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Papers

A Free Trade Area of the Asia Pacific In the Wake of the Faltering Doha Round: Trade Policy Alternatives for APEC

C. Fred Bergsten

Introduction and Summary

The APEC Business Advisory Committee (ABAC) has recommended for the past two years that APEC Leaders launch a study of a Free Trade Area of the Asia Pacific (FTAAP). The Leaders have been unwilling to do so for at least two reasons: a fear that even such a limited move in the direction of an FTAAP could undercut the ongoing Doha Round in the World Trade Organization, which remained their trade policy priority and was already in parlous condition, and the (presumably related) unwillingness of the major APEC powers (China, Japan and especially the United States) to endorse the idea. ABAC thus decided to launch its own study of the FTAAP, and alternative trade policy ideas for APEC, in an effort to restore APEC's contribution to global trade liberalization and to revitalize APEC as an institution. The immediate objective is to advance the discussion of these issues at the Leaders Meeting in Hanoi in November 2006 and during the Australian chairmanship in 2007.

This paper argues that the case for studying, beginning an APEC process of intergovernmental discussion and consultation on, subsequently launching negotiations toward, and perhaps ultimately completing an FTAAP is much more powerful in 2006-07 than when the idea was initially raised in 2004 (or indeed when its conceptual predecessor, the Bogor Goals, were adopted by the Leaders in 1993-94). There are four reasons for this important change.

First, the Doha Round is faltering badly. It now seems unlikely to achieve even minimal success without a "political jolt" of the type that an FTAAP launch by the APEC Leaders could provide. The model is the Leaders' adoption of the goal of "free and open trade and investment in the region," at the first APEC summit in Seattle in 1993, that galvanized the successful conclusion of the Uruguay Round in the GATT shortly thereafter.

Second, outright failure or indefinite extension of Doha, which largely amount to the same thing, are now quite possible outcomes (especially without a new "jolt" à la FTAAP). Hence a fallback "Plan B" may become essential to keep the global trading system from relapsing into protectionism as the momentum of liberalization stalls. An FTAAP, in addition to improving the prospect for a successful Doha, is a far more promising "Plan B" candidate than the likely alternative of a renewed explosion of bilateral and sub-regional preferential agreements within the region (and in the rest of the world).

Third, the continued proliferation of bilateral and sub-regional (e.g. China-ASEAN, Japan-ASEAN, Korea-ASEAN) FTAs within East Asia, which could evolve into a wide-ranging East Asian Community or East Asia Free Trade Area whether called that or not, is again threatening to "draw a line down the middle of the Pacific." The expansion of US subregional FTAs in Latin America, from NAFTA to CAFTA and now into most of the Andean Community, projects a similar pattern from the eastern edge of that ocean (whether or not a full Free Trade Area of the Americas is ever concluded). Such disintegration of the Asia Pacific region, with East Asia and the Western Hemisphere raising increasingly discriminatory trade barriers against each other, would raise severe political and even security, as well as economic, problems for many countries in the region. It is essential to embed any new East Asian and Western Hemisphere integration schemes within the broader transPacific context to avoid such a risk. APEC is the only institutional foundation for such

an initiative and the FTAAP is the only operational instrument that could mobilize its potential to that end.

Fourth, the United States and China are experiencing intense and growing trade tensions within the context of a bilateral imbalance that exceeded \$200 billion in 2005 and will continue to rise rapidly. The United States has already imposed a number of new barriers against Chinese exports and many more, including across-the-board Congressional sanctions, are being seriously considered. Macroeconomic policy changes, especially substantial revaluation of the renminbi, will be essential to head off or at least limit an economic conflict between the two economic superpowers that could otherwise engulf the entire region. A fresh approach to the trade policy dimension of the relationship is needed as well, however, and an FTAAP would embed any bilateral China-United States confrontation within a broader transPacific context. It would thus offer a more promising response than the bilateral route, which to date has proved largely fruitless and indeed confrontational and dangerous.

For all these reasons, the United States could come to endorse the idea of an FTAAP in the near future (as some of the smaller APEC member economies already have). Especially if pushed by some of its Asian neighbors, China could do so as well. An FTAAP is a natural for Japan, the third leading trader in the region, to avoid being drawn into an East Asian zone dominated by China and to counter the U.S. drive to complete bilateral FTAs with many of the other major countries in the region (Korea, Thailand, Malaysia, Singapore, Australia and perhaps soon Indonesia as well). An FTAAP could become quite feasible fairly soon.

This paper argues that the APEC Leaders, depending on the actual status of the Doha talks when they meet in 2006 and 2007, should therefore initiate an official study of an FTAAP and an intergovernmental discussion/consultation/negotiation to pursue the substance of the idea. The preferred sequence would be to launch the study in 2006 and the action program a year later but it might be necessary to fuse these two steps if a collapse, or indefinite delay, of the WTO round were already evident by the time of the Hanoi meetings in November. The paper provides an updated analysis of the case for an FTAAP, relates the idea to the three most likely scenarios for the Doha Round, and addresses directly the prospect that the three largest APEC economies, especially the United States, could become supporters of the idea in the changed circumstances discussed.

The Case for a Free Trade Area of the Asia Pacific

The substantive case for an FTAAP is well known and very powerful.

First, implementation of an FTAAP would represent a gigantic liberalization of trade in the world's largest and most dynamic region. All member economies would derive large welfare gains as a result. An earlier study prepared for ABAC shows that every APEC economy gains more from an FTAAP than from nondiscriminatory liberalization by APEC, the only alternative modality for pursuing the Bogor Goals on a region-wide basis and for revitalizing APEC's trade agenda, and that almost all East Asian economies (including the three large Northeast Asians) gain more from an FTAAP than from an "ASEAN Plus 3" FTA.¹

A truly Free Trade Area of the Asia Pacific would indeed achieve much greater economic benefits, for the world as a whole as its sizable gains for the large number of participating economies more than offset the losses to some non-members, than any conceivable multilateral/WTO liberalization. The Doha Round, like the Uruguay Round and its other predecessors, would at best achieve marginal liberalization of 25-30 per cent of existing barriers.

Since APEC economies account for more than half of world output and trade, elimination of *all* barriers between them would provide a much larger *global* payoff than any realistic Doha outcome. Even if APEC were to achieve liberalization of “only” 80-90 per cent in goods, which would be necessary to meet the WTO test of covering “substantially all trade,” the gains for the global economy as a whole would be far superior to those attainable via any plausible WTO negotiation. Those gains would of course accrue primarily to the members of the FTAAP itself and some non-members would lose, due to the resulting discrimination against them, which is why the latter would then be likely to promptly seek significant further multilateral liberalization via the standard logic of “competitive liberalization.”

Second, serious pursuit of the FTAAP idea by APEC is much more likely to promote than undermine the prospects for a successful Doha Round. The countries that represent the primary barriers to a successful Doha all lie outside APEC: the European Union, Brazil, India and some of the Africans. Hence the prospect that a new APEC liberalization initiative would strengthen the outlook for Doha, by focusing the recalcitrants on the risk of facing substantial new discrimination if they continue to block a successful WTO outcome, is even greater than at the end of the Uruguay Round when “only” the EU needed to be shocked into cooperation by APEC’s initial Seattle summit and “free trade in the region” commitment.

A parallel launch of the FTAAP idea at this time would, at a minimum, thus enhance the prospects of achieving the modest but highly desirable trade liberalization that could result from a successful Doha Round – as long as the APEC members made clear that this outcome remained their top priority as they surely would (and as their predecessors did vis-à-vis the Uruguay Round in 1993-94). If APEC would then follow through and actually create an FTAAP, to maintain the forward momentum of liberalization by building on a successful Doha, its far larger “WTO plus” gains would accrue in addition to those produced by Doha. The resulting discrimination against outsiders would in turn be likely to prompt insistence by those outsiders, led by the EU, to launch another multilateral WTO round to reduce the new preferences (just as the United States insisted on the three major postwar GATT rounds in large part to reduce the preferences stemming from EU creation and subsequent expansion). An effective FTAAP process in APEC could thus make a huge double or triple contribution to global trade liberalization and economic welfare.

If Doha were to fail anyway, despite an APEC effort to revive it via the launch of an FTAAP process, the FTAAP initiative would provide the APEC member economies with a ready “Plan B” to restore momentum for trade liberalization. This would be extremely important, especially for the trade-dependent economies of the Asia Pacific region, in a world in which the global bicycle had stalled out. The FTAAP idea thus simultaneously offers a spur to Doha and a ready alternative if it were to fail.

Third, an FTAAP could, at least over time, sweep under one roof the exploding proliferation of bilateral and sub-regional preferential trade arrangements (PTAs) throughout the area (and help head off the further proliferation that is highly likely in the absence of an FTAAP alternative if Doha fails). It would eliminate, in whole or in part (since some PTAs would probably continue to exist even with an FTAAP), the increasing discrimination that such pacts are producing within the region. In particular, it could start rolling together the conflicting rules of origin (ROOs) that are becoming so costly to business and trade throughout the region.

This benefit of an FTAAP is vitally important in light of the steady movement of the East Asian members of APEC toward establishing their own region-wide PTA. Creation of an East Asian Community, or even an East Asian Free Trade Area, could contribute substantially to

liberalization and thus have a positive impact on the world economy.² It would also generate a major new source of discrimination within the broader Asia Pacific setting, however, and thus, as with the Mahathir proposal for an East Asian Economic Group in the early 1990s, threaten to “draw a line down the middle of the Pacific.”³ Initial studies suggest that the United States would immediately lose at least \$25 billion of annual exports solely from the static discriminatory effects of an EAFTA.

This outcome will occur whether or not the East Asian regional integration process formally produces a single economic entity, per Japan’s recent “ASEAN Plus Six” FTA proposal, because the overlapping network of existing and potential agreements, especially the “10+1+1+1” arrangements between ASEAN and the three Northeastern Asian powers, will move substantially in the same direction. Such new trade discrimination across the Pacific could also have important security effects, inevitably loosening the current transpacific alliances (e.g., US-Japan), not least because of negative Congressional reactions to such Asia-only initiatives (regardless of the parallel Western Hemisphere-only initiatives being conducted by the United States itself). With the rise in economic and political importance of the Asian economies, and the tensions already existing over some elements of US foreign policy, the impact of such Asia Pacific disintegration would be far more costly today – to both sides of the Pacific – than would have been the case in the early 1990s.

Similar implications would of course accrue from the de facto completion of a Free Trade Area of the Americas (FTAA) as is occurring on the eastern edge of the Pacific. Formal negotiations for a full-blown FTAA have stalled, along with the Doha Round, because its conclusion has always been inextricably linked to the Round’s outcome on agricultural trade. Hence a failure of Doha would probably mean a failure for the formal FTAA too.

However, the de facto integration of the Western Hemisphere is already far advanced. The United States has expanded its FTA ties beyond NAFTA to include Chile, all of Central America and the larger parts of the Andean Pact (Colombia and Peru). A failed Doha Round could prompt US-Brazil negotiations. Asia Pacific disintegration is being fed from the eastern as well as western edge of the Pacific in equally messy but also equally discriminatory ways.⁴

The United States has no basis for asking to participate in the East Asian summits. Asians are not invited to the Summits of the Americas. Neither Americans nor Asians are invited to the summits of the European Union. Both the United States and the Asians do, however, have a clear right to be consulted about the hemispheric initiatives of their transPacific neighbors, especially in light of their commitments to each other to move to “free and open trade and investment” in the Asia Pacific region as a whole. They have an obligation to conduct such consultations with full faith and transparency and to consider new ideas, such as an FTAAP, that would obviate the major costs and risks of East Asia-only or Western Hemisphere-only integration. APEC is of course the natural venue for such consultations. A failure to pursue them would be extremely risky for all APEC economies.

One clear lesson from the history of large regional economic initiatives is that it is important to embed them in broader geographic contexts to avoid the risk that they may subsequently resist liberalization toward non-members and become closed blocs. The European Union and its predecessors, by far the most important preferential trade agreement ever implemented, have been sufficiently nested in the GATT/WTO system that they could not resist global steps to temper their discrimination against outsiders. In addition, the integrating Europeans were embedded in an extremely thick network of transAtlantic relationships with the United States and Canada, including most importantly the Marshall Plan, NATO and the OEEC/OECD but many more as well, which

virtually obviated the risk of “drawing a line down the middle of the Atlantic” despite the historic depth of integration that the EU was in the process of achieving.

By contrast, Mercosur’s apparent desire to maintain its sub-regional preferences, and resist reducing them in any broader framework even with full reciprocity, probably derives at least partly from this absence of broader nesting. The faltering of the WTO system likewise reduces its potential for limiting the risks inherent in a preferential de facto EAFTA or FTAA. Especially in light of the salience of transPacific relationships traced above, and drawing on the historical lessons from the transAtlantic relationship, it is essential to embed new Pacific Asia and Western Hemisphere sub-regional agreements within a broader Asia Pacific context. (For the same reason, an FTAAP should be embedded in an effective WTO system and FTAAP members should do everything they can to strengthen or, if necessary after a failure of Doha, to revive that global institution.)

Fourth, launch of an FTAAP initiative would revitalize APEC itself. Whatever its record in other areas, APEC has declined steeply in both regional and global relevance as its inability to effectively pursue its own Bogor Goals has become (painfully) apparent. In choosing to become solely a cheerleader for the WTO and Doha, without any trade agenda of its own, APEC has abdicated the significant role that it played in global as well as regional trade policy from 1993 at least through 1997 [vis-à-vis the Uruguay Round, as already noted, and in both negotiating most of the hugely liberalizing Information Technology Agreement (ITA) and teeing up nine important sectors for complete liberalization (which unfortunately failed later) in the teeth of the Asian financial crisis]. It has looked on helplessly as its member economies pursue their own PTAs without reference to, or even notice of, APEC and the commitments they had supposedly accepted under its aegis.

This weakening of APEC should be of major concern to all its member economies. The rapid growth of economic (and broader) tensions between the United States and China, and the increased risks of “drawing a line down the middle of the Pacific” due to the advent of Asia-only (and perhaps Americas-only) economic arrangements, underline the enhanced need for effective transPacific linkages and institutional ties for security as well as economic reasons. ASEAN, in particular, seeks to maintain active US engagement in the region as a “hedging strategy” against the rise, and possible hegemonial intentions, of China.

APEC is the only existing organization that can fill that role, in contrast to the large number of transAtlantic institutions that precluded the parallel risk of “drawing a line down the middle of the Atlantic” as the European Union formed and steadily deepened its integration. To pursue an FTAAP, it would of course have to acknowledge that it is already a “negotiating forum” and be prepared to point toward binding rather than purely voluntary commitments. This would ultimately strengthen the organization, however, and would in fact be nothing new for APEC since it already negotiated inter alia the Bogor Declaration, the Information Technology Agreement in 1996 (which subsequently became binding via the WTO) and the original sectoral liberalization agenda in 1997. Any new initiative that would restore purpose and credibility to APEC would generate benefits that range far beyond the gains, substantial as they would be, for that initiative itself.⁵

In sum, the substantive case for an FTAAP initiative in APEC is far stronger than when the idea was initially broached two years ago. There are powerful political and security, as well as economic and institutional, reasons for pursuing it. We must always be careful to distinguish among the three operational phases of the proposal: studying it, launching discussion/consultation/negotiation on it, and actually implementing the concept. It will be

necessary to carefully calibrate these three phases, to the global and regional contexts that exist at the time of the crucial APEC decisions, but each sequential phase of the project could have at least some of the beneficial effects described here. The substantive case is very strong and argues for serious consideration of APEC's moving ahead on the idea in the near future.

The FTAAP and the Doha Round

I have already suggested that the launch of an FTAAP initiative by APEC (building on the current study by ABAC) could both have a highly positive effect in galvanizing a successful outcome for the Doha Round and offer a fallback "Plan B" if Doha were to fail. The relationship between the FTAAP and Doha is so central, however, and has been such a major factor in inhibiting APEC consideration of such an initiative, that it deserves more detailed analysis. I will do so by tracing the implications for the FTAAP idea of the alternative scenarios that now seem plausible for the Doha talks as they approach their current deadline, driven by the expiration of U.S. negotiating authority, of late 2006/early 2007.

My colleagues Gary Hufbauer and Jeffrey Schott have developed a careful analysis of the three most likely outcomes for Doha in their paper "The Doha Round After Hong Kong" (Institute for International Economics, Policy Briefs in Institute Economics Number PB06-2, February 2006), and the prognosis seems even gloomier now in June 2006 in light of events that have transpired since they wrote earlier this year. The three possibilities are:

- Outright failure or collapse;
- A minimalist "success"; or
- A substantial further delay, at least until the end of 2007 and perhaps beyond the U.S. elections in late 2008.

I and my colleagues at the Institute, especially Hufbauer and Schott, are very strong supporters of the Doha Round. We have indeed participated actively in developing many of its components, and have testified and written incessantly in an effort to promote a substantively successful outcome. We fully realize, from our long experience with earlier GATT rounds, that all such multilateral negotiations have looked exceedingly bleak prior to their more-or-less successful conclusions. But our best analytical judgments now lead us to see a strong possibility of a demise of Doha, which we do with great reluctance and only because we believe it is imperative for the world to begin planning on the basis of the real prospects for such an outcome.

We doubt that the major governments, especially the United States and the European Union, would want to explicitly admit the failure of the Doha Round and accept a formal collapse of the negotiations. However, the developing countries could trigger such an outcome by again rejecting the offers of the rich nations as grossly inadequate – as they correctly did at the Cancun Ministerial in 2003. Even the United States negotiators, pushed by the Congress and the US business community, might reject a deal that failed to achieve at least a substantial portion of their negotiating objectives. Hence the first option is, unfortunately, a real possibility.

The consequences for the world trading system of an outright failure of Doha would be devastating. Protectionist relapses could be expected everywhere, especially as the global trade imbalances (which always spawn protectionism in the United States) continue to expand and as

most economies soften, with unemployment rising, over the coming couple of years⁶. A further proliferation of PTAs could be expected as governments tried to find some politically viable modality for resuming trade liberalization. Under these circumstances, a “Plan B” would be desperately needed. Launch of an FTAAP should be extremely attractive in this context, especially as transPacific trade ties would be the most likely to suffer in the context of a renewed outbreak of (especially US) protectionism.

A minimalist outcome, the second possibility, is clearly possible. WTO Director General Pascal Lamy signaled such a strategy in his report on Hong Kong to a large conference at the Institute for International Economics on February 17, and Deputy Director General Rufus Yerxa repeated the concept in a speech in Washington on May 24. Their message has essentially been that, facing profound difficulties in meeting the original goals of the Round or even advancing the negotiations beyond where they have stalemated over the past year, the WTO membership should “declare victory and go home.”

There are two problems with this approach. The first is that the offers to date are quite minimal, and it is doubtful that the world as a whole – as opposed to the ministers who would try to sell such an outcome – would view it as much better than an explicit failure. The second, which compounds the first, is that some of the present “offers,” such as the US willingness to limit agricultural subsidies in its next farm bill if the EU and others significantly expand market access in that sector, will almost certainly be withdrawn unless substantially better proposals emanate from their trading partners.

Hence any “declared victory” would be quite hollow and extremely difficult to sell. The global trade policy consequences might not be quite as bad as under an outright failure but neither would they be attractive to contemplate. All of the major trade problems would remain unresolved and the developing countries, in particular, would (rightly) feel betrayed for a second time. The resulting bad taste all around would make it virtually impossible to contemplate another WTO round⁷, or even any major sectoral negotiations, in the foreseeable future. The bicycle might not topple completely but it would become very wobbly. A “Plan B” would still be sorely needed.

The third option, which Hufbauer and Schott regard as the most likely, is extension of the talks from the current “deadline” of late 2006/early 2007 until anywhere from the end of 2007 (after the next French elections) to 2009 (after the next US elections) or even beyond. This would be similar to the end game of the Uruguay Round, which was initially scheduled to conclude in 2000 but continued until late 2003 (after completion of NAFTA and the initial Seattle summit of APEC, as described above). It would be tantamount to the failure outcome in the short run but of course without the definitive finality thereof, and indeed with some prospect of ultimate success or at least renewed effort down the road.

The global trade policy consequences of this quite plausible “outcome” are the most conjectural. They would depend partly on whether credible new deadlines could be set. They would also depend heavily on whether the Congress seemed likely to extend the President’s Trade Promotion Authority, which would be highly uncertain with Doha in suspense due to lack of success and hence unlikely to provide much motivation for the United States to resume the talks. Victories by the Democrats in the Congressional elections of 2006 or 2008, or in the Presidential election of 2008, could of course inject huge additional uncertainties into the picture.

The launch of an FTAAP in this context could provide a quadruple benefit. It would represent a new driver of liberalization to maintain forward momentum. It would offer a major

incentive for Congress – and the US business community, which is its most important constituent on these issues – to renew TPA and thus enable the United States to remain involved, and hopefully provide the needed leadership, in the related sets of global trade negotiations. It would offer a credible “political jolt” to the rest of the world, providing substantial motivation for others to make new offers that would revive Doha.⁸

If an FTAAP proceeded to fruition even in the wake of a reinvigorated and successful Doha Round, produced in part by the launch of the FTAAP itself, it could also galvanize a future WTO negotiation to reduce the new “Doha plus” discrimination that it created. The creation of the EU, and its subsequent broadening and deepening, were likewise important triggers for all three of the major GATT rounds (Kennedy, Tokyo, Uruguay) of the past half century. The formal launch of the Bogor Goals in 1994, coming just after the completion of the Uruguay Round, clearly stimulated successful multilateral/WTO negotiations (on telecom and financial services, in particular) for several more years; Sir Leon Brittan, the chief EU trade negotiator at the time, said repeatedly and publicly that “the EU will not be left behind if APEC does what it says it will do” and used the specter of APEC discrimination to bring his more recalcitrant member states into all these global liberalization packages.

The United States and the FTAAP

The FTAAP idea must of course be credible if it is to provide the numerous substantial benefits suggested above. This does not require the United States and the other major APEC powers, especially China and Japan, to fully endorse the idea at this time. It does require them to accede to at least the first stages of the process, an official APEC study and/or exploratory discussion of the concept, and it requires a plausible prospect that they will eventually come to embrace it. The most salient criticism of the FTAAP to date has been that “it will never fly” with the big countries, especially the United States.⁹

The United States is probably the most important single variable in this equation. It remains not only the largest APEC economy and trading nation but the traditional leader, to which most of the other members (including even China and Japan) look, on trade policy issues at both the global and regional levels. It was the chief driver of the Bogor Goals at Seattle and at Bogor itself, and their very positive interaction with the Uruguay Round in the GATT, and would probably have to play that same role again if Bogor were to be revived via an FTAAP.

On the other hand, in view of its huge trade deficits and the unique role of the Congress, the United States is in many senses the largest problem for APEC (and broader) trade policy at this time. Any significant US adoption of new protectionist measures, especially against China or Asia more broadly as is all too possible, would accelerate the Asia-only trade cooperation momentum and thus deepen the conflict across the Pacific.

Top US officials to date have clearly not endorsed an FTAAP. Neither have they rejected the idea, however, seeking to keep it alive as a possible alternative. They have indeed encouraged private Americans, including leaders of the business community, to promote the idea for that purpose. They have reiterated this stance very recently to the author (“we neither embrace nor discount the idea and genuinely want to see the ABAC report”).

Prior to the Presidential election in 2004, and thus in the runup to Santiago, the Administration was deterred by the implication that an FTAAP would produce “free trade with China.” This fear has continued since the election, in light of the huge and rapidly growing trade

imbalance between the countries, and remains the major US hangup on the issue. I will return to it below.

The key point regarding the US attitude toward an FTAAP, however, is how it will be affected by the likely paths for the Doha Round analyzed above. I and my colleagues at the Institute for International Economics often criticize the Bush Administration, and do not always support its trade policy, but it is clear to us that the Administration and the President personally are deeply committed to freer trade. They have led the way on Doha; indeed, there would be no Doha without the United States, including the major battle conducted by the Administration to win Trade Promotion Authority from the Congress by the narrowest of margins in 2002. The Round would have no chance for even a minimal success absent the bold initiatives taken by the Administration, as recently as just before the Hong Kong Ministerial, to liberalize agricultural, non-agricultural goods, and services restrictions around the world including its own. As recently as last summer, it again mobilized all its (admittedly waning) political muscle to win Congressional acceptance of CAFTA in the latest pitched battle between globalization and anti-globalization forces in the United States. The United States has also caused problems for the Round, to be sure, especially with its unwillingness to consider serious reform of its antidumping regime or immigration rules, but overall it has been by far the strongest single source of support for Doha.

Moreover, the Administration clearly sees trade policy as an integral part of its overall foreign policy and would be unwilling to let that central dimension of its global strategy disappear. In the specific case of East Asia, it is clearly concerned by the increased risk of “drawing a line down the middle of the Pacific,” especially between the United States and China, and has recently launched a major interagency review of the “East Asian architecture” movement, how that will affect US interests, and how the United States should respond. It is virtually inconceivable that the Administration would accept any of the three posited outcomes of Doha without mounting a major successor initiative, especially with respect to its chief trading partners/competitors in East Asia. It would surely want to restart the liberalization momentum, maintain its strategy of competitive liberalization and find a basis for extending TPA when it expires in July 2007.¹⁰

One possible US response is to launch additional FTAs with individual Asian partners. Korea and Malaysia have recently been added to the list that already included Singapore, Australia and Thailand. Indonesia is a favored candidate for subsequent inclusion. Subsequent USTRs have offered to pursue an FTA with Japan once it, like Korea has now done, is ready to put agriculture seriously on the table.

Another US alternative would be to offer “docking rights” to its existing FTAs for APEC members that were willing to accept the obligations of the existing agreements. NAFTA, for example, has an explicit “open accession” clause that has never been used. This might be a more practical way to achieve an eventual FTAAP than an “all in” negotiation from the outset. At the commencement of the APEC strategizing that ultimately produced the Bogor Goals, Senior Minister Lee Kuan Yew of Singapore in fact proposed that the United States open NAFTA to accession by all APEC members and argued that, since some would immediately accept, the entire membership would eventually have to do so via the logic of competitive liberalization. The United States is already employing a variant of this strategy in its Enterprise for ASEAN Initiative, through which it is pursuing bilateral FTAs with individual ASEAN members as they become ready with an ultimate goal of consolidating the bilaterals into a single agreement.

It would surely be superior for the United States, however, and even more so for its Asian partners, to pursue an FTAAP instead of adding further to the “spaghetti bowl” (or “noodle bowl”)

of PTAs in the regions. More US FTAs, including via “docking” to existing US FTAs by current non-members, would increasingly create a “hub-and-spoke” network centered on the United States (and thus encourage further proliferation of similar “hub-and-spoke” configurations centered on other major trading powers) rather than an integrated Asia-Pacific economy. Moreover, this approach would leave unresolved the central issue of US-China trade and broader economic relations. Indeed, US pursuit of FTAs throughout East Asia that excluded China would be likely to further exacerbate the Washington-Beijing tensions: it would add an economic dimension to the “surround China” strategy that the United States is already clearly pursuing in the security sphere, with its new overtures to India along with the deepening of the Japan alliance, that could trigger additional Chinese pushback in both the economic (more PTAs) and security arenas.

Both the international and domestic politics of the FTAAP issue in the United States will thus turn importantly on how it will be seen as affecting the US-China relationship. That relationship is clearly on a very risky path. The bilateral trade imbalance, which now exceeds \$200 billion annually and can only increase because US imports from China are six times greater than US exports to China (twice as large as the US-Japan imbalance ever became), is irrelevant per se in economic terms but toxic in domestic political terms. Moreover, the bilateral position accurately reflects the global position of the two countries: each is now running a multilateral imbalance that exceeds 7 percent of its GNP and is rising rapidly (in China’s case, the global surplus doubled in 2005 and rose another 55 percent in the first five months of 2006). The currencies of both countries are severely misaligned, with dollar overvaluation and RMB undervaluation of at least 20 percent and probably more on the order of 30-40 percent.

Such conditions in the United States have always been accurate predictors of major protectionist reactions. At the present time, the United States has already slapped new controls on six sectors of Chinese exports (apparel, color television sets, furniture, semiconductors, shrimp and textiles). The House of Representatives has passed anti-China legislation (the English bill in July 2005) and the Senate is considering at least two sweeping across-the-board proposals (Grassley-Baucus and Schumer-Graham) --some of which, if implemented, would violate US commitments under the WTO and thus justify Chinese retaliation. This could trigger a trade war between the two chief drivers of the world economy over the past five years and would almost surely provide added impetus for China and the rest of East Asia to pursue their Asia-only trade initiatives.¹¹

All this is occurring with a booming US economy that is enjoying full employment. The prospect for US trade policy is frightening if in a year or two we face a combination of slowing growth (or even a recession), rising joblessness, a global current account deficit of \$1 trillion and a bilateral imbalance with China of \$300-400 billion. President Hu Jintao’s visit to Washington in April 2006 produced no serious discussion of these issues let alone any resolution of them.

At the same time, China can make a powerful case that its trade policy is not a major problem. China is one of the most open of all developing countries: its trade to GDP ratio is more than 60 percent, double that of the United States and triple that of Japan. Its realized tariff average, the ratio of its customs collections to GDP, was 2.2 percent in 2004. Even its nominal tariff average is only about 10 percent. Virtually all import quotas have been eliminated and licensing schemes are being simplified. China clearly needs to follow through more aggressively on some of its WTO commitments, especially with respect to intellectual property rights, and would be well advised to respond to the external pressures by leading a new effort to bring the Doha Round to a successful conclusion. But its overall trade policy regime is not the main problem.¹²

The central strategic issue for the United States, with respect to overall China policy as well as trade and foreign economic policy, is how best to head off the potential confrontation despite these realities of China's trade policy¹³. The current bilateral strategy is proving to be largely fruitless; the results, as with Japan for three difficult decades, are at best minimal and case-by-case while the Chinese partner, even more than Japan, resents overt pressure and may even be less responsive as a result. Resort to the WTO dispute settlement mechanism can help resolve individual quarrels but many of the key issues are not covered by WTO rules and, again, the best possible outcome is case-by-case and drawn out over extended periods of time.

Hence there is compelling logic for the United States and China to bring their trade policy problems within the broader regional construct of APEC and an FTAAP. The idea should not be presented as mainly, or even importantly, aimed at resolving the US-China dispute; doing so might even backfire by making the other APEC members, as well as China and the United States themselves, uncomfortable with the prospect. Fortunately, the rationale for the FTAAP is straightforward and clear as developed in the first part of this paper.

But it would greatly behoove both the United States and China to embed their trade policy disputes into a broader context that would promise eventual elimination of most or all barriers between them. For the United States, the standard logic that has always persuaded the Congress to support such agreements would again prevail: that the partner country's barriers are higher and thus the United States can only gain on balance from their mutual elimination, even if further adjustment is required in a few US sectors. For China, a phased-in liberalization of its remaining restrictions would produce the culmination of its brilliant strategy to join the WTO in the first place: full integration with the world economy with the catalyzing effect thereof on its domestic reform process and the creation of the globally competitive firms that it so desperately desires.¹⁴ For both countries, the leavening presence of the rest of the APEC membership should help dilute and diffuse bilateral tensions and thus promote productive outcomes.¹⁵

It would be incorrect to suggest that the US Administration has accepted this argument at the present time. However, it is thinking very actively about the issues. I believe there is a real possibility that it will move in the proposed direction when it is faced by the confluence of three likely developments:

- indefinite delay, if not outright failure or even a minimalist outcome, of the Doha Round;
- continuing escalation of trade and economic tensions with China, clouding the future of the critical overall relationship between the two countries; and
- further increase of protectionist and mercantilist sentiments in the Congress as a result of the Doha and China developments along with a slowing of the economy and further increase in the global and bilateral trade deficits.

The very real possibility that the United States might adopt a favorable attitude toward an FTAAP in such circumstances should be enough for ABAC, and indeed APEC itself, to begin to lay the necessary foundations for the initiative.¹⁶ Indeed, the other member economies of APEC should make every effort to push the United States in the FTAAP direction under those conditions as it is they who would be hurt most by a United States that was backsliding into protectionism and becoming unable to negotiate internationally because of a lapse of TPA.

Conclusion

The FTAAP is an idea whose time is coming if it has not already arrived. Events of the next six months, particularly with respect to the Doha Round but concerning United States-China relations and global trade policies more broadly, are likely to clarify the situation in the direction of commending an FTAAP initiative by APEC as the best, or perhaps only, way to:

- catalyze a substantively successful Doha Round;
- offer an alternative “Plan B” to restore the momentum of liberalization if Doha does falter badly;
- prevent a further, possibly explosive, proliferation of bilateral and subregional PTAs that create substantial new discrimination and discord within the Asia Pacific region;
- avoid renewed risk of “drawing a line down the middle of the Pacific” as East Asian, and perhaps Western Hemisphere, regional initiatives produce disintegration of the Asia Pacific rather than the integration that APEC was created to foster;
- channel the China-United States economic conflict into a more constructive and less confrontational context that could defuse at least some of its attendant tension and risk; and
- revitalize APEC itself, which is now of enhanced importance because of the risks of Asia Pacific and especially China-United States fissures.

I thus believe that it is the duty of ABAC, as a trusted advisor to the APEC Leaders, to recommend that the Leaders begin to position themselves to move in the FTAAP direction, depending on the course of the main variables over the coming months. The Leaders should place the issue on their agenda for discussion at Hanoi. At a minimum, they should plan to commission their own study of the topic, drawing of course on the ABAC work to date. If Doha and other external developments evolve poorly, they should have a more extended conversation on both the pros and cons of the idea and on the initial modalities for moving it forward. Again depending on events, and on initial reactions to the idea within key member economies, the FTAAP proposal could then become the centerpiece of APEC deliberations under Australian chairmanship in 2007.¹⁷

Prior to the initial APEC summits, in Seattle in 1993 and Bogor in 1994, very few observers believed it would be possible or even conceivable for the APEC Leaders to endorse the concept of “free and open trade and investment in the region” by the dates certain of 2010 and 2020. Many member economies were particularly skeptical of the willingness and ability of the United States to take part in such an initiative, let alone lead it. The Leaders did adopt the Bogor Goals, however, and the United States played a central role in that process. They did so for many of the same reasons that seem so compellingly in favor of resuscitating the Bogor strategy via an FTAAP today.

ABAC of course cannot make these decisions. It has already played a vital role, however, in raising the topic and bringing it forcefully to the attention of APEC Leaders and the Asia Pacific community more broadly.¹⁸ It should now take the next logical steps by developing more fully the case for the idea and how it might work in practice, by urging the Leaders even more strongly to pursue it, and by starting to mobilize domestic support in the member economies. I hope this paper will contribute at least modestly to those critical goals.

Endnotes

¹ Preliminary Assessment of the Proposal for a Free Trade Area of the Asia Pacific (FTAAP), an Issues Paper for the APEC Business Advisory Council (ABAC) prepared by Robert Scollay from the PECC Trade Forum, especially pp. 25-30 and Table 3.

² A similar case can be made for the Asian Monetary Facility that seems to be emerging as a result of the expansion and multilateralization of the Network of Bilateral Swap Arrangements under the Chiang Mai Initiative.

³ Another possible tendency is for the China-Japan rivalry to create a dividing line within Asia: between a “coastline perimeter” consisting of Japan, Taiwan, Australia and perhaps a few others vis-à-vis a China-dominated “mainland bloc.” This too would be extremely dangerous, perhaps even more so in terms of possible intra-Asian conflict that (as in the past) could draw in the United States, and an FTAAP would also be of great help in countering this risk.

⁴ The US network of FTAs is generally of broader coverage and deeper liberalization than those in East Asia so its preferential impact is presumably greater.

⁵ There is an understandable and laudable desire in many quarters to strengthen both the APEC Secretariat and the level of attention paid to APEC within member economies. The only way to achieve these goals, however, is to restore the substantive importance of APEC and thus raise its priority for members. Serious pursuit of an FTAAP would substantially heighten the salience of APEC to all participating economies and thus inevitably expand their dedication of resources to the institution.

⁶ Protectionist pressure will rise particularly sharply in Europe if the inevitable large decline in the value of the dollar, which is an essential component of any significant correction of the large and growing international imbalances, takes place mainly against the euro because China and the other Asian surplus countries continue to block significant appreciation of their own currencies.

⁷ There have been exhausted cries of “never another round” at the end of every previous round negotiated in the GATT/WTO. All three of the previous major rounds, however, have been widely viewed as extremely successful in advancing global liberalization and improving the rules-based trading system. Hence, whatever the attitudes at the time of their completion, they provided a solid foundation for the next succeeding round. A minimal outcome from Doha, however, let alone its explicit or implicit failure, would radically alter that history and raise serious doubts over the future of the multilateral trading system.

⁸ It could also induce others, especially the European Union, to accelerate their own FTA strategies instead but the magnitude of an FTAAP would be much more likely to bring those countries back to the multilateral WTO table.

⁹ It should be noted that a number of smaller APEC member economies have already, especially at Santiago in 2004, endorsed the FTAAP at least conditionally “if the large countries were to do so as well.” This group includes at least Australia, Chile, New Zealand, Singapore and Chinese Taipei.

¹⁰ Some observers, particularly within the United States, raise doubts about the capacity of the US Government, specifically USTR, to support a major new negotiating effort like the FTAAP. In a world in which the Doha Round was either concluded or suspended, however, the resources now being devoted to that enterprise could readily be shifted to an FTAAP, which would be addressing the same set of issues. A similar shift of US personnel occurred in 1991-92 when the Uruguay Round went into suspended animation and the freed-up resources were largely used to negotiate NAFTA.

¹¹ This would be even more likely if the EU joined the US in applying new trade restrictions to China, and perhaps East Asia more broadly, which could easily result if China continues to block meaningful appreciation of its currency (and thus the currencies of other East Asians) so that the next major dollar decline also occurs primarily against the euro and pushes it to substantial overvaluation against Asia.

¹² See Center for Strategic and International Studies and Institute for International Economics, *China: The Balance Sheet: What the World Needs to Know Now About the Emerging Superpower* (2006), New York: Public Affairs Press, especially Chapter 4.

¹³ As opposed to its currency policy, which does raise major problems because of the country's massive intervention ("manipulation") to block any substantial rise in the value of the RMB.

¹⁴ A technical but very important question is the differing concept of "FTAs" maintained by the United States and other APEC members such as Australia, Canada, Chile, New Zealand and Singapore, on the one hand, and by China and some other Asians on the other. The former group insists on "high quality" FTAs, though they sometimes falter in practice as when sugar was totally excluded from the US-Australia agreement, whereas the latter define "free trade" more loosely and seem to place overriding emphasis on political considerations. These differences would clearly have to be addressed in seriously considering an FTAAP. So would some of the US deviations from its own high-standard principles, however, such as the "yarn forward" concept that dominates the rules of origin for textile/apparel trade in US FTAs and would represent a formidable hurdle to rolling the existing US agreements into a single FTAAP.

¹⁵ Another major plus for the United States is that an FTAAP initiative would presumably include Chinese Taipei under the standard rules governing its participation in all APEC non-political activities.

¹⁶ One way for the United States to signal its interest in an FTAAP would be for the Administration and/or the Congress to ask the International Trade Commission to conduct a study of the idea. All formal US trade negotiations are preceded by such an "official" analysis.

¹⁷ A decision to seriously pursue the FTAAP could also have important implications for the possible expansion of APEC's membership that will be on the agenda in 2007. Any such effort to deepen APEC cooperation would presumably counsel against broadening the makeup of the group, at least to include large new economies such as India, while that process was underway. It might also be desirable, however, to add India to both APEC and an FTAAP before the latter was actually implemented in order to avoid new discrimination between that country and the current membership.

¹⁸ It is unfortunate that the APEC Leaders did not pursue the original ABAC recommendation for a study of the FTAAP at Santiago in November 2004. The Doha Round might now be much further along as a result.