

# 1. Introduction and overview

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## 1.1 AIM OF THE BOOK

The 1995 creation of the World Trade Organization – as an institutional extension of the General Agreement on Tariffs and Trade (GATT) – held out the promise of an effective, rules-based world trading system where all countries were treated alike. In addition to establishing a global judiciary for trade disputes, the WTO was expected to provide a forum for trade negotiations and undertake other related functions. Progress on the judiciary side has been brilliant, but the negotiation promise is largely unfulfilled (Hoekman and Kostewei 2010).

The world trading system is in a state of flux characterized by new developments and uncertainties about global trade governance under the WTO. Fundamental changes are occurring because of the rise of emerging economies (such as Brazil, Russian Federation, India, People's Republic of China, and South Africa – the BRICS), the expansion of international production networks and supply chains, signs of new commercial and industrial policies, and the proliferation of free trade agreements globally. These developments are all here to stay but the WTO has not kept up with them. Furthermore, the WTO Doha Round has been going on for more than a decade. Despite being the longest multilateral trade talks in history, it shows little sign of concluding comprehensively anytime soon. The WTO's centrality in global trade governance is eroding and risks continuing to erode.

The profound nature of these developments has prompted a debate on the future shape of the world trading system and the rules governing trade (Hufbauer and Cimino 2013; Trebilcock 2014; WTO 2013). The chapters in this book, written by leading Asian and international trade experts, conduct a broad and comprehensive examination of key changes taking place in the world trading system and traces policy implications for Asia. The links among global production networks and supply chains, national commercial and industrial policies, and the governance of global and

regional trade are also explored in the book. Also, the book offers lessons for other regions.

The chapters cover several specific issues:

- stylized patterns, measurement, and participants of global production networks and supply chains;
- the economic effects of commercial and industrial policies pursued by countries;
- the evolving architecture of regional trade governance characterized by the spread of FTAs and attempts at consolidation into large region-wide agreements; and
- the state of global trade governance centered on the WTO and proposals for reform.

Given Asia's economic importance in the world economy, how it thinks and acts on these issues will likely influence the future shape of the global trading system. As the former Director-General of the WTO, Pascal Lamy, writes in the Foreword to this book:

Asia has been a successful model of development through trade, which has inspired many others around the world. There is no doubt that the region will continue to inspire the trade community in the next decades to come.

With its significant economic and trade weight in the global economy, Asia is expected to shoulder more responsibilities and take the lead in the global trading system in the future.

This book is timely. Roberto Azevedo became the new Director-General of the WTO in May 2013 and began to facilitate intense negotiations among WTO members on the Doha agenda. At the 9th WTO Ministerial Conference in Bali, in December 2013, WTO members agreed on a set of issues covering trade facilitation, agricultural subsidies, and cotton, as well as development and least developed country issues. The so-called 'Bali package' is the first tangible result from the Doha Round since it was launched in December 2001 and has given multilateralism a small boost. However, uncertainties remain in multilateral trade negotiations on wider issues under the WTO. The Bali package is only distantly related to the core of the 2001 Doha negotiating agenda. Furthermore, what little of the original Doha agenda that could be done was done in Bali. This suggests that the WTO risks drifting for the foreseeable future, and WTO centrality in world trade governance may continue to erode.

The chapters in this book arose from a conference on the future of the world trading system held at the WTO in Geneva in March 2013 organized by the Asian Development Bank Institute and the Centre for Trade

and Economic Integration at the Graduate Institute of International and Development Studies, in collaboration with the WTO. Summaries of these chapters, along with pieces by other trade experts, were published in a VoxEU e-book (Baldwin et al. 2013).

## 1.2 GLOBAL PRODUCTION NETWORKS AND SUPPLY CHAINS

One important factor underlying the growth of trade and investment, and the resulting regional economic integration in Asia, is the formation of global production networks and supply chains, particularly the growth of vertical intra-industry trade in parts, components, other intermediate goods, and finished manufactured products (OECD, WTO, and UNCTAD 2013). The increasing share of Asia's trade in intermediate goods has been aided with improvements in physical infrastructure and logistics services, rapid developments of information and communication technology, and falls in trade barriers and trade costs, all of which have helped expand trade and foreign direct investment.

As Richard Baldwin notes in Chapter 2 entitled 'WTO 2.0: governance of global supply-chain trade', the formation of global production networks and supply chains has changed the center of gravity of the world economy. Globalization since the 1990s has been accompanied by a steep rise in shares of world output and world trade of developing countries that have achieved industrialization by joining supply chains. The major gainers were Asia's emerging economies – including the People's Republic of China (PRC), Indonesia, the Republic of Korea, and Thailand – which were part of supply chains of the United States, Germany, and Japan. The chapter argues that the WTO has not kept up with the need for new rules governing the intertwining of trade, investment, intellectual property, and services. Bringing these rules to the multilateral level needs the creation of a new international organization: a 'WTO 2.0'.

The world trading system will have to take better account of the formation of global and regional supply chains as this phenomenon alters how countries interact with each other through trade and FDI. In addition, the assembly of intermediate products into final products for export shipment means that imports matter as much as exports for trading nations, which implies a strong complementary relationship in economic activity among countries that are part of these value chains.

Better trade policy-making in this context requires more accurate data, using innovative measurement of trade flows based on value added, rather than gross commercial values as recorded in conventional trade statistics,

to identify the national content of imports and exports. Recent work (e.g., Koopman et al. 2014) suggests an accounting framework that decomposes national gross exports into various value-added components by source and additional double-counted terms. In Chapter 3, entitled ‘Trade in value added: concept, development, and an East Asian perspective’, Satoshi Inomata argues that the recent Asian International Input–Output Table facilitates the mapping of patterns of trade in value added between countries engaged in global production sharing arrangements. Among other benefits, the trade in value added approach avoids multiple counting of trade flows and allows a more realistic depiction of bilateral trade in the light of global production sharing. The trade in value added approach provides fresh insights on thorny international issues like the size of the United States’ trade deficit with the PRC. The chapter points out that using the trade in value added approach, the United States’ trade deficit with PRC is lower than conventional trade statistics show.

Furthermore, better trade policy-making also requires the use of micro-level data from enterprise surveys to understand the role of different firms in production networks. Firms are considered different in terms of efficiency as well as fixed and variable costs when involved in production networks. Accordingly, firm heterogeneity (or firm-specific characteristics) shapes the participation in production networks. In Chapter 4, entitled ‘Joining the supply chain: a firm-level perspective’, Ganeshan Wignaraja undertakes a comparative, firm-level analysis of joining the supply chain in five Southeast Asian economies to improve our understanding of fragmentation of manufacturing across borders in Asia. He suggests that firm size (reflecting economies of scale to overcome entry costs) matters for joining supply chains, with large firms playing the dominant role in Asia. Meanwhile, small and medium-sized enterprises make a small contribution to supply-chain activity relative to the sector’s employment or GDP contribution in Southeast Asian economies. However, firm size is not the whole story. Efficiency – particularly investment in building technological capabilities and skills – and access to commercial bank credit also influence joining supply chains. The chapter suggests that governments can facilitate SMEs joining supply chains through a market-oriented strategy for SMEs, modern physical infrastructure, streamlined bureaucratic procedures, and good quality business support services.

### 1.3 COMMERCIAL AND INDUSTRIAL POLICIES

Several factors have been critical in Asia’s successful outward-oriented industrialization and structural transformation. A favorable world

economy – notably, a booming world economy which stimulated demand for labor-intensive imports from Asia and falling tariffs in developed country markets – provided the impetus. Developing Asian economies had ample supplies of low-cost highly productive labor and were geographically close to an expanding developed Japanese economy. Efficient Japanese multinational corporations (MNCs) were actively seeking to move production to less costly locations in Asia. Through technology transfer and training, firms in host countries acquired manufacturing capabilities to become suppliers and subcontractors to MNCs. These efforts were supported at individual economy levels by outward-oriented development strategies, high domestic savings rates, creation of strong infrastructure, and investment in human capital. Outward-oriented development strategies often emphasized gradual import liberalization and a strong export promotion (using various incentives for exports and export processing zones, among others).

As participation in global value chains is increasingly prevalent in Asia, there is growing interest in how the benefits from participation are distributed among countries and enterprises. At the national level this is related to the pursuit of development objectives such as poverty reduction, job creation, better productivity, technological upgrading, and economic diversification. Some economies have added industrial policies – with a plethora of incentives to encourage specific industrial sectors or particular geographical locations – to their outward-oriented policy framework. Patrick Low and Julia Tijaja, in Chapter 5 entitled ‘Effective industrial policies and global value chains’, examine a variety of approaches to industrial policy. They suggest that some are more promising than others in the context of global value chains. The size of domestic markets, resource endowments and country-specific circumstances are crucial to determining opportunities. Furthermore, the chapter argues that implementation of industrial policy carries the risk of government failure which may be mitigated by developing solid government capabilities (technical, analytical, and operational) and forging close relations with the private sector and non-state actors.

Since the global financial crisis of 2008, protectionist tendencies have been on the rise in some economies including within Asia. In Chapter 6, entitled ‘Mapping crisis-era protectionism in the Asia and Pacific region’, Simon J. Evenett argues that while there are many ways to implement protectionism, several governments have implemented what are called ‘murky forms of protection’. These do not involve a direct violation of WTO obligations, but represent an abuse of the policy discretion that discriminates against foreign goods, services, firms, and workers. Examples include the use of health and safety regulations to restrict imports, export taxes on

native food and resources to keep them at home, clauses in stimulus packages that confine spending to domestically produced goods and services, and 'green protectionism' that subsidizes domestic firms only. The implications of these measures for trade policy are clear. As the world economy recovers, policy makers should resist temptations for protectionism and unwind these discriminatory measures. In the medium to long term, the chapter argues that policy makers may wish to initiate negotiations on new rules on public procurement, export taxes, and other less-transparent forms of protection.

The multilateral trading system of the future will have to address important global issues that are not addressed under WTO rules. The blurring between trade policy and other policies, such as climate change and exchange rate policies, will require the attention of policy makers. For the efficiency gains from trade to translate into reduced greenhouse gas emissions, the right environmental context must be set for trade. Appropriate pricing is vital to bolster incentives to consume low-carbon products and use low-carbon technologies. For example, putting the right price on carbon will provide a clear market signal in reducing the consumption of fossil fuels and making low-carbon technologies commercially viable. If this is difficult, a subsidy may be provided for firms, whether domestic or foreign, that produce low-carbon goods and services or utilize low-carbon technologies.

The international monetary system needs to facilitate the free flow of international goods and services and cross-border investment. The system must be supported by stable exchange rates consistent with the underlying fundamental economic conditions. Policies to maintain undervalued exchange rates over an extended period can, like tariffs and trade subsidies, distort trade by making the country's exports artificially competitive and imports less attractive. Countries are advised to avoid such trade-distorting exchange rate policies as they have negative consequences not only for the trading partners but ultimately for the countries concerned. In Chapter 7, entitled 'Exchange rate policy and regional trade agreements: a case of conflicted interests?', Victor Pontines and Richard Pomfret argue that formation of a large number of FTAs in Asia means that trade policy is less effective than in the past and countries are tending to use exchange rate policy more. Within FTA blocs, countries are tending toward exchange rate stability. However, some countries even within FTA blocs are using exchange rate depreciation as a beggar-thy-neighbor form of exchange rate protectionism. The chapter suggests that this is harmful to others and implies the need for some coordination and monitoring mechanism within FTA blocs.

## 1.4 REGIONAL TRADE GOVERNANCE

Regional trade governance has become an increasingly important issue in the world trading system in recent years. Free trade agreements are spreading globally, including in Asia. Many Asian economies have embarked on FTA negotiations with their trading partners, both within Asia and outside. The move toward FTAs in Asia is linked to the need to remove impediments to broadening the spread of global and regional supply chains, the intensification of FTA activity in Europe and the Americas, and slow progress in the WTO Doha Round trade talks. Today, Asia is a world leader in FTAs. This has sparked concerns (for example, Bhagwati 2008) about the erosion of the WTO trading system and the Asian 'noodle bowl' (multiple and possibly conflicting FTAs).

In Chapter 8, entitled 'Policy challenges posed by Asian free trade agreements: a review of the evidence', Masahiro Kawai and Ganeshan Wignaraja review patterns of FTAs in Asia and examine key policy challenges faced by Asian economies. They argue that maximizing the benefits of Asian FTAs while minimizing their costs would be highly pragmatic as FTAs seem here to stay. These challenges include their use, scope, and impact on regionalization trends. This analysis supports strengthening business support for FTAs, rationalizing rules of origin and upgrading their administration, expanding coverage of agricultural and services trade, forging comprehensive 'WTO-plus' agreements, and encouraging a region-wide FTA. The chapter suggests a bottom-up approach to global trade liberalization as a complement to WTO processes. Kawai and Wignaraja argue for the consolidation of multiple FTAs into a single Asia-wide FTA starting with the Regional Comprehensive Economic Partnership. A broad-based, region-wide FTA to be formed by 16 East Asian countries could help mitigate the harmful noodle bowl effects. It could simplify schedules for tariff reductions, exclusion lists, and the myriad rules, regulations, and standards.

Shujiro Urata, in Chapter 9 entitled 'Constructing and multilateralizing the Regional Comprehensive Economic Partnership: an Asian perspective', examines the patterns of commitments in trade liberalization in goods in ASEAN's FTAs with major regional economies and points out that the construction of the RCEP within a short period of time may be difficult because of differences in patterns of tariff elimination and definitions of rules of origin adopted in such agreements. The chapter argues that a practical way forward for trade liberalization under the RCEP is for a gradual approach in tariff elimination and a co-equal approach in rules of origin.

ASEAN – viewed as the driver of the process of regional economic

integration in Asia – embarked on an ambitious project to form an ASEAN Economic Community (AEC) by 2015 including a single market and production base. In Chapter 10, entitled ‘The ASEAN Economic Community: progress, challenges, and prospects’, Siow Yue Chia assesses ASEAN’s efforts at achieving an ASEAN Economic Community by the desired target of 2015. Encouragingly, intra-ASEAN tariffs have been virtually eliminated and trade facilitation improved which have resulted in the growth of intra-ASEAN and extra-ASEAN trade. Furthermore, the ASEAN Comprehensive Investment Agreement was ratified in 2012 and may spur inward investment. Nonetheless, further progress is needed in other areas such as eliminating non-tariff barriers and liberalizing restrictions on services trade. The chapter concludes that there is general acceptance in ASEAN policy circles that the achievement of the AEC project will extend beyond 2015 as residual measures will take time to implement.

Some question whether ASEAN centrality in driving Asian regional integration will persist in the future in a changing trade policy landscape in Asia. The emergence of an alternative mega regional integration scheme, the Trans-Pacific Strategic Economic Partnership (TPP), may have raised concerns, at least among some experts, about the future relevance of ASEAN centrality and also the prospect of a future clash between the TPP and the RCEP.

However, those concerns can be addressed squarely. By focusing on the creation of the AEC and undertaking the needed domestic structural reforms, ASEAN can retain its centrality. Countries which are negotiating members of both the RCEP and the TPP – such as Japan, Singapore, and Malaysia – can ensure that the two initiatives are consistent with each other and are open to new membership. The RCEP and the TPP are key processes to create a larger Asia-Pacific FTA, which would require successfully addressing the difficult task of forging a US–PRC agreement in the future. The two processes are not mutually exclusive and will likely prove to be complementary. A harmonious Asia-Pacific would likely see a convergence of the RCEP and the TPP. This would be a win–win outcome for the Asia-Pacific community.

## 1.5 GLOBAL TRADE GOVERNANCE

International trade rules and institutions can have profound and lasting effects on the shifts and redefinition of trade relationships in Asia and globally. The responsibility for global trade governance has rested with the WTO since its creation in 1995, and its membership had grown to 159 countries by March 2013. The WTO’s central function is to



provide a forum for international trade negotiations which result in WTO agreements. The WTO's other functions include administering WTO agreements, monitoring national trade policies, and providing technical assistance and training for developing countries. The slow progress in the WTO Doha talks means that new multilateral trading rules will take time to evolve amid calls for WTO reforms.

Biswajit Dhar, in Chapter 11 entitled 'The future of the World Trade Organization', assesses prospects for the Doha Round and the future work program for the WTO. The focus of the negotiations, which commenced in November 2001, was lower trade barriers in agriculture and non-agricultural market access (NAMA). The talks stalled in 2008 largely over a divide on major issues such as agricultural subsidies, industrial tariffs and non-tariff barriers. Furthermore, some key players seem to have been preoccupied with domestic economic issues since the economic downturn after the global financial crisis and have given less attention to the trade talks. The chapter points to two challenges for the future. One challenge faced by the global community is to assess the key developments in the Doha Round which have contributed to the present stalemate. Another is to develop a new program for the WTO to tackle behind-the-border issues relevant to fragmented production systems and supply chains particularly, trade facilitation, investment policy, and non-tariff barriers.

The narrow negotiating agenda and slow progress of the WTO Doha Round may be partly due to the nature of the WTO's decision-making mechanism and its underlying principles of consensus and single undertaking. Michitaka Nakatomi, in Chapter 12 entitled 'Plurilateral agreements: a viable alternative to the World Trade Organization?', explores the role of plurilateral agreements which focus on rule making and liberalization on single trade issues. An example is the Information Technology Agreement (ITA) with an open accession clause. Plurilateral agreements permit interested parties to freely choose the issue for an agreement and voluntarily participate in the negotiations. The chapter argues that well-designed issue-based plurilateral agreements can serve the needs of like-minded developed and developing countries alike, enhance the spread of FDI-driven global supply chains, and complement rule-making in the WTO and FTAs. Services, trade facilitation, and electronic commerce may be candidates for future issue-based plurilateral agreements.

Foreign direct investment flows are fundamental to the spread of global production networks but, while barriers to goods trade have typically fallen over past decades, barriers to FDI remain high including in Asia. Apart from the usual issues relating to non-national treatment of foreign firms, protectionist tendencies and national security considerations seem

to be driving new restrictions on FDI. Yunling Zhang and Rongyan Wang, in Chapter 13 entitled 'The role of foreign direct investment flows and a possible multilateral agreement', discuss the importance of FDI to sustaining global growth, the conditions generating new restrictiveness on FDI, and policy options. New Asian FTAs emphasize national treatment of FDI and more liberal FDI rules, and international organizations have developed good practice guidelines for FDI, but this seems insufficient. According to the analysis in the chapter, a case emerges for an eventual multilateral agreement on investment covering transparency on investment rules and investor facilitation, ideally housed in the WTO.

## 1.6 CONCLUSIONS

The world trading system has changed fundamentally over past years with the expansion of production network and supply-chain trade, adoption of new commercial and industrial policies, and the spread of FTA-led regionalism. These developments are all likely to stay but the WTO has not adjusted to cope with them. The WTO's centrality in global trade governance is eroding and risks continuing to erode. The rise of Factory Asia through supply-chain trade has placed it increasingly at the heart of the global economy. The region is also experimenting with new approaches to FTAs and economic policies to sustain economic growth amid a fragile world economy.

Asia's experience of open trade-led development offers many valuable lessons for other regions. These include the importance of pursuing market-friendly trade and industrial policies to develop supply-chain trade, improving surveillance of non-tariff measures, and consolidating FTAs into a single large region-wide FTA. Using more accurate data to measure value-added trade and participants in supply-chain trade (for example, small firms) provides empirical insights for policy development.

In the longer term, better coherence is vital between Asia's regional trade rules and global trade governance. Improving the quality of large Asia-wide FTAs, a WTO agenda on supply chains and FTAs, and significant reforms of the WTO are necessary moves toward this end. Issue-based plurilateral agreements and an eventual multilateral agreement on investment can also play a role in facilitating coherence between regional and global rules on trade.

The debate on global and regional trade governance in the new era is a work in progress and we hope that this book will better inform the search for policy options. We look forward to further policy commentary and analysis as they arise.

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