

The Drawbacks of Preferential Trade Agreements in Asia

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Abstract Preferential trade agreements are mushrooming in Asia. However, they have not been facilitating intra-regional trade as much as the supporters of these exclusive arrangements have suggested. The complexities of rules of origin – part and parcel of all preferential agreements – have resulted in low utilization rates in Asia. The key driver of trade integration in Asia has been the rise of China, and not preferential trade agreements. In the past two decades, China has managed to establish itself as the indispensable trading partner in the region. In 2011, China accepted a trade deficit with its neighbouring countries whilst producing surpluses with the USA and the EU. At the same time, deeper trade integration in Asia, e.g. an Asian wide customs union, appears to be unrealistic. At this juncture, the political obstacles that hinder a deepening of co-operation are formidable. Other Asian countries wish to co-operate with China, but they demonstrate an even rising reluctance to enter far-reaching integration projects with Beijing.

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1 Introduction

After decades of preoccupation with traditional security issues, trade, finance and investment have become key areas of concern to policy makers in Asia, broadly defined to include South Asia, Southeast Asia and East Asia. Whereas in the past, governments in Asia applied a traditional understanding of security, today ‘economic security’ is part of a broadened concept of security that most countries in Asia apply (Pempel 2010a: 213). Of course, international trade and the efforts to deepen intra-regional trade integration are part of this process.

In the midst of the global financial crisis in 2008 and 2009, international trade seemed to be collapsing. Especially those economies that showed very high levels of integration into the global economy, e.g. Singapore, suffered badly. In 2010, however, trade is recovering quickly two years after the crisis broke. Asian economies have of course not been hit as hard by the global financial crisis as the European and American economies. After the crisis, their recovery is once again led by trade. Thus, the topic of trade integration is enjoying renewed attention in the region and beyond.

In Asia, trade integration has been shaping the economic and political debate for decades. There has always been a distinction between market-led and policy-led trade integration. The former refers to the tendency of firms to obtain raw materials, intermediate products and end products across borders from the cheapest source. The second form is government-induced trade integration, in particular the creation of preferential trade agreements such as free trade areas and customs unions.

Lines demarcating between the two types of integration are however hazy. Market-led integration is not occurring in an economic space free of government regulation, but relies primarily on the multilateral regulatory framework that has been created by governments. The multilateral regulation of trade has of course been suffering in the last decade, both because of the unwillingness of WTO member countries to conclude the Doha Round of trade negotiations and due to the increasing competition from preferential trade agreements. Often, policy makers perceive preferential trade agreements as a substitute for multilateral regulation. This can be observed in Asia and elsewhere.

The creation of preferential bilateral or regional trade agreements in Asia and elsewhere occurs at a time of market-driven internationalisation of production. Dicken has suggested that in the last decades, the global economy has been affected by two distinct, but related developments: the increasing transnationalization of production networks and the rapid emergence of regional trade agreements (Dicken 2005: 1). Both developments are important for developed and developing countries alike. Transnationalization of production networks results in the relocation of production to other countries, and these changes affect the economic prospects in many parts of the world.

In this article, the evolution of trade integration in Asia in the past decade will be analysed. First, I will look at the actual development of trade in the region. Needless to say much of the increase of trade in the region is due to the phenomenal rise of China as a player in international economic relations. Subsequently, I will examine the mushrooming of preferential trade agreements in Asia. Whilst their coverage and appeal

varies, all of them contain the creation of a free trade area between the participating economies as a core element. Subsequently, I discuss whether this is a wise approach and analyse the limited utility of preferential trade agreements in an era of growing economic integration including the increasing use of intra-regional production networks. Against this background, the prospects and efficacy of an Asian customs union are considered at the end of this article.

2 Market-led trade integration

In the two decades since 1990, the deepening of trade integration has been primarily market-driven, not state-led. As will be demonstrated in the article, government initiatives in Asia, primarily the creation of preferential trade agreements, has not been contributing significantly to the deepening of trade relations. Instead, transnational corporations were operating across national borders and have set-up production networks in Asia, even though there has been little government support for the deepening of intra-regional trade. The result has been a region-wide ‘factory Asia’, driven by markets rather than by governments (Pempel 2010a: 215).

Of course, one of the main factors for the rise of trade integration, both market-led and policy-driven, has been the rise of China, occurring at a time when the USA under George W. Bush implemented a policy of hostile unilateralism. China has utilised this opportunity to fill the void. As America put security issues in the centre of its foreign policy, China demilitarised its rhetoric and policies. In contrast to previous decades, in the 21st century China promises a common future in harmony and prosperity. China’s policy shift has resulted in a remarkable revision of perceptions in East Asia, as David Shambaugh has noted earlier this decade: “Today China is an exporter of goodwill and consumer durables instead of revolution and weapons” (Shambough 2004: 65).

In the early 21st, the rise of China has been the most important development for all Southeast and East Asian countries and their economic cooperation endeavours (Ravenhill 2008: 48). In recent years, China’s clever diplomacy has made a significant contribution to the rise of the country’s status in the region. China, for example, was the first non-ASEAN country to sign ASEAN’s Treaty of Amity and Cooperation (TAC). It signed the TAC at the ASEAN summit in Bali in 2003, and by signing this non-aggression treaty Beijing has contributed to relieving fears of China’s military intentions, at least temporarily (Narine 2007: 214). Beijing has been willing to accommodate the fears that continue to exist in the region with regard to the country’s leadership ambitions. China’s current popularity among policy makers in Asia is also reflected by the numerous preferential agreements it has either been able to conclude or is negotiating.

In the last three decades, China has developed into an economic hub in Asia. Both in trade and in production, other countries in the region increasingly benefit from intensive relations with China. Today, about 50 percent of China’s trade is intraregional. Even for Japan, the world’s second-largest economy, China is more important than ever. In 2009, China has replaced the US as Japan’s largest export market, and China is the largest importer to Japan (IMF Directions of Trade 2009). Moreover, China does not generate a large surplus in trade with its neighbours.

Of course, the rise of China to the world's largest exporter has been widely debated. However, the country has also overtaken Japan as the world's third largest importer (after the USA and Germany). This makes China a sought-after partner worldwide. Furthermore, the much-discussed trade surpluses of China are solely generated in trade with OECD-countries (Table 1). In 2011 the surplus in trade with the USA was 205.7 billion dollars (with exports of 324.8 billion dollars) and the surplus with the EU 145 billion dollars (with exports of 356.2 billion dollars). By contrast, in 2011 China generated a *deficit* in trade with most of its Asian neighbours, including ASEAN, Australia, Japan and South Korea. Effectively, China generates deficits with allies and surpluses with rivals.

In many political systems, exports are considered more important than imports. This is particularly the case for those countries that have followed a strategy of export-led growth. Virtually all Asian countries fall into that category. The political survival of many governments in Asia, including of course China, depends on the delivery of economic growth (Pempel 2010a: 213). Across Asia, both policy makers and civil society has developed a conviction that economic growth and prosperity are tools to enhance a nation's power and prestige (Pempel 2010b: 473).

Thus, China's trade relations may reflect a foreign policy strategy that aims at establishing China as an indispensable nation in Asia. Of course, this assessment requires further analysis. To start with, one has to ask how the government in Beijing has been able to steer the direction of Chinese exports and imports. Considering the high level of government planning in the formulation of economic strategies in China, it appears quite likely that the described outcome is the result of government strategy, rather than the result of market forces. In any case, Chinese foreign economic policy has been successful in anchoring the country as a key player in Asian economic affairs.

*Table 1: China's major trading partners and trade balance (countries and regions) (2011)**

	Exports to	Imports from	Balance of trade (EX-IM)
ASEAN	169,860	192,466	-22,606
South Korea	82,924	161,673	-78,749
Japan	147,290	194,409	-47,119
Australia	33,906	82,929	-49,023
New Zealand	3,736	4,990	-1,254
United States	324,856	119,163	205,702
EU	356,215	211,200	145,045
Total Trade	1,901,478	1,741,449	160,029

*Scale: Millions, Unit: US dollars

Source: International Monetary Fund, Direction of Trade Statistics, 2012.

Since 1990, Asian economies have significantly increased their share of global trade. In 2006, the emerging Asian economies (including India, without Japan) generated as much as one third of world trade, up sharply from twenty-one percent in 1990 (IMF 2007).¹ While trade with the rest of the world has also increased, the growth of trade within emerging Asia has been particularly spectacular. Intraregional trade between emerging Asian economies increased more than nine times between 1990 and 2009 to about 1,224 billion dollars (IMF DOT 2009). Both growth and volumes are remarkable even when contrasted with the European Union (EU-15). In Europe, intraregional trade reached three thousand billion dollars in 2009, an almost threefold increase from 1990 (IMF DOT 2009).

In 2009, the share of intra-East and Southeast Asian exports reached close to forty-one percent of overall trade (UN ESCAP 2009: 9), not much lagging behind NAFTA (52.5 percent) or the European Union (EU-15, 59.2 percent). The number is even higher for imports, indicating closer integration. Intraregional import figures for this block reached forty-nine percent in 2009 (UN ESCAP 2009: 9), not significantly lower than EU's intraregional imports (64 percent) (IMFDOT 2009). As noted before, the main factor driving this impressive increase of intraregional trade and intraregional division of labour has been the rise of China. From 1997-2007 China's share of intraregional trade has doubled. In 2009, the share of China in intra-East and Southeast Asian imports alone was close to thirty-three percent (UN ESCAP 2009: 8)

In general, it can be observed that China has become more important as a destination of exports at the expense of established OECD-economies. Between 1990 and 2006, for the four most advanced newly industrialised countries of Asia (South Korea, Taiwan, Hong Kong, Singapore) China as an export destination grew from 7.9 to 25.4 percent, whilst exports to the rest of the world, including OECD countries, shrank from 57.0 to 38.3 percent. Even for ASEAN-countries, which directly compete with China, trade with China grew dramatically. In 1990, only 2.2 percent of exports from Indonesia, Malaysia, Thailand, the Philippines and Vietnam went to China, while in 2006 this figure had risen to 11.1 percent (IMF 2007: 44).

In effect, the growing economic ties have led to a rise of China-centred regionalism, if not de-jure but de-facto. This can not only be recognized in an increase of cross-border trade and investment but also in the intensification of formal integration projects, probably the most important one being the China ASEAN Free Trade Agreement (CAFTA), in effect since 2010.² However, China is of course not the only player pushing its preferential trade agreements in the region. This trend raises the question why Asian economies have departed from the multilateral regulation of trade and are increasingly opting for the discriminating preferential alternative.

¹ Emerging Asia, following IMF definitions, includes China, India, Hong Kong, South Korea, Singapore, Taiwan, Indonesia, Malaysia, the Philippines, Thailand and Vietnam (IMF 2007: vi).

² One of the key foreign policy questions in the coming two decades will be the modernization of the current regime of global economic governance. John Ikenberry has pointed out that while the rise of China is a challenge, so far the Chinese have operated within the existing order and refrained from staging a full-fledged confrontation (Ikenberry 2008: 37). However, the effects of the rise of China for global economic governance are not a key question of this article.

3 Why has the support for multilateral regulation of trade disappeared?

The traditional debate on this issue has been characterised by the ‘stepping-stone’ or ‘stumbling bloc’ arguments. Bilateral or plurilateral agreements were regarded as either contributing to improvements of the multilateral regime or undermining it. However, until today, the multilateral regime has received very little, if any, stimulus from bilateral agreements. Indeed, the lasting stalemate in the Doha-Round can at least partly be attributed to the existence of alternative, bilateral regimes.

Today, there are almost four hundred free trade agreements and a few customs unions already recognized by the WTO. More are currently being negotiated and all regions of the global economy are participating. This could not be said a few years ago, as the entire Asia-Pacific region, for example, largely avoided these agreements. Countries like Japan and South Korea, and even Australia, were staunch supporters of the multilateral regime. Only ASEAN countries were advancing preferential trade within their ASEAN Free Trade Area (AFTA), which started in 1992. However, this pattern has changed dramatically. In recent years, no major economy has been willing to abstain from the current trend for preferential trade agreements.

Both the US and the European Union have actively contributed to the weakening of the World Trade Organization’s position in economic governance. While both continue to rhetorically support the WTO, in practice neither is providing the leadership in trade governance that characterized earlier periods, in particular the 1970’s, 1980’s and 1990’s. Immediately after 1945, the newly established American hegemony created the global economic order. In the aftermath of World War II, the USA used its then unchallenged material and ideological power to set in place an international institutional framework for global economic governance. Although underwritten by US hegemony, the Bretton Woods System and the General Agreement on Tariffs and Trade (GATT) were multilateral in both tone and practice. Though many countries were excluded or excluded themselves from the Bretton Woods regime, such as most countries of the Warsaw Pact, the regime was open and inclusive by definition. The GATT in particular was a tremendous success. Starting with twenty-three countries in 1948, the list of contracting parties grew longer rapidly, reaching 128 in 1994. The GATT quickly became a central pillar of global economic governance.

As such, the US saw the GATT as beneficial to its national interest and its view of world order. However, in the first decades after 1945, the US defined its interests broadly and in a sufficiently inclusive manner. Other countries felt able to sign onto a vision that stressed the importance of due process and the rule of law. Europe, an important player in trade policy after the completion of the customs union of the European Economic Community in 1968, by and large was a constructive force in supporting the further development of the multilateral trade regime. Asian players, in particular Japan and subsequently the rapidly emerging economies of Southeast and East Asia, were loyal supporters of the GATT and later the WTO. This is best exemplified by the fact that there were hardly any preferential trade agreements in Asia prior to the year 2000.

Nowadays, at the end of the first decade of the 21st century, the situation has changed significantly. Since the days of the administration of George Bush Sen., the US has defined its national interest much more narrowly. Whilst the rhetoric of the Clinton

Administration may have been more benign and gentle, it nevertheless pushed primarily its own agenda in international affairs (Dieter and Higgott 2007: 151-174). This pattern continues in the first years of Obama Administration, although with a change in rhetoric as not all policy is overshadowed by security concerns. Whilst President Obama has so far stay refrained from implementing trade restrictions, the continuing weakness of the American economy, particularly high unemployment, may well result in a protectionist policy shift before the presidential elections in 2012. Moreover, resentment towards multilateral, rule-based regimes is still a prevalent sentiment within most US policy circles.

Even more importantly, in recent years Asian economies have firmly embraced preferential trade agreements (Pempel 2006: 239-254), although these policies have been causing some friction in the transnational production networks in the region. Nevertheless, the changing policy choices of Asian governments have resulted in a further weakening of support for the multilateral trade regime.

Of course, the multilateral trading system has always depended on the support of major players. The US had been the single most important supporter of the GATT in the first two decades after its implementation, nurturing a rules-based world trading system (Irwin 2002: 225). When the European Economic Community completed the creation of a customs union in 1968, Europe became the second major player in the multilateral trading regime. Some of today's important trading nations, China in particular, were not yet members at that time, while the countries under the influence of the USSR primarily traded with each other.

As such, the US and the EU continued to shape and further the multilateral trading regime in the three decades after 1968. While the evolution of the trading regime was neither linear nor without contradictions, it is clear that the GATT can be considered a success, both with regard to the liberalization of trade and the continuously expanding membership. Furthermore, during the bipolar era, all GATT negotiation rounds eventually managed to be completed, though often after long negotiations. The most important development, however, has been the creation of the World Trade Organization in 1995, which has been providing member countries with a substantially improved dispute settlement mechanism. Prior to the creation of the WTO in 1995, dispute settlement could be blocked by the party accused of an illegitimate policy. This has changed with the WTO; it is one of the few multilateral organizations where any country can take the EU or the US to court and have a legitimate chance of rectifying the situation, though it may take some time. The implementation of the dispute settlement mechanism was not only a milestone for the creation of a rules-based system of international trade, but it can also be interpreted as one of the few building blocks of global governance.

4 The mushrooming of trade agreements in Asia

While the use of free trade agreements as instruments of foreign (economic) policy was pioneered by the EU and the USA, the use of free trade agreements has spread to other regions. Asian nations, which had avoided such agreements for a long time, have rapidly implemented numerous FTAs (see Table 2). Of course, this in part reflects the unresolved rivalry between China and Japan for leadership in Asia.

Table 2. Preferential trade agreements by status across Asia and Asia-Pacific as of August 2012

COUNTRY	Consultation and Study	Under Negotiation	Signed and in Effect*	TOTAL
Australia	3	10	8	21
Brunei Darussalam	4	4	8	16
Cambodia	3	1	6	10
China, P.R.	8	5	12	25
Hong Kong	1	1	2	4
India	7	13	13	33
Indonesia	6	5	9	20
Japan	8	2	13	23
Korea, Republic of	16	7	10	32
Lao PDR	3	1	8	12
Malaysia	8	6	12	26
Myanmar	4	1	6	11
New Zealand	5	5	9	19
Philippines	5	1	7	13
Singapore	5	10	21	36
Taipei	2	2	5	9
Thailand	6	7	12	25
Vietnam	7	2	8	17

* Includes FTAs signed but not yet in effect.

Source: Asian Development Bank, Asia Regional Integration Centre Data, available at <http://www.aric.adb.org/FTAbByCountryAll.php> (last accessed on 15 August 2012).

China has become one of the most active players pushing bilateral agreements. According to the Asian Development Bank's Asia Regional Integration Center, as of July 2010, China is participating in a total of twenty-five FTAs (both bilateral and plurilateral). In 2010, China and the ASEAN countries have created the world's largest free trade zone by number of inhabitants, the ASEAN-China Free Trade Area ACFTA. However, beyond that FTA China has not been able to conclude an agreement with an important economic player. The country has mainly concluded FTAs with smaller economies, such as Chile, Costa Rica, Peru and Singapore. Both the potentially relevant FTAs with India, Japan and South Korea show little signs of progress. In particular the China-Japan-South Korea FTA, proposed in 2003, would have some impact. The project is not pursued with any vigor and ought to be considered a failure. However, FTA negotiations are rarely abandoned, but instead usually hibernate for years. From a diplomatic perspective, not completing a project is less of a problem than officially abandoning one.

At the turn of the century, Asian economies by and large showed very little interest in trade regimes outside the WTO. This has changed dramatically. Today, a myriad of initiatives can be observed. Although the effects of these preferential agreements, most of them bilateral, may be negative both for the welfare of the participating countries and for the stability of the multilateral trade regime; the frenetic activities of policy makers reveal their concerns about the current regime of global economic governance.

In previous eras, i.e. before the Asian crisis of 1997/98, countries in Asia were not closely tied together in the economic domain. In both Southeast and East Asia, the dominant model of development was characterised by a unilateral opening to the world market, primarily for exports, and virtually no regional cooperation with regard to joint macroeconomic or monetary policies. One expression of the dominance of unilateral economic policies is the fact that the finance ministers of ASEAN countries had never met in their official capacity prior to 1997. The linkage between economic instability and regional stability has emerged during the Asian crisis, and policy makers have been accepting this new reality surprisingly quickly. For instance since 1998, in trade alone, there has been an 80 percent rise in the number of bilateral FTAs and a ninety percent increase in the number of plurilateral (arrangements with more than two parties) FTAs in Asia (ADB Asia Regional Integration Center, data for 2010).

The reasons for these changes in priorities are manifold. First, traditional security issues are no longer as important as they used to be. Whilst some tensions persist, there has been a remarkable reduction in armed conflict in the whole of the Asia-Pacific. The numerous conflicts that shaped foreign policy in the past – from the Korean and Vietnam Wars to the conflicts in Southeast Asia in the 1970s and 1980s – have either been solved or are dealt with in a non-military manner. Secondly, the countries in the Asia-Pacific, in particular the countries in Southeast and Northeast Asia, have learned that economic instability is a greater concern to them than classical security risks. The Asian crisis of 1997/98 has demonstrated that the lives of millions of people can be severely affected by economic turbulence. Moreover, the stability of some political systems in the region depends on the provision of economic growth, and a period of no or limited growth may put the legitimacy of governments into question. Thirdly, the economies in Asia are growing ever closer together. The deepening of transnational production networks, the growing share of intraregional trade and substantial investment flows provide the basis on which a process of regional political cooperation, resulting in regional governance of economic affairs, is gradually being built. Fourthly, the political rivalry between China and Japan has been a major factor to providing a stimulus to Asian regionalism in general and preferential trade agreements in particular.

The ties between Asian economies have significantly deepened over the last two decades, and this change in economic interdependence has fuelled a range of political activities to secure this cooperation. Initially, market processes have driven the deepening of ties, but in recent years, these de facto integration processes have been augmented by political initiatives, i.e. integration by agreements. Integration by markets forces and integration by agreements are certainly not excluding each other, but are related and complementary (Aminian et al. 2008: 3).

In the early 21st century there is an increasing rivalry between a handful of major players who are competing for both political and economic influence. The new battlefields are preferential trade agreements. Leading powers such as the US, the EU, and China are no longer emphasizing multilateralism, but are instead pushing for

preferential agreements. This reflects both the inability to cooperatively advance the multilateral regime and the damaged position of the previous hegemon, the US. Since the start of the global war on terror, the US has lost popularity in many countries that traditionally supported the United States. The unilateral moment of US hegemony may have lasted shorter than some had predicted in the late 1990s (Zuckerman 1999). The financial crisis originating from the US has only contributed further to at least a temporary weakening of the US popularity (Altmann 2009: 6).

In the first decade of the 21st century, China has been successfully pushing preferential agreements in its immediate neighborhood. Starting with the proposal for the ASEAN-China FTA in 2001, Beijing has been setting the pace in the region and has forced Japan in particular to offer comparable agreements. Despite the fact that in July 2010 Japan had even been able to have more PTAs in effect than China, there is little doubt that Japan's strategy is a defensive one.

At the beginning of the second decade of the 21st century, these trends in trade policy have led to a messy situation. A web of overlapping PTAs has resulted in the creation of a "noodle bowl" of regulations in Asia. Rather than enabling companies to trade more freely with each other, the wave of regional agreements has resulted in a less transparent, even opaque trading system. Companies are confronted with the choice to either trade on a most-favoured nation basis, which means to pay the appropriate tariff, or establish the origin of a product. Since most of the PTAs in Asia have only been in force since a few years, it is probably a bit early to establish a region-wide pattern of company's willingness to engage in the process of establishing origin. Evidence from ASEAN's internal PTA shows that most trade is not conducted using the tariff-free option requiring a certificate of origin, but instead more than ninety percent of ASEAN-internal trade is conducted on a most-favoured nation basis (Corning 2009: 647). There is no reason to believe that utilization rates in other PTAs in Asia will be any higher, because ASEAN uses relatively simple and thus manageable rules of origin, whilst the rules in other PTAs tend to be more complex and use, for example, higher value-added requirements than the forty percent threshold used in ASEAN. In particular PTAs involving larger developed economies tend to have more complex rules (Corning 2009: 660).³

The proliferation of bilateral PTAs therefore represents the greatest divide between entrenched economic theory and short-term political practice in the global economy since the introduction of protectionist measures in the 1930's. Both economists and political scientists agree that bilateral trade deals are suboptimal and pose major threats to the multilateral trading system. When looking closely at some of the details, the disadvantages of bilateral deals become even more evident. One major drawback is that the important and useful dispute settlement mechanism of the WTO might be diluted because of the mushrooming of preferential agreements.⁴

³ It should be noted that there is a bias against smaller companies in PTAs. Whilst transnational corporations tend to have large, competent administrations that are able to handle the complexities of rules of origin, smaller companies are often less well placed to master the administrative requirements.

⁴ Whilst parties to preferential trade agreements can continue to use the WTO's dispute resolution mechanism, many prefer not to use this option and implement dispute settlement mechanisms within the PTA.

5 The limited utility of preferential trade agreements

A major disadvantage of free trade agreements is the administrative burden caused by rules of origin. In an entirely open world economy with no restrictions on the flow of goods, these rules of origin would not matter because it would be irrelevant where goods originate. Today, however, the origin of a product matters, in particular in preferential agreements. All free trade agreements including bilaterals, require rules of origin to establish the ‘nationality’ of a product. The reason is that in FTAs, participating countries continue to have diverging *external* tariffs. One country might have a high tariff on, say, cars in order to protect domestic producers, whilst the other might have a low or no tariff on that product. Since only goods produced within the free trade area qualify for duty free trade, there have to be procedures that differentiate between goods produced within the FTA and goods from the rest of the world. Thus, the preferential system becomes complicated and expensive. On average, the cost of issuing and administering certificates of origin is estimated to be five percent of the value of a product (Dieter 2004: 281; Roberts and Wehrheim 2001: 317).

In the past forty years, the use of rules of origin has changed significantly. After decolonisation, many developing countries used rules of origin as instruments to enhance their economic development. Rules of origin were used to increase the local content of manufactured products and to protect the infant industries in those economies against competition from imports. This function of rules of origin is of relatively minor importance today. Rather, developed countries use strict rules of origin to protect their aging domestic industries.

First, it is important to understand that there are two categories of certificates of origin, non-preferential and preferential ones. The former are used to differentiate between foreign and domestic products, for instance for statistical purposes, for anti-dumping or countervailing duties or for the application of labelling or marketing requirements. The second type is the one that can distort trade because it provides preferential access to a market.

There are four methods to establish the “nationality” of a product, to establish origin. There is natural origin and origin due to substantial transformation, this category being subdivided into three other forms: a change in the tariff heading, a minimum percentage of value added and specific production processes (Estvadeordal and Suominen 2003). Natural origin (wholly produced or obtained) is the least complicated approach. This applies to raw materials and non-processed agricultural products, i.e. to a relatively small part of international trade.

A change of tariff heading is already much more complicated. The Harmonized System (HS) is a set of regulations that has been agreed upon in the World Customs Organisation (WCO). It consists of 1241 categories on the four-digit level and more than five thousand categories on the six-digit level. If a product receives a different tariff heading after the production process, this can be used to qualify for origin. This method has considerable advantages. It is both transparent and easily established. Using the Harmonized System is simple, easy to implement and causing relatively little cost. The necessary documentation is undemanding. The trouble is that a change of tariff heading does not necessarily constitute a significant step in the production process. Minor changes to a product can lead to a change of tariff heading. Therefore, merely

requiring a change of tariff heading to establish origin is the exception in PTAs in Asia and elsewhere.

The minimum value-added rule is probably the most complicated method to establish origin. Incidentally, it is also the most widely used scheme in Asia. A certain percentage of the value of the product has to be produced within the FTA to qualify for duty free trade. Finally, specific production processes can be identified and agreed upon in order to establish origin. The trouble is that this method both requires complex negotiations on agreed production processes and continuous updating. Due to the changing patterns of production, new forms of production emerge that would constitute substantial transformation, but unless they are listed in the catalogue of agreed production processes, they would not qualify for duty free trade.

When criticising the negative consequences of rules of origin, there is a caveat. By paying the appropriate tariff, they can be easily overcome. Since peak tariffs continue to cause difficulties in some sectors, the protectionist effect of rules of origin should nevertheless not be underestimated. The combination of tariffs and stringent rules of origin can be an efficient instrument for the protection of a market. One example for that approach is the textile market in NAFTA, where rules of origin require the yarn to be spun in NAFTA (the yarn-forward rule) or even the fibre to be produced in NAFTA (the fibre-forward rule), which is used for many textiles containing cotton. The consequence is that Canadian or Mexican textile producers cannot source their cotton from for example African cotton producers, but instead have to buy cotton from US producers. Rules of origin are opaque protectionist instruments. They often render PTAs a useless endeavour, at least from an economic point of view.

In Asia, the administrative obstacles associated with rules of origin have resulted in quite low utilization rates. Out of all firms that we responding to a survey by the Asian Development Bank a mere quarter (28.4 percent) were utilizing preferences (see Table 3). The majority of firms preferred to pay the appropriate tariff. The economic benefit from the preferential trade agreements has thus been limited. In addition, it is reasonable to assume that in reality, utilization rates are lower still, since those companies that were not responding to the questionnaire probably were not interested in the subject altogether.

Table 3. Utilization rates in Asian preferential trade agreements

Firms utilization of preferences	Using preferences in percent of respondents	Planning to use preferences
All firms	28.4	53.0
Japan	29.0	47.4
China	45.1	77.9
South Korea	20.8	54.2
Singapore	17.3	28.0
Thailand	24.9	45.7
Philippines	20.0	40.7

Source: Kawai and Wignaraja (2011).

Thus, the economic utility of preferential trade agreements in Asia continues to be limited. Corning suggests that the ASEAN-Japan Comprehensive Partnership Agreement (AJCEP), praised by its supporters as more wide-ranging than WTO agreements, has not produced convincing results (Corning 2009: 639). Other observers have criticised preferential trade integration sharply. Ross Garnaut and David Vines have argued that the trend towards discriminatory bilateral agreements is “... an ill-thought-out early-twenty-first century response, and it is deeply disturbing” (Garnaut and Vines 2007). Richard Baldwin has also characterised the situation of East Asian regionalism harshly: “[w]hen it comes to East Asian regionalism, the state of play is easily summarised – it is a mess. Dozens if not hundreds of trade deals are under discussions, under negotiation, or already signed” (Baldwin 2006: 3).

Baldwin has been coining the term “noodle bowl” for Asian trade relations.⁵ The consequence of the noodle bowl is an increasing fragility of production in East and Southeast Asia. The variation of rules between the various bilateral agreements is causing significant problems for the private sector. Richard Baldwin has identified three factors that contribute to this fragility. First, each nation’s industrial development and the competitive position of companies in these countries depend on the smooth functioning of intra-industry trade flows. Second, the tariff cutting that created Factory Asia was done unilaterally by most Asian countries. These tariff cuts were not ‘bound’ in the WTO, and consequently they are not subject to WTO discipline. This so-called bindings-overhang means that tariffs in Asia could go up overnight without violating WTO rules. Third and most important, there is no political regulation in the region that could substitute WTO discipline. By contrast, European regulation has both top-level management, i.e. the European Commission, and WTO discipline, because European countries have bound their tariffs at very low levels (Baldwin 2006: 1f). Thus, the private sector in Europe has a better, more transparent political and trade environment than the private sector has in Asia, at least when considering the conditions for trans-national production.

6 Which way forward? Should Asian economies consider a customs union?

Ever since East Asian countries have been evaluating options for further integration, there has been debate on which form the economic integration should take. In 1994, the APEC member countries agreed to create an open trading regime in the Asia-Pacific by 2010 for the more advanced and 2020 for the less developed economies. It was, however, unclear what precisely the ‘open regionalism’ advocated meant. Would the participating economies liberalise unilaterally and offer the reductions of their levels of protection on a most-favoured nation basis to all member countries of the WTO, including, say, the European Union? Or would ‘open regionalism’ permit other economies to join a scheme which would only provide the benefits to its member countries?

⁵ Alternatively, the term “spaghetti bowl” is used. Both mean the same thing – a system of unconnected preferential trade agreements.

Since Bogor, the discussion has moved on and there is now much less ambiguity about the avenues open to policy makers. In essence, the creation of a discriminating preferential trade agreement is one option that is evaluated by policy makers. For example, the East Asia Study Group (EASG), formed as an advisory body in the year 2000, has suggested the creation of an East Asian Free Trade Area in its report, presented to the ASEAN Plus Three Summit in November 2002 in Cambodia (EASG 2002).

Of course, the wave of preferential trade agreements that already have been created in the region and the above named proposal raise the question whether there aren't any more convincing alternatives, both from an economic and from a political perspective. The current system of preferential trade agreements with their divergent rules of origin and little economic utility are the third-best option. Bilateral PTAs do not contribute to the creation of a unified economic space, but instead create an administratively complex trade regime. Moreover, from a political perspective they are even counterproductive since PTAs contribute to the deepening of the rivalry between the two most important players in Asia rather than offering a possible co-operative solution.⁶

An Asia-wide free trade agreement would constitute an improvement with regard to both the economic and the political dimension. From an economic point of view, a region-wide PTA would at least reduce the complexity of the administration of trade. There would be one set of rules of origin instead of dozens of them, and companies would potentially benefit from the creation of the world's largest PTA. At the same time, even a region-wide PTA would offer suboptimal results. Whilst the need for certificates of origin would be reduced, it would still be necessary to establish origin of any product traded duty-free in the region. Participating economies would continue to implement their own, country-specific trade policy and would be free to engage in other PTAs with third economies, e.g. the USA or the EU. Given the complex nature of today's international production networks, the origin of inputs sourced from outside the PTA would still have to be subject to complicated administrative processes.

Politically, an Asia-wide FTA would eliminate the current competition between China and Japan with regard to trade policy. Since there would be only one PTA, neither country could engage in a beauty contest with the aim of demonstrating the attractiveness of its own scheme. However, an Asian PTA would still be suboptimal when compared with a customs union in the region, which would both reduce transactions costs due to the lower requirements for rules of origin and streamline the region's foreign economic relations. A customs union constitutes a higher level of integration than a free trade agreement and creates an economic space with a unified trade policy vis-à-vis the rest of the world. Thus, it is both more difficult to agree on than an FTA, but also offers the greater benefits.

By definition a customs union contributes to the elimination of trade barriers, tariffs and quantitative restrictions on trade amongst partners and imposes a harmonised external tariff on trade with third countries. This is the key difference with a free trade area; however technically different, in notion and purpose a customs union is akin to a free trade area as they are both said to increase specialization and trade with welfare benefits for the parties involved. An important benefit of a customs union is that it

⁶ Of course, there are other arenas in Asia where China and Japan do co-operate meaningfully, e.g. monetary regionalism in the context of the Chiang Mai initiative.

contributes directly to trade creation, i.e. more expensive domestic products are replaced by cheaper imports from member countries.

In this context, it should be remembered that the European Economic Community never aimed at the creation of a free trade area, but from 1957 aimed at the establishment of a customs union, which was achieved in 1968. Ever since there is only one trade policy, and Europe's weight in international trade has greatly risen since 1968. The economic utility is probably greater still: Once a product from a third country has entered the economic space and the duty is paid, the product can be used in production without requiring additional documentation processes.

The creation of a customs union in Asia, however defined, would certainly not be an easy task. The key stumbling bloc is the creation of a joint external tariff, which would have to consider the diverging political preferences of all member countries. In essence, most participating economies would have to liberalise trade in sectors they previously considered too problematic for liberalisation; Japanese agriculture is a case in point. Even if the more advanced economies could politically accept the opening of their hitherto protected agricultural sectors, the effects of a common external tariff on the less developed member countries of an Asian customs union are to be considered. For these less developed economies, the creation of a customs union would result in a dramatic increase in competition, and most probably many industries would not survive such a shock.

Nevertheless, given the disadvantages of the current mess in Asian trade – characterised by overlapping and inefficient preferential trade agreements on the one side and lukewarm support for the multilateral system on the other – exploring the potential of an Asian customs union is a worthwhile endeavour. One potential avenue for solving the obstacles outlined above would be a structured introduction of a customs union, with developed economies including China taking the lead and the poorer economies following five or ten years later.

In the last decade, dynamic processes have emerged that may lead to the creation of an integrated economic space in Asia. Of course, it is highly speculative to engage in a debate on the potential shape of such a regime, its membership and its relationship with non-participating economies. Nevertheless, given the high level of economic interdependence that can be observed already, the interest in a formalised, de-jure integration project in Asia seems to be quite high. A potential venue for this pan-Asian project could be the ASEAN-China FTA (ACFTA), which has come into effect in 2010. This large group, comprising more than 1.7 billion people, can over time alter the nature of economic relations in Asia and may possibly also change political and security relations in the entire region (Narine 2007: 205).

Whilst there are numerous bilateral preferential trade agreements either in force or currently negotiated in Asia, ACFTA has the economic potential to serve as the nucleus of an Asian integration project. China has not only made sure that the FTA offers sufficient rewards to the less-developed members of ASEAN (Vietnam, Cambodia, Laos, Burma), but has also succeeded in attracting support of the more advanced economies, e.g. by providing so-called early harvest programmes for agricultural exports from Thailand. Given the importance of China in Asian trade, the expansion of the existing preferential trade agreement into a region-wide customs union would, from an economic perspective, be a sensible step forward.

However, from a political perspective it appears naïve to expect both Japan and South Korea as well as ASEAN to agree to such a proposal. Suspicion of Beijing's long-term goals continue to exist in the region, and given the recent assertiveness of Chinese policy makers in international affairs this suspicion may even have grown of late. Rather than continuing to successfully portray its rise as an opportunity to Asian and other countries, China appears to be perceived more critically than, say, before 2010. Whilst it is difficult to name a single incident that may have contributed the change in perception, the cumulative effect of the continuing production of current account surpluses, the buying of agricultural land and other natural resources in Africa and elsewhere, the unwillingness to consider a more robust appreciation of the exchange rate of the yuan vis-à-vis the dollar and the sabotaging the Copenhagen climate have all contributed to a deteriorating image of China abroad. Considering the increasing bullishness of Chinese foreign economic policy, the creation of an Asia-wide customs union appears to be a rather distant prospect.

7 Conclusions

Following the departure from a security-driven agenda in international relations after the Asian crisis, countries in the region continue to search for an improvement of both their trade and other economic policies. Pempel has suggested that this process constitutes what he terms 'institutional Darwinism', a process of institutional competition and selection (Pempel 2010a: 233). Some forms of co-operation will flourish; others will probably languish and become irrelevant. Preferential trade agreements most probably belong to the latter category.

The arguments and evidence in this article show that, taken together, preferential trade agreements have very few advantages for Asia. They are inferior to regulating trade in the WTO, and they are not as useful as large regional agreements can be. Bilateral free trade agreements are a third-best solution for regulating international trade. They violate established conditions for economic efficiency and they are imbalanced, because they disadvantage the poorer players and systemically strengthen the more developed players.

The trend towards bilateralism is often justified with the notion that simply relying on the WTO is like doing nothing. This is not the case. Multilateralism continues to function and to represent a superior form of regulation compared to preferential trade agreements. In trade policy, pushing preferential agreements is a second-best solution, if that. Furthermore, bilateral trade agreements contain an element of discrimination which is causing concern. In the 1930s, discriminatory preferential regimes were dominating the organisation of international trade. Today, economies are returning to a regime where goods originating from befriended countries have easier access to a national market than others. There is discrimination between friends and foes. The post-war trading regime had the explicit goal of non-discrimination, and today's policy makers are sacrificing this philosophy for quick, but uneven and unsustainable, economic gains.

The irony is that Asian economies, who have been major beneficiaries of today's open trade regime, have firmly embraced the trend towards preferential trade agreements. This may be due to the perception that the World Trade Organisation has, in essence, been a transatlantic organisation. Whilst it is true that the GATT and

subsequently the WTO have been shaped by the transatlantic powers, preferential trade agreements are not a sound alternative to the WTO. They cause high administrative costs, do not support the creation of intra-regional production networks and do ultimately not lead to a sustainable trade regime.

For Asian and other economies, including the European Union, the current trend towards preferential trade agreements is a policy error of massive dimensions. Beyond the ever-lasting rhetoric, major players, in particular China, the EU, Japan and the USA, should abandon preferential agreements and should return to the WTO as the main platform for regulating international trade. For Asia in particular, the current spaghetti bowl of trade agreements is neither efficient economics nor providing the participating economies with enhanced political influence. The only preferential trade agreement in the region that appears sensible from an economic perspective is an Asia-wide customs union, which would reduce transactions costs significantly and stimulate intra-regional trade beyond the existing levels. At the same time, the increasing distrust of other countries in Asia vis-à-vis China and its long-term goals will probably impede the creation of such an economically sound, but politically naïve measure.

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