



# Back to Basics on Asian Trade

by Hal Hill and Jayant Menon

**T**HE NEXT TIME your trade minister announces that a “free trade deal” has been signed, we suggest you be wary. First, the deal will likely be a “preferential” one, meaning it will discriminate against nonmember countries. Second, the deal will likely exclude a range of sensitive items. How often, for example, has sugar been included in United States’ trade deals or rice in Japan’s? Third, the deal will be a gold mine for lobbyists and lawyers, and it will create a lot of employment for the bureaucrats who implement it. A lot of this has to do with complex “rules of origin,” or roos, that determine whether a good or service qualifies as domestically or regionally produced. Fourth, business in general, and particularly small- and medium-sized companies (the ones governments proclaim they support), may not avail of the deal, owing to administrative complexities, or the slim margin between general (most-favored-nation, or MFN) and preferential tariff rates.

For these reasons about 90% of trade that takes place between members of the Association of Southeast Asian Nations,

does not avail of concessions granted under the ASEAN Free Trade Agreement. Finally, the deal may never eventuate, especially in countries like the United States where there is a significant division of authority between the executive and the legislature.

There’s no doubt that these trade agreements (plurilateral or bilateral, PTAs and BTAs)—better in fact described as discriminatory trade deals—are proliferating. Practically every country in the world today is a member of at least one PTA and BTA, and most are members of multiple BTAs. If PTAs were considered the main threat to the world-trade system in the 1990s, the concern has since shifted to BTAs. The number of BTAs has been growing at an astounding pace. For the countries of Asia-Pacific Economic Cooperation group and South Asia, the number of concluded BTAs more than doubled between 2000 and 2004, and then doubled again to reach 77 by January 2008 (see chart nearby). At the moment, there are another 65 BTAs that are currently un-

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der negotiation, and 44 more that have been proposed. This last number in particular keeps increasing. Worldwide there are close to 400 in existence. The outcome of this proliferation of overlapping BTAs and PTAs is described as the “spaghetti bowl” effect or, in Asia, the “noodle bowl” effect. It refers to the increased cost of doing business, and to the welfare losses associated with trade diversion, due to inconsistencies between elements of the agreements.

Both intuition and empirical research shows the wider these agreements, the greater will be the benefits of trade creation and the smaller the costs of trade diversion. In their article, Asian Development Bank economists, Masahiro Kawai and Ganeshan Wignaraja (REVIEW, April 2008), speak of a “groundswell of talk...of the merits of consolidating these multiple and overlapping FTAs into a single East Asian FTA.” While it is true that there is a lot of discussion on how to address the proliferation of overlapping FTAs, and make the best of the current mess, the “consolidation” approach is only one of a number of remedies. Other options aim to achieve the same outcome without creating yet another FTA.

Two such alternatives include the multilateralization of preferential accords, and the dilution of ROOs. The original members of Asean have employed the multilateralization approach with success, and today close to 90% of the preferences of their FTA are available to nonmembers on an MFN basis. This is a model of how so-called “open regionalism” can work. As a result, overall tariffs have fallen sharply on trade with all countries, because the FTA liberalization program has been more ambitious and rapid than the WTO alone could have delivered. Consequently, as noted above, utilization rates of remaining preferences have also fallen to negligible levels. Joining a new East Asian FTA would be a step backwards, as it would bring this process of multilateralizing preferences to a halt.

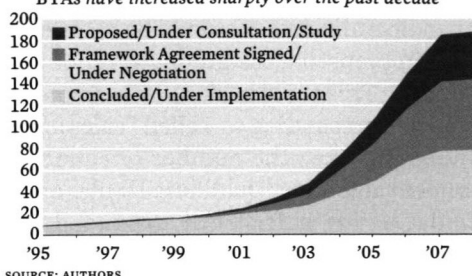
If members of the BTA or PTA are not yet ready to give up reciprocal preferences, then liberalizing ROOs could be an interim step in preparing the groundwork for that process. This could be done by harmonization, and expanding so-called “rules of cumulation” (i.e., the number of countries whose value added qualifies). If rules of cumulation are sufficiently expanded and then harmonized across agreements, the outcome could no longer require formal multilateralization of tariff accords. Here again, a new and larger FTA would in fact be a less desirable option.

Both these alternatives could be applied to intraregional and extraregional BTAs. The consolidation approach, on the other hand, is only designed for intraregional BTAs. But most BTAs are extraregional. An ASEAN+3 FTA (i.e., ASEAN plus Japan, China, Korea) would address only 6% of all BTAs of the countries concerned, while an ASEAN+6 FTA (i.e., ASEAN+3 plus Australia, New Zealand, India) could potentially neutralize a quarter of them. But these figures prompt the question why most BTAs are extraregional to begin with? A common explanation is that they restore market access in traditional trading partners that may have joined a regional FTA. If this is true, then a consolidated East Asian FTA may spark a new wave of extraregional BTAs. An East Asian FTA could actually be counterproductive, leading perversely to an increase in the total number of BTAs.

There is also little evidence that a consolidated FTA can neutralize BTAs between members. In South Asia, the establishment of a regionwide FTA had no effect on intraregional BTAs. To the contrary, the FTA has been rendered redundant while the BTAs have thrived. For instance, 93% of Sri Lanka’s exports to India currently enter duty free under their BTA. Bangladesh Minister of Commerce Amir Chowdury, explains why: “When it comes to [our] regional FTA, big economies like India and Pakistan may

### BILATERAL TRADE AGREEMENTS

BTAs have increased sharply over the past decade



SOURCE: AUTHORS

not offer handsome duty cuts due to distinct interests with an individual country. But they may offer large duty cuts in bilateral FTAs with Bangladesh.” This is why Bangladesh and other South Asian countries continue to pursue BTAs with each other (and outsiders) even after the formation of the consolidated FTA. In short, consolidation does not appear to provide a solution, and may actually contribute to the problem, by adding another strand to the spaghetti bowl or, worse still, inducing a new wave of extraregional BTAs.

There are other, deeper problems with the push for these trade deals. For one thing, BTAs are fundamentally incompatible with the fact that the world is going global in its production and marketing networks. The fastest growing segment of world trade is in electronics and components. Here production is being “sliced up” across international boundaries more than ever, as multinational enterprises search for efficient, low-cost production centers that are integrated into their multicountry production and distribution systems.

Asia is the driving force behind the growth of this trade. Between 1969-70 and 2005-06, the share of Asian (almost entirely East Asian) countries in global nonoil exports recorded a three-fold increase, from 11.1% to 33.4%. The fastest growing sector has been information and communication technology (ICT) products. These have played a pivotal role in this major relocation of global trade to East Asia, with over 67%

of total world ICT exports currently originating from Asia.

The big MNEs in these sectors—Intel, Dell, Sony and others—typically produce, source and distribute in a dozen or more countries. It is inconceivable that these globally integrated giants can operate effectively across so many customs zones, each with their own set of ROOs. In fact they don’t. Instead they generally choose to operate in export zones, where goods flow in and out on a duty-free basis, beyond the reach of PTAs or BTAs. The more these PTAs and BTAs spread, the more these firms will be driven into export zones to escape them, creating an unhealthy dualism between the zones and the rest of the economy. Unless the countries continue down the path of unilateral liberalization and become, like Hong Kong and Singapore, one big free trade area. Thus BTAs are likely to collapse under their own weight.

A second major concern is that the more the world goes bilateral, the more the global trade rules are set by the major economic powers, the U.S., the European Union, Japan, and increasingly China and India. Smaller economies have a seat at the table only in a multilateral environment, a principle enshrined in the General Agreement on Tariffs and Trade, the forerunner of today’s World Trade Organization.

This issue appears in even sharper relief for the many Asia-Pacific countries that are emerging out of conflict, making the transition from plan to market, or suffer from being landlocked or geographically isolated. With their weak institutions, and limited human resources and commercial experience, they risk being marginalized even further. Take the case of Laos, for example. It has now found it necessary to establish a Department of Bilateral Trade Negotiations. Yet it has only recently completed codifying its tariffs, it is struggling to meet the requirements for its WTO membership application, and its policy reformers have

much on their agenda at home. Does it really make sense for the international community to divert the country's handful of technically equipped trade officials into a series of BTAs, or another PTA?

In sum, our arguments are four-fold:

- First, the current proliferation of trade deals is administratively very costly, and it is seriously distracting policy makers from the main game of multilateral and unilateral reform. There is a lot of money and effort being spent on negotiating and implementing BTAs, and this is a particularly significant burden for smaller, poorer countries. The evidence from surveys conducted by the Japan External Trade Organization and the Asian Development Bank suggests very low rates of utilization of these "preferences" in the Asian region. This is mainly due to low preference margins and the complexity of overlapping ROOs, etc. If a BTA were to be proposed as an investment project, it would almost always fail the cost-benefit test!

- Second, we are very skeptical of the proposition that the many BTAs can somehow be folded into a much broader multilateral agreement. On this issue, we need to put the ball back in the court of the "consolidators," who advocate this case. Thus far, we appear to have very little detail to go on. Moreover, the contrary case, that it would be very difficult to achieve, is compelling. This arises because the BTAs are a highly heterogeneous group of agreements. They invariably have different tariff rates, different treatment of quantitative restrictions (QRs), different sector exemptions (and often different "phase-in" rates for them), different ROOs (often defined product by product), and a host of other arrangements ranging from some service sector liberalizations to labor and standards provisions. If consolidation were to proceed, the more likely outcome is some sort of "lowest common denominator" result, which achieves very little.

- Third, for all its problems, the WTO still remains the best forum to address the most difficult trade issues, especially those FTAs that exclude key sectors, because of the Organization's facility to trade concessions across disparate interests in a multilateral setting. It enables countries to weigh up the costs of conceding protection in sensitive sectors, such as agriculture, against the benefits of increased market access in areas in which they have a comparative advantage. Every time a BTA allows a country to bypass this trade-off simply through its choice of partner, and seemingly secure benefits without incurring costs, the task of liberalizing these sensitive sectors is rendered more difficult. The Doha Round may have stalled, but the increasing realization of the unsustainability of BTAs, coupled with food and energy crises in a financially turbulent world, may provide sufficient motivation to try and jump-start it. Indeed, a silver lining from the recent food price spike is that the Doha agenda on reducing farm subsidies could now be met with little impact on the incomes of American and European farmers.

- Fourth, the main game will always be reform at home. The overwhelming evidence, both from crosscountry econometrics and detailed country case studies, is that more open economies perform better. The task for proponents of reform will always be easier when the rest of the world is reforming, and playing by multilateral rules of the game. But countries don't have to wait for international or regional trade negotiations to be completed. Converting opaque and corruption-prone QRs on trade into more transparent tariffs, then consolidating these rates around a uniformly low average, can start now. It will be a sign of real reform—and political courage—when the same trade ministers who claim they are negotiating "trade deals" all over the world are also able and willing to pursue free trade ideals at home. ■