

**AMERICA, AUSTRALIA AND ASIA AFTER CANCUN**

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The failure at Cancun means at least that the first round of trade negotiations since the GATT became the more ambitious WTO eight years ago will not conclude on schedule in early 2005.

A larger consequence is that when high-level meetings resume, Cancun and its consequences may have made the climate less favourable for a liberalizing outcome than it had been in mid-September 2003.

The deal on agriculture that had been offered by the United States and the European Union (after it was strengthened at Cancun) was disappointing to agricultural free traders. But, unlike the bilateral Free Trade Agreements that have been offered to a few by the United States, the proposal that was emerging at Cancun embodied substantial reductions and bound limits on production and export subsidies. Japan and Korea would not have been able to stand outside an agreement on agriculture. This was much the best agricultural liberalization deal that had ever been available in any context.

The downside risk to the open trading system is considerable in the year ahead. President Bush is entering the active period for the 2004 election race as the first President since Herbert Hoover in the Great Depression to have had employment fall during his term. However unreasonably, open trade is being blamed by some for the loss of jobs. The recent discussion in the United States of trade with China is ominous.

An even larger risk is that two years of rising interest in bilateral and regional free trade areas over the past two years, since their elevation in United States strategy, will now crystallize in a plethora of discriminatory trading arrangements. Supporters of bilateral free trade agreements dream that they can contradict the most favoured nation (even-handed treatment of all partners) principles of the multilateral trading system, without weakening the system. They will still be here tomorrow, but their dreams may not.

The breakdown at Cancun was immediately over the “Singapore issues” of investment, competition policy, trade facilitation and Government procurement. Australian Trade Minister Mark Vaile is right to be annoyed at the unexpected prominence that these issues assumed in Cancun. The practical implications of dealing with them at this time were slight, compared with what else was at stake, for both proponents and opponents of the Singapore issues.

Agreement should have become easier when the European Union offered to take the hardest of the Singapore issues, investment and competition policy, off the table.

The new Group of 21 (later 22, and for a while 23, including Indonesia) developing countries has been credited with blocking agreement. To the extent that this accreditation is correct, the reality has some surprising elements. A majority of Group 21 members, including its leader Brazil, are also members of the Australian-convened Cairns Group of agricultural exporters. Its most influential member, China, counts itself as having strong interests in common with agricultural exporters. It is a puzzle why this combination of countries would deliberately scuttle the opportunity for substantial agricultural trade

liberalization. It is a puzzle why Mexico, a member of the group, supported positions that compromised the success of the meeting, when the Foreign Minister of Mexico was in the Chair. It is a puzzle why Australia seems to have been an unimportant country in the deliberations of these Western Pacific and agricultural exporters, amongst which it was influential in leadership in preparation for and during the Uruguay Round.

Some of the puzzles seem to have arisen out of diplomatic muddle. Failure was more the consequence of inadequate preparation, presentation, leadership and diplomacy involving many parties, than irreconcilable differences on the substantive issues.

The increase in interest in bilateral and regional Free Trade Areas (FTAs) in recent times played a part in the poor preparation for the meeting and in the dynamics of the meeting itself.

Statements by the Agriculture Minister after the meeting indicate that Brazil was concerned to avoid any compromise on United States agricultural subsidies that might constrain its position in anticipated discussions of free trade within the Americas.

The apparently contradictory Mexican positions are more comprehensible if one keeps in mind that Mexico's protection and extension of preferred positions in the North American FTA were prominent amongst its interests at Cancun.

The huge recent effort in the Americas and East Asia on bilateral and regional FTAs helps to explain why the groundwork for negotiation on many issues was thinly laid, why there were so many surprises in negotiations, and why countries that might have been expected to provide effective leadership towards agreement were not able to do so.

In the hours and days immediately following the Cancun meeting, political leaders from several countries announced that they would now be placing greater emphasis on the negotiation of small-group FTAs. These included the United States Special Trade Representative, the Australian Prime Minister, the Brazilian Minister for Agriculture, and the Thai Deputy Prime Minister (at the Chicago conference).

Unfortunately, there are five compelling reasons why the proliferation of small-group FTAs is neither an alternative, nor a stepping stone on the way, to an effective multilateral system.

First, the FTAs that are currently under negotiation would provide poor models for trade agreements. Countries either avoid partners that would be associated with high levels of trade creation (this rules out Japan-Australia and Japan-United States, for example), or seek to make exceptions for sectors that would involve high levels of trade creation (the United States refusal to include reduction of agricultural subsidies in bilateral FTAs). More generally, there are political economy reasons why progress in the hardest areas of trade liberalization, including removal of agricultural subsidies, is inherently more difficult in a bilateral than a multilateral setting.

Second, the establishment of small-group FTAs changes the political economy adversely for subsequent multilateral liberalization. Some beneficiaries from preferences resist their removal through multilateral liberalization. Some exporters fulfill objectives in small-group FTAs, and withdraw from the policy contest over multilateral liberalization.

Third, one country's entering small-group FTAs with a proportion of the world's economies does not give that country anything like that proportion of the benefits of multilateral free trade. The first and sufficient reason for this is the presence of trade diversion. In addition, to ensure that the preferential treatment goes to the parties for which it is intended, FTAs require the enforcement of rules of origin for inputs used in production. This increases transactions costs in trade—considerably for a single agreement, and increasing more than proportionately as the number of such agreements expands.

Fourth, some countries are unattractive partners in small-group liberalization, because of location, small size, poverty, current political orientation or historical relationships. These would be marginalized in a trading system that was fragmented into FTAs. The marginalized countries would include disproportionately the world's poor people, including countries in the difficult early stages of internationally-oriented economic reform.

Fifth, when some countries seek advantage by joining small-group FTAs, others are led to seek alternative arrangements for defensive reasons, leading to proliferation and increasing costs for everyone. Even if a particular FTA were judged to confer advantages to its members, these could be negated and reversed if others entered arrangements that excluded the members of the original agreement.

At this time in history, the defensive motives for establishing FTAs are most influential in the Western Pacific. Within a couple of years, this region has shifted from being the most committed to even-handed multilateralism in the world, to being the locus of the most intensive discussion of discriminatory arrangements. The failure at Cancun seems likely to add momentum to the rush into FTAs in this region.

The East Asian economies would be offering more favourable terms of access to each other than to Australia and the United States. The United States, on the other hand, on current tendencies, would be seeking to enter discriminatory FTAs with the Americas, Australia and a number of economically unimportant countries. The United States would be barred from entering FTAs with Japan and Korea by the agricultural issues, and with China by the current prominence of political tests in choosing partners. The economies of East Asia would suffer the costs of small-group trade discrimination like the rest of the world, but these would be offset to some extent by preferred access to the world's most dynamic region for international trade which happened to be, which together are their most important trading partner. The United States and Australia would suffer the general costs of deterioration of the world system, and an additional cost from being tied artificially to a region the trade of which was expanding relatively slowly. The costs

would, of course, be much higher for Australia, because economic factors cause the East Asian economies to be proportionately much more important markets for its exports.

An additional cost to East Asia would be the concentration in the region of an even greater proportion of the international adjustment to China's extraordinary growth and structural change.

In addition to the economic concerns, there are unfortunate strategic implications of the breakdown of the global trading system into small-group FTAs. The tendency to seek as partners countries that are politically close would have as its end point the entrenchment of contemporary political differences, at a time when the war on terrorism and other challenges require cooperation across a global community.

The world and especially the Asia Pacific region has prospered exceptionally within a multilateral trading system over recent decades. The GATT and then the WTO have supported that system.

In the Western Pacific region, the commitment to increasingly open trade reached its highest point from the mid-1980s until the eve of the 1997-98 financial crisis. This period was characterized by mutually reinforcing trade liberalization, economic growth and trade expansion in every substantial Western Pacific economy.

Unilateral, regional and multilateral pressures were all important in trade liberalization decisions, but the mix of pressures differed across countries. In the high-income Northeast Asia economies, Japan, Taiwan and Korea, reduction of manufacturing protection was mainly undertaken unilaterally, with a view to improving domestic economic performance. Agreements in the GATT were important to the politically more difficult agricultural liberalization. In the developing economies of Southeast Asia and China, trade liberalization was overwhelmingly unilateral in the interests of development at home, although participation in regional (after, 1989, APEC) and multilateral fora reinforced the interest in liberalization. China's interest in joining the GATT and then the WTO, (and from 2001 the implementation of its entry commitments) added to the trade liberalization impetus. In Australia and New Zealand, the origins of liberalization were mainly domestic.

Unilateral, regional and multilateral liberalization in the Western Pacific were fully consistent with each other because the reduction of trade barriers was overwhelmingly on a most favoured nation (m.f.n) basis.

Regional was fully compatible with unilateral and multilateral liberalization because the guiding concept was "open regionalism", which did not involve discrimination against non-participants. In this, regionalism in the Asia Pacific was distinctive.

The idea of open regionalism emerged from long discussion of economic cooperation within the Asia Pacific because it was the practical way to move forward. Regional cooperation to reduce trade barriers could be advanced pragmatically over time, with

different countries and sectors moving at different rates, if it did not involve trade discrimination and therefore the requirements for an FTA to be legal under the international rules.

The regional commitment to trade liberalization had its apogee at the APEC Leaders' Meeting in Jakarta in 1994, when participating economies committed themselves to free and open trade and investment in the Asia Pacific region by 2010 (for developed economies) and 2020 (for developing economies). The flaw in the commitment was that APEC leaders did not share any perspective on how to reach the agreed goals. There was a tendency for Western Pacific leaders to think in terms of open regionalism (the Asia Pacific becoming a region of free trading economies amongst themselves as well as with the rest of the world), while North American leaders had in their minds a model of the traditional FTA, with its discrimination against outsiders. In the old Chinese saying, it was a case of "same bed, different dreams".

In the event, the subsequent leaders' meetings in Osaka (1995) and Manila (1996) defined the way forward on the Bogor declaration in terms of open regionalism, and developed approaches to making the agreement operational. In the first several years after the Bogor declaration, the momentum of unilateral liberalization meant that all Western Pacific economies were reducing trade barriers at a rate that, if maintained linearly, would achieve free trade by the Bogor dates.

That is now history. Trade policy in the Western Pacific, other than rapidly liberalizing China, trod water for several years after the financial crisis, and recently has shifted course towards interest in FTAs. While some APEC members continue to pay lip service to the Bogor Declaration, it is dead as an element of current trade policy.

The period of open regionalism does, however, have continued relevance. The memory of policies that were in place in more successful times keeps alive a possible model for the future, in the Asia Pacific region or more generally in the world.

The new era of preferential trade in the Western Pacific began with the Singapore-Japan agreement of early 2002. A large number of FTAs between Western Pacific economies and others inside and outside the region are currently under negotiation and some are expected to be consummated in the near future. The most important of these are between Australia and the United States, China and ASEAN and Japan and ASEAN.

While the China-ASEAN arrangements are still under negotiation, an "early harvest" in agricultural trade is due to come into effect in October 2003. The Thai Deputy Prime Minister advised the Chicago Conference that prices of fruit and vegetables were already rising in Thailand in mid-September 2003 in anticipation of the "early harvest".

The Western Pacific is entering dangerous territory against which the first Director-General of the WTO, Renato Ruggiero, warned in his keynote address to the first ministerial meeting of the WTO in Singapore in 1996:

“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 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 that 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 would become the rule, and this would change 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 liberalization 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...

In the first case, the point at which we would arrive in no more than 20 or 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...

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, based 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 Organisation, cited in Garnaut, 1996, pp2-4.)

How can we reduce the risks of the international trading system breaking down into discriminatory blocs; and raise the prospects for resumption of productive discussions within the World Trade Organisation?

I suggest seven steps.

The first step is for governments of all substantial trading economies to acknowledge that the Doha Round, the WTO and the open multilateral trading system are at risk and are worth saving.

The second step is to recognize that there is a conflict between energetic pursuit of small-group FTAs, and maintaining and extending the rules-based multilateral system. Ideally,

all countries would follow the lead of the European Union in announcing that there would be no negotiations on small-group FTAs until the conclusion of the Doha Round. At very least, it would be made clear that bilateral and regional negotiations had clearly lower priority. Bilateral and regional economic agreements could still have a place, if they reduced barriers to trade and investment without introducing trade discrimination of a kind that would bring the GATT's Article 24 and GATS' Article 5 into play. The Australia-Japan and Australia-China agreements that are currently under discussion fall into this category, and investment, migration and trade facilitation elements of an Australia-United States agreement could do so. Much of the energy that is now going into discussion of bilateral FTAs could be redirected into these more productive channels.

A third step would replace current international pressure on China for appreciation of its exchange rate against the United States dollar, by recognition that macro-economic adjustment in China could be achieved with better domestic and international resource allocation and systemic effects through accelerated trade liberalization.

The fourth step is to seek agreement that gains in preparation for the Cancun meeting must be part of a future agreement.

A fifth step would see APEC members seeking common ground on the broad shape of a liberalizing Doha Round outcome, and agreeing to take it into the continuing negotiations. This is very much in the spirit of earlier APEC support for the multilateral system, including for in the Uruguay Round, and in the launch of the Doha Round.

The final two steps draw implications for the multilateral system from the Western Pacific experience of open regionalism. They are based on the reality that free trade in one country confers the greatest benefits on that country itself, but that governments are constrained by popular perceptions that liberalization benefits other countries and therefore is a concession to them. If a number of countries liberalise together, the benefits will be even greater for any one of them, and domestic political resistance less, than if it reduced protection alone.

The Wall Street Journal editorial on the Tuesday after the winding up of the Cancun meeting suggested that the time was ripe for the United States to embrace unilateral liberalization in its own economic interests. The remaining proposals are in the spirit of that suggestion.

The sixth step is for major trading economies to establish domestic institutions for independent and transparent analysis of the costs and benefits of alternative trade policies. A proportion of a more informed electorate would be harder to persuade in protectionist arguments.

The final step is to acknowledge that the value of the Doha Round to the major economies depends hardly at all on whether there is reciprocation from the many economically small, "least developed" countries. Botswana played a prominent role in the breakdown in the Cancun discussions. It is a relatively large trading economy in the

context of Africa and the Caribbean. However, its total annual foreign trade is much less than an average month's increase in China's foreign trade. It is in the interests of the major economies with the largest stakes in a successful Doha Round, to allow the lowest income economies to opt out from reciprocity requirements and from participation in the negotiations. While full participation in the negotiations leading to bound trade liberalization would be helpful to their own development, participation in and risking the successful conclusion of multilateral negotiations is not a cost-effective means of approaching the development objective.

The world's substantial trading economies would be applying "open regionalism" on a global scale.