

POLICY BRIEF

Economic Implications of RCEP for the EU and Japan¹

I. Introduction

On 6 November 2020 the 15 negotiating parties of the Regional Comprehensive Economic Partnership (RCEP) signed the largest free-trade area (FTA) ever in terms of size (\$26 trillion) and population (2.3 billion). It follows the Comprehensive and Progressive Agreement on Trans-Pacific Partnership (CPTPP), which was signed in March 2018 and went into effect in December 2018, as the second 'megaregional' trade agreement in the Asia-Pacific region. These two agreements have the potential to mold regional trade and investment patterns well into the future and to influence the direction of global economic cooperation at a challenging time. In addition, they will no doubt expand in the coming years; the agreements are open to new membership with specific chapters on enlargement and each has potential members already in the queue. For example, the United Kingdom on 1 February 2021 formally expressed its intent to open negotiations to join the CPTPP, and Chinese President Xi at the APEC Summit in November 2020 noted that China is studying the possibility of applying as well.² Hong Kong will likely be the first new member in line for RCEP.³

Thus, the recently concluded RCEP agreement could have significant implications for developed and developing economies alike. The cases of the EU and Japan are particularly interesting; while they are non-combatants in the US-China trade war, Japan is a key country in both the CPTPP and RCEP while the EU is a par-

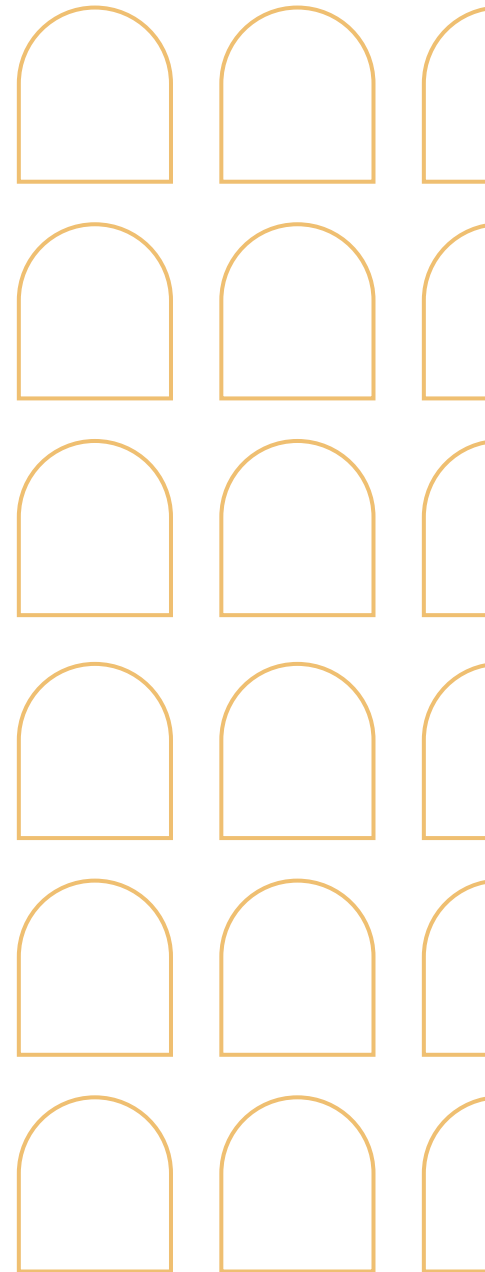
1 The authors are grateful to Professors Stephanie Rickard and Giulio Pugliese, as well as to participants at the EUI conference, "The EU, Japan and a Fraying International Order," for their insightful and useful comments.

2 http://www.xinhuanet.com/english/2020-11/20/c_139531308.htm .

3 E.g., <https://www.info.gov.hk/gia/general/202011/16/P2020111600779.htm> .

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ticipant in neither. The goal of this short Policy Brief is to consider the economic implications of RCEP for these economies, in the context of the Phase I agreement of the US-China trade war and the CPTPP. We employ a Computable General Equilibrium (CGE) model to estimate the country- and region-specific effects on income and trade, as has been done in Petri and Plummer (2020) and in Park, Petri and Plummer (2021). In sum, we find that: (1) the US-China trade war will be costly to the global economy, leading to a permanent decrease in global incomes of \$514 billion per year and a decrease in global trade of approximately \$1,053 billion, or about 3 percent of global trade beginning in 2030; (2) the CPTPP and RCEP together increase global incomes sufficiently to compensate almost entirely for the trade war at the global level; and (3) the effects of these policy initiatives will be asymmetric, with China and the United States being the big losers from the trade war but with Japan being a big winner. Europe will lose from the trade war but gain from external trade creation resulting from Asia-Pacific megaregionalism. Importantly, RCEP will lead to deeper integration between China, South Korea and Japan, countries which currently have no trilateral free-trade area (FTA) in place. This will make northeast Asia increasingly dynamic and competitive in certain sectors, particularly in advanced manufacturing (Petri and Plummer 2020).

The Policy Brief is organised as follows. Section II gives an overview of the RCEP agreement, followed in Section III by a summary of the estimated economic effects of the CPTPP and RCEP in the context of the US-China trade war. We consider some implications of Asia-Pacific megaregionalism for Japan and the EU in the concluding section.

II. The RCEP Agreement

While the CPTPP agreement has been in the public domain for a few years now and has been extensively analysed in the literature, the text of the RCEP agreement was only released several months ago and, hence, its scope and depth are just now starting to be unpacked. Understanding the 'value added' impact of RCEP is critical to estimating its economic effects, and is inherently difficult. Multiple layers of existing FTAs across RCEP countries raise difficult questions about the incremental effects of any new agreement. For example, ASEAN economies already have in place FTAs with each other and an ambitious economic integration programme continues to deepen. RCEP will not

significantly lower intra-ASEAN barriers to trade and investment. The same would be true of barriers between Australia and New Zealand, whose Closer Economic Relations (CER) agreement is one of the most advanced FTAs in the world. Further, all RCEP members have an FTA in place with ASEAN (a condition to join negotiations), called 'ASEAN+1' agreements, and many other RCEP members have FTAs with each other. While China and South Korea also have a limited FTA in place, as noted above, northeast Asia is the only remaining subregion where regionalism has not yet taken a firm hold.

At the same time, a more comprehensive template added to many existing FTAs along with a common set of rules binding the 'noodle bowl' of bilateral agreements together, could, in itself suggest significant benefits from RCEP. For example, expanded market access in goods and services stemming from lower non-tariff barriers (NTBs), often ignored in existing ASEAN+1 agreements, and clear, cumulative rules of origin (RoO) could bolster integration significantly. Consolidated rules and streamlined procedures will also facilitate trade and investment.

In fact, given its larger and more diverse membership, RCEP was never expected to be as rigorous as the CPTPP. While the CPTPP will eliminate tariffs on 96 percent of products that enter intraregional trade, RCEP will cover around 92 percent⁴ of these products, and even for these, goods tariffs will not be fully eliminated in the transition period. In addition, RCEP includes extensive flexibility in virtually every chapter for low-income member-countries; CPTPP does not allow for any form of special and differential treatment in this regard.

RCEP will also fall short of the CPTPP on behind-the-border barriers. Its intellectual property provisions add little to those that most members have already accepted in the World Trade Organization (WTO) or other agreements. RCEP does not have chapters on labour, the environment or state-owned enterprises. Its services and investment chapters include some positive-list approaches to market access, rather than the negative lists used by all countries in the CPTPP. While RCEP includes a chapter on electronic commerce, its provisions are much more modest than those of the CPTPP. Provisions on investor-state dispute settlement (ISDS) are included in the CPTPP but the RCEP accord stipulates that, if they so desire, member-states can begin to negotiate an ISDS mechanism two years after the agreement enters into force, one example of how RCEP is a 'living' agreement that will

4 Baker McKenzie (2020).

deepen over time, as has been the case in other ASEAN-led initiatives. The CPTPP and RCEP each outline accession procedures for new members, though applicants wishing to join RCEP economies must wait at least 18 months from entry-in-force.⁵

III. Economics of Trade War, CPTPP and RCEP: Implications for Japan and Europe

We estimate the effects of trade agreements using a long-standing CGE model developed in Petri and Plummer (2016) and Petri, et. al. (2012). The model, underlying data, and results, including prior applications, are described on the website www.asiapacifictrade.org and in publications found therein.

Briefly, a CGE model is a numerical implementation of general equilibrium theory, using neoclassical economic assumptions about the motivation of agents in the economy, market structure, consumer preferences, production technology and market equilibrium conditions. Behavioural equations in CGE models are derived from these assumptions and determine how the agents in an economic system respond to changes in relative prices and incomes.

In addition to behavioural equations, CGE models incorporate various accounting identities that define the budget constraints of each agent as well as total resource constraints. In a CGE model, most of the parameters in behavioural equations are elasticities (i.e., they measure the responsiveness of one variable to changes in another) or share parameters, such as the share of consumption demand in aggregate demand.

A CGE model typically has four agents: firms, consumers, investors and the government. Firms produce output, which is purchased by consumers, investors and the government, both at home and abroad. Firms maximise profits and use market prices in deciding how much output to produce and with which inputs. Sector output is represented by a production function, which shows the relationship between inputs and output. We employ a Melitz-style ‘heterogeneous firms’ specification, which assumes monopolistic competition among firms that have different productivity levels along a statistical distribution (Zhai 2008). Consumers in each country are modelled with reference to a represen-

tative household, which maximises a utility function defined over the consumption of final goods from each industry. Consumers are endowed with capital, land, labour and other factors of production. Based on market prices, they supply their factors and receive income in return. Investors receive savings (from consumers and government) and purchase bundles of goods to establish and maintain productive capacity.

Government administers market-related policies, such as taxes, subsidies, and trade tariffs. The specifications of alternative scenarios examined in our study differ mainly in terms of assumptions about the direction of government trade policy. For example, for the US-China Trade War scenario, we use the actual tariff parameters stipulated in the Phase I agreement (December 2019) and include tariff and NTB liberalisation measures as detailed in the actual CPTPP study. For RCEP, we assume a 90 percent reduction in tariff barriers and, for NTBs, the average of recent ASEAN+1 agreements. Since both the CPTPP and RCEP are outward-looking agreements with external benefits to outsiders, we assume non-preferential NTB reductions of 10 percent for both RCEP and the CPTPP. These policies enter exogenously into the CGE model. We ‘close’ the model by assuming that the economy’s level of net investment is fixed, based on a variety of factors not examined in the study. This in turn requires overall trade balances to be fixed across scenarios. We also assume that in a distant future year, all economies operate at ‘normal employment’ levels; 2030 is normally the end year of model simulations. It is possible to employ different labour-market closures, and we allow for endogenous labour supply in Park, Petri and Plummer (2021). Scenarios are simulated over a multi-year period, with investment decisions made in one year affecting the capital stocks available in the next year.

In what follows, we use our CGE model to first assess the impact of the US-China trade war, which (unfortunately) is establishing the context in which the megaregionals are being implemented. Our assumption is that the Phase I agreement will continue to be in place throughout the implementation period for megaregionalism initiatives, i.e., through 2030.⁶ We then show our results for the CPTPP and RCEP scenarios, focusing on the income and trade effects.

5 The exception is India, which was an original negotiating partner but who dropped out of negotiations in November 2019. The RCEP agreement notes that India can rejoin negotiations at any time.

6 For a “snap back” or “business-as-usual” scenario in which US and Chinese tariffs return to their levels before the trade war, see Petri and Plummer (2020).

The Effects of the US-China Trade War and Megaregionals

Table 1 summarises our estimates of the changes in income due to the policy initiatives in question, that is, US-China trade war, the CPTPP and RCEP. We model these as a progressive series of policy initiatives, that is, we begin with the effects of the trade war, then add the incremental effects of the CPTPP and, finally, RCEP. All effects are expressed as permanent changes relative to the baseline beginning in 2030. As can be seen from column 3 in Table 1, a sustained US-China trade war will generate powerful headwinds for the global economy. These include large negative effects on China's national income (-\$515 billion) and smaller losses for other regions closely connected to the United States or China (including the United States itself). The simulation also projects small gains for countries that compete with China in US markets, including Japan, which experiences a small increase in income of \$7 billion. Europe is negatively affected; its income falls by \$12 billion, but, of course, this is a small effect for a \$23 trillion economy in 2030.

The next two columns of Table 1 underscore how the trade war will affect the implementation of the CPTPP (column 4) and RCEP (column 5). The CPTPP has the effect of increasing global incomes by \$188 billion, compensating in part for the \$514 billion hit from the US-China trade war. As expected, the agreement benefits member-countries but its effects on non-members are mixed. Trade diversion negatively affects both China and the United States, whose respective incomes fall by an additional \$14 billion and \$4 billion on top of the trade war losses. However, the outward-oriented nature of the agreement actually benefits Europe, whose losses from the US-China trade war are more than compensated for by the positive effects of the CPTPP (\$14 billion). As a member of the CPTPP, Japan experiences a particularly large gain of \$57 billion on top of the US-China trade war. Indeed, its gains are twice that of any other CPTPP country save Malaysia, which gains \$29 billion.

Adding RCEP to these scenarios generates a marginal increase of \$263 billion on a permanent basis, \$245 billion of which accrues to member economies. Thus, despite RCEP's building on existing FTAs and its more limited scope compared to the CPTPP, it does generate significant net gains. Indeed, together with the CPTPP, it compensates for \$451 billion of the \$514 lost from the US-China trade war. The benefits flow mostly to mem-

ber-economies but even all non-members gain with the exceptions of India and Taiwan. China's income increases by \$127 billion, making up for one-fourth of the losses from the previous two scenarios. Next to China, Japan is the biggest winner from RCEP (marginal increase of \$60 billion), followed by South Korea (\$28 billion). Europe also gains from RCEP, more than compensating for the trade war.

V. Implications for Japan and EU

In short, the direct economic effects of the US-China trade war are large. In addition to the negative effects on global incomes, international trade is severely affected: trade falls by close to \$1 trillion annually, i.e., twice the fall in income. China is especially affected by the trade war, of course, but so is the United States. There are collateral effects on other regions, including the EU. But the trade war is symptomatic of an international trading system that is stalled and perhaps even retreating. Even prior to the pandemic, global trade flows were struggling and actually fell (slightly) despite stable economic growth.⁷

A reset is certainly in order. With the WTO at an impasse, the rise in Asia-Pacific megaregionalism arguably constitutes an important positive force for the global trading system. The CPTPP, which is virtually the same as its predecessor, the Trans-Pacific Partnership (but without the United States), is a modern, 21st century trade agreement that addresses key issues facing global economic interaction, from state-owned enterprises to the digital economy. Its chapters may well serve as future templates for multilateral agreements. The RCEP is far less ambitious than the CPTPP but is surprisingly comprehensive, given the diversity of its membership, which includes some of the largest and richest economies in the world, and some of the poorest. There are aspects of RCEP that also show how compromises might be made at the global level; after all, the Doha Development Agenda essentially stalled because of an inability to meet the interests of both developed and developing economies.

Japan holds a central place in Asia-Pacific regionalism, being a member of RCEP and the CPTPP. Of all the integrating economies our estimates suggest that it stands to gain the most from this process. It will especially profit from free-trade in northeast Asia and establishing new partnerships with China and South Korea, enhancing its competitiveness in advanced manufacturing and, importantly, building bridges with these two countries with which it has

7 World Trade Organisation, https://www.wto.org/english/news_e/pres20_e/pr862_e.htm

fraught relationships. Moreover, adopting the modern rigours of the CPTPP will be important as Japan guides its own structural reform programme; joining the CPTPP was included as part of the ‘third arrow of Abenomics’.

Our estimates suggest that Europe will also gain (marginally) from Asia-Pacific megaregionalism; the open nature of the CPTPP and RCEP will lead to some external trade creation and the more attractive environment for Europe’s multinational corporations will also be advantageous. The agreements will also signal hopeful signs for the global trading system at a time when there are precious few. Still, Europe will have to contend with a more integrated region that will become more competitive in areas in which it has comparative advantage, such as advanced manufacturing. Moreover, the RCEP in particular is a ‘living’ agreement and its rules and disciplines will be updated over time. The seeds for such changes are already in the agreement and, historically, ASEAN-centric agreements have always started out slow and then became more comprehensive over time. The same will likely happen with RCEP, to the extent that the new measures that are crafted in the agreement have the potential to become global norms, the EU will be outside that process. This does not imply that the EU should be wary of RCEP or the CPTPP but rather, that it should strive to actively engage with both.

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Table 1: Income Effects of Asia and Pacific Policies

	2030 Income	Est. Incremental Income (\$ billion)			Percent Income Change (%)		
		US-PRC Trade War	CPTPP	RCEP	US-PRC Trade War	CPTPP	RCEP
Americas	39,569	6	60	3	0.01	0.15	0.01
Canada	2,717	6	26	1	0.23	0.96	0.02
Chile	463	-1	4	0	-0.18	0.82	0.03
Colombia	684	1	0	0	0.12	0.00	0.03
Mexico	2,169	29	21	1	1.33	0.98	0.03
Peru	442	1	12	0	0.16	2.64	0.00
United States	25,754	-41	-4	0	-0.16	-0.01	0.00
Latin America nie	7,341	11	1	1	0.14	0.01	0.01
Asia	50,659	-490	91	234	-0.97	0.18	0.46
Brunei Darussalam	31	0	1	0	-1.28	3.01	0.53
China	27,839	-515	-14	127	-1.85	-0.05	0.46
Hong Kong, China	461	-25	2	2	-5.42	0.38	0.42
India	5,487	17	-5	-7	0.31	-0.09	-0.13
Indonesia	2,192	3	-2	4	0.15	-0.09	0.18
Japan	4,924	7	57	60	0.13	1.17	1.22
Korea	2,243	7	-4	28	0.31	-0.16	1.27
Malaysia	675	4	29	7	0.60	4.36	1.03
Philippines	680	3	0	3	0.43	-0.05	0.39
Singapore	485	-3	15	0	-0.70	3.14	0.05
Taiwan	776	0	0	-4	-0.04	-0.02	-0.47
Thailand	812	6	-5	7	0.68	-0.67	0.88
Viet Nam	497	5	17	5	1.01	3.38	0.97
ASEAN nie	283	1	0	2	0.29	-0.06	0.56
Asia nie	3,272	2	0	0	0.07	0.00	0.01
Oceania	2,854	-2	19	2	-0.07	0.65	0.08
Australia	2,590	-2	15	2	-0.09	0.58	0.06
New Zealand	264	0	4	1	0.06	1.38	0.28
Rest of the World	40,720	-28	19	24	-0.07	0.05	0.06
Africa (Sub-Saharan)	4,068	4	0	1	0.09	0.00	0.01
Europe	23,189	-12	14	14	-0.05	0.06	0.06
EMENA	10,001	-17	4	7	-0.17	0.04	0.07
Russian Federation	3,371	-3	1	2	-0.09	0.02	0.04
Others	90	0	0	0	0.52	0.12	0.11
WORLD	133,801	-514	188	263	-0.38	0.14	0.20
<i>Memorandum</i>							
RCEP15 members	43,516	-486	113	245	-1.1	0.3	0.6

ASEAN = Association of Southeast Asian Nations, CPTPP = Comprehensive and Progressive Agreement for Trans-Pacific Partnership, EMENA = Europe, Middle East, and North Africa, nie = not included elsewhere, RCEP = Regional Comprehensive Economic Partnership, US = United States.

Source: Park, Petri and Plummer (2021).

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