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Executive Summary 2006

NEW ZEALAND AND THE DEVELOPING FTA ARCHITECTURE OF THE ASIA-PACIFIC REGION

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Robert Scollay
APEC Study Centre
University of Auckland

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THE ASIA-PACIFIC REGION IN NEW ZEALAND'S OVERSEAS TRADE

The Asia-Pacific Economic Cooperation (APEC) economies account for just over 70 percent of New Zealand's trade and the Asia-Pacific region as a whole accounts for about 75 percent of New Zealand's exports. These percentages have been relatively stable for several years. The share of exports going to Northeast Asia has tended to decline in recent years, while the share of exports going to North America increased from 1997 through to 2002. Over the last decade there has been a steady decline in New Zealand's share of the import market in several key markets in the western Pacific, including Australia, Japan, Korea and China.

PREFERENTIAL TRADE IN THE ASIA-PACIFIC REGION: WHAT HAS BEEN HAPPENING?

Since 1998 there has been a dramatic explosion of interest and activity in preferential trading arrangements (PTAs) in the Asia-Pacific region. In the last five years at least 18 PTAs between APEC members have been concluded, with at least a further 20 under negotiation. A full list of these initiatives is given in Table 5 of the full report. All but two of the concluded agreements are bilateral free trade agreements (FTAs). A number of others are at various stages of study or discussion, and in some of these cases the opening of negotiations is believed to be imminent. Adding in the five agreements that were already in existence in the region before 1999, a realistic assessment of current initiatives suggests that there could be over 40 PTAs operating in the APEC region in the near future, possibly more. This is in addition to the PTAs that APEC members have been pursuing and concluding with partners outside the APEC region.

At least one of the partners in these FTA initiatives is invariably a smaller economy. The trends observed in the bilateral FTAs include:

- Those smaller economies in a position to do so have given priority to negotiating FTAs with the major economies of the region. One consequence is that the major economies are emerging as “hubs” in a series of “hub and spoke” configurations of FTAs in the region. The US is emerging as a global “hub”.
- Some smaller economies, notably Chile, Singapore, Mexico and to a lesser extent Thailand clearly have a strategy of seeking FTAs with all their significant trade partners.
- In terms of regional orientation, the bilateral FTAs are a mixture of intra-East Asian FTAs, trans-Pacific FTAs, and FTAs linking East Asia and Australasia.
- A powerful “domino effect” is in operation and can be expected to continue to propel the proliferation of FTAs in the Asia-Pacific region for some time to come.

New Zealand’s FTA with Singapore was the first of the new agreements to be concluded.

Since then New Zealand has concluded an FTA with Thailand and the Trans Pacific Strategic Economic Partnership (TPSEP), establishing free trade between Chile, New Zealand, Singapore and Brunei Darussalam. The TPSEP will operate in parallel with the FTA with Singapore.

New Zealand is in the process of negotiating FTAs with China and Malaysia, and is negotiating jointly with Australia for an FTA with the full ASEAN group, which includes Singapore, Thailand, Malaysia and Brunei Darussalam.

The new FTAs in the region generally provide for eventual elimination of tariffs and other barriers on the majority of goods and on a high proportion of trade, although they nevertheless vary in the percentage of goods and services on which barriers are eliminated, the period over which the elimination takes place, and the use of supplementary measures such as safeguards and tariff rate quotas.

In New Zealand’s FTAs the timetabling of the removal of tariffs ranges from immediate in the FTA with Singapore to a phased elimination over 20 years in the FTA with Thailand. Rules of origin in the new agreements in the region are often complex and there is at least anecdotal evidence that in some cases they may have a restrictive effect on trade. Many of the new agreements also contain provisions on matters such as services trade, investment, competition policy, government procurement and intellectual property as well as dispute settlement. However, there is considerable variation in the extent to which these provisions impose substantive obligations on participants. There is no services chapter in New Zealand’s agreement with Thailand and no investment chapter in the TPSEP.

In parallel with the proliferation of bilateral and some plurilateral FTAs in the region, processes have also been operating that aim at wider regional integration. Two visions of region-wide integration are now in play in the Asia-Pacific region. One vision is of an integrated Asia-Pacific region, embracing both sides of the Pacific. This vision has been pursued through APEC, which in 1994 set out a goal of free trade and investment in the Asia-Pacific region. APEC is characterised by voluntary, non-binding processes and an emphasis on non-discriminatory liberalisation.

The other vision, pursued in East Asia since 1998, is of an integrated East Asian region, based on the “ASEAN-Plus-Three” group comprising China, Japan, Korea and the ten members of the Association of South East Asian Nations (ASEAN). A third vision, of Asia-wide integration embracing East Asia and South Asia, has begun to be promoted in some quarters. The future role of the East Asian Summit in relation to trade initiatives is unclear at this point.

Difficulties in the economic and in some cases also the political relations between the major powers of the region are a key obstacle to the realisation of either of these visions. In East Asia the principal obstacle lies in the China-Japan relationship and there are also significant problems in the Japan-Korea and China-Korea relationships. In addition to these relationship issues, problems in the US-China and US-Japan relationships are also important obstacles to wider integration across the Asia-Pacific region. There are also important obstacles to closer East Asia/South Asia integration, including relationship difficulties within South Asia as well as East Asia and divergences between East Asian and some South Asian governments in approaches to trade liberalisation.

Rivalry between the major East Asian economies has led them each to pursue separate “ASEAN Plus One” trade initiatives: ASEAN-China, ASEAN-Japan and ASEAN-Korea. China and Korea have from the beginning emphasised FTA negotiations with ASEAN as a group, although Korea in particular has also negotiated bilaterally with some ASEAN members. Negotiations for an ASEAN-China FTA in goods

have been completed and the ASEAN-Korea FTA has now apparently also been concluded. Japan on the other hand focused initially on negotiating bilateral FTAs with individual ASEAN countries and is only now beginning to give serious consideration to negotiation of an FTA with ASEAN as a group.

ASEAN has welcomed the “ASEAN Plus One” initiatives as an opportunity to place itself at the centre of evolving trade arrangements in the region. ASEAN’s difficulty in maintaining cohesion among its members in negotiation with the “Plus One” partners has, however, constrained its ability to take full advantage of the opportunity. ASEAN’s negotiations with Australia and New Zealand, and with India, represent further extensions of the “ASEAN-plus” approach.

East Asia is now looking further a field in spreading its FTA linkages, including to South Asia and Europe. A number of initiatives to promote closer East Asia/South Asia linkages are under way. Some East Asian and South Asian governments can be expected to continue pressing for further development and strengthening of these linkages.

While there are several tendencies at work in the evolution of the PTA architecture of the Americas, one clear result is the growing number of Latin American countries, including some that are direct competitors of New Zealand, that enjoy preferential access to New Zealand’s important export markets in North America, especially the US and Mexico.

New Zealand and Australia have tended to “shadow” each other in negotiating PTAs with the same partners. The major divergence has been Australia’s success and New Zealand’s failure to date in securing an FTA with the US.

A Free Trade Area of the Asia-Pacific (FTAAP) has been proposed by the APEC Business Advisory Council (ABAC), but appears unlikely to proceed in the near future, due to lack of support by major APEC economies.

THE SPREAD OF PTAs AND NEW ZEALAND'S INTERNATIONAL TRADING ENVIRONMENT

The rush to preferential trading arrangements in the Asia-Pacific region is radically changing the international trading environment in which New Zealand must operate.

The traditional mainstays of New Zealand's trade policy, WTO (World Trade Organisation) and APEC, have both lost momentum as instruments of trade liberalisation. This is an unfortunate development for New Zealand, because the non-discriminatory approach to liberalisation enshrined in the WTO and emphasised in APEC provides small countries like New Zealand with the best assurance that international markets will be opened in a way that maintains their competitive position relative to competing exporters. New Zealand's interests are also served by an effective WTO dispute settlement mechanism, by the existence in the WTO of a comprehensive framework for dealing with agricultural trade issues and by the inclusion in APEC of all its major trading partners with the exception of the European Union.

New Zealand may now be entering a period where most liberalisation that occurs in the region will take place on a preferential basis, with little or no offset from non-discriminatory liberalisation through the WTO or unilateral liberalisation processes.

The challenge to New Zealand can usefully be divided into two parts. The first challenge is to take advantage of the market access opportunities available through PTAs. There is an important competitive dimension to this challenge.

Generally New Zealand's partners in these FTAs will be offering the same or similar access to a range of other partners as well, including New Zealand's competitors. Thus in many cases New Zealand will be maintaining rather than improving its competitive position in the markets of its new FTA partners. Some improvement for New Zealand might be possible if a competitor fails to secure access to one of New Zealand's partners, or if New Zealand secures more advantageous terms than its competitors in some respects, but there is of course also the risk that it will be the competitors who secure the more advantageous terms.

The second challenge is to manage situations where New Zealand is unambiguously disadvantaged by new PTAs. These situations arise obviously where New Zealand's competitors secure an FTA with a partner that proves unwilling to negotiate an FTA with New Zealand, as in the case of Australia's FTA with the US. Less obviously they arise also where competitors gain access to the Australian market, where New Zealand was for many years the only APEC member to receive preferential access on a duty-free basis. New Zealand's preferential access to the Australian market is being progressively eroded as more and more partners secure FTAs with Australia.

A “scorecard” of New Zealand’s position to date in the evolving preferential trade architecture of the Asia-Pacific region reads as follows:

- New Zealand is facing the progressive erosion of its preferential position in the Australian market (20 percent of exports) as new partners conclude FTAs with Australia. This trend is likely to continue.
- New Zealand has achieved market access parity, or is negotiating for market access parity with a wide range of competitors in several Asia-Pacific markets. This market access parity has already been achieved in Singapore, Thailand, and Brunei and is being sought with China and Malaysia through bilateral negotiations and with Philippines and Indonesia through joint negotiations with Australia for an FTA with ASEAN. New Zealand has also placed an FTA proposal before Mexico. These economies together account for 14 percent of New Zealand exports
- As a result of its inability to secure an FTA with the US, New Zealand is unambiguously disadvantaged in the US market relative to Australia and several other competitors that have concluded FTAs with the US. This disadvantage was softened somewhat by the relatively unfavourable terms granted to Australia by the US. Further disadvantage is likely as additional partners conclude FTAs with the US. The US accounts for 14 percent of New Zealand exports.
- In Japan and Korea New Zealand is already at some disadvantage from existing FTAs, and risks significant disadvantage if those countries conclude FTAs with partners more directly competitive with New Zealand, such as Australia. Japan and Korea account for 16 percent of New Zealand exports.

- New Zealand does not currently face significant competitive threats from new FTA activity by Canada, Hong Kong or Taiwan, although the older North American Free Trade Agreement (NAFTA) does of course provide preferences in the Canadian market for the US and Mexico over other trading partners such as New Zealand.

ESTIMATES OF ECONOMIC EFFECTS OF ASIA-PACIFIC PTAS

Quantitative estimates of the impact on New Zealand and its partners of anticipated future preferential trading developments in the Asia-Pacific region have highlighted the following points:

- New Zealand will benefit economically from the proposed New Zealand China FTA and ASEAN–CER FTA (AANZFTA), but the benefit will be diluted by other preferential trading developments occurring in the region at the same time.
- Other preferential trading developments likely to occur in the region will have adverse economic effects on New Zealand, which can be offset by the New Zealand China FTA and AANZFTA.
- The cost to New Zealand of failure to realise the New Zealand-China and ASEAN-CER FTAs will in all likelihood not be limited to simply foregoing the potential welfare gains from these agreements, but is likely also to include greater vulnerability to economic damage from other PTA developments involving East Asian economies. In effect the New Zealand-China and ASEAN-CER FTAs represent a form of insurance for New Zealand against the possibility that it could be disadvantaged by being left out of East Asian preferential trading developments.

- For many East Asian economies the welfare effects of prospective new preferential trading developments in the East Asia region, whether positive or negative, are much larger than the welfare effects on New Zealand. East Asian economies thus have much more at stake than New Zealand in the new preferential arrangements under consideration. The economic impact on East Asian economies of New Zealand participation in these arrangements is generally minor, although there are of course deep sensitivities over agricultural trade in several East Asian economies.
- The new preferential trading arrangements in East Asia will give rise to significant adjustments across New Zealand industries. Other developments in the region would still give rise to such adjustments even if New Zealand did not successfully conclude the New Zealand-China FTA and AANZFTA.
- The new preferential arrangements will also have a significant impact on New Zealand's patterns of bilateral trade with countries in the region.

NEGOTIATING ISSUES

In the negotiation of new preferential trading arrangements with East Asian partners New Zealand's "defensive agenda" of avoiding exclusion from the emerging preferential trading architecture of East Asia should be viewed as being of at least equal importance with the "positive agenda" of creating new market access opportunities.

Negotiations for the New Zealand China FTA and AANZFTA will inevitably be difficult, but it is important for New Zealand that they be successfully

concluded, both for the economic benefits they will provide and as steps towards avoiding exclusion from the evolving East Asian preferential trade architecture.

If these two negotiations can be successfully concluded, Japan and Korea will be the remaining East Asian markets where New Zealand is potentially vulnerable to the granting of preferential access to its competitors, including Australia. These two countries account for almost half of New Zealand's exports to East Asia. Agriculture is obviously a major factor inhibiting any willingness on the part of Japan and Korea to negotiate FTAs with New Zealand. The recently launched US-Korea FTA negotiations should be closely watched for signs of a breakthrough in Korea's approach to agricultural trade liberalisation and any "spill over" from this to attitudes in Japan.

Proposals for an FTA covering East Asia, Australia, New Zealand and India should be welcome to New Zealand. It remains unclear, however, whether East Asian economies will give serious practical support to such a proposal. At present East Asian attention is focused more on the proposed East Asian FTA (EAFTA), which excludes Australia and New Zealand.

Rules of origin become a vitally important negotiating issue in a world or region of multiple PTAs. If the benefits offered by trade agreements are to be realised it is important that rules of origin should be as straightforward and non-restrictive as possible. In an environment of multiple FTAs it would obviously encourage beneficial trade to take place if a common set of preferential rules of origin could be agreed, provided the foregoing criteria are satisfied.

Much attention has been given to the so-called “spaghetti bowl” – the phenomenon of multiple overlapping and intersecting PTAs with rules of origin and possibly other provisions as well that are inconsistent with each other. The concern is over the compliance and other transactions costs imposed on businesses facing different rules in each of their export markets, which may prove especially onerous for small and medium sized enterprises (SMEs).

The divergence that has emerged between ASEAN and CER (Closer Economic Relationship) approaches to rules of origin is potentially a significant problem. ASEAN, like CER in the past, favours a Regional Value Content (RVC) approach, and seeks acceptance from its partners of the apparently liberal 40 percent RVC requirement with full cumulation that has been established for Asean Free Trade Area (AFTA).

Australia and New Zealand on the other hand have become converted to the view that rules based on change in customs classification (CTC) are much to be preferred as trade-facilitating rules because of the greater certainty that they provide. The two countries are in the process of changing the CER rules of origin to a CTC basis, and are strongly advocating CTC rules for future FTAs in which they are involved.

It has to be said that Australia and New Zealand’s advocacy of the superiority of CTC rules is tarnished somewhat by the restrictive rules applied to products sensitive to themselves in their agreements with Thailand and TPSEP. In these agreements rules for many textile and garment

products for example combine a CTC rule with a restrictive 55 percent RVC requirement in Australia’s case and a 50 percent RVC requirement in the case of New Zealand.

It is very important for the facilitation of future trade with New Zealand’s prospective preferential trading partners that the issues surrounding the relative merits of RVC-based and CTC-based rules be resolved, and that the approach to rules of origin adopted in future FTAs should be as trade-facilitating as possible.

Another potentially important issue is the extent to which market access within FTAs is impeded by regulatory differences between the partners. Where this is the case it is important that as part of the negotiating process the regulatory authorities in the respective partners should be brought into contact with each other, for the purpose of resolving the problems that have been identified.

THE “AUSTRALIA FACTOR”

It has become standard practice for Australia and New Zealand to go their own ways in negotiating parallel but separate bilateral FTAs with the same partners. Maintaining parallelism in FTA partners obviously assists in managing the risks associated with the fact that New Zealand and Australia are direct competitors in a number of markets. At the same time this practice is potentially disadvantageous for New Zealand because of Australia’s greater attractiveness as an FTA partner, due to its much greater market size and the wider range of products that it continues to protect. The disadvantage would be compounded to the extent that Australia in its preferential trade negotiations sought to actively advantage itself relative to New Zealand.

The principle divergence to date has been Australia's success and New Zealand's failure in securing an FTA with the US. Looking to the future, New Zealand would also be significantly disadvantaged, possibly more so than in the case of the US, if Australia were to secure FTAs with Japan and Korea while New Zealand did not.

The two countries are now negotiating jointly with ASEAN. However it will clearly be difficult now to persuade Australia to adopt as standard practice the negotiation of FTAs jointly with New Zealand, although in principle there would appear to be no insurmountable obstacle to this, as the ASEAN-CER case illustrates.

In the meantime a practical measure that the two countries could adopt, which would safeguard existing trans-Tasman integration, would be to reach agreement to negotiate for cumulation to be extended to each other in the rules of origin of their respective FTAs with third parties.

IMPLICATIONS FOR APEC

Although the rapid embrace of preferential trade by APEC members runs counter to the APEC vision, APEC has been powerless to prevent these developments. Instead APEC has turned its attention to identifying the properties of FTAs in the region that would be consistent with the achievement of APEC's Bogor goals.

A set of "best practice guidelines" for design of FTAs was adopted by APEC leaders at their 2004 meeting. APEC officials have now embarked on a programme for developing "model FTA chapters" to be offered for adoption by APEC members on a voluntary basis.

Two possible ways forward that have been identified for APEC members are the negotiation of an APEC-wide FTA, the Free Trade Area of the Asia-Pacific (FTAAP), and the progressive expansion of the membership existing bilateral arrangements, along the lines pioneered by the TPSEP. There is as yet no consensus within APEC in support of the former proposal, while it remains to be seen whether the latter approach will be supported by the larger APEC economies.

AREAS FOR FURTHER WORK

A number of areas for further work emerge from the report:

- As part of the ongoing development of New Zealand's FTA strategy it is important to identify where New Zealand might be most vulnerable to FTA activity by its competitors, to monitor the emergence of threats that might expose those vulnerabilities, and to formulate effective responses to those threats.
- Japan and Korea are key gaps in New Zealand's current FTA initiatives. The obstacles to FTAs with both countries are well-known, but it is important to continue monitoring possible opportunities for progress as well as competitor activity directed towards FTAs with those two countries.
- Promotion of more inclusive approaches to PTA architecture in the Asia-Pacific region is very much in New Zealand's interest. Two avenues currently receiving attention are the proposed FTAAP, and expansion of the membership of existing initiatives along the lines pioneered by the TPSEP. Research directed towards supporting both these approaches should be strongly supported by New Zealand.

- It is important to explore opportunities for greater coordination of FTA activity with Australia, despite the difficulties of doing so. One possibility suggested in the report is the development of a common approach to rules of origin that would involve cumulation and would safeguard rather than undermine the existing degree of integration achieved between the two countries. Another possibility that could be explored is the establishment of a customs union with Australia, although it is recognised that this might prove difficult in practice.
- Assessment of the provisions for liberalisation of services trade, both in New Zealand's FTAs and FTAs entered into by its competitors is a major undertaking. The pilot study by Sherry Stephenson of Pacific Economic Cooperation Council (PECC) offers an approach that could be extended to additional sectors and FTAs.
- There is an urgent need for additional work aimed at improving the approach to rules of origin in New Zealand's FTAs with East Asian (and other) partners. At least four lines of enquiry need to be pursued:
 - There has been much anecdotal but little hard empirical evidence on the costs imposed on business by the "spaghetti bowl" effect. Detailed work in this area is urgently needed. It is already known, however, that in some cases the costs are high enough to deter business from utilising available FTA preferences, preferring to export and import at Most Favoured Nation (MFN) duty rates instead. The extent both of the additional costs and of the resulting non-utilisation of preferences need to be quantified.
 - There is an urgent need for a definitive assessment of the relative merits of CTC-based and RVC-based rules of origin. If the assessment favours CTC-based rules, then Australia and New Zealand should not only continue to press for their adoption in AANZFTA but also should also endeavour to persuade ASEAN of the merits of switching to this approach in other agreements as well. If RVC-based rules are shown to be substantially inferior it would be very unfortunate if they became further entrenched as the standard approach to rules of origin in FTAs involving East Asian economies.
 - If CTC-based rules are to be advocated there is also a need to assess the precise form of CTC rules that should be adopted. The combination of CTC-based and RVC-based requirements used for some products by Australia and New Zealand in their agreements with Thailand is clearly not desirable if the aim is to facilitate trade, but it may be that the CTC-only rules used for other products in those same agreements could provide suitable models. In general there are likely to be differences between products as to the precise form of CTC-rule that will be most suitable in each case.
 - Once the TPSEP has entered into force it will be useful to assess the experience of allowing New Zealand and Singapore exporters to choose between alternative rules of origin for their exports to each other. If the experiment proves successful it may offer a way out in a situation where a change in approach is considered desirable, but where it is also difficult to change the existing rules.