

Chapter 1¹

Bilateral Trade Arrangements in the Asia-Pacific

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I. INTRODUCTION

Countries in the Asia-Pacific region increasingly fear that multilateral trade forums such as the World Trade Organization (WTO) and the Asia-Pacific Economic Cooperation (APEC) cannot always effectively hammer out the terms of global trade liberalization. In 1999, WTO participants in Seattle unsuccessfully attempted to launch a new trade round. The success of the November 2001 Doha meeting of the WTO in setting a timetable for negotiations was followed by the dramatic collapse of the Cancun negotiations in September 2003. The success of the Geneva July 2004 WTO meeting, however, raised hopes that the multilateral approach was once again gaining traction. Yet the uncertainty of when a new round might be concluded and what issues might eventually be resolved in the WTO forum has created great unease about the global approach to trade negotiations. In this environment, given the likelihood of prolonged talks before an agreement is reached, many countries have been searching for other options to liberalize trade.

In East Asia, the shift toward alternatives to the WTO and APEC took its most pronounced turn with the conclusion of Japan's first post-World War II bilateral free trade agreement (FTA), the Japan-Singapore Agreement for New Age Economic Partnership. Ironically, the agreement was reached at the APEC meeting summit in Shanghai on October 2001. Other Pacific Rim countries, traditionally loyal supporters

and beneficiaries of postwar multilateral trading regimes, are also actively weaving a web of bilateral FTAs, targeting countries both within and outside the region in hopes of securing access to much-needed export markets. Six years after the bruising financial crisis of 1997-98, Asia-Pacific countries face growing pressure to diversify trade to avoid another meltdown. For many countries in the region, in the absence of effective multilateral options, bilateral arrangements between like-minded countries has become a leading alternative among several trade arrangement options.

Analytically, we can think of four dimensions based on the number of participants involved: unilateral, bilateral, minilateral, and multilateral. While unilateralism is the preferred approach of most economists to trade liberalization, it is also relatively uncommon; in the Asia-Pacific, Singapore and Hong Kong are the rare examples of economies that unilaterally reduced barriers. Bilateralism, the currently favored means for states, can either be geographically concentrated (e.g. Japan-South Korea), or geographically dispersed (e.g., Singapore-New Zealand). Similarly, minilateral arrangements may also be concentrated (e.g., ASEAN [Association of Southeast Asian Nations] Free Trade Agreement (AFTA), East Asian Economic Caucus (EAEC), North American Free Trade Agreement (NAFTA)) or dispersed (e.g. Free Trade Agreement of the Americas (FTAA)). Finally, the WTO best embodies a multilateral agreement.

These four types of trade arrangements interact and change the dynamics of accords in different categories. Each of these agreement types derives its advantages and disadvantages from tradeoffs between political and economic efficiency. For example, agreements among few states develop easily, but implicitly involve welfare losses due to trade diversion and marginalization of weaker countries. Conversely, larger agreements

maximize economies of scale by expanding markets, promoting broad-based trade liberalization, and enabling global integration, but demand more political effort to negotiate.

Mindful of such a background, this book examines Asia-Pacific bilateralism with special attention to the following three sets of questions:

- 1) Why does bilateralism develop? How does the context of informal and formal trade relationships drive the formation of bilateral agreements?
- 2) How will bilateralism evolve? What are the different paths that bilateralism might take? Will it be deepening or widening? Trade diverting or trade creating?
- 3) How will bilateralism affect other types of trade arrangements? Will it play a complementary or substitutive role? Will conflict arise among different accords and spill over into broader political relations among states?

These questions form the heart of this book and are developed as analytical themes in the following sections of this introductory chapter. Section II presents a conceptual framework to categorize various modes of trade governance and an overview of the phases of bilateralism. Section III presents economic and political factors that might be used to explain the evolution of trading arrangements. Section IV considers the first phase of the origins of bilateral trade agreements as a result of responses to some shock. In section V, I look at factors that might affect the evolution of bilateral trade accords. Section VI considers the impact that bilateralism might have on existing trade institutions. Finally, section VII reviews the layout of the book.

II. THE POLICY OUTCOMES: TRENDS IN BILATERALISM

Countries structure their trading relationships in a number of ways. In what follows, I begin by systematically categorizing these modes of trade arrangements to provide a context for understanding how bilateral agreements fit into the broader trade liberalization picture. Then, an analytical overview summarizes the approach to examine the development, evolution, and impact of bilateralism.

Policy Outcomes: Categorizing Modes of Trade Liberalization

In examining trade liberalization (or protection, for that matter), one needs to look to the range of general policy options states have utilized to control trade flows. As noted above, these include unilateral, bilateral, minilateral, and multilateral arrangements. These arrangements can further be classified as geographically concentrated or dispersed.² Additionally, agreements may vary in product coverage (few or many) and their effect on market behavior (opening or closing).

Table 1.1 classifies different types of trade arrangements, but in only *two* dimensions of trade bargaining approaches—the number of nations involved and geographical scope. The empirical analysis of the country cases, however, will address product coverage and degree of protectionism.³

This simplified six-cell chart captures the variety of Asia-Pacific countries' trade liberalization accords. Cell 1 refers to unilateral liberalization, including measures in Singapore and Hong Kong, as well as APEC-fostered efforts, such as Individual Action Plans (IAPs). In cell 2, the proposed Japan-South Korea Free Trade Agreement fits the category of *bilateral regionalism*. Cell 3 lists geographically dispersed bilateral

Table 1.1. Categorizing Modes of Governance in Trade*

<i>NUMBER OF ACTORS</i>						
	Unilateral	Bilateral		Minilateral		Multilateral
		<i>Geographically concentrated</i>	<i>Geographically dispersed</i>	<i>Geographically concentrated</i>	<i>Geographically dispersed</i>	
Trade Liberalization Measures	(1)	(2)	(3)	(4)	(5)	(6)
	Various trade liberalization measures taken by Singapore and Hong Kong APEC Individual Action Plans (IAPs)	Japan-South Korea FTA (under negotiations) China-South Korea FTA (under study)	Singapore-New Zealand CEP (2000) Japan-Singapore EPA (2002) Korea-Chile FTA (2002) U.S.-Singapore FTA (2003) Taiwan-Panama (2003) Japan-Mexico (2004) Korea-Mexico (under study)	ASEAN (1967) AFTA (1991) NAFTA (1993) China-ASEAN FTA (2003) Northeast Asian FTA (proposed)	APEC (1989) EAEC (1994) ASEM (1996) ASEAN Plus Three (1998) ASEAN-Japan Closer Economic Partnership (proposed) FTAA (proposed)	GATT/WTO (1947/1995) ITA (1997) BTA (1998) FSA (1999)
	Unilateralism (1)	Bilateral Regionalism (2)	Bilateral Transregionalism (3)	Regionalism (4)	Transregionalism (5)	Globalism (6)

**Adapted from Aggarwal (2001); Updated as of January 2005 with illustrative examples.*

agreements, or *bilateral transregionalism*, such as the Closer Economic Partnership (CEP) agreement between Singapore and New Zealand and the Economic Partnership Agreement (EPA) between Japan and Singapore. Cell 4 focuses on classically defined *regionalism*, such as the AFTA and the China-ASEAN FTA framework agreement. Cell 5 refers to *transregional agreements* such as APEC, which bring together countries across more than one region. Finally, cell 6 points to the single case of a global trading arrangement, namely a multilateral, multi-product arrangement: the GATT and its successor organization, the WTO.⁴

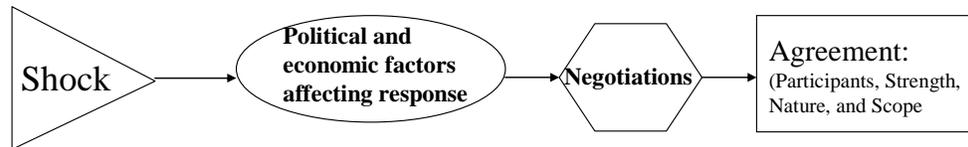
Phases of the Bilateralism Process

Figure 1.1 illustrates the book's approach to analyzing the evolutionary process of bilateralism. Phase 1 focuses on the origins of bilateralism. In this phase, an external shock—a problem with extant international institutions or financial crisis, for example—creates pressure for change. Subsequently, various political and economic factors influence how different countries respond to these shocks. Countries may respond by developing some type of trade agreement to cope with these shocks.

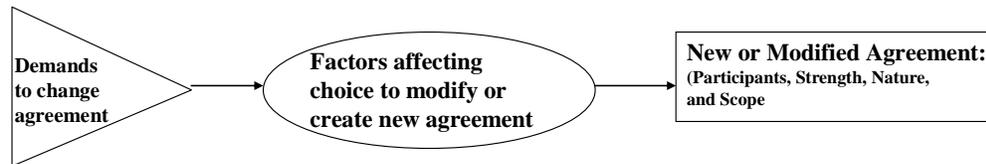
For illustrative purposes, we consider the case of negotiations leading to a bilateral agreement. If such an agreement is concluded, we can consider the characteristics of the accord on a number of dimensions. The first involves the *participants* in the accord and speaks to whether the accord is regionally concentrated or dispersed. In addition, the agreement's *strength* can range from strong to weak (in terms of being highly binding on the participants to an accord), can be of a liberalizing or more protectionist *nature*, and can have a wide or narrow issue *scope* of coverage.

Figure 1.1: The Three Phases of Bilateralism

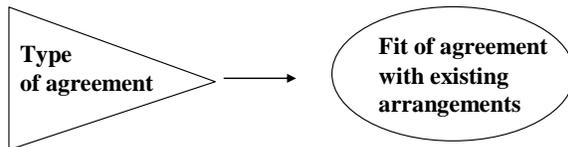
Phase 1: The origins of bilateralism



Phase 2: The evolution of bilateralism



Phase 3: The impact of bilateralism



In Phase 2, various domestic groups may demand changes, from expanding product coverage to including other countries in the agreement. As in the initial phase, both political and economic factors will affect this decision. In this phase, we can see how bilateralism may expand, in terms of the number of participants involved and of the strength, nature, and/or scope of the accord.

Finally, Phase 3 depicts how the characteristics or type of agreement will affect existing agreements. Will new trade agreements smoothly fit within broader regional or multilateral arrangements or disrupt the current trading order? This institutional consistency, or what can be termed “nesting” with broader arrangements,⁵ is an important focus of this work.

III. POLITICAL AND ECONOMIC FACTORS IN THE FORMATION OF TRADE AGREEMENTS

From both a political and an economic standpoint, efforts to explain the origin, evolution, and impact of bilateralism are in their infancy.⁶ To examine these questions, I take a political-economic approach. Throughout the 19th century, as well as during the interwar period, bilateral agreements were the prevalent form of trade negotiation. With the creation and evolution of the GATT in 1947 and its successor, the WTO in 1995, however, this previously accepted bilateralism has been discouraged. Thus, the broader institutional context within which agreements have been and are being negotiated is obviously central to understanding the current zeal for such accords.

Both political and economic approaches have been used to explain trade negotiations in general, and these can be readily adapted to understand specific trends in bilateralism. We can categorize types of arguments about bilateralism on a number of different dimensions (domestic vs. international, economic vs. political, ideas vs. material interests). For the present argument, the simplest and most important division is one focusing primarily on economics and politics. Before turning to the applicability of specific theories to different phases of bilateralism, I first review some of the key economic and political arguments that are likely to prove relevant in explaining the three phases.

Economic Arguments

Many arguments about bilateralism focus on the perceived economic benefits of FTAs. These include trade creation, investment expansion, and financial stability. With respect

to trade creation, bilateral FTAs should (in theory) expand bilateral trade between a pair of countries by lowering tariff and non-tariff barriers. Unless exceeded by trade diversion, the welfare implication of trade creation through a bilateral FTA is clear: both countries will be better off by opening up trade with each other. In addition, trade diversion from other countries' bilateral agreements may create strong incentives for countries to pursue their own bilateral accords.⁷

A central issue is whether there exists a “fit” between two countries' industrial structures, which will affect the potential benefits of a bilateral agreement. For example, Japan and South Korea are both likely to benefit from a successful launch of their prospective bilateral FTA because their industrial structures are somewhat complementary. South Korea's trade structure depends heavily upon Japanese parts, intermediate goods, and equipment in various industries. South Korea's tariff rates on Japanese goods are also generally higher than those of Japan's on South Korean goods. A bilateral FTA would lead Japan to capture the export opportunities missed thus far due to South Korea's high tariff/non-tariff barriers. Meanwhile, South Korea is also likely to gain significantly from Japan's reduced nontariff barriers, but the benefits from cutting already low Japanese tariff rates seem somewhat limited. One might also expect that—as is well known from the economics literature—countries tend to favor trade with their relatively proximate neighbors, thus providing insight into the preference for geographically concentrated bilateralism. Analysis of these and other pairs would help to account for the motivation of economic actors in pressing for bilateral accords.

A second economic driving force behind bilateral agreements is related to investment gains. Bilateral FTAs often include an investment treaty, and are likely to

trigger an investment creation/expansion effect as well. In the developing Asia-Pacific region in particular, foreign investment has been both exposed to relatively high risks and constrained by strict regulations such as local content rules. Bilateral FTAs, which contain key institutional improvements in the field of trade and investment, reduce economic and political risks as well as transaction costs, thereby promoting foreign investment. Following an agreement, firms may shift their investment to member countries because of the more favorable terms for trade and investment available through an FTA. For example, in the case of Mexico, many observers have noted that NAFTA was as much about increasing Mexico's attractiveness to investors as it was about securing trade access to the U.S. market.

Third, financial incentives may also drive bilateralism. Closer economic integration may make parties to a bilateral accord more willing to help one another in times of financial difficulty. In light of the damage done during the financial crisis, most Asia-Pacific countries have a strong incentive to access the financial resources that might accompany a bilateral FTA. Given its status as the region's financial giant, Japan is particularly attractive as a potential partner in bilateralism. Japan's attempt to create an "Asian Monetary Fund (AMF)" during the early stages of the 1997 financial crisis were immediately rejected by the United States, owing to fears that an AMF could undermine the leadership role of the International Monetary Fund (IMF) and foster a split between Asia and North America. Following that debacle, instead of directly confronting American opposition, there have been low-key efforts to make regional currency swap arrangements among the ASEAN countries and Japan, South Korea, and China as a "firewall" against future financial crises. However, to date discussion of such

arrangements has borne little in terms of formal financial commitments. The absence of a robust financial firewall provides a significant incentive for some countries to pursue a bilateral FTA with Japan to secure emergency financial support.

Political-Economic Arguments

The existing literature in political economy suggests at least four key variables for theorizing about a country's choice of foreign economic strategies: (1) pressure group activities; (2) regime type; (3) changing economic ideas; and (4) the political-economic international environment.

Pressure Groups. The pressure group approach argues that trade policy choices are determined by the preferences of interest groups—in particular, industries with greater or lesser exposure to trade.⁸ Given that trade policy has significant implications for market opportunities and competitiveness of an industry, an industry's preference should depend on whether it competes for export markets or against imports. Following the existing literature, I hypothesize that a competitive industry with more export market exposure is likely to be more politically active for and supportive of trade liberalization, and thus may pressure its government to pursue bilateral deals, as multilateral prospects grow slimmer. In Japan, for instance, it appears that the highly competitive, export-oriented industries are the ones pressing hardest for their government to embrace the new bilateralism.

Political Regime Type. The literature on political regimes contends that countries' policy responses will vary with their regime types. In this study, we shall focus on whether there is a "democratic difference" in trade policy—that is, whether democracies are more responsive to interest group pressures to liberalize trade than authoritarian regimes.⁹ State structures vary significantly in the Asia Pacific—ranging from highly democratic (e.g., Japan and the U.S.) to highly authoritarian (e.g., China) regimes. As such, we hypothesize that in response to growing pressure to diversify export markets, a more democratic, responsive government is more likely to make a move towards bilateralism than an authoritarian government.

Economic Ideas. The Asia-Pacific region as a whole shows a wide range of economic perspectives. Many have traditions of active government involvement to promote economic development, while others—like Singapore and Hong Kong (China)—have maintained laissez-faire policies. In some countries, traditions of free trade are strong; in others, protectionism has been the norm. Nevertheless, there has been one common feature in the region's diverse trade strategies: most countries have relied on multilateral negotiations in dealing with trade liberalization, while depending heavily on the U.S. export market. The setback in Seattle has significantly eroded their traditional confidence in multilateralism and in ready access to the U.S. market, leading to the construction of a new political willingness to support bilateral alternatives.

International Environment. The international environment critically affects the formulation of national trade strategies. Three aspects of the international context have

provided a basis for theorizing about trade relationships: existing institutions and arrangements; relative economic capabilities; and political-military rivalries. The first of these focuses on the existence of various institutional forms. Changes in existing institutions are thus likely to affect various groups' desire to create or modify existing trade arrangements.¹⁰ Moreover, actors are likely to bring lower-level arrangements into conformity with broader level trade agreements, both for strategic reasons and due to institutional constraints (such as Article 24 of the GATT). This nesting of arrangements is particularly important to understand the impact of bilateralism on the broader trading system. Moreover, the creation of bilateral FTAs will serve as an example that may possibly encourage emulation by other countries (in addition to the above-mentioned economic motivation created by trade diversion from others' accords).

A second international factor concerns a country's general economic size and relative position on the international continuum of economic development as key determinants of trade strategies. For instance, Malaysia's apathy towards bilateral FTAs may reflect its relatively early stage of industrialization, which tends to minimize the perceived benefits of trade expansion (as compared to the other "tiger" export economies in the region). A country with a large market will also entice others to seek it out as a bilateral trading partner. This attractiveness may also provide the large country with greater leverage in bilateral negotiations.

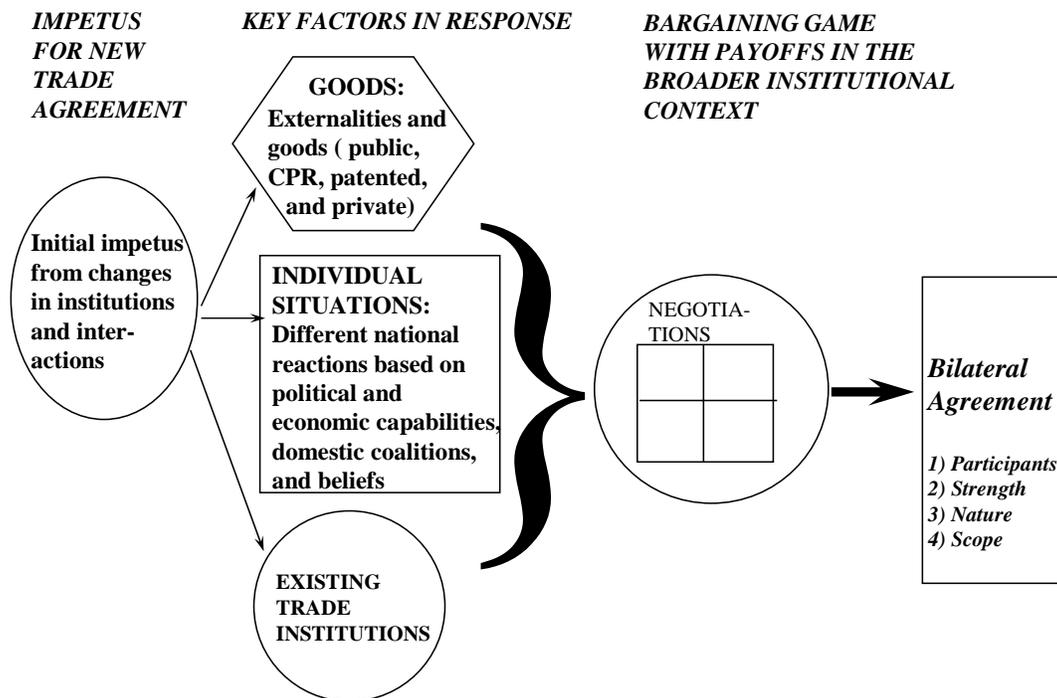
Third, security concerns may also drive an interest in bilateral agreements, as a means of linking one's fate to another country. In short, we hypothesize that a more industrialized country has a higher stake in bilateral deals with specific countries whose assistance is vital in the event of adverse political security developments. Based on these

theoretical arguments, I now turn to a specific examination of how they might apply to different phases of bilateralism.

IV. THE ORIGINS OF BILATERALISM

As suggested in Section II, some type of shock generally sets the process of trade bilateralism in motion. Countries then respond to these shocks based on a variety of political-economic factors, and they may negotiate bilateral agreements that vary in scope, strength, and nature. Figure 1.2 provides a detailed and systematic conceptualization of this process, and the discussion of this figure draws upon the theories discussed in Section III.

FIGURE 1.2: PHASE 1-- THE ORIGINS OF BILATERALISM



As Figure 1.2 indicates, an initial impetus of some kind will alter the preexisting bargaining context. For example, in the case of the trading system, the problems in the Uruguay Round were crucial in pushing the United States to seek a bilateral agreement with Canada in 1988. An impetus to seek new trade agreements can also come from economic shocks such as the Asian financial crisis or from broader security shifts such as the end of the Cold War.

In the specific case of Asian bilateralism, the broad impetus to seek bilateral agreements would appear to stem from a combination of several factors, mainly at the international level. First, the problems at the Seattle meeting of the WTO created fears that the multilateral trading system will not continue to function smoothly. The WTO Doha agreement to start a new round of trade negotiations might have changed this view, but the breakdown of the September 2003 WTO meetings in Cancun and then success in getting the round moving again in July 2004 indicates that a great deal of uncertainty and skepticism still surrounds the multilateral process. Second, the Bush Administration's focus on South America with the Free Trade of the Americas Agreement (FTAA) has been of concern for Asian countries. Third, some countries are concerned that a shift in U.S. policy, combined with the changed international security environment after the end of the Cold War, may lead to declining market access. Fourth, these uncertainties have been compounded by the economic slowdown resulting from the Asian financial crisis, leading states to reconsider their reliance on the U.S. and European markets and encouraging them to pursue more formalized arrangements in the region.¹¹

As discussed in the survey of country cases below, the response to these general trends has been far from uniform. To analyze why different countries respond in different

ways, I hypothesize that three interrelated elements must be looked at —goods, individual situations, and existing institutions—which together create what can be termed an “institutional bargaining game.”¹²

Goods

Economic or political changes may stimulate or impede the provision of some type of “good,” namely public goods, common pool resources (CPRs), inclusive club goods, or private goods.¹³ In the case of public goods, actors face a collective action dilemma because all can benefit from the joint nature of the good (e.g., national defense) but, because exclusion is not possible, beneficiaries need not contribute to its creation or maintenance. In such cases, analysts have focused on the incentives for differently situated states to provide public goods. The classic representation of the provision problem for public goods is the n-person prisoners’ dilemma (PD): in such cases, cooperation can potentially help all players, but actors have a dominant strategy to defect and the good may not be provided.¹⁴

Common pool resources, which include global commons like fishery resources, are goods where preventing consumption of the good is not feasible.¹⁵ In such cases, providers of CPRs risk being exploited, since they will not only end up paying for the cost of the good but will also suffer from free riding that will diminish the available supply of the good (due to its lack of jointness). Thus, at least in principle, the provision of such goods will be a more severe form of a PD.

Inclusive club goods refer to goods that exhibit jointness (i.e., they are not diminished by use and thus are non-rival), but where exclusion is possible. Two examples

of this type of good are the provision of satellite transmission of television and the use of scrambling technology to prevent noncontributors from accessing the good. Private actors are generally more willing to provide patented goods, since the producer can charge for use but can also provide the good to additional consumers at little cost. Because of the benefits of having additional consumers of inclusive club goods, we might expect that in the case of international institutions, actors will compete to have their institutional approach adopted as the standard by all participants to maximize their revenue possibilities.

Finally, private goods, which reflect the possibility of exclusion but not jointness, include the consumption of goods diminished by use. Individual actors will have an incentive to produce these goods and to charge according to their marginal cost of extending these goods.

As applied to the trade area, there is significant debate, reflecting different economic ideas, about how to characterize trade liberalization. Classical trade theory suggests that international trade liberalization should be seen as a harmony game, where everyone's optimal strategy is to liberalize, independent of others' choices. Others, such as neoliberal institutionalists, see the game of liberalization as a PD game, where everyone could be better off if cooperation is achieved, but where the dominant strategy is to defect. From this perspective, the GATT/WTO system provides an institutional basis for fostering cooperation in a PD game (although the WTO for the most part is an inclusive club good) by providing information, lowering organizational costs, and promoting future transactions, thereby increasing actors' willingness to cooperate. Bilateralism, in this context, may be seen as a way of deterring possible free riders and

ensuring that gains from trade liberalization are a private good that accrues only to the participants of the agreement.

Individual Bargaining Situations

States are likely to have varying interests in the issue area over which bargaining takes place. While there are many factors that might affect actors' interests (and hence their payoffs), the most significant influences on national responses include:

- (1) an actor's international position, as defined by its overall power and its more specific economic competitiveness in trade, finance, and investment;
- (2) the makeup of its domestic coalitions, reflecting pressure groups and political regime type;
- (3) elite beliefs and ideologies.

An actor's position in the overall international system and its relative capabilities in the economic arena will influence a state's objectives as well as its ability to secure its desired outcomes in negotiations. A state's domestic coalitions and regime type reflect how responsive states must be to demands by various groups either for trade liberalization or protection. Elite beliefs and ideologies about the causal connections among issues and the need to handle problems on a multilateral or bilateral basis will obviously influence the payoffs and actors' responses.

The Institutional Context

As states attempt to secure their preferred outcomes in trade, they interact strategically within the context of broader institutional arrangements such as the WTO, APEC, and

ASEAN/AFTA. As we have seen, trends in these broader institutions influence how actors interact. Specifically, the principles, norms, rules, and procedures of these organizations constrain actors' behavior. The best example of this effect in the context of the GATT/WTO is Article 24, which clearly specifies conditions under which signatories can negotiate free trade agreements or customs unions.¹⁶ Each state's attitude regarding the importance of continued support for multilateral institutions will, of course, affect the impact of these institutions and the choice of bilateral or other mechanisms. Until recently, for example, Japan was a key supporter of the multilateral process and chose to refrain from pursuing bilateral agreements. While it remains a supporter of the WTO and APEC, it has recently reacted to problems in these institutions (and the accompanying focus within the U.S. and Europe on regional agreements) by seeking to negotiate bilateral accords.

The Trade Bargaining Game

Accounting for types of goods, individual situations, and existing trade institutions helps explain the variation among countries in choosing to negotiate bilateral agreements. Differing views of what types of goods are being provided by the WTO, APEC, and AFTA as compared to what goods might accrue from the negotiation of bilateral agreements will be a key element in explaining this variation. Furthermore, the individual situations of countries, which reflect possible economic gains and states' abilities to cope with domestic pressures, will also be crucial in accounting for variation in bilateral agreements. And finally, the institutional context, as reflected in how domestic actors respond to the constraints of institutions and how governments perceive the payoffs from

sustaining such arrangements, combine with the other factors mentioned to set up the bargaining game.

Choosing Partners and Agreement Characteristics

In the negotiations themselves, issues of economic market size, investment opportunities, financial reserves, and the political context will influence the bargaining outcome and choice of partners. For example, it is well known that the Mexican government was willing to make many concessions to the United States during the NAFTA negotiations because of its eagerness to secure favored access to the American market. Similarly, in the Asia-Pacific, Japan, China, and the United States are generally seen to be desirable partners. At the same time, smaller countries' enthusiasm for access to these markets is likely to be tempered by the fear in some domestic sectors that they will be overwhelmed by more competitive producers in the larger countries.

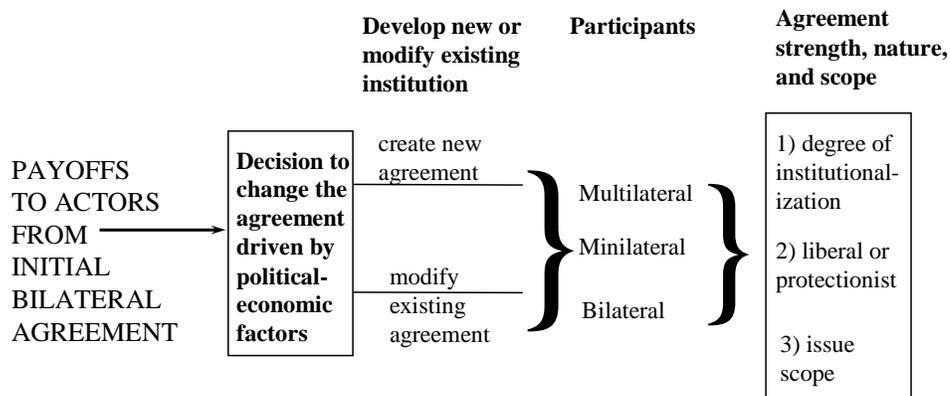
Finally, in negotiating a bilateral agreement, actors must also decide on the characteristics of the agreement. The strength of the agreement will reflect not only the power of different actors, but also the willingness of governments to give up some autonomy to their trading partners. Moreover, the agreement's nature and scope of coverage will also be driven by economic concerns about trade competition, investment flow patterns, and the danger of rapid capital flows; and by the different relative positions of domestic actors, and their ability to influence the government in view of its regime type. Many states in Asia have very strong protectionist agricultural sectors that are likely to try to continue excluding agriculture from any trade liberalization—be it multilateral, minilateral, or bilateral. In addition, the international context influences the

characteristics of agreements, as a result of both direct pressures from adversely affected states as well as particular institutional rules such as Article 24 of the GATT/WTO.

V. EXPLAINING THE EVOLUTION OF BILATERALISM

Once a bilateral agreement has been negotiated, various actors (including governments, firms, labor groups, and environmental groups) will be affected by changes in trade, investment, and portfolio flows between the countries party to an agreement. Figure 1.3 provides a conceptualization of the evolutionary process in Phase 2 by which bilateral agreements might change.

FIGURE 1.3: PHASE 2--THE EVOLUTON OF BILATERALISM



The Initial Payoffs and Pressures to Change the Agreement

Depending on their payoffs from the agreement, actors in one or the other country may be motivated to alter the agreement in some fashion. Of course, states may also simply maintain the agreement without changes. From an economic standpoint, import-competing firms, export-competing firms, and labor groups are likely to press for some changes as the pattern of economic flows begins to change. Similarly, financial groups, environmental groups, and human rights groups are also likely to become active, as will adversely affected groups in other countries.

From a political standpoint, the motivation of actors provides a first cut into understanding the likelihood of pressures for change. But most centrally, the relative power of different groups, and the relationship of the government to interest groups, will affect their ability to realize their desired policies. Here, the type of political regime and its ability to resist pressures will affect its response. Its power position in the international system, both economic and political, will also influence the response to possible pressures from other states. In short, just as countries' individual situations affected the initial agreement, so too will differing situations influence the prospects for changes in the agreement.

Modifying Agreements versus Creating New Ones, and the Number of Participants

Simple inertia would lead us to expect that actors' first instinct will be to utilize or modify an existing bilateral agreement to their advantage rather than to pursue the development of a new accord or broader-based agreement with more actors. In this case,

they may bargain within the context of the existing agreement and attempt to promote new issues and engage in a variety of issue linkages. Thus, if actors can achieve their objectives by simply modifying an existing agreement, this will likely be the preferred course. Otherwise, actors may create new institutions.

One of the key issues in choosing whether to alter existing institutions or create new ones relates to the goods that are involved in the negotiations. For example, to prevent free riding with public and CPR goods, neorealist institutionalists point to institutional strategies that might alter the nature of the good. An example of this is the decision by major powers to prevent developing countries from free riding via the most-favored-nation (MFN) norm of the GATT. Thus, in the Tokyo Round, only those countries that signed on to specific codes (subsidies, government procurement, etc.) were given the benefits of liberalization entailed by these codes.¹⁷ We can also hypothesize that an important constraint on the innovation of new institutions will be the degree to which existing institutions are deeply embedded among other institutions.

In theory, neoliberals would expect that multilateralism would be the preferred institutional avenue to reduce transaction costs and provide the widest dissemination of information. By contrast, from a neorealist perspective, unless an actor is exceptionally strong, it might prefer bilateral over multilateral arrangements to maximize its leverage.¹⁸

With respect to the role of ideas, changes in knowledge stemming from economic research may lead to evolving understandings of the merits of APEC or the WTO as compared to bilateralism. Combined with economic changes and political pressures, we might well expect new thinking about the benefits of existing arrangements. For example, when several states in the Asia-Pacific became worried about the prospects for a

successful conclusion to the Uruguay Round—but at the same time did not wish to undermine GATT—they decided to pursue the formation of APEC within a GATT umbrella. More recently, the option of modifying existing global and transregional arrangements seems to be less attractive. Many Asia-Pacific countries now appear to believe that they would be better off (or at least not worse off) by creating a web of new bilateral institutions. Moreover, one might expect that as these bilateral accords develop, there will be emerging pressures to possibly widen or change their nature, or expand or link up bilateral arrangements into a single accord with more actors. The history of the U.S.-Canada agreement--which began with a bilateral auto accord in the 1960s, moved on to a free trade agreement in 1988, to NAFTA in 1994, and now possibly the FTAA--may be instructive in this regard.

Characteristics of Institutions: Strength, Nature, and Scope

If a state decides to modify or create a new trading arrangement, it must decide on the strength, nature, or scope of the agreement. As we have seen, bilateral agreement characteristics will depend on both economic and political factors related to effects on interest groups and their political abilities, as well as the international context within which they are negotiated. These same factors will, of course, affect the choice of characteristics in modifying bilateral agreements or creating new trading arrangements.

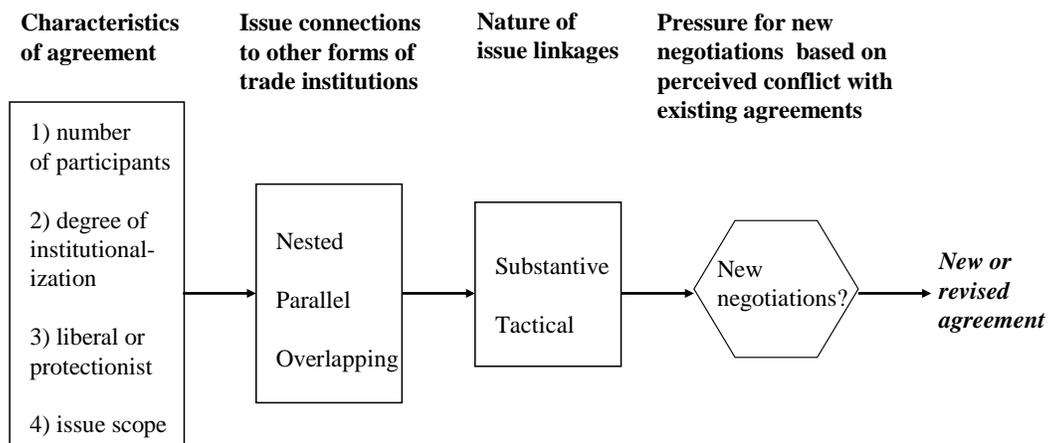
Various countries' newfound enthusiasm for bilateral agreements suggests that they are likely to track the development of other bilateral agreements and use these as models for negotiating their own agreements. Thus, the new trend in U.S. bilateral agreements to include environmental and labor provisions suggests that over time

demonstration effects might increase pressures for such provisions in Asian bilateral agreements as well.

VI. EXPLAINING THE IMPACT OF BILATERALISM

The negotiation of bilateral agreements, their possible expansion to minilateral agreements, and the trade and investment diversion that they may create will affect broader trade agreements such as AFTA, APEC, NAFTA, and the WTO. To analyze the likely effects, we can consider the question of linkages as depicted in Figure 1.4.

FIGURE 1.4: PHASE 3--THE IMPACT OF BILATERALISM



As this figure indicates, analyzing the characteristics of the bilateral (or minilateral) trade agreement in terms of participants, strength, nature, and scope is the first step in considering the likely implications for broader agreements. With these

characteristics in mind, I can then turn to focus on how these trade arrangements will be linked to broader arrangements, as indicated in the second step of Figure 4.

Issue Connections: Nested, Horizontal, Overlapping, and Independent Agreements

Whether agreements are newly created or modified, a key question concerns their connections with existing trade agreements. From a theoretical perspective, I define four possibilities: nested links, whereby arrangements conform to broader accords (say through Article 24 of the GATT/WTO); horizontal connections, whereby arrangements reflect a division of labor among institutions; overlapping agreements, which may create conflict among institutions; and agreements that deal with different issues and that are thus independent of each other.

To elaborate, we can consider how nesting and horizontal arrangements might work. In the case of nesting, one can think of the problem of reconciling institutions from both an issue-area and a regional perspective.¹⁹ Nested arrangements in the trade issue-area are illustrated by the relationship of the international regime for textile and apparel trade with respect to the GATT. In the 1950s, continental European protectionist measures in textiles were inconsistent with the GATT's objectives. The United States had negotiated bilateral textile agreements with Japan and Hong Kong and was considering the negotiation of other bilateral accords, largely in reaction to pressure from a strong domestic lobby. But in view of President Kennedy's desire to promote a new round of tariff reductions, the U.S. government found itself in a quandary since European and American bilateral agreements eroded American efforts to bolster an open multilateral trading system. To cope with these competing pressures, it promoted the formation of a

sector-specific international regime under GATT auspices—the Long-Term Arrangement, and its successor, the Multifiber Arrangement (MFA). This “nesting” effort ensured a high degree of conformity with GATT provisions.²⁰ Although the textile regime deviated from some of the GATT’s norms in permitting the discriminatory treatment of developing countries, it did adopt and adapt the most-favored nation norm of this institution, treating all developing countries alike. Moreover, while allowing protection against imports, the textile regime remained at least partially consistent with GATT liberalization norms by calling for the dismantling of restrictive measures over time. It is worth noting that the use of the MFA to restrict trade came under fire at the Doha WTO meeting as developing countries called for an accelerated phase-out of the MFA (which is slated to disappear after 2005 per the Uruguay Round agreement).

For an example of the nesting of regional institutions, we can turn to the development of APEC in 1989 and its relationship to the GATT. APEC’s founding members were extremely worried about undermining the GATT, and sought to reconcile these two institutions under the rubric of “open regionalism.” APEC members saw this approach as a better alternative to using Article 24 of the GATT (which permits the formation of free trade areas and customs unions) to justify this accord. Although the interpretation of “open regionalism” continues to be contested, the idea behind this concept was that while the members of APEC would seek to reduce barriers to goods and services amongst themselves, they would do so in a GATT-consistent manner. The options to achieve this consistency include dealing with non-WTO issues or pursuing unilateral liberalization measures that would be open to all WTO signatories (regardless of membership in APEC).

An alternative mode of reconciling institutions would be to develop “horizontal” institutions that would simply create an institutional division of labor, as exemplified by the GATT and Bretton Woods monetary system. In creating institutions for the post-WW II era, policymakers were concerned about a return to the 1930’s era of beggar-thy-neighbor trade policies, particularly competitive devaluations and high tariffs. As a consequence, policymakers created institutions that would help to encourage trade liberalization. By promoting fixed exchange rates through the IMF and liberalization of trade through the GATT, policymakers hoped that this horizontal connection would lead to freer trade. In the current negotiations of bilateral trade agreements, the issue of the scope of the agreements has led to questions about the conformity of such agreements with Article 24. In some cases, bilateral agreements have sought to emphasize new investment and technology issues, thus creating a horizontal division of labor and obviating the need to conform to Article 24.

Finally, on a regional basis, one can see the development of the European Economic Coal and Steel Community (ECSC) and the Western European Union as horizontal organizations. The first was oriented toward strengthening European cooperation in economic matters (with, of course, important security implications), while the WEU sought to develop a coordinated European defense effort. It is worth noting that the ECSC failed to conform to the GATT because it was a sector specific agreement, but a GATT waiver solved the problem until the EEC came into existence and replaced the ECSC.

In reconciling new and old agreements (or significantly modifying old ones), the choice of whether to support nested institutions will depend on the existing institutional

environment. If institutions already exist, actors contemplating institutional innovation must decide how important it is to reconcile those institutions. If one is developing narrow issue-area or regional-based accords, and the issue's salience is low relative to broader issue-area or regional arrangements, actors will make strong efforts to nest the new institution within the broader one—even if there is no clear substantive connection among issues. Thus, we should also expect to see consistent goal ordering, and hence nested institutions, when broader external threats are significant. By contrast, if issue areas or regional institutions are crucially important to actors, they may be willing to risk conflict with other institutions by developing overlapping arrangements. This decision, of course, has great significance for the WTO and APEC, as a lack of faith in their ability to achieve trade liberalization could rapidly drive a proliferation of bilateral agreements.

Types of Linkages: Tactical vs. Substantive Linkages

A second dimension of issue connections concerns the nature of issue linkage.²¹ Will horizontal connections among issues or institutions be perceived as power-driven or as a logical division of labor that ensures compatibility among issues or institutions? And, if there is a hierarchy of arrangements, will they be driven by power considerations or an accepted ranking of goals among the participants? To address these considerations, we must look at the nature of linkages, which reflects the intellectual basis for the issue connection. There are two general types of linkages. If two issues are perceived to be unrelated but are tied together in negotiations, this can be considered a power-based or tactical linkage. By contrast, if the issues exhibit some intellectual coherence, then the linkage can be labeled substantive.

When actors do not share a cognitive consensus on the relationships between issues, power-based tactical linkages will create conflict among institutions as power relationships change. We thus should expect it to be more difficult to achieve a clear cognitive consensus in favor of creating new agreements (as opposed to modifying existing ones). Whereas cognitive consensus regarding connections between individual issues may be sufficient to make minor modifications to existing arrangements, for new or significantly modified agreements, actors must agree on the nature of the relationships between complex sets of linked issues. Thus the creation or major modification of institutions is likely to be difficult because of the number of issues involved, and the nesting of new and old arrangements will be more difficult than simply modifying old ones.

To summarize, the characteristics of an initial bilateral agreement and its possible expansion in scope will be critical to how actors perceive its relationship to broader agreements. Moreover, as ideas about the viability of broader agreements change and political pressures for trade liberalization from various interest groups increase, we are likely to see increasing inconsistency among trade arrangements and greater use of power-based linkages, both of which could exacerbate conflicts among countries in the Asia-Pacific.

VII. THE LAYOUT OF THE BOOK

Bilateral trade agreements have been growing dramatically, both in the Asia-Pacific Region and elsewhere. As I have argued, the motivations for concluding such agreements have varied widely among countries, and simple economic welfare analysis

does not adequately explain the rise of such accords. Instead, I have suggested that the systematic incorporation of political factors into an analytical framework can help us analyze the origin, evolution, and impact of bilateral agreements. In the case studies that follow (in Part III), this approach provides a handle for case study authors to investigate accords in the region.

To set the stage for the individual case studies, Part II of the book provides both an economic and political-institutional overview of developments in the Asia-Pacific. In Chapter 2, John Ravenhill surveys the current status of bilateral agreements in the region. He shows how asymmetrical power relationships have resulted in unequal treaties, however weaker countries in the region are nonetheless anxious to sign to ensure market access to major countries and to increase their attractiveness to foreign investors. He then examines the impact that these arrangements are likely to have on countries' domestic political economies, with a focus on the link to Article XXIV.8 of the GATT/WTO, the key article allowing the negotiation of free trade areas and customs unions. In particular, he shows how countries have exploited the ambiguity in this article to reduce the domestic political implications of arrangements by strategically excluding key sectors and how preferential trade agreements (PTAs) alter the dynamics of international negotiations. Ravenhill then explores both the economic and political implications of PTAs on potential and existing and potential regional and global trading arrangements. Specifically, he argues that bilateral accords may well diminish prospects for future regional or global negotiations, and that both APEC and the WTO are likely to be negatively affected.

The economics of bilateralism in the Asia-Pacific is the subject of Chapter 3. Fukunari Kimura begins by looking at the economic motivations for the negotiation of PTAs in the Asia-Pacific. He then focuses on the development of international production and distribution networks as an important aspect of economic development in the region—one that is increasingly supplanting the previous combination of import substitution and export promotion policies. Kimura argues that FTAs in the region are oriented toward increasing the competitiveness of previously protected sectors in various countries while simultaneously enhancing production networks. He then provides an incisive analysis of some of the problems that have plagued the most popular approach to evaluating the impact of PTAs—computable general equilibrium (CGE) models. In concluding, Kimura considers the prospect of a broader arrangement in East Asia that might build on bilateral accords.

Part III of the book examines key countries that have been pursuing bilateral trade agreements in the Asia-Pacific. The countries include China, Japan, the U.S., South Korea, Malaysia, Thailand, Taiwan, Singapore, and Mexico.²² To provide a comparative analysis with an eye to understanding the different political and economic factors driving bilateralism in the region, each chapter is similarly structured. Authors begin each case study with a general overview of their country's trade policy as well as an overview of the bilateral agreements that have been negotiated or that are currently in the works. They then turn to the consideration of economic factors that have been driving the origin and evolution of agreements. This analysis is followed by an examination of political factors that have driven agreements. Finally, each country case study provides an in-

depth analysis of one or more bilateral agreements to provide us with a more nuanced understanding of different countries' negotiating strategies.

Part IV of the book concludes with an overview of the findings of the book. It assesses the theoretical arguments developed in this chapter with an eye to empirically evaluating the driving factors in the new trend toward Asia-Pacific bilateralism. Will this approach to trade agreements continue? What are the likely implications of such an approach for existing accords? And how might bilaterals be either building blocks or impediments to some type of East Asian regionalism? By attempting to provide insight into these key issues, I hope that this book will prove valuable to both theorists and policymakers concerned with the future of the trading system.

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NOTES

¹ I would like to thank Min Gyo Koo for his many valuable comments and Yin Chen for his editing help.

² It is worth noting that this category is quite subjective, since simple distance is hardly the only relevant factor in defining a “geographic region.” Despite conceptual difficulties, we find this to be a useful category.

³ A more elaborate table and discussion can be found in Aggarwal (2001).

⁴ Multilateral accords can also be sector specific, as in the case of the recently negotiated Information Technology Agreement (ITA), Basic Telecom Agreement (BTA), or Financial Services Agreement (FSA). For a discussion and critique, see Aggarwal (2001) and Aggarwal and Ravenhill (2001).

⁵ See Aggarwal (1998) for a discussion of nested agreements.

⁶ Some exceptions include Krugman (1991) and Irwin (1993).

⁷ The classic discussion of trade diversion and creation can be found in Viner (1950).

⁸ This argument was first developed by Helleiner (1981). See also Milner (1988) and Frieden (1991).

⁹ See for example Haggard and Kaufman (1992).

¹⁰ See Aggarwal (1998).

¹¹ See Aggarwal and Koo (2005) for detailed examination of post-Asian crisis responses.

¹² See Aggarwal (1998) for a discussion of such bargaining games.

¹³ Differences among goods can be characterized along two dimensions: jointness, which refers to the extent to which goods are affected by consumption; and by the possibility of exclusion, which refers to whether noncontributors to the provision of the good can

be kept from consuming it. For a discussion of these four types of goods and actors' motivations to provide them, see Aggarwal (1996). On common pool resources in particular, see Ostrom (1990). For an earlier insightful discussion of types of goods see Snidal (1979). The best summary of the literature on goods is by Cornes and Sandler (1996).

¹⁴ Hardin (1982).

¹⁵ For a good discussion of CPRs and international institutions, see Keohane and Ostrom (1994).

¹⁶ Article 24 allows free trade areas or customs unions, which must substantially cover all trade and requires that the average tariff of a customs union not be raised above the level of the individual member states before they entered into an agreement.

¹⁷ See Krasner (1979) and Grieco (1990) on this issue.

¹⁸ For a discussion of these ideas, see among others Diebold (1952), Keohane (1984), and Gilpin (1987).

¹⁹ See Oye (1992) for a good discussion of regionalism. Also see Gamble and Payne (1996) and Lawrence (1996), among others.

²⁰ See Aggarwal (1985) for a discussion of nested systems in the context of sectoral arrangements.

²¹ On issue linkages, see Haas (1980) and Aggarwal (1998).

²² Chile and Canada, among others have also been actively negotiating bilateral agreements in the Asia-Pacific. Owing to space limitations, however, we do not examine these or other countries, but rather focus on a selection from the region.