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Moving towards the FTAAP and Strengthening Regional Economic Integration in APEC

The foundation for success in building free markets

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The classical role of trade agreements

The axiom of free trade is it makes every economy more competitive and more efficient, thereby securing greater economic growth if there are no barriers to trade. When economies produce and supply to each other the products they produce most efficiently all achieve optimal growth. When trade barriers prevent consumers acquiring cheaper products from other parties, growth is impaired.

This is the basic working principle that underpins the Agreements of the World Trade Organization (WTO). The construction of the General Agreement on Tariffs and Trade (GATT), the foundation of the WTO, based on those principles has resulted in low tariffs in most trade worldwide. It also informs good Free Trade Agreements.

Adoption of GATT rules after World War Two raised living standards supported elimination of poverty in Europe. Removal of trade barriers in Asia and Latin America in the 70's and 80's promoted growth and had a similar effect.

The WTO reports today there are over 300 bilateral and regional free trade agreements. Most have little economic impact. Some are even counterproductive.

Economists warn this can occur where agreements provide greater access to the domestic market of only one or a few trading partners rather than to most trading partners (other members of the WTO). This diverts trade. While trade in those products may expand and imports from parties outside the agreement, the parties inside the agreement will lose global competitiveness. This is generally the effect of the Mercosur Agreement[1].

Some economists oppose all FTAs, arguing only two strategies should be followed – only liberalize under WTO rules where access granted to all trading partners is the same; or simply unilaterally reduce any trade barrier to all trading partners.

The general claims by some economists that FTAs risk trade distortion is overstatement. Worldwide average real[2] tariff barriers are low, around 5 percent. With fluctuations in currency rates 5 percent becomes relatively insignificant. And while there is still some distortion in trade, for example in agriculture, with high tariffs and quotas and preferential market access provided for all sorts of reasons, the global trade pattern is benign.

The other remaining problem with FTAs is how "rules of origin" operate. They can create differences in the capacity to access to markets and put small traders at disadvantage.

[1] Between Argentina, Brazil, Paraguay, Uruguay and Venezuela.
[2] Average trade barriers are bound under WTO commitments are higher, but many countries in fact apply lower tariffs.

Compliance with complex regulations can be costly.[3] However the trend is to eliminate this problem in the larger regional free trade agreements in Asia and the Pacific.

New drivers of growth

With average applied tariffs on goods now relatively low worldwide, the focus on opening markets increasingly is on liberalizing services sectors and removing barriers to investment. The contention, starting nearly 30 years ago, that controls on services industries need to be reduced or removed, as tariffs were, if optimum economic growth is to be secured, is now mainstream. Focus on this has moved attention to the need also to liberalize investment. Many services can only be effectively delivered in foreign markets if enterprises in other markets can invest to deliver those services to local consumers.

This has already been achieved in most developed economies. In the late 90's there was clumsy effort in the OECD to develop a Multilateral Agreement to free investment. Activists attacked it and the OECD retreated. Reducing barriers to investment barriers was on the agenda of the Doha Round for a short time, and then dropped as proposed by the EU following protest by some developing countries.

Common economic sense still prevailed. In economies that understood the importance, barriers were unilaterally removed.

In the wake of the Asian currency crisis a change in the pattern of global commerce has emerged. Whereas before the crisis it was conventional wisdom rises and falls in international trade were the leading indicator of economic growth, today it appears that rates of foreign investment now play that role.

Foreign investment is now outpacing trade as a driver of earnings in foreign markets. Other research shows the contention, usually made by organized labour in industrialized economies, that investment in foreign markets means jobs are exported is also wrong. Not only are returns from enterprises in foreign markets now a bigger contributor to national economies in industrialized countries than exports of goods, research shows successful operations of foreign arms generates better performance in the parent company.

Yet most foreign investment remains directed to industrialized economies rather than developing economies. The reason is restrictive regulations and high levels of risk. Investment is not considered protected.

This also closely relates to what generates growth in national economies. In industrialized economies between 70 and 80 percent of GDP is generated by services industries. In developing countries it is between 40 and 60 percent. This is clear among the developing economies in APEC.

[3] Large businesses can computerize regulatory compliance which significantly reduces the cost of compliance.

The disinclination to open services markets and remove restrictions on foreign investment is clearly reflected in the stalling of the plan of ASEAN's ten economies to build an ASEAN economic union. While barriers to trade in goods in ASEAN economies are low, the parallel agreements to open services markets and remove barriers to investment remain virtually dead letters. The provisions in those agreements are sound, but very few legally-binding commitments have been made.

This raises some serious challenges about what will be achieved in the negotiation of the Regional Comprehensive Economic Partnership (RCEP) among ASEAN's free trade partners[4].

It is also notable that no ASEAN economy is participating in the current program in the WTO to revise and improve the commitments in the services schedules of the General Agreement on Trade in Services.

However some ASEAN members (Brunei, Malaysia, Singapore and Vietnam) have joined the TPP process and have accepted commitments to some opening of services markets and reduction of investment barriers.

The ASEAN countries have negotiated an agreement to liberalize services, but so far few commitments have been made to bring the ASEAN Agreements to life. The situation is similar with services. A well-developed agreement to liberalize has been negotiated by ASEAN countries, but few commitments have been made.

There are also general commitments among Pacific Alliance economies to reduce barriers to services, investment and movement of labor. Important national commitments to support those measures have been made. While negotiations to turn those commitments into legally binding agreements await, Chile, Mexico, and Peru have used the TPP Agreement to liberalize services and investment in the TPP Agreement, giving coherence to the Pacific Alliance commitments.

TPP includes a de facto plurilateral investment agreement

The TPP includes provisions which effectively embed into it a plurilateral agreement on investment. Other than commitments in EU agreements and NAFTA to provide freedom to invest, this provision in the TPP constitutes the most comprehensive agreement among any group of economies to liberalize foreign investment.

It obliges parties to provide national treatment and MFN treatment to other parties, unless exceptions are set out in Annexes. These are similar to the annexes for commitments on services. In some cases the specific commitments are limited. But the Agreement establishes a mechanism for ongoing negotiations to continue to reduce commitments.

[4] The ten members of ASEAN (Brunei, Burma (Myanmar), Cambodia, Indonesia, Laos, Malaysia, the Philippines, Singapore, Thailand, Vietnam) and the six states with FTAs with ASEAN – Australia China, Korea, India, Japan and NZ.

TPP – More liberalizing than GATS in key respects

The TPP now also creates a bigger platform than ever before for its parties to open services markets and reduce investment barriers.

Commitments to reduce barriers are now “negative list” (that is only measures not approved are scheduled, otherwise access to services markets is permitted) whereas previously they were “positive list” (only measures listed as open to foreign services industry providers were accessible).

The difference may seem arcane, but the political intent is profound. In case one, only some restrictions on service imports are listed for liberalization; in case two all measures will be liberalized except those set aside.

In the WTO Doha Round negotiations, developing countries ultimately objected to inclusion of investment in the program to expand reach of the General Agreement on Trade in Services (GATS). This created a policy vacuum. Liberalization of services cannot be considered without liberalizing investment to provide those services. The TPP has accommodated parties wanting so to move into that policy vacuum.

The result is that TPP parties have made commitments to liberalize services and listed exemptions to them. The extent to which those exemptions diminish the liberalizing of the measures is yet to be assessed. On the flip side, it is open to the parties to the TPP at any time to cancel exemptions.

Bringing TPP into effect

The TPP commitments won’t become law until the requisite number of states covering a significant percentage of the combined GDP of TPP parties is reached. This effectively necessitates entry into force by the US and Japan. Whether or not that happens this year depends on the politics of the US election cycle.

Building towards an FTAAP

APEC members decided in 2014 that they would review the question of developing a Free Trade Area of Asia and the Pacific (FTAAP) embracing all APEC members at the end of 2016. Intensive research on the implications has been undertaken by APEC economies. Their work will be studied with intense interest.

Two developments since that research was initiated have altered the picture somewhat. The initial thinking among scholars and officials was how to breach the differences between the TPP agreement and the emerging RCEP agreement (not yet completed). Both present as platforms on which to build an FTAAP agreement. A second, more complicated but probably more central, question was how can an agreement be developed which accommodated China? This in turn raises a broader question about how FTAAP should advance free markets.

Finally what is the contribution the Pacific Alliance can make to building an FTAAP?

Prospects for the Regional Comprehensive Economic Partnership - RCEP

If the outcome of the RCEP is to dovetail with the terms of the TPP, clearly there will have to be proximity in the content of the agreements. This looks challenging:

- ASEAN members have made few commitments to open services markets and liberalize investment in their respective ASEAN Agreements (AFAS – trade in services, AIA – agreement on investment)
- No ASEAN members have participated in the negotiation of new commitments on services in the TiSA negotiations being conducted by a set of WTO members (Although Brunei, Malaysia, Singapore and Vietnam have agreed to services commitments in the TPP. Engagement is a clear demonstration of interest in advancing liberalization of services).
- Indonesia has indicated it wants to negotiate FTAs with others, including Australia, and consider joining the TPP, but faces considerable domestic hurdles
- India is participating in the RCEP negotiations, but has only signed an agreement with ASEAN to liberalize trade in goods, but appears to have no interest in committing to liberalize services or investment
- The ASEAN Agreements provided delayed terms for adherence to commitments to remove trade barriers by less developed members of ASEAN – Cambodia, Laos, Myanmar and Vietnam.

With these policy positions it is hard to see how the ASEAN group is likely to settle on more advanced commitments on liberalization of services which match those of TPP parties.

It is not clear if investment will be treated as a significant issue in the RCEP negotiations.

China's position

China has indicated clear interest in participating in work on an FTAAP.

The United States has standing positions on negotiating FTAs with other parties. It requires negotiation of a Bilateral Investment Agreement (BIT) with communist governments before negotiating an FTA. This was the path it followed negotiating its FTA with Vietnam. It has not completed its BIT negotiations with China.

China has declared as a national objective the intention of lifting the performance of its services industries to as a tool to foster economic growth. This reflects a national switch away from generating wealth from manufacturing and exports of those products. The change is sought is underway.

Yet in terms of exposure to foreign services suppliers, China has not been able to implement the extensive commitments it made when joining the WTO to liberalize its financial services sector. These were ambitious and were not necessarily regarded as condition by other WTO members.

Nevertheless Chinese officials are well aware of the problem and the need in the long term to fundamentally revise the regulatory structure governing financial services. It recently introducing new measure to trial some opening of financial services markets in some provinces (including in its recent FTA with Australia). However the basic task is yet to be tackled.

It is difficult to believe China could undertake significant commitments to further liberalize its financial services sector in any major regional agreement until this fundamental reform has been undertaken.

The Pacific Alliance

Three of the four members of the Pacific Alliance – Chile, Mexico and Peru are already participants in the TPP negotiation. The fourth is Colombia.

The ambitions of the Alliance in some ways foreshadow where TPP might lead. Through the TPP negotiations the four TPP members have already committed to new measures to facilitate trade in services and investment. The Alliance also has a strategy of enhanced movement of labor among the parties.

They cannot of course participate in the RECP negotiations, but the platform for improving the competitiveness of their own markets sets a yardstick for the RCEP negotiations and is an exemplar for developing country parties in an FTAAP.

Domestic Market Reform

It is essential to bear in mind the point of agreements to liberalize markets is not to foster good political relationships but to act in mutual interest to make domestic markets more efficient to increase growth and raise domestic living standards.

In this respect, Governments will not secure the full benefits of agreements to share market opening with other economies unless they foster competitive domestic markets. Domestic policies which foster competitiveness and prevent control of markets by large players to maximize returns are features in all markets which enjoy high levels of competitiveness.

It is not the function of trade agreements to set quantitative standards for domestic competitiveness in the markets they cover. It could not work. However it is increasingly commonplace to include general commitments to undertake domestic action to ensure competitiveness.

The GATT included provisions to limit the capacity of monopoly entities which were established to trade goods from inhibiting the capacity of foreign suppliers to trade. Such organizations were relatively common in agricultural circles. Australia and Canada had a monopoly organization to control the sale and trade of grain for many years. They clearly contravened GATT obligations and in Australia's case were regarded by economists as tools which impeded the competitiveness of the Australian grain market and there by grain producers. It has since been dismantled.

Where state-owned or controlled businesses play a major role in a domestic economy, they also impede efficiency, reduce optimal returns and plainly risk undermining the rights provided or implied in free trade arrangements of foreign operators to do business in the market of an FTA trading partner.

When the US agreed to negotiate an FTA with Singapore, US business challenged the influence and roles of the major state-owned corporations in Singapore. They were listed on the Singapore Stock Exchange but were controlled by State owned investment funds. US officials required Singapore to adopt domestic competition policy laws (there were none) to provide some external disciplines to ensure the companies had external disciplines to obviate prospective exercise of influence in the market to reduce the implied disadvantage to US companies operating in Singapore. The Government of Singapore complied.

A similar issue prospectively lies in the background when it comes to the question of China's joining new trade agreements to foster economic growth and efficiency in the Asian Pacific region. There is no question a rapidly growing, whole privately-owned and controlled business community is emerging in China. Some estimates suggest it generates around 25 percent of output. On the other hand it is also palpably the case that most of the biggest corporations in China are state-owned enterprises. This has not before been a feature in modern times which has spawned the open market model which has been so successful in raising living standards.

There is no question this will be a major issue to be addressed if an FTAAP is to be developed which boosts continuous rises in living standards in the Asian Pacific region.

The key focus – building free markets with FTAAP

It is tempting for politicians to work to win headlines and for bureaucrats and negotiators to work to complete agreements. Trade agreements have become immensely complicated and provide many opportunities for politicians and senior bureaucrats to claim victory.

FTAAP will only be achieved by long and rigorous negotiations and action by governments at the propitious moment.

There is only one true measurement of success. Did the results improve the competitiveness and efficiency and raise living standards?

If we succeed in that there will be huge economic benefit to the people of the Asian Pacific region.