Global Value Chain Governance in the Era of Mega FTAs
and a Proposal of an International Supply Chain Agreement

Full Version

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As the Doha Round of trade negotiations under the World Trade Organization (WTO) continue to stagnate, free trade agreements (FTAs) will likely serve as the primary driving force to promote liberalization and rulemaking in the area of trade for some time to come. Especially, mega FTAs having comprehensive coverage both in terms of economic activities and trade—such as the Trans-Pacific Partnership (TPP); the economic partnership agreement (EPA) between Japan and the European Union (EU); the Regional Comprehensive Economic Partnership (RCEP); the trilateral FTA among Japan, China, and South Korea; and the Transatlantic Trade and Investment Partnership (TTIP) between the United States and the EU—are expected to play an important role in changing the global trade system.

At the same time, however, mega FTAs are by nature geographically closed and meant to enhance supply chains within specific geographic regions. Without sufficient progress in harmonization, they will not lead to the creation of truly global trade rules. They even pose a significant risk of creating a “spaghetti bowl” of conflicting rules.

Furthermore, as an agreement between or among specific member economies, FTAs are predicated on the assumption that there will be discrimination between members and non-members. FTAs are different from economic blocs in the 1920s in that the former is a mechanism to lower barriers between members relative to those to non-members whereas the latter is a mechanism to raise barriers to non-members. But they are no different in that they are both intended to discriminate between members and non-members in the treatment of trade. As such, mega FTAs are prone to give rise to the problem of discrimination

1 See VoxEU column (http://www.voxeu.org/article/it-time-international-supply-chain-agreement) for a summary (Nakatomi (2013b))
between those invited and those not. Debate over the adverse effects of trade diversion has somewhat subsided recently. However, even if the magnitude of trade diverting effects of FTAs is insignificant relative to the size of the global trade, their impact on the competitive relationship between countries is significant.

Also, as shown by two separate studies on trade in value added, one conducted by the Institute of Developing Economies, Japan External Trade Organization (IDE-JETRO) and the WTO and the other by the Organisation for Economic Co-operation and Development (OECD) and the WTO, global value chains (GVCs) are continuously changing in shape and structure, and there is no guarantee that an FTA covering a specific geographic region will continue to contribute to the facilitation of value chain development. ² ³

1. Four Scenarios

How should we understand the relationship between the establishment of truly global rules and value chains, and mega FTAs? What impact will mega FTAs have on the global trade regime or what role will they play over a medium to long term horizon? It is hard to say that sufficient discussion has been made regarding this point.

In what follows, I would like to outline three possible scenarios and propose a set of measures to bring them closer toward a more desirable scenario which is Scenario 4.

Scenario 1: Euphoric Scenario

Let me venture to expatiate on a euphoric scenario implicitly assumed by mega FTA advocates. Their argument is inferred to be based on the following premises:

1) Mega FTAs will be concluded before long
2) There will be no or little fragmentation (no or only a modest spaghetti bowl) of rules across different FTAs
3) Entangling rules can and will be harmonized
4) Harmonization will not take much time
5) Rules resulting from harmonization will serve as the basis for rulemaking at the WTO
6) Differences in rules applicable inside and outside of mega FTAs (members versus non-members) will not pose any major problems (or, even if they do, any conflict arising from such differences is of secondary importance and can be addressed later)

These premises point to an ideal scenario: mega FTAs will be concluded soon, fragmented

² IDE-JETRO and WTO (2011)
rules will converge (or “spaghetti bowls” will turn into “lasagna plates”) in due time, and a new set of de facto global trade rules—particularly for areas not covered by the existing rules—will emerge to serve as the basis for future rulemaking at the WTO. However, in order for this to be realized, all of the above premises must be correct.

**Scenario 2: WTO 2.0**

Next, let’s take a look at the WTO 2.0 scenario advocated by Professor Richard Baldwin. Professor Baldwin has been arguing that mega FTAs will create a “WTO 2.0,” a new governing body for 21st century trade rules as compared to the existing WTO which governs 20th century trade rules.

His argument seems to be predicated on the assumption that the WTO 2.0 will be organized as a separate body because its members and applicable rules differ from those of the existing WTO. He considers the WTO 2.0 separable from the WTO because the former is to set rules that address the needs of the 21st century (investment, competition, etc.) in tune with the global operations of multinational enterprises (MNEs) whereas the latter deals with rules for 20th century trade, and contends that the existing WTO is incapable of creating 21st century rules because of flaws in its decision-making mechanism. Meanwhile, in terms of membership, Professor Baldwin focuses on North America, the EU, and Asia as the primary members in view of the actual state of supply chain trade, whereby the universality of membership is of secondary importance at the best. These are the assumptions based upon which he predicts the emergence of a trade system in which the WTO and the WTO 2.0 co-exist.

**Scenario 3: Spaghetti Bowl of Rules (Fragmentation Scenario)**

Obviously, both Scenarios 1 and 2 have been driven by strong dissatisfaction with and a growing sense of resignation about the stalemate of the WTO and the Doha Round. And there is no doubt that mega FTAs will become a major driving force to promote international rulemaking and liberalization. However, taking an excessively optimistic view of mega FTAs is dangerous. Let’s examine each premise underlying Scenario 1 to see whether it is realistic.

Regarding premise 1), given the level of ambition, complexity, the magnitude of potential economic impact, and the sheer number and diversity of countries involved, concluding a mega FTA is not an easy task. It is rather natural to expect negotiations to be long and

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4 IDB and ICTSD (2012), pp. 24-25
5 Baldwin (2011 and 2012)
6 Professor Baldwin’s argument is not necessarily an organizational theory and therefore WTO 2.0 can be taken as referring to a collection of 21st century rules evolving from mega FTAs. A process for harmonizing the existing WTO rules and those of the WTO 2.0 in the future is not necessarily clear.
drawn out. Cases of mega FTA negotiations in the past—such as those for the North American Free Trade Agreement (NAFTA)—caution against making optimistic assumptions about time. Indeed, one misstep could derail or end the entire negotiations.

As such, while all participating countries' dedicated efforts for an early conclusion are absolutely necessary, it is reasonable to assume that the negotiation of mega FTAs will take a significant period of time even with the strong will of all of the participants.\(^7\)

Premises 2) and 3) will need to be examined in consideration of the future development of mega FTA negotiations. Considering significant differences across countries in regulatory frameworks and economic infrastructure, however, it is only natural to expect that negotiations for mega FTAs, which tend to involve the ironing out of differences in economic systems, will be as heavy going and time consuming as those under the General Agreement on Tariffs and Trade (GATT) and the WTO. There is no guarantee that rules and disciplines in specific areas will converge across different mega FTAs. In concluding its FTAs with the EU and the United States, South Korea had to apply different definitions with respect to international standards in the area of automobiles as well as in that of electronics and electrical products. As such, it seems unavoidable that the emergence of a series of mega FTAs—the TPP, the Japan-EU EPA, the TTIP, and so forth—will result in numerous conflicting rules reflecting differences in regulations and regulatory philosophies among major economies in various areas including intellectual property (e.g., treatment of right infringement on the Internet), information (e.g., relationship between the cross-border transfer of information and privacy), and competition (e.g., definition of “state-owned enterprises” and discipline on their behavior).\(^8\) This is to say that there is no guarantee for rules and disciplines to be set in a harmonized manner across mega FTAs. Furthermore, as negotiations take place separately for respective mega FTAs, it is naturally expected that they will produce different agreements and hence resulting in the current presence of different rules and disciplines.

For the same reason, if such negotiations result in a spaghetti bowl of rules, there is no guarantee that differences among mega FTAs will be harmonized in a short period of time as assumed in premise 4). And if no harmonization takes place, premise 5) fails, and providing a basis for rulemaking at the WTO will not occur.

As to premise 6), differences in rules applicable inside and outside of mega FTAs or different treatment between members and non-members could pose a major problem.

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\(^7\) This is not meant to refer to the prospect of any specific mega FTA.

\(^8\) As a hub of mega FTAs and a forerunner in the area of rulemaking, Japan is positioned to prevent a tangle of rules, and it can and should play a leading role in doing so. See Nakatomi (2012b).
Supply chains are changing constantly in all aspects—i.e., procurement, production, and distribution—and in terms of countries concerned as they adapt to changes in the global operations of MNEs. Indeed, the globalization of supply chains is proceeding apace. What is truly needed now is not regional trade rules but global trade rules and supply chains.

The close examination of those premises should reveal that Scenario 1 is fraught with the real danger of turning into Scenario 3, which is to give rise to a spaghetti bowl of rules.

2. Toward the Development of a Harmonized Trade Policy (Scenario 4)

In order for mega FTAs to be able to become the basis for a truly global system, what perspectives are needed?

As the WTO and the Doha Round continue to stagnate, mega FTAs will no doubt serve as the basis for the formation of a new international trade regime in the years to come. However, it is dangerous to count too much on mega FTAs to automatically bring in a new order for international trade to accommodate the newly arising needs of GVCs. Although earnest efforts and dialogue for and under mega FTAs will be the basis for global rulemaking, it is important to keep in mind the following five perspectives:

(1) Clear vision of the future trade system

First, we need to have a clear vision of the future trade system we intend to build. As in other areas, the United States and the EU tend to compete for hegemony in the area of international trade. In this regard, Japan’s role is extremely important as it is well-positioned to mediate between the two big powers (as a “hub” of international trade policy through the TPP and the Japan-EU EPA), and its economic system is generally flexible (though there are some difficult areas). The United States and the EU have had many attempts to adjust their regulatory differences, but they have not necessarily been successful. Against this backdrop, Japan is not a peripheral player but has the casting vote to determine the form and nature of the global trade system in the coming years.

(2) Global Solution

Second, it is important to design a global solution, not a regional solution. Indeed, what the business community is looking for is not a regional solution by means of FTAs but a global solution and GVCs. In this regard, drawing a strategy with an eye set on the future of the

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WTO and future WTO rules is essential.

It is dangerous to forget and underestimate the role of the WTO. The ongoing state of the WTO and the Doha Round is surely problematic. However, it is high time that we should start having a full-blown discussion on the reform of the WTO without looking away from the reality.\(^\text{10}\)

Also, even though the WTO and the Doha Round are in a very difficult situation as discussed above, its function as a judiciary body and the day-to-day monitoring and administrative functions of its various committees are working properly and effectively. In addition to supporting and utilizing the judicial function of WTO panels, we must support various committee activities and soft law making at the WTO, which are extremely important in order to support and maintain the global trade system.

(3) Transparency, disclosure, and information sharing

Third, ensuring transparency, disclosure, and information sharing is also critically important. The effective halting of the WTO's function to assess the consistency of FTAs has given leeway for some FTAs—mega FTAs in particular—to introduce provisions overriding those of the relevant WTO agreements. As such, there is a compelling need to promote the multilateralization of FTAs and the localization of WTO rules. Transparency and the distribution of accurate information are what constitute the foundation of this endeavor. In order to avoid a spaghetti bowl of rules and prevent the polarization of trade systems as a result of mega FTAs, it is essential to establish appropriate procedural rules and ensure transparency in their application (e.g., public comment procedure) within FTAs as well as to ensure transparency in the eyes of those outside of FTAs. This would directly contribute to the establishment of GVCs.

(4) Concept of GVCs

Fourth, the concept of GVCs and the viewpoint of the business community must be fully taken into consideration. The necessity of GVCs is now becoming a common view of business communities across the world. The WTO is often criticized for its inability to listen to the voices of the business community and the same holds true for mega FTAs. If participating countries are drawn into a power struggle for hegemony and forget about the needs of the business community, they would repeat the same mistake made by the WTO.

The business community has been too indifferent to developments at the WTO, while the

\(^{10}\) See Nakatomi (2011).
WTO has been too insensible to the needs of the business community and the reality of the
global economy. This is exemplified by a lack of communication between the business
community and the WTO. In the case of the Asia-Pacific Economic Cooperation (APEC), an
advisory body called the APEC Business Advisory Council (ABAC) has been serving as a
channel for listening to and reflecting the voices of the business community, while the OECD
has the Business and Industry Advisory Committee (BIAC). Both the ABAC and the BIAC
have been actively providing inputs to policymakers under their respective frameworks. The
WTO, however, has no such advisory body representing the voices of the business
community.

Too much emphasis on the nature of the WTO as a government-to-government forum has
resulted in the current stalemate, i.e., inability to deliver tangible results over a long period of
time due to inter-governmental conflicts and rivalry, causing the business community to lose
interest in the WTO and intensifying the global race for FTAs. Members of the business
community should make inputs to the WTO in a more straightforward manner, and the WTO
should listen to their voices. Otherwise the WTO would be forced into irrelevancy and its
existence put at stake.

(5) Issue-based global rulemaking

Fifth, we should embrace the concept of issue-based international rulemaking.\(^\text{11}\)\(^\text{12}\) Mega
FTAs must not be seen as something opposed to the WTO. Instead, we should promote the
results of mega FTAs as a foundation for future WTO rules on an issue-by-issue basis and
better utilize issue-based plurilateral agreements.

In a set of proposals put forward on April 2013, Keidanren (Japan Business Federation)
underlined the need to set a “unified axis” for Japan’s trade strategy.\(^\text{13}\) Indeed, it is very
important for Japan to define its unified axis on a sector-by-sector and issue-by-issue basis
and take a coherent approach in negotiating various mega FTAs.

It would be extremely difficult to solve a spaghetti bowl of rules after concluding mega FTAs.
In order to avoid this, major players—including the United States and the EU—should
promote plurilateral initiatives on a sector-by-sector and issue-by-issue basis.

Last year, I proposed an International Supply Chain Agreement (ISCA), to be detailed in the

\(^{11}\) See Nakatomi (2012b)
\(^{12}\) See Nakatomi (2013a)
\(^{13}\) See Keidanren (2013). “Unified axis” is the term I used in briefing Keidanren’s Committee on Trade and
Investment in March 2013 and I am glad to see it used as a keyword in the report.
following section, as a vehicle to facilitate global supply chains. In view of the ongoing developments in mega FTA negotiations and the need to avoid the fragmentation of rules and provide a basis for future rulemaking at the WTO, it is extremely important for the governments of major economies to pursue plurilateral agreements in priority areas as defined in collaboration with the business community.

3. What is the ISCA?

The ISCA is a concept of a comprehensive plurilateral agreement on GVCs, which I proposed at the E15 Expert Group Meeting on Global Value Chains in Geneva in November 2012, co-organized by the Inter-American Development Bank (IDB) and the International Centre for Trade and Sustainable Development (ICTSD). As someone who was closely involved in and contributed to the successful conclusion of the Information Technology Agreement (ITA) and the Anti-Counterfeiting Trade Agreement (ACTA), I have been focusing on the potential of plurilateral agreements as a tool to complement the WTO. In particular, I have pointed out that we can negotiate not just a single issue but multiple issues in a bundle by designing plurilateral agreements strategically.\textsuperscript{14} Considering successful examples in the past as well as the increasing interest in and support for GVCs within the business community, it is necessary and quite possible to discuss and negotiate rules governing GVCs as a plurilateral agreement.

Readers are advised to refer to the proposal\textsuperscript{15} for details, but I would like to provide a general overview and idea of the concept.

(1) Outline of the ISCA

i) Basic principles

In proposing the ISCA concept, I defined some basic principles which, inter alia, include:

1) Creating rules that are consistent with and complementary to the existing WTO rules and provide the basis for future WTO rules;
2) Not undermining the Doha Round;
3) Extending resulting benefits to non-participants on a most favored nation (MFN) basis in general;
4) Contributing to the elimination of the spaghetti bowl phenomenon in the rules of origin and other rules

\textsuperscript{14} See Nakatomi (2012b), p.71.
\textsuperscript{15} See Nakatomi (2012a).
5) Aiming to achieve an early conclusion; and
6) Cooperating and consulting closely with the business community.

Among those, 1) and 4) are the two sides of the same coin. However, as the goal of GVCs is to create an efficient global business environment, simply contributing to the facilitation of value chains within a specific geographic region is not enough and allowing for the presence of multiple conflicting rules is inappropriate. Although mega FTAs contribute to value chain enhancement, they are not meant to provide a global solution. Limited in geographic scope and intended to set regional rules, mega FTAs per se cannot substitute the WTO that has members from all over the world and globally applicable rules.

Although it may seem that 2) is something we can take for granted, such is not the case in fact. If certain issues subject to the ongoing Doha Round are taken out and agreed upon under a plurilateral framework, it could halt the Doha Round negotiations in the relevant areas. Therefore, it is appropriate to exclude the issues covered by the Doha Round from the scope of plurilateral negotiations. As a consequence of the WTO Ministerial Conference in 2011, consensus is being built among WTO members on the possibility of unbundling issues and negotiating different issues at different paces (e.g., ITA, trade facilitation). However, discussing issues on the Doha agenda—i.e., those being negotiated within the WTO—elsewhere outside the WTO would create great confusion.

Being a plurilateral agreement, the ISCA should naturally seek to secure the participation of major economies that would constitute a critical mass, but there are pros and cons regarding 3), i.e., the MFN extension of benefits resulting from the agreement. This is the question of whether or not to allow free-riding by non-participants, and opinions are sharply divided among WTO members. However, successful plurilateral agreements—the ITA, the Basic Telecommunications Services Agreement, and the Financial Services Agreement—extend their benefits to non-participants on an MFN basis, and following those examples will definitely increase the chance for successful conclusion. Conversely, it would be extremely difficult to justify any plurilateral agreement under the framework of the WTO, if not premised on the principle of MFN extension.

In order to design a global system with an eye on multilateral rules in the future against the backdrop of increasing attempts to pursue a non-MFN approach through mega FTAs, we need to have a concept of global common rules. This is closely related to 4), as simply piling partial solutions achieved through mega FTAs is a promising recipe for a spaghetti bowl of rules. Even if the tangle of conflicting rules resulting from mega FTAs can be disentangled afterward, it would be a long and difficult way to achieve that end.
Given the ongoing “failure” of the Doha Round, 5) is a natural requisite. Speed is one of the major factors explaining many countries’ preference for FTAs over the Doha Round. Negotiations for the ISCA must proceed with a sense of speed and without undue delay, and, in order to enable this, it would be necessary to adjust or compromise on the agenda and the level of ambition. This is because I find it necessary to conclude the ISCA before too much harm is done by the multipolar system that would result from mega FTAs. Speed is also of high priority for the business community where companies operate in dog years.

What all of this tells us is that countries and economies joining the ISCA must not indulge themselves in a hegemonic war. Instead, it may be necessary to set a clear timeframe for negotiations, for instance, to achieve a conclusion within three years, and limit the scope of negotiation to priority areas so as to ensure its conclusion within that period of time. Also, participants should focus their efforts on institutional and regulatory harmonization, not on sprawling negotiations that may never reach conclusion. Harmonization, by its own virtue, means a lot to the international trade regime and GVCs. (Please recall the case of the ACTA.)

Promoting close cooperation and consultation with the business community, as stated in 6), is extremely important as we need to have a clear idea as to why and for whose benefit we should negotiate. One big problem with the WTO is the distance with the business community. Placing so much emphasis on its role as an intergovernmental coordinator, the WTO has become a political battle field for member economies, looking away from the reality of the global economy and business activities. This resulted in the ongoing crisis of the WTO and the Doha Round.

ii) Areas to be covered by the ISCA

What specific areas should be covered by the ISCA? First and foremost, it is necessary to coordinate views with the business community as discussed above. After that, it is necessary to narrow down the focus so as not to create too heavy an agenda. For example, potential areas for negotiation include the following:

To begin with, including those areas currently negotiated in the Doha Round is both detrimental and counterproductive. Given that, two types of behind-the-border measures that are of strong interest to the business community and not covered the Doha Round—i.e., technical barriers to trade (TBT) and sanitary and phytosanitary (SPS) measures—can be highlighted as potential areas for ISCA negotiation, whereas trade facilitation can be a candidate only if the Doha Round fails on this issue. Export restrictions can be cited as

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16 See Nakatomi (2012b), pp. 33-35.
another important candidate.

Among the areas not covered by the existing WTO agreements, the issue of trade and investment and that of trade and competition—both of which had been initially on the Doha agenda as “Singapore Issues”—can be cited as candidates along with electronic commerce and preferential origin rules.

In reality, it is no easy task to press forward with the ISCA initiative in the midst of a stream toward mega FTAs. Obviously, mega FTAs are of primary concern for major economies. And it is certain that mega FTAs will be a major driving force for international trade policies in the future. Furthermore, attempting to negotiate the ISCA by covering all of the potential areas cited above is tantamount to initiating a mini round, and we would end up wrecking the initiative. Thus, a realistic approach is for the government and the business community to cooperate closely, select truly important areas (such as investment and competition), and proceed with the ISCA initiative by concentrating on such areas. What is required today is to take it as a premise that mega FTAs will be playing a leading role in the coming years, anticipate problems and risks that may arise from mega FTAs, and seek to create future multilateral rules based on such premise and anticipation.17

(2) WEF Enabling Trade Report and a World Bank blog

The World Bank has since taken interest in the ISCA. A World Bank blog coauthored by Bernard Hoeckman and Selina Jackson in January 2013 introduced the ISCA as a holistic approach to addressing GVC barriers.18 The initiative was also introduced in the World Economic Forum’s Enabling Trade report in 2013 as well as in the Swedish National Board of Trade’s report on GVCs and the U.S.-EU FTA.19 20

The ISCA proposal is meant to present a path toward finding a concrete solution to problems surrounding GVCs. The underlying idea is that the governments and business communities of concerned countries from around the world should work together to find, communicate, and realize global solutions on an issue-by-issue basis. This initiative is a realistic approach, and, if those governments and business communities work in earnest to address GVCs barriers, it will definitely deliver tangible results just like the ITA and the ACTA. Relying solely on mega FTAs is dangerous not only for Japan but for the world. It is strongly hoped that the global community will navigate the stormy sea of mega FTAs with viable strategic options such as the ISCA in hand.

17 See Nakatomi (2013a).
18 Hoeckman and Jackson (2013)
20 National Board of Trade, Sweden (2013), p.6, p.20
Specific issues or areas to be covered by the ISCA can be determined flexibly through consultation between governments and business communities. Needless to say, the selection of issues must be a realistic one. Carrying out this task in this era of mega FTAs is surely difficult, but this may be one of those cases where the longest way around turns out to be the nearest way home. I hope that vigorous discussion will be made on the ISCA as a new, government-business collaborative approach.

It should be noted that issue-based coordination is meaningful even when it falls short of a formal agreement. Japan, the United States, the EU, and Canada used to form the Quadrilateral group, or the Quad, to make close coordination on important trade issues. Although this particular mechanism no longer exists today, such an informal framework for coordination among major players in international trade can play a crucial role in the era of mega FTAs. It is high time to explore some sort of coordination framework.

The five perspectives discussed in Section 2 (Scenario 4) are for illustrative purposes. Meanwhile, in order to steer mega FTAs in a way to contribute to the formation of a more harmonious trade regime, international collaboration of governments and business communities is indispensable.

Today, GVCs are subject to an increasingly vigorous debate, which has been driven by diverse concerns and interests. Indeed, against the backdrop of the rise of mega FTAs and the continuing stagnation of the WTO Doha Round, GVCs offer an effective viewpoint and a fresh dimension from which to explore the new frontier of international trade policies and global governance. Governments and business communities from all around the world should actively cooperate and work together toward the facilitation of GVCs and the realization of global governance of trade policies. I hope that this paper, the proposal of the ISCA in particular, could be of help toward achieving that end.
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