

Chapter 13

The Evolution and Implications of Bilateral Trade Agreements in the Asia-Pacific

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I. INTRODUCTION

The Asia-Pacific region has witnessed a dramatic rise of bilateral free trade agreements (FTAs) at the beginning of the 21st century. This shift away from the previous focus on the World Trade Organization (WTO) and the Asia-Pacific Economic Cooperation (APEC) forum could have potentially dramatic effects on trading patterns of countries in the trans-Pacific region. This book has considered the evolution of such bilateral trade agreements with an eye to understanding their origins, possible proliferation and expansion, as well as their impact on broad-based multilateral trade accords.

The main purpose of this chapter is to extract lessons from the empirical analyses of the political and economic factors that have driven Asia-Pacific bilateralism. Section II briefly reviews the theoretical arguments of Chapter 1, focusing on the explanatory approaches that guided the empirical analyses of this book. Section III considers the lessons emerging from Part II of the book, which provides the political-institutional and economic contexts for Asia-Pacific bilateralism. Then, Section IV reviews the nine country case studies. These include the “Big Three” of the U.S., Japan, and China, and the small and medium-sized “pace-setters” of South Korea, Singapore, Taiwan, Malaysia, Thailand, and Mexico. Section V then uses the empirical findings of country analyses to

systematically evaluate the importance of political and economic factors in a comparative perspective. In conclusion, Section VI considers the likely implications of this new bilateralism for broader trading arrangements and avenues for further research.

II. REVIEW OF THE THEORETICAL ARGUMENTS

In Chapter 1, Vinod Aggarwal develops the theoretical framework for the book. Two questions lie at the crux of the analysis. First, how might one categorize bilateral trade agreements in the broader context of the possible array of arrangements that might be used? Second, how can we explain the origins, evolution, and impact of bilateral accords? We address each in turn.

Categorizing Trade Arrangements

Historically, countries have used a variety of instruments to influence trade patterns. Whether oriented toward protecting or opening markets, countries can choose among a panoply of accords, or simply open or close markets unilaterally. Chapter 1 provides an analytical classification scheme that allows us to arrange the large number of possible factors in a systematic fashion (see Table 1.1 in Chapter 1).

In terms of the number of actors involved, one can have unilateral actions or bilateral, minilateral, and multilateral arrangements. These arrangements can be further categorized as either geographically concentrated or dispersed. Additionally, agreements may vary in product coverage (few or many) and their effect on market behavior (opening or closing). As Aggarwal argues, the bulk of the Asia-Pacific's recent preferential agreements have been bilaterally focused and geographically open. To a

large extent, most bilateral agreements in the Asia-Pacific have also been market-opening and relatively wide in their product coverage, while a large number of recently concluded bilateral agreements have excluded politically sensitive products and sectors, which is potentially inconsistent with the multilateral norm of GATT/WTO. It is this trend that underlies the focus of the volume: why are such arrangements being developed, how do they vary among country pairs, how are they likely to evolve, and what might their impact be?

Phases of the Bilateralism Process

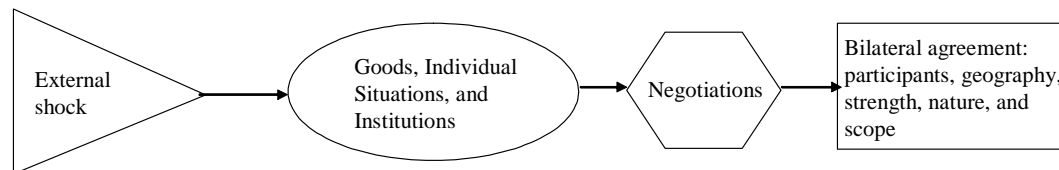
With an eye to addressing questions about the evolution and impact of bilateral trade accords, Aggarwal then presents a theoretical framework to categorize the phases of bilateral trade agreements. Figure 13.1 integrates the elements of the framework, based on Figures 1.1 through 1.4 in Chapter 1.

Phase 1. Focusing first on the origins of bilateralism, Aggarwal highlights the role of some type of external shocks. The pressure for a shift toward new Asia-Pacific bilateralism came about through three external shocks.

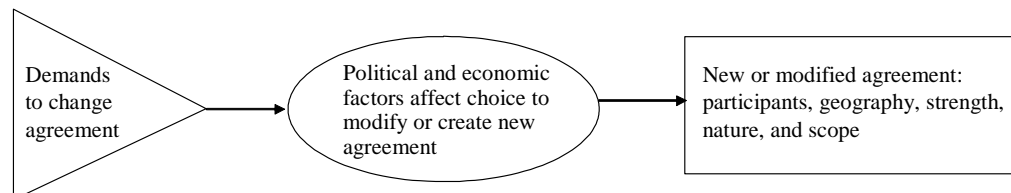
First, broader security shifts such as the end of the Cold War made it politically easier for Asia-Pacific countries to pursue bilateral FTAs with each other. The end of bipolarity has reduced the significance of Cold War perceptions and divisions, breaking down barriers that had previously precluded formal trade arrangements between capitalist and communist blocs. In addition, the U.S. no longer adopts an antithetical position towards preferential arrangements.

Figure 13.1: The Three Phases of Bilateralism

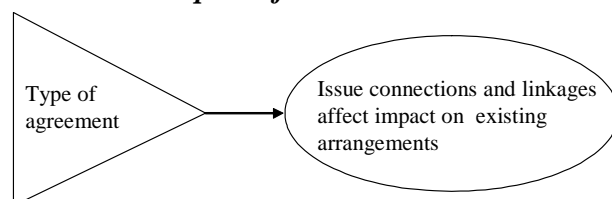
Phase 1: The origins of bilateralism



Phase 2: The evolution of bilateralism



Phase 3: The impact of bilateralism



The second critical turning point came in the wake of unprecedented economic hardships for the small and medium-sized economies in the region during the last years of the 1990s. Many of them came to recognize that tighter institutionalization—rather than loosely-structured regional production networks—might be a better commitment mechanism for providing economic security, and, therefore, began to actively weave a web of bilateral trade arrangements.

Thirdly, the Seattle meeting of the WTO created fears that the multilateral trading system would not continue to function smoothly. Although the WTO Doha agreement to start a new round of trade negotiations might have changed this view, the breakdown of the September 2003 WTO meetings in Cancun and subsequent success in getting the round moving again in July 2004 highlights the uncertainty that still surrounds the

multilateral process. Furthermore, the Bush Administration's strong interest in pursuing a Free Trade of the Americas Agreement (FTAA) has been of concern for Asian countries, who fear a shift in U.S. interests.

Pursuant to a shock, the new trend in the Asia-Pacific reflects a convergence of interests in securing inclusive "club goods" in the face of anemic, if not shrinking, export prospects. The seemingly endless export boom of the 1980s and early 1990s began to face problems in the mid-1990s. The "trade triangle" that had linked Japanese (and overseas Chinese) capital, developing East Asian manufacturing capacities, and the U.S. market appeared to be in trouble, as the U.S. began to focus on its NAFTA neighbors, namely Canada and Mexico, as key trading partners. With traditional mechanisms within WTO and APEC offering no salient solutions, East Asian countries quickly turned toward bilateral FTAs to assure a market for their products.

More generally, the key economic incentives to form bilateral agreements include trade creation, investment expansion, and financial stability. First, trade will increase when tariff and non-tariff barriers are removed, although product exclusions can create distortions and the actual benefits will depend on the fit between the participants' economic structures. It is also worth noting that trade diversion as a result of other countries' bilateral agreements may drive actors to pursue their own accords. Second, bilateral accords could also bring about an investment creation/expansion effect as well. This could occur not only between the two countries involved but also through investment attraction from third countries that wish to secure access to specific markets. A good example of this is Mexico's increasing attractiveness to investors as it has developed a web of bilateral trade accords. Third, bilateral accords may lead to greater

willingness to help one another in times of financial difficulty—particularly if the partner is large and financially powerful.

With respect to political arguments as driving forces, four arguments are most salient, namely the role of pressure groups, regime types, ideas, and international context. First of all, in the Asia-Pacific, individual bargaining situations in terms of pressure groups and regime type have changed significantly as a result of the end of the Cold War and the financial crisis. Though with different degrees, many developing countries in the region experienced challenges to their political legitimacy and actual political turnover by groups and individuals who had previously tolerated cronyism and familism. Such a development in regime structure has altered the economic payoffs confronting individual countries, as they march toward more liberal and democratic regimes, rendering cooperative outcomes at the inter-governmental level more likely and the requirements of institution-building less daunting. In addition, countries' changing perceptions regarding the importance of supporting multilateral institutions has affected the choice of bilateral mechanisms. Many Asia-Pacific trade experts now are part of an "epistemic community" which shares the view that bilateral trade arrangements can be trade-enhancing and serve a similar purpose of multilateral trade liberalization. Finally, from an institutional perspective, the uncertainties about the prospects for the WTO Doha Round and the weak role of APEC have stimulated concern about alternative arrangements that might secure access to markets in a more difficult institutional environment.

Phase 2. 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.

Depending on the perceived benefits from a bilateral accord as well as actions taken by other states, countries may be motivated to alter the agreement in some fashion. From an economic standpoint, as the pattern of economic flows begins to change, import-competing firms, export-competing firms, and labor groups are likely to press for some changes. 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 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 affect the initial agreement, so too will differing situations influence the prospects for changes in the agreement as well as the likely characteristics of the modified accord—if that is indeed the path they choose to pursue.

Phase 3. In this third phase, we focus on 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? 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. As John Ravenhill notes at

length in Chapter 2, the extent to which bilateral preferential agreements are consistent with Article 24 of the GATT/WTO will greatly influence the extent to which they might be disruptive to the broad-based trading system.

In his analysis, Aggarwal focuses on two aspects of institutional connections: how issues are connected and the nature of any issue connections. With respect to the former, Aggarwal defines 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. And with respect to the nature of issue connections, he focuses on whether links are driven by power considerations or by some type of intellectual consensus. As he notes, 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. In short, 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.

III. AN INSTITUTIONAL AND ECONOMIC OVERVIEW

Part II of the book provides both an economic and political-institutional overview of Asia-Pacific bilateralism. In Chapter 2, John Ravenhill undertakes three tasks to provide the setting for an analysis of bilateral trade agreements: (1) a survey of the move to bilateral preferential trade arrangements, focusing on those involving East Asian countries; (2) examination of their effect on the domestic political economy of the

participants to these agreements; and (3) the impact that these arrangements are likely to have on regional and global liberalization.

Ravenhill begins by surveying the 12 bilateral preferential agreements that have already been implemented, another 15 currently under negotiation, and another 10 being studied. He shows that many of these agreements have been asymmetrical and driven by political factors, that larger concessions have been made by weaker parties, and that the resulting agreements generally exclude several sectors and are only weakly consistent at best with Article 24 of the GATT/WTO. Ravenhill's argument can be extended to include the 40 plus current and prospective FTAs that involve North and South American countries. These outcomes are consistent with the expectations developed by Aggarwal in the Phase 1 analysis reviewed above.

Ravenhill then provides a detailed analysis of how the exclusion of sectors in the accords under negotiation may affect the domestic balance of power, and thus change the political atmosphere for negotiating further agreements (Phase 2 of Aggarwal's analysis). He suggests that while such agreements provide governments with political benefits, the agreements create a new structure of protectionism that may harm consumers, create trade diversion, and encourage further lobbying by those who manage to secure exclusion from bilateral liberalization efforts. Ravenhill notes that some analysts believe that liberalization along bilateral lines may lead to the strengthening of pro-liberalization forces, which may then foster overall market opening. Yet he believes that the more likely outcome is the one raised by Aggarwal and Ravenhill (2001) about open sectoral agreements in the information technology and telecommunications industries. As they suggest, piecemeal liberalization is likely to undermine the creation of a broad coalition

for opening trade by giving pro-liberalization what they want through sector specific agreements, thus diminishing their incentives to lobby against protectionist interests.

Ravenhill then examines how bilateralism is likely to impact and be linked to broader trading arrangements (Phase 3 in Aggarwal's framework). In reviewing the theoretical literature on the first issue and their impact, Ravenhill notes the sharply competing views of bilateral agreements as being possible "stepping stones" or "stumbling blocks" to broader accords. On the negative side are arguments about trade diversion resulting from a proliferation of preferential accords, the diversion of bureaucratic attention from broader arrangements, and the sunk costs from having focused on bilateral arrangements. On the positive side, some argue that excluded countries will be motivated to join such agreements, that bilaterals can be negotiated more readily, and that the possible inclusion of a broader range of issues in the arrangement may stimulate their consideration in broad-based, multilateral fora. How does the evidence from the Asia-Pacific stack up? Ravenhill finds that while some bilateral agreements have been negotiated rapidly, some of the same issues that beset broader negotiations may hinder bilateral efforts as well. With respect to the inclusion of previously excluded countries, the evidence for this is not there, with agreements being negotiated *de novo*, rather than incorporating new members. And with respect to issue scope, while new issues such as investment, competition policy, and the like have made their way into bilateral accords, these have not led to a new agenda at the broader level.

Lastly, with respect to the second question of connections to broader arrangements, Ravenhill examines the Association of Southeast Asian Nations (ASEAN), ASEAN, APEC, and the WTO. With respect to the former, the record is mixed at best.

In terms of APEC's principles, the lack of clear directives makes it hard to evaluate inconsistencies. On several dimensions, however, there does seem to be conflict. At a minimum, the notion that sub-regional agreements would be extended to other members has been violated, the 2020 deadline for free trade in the region does not appear in bilateral agreements, and the current and prospective bilateral agreements are often incompatible with the calls for a comprehensive inclusion of all sectors. In terms of their impact on ASEAN, there appear to be some pluses in that bilateral agreements have stimulated some unity through the negotiations that they have undertaken with Japan and China. On the negative side, there have been disputes among ASEAN members on the decision of some states, such as Singapore, to actively pursue bilateral arrangements. Finally, with respect to the WTO, we have already seen the possible conflicts with Article 24. Beyond this, Ravenhill suggests that bilateral agreements will create a diversion of political-economic lobbying away from the WTO to bilateral arrangements.

In Chapter 3, Fukunari Kimura presents an economic overview of Asia-Pacific bilateralism. His chapter examines five aspects of free trade arrangements (FTAs), namely: (1) the economic motivation driving bilateralism; (2) the role of international production and distribution networks in economic development; (3) the effects of FTAs on development strategies; (4) the limitations of computable general equilibrium (CGE) model simulations; and (5) future prospects for broader bilateral accords.

Kimura's analysis begins by looking at the economic motivation for the negotiation of FTAs in the Asia-Pacific. He notes that although FTAs have been developed on a bilateral basis for the most part, the common view in the Asia-Pacific is

that these efforts will ultimately result in economic integration of the entire East Asian region. As latecomers to FTA formation, East Asian countries share several distinct elements that have characterized their efforts in developing bilateral FTAs. These include: pressure to formulate FTA networks quickly; motivation from external rather than domestic sources; and the advantage of learning from the experiences of other regions.

Kimura then turns to an analysis of the development of international production and distribution networks, an important aspect of economic development in the Asia-Pacific region. He details three theories to help us better understand international production/distribution networks in East Asia—fragmentation, agglomeration, and internalization. Drawing from these theories, Kimura demonstrates the importance of production and distribution networks in East Asia by citing a case study on the machinery industry's production/distribution network involvement.

Next, Kimura examines the impact that international production/distribution networks have had on development strategies in the Asia-Pacific. He shows that the evolving combination of import substitution and export promotion policies is linked to FTAs, because such agreements seek to reorganize inefficient import-substituting industries through increased international competition while simultaneously enhancing international production/distribution networks through measures that go beyond simple tariff removal. In his fourth section, Kimura points to several problems surrounding CGE models. As he notes, while CGE models are the most popular approach to evaluating the impact of FTAs, one must be cautious in interpreting their results. To this end, he offers several caveats for interpreting their results.

Lastly, Kimura provides insight into the future prospects of Asia-Pacific FTAs. If East Asian countries are to continue towards region-wide integration, he argues that several policies must be followed in constructing FTAs. These include trade liberalization with minimal exceptions, forming bilateral FTAs with wide scope, learning from the experience of other regions, and utilizing other policy modes. He concludes by arguing that this approach would then allow bilateral accords to foster broader Asia-Pacific arrangements.

IV. SUMMARY OF COUNTRY ANALYSES

Our nine case study authors follow a similar format in their analysis. After identifying the types of bilateral agreements that countries in the Asia-Pacific have negotiated or are currently negotiating, they systematically assess the economic and political driving forces underlying these arrangements. This analysis provides important data for our effort to analytically summarize the key elements that have led to the creation of bilateral arrangements in the Asia-Pacific. After looking at the large countries in the region (the U.S., Japan, and China), we turn to a focus on the efforts of six small and medium-sized countries—South Korea, Singapore, Taiwan, Malaysia, Thailand, and Mexico.

The Big Three: The U.S., Japan, and China

The U.S. Richard Feinberg argues that the U.S. has begun to dramatically shift its position on trade negotiations. Although the U.S. Trade Representative (USTR) remains engaged in the Doha Development Round (DDR) of the WTO, the White House has been unwilling to put enough on the table to seriously move negotiations forward at the

multilateral level. Instead, under the new rhetoric of “competitive liberalization,” the U.S. is currently mobilizing different types of trade arrangements, be they unilateral (e.g., Generalized System of Preferences), bilateral (e.g., FTAs with Chile, Singapore, Australia, Israel, Jordan, Morocco), regional (e.g., NAFTA), transregional (e.g., agreement with Central American countries and the FTAA), or global (e.g., DDR).

As he notes, the economic impact of FTAs on the U.S. economy has been small because most of the FTAs that the U.S. has concluded so far are with small, distant economies. Nevertheless, Feinberg argues that the current and prospective FTAs of the U.S. satisfy at least some, if not all, of four basic national interests: (1) creating asymmetric reciprocity for U.S. traders and investors; (2) widening the scope of trade agreements; (3) rewarding and supporting market-oriented reformers in trading partner countries; and (4) strengthening strategic relationships with trading partners.

Indeed, a consensus that FTAs advance U.S. interests domestically and internationally has emerged within the policy circle, particularly in the USTR. U.S. Trade Representative Robert Zoellick’s idea of “competitive liberalization” represents such a change in thinking. By contrast, Feinberg argues that interest groups have had relatively little interest in the bilateral FTAs pursued so far outside of the Western Hemisphere. It is only with pressure from Singapore and Australia that the U.S. finally moved towards bilateral trade pacts in this region. The USTR asserts that any future FTAs with ASEAN countries will be based on the high standards set in the US-Singapore FTA. At this moment, there is only a slim possibility that bilateral FTAs with Japan and South Korea will be concluded in the foreseeable future, mainly due to the unresolved differences over the terms of agricultural trade liberalization.

Japan. T.J. Pempel and Shujiro Urata examine Japan's new move toward bilateral FTAs. They note that the Japan-Singapore Economic Partnership Agreement represents a striking break with Japan's past approach to trade, which had relied heavily on global trade agreements. Currently, South Korea is third in line after Singapore (2003) and Mexico (2004) on Japan's FTA list. Japan also has a strong interest in first establishing FTAs with ASEAN countries bilaterally and eventually with ASEAN as one group.

For Japan, greater access to foreign export markets is one of the most important economic motives. The results of Pempel and Urata's simulation analysis indicate that FTAs would enable Japan to promote economic growth by shifting scarce resources from non-competitive sectors to competitive ones. At the same time, Pempel and Urata predict that FTAs would force non-competitive sectors to face difficult structural adjustment. In the presence of a dualist Japanese economy of protected inefficient firms, and highly competitive exporters, the political cost of liberalizing the protected industries has been prohibitively high in Japan.

Yet, given the reality of the worldwide proliferation of FTAs, Japanese ministries with a structural reform agenda have argued that Japanese exporters are being damaged by this trend. Supported by the business community, the Ministry of Economy, Trade and Industry, and the Ministry of Foreign Affairs are pressing for FTAs as devices that will bolster national economic restructuring in a more palatable manner due to their gradual impact—rather than the alternative of sweeping domestic reforms driven by multilateralism. It seems increasingly likely that the FTA strategy chosen by Japanese

reformers may in fact provide an important catalyst for long-term structural changes in the Japanese dual economy that has for so long successfully resisted them.

At the regional strategic level, China's active pursuit of an FTA with ASEAN has greatly alarmed and motivated Japan to do the same. Japan's bilateral FTA negotiations with Malaysia, Philippines, and Thailand began in early 2004 with a goal of concluding respective negotiations sooner rather than later. However, Japan did not accept a proposal by China in November 2002 to study a possible FTA with China and South Korea as a step toward the establishment of a Northeast Asian FTA, presumably for reasons of the enduring rivalry with China.

China. Elaine Kwei attempts to unravel the puzzle surrounding China's stance on bilateralism. At first glance, China appears to be moving more slowly than its neighbors with regard to bilateralism, while operating with somewhat different calculations about its potential costs and benefits. This approach may reflect the pragmatism adopted by China's reformist leadership, currently under President Hu Jintao and Premier Wen Jiabao, given alternative trade arrangement possibilities.

Kwei argues that the course of China's bilateralism is defined by the interaction of at least four underlying logics: (1) China believes its future lies with multilateral or minilateral regional frameworks rather than strictly bilateral options; (2) as a highly attractive market with economic leverage, China is more likely to pursue multilateral or minilateral trade arrangements, especially "one-to-many" deals, while taking advantage of private and informal Overseas Chinese business networks; (3) China will not completely discard bilateral options as long as it can exercise control over the process;

and (4) China is interested in bilateralism primarily for political rather than purely economic motives, as illustrated by the inclusion of confidence and security enhancing measures in the China-ASEAN FTA framework agreement.

Based on this analysis, Kwei concludes that China is not in a hurry to conclude bilateral FTAs for economic reasons; by contrast, it is more inclined to capitalize on the marginal political benefits from bilateralism as much as possible, while continuing to pursue broader rather than narrower trade arrangements.

Small but Pacesetting Six

One of the most striking characteristics of Asia-Pacific bilateralism is that the recent move toward bilateral FTAs is a product of small and middle-sized countries as much as a function of the three regional giants of the U.S., Japan, and China. In this book, we focus on six: South Korea, Singapore, Taiwan, Malaysia, Thailand, and Mexico. By many indications, they have set the ball rolling in a bilateral direction in recent years.

South Korea. Min Gyo Koo analyzes South Korea's departure from multilateralism toward a multidimensional trade strategy including bilateral FTAs. Since the Seattle Round, South Korea has realized the possible welfare gains associated with bilateral FTAs. South Korea's ratification of its first FTA with Chile on February 16, 2004 marks the beginning of a dramatic embrace of sub-multilateral methods to liberalize trade and investment.

Koo argues that the socio-economic restructuring that followed the financial crisis of 1997-98 has resulted in a new internationalist social coalition that overshadows

protectionist interests, particularly in agriculture and import-competing industries. Most importantly, he contends that the change in political leadership, namely reform-minded Kim Dae Jung's rise to the presidency in 1998, is at the heart of the dramatic policy shift. The new momentum generated at the top leadership was followed by an emerging cognitive consensus within government policy circles that a new bilateral approach is not only complementary to the traditional multilateral strategy, but is also a crucial element of South Korea's economic survival in a world of shrinking export markets. Finally, Koo notes that strategic considerations for the present and future Asia-Pacific political economy, as well as growing peer pressure, motivates South Korea to surf on the web of bilateral FTAs, while playing a bridging role between the three regional giants—the U.S., China, and Japan.

Singapore. Despite its wealth, Singapore is one of the smallest countries in the Asia-Pacific in terms of population and land area. But it has played an agile “David” capable of alluring the “Goliaths” in the Asia-Pacific toward bilateralism, belying its “physical” size. Seungjoo Lee examines Singapore's two-track strategy for trade liberalization. Singapore's efforts at bilateral FTAs clearly mark a fundamental shift in its trade policy, which had hinged upon multilateralism and close ties with ASEAN members for the last four decades.

Singapore's search for sub-multilateral alternatives beyond ASEAN is motivated by a dismal prospect for the progress of AFTA. Lee argues that a strong political leadership of former Prime Minister Goh Chok Tong and the institutional strength of the Ministry of Trade and Industry have been essential in making such a policy shift to

bilateralism, while domestic interest groups and foreign companies playing a secondary role. Relatively free from societal pressure, the Singaporean state is in an advantageous position to impose its preference for bilateral FTAs on the society with ease.

As Lee notes, the Singaporean government has also dealt adroitly with “pull factors” such as the neighboring countries’ woes about Singapore’s multidirectional FTA strategy by assuring them that the FTAs would have a positive effect on ASEAN rather than becoming a backdoor to ASEAN markets. Indeed, Singapore’s bilateral activism has inspired and motivated many of its neighbors, both close and distant, including its ASEAN cohorts, Japan, South Korea, China, and the U.S.

Taiwan. Having secured WTO membership in January 2002, Taiwan, one of the four East Asian tigers, began to pursue bilateralism. As compared to its neighbors, South Korea and Singapore, however, Taiwan occupies a rather uncomfortable place in Asia-Pacific bilateralism. More generally, with limited political and diplomatic capital, Taiwan has suffered setbacks in the race to formalize economic relations with its trading partners.

Roselyn Hsueh explains Taiwan’s daunting attempts to form FTAs with its “natural” trading partners, which have largely run into obstacles raised by China’s opposition. Taiwan’s extremely limited bargaining position is reflected in its abortive attempt to negotiate a FTA with New Zealand and the choice of Panama as its first FTA partner—despite few expected economic gains. For Taiwan’s trading partners, there are few economic and political incentives to risk economic and political retaliation from China by forming an FTA with Taiwan. In conclusion, Hsueh suggests that, for bilateralism to be of any consequence for Taiwan, Taiwan has to find a new political

formula that makes China more tolerant toward Taiwan's bid for bilateral FTAs. But, how and when to achieve this remains to be seen.

Malaysia. Yumiko Okamoto analyzes Malaysia's surprising departure toward bilateralism. Former Malaysian Prime Minister Mohammed Mahathir had looked warily upon the FTA forays of fellow ASEAN members, criticizing their actions as "worrisome" and "damaging to the unity of regional groupings such as ASEAN." Malaysia was frustrated by the possible erosion of FDI inflows resulting from bilateral FTAs with non-ASEAN countries. In December 2002, however, Mahathir showed, for the first time, an interest in promoting trade and investment through bilateral talks with Japan.

In addition to traditional trading partners including the U.S., Japan, South Korea, India, and ASEAN members, Malaysia beckons China as an important FTA partner, both for trade and investment. Okamoto notes that because tariff rates between Malaysia and its prospective FTA partners are relatively low (except for India), the reduction of tariff alone may not generate substantial trade and investment creation. Instead, Okamoto predicts that Malaysia will gain from trade and investment liberalization in the service sector.

Japan is most likely to be the first FTA partner for Malaysia, but FTA negotiations between the two countries have yet to overcome a number of thorny issues. Okamoto argues that it may not be easy for Malaysia to accept a bilateral FTA with Japan unless careful attention is paid to ethno-politically sensitive sectors in Malaysia such as automobiles, energy, water, telecommunication, and finance.

Thailand. Among ASEAN members, Thailand presents an intermediate position between Singapore and Malaysia, as it is neither a vocal supporter nor a strong opponent of Asia-Pacific bilateralism. As Kozo Kiyota shows, in the aftermath of the financial crisis of 1997-98, Thailand placed the revitalization of its economy at the forefront of its policy agenda. However, the results were mixed at best, as its exports kept dwindling and foreign investment continued to flow out of the country. Against this background, Kiyota explores why and how the incumbent populist government led by Prime Minister Thaksin Shinawatra began to seek trade and investment expansion through FTAs beyond ASEAN.

Kiyota argues that Thailand's new interest in FTAs is a result of political leaders' response to growing domestic pressure due to economic stagnation. According to Kiyota, international factors include the stalemate in AFTA negotiations and competition with Singapore and China to attract new FDI. Using a simulation model, Kiyota examines several scenarios on the economic gains of Thailand's prospective FTAs. He finds that the combination of an AFTA and bilateral FTAs will be more beneficial to Thailand than geographically dispersed minilateral trade agreements. This may provide Thailand with an incentive to promote trade liberalization through geographically closed bilateral and minilateral trade arrangements at the cost of non-member countries. His findings imply that Thailand's bilateral FTAs need to be nested within multilateral trade agreements.

Mexico. Ralph Espach analyzes the economic and institutional rationale for Mexico's bilateral trade agenda. He argues that Mexico's recent efforts at bilateral FTAs with East Asian countries are a logical extension of its long-term program of economic liberalization in the Western Hemisphere. The motivation for bilateral talks has

increased as efforts at the multilateral and regional levels have slowed down or faced significant impediments.

According to Espach, bilateral FTAs are also a response to several problems that previous trade agreements have either worsened, as in the case of NAFTA, or failed to correct sufficiently, as in the case of the FTA with the European Union. He predicts, however, that bilateral FTAs with East Asian countries are not likely to diminish significantly Mexico's deepening economic ties with the U.S.

With its complex web of bilateral FTAs, both current and prospective, Mexico would likely find the further gains through multilateral negotiations, if any, to be marginal. Espach predicts that if Mexico were to succeed in addressing its strategic goals of export improvement and diversification through an agenda of aggressive bilateralism, other developing countries may well be convinced to follow suit.

V. DRIVING FORCES FOR ASIA-PACIFIC BILATERALISM

Using the empirical results from the case studies, we summarize our key findings and their implications in light of three questions: (1) how can we evaluate the extent to which the trade policy of individual Asia-Pacific countries have evolved toward bilateralism over the past several years?; (2) of the three economic motivations including trade expansion, investment expansion, and financial cooperation, which factors are more important in determining individual countries' move toward bilateralism?; and (3) of the four political and institutional factors including interest groups, political institutions, ideas, and international balance of power, which one is the most and least important

driving force toward bilateralism? Our findings to these questions are summarized in Table 13.1.

Table 13.1: Summary of Findings

	Overall strength and extent of new bilateralism (1: highest; 4: lowest)	Economic factors (1: highest; 3: lowest)			Political factors (1: highest; 4: lowest)			
		Trade expansion	Investment expansion	Financial cooperation	Interest groups	Political institutions	Ideas	International balance of power
U.S.	2	2	1	3	4	2	1	3
Japan	2	1	2	3	3	1	4	2
China	4	2	1	3	4	2	3	1
South Korea	2	1	2	3	4	1	2	3
Singapore	1	1	2	3	4	1	2	3
Taiwan	3	1	2	3	4	3	2	1
Malaysia	3	1	2	3	3	1	2	4
Thailand	2	2	1	3	2	1	4	3
Mexico	1	1	2	3	2	1	4	3

The Overall Importance of the New Bilateralism

Among the Big Three players, the U.S. and Japan have shown a strong, if not the strongest, interest in forming bilateral FTAs with the rest of the Asia-Pacific, whereas China appears to be least interested in relying on the new bilateralism. The future evolution of Asia-Pacific bilateralism in terms of its economic impact largely rests on the Big Three who together represent about 79 percent of GDP of the Asia-Pacific region—primarily consisting of the North and South America, Northeast and Southeast Asia, and Oceania—and 62 percent of its total trade in goods and services as of 2002.¹ The fact that small and medium-sized countries are approaching the Big Three as FTA partners

illustrates the importance of a large market in enticing the negotiation of trade arrangements. This attractiveness, of course, provides larger countries with greater leverage in negotiations.

Yet what is most striking is in the Asia-Pacific bilateralism is that small and medium-sized countries—particularly, Singapore, Mexico, South Korea and Thailand—have played a central role in setting the pace toward bilateralism. In particular, Singapore in the Western Pacific and Mexico in the Western Hemisphere have served as inspiration and motivation for their neighbors, both big and small, to form bilateral FTAs for the past several years. This intriguing development indicates that the new Asia-Pacific bilateralism has resulted from a bottom-up rather than top-down strategy of small and medium-sized countries, as opposed to the post-war multilateralism that was largely imposed from top (the U.S.) to down (U.S. allies in the region).

Economic Motivations for Bilateralism

With respect to economic motivations for Asia-Pacific bilateralism, we found that for the majority of our selected countries (six out of nine), expanding trade in goods and services through bilateral FTAs is the highest priority when they negotiate bilateral FTAs. For the other three (the U.S., China, and Thailand), facilitating the inflows and outflows of foreign investment is the number one consideration concerning bilateral FTAs. For all the nine countries that we examined, financial cooperation appears to be the least important economic incentive. These findings have at least three implications.

First, this finding suggests that big economic players have strong incentives to form bilateral FTAs with each other since many of them consider bilateral FTAs as a

promising avenue towards trade liberalization in the absence of alternative measures at the broad-based, multilateral level.

Second, the growing interest in bilateral FTAs as an “insurance policy” to liberalize trade often goes beyond trade in goods and services. Many of the current and prospective bilateral FTAs among Asia-Pacific countries cover broader areas and elements like factor mobility, investment rules, intellectual property rights, government procurement, and other trade facilitation measures such as mutual recognition of product standards and harmonization of customs and quarantine procedures. At the same time, however, these agreements are potentially incompatible with the WTO provisions since some sensitive sectors are deliberately excluded, thus setting up the possibility of institutional conflict.

Third, many East Asian countries had a strong incentive to secure financial resources, especially with the region’s financial giant, Japan, when they began to consider preferential accords in the aftermath of the financial crisis of 1997-98. More recently, however, financial and monetary cooperation through bilateral FTAs and/or regional financial arrangements such as an Asian Monetary Fund has taken a back seat, as most countries have recovered from the crisis.

Political Motivations for Bilateralism

With respect to political motivations for Asia-Pacific bilateralism, we found that for the majority of our selected countries (six out of nine), political leadership and institutions are the most important driving force. For the U.S, the new view of bilateralism as a building block rather than a stumbling block for multilateralism is the most important

determinant. As for the two Chinas, international balance of power is the most important factor that drives their somewhat slow move toward bilateralism.

We also found that interest groups play a relatively minor role in the politics of new bilateralism. In fact, interest group politics appears to be the least significant factor in five countries and the second least important for two countries out of nine. This implies that new bilateralism is driven from the top at the national level. In addition, these findings are closely related to the emerging consensus at the political leadership level that FTAs will advance national interests while presenting an alternative road to trade liberalization compatible with multilateralism. Unsurprisingly, most Asia-Pacific countries considered in our study, except for the U.S., are thought to have a “strong” state that is relatively free from societal pressure when pursuing preferred trade policy.

VI. BEYOND ASIA-PACIFIC BILATERALISM?

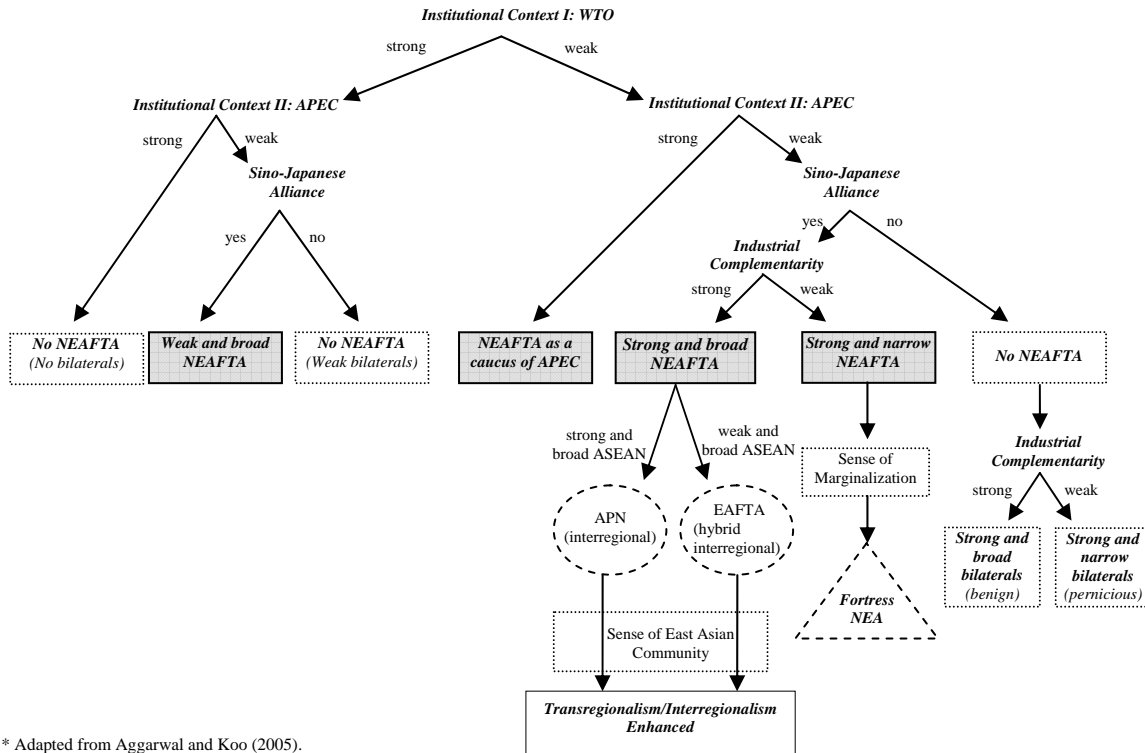
How is Asia-Pacific bilateralism likely to evolve over the next decade? This is a highly speculative question, but in a recent study, we build upon the institutional bargaining approach discussed in this book to tackle this issue.² We attempt to obtain insights on possible paths beyond the new bilateralism in the Asia-Pacific by focusing on Northeast Asia, since this sub-region is at the heart of new trend in bilateralism as well as economic dynamism in the Asia-Pacific.

To systematically construct our simplified scenarios, we assume a certain hierarchical order among the variables in our institutional bargaining game. To begin with, drawing on the factors illustrated in Figure 13.1, we give pride of place to the status of extant broad-based, international institutions as a primary source of *external shock* for

change. We believe that the weakness of each of these institutions will encourage the pursuit of club goods, whereas their strength will discourage incentives for pursuing club goods. For the variables of individual bargaining situations, we focus on three in order of their presumed significance—the institutional strength of the WTO and APEC, alliances, and economic complementary between countries. We draw the following causal relationships from our theoretical and empirical observations. The number of participants, strength, and scope of prospective PTAs are: (1) a negative function of the WTO and APEC; (2) a positive function of alliances and economic complementarity.

With these assumptions and theoretical propositions, we can identify four principal pathways toward a Northeast Asian FTA (NEAFTA) as illustrated in Figure 13.2.³ First of all, a combination of a strong WTO and a weak APEC will create some incentives for pursuing club goods. If a positive, albeit tentative, trilateral alliance among the Northeast Asian Three (China, Japan, and South Korea), a weak but broad NEAFTA might be a possibility. The logic here is that the strength of the WTO would dissuade a major departure from multilateralism (particularly Article 24), but the weakness of APEC would motivate politically allied Northeast Asian countries to form a NEAFTA in order to maximize the benefit from the geographic proximity and size of their economies.

Figure 13.2: Paths to NEAFTA and Beyond*



* Adapted from Aggarwal and Koo (2005).

Secondly, a combination of a weak WTO and a strong APEC is likely to result in a very weak NEAFTA. WTO's weakness would motivate the Northeast Asian Three to pursue trilateral club goods, even without formal alliance arrangements amongst themselves, since a strong APEC would decrease relative gains concerns. In this case, NEAFTA would be reduced to a caucus of the three countries within APEC—rather than a separate, strong negotiating body—since APEC operates as a principal locus of trade liberalization.

Thirdly, if both the WTO and APEC are weak, considerable institutional space and a multiplicity of options are likely to emerge. If the Northeast Asian Three reach a political alliance, the formation of a strong NEAFTA is highly likely. In this case, the scope of a resulting NEAFTA is hinged upon economic complementarity. If such

complementarity exists among the three countries, it will broaden the scope of product coverage, leading to a strong and broad NEAFTA.

Finally, if there is weak economic complementarity among the politically allied Northeast Asian Three in the face of a weak WTO and a weak APEC, we can expect a strong but narrow (or sectoral) NEAFTA.

Among these four likely pathways toward a NEAFTA, the last two cases are theoretically most interesting. How would a strong and broad NEAFTA evolve if we broaden our focus beyond Northeast Asia? Within East Asia consisting of Northeast and Southeast Asia, if this type of NEAFTA is combined with a strong and broad ASEAN, the most likely outcome is an interregional arrangement—that is, a bilateral arrangement between two separate PTAs—possibly in the form of an ASEAN Plus NEAFTA (APN). Alternatively, if a strong and broad NEAFTA links up with a broad but weak ASEAN, we can expect the advent of a hybrid interregional arrangement that creates an East Asian FTA (EAFTA), currently manifesting itself in the reverse form of ASEAN Plus Three (APT) or East Asian Community (EAC) where state actors participate in the capacity of members of ASEAN as a group on the one hand, and individual Northeast Asian countries on the other.

These East Asian groupings—be they APN, APT, EAFTA, or EAC—might contribute to broader transregional and/or interregional arrangements such as APEC and Asia-Europe Meeting (ASEM). If the East Asian groupings that are created prove stable, the growing interconnectedness and the networked nature of interstate economic activities may produce an increasing awareness and sense of community among East Asian countries (Terada 2003). As either APN or EAFTA countries become more

confident in their ability to create their own transregional grouping, they might be more willing to extend their institutionalization efforts to the transregional level of APEC, thereby giving it new life. Similarly, the increasing sense of community within East Asia could facilitate the ASEM forum, leading to pure Asia-Europe interregionalism.

But what about the likely paths that a strong but narrow NEAFTA will take beyond Northeast Asian region? In this case, we could end up with the formation of an exclusive, if not pernicious, “Fortress Asia” commensurate with the oft-voiced fears of a “Fortress Europe” and “Fortress America.” The strategic relationship between Northeast Asia and the rest of the world will be of key significance here. Most importantly, if the U.S. continues its focus on the Free Trade Area of Americas (FTAA) and the European Union (EU) continues on an eastward and possibly southward expansion path, others may feel excluded. Under these circumstances, the decade-long perception among Northeast and Southeast Asians that Western regional arrangements are forming against them may well rekindle the Mahathir-promoted notion of an exclusive East Asian bloc.

Finally, we consider the cases where a NEAFTA is ruled out but strong bilateral agreements can still come into play. If both the WTO and APEC are weak, considerable institutional space and a multiplicity of options are likely to emerge. If there is no alliance among the Northeast Asian Three, a NEAFTA is not a possibility. Nevertheless, two separate dyads—Japan-South Korea on the one hand, and China-South Korea on the other—are still likely to have strong incentives to secure club goods through bilateral agreements between themselves. The strength of these bilaterals would be heightened due to the weakness of both the WTO and APEC. If there exists strong economic complementarity, it might result in a strong and broad bilateral agreement. This path can

lead to benign bilateralism if it catalyzes a competitive dynamic to liberalize among other countries (Bergsten 1996; Schott 2004). Conversely, if there exists weak economic complementarity, it might lead to a strong but narrow bilateral agreement. In this case, it is plausible that the Northeast Asian countries may be polarized between two camps—China versus Japan—on a sectoral basis. Ultimately, a pernicious web of competitive, sectoral bilaterals would likely damage other broad-based, multilateral trading accords, if any (Irwin 1993; Aggarwal and Ravenhill 2001; Bhagwati 2002).

As this book has argued, the motivations and implications of concluding bilateral FTAs vary widely among Asia-Pacific countries, and static economic analyses alone do not adequately explain the rise of such accords. Bringing in political and institutional factors, both domestic and international, as a key part of the explanation provides us with considerable analytical purchase. Building upon an institutional bargaining game approach, we developed a more fine-tuned analysis of the origins and likely evolution of Asia-Pacific bilateralism. As we have seen, the future of Asia-Pacific bilateralism remains wide open. On the one hand, our findings indicate that current and prospective bilateral agreements show strong potential to evolve into regional, transregional and/or interregional accords with varying degrees of strength and scope. On the other hand, there is a real danger that Asia-Pacific bilateralism will likely lead to pernicious, conflicting arrangements, rather than becoming nested within broader institutions. The undetermined future of Asia-Pacific bilateralism, therefore, calls for conscious and calculated efforts of coordination from all of the parties concerned, both small and large.

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Notes

¹ The World Bank, *World Development Indicator Online*.

² For more detail, see Vinod K. Aggarwal and Min Gyo Koo (2005).

³ According our scenarios analysis, there are three hypothetical paths that do not lead to a NEAFTA. First, if both the WTO and APEC were strong, there would be little incentives for a NEAFTA as well as bilateral agreements. Second, if there is no trilateral alliance among the Northeast Asian Three in the presence of a strong WTO and a weak APEC, a NEAFTA is highly unlikely, although there might be some residual incentives for bilateral agreements. Finally, if both the WTO and APEC are weak and if there is no trilateral alliance, strong bilateral agreements will emerge instead of a NEAFTA. We discuss this last possibility in more detail at the end of this section.