POLITICAL EXTERNALITIES OF FREE TRADE AGREEMENT:
THE OPPORTUNISTIC FTA STRATEGY IN EAST ASIA

A Thesis
submitted to the Faculty of the
Graduate School of Arts and Sciences
of Georgetown University
in partial fulfillment of the requirements for the
degree of
Master of Arts
in Asian Studies

By

Hyeon Young Ro, B.A.

Washington, DC
December 13, 2013

POLITICAL EXTERNALITIES OF FREE TRADE AGREEMENT:
THE OPPORTUNISTIC FTA STRATEGY IN EAST ASIA

Hyeon Young Ro, B.A.

Thesis Advisor: Victor Cha, PhD.

ABSTRACT

How much do political incentives play a role in free trade agreements (FTAs)? While political economists focused much on the interaction between state and market, they have paid scant attention to analyzing the role of state's preference on trade strategies. I argue that when policy-makers face tough FTA negotiations, which often entail higher social costs, they tend to pay more attention on possible political externalities from trade policy. By utilizing the earlier literature on security externalities, I design a game-theoretic model that explains the role of political externalities on the leader's trade strategy. This leads to a conclusion that when policy-makers expect higher positive political externalities, they are more willing to cooperate in trade negotiations. The model effectively explains the recent FTA boom in Asia and the opportunistic strategies of the three major economies in East Asia—China, Japan, and South Korea.

Key Words: Free Trade Agreement (FTA), political externalities, Prisoner's Dilemma, Grim-trigger strategy, China, Japan, Korea, ASEAN

TABLE OF CONTENTS

INTRODUCTION

A Free trade agreement (FTA) requires high levels of cooperation between two or more states. Despite significant economic benefits resulting from such legally binding contracts, states have to bear considerable amount of social costs: tariff reduction, and the concession of state autonomy over trade rules and political costs to deal with domestic oppositions. Thus, policy-makers have to make the best rational choice based on their calculation of the costs and benefits of having FTAs with other countries. The calculation of costs and benefits comes from two sides of trade policy: (1) the demand-side: individuals and interest groups and; (2) the supply-side: policy-makers and political institutions.[a] A great deal of literature in the international political economy has demonstrated the interaction between the supply and demand.

In this paper, I focus on the supply-side of the trade policy, especially on how the policy-maker's preference affects the trade strategies and negotiation outcomes. Expanding on the previous literature on free trade and security externalities, I broaden the scope of externalities to political externalities for two reasons: (1) the story of security allies and adversaries does not fit well in the recent worldwide FTA patterns; and (2) policy-makers expect both short-term and long-term political benefits that are not limited to security.[b] By doing so, I argue that policy-makers are more likely to be cooperative when they expect higher political externalities from having FTA with the counterpart, whether or not they are allies or adversaries.

---

[a] Rodrik (1995) separates the "demand-side" of trade policy to "supply-side" of trade policy. Demand-side of trade policy comes from the individual preferences, which are then carried out through interest groups mechanism. Supply-side of the trade policy comes from policy-makers' preferences which are implemented or required to go through the institutional structure of government. Final trade policy comes from the interaction between the two. See Rodrik, Dani. "Political economy of trade policy." *Handbook of international economics* 3 (1995): 1457-1494.

[b] The model directly comes from a paper coauthored by Gowa and Mansfield (1993). The paper points out that the prisoner's dilemma does not reflect security aspects of FTAs in anarchic international system. See Joanne Gowa, and Edward D. Mansfield. "Power politics and international trade." *American Political Science Review* (1993): 408-420.

The features of FTAs in East Asia can be explained well through this model because of their three major trade policy characteristics: selective, low-level, and obscurity. No other region is as dynamic as Asia in its formation of economic architecture. Particularly, the three major economies in Northeast Asia—China, Japan, and South Korea (hereafter Korea)—are aggressively expanding their regional FTAs and economic partnerships agreements (EPAs). Interestingly, however, the outcomes of FTA negotiations do not contribute significantly to their economic growth, nor do their domestic and international firms actively utilize the FTAs. Moreover, while the three Northeast Asian countries proactively signed FTAs with various different partners within and outside the region, the patterns are highly inconsistent and FTA talks among the three major countries of Northeast Asia remain merely political rhetoric.

Therefore, the success and the failure of FTA in this region cannot be analyzed only by the direct economic or short-term political costs and benefit calculations that come from FTAs. The political will of policy-makers to push forward an agreement which can be shown by giving more concessions and cooperation with the counterpart in the negotiation plays a significant role in the outcomes. The policy-maker's preference to push forward an FTA is possible only if it sees long-term positive political externalities. The time frame is also an important consideration, given that policy-makers rationalize their choice not just based on short-term cost-benefit calculations but also consequences in further future.

The structure of this paper is as follows. I start with a discussion of previous works on how state-market relations affect international trade and cooperation. Then, I present the model of prisoner's dilemma in a repeated game scenario where states adhere to a "grim" strategy. Then, I analyze the FTA strategies of China, Japan, and Korea and show how positive political

externalities affected the negotiation outcomes. In order to respond to the possible counter

argument that FTA strategies are mostly driven by economic reasons, I analyze the general

characteristics of East Asian FTAs and point out that major economic actors, firms, do not utilize

FTAs and do not have much information of FTAs. Finally, I conclude with the implications for

further research.

Political Economy of Trade Policy

Figure 1.
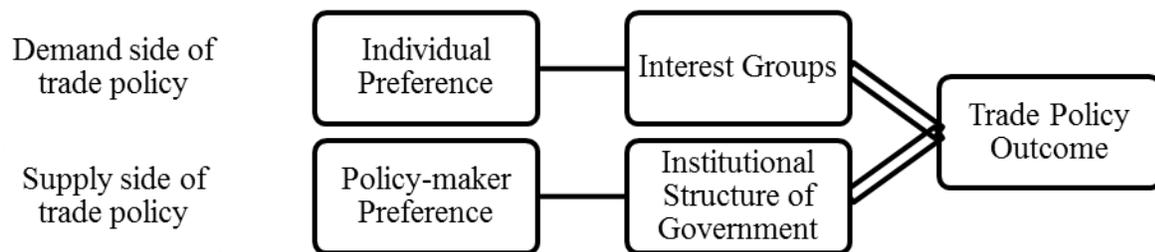
Source: Rodrik, Dani (1995) "Political Economy of Trade Policy": p.1459

Demand-side of Trade Policy

Standard theories of international trade and the motivations for more open economy with

other countries center on economic costs and benefits that determine social welfare. Based on the

price model presented by Heckscher and Ohlin, trade affects different domestic factor, and

changes the relative price of the domestic market. Gains exist from the factor intensities of goods

and thus there are domestic demands for freer trade. This was later advanced by Stolper-

Samuelson as labor cost-endowment and contributed to the protectionist argument for the United

States trade policy. This theory focuses on the producers' part of the individual preferences.

Other studies have focused on the consumer-side of the story and explain individual

3

preferences based on intra-industry trade and increasing returns to scale of factor-endowment. This theory is especially true after the post-World War II economic development. The so-called "New trade theory" (Krugman, 1980; Helpman and Krugman, 1985; Helpman, 1999) argue that the rising incomes of consumers have resulted in their demand for product diversity. Thus, unlike Heckscher and Ohlin's assumption of constant returns of scale of production, industries are experiencing increasing returns to scale. Consumer's taste for variety leads to intra-industry specialization and thus flows of trade not only happen between different factors but also similar factor endowments.

These individual preferences mentioned above are realized into trade policy through the mechanism of interest groups and their interaction with the politicians by lobbying their preferences (Rodrik, 1986). Another related theory, which is the political support function approach, argues that the policy-makers are preferential to certain interest groups representing a particular industry. Simultaneously, however, they are also assumed to care about the inefficiency of restricting international trade (Hillman, Long, and Moser, 1999). Similarly, by utilizing the Heckscher-Ohlin model, the median voter theory also argues that each factor owner has their own optimal tariff level, and policy-makers will decide the tariff by maximizing the utility of the median voter (Mayer, 1984). The problem of this argument, however, is that trade policy or specific tariff levels are rarely determined by majority of the median voters' voting preferences.

Interaction between the Demand and Supply-side of Trade Policy: Domestic institutions

In the literatures so far, trade policy has focused on the demand-side of the trade policy, mainly analyzing individual's preferences. In the campaigning contributions approach, Magee,

4

Brock, and Young (1989) explicitly demonstrate the interaction between the demand and supply-side of trade policy. This approach is based on the close alliance formation between a certain type of factor owners with the political parties they support, for instance, pro-capital party and pro-labor party. Then the two player play the Nash game against each other, and the equilibrium outcome becomes the result of trade policy. Helpman and Grossman (1994) also take the political contributions approach and explains the reason for free trade or protectionism is derives from the domestic sector-endowment. They focus on how interest groups influence government policies by informational lobbying or campaign contributions which will then affect election outcomes.

In a similar line with the argument made by Helpman and Grossman, many IPE literatures have expanded the study of the interaction between domestic politics and international relations with regard to trade policies. Most notably, many scholars have found out that pairs of democratic states will have more trade than pairs of autocracies or others (Dixon and Moon, 1993). The similar political systems will likely lower the barriers compared to dissimilar systems. Mansfield, Milner, and Rosendorff (2000) also argue that pairs of democracies are more likely to negotiate lower barriers to trade than do pairs of nondemocratic states because legislatures in democracies often represent protectionist interests. Intuitively, democracies seem to appear more protectionists due to the legislatures, but because they have the strong opposition, policy-makers are advantageous in the bargaining situations.

Supply-side of Trade Policy: Political and Security Externalities

The explanation of trade policies from domestic institutions is suitable to analyze the

levels of trade. However, it over-focuses on the interaction between policy-makers and the interest groups and somewhat obscures the motivations of the policy-makers, the major agent of trade policy, to push forward FTA negotiations. By focusing solely on the supply-side of the trade policy, arguments explain direct and indirect effects of politics on trade policy. From the perspective of indirect influences of politic on trade, Pollins (1989a, 1989b) show that individual economic actors care about the possibility of political risk when they do business and trading. Thus, the assessment of risk premium hinders enterprises to consider establishing and continuing trade with their counterparts. Therefore, pairs of states that are friendlier will have less risk premium while pairs of state that have hostile relationships increase the likeliness of conflict in the future. Thus low political risk will lead to more trade.

Studies of the direct influence of politics on trade point out the inconsistency with actual trade policy and the outcome of trade agreements. Ethier (2004) presents two kinds of political externalities: terms-of-trade motives and political-support effects. According to the Received theory, trade agreement exists because countries with market power tried to remove the risk of trade barriers and to shift the terms-of-trade into their favor.[c] In theory, this should prevent other countries from carrying out their terms-of-trade. However, in the real-world multilateral trade, the trade agreements do not prevent participating states from implementing their preferable terms-of-trade. Moreover, political-support effects of trade will promote two governments negotiate what they can offer to their domestic export lobbies for an exchange of concession made during the cooperation process.

---

[c] According to Either (2004), Harry Johnson (1953), Bagwell and Staiger (1999, 2000), and Grossman and Helpman (2002) argue the Received theory. See Ethier, Wilfred J. "Political externalities, nondiscrimination, and a multilateral world." *Review of international Economics* 12, no. 3 (2004): 303-320.

The third political externalities have to do with state power and security issues. Realist theories of IPE argue that a state will be reluctant to trade with rivalries because the increase of wealth from trade will add more military capability against it. This effect is particularly true under a bipolar system than in the multipolar system (Gowa 1989, 1994; Gowa and Mansfield 1993). Therefore, allies will enjoy freer trade since they do not fear security externalities and adversaries tend to have lower trade due to potential military threat. Dingman (1979) and Morrow (1991), however, argue that while alliances, in general, indicate similarity of relations, it is not a precondition for countries to coordinate their policies. A more optimistic perspective of political externalities comes from Gartzke and Li (2003). Based on the Capitalist Peace theory, they argue that interactions between state and markets generate positive political externalities. The recent globalization, economic interdependence, and audience cost from signaling make threats of disruptive conflict costly for political competitors.

Given the current trend of FTAs, which are not restricted to alliances, the previous analysis of security externalities needs to be reevaluated. While alliance had significant influence on international trade policy before 1990s, the economic rise of East Asia since the mid-1990s has changed the dynamics of FTA policies. More states are willing to sign FTAs within and across regions regardless of political or security relationships. However, relying on the simple calculation of economic cost and benefit does not sufficiently explain the aggressive, yet selective and low-level FTAs signed among East Asian countries. Therefore, this paper aims two goals on the recent FTA boom in Asia: (1) to reevaluate the political externalities of international trade; and (2) to explain the opportunistic FTA strategies of East Asian countries.

7

Political Externalities of Free Trade Agreement

An externality in economics is "a cost or benefit which affects a party who did not choose to incur that cost or benefit."[d] In a negative externaly, marginal private cost is less than the marginal social or public cost by the amount of the external cost (Figure 2-a). On the other hand, external benefits show that the marginal private benefit is less than marginal social or public benefit by the amount of the external benefit (Figure 2-b). When applied to the FTA, the overall cost of FTA negotiation increases with negative political externalities. However, if there are positive externalities states can have additional social welfare as a result of FTAs with other countries. Therefore, policy-makers will be more cooperative in trade negotiations when they expect higher positive political externalities.

Figure 2-a

Figure 2-b
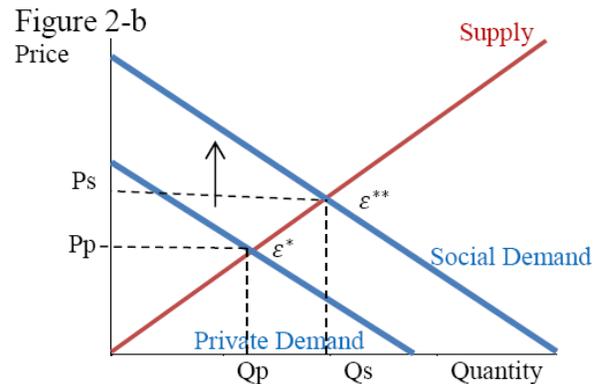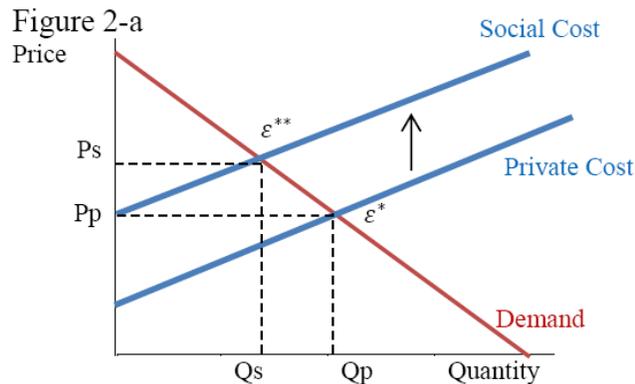
Note:
1. Ps is price of social cost and Pp is the price of private cost.
2. Qs is the outcome of social cost and Qp is the outcome of private cost.
3. ε^* is the original equilibrium and ε^{**} is the new equilibrium after an externality

Source: by the author

---

[d] James Buchanan, Wm. Craig Stubblebine. "Externality." *Economics* 29, 116 (November 1962): 371-384

Trade Negotiation Games

Now I apply this concept to the prisoner's dilemma game, where both states adhere to a "grim" strategy," which means that states begin with cooperation. The payoff matrix is shown in Figure 3. This game is a prisoner's dilemma in which two players, State 1 and State 2, play. A is the payoff of both choosing to cooperate, and B is the payoff of both choosing to defect. C and D are the payoffs when one cooperates while one defects. The amount of payoffs is $C > A > B > D$. Every time a state decides to deviate while the other is cooperating, there is a gain from defection, which is denoted as δ. Small i refers to either state 1 or state 2.

While states start off with cooperative mood, one of the states tries to bring trade policies that are more favorable to itself. In other words, a state starts to deviate. The strategy will remain cooperation in this game until the discounted sum of cooperative payoffs, $A_i/(1-\delta_i)$, is greater than the sum of a one-time gain from defection and the discounted sum of punishment payoffs $C_i + \delta_i B_i/1-\delta_i$. Thus, cooperation can be sustained by a grim strategy if

$$A_i/(1-\delta_i) \geq C_i + \delta_i B_i/1-\delta_i \quad \text{or} \quad \delta_i \geq C_i-A_i/C_i-B_i$$

Cooperation is harder to be maintained and requires a higher discount factor in order to prevent states from defecting. When we assign numeric values for each payoffs, for instance, let C=3, A=2, B=1, D=0, and ω to be a fraction of 0.40 and the cooperation point is 0.50.[e]

Figure 3				
The Prisoner's Dilemma				
			State 1	
			Cooperate	Defect
State 2		Cooperate	A_1, A_2	D_1, C_2
		Defect	C_1, D_2	B_1, B_2
Note: $C > A > B > D$				

Trade Negotiation Games: States with Negative Political Externalities

The payoff matrix of the trade negotiations game assumes that there is no difference between private and social returns to interstate trade. However, in reality, policy-makers make decisions not only based on short-term economic calculations, but consider long-term national strategies and potential cost and benefits as well. Because policy makers are the suppliers of trade policy, they consider political externalities, such as enhancing the international support or increase bargaining leverage through trade negotiations is important factors for successful FTA negotiations. Therefore, both social costs that result from trade negotiations and the benefits coming from cooperating in the negotiation should be taken into account when calculating the utility-maximizing equilibrium and its payoffs from trade. Thus, the payoffs a state assigns to the outcomes of any given trade game differ from those of the standard optimal tariff game.

In the case of trade with state with a negative political externality a state incurs a marginal social cost and possible externalities that the standard matrix does not reflect. This transforms the standard matrix as shown in figure 4. In each cell, the social cost that State 1 incurs is denoted with a fraction ω_1, of the payoff that accrues to its counterpart, State 2. For example, $\omega_1 A_2$ is the social cost or political externality that is given to State 1 when it goes on and negotiates with State 2. I define marginal social cost as the any costs that come from continuing the negotiation. Whether this is directly related to the concessions that have to make, or in directly related, for instance, the time and transaction costs in order to hold the negotiation meeting, costs incur during the trade negotiation. I assign political externalities as an ϵ which is a fraction greater than 0 and smaller than 1 ($0 < \epsilon < 1$).

Figure 4		State 1	
The Prisoner's Dilemma: **Negative Political Externalities**			
		Cooperate	Defect
State 2	Cooperate	$A_1-\omega_1 A_2-\mathcal{E}A_2$, $A_2-\omega_2 A_1-\mathcal{E}A_1$	$D_1-\omega_1 C_2-\mathcal{E}C_2$, $C_2-\omega_2 D_1$
	Defect	$C_2-\omega_1 D_2$, $D_2-\omega_2 C_1-\mathcal{E}C_1$	$B_1-\omega_1 B_2$, $B_2-\omega_2 B_1$
Note: $C > A > B > D$			

Calculating the same game strategy as the previous one, state 1 will cooperate if

$$(A_1-\omega_1 A_2-\mathcal{E}A_2)/(1-\delta_1) \geq (C_2-\omega_1 D_2)+ \delta(B_1-\omega_1 B_2)/1-\delta$$

or

$$\delta_1^* \geq \frac{(C_2-\omega_1 D_2)-(A_1-\omega_1 A_2-\mathcal{E}A_2)}{(C_2-\omega_1 D_2)-(B_1-\omega_1 B_2)}$$

After plugging in the same numeric values assigned in the original strategy game, the results become clearer. The new cooperation point rises to $0.75+\mathcal{E}A_2$ compared to the previous matrix, which was 0.50. Thus, negative political externalities even further increases the overall cost of state 1's cooperation in the trade negotiation.

Trade Negotiation Games: States with Positive Political Externalities

Similarly, the trade negotiation between states that have positive political externalities also have to bear some social costs that is generated naturally. However, in this case, they have positive political externalities which will offset the social costs that come from continuing to cooperate in the trade negotiations. Thus, policy-makers are more willing to continue the game and cooperate with the counterpart until they reach an agreement. Calculating the same game strategy, state 1 will cooperate if:

11

$$(A_1-\omega_1 A_2+\mathcal{E}A_2)/(1-\delta_1) \geq (C_2-\omega_1 D_2)+ \delta(B_1-\omega_1 B_2)/1-\delta$$

or

$$\delta_1^{**} \geq \frac{(C_2-\omega_1 D_2)-(A_1-\omega_1 A_2+\mathcal{E}A_2)}{(C_2-\omega_1 D_2)-(B_1-\omega_1 B_2)}$$

Therefore, the positive political externalities $(+\mathcal{E}A_2)$ reduce the social cost of trade negotiations. Plugging in the same numeric values that were assigned above, the discount factors between states that have higher positive political externalities will be $0.75-\mathcal{E}A_2$, which will further reduce State 1 will be more willing to cooperate in this trade strategy.

Figure 5			
The Prisoner's Dilemma: **Positive Political Externalities**			
		State 1	
		Cooperate	Defect
State 2	Cooperate	$A_1-\omega_1 A_2+\mathcal{E}A_2$, $A_2-\omega_2 A_1+\mathcal{E}A_1$	$D_1-\omega_1 C_2+\mathcal{E}C_2$, $C_2-\omega_2 D_1$
	Defect	$C_2-\omega_1 D_2$, $D_2-\omega_2 C_1+\mathcal{E}C_1$	$B_1-\omega_1 B_2$, $B_2-\omega_2 B_1$
Note: $C > A > B > D$			

The political externalities and its effect on trade negotiation strategies demonstrate that policy-maker's preference matters during the repeated game of trade negotiations. While countries start negotiation with cooperative mood, as the negotiation goes on many social costs, not to mention domestic oppositions, as well as media, transaction costs may cause countries to defect from trade negotiations. There may be short-term benefit coming from defection. The counterpart may be giving out more concessions to bring back two states into negotiation table or the defected state can go on and start a new FTA negotiation using the current ongoing FTA negotiation as a leverage to enhance its bargaining position. However, such strategy will be punished by the counterpart, who will unilaterally declare the collapse of negotiation. When

there are positive political externalities between the two states, policy-makers will try to come

back to the negotiation and start the cooperative game. On the other hand, without much political

incentives, it is highly likely that FTA negotiations will be stuck in a stalemate situation.

East Asia FTA Strategy

China-ASEAN FTA: Positive political externalities

China may be the best example of the case where political externalities matters much on

their FTA strategies. Although China's economic goals such as energy security and domestic

economic reforms are the basis for FTA strategies, many scholars also point out the non-

economic factors that cause China to aggressively participate in FTA negotiations with regional

partners.[f] With regard to security and political incentives to promote FTA, it is argued that the

increase in regional FTAs both bilateral and multilateral will help China to improve its influence

in the region in international political economy and expand its security space.[g] Moreover, China

is concerned of Japan's influence in Southeast Asia as it negotiates FTAs and Economic

Partnership Agreements (EPAs) more aggressively than China. It is undeniable that ASEAN is

crucial to the Chinese security strategy of promoting its political influence in the region. In fact

scholars have noted that China's FTA regionalism is to potentially dilute the U.S. influence in

Southeast Asia.[h]

---

[f] Hoadley and Yang explicitly addresses China's regional economic strategy has not only been dominated by economic factors but also a number of diplomatic and security strategies affect their policies. Hoadley, Stephen, and Jian Yang. "China's cross-regional FTA initiatives: towards comprehensive national power." Pacific Affairs 80, no. 2 (2007): 327-348; Hoadley, Stephen, and Jian Yang. "China's Free Trade Negotiations: Economic, Security, and Diplomacy." In *Cross Regional Trade Agreements*, pp.123-146. Springer Berlin Heidelberg, 2008.
[g] Sheng, Lijun. "China-ASEAN Free Trade Area: Origins, Developments and Strategic Motivations. Singapore: ISEAS working paper 1 (2003): 1-24.
[h] Sheng, p.12

Another reason why political interest plays an important role in the negotiation is because of the uncertain economic benefit from the FTA. Despite the economic necessities, political externalities cannot be ignored in this FTA because the short-term economic benefits of China-ASEAN FTA were rather uncertain.[i] China has to secure the oil import route in the South China sea because of the conflicting maritime claims. Therefore, the region's high dependence on the United States or Japan came as a security threat to China. By economically drawing closer in the long-term through FTA, Chinese leaders expected positive political externalities to reduce the immediate social cost.

Japan-Korea FTA at Stalemate Situation: Negative political externalities

The General atmosphere in Korea for the FTA was positive. Nevertheless, Japan lacked political leadership that can push the FTA forward to overcome the discrepancies that existed with the Korean government. Therefore, the final stage where Japanese Prime Minister and the cabinet members intervene in the negotiation and showing their leadership was absent. Many reasons affect Japanese officials not to put Korea-Japan FTA as its priority, but there are mainly three reasons: (1) Japan was focusing on joining Transpacific Partnership (TPP); (2) Japanese international economic strategy favors foreign direct investments to FTAs; and (3) Japan is more interested in finding a region where they can secure their energy supply. Moreover, the nature of Japan's FTA strategy prefers EPAs rather than FTAs. EPAs allow Japan with more flexibility in tariff lines and maintain commercial regulatory measures for important aspects of economy:

---

[i] John Wong and Sarah Chan. "China-ASEAN Free Trade Agreement: Shaping future economic relations." *Asian Survey*. 43, no. 3 (2003): 507-526

investment, intellectual property, and competition policy, as well as economic cooperation.[j] On the other hand, Korean government was unwilling to open investment and high-service market. Both economic and political calculations combined, not enough, or almost no political externalities existed in this trade negotiation.

Unlike Japan, Korean public sentiment has been highly negative due to the ongoing historical and territorial disputes. The comfort women issues and the territorial sovereignty claim over *Dokdo/Takeshima* has remained unresolved ever since the end of the second World War. Moreover, small-and-medium side enterprises in Korea have been very reluctant to have FTA with Japan. Nevertheless, a number of recent survey shows that Koreans, both businessmen directly involved or affected by the FTA and the public, perceive the Korea-Japan FTA to be slightly more desirable while much less threatening compared to Korea-China FTA. In the recent research on the survey of Korea-China and Korea-Japan FTA public perspective, ordinary Koreans are more positive to Korea-Japan FTA than Korea-China FTA. While 61% majority answered "against Korea-China FTA, 55% answered "for" Korea-Japan FTA.[k] In the end, however, Korean policy-makers felt the lack of political incentives to cooperate or to resume the negotiation. In 2008, the former Trade Minister Kim Jong-hoon said "There are many other FTAs with other countries we have to deal with. Korea-Japan FTA is not our priority."[l] In other words, there was not enough positive political externalities on which the government can expect in order to bear the high social costs that generates from the two countries cooperating in FTA negotiations.

---

[j] Christopher M. Dent *East Asian Regionalism*. Routledge, 2008, pp.198-99.
[k] Korea Institute for International Economic Policy Report (2008, 2010), "Major Issues in Korea-Japan FTA and Strategies to Promote Korea-Japan FTA." P. 15.
[l] *MK News* (Kim Jong Hoon Bonbujang "Il bon gwa FTA neun oept da." Jul. 17, 2008).

The failure of the Korea-Japan FTA is not simply because of their difference in economic objective or the possibility of strong domestic opposition. As mentioned in the beginning, when countries desire to cooperate in a strategy game, policy-makers need to have positive political externalities that can reduce the social cost generated by the repeated negotiation game. In this sense, both Korea and Japan currently do not have enough political incentives linked to the two countries' bilateral FTA. Japan feels the necessity, but is putting more priority in gaining access to other markets such as TPP or investment in the regions where Japan can secure its energy supply. For the Korean government, although Japan is a tempting partner for regional security and technological improvement, it sees more future benefits from expanding its market to China. Thus, both the Japanese and Korean governments' best response was to defect.

Not Enough Economic Benefits?

A possible counter-argument to the emphasis on political externalities is that trade policies are mainly driven by economic benefits rather than political interests. Thus, even in the cases I discussed above, the success for China-ASEAN FTA may be the result of foreseeable economic incentives while the failure for Japan-Korea FTA is a result of economic benefits. Although this analysis may work in the cases I chose, it is still difficult to understand why East Asian FTAs are selective, low-level, and opportunistic. These characteristics cannot solely be explained by economic interests. State-centric political calculations should also be considered as an important driving factor of FTA promotion in this region.

The FTAs in East Asia are selective and often characterized as "Asian noodle bowl."[m] While ASEAN countries are largely preferred FTA markets, it is only Japan who has the highest FTA/EPAs bilaterally. China only has a multilateral FTA with ASEAN as a whole, and it is further seeking to have bilateral FTAs with Latin American countries. South Korea is also seeking to expand its FTAs in Southeast Asia and Latin America as well, but they are more interested in huge markets such as the United States, the European Union, and recently China. Clearly, there is no unity or pattern in East Asian FTA strategies. Such inconsistency of trade patterns comes from each country's different geopolitical strategy and political interests.

Moreover, while the numbers of FTAs are higher than in any other region, firms from East Asia do not utilize FTAs to maximize benefits. In a survey conducted by the Asian Development Bank, Japanese has the highest number of firms that utilizes FTA preferences but only 29% of the firms utilize FTA preferences. Other countries like Korea (21%), the Philippines (20%), and Singapore (17%) companies do not engage much of FTA preferences.[n] This raises a serious question of whether the companies or the individuals that is the demanders of FTA in this region. Although they may somewhat agree to open trade policies, the major agencies that demand and supply FTAs in this region seems to be the state rather than the market. Finally, the low-level or low-standard free trade also makes raises questions as to whether FTAs signed or negotiated in this region is for economic purpose or political purpose. Often times the standard of tariff, regulations, or product coverage do not meet up with the WTO-standard of trade. These

---

[m] This concept is frequently used from the Asian Development Bank papers. The spread of FTAs in East Asia raised "systemic concerns about crisscrossing FTAs. Jagdish Bhagwati calls this a "sphaghetti bowl" of trade deals (Bhagwati 1995, 2008)

[n] Masahiro Kawai and Ganeshan Wignaraja. *The Asian'noodle bowl': Is it serious for business?*. No. 136. ADBI Working Paper Series, 2009.

facts also indicate that East Asian countries have non-economic reasons to sign FTAs within the region.

Conclusion and Implications

In this paper, I have argued that FTA strategies should be understood through states' political calculations. When positive political externalities are present, the chances of policy-makers willing to cooperate in trade negotiations increase. By focusing on the policy-maker's motivations to push forward FTA negotiations despite the social costs, cooperation will increase when there are positive externalities expected from the FTA. Thus, the standard prisoner's dilemma does not capture the better chance of two states cooperating when defecting "appears" to be the best option. The study of security externalities by Gowa and Mansfield correctly points to this shortcoming but this model does not explain the current FTA strategies of East Asian countries, who are the most aggressive FTA seekers in the world. Therefore, states' calculation of whether to play cooperatively in FTA negotiations depends on whether there are large enough political interests such as geopolitical significance, possibility of the expansion of political influence in the region, and effectiveness to counter against the regional and global rivalry. As long as these political externalities are foreseen, states will play cooperatively regardless of alliances or adversaries.

The FTA patterns in Asia is about to enter a new phase where the world's most ambitious FTA, the Transpacific Partnership Agreement, is coming towards the end of negotiations. Japan's participation has led China and Korea to consider a new FTA strategy in order to stay on the right track and not fall behind. China has emphasized the need to promote only a Regional

18

Comprehensive Economic Partnership, which includes Asian countries. Korea is pushing

forward an FTA with China and is reaching towards Southeast Asia and Latin America for

bilateral FTAs. It is true that economic factors are the major driving factors for states to look for

FTAs. However, considering the high social cost, it is equally important to know what are the

policy-makers' preference to play cooperative in a trade negotiation. So far, the positive political

externalities contributed to cooperation among states in trade negotiation meetings. However, the

noodle bowl FTAs in Asia may inevitably trigger conflict among countries and perhaps other

mechanism for states to play cooperative games should be studied in the future

Bibliography/Reference

Aggarwal, V. K. (2011). *Trade Policy in the Asia-Pacific*. Springer Science+ Business Media.

Asian Development Bank (Statistics)

Baier, Scott L., and Jeffrey H. Bergstrand. "Economic Determinants of Free Trade Agreements." *Journal of International Economics* 64, no. 1 (2004): 29-63.

Cheong, Inkyo. "Evaluation of Recent Progress of FTAs in East Asia—A Korean Perspective." C.Y. Ahn et al (eds.). *East Asian Economic Regionalism* (2005): 37-56.

Chirathivat, Suthiphand. "ASEAN–China Free Trade Area: background, implications and future development." *Journal of Asian Economics* 13, no. 5 (2002): 671-686.

Choi, Tae-wook. "South Kora's FTA Policy-making Process." *Korea and International Politics vol. 22, no. 2.* (2006): 87-118.

Cho, Jung-ran, and Inkyo Cheong. "Han · Il FTA hyeop sang jae gae doer su it na?." (2008 HanIl Kokjae Seminar 2008 Korea-Japan International Seminar) *發表論文集*, (2008): 91-106.

Dent, C. M. (2008). East Asian Regionalism. *Routledge.*

Dixit, A. K. (1998). *The making of economic policy: a transaction-cost politics perspective*. The MIT Press.

Dixon, William J., and Bruce E. Moon. "Political similarity and American foreign trade patterns." *Political Research Quarterly* 46, no. 1 (1993): 5-25.

Ethier, Wilfred J. "Political externalities, nondiscrimination, and a multilateral world." *Review of International Economics* 12, no. 3 (2004): 303-320.

Fukagawa, Yukiko, "Economic Integration among Japan, Korea and China: Lessons from Asia Pacific Economic Cooperation (APEC)." *Faculty of Political Science and Economics, Waseda University* (2010).

Gartzke, Erik, and Quan Li. "War, peace, and the invisible hand: Positive political externalities of economic globalization." *International Studies Quarterly* 47, no. 4 (2003): 561-586.

Goh, Evelyn. "Great powers and hierarchical order in Southeast Asia: analyzing regional security strategies." *International Security* 32, no.3(2008) : 113-157

Gowa, Joanne, and Edward D. Mansfield. "Power politics and international trade." *American Political Science Review* (1993): 408-420.

Grossman, Gene M., and Elhanan Helpman. *The politics of free trade agreements*. No. w4597. National Bureau of Economic Research, 1993.

Han, Hyung Keun. "Korea-Japan FTA and Its Political Obstacles." *Kukche Chŏngchi*(*Studies of International Politics) vol. 10, no.1 (국제정치연구 제10집 1호)* (2007): 77-106

Hidetaka Yoshimitsu and Patrick Ziltener, "Japan's FTA Strategy Toward Highly Developed Countries: Comparing Australia's and Switzerland's Experiences, 2000-09," Asian Survey, vol. 50 no. 6 (2010), pp. 1058-1081.

Hillman, Arye L., Ngo Van Long, and Peter Moser. "Modelling Reciprocal Trade Liberalization: The Political-economy and National-welfare Perspectives." *Swiss Journal of Economics and Statistics (SJES)* 131, no. III (1995): 503-515.

Hoadley, Stephen, and Jian Yang. "China's Cross-Regional FTA Initiatives: Towards Comprehensive National Power." *Pacific Affairs* 80, no. 2 (2007): 327-348.

Honma, M. (2006). WTO Negotiations and Other Agricultural Trade Issues in Japan. *The World Economy*, *29*(6), 697-714.

Yi, Si-yeong, Dae-yeong Kim, Seong-hui Jeon. "*Han Jung Han Ir FTA gukmin insig josa mic jeongchaekjeog sisajeom* (Korea-China·Korea-Japan FTA Public Perception and Policy Implications)" Korea Institute for International Economic Policy (KIEP), 2012

Jiang, Yang. "China's pursuit of free trade agreements: Is China exceptional?."*Review of International Political Economy* 17, no. 2 (2010): 238-261.

Jung, Sung Chun. "Nikan FTA Kyoshoto teiketsuheno shoukai yoyin (Obstacles for Korea-Japan FTA Negotiations and Conclusion)," *JETRO V.R.F Series*, No.470, Dec. 2011

Kawai, M. (2011). *Asia's Free Trade Agreements: How is Business Responding?*. Edward Elgar Publishing.

KIEP Report (2008, 2010), "Major Issues in Korea-Japan FTA and Strategies to Promote Korea-Japan FTA."

Krugman, Paul R., ed. *Strategic trade policy and the new international economics*. MIT Press, 1986.

Lee, Hong-bae and Satoru Okuda. "Possibility of Realizing a Korea-Japan FTA." *The Journal of East Asian Affairs* (2004): 131-156.

Lee, J. W., & Park, I. (2005). Free Trade Areas in East Asia: Discriminatory or Non-discriminatory?. *The World Economy*, *28*(1), 21-48.

Lee, Seungjoo. "The Evolution of Japan's FTA Policy: Dynamic Interaction between Players and Policymaking Institutions. Korea *and International Politics vol. 25, no. 3.* (2009): 65-97.

Sheng, Lijun. "China-ASEAN Free Trade Area: Origins, Developments and Strategic Motivations." *Singapore: ISEAS working paper* 1 (2003): 19.

Magee, Stephen P., William A. Brock, and Leslie Young, eds. *Black hole tariffs and endogenous policy theory: Political economy in general equilibrium*. Cambridge University Press, 1989.

Mansfield, Edward D., Helen V. Milner, and B. Peter Rosendorff. "Free to trade: Democracies, autocracies, and international trade." *American Political Science Review* (2000): 305-321.

Mayer, Wolfgang. "Endogenous tariff formation." *The American Economic Review* 74, no. 5 (1984): 970-985.

Republic of Korea, Ministry of Strategy and Finance, "National Competitiveness Report 2010"

Morrow, James D., Randolph M. Siverson, and Tressa E. Tabares. "The political determinants of international trade: The major powers, 1907-90." *American Political Science Review* (1998): 649-661.

Park, Cheol Hee. "Cooperation Coupled with Conflicts: Korea-Japan Relations in the Post-Cold War Era." *Asia-Pacific Review*, vol. 15, no. 2. (2008): 13-35

Park, Cheol Hee. "The Pattern of Cooperation and Conflict between Korea and Japan: Theoretical Expectations and Empirical Realities." *Japanese Journal of Political Science 10 (3).* (2009): 247-265.

Park, Hong-Seok. "Political Economies of Northeast Asia and Future of Korea-Japan Cooperative Relation. (동북아시아의 정치경제와 한일협력관계의 미래)" *Peace Studies (평화 연구) vol. 13, no. 2.* (Fall 2005): 53-82

Pollins, Brian M. "Conflict, cooperation, and commerce: The effect of international political interactions on bilateral trade flows." *American Journal of Political Science* (1989): 737-761.

Rodrik, Dani. "Political economy of trade policy." *Handbook of international economics* 3 (1995): 1457-1494.

Katada, Soari and Mireya Solis, "The Japan-Mexico FTA: A Cross-Regional Step in the Path towards Asian Regionalism," *Pacific Affairs*, vol. 80 (2007), pp.279-301

Solís, Mireya. "Can FTAs deliver market liberalization in Japan? A study on domestic political determinants." *Review of International Political Economy* 17.2 (2010): 209-237.

Takahashi, Katsuhide, and Shujiro Urata. "On the use of FTAs by Japanese firms: Further evidence." *Research Institute of Economy Trade and Industry, Tokyo* (2009).

Urata Shujiro. "Japan's Free Trade Agreement Strategy." *The Japanese Economy, vol. 36, no. 2*. (Summer 2009): 46-77.