

# The Formation of Bilateral FTA in Political-Economic Perspective: Comparing the US and the Japanese Model of FTA

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## Abstract

*The formation of bilateral Free Trade Agreement (FTA) has proliferated in various regions since the United States (US) initiated the formation of NAFTA in 1992. What was striking from the phenomenon was that many FTAs were formed between developed and developing countries not only regionally but also cross-regionally. In fact, only a fraction of initiated FTAs successfully delivered the expectations of the parties involved. Conversely, it tended to yield unequal economic benefit to the parties. This has raised the question of: why states rush to jump on FTA bandwagon? Many analysts argued that states form bilateral FTA for the sake of reputation without considering much the consequences derived from such arrangements. This article examines the motives, interests, and preferences of states in forming FTA using political-economic approach, to clarify the determinants of FTA formation. Presenting the case of the United States (US) and Japan—two influential advanced economy states in international trade—this article took the US FTA model and the Japanese FTA model into considerations, provided analytical explanations on the political-economic reasons behind the developed countries' initiative to form FTA, and its implications for developing countries.*

*Keywords: bilateral FTA, the US FTA, the Japanese FTA*

## A. INTRODUCTION

The formation of bilateral FTA has proliferated in various regions since the US initiated NAFTA in 1992. A number of states were tempted to join into FTA arrangements with the expectations of improving their economy through the expansion of trade and investment. However, only a fraction of the initiated FTAs successfully delivered the expectations of the parties involved. In particular, FTA formed between developed and

developing countries tend to generate unequal economic benefit to the parties. This has raised the question of: *why states rush to jump on FTA bandwagon? What determine states' decision to join bilateral FTA?* Answer to this question is considered important since more states are likely following the others in forming FTA, indicating that the trend is not going to abate in the near future. Understanding the motives, interests and preferences of states in forming FTA is crucial to appraising whether such arrangements would be successful or fail to bring benefits to the parties involved.

Many analysts argued that states enthusiastically form bilateral FTA for the sake of reputation without considering

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much the consequences derived from such arrangements. This argument emanated from the phenomenon of intensified FTA formation globally since the last decade. By 1990 there were 16 FTAs in force out of 40 FTAs that had been notified to the GATT (the WTO's predecessor). By 1997 the number of FTAs worldwide had increased to 72, and by 2005 it has risen to 153, with the vast majority (nearly 90 percent) are bilateral FTAs (Dent 2007, p. 24). Geographically, Europe has the most FTA links with countries in many regions, accounted for about 50 percent of all FTAs currently in force. Meanwhile, the US and Japan were relatively left behind with 17 FTAs for the US and 11 FTAs for Japan in force up to 2007.

Based on the above figures this article attempts to examine the motives, interests and preferences of states in forming bilateral FTA using political-economic approach, to clarify the determinants of FTA formation that motivate states decision. The case of the US and Japan—two influential advanced economy states in international trade—will be taken into considerations, since the experiences of the two countries has generated what is called the US FTA model and the Japanese FTA model. The article then provided analytical explanation on the political-economic reasons behind the developed countries' initiative of forming FTA, and sees its implications to the developing countries, before coming into conclusion.

## **B. THE DETERMINANTS OF FTA FORMATION**

Why states committed to form bilateral FTA with other states? What kinds

of benefits promised to be delivered by the FTA formation? The standard economic approach to assess the benefits of free trade (FTA) has been the neoclassical computable general equilibrium (CGE) model to justify the hypothesis that trades contribute to the overall economic growth and development of a country (WB 2002; Schott 2004; Bhagwati 2004; Dent 2007). A number of empirical tests on trade impact have been conducted by economic researchers on various countries with the result generally shows that trade contribute relatively positive gain in GDP to the countries involved. However, economic gain from free trade generally occurs once the agreement was implemented and in a short term. Meanwhile, to achieve long-term gain needs continuous efforts to increase governance capacity to manage trade relations.

Other approach to assessing the net economic welfare effects of FTA were the pair concept of *trade diversion* and *trade creation* initially introduced by Jacob Viner (Dent 2007, p.21). Trade diversion occurs when non-member country producers are disadvantaged by relative tariff changes incurred by the FTA's internal liberalization. Meanwhile, trade creation arises when the same internal trade liberalization allows more competitive FTA-based producers to expand their own share of the FTA's market once held by their less competitive rivals inside the FTA area (Dent 2007, p. 21). Using this approach, many have argued that FTA will bring benefits if it generated trade creation rather than trade diversion.

A study conducted by the US government on the impact of trade to the US economy showed that with worldwide free trade, the effect on job creation

would be small, agriculture would increase jobs but workers in textiles, and apparels, the retail trade, and some service sectors would lose their jobs (CRS 2007, pp.13-16). This indicated that the overall benefits of free trade for the US would be relatively small. If that assumption is true, then for what reason the US initiated FTA formation? There are reasons beyond just economic interests that motivate the US to form FTA. For the US, economic gain from free trade was not the only reason to form bilateral FTA. It is more likely that political considerations rather than economic considerations has played greater role in the US decisions to promote free trade.

In the case of Japan, economic interests are more prominent in determining the motives to form FTA since Japan is a country which is very much dependent on international trade. Due to its economic motives, Japan's choices of FTA partners were based on urgent economic interests. The distance in geographical position and weak political connections were not central to the Japanese government's FTA initiatives as far as it give economic benefits to the Japanese economy. As long as Japanese economic and business interests spread across geographical regions, there were economic gains to be made by engaging in FTA regionally or cross-regionally (Solis 2007, p.291). This reason justified the formation of FTA with Mexico. The Japanese business community which was discriminated in the Mexico's market due to the formation of NAFTA urged the government to form FTA with Mexico.

Instead of economic determinants, generally there are at least four determinants indentified by analysts on the reasons states form bilateral FTA as follows: 1) paradigm shift in trade policy; 2) in-

ertia of the existing trade institutions; 3) growing competition among states to form FTA; and 4) strategic diplomacy motives. The four determinants will be applied to analyze the reasons the US and Japan took bilateral FTA policy. The paradigm shift concern with the changes of trade policy undertook by the developed countries particularly the US and Japan. In the US under the Clinton and the Bush administrations underwent significant changes in its trade policy from multilateralism to bilateralism, to overcome trade deficit with its trading partners. Meanwhile, Japan under Prime Minister Koizumi also changed its trade policy from the one focusing on multilateralism to the one taking on an FTA policy to energize its economy.

The breakdown of multilateral trade negotiations in the GATT/WTO and other economic cooperation institutions such as APEC and ASEAN prompted states to seek alternatives institutions to pursue their trade interests. A number of GATT/WTO member states formed bilateral Preferential Trade Agreement (PTA) to improve their bargaining position in trade negotiations with third parties. It is believed that PTA provides participants with insurance against future disruption of commerce that might arise if multilateral negotiations stall or the system weaken as a growing number of states with heterogeneous commercial preferences accede to GATT/WTO (Mansfield, 2003, p.856). Therefore, this determinant raised the question whether FTAs will be 'building block' or 'stumbling block' to greater multilateral trade liberalization (Mansfield 2003, Bhagwati 2004). Many studies have been conducted to analyze states' preference toward multilateral or bilateral strategies in international economic cooperation, and indicated that there are some conditions

under which a multilateral approach is likely to grow less attractive, prompting states to pursue FTAs with greater intensity (Mansfield 2003, p.857)

States form FTA for the sake of not being left out by others in FTA bandwagon. The formation of FTA in one region has created a "demonstration effect" (Ravenhill 2003) where other region intended to 'catch-up' with. Another analyst, Richard Baldwin proposed a 'domino' theory to explain the motives of the developing countries in entering FTAs as a mean to seek inclusion in such agreement to ensure parity in terms of access to markets and to foreign investment (Baldwin 1997). The formation of FTA in East Asia indicated this phenomenon when Japan finally embarks upon FTA policy to catch-up with China which has initiated FTAs with ASEAN. The US also showed the tendency for not to be left out by Europe when it vigorously initiated FTA with many countries.

Of all the determinants, strategic diplomacy motives subsequently became more prominent than the other motives. The decisions of the US and the Japanese government to form FTAs were motivated by strategic diplomacy considerations, which then determined the FTA model they form with their partners. The following part will explain the FTA models derived from the interests and preferences of the US and Japan in their FTA policy.

### **C. THE US FTA MODEL**

The US initially did not have an agenda to involve into bilateral or regional economic cooperation but to support multilateral arrangements under GATT/WTO. However, with the collapse of Latin American economy in the 1980s

and the introduction of Washington Consensus measures, the Reagan administration started to incorporate (bilateral) free trade in the US foreign policy in the Americas. Moreover, the broke up of war in Iraq has urged the US to incorporate free trade to security agenda in the Middle East. The first FTA entered into by the US was the US-Israel FTA in force in 1985, as part of the Reagan administration's commitment to the Jewish state for its role in supporting the US foreign policy in the Middle East (Pang 2011, p.136). This was then followed by the formation of the US-Canada FTA in 1989. The two initial US FTAs were formed as part of the US foreign economic policy and security which then determined the US FTA model.

#### **1. Asymmetric-Neoliberal FTA Model**

The US's FTA model was once characterized by Dent as "asymmetric neoliberal FTA model" which place trade liberalization (free trade) as its main agenda (Dent 2007). This model places the US as a single dominant state with its FTA partner mostly small states (developing countries) which are economically and politically weaker than the US. Consequently it created asymmetrical relations between the US and its FTA partners. In pursuing trade liberalization the US applies considerable diplomatic pressure upon its FTA partners to comprehensively open up its market to the US commercial interests while at the same time insisting on protecting a range of domestic sectors from reciprocated liberalization (Feinberg 2003).

Having relatively more power than its partner, the US requires virtually complete liberalization of industrial and agricultural products, extensive cover-

age of market access for services (such as infrastructure, financial services, media and entertainment), rights of establishment with few exceptions for foreign investment, commitments on government procurement, policy transparency, technical barriers and standards, provisions to adhere to labor and environmental standards that are enforced by dispute settlement agreements supported by the possibility of suspension of concessions and / or payment of monetary assessments (Lawrence 2006, p 10-11). This comprehensive agreement is somewhat called as 'agreement behind the border' (Dent 2007, p. 234). In line with the neo-liberal philosophy, this model is more market-driven, more resistant to bureaucracy and more deferential to national autonomy (Pastor, 2004, p.128). The US government believes that market opening through free trade will facilitate economic development in the developing countries important to create democratic governments.

Another characteristic of this model is the uses of "hard law" in the agreement, which embodies a high degree of precision and obligation from its FTA partner. The US frequently pressures its partner to follow the regulations in its International Property Rights (IPR) regime which get beyond the regulations of the WTO's TRIPs (Trade Related Intellectual property Rights). This practice is popularly known as "WTO-plus" agreement. It has become the standpoint of the US government to build FTAs on the foundation of the WTO agreement but with more comprehensive and stronger disciplines from the WTO agreement (USTR 2012). The NAFTA agreement was one of the "economic arrangements" which emphasized the uses of hard law which was aimed to reduce intergovernmental transaction costs: reduces private risk

premiums; promote transparency; restrain strategic political behaviors; and (may) increase the integration effects (Abbott, 2000, p.520). Therefore, the US preferences in its FTA reflected clearly in the NAFTA agreements which subsequently became guidance in the making of future FTAs.

In the investment sector, the US often asks special treatment for its MNCs which get beyond 'national treatment' which used to be provided in an FTA arrangement, such as to include provision which allow the US MNCs to take legal actions against host government's policy which harm the investment interests of the American corporations. This demand was typically neo-liberal agenda, which prompt the developing countries to undertake structural adjustment, such as privatization as prerequisite to form FTA. The case of Singapore and Australia showed that the two countries privatized their telecommunications sector to sign FTA with the US. To promote foreign investment liberalization in the host countries, the US insisted the uses of "negative list" mechanism not only in trade of goods but also services.

Moreover, the US also incorporated issues related to labor and environmental standards as part of what were called as "broad band" trade agreement. The US FTA partners should adjust their standards to higher labor and environmental standards applied by the developed countries if they want to form FTA with the US. In fact, the US could enforce this requirement to its partners for the reason that its partner would enjoy large market access in the US. The standard argument uses by the US was that, its market are much larger than the market in its FTA partners. (Dent 2007, p.234).

The asymmetric neo-liberal model

shows that the US is very much concerned with market access opening of its partner with very little or even no clause related to economic cooperation or development assistance incorporated in the arrangements. If there is a clause concerning economic cooperation in the agreement, it usually meant as complementary and not part of the contents of the arrangements. The US-CACM-DR FTA where the US funded a program of National Action Plans for Costa Rica, El-Salvador, Guatemala, Honduras and Nicaragua to identify their needs for "capacity building" in preparing the FTA (negotiation, implementation and transition process) was an example. Therefore, the assistance was meant to help the USTR in implementing the FTA. Another case was US FTA with the SACU group (South Africa Custom Union) where the US provided economic assistants to prepare for the agreement.

## 2. Convergence FTA Model

The other characteristic of the US FTA policy was its connections with politics and security interests more than just promoting free trade. This has generated a "convergence FTA model," connected closely with the US foreign policy under President Clinton and then continued by President George W. Bush. The vision of the Clinton administration was to have the cumulative effect of converging both trade and security policies (Pang 2011, p.62). Since security became a top priority in the US foreign policy after the September 11 terrorist attacks, the national security interests are frequently preceding the formation of US FTA with its partners.

This model is mostly visible in the US FTA with the Arab states in the Middle

East, started with the US-Jordan FTA in 2000. As the first Arab states which sign FTA with the US, the US-Jordan FTA was concluded as a reward from the Clinton administration to the Jordanian government for its role in preventing major attacks of al-Qaeda in Europe and the US (Pang, Ibid). Surrounded by Iraq, Israel, Saudi Arabia and Syria, Jordan has an important role for maintaining peace in the Middle East. The trade agreement was viewed by Washington as an important way to reward Jordan's steadfastness in sticking to its peace treaty with Israel. However, most Jordanian feel that they have not benefited much from the treaty, which had been expected to lead to a flood of outside investments for industrial projects, creating significant employment opportunities (Fiona Symon 2000). The US-Jordan FTA was a security-driven cornerstone laid by the Clinton administration to largely integrate the Middle Eastern states with the US. The FTA was then followed by three Middle Eastern states consecutively: Bahrain, Oman and Morocco which signed FTA with the US between 2004 and 2009.

The US FTA policy with the Latin American countries also related to security issue, particularly concerning terrorism, drug trafficking and threat to constitutional governments. In 2003 the US signed FTA agreement with Chile while proposing FTA to Columbia and Panama. The following year (2004) FTA with Central America and Dominican Republic (US-CAFTA-DR) was signed. The George W. Bush administration intended to form FTA with all states in the American continent which is called Free Trade Area of the Americas (FTAA) consisted of 34 countries. This was part of the US greater ambition to form FTA in the Western Hemisphere which integrating free trade from "Alaska to Tierra del

Fuego" (Pang 2011, p.8). A desire that was difficult to be materialized without Brazilian support as Lula scorned the FTAs calling it a US plan to annex Latin America (Hakim 2004, p.117).

#### **D. FTA IN EAST ASIA: THE JAPANESE MODEL**

The East Asian region was relatively left behind the other regions in entering into FTA, because Japan—an advance economy state in the region—was reluctant to take an FTA policy. Japan finally changed its trade policy to embark upon bilateralism, and one of the driving forces behind Japan's thirst for FTA is China and its increasing economic influence (Japan Times 22 November 2002). However, Japan's FTA model different significantly from the American model.

##### **1. Developmental-industrial FTA Model**

The FTA model initiated by Japan was characterized as "developmental-industrial FTA model" a typical FTA in East Asia (Dent 2007). The developmental aspect of the FTA approach derives partly from Japan's developmental political economy, which concern the pivotal role of the state in realizing transformative economic development objectives in partnership with business and societal groups (Aoki 2004; Ogita 2000). In a sense, Japan which was widely known for its political economy of capitalist developmental state (CSD) reflected it in the FTA with its partners. For Japan, economic interests are more prominent than political and security interests as the driving force in the formation of FTA.

Differ significantly from the US FTA model, the Japanese FTA model empha-

sizes on trade facilitation/economic cooperation. The main agenda is liberalization of the manufacturing sector to support the expansion of the domestic industry. This motive was initially driven by Japanese MNCs' strategy to develop production network, particularly in the automotive and electronics industries. Therefore, the FTA policy was basically not far different with the regionalization strategy of Japanese manufacturing industries in Asia which has been practiced so far.

There is different philosophy between the US and Japan which differentiate their approach in the formation of FTA. A simple indication of the different philosophy was seen in the use of different term. Japan prefers to use the term of Economic Partnership Agreement (EPA) to address FTA that it forms with its partners. The reason was that Japan's EPA emerges from economic cooperation which has been a pillar in Japanese diplomacy with other countries, particularly in the Asia-Pacific (METI 2005). Instead of that, the term economic partnership was less provocative than free trade which could stir opposition movements from those against trade liberalization.

Japan's EPA policy also related to economic aid policy through ODA as a mechanism to support economic development in the developing countries of Asia-Pacific. Therefore, the Japanese motive of forming FTA was not genuinely to promote trade liberalization but to continue its policy of economic cooperation which has been developed with its trade partners in Asia-Pacific. This can be seen in how Japan places 'economic cooperation' and 'technical assistance' in the same priority as trade liberalization in its economic partnership.

## 2. Divergence FTA Model

As a capitalist developmental state Japan is identified as not in line with trade liberalization, due to the protectionist nature of the government's trade policy. Therefore, Japan faces a dilemma in its FTA policy, since the formation of FTA required reciprocal trade liberalization between parties. Meanwhile, the Japanese government was anxious to preserve protection to some economic sectors which are uncompetitive (particularly agriculture). In a sense, Japan's biggest stumbling block in forming FTA with developing countries is on agriculture sector, which the Japanese government strongly protected. Meanwhile, the developing countries which form FTA with Japan are agricultural producers which expect to gain access in the Japanese market.

The formation of FTA inflicted domestic political antagonism between those who supported liberalization and those who against it. Burdened with economic recession for more than a decade the Ministry of Economy, Trade and Industry (METI) determined to pursue trade liberalization to revitalize the Japanese economy. METI's desire was supported by the business community in the manufacturing sector, especially the electronics and automotive sectors which very much depended on international market. However, the Ministry of Agriculture Fishery and Forestry (MAFF) strongly opposed liberalization of the agricultural sector, for the reasons of protecting the interests of the Japanese farmers. In fact, politically the agriculture lobbies in Japan are very strong, due to its connection with the dominant political party, the Liberal Democratic Party (LDP). This condition put the government into difficulties in formulating

its trade policy facing trade liberalization in multilateral and bilateral level.

How does the Japanese government overcome the problem? John Ravenhill (Ravenhill 2003) presented his argument on "liberalization without political pain" which the writer of this article dubbed it as a "divergence FTA model." The bilateral FTA formed by the Japanese government gives opportunity to the protectionist supporters to maximize their political leverage in their efforts to avoid painful domestic adjustment as a consequence of signing an FTA by the mechanism of excluding sensitive sectors (agricultural products) from the FTA contents (Ravenhill 2003, p.307). This mechanism has been practiced by the EU in its FTA with Mexico and South Africa. In fact, the EU set the precedent for excluding sensitive sectors from bilateral agreements by excluding most agricultural products from its FTA. This practice was adopted by the Japanese Keidanren to win negotiation with the farmers association (*Zenchu*) which strongly opposed the inclusion of agricultural sector in the FTA.

By excluding the sensitive sectors from FTA with its partners, the Japanese government could endorse the agreement without sacrificing domestic political support. The strategy was successfully implemented in the Japan-Singapore Economic Partnership Agreement (JSEPA) in force in 2002, where agricultural sector was not covered in the agreement. Similar result was achieved when Japan was successful in having its highly protected rice market excluded from Japan-Thai FTA in force in 2007. However, in its FTA with Mexico, Japan experienced difficulties in the process due to different views concerning the agricultural sector. Mexico appeared unlikely



to agree to completely exclude the farm sector from a possible FTA (Japan Times, 22 March 2002). Japan finally agreed to include some agricultural products from Mexico to be given tariff reduction in exchange for tariff reduction for its steel plate and car sales. Japan-Mexico FTA was the first to cover agricultural sector, though it took seven years to complete the negotiations.

### **E. IMPLICATIONS FOR DEVELOPING COUNTRIES**

The different models of bilateral FTA between the US and Japan bring significant implications and consequences for developing countries which formed bilateral FTA with those countries. The asymmetric-neoliberal model is most likely suitable for countries with relatively open market economy where resistances toward neo-liberal economic liberalization agendas are inexistent. With very high standard and rigid regulations in the agreement (the uses of hard law) the developing countries which wish to form bilateral FTA with the developed countries face significant difficulties. The advanced "WTO-plus" provisions of certain FTAs have limited use and application to most developing countries because they simply lack the national capacities to accommodate the more sophisticated elements of commercial regulations as promoted by developed countries (Kovrigin, p.14).

Developing countries in the Asia-Pacific with relatively under develop economy such as Cambodia, Laos and Papua New Guinea are lacking the capabilities to carry out 'reciprocity' arrangement in the FTA. Even middle-economic countries such as the Philippines, Indonesia and Vietnam experienced difficul-

ties in the negotiation process of FTA formation with the developed countries because they lack of robust technocratic and institutional capacities (such as negotiators, trade analysts, etc.). Their institutional frameworks, such as legal and social institution were relatively insufficient to accommodate various commitments in the FTA required by their partners (Medalla and Lazaro 2004, p.19). So far, Singapore was the only Asian country which possessed the capability to meet the requirements in the formation of FTA with the US and Japan. Singapore and the US made much of promoting the supposed 'WTO-plus' nature of their FTA signed in 2003.

The US' convergence FTA model was basically connected with the existence of security alliance between the US and its partners. For the US, FTAs are the contemporary equivalent of security alliance since 'allies' are more likely to enter into FTA than other states (Mansfield 2003, p. 858). Therefore, only allies (or states which are ready to become the US allies) which are eligible to form FTA with the US. In a sense, the US is the most selective state in determining which state to be invited as its FTA partner (Dent 2007, p.235).

Differ significantly from the US, the Japanese model is less politically (and security) oriented but more economically oriented. Although economic interests occupied the main motive of the Japanese FTA, there is development dimension in it. This was shown in the 'thematic content' of Japan's FTA, where economic cooperation became important part (where it was absent in the US FTA). Among the thematic content of economic cooperation are: trade facilitation for agriculture / primary industry cooperation; capacity building through

education and human resource development cooperation; energy industry cooperation; environment cooperation; SMEs cooperation, etc (Dent 2007, p.287). The development dimension to some extent reduces the economic gap which might occur from FTA with Japan. Therefore, theoretically the Japanese FTA model is more suitable for developing countries seeking to improve their economy not only through free trade but also economic cooperation and partnership.

## F. CONCLUSION

In understanding the formation of bilateral FTA between the developed and developing countries, political-economic approach provided a more comprehensive analysis on the motive, interests and preferences of state in forming FTA. When economic approach (through empirical testing) justified that FTA formation generates economic gain and welfare of states, but it fails to explain why states persistently form FTA with other states in the absence of economic benefit. In this case, political-economic approach took part by analyzing the reasons beyond just economic motives of FTA formation.

The cases of the US and Japan have shown how the different motives in forming FTA generated different interests and preferences that influence the resulting model of FTA. The main motive of the US FTA formation is politics and security, while the Japanese motive is economy. The asymmetric neo-liberal model of US FTA is most likely suitable for states with relatively advanced economy and market oriented where there is no domestic resistance to neo-liberal economic agenda. Meanwhile, the convergence models will incorporate the US FTA partner into the US political security agenda.

The Japanese developmental-industrial FTA model is most likely suitable for developing countries which depend on Japan's ODA and investment through economic cooperation. The 'development' dimension of the Japanese FTA reflected the interest to strengthen economic cooperation with the developing countries as part of the Japanese foreign policy.

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