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Regional Trade Agreements in Asia Implications for the Multilateral Trade System

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Introduction

The past two decades have seen the emergence of two paradoxical developments in international trade policy making. The multilateral trade system (MTS) has grown and expanded to include 149 member countries. Most of the new members are developing countries and their accession was interpreted as a vote of confidence in the system to promote economic development and poverty reduction. The creation of the World Trade Organisation (WTO) in 1995, brought the Uruguay Round to a conclusion as the most ambitious round of multilateral trade negotiations since the formation of the General Agreement on Tariffs and Trade (GATT) in 1947. Global trade rules were extended to new areas including services and agriculture, trade protectionism was tackled and GATT rules were explicitly provided with an international organisation to administer them in the form of the WTO.

Paradoxically, the vast expansion of MTS trade rules that accompanied the establishment of the WTO was followed soon after by unprecedented growth in the number of regional trade agreements (RTAs)¹ notified to the WTO. More RTAs have been notified during the first decade of the WTO than during the half-century under the GATT (Gavin and Van Langenhove (2003)). RTAs covering goods and services have been applied in a wide array of designs including bilateral, plurilateral, regional and inter-regional trade agreements. Today, there are more than 159 RTAs covering goods and 38 concerning services². Not only are there more RTAs than WTO members, but more than half of world trade is already conducted within them³.

Another paradoxical element in these developments is how rule-making on the 'new trade issues' has been stymied multilaterally but advanced regionally. Since 1996, new trade issues including investment, competition, transparency in public procurement and trade facilitation have come to be known as 'the Singapore issues'. The Ministerial meeting of that year, held in Singapore, mandated the WTO to explore the possibility of opening up multilateral negotiations on those topics. But they proved to be extremely controversial. All but trade facilitation were dropped from the Doha Round following the failure of the Cancun Ministerial conference in 2003.

Historically, Asian countries have been among the staunchest supporters of multilateralism. 'In GATT we trust' was the credo of Asian countries. The World Bank attributed Asia's economic miracle in the early 1990s to its openness to the world and

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¹ The generic term RTA covers free-trade areas (FTAs), under which partner countries agree to liberalise trade between them, and customs unions (CUs), which go a step further by agreeing on the implementation of a common external tariff. RTAs also cover preferential agreements to liberalise trade in services.

² These totals only include RTAs that have been formally notified to the WTO.

³ OECD (2003).

its ability to integrate into the global economy⁴. In contrast to other regions, notably, Europe, Asia kept conspicuously away from RTAs. As the oldest regional organisation in Asia, ASEAN was limited to regional cooperation on security issues for its first twenty-five years of existence.

But this was to change with the most recent burst in RTA activity. Indeed, the rapidly evolving kaleidoscope of trade agreements provides a bewildering array of arrangements that come in many shapes and sizes and includes a growing number in Asia. The new trade map of Asia has been comprehensively charted by international agencies, notably the United Nations Economic and Social Commission for Asia-Pacific (UNESCAP) and the WTO⁵.

East Asia, which is the most globalised part of Asia, has changed dramatically. Prior to 1998, the only significant regional agreement was the ASEAN Free Trade Agreement (AFTA). Today there are 16 FTAs in the process of implementation, a further 22 under negotiation, and more than a dozen others in the pipeline. Every East Asian country has at least one bilateral trade agreement with its Asian neighbours, and many have several overlapping agreements⁶.

What all of those agreements have in common is that they provide for discriminatory trade and are, therefore, departures from the principle of non-discrimination, which is the corner stone of the MTS. It is not surprising then that a vigorous debate has grown up around the relationship between regionalism and multilateralism. Are they mutually exclusive, or can they be complementary? This debate has been characterised by slogans questioning whether RTAs are 'building blocks' or 'stumbling blocks' to further trade liberalisation under the MTS.

To answer this question, two differing analytical approaches have been taken to assess the relationship between RTAs and the MTS. It should be recognised that these two approaches are not necessarily mutually exclusive. One approach focuses on the global welfare effects of discriminatory tariff liberalisations created by RTAs and the other on the rule-making aspect of RTAs and their relationship with existing WTO rules. The former approach dating at least to 1950⁷ considers the relationship between RTAs and the MTS in terms of the 'trade creation' and 'trade diversion' they generate. *Trade creation* is represented by the total amount of new trade generated by trade liberalisation between RTA partners. *Trade diversion* is represented by trade flows re-directed from more efficient producers in non-RTA partners to less efficient producers within the RTA as a result. In terms of compatibility with the principles of the MTS, higher levels of trade creation and lower levels of diversion are preferable.

A second approach to assessing the relationship between RTAs and the MTS focuses on the rule-making aspect of RTAs. Successive rounds of trade liberalisations under the

⁴ World Bank (1993).

⁵ UNESCAP (2006) and Crawford (2005).

⁶ Asian Development Bank figures, March, 2006.

⁷ Viner (1950).

GATT and continuing under WTO have resulted in low average tariffs levels in most industrialised countries, which are also the predominant sources and destinations of trade within the MTS. Over time, non-tariff related trade rules will continue to grow in importance relative to tariffs as determinants of trade flows within the MTS. This trend is particularly clear in the case of domestic regulations concerning international trade in services, competition policy, investment, transparency in government procurement and trade facilitation, which do not themselves affect trade via tariffs and are thus not readily subject to quantitative analysis under the first approach.

Much of the recent analysis on the relationship between RTAs and the MTS takes a rule-making approach by looking at provisions concerning the Singapore issues and services, which are diverse and vibrant in new RTAs.⁸ Topics rejected for work at the multilateral level, now appear to be making more progress at the regional level.

Positive aspects of this development can be considered in terms of increased economic liberalisation resulting from better rules. In addition, the diversity of approaches to rule-making on the new issues taken in differing RTAs is – to use a cliché – a double-edged sword. On the one hand, policymakers are accruing substantial experience with various novel approaches to rule-making on the new issues. The more successful ones will likely be adopted in newer RTAs and may even be retroactively adopted in existing ones.

Negative aspects of this development can be considered in terms of the diverse and thus inconsistent rule-making approaches taken to deal with new issues across the new RTAs. The fact that they have not yet been coherently addressed in the WTO may increase divergences between new rules in RTAs and those of – or absent under – the MTS. The coherence (relevance) of the MTS may be increasingly eroded over time. It remains unclear how the simultaneous and yet diverse rule-making activities at different levels of the international trading system will impact that MTS. Still, there is room for optimism that increasing divergence in rule-making processes across RTAs will itself result in political economy pressures for convergence over long-term as has been the case for the rules of origin regime administered by the European Union⁹.

There is no general agreement among academics on the foreseeable impact of the new wave of RTAs in Asia. Some see it in a positive light emphasising that the proliferation of RTAs result in competitive liberalisation that triggers faster and deeper integration than what can be achieved by multilateral liberalisation. Furthermore, new those RTAs often have far more comprehensive coverage than traditional ones as they often include stronger provisions on services, investment, trade facilitation and government procurement in addition to greater liberalisations on industrial and even agricultural products. And ‘Early Harvest’ provisions in at least one agreement has already led to significant liberalisation i.e. in the case of the China-ASEAN in the difficult area of agriculture¹⁰.

⁸ See OECD (2003).

⁹ Baldwin (2006b).

¹⁰ See Tsai (2006).

But others see the emergence of a ‘noodle bowl’ composed of multiple, overlapping trade arrangements that will create confusion and increased transaction costs for businesses¹¹. In particular, they consider the high level of ‘tariff overhang’¹² in Asia to be a significant political economic liability as recently concluded RTAs in the region begin to alter trade flows when discriminatory trade liberalisations are phased in. The concern is that increasing levels of discrimination may cause trade frictions which make WTO compatible retaliation in the form of lifting applied tariffs towards most favoured nation (MFN) levels more attractive¹³.

This paper will concentrate on the sub-region of East Asia as it is the central topic of this conference. The question addressed is whether the emerging and rapidly growing number of RTAs in East Asia will strengthen regional integration and also help to achieve better integration of East Asia into the global economy. Towards this end we will analyse the interaction between the MTS and RTAs in order to see whether the relationship is positive (building block) or whether it is negative (stumbling block). This paper will conclude that it is too early to tell. The following analysis will 1) review multilateral trade rules concerning RTAs, 2) provide an overview of globalisation and regionalism in East Asia, 3) consider RTAs in East Asia against the background of the MTS 4) assess the current state of play in East Asian RTA activity, 5) address the importance of trade in services and 6) conclude with discussion on how RTAs may enhance the credibility of unilateral trade liberalisations by locking them into legally binding agreements.

Multilateral Trade Rules and RTAs

Provision has been made for RTAs since the establishment of the GATT 1947. But because they are departures from the principle of discrimination, they must be notified to the WTO and examined for conformity with WTO rules. This is intended to minimise the adverse effects of RTAs on third-countries and to prevent them from becoming narrow discriminatory entities.

For developing countries, special provisions on RTAs are provided under the Enabling Clause¹⁴ resulting from the Tokyo Round in 1979. Developing countries may enter into regional trade agreements among themselves for mutual reduction of tariffs on goods. Developing countries are not, however, subject to the ‘substantially all trade’ requirement of Article XXIV of the GATT, but they must not ‘raise trade barriers’ in the process of forming an RTA.

¹¹ Baldwin (2006a).

¹² Tariff overhang refers to difference between the rates at which tariff rates are applied and the levels at which they are bound under WTO rules.

¹³ Ibid.

¹⁴ *Decision on Differential and More Favourable Treatment Reciprocity and Fuller Participation of Developing Countries*, GATT, L/4903, 28 November 1979.

In the case of services, the General Agreement on Trade in Services (GATS) similarly contains an exemption for regional economic integration based on guidelines similar to that of Article XXIV of GATT for trade in goods. GATS Article V agreements are required to provide for ‘substantial sectoral coverage’ and may not ‘a priori’ exclude any of the four modes of supply¹⁵. As true liberalisation of trade in services involves the elimination of discriminatory regulatory barriers, countries are allowed to enter into mutual recognition agreements (MRAs) with regard to regulatory standards under Article VII of the GATS, on condition that they are notified to the WTO.

Rule-making within the WTO on RTAs has not kept pace with the rapid evolution of RTAs over the past twenty years. In recognition of the fact that RTAs are now considered a vital tool of trade policy for most countries, the WTO has stepped up efforts to deal with them. Part of the Uruguay Round package, the WTO’s Committee on Regional Trade Agreements (CRTA) established in 1996, created a permanent institutional framework with a two-fold mandate to address RTAs. The first is to assess the conformity of RTAs with Article XXIV of the GATT and Article V GATS. The second is to consider the systemic implications of RTAs for the MTS. Lack of progress by the CRTA in fulfilling its mandate is, in part, due to the lack of precision in existing WTO rules governing RTAs. WTO members sought to address this lack of precision via the negotiating mandate contained in the 2001 Doha Declaration to ‘clarify and improve’ WTO rules and disciplines governing RTAs, while ‘take[ing] into account the developmental aspects of regional trade agreements’.

WTO rules governing RTAs aim to ensure that the relationship between the two levels of trade policy making are mutually complementary, promote global economic welfare, and support the integration of developing countries into the global economy. However, the negotiations under the Doha Mandate have made little progress on the clarification of WTO rules on RTAs which, in practice, means that no authoritative guidance exists for the CRTA on how to implement key WTO provisions applying to RTAs.

The essential requirement for RTAs to be in conformity with Article XXIV is that they eliminate all ‘duties and other restrictive regulations of commerce...with respect to substantially all the trade’ between RTA members. The key concept of substantially all trade (SAT) does not mean *all* trade, or free trade per se. There is no agreement among WTO members on what a generally acceptable benchmark for SAT should be.

In practice two SAT benchmarks have been discussed. One is a quantitative approach, based on the percentage of existing trade covered by the agreement, and the other is

¹⁵ The four modes of supply as defined by the GATS are as follows:

Mode 1: Cross-border supply - Service delivered within the territory of the Member, from the territory of another Member

Mode 2: Consumption abroad - Service delivered outside the territory of the Member, in the territory of another Member, to a service consumer of the Member

Mode 3: Commercial presence - Service delivered within the territory of the Member, through the commercial presence of the supplier

Mode 4: Presence of a natural person - Service delivered within the territory of the Member, with supplier present as a natural person

qualitative benchmark based on assessing the percentage of tariff lines covered. Although no definitive interpretation exists, the percentage of trade approach is considered by some WTO members to have been fulfilled if 90% of total trade existing prior to the agreement is covered at the end of the implementation period. Similarly, some WTO members consider that an RTA must cover 95% of total tariff lines under the harmonised system for it to be in conformity with WTO rules.

The major issue behind the different approaches is agricultural trade liberalisation. Under the percentage of trade approach, entire sectors such as agriculture could be excluded from liberalisation. Indeed they frequently were in the past, its critics argue. But that was merely a reflection of the treatment of agriculture at the multilateral level, its defenders say. And, since the WTO only began to liberalise agricultural trade in the 1990s, it would be unrealistic to treat it on a par with industrial liberalisation that has progressed gradually over the past fifty years.

Article XXIV is also vague on transition periods, saying that the liberalisation should be completed within a 'reasonable length of time'. This has been somewhat clarified to say that it should exceed ten years only in 'exceptional cases'. In practice, however, many RTAs have implementation periods going well beyond the ten years. There is a lack of authoritative guidance on the meaning of *exceptional cases*. An understanding exists that developing country RTAs may apply twelve-year implementation periods, but great uncertainty exists over implementation periods for RTAs between developed and developing countries.

As a result of this unsatisfactory situation, there are considerable differences in the scope, depth and ambition of RTAs. The various motivations behind RTAs are the most important factors that will shape the outcome of the negotiations. Therefore, any assessment of their effectiveness must be made in light of the objectives of the agreement concerned.

Do we have any common yardstick at all, then for assessing RTAs? One approach has been to assess RTAs to the extent that they are 'WTO-plus'. In other words, do they include commitments on rule-making that reach beyond existing WTO rules? Will rule-making on new issues bolster tariff liberalisation with commitments on domestic regulations that would enhance the value of MFN tariff liberalisations beyond what would be possible under existing WTO rules? Such commitments would enhance the likelihood that RTAs contribute to trade creation and, hence to increased global welfare. Some argue that such a benchmark is justified by assessments of RTAs between industrialised countries, for example in the EU and North American Free Trade Agreement (NAFTA).

But such a benchmark may not be acceptable for RTAs involving developing countries. While trade liberalisation is, in principle, good for development, there are great asymmetries of economic power and capacity between trade partners in North-South trade negotiations. It is possible that liberalisations and rules applied equally between developed and developing country members may in-fact be disadvantageous to the developing country partner in practice. One might consider the lack of agricultural or mode four services liberalisations by Japan in its Economic Partnership Agreements

(EPAs) with Malaysia, the Philippines and Singapore as potential examples of this. Alternatively, asymmetric negotiating power may result in RTAs that codify rules and liberalisations biased against a developing country member. The fact that negotiations for EPAs with the remaining ASEAN members are being conducted bilaterally as well and as a whole may also be contemplated in this respect.

Therefore, measures must be built into those agreements to ensure a development dimension. In the case of South-South RTAs under the Enabling Clause, it may be necessary to have 'WTO-minus' agreements to allow low-income developing countries the policy space that they need to overcome their domestic production constraints that are a precondition for being able to exploit the gains from trade. ASEAN itself and the ASEAN-China FTA have been notified to the WTO under the Enabling Clause. The ASEAN agreement with China is probably the most interesting to date. The Framework Agreement signed in 2002 is comprehensive in terms of the subjects it covers, but the actual provisions to address the ambitious number of subjects remain to be negotiated and implemented. It remains to be seen whether the unusual 'early harvest' provisions of the Framework Agreement which have largely liberalised trade in agricultural products spanning HS Chapters 1-8 between China and ASEAN will be followed by market access commitments and rule-making so ambitious in nature.

Globalisation and Regionalisation in East Asia

East Asia is at the forefront of globalisation. Countries have become increasingly integrated into the global economy over the past 50 years. Japan first, followed by the four tigers – Korea, Taiwan, Singapore and Hong Kong, then ASEAN-5, and, more recently, China. Openness to trade and investment have been paramount as demonstrated by the high ratio of trade to GDP of 130% for South East Asian countries. Likewise, openness to foreign direct investment (FDI), has been very high - with a ratio of FDI stocks to GDP of approximately 40% of GDP (Sally, 2006). Of course, the new ASEAN-4 countries (Cambodia, Laos, Myanmar and Vietnam) are much less integrated into the global economy and continue to have higher levels of protectionism.

Integration into the global economy has been promoted since the 1980s when East Asian countries embarked on market-oriented reforms of their domestic economies. As a result of those reforms the original ASEAN-5 countries have relatively liberal trade policies. Average tariffs are relatively low, non-tariff barriers have been reduced and the regime for FDI in manufacturing is very open. But progress on liberalisation of services has been much slower. And, in the new ASEAN-4 countries, which have lower levels of economic development, tariff levels remain relatively high. However, tariff reduction schedules for the ASEAN-4 are already in place to bring them into conformity with more advanced ASEAN members.

China has made significant progress on internal and external liberalisation. During the first period of reform in the 1980s, China concentrated on internal reform and agriculture. The following decade was a period of considerable external liberalisation in trade and investment. China, which is the world's largest developing country, has consolidated its liberalisation through accession to the WTO at WTO-plus levels of

liberalisation commitments. Its trade policy today is very liberal by developing country standards, albeit not without blemishes that any country boasting such a large trading relationship with the world is likely to have.

Openness to global competition is reflected in the dynamic, evolving comparative advantage of East Asia. Japan and the four tigers have moved up to high-value added goods and services. Most of China's trade is still in manufacturing goods as it has comparative advantage in labour intensive and lower value added products. ASEAN-5 is now experiencing increasing erosion of its labour-intensive production by China, so it is now moving more into services. The new ASEAN-4 countries will continue to exploit labour-intensive industries as China moves up the value added ladder.

Globalisation and regionalisation have advanced together in East Asia. According to the (Asian Development Bank, 2006), intra-regional trade in East Asia makes up 55% of the region's total trade, up from 35% in 1980. This surpasses the intra-regional trade of NAFTA at 46% and is comparable to that of the EU in the early 1990s. Intra-regional trade is FDI driven in East Asia. It is an integral part of the global value chains built by multinational corporations (MNCs) in response to declining transport and information costs, together with rapid technological progress. The phenomenon of 'Factory Asia' has produced market led regional integration. Asian governments are now increasing their efforts to develop more formal arrangements for regional integration.

RTAs in East Asia and MTS

The Doha Round seeks to achieve a balance between liberalisation of manufacturing, agricultural and services trade. Considered in this light, the story for East Asia is mixed. In the case of manufacturers, although very few if any exceptions to the Common Effective Preference Tariff (CEPT) remain among the core ASEAN members, the level of tariff preference utilisation is remarkably low¹⁶. Inter-ASEAN trade is 'covered' within the AFTA, but the vast majority of it is conducted on an MFN basis. As a result, the implementation of AFTA itself is unlikely to have generated significant trade creation or diversion. Very low MFN tariff rates on intensively traded manufactured goods throughout East Asia tend to reflect a similar pattern. Thus for manufactured products, which are by far the most important inter-regionally traded good in value terms, RTAs are unlikely to have created much divergence from the MTS.

While the value of total agricultural trade in the region pales in comparison to that of manufactured goods, RTAs in the region have a much higher potential to impact the relatively insignificant agricultural trade flows that do exist and are likely to grow over time. This is due to the fact that average MFN tariffs on agricultural products are high throughout the region and thus carry the potential for much larger margins of preference. It should be born in mind that little potential exists for significant further RTA induced agricultural liberalisation in the near term. But two regional RTAs bear mentioning. The coverage of agriculture in AFTA is actually more complete than most functioning RTAs today. Among the ASEAN-6 members, the highest percentage of

¹⁶ Baldwin (2006a).

agricultural tariff lines formally excluded from liberalisation was not more than 10%¹⁷. The unusual Early Harvest provision in the Framework Agreement between ASEAN is further discussed below.

Over the long-term, changing patterns of consumption as the countries of the region become more affluent are likely to change the political economy dynamics behind agricultural liberalisation within regional RTAs. A great deal of uncertainty hovers over the actual impact that regional RTAs will have on agricultural trade in the region, particularly as most RTAs have not addressed agriculture. Still, it is logical and significant nonetheless that unless MFN tariffs on agriculture throughout the region drop significantly over time, progress on agricultural liberalisation will be confined to RTAs.

Like agriculture, MFN liberalisation on services has not been dramatic within East Asia to date. Likewise, progress on liberalisation within ASEAN has also been incremental. Few if any RTAs within the region contain dramatic departures from GATS services commitments. Ironically, it is the increasing competitive pressure from China in labour intensive manufactures that is a key driving force behind renewed interest within ASEAN for strengthening regional liberalisation of trade in services (e.g. in transport, communications and R&D). An efficient ASEAN services sector is increasingly seen as the foundation for increasing the scope for efficiency gains and value added within the ASEAN manufacturing sector to compete China. To support liberalisation of services, ASEAN Economic Ministers established the goal of achieving the free flow of services within ASEAN by 2015¹⁸.

The following provides a synopsis of the variables and trends that are likely to affect progress on manufacturing, agriculture and services as RTAs continue to develop within East Asia.

➤ *Manufacturing*

To date Asia has concentrated on manufacturing trade and the growth of its manufacturing exports has been very impressive. Indeed, the term Factory Asia closely describes the sophisticated value chains that enable production lines for a single product to span multiple countries¹⁹. As suggested above the low levels of tariff preferences in manufactured products traded between ASEAN countries are not high enough to offset the cost of complying with rules of origin regimes for the vast majority of intra-ASEAN trade. Indeed, the tariff preference utilisation rate for Thailand and Malaysia in 2002 was only 11.2% and 4.1%, respectively²⁰.

Still, it should be born in mind that as average MFN tariff rates decrease, margins of preference become increasingly important to competitiveness, particularly if rules of

¹⁷ Tsai (2006).

¹⁸ ASEAN (2005).

¹⁹ Baldwin (2006a).

²⁰ Ibid.

origin regions are made less onerous²¹. If Asian RTAs progress and follow a developmental path to akin to the EU, the long-term prospect for a pan-Asian system of cumulation for rules of origin spanning the RTAs of the region would be an obvious area for further consideration. Such a development would tend to enhance trade creation within the region as well as trade diversion vis-à-vis extra-regional trade partners.

➤ *Agriculture*

At least one example exists of strong growth in inter-regional agricultural trade occurring alongside a framework RTA. Possibly more significantly, the likelihood that China will become a major agricultural importer in the coming years also highlights the potential for increased discontinuity between regional and multilateral trade in agricultural products. While trade in agricultural products within Asia is negligible in comparison to trade in manufacturers, pockets of highly competitive production exist. The case of the Framework Agreement between China and ASEAN is illustrative of the potential that regional RTAs can have on regional agricultural trade flows. Although United States apple producers considered China an attractive import market for apples during negotiations for China's accession to the WTO, China has since overtaken US as the largest producer of apples and today represents four times the US production. This has led to Chinese apples displacing US fruit in many ASEAN economies, for instance, in Singapore where it supplies almost 60% of the market – US sales declined by half over the previous five years.

However, changing patterns of agricultural production and consumption throughout the region may actually be more important over the long-term. The case of China is once again illustrative. Chinese exports of broccoli to Japan have tripled since 1995, while US exports have declined by a third in the same market²². China is also among the top producers of tomato paste and apple juice in the world, and accounts for half of global vegetables and melons up from a just over a third in 1995. However, the expansion of vegetable cultivation in China by 90% has reduced farmland for staple crops by 10%²³. Over the long-term, China is expected become a substantial importer of wheat, high-quality rice and soybeans as well as other cereals for food and beverages, which will produce significant export opportunities for international producers. Given the current infancy of RTA development within East Asia, it is difficult to assess how they will impact regional and extra-regional agricultural producers and thus the MTS over the long-term. It is too early to tell whether preferential trade in agricultural products will reduce access for extra-regional producers such as the US, particularly as intra-regional RTAs may also be negotiated in the meantime.

➤ *Services*

Over the past few decades trade in services has grown faster than merchandise trade. A similar trend can be observed in foreign investment where services account for over

²¹ Ibid.

²² Wattanaputtipaisan (2005a).

²³ Ibid.

50% of recent FDI flows. Services are no longer an economic activity associated with high-income industrialised countries. While the share of services in GDP steadily rises with the level of income, recent trends have shown that services are among the fastest growing sector in low- and middle-income developing countries.

Liberalisation of trade in services is now understood as a vital tool for development. The World Bank has estimated that the potential gains from services liberalisation would be four times greater than those from goods liberalisation. Although the basic arguments for liberalisation of trade in services are similar to those of trade in goods, some sectors such as banks, transport, and telecommunications services provide the essential infrastructure for a modern economy and by virtue competitive manufacturing sectors. Services have a much greater potential to benefit the economy as a whole.

Asian countries stand to benefit from further liberalisation of services. Asian countries rank among the top twenty-five countries exporting services. Importing countries will benefit from technology, skills and experience transferred through trade and investment. Developing countries would benefit from liberalisation relating to movement of persons – which has become a growing source of income for those countries. As in the case of agriculture, it is difficult to assess at present whether efforts to promote liberalisation of services in ASEAN, or in East Asia generally, will develop given the momentum for extra-regional RTAs.

RTAs – present state of the art

Thinking on regionalism in Asia began with ASEAN and later evolved in the direction of ASEAN + 3 including China, Japan and Korea. More recent discussions consider the prospect of ASEAN + 6 which will include also Australia, India and New Zealand. The dialogue on the most recent proposal is reminiscent of that which took place over EU expansion. What is the proper balance between strengthening integration among a core membership and enhancing the breadth of the membership? It is useful to note that although some substantive progress has already been made under the ASEAN + 3 format, with particular attention to the Framework Agreement between ASEAN and China, none of the ASEAN + 3 agreements is yet complete. Analysis here focuses on ASEAN + 3 for the reason that no substantive results are yet available for examination under the ASEAN + 6 approach.

Since the launching of its FTA in 1992, ASEAN has taken a number of additional measures on customs cooperation, services liberalisation, MRAs on standards, and investment liberalisation, to deepen its integration. Since the set-back of the financial crisis in 1997-98. ASEAN has regained momentum and is now committed to becoming a fully-fledged Economic Community by 2020. Furthermore, ASEAN has enlarged its group to include four former communist countries of Cambodia, Laos, Myanmar and Vietnam.

Underpinning ASEAN's renewed commitment to liberalise trade in services, is the continuing commitment by ASEAN Ministers to progressively eliminate all forms of restrictions that affect national treatment and market access limitations by 2015 'with

flexibility'. ASEAN Senior Officials are now exploring alternative modalities for achieving free flow of services and are to report back to the Ministers' preparatory Meeting before the 12th ASEAN Summit.

A key element of the ASEAN approach is to conduct MRAs in support of the free movement of professionals and skilled labour in ASEAN. And progress continues under efforts to develop sectoral MRAs. ASEAN concluded an MRA on Engineering Services in 2005 and expects to complete an MRA on Nursing Services at the 12th ASEAN Summit.

Transportation services are a focus of attention within ASEAN for liberalisation. Efforts are under way by ASEAN Transport Ministers to implement arrangements to accelerate the integration of the air travel sector. An ASEAN Multilateral Agreement on the Full Liberalisation of Air Freight Services is being finalised and an ASEAN Multilateral Agreement on Air Services is being developed.

On the external front, as indicated above, ASEAN has negotiated framework agreements with all its East Asian partners – China, Japan and Korea. ASEAN's negotiation of Framework Agreements as one bloc is evidence of openness and willingness to become a unified external actor. Those agreements with its East Asian partners should also help to pave the way for the East Asian Community. However, the fact that they are only framework agreements leaves the door wide open for speculation on what the actual agreements are likely to look like when complete.

Liberalisation of Trade in Services

The ASEAN Agreement on Services (AFAS), which was signed in 1995, aimed to enhance liberalisation in the region. The goal was to achieve GATS plus liberalisation – focusing on the 5 major sectors which are similar to the WTO ranking list. However, intra-ASEAN liberalisation has turned out to be weak, no doubt a result of the financial crisis, and fall far short of GATS plus.

The multilateral trade system has made relatively little progress on liberalisation of trade in services for a number of reasons. First, liberalisation of services only started with the conclusion of the GATS at the end of the Uruguay Round. Although the GATS is based on the traditional GATT principles of MFN and national Treatment (NT), the procedures for liberalisation of services differ from those governing liberalisation of merchandise trade. The GATS approach defines four modes of service trade including cross-border services, consumption of services abroad, commercial presence of a foreign supplier in a country, and the presence of natural persons where there is movement of personnel by firms.

Second, the GATS approach is based on a commitments approach that has been criticised for being too slow. The procedure of negotiating detailed national commitments, sector by sector, places countries in a defensive position, with each intent on defending its national status quo. The commitments approach of the GATS contrasts

with the rules approach of the original GATT. One of the major reasons for the success of the GATT in liberalising merchandise trade was its procedure for streamlining the negotiating process between the large numbers of heterogeneous countries into an efficient multilateral mechanism which minimised the mercantilist elements of countries trade policies. The rules approach sets up general rules and principles and then specifies exceptions in a 'negative list' that is contained in an annex to the final agreement.

It is difficult to objectively evaluate how much liberalisation has been achieved by the GATS agreement because non-tariff barriers determine market access. What has been achieved is legally binding commitments of existing market access on a sectoral basis. The ranking of liberalisation commitments show the top six service sectors to include tourism, business, financial, communication, transport and construction services (Gavin, 2001)

Liberalisation at the regional level may increase market access commitments and thereby contribute positively towards the goals of the MTS. This may occur when unilateral liberalisation is transformed into legally binding commitments at the regional level, or where RTAs lead to greater liberalisation than what has been achieved in GATS. The creation of regional standards may facilitate competitiveness and trade. But they could create new barriers too.

Analysis of RTAs in Asia shows the emergence of two models of service liberalisation. The 'GATS-consistent' model replicates the WTO model at regional level. It distinguishes between the four modes of supply used in GATS, employs a positive list approach and proceeds on a sectoral basis. An alternative model, which follows NAFTA approach takes a horizontal approach with a single set of commitments covering cross border services (modes 1, 2 and 4 of GATS), while commercial presence (Mode 3) is covered separately in an investment chapter. Contrary to GATS, this model adopts a negative list approach in which liberalisation applies to all sectors except those specifically listed as exceptions. While both models are, in principle, capable of achieving liberalisation, the NAFTA model achieves more liberalisation in practice and tends to be GATS plus.

Most of the liberalisation under this model occurs in cross border supply of services, in which regulatory cooperation and harmonisation of standards play an important role. For example, financial services prior to opening up to international competition need to be handled carefully. The domestic regulatory environment needs to be strengthened before liberalisation and cooperation between prudential regulatory authorities needs to be strengthened. In the absence of such measures, liberalisation runs the risk of severe disruptions not only to the financial system but overall macroeconomic stability.

Conclusions

The development of regionalism in East Asia is in its infancy, but is being pushed forward by two developments in the current MTS. First, negotiations for further multilateral liberalisation of goods, agriculture and services are stalled. Second, the growth of RTAs outside the region that have had an earlier start, are advancing more

rapidly outside than within the region. While unilateral liberalisation is always an option, receiving reciprocity for them is beneficial both because it enables increased welfare gains (and potentially more ambitious liberalisation) and enhances the credibility of unilateral tariff liberalisations.

For manufactured products, the case of RTAs in East Asia is interesting in that applied rates on the trade flows characterising Factory Asia are so low that regional tariff preference where they exist are often rarely used in practice. Although this suggests that further tariff liberalisations on these trade flows are unlikely to generate significant welfare gains, it also highlights the fragility of the system given that high levels of tariff overhang remain on trade flows not guaranteed by existing preferential tariff regimes such as AFTA. (Baldwin, 2006a) argues *inter alia* for binding these sub-MFN applied tariff rates within the WTO as a precaution against potential trade conflicts. However, binding them at the regional level in an ASEAN + 3 scenario for instance would also be an option, and potentially more realistic given the current state of negotiations at the multilateral level.

This finding is suggestive of a corollary that liberalisation of the tariffs beyond currently applied rates is unlikely to generate significant welfare gains in the region. Which means that the gains from RTAs within the region are more likely in areas where existing levels of protection are higher. At present, agriculture appears too sensitive for further progress, however this paper has suggested that changes in regional patterns of consumption of agricultural products and the social evolution of domestic structures of agricultural production may – in time – allow for tangible advances in regional RTAs not possible today.

Other areas where RTAs could bring significant welfare gains would be under services and the new issues including investment, competition, trade facilitation and government procurement. In short, progress in these areas holds the greatest potential for economic gains from regionalism in East Asia. Given the nascent stage of negotiations for RTAs in the region, it is too early to prognosticate a likely outcome. And yet, there are risks involved too. Different regulatory models could emerge in the region causing confusion. More important, in financial services, lack of regulatory harmonisation and cooperation is highly risky. Opening of developing countries to imports of financial services may not serve the needs of capacity building. Indeed, it is too early to tell what the outcome of the current negotiations to complete framework agreements in the region will produce – much less their impact on the MTS.

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