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**Working Paper**

Building the pillars of a regional economic partnership. A report to inform New Zealand's contribution to Phase II of CEPEA

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# Building the pillars of a regional economic partnership

**A report to inform New Zealand's contribution to Phase II of CEPEA**

Prepared by NZIER in February 2009

New Zealand Trade Consortium working paper no. 47

## About NZIER

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We pride ourselves on our independence and reputation for delivering quality analysis in the right form, and at the right time, for our clients. NZIER is also known for its long-established Quarterly Survey of Business Opinion and Quarterly Predictions.

## Authorship

This report has been prepared at NZIER by John Ballingall and reviewed by Brent Layton. The assistance of Professors Shujiro Urata of Waseda University and Mitsuyo Ando of Keio University on modelling matters is gratefully acknowledged.

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The views in this report are those of the authors and do not necessarily reflect the views of the New Zealand government.

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# Executive summary

## Background

The Track II Study Group on a Comprehensive Economic Partnership in East Asia (CEPEA) released its Phase I report in 2008 on the desirability of further regional integration amongst East Asia Summit countries. It recommended as an option further Track II research into the three 'pillars' of a CEPEA: economic cooperation, facilitation of trade and investment and liberalisation of trade and investment. East Asia Summit Economic Ministers endorsed this further Track II research in August 2008 and asked that institutional development necessary to support a CEPEA be added to the research agenda.

Based on the outcomes of the December 2008 Ad Hoc Meeting of the Study Group in Tokyo, the Chair invited country experts to submit in early 2009 a detailed paper on one or more of the topics above. This report is the New Zealand expert's response to this invitation.

## Objectives of research

This report builds on, and explores new ground related to, the three pillars of a CEPEA noted above, plus institutions, and deepens the analytical knowledge base for future discussions.

It aims to inform and focus Study Group discussions for the next phase of this initiative by:

- Making specific suggestions on the nature and scope of provisions that fall under the various pillars of CEPEA. These suggestions add some "meat on the bones" of the conceptual framework presented in the Phase I report and move discussions towards considering the optimal design of a CEPEA.
- Updating the general equilibrium modelling exercise in the initial report by employing the recently-released version 7 of the GTAP database. This analysis estimates separately the impacts of a CEPEA on 15 of the 16 East Asia Summit countries, including Cambodia, Laos and Myanmar (which were not analysed separately in the Stage I report modelling)
- Identifying areas of future research for the Study Group to consider.

## Approach

We first examine the vast and ever-expanding international literature (including from the OECD, ADB, APEC) on trade liberalisation, regional trading agreements and deeper economic integration to determine some best practice guidelines for designing liberalisation, cooperation and trade facilitation measures under a CEPEA.

We then undertake a computable general equilibrium modelling exercise to estimate the potential benefits from a comprehensive CEPEA that is designed along the best principles outlined above.

Based on this review of literature and modelling exercise, we put forward some conclusions regarding the optimal design of a CEPEA and make some recommendations for further research.

## Conclusions

Given the intra-East Asia liberalisation witnessed to date, and the potential costs of the region continuing to go down the “hub and spoke” route outlined on page 10, this study concludes that there is a clear case for the introduction of a more coordinated approach to regional economic integration through a CEPEA that:

- Improves the efficiency of resource allocation within the region to the benefit of firms and households via improved profitability and higher per capita incomes.
- Enhances rather than hinders the development of regional production networks.
- Provides for deeper regional engagement than a simple tariffs-only agreement through increased facilitation and technical assistance activities.
- Does not act as a ‘stumbling block’ to future multilateral liberalisation.

Such integration must be based on economic principles, rather than on political foundations. A CEPEA must avoid becoming “trade-light” due to not being driven by economics.

In the present economic environment, there is ample justification for taking bold steps to progress regional integration: the very last thing countries should be doing right now is becoming more inward-looking. Most firms and households in East Asia will recognise this fact, despite the traditional pockets of resistance. This should provide considerable impetus to political leaders’ efforts to implement a CEPEA.

In considering the optimal design for a CEPEA, based on the three pillars identified in the Phase I report (liberalisation, facilitation and cooperation) as well as institutions, our report has suggested some key principles. These principles have been developed based on the international literature on Preferential Trade Agreements (PTAs), commonly-accepted best practice guidelines from international agencies and economic modelling. The key implications from our analysis include:

1. A comprehensive, high quality and ambitious CEPEA should be approached as a ‘single undertaking’. It is not sufficient to solely consider goods liberalisation. A CEPEA must also include substantial services and investment liberalisation so that East Asian countries can better exploit their comparative and competitive advantages and to reallocate resources in a more efficient manner.
2. A CEPEA will deliver the greatest benefits when it covers a larger number of countries and does not exclude any sectors from liberalisation. Levels of ambition under a CEPEA should therefore remain high.

3. A CEPEA should contain provisions on government procurement, competition policy and intellectual property. Such provisions help to lock in the benefits of trade liberalisation. While these are sometimes contentious issues, and their exact form can be debated, they should remain 'on the table' for negotiators to discuss.
4. The differing development levels of potential CEPEA members must be acknowledged. However, given that a large proportion of the benefits from trade liberalisation are generated by domestic reallocation of resources and regulatory reform, deeper economic integration provides the best opportunity for closing existing development gaps within East Asia.
5. The gains from a comprehensive CEPEA that incorporates trade facilitation and technical assistance provisions are estimated to be far greater than those estimated for an agreement that covers tariff liberalisation only. Therefore trade facilitation and cooperation must be considered in addition to (not in lieu of) trade liberalisation.
6. Cooperation activities under a CEPEA should involve knowledge transfer and information sharing on issues of mutual interest amongst members. Important areas of cooperation could include agricultural technology, environmental and energy issues, financial cooperation and assisting small and medium enterprises. Cooperation could also include training on using analytical tools such as computable general equilibrium modelling to assess and disseminate the benefits and adjustments costs of a CEPEA. All cooperation activities should be centred on improving resource allocation to enhance the ability of members to harness the potential economic and development benefits arising from deeper regional economic integration.
7. A key focus of CEPEA trade facilitation activities should be simplifying border procedures. This will reduce the transaction costs of trading activities, which will improve economic outcomes for businesses and consumers alike through improved profitability and lower prices respectively. Of particular importance are customs procedures and the way in which standards (TBT and SPS) are applied.
8. The nature of ROO under a CEPEA negotiation will be crucial to ensuring that intra-CEPEA trade flows are boosted after liberalisation. ROO should ensure that trade deflection is minimised and that intra-CEPEA trade is facilitated. ROO must not be used as a form of protection in disguise, or the gains from integration could be undermined.
9. When combined, liberalisation, facilitation and cooperation/assistance spur enhanced and more efficient regional production networks and encourage dynamic gains and technology transfer that can deliver improved productivity growth rates. These three pillars can also generate higher levels of investment that are important for developing infrastructure.
10. Existing regional institutions such as the East Asia Summit, the ADB and ERIA provide a sound foundation for driving, coordinating, implementing and monitoring progress under CEPEA. An additional institution of modest size may be required in the form of a CEPEA Secretariat to monitor progress and co-ordinate efforts.



## Background

In June 2008 the Track II Study Group on a Comprehensive Economic Partnership in East Asia (CEPEA) released its report on the desirability of further regional integration amongst East Asia Summit countries. The recommendations of this report included the option of commissioning further Track II research into the three 'pillars' of a CEPEA:

- Economic cooperation
- Facilitation of trade and investment
- Liberalisation of trade and investment

East Asia Summit Economic Ministers endorsed this further Track II research in August 2008. Ministers asked that any institutional development necessary to support CEPEA be an additional area of research interest for this further work.

Based on the outcomes of the December 2008 Ad Hoc Meeting of the Study Group in Tokyo, the Chair invited country experts to submit by the end of January 2009 a detailed paper on one or more of the topics above. This report is the New Zealand expert's response to this invitation.

# Objectives of report

The Phase I CEPEA Study Group report presented an overview of CEPEA's objectives and scope, estimated the economic impact of a comprehensive agreement and provided some high level suggestions regarding selected key elements of such an agreement. This report builds on, and explores new ground, related to the four pillars of CEPEA noted above, and deepens the analytical knowledge base for future discussions.

This report aims to inform and focus Study Group discussions for the next phase of this initiative by:

- Making specific suggestions on the nature and scope of provisions that fall under the various pillars of CEPEA. These suggestions add some “meat on the bones” of the conceptual framework presented in the Phase I report. This will help the Study Group to develop a view on what a CEPEA could look like in practice, and to better understand some of the complex issues and trade-offs that will arise if a comprehensive agreement is to be negotiated.
- Updating the general equilibrium modelling exercise in the initial report by employing the recently-released version 7 of the GTAP database. This analysis estimates separately the impacts of a CEPEA on 15 of the 16 East Asia Summit countries.<sup>1</sup> This modelling update will provide researchers, policy makers and Ministers with a clearer sense of the potential benefits that CEPEA would deliver to member countries.
- Identifying areas of future research for the Study Group to consider.

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<sup>1</sup> In the Phase I report, Cambodia, Laos, Myanmar and Brunei were examined only as part of a composite region due to a lack of country disaggregation in version 6 of the GTAP database. This made it difficult to assess the impacts of CEPEA on these economies. The recent publication of version 7 of the database makes it possible to examine the first three of these countries separately. Brunei is now the only country in the region for which separate country specific data are not available.

# Context

## East Asian regionalisation to date

The history of East Asian regionalisation is fairly outward-looking (Sally, 2009). Unilateral liberalisation in East Asia, particularly in the 1980s by Asian 'Tigers', has resulted in the development of regional production networks (through lower import and inward investment barriers) as capital-intensive countries seek to utilise the vast pools of relatively cheap labour available in nearby economies. In particular, East Asian countries' desire to become closely linked into China's production networks has triggered further unilateral liberalisation.

But this unilateral liberalisation has been patchy across sectors and isn't bound, meaning that previously removed barriers could be re-imposed at will. As such, unilateral actions cannot be relied upon to provide the certainty required to move regional integration forward for the benefit of East Asian businesses. This points to the need for a more cohesive, rules-based regional economic integration framework to provide fair, stable and predictable rules for trade and investment. Various options for more cohesive, region-wide integration have been put forward, including an APEC PTA (FTAAP), Asian PTA (EAFTA or ASEAN+3), CEPEA and, more recently, TransPac<sup>2</sup>.

This is not to say that regional integration has not already taken place in East Asia: indeed the region is "awash" with various forms of regional economic integration. However, current arrangements may be slowing down and distorting integration of regional production networks (Sally, 2009). Some East Asian bilateral Preferential Trade Agreements (PTAs) to

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<sup>2</sup> TransPac refers to the PTA between Brunei, Chile, New Zealand and Singapore (previously known as the Trans-Pacific Strategic Economic Partnership Agreement or P4). The US has recently agreed to engage with TransPac. Australia, Vietnam and Peru have also expressed a strong interest in acceding. As noted in NZMFAT (2008), "one of the objectives of the Trans-Pacific Agreement was to create a trade agreement that could be seen as a model within the Asia-Pacific region and could potentially attract new members. The agreement is open to accession 'on terms to be agreed among the parties, by any APEC economy or other state'". TransPac is a concrete example of open regionalism, as espoused in the CEPEA Phase I Report.



date have been somewhat “quick and dirty”. They have significant sectoral exclusions, primarily related to agriculture (ADB, 2002, p182), and some are focused mainly on goods liberalisation, rather than on ‘new economy’ issues such as services and investment, competition policy, government procurement, etc. As a result, a pattern of patchwork ‘hub and spoke’ agreements has been established – there has been a degree of intra-regional competitive liberalisation.

The ‘hub and spoke’ arrangements present some well-known problems for regional integration (Scollay, 2003). Such agreements “tend to reinforce the unequal bargaining strength of the parties, since the “hub” can exploit competition among the “spoke” economies, and use precedents established in PTAs with one “spoke” to strengthen the case for inclusion of similar provisions in agreements with other “spokes”. As a result, spokes tend to seek additional PTAs with each other, and some larger spokes attempt to act as “mini-hubs”. This all adds up to a complex set of overlapping PTA arrangements, which has been described as a “noodle bowl”.<sup>3</sup>

As noted in Sally (2009, p38) and Petril (2008, p8), this noodle bowl could potentially impose tariffs on products that result from production chains spanning several countries within the regional network of PTAs. This increases the administrative burden facing businesses, and thus reduces efficiency. This in turn threatens to slow down the integration of regional production networks, which is so important to the economic development of the region.

These factors indicate that there is a good case for further examining deeper regional integration in East Asia through a vehicle such as a CEPEA.

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3 In the longer run, as the complexity of overlapping ROO increases in East Asia, and the benefits from regional PTAs reduces (as a result of previous efficiency gains delivered by already-signed agreements), it could be posited that some harmonisation will naturally be induced (Petri, 2008, p.8). While this may be true in theory, such a process could be quickened through implementing a shared coordinating mechanism such as that which might be established under a CEPEA.

## A note on the global economic environment

The global economic outlook has deteriorated significantly over the past two years. In such an environment, there is a risk that countries will start to become more inwardly-focused, and concentrate policies on protecting domestic jobs rather than on becoming more integrated with the rest of the world. This can result in trade barriers such as export subsidies and export taxes being unilaterally imposed, rather than being gradually removed over time. Such knee-jerk reactions can lead to retaliatory actions by trading partners who are affected by these trade barriers. As witnessed by the period following the 1930s Great Depression and the introduction of the Smoot-Hawley Tariff Act in the US, these actions can have significant anti-integration 'signalling' effects. They also prevent resources being used efficiently at the very time when such allocation is most vital and can impose substantial costs on households and businesses when both are already facing economic hardship.

It is, therefore, essential that the current international economic downturn should act as a spur to regional integration, not a brake on it. As noted by Sally (2009, p15), "an economic crisis...is when a period of 'extraordinary politics' can provide a window of opportunity for thoroughgoing reforms (that would not be possible in "normal" political circumstances)". The experience of Australia and New Zealand in the mid-1980s strongly aligns with this view – trade liberalisation and regulatory reform are both politically much easier to implement and more beneficial during very difficult economic times.

It is particularly essential for economies in the East Asian region to retain an emphasis on reducing existing trade barriers because of the current difficult economic circumstances, and not despite them. As noted by Sally (2009, p28), "labour-abundant countries in East Asia, and in South Asia, have the most promising political economy to support external liberalisation and global integration". The slow pace of discussions at the multilateral and regional level is not in the economic best interests of the region. Current circumstances require a significant acceleration of the pace of work on a CEPEA as a valuable vehicle for enabling regional integration to meet the challenges of the global economic environment.

We now examine each of the CEPEA pillars outlined in the Phase I report in more detail.



# Liberalisation

The liberalisation of trade in goods and services and investment flows has long been recognised as important to economic growth and social development. In-depth studies by the OECD, World Bank and NBER strongly support that countries with more liberal trade policies have more open economies that grow faster than those with more protectionist policies. Some major developing countries (sometimes referred to as “new-globalisers”) have registered significant increases in their trade to GDP ratios, alongside per capita income increases, poverty reductions and improvements in human welfare measures such as literacy, infant mortality and nutritional intake (Sally, 2009, pp3-4).

In order to inform stakeholders that may be affected by trade liberalisation in East Asia, it is useful to provide estimates of the potential gains from deeper regional integration.

## Modelling

### Approach<sup>4</sup>

In this study, we essentially replicate the computable general equilibrium (CGE) modelling exercise conducted in the Stage I report, with one major difference – we use the recently released version 7 of the GTAP database. This database differs from the version 6 used in the Stage I report in a number of ways (see Narayanan and Dimaranan, 2008), but the two most significant improvements are:

- The global economy is portrayed as at 2004 (compared to a 2001 base year in version 6), with trade flows and trade protection data updated accordingly.
- There are 113 regions in the database (compared to 87 in version 6). Of particular interest for this report is the addition of Cambodia, Laos PDR and Myanmar as separate regions (these countries were part of a composite region in version 6).<sup>5</sup>

<sup>4</sup> The assistance of Professors Shujiro Urata of Waseda University and Mitsuyo Ando of Keio University on modelling assumptions used in the Stage I report is gratefully acknowledged. We do not discuss the magnitude of the trade facilitation and technical assistance shocks in this paper, although note that this could be examined in more depth in future work.

<sup>5</sup> Unfortunately Brunei remains in a composite region alongside Timor Leste, so we cannot definitively estimate the impacts of East Asian regional integration on Brunei. However, given the economic size of Brunei compared to Timor Leste (Brunei’s economy is around 10 times as large and thus dominates the composite), it is reasonable to expect that the impacts on the composite region in our analysis are largely reflective of the likely impacts in Brunei. Splitting Brunei out from this composite region is an avenue for further research.

We aggregate the database into 22 regions and 16 sectors (see Table 2 in Annex for aggregation details). As was done in the Stage I report, we model a number of scenarios for regional integration using the static GTAP CGE model (see Hertel et al, 1997, for a description of the GTAP model). In addition to removing tariffs, which is a representation of the most basic PTA that could be considered, we also incorporate trade facilitation and technical assistance/cooperation effects. Specifically, and following Ando (2008) and the Stage I report, we assume that trade facilitation would lead to a 10% improvement in the efficiency of importing goods<sup>6</sup> to countries involved in a CEPEA. We further assume that technical assistance and economic cooperation resulting from regional integration under a CEPEA lead to a 1% productivity improvement in developing countries.<sup>7</sup>

### *Modelling scenarios*

- Scenario 1 East Asia Summit: Tariff elimination only
- Scenario 2 East Asia Summit: Tariff elimination plus trade facilitation plus cooperation
- Scenario 3 East Asia Summit: Tariff elimination plus trade facilitation plus cooperation; all agriculture and food products excluded
- Scenario 4 ASEAN+3: Tariff elimination only
- Scenario 5 ASEAN+3: Tariff elimination plus trade facilitation plus cooperation

### **Results<sup>8</sup>**

The key macroeconomic modelling results are presented in Table 3 and Table 4 in the Annex. They are consistent with those presented in the Stage I report. The most salient points are as follows:

- The welfare gains from a comprehensive CEPEA that incorporates trade facilitation and technical assistance provisions are far greater than those estimated for an agreement that covers tariff liberalisation only.
- All CEPEA countries experience welfare gains and higher economic activity under a comprehensive agreement.

<sup>6</sup> This 10% trade facilitation applies to all East Asia Summit countries, apart from Singapore, which takes a 5% efficiency improvement, reflecting its already efficient customs system. By way of comparison, the second APEC Trade Facilitation Action Plan aims for a further reduction of trade transaction costs by 5 per cent in the period 2007-2010 (APEC, 2007).

<sup>7</sup> Developing countries are defined as all ASEAN countries (excluding Singapore), China and India.

<sup>8</sup> As noted in Kiyota et al (2009) "It is important to understand that CGE modelling simulation results provide indications of the potential economic changes involved. In this respect, they are not meant to be empirical forecasts or predictions of the changes since they are not derived from econometric methods that can yield statistically-based estimations... CGE modelling results are therefore to be interpreted as the potential effects of trade liberalisation at the microeconomic level, holding macroeconomic influences constant".

- Developing CEPEA countries gain more, in relative terms, than developed countries from a comprehensive agreement.
- Cambodia, Laos PDR and Myanmar all experience significant welfare and GDP improvements as a result of comprehensive regional integration.
- The gains to almost all ASEAN+3 countries are larger under a CEPEA agreement than they are under an ASEAN+3 agreement.
- In addition to the smaller welfare gains for most ASEAN+3 countries (relative to a CEPEA agreement), an ASEAN+3 agreement would have negative economic implications for Australia, India and New Zealand. GDP drops in these three economies if they were excluded from regional integration in East Asia.
- Excluding agriculture and food products from a CEPEA reduces the potential GDP gains to all members. The welfare gains to agricultural exporters such as New Zealand and Australia are reduced considerably (by 23% and 28% respectively) if agriculture is excluded. The welfare gains to some other countries such as Indonesia, Thailand, Cambodia, India and Vietnam also drop by between 10% and 16%.
- A decomposition of the welfare results (not shown, but available upon request) indicates that the main gains are from own-country liberalisation, rather than through enhanced market access in trading partners. That is, it is the competitive pressures from liberalisation that deliver efficiency improvements in both developed and developing East Asia Summit countries under a CEPEA.

In summary, the modelling exercise provides evidence, which is consistent with theory and previous empirical work<sup>9</sup>, that the greater the number of countries in an PTA in East Asia, the greater the economic gains to participants. It also shows that more comprehensive agreements, in terms of product coverage and provisions to effect technical assistance and trade facilitation, deliver more substantial gains than agreements with partial liberalisation or a tariff-only focus.

This raises the question of how goods modalities might be designed under a CEPEA. There is a wide range of modalities employed in existing regional agreements, and caution needs to be taken in being too specific or prescriptive and presenting a 'one-size-fits all' set of rules, particularly as a CEPEA contains countries of varying levels of development. That said, some general principles can be developed to shape the discussions:

- The agreement must be consistent with the provisions of GATT Article XXIV. It must eliminate duties and other restrictive regulations on "substantially all trade". While no specific threshold for "substantially all" has ever been widely accepted, consideration should be given to both volume and value aspects of trade in setting thresholds.
- A CEPEA should remove barriers on a high percentage of tariff lines, and also on lines where trade is heavily concentrated<sup>10</sup> (so as to incorporate sectors which may have been non-traded or traded at a very low level due to trade chilling effects).

<sup>9</sup> E.g. Scollay and Gilbert (2001), Wang and Schuh (2000).

<sup>10</sup> Scollay (2005) suggests that 90% of tariff lines can be considered an absolute minimum, although many PTAs in the Asia Pacific have liberalised a greater proportion of trade.

- The precise proportion may vary between PTA members, according to their development levels, but should not deviate significantly from this benchmark.
- The removal of the vast majority of tariffs should occur upon entry into force.
- Any tariffs that are not eliminated upon entry into force should be phased to zero in a commercially meaningful timeframe, generally accepted as being a period of 10 years.<sup>11</sup> This timeframe and phasing sequence should be specified upon signing the PTA.
- No sector should be excluded from the tariff reductions unless there is a legitimate reason under the GATT for public health, safety, morals, national security, etc purposes.
- Concerns about sensitive sectors such as agricultural products should be addressed using slower phase-outs and consideration of safeguard mechanisms if necessary, rather than being excluded entirely.

## Services and investment

The modelling work above has focused on merchandise trade liberalisation, primarily because standard CGE models are not generally well set up to consider the impacts of services and investment liberalisation. This in turn is due to the well-known considerable statistical difficulties inherent in measuring the size and nature of services trade flows and the barriers that may inhibit these trade flows. However, given the size of most countries' services sectors (often around 2/3 of GDP), and the rapidly growing nature of cross-border trade in services, it is essential that any CEPEA negotiation take a comprehensive approach to services liberalisation. Services are an important element of regional integration and complement goods and investment liberalisation provisions.<sup>12</sup>

Services trade takes place through a variety of channels or 'modes'. Trade through commercial presence (Mode 3) represents around half of total services trade and cross border supply (Mode 2) around 35%. Consumption abroad (Mode 1) accounts for 10 to 15%, with only a small 1 to 2% being attributable to the presence of natural persons (Mode 4). The prominence of Mode 3 in particular indicates that services "trade" is to a large extent about foreign investment (Fink and Jansen, 2007, p3). As outlined below, many of the services trade barriers are indeed related to investment issues.

## Nature and impacts of services trade barriers in East Asia

A wide range of barriers to services trade exist in global markets. Such barriers include (UNCTAD, 1996; Australian Productivity Commission):

- Bans on foreign investment in certain sectors.
- Ownership restrictions (e.g. limit of 25% foreign ownership in a sector).

<sup>11</sup> As per the 1994 "Understanding on the Interpretation of Article XXIV" (WTO, 1994).

<sup>12</sup> This section draws extensively on Ballingall and Stephenson (2005).

- Screening and approval (sometimes involving national interest or net economic benefits tests).
- Restrictions on the legal form of the foreign entity.
- Minimum capital requirements.
- Conditions on subsequent investment.
- Conditions on location.
- Admission taxes.
- Compulsory joint ventures with domestic investors.
- Limits on the number of foreign board members.
- Government appointed board members.
- Government approval required for certain decisions.
- Restrictions on foreign shareholders' rights.
- Mandatory transfer of some ownership to locals within a specified time (e.g. 15 years).
- Performance requirements (e.g. export requirements).
- Local content restrictions.
- Restrictions on imports of labour (e.g. visa restrictions), capital and raw materials.
- Operational permits or licences.
- Ceilings on royalties.
- Restrictions on repatriation of capital and profits.

The cumulative effect of these services trade barriers distorts services trade in much the same way as do agricultural and manufacturing barriers in East Asia. They impose costs on firms and consumers, limit international competition, prevent efficiency gains from resource reallocation and allow protected services providers to price at levels that are above where they would be in a fully competitive market. They also prevent important technology transfer possibilities that could allow economies (and particularly developing countries) to become more technologically advanced.

In addition, services barriers not only limit market access to relatively efficient foreign providers, they often prevent domestic firms entering the market. The result is that domestic services markets can become dominated by potentially inefficient firms which do not need to adjust their rent-seeking behaviour due to competitive pressures.

### **Benefits of services trade liberalisation in East Asia**

Given the negative efficiency effects of services trade barriers as outlined above, the removal of services barriers in CEPEA is desirable for many of the same reasons that goods liberalisation has been rigorously pursued for many decades: to allow East Asian countries to better exploit their

comparative and competitive advantages and to reallocate resources in a more efficient manner. In addition, services liberalisation can deliver important welfare gains that result from increased domestic competition. That is, as services barriers are lifted, other domestic firms can enter the domestic market, potentially creating significant efficiency gains.

Developing countries in particular stand to gain relatively more from a managed liberalisation of services trade. For example, reduced barriers to trade in transportation services makes imported intermediate goods cheaper (which is especially important given the high value of intra-East Asia Summit trade) and subsequently final goods exports more competitive. Liberalisation of transport services can also assist developing countries in attracting badly-needed foreign investment and foreign expertise to develop existing infrastructure or create new infrastructure. Thus services liberalisation can help to stimulate investment in infrastructure development where domestic funding may have otherwise been difficult to secure (given public sector budget constraints and limited access to international capital markets) (OECD, 2008b). Indeed, OECD (2008a) suggests that the productivity-enhancing effects of FDI are the strongest (relative to agriculture and manufacturing) when foreign presence is encouraged in services industries.

Tourism is another sector which can benefit from services liberalisation and which is becoming increasingly important to developed and developing countries alike (OECD, 2006b). If services that are closely related to the tourism sector (air transport, telecommunications, internal transport, accommodation, etc) are liberalised, their costs will decrease as efficiency gains are generated. This will make tourism services cheaper and more internationally competitive.

Mode 4 services, whilst presently a small proportion of services trade, has the potential to deliver significant welfare gains if liberalised. One study estimates a US\$150 billion gain from a 3% increase in the temporary movement of natural persons from developing to developed countries (Winters, 2002). The enhanced linkages that Mode 4 services trade can deliver can increase investment flows and skill transfers between countries, which in turn improve a country's wealth and create jobs (Cattaneo and Nielson, 2003).

Services liberalisation is also an important tool for development in that it can confer long run growth benefits. This is because trade in services, particularly imports of services, can enhance physical, social, human, and institutional capital in a fashion that does not necessarily come so obviously from increased goods trade (UNCTAD, 2004). Services liberalisation can help developing countries to better exploit their comparative advantages through technology transfer. For example, many East Asian economies have a large proportion of their resources (land and labour) devoted to agricultural production. However, they are often capital and knowledge-poor. Services liberalisation, particularly through Modes 3 and 4, would allow economies that have strengths and know-how in agricultural techniques (such as Australia and New Zealand) to work with domestic producers to lift domestic agricultural productivity. This will have important economic development implications.

Recent theoretical advances in the trade literature (namely Grossman and Rossi-Hansberg, 2008) have highlighted the growing importance of 'trade in tasks'. This is closely related to offshoring, trade in services and investment flows. In this context, a 'task' refers to a small piece of value added being completed by each factor of production (capital, labour, etc) along the length of a regional production network or supply chain. This production network can span many countries or regions as technological and communications advances have reduced the costs of moving from one part of the production chain to the next: thus weakening the need for labour specialisation and geographic concentration to be inextricably linked.

This is precisely the nature of East Asian regional production networks – a final good will often have passed through several countries and several production processes before it is sold to the end consumer. Grossman and Rossi-Hansberg (2008) use this framework to demonstrate that if the costs of trading in tasks fall, which could occur via services or investment liberalisation, significant positive productivity effects result.

Therefore it can be suggested that services and investment provisions under an ambitious CEPEA would lead to trade in tasks taking place more efficiently across East Asia: regional production networks would become more profitable, and the returns to labour and capital should increase.

Specific aspects of services and investment negotiations to be considered under a CEPEA include:

- The outcomes of the negotiations must comply with Article V of GATS so that there is substantial sectoral coverage, national treatment-type discrimination is substantially eliminated and barriers are not raised against non-members. 'Substantial' should be taken to mean that most sectors, covering the vast majority of trade volumes in all modes, are liberalised.
- Liberalisation should occur in a reasonable period of time, perhaps phased in where necessary within a 10 year period (at maximum).
- Regulations on domestic service sectors do not have to be scrapped, but any discriminatory treatment afforded by these regulations must be removed. General exemptions related to security and balance of payments concerns are permitted and should be made in a transparent fashion.
- A negative list approach to services liberalisation is preferable.

While the positive list approach is used in GATS and is therefore familiar to many countries, there are some difficulties associated with it (ADB, 2008, pp64-67). First, discussions progress more slowly than under a negative list approach, as a number of rounds of 'offer-request' negotiations are required to move towards agreement. Second, and more importantly, a positive list does not 'future proof' liberalisation provisions for new services to be added to the agreement, whereas a negative list assumes that all current and future services are considered free of restrictions unless listed in the 'non-conforming measures' Annex. A negative list approach can thus be considered as more transparent and flexible.



# Cooperation

## Why are cooperation activities important?

While much of the focus of countries negotiating PTAs is on enhancing market access, it should be recognised that there are broader economic and developmental gains to be had from regional integration. As noted by the IMF (2007) "Regional trade integration can serve as a vehicle for dialogue and coordination on regional issues that are not part of the multilateral agenda. These might include regulatory harmonization, infrastructure development, and collaboration among members to facilitate transit trade and transport. And they can stimulate inward foreign direct investment and growth through technological transfers". It is through these types of 'dynamic gains' from trade that trade liberalisation can result in not just one-off lifts in economic activity, but sustained increases in the productivity growth rate (OECD, 2006a).

The modelling exercise in this report has illustrated that the potential economic benefits from technical assistance or cooperation activities under a CEPEA that boost domestic productivity growth are significant. Cooperation activities are thus likely to be vital to the overall success of deeper integration in the East Asian region, where economic development levels are varied (ADB, 2002, p174) and some economies will be better placed to deal with the requirements of deeper regional integration than others. This creates an information gap that can be usefully filled by cooperative activities. The issue is well summarised by Urata (2005) who suggests that "it is important to deepen mutual understanding through closer communications and active exchange of people at all levels, such as exchange programs for high school and college students, politicians, and bureaucrats". To this list one could also add business owners and managers who will be engaged in trading activities.

## Types of cooperation exercises

Cooperation activities typically incorporated into PTAs as part of the overall package of measures designed to boost trade, services and investment linkages between members – over and above market access provisions – include:

- Capacity-building through inter-governmental seminars and workshops.
- Training, information-sharing and transfer of know-how between businesses and officials in trade-related matters.
- Visits of experts between countries for in-market demonstrations of key aspects of trade liberalisation and facilitation.
- Memoranda of Understanding on issues of mutual importance.

Examples of such cooperation exercise can be seen in many recently concluded PTAs, such as the Australia-New Zealand-ASEAN PTA.

## Areas for cooperation activities

Such cooperation activities commonly cover areas such as:

- Customs and origin matters
- Technical standards
- Trade facilitation (particularly related to small and medium enterprises)
- Intellectual property rights
- Counterfeited goods
- Agricultural technology
- Environmental and labour issues.

These activities are designed to give officials in developing countries in particular a better understanding of the key issues that stem from trade liberalisation.<sup>13</sup> They will then be able to communicate more effectively with domestic stakeholders and interest groups. Some are discussed in more detail in the chapter on facilitation of trade and investment (page 22) as they tend to overlap with trade facilitation.

## Agricultural cooperation

Given the diverse levels of agricultural sophistication amongst East Asia Summit members, the importance of agriculture in some countries' trade profiles, and the significant benefits that can be generated through domestic agricultural reform<sup>14</sup>, special mention might be given to agri-tech cooperation covering production, processing and storage technologies.

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<sup>13</sup> Such cooperation activities need not solely relate to the implementation of a CEPEA. There is likely to be value in investing cooperation resources in improving the technical capacity of actual or potential trade negotiators so that they are able to have more informed and confident discussions at the negotiating table.

<sup>14</sup> See, for example, Sandrey and Reynolds (1990) and Lattimore (2005).

This cooperation can help countries that have land and labour resources in agriculture, but which may be lacking in productivity-enhancing capital or innovative farming and processing techniques.

Encouraging technology transfer in agriculture and creating a better understanding of how agricultural sectors in East Asia can compete on global markets without the need for ongoing and potentially trade-distorting government support can also contribute to longer run food security and food safety objectives in the region.<sup>15</sup> As noted above, such technology transfer can also be encouraged through the liberalisation of agri-services trade.

## Environmental and energy cooperation

Another area of cooperation that is becoming increasingly important in the modern trading system relates to environmental and energy issues. A major global trend in many developed countries is that consumers (and subsequently retailers) are becoming more aware of the environmental and ethical qualities of the goods and services that they purchase. Climate change has become one of the major economic and social issues of the 21st century. Managing and mitigating anthropogenic greenhouse gas emissions have become significant priorities for governments, businesses and individuals around the world. Issues such as 'buy local' campaigns, carbon footprints, traceability and fair trade are starting to affect consumer preferences. This presents both challenges and opportunities for producers and exporters, and cooperation activities could usefully consider issues such as:

- How could trade in environmentally-friendly goods and services be liberalised in order for a CEPEA to contribute to improved climate change (as well as trade) outcomes?
- How can agricultural exporters use technological advances (such as more efficient fertilizer application techniques or feed improvements) to boost production while reducing environmental externalities?
- How can on-farm producers and primary processors reduce their energy input whilst maintaining production (i.e. enhancing their energy productivity)?

## Financial cooperation

Financial cooperation may be another area of cooperation warranted in light of the global crisis. It has been suggested by some that the accumulated reserves of East Asia Summit members could be used to improve region wide soft and hard infrastructure. While this idea has some merits, great care would be needed to ensure that any use of accumulated reserves is approached through an efficiency lens. Funds should not simply be transferred between consumers/firms/governments in region. Bids should only be allocated to those projects that have completed robust cost-benefit analyses of strategically important region infrastructure developments.

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<sup>15</sup> For an interesting discussion of Japan's agricultural system, and how reform of the sector could generate economic gains at the same time as contributing to greater food security, see Honma et al, 2009.

## Small and Medium Enterprises

A key target audience for cooperation activities under a CEPEA is likely to be Small and Medium Enterprises (SMEs). SMEs are vitally important to many East Asian economies but may find it difficult to take full advantage of trade liberalisation opportunities due to the proportionally high set up costs associated with greater internationalisation efforts. Outreach activities that help SMEs to harness the potential benefits that are presented by regional economic integration might include regional 'roadshows' and dedicated trade liberalisation and facilitation websites.

## Use of analytical tools

As this report has demonstrated, there is considerable value, in terms of informing policymakers and other stakeholders, in using economic modelling techniques to illustrate the potential benefits and adjustments that result from deeper regional integration. There may not be a good understanding of how to use such modelling techniques in all East Asian countries. This may reduce the ability of researchers to answer important economic and political economy questions such as "how will a CEPEA benefit my country?" and "which sectors will gain the most?" There is scope for cooperation activities, possibly training courses and workshops coordinated by ERIA, that focus on improving the economic modelling capacity of interested researchers and policymakers. that could usefully boost the analytical capacity of interested parties.

# Facilitation of trade and investment

The economic modelling presented in this report clearly highlights the importance of trade facilitation. CEPEA countries need to get at-the-border and behind-the-border policy settings right to maximize gains from co-operation and liberalisation. Facilitation of trade and investment is much wider than trade facilitation at the border. It is defined by APEC as "the simplification and rationalisation of customs and other procedures that hinder, delay or increase the cost of moving goods across borders... so that goods are delivered in the most efficient manner" (APEC, 2007, p1). Trade facilitation in its broader sense covers, inter alia, trade facilitation and investment protection, government procurement, harmonization of rules of origin, mutual recognition agreements, competition policy and intellectual property rights. We touch on these areas briefly below.

It has been estimated that the 'hidden' costs of trade equate to as much as 15% of the value of the goods traded in some cases (OECD, 2005). These costs are imposed on businesses through higher than necessary administrative and processing costs (red tape) and on governments through lost revenue resulting from incorrectly identifying the origin of products or through smuggling. These costs are ultimately, and inevitably, passed on to the final consumer.

Therefore measures implemented under a CEPEA to improve trade facilitation could deliver significant welfare gains by reducing the 'wedge'

between producer and consumer prices. As shown in the modelling section of this report, these gains are possibly as large as those attributable to tariff liberalisation. Scollay and Vigil (2003) agree that “a comprehensive package of trade and facilitation measures can provide benefits to PTA members at least as great as the traditional PTA elements of trade liberalisation”. They add that “member-specific facilitation measures should be applied only where it is not possible to use international standards” (Scollay and Vigil, 2003).

Furthermore, developing countries are likely to gain more, in a relative sense, than developed countries from improved trade facilitation because of the relative inefficiencies in their customs and other procedures. Countries that are dependent on agro-food exports and/or have a high proportion of the business structure being SMEs are likely to make the largest gains, as the costs of poor facilitation systems imposes disproportionately on these parts of the economy (OECD, 2003; OECD, 2005). Undertaking trade facilitation reforms is not cost-free, however, which may explain why some countries display reluctance to commit to investing in these improvements. In addition, there may be a lag between implementing reform (absorbing the cost) and subsequently experiencing improved trade flows and higher government revenue (the benefits). This suggests that there may be a potential role for cooperation activities, as outlined in the chapter on cooperation, under a CEPEA to assist with the adjustment costs.

## Customs facilitation

Simplifying border procedures is the key to trade facilitation. As ‘trade in tasks’ and fragmentation of regional production networks intensifies, the incidence of intermediate goods crossing multiple borders before being moulded into final goods increases. This brings into sharp focus the costs of each economy’s customs processing functions.

Options to streamline border processing functions may include (OECD, 2005; APEC, 2007):

- Allowing traders to file the documentation for shipment before it arrives at the border, preferably using an online system.
- Introducing electronic systems for paying duties.
- Developing border risk identification assessment processes so that low-risk shipments are paid minimal attention and processed rapidly, with the freed up resources redirected towards higher risk shipments.
- Ensuring that the various domestic agencies that may need to be involved in processing and inspecting goods (customs, police, agriculture ministry, etc) do so in a coordinated and efficient way so as to avoid double handling shipments.

Given the diverse levels of customs procedures efficiency within East Asia Summit countries, there would seem to be a logical case for cooperative activities that allow for the transfer of know-how in this area. This could

build on, for example, the 'single window' project that is already operating in ASEAN countries.<sup>16</sup>

## Government Procurement

We have so far focused on trade in goods and services carried out by private firms and individuals. It should be noted, however, that central and local authorities account for a large proportion of economic activity in most economies and are a major demander (and supplier) of goods and services. In East Asia, government procurement typically accounts for around 15-20% of GDP in developed countries, and 8-12% in developing countries (OECD, 2002). It follows that there are large gains to be made from ensuring that government purchases of goods and services in East Asia are directed as efficiently as possible.

As with private expenditure, government procurement can benefit from increased competition, including from foreign providers. The openness of government procurement sectors varies widely in East Asia.<sup>17</sup> It is important to recognise the unique nature of some aspects of government procurement that may preclude it from being fully opened up to competition and the sovereign rights of governments to design domestic regulations accordingly. That said, encompassing government procurement under a CEPEA is not about exposing domestic suppliers unfairly or 'selling off the family silver'. Rather, it is about ensuring that such regulations do not – as much as is practicable – unduly discriminate against foreign providers.

Government procurement provisions are often viewed through a defensive negotiating lens – negotiators are often concerned with protecting domestic (and possibly inefficient) participants in supply chains. It is important to balance this view by considering:

- The potential benefits that could accrue to domestic suppliers who are internationally competitive from greater entrance opportunities in overseas government procurement markets.
- The potential productivity gains to domestic providers: Opening up some parts of government procurement supply chains to international competition will make inputs into these sectors cheaper and/or of superior quality so that more output can be delivered for the same cost. These productivity gains will lead to improved development and social outcomes.

## Standards

Another important area of trade facilitation relates to the harmonisation of standards between countries. Specific standards of interest are Technical Barriers to Trade (TBT) and Sanitary and Phytosanitary (SPS) measures. While such measures are permitted under the WTO for reasons of food

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<sup>16</sup> See <http://www.aseansec.org/18005.htm>

<sup>17</sup> Of the 53 countries covered, the IMD Competitiveness Yearbook (2006) ranks Australia, New Zealand and Singapore as having the most open government procurement regimes amongst the countries covered by the East Asia Summit. Some larger East Asian economies such as Korea, China and Japan are considered to be less open to foreign competition. South-East Asian economies such as Thailand, India and Malaysia are generally ranked somewhere in the middle of these two groups.

safety or protecting human, animal or plant health, they must be based on sound science and must not arbitrarily or unjustifiably discriminate against countries where similar conditions prevail.

When considering how standards might be harmonised and streamlined under a CEPEA in order for trade to flow more freely, whilst maintaining appropriate safety levels, some basic principles of efficient regulation are worth considering (Kleitz, 2002; ADB, 2002):

- The development and administration of standards by decision-makers should occur in a transparent fashion. Domestic and foreign businesses and relevant authorities should be aware of the potential costs and benefits of any changes to TBT, SPS and other standards. These changes should be signalled well in advance and not adjusted often, so that businesses can operate in a stable and predictable regulatory environment.
- Imposed standards should encourage non-discrimination among market participants so that any unnecessary trade restrictiveness is avoided.
- Wherever possible, international standards or recognition of equivalency should be employed as a basis for domestic regulations. This will reduce the information costs of new regulations for businesses.

In short, a CEPEA measures on standards should seek to be trade-facilitating and efficiency-generating rather than protectionist in nature.

## Rules of Origin

All trade agreements require the design and implementation of rules of origin (ROO). These rules ensure that preferences are given only to those countries which are members of the PTA and to the extent intended. However, as Scollay (2003) notes, they also serve other purposes besides assuring the 'integrity' of the agreement. Depending on how they are designed and implemented, they can facilitate trade at one end of the scale, or serve to chill trade by being protectionist in nature at the other end of the scale.

As such, ROO are not always used as a "neutral instrument of preferential trade". ROO can be driven by the same political economy factors as tariff protection (Estevadeoral and Suominen [ES], 2003, p.3). Indeed it is possible for ROO to be used as devices to pacify sectors that are particularly vocal or influential in their protectionist lobbying efforts. Poorly designed ROO can result in economic inefficiencies (as with any other trade barrier) and can make market access outcomes less effective (Cadot et al, 2006, pp10-15).

In general, when considering whether products that are not 'wholly obtained' from within a PTA are 'substantially transformed' and thus eligible for preferential tariff rates, three possible types of ROO are employed:

- Change of Tariff Classification (CTC) – this approach requires that there is a change in classification at the HS2 (chapter), HS4 (heading), HS6 (sub-heading) or HS8-10 (item) digit level between the inputs

from non-PTA countries and the manufactured good.

- Regional Value Content (RVC) – this approach requires that a product must acquire a certain minimum local value in the exporting country.
- Technical/Process requirements – this approach requires goods to have undergone certain manufacturing operations within the originating country.

Many PTAs in the East Asian region use combinations of these approaches, which probably reflects the lack of a commonly accepted 'best practice' way of implementing ROO under PTAs. Countries have also tended to change their approach over time. Furthermore, the empirical evidence on the restrictiveness or otherwise of these different approaches remains very limited.

It is therefore difficult to provide a simple answer to the question: Should ROO be liberal or strict? As noted in BERR (undated, p3) "Too strict a ROO will mean that the exporters in the recipient country cannot comply with the ROO or can only do so at prohibitive cost and therefore loses the benefit of the preference. Too liberal a ROO and the benefit of the preference accrues to some third party. The optimal ROO strikes a balance between the costs imposed on the recipient on the one hand and providing incentives to add value in the recipient on the other. But the optimal ROO will vary according to the specific product and country in question".

This point is borne out by the wide range of approaches to ROO witnessed in current East Asian PTAs. The complexity of ROO under East Asian PTAs ranges from very high (especially in some of Japan and Korea's earlier PTAs) to relatively low (the China-ASEAN PTA, for example). Complying with ROO can present challenges for businesses – the ROO provisions of PTAs often run into hundreds of pages. At a firm level, the costs of complying with rules of origin have been estimated at between 3 and 5% of the free on board value of the exported goods. As many businesses trade across a large number of borders, these costs are likely to escalate. This hits small to medium exporters particularly hard as they may be less able to pass these additional costs on to the final consumer (Scollay, 2003).

For multinational companies engaged in regional production networks, aside from the administrative cost, the major concern is that complex ROO can reduce their ability to allocate resources efficiently among operations that are located in different geographic locations inside and outside of the PTA (Petri, 2008, p8). In contrast, well-designed and flexible ROO can attract efficiency-seeking foreign direct investment from firms engaged in such networks (APEC, 2008).

It is therefore essential that a CEPEA incorporates a ROO framework that complements and reflects:

- The tariff liberalisation agreed to under the agreement.
- The highly inter-dependent nature of intra-Asian trade flows.
- The rapidly-changing nature of the global economy and the way

in which goods and services are traded in regional production networks.

With these three factors in mind, some possible guidelines for ROO negotiations under a CEPEA include:

- The ROO should first and foremost prevent unwanted trade deflection involving non-members and should be sufficiently liberal that they actively facilitate trade amongst members.
- The ROO should be transparent and predictable for both businesses and the officials implementing the regime. In this respect, RVC can be problematic as there is no commonly accepted way of valuing products, and national authorities can have too much scope to arbitrarily apply valuation rules (ADB, 2002).
- The ROO should be flexible and responsive to changes in economic structure/production techniques. Cumulation rules<sup>18</sup> should facilitate participation in regional production networks and avoid compounding tariffs due to trade in tasks.
- As far as is practicable, ROO should be consistent across countries and products, and with a longer term view towards harmonisation with the ROO of other PTAs.

## Intellectual Property and Competition Policy

An increasingly important aspect of modern, comprehensive PTAs relates to ensuring that domestic regulations on competition policy (CP) and intellectual property (IP) reinforce rather than retard the flows of benefits that stem from goods and services trade liberalisation. This is because it is broadly agreed that open, competitive markets are better placed to deliver the positive welfare gains from trade liberalisation.

It would be fair to say that there has been to date some nervousness amongst some East Asian countries about making firm or deep commitments on CP and IP in their PTAs. This may in part reflect the view that new or more sophisticated regulatory frameworks are sometimes required in order to ensure that liberalisation delivers the expected benefits (OECD, 2008b, p3). However, the degree of commitment required on these two issues is something that should be discussed in preparations for a CEPEA negotiation. As with government procurement, there is no suggestion here that provisions under a CEPEA should undermine the right of members to implement sensible and equitable domestic regulations on competition and IP. However, processes (dialogue between national experts, information-sharing and cooperation at the very minimum) should be put in place under a CEPEA to work towards building understanding of members' policy settings and how they might impact upon other members. The crucial point here is that it is important to seek to ensure that the benefits of trade liberalisation in East Asia are not undermined by anticompetitive practices.

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<sup>18</sup> Cumulation refers to the degree to which inputs wholly or partly originating from one preferential trading partner are allowed to count towards satisfying a ROO governing processes carried out in another preferential partner.

# Institutions

As well as the specific provisions that would need to be included in the text of a CEPEA agreement, thought also needs to be given to the institutional arrangements that would underpin the liberalisation, facilitation and cooperation activities. Several regional institutions, all with differing but equally important roles, could be considered, as discussed briefly below.

## Domestic institutions

### Inter-agency dialogue

If deeper economic integration under a CEPEA is to be successful, it requires more effective inter-agency collaboration and improved institutions in each member country. This is because, as outlined above, trade policy is no longer solely about at-the-border barriers to trade. Many of the issues considered in PTAs and multilateral negotiations are 'trade-related' regulatory matters that extend deep into the domestic economy. Getting the policy settings right therefore requires input from a broad range of domestic agencies, not just commerce and industry departments. These agencies should have a common view on the objectives of the PTA in question and take a coordinated approach to the processes involved in negotiating the agreement. A failure to achieve this common view can be damaging to the overall level of ambition (and hence expected economic benefits) of PTAs (Sally, 2009).

### Communication with stakeholders

As trade policy decisions have the potential to have significant impacts on businesses, households and other organisations, many countries have developed strong stakeholder communication processes. The objective of such processes is to inform the public of trade policy developments so that there are no 'nasty surprises' once the agreement is concluded. This is important for political economy reasons and helps to engage stakeholders in the economic integration process as it develops.

Sally (2009, p42) summarises this well: “Public discussion of policy choices is usually uninformed and misguided...what is lacking is what Patrick Messerlin calls a ‘culture of evaluation’... Independent think tanks and even government bodies should do much more detailed research and analysis on the costs and benefits of trade policies in different sectors of the economy, and then disseminate findings to the public. This would facilitate more informed, intelligent public discussion of policy choices.” Organisations such as the Economic Research Institute for ASEAN and East Asia (ERIA) could greatly assist by doing more studies of trade agreements and engaging in greater outreach to stakeholders through workshops, seminars, website publications and capacity-building activities.

For governments, communication processes often start with invitations for the public to submit their views on PTAs that are about to be negotiated<sup>19</sup>. Once negotiations begin, ongoing discussions with stakeholders can ensure that priority negotiating areas are addressed. Regular updates on the progress of negotiations should be widely circulated, although the precise details may not be suitable for dissemination due to negotiating sensitivities. This contributes to trade policy transparency and building a domestic consensus around trade liberalisation. Finally, once an agreement has been concluded and signed, it is important to help businesses understand how the PTA might affect their operations, and indicate where they should turn to for further advice. An increasingly-used media for such communication is through dedicated PTA websites – effectively ‘one-stop shops’ for interested parties.<sup>20</sup>

## Existing regional institutions

As noted earlier, there is already a high level of regional economic integration activity in East Asia. A CEPEA could usefully draw on – without duplicating the efforts of – some of the regional institutions already in place to help achieve its objectives.

At a political leadership level, the East Asia Summit provides an excellent opportunity for regular meetings of key Ministerial level representatives. This allows progress to be reported and any emerging issues and difficulties to be quickly addressed so that officials can receive clear guidance.

A coordinated cross-country research body will be a valuable source of analytical research into the potential for a CEPEA. Such a body already exists in the shape of ERIA. As well as analysing the potential impacts of a CEPEA and communicating effectively with public and private sector interested parties, this body could also assist with trade policy capacity building to address any competency/capacity of concerns of negotiators and researchers.

A CEPEA would also require some form of regional funding body to assist with resourcing the negotiations proper. The ADB could be a suitable agency for such a task.

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<sup>19</sup> See, for example, <http://www.beehive.govt.nz/release/submissions+called+possible+fta+korea> regarding the proposed New Zealand-Korea agreement or [http://www.dfat.gov.au/media/releases/department/d019\\_04.html](http://www.dfat.gov.au/media/releases/department/d019_04.html) regarding the Australia-NZ-ASEAN agreement.

<sup>20</sup> See, for example, <http://www.chinafta.govt.nz/> for information on the New Zealand-China Free Trade Agreement and <http://www.dfat.gov.au/trade/ftas.html> for an overview of Australia’s current and potential Agreements.

## A CEPEA Secretariat

In addition to drawing on existing institutions, a CEPEA would require the creation of a new body, akin to a Secretariat, that would be responsible for coordinating the negotiations process, storing official documents, monitoring progress on implementation and reporting problems to leaders.

Such an institution may also need to be responsible for housing a Disputes Settlement Mechanism (DSM). DSMs are critical to ensuring that the economic benefits from trade, services and liberalisation under a CEPEA that are outlined above are 'locked in'. While DSMs vary between existing PTAs in terms of detail (see ADB, 2002, pp94-96) they generally take an approach based on the WTO process:

- When potential disputes are raised between members, state to state consultations between parties (possibly facilitated by a CEPEA Secretariat) are the first avenue to take towards resolution.
- If these consultations are not successful, the appointment of an arbitration panel or tribunal may be required.
- Based on the tribunal's rulings, continued non-compliance or non-conformity with the provisions of the PTA may result in the removal or adjustment of concessions.

ADB (2002, pp96-97) suggest that the following best practice principles should be applied to developing a DSM under PTAs:

- The DSM provisions should be consistent with, and if possible, build on WTO obligations. Consideration should be given to which regime has the ultimate jurisdiction if both WTO and PTA rules apply.
- Formal (and often costly) dispute settlement proceedings can often be avoided through a systematic process of informal and formal bilateral consultations when trade irritants arise.
- Technical assistance for developing countries may be required to ensure that these countries are able to participate effectively in disputes settlement processes.

The physical location of a CEPEA Secretariat should be such that it is easily accessible to all members (to the extent possible under such a large and geographically dispersed membership) and it should operate under standard principles of good governance and transparency so that all members share ownership of its operations and outputs.

# Conclusions and suggestions for further research

## Conclusions

Given the intra-East Asia liberalisation witnessed to date, and the potential costs of the region continuing to go down the “hub and spoke” route outlined on page 18 and 19, this study concludes that there is a clear case for the introduction of a more coordinated approach to regional economic integration through a CEPEA that:

- Improves the efficiency of resource allocation within the region to the benefit of firms and households via hence improved profitability and higher per capita incomes.
- Enhances rather than hinders the development of regional production networks.
- Provides for deeper regional engagement than a simple tariffs-only agreement through facilitation and technical assistance activities.
- Does not act as a ‘stumbling block’ to future multilateral liberalisation.

Such integration must be based on economic principles, rather than on political foundations. A CEPEA must avoid becoming “trade-light” or “PTA-lite” due to not being driven by economics. In the present economic environment, there is ample justification for taking bold steps to progress regional integration: the very last thing countries should be doing right now is becoming more inward-looking. Most firms and households in East Asia will recognise this fact, despite the traditional pockets of resistance. This should provide considerable impetus to political leaders’ efforts to implement a CEPEA.

In considering the optimal design for a CEPEA, based on the three pillars identified in the Phase I report (liberalisation, facilitation and cooperation) as well as institutions, our report has suggested some key principles. These principles have been developed based on the international literature on PTAs, commonly-accepted best practice guidelines from international agencies and economic modelling. The key implications from our analysis include:

- A comprehensive, high quality and ambitious CEPEA should be approached as a 'single undertaking'. It is not sufficient to solely consider goods liberalisation. A CEPEA must also include substantial services and investment liberalisation so that East Asian countries can better exploit their comparative and competitive advantages and to reallocate resources in a more efficient manner.
- A CEPEA will deliver the greatest benefits when it covers a larger number of countries and does not exclude any sectors from liberalisation. Levels of ambition under a CEPEA should therefore remain high.
- A CEPEA should contain provisions on government procurement, competition policy and intellectual property. Such provisions help to lock in the benefits of trade liberalisation. While these are sometimes contentious issues, and their exact form can be debated, they should remain 'on the table' for negotiators to discuss.
- The differing development levels of potential CEPEA members must be acknowledged. However, given that a large proportion of the benefits from trade liberalisation are generated by domestic reallocation of resources and regulatory reform, deeper economic integration provides the best opportunity for closing existing development gaps within East Asia.
- The gains from a comprehensive CEPEA that incorporates trade facilitation and technical assistance provisions are estimated to be far greater than those estimated for an agreement that covers tariff liberalisation only. Therefore trade facilitation and cooperation must be considered in addition to (not in lieu of) trade liberalisation.
- Cooperation activities under a CEPEA should involve knowledge transfer and information sharing on issues of mutual interest amongst members. Important areas of cooperation could include agricultural technology, environmental and energy issues, financial cooperation and assisting small and medium enterprises. Cooperation could also include training on using analytical tools such as computable general equilibrium modelling to assess and disseminate the benefits and adjustments costs of a CEPEA. All cooperation activities should be centred on improving resource allocation to enhance the ability of members to harness the potential economic and development benefits arising from deeper regional economic integration.
- A key focus of CEPEA trade facilitation activities should be simplifying border procedures. This will reduce the transaction costs of trading activities, which will improve economic outcomes for businesses and consumers alike through improved profitability and lower prices respectively. Of particular importance are customs procedures and the way in which standards (TBT and SPS) are applied.

- The nature of ROO under a CEPEA negotiation will be crucial to ensuring that intra-CEPEA trade flows are boosted after liberalisation. ROO should ensure that trade deflection is minimised and that intra-CEPEA trade is facilitated. ROO must not be used as a form of protection in disguise, or the gains from integration could be undermined.
- When combined, liberalisation, facilitation and cooperation/assistance spur enhanced and more efficient regional production networks and encourage dynamic gains and technology transfer that can deliver improved productivity growth rates. These three pillars can also generate higher levels of investment that are important for developing infrastructure.
- Existing regional institutions such as the East Asia Summit, the ADB and ERIA provide a sound foundation for driving, coordinating, implementing and monitoring progress under CEPEA. An additional institution of modest size may be required in the form of a CEPEA Secretariat to monitor progress and co-ordinate efforts.

## Options for further research

This report has aimed to provide some insights into the potential benefits of a comprehensive, high quality CEPEA. However, it is clear that further research is warranted in a number of areas, such as:

- An investigation into the nature and severity of barriers to services trade and investment flows in East Asia, and the potential benefits from removing/reducing them. This work is already underway through ERIA.
- Additional work on identifying and measuring the 'dynamic gains' from trade that could be generated by deeper economic integration in East Asia.
- Further empirical work on the channels through which trade facilitation and cooperation activities can enhance regional economic growth under a CEPEA.
- Case studies of sectors that have benefited from existing PTAs in East Asia. This work is also already underway through ERIA.
- The optimal design of ROO. This work is also already underway through ERIA.
- Options for designing and funding the institutional arrangements required to coordinate, implement and monitor a CEPEA.

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# Appendix A GTAP aggregation

## Regional and commodity aggregation

|    | Regions               | Commodities                                                                                                                                                                                                                                                                                                                                                                                                                                                                                     |
|----|-----------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 1  | Japan                 | Agriculture and food<br>Paddy rice; wheat; cereal grains; vegetables, fruits and nuts; oil seeds; sugar cane, sugar beet; plant-based fibres; crops nec; Bovine meat products; meat products nec, Bovine cattle, sheep and goats, horses; animal products not elsewhere classified (nec), raw milk; wool and silk-worm cocoons; Meat products; Dairy products; Other food products; Miscellaneous food products; Vegetable oils and fats; processed rice; sugar; beverages and tobacco products |
| 2  | China                 | Fishing and Forestry                                                                                                                                                                                                                                                                                                                                                                                                                                                                            |
| 3  | Korea                 | Mining and Extraction<br>Coal; oil; gas; minerals nec                                                                                                                                                                                                                                                                                                                                                                                                                                           |
| 4  | Indonesia             | Textiles, Clothing, Footwear<br>Textiles; wearing apparel; leather products                                                                                                                                                                                                                                                                                                                                                                                                                     |
| 5  | Malaysia              | Wood & paper<br>Wood products; paper products                                                                                                                                                                                                                                                                                                                                                                                                                                                   |
| 6  | Philippines           | Mineral products<br>Petroleum, coal products; chemical, plastic and rubber products; mineral products nec;                                                                                                                                                                                                                                                                                                                                                                                      |
| 7  | Singapore             | Iron and steel                                                                                                                                                                                                                                                                                                                                                                                                                                                                                  |
| 8  | Thailand              | General machinery/metal products<br>Metals nec; metal products                                                                                                                                                                                                                                                                                                                                                                                                                                  |
| 9  | VietNam               | Electronic Machinery                                                                                                                                                                                                                                                                                                                                                                                                                                                                            |
| 10 | Cambodia              | Transport equipment<br>Motor vehicles and parts; transport equipment nec; machinery and equipment nec                                                                                                                                                                                                                                                                                                                                                                                           |
| 11 | Myanmar               | Other manufacturing                                                                                                                                                                                                                                                                                                                                                                                                                                                                             |
| 12 | Laos PDR              | Utilities and Construction<br>Electricity; gas manufacture and distribution; water; construction                                                                                                                                                                                                                                                                                                                                                                                                |
| 13 | Brunei and East Timor | Retail and wholesale trade                                                                                                                                                                                                                                                                                                                                                                                                                                                                      |
| 14 | Australia             | Transport and Communication<br>Transport nec; water transport; air transport; communication                                                                                                                                                                                                                                                                                                                                                                                                     |
| 15 | New Zealand           | Public Services                                                                                                                                                                                                                                                                                                                                                                                                                                                                                 |
| 16 | India                 | Other services<br>Financial services nec; insurance; business services nec; recreation and other services; dwellings                                                                                                                                                                                                                                                                                                                                                                            |

Source: GTAP v7 database, Narayanan and Walmsley (2008)

## Appendix B Modelling results

### *Modelling scenarios*

|            |                                                                                                                           |
|------------|---------------------------------------------------------------------------------------------------------------------------|
| Scenario 1 | East Asia Summit: Tariff elimination only                                                                                 |
| Scenario 2 | East Asia Summit: Tariff elimination plus trade facilitation plus cooperation                                             |
| Scenario 3 | East Asia Summit: Tariff elimination plus trade facilitation plus cooperation; all agriculture and food products excluded |
| Scenario 4 | ASEAN+3: Tariff elimination only                                                                                          |
| Scenario 5 | ASEAN+3: Tariff elimination plus trade facilitation plus cooperation                                                      |

## Impacts on GDP

% change in GDP quantity index

| Regions               | Scenario 1 | Scenario 2 | Scenario 3 | Scenario 4 | Scenario 5 |
|-----------------------|------------|------------|------------|------------|------------|
| Japan                 | 0.04       | 0.64       | 0.56       | 0.02       | 0.63       |
| China                 | -0.03      | 4.65       | 4.64       | -0.05      | 4.49       |
| Korea                 | 0.38       | 2.67       | 2.28       | 0.34       | 2.64       |
| Indonesia             | 0.13       | 4.35       | 4.13       | 0.11       | 4.15       |
| Malaysia              | 0.62       | 9.53       | 8.95       | 0.57       | 9.24       |
| Philippines           | 0.12       | 5.95       | 5.51       | 0.11       | 5.77       |
| Singapore             | -0.02      | 3.83       | 3.65       | -0.02      | 3.63       |
| Thailand              | 0.59       | 7.46       | 7.17       | 0.56       | 7.21       |
| VietNam               | 1.61       | 11.04      | 10.17      | 1.6        | 10.79      |
| Cambodia              | 0.38       | 8.59       | 7.17       | 0.29       | 8.38       |
| Myanmar               | 0.07       | 6.15       | 5.36       | 0.07       | 6          |
| Laos PDR              | 0.4        | 5.99       | 4.69       | 0.4        | 5.94       |
| Brunei and East Timor | 1.86       | 6.98       | 6.14       | 1.86       | 6.92       |
| Australia             | 0.11       | 1.27       | 1.2        | -0.03      | -0.03      |
| New Zealand           | 0.08       | 1.94       | 1.77       | -0.04      | -0.02      |
| India                 | 0.45       | 3.4        | 2.7        | -0.03      | -0.07      |
| Hong Kong             | 0          | 0.02       | 0.02       | 0          | 0.02       |
| Taiwan                | -0.1       | -0.18      | -0.15      | -0.11      | -0.17      |
| NAFTA                 | 0          | -0.02      | -0.02      | 0          | -0.02      |
| EU25                  | -0.03      | -0.09      | -0.09      | -0.02      | -0.08      |
| Latin America         | -0.02      | -0.05      | -0.05      | -0.02      | -0.04      |
| Rest of World         | -0.03      | -0.08      | -0.09      | -0.03      | -0.07      |

Source: Authors' calculations

## Impacts on welfare

Equivalent Variation<sup>1</sup>, % of GDP

| Regions               | Scenario 1 | Scenario 2 | Scenario 3 | Scenario 4 | Scenario 5 |
|-----------------------|------------|------------|------------|------------|------------|
| Japan                 | 0.18       | 0.92       | 0.92       | 0.17       | 0.92       |
| China                 | -0.03      | 4.37       | 4.3        | -0.05      | 4.22       |
| Korea                 | 0.68       | 3.27       | 3.02       | 0.64       | 3.23       |
| Indonesia             | 0.68       | 5.13       | 4.57       | 0.17       | 4.51       |
| Malaysia              | 2.08       | 13.23      | 12.45      | 1.51       | 12.35      |
| Philippines           | -0.06      | 6.18       | 5.8        | 0.01       | 6.08       |
| Singapore             | 0.97       | 7.4        | 6.82       | 0.86       | 6.86       |
| Thailand              | 2.35       | 10.01      | 9.08       | 2.43       | 9.84       |
| VietNam               | 1.99       | 11.3       | 9.74       | 2.14       | 11.18      |
| Cambodia              | -0.06      | 7.08       | 6.02       | -0.05      | 7.04       |
| Myanmar               | -0.47      | 6.01       | 5.48       | -0.59      | 5.55       |
| Laos PDR              | -0.92      | 4.69       | 4.6        | -0.84      | 4.72       |
| Brunei and East Timor | 5.74       | 13.35      | 12.68      | 5.55       | 12.84      |
| Australia             | 0.84       | 2.49       | 1.87       | -0.17      | 0.06       |
| New Zealand           | 0.24       | 2.61       | 2.05       | -0.21      | -0.02      |
| India                 | -0.19      | 2.77       | 2.44       | -0.1       | -0.09      |
| Hong Kong             | -0.48      | -0.83      | -0.76      | -0.42      | -0.72      |
| Taiwan                | -0.92      | -2.52      | -2.45      | -0.85      | -2.39      |
| NAFTA                 | -0.05      | -0.15      | -0.13      | -0.04      | -0.12      |
| EU25                  | -0.07      | -0.18      | -0.18      | -0.06      | -0.15      |
| Latin America         | -0.07      | -0.19      | -0.14      | -0.05      | -0.15      |
| Rest of World         | -0.1       | -0.46      | -0.47      | -0.07      | -0.36      |

Source: Authors' calculations

<sup>1</sup> The equivalent variation is a measure of the amount of income that would have to be given or taken away from an economy before a change in policy in order to leave the economy as well off as it would be after the policy change has taken place. If the equivalent variation is positive, it is indicative of an improvement in economic welfare resulting from the policy change.



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