



## **ADB Working Paper Series**

### **The Free Trade Area Of The Asia-Pacific: A Constructive Approach To Multilateralizing Asian Regionalism**

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C. Fred Bergsten, Marcus  
Noland, and Jeffrey J. Schott

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C. Fred Bergsten is the director of the Peterson Institute for International Economics. Marcus Noland is deputy director and fellow at the Peterson Institute for International Economics. Jeffrey J. Schott is a senior fellow at the Peterson Institute for International Economics.

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Please contact the author(s) for information about this paper.

Email: [kstewart@piie.com](mailto:kstewart@piie.com); [mnoland@piie.com](mailto:mnoland@piie.com); [jscott@piie.com](mailto:jscott@piie.com)

Asian Development Bank Institute  
Kasumigaseki Building 8F  
3-2-5 Kasumigaseki, Chiyoda-ku  
Tokyo 100-6008, Japan

Tel: +81-3-3593-5500  
Fax: +81-3-3593-5571  
URL: [www.adbi.org](http://www.adbi.org)  
E-mail: [info@adbi.org](mailto:info@adbi.org)

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**Abstract**

This paper examines the prospect of realizing regional economic integration via the mechanism of a Free Trade Area of the Asia-Pacific (FTAAP). The FTAAP initiative represents a politically ambitious, high potential benefit option for achieving Asian regional integration. Among its desirable attributes, the FTAAP initiative could help revive and promote a successful conclusion of the Doha Round negotiations; constitute a “Plan B” hedge if Doha fails; short-circuit the further proliferation of bilateral and sub-regional preferential agreements that create substantial new discrimination and discord within the Asia-Pacific region; defuse the renewed risk of “drawing a line down the middle of the Pacific” as East Asian, and perhaps the Western Hemisphere, initiatives produce disintegration of the Asia-Pacific region rather than the integration of that broader region that the Asia-Pacific Economic Cooperation (APEC) forum was created to foster; channel the People’s Republic of China (PRC)-United States economic conflict into a more constructive and less confrontational context; and revitalize APEC, which is of enhanced importance because of the prospects for Asia-Pacific and especially the PRC-US fissures. An incremental approach to the FTAAP, explicitly embodying enforceable reciprocal commitments, offers the best hope delivering on the concept’s abundant benefits.

**JEL Classification:** O16; O53; R11

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## 1. INTRODUCTION

In 1988, after almost two years of intensive negotiations, the United States and Canada signed a comprehensive free trade agreement (FTA). This initiative, the first of its kind for either country, was conceived amid concern about the start of new global trade talks in the General Agreement on Tariffs and Trade (GATT) in Geneva, and concluded amid concern that the Uruguay Round of multilateral trade negotiations was adrift and heading toward a tumultuous ministerial bust-up. The Canada-US FTA was designed to deepen trade and investment ties, and to propel the Uruguay Round by offering new precedents for global accords (e.g., services) and regional alternatives if the GATT process faltered (Schott and Smith 1988).

Given the uncertainty in Geneva, East Asian countries chafed at the prospect that North American economic integration would discriminate against shipments to their most important export market. Their responses fell into two categories: emulation and competition. Some Asian officials suggested similar arrangements across the Pacific; proposals to that end were vetted but never seriously considered (Schott 1989). Others sought to build an East Asian Economic Caucus that excluded the US. In the event, and in typical Asian fashion, Asian countries did a little of both; economic integration among members of the Association of South East Asian Nations (ASEAN) was given new impulse, while at the same time countries, led by Australia, joined in a new trans-Pacific forum in 1989 under the banner of Asia-Pacific Economic Cooperation (APEC). Participants in APEC sought to sustain US military and economic engagement in the region and to deepen trans-Pacific economic relations.

APEC has largely met its political objectives. The US remains fully engaged in the region and the advent of annual summits of Asia-Pacific leaders (starting with the Blake Island Summit of 1993), plus the expansion of APEC's membership to the People's Republic of China (PRC) and Taipei, China, have created new opportunities for diplomatic responses to difficult political problems.

By contrast, APEC's track record on economic integration has been mixed and very modest since its two notable achievements in the early 1990s. First, APEC members worked together in late 1993 to push for the successful completion of the Uruguay Round—which was concluded and signed in April 1994. Second, APEC leaders committed to a broad vision of region-wide free trade and investment at the Bogor Summit in 1994. In their Bogor Declaration, APEC leaders pledged “to complete the achievement of our goal of free and open trade and investment in the Asia-Pacific no later than the year 2020.”<sup>1</sup>

The Bogor Declaration set different target dates—2010 for developed and 2020 for developing countries—to achieve the free trade goals, without specifying (1) which members would be expected to open their markets first and (2) how the liberalization process would be implemented. As Scollay (2004) has observed, the Bogor consensus was “facilitated by a degree of imprecision in defining the objectives.”

APEC's subsequent embrace of “concerted unilateralism” essentially meant that members agreed to “the ASEAN way.” This form of consensus decision-making may be adequate for a partnership of smaller countries with common interests seeking to amplify their collective voice on the world stage. However, in a context involving major powers with conflicting interests, this modus operandi has proved inadequate to advance a common agenda among the diverse APEC membership. Consequently, efforts to implement the Bogor mandate foundered when the Early Voluntary Sectoral Liberalization (EVSL) initiative ran aground in 1998 in the wake of the Asian financial

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<sup>1</sup> [www.apec.org/apec/leaders\\_declarations/1994.downloadlinks.0001.LinkURL.Download.ver5.1.9](http://www.apec.org/apec/leaders_declarations/1994.downloadlinks.0001.LinkURL.Download.ver5.1.9)

crisis. APEC members did contribute importantly to the success of the global accord on information technology products subsequently adopted in the World Trade Organization (WTO) but failed in efforts to develop region-wide disciplines on investment and EVSL faltered.

APEC has since devolved into a consultative organization to encourage trade and investment facilitation, promote technical assistance, and provide an annual opportunity for pan-Asia-Pacific heads of government meetings. With its conventional trade liberalization role stymied, emphasis shifted toward softer forms of trade and investment facilitation and technical assistance, and an opportunity for annual heads of government meetings. In these areas, APEC is not without its merits.

Today, in a role reversal, the US is facing the proliferation of Asian regionalism among countries that represent the fastest growing US export markets. The ten-member ASEAN is at the core of many of these groupings, and is proceeding with parallel trade accords with the three major economies of Northeast Asia (the so-called “10+1” pacts). Though they have not progressed very much in bilateral or trilateral discussions among themselves, the PRC, Japan, and the Republic of Korea (henceforth, Korea) effectively have established, through their separate deals with the ASEAN, the framework for an eventual “10+3” arrangement that would echo the vision of an East Asian grouping vetted two decades ago. At the same time, each also has concluded or is negotiating trade deals with other countries in Asia, Oceania, and the Western Hemisphere.

To its credit, the administration of US President George W. Bush reacted to growing Asian regionalism by seeking to deepen its engagement in the region—through bilateral and regional initiatives (FTA talks with Korea, Malaysia, and Thailand; the Enterprise for ASEAN Initiative) and new proposals to revive momentum to achieve the goal of Asia Pacific economic integration first raised in Bogor almost 15 years ago. To that end, it advocated, at least rhetorically, a Free Trade Area of the Asia Pacific (FTAAP).

Is such an initiative feasible? Region-wide efforts toward free trade remain on the back burner for many APEC members—though Chile and Singapore are trying to create a regional network of bilateral FTAs that would effectively build an Asia-Pacific FTA over time.<sup>2</sup> But the issue has been engaged in APEC deliberations. In the autumn of 2004, the APEC Business Advisory Council issued a report recommending renewed efforts to build an FTAAP. Not surprisingly, the official reaction was muted and APEC members deferred consideration of the proposal for several years. However, at their meeting in Hanoi in November 2006, the APEC leaders called for “further studies” on approaches to regional economic integration, including the FTAAP “as a long-term prospect.” Subsequently, the APEC leaders’ meeting in Sydney in September 2007 committed to “examine the options and prospects for a Free Trade Area of the Asia-Pacific” by reviewing, among other things, existing pacts among APEC members, academic analyses of them and of a potential FTAAP, and “the feasibility of docking or merging” FTAs.

In the past decade, most APEC members have demonstrated a capacity to enter into enforceable preferential trade agreements, and it thus is worth considering whether 15 years after turning into the cul-de-sac of “concerted unilateralism” that it might be possible to actualize the Bogor vision of free trade in the Asia-Pacific region. Admittedly, the goal is dauntingly ambitious, but it may be possible to achieve it

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<sup>2</sup> The P-4 group—comprising Brunei Darussalam, Chile, New Zealand, and Singapore—represents a small core of a prospective grand Asia-Pacific compact. The US joined the P-4 in efforts to expand sectoral coverage of their current FTA (based largely on the US FTAs with Chile and Singapore) to financial services and investment (see USTR press release, 4 February 2008, accessed at [www.ustr.gov](http://www.ustr.gov)).

incrementally by building outwardly from a core group of liberalizers to encompass the whole region.

This paper examines the prospect of realizing regional economic integration via the mechanism of an FTAAP. We begin by examining the normative case for an FTAAP, followed by a brief review of the prospective impact of the agreement, before taking up the knotty issue of how such an end-state might be achieved. Our conclusions are summarized in the final section.

## 2. THE NORMATIVE CASE FOR FTAAP

All major Asian economies are members of the WTO. In principle, WTO liberalization is the preferred means of capturing economic efficiencies and avoiding adverse diplomatic fallout arising from discrimination among partners. Yet the organization's negotiation in the Doha Round has stalled for a variety of reasons: a complex negotiating agenda; the increasing role and assertiveness of a number of middle powers; and political weakness in the traditional major powers that has made compromise, particularly on the central issue of agriculture, more difficult (Schott 2008).<sup>3</sup> Moreover, the sheer breadth of the WTO's membership and its decision-making processes create incentives for broad but shallow liberalization, which may fall well short of measures to which a more limited set of members would be prepared to commit.

As trade liberalization has stalled at the global level, action has naturally shifted toward sub-regional and bilateral initiatives. Preferential trade pacts among Asian countries of varying shapes and sizes have proliferated, spurred by the PRC's overtures to ASEAN members earlier this decade. India, Japan, and Korea subsequently emulated the PRC's trade strategy and negotiated agreements with ASEAN members creating a network of broadly comparable "10+1" agreements. In so doing, ASEAN has positioned its own ASEAN free trade agreement as the center of a hub-and-spoke system of Asian regionalism.

The intra-Asian pacts differ significantly from North American pacts in terms of substance and time horizon. Simply put, US initiatives are more concrete and focused on near- to medium-term results; most Asian pacts lack the comprehensive scope of provisions contained in US FTAs and chart a more flexible and incremental integration path without the legally-binding and enforceable obligations embraced by litigation-minded US officials. To be sure, some Asian pacts, such as Japan's Economic Partnership Agreements, cover a broader range of economic activities but tread softly on agricultural reforms and on services and other domestic regulatory issues. But in part because of their amorphous nature, and the fact that the conclusion and implementation of these agreements coincided with a period of trade expansion driven in significant part by falling transactions costs as a result of technological change, there is real uncertainty about how much additional trade integration these intra-Asian pacts have delivered (Manchin and Pelkmans-Balaoing 2008).

In this context, FTAAP represents a way to achieve the APEC liberalization goals. With the Doha negotiations adrift, the "noodle bowl" proliferation of sub-optimal and potentially inconsistent preferential agreements is likely to accelerate. FTAAP can subsume many of them under one umbrella. Ultimately, it should seek to achieve a

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<sup>3</sup> On the key issue of agriculture, Asia has no coherent regional interest. Some Asian countries, such as Japan and Korea, number among the world's most inefficient and protected agricultural producers, while others such as Indonesia, the Philippines, and Thailand are members of the Cairns Group of self-identified, non-subsidizing agricultural exporters.

harmonization of the conflicting rules of origin that are an impediment to business and trade, following the precedent of the 1997 Pan-European Cumulative System that multilateralized the panoply of preferential trade agreements (PTAs) then existing in Europe (Baldwin 2006).<sup>4</sup>

Importantly, the FTAAP advances political and economic objectives. It reinforces the longstanding APEC interest in ensuring a strong and enduring US presence in the region and mitigates concerns that intra-Asian pacts would, in the memorable words of former US Secretary of State James Baker, “draw a line down the middle of the Pacific.” This consideration is especially important in light of the steady movement of the East Asian members of APEC toward establishing their own region-wide preference area. Creation of an East Asian Community, or even an East Asian Free Trade Area, could contribute substantially to liberalization and thus have a positive impact on the world economy. Yet it would also generate major new discrimination within the broader Asia-Pacific setting. One model found that the US could lose as much as \$25 billion of annual exports solely from the static discriminatory effects of an East Asian Free Trade Area (Scollay and Gilbert 2001) while another, dynamic, model concluded that real welfare loss could approach \$5 billion (Jiang and McKibbin 2008). Such losses could add substantially to the protectionist and isolationist pressures that are of worrisome strength in the US.

This outcome will occur whether or not East Asian regional integration formally produces a single economic entity, such as an “ASEAN+3” (ASEAN plus the PRC, Japan, and Korea) free trade area or Japan’s recent proposal for an “ASEAN+6” (ASEAN plus Australia, the PRC, India, Japan, Korea, and New Zealand) economic partnership agreement. The overlapping network of existing and potential agreements, especially the “10+1+1+1” arrangements between ASEAN and the three Northeast Asian powers, will move substantially in the same direction. Such new trade discrimination across the Pacific could also have important security effects, such as loosening the current transpacific alliances (e.g., Japan-US), not least because of negative congressional reactions to such Asia-only initiatives (regardless of the parallel Western Hemisphere-only initiatives being conducted by the US).<sup>5</sup>

It is important to embed regional economic initiatives in broader geographic contexts to avoid the risk that they may subsequently resist liberalization toward nonmembers and become closed blocs. The European Union (EU) and its predecessors, by far the most important preferential trade agreement (and of course much more) ever implemented, have been sufficiently nested in the GATT/WTO system that they could not resist global steps to temper their discrimination against outsiders. The integrating Europeans were also embedded in an extensive network of transatlantic relationships with Canada and the US, including the Marshall Plan, the North Atlantic Treaty Organization, and the Organization for Economic Cooperation and

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<sup>4</sup> Some PTAs would probably continue to exist even with an FTAAP. However, an FTAAP could follow the precedent of the other mega-regional trade negotiation that has proceeded in a geographical area with a number of preexisting PTAs, the Free Trade Area of the Americas (FTAA), whose negotiators agreed that while the new arrangement would not displace preexisting sub-regional integration agreements, the provisions of the latter would prevail only to the extent that “the rights and obligations under those agreements are not covered by or go beyond the rights and obligations of the FTAA” (Stephenson 2007, p. 135). It would also be highly desirable for the APEC members to declare a moratorium on the launch of any new PTAs once they had commenced negotiations on an FTAAP (among other things to free the necessary resources within the member governments to pursue an FTAAP).

<sup>5</sup> The US and Asian nations have a right to be consulted about the hemispheric initiatives of their transpacific neighbors in light of their close historical ties and especially in light of their commitments to each other to move to “free and open trade and investment” in the Asia-Pacific region. They have an obligation to conduct such consultations with full faith and transparency and to consider new ideas, such as an FTAAP, which would obviate the major costs and risks of East Asia-only or Western Hemisphere-only integration. APEC is, of course, the natural venue for such consultations.

Development, among others. These trans-Atlantic institutions linked Europe and North America despite the unprecedented degree of regional integration unfolding in Europe. By contrast, the apparent desire of the Southern Cone Common Market (Mercosur) to maintain its subregional preferences and to resist reducing them in any broader framework, even with full reciprocity, probably derives at least partly from the absence of such broader nesting. In this light, the results of a recent poll of “600 Asian opinion leaders” conducted by the Asian Development Bank (ADB), which appears to document a mild preference for the relatively narrow ASEAN+3 concept, is a little disturbing, though several aspects of the poll raise unresolved methodological questions (ADB 2008).

Finally, moving forward on the process of building an FTAAP could prove an effective catalyst for reviving and successfully concluding the Doha negotiations. APEC members include major trading nations whose participation is crucial for any multilateral trade accord, and together account for about 60% of world trade and more than half of world output (Table 1). The prospect of an evolving FTAAP could spur trading powers outside the Asia-Pacific region to reassess the risk of facing substantial new trade discrimination if they continue to block a successful WTO outcome—much like the “free trade in the region” commitment of APEC’s initial Seattle summit in 1993 encouraged increased EU negotiating flexibility and spurred the successful conclusion of the Uruguay Round negotiations more than 15 years ago. In other words, following the standard logic of “competitive liberalization,” the EU and others would likely try to use multilateral negotiations to avoid discrimination (just as the US used the three major postwar GATT rounds in large part to reduce the preferences stemming from the creation and expansion of the EU). Of course, this tactic is only credible if the APEC process advances from the current stage of “serious consideration” and “further studies” of a “long-term prospect” to active discussion, and eventual full-fledged negotiation, of the FTAAP, the prospects for which are discussed below.

| <b>Table 1. APEC Regional Trade in 2007</b> (billions of US dollars)  |                               |                          |
|---|-------------------------------|--------------------------|
|   | <b>Imports from the world</b> | <b>Imports from APEC</b> |
|   | US\$ billions                 | US\$ billions            |
| <b>Australia</b>  | 170.32                        | 118.79                   |
| <b>Brunei Darussalam</b>  | 2.32                          | 1.88                     |
| <b>Canada</b>   | 418.53                        | 327.37                   |
| <b>Chile</b>  | 43.80                         | 19.10                    |
| <b>PRC</b>  | 952.79                        | 504.07                   |
| <b>Hong Kong, China</b>   | 387.17                        | 341.52                   |
| <b>Indonesia</b>  | 115.03                        | 92.38                    |
| <b>Japan</b>  | 621.87                        | 397.93                   |
| <b>Korea</b>  | 364.13                        | 237.18                   |
| <b>Malaysia</b>   | 146.98                        | 111.53                   |
| <b>Mexico</b>   | 270.81                        | 208.90                   |
| <b>New Zealand</b>  | 30.78                         | 23.10                    |
| <b>Papua New Guinea</b>   | 3.04                          | 2.76                     |
| <b>Peru</b>   | 21.10                         | 10.65                    |
| <b>Philippines</b>  | 70.62                         | 61.47                    |
| <b>Russia</b>   | 238.22                        | 64.19                    |
| <b>Singapore</b>  | 263.33                        | 185.29                   |
| <b>Taipei,China *</b>   | 200.41                        | 122.10                   |
| <b>Thailand</b>   | 141.35                        | 96.34                    |
| <b>US</b>   | 2017.38                       | 1269.70                  |
| <b>Viet Nam</b>   | 61.96                         | 52.73                    |
| <b>APEC totals</b>  | 6541.93                       | 4249.01                  |
| <b>APEC trade with the world as<br/>a share of global trade</b>   | 60%                           |                          |
| * Figures for Taipei,China are only available to and from the following partners: Australia; Canada; Hong Kong, China; Indonesia; Japan; Korea; Malaysia; New Zealand; the Philippines; Singapore; Thailand; the United States; and Viet Nam. |                               |                          |
| <i>Source: International Monetary Fund Direction of Trade Statistics June 2008 and Taipei,China Economic Statistics Volume 6 Number 5 May 2008</i>  |                               |                          |

An Asia-Pacific FTA would likely generate greater aggregate economic benefits than any plausible multilateral/WTO liberalization. The Doha Round, like the Uruguay Round and its other predecessors, would at best achieve incremental liberalization of existing barriers (Martin and Mattoo 2008). Indeed, for many WTO members, the prospective trade deal would only reduce bound duties toward the levels now applied. Because APEC economies account for more than half of world output and trade, elimination of all barriers between them would provide a much larger payoff—at the global level—than any realistic Doha outcome. Even if an FTAAP contained the modest exceptions that are normal in major trade pacts, the gains for the world economy would be far superior to those attainable via any plausible WTO negotiation.

Those gains would of course accrue primarily to the members of the FTAAP, and some nonmembers would lose due to the resulting discrimination against them. Nonmembers would then be more likely to seek to associate with the FTAAP or

negotiate their own regional agreements. Indeed, advancing work on an FTAAP—even incrementally—could well encourage the EU to follow suit and turn the Asia-Europe forum, along with evolving EU trade pacts with ASEAN and Korea, into an FTAAP clone. Linking the APEC and ASEM initiatives would produce a trade pact that closely approximates a global deal.

### 3. QUANTITATIVE ASSESSMENT OF FTAAP

APEC members account for about 60% of world trade. Table 1 shows intraregional trade intensity runs a bit higher at about 65% despite the large deficit in oil and other energy products that the region runs with the rest of the world. For some economies in the region, the degree of intraregional trade intensity is high. If oil is excluded, the degree of intraregional trade orientation would be even higher yet. APEC would appear to be at least a plausible candidate for deeper formal integration.

Two common methodologies for assessing preferential trade agreements are computable general equilibrium (CGE) models and gravity models. Not surprisingly, given the breadth and depth of liberalization embodied in the FTAAP concept, existing assessments document large and widely-shared benefits.

Typical CGE results show that every APEC economy gains more from an FTAAP than from nondiscriminatory liberalization by APEC, the only alternative modality for pursuing the Bogor goals on a regionwide basis and for revitalizing APEC's trade agenda (Scollay 2004). Almost all East Asian economies (including the three large Northeast Asian nations) gain more from an FTAAP than from an "ASEAN+3" or East Asia Free Trade Area (Scollay 2004). A more sectorally aggregated, but dynamic, CGE obtains similar results: The PRC and Japan gain more from FTAAP than from any of the more narrow regional initiatives, though ASEAN gains less—it faces more competition and as a result its capital stock increases less under the FTAAP than the more limited alternatives (Jiang and McKibbin 2008).

For tractability most CGE models impose relatively simple and stringent assumptions such as constant returns to scale production and appear to underestimate the impact of trade agreements *ex post* (Burfisher, Robinson, and Thierfelder 2001, Robinson and Thierfelder 2002). One response to this "search for large numbers" has been to supplement CGE analyses with econometrically estimated gravity models that tend to generate larger estimated effects of trade agreements, though have the disadvantage of generating results only for trade volumes, and not economic efficiency or welfare *per se*. (One would expect significant trade creation in the absence of large trade diversion to be welfare-enhancing.) Modeling by Hufbauer and Schott (2007) indicates that an FTAAP would increase two-way trade coverage of partner countries from about 50% to 80% of their world commerce (Table 2). Of the major countries, the impact on the PRC would be the smallest in percentage terms and the impact on Japan would be the largest. Agricultural trade would increase by roughly 65% (\$260 billion) and manufactures by roughly 85% (\$5.2 trillion). In the case of the FTAAP the impact of trade diversion would be small and largely involve agricultural products, and would be further reduced if an FTAAP had the expected impact of rejuvenating liberalization via the WTO (Hufbauer and Schott 2007).

Table 2. Gravity Model Estimate of FTAAP

|                          |               | (1.1)                                      | (1.2)  | (1.3)   |
|--------------------------|---------------|--|--|---|
|                          |               | Average levels of<br>merchandise trade     | Average annual<br>impacts of FTAAP on<br>total merchandise trade | Average annual percentage<br>impacts of FTAAP on total<br>merchandise trade |
|                          |               | 2001-2005                                  |  |   |
|                          |               | All Traded Goods (SITC 0 to 9)             |  |   |
| Region                   |               | (billions of US dollars<br>at 2005 prices) | (billions of US dollars<br>at 2005 prices)                       | (%)   |
| <b>Exports + Imports</b> |               |  |  |   |
| Asia-Pacific             | US            | 2,286                                      | 1,190  | 52.1  |
|                          | PRC           | 1,111                                      | 598  | 53.9  |
|                          | Japan         | 994  | 883  | 88.9  |
|                          | Korea         | 432  | 245  | 56.7  |
|                          | APEC          | 7,944                                      | 4,839  | 60.9  |
| Asia                     | ASEAN         | 988  | 644  | 65.2  |
|                          | CER           | 215  | 143  | 66.5  |
|                          | SAFTA         | 204  | 0  | 0.0   |
|                          | Other Asia    | 904  | 597  | 66.1  |
| Pacific                  | NAFTA         | 3,244                                      | 1,698  | 52.4  |
|                          | Other America | 466  | 30   | 6.5   |
| <b>Exports</b>           |               |  |  |   |
| Asia-Pacific             | US            | 842  | 496  | 58.9  |
|                          | PRC           | 688  | 377  | 54.8  |
|                          | Japan         | 567  | 513  | 90.4  |
|                          | Korea         | 232  | 132  | 57.1  |
|                          | APEC          | 3,934                                      | 2,420  | 61.5  |
| Asia                     | ASEAN         | 535  | 327  | 61.1  |
|                          | CER           | 105  | 68   | 64.4  |
|                          | SAFTA         | 103  | 0  | 0.0   |
|                          | Other Asia    | 432  | 225  | 52.0  |
| Pacific                  | NAFTA         | 1,342                                      | 763  | 56.9  |
|                          | Other America | 268  | 15   | 5.5   |
| <b>Imports</b>           |               |  |  |   |
| Asia-Pacific             | US            | 1,443                                      | 694  | 58.1  |
|                          | PRC           | 423  | 222  | 52.4  |
|                          | Japan         | 426  | 371  | 87.0  |
|                          | Korea         | 200  | 113  | 56.3  |
|                          | APEC          | 4,010                                      | 2,420  | 60.3  |
| Asia                     | ASEAN         | 453  | 317  | 70.0  |
|                          | CER           | 110  | 75   | 68.5  |
|                          | SAFTA         | 101  | 0  | 0.0   |
|                          | Other Asia    | 471  | 372  | 79.0  |
| Pacific                  | NAFTA         | 1,902                                      | 935  | 49.2  |
|                          | Other America | 198  | 15   | 7.7   |

Source: Hufbauer and Schott (2007) tables, 6, 7, 8

## 4. THE LIKELIHOOD OF REALIZING FTAAP

Singapore Prime Minister Lee Hsien Loong said: “America has proposed an APEC-wide Free Trade Area of the Asia Pacific as a long-term goal. This will not be easy to achieve. No free trade agreement that includes America, Japan, Russia, together with the PRC; and Taipei, China, can be a straightforward matter, for all sorts of reasons other than trade. Nevertheless, the FTAAP is a worthy long-term objective to work towards. It will add substance to the APEC grouping, and have a positive effect on world trade negotiations” (Lee 2007). Per Lee, we can summarize: FTAAP is a long-term objective viz near-term negotiation. In the short run, economic and political roadblocks exist to starting formal FTA negotiations, but it is important that APEC begin building consensus on the APEC goal and then start incremental construction by “melding” (rather than harmonizing or docking) together core groups and legally binding pacts.

To realize the potential of an FTAAP, the first step is for the US and the other major APEC powers, especially the PRC and Japan, to endorse and embrace the long-term vision. The most salient criticism of an FTAAP to date has been that “it will never fly” with the big countries. Morrison (2007, p. 7), for example, concludes that “negotiation of a high-quality FTAAP is not politically feasible at present or in the near term.”<sup>6</sup> The US is key: Not only is it the largest APEC economy and trading nation, but it is the traditional leader, to which most of the other members look, on trade policy issues at the global and regional levels. It was the chief driver of the Bogor goals at the prior Seattle leaders’ meeting and at Bogor itself and of their very positive interaction with the Uruguay Round in the GATT.

FTAAP has received support, rhetorically at least, at the highest levels.<sup>7</sup> To date, however, the summit declarations have been hortatory. This is not surprising given (1) APEC’s track record of inability to surmount collective action problems, and (2) the numerous political obstacles that stand in the way of successfully implementing the FTAAP, particularly the deteriorating political environment for constructive trade policy in the US. Fundamentally, these problems reflect the increasing skepticism toward trade liberalization at the popular and elite levels, and the increasing political partisanship surrounding trade policy in the US (Destler 2005; Layman, Carsey, and

<sup>6</sup> Aggarwal (2007) reaches a similar skeptical conclusion arguing that the US can no longer be counted on to support any large multilateral trade liberalization—a critique that applies equally to the Doha Round as well as to an FTAAP.

<sup>7</sup> At their annual summit in Viet Nam in November 2006, the leaders of the 21 members of APEC agreed to “seriously consider” an FTAAP negotiation and instructed their officials to “undertake further studies on ways and means to promote” the initiative; they subsequently agreed in the 2007 summit to continue assessing the idea as a long-term proposition. In a speech just before the 2007 APEC summit, US President George W. Bush echoed the call for “serious consideration” of the idea, Japan welcomed the idea along with its own recent proposal for an “economic partnership agreement” among the 16 leading Asian countries (including India, which is not a member of APEC). Australia, which played a key role within APEC reiterated its support, as did Canada and Mexico, two of the six largest APEC economies and traders, and several of the smaller members. A number of smaller APEC member economies, including Australia, Chile, New Zealand, Singapore, and Taipei, China, had endorsed an FTAAP at the APEC summit in Santiago in 2004 “if the large countries were to do so as well.” The initiative has been actively promoted by APEC’s Business Advisory Council since 2004 as the only means by which APEC could achieve its signature Bogor goals, adopted in 1993 and reaffirmed every year since (including at Sydney), of achieving “free and open trade and investment in the region.”

Horowitz 2006; Kupchan and Trubowitz 2007). A 2008 poll by the Pew Center for the People and the Press concluded that “Americans express increasingly negative opinions toward the World Trade Organization and free trade agreements such as NAFTA. In the current survey, a 48% plurality says that free trade agreements are a bad thing for the country, compared with 35% of the public who call them a good thing. Last November [i.e. 2007], opinion about free trade’s impact on the country was evenly split; for the previous decade, modest pluralities said that free trade agreements were good for the country. There is now a broad agreement that free trade negatively affects wages, jobs, and economic growth in America” (Pew Center 2008).

The Pew Center results of deteriorating popular support for trade are generally reinforced by the limited amount of longitudinal polling on the topic (Figure 1).<sup>8</sup> It is possible that this decline in support for trade represents a temporary dip rather than a permanent shift in attitudes; evidence suggests similar trade skepticism existed during the 1992 US recession that was followed by Congressional passage of NAFTA and the Uruguay Round agreement.

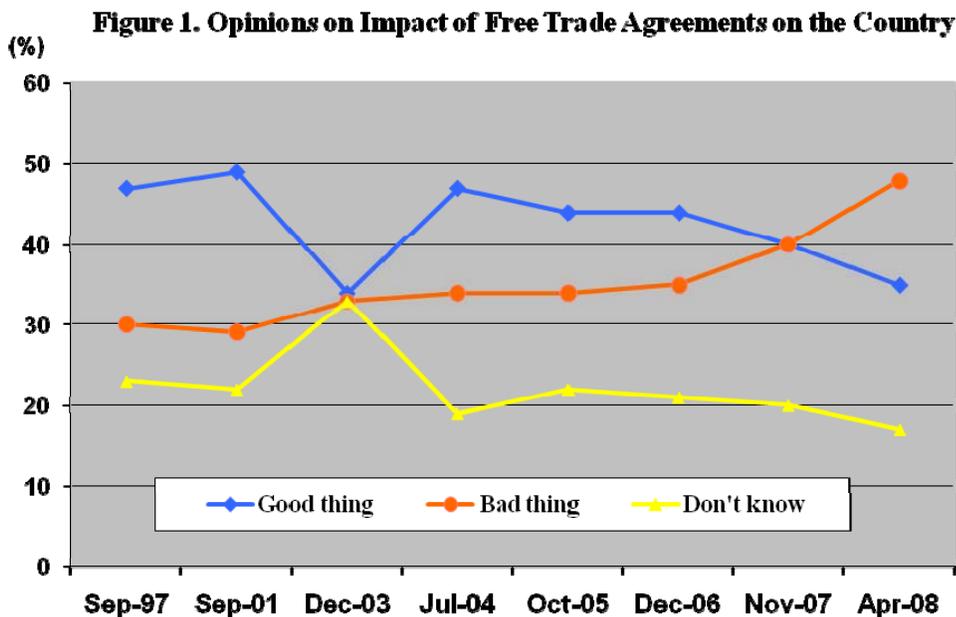
The 2008 Democratic Party statement on trade reaffirms the party’s commitment to achieving a successful completion of the Doha Round and strengthening the rules-based multilateral system.<sup>9</sup> But the document says very little about liberalization per se; instead, its focus is on emphasizing enforcement of foreign government obligations of existing agreements, including provisions on labor, environment, and safety standards in trade agreements, and combating currency manipulation. Such priorities presage sharp trade confrontations with the PRC in particular as well as other developing countries. It says nothing about other potential regional initiatives such as the FTAAP.<sup>9</sup> Such evident apprehensions inevitably will be intensified by financial market turmoil and deteriorating macroeconomic performance in the US.

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<sup>8</sup> See also PollingReport.com [www.pollingreport.com/trade.htm](http://www.pollingreport.com/trade.htm).

<sup>9</sup> Democrats are much more trade skeptical than Republicans, with solid majorities holding negative views. Republicans are essentially evenly split, 43% v. 42% in support of FTAs (Pew Center 2008).

<sup>9</sup> By contrast, the Republican Party platform essentially endorses current US trade policy and calls for prompt congressional action on the pending FTAs.



Source: May 2008 Pew Research Center

Operationally, the near-term prospects for US trade liberalization at either the global or regional level has been dimmed by the expiration of “fast-track” negotiating authority. The “fast-track” procedure pre-commits the Congress to a simple up or down vote on implementing legislation—without amendment and within a specified time frame. Given the increasingly fractious US trade politics, it is highly unlikely that—in the absence of such expedited procedures—trade accords with major partners could be successfully concluded and enacted. US credibility was dealt a blow in April 2008 by the Congressional decision to alter the fast-track rules ex post in the case of the US-Colombia FTA (Bergsten 2008). Some in Congress argue that the Colombian case is unique and should not set a precedent for other fast track cases. However, what matters in this context is not attitudes on Capitol Hill, but rather whether foreign governments will hold back in trade negotiations with the US for fear that the negotiated deal will be reopened before a Congressional ratification vote. In other words, US trading partners will be the ultimate arbiters of how badly the Congress has damaged US negotiating credibility.

Among APEC members, the US has ratified free trade agreements with Australia, Canada, Chile, Mexico, Peru, and Singapore—a “network” that is in large part reproduced among the US FTA partners (Hufbauer and Schott 2007, figure 1). But negotiations with several other Asian countries, including Malaysia and Thailand, have stalled.<sup>10</sup> The fate of the Korea-US pact is key. Successful implementation of that agreement would simultaneously encourage Japan to restart stalled FTA negotiations with Korea, and to pursue similar negotiations with the US. For now, agriculture in Japan and manufacturing in the US remain large obstacles to a comprehensive Japan-US FTA, though US officials have indicated an interest in pursuing such a

<sup>10</sup> Indonesia has been touted as a possible partner as well (Hufbauer 2007).

deal once Japan is ready to put agriculture seriously on the table, as Korea has done. In the near-term, a more limited pact focusing on trade and investment liberalization in services may be all that both governments can swallow. Over time, however, we believe that Japan's inclusion into this APEC subgroup is a plausible outcome, given the country's FTAs or weaker economic partnership agreements (EPAs) with Chile, Malaysia, Mexico, Singapore, and Thailand, as well as others in progress.<sup>11</sup>

In practical terms negotiation of an FTAAP is more likely to be achieved by building outward from an initial "coalition of the willing" core to eventually encompass all APEC members, rather than an "all in" negotiation from the outset.<sup>12</sup> Because the underlying economic conditions are so different in APEC countries, the process of developing consensus will be laborious and evolutionary. But the task is doable, and APEC members are examining different approaches to this end.

One option is to build on the precedents of existing trade pacts and gradually enlarge membership via accession or "docking." ASEAN is essentially, albeit slowly, following this strategy through its "10+1" pacts that set ASEAN as the core of the regional process. More recently, Singapore and its P-4 partners Brunei Darussalam, Chile, and New Zealand, suggested that their more comprehensive FTA, stitched from the fabric of the US FTAs with Chile and Singapore, could provide the seed of APEC free trade by offering "docking rights" to APEC members willing to accept the obligations of the existing agreement. In September 2008, the US agreed to negotiations on a Trans-Pacific Strategic Economic Partnership Agreement with the P-4 countries, with the expectation that "other nations that share our vision of free and fair trade" would soon join the pact (USTR 2008).

Is "docking" a viable strategy? There are two distinct precedents: the agglomeration of the EU over the past half century, and the addition of the Dominican Republic into the FTA between Central America and the US. In most instances, however, such knitting hasn't worked for simple economic and political reasons. On the economic side, expanding the geographic area of a free trade zone effectively dilutes remaining protection for domestic industries and is thus strongly resisted. On the political side, the rules of origin—different in each agreement—are meant to restrict competition and to provide side payments to domestic companies. National legislatures are loathe to reduce such protection without additional compensation from trading partners.

The most practical approach to dealing with the rules of origin problem is harmonizing MFN tariffs over time down to the level of the low tariff country. Among some APEC partners, such harmonization is probably feasible; indeed, Hufbauer and Schott (2007) suggested that approach in the NAFTA context. But implementing such a policy among a more diverse group would be much more complicated, especially since many of the APEC members maintain their MFN tariffs to buffer their domestic industries from Chinese competition. Hill and Menon (2008) make suggestions as to how rules of origin could be diluted as an interim step.

Alternatively, a "pathfinder" agreement could be negotiated among all members, with only a subset initially assuming obligations and others joining later (see Scollay

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<sup>11</sup> In September 2008, Japan concluded EPA negotiations with Switzerland and Viet Nam.

<sup>12</sup> At the commencement of the APEC strategizing in 1993 that ultimately produced the Bogor goals, Senior Minister Lee Kuan Yew of Singapore proposed that the US open NAFTA to accession by all APEC members and argued that, since some would immediately accept, the entire membership would eventually have to do so via the logic of competitive liberalization. Some Asian nations have recently suggested that other APEC members could "dock" onto the P-4 FTA that has been agreed by Brunei Darussalam, Chile, New Zealand, and Singapore, but this grouping is clearly too small to provide a foundation for APEC-wide arrangements.

2004). In other words, an FTAAP could be started by less than the full membership of APEC. There is some precedent for such “21-x” and “pioneer” initiatives within APEC, albeit in more limited areas such as the APEC Business Travel Card Program and the initial construction of the WTO’s Information Technology Agreement, which proceeded with coverage of 80% to 90% of the relevant trade (and most-favored nation extension to the rest despite their free-riding). The probably fatal problem with a “pathfinder” approach to negotiating an FTAAP is the prospect that one or more countries would play spoiler roles, subverting negotiations on the expectation that their likelihood of joining was low and potential losses in the interim might be high.

In applying any of these strategies, APEC members need to recognize the threat of creating new fissures in the group. Risks include splitting the Asia-Pacific region along the lines of relatively high income, trade liberal economies, and lower income more protectionist ones, exacerbating the PRC-Japan rivalry dividing Asia between a littoral coalition and a PRC-dominated continental bloc, and intensifying PRC-US tensions. In that regard, such an APEC initiative could add a trade policy dimension to concerns that the US was seeking to “surround” the PRC, which finds echoes in intensified security cooperation with Australia, India, and Japan, among others, as well as proposals for “A League of Democracies” at the political level. Unless properly managed, these developments could trigger Chinese pushback in the trade, security, and diplomatic spheres, and as a consequence, the expansion of the coalition to include the PRC would be the top priority, despite Hufbauer and Schott’s (2007) observation that “no American or Japanese politician wants to talk about free trade with [the PRC]—even as a long-term proposition” (page 36).

For its part, the PRC has expressed skepticism about an FTAAP. It cites two concerns: a possible adverse effect on the Doha Round and a delay in implementing APEC’s Bogor goals. Previously, the PRC did not show much interest in Doha, but at the WTO ministerial meeting in Geneva in July 2008, the PRC joined the organization’s inner steering committee. It seemed that the PRC would be willing to help promote a fruitful outcome. But the PRC, far from supporting liberalization, has used its leadership position to join India in seeking new protection beyond the red lines of most of the other participants, including many developing countries. Hence the PRC’s concerns must lie elsewhere, including the possibility that it is not ready to accept the depth of liberalization envisioned in the agreement, particularly in relation to Japan and the US.<sup>13</sup> Such an interpretation might be reflective of the Politburo’s 25 July 2008 statement underscoring the political imperative to maintain growth—and employment growth—over other economic considerations.

Another problem may be the inclusion of Taipei,China in an FTAAP. In APEC initiatives, the PRC has accepted dealing with Taipei,China in a consultative forum but has objected to formal initiatives that involve legal obligations that would convey a sense of legitimacy on its government. These political concerns trump the competitiveness issues in an FTAAP. Nonetheless, Sheng (2007, p. 95) opines that the PRC might “join the FTAAP at a later date” if it proceeded without it at the start.

Such considerations would be short-sighted on the PRC’s part in light of its escalating trade conflicts with the US and other APEC members. These conflicts are growing and will escalate as the PRC maintains robust growth. The PRC’s large

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<sup>13</sup> It is possible that the PRC wants to preserve Bogor’s distinction between advanced countries and self-declared developing countries (which are given until 2020 to do so). It is also possible that, in regard to FTAAP, the PRC mainly wants to continue emphasizing its bilateral and regional trade pacts with other Asian countries, which are undertaken primarily for political reasons and are of low economic quality, instead of pursuing an FTAAP with its broader geographical scope and presumably higher standards. Perhaps it is reluctant to include Taipei,China, which has been accepted as a full participant in all APEC activities since 1991 so long as they are clearly “economic” rather than “political.”

trade surpluses and trade barriers will likely provoke remedial trade actions by the US and other industrial countries. These problems could be at least partly defused if the PRC entered into comprehensive liberalizing and rule-making negotiations via an FTAAP.<sup>14</sup>

Moreover, if most APEC members support the idea, the PRC would not want to be viewed as throwing its weight around by blocking the initiative. Recall that PRC President Hu Jintao did not dissent from the agreement of the leaders at Hanoi in 2006 to commission studies of an FTAAP and the PRC's definitive view is yet to emerge.<sup>15</sup> Typically, Asian countries have acceded to studies of possible trade initiatives because this approach leaves open the option to proceed or to defer action. In other words, countries do not have to invest political capital in either supporting or killing the proposal while academics and government officials proceed with their advance assessments. But it is noteworthy that, in a recent study that simulates the gains to the PRC from pursuing a series of regional trade pacts, the authors conclude that the PRC's "benefit increases along with the increase in coverage of the FTAs, that is the APFTA [FTAAP] has the biggest positive impact on the [PRC] economy, among the three FTAs considered in this study" and that the PRC would lose by not joining an FTAAP (Jiang and McKibbin 2008, p. 1).

That leaves the issue of ASEAN. Politically there is probably something to be gained by negotiating with ASEAN, building on the existing ASEAN free trade agreement, and establishing a "variable speed" geometry in which the more advanced ASEAN countries would take on their obligations more quickly than the less advanced members. In some sense this has occurred—despite their pan-ASEAN rhetoric, Malaysia, Thailand, and Singapore are in various stages of completing preferential agreements with the US and other partners bilaterally. The recent rapprochement between ASEAN and Australia and New Zealand over linking AFTA with their Common Economic Region may provide a political template.

#### **4.1 Embedding the US-PRC relationship in a broader regional rubric**

The international and domestic politics of the FTAAP issue in the US will thus turn importantly on how it will be seen as affecting the US-PRC relationship. That relationship is clearly on a very risky path. The large trade imbalance (\$262 billion in 2007) is irrelevant per se in economic terms but toxic in domestic political terms.<sup>16</sup> Paralleling the case of Japan in the 1980s, the politicization of trade policy in the US has spilled into the exchange rate arena as well (Noland 2004, Frankel and Wei 2007). In this regard, the explicit mention of currency manipulation as an unfair

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<sup>14</sup> The PRC has taken steps in that direction by concluding FTAs with Chile, New Zealand, and Singapore, effectively linking itself to the core P-4 group.

<sup>15</sup> The most authoritative Chinese statement to date on an FTAAP concludes that the PRC "would undoubtedly benefit from joining a [high-quality] agreement and therefore would be likely to join," though it also expresses skepticism with respect to achieving this outcome, and concludes that the PRC's trade policy priority is clearly its regional FTAs (Sheng 2007, 91).

<sup>16</sup> The PRC can make a powerful case that its trade policy is not a major problem. It is one of the most open of all developing countries: Its trade to GDP ratio is more than 60%, double that of the US and triple that of Japan. Its realized tariff average, the ratio of its customs collections to GDP, was 2.2% in 2004. Even its nominal tariff average is only about 10%. Virtually all import quotas have been eliminated, and licensing schemes are being simplified. The PRC needs to follow through more aggressively on some of its WTO commitments, especially with respect to intellectual property rights and some of its other regulatory policies, and would be well advised to respond to the external pressures by leading a new effort to successfully conclude the Doha Round. But its overall trade policy regime is not the main problem (Bergsten et al. 2006, chapter 4).

trading practice in the Democratic Party platform in August 2008 is notable. Such trends are likely to intensify because the US Congress will insist on it.

The central strategic issue for the US, with respect to PRC policy, as well as overall trade and foreign economic policy, is how best to head off the potential confrontation. The relationship between the US and the PRC is akin to strategic rivalry, and as a result the PRC is likely to react very differently to US pressure than Japan did a generation ago. Japan and the US had no real alternative to highly politicized dispute resolution, and in this regard the establishment of the WTO and the prospect of relatively depoliticized dispute settlement according to pre-established rules and procedures represents real progress. But while resorting to the WTO dispute settlement mechanism can help resolve many particular quarrels, the WTO rules do not cover some of the key issues.

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

In addition, APEC members need to be cognizant of the potential problem that could arise as a result of proliferating Asian regionalism and new US FTAs. None of the Asian regional deals include Taipei,China, but many of them discriminate against Taipei,China exporters. This is also true of the Korea-US FTA and prospectively of a US-Japan FTA; these countries have a similar manufacturing export profiles and trade preferences provided by these pacts could thus divert trade from Taipei,China suppliers. Economic frictions may then exacerbate political tensions in East Asia (Schott and Goodrich 2004).

It would be advisable for the PRC and the US to embed their trade policy tensions into a broader, less politicized context that would reduce the perception in both countries of trade issues as a bilateral zero-sum struggle, defuse disputes, and offer the promise of the elimination of most or all barriers between them. The WTO system offers one such possibility, regional initiatives another. For the US, the standard logic that has always persuaded Congress to support such agreements would again prevail: That the partner country's barriers are higher and in a mercantilist sense the US can only gain on balance from their mutual elimination, even if further adjustment is required in a few US sectors.<sup>17</sup> Other APEC members, who share the US desire to reduce the PRC's import restrictions and other governmental trade intervention, might be expected to support most of the US agenda. For the PRC, a liberalization of its remaining restrictions that was phased in over time would produce the culmination of its brilliant strategy to join the WTO in the first place: full integration with the world economy with the catalyzing effect thereof on its domestic reform process and the creation of the globally competitive firms.<sup>18</sup>

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<sup>17</sup> The US must also do a better job of supporting that adjustment and cushioning the transition costs for displaced American workers. A comprehensive agenda is proposed in Bergsten and the Institute for International Economics (2005, especially chapters 1 and 10).

<sup>18</sup> A technical but very important question is the differing concept of "FTAs" maintained by the US and other APEC members such as Australia, Canada, Chile, New Zealand, and Singapore on the one hand, and by the PRC and several other Asian nations on the other. The former group insists on "high-quality" FTAs, though they sometimes falter in practice as when sugar was excluded from the Australia-US agreement, whereas the latter define "free trade" more loosely and seem to place overriding emphasis on political considerations. These differences would have to be addressed in seriously considering an FTAAP. So would some of the US deviations from its own high-standard principles such as the "yarn forward" concept that dominates the rules of origin for textile and apparel

## 4.2 What if the US cannot liberalize?

The US, as a post-industrial economy, strongly emphasizes beyond-the-border issues such as investment and services, which are more difficult to negotiate than more traditional border measures such as tariffs that are the focus of intra-Asian deals. The US penchant for loading labor standards and environmental concerns into these agreements creates a situation in which the hurdle of negotiating an FTA with the US is higher than other potential partners, particularly the PRC.

Through the process of diverting trade from globally efficient producers to less efficient, though preferentially favored producers in signatory countries, preferential agreements can potentially harm both signatories and third parties alike. The prospect of being adversely affected by discriminatory deals in Asia (especially those involving the large economies of Northeast Asia) might possibly constitute a “wake-up call” for the US Congress, forcing the US to reassess its stance and adopt a more forthcoming posture.

The most constructive course would be to re-emphasize global liberalization through the WTO and thereby reduce the value of preferential deals. Alternatively, the US could play tit-for-tat either by trying to match or join the Asian initiatives, or by expanding its own web of preferential agreements. The FTAAP could be a cornerstone of such a strategy. Either option assumes that the US has the political capacity to liberalize trade.

## 5. CONCLUSION

The FTAAP initiative represents a politically ambitious, high potential benefit option for achieving Asian regional integration. Among its desirable attributes, the FTAAP initiative could help revive and promote a successful conclusion of the Doha Round negotiations; constitute a “Plan B” hedge if the July 2008 bust-up in Geneva marks the permanent failure of the Doha Round; short-circuit the further proliferation of bilateral and sub-regional PTAs that create substantial new discrimination and discord within the Asia-Pacific region; defuse the renewed risk of “drawing a line down the middle of the Pacific” as East Asian, and perhaps Western Hemisphere, initiatives produce disintegration of the Asia-Pacific region rather than the integration of that broader region that APEC was created to foster; channel the PRC-US economic conflict into a more constructive and less confrontational context; and revitalize APEC, which is of enhanced importance because of the prospects for Asia-Pacific and especially PRC-US fissures.

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

That earlier effort foundered in the insistent embrace in some quarters of non-conditional and non-reciprocal liberalization under the slogans of “open regionalism” and “concerted unilateralism”—a stance that did not comport with the economic interests of the major players and was a political non-starter in nearly all national

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trade in US FTAs and would represent a hurdle to rolling existing US agreements into a single FTAAP.

capitals. Since then nearly all the APEC members have negotiated traditional reciprocal trade deals with each other. An incremental approach to the FTAAP, explicitly embodying enforceable reciprocal commitments, offers the best hope of overcoming this fatal conceit and delivering on the concept's abundant benefits.

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