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**Research Report**

## Trade policy in Asia: Where next with a crippled WTO and weak FTAs?

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# Trade Policy in Asia

## WHERE NEXT WITH A CRIPPLED WTO AND WEAK FTAS?

**Razeen Sally**

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TRADE POLICY IN ASIA is now highly unbalanced and ill-suited to the imperatives of growth and development. Discriminatory bilateral and regional free trade agreements (FTAs) are centre-stage. Multilateral liberalization has stalled; and most governments have become less active in the World Trade Organisation (WTO). Not least, the enthusiasm for unilateral trade liberalization and related structural reforms (i.e. done autonomously by governments, outside trade negotiations) has waned. The conspicuous exception is China. There, liberalization has continued to race ahead, and has been anchored by very strong WTO commitments.

The picture looked very different only a decade ago. Pre-Asian crisis, the emphasis was on unilateral, non-discriminatory liberalization of trade and foreign direct

investment (FDI). This was critical to global integration and catch-up growth, especially in north-east and then south-east Asia. And it was reinforced by East-Asian multilateral commitments at the end of the GATT's Uruguay round. South Asia, on the other hand, liberalized later, less substantially and with weak Uruguay round commitments.

Now, with the collapse of the Doha round, the stage is set for a further and decisive switch from the WTO to FTAs. This will be bad news for Asia, unless trade-policy priorities are revised drastically.

### TRADE, FDI, POLICY REFORMS

FIRST, SOME BACKGROUND on trade-and-investment trends and policy reforms across Asia. The focus is on

## SUMMARY

Trade policy in Asia is dangerously unbalanced. It rests on a shaky leg of discriminatory bilateral and regional FTAs. Its other WTO leg has gone to sleep: most Asian countries have neglected the WTO in favour of FTAs. Its regional-cooperation arm is limp: grand visions for regional economic integration are mostly empty conference chatter. Above all, core abdominal strength through unilateral

liberalisation and pro-market domestic reforms has weakened post-Asian crisis. China is the conspicuous exception. Now, after the collapse of the Doha round and a fraying multilateral trading system, three priorities are called for. First, a clutch of East-Asian countries plus India should be active in "coalitions of the willing" to set the WTO on its legs again. US leadership and a Chinese helping hand will be crucial.

Second, existing FTAs should be cleaned up and new FTA initiatives only launched with caution and a sense of economic strategy. Third, and most important, it is vital that the engine of Chinese unilateral liberalization does not stall. That is the only major route to further liberalization and regulatory reform across Asia and beyond – through competitive emulation, not trade negotiations.

East and South Asia – “globalising Asia”. This leaves North and West Asia – which remain largely non-globalised – out of the picture.

For the last half-century, Japan and the next generation of Tigers (South Korea, Taiwan, Hong Kong and Singapore) have dominated Asian economic activity. Japan still accounts for over 50 per cent of East and South Asian combined GDP (at market prices). But China is catching up fast. It is already more globally integrated than Japan in terms of trade and FDI penetration, and has recently displaced Japan as the world’s third largest trading nation. Trade in goods is 63 per cent of GDP; FDI stock stands at 35 per cent of GDP; and multinational enterprises account for an astounding 60 per cent of merchandise trade. Thus the world’s most populous nation has, in quick time, mutated from almost-complete autarchy to assume the characteristics of a small-to-medium-sized open economy like South Korea.

India’s global integration pales in comparison, but it has come far by its own standards. It is the world’s 30th largest trading nation in goods. Its share of world exports in goods and services is 1.3 per cent, compared with 6.6 per cent for China. Trade and FDI stock are 30 per cent and 5 per cent of GDP respectively – way below China, but still registering fast growth from a very low base. Annual FDI flows (about \$4 billion) and overall FDI stock (just over \$30 billion) are much less than a tenth of Chinese levels. As for other South-Asian countries, severe political instability and ethnic strife hamper their global integration and economic progress.

FINALLY, COUNTRIES IN South-East Asia are highly dependent on the world economy. Like China, FDI-driven exports are central to their growth models. South-East Asian trade levels are roughly on a par with China, though this represents rapid Chinese trade growth, and catch up over the past decade. The average trade-to-GDP ratio in South-East Asia is over 130 per cent. FDI inflows (at about \$16 billion annually) are well below Chinese levels but some way ahead of Indian levels.

What does this tell us about the emerging international and Asian division of labour? Japan, South Korea, Taiwan, Hong Kong and Singapore have comparative advantage in high-value goods and services. China has clear-cut comparative advantage in labour-intensive manufacturing exports, and increasingly in labour-intensive agricultural exports.

Given its huge pool of cheap labour, India too should be a labour-intensive, FDI-driven exporting powerhouse in industrial goods, as well as a budding exporter of labour-intensive agricultural products. But severe labour-market restrictions strangle industrial employment. Less than 10 million Indians are employed in the formal manufacturing sector, out of a total employable population of about 500 million. This compares with upwards of 150 million Chinese in manufacturing employment. Indian agriculture is hobbled by external and internal trade restrictions – much more so than in China. And the employment-generation effect from services exports is a drop in the ocean compared with what it could be in manufacturing. The much-hyped IT sector employs only 1 million relatively skilled and educated people.

SOUTH-EAST ASIA IN between stands to gain from deeper integration into East-Asian manufacturing supply chains, now including China. It is this “Factory Asia” phenomenon that has driven phenomenal growth in trade between China, North-East and South-East Asia during the past decade. But to exploit these niches fully, the older ASEAN members must liberalize further, especially in services and agriculture, and strengthen domestic institutions in order to compensate for eroded cheap-labour advantage. The newer, poorer ASEAN members should exploit cheap-labour advantage, especially as relative incomes rise in China. India and the rest of South Asia remain very far from being integrated into East-Asian supply chains.

What about trade-policy reforms? Since the early 1980s, a veritable trade policy revolution has spread across the developing world as part of wider packages of market-based reforms. The Asian financial crisis, however, raised strong doubts about further liberalization. This has centred on financial liberalization, especially of short-term capital flows, but it has had a knock-on effect on trade and FDI. Broadly speaking, previous liberalization has not been reversed, but its forward momentum has slowed.

South-East Asia fits this pattern. The real burst of trade-and-investment liberalization took place in the 1980s and first half of the 1990s. These measures were generally not reversed in the post-Asian crisis. But, with the exception of Singapore, government enthusiasm for further liberalization declined markedly. Overall, South-East Asia presents a varied picture: free-trade Singapore is at one extreme; other old ASEAN members have relatively liberal trade policies (with average tariffs under 10

per cent, correspondingly low non-tariff barriers and an open FDI regime in manufacturing), but with large pockets of protection in agriculture and services; and the new ASEAN members are still highly protected.

How does China fit in? Its first decade of reforms centred on internal liberalization, especially in agriculture. Then followed a brief period of uncertainty and suspense after the Tienanmen massacre. The last 12 years, however, have seen the biggest trade-and-investment liberalization programme the world has ever seen. In short time, China has swung from extreme protection to rather liberal trade policies, indeed very liberal by developing-country standards. The protective impact of classic non-tariff barriers (NTBs) has come down to less than 5 per cent; and the simple average tariff has come down from 42 per cent in 1992 to 9.8 per cent after WTO accession. This is well below the developing-country average. The pace of internal and external liberalization has not let up since. It is now clear that the main obstacles to doing business in China have less to do with formal border barriers and more with (formal and informal) non-border barriers.

INDIA HAS HAD a rather different trajectory. Its retreat from the “licence raj” – its equivalent of Soviet-style central planning – began half-heartedly in the 1980s; but it was a foreign-exchange crisis in 1991 that provided the window of opportunity for more thoroughgoing market-based reforms. These were radical by Indian standards, though less so compared with policy reforms elsewhere. They covered macroeconomic stabilization, trade liberalization, relaxation of FDI restrictions, privatization and, not least, the dismantling of domestic licensing arrangements that had governed most formal economic activity. The average tariff has come down to about 20 per cent from 125 per cent in 1991. Most border NTBs, internal licensing restrictions and restrictions on manufacturing FDI have gone. This still leaves high protection in agriculture and services.

Since the initial burst in 1991-93, Indian reforms have proceeded in a stop-go manner. They have not been reversed; but they have moved ahead more slowly and fitfully compared with South-East Asia (pre-Asian crisis) and China (pre- and post-Asian crisis). Democratic politics, including the complications of multi-party governing coalitions and the federal division of powers between the Union government and the states, has made faster, more decisive reforms elusive.

Japan, South Korea and Taiwan have sent mixed signals on market-based reforms. Japan and South Korea have been reluctant to liberalize trade and FDI further (though South Korea did partially open its financial sector as part of an IMF bailout package). Taiwan did liberalize substantially in the run up to its WTO accession in 2001.

#### TRADE NEGOTIATIONS: WTO

NOW TURN TO trade negotiations, starting with the WTO.

Japan, South Korea, Hong Kong and the ASEAN countries were active in the Uruguay round, and generally benefited from the resulting agreements. But they have been visibly less active – indeed mostly disengaged – in the Doha round. With the chief exception of China, they have neglected the WTO in favour of new FTAs.

Japan and South Korea remain arch-defensive on agriculture. Japan in particular – Asia’s economic giant and the second largest economy in the world – punches well below its weight in the WTO. Taiwan acceded to the WTO the day after China, but cross-straits political tensions have prevented it from becoming a fully active WTO member. Hong Kong remains a separate member of the WTO after its handover to China. Its WTO activity, however, has been overshadowed somewhat by the accession of the mainland.

The ASEAN countries have had a kaleidoscope of Doha round positions: Singapore has clear market-access priorities; the others have mixed positions, with Indonesia and the Philippines particularly defensive on agriculture. All have been distracted by FTAs. Of the new ASEAN members, Cambodia joined the WTO in 2005, and Vietnam in late 2006. Vietnam’s WTO accession, like that of China, will be the crowning point of its transition from Plan to Market, and spur further integration into the global economy.

The big news for Asia in the WTO is China’s accession in 2001. China’s WTO commitments are by far the strongest of any developing country in the WTO. This holds for tariff ceilings on goods (including agriculture); non-tariff barriers in goods and services (with big-ticket sectors like financial services, telecoms, retail, transport and a host of professional services thrown open to foreign competition); all manner of strong domestic regulatory disciplines to improve transparency and promote competition; and administrative and judicial-review procedures to ensure that WTO commitments are implemented domestically.

As a result, China's levels of trade protection are rather low by developing-country standards; and it has acquired a strong stake in a rules-based multilateral trading system. More than any other major developing country, China has internalized the classic logic of the GATT/WTO: as an instrument of defence against the arbitrary protection of other powerful countries; a lever to expand access to export markets; and a framework of rules to buttress domestic market reforms and integration into the global economy. Hence China has been active in the Doha round, though in a quiet, behind-the-scenes manner. It has been decidedly non-dogmatic and non-confrontational, indeed quite pragmatic and flexible, on the main negotiating issues.

INDIA'S WTO COMMITMENTS are much weaker than China's, and it has been generally defensive in the Doha round, as it was in previous GATT rounds. It has become slightly more flexible on market-access issues, and has discovered offensive interests in the services negotiations. But it needs to be much more flexible in offering concessions to open its own market in order to extract concessions from others. That would bring India's WTO activity closer into line with unilateral reforms at home, and send a powerful liberalizing and system-supporting signal to other WTO members. The problem is that severe domestic political constraints prevent the Government of India from showing greater flexibility in the WTO, just as it is prevented from pursuing more ambitious market-opening reforms at home.

The Irish poet W B Yeats wrote that when things fall apart, the centre cannot hold. The Doha round has finally fallen apart; and it is going to be very difficult to hold the "centre" of the multilateral trading system together. Much more trouble lies ahead. The WTO is in seemingly inexorable drift – away from the hard politics of trade liberalization and the rules that underpin it. Serious players will switch further to discriminatory bilateral and regional trade agreements; and they will be tempted to flout existing multilateral rules.

Unfortunately, East-Asian neglect of the WTO, combined with Indian defensiveness, has contributed to the collapse of the Doha round and helped to undermine the multilateral trading system. That is extremely myopic, and may prove to be a monumental miscalculation. Asia needs an effective WTO. East Asia's integration with the world economy gives it a long-term stake in a liberal trading system underpinned by strong, non-discriminatory rules. A

patchwork of overlapping and discriminatory FTAs is not enough; and, in the absence of a healthy multilateral system, will probably be damaging. This logic applies compellingly to South-Asian countries too, given their increasing integration into the world economy.

To get the WTO out of its rut after Doha, its members need to do three things: restore focus on a core trade-liberalization agenda; revive effective decision-making; and, not least, scale back ambitions and expectations. Refocusing on a manageable pro-market agenda requires leading players to counter, rather than pander to, anti-market forces inside and outside the WTO. But it also requires realism; a better sense of the limits to what the WTO can do given its huge political complications. Hence market-access and rule-making negotiations should be cautious and incremental; and trade rounds should probably become a thing of the past. There should be more emphasis on the everyday tasks of improving policy transparency and administering existing rules better. And dispute settlement should not degenerate into backdoor lawmaking.

NONE OF THIS can be achieved in the chaotic UN-style talking shop the WTO has become. Workable decision-making demands recognition of hard-boiled realities outside Geneva. About 50 countries – the OECD plus 20-25 globalising developing countries – account for almost 90 per cent of international trade and FDI. These countries, which include Japan, South Korea, Taiwan, Hong Kong, China, India and the more advanced ASEAN members, should explore ways of reviving negotiations on core market access (agriculture, industrial goods and services) and rules (such as anti-dumping procedures and subsidies), though in a restricted plurilateral setting and not as part of another "round". Such a plurilateral track will need to be insulated from noxious influences in the WTO: anti-market governments, old-style protectionist interests and new-style NGOs.

Negotiated concessions should be extended to the rest of the WTO membership via the Most-Favoured-Nation clause. Negotiations on newer regulatory issues, such as trade facilitation and government procurement, could proceed among smaller groups of willing and like-minded members. Finally, within this outer core of about 50 there is an inner core of five "big beasts": the USA, EU, India, China and Brazil. They must exercise leadership. Otherwise nothing will move, and the WTO will be consigned to a permanent state of UN-style infantilism.

Getting such initiatives going will invariably require US initiative and leadership. Barring a global economic crisis, that will not happen soon. A John McCain presidency might be its best prospect. But this will also depend on Asian, and particularly East-Asian, support. Most important will be a Chinese helping hand. Once the dust of the Doha round settles, it is vital that China move to the WTO foreground and play an active co-leadership role.

#### TRADE NEGOTIATIONS: FTAS

A CRIPPLED WTO has allowed FTAs to spread like wildfire and dominate trade policy across Asia. There are 17 FTAs in force and about 60 in the pipeline in China, India and South-East Asia alone. All the major regional powers – China, India and Japan – are involved, as are the USA, South Korea, Australia, New Zealand, Hong Kong, other South-Asian countries and the ASEAN countries. Bilateral (country-to-country) FTAs are most in evidence, but there are plurilateral negotiations too, especially those involving ASEAN collectively. An ASEAN Plus Three (China, Japan and South Korea) FTA has been proposed, as has an East Asian Economic Community (bringing in Australia and New Zealand); and there is even talk of an Asian Economic Community (involving India and other South-Asian countries).

Government-led conventional wisdom holds that FTAs can take liberalization and regulatory reform further than would be the case in the WTO. This can in turn stimulate multilateral liberalization. But the real picture looks rather different. Nearly all negotiations in east and south Asia look like delivering weak, partial, “trade-light” agreements. This would replicate the hotchpotch of “dirty” FTAs in Latin America, Africa, the Middle East and the ex-Soviet Union. Negotiations tend to be driven by vague, muddled and trivial foreign-policy goals and empty gesture politics, with little sense of economic strategy. This can amount to little more than symbolic copycatting of other countries’ FTA activity. The predictable results are patchy, quick fix sectoral deals while sensitive areas (especially in agriculture and services) are carved out. They hardly go beyond WTO commitments, deliver little, if any, net liberalization and regulatory reform, and get tied up in knots of restrictive, overlapping rules of origin. Especially for developing countries with limited negotiating capacity, resource-intensive FTA negotiations risk diverting political and bureaucratic attention from the WTO and from necessary domestic reforms. Finally, the sway of power

politics can result in highly asymmetrical deals, especially when one of the negotiating parties is a major player.

China appears to be more serious than other regional players. It has relatively strong FTAs with Hong Kong and Macau (both admittedly special cases), and the China-ASEAN FTA negotiations have made reasonable progress in eliminating tariffs on trade in goods (though with little progress to date on other issues). But China is negotiating very weak FTAs elsewhere in the developing world, allowing feel-good diplomacy to crowd out sensible economic strategy. These are mostly preferential tariff reductions on a limited range of products.

TURNING TO SOUTH-EAST Asia, only Singapore has reasonably strong FTAs, and an especially strong FTA with the USA with comprehensive coverage and strong rules for goods, services, investment and other issues. But Singapore, with its free-port economy, centralized city-state politics, efficient administration and world-class regulatory standards, is a misleading indicator for the region. Thailand provides a better indicator. Its FTAs have been rushed: too many negotiations have been launched, and they have proceeded too fast, with little overarching strategy. The residual FTA logic seems to be narrowly mercantilist: export market access in a few sectors is sought in return for import concessions in a few others, while otherwise preserving the domestic-protectionist status quo. This trade-light approach has resulted in weak FTAs that will make little positive difference to competition and efficiency in the Thai economy, but will create complications in the process (not least with a bewildering array of rules-of-origin requirements). The US-Thai FTA is likely to be the sole exception due to American demands for wide and deep commitments. But negotiations have run into serious domestic opposition in Thailand, which threatens to derail them altogether. All signs point to other ASEAN countries following the Thai, not the Singaporean, example.

India is also negotiating lots of FTAs, in its South Asian backyard and elsewhere. Especially in its negotiations outside South Asia, its approach is trade light: it exempts large chunks of politically sensitive products from liberalization, and insists on very restrictive rules of origin. Japan also has a trade-light approach to FTAs. Politically, it is reacting to China’s active pursuit of FTAs, but on the economic front it carves out much of agriculture, insists on restrictive rules of origin and is unambitious in other areas. South Korea is similar.



Finally, big-block East-Asian or pan-Asian FTA initiatives are not to be taken too seriously. They are mostly empty conference chatter, far removed from commercial ground realities. Regional players are speeding ahead with quick and dirty bilateral (country-to-country) FTAs, while little progress is being made with the larger ASEAN FTAs (with the exception of the ASEAN-China FTA). The emerging pattern is of a patchwork of bilateral “hub-and-spoke” FTAs, in a “noodle bowl” of trade-restricting rules of origin. More generally, bitter nationalist rivalries (especially in North-East Asia and between India and Pakistan), and vast inter-country differences in economic structure, development, policies and institutions, will continue to stymie Asian regional-integration efforts for a long time to come. This applies to East Asia; it applies even more to South Asia.

The heart of the matter is that cross-border commerce in Asia, as elsewhere in the developing world, is throttled by the protectionist barriers that developing countries erect against their equally poor or even poorer neighbours. The type of FTAs that are being negotiated do not presage a return to 1930s-style warring trade blocs. But they are highly unlikely to make a big dent in existing barriers and thereby spur regional economic integration. They might complicate East-Asian intra-regional production networks (the Factory Asia phenomenon), and distract attention from further unilateral liberalization and domestic reforms. Not only are the new Asian FTAs trade light: some might even come close to being “trade-free”. A blunt, uncharitable Texan would say that they are “all

hat and no cattle”. As Montaigne said of Seneca’s writing, most of these FTAs make “more sound than sense”, and some might even be “pure wind”.

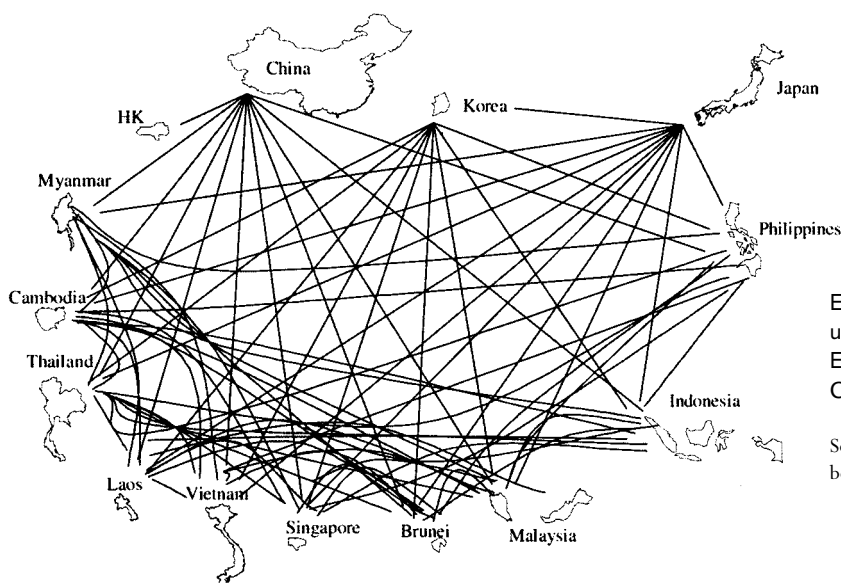
#### CHINA AND THE UNILATERAL PROGRESS TO FREER TRADE

It is customary to look first to the WTO, or now to FTAs, or to a combination of the two, to advance the liberalization of international commerce. This is questionable. In Asia and elsewhere, there is too much emphasis on trade negotiations and not enough on trade policy linked to sensible home-grown economic and institutional reforms. Trade negotiations have their place; but they have distinct limits. The transition from GATT to WTO has narrowed the possibilities for multilateral liberalization and rule strengthening – as the Doha round has amply demonstrated. Similarly, much-hyped bilateral and regional FTAs are unlikely to inject large doses of additional liberalization, but will create extra political and economic complications.

Therefore, governments in the region cannot rely on external negotiations for meaningful trade-policy reform. Rather the bulk of external liberalization and associated “second-generation” domestic institutional reforms will likely come from unilateral measures that spread through competitive emulation – outside trade negotiations.

This Nike strategy (“Just Do It!”) is indeed the recent track record. The World Bank estimates that 65 per cent of developing-country tariff liberalization between 1983 and 2003 has come about unilaterally, with 25 per cent

figure 1  
The East Asian ‘Noodle bowl’ syndrome



Explanation: The map shows FTAs signed or under negotiation in January 2006. East Asia is defined here as the 10 ASEANs, China, Japan and Korea.

Source: Richard Baldwin (2006) *Managing the noodle bowl: The fragility of East Asian Regionalism*. *Mimeo.*

coming from the Uruguay round agreements and only 10 per cent from preferential trade agreements. North-East and South-East Asian trade-and-FDI liberalization has been overwhelmingly unilateral. Now this applies to South Asia too. Most recently, the bulk of China's massive external liberalization was done unilaterally, not through international negotiations, and before WTO accession. China's extremely strong WTO commitments, and its pragmatic and businesslike participation in the WTO post-accession, are more the consequence than the cause of its sweeping unilateral reforms.

Arguably, China is in many ways today what Britain was in the second half of the nineteenth century: the unilateral engine of freer trade. True, China is far from being the top dog Britain was in the nineteenth century. Nevertheless, it is probably spurring a pickup in trade-and-FDI liberalization elsewhere in East and South Asia – notably in India. Would all this have happened, or happened as fast, if China had not concentrated minds? Probably not. For India and South-East Asia to take advantage of the opportunities offered by China's global integration, and overcome more-exposed weaknesses caused by protectionist policies and weak institutions, there has to be further liberalization and regulatory reform. This is less likely to come about through the WTO, FTAs and regional institutions such as SAFTA and ASEAN, and more likely to result from unilateral measures by individual governments in response to internal and external conditions.

That is not to say that a China-induced unilateral method is a total solution. It is unlikely to induce unilateral liberalization in the developed world, and least of all from the USA, EU and Japan. In the developing world, its results will inevitably be patchy and messy. On its own it cannot slay protectionist dragons and solve international commercial conflicts – least of all in agricultural trade, where unilateral liberalization has been much more limited than in industrial goods and services. That leaves room for the WTO and FTAs, but these are at best second instances of trade policy. Hence it is important to get priorities right and follow the process bottom-up, not top-down.

## CONCLUSION

Trade policy in Asia now rests on a shaky FTA leg. Its other WTO leg has gone to sleep; its regional-cooperation arm is limp; and, above all, core abdominal strength through unilateral reforms has weakened. China is the conspicuous exception. With the collapse of the Doha

round, the Gadarene rush to do more dirty FTAs, and the consequent fraying of the multilateral trading system, three new priorities are called for.

- China, India, Japan, South Korea, Hong Kong and the ASEAN countries should be active in plurilateral “coalitions of the willing” to restore the WTO's fortunes, albeit in a sober, realistic manner. This will require US leadership and the cooperation of other major powers, especially China and India in Asia. China's helping hand will be indispensable.
- There should be much more caution with FTAs. Existing FTAs should be cleaned up (i.e. with comprehensive coverage, stronger rules and liberal rules of origin), and new initiatives only launched with a credible economic strategy. FTAs are a reality; they cannot be wished away; but they can be improved; and they can fit better with trade policy on unilateral and multilateral tracks.
- Most important, it is vital that the Asian – particularly Chinese – engine of unilateral liberalization does not stall. That depends on internal conditions in China, and increasingly in India too. But it also depends on a clement external macroeconomic and trade environment. Thus the USA, EU and leading Asian powers (China, India and Japan) must strengthen “constructive engagement” across a broad range of economic and foreign-policy issues, while containing belligerent and protectionist forces at home. This is more a matter of unilateral example-setting and bilateral cooperation than of trade negotiations.

ULTIMATELY, FREER TRADE in the early twenty-first century, and modern globalisation more generally, are happening more “from below” than “from above”. Their engine, now to be found in Asia, particularly in China, is bottom-up liberalization and regulatory reform that spreads through competitive emulation, like ripples and waves across seas and oceans. This process is not driven by international institutions or “global governance.” As the German economist Wilhelm Röpke noted: “Internationalism, like charity, begins at home,” it emerges “from within and beneath”; like a house, it cannot be built “starting with the roof”; and “more important than international institutions and legal constructions are the moral-political forces behind the market that are only really effective within nations”.



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