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The RCEP – A challenge for Europe too

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The ASEAN states (Brunei, Indonesia, Cambodia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, Vietnam), the People's Republic of China, Japan, South Korea, Australia and New Zealand are setting up the world's largest free trade area in the form of the Regional Comprehensive Economic Partnership (RCEP). This agreement also constitutes a challenge for Europe.

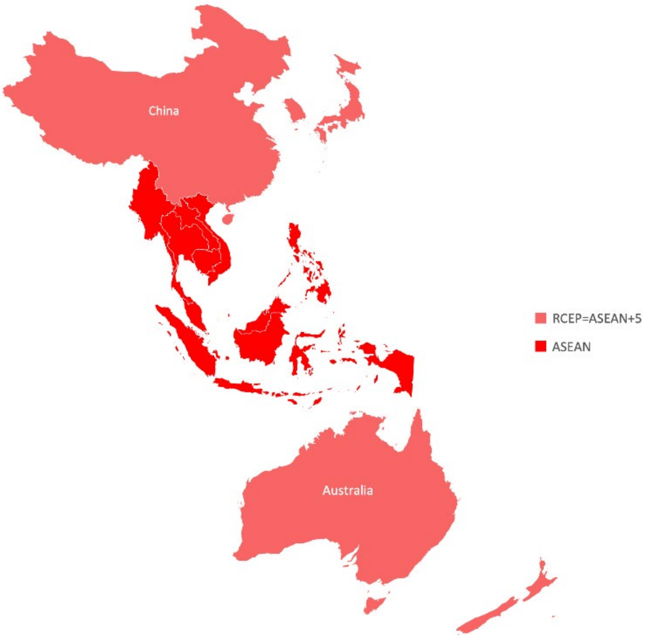
- The RCEP encompasses some 2.2 billion people and, comprising GDP of about USD 26,000 billion, accounts for approximately 31 percent of global aggregate economic output and 28 percent of the global trade volume.
- The agreement has a decidedly substantial reach and has sufficient potential to provide additional impetus to Asian-Pacific trade.
- However, it is likely to take quite some time before the RCEP unfolds its full effect. The transition periods for tariff dismantling are very long. In addition, most of the trade-facilitation measures provided for by the RCEP only replace ones that member states have already granted each other within the framework of numerous bilateral free trade agreements.
- Nevertheless, the agreement still constitutes a milestone in the economic integration of the Asia-Pacific region - and not just because it is the first time that three of Asia's leading economic powers (China, Japan and South Korea) have concluded a joint free trade agreement.
- The fact remains that the RCEP also contains considerable weaknesses, which Europe should exploit in order to forthrightly negotiate a market opening in the interest of European companies, e.g. with ASEAN state
- Over and above this, the EU should launch a second attempt to attain a transatlantic free trade agreement with the USA now that the Biden administration is in place.

The RCEP free trade zone is putting Europe under pressure to act

The RCEP has created the largest free trade zone in the world

With their signatures in Hanoi on November 15, 2020, the heads of state of 15 Asian-Pacific countries launched the world's largest free trade agreement (FTA) under the name "Regional Comprehensive Economic Partnership" (RCEP) in what is the world's most dynamic growth region. In addition to the ten ASEAN states (Brunei, Indonesia, Cambodia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand and Vietnam), the founding members include the People's Republic of China, Japan, South Korea, Australia and New Zealand.

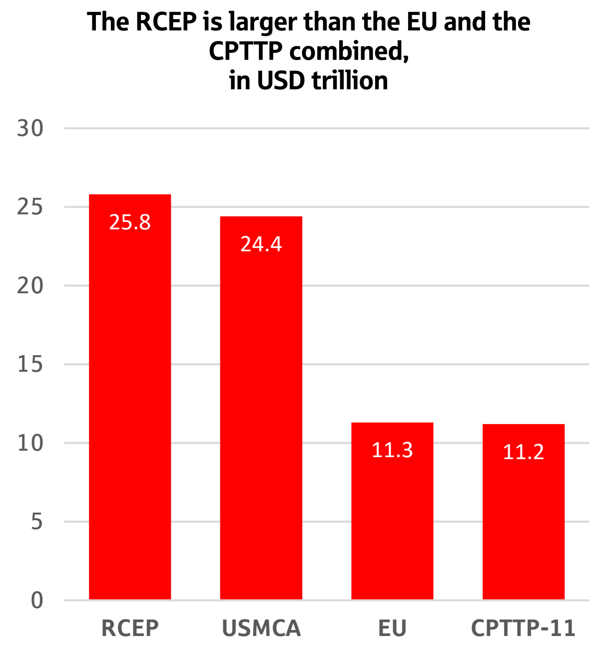
The RCEP: Member States



Source: Jacques Delors Institute, Paris

The RCEP encompasses around 2.2 billion people and, comprising GDP of around USD 26,000 billion, accounts for approximately 31 percent of global aggregate economic output and 28 percent of the global trade volume. The RCEP thus boasts a level of aggregate economic output which is greater than that of the USMCA (formerly "NAFTA"), which consists of the United States, Canada, and Mexico, and more than twice as high as EU GDP. Even the Comprehensive and Progressive Trans Pacific Partnership (CPTPP) signed in 2019 in the Asia-Pacific region is not nearly as large.

Trade agreements ranked in terms of the GDP of member states:



Source: Institute for Strategic and International Studies (ISIS), Malaysia
Note: The calculation of RCEP GDP excludes India

In addition to the complete phasing-out of all remaining (residual) customs duties on 92 percent of all traded goods over a period of 20 years, the agreement provides for a host of other measures designed to significantly facilitate cross-border trade in the region. These include uniform rules on origin of goods, the regulation of technical standards, the protection of intellectual property, a dispute-settlement procedure, and much more. The RCEP is thus a substantial FTA that has sufficient potential to impart additional powerful stimuli to already dynamic Asian-Pacific trade.

The RCEP is not a single market, ...

Per se, the framework data relating to the RCEP are indeed impressive. However, the planned free trade area is still far from being a deeply integrated internal market with a uniform trade policy, comparable, for example, to the set-up in the EU. The RCEP is not even a customs union because, within such a construct, customs duties have to be completely abolished and there is a common external tariff. It is certainly not a "single market" that guarantees, for instance, free choice of residence and employment for all citizens of member countries. Within the EU, there is a blanket guarantee for the free movement of goods, services, capital and persons. Although the RCEP enables trade facilitations of all kinds, it falls far short of the accomplishments of a single market on the EU model.

Moreover, agreements reached within the framework of the agreed dispute-settlement procedure are far from having the universal validity of the verdict of a supreme court, which - as in the EU - pronounces final and binding judgments for all. The advantages of an FTA must therefore first prove their worth in daily economic life and constantly hinge on the will of the parties involved to put concrete flesh on the abstract bones of the agreement.

In any case, it will probably take some time before the RCEP has a palpable effect. For one thing, the transitional periods, e.g. for tariff dismantling for many central goods categories, are very long at up to 20 years, in individual cases even 30 years. For another thing, important domains such as the tender procedure for public contracts or the subsidisation of state-owned enterprises, for example, have been excluded from the agreement in important sections - very much in line with China's wishes. What is more, the rules governing the services sector are hardly superior to the WTO standards that apply almost everywhere. Most of the RCEP's trade-facilitation measures merely replace ones that the member states have already granted to each other under the auspices of numerous bilateral free trade agreements. Already in 2017, the average tariff rate for trade in goods between states now belonging to the RCEP was just 1.6 percent, according to the Confederation of German Industry (BDI), and this rate is now set to slowly drop towards 0 percent. The RCEP is therefore by no means a tempestuous storm that, with primeval force, will suddenly tear away the barriers between countries previously strictly closed off from one another.

... but is nonetheless a milestone for the Asia-Pacific region

That said, the agreement is definitely a milestone in the economic integration of the Asia-Pacific region. And not just because this is the first time that Asia's leading economic powers - the People's Republic of China, Japan and South Korea - have concluded a joint FTA. Thanks to the standardisation of what used to be a chaotic jumble of bilateral regulations, many things will now be considerably simpler, more transparent, less bureaucratic and more cost-efficient. Although the RCEP is not a single market, it at least adds up to a clearly structured "second-best solution," replacing a previous regime of disorderly free-trade multilateralism. This is because the RCEP unifies and consolidates rules of origin, for example. In de facto terms, this effect is actually more significant than the tariff reductions, from day one favouring above all companies with highly diversified value-added chains that extend across a number of Asia-Pacific countries. When calculating domestic value added, for example, inputs from all RCEP member states can now be included, which makes it much easier to meet the requirements for duty-free imports into another RCEP country. In the past, if the share of domestic value added to an export good was too low, preferential tariff treatment during the importing process did not apply. The RCEP is now likely to result in even greater economic integration between the member states, particularly with regard to the building-out of supply chains.

It is therefore becoming apparent that an economic cooperation is going to emerge here over time representing a huge market destined to grow together, at least to a certain extent. Such a market will have the "critical mass" it needs to engender self-sustaining economic growth, i.e. to generate growth-promoting economies of scale, and also to set technological standards. So far, only countries or alliances on the economic scale of the USA or the EU have been able to bring off this feat. Ceteris paribus, it will probably become increasingly difficult going forward for outsiders to compete for customers with companies from RCEP member states on their “home turf” or to connect to internal value chains as long as the RCEP maintains its current barriers to entry vis-à-vis the outside world.

Technologically speaking, the region has long since become a "hot spot" for high tech - e.g. digitalisation technology. Among its member states, the RCEP has one or more countries that are among the world's cutting-edge nations on the technology front (e.g., China, Japan, South Korea, Singapore) in almost every economic sector that is commonly regarded as "a technology of the future."

So is the rest of the world now condemned to look on passively as the New World Economic Order is being forged in Asia?

The RCEP is one of Trump's political legacies

It does not necessarily have to be that way. The fact is that the RCEP also has some serious weaknesses. If Donald Trump had not torpedoed the Trans-Pacific Partnership (TPP) initiated by his predecessor Obama and announced in 2017 that the USA was withdrawing from the already completely negotiated agreement, the TPP rather than the RCEP would have been the first choice of the vast majority of countries involved in the negotiations on the two FTAs. After the US withdrawal, however, these countries probably preferred the proverbial “one bird in the hand” to the proverbial two birds allegedly lurking somewhere beyond reach in the bush. Without the USA as a "central star," the "rump alliance" CPTPP has nowhere near the same level of attractiveness as the originally envisaged TPP. And the fact the United Kingdom is seeking membership of this constellation is hardly going to fill this gap. And so, almost like a Trumpian legacy, the RCEP has won the race but is now revolving around an "alternative central star," namely China.

Against this backdrop, Trump's post-2017 efforts to "contain" China seem rather grotesque. After all, the US withdrawal from the TPP is what made the RCEP significant in the first place, accordingly rolling out the red carpet for China in the region. The TPP was specifically intended by Obama as a means to hedge China's influence in the region by having the Pacific Rim countries rally around the USA in a free trade area excluding the People’s Republic. This would not only have been economically attractive to such countries - as well as to the United States - but would also have fitted in neatly with the security interests of most Asia-Pacific states. After all, China's political interests hardly coincide with those of most of the states in its neighbourhood.

The inference, then, is that the cohesion of RCEP is always going to be in question politically. This can be gauged, for example, from the recent dispute between China and Australia. Although both these countries have signed the RCEP agreement, the People's Republic is taking punitive action against the Republic of Australia primarily for primarily politically-motivated reasons, using economic leverage such as far-reaching import restrictions on Australian goods. And although China is now forming a free trade zone with most of the countries bordering the South China Sea, the region remains a potential political flashpoint. This is because China, flouting international law, claims the lion's share of the South China Sea for itself alone, and aggressively asserts its claims here at the expense of many of the states with which the People's Republic is now linked in a free trade agreement. Looking at Australia's experience, the countries concerned can already work out mentally what RCEP agreements will be worth if there is ever a political confrontation with China, e.g. over territorial claims in the South China Sea.

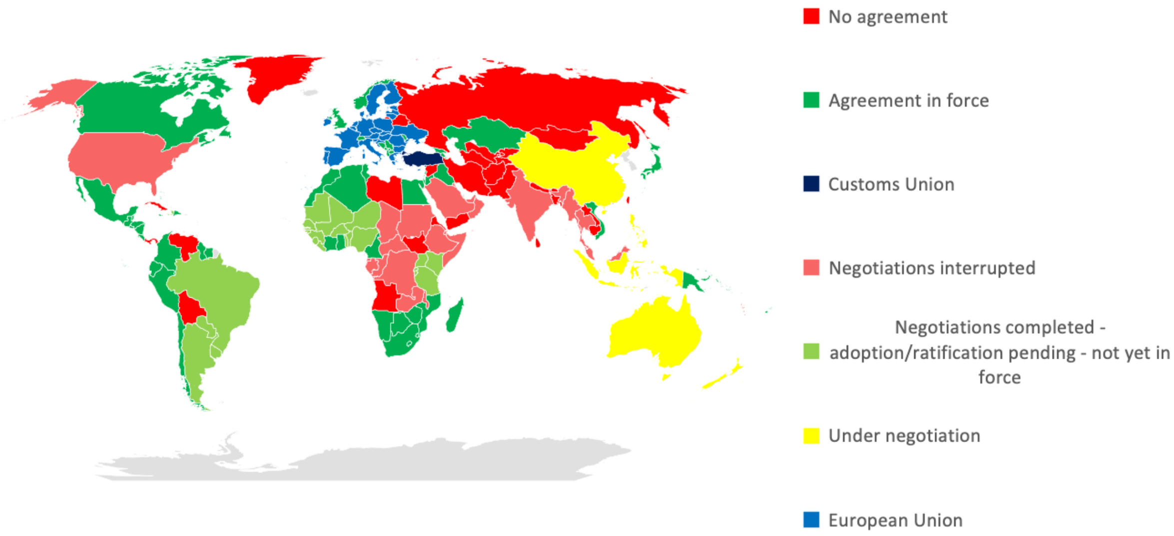
As a consquence, the willingness of most RCEP states to open up to each other internally while simultaneously closing themselves off to the outside world and thus becoming increasingly dependent on China economically and politically is not likely to be all that strong - provided that there are alternatives. Since US President Biden has announced that he will be seeking cooperations with other states in the competition with China, the USA is likely to once again promote the stepping-up of relations with countries in the region to an increasing extent.

From Europe's point of view: Attack is the best form of defence

But opportunities are also beckoning for Europeans. If the EU takes pains to conclude far-reaching FTAs, for example with ASEAN countries, one of which has already been concluded with Japan, European companies will "keep their foot in the door" here and companies from the Asia-Pacific region will expand their business relations with Europe despite the RCEP. That would be to the benefit of all concerned. It can be assumed that many ASEAN states would be interested, because the more diversified the economic relations of these states become, the better it is for their economies and the less they can be put under pressure, for example by China. Especially now that the RCEP has been signed and sealed, the EU may perhaps not be able to immediately find open doors, but it will certainly meet with open ears.

At any rate, doing nothing would be a rather disastrous strategy from Europe's point of view. The best strategy for continuing to hold one's own on world markets would, in any case, be to regard attack as the best form of defence. Along with a return to the multilateral approach under the auspices of the WTO, the following "iron law" applies to the EU: The more substantial the free trade agreements with other important economic areas it can fall back on, the better it will be for European exporting companies and the more attractive the Community as a whole will become as an investment destination and as a market. And the easier it will then be to negotiate fair market access to other major economic areas as well. Fortunately, the EU has never been inactive on this front.

Free trade: EU agreements and activities (as of 2021)



Source: Germany Trade and Invest (GTAI) 2021

The RCEP also unlocks opportunities for European companies

Opportunities beckon for companies due to the "Mexico effect"

For European companies willing to take an exposure to the outside world in the form of foreign direct investment (FDI), the RCEP also represents an opportunity. We call this the "Mexico effect." Mexico benefits greatly from FDI due to the FTA it has struck with the USA and Canada. In order to supply the US market, many companies - including German ones - produce in Mexico and take advantage of the favourable manufacturing costs there as well as of the option of being able to deliver goods from Mexico to the United States duty-free. In future, the RCEP is also likely to offer such opportunities with regard to the Chinese market. Companies that produce in an ASEAN country at lower labour costs than in China, for example, will then be able to supply the immense Chinese market from there relatively unshackled by restrictions and tariffs.

Conversely, this will admittedly prove a disadvantage for the EU as a production location. The logic here: when considering where to build a new production plant to serve, for example, the Chinese market, locations in RCEP countries clearly now have an advantage and are therefore ahead of the game. This effect can only be mitigated by correspondingly far-reaching FTAs between the EU and RCEP countries in order to keep at least part of the production of intermediate inputs within the EU.

In future, relocating production to RCEP countries instead of producing in China itself will give companies the advantage of exposing their proprietary technology less than before to the risk of being "copied," for instance by Chinese joint venture or by other local business partners. For it is clear that the new Chinese five-year plan, which is to be adopted this spring, is to be understood as a strategic continuation of the previous "Made in China 2025" strategy. Ultimately, this means nothing other than that China's declared goal is to lead the country to technological self-sufficiency, i.e. to see to it that Chinese companies gain technological leadership in all future-oriented fields of technology. Every foreign company that produces in China or works with Chinese partners must be aware of this and must weigh the opportunities and risks of its involvement.

Foreign companies could get caught between the fronts

What is more, in the light of the escalating Sino-US showdown, foreign companies producing in China could very quickly find themselves caught between the fronts, even under US President Joe Biden. This is because not only the USA, but also China, is likely to increasingly force foreign companies to "opt for one side" in the event of a conflict. To this end, an "export control law" came into force in China in December 2020, which, inter alia, prohibits foreign companies from exporting goods out of China if this were to contradict the Middle Kingdom's "national security interests". Foreign companies can likewise now be sanctioned if they (have to) participate in (US) sanctions against the People's Republic. This "sandwich position" could be extremely unpleasant, especially for companies producing in China, if a conflict were to break out.

Our advice: Seize the opportunity now

An FTA with ASEAN states and the USA would be the appropriate response to the advent of the RCEP

In the interests of European companies and in order to keep jobs in Europe viable even in a further globalising market, the EU should redouble its efforts to reduce trade barriers. As well as endeavouring to cooperate much more closely than before with as many ASEAN countries as possible so as to keep the dynamically growing RCEP market open for European companies, the EU should also attempt to seize the opportunity and make the new US president an offer to negotiate a free trade agreement between the EU and the United States.

That would by no means require starting from scratch. The fact that the transatlantic free trade area TTIP failed not least because of the unwillingness of the Europeans to open up their market for agricultural products, and the fact that the deal was killed off by such marginal issues as whether or not to permit imports of US chlorinated chicken, seems anachronistically behind the times given the pace at which the Asia-Pacific region is progressing. Someone failed to perceive the flash of lightning; now the thunderclap is resounding from the Asia-Pacific region.

Perhaps there is now more willingness for a transatlantic FTA in the aftermath of Trump and the RCEP. The Trump years have clearly shown, not least to the Europeans, how quickly one can be exposed without protection to political arbitrariness even with "value partners" in the absence of firm and enforceable treaties concluded for mutual benefit. Boris Johnson, at any rate, would no doubt gladly eat a dozen US "chlorinated chickens" while a blitz of cameras was flashing - all on one single day if necessary - if he could obtain an FTA with the USA in return.

The new US president is certainly not a "free trader," one of the slogans he used to kick off his election campaign being "buy American," but Biden will certainly approach the issue more constructively than his predecessor. Despite many differing views, Biden does, after all, have a very close affinity with ideas that are central to Europeans, e.g. in matters of international cooperation, a fair balance of interests, climate protection, social security and human rights. Future cooperation should now be cemented on this basis in order to make the transatlantic alliance "seaworthy," so as to be able to withstand the bouts of turbulence which are certain to recur sooner or later. An EU that has become significantly smaller cannot afford to remain inactive if it does not wish to be degraded to a junior partner on a global scale in the face of the large new economic alliances that are in the process of being forged - a partner that has no choice but to submit to the standards and specifications of others.

Let us Europeans make use of the tailwind of the free trade spirit shown by the RCEP to integrate ourselves even more strongly into the global economy. This would also entail beneficial risk diversification: after all, the greater the networking effects on the production side, the easier it is to make up for shortfalls in one location with deliveries from other regions. If European industrial production had been concentrated exclusively in Europe during the current pandemic, repairing supply chains would have taken considerably longer in view of the ongoing partial lockdowns in large swathes of Europe, and German industry, for example, would be hobbled by supply failures in other parts of Europe even today.

Disclaimer

This position paper by the Chief Economists of the German Savings Banks Finance Group does not necessarily reflect the stance of DekaBank or the position of the respective Landesbanken and savings banks.

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