

A NEW OPEN REGIONALISM IN THE ASIA PACIFIC

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“Open Regionalism” was the term that came to describe Asia Pacific economic cooperation and the approach to trade facilitation and liberalisation in the late 1980s and 1990s. It emerged from early Asia Pacific discussion of regional trade expansion with a precise meaning: the removal of barriers to and the encouragement of regional cooperation without discrimination against outsiders. In the early twenty first century, it has been challenged by the conventional FTA as the organising idea for Asia Pacific economic cooperation.

While APEC practice in the mid-1990s was consistent with the rigorous form of the concept, there was always some discomfort with it in North America. This discomfort meant that Open Regionalism was never secure in Asia Pacific economic cooperation. This turned out to be of critical importance when events in the East Asian and global economies in the late 1990s put the established fabric of Asia Pacific trade liberalisation under stress.

The term Open Regionalism is now sometimes applied loosely to almost any form of cooperation amongst APEC members, including to the traditional discriminatory “free trade agreements” (FTAs) that are now ubiquitous. This usage brings to my mind the famous remark of Lloyd Bentson in the debate in the 1992 United States election campaign, when Dan Quayle sought to compare himself with President John Kennedy. To paraphrase Bentson: “I knew Open Regionalism. Open Regionalism was a friend of mine. This is no Open Regionalism”.

The great momentum in the recent proliferation of FTAs has now generated concern, even among some of their most influential early advocates. There is growing recognition that the current path leads to serious fracture in the Asia Pacific and global trading systems. One of the proposed remedies is to link the

emerging Asia Pacific FTAs in one large FTA, the Free Trade Agreement of the Asia Pacific (FTAAP). In my view, this project has all the risks and problems of implementation and ultimate effect that led the Western Pacific towards Open Regionalism in the first place.

History can never be rewound and played again. The evolution of trade relations over the past six or seven years has made it impossible in the years immediately ahead to restore the old commitments to deepening Asia Pacific or even Western Pacific integration without discrimination against outsiders. Some of the old insights from the Asia Pacific discussion of Open Regionalism, however, may have a place in efforts to remedy emerging defects in the trading system.

This paper describes the origins of the APEC conception of “Open Regionalism”, and the early attempts to make it operational. It discusses the differences in opinion, especially across the Pacific, about its value, and the eventual ascendancy of skeptical North American perspectives. It describes recent developments in Asia Pacific trade diplomacy based on alternative approaches, and the problems that are inherent in them. It concludes with some suggestions for ways in which insights from the old concept of Open Regionalism may be helpful in the contemporary Asia Pacific economy.

THE ORIGINS OF OPEN REGIONALISM

The concept of Open Regionalism emerged over a quarter century of discussion from 1968 of economic cooperation in the Asia Pacific. In its early usage, it was mainly descriptive of the reality of Asia Pacific trade expansion as it emerged in the postwar decades. The huge expansion of trade and investment and deepening integration amongst Asia Pacific economies was driven by market forces once individual governments had gone a certain distance in liberalising external trade and payments. Regional

intergovernmental agreements and institutions and formal trade discrimination made little contribution or none.

The discussion of Asia Pacific economic cooperation from the late 1970s recognised this reality. It sought to reinforce and extend the reality at first through efforts to improve private sector knowledge of opportunities within the region, and then to render the conduct of economic policy within individual economies more sensitive to its effects on Asia Pacific neighbours.

This strand of thinking about Open Regionalism—cooperation across national borders in a region to reduce transaction costs—became a distinctive feature of discussion of Asia Pacific economic cooperation. Governments could augment private processes by providing some public goods to reduce the costs of international exchange. The role of government in support of open trade expansion in the Asia Pacific came to be known as “trade facilitation” (PECC, 1992; APEC, 1992; Elek 1992a, 1992b, 1992c.; Eminent Persons Group 1993, 1994).

Trade facilitation utilises instruments that have no inherent tendency to discriminate against non-participants in regional arrangements. In this, they are unlike conventional FTAs. However, there may be some degree of diversion of attention and focus and therefore of economic activity from non-participants in successful trade facilitation.

Alongside trade facilitation, trade liberalisation on a non-discriminatory basis represented a second dimension of Open Regionalism in the Asia Pacific. Three separate elements could be identified. One was regional cooperation in multilateral and other extra-regional trade negotiations to secure non-discriminatory trade liberalisation at home and abroad. The second was cooperation to reinforce efforts in unilateral liberalisation amongst like-minded regional economies, with the objective of reinforcing political support for and

economic gains from liberalisation in each one of them. This element came to be known as concerted unilateral liberalisation in the lead-up to and at the Osaka meeting of APEC leaders in 1995. The third was agreement to liberalise on a most favoured nation basis in particular sectors that were of interest to regional economies. This was the basis of the initiative for Early Voluntary Sectoral Liberalisation (EVSL) that was launched at the APEC Summit in Vancouver in 1997.

Why did the Asia Pacific discussion of trade liberalisation emphasize non-discrimination? There were three types of reasons. The first was highly practical, and in the Asia Pacific in the 1980s and 1990s compelling. The main regional governments were committed to working within the rules as well as the spirit of the GATT (and later the WTO), so that a discriminatory FTA, for good reasons, had to meet a number of demanding conditions. It had to remove all barriers to substantially all trade over a specified period, which came to be defined as ten years. It had to specify a timetable and a schedule for achievement of substantially free trade over this period. None of these conditions was thought to be practically attainable for free trade within the Asia Pacific in the lead-up to or after the establishment of APEC in 1989—certainly not in the major economies of the United States, Japan, China and ASEAN. In particular, it was clearly recognised that the most costly protection in the Asia Pacific region, related to agriculture, was not amenable to regional as distinct from global negotiations. If regional trade liberalisation were to be secured through a conventional free trade area, progress would have to wait an indefinite time while divisive negotiations explored the possibility (or, more likely, impossibility) of meeting the GATT-WTO conditions.

The second was that the crucial trading interests of Asia Pacific economies extended beyond the APEC region. In particular, all had important economic and political interests in successful internationally-oriented growth in a number of transitional and developing economies. A conventional FTA would

introduce unwelcome tensions into trade relations with these and other economies, and weaken internationally-oriented reform and growth in the developing and transitional economies.

The third came out of straightforward economic analysis. Trade discrimination introduces costs of trade diversion, and these were unwelcome in economies for the time being committed to uninhibited improvements in productivity through deep integration in the international economy.

The commitment to non-discrimination was emphasised by Australian Prime Minister Bob Hawke in his opening address to the first APEC meeting, in Canberra in 1989:

“Some of the earlier thinking about Asia Pacific cooperation was confused by a mistaken belief that we could or should move towards some kind of Pacific trading bloc.

Then as now, such an idea was an impractical one that failed to take into account the diversity of the region’s economic development.

More seriously still, such an outcome would be a foolish one, in that it would run counter to the region’s absolutely compelling interest in the maintenance of a strong and open multilateral trading system. It is on such a system that the region’s economic prosperity has been built and continues to rely”. (Hawke, 1989).

This approach was reinforced in the subsequent confirmation of continued participation in APEC by ASEAN economic and foreign ministers in Kuching in 1990:

“APEC should not be directed towards the formation of an inward looking trading bloc, but, instead, it should strengthen the open, multilateral economic and trading systems in the world.”(ASEAN, 1990)

When the APEC leaders at Bogor in Indonesia in 1994 committed themselves to free and open trade in the Asia Pacific region by 2010 (for developed countries) or 2020 (developing), it appeared that the goals were to be achieved

within the rigorous conception of Open Regionalism, although there was some ambiguity within the documentation. The uncertainty was sufficiently important for the Director-General of the WTO at the organisation's first ministerial meeting, in Singapore in 1996, to put his weight behind the case for non-discrimination:

“I see the ensuring that national barriers are not just replaced by regional ones, but that, on the contrary, regionalism and multilateralism converge at the end of the road as the main challenge facing the multilateral system at present, one which will shape its future and help shape the world of the 21st century.

The trading system is now moving forward on two tracks—regional and multilateral...

Some of the newer regional groups (such as APEC and MERCOSUR) contain a commitment which is very important for the future of the multilateral system: this is *open regionalism*.

Of course, we need to be clear about what *open regionalism* means. Among the different possibilities, I see two basic alternatives.

The first is based on the assumption that any preferential area under consideration will be consistent with the legal requirements of the multilateral system. This would mean that such areas could at the same time be legally compatible with the WTO's rules and preferential in their nature, which means they would be an exception to the m.f.n. clause which is the basic principle of the multilateral system. The possibility of making such a legal exception to the m.f.n. principle within the rules was conceived in a completely different time and situation. Today, with the proliferation of regional groupings, the exception could become the rule, and this would risk changing completely the nature of the system.

The second interpretation of *open regionalism* is the one I hear from a number of governments who are members of APEC. In this scenario, the gradual elimination of internal barriers to trade within a regional grouping will be implemented at more or less the same rate and on the same timetable as the lowering of barriers towards non-members. This would mean that regional liberalisation would be generally consistent not only with the rules of the WTO but also—and this is very important—with the m.f.n. principle.

The choice between these alternatives is a critical one; they point to very different outcomes. In the first case, the point at which we would arrive

in no more than 20 to 25 years would be a division of the trading world into two or three intercontinental preferential areas, each with its own rules and with free trade inside the area, but with external barriers still existing among the blocs. Is this the sort of world any of us would want?

I leave you to imagine the consequences of this vision in terms of economic and political equilibrium; the problem of those who did not fit into any of the blocs would be a serious one—and where would China and Russia be in such a world?

The second alternative, on the other hand, points towards the gradual convergence on the basis of shared rules and principles of all the major regional groups.” (Renato Ruggiero, Director-General of the World Trade Organization, first WTO Ministerial Meeting, Singapore, 1996; (Ruggiero, 1966, cited in Garnaut 1996, p.3).

Scollay (2004) has recently noted that consensus around the Bogor Declaration and its underlying principles was facilitated by the absence of any formal definition of Open Regionalism by APEC itself. Policy makers and analysts with quite different views of its meaning were able to subscribe to the principle. On the one hand, there was widespread acceptance of the view that Open Regionalism implied a commitment to non-discriminatory liberalisation on an “unconditional” basis, meaning that it did not depend on reciprocation by others. On the other hand, those who were uncomfortable with this definition, most notably some Eastern Pacific members of APEC, could quietly presume a requirement of reciprocity. This failure of clarity, while helpful to early perceptions of progress, was to be a fatal flaw in APEC ambitions for trade liberalisation. As in the Chinese saying, it was a case of same bed, different dreams.

THE FATE OF OPEN REGIONALISM: SAME BED, DIFFERENT DREAMS

The early and mid-1990s were a high tide of trade liberalisation in the Asia Pacific within the framework of Open Regionalism. Every one of the Western Pacific economies embarked on far-reaching unilateral liberalisation of trade and in many economies investment. Trade and investment facilitation to reduce

transaction costs was given substantive form in APEC. Western Pacific and APEC support was important to maintaining progress and to eventual success in the Uruguay Round, and in establishing a core of support for the entry of China and Taiwan into the WTO. The Soeharto Government in Indonesia, Ramos in the Philippines and Jiang Zemin and Zhu Rongji in China used the Bogor Declaration skillfully to accelerate domestic trade liberalisation. By 1997, liberalisation in every Western Pacific developing member of APEC, and in Australia and New Zealand, had proceeded more rapidly than the linear rate required to meet the Bogor targets.

This is the point at which two narratives begin to diverge. There is no doubt that trade liberalisation faltered after 1997 throughout the Asia Pacific region. What is contested is the cause of the faltering. Was it the combination of ambivalent commitment to Open Regionalism by Governments of one or more major economies, combined with weaknesses in response to difficult external shocks—an explanation to which I would give considerable weight? Or was it inherent flaws in Open Regionalism as a conceptual basis for sustained trade liberalisation—as contended by Fred Bergsten and others?

The idea at the centre of Open Regionalism is that each economy benefits from its own liberalisation, and benefits even more if one or preferably as many as possible trading partners are liberalising at the same time. In addition, trade liberalisation is associated with adjustment costs, and the political costs of confronting domestic vested interests that benefit from protection. The adjustment costs can be lower if opportunities to expand exports from the liberalising countries are supported by rapid import growth in trading partners.

More importantly, the political costs can be eased by coincident liberalisation in trading partners. It weakens the common protectionist demand that there should be no liberalisation without reciprocity. There is less scope for arguing that domestic liberalisation should be delayed to retain negotiating coin. And

the political catch cry, “if free trade is so good for an economy, why aren’t others doing it”, is less compelling. In the best of circumstances, in which a long period of trade liberalisation is associated with rising prosperity, as was the case throughout the Western Pacific in the decade from the mid-eighties, the success of trading partners’ liberalisation becomes influential in the domestic economic debate.

So the viability of Open Regionalism depends on acceptance of the economists’ wisdom, that movement towards free trade is good for an economy whatever others are doing. It looks to coincident action by trading partners to expand the benefits and reduce the political difficulties of proceeding down that path.

By contrast, traditional “trade negotiators” demands for reciprocity are premised on a mercantilist view of trade, that one’s trading partners’ liberalisation is a good thing for the domestic economy, but one’s own a bad thing. This is commonly held alongside acceptance that there are net gains for the domestic economy in reciprocal movement towards free trade. A more sophisticated reciprocist view accepts that there are domestic gains to the liberalising economy whatever others are doing, but argues that it is impossible politically to liberalise domestically without reciprocation within a trade agreement.

The demand for reciprocity is a useful defence for protectionist interests when the value of free trade is receiving recognition in the political process. It allows the protectionist to resist liberalisation without straightforwardly opposing it. For reasons that are well understood by economists, the protectionist position has many advantages politically, and this sophisticated version of the argument is often effective in the contemporary world in which outright opposition to integration into the international economy lacks credibility.

We cannot lightly dismiss the argument that in some countries, at some points in history, the mercantilist perspective is so powerful that reciprocity really is a condition for domestic liberalisation. This argument is obviously not universally valid, as unilateral liberalisation has been a feature of trade policy in all successful economies at some time or other. Virtually all of the radical liberalisation in all East Asian developing economies and in Australia and New Zealand from the mid-eighties to the mid-nineties was unilateral, albeit in the context of liberalisation in many important trading partners.

The United States in the modern era is a political economy with powerful commitment to reciprocity—a position that has been influential in many other countries in the Americas. This was recognised by many supporters of Open Regionalism as an organising idea for APEC trade liberalisation, and explicitly taken into account in the development of APEC trade strategy.

The US was not going to be an active participant in the early stages of APEC “concerted unilateralism” towards the Bogor goal of free and open trade and liberalisation in the Asia Pacific region. This was not fatal to the trade liberalisation exercise: the Western Pacific had strong momentum for trade liberalisation without any requirement of reciprocity from across the ocean; the US was already a relatively open economy, and many (but by no means all) of the Western Pacific economies would need to reduce their own protection considerably before US trade barriers were among the most notable flaws in the Asia Pacific framework of free and open trade and investment. In the meantime, recognition of progress on trade liberalisation in the Western Pacific, including in such major and rapidly growing economies as China, may loosen the political constraints on US participation in concerted unilateral liberalisation.

Whether or not radical and sustained trade liberalisation in the Western Pacific transformed the US attitude to concerted unilateral liberalisation in general, it

was always envisaged that the final stages of progress towards the achievement of free and open trade and investment in the Asia Pacific would be played out in global negotiations within the WTO (until 1996, the GATT). This was obviously necessary for the removal of the most damaging impediments to open trade in Asia and the Pacific: egregious agricultural protection in the US, Japan, Korea and Taiwan. Powerful political economy constraints meant that the agricultural issues were only ever going to be challenged in global negotiations involving the European Community. The idea that the final stages of progress towards free and open trade in the Asia Pacific would be achieved in the context of a global trade deal were rendered more credible by repeated statements of European Union Commissioner for Trade, Leon Brittain, that the European Union would not fail to respond commensurately if APEC did in fact move towards free trade on a multilateral basis on the Bogor timetable (see, for example, Brittain's statement in Australia in June 1996).

The skeptics on Open Regionalism were sidelined for a while by the continuing momentum of concerted unilateral liberalisation in the Western Pacific through to the late 1990s. From that time, however, the established and beneficent processes of liberalisation ran into the ground in one after another economies—although not in the most rapidly growing and the most rapidly liberalising of all the large economies, China. This set the scene for the rapid replacement of Open Regionalism by proliferation of bilateral FTAs as the dominant tendency in Asia Pacific trade policy.

The EVSL initiative at the Vancouver Summit was an attempt to introduce elements of specific reciprocity into APEC trade liberalisation. It failed comprehensively. Some APEC members attribute failure to Japanese intransigence. Japanese and some other East Asian participants say that the attempt to negotiate formal and binding agreements contradicted the ethos and the founding understandings of APEC. Either way, the failure was unfortunate, and accelerated disillusionment with APEC as a useful locus of trade policy

initiative at a time when the momentum of unilateral trade liberalisation in the Western Pacific was being challenged by the Asian financial crisis.

What were the causes of the rapid change in the organising idea of APEC trade liberalisation?

One was the influence of the Asian financial crisis, which weakened the legitimacy of free trade and investment in several of the most affected economies, including, influentially, Indonesia and Malaysia. In Indonesia, this intellectual development was reinforced by the collapse of the authoritarian Soeharto regime in the course of the economic trauma, which ended for a while Indonesia's leading role as a source of coherence in ASEAN trade policy. Japan, once the most strongly committed to multilateral trade policy of all the developed economies, entered a period of trade policy confusion, under the influences of economic stagnation and mobilisation of protectionist agricultural interests in response to realisation that future multilateral negotiations would be associated with more effective pressure for liberalisation. Australia, long a leader on liberalisation in an Asia Pacific context, went through a period of reduced commitment to engagement with its Asian neighbourhood in the aftermath of the Asian financial crisis.

Disillusionment with the multilateral system, after the Seattle ministerial meeting of the WTO in 1999 broke up in disorder and failed to launch a new round of negotiations, was also discouraging to those who had hoped that Asia Pacific Open Regionalism might survive the political shocks. APEC trade policy had always been built around support for the multilateral framework, and the apparent impotence of the WTO at that time encouraged doubts.

These were all contributing causes. But none would have been decisive without Gresham's Law of trade policy.

GRESHAM'S LAW OF TRADE POLICY AND THE PROLIFERATION OF FTAS

It is part of the ancient wisdom of economics, summed up in Gresham's Law, that bad money drives out good. If pure and debased coins are allowed to circulate side by side, every participant in exchange will have an incentive to retain any pure coin that comes into her possession, and to pass on debased coin. In consequence, the coin in circulation comes to be disproportionately debased.

Something similar to Gresham's Law operates in trade policy. In the domestic political contest, one candidate's espousal of protectionist nostrums usually forces competitors to tailor at least their rhetoric to the new cloth.

There are several sources of debasement of the trade policy coin when FTAs are introduced to a polity that had been committed to trade on a most favoured nation basis.

FTAs are in their nature reciprocal, and there is an increase in the profile and standing of reciprocist approaches to trade liberalisation. A promising new defence arises for protectionists. As with protection, there is a superficial attraction to the idea of reciprocity, against which economics-based views on the superiority of unilateral liberalisation have difficulty in competing in a political arena once the reciprocal approach has been introduced as a credible choice.

FTAs, unlike unilateral and multilateral trade liberalisation, allow a polity to choose amongst the economies the products of which are allowed free entry. Protectionists can promote FTAs with countries which provide ample opportunity for welfare-destroying trade diversion, and discourage those with opportunities for welfare-enhancing trade creation.

FTAs require rules of origin to define which products qualify for preferential treatment. Cooper (2004, p22) has observed that the rules of origin create a playground for protectionist interests. Cooper explains why:

“Rules of Origin are arcane and technical. Outsiders, such as academics or journalists, have a hard time paying serious attention to them, and even the negotiators quickly lose interest...The rules of origin governing NAFTA cover 200 pages. You can be sure that the folks that are most interested have scrutinised every line, indeed have written many lines, and they come to dominate the process. So the rules of origin often turn out to be highly protectionist...The need for rules of origin, effectively dominated by the special interests, increases trade diversion relative to trade creation.”

Finally, FTAs absorb the limited capacities that political leaders have to promote trade liberalisation. Political leaders' time spent on promotion of FTAs is unlikely to lead to a large increase in total time allotted to trade policy, so there is diversion of attention from unilateral and multilateral liberalisation. At the official level, too, scarce personnel resources are diverted to the analysis and negotiation of FTAs. FTAs seem to lay observers to be movements towards free trade, and as they can often be negotiated quickly and at low domestic political cost, they have obvious political advantages for the leader interested in the sound rather than the substance of trade policy.

The completion of an FTA involving one or more of a country's important trading partners leads to concern about loss of established access to important export markets. This concern has some validity: trade diversion in a bilateral FTA damages the exports of other trading partners of the FTA members. The damaged parties are encouraged to negotiate their own FTAs, to end or to offset the discrimination against them.

The economic costs of exclusion from an FTA are not usually as high as is commonly supposed. The FTA members' competitiveness in third markets tends to fall upon entry into trade-diverting FTAs. For example, Australian and

Southeast Asian exporters gained from the dramatic fall in Canadian exporters' shares in East Asian markets after the formation of NAFTA in the mid-1990s (Table 1). And the economic gains from any country pressing ahead with unilateral liberalisation towards free trade at home would in most cases outweigh the costs of exclusion from others' trading blocs. Nevertheless, the costs of exclusion are real, and play heavily in favour of excluded economies seeking FTAs of their own.

The Gresham's Law of trade policy has been influential in the discussion of FTAs in the Asia Pacific since 1997.

NAFTA had a strong rationale from a global as well as a North American perspective. For Mexico and Canada, with their trade overwhelmingly focussed on the United States independently of any trade discrimination, free trade with the United States had the potential to create almost as much new trade as free trade with the world. For the same reason, NAFTA involved proportionately less trade diversion than most FTAs.

Nevertheless, NAFTA did introduce trade diversion against excluded countries, including against all of North America's other APEC partners. For example, Mexico and Canada, for a while, became larger suppliers than China of textiles and clothing to the United States—a development that contradicted comparative advantage and the contemporary experience of all other APEC members. North American replaced Chilean suppliers of tomato sauce to Mexico. Suppliers of electronic goods from Mexican bases to the United States replaced Japanese and Korean firms drawing components according to comparative advantage across East Asian developing economies.

So trade diversion within NAFTA provided impetus to East Asian countries' consideration of FTAs amongst each other and with North American

economies, especially in the aftermath of the Asian financial crisis. This was particularly important to Japan's historic retreat from multilateralism.

A second pivotal point for the application of Gresham's Law of trade policy was the Bush-Zoellick administration's enthusiastic embrace of bilateral and regional FTAs from the beginning of the new Presidency in early 2001. This enhanced the legitimacy of FTAs throughout the Asia Pacific. The switch to preferential trade in Japan, and the increased emphasis in the US, gave smaller countries with weaker commitment to multilateralism a stage upon which to apply their new scripts. Australia's FTA with the US—sought by the Australian Government from the time of election of President Bush in late 2004, was influential, as Australia and Japan had been the most active supporters of multilateral trade and Open Regionalism in the Asia Pacific. The Australia-US agreement is the first intercontinental FTA between economies of significant size.

Scollay (2004) has documented the rapid spread of FTAs involving APEC members in recent years. There has been steep acceleration in the rate of entry into negotiations and of completion of agreements since the new trend became firmly established in 2002.

Scollay notes that at least 12 new FTAs have been negotiated between APEC members since 1999. At least 15 are under active negotiation. Many more are at various stages of discussion or study. Many economies that have to date been bystanders, notably Malaysia, are gearing up for active participation in formation of FTAs. In addition, APEC members are active in discussing or negotiating FTAs with non-members—notably Southeast Asian countries with India, and American APEC members with Latin American non-members.

Smaller economies feel impelled to react to the success of their competitors in securing FTAs with major partners by seeking FTAs with the same partners.

Where this is not possible for political or other reasons, the excluded partner is increasing efforts to secure privileged access to the markets of others—as New Zealand has done with China following its exclusion from the Australia-US FTA. Scollay concludes—regrettably with good reason—that the strength of the “domino effect” is such that the trend to proliferation of FTAs in the Asia Pacific region is probably unstoppable.

The entry into the field of the largest economies—the US, Japan and China—has raised the prospect of “hub and spoke” configurations based on each of them. Significantly, there are no negotiations across the hubs, and at this stage no tendency towards them.

There are some other significant omissions from the recent FTAs and the current round of negotiations. The pattern includes omission of partnerships with the potential for very high levels of trade creation, as between Korea and Japan on the one hand, and the major agricultural exporting countries on the other. There are several significant political exclusions: New Zealand and the United States as previously noted, and all other countries with Taiwan. This raises a possibility of systematic and comprehensive discrimination against Taiwan—an eventuality the avoidance of which had been the focus of much productive effort in the early years of APEC.

Where the FTA would join economies with large opportunities for trade creation, especially in the sector, agriculture, in which protection has been most damaging to regional economic welfare, there has been an acceptance that there should be major exclusions, or at best excessively long transition periods. Here the Australia-US FTA is outstanding, with its exclusion of sugar, and minimal progress over periods up to 18 years for other agricultural products that are important in potential trade. As two of the most active and interested demanders in wider negotiations on agricultural trade liberalisation, Australia

and the US have legitimised the exclusion of sensitive agricultural industries from trade liberalisation agreements.

Nor does the recent crop of Asia Pacific FTAs provide a good model in other areas of design. Despite the presence of liberal and simple rules of origin in an early generation of Asia Pacific FTAs—the Australia-New Zealand and ASEAN agreements—the model for recent Asia Pacific FTAs has been the made-to-measure, complex and restrictive NAFTA style rule of origin.

PROBLEMS IN THE CONTEMPORARY REALITY

No serious analyst of the international trading system is sanguine about the implications of the current momentum towards formation of FTAs, most powerfully of all in the Asia Pacific region. Some authoritative analysts fear that the Asia Pacific and global trading systems have fragmented to an extent that is seriously damaging to economic welfare and has the potential to deteriorate much further. The most positive view amongst analysts with an economics perspective is that the proliferation of FTAs in the Asia Pacific region has at least kept some version of trade liberalisation moving forward at a time of stasis in unilateral and multilateral liberalisation; that the FTA momentum can provide the impetus to a process of “competitive liberalisation” that can eventually play itself out in WTO negotiations; and that the damage can be avoided by effective action now to improve the quality of FTAs and to merge them into much larger preferential trading areas.

The mainstream supporters of multilateral trade emphasise the contribution that bilateral negotiations have made to neglect of the multilateral trade negotiations that were launched at Doha in November 2001; the considerable trade diversion within established FTAs and the likelihood that this will increase rapidly as the proliferation accelerates; and the immense transactions costs and additional layers of trade diversion that are being introduced through complex and restrictive rules of origin (see Supachai, 2004; Cooper, 2004; Ruggiero,

2004; de Jonquieres, 2004; Drysdale, 2004; Findlay, 2004; Bhagwati and Garnaut, 2004; Soesastro, 2004).

Ruggiero (2004, pp26-29), as Director-General of the WTO in 1996, had referred to the possibility that the APEC's doctrine of Open Regionalism might provide the means of reconciling a growing legitimacy of regionalism with an integrated, rules-based global trading system in the extract reproduced above. He now comments that "globalisation is the word on everyone's lips, yet regional agreements have never been so popular". He describes as a "cruel irony" the fact that just as the multilateral trading system has scored one of its greatest successes—China's accession and the launch of the Doha Round—it seems to be at risk. He describes the central problem in the following terms: whereas the preferential agreements should be exceptions to the main principle of the multilateral trade system, the most favoured nation clause, "there is a very real risk that regionalism is now becoming the preferred road to liberalisation".

No-one sees any evidence that "competitive liberalisation" involving FTAs has yet been helpful to the Doha Round. Mainstream economists point to political economy reasons why the establishment of new sources of economic rents through preferences conferred by FTAs is likely to hinder rather than to assist the process of liberalisation on a most favoured nation basis.

One telling critique of the effects of recent developments in the multilateral system is that the increasing importance of restrictive rules of origin cuts across the source of most growth in developing countries' exports of manufactured goods. In East Asia, at least, competitive production of manufactured goods for export relies on components being imported from a wide range of countries according to their comparative advantages. A major part of manufactured exports from East Asia now takes the form of components, for final assembly in the economy which has comparative advantage in that part of the process.

This is globalisation in its productive, contemporary form (Athukorala, 2004; Garnaut and Song, 2004; Table 2, this paper).

A recent study by the Australian Productivity Commission (2004), shows that the uniform and relatively liberal rules of origin in the Australia-New Zealand FTA—50 per cent of value added across all industries to come from within either Australia or New Zealand—were once economically suitable to patterns of production. However, the economically optimal level of imported inputs has increased in many industries. The avoidance of significant economic loss would now require no more than 40 per cent of value added to come from within the member countries.

The low and uniform requirements in the Australia-New Zealand agreement can be contrasted with the much more restrictive, complex and distorting rules in NAFTA and virtually all subsequent FTAs in the Asia Pacific region. Almost no manufacturing production under contemporary processes in Singapore meets the rules of origin of the Singapore-US FTA, and only modest amounts from Australia will do so. Firms wishing to qualify for preferential access to the US market will be able to do so only by diminishing the proportion of components purchased from outside the FTA.

If more and more trade in final goods is conducted within NAFTA-style FTAs, there will be powerful tendencies to reduce the use of imported components. This would seriously diminish the prospects for export expansion in many developing countries, through reducing opportunities for supply of components, and undermining the competitiveness in final goods assembly and production of all but the largest economies.

The costs of regulatory compliance with complex and restrictive rules of origin are high, independently of the distortions that the rules introduce in the course of meeting tests of regional value added.

Schott (2004, p15) has acknowledged the costs of meeting rules of origin, but has noted that these can be avoided by the simple expedient of ignoring the opportunity for preferential access, and paying the general (most favoured nation) tariff. This is in fact the expedient adopted by most Canadian and virtually all Singapore manufacturing exporters to the US since the coming into effect of the two FTAs.

Ignoring the trade preference would indeed be a solution to the trade diversion and rules of origin problems if it were adopted by all members of all FTAs. It would render the trade dimensions of the FTAs irrelevant. While the new agreements could still be criticised for having weakened unilateral and multilateral liberalisation, in their own effects they would, to paraphrase the bard, be sound and fury signifying nothing.

There are two reasons to be doubtful of such a benign solution. First, the FTAs are likely to continue to be utilised in industries in which protection and therefore the margin of preference is highest. These happen to be the industries in which the costs of distortion are greatest.

More fundamentally, not all firms and economies would be affected in similar ways by the costs of meeting and complying with rules of origin.

The costs of meeting rules of origin will favour systematically suppliers in large economies, in the end especially China and the United States. US suppliers are much more likely to be able to meet rules of origin in the FTAs than their counterparts in Singapore or Australia, because, in the larger economy, a much wider range of inputs is competitively supplied from domestic sources. The cost at the margin of replacing some imported by domestic components, when this is necessary, will be much lower in a large and diverse than in a small and specialised economy. So in a world that has

fragmented into bilateral and small-group FTAs, substantial amounts of exports from the largest economies may still be traded preferentially, when most exports from smaller economies are confined to the most favoured nation tariff. Smaller economies, and perhaps all except the US and China, will be competing on less favourable terms in final goods markets, at the same time as their opportunities for components exports have been diminished.

There will also be systematic discrimination against smaller firms in a world in that is fragmented into bilateral and small-group FTAs. This arises from economies of scale in compliance with complex and restrictive rules of origin.

The most interesting part of the recent discussion of emerging trends in the Asia Pacific and international trading systems is the extent of concern that is being expressed by analysts who initially thought that new FTAs would be helpful to economic welfare. For them, the concerns are rooted in imperfections of design in the FTAs that have been completed to date, and in the international community's response to them.

Bergsten (2004) is the most authoritative of the commentators who have seen positive potential in the new currents in Asia Pacific trade policy. He is nevertheless concerned that current trends lead not to increased international integration, but to what most observers agree would be the most damaging of all potential developments: the breakdown of the global trading system into several inward-looking trading blocs. He acknowledges the problems arising from industry exemptions in the FTAs that have been executed to date, from the restrictive rules of origin, from the failure of major economies (particularly the US, China and Japan) to negotiate with each other, and from the absence of any current tendency for the new FTAs in the Asia Pacific region to generate increased momentum in multilateral trade liberalisation.

His proposed solution, taken up by some others including Canada's APEC business group, and recommended for consideration at the November 2004 APEC leaders' meeting in Santiago, was the formation of an APEC-wide Free Trade Agreement of the Asia Pacific (FTAAP).

SALVAGING PARTS FROM THE OPEN REGIONALISM WRECK: NEW FRONTIERS IN TRADE FACILITATION

Asia Pacific economic cooperation began with trade and investment facilitation. There has been continued steady and understated progress in reducing impediments to international economic transactions in the region, beyond the higher profile trade liberalisation issues.

Trade facilitation makes few demands on secretariat resources, as it does not require formal negotiations or binding agreements. Trade and investment facilitation is in its nature consistent with the original conception of Open Regionalism. This is an area in which APEC has comparative advantage.

One encouraging element of discussion of Asia Pacific economic cooperation has been recent business interest in extending the APEC trade and investment facilitation agenda. The Asia Pacific business group, ABAC, has recently endorsed Australian proposals for an upgrading the ambitions of trade and investment facilitation under APEC auspices (see Elek, 2004, and the ABAC Australia (2004).

The following new steps are proposed:

- An intensified program of mutual recognition of product standards and professional qualifications, comparable in scope to that achieved by the European Union.
- Full compatibility and fully electronic data interchange of customs documentation and clearance procedures, including agreed minimum standards for auditing and disclosure.

- Harmonised fiscal incentives for international investment and an APEC code for the taxation of international income.
- Region-wide minimum standards for competition policy, which are sufficiently rigorous to avoid the need for anti-dumping actions among APEC economies.

A number of even more ambitious proposals were put forward for future consideration:

- Full rights of establishment and national treatment of all firms, in all significant sectors.
- Open seas and open skies in the Asia Pacific, subject to an agreed set of traffic control and other safety and security procedures for ports and airports
- An end to all restrictions on short-term business-related travel

The adoption of these facilitation measures would, in the APEC tradition, be voluntary. The prime motive for participation would be to improve incentives for income-raising inward and outward investment and related services trade. ABAC has called the set of measures the Trans Pacific Business Agenda (TPBA). It is in the nature of trade facilitation measures of this kind that they can be taken forward by sub-groups of APEC members (“pathfinders” in the APEC nomenclature), without damaging the interests of non-participating APEC members or outsiders.

An earlier version of the TPBA was ambitiously called the “Single Market Agenda for the Asia Pacific” by the ABAC members who first brought forward the proposal. The establishment of a “single market” in the sense that the term is used in Europe would, of course, require comprehensive trade liberalisation. However, the expanded trade facilitation agenda is capable of significantly raising economic welfare in participating economies through the deepening of international integration, whatever the progress on trade liberalisation. Its adoption by APEC and subsequent implementation would launch a productive new phase in the story of Open Regionalism in the Asia Pacific.

SALVAGING PARTS FROM THE OPEN REGIONALISM WRECK: MAKING THE MULTILATERAL SYSTEM WORK, AN FTAAP, AND AN OPEN TRADE ARRANGEMENT

The immense problems deriving from the proliferation of preferential trading arrangements have generated a plethora of proposed remedies. Some relate to improvement in the quality of FTAs, to remove or to reduce their most damaging features. There has been recent renewal of interest in a region-wide Free Trade Agreement of the Asia Pacific (FTAAP).

Few who focus on the extent of the current systemic problem fail to recommend increased effort to strengthen the multilateral system. Bergsten notes that the best possible outcome from his current re-launch of the FTAAP would be the revitalisation of multilateral negotiations, which would make it redundant.

It is welcome that the APEC Leaders' meeting in Santiago put its main weight on trade policy matters behind the strengthening the multilateral system. The WTO is the logical locus of the trade liberalisation discussion, and APEC's comparative role on those matters is in marshalling support amongst its members for effective contributions to global liberalisation.

The extent of APEC's influence as an institution in the global system will now be constrained by the continued momentum in bilateral trade negotiations and by the weight of vested interests in established patterns of preferential trade.

But within the constraints, the ghost of Open Regionalism recommends a maximum of cooperative effort within APEC for a strong outcome at Doha. Bergsten's espousal of the FTAAP is motivated partly by recognition that the Bogor Declaration will soon disappear into history unless a major new attempt at its implementation is made now. It is not at all clear, however, that the practical problems of negotiating an FTAAP with substantial content, are less

than those associated with working directly for a strongly liberalising outcome in the WTO.

Indeed, the most intractable problems in an FTAAP, notably in relation to agriculture and multifibres, would be easier to negotiate in a global than an Asia Pacific context. For agriculture, liberalisation within the US is not feasible for the foreseeable future without comparable adjustment in both the European Union and Japan. Moreover, Japan is most unlikely to move significantly from the status quo except in the context of a global agreement. For multifibres, liberalisation within an FTAAP would concentrate adjustment to the industrial expansion in China within member countries, whereas a global agreement would spread adjustment across the global trading community.

The FTAAP has no merit at all relative to multilateral liberalisation if it is not easier to negotiate and to implement. An FTAAP would leave problems of discrimination against excluded countries, including developing and emerging economies of great importance politically and some importance economically to sets of APEC members. It would leave residual problems of rules of origin.

The apparent attraction of the FTAAP arises from its seeming to deal with the problems of the FTAs without tackling the problems at their source—in the exceptional legitimacy that preferential trade currently enjoys.

Even with the best possible progress on multilateral liberalisation, the current round of FTAs and its inevitable extension will be a source of major trade distortion in the Asia Pacific for the foreseeable future. It has been proposed by several analysts and endorsed by APEC Leaders at Santiago that new efforts should be made to develop a model of an acceptable FTA, and to encourage its voluntary acceptance by APEC members. It would indeed be a step forward if the requirements on coverage of “substantially all trade” of Article XXIV of the GATT and Article V of the GATS were respected. It would be a step

forward if APEC members insisted on simple, liberal, uniform rules of origin in all their FTAs.

Unfortunately, the political economy attractions of FTAs depend on exactly those imperfections of design that the model FTA would seek to exclude. This does not look to be a realistic way forward.

So what is to be done to minimise the damage, especially to smaller economies who have much to gain from extension of recent gains from fragmentation of the production across economies according to comparative advantage?

My suggestion is entirely focussed on amelioration of problems of trade diversion and rules of origin. Its end point is a reduction in the costs of the recent proliferation of Asia Pacific FTAs, and not free trade in the Asia Pacific region. Its implementation would be helpful rather than damaging to progress on genuine trade liberalisation, but that is not its rationale.

It is suggested that one pair or small group of Asia Pacific economies that are contemplating a new FTA establish instead an Open Trading Arrangement (OTA). It is best that these be economies of substantial size—China-ASEAN could be a good place to start, but perhaps one of Australia-China or Australia-ASEAN could also be a launching pad. If Australia was an initial member, it would be helpful for its Closer Economic Relations partner, New Zealand, to participate as well.

The OTA would have the following elements.

First, the OTA would be an FTA embodying simple, uniform and liberal rules of origin. I would suggest the uniform 40% of the ASEAN FTA, or if that were not feasible, at worst the uniform 50% of Australia-New Zealand Closer

Economic Relations. Any value added from an OTA member would count for the rules of origin.

Second, the members of the OTA would extend to each other the most liberal of the terms of access, sector by sector, product by product, that they had extended to any other country. In effect, the OTA would form a tier of “conditional most favoured nation’ treatment, being available to all other members of the OTA. Thus if Australia were a founding member, it would extend to all other OTA members the favourable treatment (free entry) that it extends to its partner in Closer Economic Relations, New Zealand. If ASEAN were an initial member of the OTA, it would extend to all economies the favourable treatment that each ASEAN country extends to its ASEAN partners. If China were an initial member, it would extend to other OTA members the most favourable of the terms it offers to Hong Kong under Closer Economic Partnership and to ASEAN under the emerging FTA arrangements.

Third, membership would be available to any country in the world that accepted these rules. OTA members would be under peer pressure to introduce liberal terms of access to its own markets, but this would not be subject to long negotiations over trade liberalisation. It would be enough that the terms offered met the requirements of Article XXIV of the GATT and V of the GATS—and, of course, the conditional most favoured nation requirements.

Thus the OTA would have a defensive rather than a trade liberalisation objective. It would protect an economy against discrimination and exclusion from opportunity as a result of partners’ membership of other FTAs.

There would be some trade liberalisation, as a result of extending to OTA partners the most favourable terms that had been offered to others. But that would be an incidental benefit. I myself would favour introduction of an additional impetus to trade liberalisation within each OTA member: a

requirement that each member establish a well-resourced, independent body to undertake on a continuing basis and publicise the results from authoritative studies of the effects on domestic incomes and distribution of remaining trade barriers. Over time, this would help to restore a basis for unilateral liberalisation in each economy, and so to restore one of the conditions that made concerted liberalisation feasible and economically successful in the Western Pacific.

The OTA has one undeniable resemblance to the old Open Regionalism. Some economies would be required to extend to new partners more liberal access to their markets, without specific reciprocity. For this reason, the OTA may gain traction earlier in the Western Pacific, where the memory of recent unilateral trade liberalisation is recent enough to be brought to account in the domestic policy debate. Once established by two or more economies, it may turn out to be attractive to many new members in the Asia Pacific region and beyond.

A NEW OPEN REGIONALISM IN THE ASIA PACIFIC

The old concept of Open Regionalism still has a place in Asia Pacific economic cooperation, albeit a place that is now constrained by past failures and successes.

APEC has a comparative advantage in trade and investment facilitation, and there is room for higher ambition in this area, encompassing the proposed Trans Pacific Business Agenda.

There is a productive role for APEC in marshalling support for the multilateral trading system and for a productive outcome from multilateral negotiations. In the end, the fate of the APEC Bogor declaration on free and open trade in the Asia Pacific region will depend above all on these efforts. Early success with unilateral trade liberalisation in the Western Pacific would be difficult to

replicate in a new era in which protectionist and recipocist doctrines have deepened their roots.

There is still frequent reference to the Bogor goals for free and open trade and investment in the Asia Pacific region. The references are usually respectful and accompanied by sentiment that suggests that many in the region would be unhappy for the goals to disappear without trace. This may provide the basis for an appropriately structured effort to mobilise interest in multilateral trade liberalisation. Qualifications would now need to be made to the end points and coverage of the Bogor goals, in recognition of the hiatus in progress since the late 1990s. But if APEC members were to make one large effort at achieving the Bogor goals by developing a comprehensive set of offers for negotiation in the Doha Round, it may still be the case, as the European trade commissioner suggested in 1996, that Europe would not fail to respond.

Whatever the progress in multilateral liberalisation, the costs and dangers in the contemporary proliferation of preferential trading arrangements are going to be with us for the foreseeable future.

I have in this paper advanced a suggestion for an Open Trading Arrangement that would ameliorate these problems for member economies. It would reduce the costs of trade diversion and more generally of rules of origin. It would remove most of the costs if enough of the right trading partners also accepted membership.

I do not propose the OTA with enthusiasm. After all, conditional most favoured nation treatment is a remedy from the nineteenth century. Unfortunately, in the fragmentation of the Asia Pacific and the global economies into bilateral preferential areas, we have managed to rebuild for ourselves a nineteenth century problem. The last time the nineteenth century problem returned to haunt humanity, in the 1930s, the multilateral trading system based on the

GATT was the solution. It was a good solution. The OTA will cease to have an important role when we have helped the GATT's successor, the WTO, to the higher levels of achievement that render FTAs redundant.

Table 1 Exports of East Asia, North America and European Union, 1985-2002,
(Billion US\$, current prices)

Importer/ Exporter	East Asia				EU				North America			
	1985	1992	1995	2002	1985	1992	1995	2002	1985	1992	1995	2002
	10.2	20.3	29.4	33.4	3.2	5.4	5.9	7.3	2.7	4.2	4.3	7.5
Australia												
New Zealand	1.4	3.2	4.7	4.7	1.2	1.4	1.9	2.4	1.0	1.4	1.7	3.0
East Asia	115.4	336.6	591.3	659.8	44.4	134.2	191.9	227.7	127.1	210.9	317.4	383.0
Japan	37.7	112.4	158.5	163.8	23.3	67.1	70.4	58.4	72.2	107.4	131.4	126.3
Korea	7.6	31.2	54.7	68.7	3.6	9.8	16.3	19.2	12.0	20.7	27.1	37.4
China	16.0	56.6	80.9	138.1	2.5	8.0	19.3	46.5	2.6	9.4	26.5	91.9
ASEAN 6	34.3	89.5	156.1	207.3	8.1	30.2	45.3	51.2	14.4	38.7	62.7	75.8
EU 15	29.4	92.8	146.3	158.5	422.4	1,043.6	1,259.7	1,405.6	81.3	121.5	154.5	245.0
North America	51.7	123.8	172.8	182.3	61.3	113.8	138.3	164.9	143.2	263.8	394.5	598.7
United States	43.3	110.9	155.2	167.1	51.9	100.5	123.6	148.2	60.9	122.1	172.3	254.5
Canada	6.5	11.7	15.8	11.9	5.4	9.9	11.3	11.2	68.6	103.5	153.7	215.6
Mexico	1.9	1.2	1.8	3.3	4.1	3.4	3.4	5.5	13.7	38.3	68.5	128.7
Rest of World	50.5	82.4	118.4	158.6	170.6	242.7	308.0	409.3	58.7	84.6	103.3	182.4
World	258.6	659.1	1,062.8	1,197.2	703.1	1,541.0	1,905.7	2,217.2	414.0	686.4	975.6	1,419.6

	Rest of World				World			
	1985	1992	1995	2002	1985	1992	1995	2002
	7.1	8.2	11.0	12.5	23.1	38.1	50.6	60.6

Australia												
New Zealand	2.4	3.3	5.0	4.0	5.9	9.3	13.3	14.1				
East Asia	80.1	114.5	178.9	173.0	367.0	796.2	1,279.5	1,443.5				
Japan	44.6	52.5	54.0	18.1	177.9	339.5	414.3	366.7				
Korea	8.2	14.7	29.3	21.6	31.4	76.4	127.5	146.9				
China	6.2	10.9	19.3	33.6	27.3	84.9	145.9	310.1				
ASEAN 6	12.7	25.3	45.5	29.8	69.5	183.6	309.6	364.1				
EU 15	198.2	320.1	444.8	442.4	731.3	1,577.9	2,005.3	2,251.5				
North America	74.3	97.6	127.2	111.0	330.6	599.0	832.7	1,056.9				
United States	57.7	87.3	113.2	96.8	213.7	420.8	564.3	666.6				
Canada	13.9	7.0	8.2	6.2	94.4	132.1	189.0	244.9				
Mexico	2.7	3.3	5.8	8.0	22.5	46.2	79.5	145.5				
Rest of World	162.5	162.1	276.0	348.9	442.3	571.7	805.6	1,099.2				
World	524.6	705.7	1,042.9	1,091.9	1,900.3	3,592.3	4,987.0	5,925.9				

Source: International Monetary Fund, Direction of Trade, International Economic Databank, Australian National University.

Table 2 Contribution of parts and components to export growth, 1992-2000 (per cent)

	ASEAN	East Asia	EU-12	NAFTA	World
China	32.9	31.1	12.6	10.3	17.9
Korea	58.9	51.2	35.4	40.6	41.0
Japan	66.9	52.7	86.2	34.1	50.1
Korea	58.9	51.2	35.4	40.6	41.0
Taiwan	67.6	50.8	37.5	54.9	47.4
Hong Kong	29.2	21.6	34.9	8.8	16.3
ASEAN	67.6	60.0	53.1	52.1	54.7
East Asia	64.2	52.6	40.9	35.0	42.8
EU-12	48.8	31.1	20.0	18.1	22.0
NAFTA	74.4	55.8	34.2	23.3	29.9
United States	73.9	55.9	34.8	30.7	38.1
World	63.0	49.6	21.1	25.1	27.0

Source: Made by using the data from Table A-3 (B) from Athukorala (2003).