

## Mega-Regionalism in Asia and Its Implications for Europe

### ABSTRACT

The rise of mega-regionalism in the Asia-Pacific has become a significant development for the region itself as well as the global trading system. Europe, in particular, has a great deal at stake in this process. This paper considers the economic costs of EU exclusion from Asia-Pacific economic cooperation initiatives.

**KEYWORDS:** mega-regionalism, Asia, European Union, Trans-Pacific Partnership, FTAs

### INTRODUCTION

Prior to 2000, there were actually few bilateral or regional trading arrangements in Asia, but the number rose substantially thereafter, from 30 accords signed and in effect as of 2000 to 147 today.<sup>1</sup> Still, the vast majority of these agreements are bilateral free trade agreements (FTAs) and many of them overlap, resulting in the infamous “Asian noodle bowl” of crisscrossing trade accords. The bilateral nature of these agreements makes them of limited use in regional production networks, which is one reason most Asian FTAs have low utilization rates. Hence, in recent years, there has been a strong incentive to consolidate. Two major initiatives currently being negotiated include the Trans-Pacific Partnership (TPP) and the Regional Comprehensive Economic Partnership (RCEP).

The TPP is the most ambitious and in many ways the pioneer of this movement toward mega-regional agreements. It began in 2006 as an agreement between four small, outward-oriented economies—Brunei Darussalam,

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1. Asia Regional Integration Center, “Free Trade Agreements,” <<http://www.aric.adb.org/fta>>, accessed August 25, 2016.

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Chile, New Zealand, and Singapore—but expanded greatly when the United States and other Asia-Pacific economies decided to build on it in a region-wide arrangement. It now includes 12 negotiating partners,<sup>2</sup> with a 13th—South Korea—in preliminary talks to join and several others (including Indonesia, the Philippines, Thailand, and Taiwan) expressing interest in doing so. China is conspicuously absent from the TPP, but in fact the Beijing government has considered the possibility of joining.<sup>3</sup> The TPP agreement was reached in October 2015 and signed in February 2016, giving the member countries up to two years to ratify it.

The TPP is a modern, comprehensive, “twenty-first-century agreement,” with an ambitious set of deep integration measures, from elimination of tariff and non-tariff barriers to trade to intellectual property protection, competition policy, cumulation of rules of origin, and even labor and environmental standards.<sup>4</sup> But as is the case with any trade agreement, the TPP accord reflects a compromise between provisions that genuinely advance integration and those that secure political support in the negotiating countries. Trade agreements are hammered out by policymakers. Hence, trade policy ultimately reflects political considerations, but even these can usually be designed to enhance trade and investment, or at least to be economically neutral. In any case, the potential advantages from integration (discussed below) are large enough to justify the necessary compromises.

The RCEP was created in November 2012 as an “ASEAN-centric” organization. Its membership includes all countries that have a bilateral FTA with ASEAN in effect (indeed, an FTA with ASEAN is a precondition for candidacy). Thus, in addition to the 10 ASEAN economies, it includes China, South Korea, Japan, India, Australia, and New Zealand. The RCEP held its 14th round of negotiations in August 2016. It had a deadline of end-2015 to complete the agreement—the same year that the ASEAN Economic Community was to be created—but much remains to be done, though arguably

2. Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, United States, Vietnam.

3. Peter A. Petri, Michael G. Plummer, and Fan Zhai, “The TPP, China and the FTAAP: The Case for Convergence,” in *New Directions in Asia-Pacific Economic Integration*, ed. Guoqiang Tang and Peter A. Petri (Honolulu: East-West Center, 2014), <<http://ssrn.com/abstract=2438725>>.

4. For a detailed evaluation of the agreement, see Cathleen Cimino-Isaacs and Jeffrey J. Schott (eds.), *Trans-Pacific Partnership: An Assessment*, Policy Analyses in International Economics 104, Peterson Institute for International Economics, Washington, DC, 2016.

the conclusion of the TPP provides an incentive to speed up the process. The objectives of RCEP are similar in many ways to the TPP: to create a region in which goods, services, foreign direct investment, and skilled labor would flow freely, but with greater “flexibility.” RCEP would be an ambitious, comprehensive FTA but with more flexibility in terms of trade-related domestic policies, particularly for developing economies. Product and sectoral coverage will also be more modest.

As all the negotiating countries already have FTAs in place with ASEAN, the most important missing piece in the RCEP puzzle is an agreement among China, Japan, and South Korea. These countries concluded a trilateral investment treaty that went into force in 2014, and they started negotiations on a trilateral FTA in November 2012 that has now held 10 rounds, the latest in June 2016. A China–South Korea FTA was ratified at the end of 2015. The relationship among these three countries historically has been fraught, and they continue to have a number of diplomatic disputes; the success of a trilateral FTA or even RCEP rests on their ability to handle these issues effectively.

The TPP and RCEP mega-regional agreements have the potential to transform not only intra-regional trade in the Asia-Pacific but, given their size and ambitions, the global trading system itself. Indeed, some chapters in the TPP, for example with respect to intellectual property rights, disciplines on state-owned firms, and rules governing the digital economy, are already being identified as possible industry standard-setters. The mega-regionalism trend in the Asia-Pacific is also leading to “competitive liberalization” globally. For example, the proposed Transatlantic Trade and Investment Partnership (TTIP) and EU–Japan FTA negotiations reflect in part a concern in the EU that its member countries are being excluded from the process.

The purpose of this paper is to gauge the economic implications of TPP and RCEP and consider the economic costs of EU exclusion from economic cooperation initiatives in the Asia-Pacific. The paper finds that, while on the whole the direct effects on the aggregate economy will be small and perhaps even positive, the EU could face significant trade diversion at the commodity level and risks losing influence in the setting of rules governing international trade. It considers possible policy responses, from initiatives under the WTO to its own regional accords such as the TTIP.

## ECONOMIC ESTIMATES OF THE EFFECTS OF TPP, RCEP, AND THE FTAAP: A GENERAL EQUILIBRIUM APPROACH

The economic estimates of the potential effects of these mega-regional arrangements are large. In previous work with Peter Petri and Fan Zhai,<sup>5</sup> we used a cutting-edge computable general equilibrium (CGE) model to estimate gains associated with RCEP and two TPP scenarios: TPP12, which is the current configuration of negotiators; and TPP16, which is TPP12 plus South Korea, the Philippines, Thailand, and Indonesia, the likely members in a subsequent enlargement phase of the TPP (Figure 1).<sup>6</sup> The basics of the CGE model can also be found at <<http://www.asiapacifictrade.org>>. We project liberalization of trade and investment barriers to be based on accords previously negotiated by leaders in these agreements, that is, the US for TPP and ASEAN for the RCEP. Given that US-based agreements tend to be far deeper and more comprehensive than ASEAN-based ones, the TPP scenarios include a more extensive liberalization template than the RCEP scenario. Changes are estimated relative to a baseline in which all previously negotiated agreements are included, thereby giving us marginal changes in economic activity attributable to TPP or RCEP.

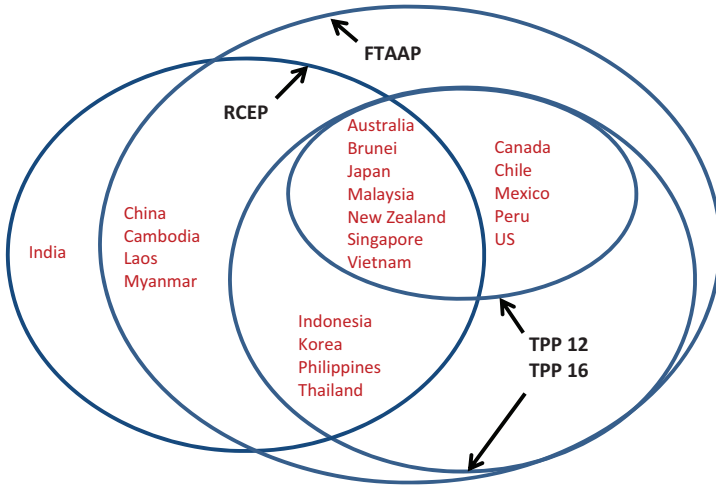
The results are given in Table 1. All scenarios produce substantial benefits: global income rises by US\$ 223 billion and US\$ 451 billion in the TPP12 and TPP16 scenarios, respectively. Hence, the addition of South Korea, Indonesia, the Philippines, and Thailand to the TPP more than doubles the aggregate gains. In large part, these sizable numbers are due to the latter three economies' not having an FTA in place with the US. Moreover, the lion's share of these gains is due to trade creation; trade diversion and preference erosion<sup>7</sup> come to about one-fourth the total gains in both TPP scenarios, with

5. Peter A. Petri, Michael G. Plummer, and Fan Zhai, *The Trans-Pacific Partnership and Asia-Pacific Integration: A Quantitative Assessment* (Washington, DC: Peterson Institute for International Economics, 2012).

6. For estimates of the effects of the TPP (only) based on an updated model and features of the actual TPP agreement, see Peter A. Petri and Michael G. Plummer, "The Economic Effects of the Transpacific Partnership: New Estimates," ch. 1 in PIIE Briefing 16-1, *Assessing the Transpacific Partnership: Volume 1, Market Access and Sectoral Issues*, Peterson Institute for International Economics, Washington, DC, 2016, pp. 6–30, <<https://piie.com/publications/briefings/piieb16-1.pdf>>.

7. "Trade diversion" refers to the displacement of more-efficient trading partners not party to a given FTA in favor of less-efficient partner country(s), which gain due to preferential treatment. Preference erosion is the reverse of trade diversion. For example, in the TPP estimates, China loses due to trade diversion, but South Korea, given that it already has an FTA in place with the US (and

FIGURE 1. RCEP, TPP, and FTAAP Tracks



SOURCE: Adapted from Peter A. Petri, Michael G. Plummer, and Fan Zhai, “The TPP, China, and FTAAP: The Case for Convergence,” Ch. 6 in *New Directions in Asia-Pacific Economic Integration*, ed. Tang Guoqiang and Peter Petri (Honolulu: East-West Center, 2014).

China bearing the greatest share of the burden (but less than 0.5% of Chinese GDP). All participating economies benefit from the TPP. In absolute numbers, Japan and the US tend to be the biggest beneficiaries, but relative to GDP the outward-oriented ASEAN economies of Vietnam (14%) and Thailand (8%) gain the most under TPP16.

The EU faces very little trade diversion: welfare declines by US\$ 4 billion and US\$ 5 billion under the TPP12 and TPP16 scenarios, respectively. This is a negligible amount given that in 2025 the EU economy is forecast to be almost US\$ 27 trillion. In fact, given that many TPP liberalization and harmonization measures will be applied in a non-discriminatory manner to all countries, rather than to TPP partners alone (e.g. customs, other trade-facilitation-related measures, regulatory transparency, and intellectual-property protection), the EU could actually benefit. Assuming that 20% of non-tariff-barrier liberalization under TPP12 applies to all countries, we estimate in our updated model that the EU would gain from the actual TPP

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some other TPP members), loses in part because it will no longer have preferential treatment in the US market.

TABLE I. Income Effects of TPP Scenarios, RCEP, and FTAAP

	2025 baseline GDP	2025 change from baseline (US\$ billions)				2025 change from baseline (%)			
		TPP12	TPP16	RCEP	FTAAP	TPP12	TPP16	RCEP	FTAAP
<b>Americas</b>	<b>24,867</b>	<b>101.7</b>	<b>160.8</b>	<b>2.5</b>	<b>452.3</b>	<b>0.4</b>	<b>0.6</b>	<b>0.0</b>	<b>1.8</b>
Canada	1,978	8.7	12.4	-0.1	31.4	0.4	0.6	0.0	1.6
Chile	292	2.5	3.5	0.0	8.6	0.9	1.2	0.0	3.0
Mexico	2,004	9.9	31.2	2.8	76.3	0.5	1.6	0.1	3.8
Peru	320	3.9	5.4	0.0	7.7	1.2	1.7	0.0	2.4
US	20,273	76.6	108.2	-0.1	328.2	0.4	0.5	0.0	1.6
<b>Asia</b>	<b>34,901</b>	<b>125.2</b>	<b>299.8</b>	<b>627.0</b>	<b>1653.4</b>	<b>0.4</b>	<b>0.9</b>	<b>1.8</b>	<b>4.7</b>
Brunei	20	0.2	0.4	1.2	1.4	0.9	1.8	5.8	7.1
China	17,249	-34.8	-82.4	249.7	837.1	-0.2	-0.5	1.4	4.9
Hong Kong	406	-0.5	-1.3	46.8	118.8	-0.1	-0.3	11.5	29.3
India	5,233	-2.7	-6.9	91.3	-37.1	-0.1	-0.1	1.7	-0.7
Indonesia	1,549	-2.2	62.2	17.7	60.3	-0.1	4.0	1.1	3.9
Japan	5,338	104.6	128.8	95.8	233.1	2.0	2.4	1.8	4.4
Korea	2,117	-2.8	50.2	82.0	132.7	-0.1	2.4	3.9	6.3
Malaysia	431	24.2	30.1	14.2	44.7	5.6	7.0	3.3	10.4
Philippines	322	-0.8	22.1	7.6	22.5	-0.2	6.9	2.3	7.0
Singapore	415	7.9	12.3	2.4	26.5	1.9	3.0	0.6	6.4
Taiwan	840	-1.0	-6.4	-16.1	83.8	-0.1	-0.8	-1.9	10.0
Thailand	558	-2.4	42.5	15.5	43.7	-0.4	7.6	2.8	7.8
Vietnam	340	35.7	48.7	17.3	81.1	10.5	14.3	5.1	23.9
ASEAN	83	-0.4	-0.5	1.6	4.6	-0.4	-0.6	1.9	5.5
<b>Oceania</b>	<b>1,634</b>	<b>10.7</b>	<b>14.6</b>	<b>21.7</b>	<b>39.4</b>	<b>0.7</b>	<b>0.9</b>	<b>1.3</b>	<b>2.4</b>
Australia	1,433	6.6	9.8	19.8	32.5	0.5	0.7	1.4	2.3
NZ	201	4.1	4.7	1.9	6.9	2.0	2.4	0.9	3.4
<b>Others</b>	<b>41,820</b>	<b>-14.1</b>	<b>-24.2</b>	<b>-6.8</b>	<b>213.4</b>	<b>0.0</b>	<b>-0.1</b>	<b>0.0</b>	<b>0.5</b>
Europe	22,714	-3.7	-4.9	5.1	-40.9	0.0	0.0	0.0	-0.2
Russia	2,865	-1.4	-3.0	-5.3	339.5	0.0	-0.1	-0.2	11.9
ROW*	16,241	-9.0	-16.3	-6.6	-85.2	-0.1	-0.1	0.0	-0.5

(continued)

TABLE I. (continued)

	2025 baseline GDP	2025 change from baseline (US\$ billions)				2025 change from baseline (%)			
		TPP12	TPP16	RCEP	FTAAP	TPP12	TPP16	RCEP	FTAAP
<b>WORLD</b>	<b>103,223</b>	<b>223.4</b>	<b>450.9</b>	<b>644.4</b>	<b>2358.5</b>	<b>0.2</b>	<b>0.4</b>	<b>0.6</b>	<b>2.3</b>
<i>Memorandum</i>									
TPP12	33,045	285.0	395.6	155.1	878.6	0.9	1.2	0.5	2.7
TPP16	37,591	276.9	572.6	277.9	1137.9	0.7	1.5	0.7	3.0
RCEP	35,290	137.4	322.1	617.9	1490.2	0.4	0.9	1.8	4.2
APEC	58,951	239.2	479.5	553.0	2517.1	0.4	0.8	0.9	4.3

SOURCE: Peter A. Petri, Michael G. Plummer, and Fan Zhai, *The Trans-Pacific Partnership and Asia-Pacific Integration: A Quantitative Assessment* (Washington, DC: Peterson Institute for International Economics, 2012).

\* ROW = Rest of World.

agreement by US\$ 48 billion (0.2% of GDP) by 2030.<sup>8</sup> Still, as we note in our partial equilibrium analysis below, the disaggregated sectoral effects could be negative and, in some cases, significant.

The RCEP scenario generates larger gains than the TPP scenarios, in particular due to the liberalization of trade among China, India, Japan, and South Korea and other factors such as the cumulation of rules of origin. The total increase in income is estimated to be US\$ 644 billion, or 2% of Asian GDP, relative to the baseline projections. Trade diversion is very small, at 1% of the total gains; in fact, given the associated growth and terms of trade effects, some excluded economies, including the EU, actually benefit from RCEP. As expected, the biggest beneficiaries in absolute terms are the large countries without bilateral FTAs with each other in the block: China, Japan, South Korea, and India.

As a final scenario, we consider the effects of an APEC-wide Free Trade Area of the Asia-Pacific (FTAAP), which is an explicit goal articulated at the November 2010 APEC Summit in Yokohama, Japan (hence the sobriquet Yokohama Vision).<sup>9</sup> Indeed, at that meeting, APEC leaders endorsed the

8. Petri and Plummer, "Economic Effects."

9. The 2010 APEC Leaders' Declaration at Yokohama ([http://www.apec.org/meeting-papers/leaders-declarations/2010/2010\\_aelm.aspx](http://www.apec.org/meeting-papers/leaders-declarations/2010/2010_aelm.aspx)) does not specify which countries would be included in

TPP and an “Asian track” (which has emerged as the RCEP) as pathways to this ultimate goal. At the Beijing APEC Summit in November 2014, a major two-year “collective strategic study” was launched to consider modalities that the FTAAP might embrace, as well as its economic costs and benefits.<sup>10</sup> In general, the idea would be to create an ambitious, comprehensive, inclusive, outward-oriented FTA that would begin negotiations in 2020. As is clear from the estimates in Table 1, the gains from the FTAAP are far larger than for the RCEP and the TPP scenarios, coming to US\$ 2.4 trillion, or 2.3% of global GDP. This incremental increase exceeds estimates of even ambitious scenarios of multilateral liberalization under the Doha Development Agenda (DDA). The big gains, of course, derive from the fact that in the FTAAP the US and China—the first- and second-largest economies in the world—form an FTA with each other. Estimated gains to the US are US\$ 328 billion, more than four times its gains from the TPP16, and to China, US\$ 838 billion, more than three times its gains from the RCEP.

In the FTAAP scenario the EU takes a hit of US\$ 41 billion, or 0.2% of GDP, on par (relatively) with the negative effect of the TPP on the Chinese economy seen in Table 1. While much larger for the EU than in the TPP cases, this amount is still relatively small at the aggregate level (but, arguably, not insignificant).

In short, the mega-regional trend in the Asia-Pacific region is the result of a strong demand to reduce barriers to economic integration. Such deep integration has proven to be overly difficult—at least for the short-to-medium term—at the multilateral level, which is why success at the DDA has been so elusive despite more than 14 years of negotiations, the 2013 Bali “trade facilitation agreement” (not yet in effect) and the 2005 “aid for trade” initiative notwithstanding. We have shown that the TPP and RCEP could yield substantial benefits and could eventually lead to Asia-Pacific free trade. This is an important consideration for Europe.

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the FTAAP outside of APEC members, but its focus on building on existing undertakings that include non-members—e.g. India, Cambodia, Lao PDR, and Myanmar—suggests that the FTAAP membership could go beyond the existing membership. In any event, it will be negotiated outside of APEC, which is not a negotiating forum.

10. The study is due at the end of 2016. For details of the declaration, see APEC, “Annex A: The Beijing Roadmap for APEC’s Contribution to the Realization of the FTAAP,” November 2014, <[http://www.apec.org/meeting-papers/leaders-declarations/2014/2014\\_aelm/2014\\_aelm\\_annexa.aspx](http://www.apec.org/meeting-papers/leaders-declarations/2014/2014_aelm/2014_aelm_annexa.aspx)>.



## ECONOMIC ESTIMATES OF THE EFFECTS OF TPP, RCEP, AND THE FTAAP: A PARTIAL EQUILIBRIUM APPROACH

Most CGE studies note the limitations of their models, stressing their inability to effectively capture many of the dynamic effects associated with regional integration. This becomes increasingly problematic with high-quality FTAs, which focus much more on behind-the-border measures rather than traditional ones (e.g. tariffs alone). The models do a better job of identifying effects such as structural change and relative changes in factor returns for the integrating countries, as opposed to realistic estimates of welfare change.

Caveats notwithstanding, the CGE results may not present a pressing case to the EU in terms of the potential costs associated with staying outside the Asian integration process. Indeed, it would be hard to envision a different result, given the nature of CGE modeling: as Asian trade constitutes less than 10% of total EU trade, and Asian commercial policies are already liberal, one would not expect a priori that trade diversion could be high in the aggregate.

Still, sectoral effects may be important. In other words, if the bulk of the expected trade diversion effects were to fall on a few select sectors, the political-economy implications could be significant. A problem with CGE modeling is that many of the sectoral details are still at a highly aggregated level, whereas trade policy emanates from considerations at a disaggregated level. Hence, it would behoove us also to consider EU exports at the product level and match these against existing protection. In this section, we focus on data at the disaggregated Harmonized Commodity and Coding Systems (HS) six-digit level (HS6).<sup>11</sup> Specifically, we consider EU27 exports to major countries in Asia and for which we have appropriate 2012 data.<sup>12</sup> Fortunately, this includes almost the entire sample: we exclude only Brunei and the smaller ASEAN transitional countries (Cambodia and the Lao PDR). We do not include the 28th EU country—Croatia—because it joined the EU after 2012.

Arranging the data in an easy-to-grasp way is difficult. Even using a cutoff of US\$ 1 million, we find that in 2012, EU27 exported over 4,000 commodity lines to East Asian countries at the HS6 level. Hence, in order to focus on the most salient EU27 HS6 exports, we include in Table 2 all commodities

11. The HS-6 includes about 5,300 article/products grouped in 21 sections (<http://unstats.un.org/unsd/tradecb/Knowledgebase/Harmonized-Commodity-Description-and-Coding-Systems-HS>).

12. This section borrows from Michael G. Plummer, “Asian Regionalism and Its Implications for Europe ‘Post-Doha,’” *Asian Economic Papers* 13, no. 1 (2014), pp. 53–79.

TABLE 2. EU Exports to East Asia Exceeding US\$ 1 Billion and Tariffs Exceeding 3%

<i>Item</i>	<i>Code (HS)</i>	<i>Commodity description</i>	<i>EU-27 exports (US\$ millions)</i>	<i>Average tariff (%)</i>
<b>EU exports to China (2012)</b>				
1	870323	Vehicles for the transport of persons, exceeding 1,500 cc but not exceeding 3,000 cc	16,057	25.0
2	880240	Airplanes and other aircraft, exceeding 15,000 kg	7,107	3.0
3	870324	Vehicles of a cylinder capacity exceeding 3,000 cc	6,802	25.0
4	300490	Other medicaments	4,074	3.6
5	870840	Gear boxes and parts thereof	3,128	9.0
6	870829	Other parts and accessories of bodies for motor vehicles	2,047	10.0
7	853710	Bases for electric control or distribution, not exceeding 1,000 V	1,849	6.1
8	848180	Taps, cocks, valves & similar appliances for pipes / boiler shells / tanks / vats	1,288	6.7
9	870899	Other parts & accessories for motor vehicles	1,217	14.1
10	853890	Parts of switches, automatic circuit breakers, relays or connectors	1,100	7.0
11	270750	Aromatic hydrocarbon mixtures	1,067	7.0
12	903180	Other measuring or checking instruments, appliances and machines	1,063	5.0
13	271011	Light petroleum oils & preparations	1,041	7.0
14	845710	Machining centers for working metal	1,003	9.7
<b>EU exports to India (2012)</b>				
1	710231	Nonindustrial diamonds, unworked	9,225	10
2	880240	Airplanes and other aircraft, exceeding 15,000 kg	1,292	3
<b>EU exports to Japan (2012)</b>				
1	020329	Meat of swine, frozen	1,057	4.3
<b>EU exports to Korea (2012)</b>				
1	270900	Petroleum oils and oils obtained from bituminous minerals (crude)	3,190	3
3	848620	Machines and apparatus for the manufacture of semiconductor devices or of electronic integrated circuits	1,338	8

(continued)

TABLE 2. (continued)

<i>Item</i>	<i>Code (HS)</i>	<i>Commodity description</i>	<i>EU-27 exports (US\$ millions)</i>	<i>Average tariff (%)</i>
4	870332	Vehicles principally designed for the transport of persons, with C-I internal combustion piston engine (diesel/semi-diesel), of a cylinder capacity >1500 cc but not >2500 cc	1,320	8

SOURCE: Adapted from Michael G. Plummer, "Asian Regionalism and Its Implications for Europe 'Post-Doha,'" *Asian Economic Papers* 13, no. 1 (2014), pp. 53–79.

exceeding US\$ 1 billion, coming to a cumulative value of US\$ 66.3 billion. Our data for EU27 exports and tariffs mainly came from the UN Comtrade database and the WTO, respectively.

Our hypothesis is that if the EU27 were excluded from the process, Asian integration would cause trade diversion in sectors where protection of individual Asian markets is significant and the value of exports is large, assuming that there is competition in any given Asian market from integrating competitors. Given the size and diversity of the Asian integration process—and the fact that the US is actively linking into it—competition is essentially guaranteed, though the elasticity of substitution is obviously critical in determining the extent of potential competition. The larger the base export values, and the higher the levels of protection, and the larger the elasticity of substitution between EU27 and Asian producers (or partners), the greater the potential for trade diversion, *ceteris paribus*. We also include data for South Korea, despite the recent EU–Korea FTA, since the accord has not yet been completely implemented.

In addition, we maintain that, given the nature of modern FTAs, deep integration could lead to the diversion of exports away from the EU in favor of integrating countries, even in areas where protection is not high. Some analyses, which are consistent with the rest of the literature, suggest that reductions in behind-the-border barriers generate results that go well beyond mere tariff effects.<sup>13</sup> Such changes lead to important efficiency effects that will

13. Hiro Lee and Dominique van der Mensbrugge, "Regional Integration in Asia and Its Effects on the EU and North America," paper presented at the 18th American Committee on Asian Economic Studies Conference, Rimini, Italy, August 29–31, 2008; Petri, Plummer, and Zhai, *Trans-Pacific Partnership and Asia-Pacific Integration*.

naturally spill over into higher productivity. But they will also likely have the effect of reinforcing production chains and demand systems in Asia itself, or with integrating partners. For example, Japan and Singapore essentially have zero tariffs on electronic products, a result of both the WTO-based Information Technology Agreement of 1996 and the very open nature of their manufacturing sectors. However, the 2002 Japan-Singapore Economic Partnership Agreement is a modern, “new age” agreement that brings down many other costs to bilateral trade and economic interaction besides tariffs. This could place the EU at a disadvantage despite zero tariffs.

Moreover, the political economy of protection in the EU<sup>27</sup> is somewhat more complicated than in the case of other major economies. Although the EU has a common commercial policy and negotiates as a group, the fact that 27 nations are represented suggests that the configuration of interest groups is more complex. In particular, national interests can be brought into economic arguments more easily than, say, would happen in the case of the US. The passage of the UK referendum on leaving the EU (“Brexit”) in June 2016 is a case in point.

Turning to the results (Table 2), we note that discrimination in the Chinese market holds the greatest potential danger of trade diversion from the EU associated with the Asian economic integration process. Fourteen commodity groups register export values of greater than US\$ 1 billion and tariffs greater than 3%. The most important EU export to China (and to Asia in general) is HS 870323, transportation vehicles (with engine size 1500–3000 cc) at US\$ 16 billion, with high tariffs at 25%. Larger vehicles (greater than 3000 cc) also face 25% tariffs and come to US\$ 7 billion in value. EU exports of airplanes are also significant, coming to US\$ 7 billion, but face an average tariff of only 3%. Elsewhere in Asia, EU exports of non-industrial diamonds to India come to US\$ 9 billion and face a 10% tariff. While the value of EU exports to Japan is second only to China, the very low tariffs in Japanese manufactures suggest that potential trade diversion should be low (only frozen pig meat registers under our restrictions, and then only barely exceeding US\$ 1 billion, with a relatively low tariff of 4%).

Thus, potential trade diversion in the Asian markets due to regional integration is, perhaps, significant in a limited number of commodity groups, but these are important export categories.

Investment diversion might also be an issue. Investment diversion takes place when multinational companies invest in an FTA in order to take

advantage of barrier-free access within a given market. As protection in Asia is relatively low and multinationals invest in Asia mainly as part of a production-chain process rather than to “tariff hop,” this traditional interpretation of investment diversion is probably unimportant. However, if the rules of origin in a given Asian FTA are restrictive, this could give EU multinationals an added incentive to invest in Asia, rather than, for example, in other EU countries (or other regions).

In short, the disaggregated approach allowed us to identify a number of sectors that are of relevance in determining the “cost of disengagement” that the EU faces. While the outward-oriented nature of Asian development has brought down tariffs to relatively low levels, several sectors will be affected by trade diversion, perhaps significantly so. More important, we argue that the behind-the-border areas that will be addressed in any mega-regional arrangement in Asia could exacerbate the trade diversion effect where it exists, and cause a potential market shift away from the EU27 even in areas where border protection is negligible.

## **POLICY IMPLICATIONS**

Several policy conclusions emerge from this analysis. First, the efficiency effects of mega-regionalism will depend on the direction of commercial policy in the composite economies. There is no substitute for a strong, vibrant WTO. It is in the interests of both Asia-Pacific economies and the EU to ensure that liberalization continues to take place at the multilateral level, rather than just in the form of FTAs. Indeed, a deep, comprehensive DDA agreement would reduce the potential diversionary effects of emerging FTAs and would ensure the integrity of the multilateral system. Once it becomes politically possible to restart the talks, the EU and its Asian counterparts should do their best to bring the members of the WTO back to the negotiating table.

Second, we have used the generic term “FTA” without bringing in the importance of the characteristics of these agreements. The drawbacks of the “Asian noodle bowl” or “spaghetti bowl” effect are well known, particularly in terms of the complicated rules of origin that are included in these accords and the fact that they are inefficient in trying to meet the goal of facilitating production networks. EU–Asia accords that have been negotiated or are emerging are bilateral in nature, which would increase the size and complexity of the

“spaghetti bowl.” But this is not necessarily a reason for the EU to shun agreements with Asian countries. Rather, we suggest focusing on best practices in the agreement, an approach that we have called elsewhere “turning spaghetti into lasagna.”<sup>14</sup>

Third, it could well be that these bilateral FTAs will be overtaken by regional accords in the medium term. While multilateral approaches to trade liberalization are best, in general regional accords are superior to bilateral ones, particularly since they can overcome some of the negative effects of the spaghetti bowl, for example by reducing the costs of rules of origin and increasing the utilization rates of the FTAs. The TPP embraces cumulation and many aspects of economic harmonization; assuming it is ratified, it will constitute a key milestone in the mega-regionalism movement, particularly since it would prod RCEP countries to move more quickly toward reaching an accord and would be an important step forward in achieving the FTAAP. The EU should strive to be part of the process, not just to avoid potential trade and investment diversion—though these can be considerable in certain sectors, as noted above—or the direct gains of an FTA, but perhaps especially to be part of the process of “trade rule making” in light of the vacuum left by a failure of the DDA. As a comprehensive “twenty-first-century” agreement, the TPP has taken on a plethora of issues that have often been excluded from or glossed over in bilateral FTAs or in multilateral forums. These include state-owned enterprises, the digital economy, science and technology, and expanded rules on implementing intellectual property rights protection; the TPP could end up establishing global norms.

A concrete example might be in order. The Anti-Counterfeiting Trade Agreement (ACTA) was a major post-WTO Trade-Related Aspects of Intellectual Property Rights (TRIPs) agreement that was supported by major economies, including the US and the EU (and demonized by many NGOs). The European Commission, which is the single negotiating authority for the EU on trade matters, had signed ACTA, but in July 2012, the European Parliament vetoed it. The industry, therefore, is now counting on the TPP to create modern rules governing intellectual property rights as a benchmark. The European Commission was obviously not at the TPP table when the intellectual property rights standards were written.

14. Michael G. Plummer, “Best Practices in Regional Trading Agreements: An Application to Asia,” *World Economy* 30:12 (2007), 1771–1796.

Thus, while continuing to work on the DDA makes a great deal of sense, the mega-regionalism movement is picking up steam and will likely continue into the foreseeable future. It is worth concluding by underscoring the opportunities inherent in the TTIP in this context. We would argue that TTIP is in the interest of both the US and the EU, and ultimately the global trading system in general. The reasoning might have less to do with anticipated direct economic benefits that would accrue from such an accord—though these could be large—and more with the indirect benefits of deeper cooperation. In particular, the TTIP could contribute to a strengthening of EU–US leadership at the WTO, which in turn could help them kick-start and lead more effectively at the DDA. It would allow the US and the EU to show leadership in creating a modern “gold standard” FTA, which obviously would be easier to do in the case of EU–US than in the context of the TPP, given the similarities of interests and advanced production processes. For example, services trade, be it cross-border or through commercial presence, is a strong and growing part of the EU–US economic relationship. An EU–US accord could create a template for services, as well as in other areas such as competition policy, intellectual property protection, and the like.

Should the TPP be ratified (partners have until February 2018 to do so), we would expect it to give a political boost to the TTIP negotiations. While this is clearly speculative, if these two mega-regional agreements are successfully ratified, European firms will be able to benefit from the trans-Pacific integration process as well as trans-Atlantic integration. The cumulation of the rules of origin in the TPP will facilitate the development of production networks for European firms. Should this be the case, the EU will have succeeded in significantly reducing a potential source of trade diversion of Asia-Pacific economic cooperation.