical framework with open regionalism at its heart would be highly useful.

- *Analysis of whether or "subregionalism" can be a useful complement to regionalism and multilateralism.* The idea of "growth triangles," also known as "subregionalism," became a popular concept after the creation of the first Malaysia-Singapore-Indonesia was created in the early 1990s. Since then a number of additional arrangements have emerged, such as the East Asian Growth Triangle (Brunei Darussalam-Indonesia-Malaysia-Philippines), for which the ADB undertook a major study (ADB 1996) and more recently the Greater Mekong Subregion initiatives (see, for example, Menon 2005) and proposals that include various PRC regions; Hong Kong, China; and Macau SAR. To what degree have these initiatives been successful, and to what degree can they complement bilateral and plurilateral arrangements in the region?

Landingin and Wadley (2005), for example, suggest that while the East Asian Growth Triangle has had difficulties for various reasons, the economics would suggest that this type of approach can be effective. Menon (2005) also suggests that the Greater Mekong Subregion has been effective in helping member states integrate more effectively into ASEAN and is a good example of first-best regionalism.

- *Capacity Building for Best Practices in developing Asian countries*. As is clear from the above discussion, embracing best practices in regional arrangements is complicated, even for developed countries. Moreover, in addition to creating and implementing new policies, it will require the development of new institutions and innovative approaches to macroeconomic and microeconomic policies. Projects will need to be developed that can, *inter alia*, explain the need for associated measures and policies, convey and build capacity to evaluate their scope and implications for the economy to policy makers, businesspeople, academics, and civil society; help with related institution-building; and give instructions and training as to how they can be implemented. Strengthening capacity in these areas will be important not only for the bilateral and regional accords that these countries enter but also for the effective implementation of (hopefully successful) future accords under the WTO. Such projects will be required in the short-, medium-, and long-run.

These are but a few of a wide variety of possible issues that beg examination as the regionalism trend continues apace. Given the growing importance of Asia in world trade, what happens here will be of interest not only in the region but also in the world as a whole. The nuts-and-bolts of regionalism and its associated institutions, so often ignored by economists, require much closer study. It would behoove us to move on from the divisive regionalism versus multilateralism debate, which has not been particularly productive; accept regionalism as a reality, and work seriously to ensure that regionalism ends up promoting multilateral goals.

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