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## **Making an FTA work**

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### Toward a Free Trade Area of the Asia Pacific

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At their latest annual summit in Vietnam in November 2006, the leaders of the 21 members of the Asia Pacific Economic Cooperation (APEC) forum launched a process that could ultimately produce the largest single act of trade liberalization in history. They agreed to "seriously consider" negotiating a Free Trade Area of the Asia Pacific (FTAAP) and instructed their officials to "undertake further studies on ways and means to promote" the initiative so that they could address it at their next summit in Australia in September 2007.

The APEC members account for more than half the world economy and about half of world trade. Hence any agreement that approached free trade among the group would be even more far-reaching, in trade terms, than the European Union or the North American Free Trade Agreement (NAFTA). It would be much more extensive than any of the global liberalizing compacts previously negotiated in the General Agreement on Tariffs and Trade (GATT) or envisaged in the current Doha

Round in the World Trade Organization (WTO). Doha remains highly desirable, of course, and the APEC leaders reaffirmed their commitment to its success, but the FTAAP would be by far the best available "Plan B" to restart widespread trade-liberalizing momentum if the multilateral process fails to proceed in Geneva.

The FTAAP idea has been actively promoted by the APEC Business Advisory Council (ABAC) 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 Hanoi), of achieving "free and open trade and investment in the region." It has suddenly become a focal point of official activity because of major shifts in policy positions by several key member economies.

The United States took the lead in promoting the initiative, and the leaders unanimously endorsed President George W. Bush's call to give it "serious consideration" in a speech in Singapore just before the summit. 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 will play a key role as chairman of APEC over the coming year, reiterated its support. So did Canada and Mexico, two of the six largest APEC economies and traders, along with several smaller members.<sup>1</sup>

This enhanced interest in a new Asia-Pacific trade initiative is in turn motivated by five major developments. First, the lassitude of the Doha Round negotiations raises major doubts about the viability of worldwide liberalization and even the WTO as an institution. Second, especially for the United States, the increasing momentum toward trade liberalization within Asia itself raises the specter of major new discrimination and an unstable three-bloc world that could, in the memorable words of former Secretary of State James Baker, "draw a line down the middle of the Pacific." Third, the even wider proliferation of bilateral and subregional preferential trade pacts, which is likely to acceler-

1. A number of smaller APEC member economies had already endorsed the FTAAP at the APEC summit in Santiago in 2004 "if the large countries were to do so as well." This group includes at least Australia, Chile, New Zealand, Singapore, and Taiwan.

ate if Doha indeed fails, will further erode the multilateral system; those who worry about the “spaghetti bowl” of such deals should strongly support an FTAAP, which can subsume many of them under a single umbrella. Fourth, even the Asians skeptical of the specific FTAAP idea welcome the active engagement of the United States in the region via such a bold new initiative. Fifth, APEC has floundered badly in pursuing its own liberalization goals and has been totally ineffectual in supporting Doha. The FTAAP initiative provides an effective response to all five concerns.

APEC’s consideration of the FTAAP possibility needs to move ahead quickly for a series of reasons. Perhaps the most important is that serious APEC pursuit of an FTAAP is the most likely spur to resumption of the Doha Round negotiations. The countries that represent the primary barriers to a

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successful Doha Round all lie outside APEC: the European Union, Brazil, India, and some of the African nations. Hence the prospect of a new APEC liberalization initiative would strengthen the outlook for Doha by focusing the recalcitrants on the risk of facing substantial new discrimination if they continue to block a successful WTO outcome. This prospect is even greater than at the final stages of the Uruguay Round, when “only” the European Union needed to be shocked into cooperation by the “free trade in the region” commitment of APEC’s initial Seattle summit. To achieve this result, APEC will have to advance from the current stage of “serious consideration” and “further studies” of a “long-term prospect” to active discussion, and preferably full-fledged negotiation, of the concept.

The FTAAP initiative also needs to proceed swiftly because of the domestic political situation in the United States, intensified by the sweeping victory of the Democrats in the latest congressional elections. It was always going to be difficult for the administration to win extension of the president’s trade

promotion authority (TPA) when it expires in the summer of 2007, without which the United States cannot participate in any significant international commercial negotiations. But that prospect is now even more daunting. The administration will have to present a realistic prospect for at least one major trade initiative if it is to have any chance of obtaining congressional approval. Failure or continued suspension of Doha, or even progress toward a mini-package for the round that would provide few tangible benefits for the United States, would leave the FTAAP as the only candidate to play that role. America’s trading partners in the Asia-Pacific region have a deep interest in the extension of TPA, to keep the United States engaged in liberalizing trade initiatives and to maintain active US participation in their region, and can substantially boost that prospect by accelerating APEC’s movement toward an FTAAP in early 2007.

In addition, the prospect of a Democratic president in 2009 raises questions concerning the attitude of the next administration, in addition to Congress, toward pursuing proglobalization initiatives. Hence it would behoove US trading partners to engage in an active FTAAP process with the supportive Bush administration and move the effort as far as possible while it remains in office. Just as President Bill Clinton felt compelled to complete the NAFTA when he inherited it from his Republican predecessor in 1993, any new US president would be under a similar obligation with an FTAAP if its deliberations were already well under way.

To be sure, other important obstacles could derail this potentially historic initiative. The APEC leaders at Hanoi envisaged the FTAAP only as “a long-term prospect,” whereas, for the reasons just indicated, it may have to proceed quickly if it is to proceed at all. Their officials could effectively bury the idea if they let themselves be slowed by APEC’s traditional consensus approach and fail to create innovative mechanisms, including the use of independent outside experts, to help with the mandated studies and if they fail to conduct substantive discussions of the proposal while the studies are being carried out. Decisions must be made on the agenda of issues to be included and especially whether to seek the high standards of US free trade agreements (FTAs) or the lower standards of China’s FTAs or the middle road of Japan’s “economic partnership agreements.” APEC will have to admit that it is a negotiating institution, as it clearly already is, but must also contemplate undertaking binding commitments for the first time.<sup>2</sup>

2. For skeptical appraisals, see Morrison (2006) and Aggarwal (2006). It should be noted, however, that Aggarwal’s analysis, on which Morrison’s conclusions largely rely, suggests that the United States could no longer be counted on to support any large multilateral trade liberalization, so his views apply as much to the Doha Round as to an FTAAP.

The single largest question is probably the position of China. Its support, on top of that of the United States, Japan, and the other APEC members noted above, would clinch the launch of serious negotiations. However, China expressed some skepticism about the issue at Hanoi. It cited two concerns: a possible adverse effect on the Doha Round and a delay in implementing APEC's own Bogor goals. China has not shown much interest in Doha, however, and there is obviously no prospect for achieving "free and open trade and investment in the region" by the Bogor target date of 2010 for advanced member countries. Hence China's concerns must lie elsewhere.<sup>3</sup>

Perhaps China 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 Taiwan, which has been accepted as a full participant in all APEC activities since 1991 so long as they are clearly "economic" rather than "political."

Such considerations would be extremely short-sighted on China's part, in light of its escalating trade conflicts with the United States<sup>4</sup> and a number of other APEC members. These conflicts are growing rapidly, in light of China's large and rapidly expanding trade surpluses and the increasing criticisms of its remaining trade barriers as it maintains 10 percent growth and becomes the world's third largest trading country. Such concerns could be at least partly defused by its entering into comprehensive liberalizing and rule-making negotiations via an FTAAP. Moreover, if most of the other APEC members come to support the idea, China would not want to be viewed as throwing its weight around by blocking the initiative. In the end, President Hu Jintao did not dissent from the agreement of the leaders at Hanoi to consider an FTAAP, so its definitive view is yet to emerge.<sup>5</sup>

The initial step taken by the APEC leaders in Hanoi toward creation of an FTAAP could turn out to be one of the most significant in the history of the world economy and even of world politics. Alternatively, it could fizzle into irrelevance like many of the group's past pronouncements. Decisions

taken by the key APEC economies over the next few months will determine the outcome and perhaps with it the prospects for US trade policy and the global trading system for years to come.

## THE CASE FOR A FREE TRADE AREA OF THE ASIA PACIFIC

The case for an FTAAP is well known and very powerful. First, implementation of an FTAAP would represent a gigantic liberalization of trade in the world's largest and most dynamic region. All member economies would derive large benefits as a result. An earlier study prepared for ABAC shows 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. It also shows that almost all East Asian economies (including the three large Northeast Asians) gain more from an FTAAP than from an "ASEAN Plus 3" or East Asia Free Trade Area (Scollay 2004, especially 25–30 and table 3).

A truly Free Trade Area of the Asia Pacific would also generate much greater aggregate economic benefits than any conceivable multilateral/WTO liberalization, as its sizable gains for the large number of participating economies more than offset the losses to some nonmembers. The Doha Round, like the Uruguay Round and its predecessors, would *at best* achieve incremental liberalization of existing barriers. Since APEC economies account for more than half of world output and trade, elimination of *all* barriers between them would provide a much larger *global* payoff 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 as a whole* 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 itself, and some nonmembers would lose due to the resulting discrimination against them. The latter would then be likely to seek to associate with the FTAAP or negotiate their own regional agreements, or more likely pursue significant further multilateral liberalization via the standard logic of "competitive liberalization" (Evenett and Meier 2006), which leads to the next argument for an FTAAP.

Second, as already noted, active pursuit of the FTAAP idea by APEC can promote the prospects for a successful Doha Round and may indeed be the most likely catalyst for restarting those talks. APEC's consideration of an FTAAP can thus enhance the prospects of achieving the modest but highly desirable trade liberalization that could result from a success-

3. It is quite plausible, however, that China wants to preserve Bogor's distinction between advanced countries (which are supposed to liberalize by 2010) and self-declared developing countries (which are given until 2020 to do so).

4. See C. Fred Bergsten, "A Clash of the Titans Could Hurt Us All," op-ed in the *Financial Times*, August 25, 2005.

5. The most authoritative Chinese statement to date on the FTAAP concludes that "China would undoubtedly benefit from joining a (high-quality) agreement and therefore would be likely to join," though it also indicates that China's trade policy priority is clearly its regional FTAs. See Sheng Bin (2006).

ful WTO round—as long as the APEC members continue to make clear that this outcome remains their top trade policy priority (as their predecessors did vis-à-vis the Uruguay Round in 1993–94). If APEC would then follow through and actually create an FTAAP, to maintain the forward momentum of liberalization by building on a successful Doha Round, its far larger “WTO plus” gains would accrue in addition to those produced by Doha. The resulting discrimination against outsiders would then likely prompt those outsiders to insist

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on launching another multilateral WTO round to reduce the new preferences (just as the United States insisted on the three major postwar GATT rounds in large part to reduce the preferences stemming from the creation and subsequent expansion of the European Union). The European Union might also pursue a new “bilateral” pact of its own with East Asia, which would liberalize trade further and add pressure on the United States to launch another global round. *A successful FTAAP process could thus make a multiple contribution to global trade liberalization and economic welfare.*

If Doha were to fail anyway, despite an APEC effort to revive it via the FTAAP, the FTAAP initiative would provide the APEC member economies with a ready Plan B to restore momentum for trade liberalization.<sup>6</sup> This would be extremely important, especially for the trade-dependent economies of the Asia-Pacific region, in a world in which the global bicycle had toppled and the specter of a retreat toward protectionism was becoming apparent. The FTAAP idea thus simultaneously offers a spur to Doha and a ready alternative if it were to fail. If the Asian members of APEC were to block this particular Plan B, the United States would almost certainly turn toward Europe and Latin America to forge new megaregional pacts in those directions.<sup>7</sup>

6. See C. Fred Bergsten, “Plan B for World Trade: Go Regional,” op-ed in the *Financial Times*, August 16, 2006.

7. Alternative “Plan Bs” have already been suggested by the German government, in the form of a renewed effort to forge deeper transatlantic economic ties, and by Robert Zoellick through linking together the existing US FTAs in

Third, an FTAAP could over time sweep under one roof the exploding proliferation of bilateral and subregional preferential trade arrangements (PTAs) throughout the area (and help head off the even further proliferation that is highly likely in the absence of an FTAAP alternative if Doha fails). It would eliminate, in whole or in part, the increasing discrimination that such pacts are producing within the region. In particular, it could start rolling together the conflicting rules of origin, which are becoming so costly to business and trade, just as the Pan-European Cumulative System in 1997 multilateralized the panoply of PTAs then existing in Europe (Baldwin 2006).

Some PTAs would probably continue to exist even with an FTAAP. However, the FTAAP could follow the precedent of the other megaregional trade negotiation that is being pursued 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 subregional 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 2006, 9). 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 (including to free up the necessary resources within the member governments to pursue the FTAAP).

This benefit of an FTAAP is especially important in light of the steady movement of the East Asian members of APEC toward establishing their own regionwide PTA. 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.<sup>8</sup> It would also generate major new discrimination within the broader Asia-Pacific setting, however, and thus, as with the Mahathir proposal for an East Asia Economic Group in the early 1990s, threaten to “draw a line down the middle of the Pacific.”<sup>9</sup> Previous analyses (based on Scollay 2001) suggested that the United States

Latin America into an “Association of American Free Trade Agreements” (see Robert B. Zoellick, “Happily Ever AAFTA,” *Wall Street Journal*, January 8, 2007, A17).

8. A similar positive case can be made for an Asian Monetary Fund, which seems to be emerging as a result of the expansion and multilateralization of the network of bilateral swap arrangements under the Chiang Mai Initiative.

9. Another possible tendency at present is for the China-Japan rivalry to create a dividing line *within* Asia: between a “coastline perimeter” consisting of Japan, Taiwan, Australia, and perhaps a few others vis-à-vis a China-dominated “mainland bloc.” This division too would be extremely dangerous, perhaps even more so in terms of possible intra-Asian conflict that (as in the past) could draw in the United States, and an FTAAP would also be of great help in countering this risk.

could lose as much as \$25 billion of annual exports solely from the static discriminatory effects of an East Asian Free Trade Area, which could add substantially to the protectionist and isolationist pressures that are already of worrisome strength in the United States.

This outcome will occur whether or not East Asian regional integration formally produces a single economic entity, such as an “ASEAN Plus 3” free trade area or Japan’s recent proposal for an “ASEAN Plus 6” 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, inevitably loosening the current transpacific alliances (e.g., US-Japan), not least because of negative congressional reactions to such Asia-only initiatives (regardless of the parallel Western Hemisphere-only initiatives being conducted by the United States itself). With the rise in economic and political importance of the Asian economies, and the tensions already existing over some elements of US foreign policy, the impact of such Asia-Pacific disintegration would be far more costly today—to both sides of the Pacific—than would have been the case in the early 1990s.

Somewhat similar implications could accrue from the de facto completion of an FTAA on the eastern edge of the Pacific. Formal negotiations for a full-blown FTAA have stalled, but the de facto integration of the Western Hemisphere is already far advanced. The United States has expanded its FTA ties beyond NAFTA to include Chile, all of Central America, and the larger countries in the Andean Community (Colombia and Peru). A failed Doha Round could prompt US-Brazil negotiations as well. Asian involvement in Latin America, though it is now growing rapidly, has historically been much smaller than US involvement in Asia so the impact of this element of Asia-Pacific disintegration is considerably less acute. However, disintegration of the Asia-Pacific region is being fed from the eastern as well as western edge of the Pacific in equally messy but equally discriminatory ways.<sup>10</sup>

The United States has no basis for asking to participate in the East Asian summits, which have now become a regular feature of intra-Asian diplomacy. Asians are not invited to the Summits of the Americas. Neither Americans nor Asians are invited to the summits of the European Union. Both the United States and the Asians do, however, have a clear 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 as a whole. They have an obligation to conduct such consultations with full faith and transparency and to consider new ideas, such as an FTAAP, that 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. A failure to conduct them would be extremely risky for all APEC economies.

One clear lesson from the history of regional economic initiatives is that it is important to embed them in broader geographic contexts to avoid the risk that they may subsequently resist liberalization toward nonmembers and become closed blocs. The European Union and its predecessors, by far the most important preferential trade agreement (and, of

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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. In addition, the integrating Europeans were embedded in an extremely thick network of transatlantic relationships with the United States and Canada, including most importantly the Marshall Plan, the North Atlantic Treaty Organization (NATO), and the Organization for Economic Cooperation and Development (OECD), but many more as well. These institutions virtually eliminated the risk of “drawing a line down the middle of the Atlantic” despite the historic degree of integration that the European Union was in the process of achieving. 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.

The faltering of the WTO system reduces its potential for limiting the risks inherent in preferential megaregional groupings like a de facto East Asian Free Trade Area or FTAA. Especially in light of the salience of transpacific relationships traced above, and drawing on the historical lessons from the transatlantic relationship, it thus seems essential to embed new Pacific-Asia and Western Hemisphere subregional agreements

10. The US network of FTAs is generally of broader coverage and deeper liberalization than those in East Asia, so its preferential impact is presumably greater.

within a broader Asia-Pacific context. For the same reason, it would be highly desirable for an FTAAP to be embedded in an effective WTO system, and FTAAP members should do everything they can to strengthen or, if necessary after a failure of Doha, to revive that global institution.

Fourth, launch of an FTAAP initiative could revitalize APEC itself. Whatever its record in other areas, APEC has declined steeply in both regional and global relevance as its inability to effectively pursue its own Bogor goals has become (painfully) apparent. In choosing to become solely a cheerleader for the WTO and Doha, without any trade agenda of its own, APEC has abdicated the significant role that it played in global as well as regional trade policy from 1993 at least through 1997 (*vis-à-vis* the Uruguay Round, as already noted, and in both negotiating most of the far-reaching Information Technology Agreement and agreeing to pursue complete liberalization for nine important sectors [which unfortunately failed later] in the teeth of the Asian financial crisis). It has looked on helplessly as its member economies pursue their own PTAs without reference to, or even notice of, APEC and the commitments they had supposedly accepted under its aegis.<sup>11</sup>

This weakening of APEC should be of major concern to all its member economies. The rapid growth of economic (and broader) tensions between the United States and China, and the increased risks of Asia-Pacific disintegration due to the advent of Asia-only (and perhaps Americas-only) economic arrangements, underline the need for effective transpacific linkages and institutional ties for security as well as economic reasons. Japan, Korea, and the ASEAN countries all seek to maintain active US engagement in the region as a “hedging strategy” against the rise, and possible hegemonial intentions, of China.

APEC is the only existing organization that can fill that role, in contrast to the large number of transatlantic institutions that precluded the parallel risk of “drawing a line down the middle of the Atlantic” as the European Union formed and steadily deepened its integration. To pursue an FTAAP, APEC would, of course, have to acknowledge that it is already a “negotiating forum.” This would be nothing new for APEC since it has already negotiated *inter alia* the Bogor Declaration in 1994, the Information Technology Agreement in 1996 (which subsequently became binding via the WTO), and the

original sectoral liberalization agenda in 1997. APEC would also have to be prepared to move toward binding rather than purely voluntary commitments, which would be a much more significant step. Any new initiative that would restore purpose and credibility to APEC in such ways, like an FTAAP, would generate benefits that range far beyond the gains, substantial as they would be, for that initiative itself.<sup>12</sup>

A corollary is that an FTAAP could be launched by less than the full membership of APEC. Such “21 – x” and “pioneer” initiatives have taken place in APEC on other issues, such as the APEC Business Travel Card Program. An encouraging precedent is the Information Technology Agreement, which aimed only to include a “critical mass” of countries rather than the full membership of APEC (or, subsequently, the WTO) and came into effect with coverage of 80 to 90 percent of the relevant trade (and most-favored-nation extension to the rest despite their free riding).

The other new megaregional negotiation, toward an FTAA, *de facto* proceeded in such a manner. The all-in approach envisaged when the FTAA was launched in 1994 has given way to a series of “bilateral” deals between the United States, on the one hand, and several separate sets of partners in Latin America, starting with Chile and more recently adding the Central Americans, the Dominican Republic, and most of the Andean Pact countries. Coupled with the previous NAFTA and the Caribbean Basin Initiative, this amounts to something of a “34 – x” sequence that now encompasses virtually the entire Western Hemisphere except for the Mercosur membership. Pragmatism might require that an FTAAP proceed in a similar way, of course, one would hope, with the largest possible membership at the outset.<sup>13</sup>

If APEC institutional hurdles could not be overcome, an FTAAP could be pursued outside the organization by whatever group of APEC member economies chose to do so. This would again parallel the experience with the FTAA, where no APEC-type institution existed as a venue for the talks.<sup>14</sup> Proceeding in this manner would forgo the benefits of strengthening APEC and indeed would probably weaken it even further (perhaps

11. There is an understandable and laudable desire in many quarters to strengthen both the APEC Secretariat and the level of attention paid to APEC within member economies. The only way to achieve these goals, however, is to restore the substantive importance of APEC and thus raise its priority for members. Serious pursuit of an FTAAP would substantially heighten the salience of APEC to all participating economies and thus inevitably expand their dedication of resources to the institution.

12. APEC will also face the issue of expanding its membership in 2007 as its 10-year moratorium on new entrants expires. The key applicant is India, which has led much of the resistance to liberalization in the Doha Round. As clearly seen from the history of the European Union, including at present, broadening of an international institution makes its deepening all the more difficult. The European Union has traditionally resolved that conflict by adopting major deepening initiatives before taking on its next set of members, and APEC should do the same by proceeding with the FTAAP before adding India or anybody else.

13. Sheng Bin (2006) opines that China might “join the FTAAP at a later time” if it proceeded without China at the start.

14. The Organization of American States is primarily a political body and became one of three inter-American institutions chosen to support the initiative.

fatally) by taking the main Asia-Pacific initiative elsewhere. The United States and other APEC member economies have nevertheless committed to pursue a “Free Trade Area of the Asia Pacific” rather than an “APEC Free Trade Area,” and this alternative route is available.

In sum, the substantive case for an FTAAP initiative is far stronger now than when the idea was initially broached by the ABAC in 2004. The leaders recognized this increased salience in their decision at Hanoi to begin considering the proposal. Care must always be taken, however, to distinguish among its three operational phases: studying the concept, launching discussion/consultation/negotiation on it, and actually implementing it. It will be necessary to carefully calibrate these three phases, to the regional and global contexts that exist at the time of the crucial decisions on the idea, but each sequential phase of the project could have at least some of the beneficial effects described here. The substantive case is very strong and, augmented by the recent political developments within the United States described earlier in this brief, argues for APEC’s moving as rapidly as possible to the stage of discussing the idea actively even while still studying its full dimensions.

## THE FTAAP AND THE DOHA ROUND

I have already suggested that the launch of an FTAAP initiative by APEC could both have a highly positive effect in galvanizing a successful outcome for the Doha Round and offer a fallback Plan B if Doha were to fail. The relationship between the FTAAP and Doha is so central, however, and fears that any serious APEC consideration of an FTAAP could undermine Doha have previously been such a major factor in inhibiting APEC action on the idea that it deserves more detailed analysis. I will do so by tracing the implications for the FTAAP idea of the alternative scenarios that now seem plausible for the Doha talks as they approach their current deadline, driven by the expiration of US negotiating authority in July 2007.

My colleagues Gary Hufbauer and Jeffrey Schott (2006) have developed a careful analysis of the three most likely outcomes for Doha, and the prognosis seems even gloomier now than when they wrote a year ago. The three possibilities are

- outright failure or collapse,
- a minimalist “success,” or
- a substantial further delay, at least until the end of 2007 and perhaps well beyond the next US elections in late 2008.

I and my colleagues at the Peterson Institute for International Economics, especially Hufbauer and Schott, are very strong supporters of the Doha Round. We have indeed participated actively in developing many of its components and have testified and written incessantly to promote a substantively successful outcome. We fully realize, from our long experience with earlier GATT rounds, that all such multilateral negotiations have looked exceedingly bleak prior to their more-or-less successful conclusions. But our best analytical judgments now

### **If Doha were to fail, the FTAAP initiative would provide the APEC member economies with a ready Plan B to restore momentum for trade liberalization.**

lead us to see a strong possibility of a demise of the Doha Round, which we do with great reluctance and only because we believe it is imperative for the world to begin planning on the basis of the real prospects for such an outcome.

We doubt that the major governments, especially the United States and the European Union, would want to explicitly admit the failure of the Doha Round and accept a formal collapse of the negotiations. However, the developing countries could trigger such an outcome by again rejecting the offers of the rich nations as grossly inadequate—as they correctly did at the Cancún ministerial in 2003. Even the US negotiators, pushed by Congress and the US business community, might have to formally reject a deal that failed to achieve at least a substantial portion of their negotiating objectives. Hence the first option is, unfortunately, a real possibility.

The consequences for the world trading system of an outright failure of Doha would be devastating (Schott 2006). Protectionist relapses could be expected everywhere, especially as the global trade imbalances (which always spawn protectionism in the United States) continue to expand and particularly if key economies soften, with unemployment rising, over the coming couple of years.<sup>15</sup> A further proliferation of PTAs could be expected as governments try to find some politically viable modality for resuming trade liberalization (and escape any semblance of multilateral constraint on low-quality deals motivated primarily by foreign policy objectives). Under these

15. Protectionist pressure will rise particularly sharply in Europe if the inevitable large decline in the value of the dollar, which is an essential component of any significant correction of the large and growing international imbalances, takes place mainly against the euro because China and other Asian surplus countries continue to block significant appreciation of their own currencies.

circumstances, a Plan B would be desperately needed. Launch of an FTAAP would be important in this context, indeed almost imperative, especially as transpacific trade ties would be the most likely to suffer in the context of a renewed outbreak of (especially US) protectionism and accelerated movement toward an East Asian trading bloc (that would in turn feed even further US protectionism).

A minimalist outcome, the second possibility, is clearly possible. WTO Director General Pascal Lamy signaled such a strategy in his report on the key Hong Kong ministerial of December 2005 to a conference at the Institute for International Economics in February 2006, and Deputy Director General Rufus Yerxa repeated the concept in a speech in Washington in May 2006. Their message was essentially that, facing profound difficulties in meeting the original goals of the round or even advancing the negotiations beyond where they had stalemated over the previous year, the WTO membership should “declare victory and go home.”

There are two problems with this approach. The first is that the offers to date are quite minimal, and it is doubtful that the world as a whole—as opposed to the ministers who would try to sell such an outcome—would view it as much better than an explicit failure. The second, which compounds the first, is that some of the present “offers,” such as the US willingness to limit agricultural subsidies in its next farm bill if the European Union and others significantly expand market access in that sector, would almost certainly be withdrawn unless substantially better proposals emanate from their trading partners.

Hence, any “declared victory” would be quite hollow and extremely difficult to sell. The global trade policy consequences might not be quite as bad as under an outright failure but neither would they be attractive to contemplate. Most of the major trade problems would remain unresolved, and the developing countries, in particular, would (rightly) feel betrayed for a second time. The resulting bad taste all around would make it virtually impossible to contemplate another WTO round,<sup>16</sup> or even any major sectoral negotiations, in the foreseeable future. The bicycle of liberalizing momentum might not topple completely, but it would become very wobbly. Plan B would still be sorely needed.

The third option, which Hufbauer and Schott regard

16. There have been exhausted cries of “never another round” at the end of every previous round negotiated in the GATT/WTO. All three of the previous major rounds, however, have been widely viewed as basically successful in advancing global liberalization and improving the rules-based trading system. Whatever the attitudes at the time of their completion, the rounds thus provided a solid foundation for the next round. A minimal outcome from Doha, however, let alone its explicit or implicit failure, would radically alter this history and raise serious doubts over the future of the entire multilateral trading system and its institutional framework.

as the most likely, is extension of the talks from the current “deadline” of early 2007 until anywhere from the end of 2007 (after the next French and Korean elections) to 2009 (after the next US elections) or even beyond. This would be similar to the end game of the Uruguay Round, which was initially scheduled to conclude in 1990 but continued until late 1993 (after completion of NAFTA and the initial Seattle summit of APEC). It would be tantamount to the failure outcome in the short run, but, of course, without the definitive finality thereof and indeed with some prospect of ultimate success or at least renewed effort down the road.

The global trade policy consequences of this quite plausible “outcome” are the most conjectural. They would depend partly on whether credible new deadlines could be set. This in turn would depend heavily on whether the Congress seemed likely to extend the president’s TPA, which would be highly uncertain with Doha in suspense due to lack of success and hence unlikely to provide much motivation for the United States to resume the talks. The victories by the Democrats in the congressional elections of 2006 and their potential success in the presidential election of 2008 inject substantial additional uncertainties into the picture concerning both the extension of US negotiating authority in the short run and the basic orientation of US trade policy over the medium term.

The launch of an FTAAP in this context could provide a quadruple benefit. It would represent a new driver of liberalization to maintain forward momentum. It would offer a major incentive for Congress—and the US business community, which is its most important constituent on these issues—to renew TPA and thus enable the United States to remain involved in, and, one would hope, provide the needed leadership for, the related sets of major trade negotiations. It would offer a credible “political jolt” to the rest of the world, substantially motivating others to make new offers that would revive Doha.<sup>17</sup>

If an FTAAP proceeded to fruition even in the wake of a reinvigorated and successful Doha Round, perhaps produced in part by the launch of the FTAAP itself, it could also, as noted above, galvanize a future WTO negotiation to reduce the new “Doha plus” discrimination that it created. The creation of the European Union and its subsequent broadening and deepening were important triggers for all three of the major GATT rounds (Kennedy, Tokyo, and Uruguay) of the past half century. The initial APEC summit, at Seattle in 1993, played a crucial role in driving the Uruguay Round to its ultimate success. The formal launch of the Bogor goals in

17. It could also induce others, especially the European Union, to accelerate their own FTA strategies, but the magnitude of an FTAAP would also be likely to bring those countries back to the multilateral WTO table.

1994, coming just after the completion of the Uruguay Round, clearly stimulated successful multilateral/WTO negotiations (on telecom and financial services, in particular) for several more years; Sir Leon Brittan, the chief EU trade negotiator at the time, said repeatedly and publicly that “the EU will not be left behind if APEC does what it says it will do” and used the specter of APEC discrimination to bring his more recalcitrant member states into those global liberalization packages.

Properly managed, an FTAAP could thus provide substantial—and perhaps essential—support to the Doha Round in the short run and the global trading system over the longer run. It is understandable that some observers have adopted a different view and that the APEC leaders have previously been cautious in even initiating the FTAAP process for fear of undermining Doha. A sophisticated understanding of the political economy of trade policy, however, both among countries and within the most important ones, points clearly to the prospect of mutual reinforcement between an FTAAP process and the WTO system. The most crucial test of that thesis is the impact of such an interaction in the United States, to which I now turn.

#### THE UNITED STATES AND THE FTAAP

The FTAAP idea must be credible if it is to provide the numerous substantive benefits suggested above. This requires the United States and the other major APEC powers, especially China and Japan, to eventually endorse and embrace the idea. The most salient criticism of the FTAAP to date has been that “it will never fly” with the big countries.

The United States is probably the most important single variable in this equation. It remains not only the largest APEC economy and trading nation but the traditional leader, to which most of the other members look, on trade policy issues at both the global and regional levels. It was the chief driver of the Bogor goals at Seattle and at Bogor itself and of their very positive interaction with the Uruguay Round in the GATT.

President Bush’s decision to take the lead in placing the FTAAP squarely on the APEC agenda in late 2006 is thus an enormously important step forward. At the same time, however, I have already noted that the rise of the Democrats to control of the Congress (and possibly control of the White House in two years) raises important new questions about overall US trade policy, including this element of it. Though virtually all of Asia appears to welcome the renewed focus on the region suggested by the president’s initiative, skepticism still abounds on whether the United States will stick with it.

The likely paths for the Doha Round analyzed above will clearly affect the US attitude toward an FTAAP. I and

my colleagues at the Peterson Institute often criticize the Bush administration and do not always support its trade policy, but it is clear to us that the administration and the president personally are deeply committed to freer trade. They have led the way on Doha; indeed, there would be no Doha without the United States, including the major battle conducted by the administration to win TPA from Congress by the narrowest of margins in 2002. The round would have no chance for even a minimal success absent the bold initiatives taken by the administration, as recently as just before the Hong Kong ministerial in late 2005, to liberalize agricultural, nonagricultural, and services restrictions around the world, including its own. In the summer of 2005, it again mobilized all its political muscle to win congressional acceptance of the Central Ameri-

**One clear lesson from the history of regional economic initiatives is that it is important to embed them in broader geographic contexts to avoid the risk that they may subsequently resist liberalization toward nonmembers and become closed blocs.**

can Free Trade Agreement (CAFTA) in the latest pitched battle between globalization and antiglobalization forces in the United States. The United States has caused problems for the round, to be sure, especially with its unwillingness to consider serious reform of its antidumping regime or of trade in labor services, or to cut its agricultural subsidies by enough to satisfy its trading partners, but overall it has been by far the strongest single source of support for Doha.

Moreover, the administration clearly sees trade policy as an integral part of its foreign policy and would be unwilling to let that central dimension of its global strategy disappear. In the specific case of East Asia, it is clearly worried by the increased risk of “drawing a line down the middle of the Pacific,” especially between the United States and China. It has become concerned by the “East Asian architecture” movement that threatens to erect new discriminatory barriers against US trade, how that will affect US security as well as economic interests, and how the United States should respond. It is virtually inconceivable that the administration would accept any of the three posited outcomes of Doha, especially if coupled with accelerated movement toward an exclusionary East Asian bloc, without mounting a major new trade policy initiative, especially with respect to its chief trading partners/competitors in East Asia. It would surely want to renew the

momentum toward reducing barriers, maintain its strategy of competitive liberalization, and find a basis for extending TPA beyond its scheduled expiration in July 2007.<sup>18</sup>

One possible US response is to launch additional FTAs with individual Asian partners. In 2006 Korea and Malaysia were added to the list that already included Singapore, Australia, and Thailand. Indonesia is a favored candidate for subsequent inclusion. Subsequent US trade representatives have offered to pursue an FTA with Japan once it is ready to put agriculture seriously on the table, as Korea has now done, and Japan will probably seek such an arrangement if the US-Korea talks succeed.

Another US alternative would be to offer “docking rights” to its existing FTAs for APEC members that were willing to accept the obligations of the existing agreements. This has been a modality for EU enlargement and recently when the Dominican Republic “docked” onto the FTA between the United States and Central America. It might be a more practical way to achieve an eventual FTAAP than an “all in” negotiation from the outset.<sup>19</sup>

It would surely be superior for the United States, however, and even more so for its Asian partners, to pursue an FTAAP instead of adding further to the “spaghetti bowl” of PTAs in the region. More US FTAs, including via “docking” to existing US FTAs by current nonmembers, would increasingly create a “hub-and-spoke” network centered on the United States (and thus encourage further proliferation of similar “hub-and-spoke” configurations centered on other major trading powers) rather than an integrated Asia-Pacific economy. Similar proliferation of the network of PTAs would occur if the United States, as suggested recently by some Asians, were to negotiate its own “10+1” agreement with ASEAN and then seek at some later point to consolidate that arrangement with the other 10+1 deals that are in place or envisaged with China, Japan, and Korea (except that ASEAN would then be the unlikely hub of the system).

18. Some observers, particularly within the United States, raise doubts about the capacity of the US government, specifically the US trade representative, to support a major new negotiating effort like the FTAAP. In a world in which the Doha Round was either concluded or suspended, however, the resources now being devoted to that enterprise could readily be shifted to an FTAAP, which would be addressing the same set of issues. A similar shift of US personnel occurred in 1991–92 when the Uruguay Round went into suspended animation, and the freed-up resources were largely used to negotiate NAFTA.

19. At the commencement of the APEC strategizing in 1993 that ultimately produced the Bogor goals, Senior Minister Lee Kuan Yew of Singapore in fact proposed that the United States 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 Asians have recently suggested that other APEC members could “dock” onto the P-4 FTA, agreed by Brunei, Chile, New Zealand, and Singapore, but this grouping is clearly too small to provide a foundation for APEC-wide arrangements.

Moreover, this approach would leave unresolved the central issue of US-China trade and broader economic relations. Indeed, US pursuit of FTAs throughout East Asia, which exclude China, would likely further exacerbate the Washington-Beijing tensions: It would add an economic dimension

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to the “surround China” strategy that the United States is already pursuing in the security sphere, with its recent overtures to India along with the deepening of the Japan alliance, which could trigger additional Chinese pushback in both the economic (more PTAs) and security arenas.

Both the international and domestic politics of the FTAAP issue in the United States will thus turn importantly on how it will be seen as affecting the US-China relationship. That relationship is clearly on a very risky path. The bilateral trade imbalance, which exceeded \$230 billion in 2006 and can only increase because US imports from China are six times greater than US exports to China (which is twice as large as that US-Japan ratio ever became), is irrelevant per se in economic terms but toxic in domestic political terms. Moreover, the bilateral position now accurately reflects the global position of the two countries: Each is running a worldwide current account imbalance that exceeds 7 percent of its GNP and is rising rapidly. China’s global current account surplus doubled in 2005 and may have risen as high as \$250 billion, about 9 percent of its GDP and by far the largest of any country in the world, in 2006.

The currencies of both countries are severely misaligned, with dollar overvaluation and renminbi undervaluation of at least 20 percent.<sup>20</sup> Such conditions in the United States have traditionally been accurate predictors of major protectionist reactions. At the present time, the United States has already slapped controls on six sectors of Chinese exports (apparel, color television sets, furniture, semiconductors, shrimp, and textiles). The House of Representatives has passed anti-China legislation (the English bill in July 2005), and the Senate has

20. On a trade-weighted average basis. The undervaluation of the renminbi bilaterally against the dollar is probably about twice as great.

considered at least two sweeping across-the-board proposals (Grassley-Baucus and Schumer-Graham)—some of which, if implemented, would violate US commitments under the WTO and justify Chinese retaliation. These developments could trigger a trade war between the two chief drivers of the world economy over the past five years and would almost surely provide added impetus for China and the rest of East Asia to pursue Asia-only trade initiatives.<sup>21</sup>

All this is occurring with a booming US economy that is enjoying full employment. *The prospect for US trade policy is frightening if in a year or two the United States experiences a combination of slowing growth (or even recession), rising joblessness, a global current account deficit of \$1 trillion or so, and a bilateral imbalance with China of \$300 billion to \$400 billion.* A substantial realignment of the exchange rate between the renminbi and the dollar is an essential ingredient of any resolution of the economic tension between China and the United States, whatever changes are made in the trade policies of the two countries.<sup>22</sup>

At the same time, China can make a powerful case that its trade policy is not a major problem. China is one of the most open of all developing countries: Its trade-to-GDP ratio is more than 60 percent, double that of the United States and triple that of Japan. Its realized tariff average, the ratio of its customs collections to GDP, was 2.2 percent in 2004. Even its nominal tariff average is only about 10 percent. Virtually all import quotas have been eliminated, and licensing schemes are being simplified. China clearly 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.<sup>23</sup>

The central strategic issue for the United States, with respect to China policy as well as overall trade and foreign economic policy, is how best to head off the potential confrontation despite these realities of China's trade policy.<sup>24</sup> The

current bilateral strategy is proving to be extremely frustrating; the results, as with Japan for three difficult decades, are at best minimal and case-by-case, while the Chinese partner, even more than Japan, resents overt pressure and may even be less responsive as a result. Resort to the WTO dispute settlement mechanism can help resolve individual quarrels, but WTO rules do not cover many of the key issues, and again the best possible outcome is case-by-case and drawn out over extended periods. President Hu Jintao's visit to Washington in April 2006 produced no serious discussion of these issues let alone any resolution of them, and the initial meeting of the

### **A sophisticated understanding of the political economy of trade policy points clearly to the prospect of mutual reinforcement between an FTAAP process and the WTO system.**

new Strategic Economic Dialogue in December 2006, chaired by Secretary of the Treasury Henry Paulson and Vice Minister Wu Yi, made no substantive progress either.

Hence there is compelling logic for the United States and China 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 US-China dispute; doing so might even backfire by making the other APEC members, as well as China and the United States themselves, uncomfortable with the prospect. Fortunately, the rationale for the FTAAP is straightforward and clear as developed earlier in this policy brief.

But it would greatly behoove both the United States and China to embed their trade policy disputes into a broader context that would offer the promise of eventual elimination of most or all barriers between them. For the United States, the standard logic that has always persuaded Congress to support such agreements would again prevail: that the partner country's barriers are much higher and thus the United States can only gain on balance from their mutual elimination, even if further adjustment is required in a few US sectors.<sup>25</sup> Moreover,

21. This would be even more likely if the European Union joined the United States in applying new trade restrictions to China, and perhaps East Asia more broadly, which could easily result if China continues to block meaningful appreciation of its currency (and thus the currencies of other East Asians) so that the next major dollar decline occurs primarily against the euro and pushes it to even larger overvaluation against Asia.

22. See Morris Goldstein and Nicholas R. Lardy, "China's Revaluation Shows Size Really Matters," op-ed in the *Financial Times*, July 22, 2005.

23. These data and a more extended analysis can be found in Center for Strategic and International Studies and Institute for International Economics (2006, especially chapter 4).

24. As opposed to China's currency policy, which does raise major problems because of the country's massive intervention in the foreign exchange markets

("manipulation") that blocks any substantial rise in the value of the renminbi (and thus other Asian currencies) and thus perpetuates and exacerbates the severe misalignment described above.

25. The United States 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).

other APEC members share the US desire to reduce China's import restrictions and other governmental trade intervention and could be expected to support most of the US negotiating efforts. For China, 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 that it so desperately desires.<sup>26</sup> For

**There is compelling logic for the United States and China to bring their trade policy problems within the broader regional construct of APEC and an FTAAP.**

both countries, the leavening presence of the rest of the APEC membership should help dilute and diffuse bilateral tensions and thus promote productive outcomes.

As noted already, the assumption of congressional control in early 2007 by a Democratic majority greatly increases the stakes of the rest of the world in US policy toward the FTAAP (and all other trade issues). The economic partners of the United States, especially those that depend as heavily on trade as virtually all of the Asians do, have a major interest in avoiding an antiglobalization or protectionist turn in American policy. Hence they should eagerly cooperate with the Bush administration in forging initiatives, like the FTAAP, that will provide a compelling case for the extension of TPA in mid-2007. They should also seek to engage the United States in international negotiations that would be difficult, if not impossible, for a new president in 2009 to repudiate even if she or he wanted to do so.

Indeed, the other member economies of APEC should make every effort to push the United States in the FTAAP direction under these conditions. Despite the short-sighted preferences of some Asians to be left alone by the United

States, including to proceed with their own regional PTAs, it is they who would be hurt most by a United States that was backsliding into protectionism and becoming unable to negotiate internationally. They should thus be deeply concerned by a lapse of TPA or the advent of a new administration that was disinclined to undertake new liberalization initiatives and do everything they can to help the current administration resist such developments.

## CONCLUSION

The FTAAP initiative that APEC has already undertaken may well turn out to be the best, or perhaps only, way to

- catalyze a substantively successful Doha Round;
- offer an alternative Plan B to restore the momentum of trade liberalization if Doha fails or continues to falter badly;
- prevent a further, possibly explosive, proliferation of bilateral and subregional PTAs, which create substantial new discrimination and discord within the Asia-Pacific region;
- avoid 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 rather than broader regional integration APEC was created to foster;
- channel the China–United States economic conflict into a more constructive and less confrontational context, which could defuse at least some of its attendant tension and risks;
- revitalize APEC itself, which is now of enhanced importance because of the prospects for Asia Pacific and especially China–United States fissures; and, perhaps most important in the short and even medium run,
- maintain US engagement in Asian, and even global, trade relations by providing a basis for congressional extension of TPA in mid-2007 and a negotiating momentum that the next US president in early 2009 will feel compelled to honor.

Prior to the initial APEC summits, in Seattle in 1993 and Bogor in 1994, very 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 particularly skeptical of the willingness and ability of the United States to take part in such an initiative, let alone lead it. The leaders did adopt the Bogor goals, however, and the United States played a central role in that

26. A technical but very important question is the differing concept of “FTAs” maintained by the United States and other APEC members such as Australia, Canada, Chile, New Zealand, and Singapore on the one hand and by China and some other Asians on the other. The former group insists on “high quality” FTAs, though they sometimes falter in practice as when sugar was totally excluded from the US–Australia 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/apparel trade in US FTAs and *would* represent a hurdle to rolling existing US agreements into a single FTAAP.

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.

The APEC leaders and ministers have now taken the first steps in this process by conducting initial discussions of the idea, formally deciding to give it “serious consideration” and directing their officials to think through how it might work in practice. The next step is for APEC’s senior officials, and perhaps the region’s trade ministers at their annual meeting in July 2007, to begin serious consultations on an FTAAP even while the studies are under way. Serious consultations could lay a foundation for the leaders of at least some of the member economies to launch full-scale negotiations at this year’s summit in Sydney and to start mobilizing domestic support for the idea. The FTAAP can and should become the next major step in the evolution of both the global trading system and the architecture of the Asia-Pacific region.

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