

## KEY POINTS

- Previous studies on the impacts of free trade agreements (FTAs) in East Asia have assumed full utilization of preferences. The reality is that actual uptake is particularly low in East Asia. In this brief, we report results of impacts using more realistic utilization rates.
- We find that with more realistic utilization rates, the benefits from preferential liberalization are significantly diminished, but in a non-linear way.
- Reciprocity is an important motivation for pursuing FTAs over unilateral actions, such as multilateralization of preferences. We find that since the additional benefits from reciprocity also depend on utilization rates, they too are significantly diminished when preference uptake is low.
- Therefore, in the absence of Doha, unilateral multilateralism or non-reciprocal multilateralization of preferences, is the practical route that is most likely to deliver the greatest benefits.

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## MULTILATERALIZATION OF PREFERENCES VERSUS RECIPROCITY: RELATIVE IMPACTS OF EAST ASIAN FTAs WHEN UTILIZATION IS INCOMPLETE<sup>1</sup>

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### 1. Introduction

With the Doha Round of the WTO stalled indefinitely, bilateral free trade agreements (FTAs) have proliferated. While countries in Asia were relative latecomers to preferential liberalization, they have been catching-up rapidly. Indeed, the proliferation of FTAs has been greatest in Asia over the past decade. As of January 2013, there are 109 FTAs involving an Asian country already in effect, 132 that have been signed, 75 being negotiated, and 50 more proposals (see Menon 2013). The outcome of the proliferation of often overlapping FTAs has been described as the spaghetti bowl effect, or in Asia, the noodle bowl effect.

How do we remedy the situation? Concluding Doha would help, but the single undertaking appears increasingly unlikely, and may not even be enough. Therefore, a number of proposals that have been put forward (Baldwin 2006; 2008; Menon 2007; 2009), but they can be broadly grouped under two headings: consolidation and multilateralization. The consolidation approach proposes the creation of a region-wide FTA, in order to neutralize intra-regional FTAs. The multilateralization approach suggests that preferences be offered to non-members on a non-discriminatory basis, thereby eliminating any margin of preference. While these two proposals are aimed at addressing the noodle bowl, the impasse at the multilateral level has led to another development designed to broaden reciprocal access to markets outside the region. Recently, there has been growth in cross-regional tie-ups of FTAs, linking blocs in Asia with other blocs or countries within them. For instance, proposals to create an ASEAN-EU FTA, ASEAN-US FTA, and other similar linkages, is gathering momentum.

<sup>1</sup> The views expressed in this paper are those of the author and do not necessarily reflect the views and policies of the Asian Development Bank, or its Board of Governors or the governments they represent.

In this paper, we seek to assess the relative merits of these two approaches, as well as the recent trend for cross-regional tie-ups, by addressing a number of limitations in previous studies. In particular, we try and take into account more realistic utilization rates of preferences in estimating welfare impacts. Most previous studies, and all previous studies on East Asia, have assumed that utilization is complete, or 100%<sup>2</sup>. This is a serious limitation since the evidence suggests that utilization rates of Asian FTAs are very low, usually ranging between 10% and 20%, and rarely above 25% (see Menon 2013). Securing reciprocity is an important motivation for pursuing FTAs over unilateral actions. We isolate the impact of reciprocity, in comparing the consolidation and cross-regional tie-ups against multilateralization, and identify the conditions under which any additional benefits can be secured.

## 2. Model and Method

The analysis is conducted using the MONASH multi-country (MMC) model, which is a dynamic computable general equilibrium (CGE) model of the global economy (see Mai 2004). The version of the MMC model used for this study has 57 commodities and industries, and 14 economies and regions. These consist of six ASEAN economies (Indonesia, Malaysia, Philippines, Singapore, Thailand, and Viet Nam); the +6 economies (People's Republic of China, Japan, and Republic of Korea; and Australia, New Zealand, and India); and the US and a residual rest of the world (ROW) economy. We focus on the most commonly discussed proposal in this region— an FTA involving the ASEAN+6 countries, the so-called Regional Comprehensive Economic Partnership (RCEP).

Each of the simulations described below is a comparison with a business-as-usual (but moving background) scenario, the baseline. The baseline shows the growth of economic indicators without any trade liberalization taking place. The deviations of economic indicators from the baseline are used as measures of the effects of the various trade liberalization scenarios.

We conduct six basic simulations:

- (i) Simulation 1 (S1): Preferential Liberalization with Full Utilization of Preferences
- (ii) Simulation 2 (S2): Preferential Liberalization with Incomplete (25%) Utilization of Preferences
- (iii) Simulation 3 (S3): Multilateralization of Preferences
- (iv) Simulation 4 (S4): Cross-regional Tie-ups, with Full Utilization of Preferences
- (v) Simulation 5 (S5): Cross-regional Tie-ups, with Incomplete (25%) Utilization of Preferences
- (vi) Simulation 6 (S6): Global Liberalization

The difference between S1 and S2 is straight-forward, and relates purely to different rates of uptake of preferences. With S3, the preferences are offered to non-members on a non-

discriminatory basis. Reciprocity is introduced in S4 and S5, where non-members reduce tariffs on imports from member countries. The difference between S4 and S5 is the rate of utilization of preferences. Since reciprocity is secured through the regional FTA linking up with other FTAs, either through a series of bilateral or plurilateral tie-ups, preference utilization is still an issue. So far, tariffs on trade between non-members remain unchanged. This is where the final simulation, S6, comes in. Under S6, tariffs are also removed on trade between non-members and, therefore, we have global liberalization where trade between all countries is tariff free. As with the WTO, where members simultaneously reduce tariffs on trade with each other, reciprocity is secured through the MFN principle, and therefore incomplete utilization is not an issue.

## 3. Results

The results of our simulations are presented in Table 1. We focus on real GNP estimates in our discussion because it provides an indication of income available for current and future consumption by members of the economy. (Menon (2013) contains more detailed results, including those for individual countries and the ASEAN+3 grouping.) The first feature worth noting for all six simulations is how small the numbers are. These magnitudes are not uncommon in CGE analyses of trade liberalization. Furthermore, the size of the numbers reflects the fact that we (i) deal with only goods and not services, (ii) focus on removing tariffs only, and (iii) do not allow for endogenous productivity improvement caused by the reforms. Therefore, these results should be taken to represent lower-bound estimates. What we focus on are the differences across the six scenarios.

The RCEP raises real GNP by \$103 billion (0.42%) with full utilization and \$32.4 billion (0.13%) with incomplete utilization. With incomplete utilization, real GNP is slightly more than one-quarter of the full utilization outcome for the positive results, and slightly less than one-quarter for the negative results. This non-linearity could be attributable to the fact that incomplete utilization also reduces the extent of trade diversion, and therefore the reduction in welfare. The welfare of all non-members is reduced under both complete and incomplete utilization of preferences. This is despite global welfare being enhanced in both cases, albeit by very small amounts.

Comparing preferential liberalization with multilateralization of preferences, we find that the latter is superior in all cases, and especially when incomplete utilization is taken into account. When preferences are multilateralized, real GNP increases by \$130.1 billion (0.54%). In general, when members extend their preferential reductions to non-members on a non-discriminatory basis, welfare is enhanced because of three primary effects: (i) the extent of the liberalization is greater, (ii) the broader liberalization undoes the welfare-reducing trade diversion resulting from the preferential liberalization, and

<sup>2</sup> See Ando (2009) for a summary of these studies, and Petri et al. (2011) that assess the Trans-Pacific Partnership (TPP) with incomplete utilization.

(iii) the productivity of scarce resources within each member country is allocated more efficiently across its industries.

Scenarios S4 and S5 are akin to cross-regional tie-ups of FTAs, whereby the ROW grouping reciprocates by reducing its tariffs on exports from ASEAN+6. The benefits to members when reciprocity is introduced are greater than S3 only when there is full utilization of preferences (S4). If utilization is incomplete (S5), then members benefit more from multilateralization of preferences (S3). However, the GNP of ROW falls by 0.15% under S4 (with much smaller declines under S5). These are the largest reductions for non-members under any of the scenarios.

The additional gains to members in this scenario, with full utilization of preferences, appear to occur at the expense of non-members. This raises the potential for possible retaliatory actions by non-members, reducing the benefits to the world as a whole. If the maximum gains to members accrue at the expense of potential retaliatory actions, then the possibility of trade deflection raises the likelihood of low utilization rates. Since tariffs between large trading blocs such as NAFTA and the EU, and other significant groupings such as South America and Africa, remain unchanged, there are significant opportunities, and benefits, from trying to deflect trade in order to obtain duty-free access.

**Table 1: Percentage Deviation from Baseline—ASEAN+6, 2020 (%)**

	Preferential Liberalization, Complete Utilization	Preferential Liberalization, Incomplete Utilization	Multilateralization of Preferences	Cross-regional Tie-ups, Complete Utilization	Cross-regional Tie-ups, Incomplete Utilization	Global Liberalization
World Real GDP	0.045	0.019	0.119	0.310	0.131	0.346
ASEAN+6 Real GDP	0.344	0.108	0.857	1.235	0.388	1.025
ROW Real GDP	-0.063	-0.013	-0.147	-0.022	-0.005	0.101
World Real GNP	0.029	0.015	0.110	0.273	0.142	0.312
ASEAN+6 Real GNP	0.424	0.134	0.536	1.345	0.423	1.019
Row Real GNP	-0.113	-0.027	0.044	-0.112	-0.027	0.059
World Real Exports	1.075	0.241	1.818	2.939	0.658	3.726
ROW Real Exports	-0.104	-0.031	-0.031	0.970	0.293	2.392

Source: Authors' computation (2013).

In the final scenario (S6), we consider global liberalization, which is similar to that of a conclusion of the Doha Round as originally intended. If this were possible, the GNP of all member countries would be increased. For RCEP members, there is little difference in the welfare effects of global liberalization versus multilateralization of preferences. This finding has important implications for policy. It suggests that it is very much within the control of member countries to initiate actions that will produce almost the best welfare outcomes from trade liberalization. There is really no need to wait for an unlikely single undertaking Doha deal for members to reap the benefits from it, especially now that it appears even more unlikely after the December 2013 Bali agreement on trade facilitation. It also appears that there is little to be gained from reciprocity, given time delay, negotiating costs, and uncertainty in the magnitude of benefits if utilization is incomplete.

## 4. Conclusion

FTAs in Asia have been proliferating. Previous studies on the impacts of FTAs in East Asia have assumed full utilization of

preferences. The evidence suggests that this assumption is seriously in error, with estimated uptake particularly low in East Asia. It is not uncommon to find utilization rates as low as 10%–20%, and rarely above 25%. In this paper, we assume a more realistic utilization rate of 25%. We find that this significantly diminishes the benefits from preferential liberalization, but in a non-linear way. A utilization rate of 25% reduces benefits by slightly less than 75%, due to reduced trade diversion and terms of trade effects.

Reciprocity is an important motivation for pursuing new FTAs or expanding existing ones over unilateral actions. Proponents of FTAs argue that unilateral actions reduce the bargaining capacity of countries looking to gain greater access to traditional and new markets. We isolate the impact of reciprocity and consider whether the additional benefits that flow from it are likely to be realized. While reciprocity has the potential to impart substantial benefits, this again depends on the extent of utilization when it is pursued through preferential agreements. At 25% utilization, multilateralization of preferences (without reciprocity) still delivers greater benefits to members. Furthermore, the potential for trade

deflection combined with possible retaliatory actions may further reduce benefits to members, and to the world as a whole. Multilateralization of preferences is not subject to either trade deflection or retaliation. Therefore, in the absence of Doha, multilateralization of preferences is the practical route that is most likely to deliver the greatest benefits to members. The fact that most of the ASEAN+6 countries have already concluded, or are in the process of concluding, FTAs with their main trading partners (see Menon 2014) suggest that the time is ripe to consider multilateralization—there is little point in holding out for a small residual set of countries, especially when full utilization cannot be assured, but trade diversion and deflection are real risks.

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