Flashnote

11 November 2016

HSBC Global Research

Sad about the TPP?

Look to the RCEP…

ECONOMICS
ASIA

- Implementation of the TPP is off the table for now, but negotiations for the pan-Asian Regional Comprehensive Economic Partnership (RCEP) are continuing…
- The RCEP will link the world's three largest consumer markets (China, India, ASEAN) in a deal spanning goods, services, and investment, but its scope will be far more limited than the TPP
- The partnership will, nonetheless, provide new investment incentives for pan-Asian supply chains, particularly for ASEAN, and should spur new trading relationships…

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There are many unknowns following the election of Donald Trump. However, one thing is certain: the Trans-Pacific Partnership (TPP) is unlikely to be passed, and the US is likely to become more protectionist. This is significant for Asia. Many regional economies are members of the TPP – Japan, Singapore, Malaysia, Vietnam, Brunei, Australia, New Zealand, and Vietnam – while others expressed a desire to join. Most literature unequivocally attributed significant economic gains to the region from the TPP – above all for Vietnam – and its implementation would precipitate politically difficult, yet economically beneficial reforms. The TPP was a beacon of hope in an environment of subdued trade activity and weak global growth.

Fortunately, not all hope is lost. After all, negotiations for the Regional Comprehensive Economic Partnership (RCEP) are on-going and the 15th negotiating concluded last month. The RCEP includes ASEAN-10, in addition to China, India, Japan, Korea, Australia, and New Zealand – the countries with which ASEAN already has free trade agreements. As the first pan-Asia free trade deal, it boasts a list of impressive statistics, such as covering roughly half of the world's population and nearly 30% of global GDP.

Alas, the scope of the RCEP is more limited than the TPP. True, the RCEP covers the usual components of a free trade deal, such as trade in goods, services, investment, and intellectual property rights protection. However, there are already warning signs that the final treaty will be watered down, in particular due to India's fears about its already large trade deficit with China ballooning further and Japan's reluctance to open its agricultural sector. The final agreement will likely be replete with country-specific exemptions and many tariff lines may remain intact.

Despite drawbacks, the RCEP should help boost trade volumes across Asia and spur investment in new supply chains. The deal will be particularly advantageous for ASEAN, as it will reduce the incongruity across pre-existing free trade agreements (FTAs) and thereby strengthen the appeal of the region as a production base. Moreover, by connecting the world's three largest consumer markets, China, India, and ASEAN, the RCEP offers a new "south-south" template for growth that can partly offset subdued imports and investment in the West.

This report replaces the one of the same title and date to correct Map 1.

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What is the structure of the RCEP?

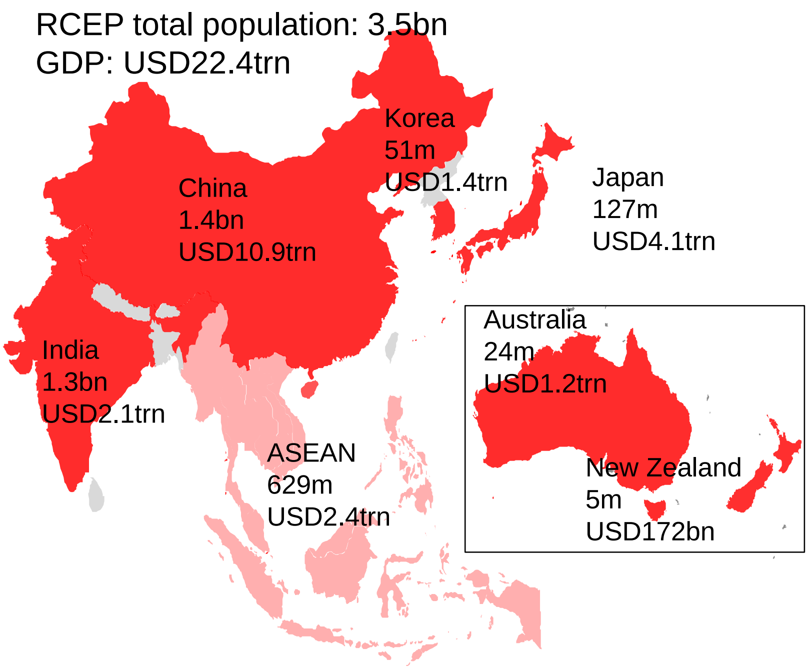
As a trade deal pioneered by ASEAN, the deal is limited to economies with which ASEAN has a free trade agreement (FTA). However, in the future, the RCEP can be expanded to include other countries. According to the original blueprint, the official coverage areas include trade in goods, trade in services, investment, economic/technical cooperation, intellectual property (IP) rights protection, competition, dispute settlement, e-commerce, and small- and medium-sized enterprises issues (the latter is included to help engage the SME sector, which makes up more than 90% of business establishments across the RCEP). Negotiations have currently reached the 15th round, and while there was hope for completion by end-2016, it seems likely that negotiations will run into 2017 and be completed by mid-year.

How is the RCEP different from the TPP?

The TPP was intended to "re-write" some of the basic tenets of international trade, incorporating IP protection alongside environmental and labour standards (see *A pretty big deal: Everything you need to know about the Trans-Pacific Partnership (TPP)*, 18 December 2013). After all, the TPP goes far beyond goods and services liberalisation and emphasises areas important for developed countries, such as business conditions, standards, regulations, and IP protection. From what we can tell following the negotiation rounds so far, the RCEP has mostly focused on tariff reduction and services liberalisation.

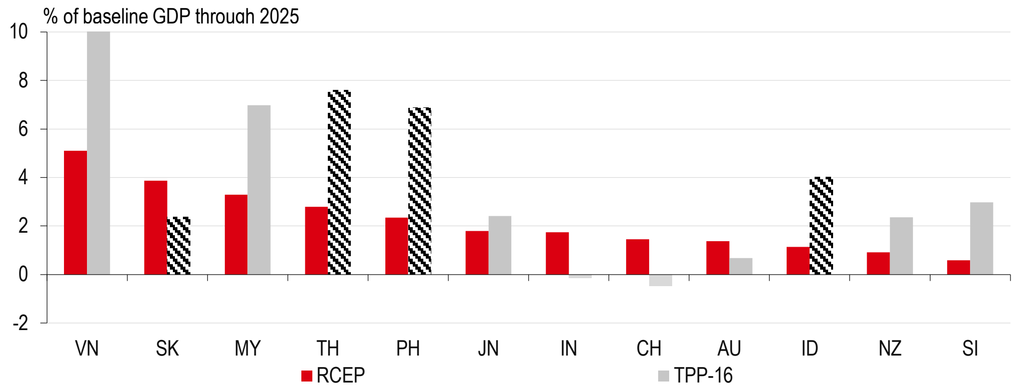
However, the fact that the RCEP doesn't focus on some of the lofty goals of the TPP doesn't mean it isn't an ambitious undertaking. For example, the RCEP links the world's two most populous countries, China and India, in a trade deal for the first time, while also pairing Asia's two largest economies, China and Japan. Since ASEAN has already undergone various negotiating rounds with its FTA partners, most of the hiccups with the RCEP have to do with these new trading relationships. For example, most of the recent debate boils down to India's reticence to offer a single tariff reduction schedule to all RCEP members – instead desiring a differentiated approach, given fears about its trade deficit. But even partial tariff reduction on trade between China-Japan and China-India trade could inject new vitality into trading relations.

Map 1. Coverage of the RCEP: ASEAN and FTA partners



Source: IMF, HSBC. Scale: Total population and nominal USD GDP.

Chart 1. The RCEP may not boost output as much as the TPP, but the benefits will be shared more equally across Asia



Source: Peter A. Petri, Economics of the TPP and RCEP Negotiations, Brandeis University and East-West Center, December 2012. Dashed line indicates nations that did not join the TPP but are expected to eventually join.

The most evident difference between the TPP and the RCEP is the inclusion of China in the latter (and the lack of the US, along with all non-Asian economies for that matter). Given the possible tariff reduction between China, Japan, and Korea, all of which are among the United States' top 6 trading partners, the RCEP could put US exporters at a disadvantage, assuming non-passage of the TPP.

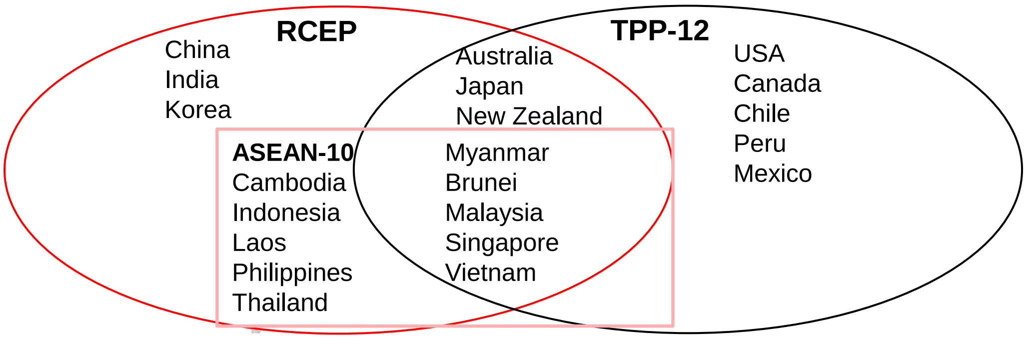
Indeed, the White House recently published a study arguing that US exporters would lose out to RCEP participants. This isn't hard to imagine. Despite the US, Japan, and China all being linked in the World Trade Organisation (WTO), which grants "Most Favoured Nation" status (or, simply put, a member nation must receive equal trade advantages as the "most favoured nation" receiving the treatment), there are various tariff lines that both the US and China face when exporting to Japan. Even if the RCEP delivers a tariff reduction on 65% of tariff lines – in line with the average in the ASEAN+1 FTAs, this would give Chinese and Korean exporters a clear advantage when accessing the Japanese market.

What are the exact welfare benefits of the RCEP?

In terms of the direct welfare impact of the RCEP compared to the TPP, we refer to the findings of Peter Petri, who uses a general equilibrium model developed by Zhai (2008) that takes into account sectoral elements. The main take-away is that the RCEP will provide a substantial boost to headline GDP for all member nations, albeit not to the extent that the TPP would have benefited some of Asia's more trade-intensive nations (see Chart 1).

The results show that Singapore benefits the least – after all, it already has free trade agreements with all of the RCEP member nations (both through ASEAN and direct bilateral

Chart 2. Significant deal of overlap between the RCEP and the TPP-12



Source: HSBC

deals). The welfare benefits shown above derive from the impact that a broader trade deal like the RCEP will have on pan-ASEAN supply chains that Singapore's industries take part in.

On the other side of the spectrum, Vietnam will benefit handsomely from the RCEP. On one hand, Vietnam would enter into new agreements and would see significant gains coming from increased sourcing of production from Japan, Korea, and China. Despite the potential boost to output from the RCEP (which is not a done deal), it is worth to point out that Vietnam also loses out the most from the non-passage of the TPP, which would have brought about increased access to the US market and spurred significant investment in Vietnam by foreign companies. As we show in (Chart 2), Vietnamese exports to the US account for 17.9% of GDP, compared to 3.8% in the case of China.

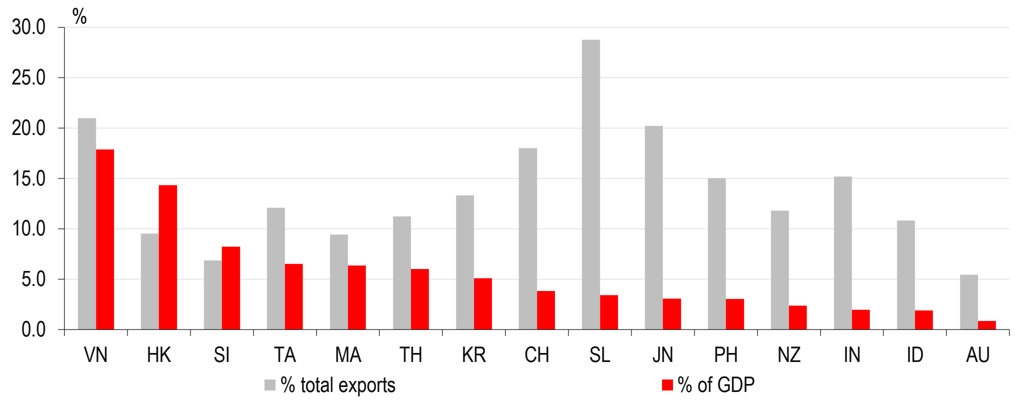
For South Korea, the benefit is more straight-forward. The country was seen as a possible "loser" in the TPP since Japan's auto industry would have advantageous access to the US auto market, while South Korea would not. However, South Korea will likely benefit from the RCEP by way of additional access to ASEAN and Japan, South Korea's second and fourth largest markets (note that in Chart 1, we show estimates assuming South Korea eventually joined the TPP).

Which countries will be connected in a FTA for the first time with the RCEP?
The most important example is China and Japan. While China, Japan and South Korea have been in preliminary negotiations for a FTA for some time now, a tangible agreement has not come to fruition, ostensibly due to political hindrances (note that South Korea already negotiated a bilateral agreement with China). However, in recent trilateral summits, trade ministers from the three countries have pointed to the RCEP as a way to achieve a similar goal. The other important linkage is between China and India. Trade between the two has blossomed in recent years, but in an asymmetric fashion, engendering a large trade deficit, which leads us to our next question.

Why are some Indian policymakers worried about the RCEP?
India currently has a USD52.3bn annual trade deficit with China: the country accounts for 16% of its imports but only 4% of exports. As such, the RCEP has generated a great deal of discussion in India, and there are fears that China may end up exporting its supply 'glut' of industrial materials, thereby hampering India's industrialisation efforts, in particular the government's well-publicised *"Make in India"* campaign.

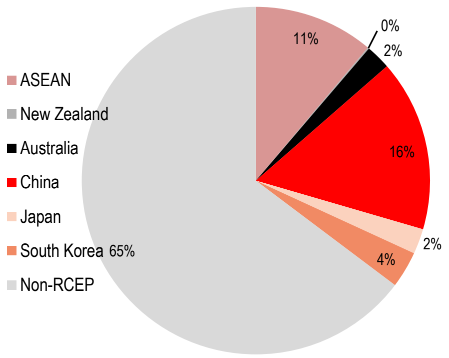
Despite the backlash, the Petri model suggests that the country would see a sizeable boost in output, roughly in the middle of the Asia-wide range. Recall that the RCEP includes services liberalisation, which Indian trade negotiations have insisted must be carried out alongside goods liberalisation. Given that services account for a significant portion of India's high value-add exports, and little liberalisation has been carried out to date, there are significant gains to be made from fewer barriers to services exports to other Asian economies.

Chart 3. Trade exposure to the US by country: Vietnam most impacted by no TPP



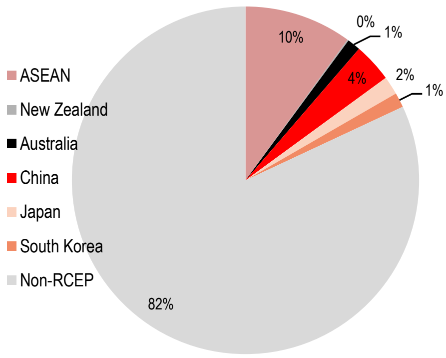
Source: CEIC, HSBC

Chart 4. The RCEP partners account for a much larger share of India's imports…



Source: UNCTAD, HSBC

Chart 5. …than its exports, with the biggest divergence having to do with China



Source: UNCTAD, HSBC

India's original approach to the RCEP negotiations was to adopt a three-tiered tariff reduction schedule in which it will offer different concession rates for ASEAN, China, and the rest. In addition to lowering the tariff elimination threshold for China, India also wants to phase in any reduction in tariffs over a longer time horizon to give Indian industries more time to adjust to the deal.

In the 15th round of negotiations, India appears to have backed off of the three-tiered approach, but there is still talk of a two-tiered approach. That said, ASEAN policymakers have made clear in the past that the purpose of the RCEP is in part to reduce the "noodle bowl" effect of duplicitous trade agreements (we expand on this concept in the next question), which clashes with India's original plans. Since all trade deals involve a fair degree of give-and-take, India may end up having to adopt a one-tier approach, that is to say, treat all RCEP partners the same. In return, Indian negotiators seem to have built consensus that services liberalisation must happen alongside liberalisation for goods trade (*The Economic Times*, 7 November). After all, services liberalisation is one area where India stands to gain.

What's in it for ASEAN?

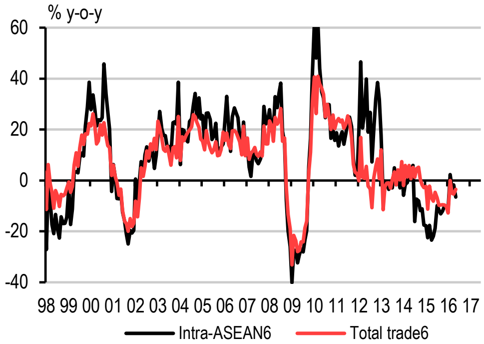
Since ASEAN already has FTAs with the member nations, what's in it for the region? With the formation of various bilateral trade agreements, a "noodle bowl" effect has developed whereby different specifications (rules of origin, tariff rates, standards) across treaties are so tangled and inter-twined that firms find it difficult to adapt, which ends up resulting in low utilisation rates of the FTAs, which has been the case in ASEAN.1 The RCEP effectively allows convergence between the agreements and should help attract foreign companies to base production in ASEAN.

Recall that in addition to ASEAN's outward FTA, the region has ambitious plans for internal integration, namely, through the ASEAN Economic Community (AEC). We estimate the agreement will boost baseline GDP by 5% through 2030, thanks to a break-down in investment barriers and services liberalisation, particularly across financial services (see *ASEAN Economic Community: The next level of integration*, 19 November 2015).

The fourth pillar of the AEC explicitly concerns the expansion of ASEAN's trading footprint. After all, the main attraction of the AEC is precisely the proposition of a single production base across

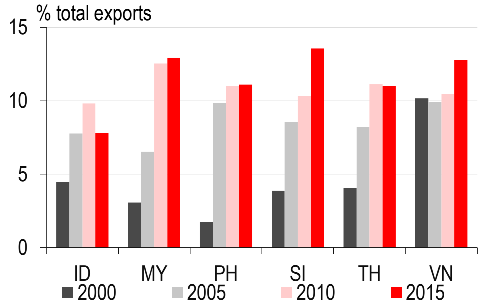
1 Fukunaga and Isono, *Taking ASEAN+1 FTAAs towards the RCEP: A Mapping Study*, ERIA, 2013

Chart 6. Intra- and extra-ASEAN trade volumes down sharply



Source: CEIC, HSBC

Chart 7. ASEAN's exposure to China has increased rapidly in recent years



Source: CEIC, HSBC

ASEAN by breaking down the barriers to cross-country supply chains (this is achieved by liberalising goods and services trade, investment, and skilled labour flow). Of course, increasing access to overseas markets is imperative too, which is why the RCEP is so important.

How does the RCEP interplay with "One Belt, One Road"?

Although there has been a trend towards increased protectionism in certain developed markets, Asian governments have largely remained committed to trade liberalisation. This is particularly true in the case of China, where it extends incentivising outward investment through the "One Belt, One Road" initiative. ASEAN, Japan, and South Korea are China's fourth, fifth, and sixth largest export partners, with significant supply chain interconnectivity, particularly in the case of ASEAN. While China already has FTAs with ASEAN and Korea, the already strong trade and economic linkages with the RCEP countries, along with China's desire to increase outward investment, heightens the economic advantages of the RCEP.

In sum: a source of optimism for Asian trade in the 'era' of President Trump

It is clear that the RCEP has clear draw-backs: the final agreement is likely to show significant exemption lists and long timelines for tariff elimination. However, it is, nonetheless, a welcome development for the region with the Doha-round in the WTO moving at a glacial pace and with the TPP's implementation all but off the table for now.

There is technically a possibility that President Obama may attempt to push through the TPP in the US Congress with the support of Republicans during the so-called "lame duck" session before the inauguration of president-elect Trump. United States Trade Representative Michael Froman believes that there may be support from both the Democratic and Republican parties in Congress to pass the legislation ratifying the TPP, despite opposition from president-elect Trump (*CNBC*, November 1). However, we think that the political environment surrounding the election and broad consensus against the TPP means that it is unlikely to be passed in the US at least over the next four years.

We believe that the victory of Donald Trump is ushering in a period of increased protectionism in the US economy (see Doug Lippoldt, *Trump: the Global Impact: Trade policy*, 9 November). The medium-term implications of the new administration will depend on which of president-elect Trump's policy pledges he is able to implement, but his seven-point plan on trade (see box below) suggests that Asian economies could be affected in a significant way. At the very least, we are likely to see a withdrawal from the TPP and the US is unlikely to initiate other trade initiatives over the next four years, which will provide additional impetus for accelerating the RCEP negotiation.

In short, the RCEP's passage should incentivise new investment in supply chains and provide some support for trade activity and GDP across Asia. The benefits discussed in this report suggest that the impact on growth is not insignificant. Sure, the impact is not as rosy as the benefits from the TPP; however, given the low-growth environment we are faced with, we'll take what we can.

6. Donald J. Trump's seven-point plan to rebuild the American economy by fighting for free trade

1. Withdraw from the Trans-Pacific Partnership (TPP), which has not yet been ratified.

2. Appoint tough and smart trade negotiators to fight on behalf of American workers.

3. Direct the Secretary of Commerce to identify every violation of trade agreements a foreign country is currently using to harm our workers, and also direct all appropriate agencies to use every tool under American and international law to end these abuses.

4. Tell NAFTA partners that we [the US] intend to immediately renegotiate the terms of that agreement to get a better deal for our workers. If they don't agree to a renegotiation, we will submit notice that the US intends to withdraw from the deal. Eliminate Mexico's one-side backdoor tariff through the VAT and end sweatshops in Mexico that undercut US workers.

5. Instruct the Treasury Secretary to label China as a currency manipulator.

6. Instruct the US Trade Representative to bring trade cases against China, both in this country and at the WTO. China's unfair subsidy behaviour is prohibited by the terms of its entrance to the WTO.

7. Use every lawful presidential power to remedy trade disputes if China does not stop its illegal activities, including its theft of American trade secrets – including the application of tariffs consistent with Section 201 and 301 of the Trade Act of 1974 and Section 232 of the Trade Expansion Act of 1962.

Source: Donald J. Trump for President, Inc., campaign web site; further details are elaborated in the Trump Campaign document, "Declaring American Economic Independence"; Doug Lippoldt, *Trump: the Global Impact: Trade policy*, 9 November 2016

Disclosure appendix

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