Chapter 1

ASEAN+1 FTAs and Global Value Chains in East Asia: Overview

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CHAPTER 1

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Background

The goal of economic integration is to capture the immediate and also the dynamic gains that it offers. The former follows from the greater degrees of specialization and levels of trade, which lead to a more efficient allocation of resources and the scope for higher real incomes on average in participating economies. Other benefits include greater access to a variety of goods and services, higher degrees of competition and access to inputs in the production of other goods and services at world prices and world-class levels of performance.

The dynamic benefits of integration follow from its association with higher rates of economic growth but one of the puzzles of research on economic integration is the origin of this effect. A variety of channels and processes have been suggested, including those focused on the effects of integration on competition. More recent work suggests that a key contributor is the extent to which firms in a particular industry participate in trade. Generally, the share of firms in an industry actually involved in trade is surprisingly low in developed and developing economies, even in industries which are internationally competitive. There is, however, an association between participation in trade and productivity. Furthermore, more productive firms crowd out those which are less productive and overall sector productivity improves as a result of this effect. Identifying and reducing the barriers to participation in trade, including the

[1] The report draws on the research reported in other chapters in this report. Authors of those chapters have commented on this summary but the author is responsible for its structure and the interpretation of the research

costs of entering export markets and then managing the transactions, can according to this analysis add to productivity and growth.

The global multilateral trading system has provided a regime in which to manage the transition in policy to higher levels of integration. More recently there has been a surge of interest in smaller group arrangements in Asia, either bilateral or multilateral, as Kawai and Wignaraja state in their online article of January 2011:

> Asian economies began emphasizing FTAs as a trade policy instrument in the late 1990s and the region is today at the forefront of world FTA activity… In 2000, only three FTAs were in effect in East Asia, including the Association of Southeast Asian Nations (ASEAN) Free Trade Area (AFTA), while another 10 were in various stages of preparation. However, in just a decade, the number of FTAs in the region increased more than ten-fold. By May 2010, East Asia had emerged at the forefront of global FTA activity, with 45 FTAs in effect and another 84 in various stages of preparation[2]

While preferential arrangements reduce the extent of restrictions on access to markets, at least for the favored partner economies, that preferential access comes with a cost. Firms based in favored trading partner economies have to establish their rights of access (these are determined by the rule of origin used in the agreement). The benefit is sometimes less than the cost of establishing the right of access and that situation helps explain the observation that rates of utilization of free trade agreements (FTAs) are relatively low, or less than expected. A number of studies have examined the contributors to this result, including the case studies prepared as part of this project.

With the proliferation of agreements, any particular transaction could be organized under different sets of rules associated with the various preferential agreements or MFN conditions. Making that choice, as well as establishing the right of access to the chosen agreement, becomes another dimension of doing international business that firms have to consider.

ASEAN has already established five free trade areas with each dialogue partner in East Asia, as shown in Table 1.

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[2] http://www.pecc.org/blog/2011/01/21/free-trade-agreements-in-east-asia-a-way-toward-trade-liberalization/

Table 1. ASEAN Free Trade Areas and Dates of Entry into Force

	Date of entry into force
ASEAN--Australia--New Zealand	January 2010
ASEAN--China	July 2005(G), July 2007 (S), August 2009 (I)
ASEAN--Japan	December 2008
ASEAN--Korea	June 2007 (G), May 2009(S), September 2009 (I)
India--ASEAN	January 2010 (G)

Data Source: Various Ministry websites
Note: G=goods, S=services, I=investment

A standard result in the research on regional arrangements is that wider membership is better, i.e. the more economies that are involved, the lower is the risk of incurring some of the costs of a regional and discriminatory approach to integration. For a variety of political economy reasons, economies tend to negotiate in smaller groups in the first instance, either bilaterally or in the case of the agreements of interest here by building on the links between ASEAN and its dialogue partners.

The question arises then of whether there is scope to bring these agreements together to form a larger and more comprehensive economic arrangement, possibly for the whole region. There are subsequent questions about the manner in which the consolidation might occur and the incentives for the economies involved to participate.

The consolidation process could be done in a variety of ways. One is by a top-down approach of constructing a new region-wide agreement, for example, based on the ASEAN+3 or ASEAN+6 groupings. However the brief in this project is to look at issues associated with constructing a region-wide agreement through a bottom-up approach, that is, by combining existing agreements, specifically the ASEAN+1 agreements. The recent ministerial discussion around the ASEAN Economic Ministers meetings in August 2011 (http://www.asean.org/26596.htm) referred to this option as ASEAN++. The media release noted the following, which stresses the commitment to ASEAN centrality in the development of these arrangements.
The material also notes a proposal from Japan and China for work on a top-down approach.

Comprehensive Economic Partnership in East Asia (CEPEA)

8. The Ministers welcomed and exchanged views on the joint proposal by China and Japan, 'Initiative on Speeding up the Establishment of an East Asia Free Trade Area (EAFTA) and Comprehensive Economic Partnership in East Asia (CEPEA)'.
9. To ensure the economic integration within ASEAN as well as with Dialogue Partners, the Ministers noted that ASEAN is still working on the structure and template for the ASEAN ++ FTA, which would include an appropriate institutional mechanism, and is taking into account the joint proposal by China and Japan in developing recommendations by November 2011.
10. The Ministers look forward to considering the ASEAN proposed structure and template for the ASEAN ++ FTA and would also give further consideration to the joint proposal by China and Japan at that time. The Ministers instructed Senior Officials to meet in November 2011 to initially consider these proposals and advise Ministers. The Ministers reiterated the importance of ASEAN Centrality in the expanded regional economic integration process.

Ministers also stressed that there were four working groups in progress:

> Ministers were pleased to note the progress of the four ASEAN Plus Working Groups (APWGs) that were tasked to look into the recommendations of the EAFTA and CEPEA studies relevant to rules of origin, tariff nomenclature, customs procedures and economic cooperation.

The preferred plan therefore is to build up from the +1 agreements (rather than a top-down approach, based either on an ASEAN+3 or ASEAN+6 grouping) by establishing a template and principles based on the results of these APWGs that allow a dialogue partner to propose to connect existing +1 agreements. Following the working group structure, the new constructs could involve a series of steps, perhaps starting with an arrangement for goods, followed by investment and services. Further comment on these steps is offered below.

There are some advantages in this bottom-up approach given the degree of common membership of the agreements under consideration. There is also a significant risk that any attempt to adopt a top-down approach based on a new region-wide agreement could add yet another agreement to the existing ‘noodle bowl’ and possibly one which is less liberal, given the difficulty of reaching agreement over the larger number of participants. This outcome will not contribute to the goals of wider and deeper integration with lower costs to business. The bottom-up process is not without these risks either, and a set of principles is important to manage them.

Managing those risks adds to the incentives to participate. ASEAN, as noted, prefers this bottom-up pathway for its own interests. As explained below, the current structure of agreements appears to be like a hub and spoke structure but with the +1 partner as the hub. Starting a process of consolidation could help ameliorate some problems in this situation for the smaller economies.

Conversely for large economies, such as India and China, the interest in participating will depend in part on how such arrangements contribute to their further integration with the rest of the world. While the pathway beyond this level of regional integration and its connection with processes in the WTO is a topic for further work, establishing some expectations of that development will help build the interest in participating in this stage. Further comments are offered below on the links to multilateral commitments.

The progress of the consolidation will also depend on the reaction of various interests within each participating economy. For instance, the consolidation of agreements could assist the business sector by lowering the costs of organizing international transactions, as long as the process at least maintained, and preferably deepened and widened, market access. There is also the possibility of real resource savings as a result of the work on trade facilitation. The measurement of the welfare gains in this path to integration and the implications for particular economies along that path are also topics for further work.

The focus in this project is on the principles that might be applied in this circumstance and for these purposes of managing the risks associated with consolidation. A decision was made to focus on trade facilitation, rules of origin, services and investment. The research reported here is based on a particular framework of supply chains, as outlined in the next section. The project also draws on the results of a series of case study papers which examined the operation of supply chains (included as Chapters 7-10 in the final report):

- Electronics in Malaysia (by Rasyad Parinduri and Shandre Thangavelu)
- The Textile and Garment Industry in Sri Lanka (by Ananda Jayawickrama and Shandre Thangavelu)
- The Automotive and Electronic Sectors in the Philippines (by Maureen Rosellon and Erlinda Medalla)
- The Automotive Industry in Thailand (by Archanun Kohpaiboon and Nobuaki Yamashita)

Supply Chain Perspective

A key feature of the region is the presence of supply chains. East Asia has achieved economic growth through the formation of global value chains by multinational firms, and the desirable region-wide economic integration should be a system which provides opportunities and captures benefits from the regional global production and sales networks.

The supply chain perspective adds value to existing research by raising new questions. It is supported by research on component trade and final goods trade and research on business strategy. It applies to goods and services: goods activities include assembly and processing activities, and services have their own supply chains, while they also facilitate other chains. The services sector questions are explored in more detail below.

The case studies in this project illustrate the different architectures of these chains. The development of these chains depends on: the degree to which a production process can be divided; the scope to complete different stages with different factor intensities; the transport costs involved (also affected by the value of an item relative to its weight); and the ability to communicate and coordinate between the stages. The participation of any particular economy depends on its stage of development, its ability to meet the delivery expectations of the next stage of production and the features of the production process of the product involved. Examples for the manufacturing sector are as follows:

- The automobile sector in ASEAN involves trade in components and finished vehicles. However, different economies take on different roles. The Philippines, for example, is linked to the regional chain through exports of standard and widely-used components, rather than finished vehicles. Thailand, on the other hand, exports finished vehicles not only to the Asian region but also to the rest of the world and is less reliant on imports of components, because of the nature of its domestic production system and the proximity of assemblers and component suppliers in the final stages of vehicle production.

- The Philippines takes a similar position in the electronics supply chain, both importing and exporting components. Malaysia, on the other hand, is more likely to import components and export final products. Most of its trading partners are within East Asia but the US is also a major destination for Malaysian exports.
- An orientation of exports towards final products is more evident in textiles and clothing in Sri Lanka. The case study finds that imports of fibre and yarn are mainly from China and ASEAN, and exports of finished products are mainly to the US and the EU.

An indicator of the significance of supply chains is the importance of components in total trade. A particular point of interest in this project was the overall trading relationship between China and ASEAN in components and final products. According to work by Yamashita and Kohpaiboon (Chapter 2), in 2005/06 the average share of components in total world trade was 24 per cent while the total for ASEAN was around 40 per cent in exports and 44 per cent in imports. Components accounted for about 44 per cent of China's imports but only 20 per cent of China's exports. The data therefore confirm China as a major assembly centre, compared to ASEAN. Its component imports are sourced from East Asia, including Japan, while exports go to the US and the EU and in some cases other high income countries in East Asia. Component shares in regional East Asian trade slumped as a result of the global financial crisis which had led to a decrease in trade in consumer durables in particular.

The strong connections between China and ASEAN reflect forces that can work in both directions. For example, China's competitiveness could drive component exports from within East Asia including ASEAN but also the competitiveness of regional components adds to that of China's finished products. The statistical work of

Yamashita and Kohpaiboon confirms the significance of the relationships between these economies but the separate contribution of these factors is difficult to identify.

Yamashita and Kohpaiboon are particularly interested in testing the impact of the FTA between China and ASEAN on trade. They observe that the impact of an FTA would depend on several factors including the degree of complexity of the rules of origin and the ease of meeting their conditions, subject to the margin of preference provided by the agreement. Yamashita and Kohpaiboon note that many components enter their destination economies duty free (or with a rebate when products are re-exported) and so the FTA has less value to business in that context. This point is reiterated in the case study papers which refer to zero tariffs on components going into Malaysia and the Philippines, and fibre and yarn imported into Sri Lanka. Tariff rates are higher on some finished products, although they are less likely to be so in the case of electronics because of commitments in the Information Technology Agreement (ITA), where tariff rates have been successfully lowered and brought under control, so much so that the focus on the further implementation of that agreement has shifted to non-tariff barriers. In those areas of high MFN tariffs, utilization rates of FTAs tend to be higher, as illustrated in the case study paper on the Thai automobile sector. In those sectors the signing of an FTA would be expected to have a larger effect.

Yamashita and Kohpaiboon do find that the ASEAN--China FTA has had a statistically significant effect on sourcing from ASEAN although the effect is very small. Again, the direction of causality is difficult to confirm, since the growth in trade may also have prompted the signing of the FTA.

The aggregate trade data do not reveal the sequence of steps involved in production. The data can be used to identify whether a component or a final product is being traded but a component may have already been traded in an earlier form. Many studies have identified the networks and the sequences of steps in production. The case studies in this project identify the different architectures involved.

The Sri Lankan case study highlights the links of that economy to the ASEAN+1 economies in terms of purchases of inputs but also its orientation outside the region in terms in exports. The global competitiveness of Sri Lanka in this sector demonstrates the value of establishing a trading regime which is open to new participants. A recommendation is that any new ASEAN++ structure adopts principles for taking in new members, and doing so on the same terms as those available to the founding members.

Trade Facilitation in ASEAN+1 FTAs

The supply chain framework draws attention to the significance of the costs of trade in this system. Items change locations a number of times so the costs of managing trade become important determinants of supply chain design. These points are stressed in key trade facilitation messages from the case studies in this project.

There are substantial gains from reform which focus on trade facilitation, which results in real resource savings, and the impact on incomes and resource allocation are significant. Further, these reform measures affect the costs of entering international markets, and as noted earlier, participation in international markets is important for productivity growth. This argument has been stressed by Hoekman[3] who has argued, in commentary on the WTO rather than FTAs in particular, that what matters is reducing trade costs since doing so helps firms enter new markets and create new products. Hoekman states: 'expansion along the so-called extensive margin is an important mechanism through which trade supports higher economic growth'. He then argues that rules and trade policy bindings that reduce uncertainty and thus expected costs may be 'more important to the investment decisions of firms and the welfare effects of trade agreements than a marginal reduction in the applied tariff affecting an existing trade flow'.

Pellan and Wong (Chapter 3) note evidence that the ASEAN region remains fragmented, partly due to difficulties of moving goods across borders. Inefficient border administration affects the competitiveness of ASEAN exports by raising costs and shipping times. While the overall performance of ASEAN may have improved in recent years, there is considerable room for improvement of trade processes and procedures in individual countries. The ASEAN Economic Community Blueprint and ASEAN+1 FTAs offer a useful framework for channelling efforts to further reduce trade transaction costs between ASEAN and its dialogue partners. This would unlock

[3] See Hoekman's statement in cuts-tradeforum@googlegroups.com on 5 April 2011.

ASEAN’s trading potential, promote the growth of regional value chains and trade in East Asia and help to rebalance global growth.

At the time of writing, negotiations are ongoing in the WTO on trade facilitation and ASEAN in 2010 made a major commitment to enhance institutional connectivity through trade facilitation. Pellan and Wong argue that the implementation of trade facilitation measures through regional agreements can complement efforts at the multilateral level. Their review of ASEAN+1 agreements finds that:

1. The agreements contain several provisions relevant to trade facilitation. However, there is no consistent approach: provisions in the different ASEAN+1 agreements vary in terms of their scope, specificity and depth of commitments.
2. The ASEAN FTA contains several provisions relevant to trade facilitation, including a framework for implementing trade facilitation initiatives, such as mutual recognition agreements (MRAs), the Single Window and the ASEAN Trade Repository, but the coverage of trade facilitation in other agreements, such as the ASEAN--China and ASEAN--India FTAs, is fairly general.
3. With the exception of the ASEAN, Australia New Zealand agreement, other ASEAN+1 FTA provisions on trade facilitation lack specificity: they are broad and aspiration and do not commit parties to undertake concrete action or to achieve specific targets or goals.
4. All of the ASEAN+1 FTAs call for economic cooperation in the area of customs with the objective of simplifying customs procedures and, to the extent possible, harmonizing such procedures to international standards. Pellan and Wong stress this connection to international developments. They say that the fact that RTAs explicitly affirm the application of international agreements, standards and instruments related to trade facilitation can contribute to further regional integration.
5. The inclusion of provisions on non-tariff barriers, including sanitary and phytosanitary measures (SPS) and measures such as standards, technical regulations and conformity assessment procedures, shows the growing

importance of these measures in global trade. Most of the provisions on these measures reaffirm WTO rights and obligations.

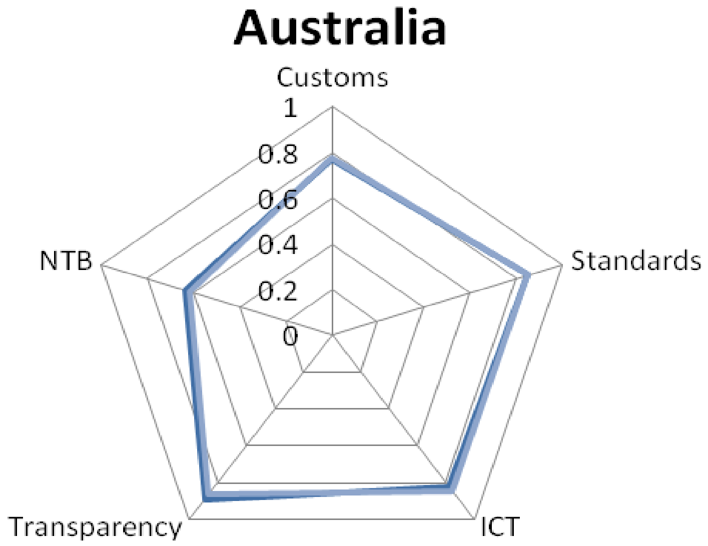
Pellan and Wong stress the value of identification of best practices or models of trade facilitation principles. They suggest that individual countries should strive to identify priority areas for action. Their more specific recommendations are summarized in Box 1. These include attention to monitoring implementation and in a further important contribution they identify a relatively low-cost method of doing so based on indicators like those illustrated in Figure 1 in which measures of performance on various indicators are presented on a scale from zero to one.

In the context of the discussion of integration of ASEAN+1 agreements and the development of an ASEAN++ framework, the recommendation here is to construct a cross-cutting agreement involving ASEAN and the +1 partners which:

i. defines a consistent set of underlying trade facilitation principles;
ii. adopts a set of specific trade facilitation measures;
iii. monitors performance in core trade facilitation areas and sets targets;
iv. shares best practices and implements capacity-building measures in priority areas; and
v. keeps abreast of developments in the multilateral process.

This trade facilitation programme would be applied to all trading partners not just the ASEAN+6 members. The programme would be the foundation of an ASEAN++ arrangement but its implementation would not be tied to progress in other areas.

Figure 1. Trade Facilitation Indicators



Box 1. Trade Facilitation Recommendations

1. Define a consistent set of trade facilitation principles

The ASEAN Trade in Goods Agreement (ATIGA), which entered into force on 17 May 2010, incorporates a set of model principles to guide member states in their undertaking of trade facilitation measures and initiatives at both ASEAN and national levels (and these are similar to APEC's principles of trade facilitation). These principles can also serve to guide ASEAN's trade facilitation cooperation with its dialogue partners. These principles are:

(1) transparency
(2) communication and consultation
(3) simplification, practicability and efficiency
(4) non-discrimination
(5) consistency and predictability
(6) harmonization, standardization and recognition
(7) modernization and use of new technology
(8) due process
(9) cooperation

2. Adopt a set of specific trade facilitation measures

Current ASEAN+1 FTAs, with the exception of the AANZFTA, often lack specificity. A consistent approach to trade facilitation in the context of greater economic cooperation in East Asia should define a specific set of measures that build on existing ASEAN initiatives and could reference as its starting point the measures as incorporated in AANZFTA. Such measures could include the establishment of a Single Window and product standards and conformity assessment procedures on a region-wide basis. As with the case of ASEAN, clear timelines could be set for implementing the various measures.

3. Monitor performance in core trade facilitation areas and set targets

ASEAN and its dialogue partners could agree to adopt a set of performance indicators to monitor progress in the implementation of trade facilitation measures. These could be in the core areas of customs procedures and cooperation; technical regulations, standards and SPS measures; NTBs, including administrative fees and charges; transparency of laws, regulations and administrative rulings; and use of ICT and E-commerce. The indicators would be compiled from data sources that are regularly updated, readily accessible and have wide country coverage for ease of tracking. They could form the basis for countries to set specific targets for improvement.

4. Share best practices and implement capacity building measures in priority areas

A review of trade performance indicators has shown that there is great disparity in trade facilitation performance across ASEAN+6 countries, which is conducive to the sharing of best practices among ASEAN countries and its dialogue partners. The performance indicators could also assist each country to identify areas of relative weakness for priority action. There are cost implications associated with implementing trade facilitation reforms. Some measures are considered elementary and relatively easy for countries to implement. Other measures are farther reaching and more costly, and therefore need to be addressed through appropriate technical assistance and capacity-building support measures in order to be carried out satisfactorily. There is scope to provide this assistance within both the regional and multilateral structures.

5. Keep abreast of development in multilateral negotiations

Multilateral negotiations may result in the creation of binding commitments on the part of WTO member countries to implement measures aimed at facilitating trade. Such commitments are likely to be accompanied by provisions on technical assistance and capacity building, as well as special and differential treatment for developing countries. The Draft Consolidated Negotiating Text could serve as a point of reference in the negotiation of future trade facilitation measures in RTAs. If a multilateral agreement is concluded in WTO, RTA provisions will have to be in line with multilateral obligations.

The Impact of Free Trade Agreements on Foreign Direct Investment

The rapid growth of trade and foreign direct investment (FDI) flows in recent decades has been one of the commonly highlighted characteristics of globalization. FDI is also one of key drivers in the development of regional supply chains.

Given the context of proliferating trading arrangements and burgeoning FDI flows, it is useful to examine the role of RTAs in the determination of FDI location. As Thangavelu and Findlay (Chapter 4) explain, investment creation and diversion effects of RTAs have been estimated in various empirical analyses. However, these studies typically focus on case studies of the European Union (EU), Mercosur (Southern Common Market) and Latin American countries and with mixed results. Attention to Asia--Pacific economies is therefore valuable.

FTAs may drive FDI flows through a variety of channels. FTAs remove export regulations by lowering of trade barriers to facilitate the movement of intermediate or final products between parent firms in source countries, and foreign affiliates in host countries. Other positive effects of FTAs on FDI could arise from other conditions negotiated in the FTA, such as investment regulations that increase the mobility of fund and capital flows. These regulations make it easier for multinational corporations to divert financial resources to their foreign affiliates. Lower exporting costs also reduce the cost of servicing markets from a home base rather than establishing a foreign operation in a host country. FTAs could also provide other less tangible benefits since their signing not only signifies economic cooperation between nations but also cooperation on the political and institutional fronts.

Thangavelu and Findlay examine the coverage of investment in selected ASEAN+1 agreements and the impact of (a wider body of) agreements on FDI flows.

They find firstly that significant sectoral barriers to investment in manufacturing and services still exist, and this forms major impediments to FDI in ASEAN and with the +1 partners.

Second, they find a high degree of variation among economies in the treatment of investment even within one agreement. This variation is much greater in the two agreements with a non-member which they study (China and Korea) than within AFTA. Even though the group negotiates as a whole, the extent of commitments that individual members are required to make varies considerably. This gives a large economy with a relatively open regime a characteristic similar to that of the hub country within a hub and spoke structure. Hub economies generally gain more from agreements than the spokes. For example, in the context of FDI flows seeking competitive cost structures compared to those in the home economy, the larger relatively open economy remains a preferred location for investment compared to others with similar cost structures. This situation puts the notion of ASEAN centrality at risk.

Third, there is further variation across agreements, with that involving China being less liberal than others. They suggest that this is because of the greater complementarily of other members with Korea and the more significant concern in those economies about competition from Chinese firms who invest in the ASEAN region.

Fourth, econometric results indicate that for a sample of economies (dominated by the OECD) multilateral agreements (such as ASEAN+1 agreements) are more likely to be FDI-flow promoting than a bilateral agreement in isolation.

Recommendations from these results in the context of consideration of consolidating ASEAN+1 agreements include firstly action to reduce the risk that

ASEAN becomes a series of spokes to partner countries' hub positions. One contribution would be to document actual policy in these agreements, rather than making commitments in which there is a gap to actual policy. This guarantees no back-sliding on actual policy at least to these trading partners. To be added then would be a commitment to further liberalization, with schedules for reform in key sectors (similar to those used in the GATS).

The question also remains of whether investment policy is easily applied in a discriminatory manner. A further suggestion is that ASEAN shows leadership by offering to take in new members to a regional investment agreement if those new members abide by the same principle of having 'no water' in investment commitments.

One question in relation to investment in an ASEAN++ building block is whether to include services commitments which are specific to that mode of delivery or whether to contain all services commitments within a services component. There is some advantage in the latter.

This assessment is based on recent work which indicates that services producers just like manufacturers take a supply chain approach to the international delivery of their outputs. To serve international markets they procure inputs from competitive origins, which might be their own offices in other (third) economies or could be other businesses. They also prefer to have access to all of the modes of supply which they use simultaneously in order to deliver their final output. To avoid biasing their choices in modes of delivery and to avoid the otherwise lost opportunities in supply chain design, there is value in making services commitments across all modes for one sector. Issues in integration in services markets are discussed in the next section.

Services in ASEAN+1 FTAs

Integration of services markets is important in its own terms, providing the same sorts of advantages as the integration of goods markets. Services also make a critical contribution to trade facilitation and the operation of production networks, through transport, logistics, information and communication services and finance.

Findings from the work here on services (Cornish and Findlay, Chapter 5) are similar to those for investment. They include:

- significant barriers to trade and investment in services remain in member economies;
- commitments to reform vary across economies within an agreement;
- an economy's commitments on services vary across agreements in a systematic manner depending on concerns about competition from the partner economy; and
- those commitments (and this conclusion also draws on other work) appear to be less liberal than actual policy, and they contain considerable 'water'.

These results suggest recommendations that are therefore similar to those made in relation to investment, which are as follows:

- to commit to actual policy in these agreements;
- to provide a commitment to further liberalization,
- to look to apply those provisions without discrimination (and since in many aspects of policy on services the operation of discrimination is not feasible); and
- to provide access to the provisions to other partner economies who are willing to join on these same principles.

Further to the earlier comments on the value of participation of more firms in trade, Hoekman has argued for action that squeezes out 'water', or the gap to actual policy, from existing commitments, including in services, and therefore lowers trade costs by reducing uncertainty. A set of commitments that achieves this result in the process of consolidating +1 agreements could be complemented by others to reduce 'water' in the services commitments in the GATS.

While these are important long-term goals, and objectives to be retained and to which regular reference should be made, progress in the short run may be difficult. There are important lessons from services negotiations in the WTO where there remain large gaps between commitments and actual policy in services. The assessment of Borchert, Gootiiz and Mattoo[4] is that:

[4] www.wto.org/english/tratop_e/dda_e/wkshop.../aaditya_**mattoo**_e.ppt

- The best offers submitted so far as part of the Doha negotiations improve on Uruguay Round commitments by about 13 per cent but are still on average 1.9 times more restrictive than actual policies.
- At present, Doha offers not greater access to markets but a weak assurance that access will not get worse.

Hoekman and Mattoo[5] identify a number of factors contributing to this result. First, governments are concerned that multilateral commitments 'will deprive them of the freedom to regulate' e.g. cross-border flows of financial and data services and activities such as cross-border gambling services; second 'regulators are unprepared for unrestricted entry and competition, especially in the smaller developing countries and especially in financial services'; and third there are 'inadequate mechanisms for the international regulatory cooperation, such as between financial regulators, competition authorities, and immigration authorities that would be needed to reap the full benefits of liberalization'.

Second, business interest has been limited. Services markets in industrialized countries, services markets are mostly open. Developing countries are unilaterally liberalizing their markets. Developing countries are increasingly the suppliers of outsourced services to OECD nations that are in turn the source of investment and know-how in sectors such as transport, telecommunications and finance. This investment flow and the interdependence it creates reduces the likelihood of a reversal of policy. Also the business community remains pessimistic because regulatory policies are not the focus of attention in the negotiations and those policies matter to them.

Hoekman and Mattoo suggest that therefore the priority is to deal with domestic regulation by working to 'strengthen regulatory institutions and identify, design and implement policies that address market failures and ensure wider access to services'. This might be based on 'services knowledge platforms' where sectoral regulators, trade officials and stakeholders come together to assess current policies and identify beneficial reforms. This could help establish the preconditions for future liberalization commitments. They also propose 'international cooperation to address regulatory externalities' e.g. prudential regulation problems arising from differences in regulatory

[5] http://www.voxeu.org/index.php?q=node/5969

standards, dangers that liberalization gain will be appropriated by international oligopolies (e.g. transport and information services), and cooperation between host and source countries as concerns temporary labour mobility.

This review of experience in the negotiation at the WTO level and the results here of the assessment of the ASEAN+1 agreements suggests that a first step for progress on services is not to move immediately to a new comprehensive and consolidated agreement but to work on the environment in which that agreement might be built. This means a focus on capacity building in services that deals with the key issues identified above. Considerable work of this type is already in progress in APEC, and an important principle for ASEAN and its +1 partners as they seek to consolidate their agreements would be to confirm their commitments to APEC work programs with specific time lines.

This recommendation does not imply that sectoral commitments in services should be avoided. The supply chain framework and the lessons from the case studies highlight the value of a well functioning transport and logistics system. The relevant bundle of activities is not readily defined in existing service industry classifications and a recommendation here is that (building on work in the WTO) a model set of commitments on that package of services be defined and implemented, and those commitments cover all the modes of supply including investment. There is further guidance on the relevant scope of this package in the strategies defined in the Master Plan on ASEAN Connectivity. This package could be adopted in advance of wider services and investment commitments. Other sectors might be examined in a similar fashion but the research here indicates that transport and logistics is the priority.

Both services and investment arrangements would also have to confront the question of rules of origin, but generally these are less of an issue compared to the commitments themselves and can be made relatively liberal (e.g. based on commercial presence).

Rules of Origin in ASEAN+1 FTAs

Medalla and Rosellon (Chapter 6) discuss the system of rules of origin used in the various ASEAN+1 FTAs in the East Asian region and how the rules of origin regimes affect the value chain.

To this end, the first task is to examine the nature of the rules of origin in these FTAs and how they are implemented. They find firstly that many different rules are used and sometimes combinations of rules are used. The rule most commonly used, however, is a regional value content of 40 per cent. Only about 30 per cent of tariff lines have basically the same rule of origin (although about 60 per cent have some rule in common). Generally the China--ASEAN FTA is the 'odd one out'.

Medalla and Rosellon, secondly, review the process for demonstrating that the conditions of the rules have been met. They find that processing times vary widely from one day in Australia to more than 30 days in other economies. The normal range is 5-10 days.

The case studies find mixed results with respect to rules of origin. In some sectors, the commonly used rules are relatively easy to meet. Larger firms report no difficulty in establishing the system to demonstrate compliance. However, there are some production processes in which the rules will be an issue, especially where combinations of rules increase the degree of restrictiveness. Small firms have more difficulty in complying, which is a problem given the goal of encouraging participation in trade. The case studies also stress the importance of the margin of preference in providing an incentive to use the conditions of an agreement. As noted earlier, these margins are more likely to be significant for final products since components imports are generally tariff free.

Any move to consolidate agreements will depend critically on the treatment of rules of origin. The great benefit of working from the base of ASEAN+1 agreements, rather than narrower, bilateral agreements, is that the area of cumulation of content is already relatively large. The consolidation process means adding another partner to an existing and relatively large group. This may be easier than combining two large agreements with a lower level of common membership. However, as work by Estevadeordal and others has shown, there is a tendency for rules of origin to become more restrictive in groups with larger membership.[6] The goal of consolidation is not to make it more difficult for economies outside the bloc to enter the market: consolidation is supposed to make those within the group more competitive and more able to respond to competition from other economies.

To illustrate, suppose ASEAN and two of its +1 partners decided to consolidate their existing agreements. The first step suggested here is to remove the nuisance tariffs, by abandoning the application of any rule of origin for relatively low tariffs, for example, those at 5 per cent or less. This step involves, in effect, the ASEAN+1 partners agreeing to multilateralism their tariff cuts at this level.

The second step is to adopt a benchmark on the rules of origin to be applied in the new agreement. This does not mean that the rules should be harmonized, since harmonization is more likely to take place around a more restrictive rule. The idea of the benchmark is to offset the tendency for higher restrictiveness with a wider area of cumulation. Rules are selected and transferred from existing agreements but with a view to moving closer to the benchmark in the combined agreement. Additional +1 partners are then welcome to join but they must accept the benchmark set.

The choice of the benchmark is clearly a talking point. It could be a change of tariff classification or a content rule, although the latter is more common in the set of agreements examined here. This benchmark would be negotiated by ASEAN and all of the +1 partners. It is an important principle that all of the +1 partners are involved in this constitutional stage. This benchmark may be a choice of rules and it could also be made more liberal over time. For example, the regional value content component, now commonly set at 40 per cent, could be reduced by 2 percentage points per year. All +1 partners could also be invited to continue to monitor the implementation of the consolidated agreements and their choice of rules. The private sector would also be involved in this monitoring process.

A decision would have to be made about whether to leave the existing +1 agreement in place. The new agreement would have a wider area of cumulation but different rules

[6] The following discussion also draws on suggestions in 'Multilateralising preferential rules of origin around the world' by Kati Suominen, Antoni Estevadeordal and Jeremy Harris, available at http://idbdocs.iadb.org/wsdocs/getdocument.aspx?docnum=1803029

of origin. As a way of managing the risk of more restrictive rules in the wider agreement, the original +1 agreements could be left in place as a choice for traders.

An even more important discipline of course is to reduce the MFN tariffs so that the margins of preference become less significant. As noted earlier, Hoekman has made the case for reducing uncertainty in the trading system by taking the 'water' from current commitments. ASEAN and its +1 partners could adopt this principle in the current round of WTO negotiations alongside the consolidation of the +1 agreements.

In other suggestions, Medalla and Rosellon propose, in terms of processing time, for the purpose of meeting a common rule of origin, establishing a system of mutual recognition of the certificates of origin and mechanisms for reaching common understanding of the correct tariff classification codes for particular products.

Last words

There are challenges in the bottom-up approach and progress on the different components of a consolidated ASEAN++ approach referring to goods, services, investment and trade facilitation may have different requirements. In meeting those requirements the elements could move at different rates and the progress on the whole project might proceed with a series of building blocks. Generally, therefore the suggestions are to:

1. put immediate priority on areas such as trade facilitation where there are 'gains all round' from reform;
2. send a strong signal about the commitment to integration by removing rules of origin in goods at the lower tariff rates, and otherwise simplify them and then adopt a liberal benchmark or reference rule (for goods, services and investment) before moving to consolidate existing agreements;
3. work to remove gaps between actual policies and those committed in goods, services and investment in the agreements and continue to work to reduce MFN tariffs on goods;

4. start work on services and investment by designing and applying commitments in services and investment in areas which are of great value to supply chain operations; and
5. back up the work on services through a capacity-building programs on domestic regulation.

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