

Visions of East Asian and Asia-Pacific Regionalism: Competing or Complementary?*

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It is really a great honour to be here in Seoul this morning. With Korea being the host economy this year for the APEC work and for the APEC economic leaders, this is an especially appropriate time to be considering the question of “regionalism” in the Asia-Pacific region.

I highlighted two visions of regionalism in my title: East Asian regionalism and Asia-Pacific regionalism. By the latter, I mean regionalism defined by the APEC countries, that used to be called the Pacific Rim countries. Both of these groups—East Asia and APEC—will hold meetings later this year that will be decisive in determining the future course for each particular vision of regionalism. So this is a particularly appropriate time to think about the trends in both these forms of regionalism, to think about whether they work together or compete against each other.

The APEC Economic Leaders’ Meeting will be in Pusan in November. Then, the East Asian Summit will be held in Kuala Lumpur this December. This East Asian Summit will be a very important event in the development of the East Asian region.

Since I will focus mainly on trade issues in this talk, though I will also refer to financial and political issues, we should remember too that another crucial meeting also being held in this part of the world later in the year will be the WTO Ministerial Meeting, to be held in Hong Kong in December. This could be decisive in determining the potential for a successful outcome to the current round of WTO negotiations. We should not forget that when we are looking at the implications of regionalism in this part of the world.

I will spend a little time tracing the history of the development of both concepts of

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regionalism. I will then use that as a background for a discussion of what is happening today in both strands of regionalism and how this relates to the proliferation of FTAs that we also observe in the region today.

We can define the Asia-Pacific as the entire Pacific Rim, which is what it used to be called. The notion of Asia-Pacific regionalism has a very long history. In the 1960s there were proposals for a Pacific free trade area. This was followed by the formation of PAFTAD and PBEC as academic and business organisations, aimed at promoting the idea of economic integration in the Asia-Pacific region. In 1980 the PECC was created. In 1989 came the formation of APEC, and in 1994 APEC issued its Bogor Declaration. This set the objective for APEC of free trade and investment in the Asia-Pacific region by 2010 for developed economies and by 2020 for developing economies.

Last year, the APEC Business Advisory Council (ABAC) put forward another bold proposal that has so far not been accepted by the APEC economies, but it is now on the table. This was a proposal to convert APEC into a free trade area, a “Free Trade Area of the Asia-Pacific” (FTAAP).

One of the most important things to recognize about this whole process of Asia-Pacific regionalism is the extent to which it is market-driven. All of these developments that I have mentioned were designed to promote further integration among a group of economies that are already very closely linked by trade and investment. Every member of APEC, except for Russia, conducts at least two thirds of its trade, and in most cases more than 70% of its trade, with other APEC members. It is a region already very closely integrated through trade and investment. The official processes have been designed to provide a stronger institutional framework for this integration that is already taking place through market processes.

If we look at East Asian regionalism, it has a longer history, at least in its modern sense, in Southeast Asia than in the rest of East Asia. ASEAN was formed in the 1960s and the early 1990s saw the creation of the ASEAN free trade area (AFTA). Initially, Northeast Asia was not involved in efforts to create an economic integration initiative within East Asia. By Northeast Asia I mean Japan, Korea, China, Hong Kong and Taiwan. In the early years, Japan and Korea in particular were not interested in creating a preferential trading area in East Asia. They were very firmly focused on the WTO and the multilateral process. But in 1994 we saw a proposal for an East Asian Economic

Grouping put forward as an alternative to APEC. It didn't succeed at that time primarily because Japan and Korea did not support it.

East Asian regionalism reemerged in a much stronger form as a reaction to the crisis in 1997 and 1998. That created a very strong sense across East Asia of the need for greater economic independence and of the need for an East Asian economic identity. There was a strong sense of the need for an East Asian institutional capability to deal with events like the crisis from within the resources of East Asia itself, rather than being subservient—as East Asians saw themselves during the crisis—to the IMF and, through the IMF, to the US Department of the Treasury.

East Asian regionalism after the East Asian Crisis initially focused naturally enough on monetary issues. But very quickly consideration turned to the possibility of creating an East Asian trade bloc as part of the formation of an East Asian economic identity.

Once again, we can highlight the market-based rationale for integration, which has become increasingly prominent in East Asia as well. There has been a very rapid growth of trade within East Asia, particularly from the late 1980s, through the 1990s and into this century. The creation of production networks within the East Asian region has been a very important feature of that increased trade and investment linkage within East Asia and the growing interdependence of East Asian economies. The rise of China, of course, has been a very important factor in all of that.

So we have two processes that have a considerable history behind them. In both cases there is also a very strong impetus being given by the development of trade and investment through market-led processes. Governments are coming in behind those market-led processes to provide some form of institutional framework for integration.

While there has been more and more emphasis given to East Asian regionalism, there continues to be a very strong rationale for both concepts of regionalism. If you look at the breakdown of trade within the APEC region, as represented by at the destination of exports within APEC, they break down in a very neat three way pattern. Trade within the western Pacific—meaning trade within East Asia, plus Australia and New Zealand—accounts for 40% of APEC economy exports to other APEC economies. Trade within North America—of course, NAFTA—accounts for another 30% of exports by APEC economies to other APEC economies. Finally, trans-Pacific trade—trade

going across the Pacific Ocean—accounts for a further 30% of such exports. There is still a very strong linkage through trade across the Pacific, as well as the very rapidly growing linkage within the western side of the Pacific, and of course the very strong regional bloc that has already been created by NAFTA in North America.

This trans-Pacific interdependence, the essential rationale to think about APEC as an appropriate vehicle for economic integration, remains very strong. For the US, for example, trade with East Asia is still a vital interest. US trade with East Asia accounts for approximately the same share of US trade as trade with its NAFTA partners. The US has roughly 30% of its trade with East Asia and another 30% of its trade with its NAFTA partners. Those figures are contrasted with only 5% of US trade with South America. Despite all the emphasis given to integration within the Americas, US trade with East Asia is far more important to the US, at least statistically, than trade with South America.

For East Asian countries, while there has been this very rapid growth of production networks that has been a major driving force behind the increase in trade within East Asia, it is still true that a large part of the activity of these production networks is, in the end, geared toward the US market.

There is also the growing financial interdependence between East Asia and North America, because of the growing US deficits and the importance of the financing of those deficits by East Asian central banks, and thus in turn the role of the US in providing an outlet for the surpluses that are being accumulated in East Asia. This financial interdependence is another factor explaining why the two sides of the Pacific continue to be joined together by very strong economic interests.

As a background to what I'm about to say, it is also useful to point out the obvious fact that, within APEC, the economically dominant sub-regions are, of course, North America and Northeast Asia. We often refer to the fact that APEC accounts for 60% of world GNP, but in reality that is almost all accounted for by North America and Northeast Asia. The six major economies of North America and Northeast Asia—Japan, China, Canada, Korea, Mexico and the US—alone account for 55% of world GNP and 90% of APEC's GNP. So the rest of us, the other 15 members of APEC, account for only 10% of APEC GNP. It's really North American and Northeast Asia that are the economic heart of the Asia-Pacific region, and equally it's of course Northeast Asia that

is the economic heart of East Asia. East Asia accounts for about 21% of world GNP, as against about 2% in Southeast Asia. So Northeast Asia accounts for approximately 90% of the GNP of East Asia as a whole.

The six major economies of North America and Northeast Asian countries also dominate regional trade. By far the largest trade flows within the APEC region are the trade flows within Northeast Asia, within North America and between North America and Northeast Asia. Those are far and away the most important trade flows in the APEC region.

However, in the case of both processes of regionalism what we see today is that there are very considerable obstacles to moving forward toward what we might think could be a logical conclusion. If we look first at APEC, APEC made a very brave effort to reconcile regionalism with multilateralism by adopting a concept of “open regionalism”. This meant that regional trade liberalisation in APEC was to take place on a non-discriminatory basis. That’s a very unique feature of the APEC process. There is no other regional integration process anywhere in the world that has attempted to liberalise regionally on a non-discriminatory basis.

It was a very innovative and very brave effort on the part of the APEC economies. But it’s one that we have to say has not, in the end, proved successful. It hasn’t proved successful because it has become clear that, while APEC has insisted on non-discrimination, a number of economies in APEC, particularly the key economies in APEC, will only liberalise if there is reciprocity not only from other APEC members but also from non-APEC members. If we insist on reciprocity, the only viable avenues for liberalisation are the WTO, in the case of non-discriminatory liberalisation, or preferential trading arrangements, in the case of regional trade liberalisation. So in the face of the insistence on reciprocity by, in particular, the most important APEC economies, APEC’s vision of “open regionalism” has proved very difficult to realize in practice. It would have to be said that the amount of liberalisation actually achieved within the APEC process itself, by what are called collective actions or individual actions within APEC, has been rather limited. Increasingly, APEC members have seen the vehicles for achieving APEC’s goal of free trade and investment in the Asia-Pacific region as being widened to include, of course, the WTO and also to include the mushrooming preferential trading agreements that have been spreading throughout the region.

If we look at the combined effects of all those vehicles for APEC liberalisation—collective action within APEC, individual action, the WTO, regional trade agreements and free trade agreements—it has become very clear that on current trends a number of the developed economies in APEC will not meet their targets by 2010. This is being highlighted in Korea this year as APEC takes stock of progress toward those targets. It is becoming clear to everybody that unless there are some dramatic changes, we will not see the larger developed economies meet those targets by 2010.

The APEC Business Advisory Council has seen this very clearly. That's why they proposed the Free Trade Area of the Asia-Pacific. They see that as, perhaps, a "circuit breaker": a bold new initiative that could reinvigorate trade liberalisation in the APEC region and produce some realistic prospect of meeting the targets for developed economies by 2010, or if not, at least a credible movement toward those targets by 2010.

If we look at the progress of trade liberalisation in East Asia, the ASEAN+3 group—that is, ASEAN plus Japan, China and Korea—has been a focus of efforts to cooperate on trade as well as monetary matters. There was in the late 1990s a proposal for an ASEAN+3 free trade area, following the ideas of the East Asian Vision Group.

That has been difficult to realize. One of the basic reasons for that difficulty has been the problematic relationship between the two largest economies in East Asia, China and Japan.

What we have seen is the emergence of the "ASEAN+1" initiatives as alternatives to ASEAN+3. China's announcement of an ASEAN-China initiative was followed almost immediately by a response from Japan with an ASEAN-Japan initiative. We've later seen the US-ASEAN "Enterprise for ASEAN" initiative. There has also been more recently an initiative to link ASEAN with the economies of Australia and New Zealand. Finally, there is now also an India-ASEAN initiative.

These "ASEAN+1" initiatives reflect, first, the rivalry between China and Japan, which is one of the reasons for the emergence of the initial ASEAN-China and ASEAN-Japan initiatives as alternatives to ASEAN+3. Second, these "ASEAN+1" initiatives also reflect the ambitions ASEAN has to exert economic leadership in the region, despite the fact that ASEAN accounts for only about 10% of the region's GNP.

There is a consistent theme in ASEAN's strategy, both toward APEC and toward East Asian regionalism. It would like to remain a central player in these developments. The inability of China and Japan to reach an accommodation has created a vacuum into which ASEAN stepped with these proposals for "ASEAN+1" initiatives, which they saw as putting—or, if you like, keeping—ASEAN in the centre of integration developments in the region.

The problem with that, of course, is that ASEAN itself has difficulty in maintaining a cohesive position of its own. The relationships within ASEAN tend to be quite loose. It's been difficult for ASEAN to maintain a common position toward East Asian integration. That has made it difficult for them to actually realize their ambition to provide leadership in the integration process in the region.

The Hong Kong WTO ministerial meeting coming up in December reminds us that the WTO is of course the third liberalisation process that is very important in the region. The Uruguay Round created the WTO. It was a major success as a liberalizing round. But it also brought with it an extraordinary increase in complexity in the multilateral system. The Uruguay Round agreements cover complex issues that were never covered before like services, agriculture and intellectual property. It brought all of the various agreements together in a single undertaking, which required every WTO member to sign up to every element of the WTO agreements, with only minor exceptions. The strengthened dispute settlement process under the WTO meant that those commitments were much more binding on members than they ever had been before.

All of those factors were combined with the rapid increase in membership and the corresponding increase in the influence of developing countries in the WTO. There was not just one group of developing countries, but different groups of developing countries, since increasingly, developing countries have not been a homogenous group, but have had quite diverse interests and sometimes conflicting interests among themselves.

It has been very difficult under those circumstances, with that increased complexity, to make progress. This has been apparent from the enormous difficulty that has been experienced in reaching a consensus on the new round of negotiations. The Seattle meeting that was supposed to launch the negotiations was a fiasco, as we know. The round was launched at Doha only with great difficulty, by the "skin of the teeth" of the

WTO members. It almost failed. The first ministerial meeting that was supposed to solidify and consolidate the negotiating agenda at Cancun also was a fiasco.

What we see now is a progressive narrowing of the agenda, with important items progressively being dropped from the agenda, such as investment, competition policy and government procurement. There has been a lowering of ambitions to what can be realistically achieved within this very complex process of negotiations. The WTO is thus in trouble as a liberalizing agency, even as its importance as a rule-making agency and the administrator of the rules of international trade is perhaps becoming more and more important.

Against that background of difficulties in the APEC process, difficulties in the East Asian trade liberalisation process and difficulties in the WTO, what we have seen in this region is a rapid proliferation of bilateral FTAs. It's realistic to see this development—this rapid proliferation of free trade agreements—as a reaction to the difficulties we have seen in all three of the liberalisation processes that I have mentioned.

In APEC, there was an initiative called the Early Voluntary Sector Liberalisation (EVSL) initiative. It sought to liberalise trade in 15 key sectors. That failed at the end of the APEC year in 1998. If you look at the chronology of the new bilateral FTAs, the renewed interest of economies in the APEC region in such agreements began following the failure of EVSL in 1998. Some people date the proliferation of FTAs to the failure of the Seattle meeting, but I think that it's clear that, chronologically, it began before that with the failure of EVSL in APEC.

This failure brought home to APEC members APEC's limitations as a vehicle for trade liberalisation. The failure of the WTO ministerial in Seattle certainly gave added impetus to the pressure for negotiation of bilateral FTAs. Subsequently, even the ASEAN+3 initiative, as well as the ASEAN+1 initiatives such as those with China, Japan and the US, have tended to break down into bilateral initiatives. We've seen China negotiate its own separate agreement with Thailand. Japan has already concluded and implemented an agreement with Singapore, it is currently negotiating bilateral agreements with Thailand and Malaysia and I believe that it has just completed a bilateral agreement with the Philippines. The US is showing a clear preference for negotiating bilaterally with individual ASEAN economies rather than with ASEAN itself. The key factor behind this breakdown toward bilateral initiatives in the "ASEAN+1"

processes has been the inability of ASEAN to establish and maintain a common position.

The difficulties in all three of these liberalisation processes have all contributed to the increasing interest and pressure within the region for the negotiation of bilateral FTAs, rather than wider regional agreements.

If we look at the trends over time, it is clear that proliferation of bilateral FTAs is actually accelerating. There have been - and the count changes almost by the month - 14 new FTAs concluded among APEC members since 2000. There are many, many more on the way. At the APEC meetings in Cheju this week, one expert counted possibly 50 bilateral agreements that could be in place between APEC economies in the near future. We can certainly expect more new agreements announced either at the trade ministers' meeting later this week or at the leaders' meeting toward the end of the year.

If you look at the agreements that have been concluded, I don't think you could really say they reflect any one concept of regionalism. They are not only about East Asian regionalism, as a number of these agreements are trans-Pacific, like the Singapore-US, Korea-Chile, Australia-US, and Japan-Mexico agreements. There is a distinct trans-Pacific dimension to these bilaterals.

Of course there is also an East Asian dimension, with the Japan-Singapore, China-Thailand, Hong Kong-China and Korea-Singapore agreements. Bilateral FTAs also provide linkages between Southeast Asia and Australasia, with agreements between Australia, New Zealand, Singapore and Thailand. On the other side of the Pacific, there has been the US-Chile agreement. It cannot be claimed that these bilateral FTAs reflect any single one of the different concepts of regionalism that I mentioned. Each concept has figured within the pattern of bilateral agreements that has been developing.

Two other very important features of these bilateral FTAs that have not been given so much attention are, first, that we don't see any FTAs covering the key trade flows between Northeast Asia and North America, or any FTAs within Northeast Asia. If you look at the three major economies of Northeast Asia and the three major economies of North America, the only FTA between those economies so far is the Japan-Mexico agreement, which covers one of the smallest of the trade flows between those economies. Within Northeast Asia, we don't have any agreement between Japan and China or between Korea and China. Though there is a proposal for a Korea-Japan FTA,

that proposal has not yet been realized. According to what we heard from our Korean friends this week at the APEC meetings, at the moment the negotiations seem to be deadlocked.

We thus don't see FTAs covering the largest and most important regional trade flows. Related to that, we also see that the FTAs that are being negotiated, perhaps quite understandably, avoid relationships where trade is potentially important in sectors that are sensitive to one or more of the member economies. So we don't see Japan negotiating FTAs with Australia or New Zealand. We haven't seen Korea negotiate FTAs with Australia or New Zealand for that matter, either. We don't see the US negotiating agreements with China, and so on.

The bilateral FTAs in effect represent a strategy by the smaller economies in the region to continue pursuing liberalisation under circumstances where the region wide processes—APEC and East Asian regionalism—are not making very much progress. The smaller economies are continuing to pursue liberalisation in ways that circumvent the sensitivities of the larger economies of the region that are perhaps among the major obstacles to region wide integration.

We see many FTAs between smaller economies in the region, economies like Singapore, Chile, Australia, New Zealand and Thailand. They are increasingly linking themselves together through FTAs. We also see FTAs between the larger economies and those smaller economies that are acceptable as partners to the larger economies, likely because there are no sensitive sectors to worry about. I don't think it's any accident that Singapore has been at the forefront of this trend. Singapore, perhaps, of all the smaller economies in the APEC region, does not threaten the sensitive sectors in any of the major economies. Even so, in the Japan-Singapore agreement, it was notable that Japan insisted on excluding even minor agricultural products like cut flowers and goldfish. So it was a "goldfish-free" FTA between Japan and Singapore.

You see agreements between the larger and smaller economies where there are no sensitive sectors to block agreements, or where the sensitive sectors can be excluded from the agreement. So we're seeing, for example, that the Japan-Thailand negotiations are excluding rice. That's already been agreed. You also see agreements where there is an absence of political conflicts or difficulties. So we've seen the US conclude an agreement with Australia but not with New Zealand. We see that there are no proposals

for FTAs involving Taiwan.

Going together with the importance of the smaller economies and the importance of links between the smaller and larger economies in this pattern of FTAs, we can also see the importance of the domino effect. It's a very important factor. Once a smaller economy succeeds in achieving an FTA with one of its larger trading partners, the pressure immediately intensifies on other smaller economies that have interests in the same larger economy market to secure their own FTA to protect their own position in that larger economy's market. So if Thailand has an FTA with Japan, it will become important for Malaysia to have an FTA with Japan. When Australia had an FTA with the US, New Zealand tried very hard to get an FTA with the US to protect its position in the US market, though it didn't succeed. That domino effect is the reason why we can expect that the trend toward bilateral agreements is not going to stop in the foreseeable future. It's likely to accelerate. It is accelerating.

If we step back and assess this proliferation of bilateral FTAs, we can see that, of course, there are clear attractions in bilateral FTAs. As liberalizing instruments, as long as they conform to the relevant WTO rules—such as Article XXIV of the GATT, Article V of the GATS, and so on— they can claim to be WTO consistent. They are not undermining the WTO system, at least in a legal sense, although they may be undermining it in a practical sense.

If they are WTO consistent, they do lead to the eventual elimination of barriers on substantially all trade between the partners. That's the WTO requirement. You may find that some sensitive sectors will be excluded, but for the majority of products the WTO rules ensure that eventually there will be free trade between the partners for most products.

Bilateral FTAs are also potential vehicles for a wide range of what we can call "WTO-Plus" provisions. These are agreements on issues that are not yet covered by the WTO, such as investment, competition policy or government procurement, as well as a wide range of trade facilitation measures on standards, customs procedures and so on that may go way beyond what can be accomplished in the WTO. So from an economist's point of view, there are those positive factors.

For individual economies, there are other positive factors that may not be positive from

an economic point of view. There is the ability to exclude sensitive sectors. Japan, for example, insists on excluding rice. The US excluded sugar from its agreement with Australia. Of course, bilaterals also mean that you can choose your partners. You can avoid FTAs with countries that have exports concentrated in sectors that cause you problems. You can avoid FTAs with partners with whom you have political problems. Thirdly, it's possible to customize these agreements to deal with the specifics of the bilateral relationship with your partner. Plus, you may be able to achieve deeper or more far-reaching provisions on issues that are of special interest to you, much more than if you had to reach an agreement with a large number of countries. So we see the US achieving in its FTAs provisions on intellectual property, labour and the environment that would be very difficult to achieve in a region wide agreement, and even more difficult to achieve in the WTO. Those are clearly reasons for the attractiveness of bilateral FTAs to many countries.

But on the other hand, there are very serious risks associated with this trend. As we all know, these agreements are discriminatory. Each FTA discriminates against the countries that are not members of that FTA. So as a consequence of the proliferation of these PTAs, we're seeing the development of very complex patterns in the region of discrimination and exclusion. Included in those patterns are what we economists call "hub and spoke" configurations, or networks of FTAs forming around the major powers. Major powers like the US or Japan would act as a hub, and then there would be a series of bilateral FTAs spreading out from the hub and acting as the spokes.

That configuration has at least two negative connotations. First, in the "hub and spoke" configuration the balance of advantages and negotiating power very clearly lies with the hub to a much greater extent than, say, in a region-wide agreement or in the WTO. Second, the "hub and spoke" patterns can become the vehicles for rivalries between the hubs, particularly if the hubs have different concepts of the way in which they would like to design trade agreements.

The customization, which I mentioned as an advantage for individual economies, from a regional point of view, leads to FTAs that have significantly inconsistent provisions particularly on rules of origin. This leads to what Jagdish Bhagwati has called the "spaghetti bowl" of preferential trading agreements. This patchwork of discriminatory and over-lapping agreements with inconsistent rules of origin creates the potential for significantly increased costs to business – for businesses in a country like Singapore, for

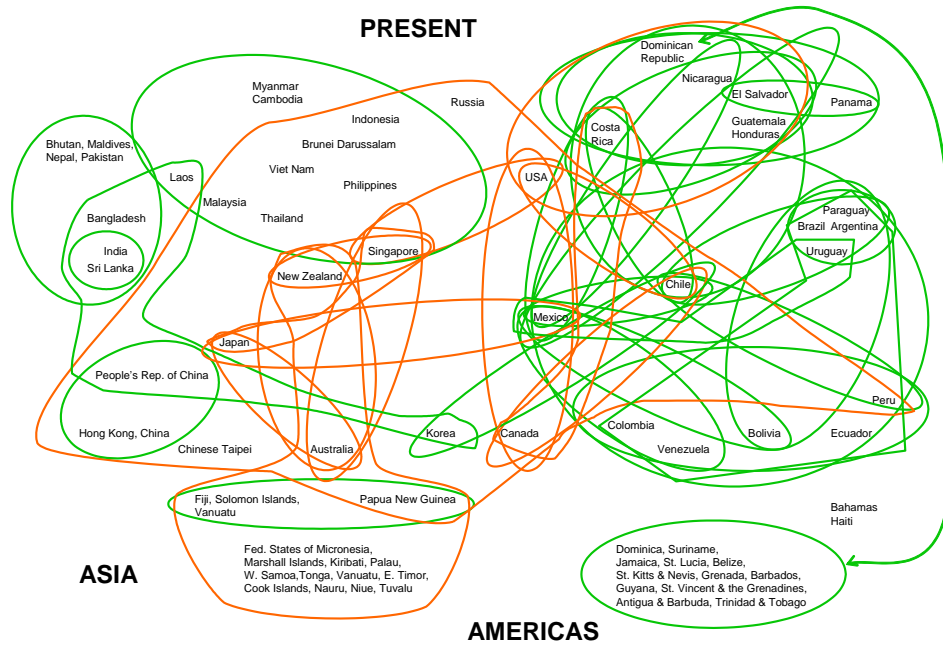
example, that already has FTAs with seven or eight countries. Chile has 16 FTAs. Mexico has 32 FTAs. Businesses have to think about the way in which they can meet the rules of origin for their exports to each of the different markets with which they have FTAs, each of which has different rules of origin applying. Figures #1, #2 and #3 are graphic illustrations of this “spaghetti bowl” effect.

There is also the likelihood that, for at least some economies, the ability to exclude sensitive sectors and to exclude sensitive partners is going to tempt them to give preference to preferential liberalisation and to FTAs over multilateral liberalisation through the WTO. If we’re thinking about the ambition of either APEC or East Asian economies to eventually form themselves into an integrated economic region, a region integrated by trade and investment flows, that’s going to be undermined by the marginalisation of some economies within this FTA proliferation process, either because they had political difficulties with potential partners—Taiwan, for example, or New Zealand with the US, for example—or because they’re too small to be attractive, or because their development status, say, in the case of Vietnam, makes them unattractive to other economies as an FTA partner. So we can see there will be a number of APEC economies and possibly also East Asian economies that may find themselves marginalized as a result of these developments.

Figure #1 is a diagram a friend of mine in the Inter-American Development Bank produced about a year ago. It’s a little out of date, therefore. It represents the state of FTAs in Asia and the Americas at that time. All the agreements that were in place at that time are represented in that diagram. Figure #2 shows the agreements that were under negotiation at the time the diagram was drawn. The final diagram, Figure #3, gives you the “spaghetti bowl” as it would be if all of those agreements under negotiation were actually concluded. You can see very clearly why some people call this the “spaghetti bowl”.

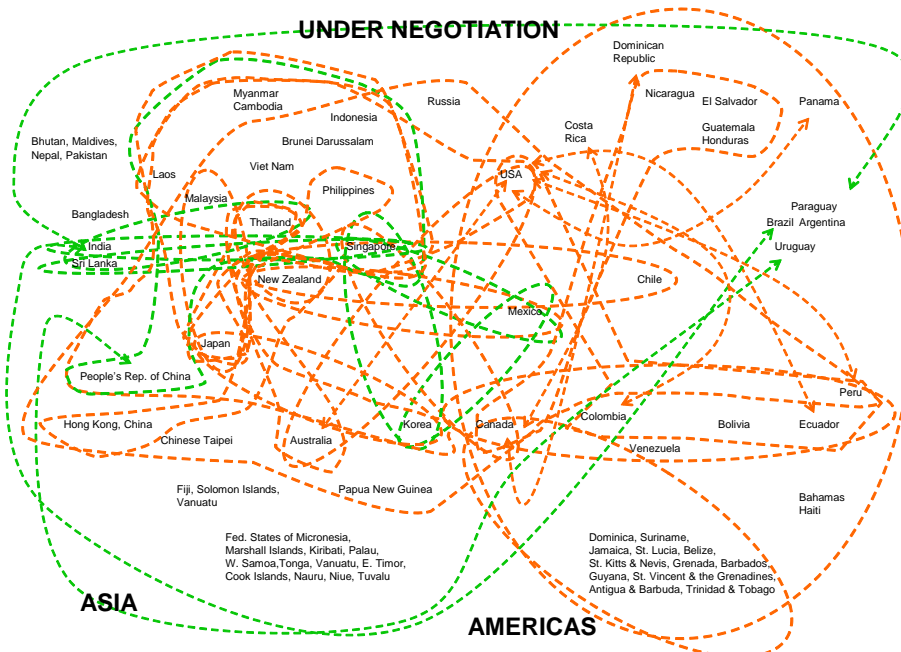
Looking at that “spaghetti bowl”, one of the first reactions would be to ask, “Why don’t the economies get together and form themselves into region-wide agreements, as an alternative to this ‘spaghetti bowl’?” Very clearly, one of the key advantages of region-wide agreements is that they do avoid that “spaghetti bowl” problem. They have the potential to simplify the “spaghetti bowl”.

<Figure #1>



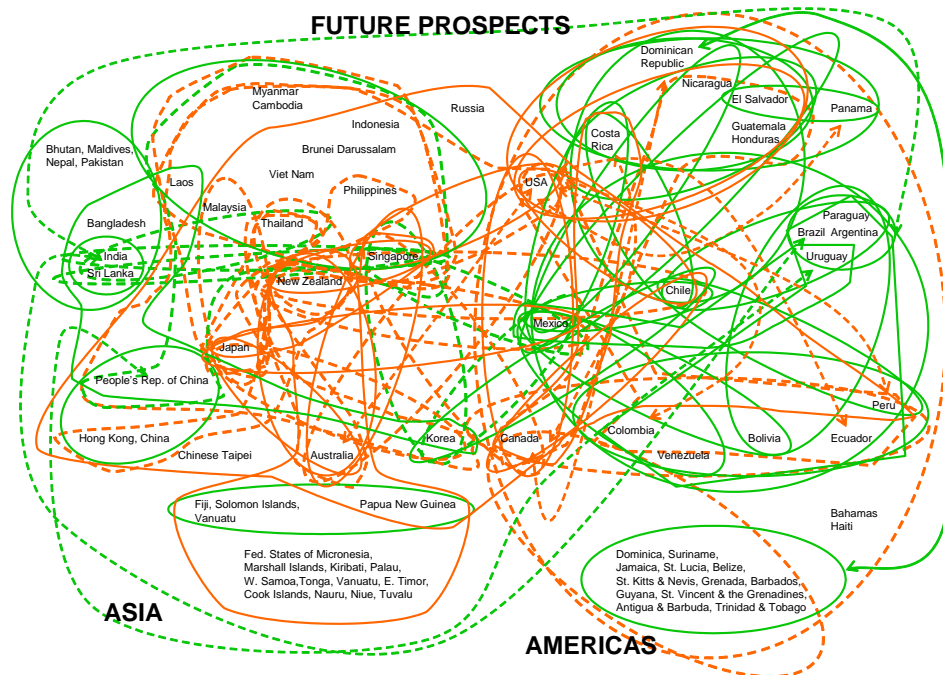
Source: Integration and Regional Programs Department, Inter-American Development Bank

<Figure #2>



Source: Integration and Regional Programs Department, Inter-American Development Bank

<Figure #3>



Source: Integration and Regional Programs Department, Inter-American Development Bank

But they also have clear economic advantages. The economic studies that have been done of the effects on economic welfare from different FTA configurations, have produced results that are pretty clear. They show that as the size and inclusiveness, in terms of the number of members of an agreement within East Asia or the Asia-Pacific, increases, the benefits to the members of that agreement also increase. At the same time, the losses suffered by non-members as a result of those agreements—the countries that would have been excluded—also tend to increase.

Comparing the effects of an East Asian FTA—an ASEAN+3 FTA—with the effects of the bilateral agreements or one of the “ASEAN+1” agreements, say the ASEAN-Japan or ASEAN-China agreement, it’s very clear that the benefits to East Asian economies from the East Asian FTA would be much greater than under either of the “ASEAN+1” agreements or under the bilaterals. At the same time, the costs imposed on the excluded western Pacific economies, such as Taiwan, Australia and New Zealand, will also be much higher under the East Asian FTA than under an “ASEAN+1” or a bilateral.

In the case of the FTAAP, the proposed Free Trade Area of the Asia Pacific that ABEC

has put forward, again, the benefits both to East Asia and to other APEC economies will be greater than just from an East Asian FTA. That's obvious in the case of the APEC economies that will be excluded from an East Asian FTA, but it's also true for the East Asian economies themselves: they stand to gain more from an FTAAP than from an East Asian FTA.

The reasons for that are very obvious and very clear. In a region that already has intense trade and investment links, the more economies of that region are included in the arrangement, the greater the number of sectors in which the agreement will include the most competitive producers and therefore the greatest potential for beneficial trade and specialization. At the same time, if the region is already closely integrated by trade and investment, the cost for those economies of the region that are excluded from an FTA between a sub-group of economies in the region are also going to be higher. The larger the FTA, the more economies of the region are inside the group, the higher the costs are likely to be on those economies of the region that are excluded from the arrangement. So it is logical to see a trend for increasing gains for the members, but increasing costs for the excluded economies, as the size and inclusiveness of the arrangement increases.

The studies that my colleague John Gilbert and I did showed that the potential economic gains from an APEC FTA—a Free Trade Area of the Asia Pacific—would be greater than the gains that APEC economies could expect if they achieved free trade and investment on the basis of non-discriminatory liberalisation, APEC's original concept of open regionalism.

But, of course, the FTAAP also creates larger economic costs for the rest of the world. In fact, the rest of the world, including the European Union, is a major loser from the FTAAP, whereas under APEC's non-discriminatory liberalisation, the rest of the world actually benefits as a kind of free rider from APEC liberalisation. That leads C. Fred Bergsten of the Institute for International Economics, among others, to argue that one of the advantages of an FTAAP is that because of the costs it would impose on the rest of the world and particularly the European Union, the rest of the world would be driven to come to the WTO negotiating table with a much more constructive approach. It would be a major factor in galvanizing a more ambitious and more complete solution or outcome to the Doha Round of the WTO.

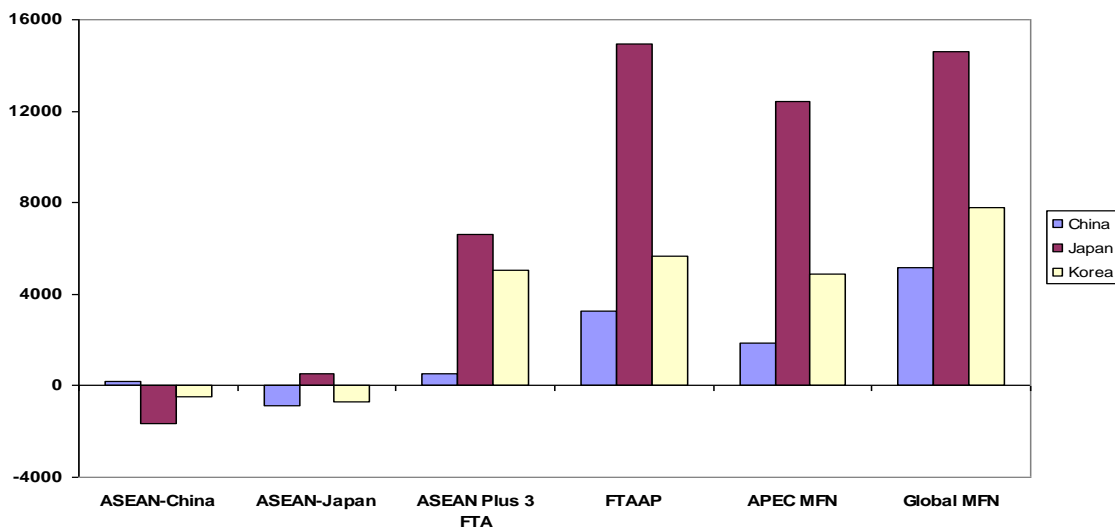
Of course, if we can achieve liberalisation through the WTO on a multilateral basis, that

makes everybody better off. That's very clear. All economies, not just APEC economies, but everyone in the world, is better off if we can liberalise multilaterally than if we do so even through something like the FTAAP.

Figure #4 shows the economic welfare effects of various configurations. Moving from left to right, there is ASEAN-China, ASEAN-Japan, ASEAN+3, the FTAAP, APEC non-discriminatory liberalisation (APEC MFN), and finally global liberalisation. Each cluster of columns represents the effects for China, Japan and Korea. The blue columns represent China, the red ones Japan and the yellow ones Korea. It is only when you move from the ASEAN+1 initiatives to ASEAN+3 or larger groupings that the benefits for Northeast Asia really begin to appear.

<Figure #4>

Welfare Effects of Alternative Trade Liberalisation Scenarios: Three Major Northeast Asian Economies
(Equivalent Variation: US\$million)

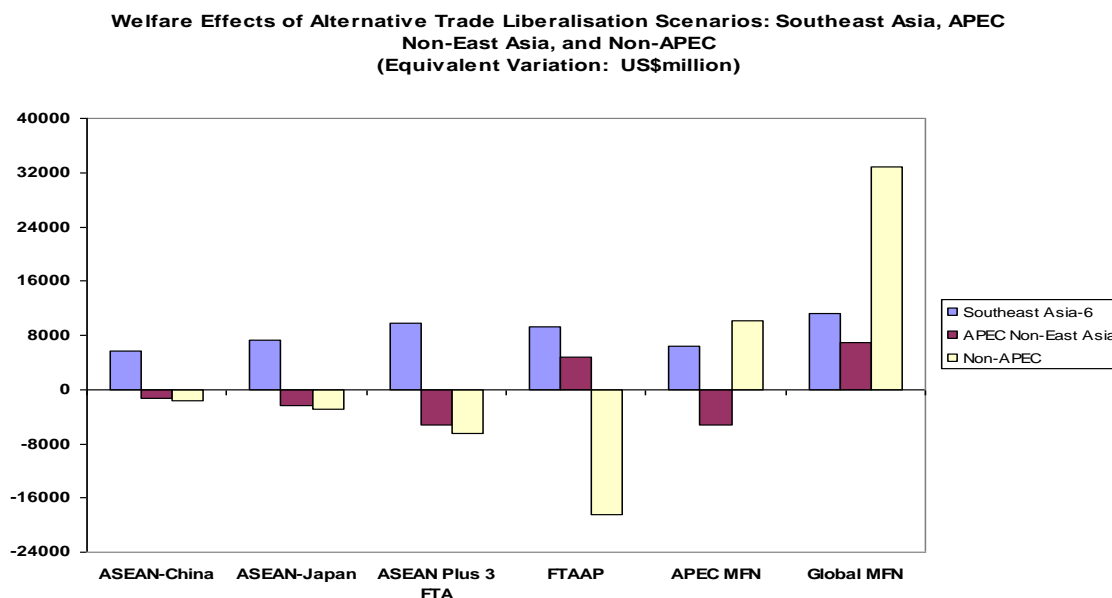


In other words, for Northeast Asia the real benefits come from agreements that include integration within Northeast Asia. If integration within Northeast Asia is not part of the arrangement, as in the ASEAN+1 arrangements, the benefits for Northeast Asia are much less.

Figure #5 shows the situation for Southeast Asia. There are increasing gains for Southeast Asia, shown by those medium gray columns, as the scale of integration increases. You see that for both APEC economies outside East Asia, represented by the

dark gray columns, and for the rest of the world outside APEC represented by the light gray columns, their losses increase as the scale of integration increases within East Asia.

<Figure #5>



But when we move from the ASEAN+3 to the FTAAP, the losses for other APEC economies turn into gains, but the losses for other economies in the world, the rest of the world, dramatically increase. That is turned around if we move to global liberalisation under the WTO, where the rather large losses suffered by the rest of the world turn into major economic gains. You can see there also that the rest of the world would be a significant gainer as a free rider if APEC pursued liberalisation on a non-discriminatory basis.

The conclusion is pretty clear. Looking at the two processes that I highlighted at the beginning, an East Asian trade bloc is a very logical objective for East Asian regionalism. If East Asia is going to focus on integration within East Asia, from a trade or economic point of view, the arrangement that makes the most sense is an East Asian FTA. That makes much more sense than any other possible arrangement in East Asia. Of course there is also a further question of whether an “East Asian” FTA should include Australia and New Zealand; the same kind of analysis shows that this would benefit the East Asian economies themselves as well as Australia and New Zealand. But perhaps that is a question for another time.

There still obviously remains an issue that is very much on the minds of East Asian policy makers, the question of what to do about the US if an East Asian FTA goes ahead. The very strong interdependence with the US in trade, in finance and in politics and security, remains an issue that does have to be addressed. We can see that in the debate that is going on about whether the US should be invited to the East Asian summit. I believe that debate has still yet to be resolved. An East Asian trade bloc would make economic sense for East Asia, but it does leave open the question of what to do about the US.

APEC-wide integration, of course, solves that problem with the US (as well as Australia and New Zealand) because it brings the US into the arrangement. From an economic perspective it's also a logical objective for the region as a whole, and potentially produces an even better outcome, even for East Asian economies, than an East Asia trade bloc. But we have to acknowledge that for the reasons I mentioned earlier, the APEC process as it stands today is not likely to lead to a complete integration across the APEC region. On the other hand the Free Trade Area of the Asia Pacific that ABAC proposed does provide a basis for a more complete integration and free trade and investment across the region.

It's clear that APEC leaders and ministers are not at this moment disposed to take up the ABAC proposal for a Free Trade Area of the Asia Pacific, but it was interesting that this week in Cheju, the APEC officials are already talking about ways to try to achieve convergence among the bilateral FTAs within the region. They are trying to make at least some tentative steps toward rationalizing the "spaghetti bowl" by looking for convergence wherever possible. They are clearly aware of the problem, even if what might appear to be the ultimate logical solution is seen as being perhaps one, or maybe several, steps too far at this stage.

Looking at the possible outcomes that one could envisage for the future, one possible outcome would be a situation where an East Asian trade bloc is established, with APEC remaining as a means of maintaining engagement with the Americas, and I guess also with Australia and New Zealand, if they're not included in an East Asian trade bloc, and of course with the WTO as the overarching process for global liberalisation. The other alternative of course would be an APEC-wide FTA, the FTAAP, again with the WTO as the overarching global process for liberalisation.

It does have to be emphasised that whatever process of regional integration we envision, the WTO and liberalisation through the WTO is going to be critical in mitigating the adverse effects, whether they are adverse effects on economies excluded from an East Asian FTA or adverse effects on economies excluded from an APEC FTA.

What are the obstacles to either of those scenarios? Essentially, I would suggest that they are all obstacles of political will and strategic objectives in the larger APEC economies. There are a number of common themes we can identify around those obstacles. They may play out differently in East Asia as against in APEC as whole, but they are common themes.

First, there is US relations with East Asia, in particular US relations with China, followed by US relations with Japan and then Korea. The politics of those relationships are a major impediment to APEC-wide integration at the moment, particularly the US-China relationship. The politics of those relationships are also a significant issue that East Asia still has to confront if it wants to pursue its own particular brand of regionalism within East Asia itself. There are, of course, many dimensions to the relations between the US and East Asia. They involve trade; sensitivity to certain sectors such as agriculture in Japan, agriculture in Korea, textile and clothing imports from China in the US; the strategic ambitions of the different countries in the region, especially the US, Japan and China: the role that East Asia sees for the US in the security of the region and the different approaches that each major East Asian power have to the role of the US. All of those are dimensions to what I call the issue of US-East Asian relations, which interacts with the possibilities for trade integration, either across the APEC region or in East Asia.

China-Japan relations are obviously a very important issue both for APEC as a whole and also for East Asia. It's not possible to envision an East Asian trade bloc unless that integration includes China and Japan as members of the agreement. Also, it's not really possible to envision APEC-wide integration unless that integration also includes China and Japan. I don't need to tell you how difficult that particular relationship looks at the moment.

The sensitive sectors are a factor, of course, in US-East Asian relations. They are also a factor which can spread beyond that. The sensitivity of sectors like agriculture is

particularly acute in Japan and I guess also in Korea. There are other sensitive sectors in other economies that also create obstacles to East Asian or APEC-wide integration.

Mainly, this is an issue for the bigger economies. I would suggest that if the larger economies, either in East Asia or APEC as a whole, were prepared to overcome the sensitive sector issue and move ahead with region-wide integration, there would be very few smaller economies, if any, that would want to stay out of that process. It's really a question of whether the major economies can overcome the issues of their sensitive sectors.

Then, of course, there is Taiwan. This is an issue that is not often talked about in the context of economic integration, even though it is in the back of everybody's mind. It is a factor that not only impedes economic relationships in East Asia and the Asia Pacific, but also has important political and strategic ramifications.

So we have to say that this is not simply an economic problem. Integration is not something that economists by themselves are going to have any hope of resolving because of the very complex way in which geopolitics, security, regional politics and so on interact with the economics and the economic sensitivities particularly in the major economies of the region.

It is possible to look ahead and think about what could be the "circuit breakers" in this situation. What could actually cut through some of these difficulties and move the process forward? Among the possible "circuit breakers", any breakthrough in relations between one of the major Northeast Asian powers and the US is likely to have a domino effect. It's also true that the eventual outcome of that could be quite unpredictable.

For example, I believe there is talk at present about a free trade agreement between Korea and the US. There may be a decision sometime this year to move ahead with negotiations. That would certainly have a domino effect within the region. Japan could not afford to remain idle, to not react to that. You would expect that announcement of US-Korea FTA negotiations would be followed by an immediate response from Japan, and possibly consideration by Japan to form its own FTA with the US or to react some other way to protect its economic interests. That would, in turn, affect relations with China, both for the US and for Japan and Korea.

How would that scenario play out? That's unpredictable. It's not really clear how China-US, China-Japan or China-Korea relationships would change under the circumstances that I just outlined. With enlightened leadership, you could envisage that it would create the sense that a more complete integration involving all those economies would perhaps be the outcome that makes the most sense. But you could also envisage that Japan and Korea coming closer to the US might actually lead to a division between the US, Japan and Korea on the one hand, and China on the other. It could lead both China and the US to start pursuing their objectives in the region in ways that tend to heighten rather than to diminish both economic and political conflict.

There are major uncertainties, mostly revolving around the politics of the relationships, as to how even some of the possible "circuit breakers" could play out toward an eventual outcome. One conclusion is pretty clear. The long-term outcome both for East Asia and for the Asia-Pacific will depend fundamentally on the approach by the US and Japan to relations with China. That's not a particularly brilliant observation. It's extremely obvious. The long-term outcome will also depend on China's strategy.

Under these circumstances, with the political uncertainties and the different ways in which the politics of these relationships could play out, it's also pretty obvious that leadership will be a key factor. We really depend on visionary leadership in these major economies to lead both regions—East Asia and the Asia-Pacific—in constructive directions. Again of course, I don't need to remind you that visionary leadership seems to be something that is in rather short supply right now, and that is a very worrying consideration.

Finally, what about the rest of us? What can the rest of us do? If the outcome in the end depends on the three major players, and we don't have any direct influence on the outcome, what can we actually do? Again, I don't have any magic solutions. It's really a matter of doing the obvious. Maintain the momentum in existing processes such as APEC. It's quite encouraging that at the recent APEC meetings we've seen a clear will on the part of the officials, at least, to maintain momentum in APEC. We must also maintain momentum in East Asia. Constructive use of the FTA phenomenon can also make a contribution. The APEC officials this week have also shown their willingness to promote at least the convergence of bilateral FTAs, even though they're not quite prepared to consider an APEC-wide FTA. This is a very sensible strategy. We're helped in this regard by the fact that APEC itself adopted a set of guidelines for best practices

in FTAs at its leaders' meeting last year. These best practices guidelines provide quite a useful basis for promoting convergence among bilateral FTAs in the region.

The final strategy we can follow is to do whatever we can to keep the US, China and Japan all engaged with the regional processes. By doing so, we would raise the stakes for each of them in choosing a path of non-engagement or conflict rather than continuing engagement. I don't think I can propose any silver bullet that would solve the problems of the region for the smaller economies that in the end have little influence over the big players. But there are constructive, long-term efforts that we can continue to make to promote a constructive outcome to the fuller benefit of all of us.

Questions & Answers

Q1 There is some kind of warring correlation between multilateral and bilateral trade liberalisation. Each time multilateralisation efforts are stalled, it's followed by a strong push toward bilaterals. I want to ask two questions about Asian regionalism. I fully agree that East Asian trade growth might have both losers and winners. But my question is about the feasibility of Asian regionalism. In the case of the EU, perhaps either Germany or France took the initiative to form the union. But in the case of Asian regionalism, who will take that kind of roll? Both China and Japan have a conflict. Who will take the roll of leader?

Secondly, I want to emphasize political leadership, not only in bilateral trade negotiations but also multilaterals. In the case of the FTA with Chile, Korea had a very long and delayed ratification procedure due to some kind of political expediency. If some kind of sensitive items were put aside due to this kind of political expediency, this kind of bilateral trade agreement might have very limited contribution to liberalisation. How do you overcome these issues? Also, with multilateral liberalising, it was reported that a French trade negotiator, Pascal Lamy, would be the new director-general of the WTO. As well, US trade promotion authority would be in place until 2007. Do you think the negotiations will smoothly move toward a multilateral agreement?

Q2 When you mentioned this network of agreements in this part of the world, you mentioned that beside the preferential aspect of these agreements, they could include

also provisions to tackle other issues, like non-tariff barriers, competition or investment. To what extent are these types of issues already included in these agreements, the ones already in place and also the ones under negotiation?

Secondly, the European Union has always given full support to the multilateral system, like the Doha development agenda, and has not engaged in bilateral negotiations until the round is concluded. However, there are some quarters, especially from business communities, that are feeling a little bit threatened by this proliferation of agreements that would put European industry at a disadvantage compared to other countries. What would be the result of a possible change in the European attitude and, if the European Union will start engaging also in bilateral and regional initiatives in this part of the world? How will this change the equation in East Asia?

Q3 I have one proposed modification to the presentation you gave this morning. Your “ASEAN+” initiatives do not include the ASEAN-Korea FTA. But, in fact, that FTA is under negotiations. The goal is actually to come to an agreement before the end of the year, hopefully at the time of the APEC economy ministerial meeting. That could be added to the presentation.

You mentioned two conceivable scenarios as to the likely evolution in the future: an East Asian FTA and an FTAAP. One common characteristic of the two scenarios is that neither one seems to be likely. I’m not sure if it would be any easier to reach an agreement on the FTAAP than to reach complete liberalisation by the WTO route. The major combatants are basically the same in both the WTO circle and the APEC arena.

In any case, I’d like to know what the currently reviewed positions are of the major APEC governments on the FTAAP. Who is opposed to the FTAAP, and for what reasons?

Also, I want to point out there are two more possible scenarios you probably should include. One is making progress toward the Bogor goals. You didn’t even mention the Bogor goals. What to do with those announced goals is a major challenge to APEC economic leaders when they meet. By omitting that scenario, you’re implicitly admitting it’s even less likely than an East Asian FTA or the FTAAP. The Bogor goals are becoming a major embarrassment to APEC economic leaders. They have to meet

that political commitment, but they are not capable of doing so.

Maybe the most likely scenario is the fourth one: to do nothing and muddle through. This would maintain the status quo. What would that mean to APEC? What would it mean if they were to forfeit the Bogor goals and make no positive contribution to the future of APEC?

Lastly, at the end of your presentation, you proposed we should keep the US, China and Japan engaged. My question is, engaged in what?

A The questions do highlight the issue of political leadership and the question of whether or not an East Asian bloc is feasible and who would play the role that Germany and France played in the formation of the EU. The obvious answer that most people would give to that, is that the role has to be played by Japan and China. We all know how difficult that is going to be for them.

A view often heard is that the China-Japan relationship is different from the Germany-France relationship and that the divisions are more deep-seated. I suspect that if you go back into history, and even if you listen to some French and Germans speaking today, I'm not sure that it's true that the divisions between China and Japan are more deep-seated than the divisions used to be between France and Germany. Clearly, that leadership role has to be played by China and Japan, with the possibility that Korea could play the role that it has played already in a number of situations as a "go between" between the two major powers. Korea has played that role very effectively in a number of cases, both within APEC and I think also within East Asia.

I heard the words "Yasukuni shrine" in one of the questions. I assume that question was along similar lines. Being completely frank, one of the real problems you see in the region, when you talk about leadership, is Japan. Why does the Japanese prime minister insist on going to the Yasukuni shrine when he obviously knows what the consequences of that will be? Why does Japan not do something about the textbook situation? I'm not an expert on Japan, but people I listen to who are experts on Japan say the Japanese political system is paralyzed over these issues. There are equally strong forces against reconciliation with China and Korea, and forces in favor of reconciliation. The political leadership cannot move in one direction or the other without offending one very large

slice of the Japanese electorate. As long as that paralysis remains in Japan, I think we're going to have problems. That's my frank opinion.

One question was about the problem of criminality and state control in China. I'm not sure whether this should be emphasised. It's often mentioned as an obstacle to integration with China. Japanese people will often say the same thing. They say that we can't integrate with China until they make more progress toward a market economy. The question is whether we wait for them to make that progress, or do we engage with them through trade agreements and encourage them to make that progress? China is in fact negotiating free trade agreements with a number of countries around the region. It's negotiating with New Zealand, with Australia, it has negotiated with Thailand and it is negotiating with ASEAN. While I certainly acknowledge the problems you mentioned, I'm not sure that these are fundamental obstacles to closer integration with China.

The next question was about the political economy of the omission of sensitive sectors, and the example of the Korea-Chile FTA. I think, again, with enlightened leadership, in some circumstances these FTAs can act as a "circuit breaker" in the domestic political economy.

I recall the experience of my own country, New Zealand. We had the most protected manufacturing sector in the OECD before our free trade agreement with Australia. Australia, at that time, had the next-most protected manufacturing sector in the OECD. The free trade agreement between Australia and New Zealand was very important in breaking down opposition in our manufacturing sector to reducing the level of protectionism.

I hear that in the Japan-Korea FTA, one reason that Korea broke off negotiations was because Japan refused to include agriculture in those negotiations. Again, you could imagine that even in an FTA between Korea and Japan, the inclusion of agriculture might have the same impact as the inclusion of manufacturing in the free trade agreement between Australia and New Zealand.

It's also true that if you think about each FTA as making incremental progress in breaking down some of the vested interests against liberalisation, as an economy engages in more and more FTAs, at some point the balance in the political economy may tip in favor of a more complete liberalisation. If you defeat enough vested interests

in each FTA negotiation, eventually you may break down the opposition to multilateral liberalisation. That may be an optimistic view, but I think there is some evidence for it. There are those who hold the opposite view, however.

As for Pascal Lamy and the prospects for the Doha round, all the comment I've heard is that WTO members are very pleased with the appointment of Pascal Lamy as the WTO director general. There is a general sense that he will not act as a representative of the EU on agricultural policy or anything else, but will represent the interests of the WTO members. Certainly my French friends tell me that one of the objections they had to Pascal Lamy as EU trade commissioner was that he never represented the French position in EU trade policy. He wasn't very popular in France because of that. We have grounds for optimism there.

While listening to the APEC senior officials reviewing current progress of the Doha development agenda, I'd have to say they are very pessimistic, unfortunately, about the prospects at least for making a major breakthrough in Hong Kong. They are not necessarily pessimistic about the eventual outcome, but they are definitely pessimistic about making a major breakthrough in Hong Kong. The prospects for Hong Kong, according to them, are not looking particularly good right now.

If you look at the agreements around the region there is an enormous variety in the extent to which they include non-trade "WTO-Plus" provisions. Some agreements are very far reaching in their approach to competition policy, investment and intellectual property. You'll see other agreements that have virtually no provisions at all on those issues. You'll see some agreements that have quite progressive provisions on services trade. Others leave services trade out completely. This is an issue for APEC economies to work on to improve the degree of convergence between the agreements in the region. They should try to simplify or rationalize the "spaghetti bowl".

Concerning the EU and preferential trading arrangements, the very clear perception in this part of the world is that one of the reasons for East Asian regionalism is a reaction to what is perceived in this part of the world as European regionalism. As well as the enlargement of the European Union, we see that the European Union has negotiated free trade deals with Mexico, Chile and South Africa. It is currently negotiating economic partnership agreements with the 77 African, Caribbean and Pacific states. We see negotiations going on with Mercosur, with Brazil, Argentina, Uruguay and Paraguay.

We also see the Barcelona Declaration, which envisages a free trade agreement covering the whole of Europe and the whole of the Mediterranean region.

So perceived from this part of the world, Europe is actually the leader in the development of these preferential trading arrangements. Certainly, when you listen to East Asian speakers, one of the first things they mention about the reason for the development of preferential trading arrangements in East Asia is the need to catch up with Europe and also with the Americas. In the Americas, you also have a kaleidoscope of preferential trading arrangements and a proposal to create a Free Trade Area of the Americas (FTAA). East Asia sees itself as catching up, rather than leading the trend toward proliferation.

I wouldn't say that failure in the WTO tends to lead to each new burst of regionalism, but it is curious that the biggest boost to the spread of regional trading arrangements has occurred since the WTO was formed. That was happening before we knew that Seattle was a failure. Right from the establishment of the WTO, we've seen a gradual acceleration in the creation of preferential trading arrangements. I think that's something that needs more analysis. It's too simplistic just to say this is a reaction to failures in the WTO. This trend started before there were any failures in the WTO. There's no hard analysis on why that is the case.

Finally, when I said two possible scenarios, I meant that these were two logical scenarios. They are also two relatively unlikely scenarios. In the analysis that the PECC has done of ABAC's FTAAP proposal, we certainly see that it would be a very difficult concept to realize. It has a lot of attractions from the perspective of economic logic. But the practical politics and the practicalities of negotiation suggest that it would be very difficult. We look across to the Americas and see the FTAA negotiations. I don't think you could yet say that they've failed, but they certainly demonstrate the difficulty of creating an all-embracing region wide agreement out of a "kaleidoscope" of smaller bilateral agreements.

Concerning the Bogor goals, if we look at the existing processes for achieving the Bogor goals, and if we think of the Bogor goals as free trade and investment in any normal sense of that term, the existing processes are not going to get all the developed economies to reach that target by 2010. There's still plenty of time for the developing economies, including Korea, which still insists on calling itself a developing economy

for APEC purposes, to reach the deadline by 2020. But the 2010 goal for developed economies will be difficult. Can APEC come up with a credible commitment, or re-commitment, to the Bogor goals that would at least show credible progress while perhaps recognizing the reality that the Bogor goals will not be achieved by 2010 by the developed economies in their entirety?

Before I came to Korea for the current round of official meetings, I was pretty pessimistic about that. I had the impression APEC members were going to be looking at a minimalist approach to reaffirming the Bogor goals, to simply say, "We're doing well. Let's keep going." But it was very encouraging at the senior officials' meeting over the past three days to hear that there's a lot of energy within the senior officials for doing much more than a minimalist approach and looking for really genuine ways to accelerate progress toward the Bogor goals. I was really quite pleasantly surprised to see the officials show a lot of support for the idea of seeking convergence among preferential trade agreements in the region. There had not been any sign of any enthusiasm for that kind of development until this week.

There is a sense among the APEC officials that APEC, if it's to remain a significant player in the region, is going to have to do something credible toward reaching the Bogor goals, even if we recognize that the targets may not be achievable in their entirety. Whether the ministers and leaders will show the same degree of enthusiasm remains to be seen, but I thought the senior officials' meetings this week had been quite encouraging.

Who opposes and who supports the FTAAP? Well, we pointed out in our PECC report that the FTAAP could only be considered possible if the major economies of the region supported it. It's clear at this stage that most of the major economies in the region are not enthusiastic. That relates to the same issues I raised in relation to their lack of support for full integration in APEC or in East Asia. If the major economies in the region did show some interest, there would be no difficulty whatsoever in recruiting the smaller economies in support of the project.

To use an old cliché the smaller economies are like ants in the grass while the elephants are fighting. We know what happens to ants when elephants fight. A rapprochement or reconciliation among the elephants is very much in the interest of we smaller economies in the region.