

## New trade agreement in Asia: liberalisation in times of geopolitical rivalry

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# SWP Comment

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## New Trade Agreements in Asia

Liberalisation in Times of Geopolitical Rivalry

*Hanns Günther Hilpert*

With the signing of the Regional Comprehensive Economic Partnership (RCEP) on 15 November 2020, the announcement of the EU-China Comprehensive Agreement on Investment (CAI) on 30 December, and the prospects of enlarging the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), trade policy with and within Asia is gathering speed. In the greater East Asia region, consisting of Japan, South Korea, China and the Association of Southeast Asian nations (ASEAN), economic integration via trade, investment, supply chains and digital connectivity will accelerate. In contrast, regions that remain on the outside – i.e. North America, Europe and India – surely fear that trade flows will be diverted. At the same time, geopolitics have become a determining factor of trade policy. Any agreement also represents political positioning in the context of the Sino-American rivalry, or at least a reinsurance against the risks of economic or technological decoupling. What are the economic and political perspectives of these trade and investment agreements? What goals and strategies are the relevant actors pursuing? And what are the consequences for Europe's trade policy?

The remarkable economic success that East Asia has achieved in the past five decades has not been built on isolation and autarky. On the contrary, such high growth rates, rapid industrialisation and regional wealth creation would hardly have been possible without foreign trade and trade-related direct investment. Intra-Asian trade is now greater than Asia's trade with the rest of the world. In fact, Asia itself has become the world's largest trading region, with China as its natural centre. However, the foreign trade environment has fundamentally changed since the turn of the millennium, and hence the continuation of the region's

decades-long upward trajectory is now less assured than before.

### From Trade Policy to Geoeconomics

Whether, and if so, for how long the well-established Pax Americana security order can continue to secure Asia's geopolitical stability has become uncertain. While the US's role as a guarantor of regional peace continues to be highly esteemed by its local allies and trading partners, China is now the most important trade centre for all



countries in the region, and its share of the regional supply and sales markets continues to grow. At the same time, the “Middle Kingdom” is increasingly acting as a revisionist superpower. Beijing’s aggressive foreign policy shows that its political supremacy and growing military clout have heightened China’s willingness to assert its interests in a conflictual manner – quite brutally, if necessary – through the use of economic and military threats.

In general, trade policy, which is ostensibly oriented towards national economic interests, is increasingly dominated by foreign and security policy considerations. The USA is actively decoupling China in technologically sensitive areas and forcing allies and partner states to follow suit. The People’s Republic, in turn, is attempting to reduce its vulnerability as it strives for technological autonomy. Companies from third countries fear, with good reason, that they will be forced to choose sides in the course of this conflict. China and the USA aren’t shying away from using sanctions, boycotts and punitive tariffs as means of coercion in their foreign policies. Other countries, first and foremost Japan, are also shaping their trade policies strategically and are explicitly pursuing geopolitical agendas.

The shift towards geoeconomics is furthered by the progressive erosion of the multilateral framework espoused by the World Trade Organization (WTO). The WTO, founded in 1994, has so far only rudimentarily fulfilled its contractual obligation to liberalise multilateral trade. The Organization’s trade dispute settlement mechanisms have been on hold since December 2019, when the corresponding judges’ positions first went unfilled. What’s more, China continuously disregards fundamental principles such as non-discrimination, most-favoured-nation (MFN) treatment and transparency while the USA (under Trump) has repeatedly violated the Organization’s treaty. Both countries’ transgressions continue to be unaddressed by the WTO and its affected member states. At the same time, if trade law and liberalisation are not ad-

vanced by the WTO, then it is hardly surprising that Asia’s trading states – which are so dependent on the global economy – are making their own bilateral and multilateral arrangements. Interest in trade and investment, which stimulate development and growth, continues unabated in the region. However, this is now increasingly supplemented by elements of geopolitics in a structure-building manner.

### **RCEP – Trade Liberalisation “the ASEAN Way”**

With the Regional Comprehensive Economic Partnership (RCEP), the ten ASEAN countries together with Japan, China, South Korea, Australia and New Zealand will establish the largest free trade area in the world. The agreement will come into force as soon as it has been ratified by at least six ASEAN countries and three other partners. In terms of its sheer dimensions – encompassing 2.2 billion people and around 30 percent of world’s production and trade – the agreement can hardly be understated. For the first time, through RCEP, the G20 countries of Northeast Asia – Japan, China and South Korea – will also be linked in a trade agreement.

RCEP documents the centrality of the ASEAN community’s foundational contribution to the agreement, for which it took the initiative and lead. The immediate motive of the negotiations was to consolidate the existing “ASEAN+1 Free Trade Agreement” framework by incorporating all relevant parties under one arrangement. As a result, RCEP should not be considered a deep, ambitious trade agreement. The agreed upon standards – for example on intellectual property rights, services, investment and trade-related free movement of persons – are consistently weak and lack a future vision. Nonetheless, it was precisely this low level of ambition that made it possible to include developing countries, which were also granted individualised elongated transition periods and differentiated adjustments. This approach was in line with the

aspirations and objectives pursued by ASEAN, namely, to unite the states of the Indo-Pacific region in a large, open trade and investment area that promotes economic integration, growth and development while simultaneously integrating less developed states and counteracting the perceived divisive tendencies of the former Trans-Pacific Partnership (TPP) initiative. The signing of the agreement does not mark the end of negotiations. RCEP is to be open to accession by third countries, particularly India, which dropped out of the agreement at the last moment. Further development of the agreement's content is also planned. This is to be expected, as we know from past experience that ASEAN trade agreements start out weak, but then are successively improved upon and modernised. It is envisaged that an RCEP secretariat, which is yet to be established, will ensure that the agreement is continuously adapted and developed.

In terms of trade policy, liberalisation and facilitation of trade in goods are at the centre of the agreement. When it enters into force, 65 percent of RCEP's intra-trade will be duty-free, and after twenty years this figure should be at least 92 percent. However, liberalisation is not uniform. About half of the countries apply different tariff rates, depending on the RCEP trading partner. In addition, varying customs tariff systems apply. Nonetheless, customs clearance will be much simpler. For example, a single document covering several processing stages and border crossings will suffice to prove the origin of goods. Documentation of data accompanying the trade will be able to occur centrally, in RCEP member countries.

Tariff reductions outlined within the agreement mainly concern industrial, less agricultural, goods. While the ASEAN countries are barely reducing their already low bilateral external tariffs, the tariff reductions by China (and to a lesser extent South Korea) vis-à-vis Japan are quite substantial. This has caused some observers in Japan to even refer to RCEP as a "China-Japan free trade agreement". An immense facilitator

of trade will be seen in the uniform application of the comparatively easy-to-handle ASEAN rules of origin, which serve as proof that only goods from the RCEP free trade area, but not from third countries, benefit from tariff exemption.

With a reasonable amount of bureaucratic effort it will be possible to cumulate rules of origin over several stages of national processing. As a rule, the minimum value-added share on a "Free On Board" (FOB) basis is set at a modest 40 percent, which means a maximum share for supplies from third countries of 60 percent. According to a forecast by Euler Hermes, harmonising the information requirements and setting a uniform minimum value-added would save US\$90 billion in costs per year in intra-RCEP goods trade.

The American economists Peter Petri and Michael Plummer estimate that RCEP trade will increase by US\$500 billion per year after treaty implementation and that trade-related income will amount to US\$186 billion per year, with China accounting for about half of these figures and Japan for just under a quarter. Accordingly, Northeast Asia will benefit more from tariff reductions than Southeast Asia, Australia, and New Zealand. There are two reasons for this: first, Northeast Asia hosts the larger economies in absolute terms, and second, China and South Korea are making the biggest cuts to their tariffs. At the same time, trade gains are offset by trade diversions. Thus, from a dynamic perspective, the intensification of trade and investment links in the RCEP region is at the expense of trans-Pacific and Eurasian trade and investment flows, even if Asian branches of European or American companies benefit from the facilitation and liberalisation of trade in goods just as much as local businesses.

Likely to be even more important than its direct effects on trade is the agreement's impact on investment and the configuration of value chains. The combination of reduced tariffs, facilitated cross-border trade and standardised rules of origin will trigger a re-organisation of supply chains. This is all the more true as China – a major producer – is

already under pressure due to costs and American punitive tariffs while Beijing pursues a policy of economic and technological upgrading. The poorer countries in Southeast Asia — including Cambodia, Myanmar, Indonesia and the Philippines — could benefit from this, as these investment destinations must now meet new and harmonised RCEP standards.

### China Wins

The boost to economic integration provided by RCEP will benefit China in particular. RCEP and the complementary CPTPP agreement (see below) support national growth in the region and its external orientation towards the Chinese industrial core by enabling trade integration in an enlarged East Asia, thereby increasing the competitiveness of “Made in Asia” goods and services. The People’s Republic is thus likely to further expand its role as a regional centre of gravity and strength. Beijing’s Belt and Road Initiative further supports this trend because it creates economic dependencies that favour China. China’s position is also strengthened by the fact that the four-decade-long trend of higher economic growth in East Asia compared to other world regions will continue. This is all the more plausible considering that the region is coping comparatively well with the COVID-19 pandemic in terms of health policy and the economy, and will have to work through fewer structural distortions after this crisis.

China is also the political winner of RCEP. Indeed, political motives are likely to have prompted the country’s willingness to compromise. With the conclusion of the negotiations in the end of 2019, China proved that it could resist America’s efforts to contain and isolate it. The signing of the agreement in November 2020 represents regional accord, despite Beijing’s aggressive foreign policy towards some of its neighbours that same year.

### India Loses

India ultimately refused the RCEP compromise in November 2019, after 31 rounds of negotiations and 18 ministerial meetings. By not participating in the agreement, India is missing out on US\$60 billion in income annually, economists Petri and Plummer estimate. The country’s exclusion from Asia’s supply chains will have a lasting impact on the development and industrialisation of the Indian subcontinent. Politically, however, New Delhi’s decision is at least partly understandable. India’s federal government feared import competition from China (industrial goods), from Australia (dairy products) and from Southeast Asia (spices) and was not prepared to accept free trade in digital data and source codes. On the other hand, India could not push through its own demands, such as those for a snapback mechanism in the face of excessive imports of goods, for more restrictive rules of origin — which would protect its industry — and for a wider opening of RCEP services markets. Above all, liberalising trade in goods with China was and is politically unfeasible in the country. This is because India already has a high deficit here; the bilateral trade structure is perceived as colonialist, Chinese competition as unfair.

From the mid-1990s, New Delhi successfully pursued a policy of foreign trade liberalisation and global economic integration, but under Prime Minister Narendra Modi, a change of course has taken place. As the current economic policy guidelines “Make in India” and “Self-Reliant India” indicate, the development strategy is once again oriented inwards. Industrial policy has gained importance and external protections are increasing, especially vis-à-vis China.

### CAI – Prioritizing Market Access

Shortly before the end of 2020, the EU and China agreed on a Comprehensive Agreement on Investment (CAI) preceded by 34 tough rounds of negotiations over seven years. The prospect of a common Western

trade front had forced China to make decisive concessions shortly before the Biden administration took office. As a result, the CAI will substantially improve European companies' access to the Chinese market and make the playing field for investors in China a bit fairer and more rule-bound on an MFN-basis, while the EU's internal market remains open to Chinese investors. With the CAI, China renounces forced technology transfer and joint venture coercion, and promises transparency of state subsidies and state-owned enterprise regulations. In a sustainability chapter, Beijing also accepts best effort clauses to comply with environmental and labour standards. It has even promised to sign the conventions of the International Labour Organisation (ILO) on forced labour.

However, it is questionable whether, and if so, how stringently the CAI will be implemented. On the one hand, due to past negative experiences, there is great scepticism as to whether China will actually keep the promises it has made. At the very least, it will require strong political efforts on the part of the EU to press for active implementation in line with the agreement. On the other side of the coin, in view of fierce criticism of the CAI in Europe, it is uncertain whether the agreement will be signed at all during 2022's French EU Presidency, let alone be ratified by the European Parliament.

It is obvious that the EU is positioning itself as an autonomous trade policy actor that not only advocates for improved market access for European companies – extracting considerable concessions from China in the process – but also for a rules-based trade order that enforces its own regulatory standards. With the CAI, the EU is sticking to its policy of integration and interdependence vis-à-vis China in principle and is not seeking to decouple itself from the People's Republic, at least economically, even if political differences have grown in recent years.

However, this trade policy positioning comes at the cost of foreign policy credibility. Under Xi Jinping's reign, China has

hardened its authoritarian stance and, especially in the past year, pursued aggressive foreign policies towards Hong Kong, Taiwan, Australia, India and Sweden. In light of this, critics from European civil society, media and politics rightly see the EU's agreement with Beijing as opportunistic acceptance of Chinese realpolitik. By consciously and visibly deciding to prioritize market access, the EU loses political persuasiveness in claiming to represent the values of democracy, freedom, the rule of law and human rights vis-à-vis its "systemic rival" China. Moreover, the timing of the conclusion of the negotiations could hardly have been worse, immediately before the Democratic Biden administration took office and openly promoted a common China policy for the West. The CAI will not make it easy for Europe and the USA to find a unified position vis-à-vis Beijing. But this is most likely what China hoped to achieve with its concessions shortly before the end of Germany's EU Council Presidency. Now China can present itself as a responsible great power committed to multilateralism. For Europe, the bitter realisation remains that the EU has yet to find the right balance between its foreign economic interests and foreign policy aspirations.

### **CPTPP – on the Way to Enlargement**

In January 2017, under newly inaugurated President Donald Trump, the USA withdrew from the Trans-Pacific Partnership (TPP) agreement, which had been negotiated under American guidance and leadership. Nonetheless, the remaining eleven countries agreed to pursue the initiative without Washington. Indeed, on 8 March 2018, Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore and Vietnam signed the agreement under a new name, the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP, also TPP-11). 22 clauses were suspended – but not removed – from the original text of the agreement, mostly in

the area of intellectual property rights. The CPTPP entered into force on 30 December 2018 for Australia, Japan, Canada, Mexico, New Zealand and Singapore, and on 14 January 2019 for Vietnam. Brunei, Chile, Malaysia and Peru have not yet ratified the CPTPP.

Even without American participation, the CPTPP is the most important trade agreement since the foundation of the WTO in 1994. Its achievements include far-reaching liberalisations, ground-breaking development of trade rules and its strategic position as a spearhead of global trade liberalisation open to accession. For the EU, the CPTPP is equally partner, competitor and adversary in the international regulatory arena. The newly established United States-Mexico-Canada Agreement (USMCA) negotiated in 2017/2018 already used numerous CPTPP treaty clauses as a template.

The agreements reached in the CPTPP look to the future. Industrial and merchandise trade will be almost absolutely liberalised. When the agreement enters into force, 86 percent of tariff lines will be duty-free; after fifteen years, this figure will be 99 percent. Non-discrimination, MFN treatment, freedom of establishment and transparency are comprehensively and legally guaranteed for analogue and digital services. All relevant protection standards apply to investments. In cases of expropriation and discrimination, investor-states can pursue arbitration. The agreement's sustainability chapters commit signatories to ILO protection standards and relevant international environmental accords. With regard to state-owned enterprises, CPTPP members commit to the principles of non-discrimination, non-subsidisation, transparency, neutral oversight and commercial orientation. Special technical committees will ensure that the agreement is implemented in accordance with the treaty and, if necessary, adjust its contents. Member states will be responsible for internal coordination and cooperation as well as external representation through annually rotating chairmanships.

The CPTPP is also on the verge of enlargement. Numerous countries have expressed interest in membership, including the United Kingdom, Colombia, South Korea, Taiwan, Thailand and even the People's Republic of China. The sequence of future enlargements will largely determine how the CPTPP positions itself in the realms of trade and geopolitics.

Nonetheless, so far only the *United Kingdom* has formally applied for membership (on 1 February 2021). The British government hopes that CPTPP membership will help it achieve its desired post-Brexit new start in trade policy while also manifesting its dream of a "Global Britain" in an anglo-sphere world. The UK's chances of acceding are good. From the CPTPP member perspective, the UK would be an economically attractive new member. Moreover, it should not be particularly difficult for the country to fulfil the obligations of the agreement. However, the character of the CPTPP would fundamentally change if a non-Pacific littoral state were to be admitted. The CPTPP would then be less of a Pacific regional free trade area and more of a free-trade-oriented globalisation club dominated by the Anglo-sphere. In this respect, Britain's accession should not be regarded as a foregone conclusion.

In principle, the return of the *USA* to the agreement is also possible. It is very likely that the CPTPP members would be willing to reinstate the 22 treaty clauses suspended during renegotiations in order to facilitate the country's accession. Such would not only bring substantial revenue to the *USA*, but would also grant it an instrument with which it could contain China's geopolitical ambitions. However, domestically, it would currently be difficult to negotiate the opening of the American market that the CPTPP requires. In view of America's precarious domestic situation, the priorities of the Biden presidency do not lie in foreign economic policy, at least for the time being.

*China's* desire to join, prominently voiced by Xi Jinping himself, has several motives. First, with CPTPP membership, the country could broaden its exports and imports,

realising significant income gains in the process. Second, similar to China's WTO accession in 2001, the admission conditions could be used to push through politically difficult domestic reforms. Third, as a CPTPP member, the People's Republic would be excellently positioned to help shape global trade rules in the future. Fourth, China's participation in the agreement could defuse the Sino-American trade conflict. And fifth, joining would be seen as a diplomatic victory over the USA. However, it is questionable whether China would ever be able to fulfil the strictly worded treaty clauses on state-owned enterprises, intellectual property rights, sustainability and freedom of establishment for foreign-controlled digital companies. For the country to join, CPTPP members would have to concede to less specific and less strict entry conditions. This is not expected however. After all, the unspoken purpose of the CPTPP is to commit Beijing to a rules-based trade regime. Once it joins, however, China would no longer be forced to change its protectionist structures and discriminatory behaviour.

*Taiwan* would have comparatively few problems meeting the CPTPP accession criteria. Admittedly, the country's politically well-connected agricultural lobby would fiercely resist a market opening, but it would probably have little domestic political clout if the agreement's proponents were to point to the upgrade to Taiwan's international political profile should it join. Unsurprisingly, however, China has already declared its opposition to Taiwan's admission even though, as a non-member, it cannot block the potential process. Still, China would likely brand such a move as interference in its internal affairs and exert political pressure on all CPTPP members to oppose Taiwan's admission.

*Japan* will play a central role in upcoming accession negotiations. The country is the de facto leader of the CPTPP and holds this year's chairmanship. The transfer of the TPP initiative to the CPTPP would not have been possible without Tokyo's decisive action. For beyond liberalisation, trade policy has been a strategic instrument of

foreign policy for both the administrations of Shinzo Abe (2012-2020) and Yoshihide Suga (since September 2020). In congruence with Japan's "Free and Open Indo-Pacific" (FOIP) strategy, officially announced in 2016, the CPTPP is meant to contain China's economic offensives. Against this backdrop, the Japanese trade bureaucracy has already made it clear that it will insist on rigorous liberalisation and regulatory standards and will not accept watering down the content of the agreement to make a major (i.e. China's) accession possible. In this context, liberal UK's application for membership comes in handy for Tokyo. London could be used as a model for accession, setting a standard that China would certainly not be able to meet.

## Conclusions for Europe

The new EU strategy for an open, sustainable and assertive trade policy sets the necessary groundwork to be able to deal with the Chinese challenge in a realistic and defensive manner. However, aside from China, Asia remains virtually unmentioned in the strategy despite being the most dynamic and, in terms of its volume, the most important economic region in the world. Moreover, if the EU is to maintain and strengthen the rules-based trade order, especially in the face of Beijing's offensives, close cooperation with like-minded actors in the Indo-Pacific region, including Japan, South Korea, Australia, Singapore and Canada, is indispensable.

European trade policy should do two things. First, it should expand Indo-Pacific trade and investment links beyond China, or at least mitigate existing dependencies on the Chinese market. Bi- and multilateral agreements can be useful to this end. In particular, the negotiations for EU-Australia and EU-New Zealand free trade agreements, which have been ongoing since mid-2018, should be brought to a swift conclusion.

Second, the EU should also enter into free trade negotiations with the CPTPP as a group. At the very least, the EU and the

CPTPP should mutually agree on further developing and modernising global trade rules, especially in the areas of intellectual property rights, sustainability, safeguards, subsidies, state-owned enterprises, digital trade and the settlement of investor-state disputes. Should a deal be reached with Australia and New Zealand, the EU would be linked in a free trade agreement with all those states that have ratified the CPTPP. This would provide an excellent political and legal basis for a Euro-Indo-Pacific partnership that would extend beyond trade policy to foreign policy.

EU-China trade and foreign relations witness both sides pursuing analogous interests that overlap in most areas. Seeing that far-reaching convergence on regulatory issues already exists (or has been achieved in individual free trade agreements), co-operation with the CPTPP would also improve the chances that EU standards are enforced globally. Finally, a Euro-Indo-Pacific partnership would also be important when looking to the USA. Such could help counter the recurring trend towards protectionism and unilateralism in America with much more persuasive and assertive power.

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