

A New Strategy for APEC

C. Fred Bergsten
Director, Institute for International Economics

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The Economic Crisis Facing the Asia Pacific

The countries of the Asia Pacific region face a series of major economic problems. First, the region's two largest economies,¹ *China and the United States, are headed toward a major clash as early as this fall.* China's soaring global current account surplus will probably approach \$150 billion and 7½ percent of its GDP this year, becoming the largest single counterpart to the US global current account deficit of about \$800 billion or almost 7 percent of its GDP. Unless China promptly revalues the renminbi by at least 10 to 15 percent, and preferably 20–25 percent, the Treasury Department will almost certainly and justifiably² label China as a “currency manipulator” in October and be compelled by US law to institute strong measures to induce it to act.

Absent a substantial Chinese revaluation, the Senate is likely to pass the Schumer Amendment, which would impose an across-the-board surcharge of 27.5 percent on all imports from China.³ The House of Representatives already passed anti-China trade legislation in July. Chinese retaliation against such new restrictions by the United States, were they ever to become law, would be both probable and justified. *The result would be a trade war between the two chief locomotives of the world economy.*

But China-United States economic relations are on a collision course even if the current impasse over exchange rates can be resolved. Bilateral imbalances are economically irrelevant but politically explosive and China's trade surplus with the United States now exceeds an annual rate of \$200 billion. US imports from China are six times as large as US exports to that country so the imbalance will almost certainly continue to grow. The United States has already imposed substantial new barriers to Chinese exports in six sectors and more such restrictions are coming. Moreover, there are widespread fears in the United States that China is moving rapidly up the technology ladder and strong emotional reactions to China's scramble to secure dedicated supplies of energy, as dramatized by the recent de facto Congressional rejection of CNOOC's bid for Unocal. Numerous political and security problems, most sensitively of course relating to Taiwan, add to this worrisome picture.

Second, when President Bush visits Seoul after this year's APEC summit, the United States and Korea are likely to initiate negotiations for a bilateral free trade agreement. This would be the first bilateral FTA between the United States and any Northeast Asian, or indeed any large Asian, economy. I strongly support such an agreement and our Institute for International Economics, at the request of Deputy Prime

¹ With exchange rates calculated at purchasing power parity.

² See Morris Goldstein “The International Financial Architecture,” in C. Fred Bergsten and the Institute for International Economics, *The United States and the World Economy: Foreign Economic Policy for the Next Decade*, Institute for International Economics, Washington, January 2005.

³ For details on these likely US developments, and an elaboration of the needed remedies, see my “The Trans-Pacific Imbalance: A Disaster in the Making?” also prepared for PECC XVI.

Minister Han-Duck Soo when he was Minister of Trade in 2000, prepared one of the first analyses of its effects.⁴

But Japan, in light of the trade diversion it would suffer from a US-Korea FTA, and even more importantly the broad foreign policy implications of such a step, will then almost certainly seek and receive an FTA negotiation of its own with the United States.⁵ The United States may simultaneously be launching FTA talks with one or more Southeast Asian countries, most likely Indonesia and/or Malaysia. *China is likely to perceive such a series of US initiatives as a “surround China” or even “containment” strategy in the economic domain, intensifying its concerns over the “surround China” strategy that the United States is already pursuing in the security domain, raising fundamental problems for trans-Pacific relations and exacerbating the more immediate United States–China conflict already noted.*

Third, the evolution toward an East Asian Free Trade Area, whether it is ever called that or not, has accelerated with the further proliferation of FTAs in the region. Virtually every possible combination of countries in East Asia, with the exception of Taiwan for obvious political reasons, is engaged in FTA negotiations or preliminary talks or at least officially sponsored studies.⁶ The huge trade (and perhaps monetary) bloc that could result would discriminate sharply against outsiders, costing the United States alone at least \$25 billion in lost exports immediately and much more over time.⁷ This process could receive a strong political push from the Asian summit that will be held in Malaysia later this year.

At the same time, the United States has just extended its own FTA network in the Western Hemisphere beyond NAFTA to include Central America. It will soon complete an FTA with the Andean Pact countries. It continues to pursue a Free Trade Area of the Americas.⁸ *The result of these regional developments in both East Asia and the Americas could be the famous “drawing a line down the middle of the Pacific,” with profound security as well as economic implications for all countries on both sides of the ocean.*

The APEC Solution

The only idea that has arisen so far for responding constructively to this series of looming clashes is a renewed and serious commitment by the countries of the Asia Pacific region, especially the largest ones, to the Bogor goals to achieve “free and open trade and investment in the region” as a whole and to APEC as an institution.

At last year’s summit in Santiago, the APEC Leaders noted that their APEC Business Advisory Council (ABAC) “presented two relevant proposals... [including] a study of the feasibility and potential scope and features of a Free Trade Area of the Asia Pacific.” They “welcomed the reports from our business community, including ABAC’s resolve for expanding trade” and “invited ABAC to provide its views... on the benefits and challenges that arise for business from the increasing number of RTAs/FTAs in the region and ways that these can be addressed.” A number of Leaders including reportedly from Australia, Canada, Chile, New Zealand, Singapore and Taiwan supported the Free Trade Area of the Asia Pacific (FTAAP) idea,

⁴ Inbom Choi and Jeffrey J. Schott, *Free Trade Between Korea and the United States?* (Institute for International Economics, Washington, April 2001), as updated in Inbom Choi and Jeffrey J. Schott, “Korea-US Free Trade Revisited,” in *Free Trade Agreements: US Strategies and Perspectives*, Jeffrey J. Schott, ed., Institute for International Economics, Washington, April 2004.

⁵ Choi and Schott, p. 67, concluded in 2001 that “Japan would likely suffer larger welfare losses than other countries from trade diversion generated by a Korea-US FTA” and that formation of a Korea-US FTA could create “strong pressure on Japan to negotiate FTAs with the United States or Korea. Indeed, if the United States and Korea merely announce their intention to explore an FTA, it could be bigger news in Tokyo than in Washington.”

⁶ For an up-to-date summary, see Gary Hufbauer and Yee Wong, “Prospects for Regional Free Trade in Asia,” a paper presented at the 8th Annual RAND-China Reform Forum Conference, June 28-29, 2005. See also my “Embedding Pacific Asia in the Asia Pacific: The Global Impact of an East Asian Community,” presented at the Japan National Press Club, September 1.

⁷ Derived from Robert Scollay and John P. Gilbert, *New Regional Trading Arrangements in the Asia Pacific?*, Institute for International Economics, Washington, May 2004.

⁸ Which has stalled for the last year but is likely to revive with a successful conclusion of the agricultural component of the Doha round.

but the largest members, including China and the United States, did not and hence no action was taken. Fortunately, however, a careful and balanced study of an FTAAP has been carried out by Robert Scollay from the PECC Trade Forum, taking account of comments from other members of the Forum,⁹ so an initial prerequisite for proceeding to negotiations exists.

The question before this panel is: “Squaring FTAs with the Bogor Goals: How Can it be Done?” The honest answer is that it can *only* be done, over time, *by rolling the individual FTAs and Economic Partnership Agreements (EPAs) and otherwise-named subregional trade agreements into a single Free Trade Area of the Asia Pacific.*

Only an FTAAP can avoid a severe risk of “drawing a line down the middle of the Pacific” as East Asia and the Western Hemisphere proceed toward creating their separate regional blocs. *An FTAAP would embed both Pacific Asia and the Americas in the Asia Pacific and obviate the risk of disintegration of the APEC region.*

Only an FTAAP can avert the intensification of hostility between the United States and China if each pursues a series of bilateral and subregional FTAs that discriminate against the other and pose geostrategic concerns as well, including China’s likely perception that the United States is pursuing a “surround China” strategy in both economic and political terms.

There is no prospect for a bilateral FTA between China and the United States.¹⁰ An FTA between the United States and the three powers of Northeast Asia, which some have proposed, would discriminate heavily against the rest of Asia and other parts of the world. Hence *only an FTAAP can subsume into a broader and cooperative context, including orderly dispute settlement mechanisms, the growing bilateral trade and other economic disputes between the United States and China that are leading those two economic superpowers toward major conflict* that will inevitably have huge spillover effects on the entire region.

US officials have resisted supporting an FTAAP primarily because it would imply free trade with China, albeit in a broader regional context, and there is no doubt that it would be a major challenge to win congressional approval of the idea. In practice, however, the same economic arguments that have led the Congress to support every previous FTA and multilateral trade round negotiated by subsequent US administrations should prevail: the United States must avoid the discrimination against its trade that would result if it did not pursue liberalization with the chosen partner(s), and the US market is already largely open so the country can only gain from an agreement that eliminates barriers in the partner countries as well. The US business community, which along with the administration must ultimately push all trade agreements through the Congress, would be strongly supportive of an FTAAP—far more than any WTO negotiation—because of its major market-opening potential. The United States ultimately decides all its trade policy initiatives on broad strategic and foreign policy grounds, however, and the considerations outlined here vis-à-vis China in particular and East Asia as a whole should thus be decisive. The administration will have to take a forceful lead on the issue, however, and work hard to convince the Congress and the American public of the merits of the idea.

Finally, *only the launch of an FTAAP process by APEC seems likely to galvanize a substantively meaningful outcome for the badly faltering Doha Round* in the World Trade Organization. Such an external jolt in 1993, in the form of the initial APEC summit at Seattle and declaration of the Leaders’ intention to pursue free trade in the region, played a central role in bringing a successful conclusion to the Uruguay Round and the creation of the WTO. A similar jolt is needed at least as badly now to stimulate a similar outcome for the current negotiation.

If the Leaders at Busan in November are not ready to launch at least a serious study of an FTAAP, as proposed by the ABAC a year ago, the best alternative would be to proceed with the large new trans-Pacific FTAs between (1) the United States and Korea and (2) the United States and Japan. This approach would be risky because of its impact on China, as noted above, and because it could ultimately “draw a line” *within* Asia

⁹ The Trade Forum as a whole was regrettably unable to reach consensus on the paper so it was submitted on the sole responsibility of the author.

¹⁰ The United States Administration can contemplate bilateral FTAs with Korea and Japan but not with China because only China of the three, like Mexico and even Central America before it, raises the three objections that create fundamental problems for congressional approval: most importantly low-wage competition but also low labor standards and low environmental standards. These problems would of course still exist in a regional agreement but would be much less prominent and more diffused among the broader range of countries involved.

that could increase tensions there. But it would augment the small trans-Pacific FTAs that are already in place (Japan-Mexico, Korea-Chile, United States–Singapore), help avoid “drawing a line down the middle of the Pacific” for at least a while, lay the foundation for a larger APEC effort in the future, and perhaps provide “competitive liberalization” pressure on China to take the lead in pursuing the FTAAP itself. They could be pursued simultaneously with an effort to reinvigorate the Doha Round and, though their jolt to the WTO would be smaller than an FTAAP launch, might succeed in galvanizing it to greater substantive success.

The Role of the PECC

During the 1980s, the PECC provided the intellectual foundation for the creation of APEC itself. The regional and global contexts have changed dramatically since that time and APEC, after a promising start in the mid-1990s, has lost its momentum and sense of purpose.¹¹ PECC’s intellectual leadership is needed once again to propose strategies for the region, and for APEC, that will respond effectively to the current formidable challenges faced by both.

A revival of APEC via launching negotiations for a Free Trade Area of the Asia Pacific is the most promising possibility that has so far come to light. A careful assessment of that approach has already been prepared under the auspices of the PECC Trade Forum. The largest countries in the region, notably including the United States, must still be persuaded to endorse it. But opponents of the idea must come up with credible alternatives, rather than simply reject the FTAAP, if they are to contribute helpfully to the debate.

With APEC now faltering badly, and the region facing the enormous challenges and risks outlined here, the PECC has an opportunity to again provide the intellectual leadership that is badly needed to revive both the policy and institutional processes. I hope that this PECC XVI will begin to do so and that APEC will again be receptive to outside advice that could help it cope with the enormous challenges that it will continue to face for the foreseeable future.

¹¹ See my “Toward a Free Trade Area of the Asia Pacific,” presentation at the APEC CEO Summit, Santiago, November 2004.