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Business Issues

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

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The Asia-Pacific Region in New Zealand's Overseas Trade

The 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 therefore 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, although 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 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.

Challenges for Business in the New 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, the World Trade Organisation (WTO) 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 new environment poses important challenges to New Zealand business. One challenge is to assess and utilise the opportunities offered by new FTAs entered into by New Zealand. In some cases FTAs will open up new opportunities that did not exist before. Often, however, 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. Thus the challenge for New Zealand business involves not only extracting whatever advantage is available from new FTAs, but also taking steps to avoid falling behind competitors from other countries that are also following the FTA route.

A second challenge is to deal with 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.

The Australia-US FTA (AUSFTA) illustrates both dimensions of this second type of challenge. Most attention has been focused on the resulting potential threat to New Zealand's exports. The availability of duty-free access to the US market for Australian but not New Zealand exports confronts New Zealand exporters with the choice between losing business to their Australian competitors or lowering their prices in order to remain competitive.

For products with access to the US market controlled by quotas, expansion of the quota allocated to Australia will in any case tend to drive down the US domestic market price, lowering returns to New Zealand exporters

while Australian exporters are compensated by the opportunity to increase their export volumes. Concerns on these grounds were partly but certainly not wholly allayed by the relatively unfavourable terms on which the US granted increased access to Australia for some products of interest to New Zealand. The access for beef and dairy products for example is phased in over 18 and 17 years respectively, with special safeguards in the case of beef and tariff rate quotas in the case of dairy products continuing to apply beyond the end of those periods.

This latter experience highlights the more general point that the economic damage to New Zealand of PTAs negotiated by its competitors is likely to be less if those agreements are "dirty". There is a tension between New Zealand's preference for "high quality" PTAs in its own agreements and the likelihood that "high quality" PTAs negotiated by its competitors will be more economically damaging to New Zealand.

A less-noticed result of AUSFTA (which would arise regardless of whether New Zealand secured an FTA with the US) is that New Zealand manufacturers will lose the preferential advantage they have hitherto enjoyed over US manufacturers in the Australian market. A study undertaken for NZ Treasury¹ on the effects of the AUSFTA on New Zealand concluded that the negative effect of the AUSFTA would be "much greater on New Zealand's exports to Australia than on exports to the US, suggesting that the loss of preferences in the Australian market is of greater significance for New Zealand exports than the intensified competition from Australia in the US market".

Consistent with this finding, the sectors in New Zealand whose exports would be most adversely affected by the AUSFTA were found to be textiles and clothing and "other manufacturing". Further competitive pressure on New Zealand exports to Australia – easily New Zealand's largest single export market - is applied with each new FTA that Australia negotiates with a new partner. New Zealand business must plan ways to address the likely ongoing erosion of the preferences they have traditionally enjoyed in the Australian market.

A further negative impact of the AUSFTA on New Zealand arises through its rules of origin, which discriminate against the use of inputs sourced from New Zealand in products to be exported to the US under the AUSFTA preferences. Food products with dairy product ingredients for example must use only Australian milk if they are to be exported to the US under the AUSFTA preferences, whereas previously products containing milk from either country would have entered the US under the same US most favoured nation (MFN) duty rates.

This is a classic example of how a new FTA may undermine the degree of integration already achieved under an existing FTA. Even where the rules of origin in other FTAs do not explicitly affect the use of New Zealand-

¹ Scollay, R. (2002) "The Impact on New Zealand of a Free Trade Area Between Australia and the United States", report for NZ Treasury and Ministry of Foreign Affairs and Trade.

sourced inputs, a rule based on regional value content (RVC) for example may still discourage the use of New Zealand inputs if their use increases the difficulty of complying with the rule.

One further potential negative effect of AUSFTA on New Zealand is the diversion of investment from New Zealand to Australia to take advantage of the latter's preferential access to the US, in some cases motivated also by the desire to avoid problems with rules of origin of the kind outlined in the preceding paragraph. This is in effect one of the defences open to New Zealand business to overcome discrimination arising from FTAs negotiated by competitor countries.

It is important to consider both New Zealand's defensive agenda as well as its positive agenda toward new FTA initiatives. The benefits of the FTAs currently being negotiated with China and ASEAN are likely to be significant but the costs of being excluded from the evolving East Asian preferential trading architecture would also be substantial. One dimension of the proposed New Zealand-China and ASEAN-CER FTAs is that they 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.

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) agreement does of course provide preferences in the Canadian market for the US and Mexico over other trading partners such as New Zealand.

Business can assist in prioritising New Zealand's future FTA efforts by identifying the potential partner that offers the most attractive opportunities for New Zealand exporters and also by identifying where New Zealand exporters might be most vulnerable to FTA activity by its competitors as well as monitoring the emergence of threats that might expose those vulnerabilities.

The Rules of Origin Issue

Rules of origin become a vitally important negotiating issue in a world or region of multiple PTAs. It is now well understood that rules of origin can be as important as, or even more important than, tariff elimination in determining the effective degree of market access offered within an FTA. New Zealand business has a long experience of rules of origin issues in its dealings with Australia under the closer economic relationship (CER).

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. Achieving this result should be a key objective in all of New Zealand's FTA negotiations. 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 common rules satisfy the criteria just set out.

An important issue relating to the choice of rules of origin has emerged in the FTA negotiations with ASEAN. ASEAN continues to favour rules of origin based on regional value content (RVC), although it has introduced rules based on change in tariff classification (CTC) as an option for some products. RVC-based rules are familiar to New Zealand business from the long and often unsatisfactory experience of their use in CER. The rules of origin in the ASEAN Free Trade Area (AFTA) require an RVC of 40 percent, with full cumulation among ASEAN members, as against the 50 percent RVC that was required in CER. RVC-based rules were also used in the New Zealand-Singapore FTA.

The preference for RVC-based rules was based on their apparent simplicity. More recently, however, Australia and New Zealand have fallen into line with the increasingly widely-accepted view that the apparent simplicity of RVC-based rules is generally an illusion and that CTC-based rules provide greater certainty and are thus more trade-facilitating.

Australia and New Zealand are accordingly in the process of changing the basis of the CER rules of origin to CTC and CTC-based rules have also been introduced in their respective agreements with Thailand and in the TPSEP. The two countries now have the difficult job of persuading ASEAN that CTC rules rather than the RVC-based rules that they have hitherto considered

“best practice” are the appropriate model for the ASEAN–Australia and New Zealand Free Trade Area (AANZFTA). In the meantime ASEAN has been pressing its other FTA partners and prospective partners to accept 40 percent RVC-based rules, with varying degrees of success. China and apparently Korea have fallen into line, but Japan is still considering whether to deviate from the 60 percent RVC-based rule that it has insisted upon in its bilateral FTA negotiations with individual ASEAN members. Negotiations between ASEAN and India are reported to have broken down at least temporarily over the rules of origin issue.

Business is in the best position to judge the relative merits of different types of rules of origin. If business agrees that CTC-based rules are preferable, it should strongly support New Zealand government efforts to persuade ASEAN on the same point. 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. There are likely to be differences between products as to the precise form of CTC-rule that will be most suitable in each case and business input on this point should be very helpful for negotiators

One problem with New Zealand’s current approach to rules of origin, which tends to undermine its case for adoption of trade-facilitating rules of origin, is the rather restrictive approach taken to rules of origin for products sensitive to itself in its FTA with Thailand and in the TPSEP. For many textiles and clothing products the rules of origin in these agreements combine the CTC rule with an RVC requirement of 50 percent. Australia has adopted an even more restrictive approach in its FTA with Thailand where a CTC rule is combined with an RVC requirement of 55 percent for a similar range of textile and garment products and the combination of a CTC rule with an RVC requirement is also used for a wide range of other manufactured products. Arguments for more trade-facilitating rules of origin would be strengthened if the restrictive aspects of the rules of origin in these existing agreements could be dropped in future negotiations.

There is also scope for Australia and New Zealand to work together to ensure that the rules of origin in their respective FTAs with other partners do not undermine the integration of the two economies under CER, which did happen to some extent with the Australia-United States Free Trade Agreement (AUSFTA), as already noted above. Such problems could usefully be addressed by an agreement between the two countries to negotiate for cumulation to be extended to each other in the rules of origin of their respective FTAs with third parties.

In the case of RVC-based rules this would mean that New Zealand content would be treated as equivalent to Australian content for purposes of claiming origin under the rules of origin in Australia’s FTAs, and similarly Australian content would be treated as equivalent to New Zealand content in New Zealand’s FTAs. In the case of CTC based rules it would mean that the requirement would be applied to the change between the tariff classification of the exported finished product and the tariff classification of inputs imported into either Australia or New Zealand.

Another issue raised by the proliferation of FTAs in the Asia-Pacific region is 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 benefits to New Zealand exporters from FTAs with multiple East Asian partners, for example, could be partly negated if they have to satisfy different rules in each market.

One of the most acute versions of the “spaghetti bowl” in the Asia-Pacific region is that currently being faced by individual ASEAN economies that have been negotiating bilateral FTAs with several trading partners. Exporters in these economies may have to satisfy different rules of origin in each of their agreements or prospective agreements with Japan, the US, China, Korea, Australia, New Zealand, and India.

The “spaghetti bowl” facing New Zealand exporters is not yet as tangled as this. The rules in CER differ from those in the FTA with Singapore, and both of these differ from the rules in the FTA with Thailand and the TPSEP. Once the TPSEP comes into force New Zealand exporters to Singapore will apparently have the choice of using either the TPSEP rules or the rules in the original FTA with Singapore. As further PTAs are negotiated, however, New Zealand can expect to face demands from its prospective partners for an increasing variety of rules of origin.

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 MFN duty rates instead. The extent both of the additional costs and of the resulting non-utilisation of preferences needs to be quantified. Business is in a position to make an important contribution to the gathering of information on this issue.

If in fact the “spaghetti bowl” is shown to be a significant problem for business this would add to the concern over the divergent approaches now being taken to rules of origin by ASEAN and the CER countries. It would be desirable to reach agreement within the region on a standard approach to rules of origin. This would involve a choice between the RVC-based and CTC-based approaches, followed by agreement on how the chosen approach is to be applied in practice. If the RVC-based approach favoured by ASEAN is shown to be substantially inferior to the CTC-based approach it would be very unfortunate if it became further entrenched as the standard approach to rules of origin in FTAs involving East Asian economies.

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