SHAPING THE FUTURE:
PROSPECTS FOR ASIA'S LONG-TERM DEVELOPMENT
OVER THE NEXT TWO DECADES

RETA 6205: Long-term Scenarios of Asian Growth and Trade
Finalization Conference

Bilateralism or Regionalism: Alternative Scenarios for Asian Trade Liberalization*

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11-12 December 2006
ADB Thailand Resident Mission Conference Room

* The views expressed in this paper are those of the authors and do not necessarily reflect the views or policies of the Asian Development Bank or its Board of Governors or the governments they represent.

"Bilateralism or Regionalism: Alternative Scenarios for Asian Trade Liberalization"

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December 2006

I. Introduction

The trend towards bilateralism in Asia is gaining momentum and may well become the main avenue for trade negotiations in the wake of the suspension of the Doha Round negotiations. The rising tide of bilateralism is well-documented and is becoming particularly notable in Asia where the former emphasis on "open regionalism" has been replaced with preferential agreements based upon reciprocity enforced by rules of origin (ADB 2006). In 1995 there were only 3 bilateral preferential trade agreements involving developing member countries of the Asian Development Bank (ADB) notified to the World Trade Organization (WTO). By 2006 over 40 such agreements involving Asian developing countries had been notified and nearly 100 others were in the process of being negotiated. Moreover, research on notified agreements that are available on the WTO homepage reveals that each has distinctive product coverage and varying rules of origin (James 2006). This means that there will be no simple process of rolling these agreements into a region-wide free trade area.

Bilateralism's key result is likely to be an unintended one. That is, it may result in creation of hub-spoke systems within Asia and the Pacific. Large hub economies of Japan, the United States, Republic of Korea (Korea), the People's Republic of China (PRC), and India will likely occupy central dominant positions within such systems. However, it is also possible that Association of Southeast Asian Nations (ASEAN) plus agreements could supplant the individual hub-spoke systems, provided ASEAN can hold together and advance towards an integrated single market. A complication with this ASEAN-plus regional scenario is that individual ASEAN members, particularly Singapore, Thailand, Malaysia, and the Philippines are actively seeking their own bilateral arrangements, particularly with the United States and Japan. Inconsistency in coverage, rules of origin, and emphasis in individual bilateral agreements may complicate efforts by the larger ASEAN group to develop agreements that are consistent with WTO and that can provide the basis for broader regional integration.

In this paper we review the requirements for bilateral or regional preferential trade agreements in the WTO and compare emerging bilateral free trade agreements against what may be termed "best practices" and consistency with relevant articles and agreements under the WTO umbrella. Complex and overlapping rules of origin are a major concern in the proliferation of bilateral agreements involving member countries of the ADB. Hence, we develop a simple model of the choices facing firms that wish to avail of preferential trade agreements using the concept of compliance cost as a key decision factor. After illustrating the choice facing firms, we then go on to develop alternative scenarios comparing open and closed hub-spoke systems with a more general region-wide free trade agreement. This exercise may provide input into the approach taken by political leaders within the Asia-Pacific region towards developing regional free trade and related institutional arrangements.

One of the key assumptions we make is that trade costs matter. We broadly define trade costs to include all impediments to trade including border measures (tariffs and tariff-rate quotas, quantitative restrictions); behind the border measures (licensing, tax and regulatory restrictions, port handling and infrastructure bottlenecks, corruption, and security); and across-the border measures (standards, testing requirements, safety, health, and environmental standards). In *Asian Development Outlook 2006* (ADB 2006) it was demonstrated that the main gains from trade liberalization are those realized on a *non-discriminatory basis*, that is, through the reduction of trade costs for all agents and firms in an economy. Such gains may result from efficiency-improving trade agreements or from unilateral policy improvements that influence productivity in a positive manner. Needless to say, bilateral trade agreements that force firms into pursuit of tariff preferences that *are applied on a discriminatory basis* and that involve substantial compliance costs may cut in the opposite direction by increasing the costs of doing trade. The standard technique for evaluating trade agreements (i.e., trade creation versus trade diversion) does not capture changes in trade costs and may understate their impact.

II. Best Practices in Preferential Trade Agreements

The principle of non-discrimination is established in Article I of the General Agreement on Tariffs and Trade (GATT 1947).[1] The principle is also referred to as *Most-Favored-Nation (MFN)* treatment. The central meaning of the principle is explained by Treblicock and Howse (2005: 28):

> "Under Article I of the GATT, with respect to customs duties or charges of any kind imposed by any country on any other Member country, any advantage, favor, privilege, or immunity granted by such country to any product originating in any other country shall be accorded immediately and unconditionally to a like product originating in the territories of all other Members."

Exceptions to Article I are permitted under Article XXIV: Territorial Application—Frontier Traffic—Customs Unions and Free Trade Areas; under the Enabling Clause: Differential and More Favorable Treatment, Reciprocity and Fuller Participation of Developing Countries (established by the decision of Contracting Members on 28 November 1979 during the Tokyo Round Negotiations); and under the General

[1] This section draws upon James (2006).

Agreement on Trade in Services (GATS) Article V: Economic Integration as Part of the Uruguay Round Agreement (GATT 1994).[2] Each of the three escape routes from the MFN principle has requirements of varying degrees.

Article XXIV specifically requires notification of customs unions or free trade agreements to the WTO Committee on Regional Trade Agreements; that such agreements cover substantially all trade in goods; that products excepted or excluded from agreements be integrated into the agreement within "a reasonable length of time" (considered to be a maximum of ten years); and forbids such agreements to increase restrictions on the commerce of non-parties who are Contracting Members relative to the situation existing prior to the entry into force of said agreements. Article XXIV also requires Contracting Members to take measures to ensure observation of the terms of such agreements by sub-national units of government and other authorities within its territories.

Preferential Trade Agreements that cover services in addition to goods require separate notification under Article V of GATS.[3] The notification requirement is to the WTO Council for Trade in Services. Other requirements under Article V include: substantial coverage of services sectors; elimination of discriminatory measures among the Members of such agreements; and prohibition of agreements from raising the overall level of barriers to commerce in services to non-partners among Contracting Members compared with the situation that existed before entry into force of the preferential services agreement.

The Enabling Clause aims at encouraging developing countries to participate more fully in international trade and provides for non-reciprocal preference programs between more developed Members and less developed Members as well as for preferential trade agreements amongst developing country Members. Requirements are lighter than under GATT Article XXIV: notification of agreements to the WTO including consultation with any Contracting Members that so request it. The Enabling Clause specifies that developed country Members that extend preferences (e.g., the Generalized System of Preferences [GSP]) to developing country Members do not expect reciprocation by the developing Members but also that such agreements create no impediment to elimination of tariffs and non-tariff barriers to trade on an MFN basis.

Non-reciprocal agreements between developed and developing or less developed countries are potentially more beneficial to the latter than are reciprocal agreements between developing countries by reason of market size and improvement in market access implied. However, the ability of developing countries to take advantage of such access under non-reciprocal preferences may be curtailed by incomplete coverage of trade in goods and by restrictive rules of origin that make compliance costly for exporters in the developing country beneficiaries.

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[2] Exceptions to Article I are elaborated upon in Trebilcock and Howse (2005: 53-55). The full texts of these articles and agreements can be downloaded from the WTO homepage: http://www.wto.org

[3] The GATT and GATS are separate agreements but are both within the overarching framework of the WTO. Trebilcock and Howse (2005: 356-372) provide a summary of the negotiations leading to GATS and its provisions.

The proliferation of preferential trade agreements (PTAs), especially bilateral free trade agreements (FTAs), in the region is making MFN treatment more the exception than the rule. As is stated in the study entitled *The Future of the WTO: Addressing institutional challenges in the new millennium* (The Consultative Board, 2004:1):

> ". . . nearly five decades after the founding of the GATT, MFN is no longer the rule; it is almost the exception. Certainly, much trade between major economies is conducted on an MFN basis. However, what has been termed the "spaghetti bowl" of customs unions, common markets, regional and bilateral free trade areas, preferences and an endless assortment of miscellaneous trade deals has almost reached the point where MFN treatment is exceptional treatment. Certainly the term might now better be defined as LFN, Least-Favored-Nation treatment."

Recent advances in research on preferential trade agreements have established that membership in a PTA makes members less willing to liberalize trade on an MFN basis on the subset of goods the country imports under a PTA (so-called "PTA Goods") than for non-PTA goods (Limao 2006). MFN tariffs on PTA goods may therefore remain higher than otherwise as almost all Contracting Members of the WTO are now party to at least one PTA. If PTA membership makes countries reluctant to engage in multilateral trade liberalization negotiations and this can be empirically demonstrated then PTAs violate the requirement in obtaining a waiver to Article I of GATT that such agreements must not constitute an impediment to lowering tariffs on an MFN basis. In practice, PTAs may also raise barriers against non-members through use of restrictive rules of origin coupled with high margins of preference. A major difficulty presented by bilateralism is that rules of origin used to determine which goods may receive preferential treatment and which may not are not subject to any discipline under the WTO at present. Efforts to incorporate preferential rules of origin into the WTO have resulted merely in a non-binding declaration as more serious efforts to impose disciplines over rules of origin have been vetoed.[4] The lack of discipline over preferential rules of origin constitutes a major loophole in the global trading rules that protectionist interests have seized upon.[5]

Despite the above caveats, there are economic reasons why countries would wish to engage in FTAs (see, for example, World Bank 2005, ADB 2002, ADB 2006, Kreinin and Plummer 2002, Frankel 1998). One of the most commonly-cited reasons is that FTAs allow for like-minded countries to pursue "deeper" integration than would be possible in the context of the WTO with its 150 Member Countries. In fact, the frustration associated with lack of progress at the Doha Development Agenda talks stems in large part from the complications of diversity. Arguably this is nothing new; the GATT/WTO has often been criticized for being too restrictive in its coverage, and, coupled with the great variance across commodities in terms of tariff cuts, this partial liberalization leads to "second best" distortions of its own. In other words, some of the negative effects associated with discrimination across *countries* (in FTAs) are applicable to discrimination across *commodities* (at the GATT/WTO). This problem is borne out in the data. For example, in a controversial academic piece in the *American Economic Review* (but widely circulated beforehand), Andrew Rose tests the hypothesis of whether

[4] James (2005) provides a review of the non-binding declaration on preferential rules of origin.
[5] James (2005) documents this. See Imagawa and Vermulst (2005) for a detailed account of the negotiation over non-preferential rules of origin in the WTO.

or not the WTO has really made a difference in stimulating world trade (Rose 2004). Using a gravity model of international trade, he rejects this hypothesis. In other words, over the 1948-2000 period, being a member of the WTO had no statistically-significant effect on influencing bilateral trade, when one controls for other relatively standard variables. One explanation for this is the fact that key sectors, such as agriculture, textiles and clothing, and other protected sectors have basically remained outside of the GATT/WTO liberalization process over the time period covered in the Rose article (1948-2000). Another would be that distortions in effective rates of protection caused by unbalanced, selective liberalization in the GATT/WTO have impeded trade among WTO Member Countries.

Thus, given the "revealed" desire to negotiate FTAs (for whatever reason) and the advantages of FTAs in terms of the possible depth of trade and investment facilitation and liberalization, it would make sense to try to ensure that preferential trading accords minimize any potential negative effects (e.g., trade diversion and investment diversion) while at the same time maximizing the advantages of FTAs. This we might call the "best practices" approach to regionalism.

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

Even though a great deal has been written on this and related issues, little has been done focusing on specific components of regional trade groupings themselves and how they influence the debate. The Asia-Pacific Economic Cooperation Group (APEC) and the Pacific Economic Cooperation Council (PECC) have also taken up the issue of best practices in FTAs, and they have articulated key general principles and guidelines that the Asia-Pacific region needs to embrace in order to reduce business-related transaction costs.[6] They stress that FTAs should embrace non-discrimination (presumably, where possible, as FTAs by their very nature are discriminatory), comprehensiveness, flexibility, WTO-consistency, transparency, and cooperation. However, as noted by Scollay (2004), the language of related statements does not go far beyond that of the relevant clauses in the 1994 WTO Understanding on Interpretation of GATT Article XXIV.

In its Trade Facilitation Action Plan (October 2002), subsequently fomalized in the 2003 "Shanghai Declaration," APEC leaders dedicated themselves to a five percent reduction in transactions costs due to red tape and other costly barriers to doing business by 2006 through trade facilitation measures. The Action Plan articulates over 50 reforms to be undertaken in the general areas of movement of goods (including expediting customs clearance), standards (e.g., harmonization of procedures and rules in goods and services trade), business mobility, and e-commerce.[7] In June 2006, the APEC Ministers Responsible for Trade considered the idea of reducing such costs by an additional 5 percent by 2010, though the modalities to achieve this were somewhat

[6] See, for example, PECC Trade Policy Forum 2004 and summaries in Scollay 2004.
[7] http://www.whitehouse.gov/news/releases/2002/10/20021027.html, accessed June 20, 2006.

unclear.[8] Interestingly, they also committed themselves to work on "high quality" regional and bilateral free-trade areas. In short, the APEC do give a high priority to the adoption of "best practices," though the road to efficiency will be a long one (and full of potholes).

APEC and PECC have also been active in trying to estimate the potential benefits that might accrue from trade facilitation measures. For example, in the APEC Economic Committee's Report, "2004: Trade Facilitation and Trade Liberalization: From Shanghai to Bogor" (APEC 2004), a methodology developing proxies for the measurement of various trade facilitation policies is offered, followed by some empirical estimation comparing trade facilitation improvements to reductions in tariffs.[9] The Report finds that the trade creation effect of tariff liberalization is greater than that of trade facilitation: when APEC economies liberalize tariffs by 10 percent, intra-regional imports rise by about 2 percent, whereas they only rise by about 1 percent in the case of trade facilitation. However, it also suggests that trade facilitation can be an excellent complement to tariff reduction.

We might propose ten "rules of thumb" in terms of best practices in FTAs[10]:

1. **Product coverage: Goods**. *Comprehensive coverage is best, to be included within a reasonable period of time (defined as 10 years by the GATT/WTO)*. While, as noted above, Article XXIV of the GATT/WTO stipulates that, in an FTA or customs union, product coverage should include "substantially all goods," few FTAs cover all goods. Exclusions of individual products can be problematic on efficiency grounds, particularly when they involve products that are used as inputs in the productive supply chain. For example, duty free inputs of steel will cause exaggerated protection of value added (the "effective rate of protection") in the automotive sector. Elimination of tariffs on imported lumber will do the same in the furniture industry if the latter is excluded from liberalization. "Positive list" approaches tend to be the worst possible mechanisms in this regard, as items that would generate trade creation are excluded and those that would generate trade diversion (i.e., promote intra-regional trade at the expense of non-partners) would be included.

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

2. **Product coverage: Services**. Again, *comprehensive coverage and a reasonable time period for implementation are best* from an economic perspective, and transparency is important in some areas. Services present some special and important challenges. Certain services are fairly easy to liberalize, e.g., in terms of allowing for the movement of professional persons, tourist-related services (the most important in terms of exports for the ASEAN countries, for example), and even high-tech/knowledge-based services. Others are extremely difficult. Educational services tend to be highly protected. Financial services are often the most difficult to include in any liberalization package.

[8] http://www.acnnewswire.net/press/en/32057/APEC.html, accessed June 20, 2006.
[9] The model used, however, is a gravity model, which has numerous shortcomings in analyzing the effects of regionalism. See, for example, Frankel (1997) and Kreinin and Plummer (2002).
[10] This discussion follows from Plummer (2006).

Even the EU, which has been a regional trading organization for almost a half-century and technically completed its "Single Market" over 10 years ago, has a long way to go before incorporating financial services at the EU level, despite commitments to do so.[11] The same is true about postal services, which continue to be protected within the EU based on their "universal service obligations" but in reality due to heavy unionization of the sector. Within the framework of GATS, some financial services will be included but education and postal services will be excluded due to their politically-sensitive nature.

Hence, if such opposition to full inclusion of services exists in advanced developed-country agreements, it is obvious that certain sectors will elicit controversy in those accords that include developing countries as well. Nevertheless, they should be included as much as possible. In fact, in many Asian developing countries, this could be one of the best policies for "forced" structural policy change in the region. Telecommunications and financial services might even be highest on the list of the most productive in this sense. Development of the telecommunications sector is extremely important in the functioning of a modern economy, as it serves as a key input to knowledge-based products and services. Financial-services development is essential in modernizing the financial sector, increasing opportunities for savers and investors, and enhancing the integrity of the financial system. And given the importance of education in the modernization of instruction and preparing populations for a highly-competitive global economy, greater competition in this sector is critical in achieving the development goals of many developing (and developed) Asian economies. Already liberalization is taking place; the process can be enhanced through FTAs. Liberalization of services such as telecommunications is highly complementary to liberalization of goods in that expansion of services within the FTA will induce greater demand for telecommunications equipment that can benefit non-members as well.

3. **Rules of Origin**. *Rules of origin should be as low as possible as well as symmetrical*. "Abuses" of rules of origin in FTAs is the most common criticism of regional agreements by economists. Existing FTAs between developed countries tend to be the most comprehensive and "deep"; however, they also have their dark sides, and the darkest of these sides is arguably the rules of origin provisions. Research as to how much compliance with rules of origin taxes efficiency is difficult to find. One estimate (Estevadeordal and Suominen 2003) calculates the cost to be in the range of 3-5 percent of the f.o.b. value of the exported goods.[12] Similar estimates have been made for the Australia-New Zealand Closer Economic Relationship (CER) by the Australian Productivity Commission (2004). One way to reduce compliance costs is to provide choice to firms wishing to avail of tariff preferences by introduction of flexible rules of origin (Lloyd 1993). For example, in application of a value-added test, firms may use either the maximum value of non-originating materials or the minimum value of originating materials. In addition, specified processes which do confer origin may be listed as an alternative to a value-added test or a change-in-tariff-heading (CTH) test. Making value-added requirements for less developed members lower would also help

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

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

poorer countries in taking advantage of preferential trade agreements. Allowing such less developed countries to use non-originating materials and single transformation rules for clothing and textiles can be especially beneficial as has been done in the case of Canada's GSP program and the US-Jordan FTA (James 2006).

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

4**. Customs Procedures**. *To the greatest extent possible, customs procedures should follow global best practices and GATT/WTO-consistent protocols*. Customs and related procedures are at the heart of "trade facilitation," a key priority in the Doha Development Agenda. They are obviously closely related to rules of origin, as one of the key challenges of customs officials is to clear countries-of-origin of imports. The extent of globalization of production combines with the need for rules of origin in the context of FTAs (and, sometimes, customs unions, if the issue relates to non-reciprocal agreements such as the Generalized System of Preferences or the EU's "everything but arms" initiative for Least Developed Countries) to ensure that customs procedures and related regulations form an essential component of any regional accord. A key issue in the customs negotiations pertains to transparency and "risk management".[13] "Best practices" under the WTO relate to the Agreement on Customs Valuation, which provides private-sector access to a review and appeal mechanism. Some agreements go further than the WTO Agreement on Customs Valuation; for example, in the context of the US-Singapore FTA, the US import declaration is the only document necessary to prove origin.[14]

Regional trading agreements can be used as instruments to modernize customs laws, regulations, administrative guidelines, and procedures. The most basic questions being asked are (McLinden 2005, pp. 76-77)): (1) has a process of continuous review been created?; (2) has an official process of the review and rationalization of exemptions and concessions been developed?; (3) is there in place an efficient cross-agency process in applying regulatory requirements?; (4) have internationally-accepted conventions and standards, including those found under the WTO Valuation Agreement, been implemented? (5) do regional trading groups adopt internationally accepted standards and work toward regionalization of best practices?; and (6) are the laws, regulations, procedures, and administrative guidelines transparent?

If "best practices" are developed, progress in this area could be an important advantage of FTAs, especially if, as part of the agreement, developed countries help modernize these procedures, build capacity, transfer related technology, and train administrators. One does see this happening in such agreements, such as in the (non-

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

[14] Chia (2005).

preferential) US-Vietnam Bilateral Trade Agreement and Japan's Economic Partnership Agreements (EPA) with ASEAN member countries.

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

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

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

6. Foreign direct investment. *Investment-related provisions should embrace national treatment, non-discrimination, shun performance requirements, and make use of a negative-list approach that is strictly limited, as well as provide the usual protection necessary for foreign investors*. Asian countries in particular place a strong emphasis on FDI, and having liberal, non-discriminatory provisions tends to be less controversial than in the case of other developing regions. Exceptions might exist with respect to FDI in state-owned enterprises and "sensitive" sectors. This is true not only for developing but also developed countries: state-owned enterprises have traditionally restricted significantly FDI penetration in areas such as defense, public morals, the media, and certain other sectors of high "national security" or "national sovereignty" importance. This will always be true with or without FTAs. For our purposes, we would stress that pacts should keep them to a minimum.

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

7. **Anti-dumping and Dispute Resolution**. *Anti-dumping procedures and dispute resolution need to be transparent and fair, and the process needs to be well specified and effective*. Anti-dumping and countervailing duties, also known as "administrative

actions," have been condemned as an important weapon in the arsenal of the "new protectionism." Anti-dumping duties have mainly been used by developed countries but some developing countries have begun to use them as well. Anti-dumping measures may or may not be stipulated directly in an agreement; sometimes, the references may be exclusively directed to the WTO dispute resolution. Anti-dumping clauses in an FTA might be used as a means to tighten anti-dumping evaluations procedures, promote transparency, and expedite any processes. But it is also important that dispute settlement procedures be clearly identified and respected. Otherwise, confusion can follow. A good model for dispute settlement is the North American Free Trade Agreement (NAFTA) panel approach where five panelists are selected from lists of experts submitted by each member (two from each country in the dispute and one selected to chair the panel chosen by agreement between the two parties). The dispute settlement procedures in NAFTA have been modeled on those of the multilateral system following reforms after the Tokyo Round and the Uruguay Round (Trebilcock and Howse 2005:147-148).

8. **Government procurement**. *Government procurement should be open and as non-discriminatory as possible, and procedures should be clear and as open as possible*. The size of the state sector varies across Asia and internationally, but in most countries government procurement constitutes a significant sector. There is a WTO Agreement on Government Procurement, but not all WTO member-countries are signatories. Moreover, rules on market access in this agreement are relatively limited. Chapters on government procurement in the deeper FTAs tend to go much further. "Best practices" would require that the arrangement produce a transparent, open, and non-discriminatory regime that would grant as much as possible national treatment to partner countries, with an excluded (negative) list as short as would be feasible and the threshold-bid level as low as would be practical.[15]

9. **Competition**. *Policies related to competition should create a "level playing field" for both locals and partners, and they should not put non-partner competition at a disadvantage*. Many countries in Asia do not have a competition policy *per se*. Even Singapore, with a relatively advanced regulatory framework, has no comprehensive competition policy or competition law, though it does have sector-specific regulatory arrangements in this regard (e.g., in utilities and telecommunications services). But trade and investment liberalization is affected by industrial organization at the domestic level, and this becomes an especially important area in countries having active state-owned enterprises (like Singapore). Hence, it follows that "deep" FTAs should have basic rules and procedures designed to prevent anti-competitive behavior from state-owned enterprises, quasi-statal firms, privately-owned domestic monopolies/oligopolies, and the like, that would grant a competitive edge over foreign competition.

10. **Technical Barriers to Trade**. *These should be kept to a minimum, harmonized in a non-discriminatory way, with clear and transparent mechanisms for determination of standards*. The WTO Agreement on Technical Barriers to Trade (TBT) attempts to "ensure that technical negotiations and standards, as well as testing and certification procedures, do not create unnecessary obstacles to trade." TBT takes on particular significance at the global level, as many of its aspects, including harmonizing standards, "mutual recognition," defining what are legitimate means of protecting, e.g., animal and

[15] Given the nature of government procurement, one would never expect to agree on comprehensive national treatment.

plant life and the environment, etc., should have global rules of conduct. International standards, however, are bound to be general; FTAs, as they only involve a few or several countries, can potentially achieve far deeper means of integration and progress in this area. What would be critical for efficiency and outward-orientation, therefore, would be that any TBT clauses in FTAs should be based on international standards, have high levels of transparency, embrace best practices, and eschew discrimination against outsiders as much as possible.[16] The Uruguay Round created a "Code of Good Practice for the Preparation, Adoption and Application of Standards" by standardizing bodies; FTAs should build on these, or at least not contradict them.

In sum, by adopting best-practices, FTAs could generate significant gains in terms of economic efficiency, well-beyond the effects of traditional FTAs (which can potentially be welfare-inhibiting) and, arguably, beyond what any realistic multilateral approach could possibly hope to generate. How much is "significant"? This would be difficult, indeed, to model. However, the EU's Single Market Programme, which did not focus entirely on best-practices but is largely devoted to improving efficiency through the harmonization of the types of policies including in this section, was estimated (Cecchini 1988) to increase EU GDP by up to 6.5 percent. Moreover, in order to compare traditional estimates—induced by liberalization of tariff and tariff-equivalent non-tariff barriers--of gains due to trade liberalization in Asia (Scenario 1) and more general trade-cost reduction effects such as improving customs clearance, lower transaction costs, and facilitation of international market access (Scenario 2), Brooks, Roland-Holst and Zhai (2005) run simulations to compare the aggregate impact on real income, exports, and terms of trade.[17] They assume that non-policy-related trade costs are around 120 percent and are cut by half over a twenty-year period for East Asia, Southeast Asia, and South Asia.[18] The results are illuminating. Under Scenario 1, real income rises in the range of 0.9-2.9 percent for East Asia, 1.9-6.6 percent for Southeast Asia, and 0.3-0.6 percent for South Asia. Under Scenario 2, the gains are many times as large, that is, 8.1-53.8 percent, 35.5-116.6 percent, and 10.4-22.4 percent, respectively.

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

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

[17] Brooks, Roland-Holst and Zhai (2005) model the Scenario 2 liberalization as an "iceberg effect," in which a fraction of goods and services "melt away in transit due to the trade costs" (p. 4, fn 4).

[18] It is important to note that this value is a guesstimate and is not derived systematically or empirically.

delineate above, as well as being between two advanced countries with less to gain from "best practices".

III. Evaluation of Hub-Spoke vs. Region-Wide Economic Integration in Asia

Rules of origin in recently notified agreements have been examined for consistency with best practices as outlined in II above (James 2006). Rules of origin for primary products are based upon the "wholly obtained" criterion (within the customs territory or within the legally defined territory of the originating country) and, although not free of controversy (Imagawa and Vermulst 2005), are less complex and simpler to harmonize than rules of origin for processed and manufactured goods where value and components are sourced in more than one country. For processed and manufactured goods the principal of "last substantial transformation" may be satisfied by one or more of three tests: a change in tariff heading (CTH) test implemented at the six-digit harmonized system level; a specified process test (identifying which operations confer origin); or a value-added or percentage test (specifying minimum regional content or maximum non-originating content); or by a mixture of the three tests.

An examination of rules of origin in newly notified PTAs involving at least one Asian Developing Country (James 2006) revealed that there is a lack of internal consistency in rules of origin in the region. That is individual PTA rules of origin are idiosyncratic so that Korea-Singapore and Korea-Chile agreements, for example, have divergent rules of origin. Rules of origin across the main hubs for PTAs in Asia (Japan, Rep. of Korea, PRC, Singapore and Thailand) are inconsistent and would be extremely difficult if not impossible to harmonize. For example, although Australia and New Zealand have a common free trade agreement (CER or Closer Economic Relations), the rules of origin of the CER are different than for Australia-Thailand, New-Zealand-Thailand and Australia-Singapore and New-Zealand-Singapore Free Trade Agreements. The value-added ratio required in Australia-Thailand is 55% in textiles and clothing compared with 50% in New Zealand-Thailand, for example. For most manufacturing sectors Australia-Thailand combines a CTH rule with a value added rule, whereas New Zealand-Thailand has only a CTH rule. The CTH rule is inappropriate for machinery sectors where assembly and testing of a product constitute a substantial transformation, however, and require supplementation by a CTSH rule (a change in tariff sub-heading). The unwillingness of New Zealand and Australia to adopt consistent rules of origin in their bilateral agreements with Asian partners illustrates why harmonization of preferential rules of origin is an unlikely prospect.

A comparison of rules of origin in free trade agreements linking bilateral partners in Asia (e.g., Korea-Singapore or Japan-Singapore) and those linking bilateral partners with countries outside the region (e.g., Korea-Chile or Japan-Mexico) reveals that bilateral FTAs within Asia provide less favorable treatment in rules of origin than do agreements that are with partners outside Asia. For example, Korea-Singapore rules of origin for manufactured goods require regional content of 55% in addition to a CTH test and for clothing also require a strict yarn-forward test. Moreover, tariffs on clothing items are phased out gradually in even annual increments over a ten-year period in Korea-Singapore. In contrast, in Korea-Chile the regional content rule is 45% for "build-down" method or 30% for "build-up" method and for clothing is waived in favor of a specified process test. Tariffs are liberalized as soon as the agreement entered into force for Korea-Chile in textiles and clothing. The implicit discrimination within Asia found in Korea's agreements is also found in those of Japan. Japan-Singapore regional content

is 60% compared with 50% for most manufactured sectors in Japan-Mexico. However, for clothing, Mexico only has to meet a CTH rule whilst Singapore must have 60% regional content and a CTH as well. Rules of origin have also been designed with protection of local industry in mind. For example, Japan-Mexico imposes a 65% rule for certain automotive products reflecting the presence of a large automotive sector in Mexico. In contrast, Japan-Singapore requires only a CTH as Singapore has a negligible automotive sector.

Thus the hub-spoke systems emerging in Asia have different and inconsistent rules of origin for manufactured products that do not bode well for development of efficient production networks. Asian hubs are offering less favorable terms of market access under rules of origin and tariff elimination schedules for other Asian countries than for partners outside the Asian region. The complexity of the emerging systems in rules of origin is likely to confront businesses with difficult trade offs and higher than necessary costs of compliance in order to take advantage of available tariff preferences. The disruption of efficient sourcing in favor of preference-based sourcing could also render industries less competitive in world markets—the opposite effect of the intention of these agreements. We examine these issues and construct a simple model and some illustrative scenarios of these issues below in Section IV.

ASEAN plus agreements may hold potential for overcoming hub-spoke marginalization of small, poor and isolated economies as well as providing a platform for a broader regional agreement. The key determinant of whether or not this will be the case is if these agreements allow ASEAN cumulation that could eventually be extended across all PTAs in the region (for example, to SAARC—South Asian Association for Regional Cooperation) in a manner similar to the European Union's Pan-European Cumulation System (PECS). The ASEAN cumulation principle is observed, for example, under Japan's GSP rules of origin and is partially adopted in its bilateral agreements with ASEAN members for textiles and clothing. This sets a good precedent but should be extended to as many manufacturing and processed product sectors as possible—at a minimum to the ASEAN priority sectors. These sectors have been identified for rapid integration in the effort to create an ASEAN Economic Community along the lines of the EEC (European Economic Communities).[19]

IV. Measuring the Impact of Good Practice Agreements

The potential welfare impacts of a variety of (hypothetical) free trade arrangements are examined in ADB (2006). A global free trade "ideal"—based on the assumptions of the "GEMAT" model—lifts developing Asia's income by 1.3% by 2025. If, instead, trade is liberalized only within Asia (including Japan), but not between Asia and the rest of the world, developing Asia's income rises by 1.1%. Taken at face value, this result suggests that Asia could capture much of the gains from global free trade by liberalizing internally. But hypothetical bilateral arrangements within Asia do not look nearly as attractive. When it is assumed that an ASEAN (free-trade) hub bilaterally dismantles tariff and non-tariff (equivalent) barriers with all other Asian countries, benefits are cut by a quarter compared to an Asia free trade area. And if PRC were to

[19] The 12 priority sectors include: 1) Agro-based products; 2) Air Travel; 3) Automotive components; 4) Electronic commerce ("e-ASEAN"); 5) Electronics; 6) Fisheries; 7) Healthcare; 8) Logistics; 9) Rubber-based products; 10) Textiles and apparel; 11) Tourism; and 12) Wood-based products.

remove all tariff and non-tariff barrier equivalents with its Asian trading partners, but they do not liberalize among themselves, benefits are nearly halved.

Recognizing that the commercial and political economy interests that drive free trade arrangements now have considerable momentum, it is worth considering to what extent "good practices" (see Section II) can deliver benefits. On the one side, any arrangement that confers preferences will entail some trade diversion, but these costs may be large or small depending on the details of the arrangement. To be set against costs, are possible gains through trade creation (including in agricultural and services trade), liberalization of investment flows and through possible reductions in trade costs. A particularly attractive feature of measures that reduce trade costs is that they are inclusive. Improved port infrastructure or more efficient customs services benefit all who trade. Some estimates suggest that for a $1 reduction in trade costs, developing Asia could stand to gain up to $3 (including the original $1 which was originally wasted) (ADB, 2006). The additional $2 benefit derives from induced multiplier effects, scale expansion, greater variety, and accumulation.

"Good practice" FTAs, are compared against "shallower" agreements along three dimensions: (i) the costs and restrictiveness of the agreements; (ii) the degree to which the spokes of the system are joined up; and (iii) the degree of diversity among the countries involved. The architecture of hypothetical agreements that vary in these dimensions is described in Table 1. Two parameters are used to characterize the nature of the FTAs: a utilization rate and a compliance cost parameter. The utilization rate measures the share of trade which is tariff and tax exempt under the agreement. Trade outside of the agreement attracts tariffs and taxes as before. Compliance costs have an "iceberg" character and are the costs of qualifying for preferences in terms of satisfying rules of origin and other requirements. Compliance costs generate no benefits and are essentially waste. High compliance costs would normally entail low utilization rates.

The first hypothetical arrangement imagines a "closed" hub and spoke system. The hub is assumed to be India. All other developing countries in Asia are assumed to be spokes. Some simplified but characteristic features of India's existing agreements are incorporated. Textiles and apparel is assumed to be a "sensitive" sector and has a very low utilization rate (10%). More generally, high compliance costs (5% of the value of exports) lead to utilization rates for other goods of just 40%.

The second simulation considers a hub-spoke arrangement that has a more open character. The hub is assumed to be Japan, and other Asian countries are spokes. Exemptions under the arrangement are more limited and compliance costs are lower. As a consequence the utilization rate for non-agricultural merchandise trade is assumed to be 70%. Agricultural trade, which is assumed to be a sensitive sector, has a much smaller utilization rate of 20%.

The third simulation looks at a regional arrangement rather than a hub and spoke configuration. ASEAN countries are assumed to eliminate their tariffs and export taxes in all merchandise sectors. No exclusions occur, as it assumed these would be difficult to agree among 10 negotiating parties. Compliance costs are modest at 2.5% and there is a 70% utilization rate of preferences.

The next three experiments broaden the hypothetical ASEAN FTA. First, the FTA is expanded to include the PRC (ASEAN+1). Next, Japan and Korea are added along with the PRC (ASEAN+3). Finally, India, Australia, and New Zealand join as full members, along with the PRC, Japan, and Korea (ASEAN+6). In these extended regional arrangements, precisely the same assumptions are used as in the ASEAN simulation.

Finally, the ASEAN+3 and ASEAN+6 FTA simulations are compared with an ASEAN hub in which there are "open" and "closed" bilateral (spoke) agreements. This allows identification of the benefits of more inclusive arrangements both in terms of country coverage and the share of trade covered by preferences.

Simulation results are reported in Table 2. All simulations are static and exclude any changes in income that could occur through induced accumulation. In some models (see ADB, 2006) dynamic gains account for as much as 50% of total income gains that accrue from liberalization. As it is variations between different FTA arrangements that are of most of interest here, dynamic effects are suppressed. They are unlikely to influence materially either rankings or comparative sizes of simulated income changes.

Table 1 Simulation Assumptions

Simulation	Assumed FTA Architecture
1) Closed hub-spoke	
India-Hub	India is the regional hub and has bilateral FTAs with all other Asian countries (spokes). Bilateral tariff and export taxes between India and its FTA spokes are removed for all merchandise sectors. There is assumed to be a 5% cost incurred for utilizing preferences. The assumed utilization rate is 40% but only 10% for textiles and apparel as textiles and apparel are assumed "sensitive" for India.
2) Open hub-spoke	
Japan-Hub	Japan is the regional hub and has bilateral FTAs with all other Asian countries (spokes). Bilateral tariff and export taxes between Japan and its FTA spokes are removed for all merchandise sectors. Firms utilizing preferences are assumed to incur 2.5% compliance costs. The preference utilization rate is 20% for the sensitive agricultural sector and 70% for other merchandise sectors.
3) Region-wide open integration	
ASEAN FTA	An ASEAN Free Trade Area is assumed: i.e. bilateral tariff and export taxes among ASEAN members are eliminated for all merchandise sectors. Given the diversity of membership, there is assumed to be no sensitive sectors. Compliance costs of utilizing preferences are 2.5%. There is an overall utilization rate of 70%.
ASEAN+1 FTA	Scenario ASEAN FTA plus PRC as a member of the regional FTA.
ASEAN+3 FTA	Scenario ASEAN+1 FTA plus Japan and Korea as members of the regional FTA.
ASEAN+6 FTA	Scenario ASEAN+3 FTA plus India, Australia, and New Zealand as members of the regional FTA.
4) ASEAN Hub	
ASEAN Hub + 3 spokes	Scenario ASEAN FTA plus PRC, Japan, and Korea as bilateral spokes. Bilateral tariff and export taxes among ASEAN members and between ASEAN and its three spokes are eliminated for all merchandise sectors. Compliance costs of 2.5% are assumed. Overall utilization rate is 70%.
ASEAN Hub + 6 spokes	Scenario ASEAN FTA plus PRC, Japan, Korea, India, Australia, and New Zealand as bilateral spokes. Bilateral tariff and export taxes among ASEAN members and between ASEAN and its six spokes are eliminated for all merchandise sectors. Compliance costs of 2.5% are assumed. Overall utilization rate is 70%.
ASEAN Hub + 3 spokes (closed hub-spokes)	The same as "ASEAN Hub + 3 spokes", except for a lower utilization rate of 40% and higher compliance costs of 5%.
ASEAN Hub + 6 spokes (closed hub-spokes)	Similar to scenario "ASEAN Hub + 6 spokes", except for a lower utilization rate of 40% and higher compliance costs of 5%.

A number of points emerge quite clearly from the simulations. Most immediately, shallow FTAs yield very small gains compared to alternative arrangements that have lower transaction costs and wider coverage. In the "closed hub" simulation, total gains for developing Asia are just 0.13% of baseline GDP and the bulk of these (71%) accrue to India as the hub nation.[20] ASEAN, as an important trading partner of India, gains. But although Bangladesh and Sri Lanka are assumed to have agreements with India they lose as they suffer from competition from more efficient producing countries in India's markets. Non-Asian countries, all of which are assumed to be outside the radius of the bilateral arrangements, lose too. This is largely a consequence of trade diversion.

The open hub assumptions for Japan generate gains that (as a % of GDP) are twice as large as those for the closed Indian hub. To some degree, this is because Japan is a much bigger economy and more closely integrated through trade with the rest of Asia and the rest of the world. But it is also because the assumed bilateral agreements are "deeper". At a global level, GDP gains double and within developing Asia they increase by 78% over the closed hub simulation. Again, the simulation results forcefully demonstrate that the largest winner from a hub and spoke configuration is the hub, with Japan capturing 75% of the total gains. ASEAN and the PRC also gain. Gains within ASEAN are captured largely by Thailand and Viet Nam, with remaining countries (other than Singapore) losing out. The estimated gains are significant. Thailand's bilateral agreement with Japan lifts its income by just over 2% and in Viet Nam the dividend is close to 1.5% of its baseline GDP. The main reason for these large impacts is that efficient agricultural producers benefit from liberalization of agricultural trade. Elsewhere, Korea and Taipei,China incur modest losses as they suffer terms of trade losses as net importers of agricultural products and foods, whose real price rises.

The simulation results for the assumed ASEAN FTA are quite striking. Even with a high utilization rate and low compliance costs, an ASEAN regional agreement generates very few benefits outside of ASEAN itself. But the benefits for ASEAN are significant, amounting to nearly 0.6% of baseline GDP. Within ASEAN, Viet Nam and the Philippines gain most. Both countries have small trade shares with the rest of ASEAN and liberalization allows these to expand without significant deterioration in their terms of trade. Also, Viet Nam's initial tariff rates are among the highest in ASEAN and so are cut by more than others.

The gains from a regional free trade area will more closely approximate those from multilateral liberalization as its membership becomes more diverse. An obvious partner for ASEAN would be the PRC given its central position in regional supply chains. The simulation results suggest that the inclusion of the PRC in an ASEAN FTA+1 arrangement is clearly beneficial for the PRC, lifting its income by 0.05% over baseline. But the benefits that accrue to ASEAN itself are larger still. ASEAN GDP rises by an additional 1% over the baseline. The PRC more than triples the economic size of the FTA and as the PRCs initial tariff rates are higher, the implied liberalization is greater. ASEAN also benefits from terms of trade gains in this scenario.

[20] The impacts are also influenced by the overall degree of "openness" of the Indian economy. As a large economy in which international trade has a comparatively small share of GDP, the potential benefits of trade liberalization measured in units of GDP are smaller than elsewhere. A completely autarkic country would gain no benefit.

Table 2 Welfare Effects of Trade Liberalization (EV as % of baseline GDP)

		India-Hub	Japan-Hub	ASEAN	ASEAN+1	ASEAN+3	ASEAN+6	ASEAN-HUB+3 spokes	ASEAN-HUB+6 spokes	ASEAN-HUB+3 spokes (closed hub-spoke)	ASEAN-HUB+6 spokes (closed hub-spoke)
East Asia		**0.01**	**0.09**	**0.00**	**0.00**	**0.27**	**0.34**	**0.03**	**0.03**	**0.02**	**0.02**
	Japan	0.01	0.13	0.00	0.00	0.17	0.24	0.04	0.04	0.02	0.02
	PRC	0.02	0.10	0.00	0.05	0.16	0.25	0.04	0.03	0.02	0.02
	Korea	0.04	-0.06	-0.01	-0.06	1.94	1.97	0.03	0.02	0.02	0.01
	Hongkong, China	0.00	0.02	0.01	0.08	0.21	0.21	0.04	0.02	0.01	0.01
	Taipei,China	0.04	-0.14	-0.01	-0.07	-0.26	-0.31	-0.10	-0.11	-0.04	-0.05
ASEAN		**0.15**	**0.43**	**0.57**	**1.56**	**2.01**	**2.45**	**2.00**	**2.52**	**0.81**	**0.96**
	Indonesia	0.17	-0.08	0.29	0.55	0.38	0.94	0.46	1.11	0.14	0.32
	Malaysia	0.34	-0.33	0.45	1.99	2.36	3.70	2.61	4.11	1.08	1.49
	Philippines	0.02	-0.09	0.91	1.45	0.86	0.88	1.21	1.29	0.72	0.77
	Singapore	-0.01	0.02	0.41	1.46	1.15	1.01	-0.04	-0.41	-0.11	-0.31
	Thailand	0.21	2.01	0.33	1.70	3.80	4.19	4.07	4.72	1.56	1.78
	Vietnam	0.00	1.46	2.59	4.93	6.76	6.81	7.00	7.06	3.12	3.12
South Asia		**0.51**	**-0.10**	**0.00**	**-0.01**	**-0.03**	**1.19**	**-0.02**	**1.18**	**-0.01**	**0.49**
	Bangladesh	-0.15	-0.04	-0.01	-0.01	0.02	0.06	-0.01	0.02	-0.01	0.00
	India	0.59	-0.11	0.00	-0.01	-0.04	1.34	-0.02	1.33	-0.01	0.55
	Sri Lanka	-0.01	-0.03	-0.01	-0.04	-0.06	-0.01	-0.03	0.02	-0.01	0.00
Rest of the world	**Australia&New Zealand**	0.00	-0.01	-0.01	-0.01	-0.02	0.89	-0.02	-0.01	-0.01	0.00
	USA	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
	Europe	0.00	0.00	0.00	0.00	0.01	0.01	0.00	0.00	0.00	0.00
	Latin America	0.00	0.00	0.00	0.00	-0.01	-0.02	0.00	-0.01	0.00	0.00
	Others	0.00	-0.01	0.00	0.00	0.00	-0.01	-0.01	0.00	0.00	0.00
Global		0.01	0.02	0.01	0.03	0.09	0.14	0.04	0.07	0.02	0.03

Source: GEMAT simulations.

In much the same way, gains rise steeply as Japan and Korea, and then India, Australia and New Zealand are added to the ASEAN FTA nucleus. At a global level, gains expand fourteen-fold over those observed with a narrow ASEAN FTA free trade arrangement. Within developing Asia gains expand by 9.4 times. From an ASEAN perspective, the inclusion of the PRC generates most benefits, followed by Japan and Korea, followed by India, Australia and New Zealand. Gains for ASEAN leap from 0.6% of GDP under the ASEAN FTA arrangement to 2.5% of GDP in the expanded ASEAN+6 FTA "community". These results illustrate vividly the benefits of enlarged market size and diversity within an FTA. Also, outside of the ASEAN+6 grouping, there are few losers. Notably, both Europe and the United States gain, though added income is small in percentage terms.

To what extent are these gains a function of the expansive and diverse nature of the free trade area, and to what extent do they reflect they "deep" nature of the assumed regional agreement? To figure this out, the impacts are recalculated on the assumption that countries outside of ASEAN are included in bilateral spoke arrangements, rather than in a full regional FTA. And within this hub-spoke configuration, deep and shallow arrangements are also compared.

When countries are added to the ASEAN FTA nucleus as spokes rather than FTA partners, there is very little change in the income gains for ASEAN. Gains for ASEAN are reduced, but only fractionally. But compared to an expanded FTA the benefits for spokes are greatly diminished. For the PRC, for example, benefits are slashed by a factor of four compared to an ASEAN+3 FTA, and by a factor of eight compared to an ASEAN+6 FTA. For India, Australia, and New Zealand, isolated bilateral tie ups with ASEAN actually result in income losses, whereas each enjoys significant gains in an expanded FTA. The reason for this is that the main benefit for Australia and New Zealand of an expanded FTA lies in their trade with the other non-ASEAN members in East Asia (Japan, Korea, and the PRC). Under a bilateral agreement with ASEAN alone, trade diversion occurs or terms of trade deteriorate.

Finally dilution of liberalization within FTA, or raising of transactions costs, has a pronounced effect on benefits. To see this most clearly, compare the results for the ASEAN HUB+3 spokes "best practice" arrangement versus the ASEAN HUB+3 spokes shallow agreement. In the case of the ASEAN Hub, best practice arrangements increase benefits by a factor of 2.5 over the bad practice arrangements. For the PRC and Korea, best practice doubles benefits. There is, however, an important rider to this result. In those cases, where the hub and spoke configuration of bilateral agreements work to the detriment of a spoke, deepening the extent of liberalization and coverage within the FTA magnifies losses rather than transforming them to gains. Where there is the potential for trade diversion, a more open FTA would seem to amplify losses.

In summary, the simulations reported here confirm the benefits of good practice, more open FTAs. They also show the superiority of regional FTAs to "hub and spoke" arrangements. Regional FTAs with diverse members come closest to delivering the benefits that might accrue from multilateral and non-discriminatory liberalization of trade. But sometimes good practice may not be sufficient as in cases where hub and spoke arrangements cause trade diversion or terms of trade deterioration for spoke countries. Indeed the simulations reported here seem to suggest that in some cases it is possible that deeper FTAs could do result in more damage than shallow ones. This underlines

the importance of initiatives that open up new areas to trade or that could reduce trade costs and have unambiguously positive impacts.

V. Conclusion

Regionalism or the creation of a wider single FTA within Asia is likely to generate greater benefits for the developing Asian countries than is bilateralism or the creation of hub-spoke systems that fail to connect the spokes. Good practices in bilateral agreements can lessen the damage they are likely to do, particularly in isolating lower income spoke countries, but cannot eliminate the damage altogether. Linking bilateral FTAs together enhances the gains when good practices are the norm but linking bilateral agreements that adopt bad practices could actually magnify harmful effects.

An Asian-wide FTA that adopts the good practices outlined in section II above provides strong benefits around the globe in comparison to hub-spoke systems, particularly those that fail to adopt good practices. However, because of the idiosyncratic nature of the bilateral agreements that are emerging involving Asian and Pacific countries (including developed countries) such an outcome is in doubt. Divergent coverage of goods, services and investment; tendencies to exclude "sensitive sectors" and adoption of complex and conflicting rules of origin under pressure from protectionist lobbying pose difficult challenges to creation of a region-wide FTA.

We have shown that a possible way out of the dilemma posed by bilateralism is to route Asian FTAs through the largest existing FTA grouping—ASEAN. The creation of ASEAN plus agreements that are themselves linked together with common coverage and rules of origin would greatly enhance the beneficial effects of freeing up trade and by reducing trade costs would have substantial benefits for non-members. Getting to this outcome is likely to be complicated to say the least. The tendency for intra-Asian bilateral FTAs to offer less favorable treatment than extra-Asian FTAs is also a cause for concern, if not alarm. This tendency could be checked by ensuring that all Asian bilateral agreements contain a clause for cumulation across the region for as many sectors as possible. Otherwise there is a danger that Asian bilateral agreements could interfere with development of efficient production networks and could, in effect, raise trade costs instead of lowering them.

Bilateral or regional agreements involving least developed countries and developed countries that involve reciprocal exchange of concessions are likely to be asymmetric in the sense that the least developed countries have far more to do in reducing border and behind the border barriers. To offset this asymmetry, inclusion of development cooperation clauses ("aid for trade") that build capacity in the poorer countries in the areas of customs administration, IPR enforcement, meeting product standards and testing requirements, improving governance and rooting out corruption, and strengthening the ability of the private sector to reduce real costs and adopt new technologies and management practices could have far-reaching beneficial effects.

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