

# **Asia-Pacific Economic Cooperation**

**2000 APEC Economic Outlook Symposium**

**APEC Economic Committee (EC)**

**2000**

## TABLE OF CONTENTS

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<b>Foreword</b>	<i>i</i>
<b>Welcome Messages</b>	
<i>Dr Felipe M. Medalla, Secretary of Socio-Economic Planning, National Economic and Development Authority, Philippines</i>	<i>iii</i>
<i>Ambassador Rosario G. Manalo, Undersecretary, Dept of Foreign Affairs and SOM for the Philippines</i>	<i>v</i>
<b>Introduction and Overview</b>	<b>1</b>
<b>Session 1: Outlook for the APEC Economies</b>	
1. Economic Prospects <i>Yun Hwan Kim, Asian Development Bank</i>	65
2. Japanese Economy in Recovery: Its Assessment and Prospects <i>Jun Saito, Economic Planning Agency, Japan</i>	69
<b>Session 2: Recovery in East and Southeast Asia: Adjustment and Reforms</b>	
3. East Asian Economic Recovery and Structural Reform <i>Masahiro Kawai, Chief Economist, East Asia and the Pacific Region, World Bank</i>	75
<b>Session 3: New Regionalism and Multilateralism: Goals and Analytical Issues</b>	
4. Old Issues in New Regionalism <i>Christopher Findlay, Australian National University, Australia</i>	93
5. Development Issues Arising from Large Economic Spaces: Options for Developing Countries <i>Bonapas Onguglo and Lucian Cernat, United Nations Conference on Trade and Development, Switzerland</i>	115
<b>Session 4: The New Regionalism: Existing Agreements</b>	
6. The New Regionalism: The New Zealand Experience <i>Tim Groser, Executive Director, Asia 2000 Foundation of New Zealand, New Zealand</i>	135
7. The Open Regionalism of the Andean Community <i>Alan Fairlie Reinoso, Pontificia Universidad Catolica del Peru, Peru</i>	145
South America Free Trade Area and APEC: Toward Relationships for Development <i>Alan Fairlie Reinoso, Pontificia Universidad Catolica del Peru, Peru</i>	159

## **Session 5: Emerging Regional Trade Arrangements**

8. Towards Closer Japan-Korea Economic Relations: A Supplementary Note 167  
*Ipppei Yamazawa, Institute of Developing Economies, JETRO, Japan*
9. Korea's New Directions towards Regionalism 169  
*Inkyo Cheong, Research Fellow, Korea Institute for International Economic Policy, Korea*
10. Australia's Approach to Regional Trade Agreements 175  
*Karen Gilmour, First Secretary, Australian Embassy, Philippines*

## **Session 6: WTO: Status and Issues**

11. 2000 Trade Agenda: A Canadian Perspective 181  
*Hon. Jonathan T. Fried, Assistant Deputy Minister, Dept of Foreign Affairs and International Trade, Canada*
12. Issues Concerning the Notification of Regional Trade Agreements to the World Trade Organization 183  
*Bonapas Onguglo, Economic Affairs Officer, United Nations Conference on Trade and Development, Switzerland*
13. Convergence Between Regionalism and Multilateralism and the Role of the World Trade Organization 197  
*Ambassador Edsel T. Custodio, Committee on Regional Trading Arrangements, WTO and Philippine Alternate Permanent Representative to the UN and other International Organizations, Switzerland*

## **Session 7: APEC and Multilateralism: Initiatives and Achievements**

14. APEC and the Multilateral Trading System 205  
*Anthony Melville, Counsellor and Deputy Head of Mission, Australian Embassy, Philippines*

- Glossary** 209

## FOREWORD

The Philippines, as the coordinating economy for the *2000 APEC Economic Outlook*, organized and hosted the “2000 APEC Economic Outlook Symposium,” which was held in Manila on 24-25 July, 2000.

The *APEC Economic Outlook* is a major annual report of the APEC Economic Committee, and it is submitted to the APEC Ministerial meeting each year. In line with tradition, the *2000 Outlook* consists of two parts. The first part overviews the recent developments in, and short-term prospects of, all APEC economies. The second part explores a topical structural issue of current interest, and this year’s *Outlook* looks into the emerging trend of forging regional trade arrangements, which has been dubbed the “new regionalism.” The key question addressed was whether the new regionalism is a building block or a stumbling block for the multilateral trade system

The primary objective of the symposium was to obtain as many views and perspectives as possible that could be used as inputs into the preparation of the *2000 Outlook*. Therefore, the discussions during the two-day event focused on the regional economic conditions and the new developments in trade arrangements in the APEC region.

The symposium succeeded in meeting its objective, as all the participants, from academia, research institutions, governments, and international organizations, contributed to active and stimulating discussions on the key issues at hand. By securing a very wide participation, the symposium was also useful as part of the Economic Committee’s effort to reach a wider audience.

As an adjunct to the *2000 APEC Economic Outlook*, the *Papers and Proceedings of the 2000 APEC Economic Outlook Symposium* is published as a record of the discussions and compilation of the papers that were presented at the symposium.



Mitsuru Taniuchi  
Chair, APEC Economic Committee  
Tokyo, November 2000

**WELCOME MESSAGE**  
**By**  
**Secretary Felipe M. Medalla \***

Excellencies, Distinguished Chair and Members of the APEC Economic Committee, Experts from the APEC Study Center Network, Honored Guests, Ladies and Gentlemen:

Good morning.

On behalf of the Philippine government, I am pleased to welcome everyone to this symposium on *APEC's Economic Outlook*. Our government considers it a distinct honor to be hosting this symposium. We are aware of the important contributions that the Economic Committee of APEC is making. For one, it has spearheaded the conduct of research, conferences, and other related activities. And these truly help APEC organize the thinking about how to advance the goal of trade and investment liberalization and facilitation. In addition, these intellectual pursuits help promote technical and economic cooperation among member economies.

One of the goals of this symposium is to generate insights and expert advice that will enable the Philippine government, which is coordinating the preparation for this year's *Economic Outlook*, come up with a report that meets the standards of previous reports. (I understand that the bar for quality standards continues to be raised each year.)

We have accepted the challenge. Our ability to face this challenge will be aided in no small way by the expertise assembled in this room today.

Of course, it feels good to be reporting about the recovery that is currently taking place in the economies hard hit by the Asian financial crisis that emerged in 1997. The domestic macroeconomic policy responses coupled with the continuing openness of the developed economies to global trade allowed some export-led recoveries to take place. All this helped make the economic contractions short-lived.

But we acknowledge the dangers of complacency. And so it is heartening to observe the affected economies making adjustments designed to deepen their structural policy reform programs. Similarly, it is encouraging to see the legal, administrative, and judicial reforms that are being ushered in to thwart the recurrence of similar crises, and to ensure soft landings just in case – heavens forbid – such crises intervene again in the future.

We are also conscious of the balancing acts that attend the conduct of stabilization and growth policies as we steer our economies toward non-inflationary growth paths. And so I'm glad to see familiar faces – some colleagues from academia, the private sector, the multilateral and regional funding institutions, and the APEC Study Center Network – who can shed additional light on these policy issues. I am sure the group's insights will go some distance as we navigate the tricky waters of stabilization and growth.

Which brings me now to the structural theme of this year's *Economic Outlook Report*. This is about the "new regionalism." Roughly, this refers to the Regional Trading Arrangements (RTAs), which are essentially Preferential Trading Arrangements (PTAs). I realize that these are allowed under the Article XXIV of the World Trade Organization (WTO). This group is very familiar with the concerns that have been raised as regards PTAs. Do they facilitate or impede the march toward multilateral trade liberalization?

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\* Secretary of Socio-Economic Planning and Director-General of the National Economic and Development Authority. Delivered during the 2000 APEC Economic Outlook Symposium held on 24 – 25 July 2000 at the EDSA Shangri-La Hotel, Mandaluyong City, the Philippines

The concerns are understandable. Developing economies, in particular, value a most-favored-nation (MFN) treatment. In various rounds of negotiations under the General Agreement on Tariffs and Trade (GATT), they sought to protect and strengthen the principle of MFN or non-discrimination. It is MFN that helps improve market access. Certainly, we would not like to see PTAs posing obstacles to further global trade liberalization.

Definitely, we cannot say that PTAs should not be allowed. Let's face it: PTAs are proliferating and even as we discuss the issues here today, several initiatives for free trade areas are being undertaken. Business and Senior Officials in the different economies are meeting, formally or informally, exploring possibilities for further regional economic integration. What to do? Let's accept the fact that PTAs and the WTO will coexist. But then we must make sure that PTAs are instruments for multilateralism rather than for trade protectionism and trade diversion.

APEC is committed to open regionalism. This is acknowledged to be the way to go as far as PTAs are concerned. I'm certainly hoping that the discussions in this symposium will give rise to principles and guidelines guaranteed to put the "new regionalism" in the service of multilateral trade liberalization. The international trade experts participating in this symposium give me reason for optimism.

We should always keep in mind the Leader's Declaration in Auckland: "APEC will continue to play a leadership role in strengthening the global economy, especially the multilateral trading system." All Ministers and Senior Officials must continue to work for this part of the Auckland challenge. I assure everyone that the Philippine government can be counted on to advance the cause of multilateral trade liberalization anchored on MFN treatment. We must overcome any slowdown caused by what happened in Seattle in December 1999.

In closing, I want to say that I have full faith that this will be a successful conference. I look forward to the published *Symposium Proceedings*, and certainly, to the completion of the *Economic Outlook 2000*, a work-in-progress that I trust is indeed progressing.

Thank you and good day.

**WELCOME REMARKS**  
by  
**Undersecretary Rosario G. Manalo**

Honorable Secretary Felipe M. Medalla, Members of the Diplomatic Corps and Regional Bodies, APEC Economic Committee Chair Dr. Mitsuru Taniuchi, Distinguished Colleagues in APEC, Distinguished Speakers and Delegates, Colleagues in Government, Ladies and Gentlemen:

I am tempted, in setting the positive tone of this conference in these welcome remarks, to provide you with a brief update on the current state of the Philippine economy and the latest economic initiatives of the government. But I am not going to do this, because I believe that the subject is better left to my colleagues in the Philippine delegation, some of whom are among the Asia-Pacific's most respected, eminent economist-scholars.

However, like a true bureaucrat in the service of the Philippine Republic, allow me to state at least that current trends and projections indicate that the Philippine economic outlook remains auspicious. The country possesses solid economic fundamentals, and these will hopefully sustain the path to recovery and further enhance trade and development growth.

And now let me proceed to my task this morning. Ladies and gentlemen, the Philippines is keenly aware of APEC's role as a forum to discuss the aspirations and legitimate interests of its developing member economies, particularly related to APEC's focus on technical cooperation and capacity-building to broaden our access to the benefits of liberalization.

Popularly known as the "APEC Way", the organization's open and informal style as well as consensus-based decision-making has created an atmosphere of congeniality among APEC delegations in contrast to the usual rigid, and sometimes unfriendly, environment that pervades negotiations in Geneva. The informal and forthright discussions that characterize APEC meetings have gone a long way in ensuring that the liberalization process in APEC remains fair and balanced.

Also worth mentioning is the organization's welcomed partnership with private sector and business organizations. The "public-private meetings" which have been an integral part of almost all APEC meetings may well be the envy of other regional economic groupings. Indeed, the recommendations and advice, as well as the economic and statistical data and analyses which private entities and business institutions provide, have contributed to the good and friendly investment climate in the region. This partnership is a hallmark of APEC.

Equally important, APEC should be lauded for encouraging its various fora to consider and discuss issues bearing on the well-being of the region, ranging from the APEC food system to the integration of women and youth concerns, to mention a few. The economic/social benefits to the economies, which APEC brings to the fore through its ECOTECH agenda, may perhaps be the organization's biggest legacy in the liberalization process.

APEC also provides a forum for its members to be heard and to have an equal voice. This situation evokes among the member economies a sense of responsibility for, and an equal stake in, ensuring the success of APEC. APEC assists the WTO in integrating its member economies, particularly the developing ones, into the global economy. As an eminent Japanese scholar once wrote, "APEC, moves the process of trade liberalization from a zero-sum to a positive-sum game – in effect capturing the very meaning and benefits of pushing for an open trading system."

In this symposium, we will be provided with data and statistics that may make us believe that all is well within our region and the world. However, whatever the positive figures may be will not

stand positive and welcomed scrutiny if the benefits of progress do not filter down to our people. Ladies and gentlemen, economic growth is simply meaningless if we continue to see some of our peoples suffer because of the poverty and inequity that still afflict some areas in the APEC region. We must therefore work for a multilateral trading and investment system that will ultimately promote, support, and sustain total human security and development. This to my mind, is where APEC must lead the way today.

So, on behalf of the Secretary of Foreign Affairs of the Philippines, and of myself as the Philippines' APEC Senior Official, allow me to bid you all a warm welcome, and to wish you a successful and fruitful symposium.

Thank you and good morning.



## **INTRODUCTION AND OVERVIEW**

The Philippines hosted the 2000 APEC Economic Outlook Symposium on 24-25 July 2000 at Mandaluyong City, the Philippines. The symposium, jointly sponsored by the APEC Economic Committee, the Philippine APEC Study Center Network, the Philippine Institute for Developing Studies (PIDS), and the National Economic and Development Authority (NEDA), served as a venue for academics, researchers, and practitioners to share their knowledge and views on economic issues and trends in the APEC region. In all, 143 delegates and expert speakers from 14 of the APEC member economies as well as from a number of international organizations participated.

Two major topics were discussed during the symposium, namely, trends in and prospects for the APEC economies and the region, and the issue of regionalism and multilateralism. This volume provides a summary of the discussions that took place at the symposium and makes available to a wider audience the papers presented and contributions made by expert speakers who gathered there.

### **THE CONTEXT**

In his opening remarks, Dr. Mitsuru Taniuchi, Chair of the APEC Economic Committee, noted that the region's economic performance and prospects are good and the positive developments from 1999 are likely to continue in 2000. There is, however, some divergence in economic performance among APEC member economies, and some risk of downward trends that have to be considered and envisioned in the future.

He likewise noted that being halfway toward the Bogor goal of trade and investment liberalization, there are a number of trade issues to be discussed. Among these are the trend towards forging subregional trade and investment arrangements, the new wave of regional arrangements and their features, and their role in both the multilateral trade system and APEC efforts for trade liberalization. Are they building or stumbling blocks? Another important issue pertains to the World Trade Organization (WTO), that is, APEC's stand on the launching of the new round and what role the APEC plays in the process.

In his welcome message, Dr. Felipe M. Medalla, Secretary of Socio-Economic Planning and Director-General of the NEDA, viewed with optimism the recovery currently taking place in the economies hard hit by the Asian financial crisis. The domestic macroeconomic policy responses, coupled with the continuing openness of the developed economies to global trade, allowed some export-led recoveries to take place and helped make economic contractions short-lived. He acknowledged adjustments made by the affected economies to deepen their structural policy reform programs, and the legal, administrative and judicial reforms that are being ushered in to thwart the recurrence of similar crises – and ensure soft landings in case they do.

He also acknowledged several initiatives for free trade areas that are being undertaken. While accepting that preferential trading arrangements (PTAs) and the World Trade Organization co-exist, he emphasized that PTAs should be used as instruments for multilateralism rather than trade protectionism and trade diversion. He further noted that APEC's commitment to open regionalism is the way to go so far as PTAs are concerned. He reminded the participants to keep in mind the Leaders' Declaration in Auckland, "APEC will continue to play a leadership role in strengthening the global economy, especially the multilateral trading system." He urged everyone to work for this part of the Auckland challenge and overcome any slowdown caused by what happened in Seattle

Ambassador Rosario G. Manalo, Undersecretary of the Department of Foreign Affairs and Philippine SOM leader, conveyed the Philippines' keen awareness of APEC's role as a forum to discuss the aspirations and legitimate interests of its developing member economies, particularly those related to APEC's focus on technical cooperation and capacity-building to broaden access to the benefits of liberalization. The organization's open and informal style as well as its consensus-based decision-making has created an atmosphere of congeniality among APEC delegations in contrast to the usual rigid (and sometimes unfriendly) environment of negotiations in Geneva.

She also noted that APEC has welcomed its partnership with private sector and business organizations and this has contributed to the good and friendly investment climate in the region. She lauded APEC for encouraging its various fora to consider and discuss issues bearing on the well-being of the region, ranging from the APEC food system to the integration of women and youth concerns; and for allowing member economies to be heard and have an equal voice. Furthermore, APEC has assisted the WTO in integrating its member economies, particularly the developing ones, into the global economy. She stressed that APEC should lead the way towards a multilateral trading and investment system that will ultimately promote, support, and sustain total human security and development.

On the first day, after the opening remarks, the symposium proper began with discussion of the following topics:

**Session 1: Outlook for the APEC Economies** with Dr. Cayetano Paderanga, Jr. of the University of the Philippines–School of Economics, Dr. Yun-Hwan Kim of the Asian Development Bank, Mr. Jun Saito of the Economic Planning Agency of Japan, and Mr. Menzie Chinn of the Council of Economic Advisers, USA, as speakers. Ms. Elley Mao of the Financial Services Bureau, Hong Kong, China served a moderator.

**Session 2: Recovery in East and Southeast Asia: Adjustment and Reforms** with Dr. David C.L. Nellor of the International Monetary Fund, Dr. Masahiro Kawai of the World Bank, Dr. Praduma Rana of the Asian Development Bank, Dr. Da Nien Liu of the Chung-Hua Institute of Economic Research of Chinese Taipei, and Mr. Peter Martin of the Treasury of New Zealand, as speakers. Dr. Mario Lamberte of the Philippine Institute of Development Studies served as moderator.

**Session 3: New Regionalism and Multilateralism: Goals and Analytical Issues** with Dr. Christopher Findlay of the Australian National University and Mr. Bonapas Onguglo of the United Nations Conference on Trade and Development as main speakers. Mr. Tim Miller of the Department of Foreign Affairs and Trade of Canada was moderator.

**Session 4: The New Regionalism: Existing Agreements** with Dr. Robert Pastor of the Emory University, USA, Ambassador Tim Groser of Asia 2000 Foundation of New Zealand, Professor Alan Fairlie of the Pontifical Catholic University of Peru and Dr. Mohamed Ariff of the Malaysian Institute of Economic Research, as speakers. Ambassador Edsel Custodio, Philippine alternate permanent representative to the United Nations and Other International Organizations, served as moderator.

## SESSION 1: OUTLOOK FOR THE APEC ECONOMIES

*This session tackled the economic performance and prospects for the economic future of APEC member economies as well as the implications for growth of recent international developments, like the increase in oil prices and the interest rate hikes in the US.*

Dr. Cayetano Paderanga, Jr. described growth in the PEO economies as a whole as reasonably strong in 1999 with a weighted average of 3.9 percent. This was achieved with historically low inflation with a weighted average increase of 1.4 percent. There was a small increase in the weighted average price level in East Asia, resulting from increases mainly in Japan, Hong Kong, China and China. There was an abrupt end to the increase in Indonesian prices precipitated by exchange rate depreciation in 1997-1998. In 1999, all PEO economies moved to positive growth after experiencing declines in output in 1998. The three North American economies had performed strongly through the East Asian crisis and grew beyond expectations in 1999. Continued robust growth in the United States anchored East Asian recovery in 1999. US imports grew by nearly 12 percent in real terms. The continued strong growth in US imports and the huge turn-around in East Asian imports lifted the weighted average for all PEO economies from a negative value to 8.5 percent and led to a very large export growth. This was brought about by a great volume/amount of intra-PEO trading in the region. The strong growth in East Asian and Pacific economies led to huge volumes/amounts of imports and a turn-around in East Asian imports. Exports increased by 4.7 percent in the PEO economies as a whole, up from only 1 percent in 1998. The pattern of growth in PEO economies generated current account deficit of US\$120 billion in 1999, which was a powerful expansionary influence in the rest of the world. This average number, however, hides the large differences among the economies in the region. By early 2000 the exchange rates in the region have started to stabilize again. Real effective exchange rates in most East Asian economies were back within the 10 percent of the allowance in the mid-1990s after wild movements in 1998. This indicated some positive signs of growth in the next several months.

For 2000-2001, growth in all PEO economies is expected to be fairly widespread, albeit with some differences in the strength of recovery. Forecasters expect the strong growth throughout the PEO economies to be accompanied by an acceleration of inflation in each economy in 2000-2001, to weighted averages of 2.3 percent and 2.5 percent, respectively. While these are still not high, they will require a policy response to control continued acceleration beyond the forecast period.

Large increases in exports are forecast for Australia; China; Columbia; and Hong Kong, China as well as for Korea; Malaysia; and Mexico. Modest increases are expected for the rest of the PEO economies. A sharp increase in the weighted average is expected for 2000 and a slower increase in 2001. On the other hand, real imports growth is forecast to be faster than that of exports for the year 2000 and more or less the same as exports in 2001, and thus there is an expectation of stabilization. There are, however, risks attached to it. The biggest 'upside' risk attaches to the possibility of underestimating the power of the transmission of expansionary tendencies across the Asia-Pacific region. It is possible that trade expansion, in particular, in East Asia will be more rapid than is anticipated in the forecasts and therefore there is a possibility of stronger output growth. This risk of growth in excess of forecast levels is apparent in number of economy analyses. For instance, the end of deflation in China could generate a faster growth in domestic demand and result in an increase in the weighted average of GDP growth. As to the 'downside' risk, there is the possibility that there will be a larger correction in US financial markets than has been allowed for in the forecasts. This could lead to another round of instability in international financial markets; higher oil prices in the year 2000 and the possibility of higher prices on other commodities and these will also generate adjustments.

**Dr. Yun Hwan-Kim** presented his views on the prospects and medium-term policy agenda for Asian APEC member economies as well as for Japan and the United States. Dr. Kim noted the

high growth performance in the first quarter of 2000 of most Asian developing economies, namely, China; Hong Kong, China; Korea; Malaysia; Singapore; and Chinese Taipei. Their strong growth has been attributed to strong growth in consumption, investments and exports, for example, electronics and automobiles. Indonesia and the Philippines, however, faced some internal problems. The Japanese economy on the other hand maintained an upward trend in output in the first quarter driven by a strong export performance, a recovery in consumer spending, a large increase in housing stocks and an increase in industrial production. The United States economy grew by 5 percent in the first quarter of 2000 due to the strength of consumer demand and fixed investments.

A strong recovery is being envisioned in 2000 on account of the following factors:

- The high growth performance of most Asian member economies in the first quarter of 2000 will have a positive impact on the forecasts for 2000 and 2001.
- Further increases in US interest rates in the second half of 2000 as well as in 2001 is expected to slowdown the US economy with the GDP growth projected at over 4 percent and almost close to 5 percent in 2000. This is expected to have positive effects on Asian economies in 2000 and 2001.
- Organisation for Economic Cooperation and Development (OECD) member economies in general are expected to perform well in 2000 and 2001.

In the case of Japan, the latest *Tankan*<sup>1</sup> survey, conducted in May 2000 and covering the first quarter of 2000, indicated positive business sentiments. Consumer confidence is at the highest point since the second quarter of 1996, while consumer spending on some items including computers and cars has been rising. Japanese exports will remain buoyant in 2000

Growth for 2001 is expected to be slower than in 2000 given the likelihood of higher US interest rates in 2000-2001 to address significantly high inflation in the early months of 2000 and record high current account deficits in 2000, and the widely held view that the economy is overheating. The impact of higher interest rates on production sectors, housing markets, and consumption (durable items) will have the most impact on US economic growth and that of other Asian economies. The increase in the interest rates in the US will also lead to a reversal of the wealth effects which have boosted consumer spending over the past few years. The foreseeable increase in the oil price is also expected to impact on the economic growth of the US and the Asian region. A lower rate of expansion of consumption and investments in major East Asian economies such as Korea will also contribute to the slowdown in economic growth for 2001.

Dr. Kim mentioned four important issues to determine the medium-term economic prospects in APEC member economies. The first issue is ensuring financial stability through a successful undertaking of the financial restructuring in the crisis economies; improved credit risk management; and a significant increase in operational efficiency. Financial options of the Asian industrial sector need to be diversified from the bank-centered method. Particular attention should be paid to capital markets, especially bond markets, which have long been neglected.

The second issue is developing the information economy. The role of information is increasingly important in socio-economic development. The concern, however, is how Asian developing economies will maximize the positive side of the information economy. As the new economy involves both constructive and disruptive outcomes, an economy needs to carefully prepare to cope with the adverse impacts (e.g., temporary unemployment, the new business culture and the older generation, and new social systems).

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<sup>1</sup> Refers to opinions and sentiments on short-term prospects of business communities. The survey covers all manufacturing and non-manufacturing enterprises irrespective of size.

The third issue is globalization. The new information economy accelerates the interdependence between economies, requiring an economy to be integrated into the global economy. It involves the opening up of finance, trade, industry and services. Any careless response to this agenda may bring tremendous adversities to the economy e.g., Asian financial crisis.

The fourth issue is reducing poverty. Many Asian APEC member economies have a large number of poor households, particularly in China, Indonesia, the Philippines, Thailand and Viet Nam. The Asian crisis has aggravated the poverty in Asia. Poverty leads to loss of opportunity for education and worse health conditions. This deprives the poor of participation in the socio-economic development process, causes lower economic productivity and may even perpetuate poverty as well as preventing equitable development. An economic spur as well as socio-economic policies targeted at the poor are essential to eliminate poverty in Asia.

**Mr. Jun Saito** spoke about the recent recovery of the Japanese economy and prospects for growth and their implications for the economic development of other economies in the Asian region. He described the experience of the Japanese economy in the 1990s as very disappointing. Some say that the Japanese economy lost a decade as it registered an average of 1 percent between fiscal years 1991–1999, way below its average in the 1980s. The gradual tightening of the monetary and fiscal policies led to the burst of the bubble in February 1991 and the recession lasted for more than two years before a series of economic policy packages, including easing of the monetary policy, succeeded in lifting the economy. The recovery started in 1993 despite the stiff appreciation of the yen during the period. Further economy packages and monetary easing led the economy to grow by 3 percent in fiscal year (FY) 1995 and 4.4 percent in FY 1996. The recovery was, however, aborted in March 1997 when the economy went into a recession lasting until 1999. Heightened fiscal policy, the Asian crisis and financial instability have had significant negative effects on the economy. The recession has been very severe for the Japanese economy as real gross domestic product (GDP) declined by 0.1 percent in FY 1997, and by 1.9 percent in FY 1998. The unemployment rate shot up to more than 4 percent while consumer prices, excluding that on fresh fruits, fell in FY 1998 and 1999. There were fears that the economy might go into a deflationary spiral.

The recession ended in April 1999 and since then gradual economic recovery has been evident with improvements in industrial production, corporate profits, expected medium-term growth rates, business investments and real GDP. Private forecasters project the economy to grow by an average of 1.7 percent ranging from 2.5 percent to 0.9 percent. The government forecast of 1.4 percent for 2000 is almost at the lower end of the private sector forecasts. Three main factors drove the economy to recovery: first, national fiscal policy; second, easy monetary policy including the implementation of the zero interest rate policy; and third, less concern for financial stability. Financial instability in 1997 led to the very cautious behavior of economic agents including households and corporate firms. In contrast, private banks have been very weak. While some business investments recovered, recovery has been somewhat soft. Private consumption is very sluggish indicating that the recovery is not yet a self-sustaining one.

Mr. Saito characterized the recovery of the Japanese economy as slow-paced. He attributed this mainly to very the sluggish growth in private consumption which accounted for about 60 percent of total GDP. This was due to two reasons. One was weak consumer confidence, which deteriorated when great uncertainty unfolded in the Japanese economy starting in 1997, and people became very anxious about the future prospects of the economy in the medium-term. The other factor was the decline in labor income resulting from a fall in employment and wages. This clearly shows that restructuring, on the one hand, makes the corporate sector more comfortable but on the other hand exerts negative pressure on the household sector. The restructuring process consequently slowed down the pace of recovery. He noted that this combination of positive and negative effects it is not completely inevitable. A more desirable scenario calls for the stock market to incorporate future improvement in profitability, which can be expected if restructuring succeeds. Then, private households will be able to enjoy a positive wealth effect. This kind of

mechanism can be a bridge between the two sides and support the kind of recovery which took place in the United States in the early 1990s – when a jobless recovery was taking place at a time of downsizing of the economy. This mechanism, however, has not been observed in Japan.

On the prospects for recovery, Mr. Saito noted that the burden inherited from the bubble period or the so-called “three excesses”, namely, excess debt, excess capacity and excess employment should be taken into account. As long as the excesses remain, they will keep exerting a negative impact on the economy. On the other hand, it has become increasingly difficult to adopt expansionary macroeconomic policies in the face of increasing budget deficits and the accumulation of public debt. However efforts should be made to avoid macroeconomic policies that exert a negative impact on the economy, and this implies that drastic and hasty changes should be avoided. Overall, recovery in the future is expected to remain slow and fragile.

He finally touched on the implications of the Japanese economic recovery on the interdependence of Japan with the other Asian economies. It owed much to the strong growth of exports to the Asian economies, which dropped significantly in the aftermath of the Asian crisis. Imports to Japan have also increased since late 1998 with the recovery of the Japanese economy. Taking imports and exports together, the recoveries in Japanese and Asian economies seemed to have reinforced each other. Furthermore, taking into account that that main commodities in both exports and imports are capital and intermediate goods, it is suggested that Japan and Asian economies have created a close interdependence between each other based on a horizontal division of labor in manufacturing.

On the other hand, the capital flow side showed a different picture. Foreign direct investments (FDIs) from Japan to Asia have not quite recovered to the level recorded in the pre-crisis period nor has it recovered as much as FDIs to the rest of the world. Bank loans to Asia remained low despite increased inflows to Asia from other economies. While the information is still fragmentary, interdependence between Japan and Asia may have slowed down in the area of capital flows.

**Mr. Menzie Chinn** spoke on the continued strong growth of the US economy in 1999 and in the first quarter of 2000 and the low and stable inflation during the period. Real GDP grew by 4.2 percent in 1999 marking the eighth consecutive year of positive output growth. Strong growth continued in the first quarter of 2000, with real GDP growing by 5.5 percent.

The robust growth of personal consumption expenditures helped strengthen household spending with real disposable income growing 4 percent. The stock market continued to soar and measures of consumer confidence reached all time highs. Stocks were, however, volatile in the first six months of 2000 but nevertheless consumer confidence remained high and household spending grew at a robust 8.3 percent in the first quarter of 2000. In 1999 real investments grew 5.8 percent as real business fixed investments grew 8.3 percent fueled by large increases in spending on computers and other information processing equipment. However, spending on business structures fell. Real exports exerted a drag on GDP growth for the fourth year in a row, growing by only 3.8 percent in 1999. In contrast, real imports grew by 11.7 percent, even faster than before, to satisfy growing domestic demand.

Inflation slightly picked up in 1999 from a very low pace in 1998. The dramatic increases in oil prices accounted for the upturn. With regard to employment, the high market pressure labor market continued its strong performance in 1999 as nearly 2.5 million private non-farm jobs were created and the service sector added 1.4 million new jobs, an increase of nearly 4 percent. In contrast, employment in the manufacturing sector was particularly hard hit by weak export demand which fell for the second year. The annual unemployment rate dipped to 4.2 percent: its lowest since 1969. Strong productivity growth in 1999 helped to keep inflation in check despite the very low unemployment rate.

The current account deficit accounted for 3.7 percent of GDP. A surplus in the balance of trade in goods and services was recorded as the merchandise trade deficit was partially offset by the services surplus of US\$80 billion. The dollar was fairly stable in real terms in 1999 but strengthened in the first four months of 2000 bringing the exchange rate levels not seen since mid-year 1998. A surplus in foreign direct investments was also registered with higher dollar inflows relative to outflows. Further, for the first time in 40 years, the federal government registered budget surpluses in two consecutive years. At 1.4 percent of GDP in 1999, the fiscal surplus was the largest relative to the size of the economy in nearly 50 years.

With regard to monetary policy: amid concern over potential build-up of inflationary imbalances, the Federal Reserve raised the target federal funds rate by 75 basis points in three steps in 1999 fully reversing the rate cuts they had instituted in 1998 during the global financial crisis. Over the first six months of 2000, the Fed raised rates three times, stating that the near-term risks were weighted mainly toward conditions that may generate heightened inflation.

On the US economy's medium-term outlook, Mr. Chinn cited that as of June 2000, the business expansion cycle has lasted 111 months. The small increase in inflation this year was attributed to the surge in world oil prices. As of July 2000, private forecasters predict that the economy will grow at a slower rate of 3.5 percent in the final three quarters of 2000. If this holds, the growth rate for the year as a whole is expected to be 4.8 percent, the same as the administration's projection in its mid-session review. Private sector forecasters project GDP will decelerate to 3.3 percent in 2001, very close to the administration's prediction of 3.2 percent

Both supply and demand-side considerations argue for some moderation in real GDP from its rapid 4.4 percent annual pace of the past 12 quarters. The unemployment rate has fallen about 0.4 percent per year over this period, indicating that this growth rate is well above potential. The labor market is very tight as indicated by low unemployment in June and increases in real wages. It is doubtful whether a further decline in the unemployment rate could be accommodated without inflationary consequences. Labor force growth has not kept up with demand in the past two years, nor can it be expected to keep up with growth at such a pace in the future. Finally, some components of demand that contributed to the rapid growth of the past few years, such as business demand for capital goods, are not likely to be sustainable over the long run. The administration's forecast as of late June for the 3-month interest rate on T-bills is at 5.8 percent on average in 2000, 6.2 percent in 2001 and 5.9 percent in 2002. Considering the above, the GDP is forecast to grow at about 3.0 percent per year through 2006. This rate is consistent with the growth for the 1990 business cycle as a whole and with labor force growth of approximately 1 percent and labor productivity growth of approximately 2 percent.

### **Open Forum 1:**

**Dr. Florian Albuero** commented that that none of the presentations dealt with the developments in the last two months, particularly in the context of the possibility of a slowdown or a soft landing of the US economy, the dramatic decline in stock prices and the changes in interest rates in the US. Insights of the speakers were requested specifically on the possibility that the fragile Japanese recovery could be aborted again given the developments in the past two weeks and the entire outlook for PEO economies.

**Dr. Paderanga** mentioned that PEO forecasters have built-in the assumption of the United States' soft landing but does not know how fully this has been built into the forecast. They were also not able to fully incorporate the complete magnification of the intra-trade relationship among the PEO economies. He believed, however, that it is going to be a different story in the case of Japan because of its large surplus with the US.

**Mr. Saito** stated that what he presented was a government forecast, which was compiled in January 2000. However, it was his personal view that Japan's economy is fragile. This means that when US economy slows down significantly it may have a double impact on the Japanese economy. He noted, nevertheless, that this will depend on what is going to take place the US economy.

Three questions were raised with regard to the state of the US economy. The first was on the argument about the new economy. There has been growing interest as well as some debate on whether the production potential of the US economy has been raised by the recent rapid advance in information technologies. Many economies tend to accept that there seems to be some significant impact of the information technology on the US economy. But there are also some skeptics like Prof. Gordon and the very influential economic magazine of the UK, *The Economist*. What does the US government make of this argument and what implications does this argument about the new economy have for the short-term prospects of the US economy?

Secondly, it was noted that over the recent months there have been some concrete signs that the US economy is finally slowing down. Over the past three or four years *The Economist* has predicted that the US economy would slow down but the US economy has continued to achieve very high growth – over 4 percent for the past three years. What are the prospects that the US economy may again continue to achieve strong growth in the next 12 months or so?

Thirdly, given the medium-term projections for the US economy, what does the government see in terms of fiscal policy in 2001 considering that year 2000 is an election year? Mr. Chinn has stated that the growth of the US economy will converge at around 3 percent over the medium-term. The actual current economic growth is higher than what has been projected.

**Mr. Chinn** explained that the higher estimates of the US growth over the long-term were based on an increasing trend of labor productivity growth in the US in the past two years relative to what was seen in between 1970 and 1980; and lower, non-accelerating, inflation and unemployment rates. For him, the new economy is a longer-term phenomenon. With regard to short-term prospects, he sees some factors including business fixed investments and net exports as pointing to the deceleration of growth in the second quarter.

**Mr. Saito** observed that information technology has raised overall economic productivity in the US in the last five to six years. Productivity is unusually high compared to previous periods and very much higher than economic productivity in Japan or in Europe. Information technology has made the US business environment more dynamic which in turn promotes economic production and trade and has also increased labor market flexibility. In a recent statement, Mr. Greenspan, chairman of the US Federal Reserve, attributed the latest recent high economic growth of the US to labor flexibility. All three factors promoted US growth of the US economy. While this high economic growth trend will be sustained for some time, he believed that the US Central Bank would continue to make efforts to slowdown the US economy in 2001. This notwithstanding, he expects the US economy to grow between 4–5 percent in 2000, and 3.5–4 percent in 2001, which he considers a soft landing.

**Mr. Chinn** acknowledged that indeed the short-term output growth is in excess of the long-term growth. The growth rate projected for 2000 is 4.8 percent and for 2001, that growth rate is predicted to fall at 3.2 percent. The long, term forecast ranges from 2.9 to 2.8 percent going into 2010. He noted that the natural operation of the macro-economy as well as the decelerating growths of net exports and investments will slow down GDP. As for fiscal policy, the US government has been building up a budget surplus on the unified account very rapidly. Most of this increase in the budget surplus is going to be saved and a good chunk of the US debt outstanding will be retired. The administration's stand has been to sustain the budget surplus.



Not everyone shared the optimism about the medium-term prospects, especially for crisis-affected economies. While the short-term prospects seem pretty good, the pace of the economic restructuring process and implementation of reforms were seen as too slow. There was a view that the recovery in East Asia has been too fast for its own good and may create serious problems in the medium-term. The politically connected relationship between the corporate sector and the government is seen to pose a major problem government's increasing share in GDP.

On the issue of policy reform, **Dr. Paderanga** recalled that a group of forecasters, in the meetings of the Pacific Economic Cooperation Council (PECC) as well as in meetings on the Asian financial crisis, were amazed at how the affected APEC economies were able to prevent the reversal of policy reforms. He pointed to how Malaysia instituted administrative controls on the foreign exchange mechanism, but also managed to move very fast to remove the most stringent of these policies in order to reassure markets that Malaysia was still moving forward. He said that the talks questioning the liberalization of open economies in Asia are actually mixed together with the potential for, if not an actual, backlash against globalization such as is happening all over the world. Looking at what happened at APEC, he was pleased to note how member economies have been able to hold on to the economic reforms that have been done despite all the pressures that have come from firstly, the invitations to question the previous policy reforms, and secondly, the pressures that admittedly came out of the Asian currency crisis. He was encouraged, that in so many of the economies being observed the reforms have not been reversed

Another view taken was that the reform is slowing down and that there is increasing government intervention. Comparing Korea, Malaysia, Thailand and Indonesia, the government led in undertaking reforms in the first two economies, while the financial restructuring in Thailand was market-led. While a high and sustained growth could be attained by Korea and Malaysia through government-led reforms, there is a danger that the government may continue to strongly intervene in the market. It was also the view that the economies affected by the financial crisis should continue to reform their financial sectors.

A question was raised on the implications of China's entry into the WTO with respect to its impact on the region, particularly on trade and investment flows, and on the economic prospects of China's neighbors in general. **Dr. Paderanga** noted that this will make the rules with regard to other economies' trade with China more stable and perhaps enable them to take advantage of some of the market openings that are there. However, in terms of quantitative numbers, China is all over the market and what causes most concern is the direction of foreign direct investment when China joins the WTO and its relationship with the rest of the world is much more stable and is clear-cut. There is the possibility of China sucking-in even more of the available FDI, and that may severely affect the smaller economies.

**Dr. Vicente Valdepenas, Jr.** made two queries on Mr. Saito's paper: specifically on page 4: a) on excess employment, what proportion of the total labor force is unemployed by the excess employment; and b) was the reduction of FDI flows to Asia a result of a general slowdown in FDI from Japan, or was it a geographic redistribution of FDI from Asia to other parts of the world, and if so, where did it go.

**Mr. Saito** responded that excess employment is estimated to be around 2 percent of the labor force. He noted that the excess employment he referred to is based on the estimates using the *Tankan* survey which asked companies whether they feel that employment is in excess or not. On the question of FDI, total FDI increased in fiscal year 1999 by more than 40 percent but FDI to Asia declined by 6.8 percent resulting in a lower share of total FDI. Mr. Saito offered a number of reasons as to why FDI to Asia shrank: fluctuations in the exchange rate, firms' difficulty in raising funds, difficulties experienced by parent companies in Japan and reviews by host companies or parent companies of overseas operations, i.e., of subsidiaries.

## **SESSION 2: FOCUS ON THE RECOVERY IN EAST AND SOUTHEAST ASIA: ADJUSTMENT AND REFORM**

*This session looked at: the short-run adjustments and policy reforms in the medium and long-term of the hardest hit economies of East and Southeast Asia in the aftermath of the financial crisis that struck in 1997, and the policy responses by both the developed APEC member economies (like the US and Japan) and the regional and multilateral financial institutions to bring about economic recovery and sustained growth.*

**Dr. David C.L. Nellor's** presentation was divided into three parts: a) policy adjustments and responses by the crisis economies b) the role of the developed APEC economies and c) the role of the multilateral financial institutions to recovery and sustaining growth.

Dr. Nellor spoke briefly on policy and economic adjustments, and financing paths (official, private sector and external sources) resorted to by crises economies to restore confidence. He noted that one aspect in the time-line of the crisis was an inconsistency in the macro policy regime. If economies choose to go for a fixed rate and/or a pegged exchange rate they lose independence on monetary policy, whereas if they choose a floating exchange rate they gain some independence in the monetary policy side. In a pre-crisis situation, there is a tendency to go towards the fixed exchange rate or a fixed peg, as well as efforts to pursue an independent monetary policy, which was one of the facts on the time-line of the crisis. In Thailand, for instance, investors were given the option of borrowing money in dollars given lower US interest rates and gaining higher returns out of the prevailing Thailand exchange rate. This could not have been done in the pre-crisis period because essentially the exchange rate was unchanged throughout this period.

He observed that crisis-hit economies, with the exception of Malaysia which chose a pegged rate, all adopted flexible exchange rates. They also undertook institutional changes. While only the Philippines had an independent Central Bank in the pre-crisis period, several economies in the region have followed suit and now have their own Central Banks. It is seen as important to develop a macro policy regime that is consistent, sustainable and will minimize volatility. Besides restoring fiscal policy, the strengthening of the financial sector was also deemed important not only in terms of supporting domestic demand but as a transition mechanism for monetary policy.

He expressed concern on the issue of repeating the same mistakes made before. He noted that the international reserves position of the Asian four plus Korea has dramatically risen since 1998. He noted that while it is entirely appropriate for these economies to rebuild reserves, the issue is at what pace and to what extent, the acquisition of foreign exchange reserves is to be done by the Central Bank. It would imply that Central Banks in the region are intervening very heavily in the foreign exchange market, and one of the consequences of that is high domestic liquidity being pumped into the system. But given the weak demand for credit in these economies, Central Banks should be enjoined to put these funds back into the banking system. Commercial bank lending to the Central Bank tends to be of very short maturity. The so-called sterilization debt as a percentage of GDP has risen to a level of about 9 or 10 percent of GDP –even higher in some economies. The concern about these sterilization debts dates back to the first half of the 1990s. As economic conditions in Asia strengthened and all the heating of economies started to take place, domestic interest rates were raised and the cost to the Central Bank of issuing its debt of borrowing from the commercial banks became very high. Central Banks were reluctant to continue the practice because the cost was just too great. It was these debts on this liquidity which was then put back into the banking system which formed the basis for the credit boom of the mid-1990s. The re-emergence of a high level of liquidity, presently being held by the Central Bank but being rolled-over in a very short time, may again be a concern in terms of feeding another credit boom in the future. A boom which at this time may not be sustained in terms of monetary policy.

He observed that credit growth remains negative in terms of year-on-year growth in several economies and in others that it may have bottomed out but still not be that robust. While a number of factors could explain the credit recovery, it was clearly credit companies who were able to bypass the banking system by issuing bonds and financing to the equity market. In Korea, for example, finance through the equity market in 1999 is about 8.5 percent of GDP compared to about 1 percent of GDP earlier in the 1990s, indicating that other sources of finance are clearly becoming very important. However, in recent months, with financial markets becoming less buoyant, the case for further strengthening of the banking system has been emphasized.

On the external environment, the issue is whether the US will have a soft or hard landing. But one important aspect with relevance for Asia is whether or not the demand for information technology products in the US (which grew by as much as 70 percent) will continue even if the US economy slows down. A recovery in Europe and Japan may support Asia even if the US has a slower growth. These economies will have to do some catching up in terms of demand for these products. Exports of electronics and non-electronic products have been very strong in Malaysia, Indonesia, the Philippines, Korea, and Thailand, which reflects the importance of growth recovery in consumption demand within Asia. Electronics also has a significant role both in terms of its growth rate and its share of total exports. Demand for information technology from Europe, US and Japan thus will remain a very important question.

In the case of Japan, Japanese lending to Asia fell dramatically from US\$500 billion as of June 1997 to US\$280 billion per year by the end of 1999. There are signs, however, that the levels are stabilizing but the withdrawal of financial measures was pretty dramatic and certainly had quite a role in the crisis. Japanese exports to Asia have also recovered. Japanese imports became important in later months, which show the interaction between Asia and the US. On the capital flows, he observed a real differentiation within Asia. In terms of FDI flows, China and Korea were doing well but the picture was not the same in much of Southeast Asia, i.e., Malaysia, the Philippines and Thailand (to a lesser degree). Data (syndicated loans, equities and bond finance to Asia) suggests that private capital flows remain fragile and remain an issue for Asia to monitor. The concern in the financial market in April poses some negative impact in terms of emerging market finance.

On the multilateral architecture, he noted a lot of progress in some areas, for example, standards and codes, financial sector assessment, norms or guidelines on private sector involvement, and some other aspects.

Dr. Nellor concluded that the recovery is robust and vulnerability has been reduced. Within APEC, there are certain Latin American economies which seem to be more vulnerable from an external perspective because they have large gross financial requirements compared to their Asian counterparts. However, sustaining recovery is still in a mode of searching for a new macro regime and considerable progress still needs to be made in terms of financial and corporate reform before one could argue that a fully sustainable recovery has been achieved. On the external environment, a favorable environment is expected although there are talks of US interest rate rises predicated on the economy's soft landing. On the capital flow side, there is certainly differentiation across economies and that differentiation may reflect in part the result of a policy in place or the stage of policy reform that those economies are in. Finally, on the external environment, strength is the rule of the game, and to make progress, APEC and the other groups should help develop the political will to ensure that reforms will sink through as these will form the framework or the environment in which the APEC economies will be working in the years ahead.

**Dr. Masahiro Kawai** spoke on the medium-term challenges for East Asian economies. He noted that clearly East Asia had recovered from the 1997-98 crisis, but the question has been whether the current economic recovery process is sustainable or not. What are the other risks involved in the recovery process? Has the Asian financial crisis produced lasting reforms? Can East Asian economies convert the current economic recovery process to long-term economic growth?

He noted that this V-shaped economic recovery has been driven by active exports, fiscal stimulus, rising personal consumption, some inventory restocking, and fixed investment which is strong in Korea but not necessarily in other economies. This recovery has been made possible as a result of financial market stabilization, exchange rate appreciation, stock market recovery and interest rate decline although in recent quarters some financial market disturbances were taking place. The current recovery process has also been made possible by counter-cyclical macroeconomic policy (fiscal stimulus in particular), some progress in financial and corporate restructuring, and also region-wide expansion supported by external demand. In this process, robust economic growth in the US has been quite vital.

On financial and corporate restructuring, a significant progress has been made in creating an institutional framework to resolve the systemic crisis in financial and corporate sectors. This includes: a framework to resolve insolvent financial institutions, closures, mergers, temporary nationalization, temporary take-over or establishment of public asset management companies to absorb non-performing loans from financial institutions or establishment of agencies to re-capitalize weak but viable commercial banks using public resources. Measures to resolve systemic corporate sector crisis include establishing legal or court procedures for bankruptcy reorganization and foreclosures, or establishing of voluntary frameworks for negotiating debt restructuring between private creditor and debtor, and the creation of an enabling environment to induce corporate restructuring through tax and regulatory changes.

There was also significant progress observed in the area of financial sector restructuring. Insolvent and non-viable financial institutions have been closed, while others were merged or temporarily nationalized. Non-performing loans held by closed financial institutions or weak financial institutions were carved out and were transferred to asset management corporations. Weak but viable financial institutions were re-capitalized although re-capitalization efforts are still needed. Some temporarily nationalized banks have been re-privatized.

Progress in the area of corporate debt restructuring has not been that fast. Court-based bankruptcy or reorganization procedures have been observed but still the pace is slow. Voluntary debt negotiations have been taking place particularly in Thailand and Indonesia but still the process is slow. Asset management company-led restructuring of corporations is also taking place but is proceeding extremely slowly.

There are, however, some important consequences of resolving this/a systemic crisis. One important consequence is that governments have become the holders of large banking assets. In Indonesia about 80 percent of bank assets (in terms of GDP) is in the hands of the government; about 60 percent in Korea, 30 percent in Thailand. The issue is how to dispose of such government assets, in what way, and to whom. Another consequence is the significant increase in public sector debt. Indonesia before the crisis, did not have any domestic currency debt but as a result of financial sector restructuring, domestic debt has been issued to re-capitalize banks. External debt has also increased to some extent with a significant jump in the ratio of external debt to GDP. The Philippines has always had a high ratio of debt to GDP. Thailand's increased debt level, while still lower than Indonesia's, is a big cause of concern.

The financial sectors continue to be weak in several economies. Thailand's non-performing loan (NPL) ratio is about 35 percent. In the case of Korea the number of NPLs is declining, i.e., are now below 10 percent, although there is some concern about the correctness of the numbers which were expected to be significantly higher. The slow debt restructuring of corporations and the corporate sectors' debt have to be addressed and resolved to ensure that the current economic recovery process is sustained. Large public debt is another domestic risk. A high interest rate could put a strain on corporate borrowers especially where, as in Thailand, corporate borrowing is still high. External shocks like a slowdown in the US economy, a stall in the Japanese economic recovery, and the oil prices also cause concern.

There are three important challenges for the East Asian economies to transform the current economic recovery into a sustained and stable long-term growth. These are: a) the need to revitalize the private sector; b) to streamline the public sector; and c) to forge a new social contract.

On the first point, the current financial and corporate restructuring efforts have to be sustained. In the medium-term, the financial sector, including the financial sector consultation, must be reformed. This is currently underway in various economies such as in Malaysia and in Korea. Japan is also going through a massive financial sector consultation. Enhanced supervision and regulatory frameworks, capital market development, and corporate governance strengthening are important concerns. Increasing productivity and competitiveness of the private sector by shifting to the so-called knowledge-based economy and investing in IT and human resources will contribute significantly to sustained economic recovery and growth. The World Bank (WB) has just released a new publication called *East Asia: Recovery and Beyond* which is a sequel to the previous publication called *East Asia: the Road to Recovery*. It discusses the knowledge-based economy among many other issues.

Secondly, an important part is to streamline the public sector. The new role of the government as a regulator rather than as a producer of products and services is an important step. However, the government is still expected to continue to provide public goods and minimal social infrastructure such as minimum education, health and social infrastructure services. These social services delivery systems have to be made efficient and for that better systems of controlling public expenditures and civil service reforms have to be done for the purpose of transparency and a higher degree of accountability.

Thirdly, is important to forge a new social contract given the phase of globalization, urbanization and demographic changes.

In summary, Dr. Kawai noted that East Asia has indeed achieved some lasting reforms by: introducing frameworks to resolve systemic crisis and bank exit policies to resolve insolvency on the part of the corporations; and by strengthening the judiciary system for these purposes. Another reform would include enhancement of financial sector supervision and regulation. This is just beginning but many economies are very serious about initiating corporate government reforms and opening their economy to foreign investors. These reforms may help change many East Asian economies permanently. The East Asian economies can help transform the current recovery into sustained growth if financial and corporate restructuring is pursued without complacency, and if public debt is managed prudently. If the US economy can soft land in the medium-term, these economies must focus on the issues of revitalizing the private sector, streamlining the public sector and forging a new social contract.

**Dr. Praduma B. Rana's** presentation dealt with the following aspects of recovery, namely asset market recovery, bank and corporate restructuring, longer-term social sector recovery and competitiveness issues. Broadly, recovery is defined as two successive quarters of positive growth. Dr. Rana believed, however, that such a definition is too narrow given the deep recession the region has experienced in the last two to three years. He defined recovery instead in terms of whether indicators have reached their pre-crisis levels and exceeded them or not. In general, he sees a lot of progress in terms of asset market and real sector recovery, but still has to see recovery in other sectors

Dr. Rana noted that recovery in 1999, led mainly by net exports, was faster than expected, although was fragile. Property markets headed south while bank and corporate restructuring has a long unfinished agenda. Social indicators had started to turn around. In 2000, recovery is consolidating further, and becoming more broad-based. Private consumption and investments, in addition to net exports, chipped in as drivers of the recovery process. There has been further

progress in corporate restructuring while social recovery is starting to put down roots. Quarterly GDP moderated to more sustainable levels but in 2000 the second quarter growth turn out was lower than the first quarter turn out which showed that recovery is prone to domestic and global risks.

The recovery process, however, is not yet complete. Per capita incomes and living standards reached pre-crisis levels in Korea last year but did not do so in other economies. It is expected to happen in the Philippines and Malaysia sometime this year but it will require another year or so in Thailand, and two more years or so in Indonesia. These figures are for full recovery in asset markets and in the real sector, the bank and corporate sectors. Social recovery will take even longer.

On asset market recovery, first quarter data for 2000 showed that the worst is over for the property market. Interest rates have started to fall in Kuala Lumpur and Bangkok, but the turn around is slower in Jakarta and Manila because of continued uncertainties. Rentals have also started to stabilize and may fall in the next quarter also. Likewise, golf shares may have started to turn around. Recovery in the financial market led Asia out of the crisis but the financial downturn since the beginning of 2000 may affect sustained recovery.

In the real sector, recovery is moderating to a more sustainable level. The drivers of recovery have also changed and real investment is starting to improve. Banking sector restructuring, however, is proceeding at an even pace while corporate reforms are lagging behind banking. The social indicators are starting to turn around but there is still a need to address issues of governance and competitiveness.

Dr. Rana expects the recovery process to be consolidated and further strengthened in 2000. External risks appear to be manageable but uncertainties remain. Domestic risks are of concern. He cautioned against the adoption of a “fast growth” strategy, which is risky. He advocated that reforms should continue.

**Dr. Da-Nien Liu** analyzed the situation in the East Asia in the wake of the Asian financial crisis, as well as valuable lessons learned from the difficulties encountered by the East Asian economies, especially the vulnerability of small open economies to the hazards of the international environment. He noted that in 1999, the year following the outbreak of the Asian financial crisis, the GDP of most East Asian economies shrank considerably. As a whole, the Pacific Basin experienced near 5 percent contraction of its GDP, a marked contrast to the extraordinary growth achieved in previous years. This contraction was also accompanied by a sharp decrease in industrial production and private investment, as well as consumption. Fortunately, there was a clear shift from crisis to recovery in 1999. Although the recovery remained uneven across the region, the economies of most of the crisis-hit economies have recovered more rapidly than many observers had anticipated. The driving force of recovery has been generally similar among the crisis-hit economies, with the initial support provided by fiscal stimulus to generate domestic demand and monetary policy aimed to stabilize the exchange rate. More recently, the recovery has primarily resulted from increasing exports, led by a surge in worldwide demand in particular from the booming US economy. In addition, as income and wealth have increased and consumer confidence returned, domestic demand, fueled especially by private consumption, has also picked up. Expansionary policies and progress in implementing structural reforms are expected to spur continued recovery and further improve the region's economic situation through year 2000 and years ahead.

The Asian financial crisis was one of the worst economic collapses recorded in modern history. The crisis-hit economies of East Asia saw their combined wealth reduced by some 20–30 percent in less than two years, after more than a decade of rapid growth. In addition, the economic shock pushed millions back to the brink of poverty and created severe unemployment. Such a devastating shock, in turn, precipitated social turmoil and unrest. As a result, consideration of the

issue of building social safety nets to protect the most vulnerable groups and to sustain economic growth has been forced to the fore.

No study of a currency crisis would be complete without detailing the lessons that can be learned from it. With the shadow of the Asian currency crisis still hanging over the region and making future developments difficult to predict, it is particularly important to take the following implications into account. First, the sequence of economic and financial reform is critical during the course of economic development. Many economists have pointed out that during the process of economic reform, the right sequence must be used for economic liberalization: a) the creation of a sound financial and tax system must take priority over financial liberalization. Before implementing financial liberalization, an economy must first strengthen its financial, taxation and budgeting structure, to prevent an imbalance in financial expenditure leading to an excessive supply of money, hurting the attainment of a stable currency; b) the creation of a sound domestic financial system should take priority over opening financial markets to international capital. Having a sound domestic financial system must take priority over integration into the international financial system. Once a sound domestic financial system has been created it will assist in raising competitiveness, and prevent exchange rates from falling with inflation; c) the liberalization of current accounts should take priority over liberalization of capital accounts. Efforts should first be made to eliminate export and import trade barriers affecting current accounts, for example by lowering tariffs and removing quota restrictions. Once this has been achieved, capital accounts can be opened. The free movement of capital in and out of the economy should be permitted only when interest rates for domestic loans have been liberalized, prices are stable, and exchange rates are not going down in line with prices. If liberalization of capital accounts is implemented too early, this may lead to unnecessary currency speculation and the accumulation of foreign debts.

The second lesson is that of strengthening the surveillance of financial institutions. One of the major causes of the Asian currency crisis was the lack of effective monitoring mechanisms in financial institutions. The banks provided financing without having first undertaken evaluation, thereby creating a large amount of bad debt. As the bad debt problem increased, the financial authorities failed to respond quickly and this caused difficulties for the banking system. Clearly, in this perspective the main lesson from the crisis is the need to maintain financial discipline. Financial discipline is essential in improving financial surveillance mechanisms and in increasing transparency and disclosure in the banking sector.

The last one is the interdependence of the Asia-Pacific region. Since the 1980s, an overall trend towards the internationalization and/or globalization of economic activities has existed. The globalization of production is generally regarded as prominent, and is reflected in the higher growth in the pace of FDI as against international trade. As a result of the internationalization and/or globalization, not only is production now reorganizing on a global scale, but national economies are also becoming increasingly interdependent, as evident in the so called “contagion effect” of the Asian financial crisis. Meanwhile, there is an emerging *de facto* integration in the Asia-Pacific region as growing trade and investment ties within the region spur regional interdependence, which is driven substantially by the outreach of the region’s developing economies, particularly the newly industrialized countries (NICs). To address the economic prospects of the region, it appears that it is appropriate to focus more on cross-national economic linkages than on the strategic trade policy of individual economies, as seen in the conventional debate on export-oriented versus import-substitution industrialization. As production systems become an integral part of cross-national production networks, the fortunes of all the economies concerned will be bound up together. The economic development and industrial development of these economies will then co-evolve in a dynamic and balanced manner. Here, APEC can play a vital role in achieving it by intensifying the economic cooperation in its process.

Dr. Liu, in his concluding remarks, compared the collapse of the Mexican peso around the end of 1994, and Mexico's strong economic recovery and growth momentum, against most East Asian

economies who still faced severe economic difficulties one year after the Asian financial crisis hit. Unemployment continued to rise and industrial production and other economic indicators showed no signs of improvement in 1998. However, through the macroeconomic adjustment policy, the assistance from the international community, and the strong world demand (which was propelled mainly by a booming US economy), the economies concerned recovered gradually in 1999. The upturn trend in the US is expected to continue in 2000. Although it is still hard to say how quickly East Asia will completely recover from the crisis and move on to create another so-called “economic miracle”, appropriate policy adjustments on the part of the crisis-hit economies, coupled with institutional adjustments, will make it possible for the region to put the crisis behind it sooner rather than later.

**Mr. Peter Martin** presented an overview of the work of the APEC Finance Ministers in response to the crisis and in managing the recovery process, which is co-chaired by New Zealand and Brunei Darussalam. One of the responses of the Finance Ministers’ process to the crisis has been to review its own working practices and make changes to improve alignment and coordination with other parts of the APEC process. Changes include re-arranging or re-organizing the timing of the annual APEC Finance Ministers’ meeting to be closer to the APEC Leaders meeting. New Zealand has also contributed to the support packages being put together by the international community under the aegis of the International Monetary Fund (IMF) for the crisis- hit economies.

In the three years since the crisis began major changes have occurred. They include the remarkable economic turnaround in the worst affected economies, as well as some major political transformations – without any of the “worst case” scenarios that were at the time deemed, if not probable, at least highly possible. There has been a systematic and widespread review of many, if not most, aspects of the international financial system – from the role and practices of hedge funds and highly leveraged institutions through the role and practices of the IMF, and of most everything in between. Mr. Martin acknowledged that understanding of the dynamics of the global financial architecture, and in particular of the risks associated with the globalization of capital markets, and their management, is considerably better now than it was before. And if some of the issues have not yet been satisfactorily resolved, such as the role of the private sector in crisis prevention and resolution, that is because these are genuinely very difficult issues, where “first best” solutions are not easy to find.

As for the role of the APEC Finance Ministers’ process in all this, he commented that the lack of alignment, and the fact that the Finance Ministers’ process was in any case less well established than other APEC processes and other international forums limited its ability to contribute. In the first phase of the crisis from mid 1997 to 1998, there was also the issue of bounded capability. In the case of New Zealand, there was next to no institutional memory to draw on in terms of how to go about joining an international support package, and those issues needed to be addressed. At the same time New Zealand’s domestic public and Ministers wanted daily assessments of the transmission effects into their economy of a rapidly evolving situation offshore. There were daily calls to the other potential contributors – whether or not they would participate, the amount of their contribution, terms and conditions, jurisdiction as well as technical issues. New Zealand at that time was also putting together their statutory economic and fiscal update, which requires them to quantify all known fiscal risks. He noted that considering such a situation, it is difficult to see how a concerted APEC Finance Ministers’ response could have been forthcoming.

The second phase, from mid-1998 to the following year could have been a time for reflection and review of the process, but the public debate at least was characterized by reaction and recrimination. The parade of suspects included IMF (Plan A was wrong, not that anyone else had a convincing Plan B), hedge funds and other HLIs and, in time, those who financed their extraordinary leverage were to blame. Policy makers came in for criticism – but those whose actions facilitated capital flows, especially where there were implicit or explicit sovereign



guarantees, and in post-crisis support packages, absent robust conditionality. Conditionality itself was criticized, for turning financial crises into economic crises, and so on.

It was his view that the rights and wrongs of what happened will be fruitful grounds for economists to interpret for years to come, and, after that, for economic historians to debate. Certain actions were taken during the second phase, though these may not all have an APEC label on them. First, APEC economies eschewed protectionism as a response to the crisis. Partly this reflected the reality of the economic situation of the worst hit economies – export-led recovery was vital to them all. Protectionist actions, given the risk of a retaliatory response, would have served no useful purpose. Partly, it reflected a genuine political attachment to the attainment of the Bogor goals. Second, although APEC as an institution did not formally take up the call for a concerted fiscal stimulus, most APEC economies did loosen their fiscal stance. Even New Zealand did a modest amount of fiscal pump priming. Others went further, providing considerable bilateral support, with the Miyazawa initiative as a very important example. Bilateral aid spending was increased or redirected, and multilateral funding increased too, with the shareholders footing some of the bill. Although there was little of that support that was uniquely tagged as “APEC”, APEC economies did quite a lot, but for the most part did it through unilateral action, or using pre-existing multilateral conditions.

Phase three is protecting the recovery through reducing risk. Mr. Martin acknowledged that many things have been learned from the crisis, many of which come under the auspices of the APEC Finance Ministers’ process as exemplified in their recent and current work programs. Hong Kong, China, has led work on bond market development, hosting a workshop in December 1998 and compiling a compendium of good practices in bond market development which was submitted to Finance Ministers and Leaders in Auckland, New Zealand, in 1999. Work on banking supervisory regimes, which includes a survey of APEC members’ compliance with the Basle Core Principles of Effective Banking Supervision, and Asian Development Bank -led training programs for improving domestic training of banking supervisors and securities regulators and for enhancing international cooperation in such training programs was undertaken. Australia, Malaysia and the US worked with the World Bank and Asian Development Bank (ADB) to present to Finance Ministers proposals for measures that can be adopted by APEC economies wishing to strengthen their corporate governance systems, with a particular emphasis on developing member economies.

This year, New Zealand is leading work to develop a process for taking forward these proposals in the form of a policy dialogue that will involve policy makers and practitioners in sharing experience and good practice in tackling corporate governance issues. A majority of APEC economies have been taking part in developing the “Voluntary Action Plan for Supporting Freer and More Stable Capital Flows” – a report on the risks and benefits of cross border capital flows and policies that will limit the risks and maximize the benefits to economies through strengthening financial markets.

Other initiatives include: managing regulatory change in the life insurance industry and surveying codes of conduct and practices currently used by various Credit Rating Agencies. Australia has proposed an initiative on managing regulatory change in the life insurance industry, among other things a major source of investment funds, focused on improving regulation through assessing international best practice and developing the skills and knowledge of life insurance regulators. This proposal is in the development stages, and is to be further discussed by officials. The Philippines is leading work to survey credit rating agencies’ rating methodologies and transparency practices. APEC Finance Ministers will consider a report on the findings of the survey in September. There are also ongoing collaborative initiatives sharing good practice on privatization, pension fund reform – a key element of social safety nets, and public management reform.

Mr. Martin concluded that at a time when the Group of Eight (G8) has just met in an APEC economy, it is worth reminding everyone that APEC is more than the sum of its parts. APEC

members, for example, represent 45 percent of the IMF shareholdings. APEC economies, and not just the G8 economies, have taken part in the various activities to review the global financial architecture. Canada chairs the G20 group of economies that is being used to extend the global dialogue. He stressed that the comparative advantage of the APEC Finance Ministers' process, as with APEC processes more generally, is in bringing together these diverse range and experience of the APEC membership to consider issues affecting all of them, and by taking this unique perspective into other forums. It provides an opportunity for politicians and officials from the APEC membership to exchange views and experience on said issues. He noted that managing the adjustment process helps ensure that costs are contained and the benefits spread through all our societies.

## **Open Forum 2:**

Two points were raised to Professor Kawai, namely, the mechanics to be adopted for bank restructuring and the importance of the capital market in supporting robust growth. In addition, Ambassador Tim Groser inquired about the lessons learned from the crisis by the private sector.

**Dr. Kawai** noted that a large proportion of commercial banks' assets are now in the hands of the governments of Indonesia, Korea, and Malaysia although the proportion differs in each economy. Government entities and public asset management corporations have to dispose of or auction off their assets, or go into corporate restructuring themselves. The process, including the disposal part, has not generally been very fast, although some earlier experience in Thailand on the disposal of finance assets showed the contrary – resulting in some criticisms. Please check carefully as the correction (original taken to mean that there were some critics of the Thai sell-offs may be wrong. IBRA in Indonesia tried to dispose of assets but encountered difficulties. Bank loans to the private sector have not been growing in Thailand and Indonesia, essentially because they remained unpaid by corporate borrowers. However, in Korea, credit growth is being observed. In the process, the capital market is developing. Corporations which are operating, those which have not paid their debts, are now running their businesses through current cash flows, while corporations which are creditworthy are now issuing bonds. The credit market in Thailand is developing, and there is potential for further development of the capital market in both Thailand and Indonesia because of the increased amount of government debts. He expects that through disclosure requirements, transparency, and corporate governance on the part of corporations, the credit market will be developed further.

On the lessons from the crisis, particularly private sector behavior, Dr. Kawai noted that it is clear that the pre-crisis accumulation of debt on the part of the crisis affected economies, or excessive investments in these economies from the point of view of private creditors, was a problem. But what is really important is for private investors to assess the risks in a prudent way, and if they make a mistake in their investment, they incur the losses.

**Dr. Rana** noted that various affected economies adopted different approaches to bank restructuring. Korea's approach was very much government-led whereas Thailand adopted a more market-led approach. In between was Malaysia, while Indonesia has just started the process of bank restructuring. Because of public sector involvement, NPLs in Korea and Malaysia have fallen significantly. Whether the public sector approach is better than a market-led approach in the longer run still remains to be seen. The whole agenda in terms of restructuring known bank/financial institutions and the operational restructuring of banks has yet to be addressed, and there are unfinished items on the financial sector reform agenda.

He observed that Korea's credit has started to expand. This is both a demand and supply phenomenon. He noted that just because credit is reduced, it could not be said that there is credit rationing: it could be a demand problem as well. Capital markets have to be developed in terms of the financing options that these economies have – financing from banks, stock markets or bond

markets. Bank financing was the most important option in the pre-crisis period, but banks are not starting to lend in the region as yet. What has been seen is basically that portfolios are coming into the stock markets of the region, although they could be a recurrence of the 'bad' capital that was discussed earlier. There has been a significant amount of capital flight from the economies of the region in the first half of this year, which necessitates the development of a long-term bond market in the region. In relation to the question of whether lessons have been learned by the private sector, Dr Rana was of the view that that lessons should be learned not only by the recipients in the affected economies but also overseas creditors who perhaps were not doing due diligence before the crisis.

### **SESSION 3: NEW REGIONALISM AND MULTILATERALISM: GOALS AND ANALYTICAL ISSUES**

*The session focused on the goals of recent regional trading arrangements and the analytical issues bearing on whether the new regionalism advances the desire towards a multilateral trading system under the WTO.*

**Dr. Christopher Findlay** summarized some of the issues involved in the trend towards construction of preferential trade arrangement in his paper entitled "Old Issues in New Regionalism." He noted the growing interest in preferential arrangements with more recent reviews of the range of issues that have emerged and literature to date by Anne Krueger, Sam Laird, and Panagaria, among others.

Dr. Findlay compared regional (preferential) trading arrangements as *street gangs*. *You may not like them but if they are in your neighborhood, it is safe to be in one.* Data from the WTO Secretariat on regional trading arrangements (RTAs) which were actually notified and those which were not formally notified to the WTO showed a real take off in the 1990s from virtually little involvement in RTAs from the late forties to the eighties. Half of these arrangements have been notified to the WTO, and still exist. The ones that still exist were actually set up in the 1990s. Not only was there a burst of interest in the preferential arrangements in the world, but a new surge of interest in East Asia. Examples are the on-going discussions between Japan and Korea, between Singapore and Japan, between New Zealand and Singapore, between AFTA members and the Closer Economic Relations (CER) members, and between Korea and Chile.

Most of the proposals are bilateral, including from within existing blocs; long distance like the one involving Chile; and between free trade areas and not economies. The other dimension of the new regionalism is the wider coverage which includes investment, services and standards.

He referred to the preferential way to reform as a second best approach. While it has some advantages because of the creation of new trade as the barriers/impediments to trade come down, there is the risk that the arrangement because the margin of preference would hide the cost and effect from within the group. Trade creation increases welfare while trade diversion generally decreases it.

The impact of preferential arrangements points to other impacts including on the terms of trade. Some explanations of the interest in cooperation among economies for the purpose of trade liberalization stress their value for offsetting adverse terms of trade effects that might otherwise be associated with unilateral trade liberalization. The presumption is that in a preferential arrangement, the members' terms of trade will improve compared to the rest of the world. The welfare of the non-members is also affected via this route. Other issues to take into account are the relocation of rents (including away from non-members). A preferential arrangement may lead to entry by firms from other member economies into the imperfectly competitive market of another member, which would see some of the profits captured by foreign firms. On the other

hand, the change in the degree of competition has other benefits. Competition rules that are fixed have their own advantage in terms of stimulating technology and productivity growth in an economy. There could also be opportunities to exploit economies of scale, and there may be positive effects from agreements on the variety of goods available. There can also be impacts on the flows of foreign capital.

These are some of the positives that the literature has been pointing to, but in the end it becomes an empirical question about whether these positives outweigh the costs associated with the margin of preference and trade diversion.

**Mr. Bonapas Onguglo** addressed two issues: the goals of the recent regional trading arrangements (RTAs) and the analytical issues arising from new regionalism. He noted that at present there are more than 200 RTAs – more than the number of members membership of the WTO. There has also been a consolidation, widening and deepening in existing RTAs. It implies an interest and deliberate policy actions by governments to get involved in the creation, expansion, widening, deepening and strengthening of RTAs. There are three conclusions that he observed from the experience of the last few years. Firstly, the creation of RTAs will remain a lasting feature of the international economic order. Secondly, mixed RTAs are evolving in which developing economies are beginning to assume obligations as stringent as their northern partners. This brings about a change in international development policy. Thirdly, RTAs are expanding beyond regions. The proliferation of RTAs, according to Mr.Onguglo, is the result of the fear of the failure of the new round. Many economies continue to see regional integration as a means to overcoming various retreat beyond what could be achieved in the WTO. Developed economies believe that there are more advantages that they can get with mixed RTAs as against PTAs, such as demanding reciprocal market access from developing economy partners, guarantees for liberalization of investment, protection of intellectual property rights, and adherence to environmental and labor standards. For developing economies, the RTAs may provide the training ground and learning process for businesses and governments of member states to acquire competitiveness, and attain experience and knowledge before engaging in the highly competitive and complex international market and in the WTO.

### **Open Forum 3:**

**Dr. Ippei Yamazawa** made a point on Japan's participation in RTAs as being far from a reality. Dr. Findlay noted that there are a lot of discussions going on about preferential trading arrangements but more work needs to be done before such formal agreements are established. Some may end up focusing on investments or standards, or implementing agreements under the APEC process. The parties to the discussions may also decide to register their commitment in the General Agreement on Trade in Services (GATS) or in negotiations focusing on services. These agreements may also end up as non-discriminatory arrangements. Dr. Findlay reiterated that, while there are a lot of discussions about them, many PTAs are still in the proposal stages. He also clarified that the architecture and principles of APEC are completely different from those involved in preferential trading arrangements.

**Dr. Robert Pastor** observed that PTAs involve a timetable for reducing trade and investment barriers. He asked if there was an entity to monitor and see whether in fact the agreement is being fulfilled. If so, he wished to know how many of the various arrangements are in fact keeping to their timetable of reducing their barriers.

**Dr. Findlay** responded that there is a lot of information on the timetable and the commitments in the AFTA arrangement. He noted that the AFTA members continue to accelerate their liberalization commitments so that the target date is continually brought forward. He suggested that APEC adopt an institutional arrangement outside the group to monitor PTA implementation.

Dr. Findlay then said that in the WTO, developing economies are expected to nominate the timetable for PTA implementation and, if the agreements were approved, then the implementation would be monitored. However, he reiterated that formal approval of these arrangements has not yet taken place in the WTO.

**Mr. Tim Miller** asked whether the cross section experiences of RTAs were ever investigated; and if so, what factors contributed to the success or failure thereof and what were the criteria researchers used to determine these factors. Dr. Findlay answered that many studies have focused on the growth of exports to partners and non-members as an indicator of impact, but this was not necessarily an indicator of success or failure. A look at the explanations of trade flows between two economies shows that they include all the things that might affect trade between them and a test for the significance of what extra benefit might be added if the PTA was conducted. He called attention to the extent to which the PTA might apply to trade with partners versus with non-members, which may give some idea of the impact on third parties. While this may not be a good test of the welfare impact on third parties, it nevertheless gives an indication that there might be some impact. Dr. Findlay cited Mr. Sandy Yeats' study on the MERCOSUR, which looked at the growth rates of different types of products within and outside the group. It showed that trade within MERCOSUR grew quickly in areas where members were least internationally competitive, which indicates that the diversion effect might be more significant in that arrangement than the creation effect.

He said that observing the patterns of trade is a powerful test but it cannot provide an indication of positive and negative welfare effects. The most sophisticated work tries to measure the change in welfare, in real income terms, as a consequence of the adoption of a PTA; but it, too, is a simulation exercise. Dr. Findlay observed that the use of Computer-Generated Equilibrium modelling results in a positive number, which increases as the modelling factors in concepts such as economies of scale and the productivity effects of perfectly competitive markets, thus painting a more optimistic picture. The issue of the counterfactual and the question of the link between commitments on a preferential basis and on a multilateral basis, remain. In meeting this challenge, Dr. Findlay proposed that APEC formulate a principle or disciplines to produce a positive welfare account. He said the cost of doing this is preferable to that which might be incurred by making a mistake in the other direction.

**Mr. Onguglo** added that, in many integration groupings formed by developing economies, trade liberalization is a very important component of cooperation. However, it is not the only component. Trade facilitation, transport and communication, and customs facilitation are also components of cooperation, even in APEC. He proposed that the success or failure of an RTA should not be judged solely on the trade criteria, but also give due consideration to the other components. The trade component often gets the most attention because it is the most visible and measurable, making it difficult to clearly assess the success or failure of integration.

#### **SESSION 4: THE NEW REGIONALISM: EXISTING AGREEMENTS.**

*This session is focused on the experiences of existing regional trading agreements such as the North American Free Trade Agreement (NAFTA), ASEAN Free Trade Area (AFTA) and Australia New Zealand Closer Economic Relations Trade Agreement (ANZCERTA). How these arrangements evolved; the status of implementation; their impact on each member's economy, and the extent of their contribution to multilateralism will be explored. Comparisons where possible, will be made.*

**Dr. Robert Pastor** opened his speech by defining some objectives regarding regional organizations as they relate to the global trading system:

- 1) a global trading system should be based on a single set of rules but also allow for experimentation and deepening of preferential regional trading arrangements;
- 2) a regional trading system should have greater economic openness and transparency that mutually reinforces greater political transparency and democracy; and
- 3) an international, specifically a regional, trading system should aim to reduce the gap between the poor and the richer economies in the world.

He said that this last challenge has previously remained unstated, perhaps in part because of the common belief that convergence will arise from reduced barriers to trade and investment, but it seems that that has not always been the case.

Dr. Pastor said that the purpose of his presentation was to address that last challenge. In the course of his speech he aimed to discuss the following:

- 1) that in the course of trying to reduce global trade barriers, three different pan-regional worlds are forming instead just one world, each one with a very different model from which ideas can be drawn and adopted to the other pan-regional trade areas;
- 2) that of these three areas, the European Union has had the most experiences in developing a regional trading system and dealing with barriers in income and wealth, and much could be learned from that experience though that particular community is different from the others;
- 3) whether this could be adopted to the North American Free Trade Agreement (NAFTA); and
- 4) a look into the reasons of the slow progress of the Free Trade Area of the Americas, and the implications thereof on the APEC and international trading system as a whole.

He said that one of the causes of World War II had been exclusive trading blocks, which showed that peace and prosperity could only be established if there was a single world trading system without barriers to trade. This led to the establishment of the General Agreement in Tariff and Trade (GATT) in 1947. The US was part of this agreement, but a decade later it would deviate from the single world principle and encourage the establishment of the European Common Market [now the European Union]. This was done largely for security reasons and in recognition of the importance of the European recovery. However, the US would resist undertaking any RTAs in favor of a generalized system of tariff preferences for developing economies. Finally, in the 1980s, the US negotiated the Canadian-US Free Trade Agreement, which then expanded to include Mexico and became the North American Free Trade Agreement. Despite the US' globalist stance, the world trading system has thrived, with world trade increasing 15 times since 1947 and expanding as a proportion of growth.

Today, instead of a single world trading system, Dr. Pastor pointed out that it has become increasingly clear that trade is growing *within* the three pan-regions of the world faster than it is *between* these regions. He enumerated these three regions as the European Union (EU), the most integrated of the three; NAFTA; and East Asia, where trade has flourished in both APEC and the Association of South East Asian Nations (ASEAN). Dr. Pastor then discussed the differences between each RTA with respect to certain characteristics. The first was the origin of the agreement: the EU was born of the desire of the major powers in Eastern Europe to seek an integrative mechanism to prevent war and permit greater prosperity and rationalization of industry. The NAFTA was largely established by the initiative of Canada and Mexico to secure their largest market from arbitrary decisions made by the US and avoid disruptions to their economies. Finally, APEC was established as a forum for discussion and to avoid other regional organizations such as NAFTA or the EU infringing on APEC members' global interests, thereby ensuring that the WTO would function as initially intended. From the circumstances surrounding the development of these agreements, it follows that the objectives of all three therefore should be quite different. For the EU, it was solidarity and unity, leading to better government with supra-national institutions, as well as the elimination of barriers to trade, investment and labor as a common market. The NAFTA also aimed to reduce trade investment barriers, and APEC was formed as a consultative mechanism, though it aspires in 20 years to be a free trade area as well.

Dr. Pastor said that only the EU has a clear set of policies to reduce disparities between poorer and richer economies. He then discussed the composition of each region's member economies, saying that the EU is comprised of economies that are reasonably similar in size; but in NAFTA, the US is many times the size of both the Canadian and Mexican economies. A similar imbalance can be found in APEC's composition. An overview of each region's security foundation showed that the EU is strengthened by the North Atlantic Treaty Organization (NATO) and a clear security rationale while NAFTA is strengthened by the Rio Pact and the overwhelming dominance of the US. However, a security foundation does not really exist for an integrated region in Asia as of yet, given the ongoing differences and concerns among China, Japan and the US. Dr. Pastor also pointed out that supra-national institutions exist only in the EU. He also said that the EU is governed by a social market philosophy, while the idea of *laissez faire* is prevalent in the NAFTA.

Dr. Pastor then focused his discussion on the EU's measures aimed to reduce disparities. It has prioritized this from the beginning and has made astonishing progress in improving the productivity of Spain, Portugal, Greece and Ireland – the four poorest members of the EU – and helping them catch up with their richer neighbors. However, he observed that:

- 1) while there has been a convergence between the rich and poor economies in the EU and NAFTA, there has also been increasing volatility, with poor economies outperforming the rich during the “boom” times and faring much worse during the “bust” periods;
- 2) in poor economies that have been successful, inequality has also grown over time, implying that within a given economy, the rich get richer and the lot of the poor does not improve;
- 3) it has been relatively easy to reduce the gap separating the rich and the poor economies, but not that between rich and poor regions in all economies;
- 4) part of the EU's problem stems from encouraging poor economies to spend more time lobbying Brussels for funds in particular areas rather than thinking of ways to improve their own economic development; and
- 5) bringing the poor economies with weaker democratic systems into the EU has led to stronger democracies in those economies, and a stronger rule of law.

Dr. Pastor listed the following as the bases for his conclusions:

- 1) the positive performance of the four poorest EU member economies suggest that mere entry into the single European market was probably the most effective and important reason for their relative success;
- 2) resources, partly from the EU's cohesion funds and partly from the investments flowing from the single market, clearly made an important difference;
- 3) the difference in performances of the four poorest economies suggest that national economic policies may have been even more important; and
- 4) the least successful funds were loans that went to individual firms, while those that made the biggest difference were for infrastructure, education, science and technology.

Dr. Pastor then sought to apply the lessons learned from the EU to an analysis of the NAFTA. He said that the NAFTA had succeeded in reducing trade investment barriers, more than doubling trade, doubling investment among the three economies of the Americas, and increasing the proportion of their trade with each other as a proportion of world trade. However, it had failed to take into account the interrelationship between trade and finance, particularly with regards to the effect of capital liberalization on capital flight. The NAFTA also lacked coordination between the central banks of the member economies and an understanding of the relationship between development and some of the other issues on the table between the three economies. It was premised on the theory that the mere removal of barriers to trade and investment would help all three economies. In applying the lessons learned from the EU experience, Dr. Pastor said that that the NAFTA made the exact opposite mistake of the EU, by not having any of the institutions formed by the EU but having the bureaucracy. Clearly, some institutions were needed if the NAFTA were to think regionally. Further, resources to deal with disparity were also needed.

While these are presently unlikely to be coaxed out of the US and Canada, the Inter-American bank and World Bank have very large programs in Mexico. For APEC, the lesson is to continue to use the existing mechanisms but that they have to be directed toward integration.

Dr. Pastor then spoke of the Free Trade Area of the Americas (FTAA). The December 1994 Summit of the Americas in Miami concluded with a pledge to negotiate a free trade area among the 34 countries of the Americas by 2005. This would represent the fastest-growing major market for the US, and implies significant market security for the Latin American economies. However, the Latin Americans and the US have not pursued this agreement aggressively. One reason is that Brazil is trying very hard to establish the South American Free Trade Agreement (SAFTA), which will then approach North America as a single unit to complete the Free Trade Area of the Americas. Another is that Canada and Mexico have secured a very powerful market in the US, and are not very eager to share that market. Further, Latin America itself has a long way to go in the reduction of trade barriers seen as integral to a successful negotiation.

In addition, the US has not shown the necessary leadership, being unable to secure the negotiating authority from Congress that would permit it to negotiate its completion. This is because President Clinton did not show a consistent effort to fast track the negotiating authority. Also, there exists a divide between the Republicans' *laissez faire* approach and the Democrats' emphasis on labor rights and environmental concerns. The US has had difficulty digesting the NAFTA and the WTO, and it may take time before the US comes back to another free trade understanding. Finally, the business community itself is presently complacent and has not pushed for another round of free trade.

Dr. Pastor said that these are the reasons, not only for the little progress in deepening the NAFTA and extending the Free Trade Area of the Americas, but also for the failure of the WTO round in Seattle.

Dr. Pastor concluded that important regional trading organizations exist, but there is also a lack of progress. While there have been sources of experimentation, there have also been stumbling blocks, for instance, the remaining impetus for the final round occurred only after Congress' approval of the NAFTA. He said that if these regional trading agreements succeed, they will prove important stimuli to go forward in the WTO.

**Ambassador Tim Groser** began by recommending that it is more accurate to call a regional trade agreement a "preferential agreement," particularly in light of some agreements presently under deliberation. He said that New Zealand maintains an ambiguous position regarding RTAs, but emphasized that ambiguity does not imply passivity, pointing out that NZ is actively seeking partners for free trade agreements. Ambassador Groser said that the ambiguous approach stems from historical experiences. One such experience was with the EU, then known as the European Community (EC). He cited studies of the economic impact of the EC formation on its trading partners, which said that 70 percent of EC expenditures until 1990 was on agricultural subsidies. Ambassador Groser said that New Zealand was heavily hit by this practice.

He then proceeded to discuss New Zealand's experiences with Australia, which reach back farther than the current closer economic relations (CER) agreement. A previous agreement illustrates the case of a grossly inadequate regional trade agreement. This was negotiated in the 1960s, when only 4 percent of New Zealand's exports went to Australia, indicating a weak economic relationship. At the time, Australia and New Zealand's economies were characterized by a highly efficient, lightly protected primary sector and a relatively inefficient, deeply protected manufacturing sector. New Zealand's exports to Australia now stand at 22 percent.

Ambassador Groser reported that, at this time, Australia abolished its import licensing system, but still maintained very high tariffs to stimulate its local industrial base; while New Zealand did nothing. It was against this economic situation that NAFTA Mark I (NZ/Australia Free Trade



Agreement)— the original trade agreement between New Zealand and Australia — was formulated. Its chief technical features included an obsession with tariffs; a non-comprehensive coverage of goods that excluded everything sensitive; and a positive list, a grossly inferior mechanism to the negative list. Thankfully, the lessons learned from this experience deeply influenced the construction of the CER.

In many respects, the CER represents the polar opposite of the earlier RTA. It was designed to correct the mistakes made earlier and provide an abundance of time and safeguards to deal with the real fears of New Zealand's manufacturers. In exchange, New Zealand had to commit to progressive liberalization and contractual certainty. The CER adhered to a principle of open regionalism while the previous RTA aimed to create a permanent preference for members of a regional trading group over outsiders, which was deeply damaging to the first base option of multilateralism.

The CER impacted significantly on New Zealand's manufacturers, who stopped trying to lobby against change, and undertook a fast and successful adjustment, which lifted import licensing requirements from all imported goods, not only those of Australian origin. He also said that the NZ-Australia free trade area no longer exists, apart from a few tariff lines, for both economies must compete with imports from other economies in each other's markets. What has happened is that subsequent global liberalization has reduced a once-substantial price wedge between the FTA preferential tariff rate and the most favored nation (MFN) rate to zero for all but a few items.

Looking into the future of free trade areas, Ambassador Groser proposed two models of regionalism. First was a benign viewpoint that the Seattle opposition will only be temporary, and that multilateral trade negotiations will resume. This suggests that some momentum of trade liberalization — such as RTAs — can be maintained in the interim as building blocks for the subsequent process, both in WTO and APEC. The second model is the more malignant viewpoint represented by the New Zealand-Australia antecedent to the CER. Such an agreement could lead to a "WTO minus" if it is not comprehensive in coverage, lacks political understanding, encourages rent-seeking behavior and the preservation of preferences, and hinders the building of political support of the 'first best' option.

Ambassador Groser concluded by saying that it is important to ensure that RTAs are designed with due consideration of previous experiences as well as visions for the future.

**Professor Alan Fairlie Reinoso's** presentation focused on two main areas: first, some characteristics of the Andean inter-relation process, and second, the relationship between the Andean community and the other regional blocs.

Professor Fairlie Reinoso began with a brief history on the Andean Community. It evolved from the Andean Group by virtue of a June 1997 protocol that modified the original 1969 Agreement of Cartagena. The Andean Community aims to promote the balanced development of its members, speed up growth via integration and cooperation, improve its habitants' lives, and impel regional integration. The new protocol (Trujillo Protocol) introduced some changes in the already strong institutional framework of the Andean group. It created a Presidential Council and a Council of Ministers of Foreign Affairs to provide political clearance to the inter-relation process; a policy-making Andean Commission endowed with legislative power so its decisions on trade and investments applied to all members; a General Secretariat; the Andean Court of Justice, accessible to all citizens of the member economies; and Business and Labor Consultative Councils, composed of representatives from the business and labor sectors. A Development Corporation has also been formed to finance projects that strengthen the inter-relation process. But the protocol did not address the difficulties faced by member economies in trying to promote closer inter-relations. These difficulties resulted from the uneven application by Andean countries of some critical decisions regarding the functioning of a customs union.

On the trade front, Andean countries at a presidential meeting in Cartagena, Columbia in December 1991, decided to establish a free trade area and to adopt a common external tariff by January 1992. However, the target was not met and instead Andean countries have implemented this decision in a sequential order. Columbia and Venezuela moved ahead independently in February 1992, joined by Bolivia in September 1992 and Ecuador in January 1993. A free trade area with no goods excepted went into effect in 1993 between Bolivia, Columbia and Venezuela. Peru did not join the free trade area at that time finding it difficult to implement the common external tariff.

The common external tariff was determined by the degree of processing, i.e., 5 percent on raw materials and industrial input; 10 and 15 percent on intermediate inputs and capital goods, respectively; and 20 percent on final goods. There were exemptions, which will be eliminated this year and higher rates applied on automobiles. Bolivia was excused from implementing the common external tariff and allowed to maintain its national tariff program. Peru, which has tariffs ranging from 15 to 25 percent for most of its products, was not ready to implement the 4-tiered tariff level.

Professor Fairlie Reinoso noted that trade liberalization in the Andean community has had important effects on trade among its members. After a decade of flat or declining growth in the 1980s, inter-Andean trade picked up in the late 1980s and began to grow steadily after 1990. Inter-regional trade has grown both in value and as a proportion of total trade and reached its peak during this period. Inter-Andean import growth has been especially strong and imports among members have quadrupled since 1990.

In 1989, the Andean Commission approved Decision 439, which sets out the general framework of principles and norms for the liberalization of trade in services, considered as instrumental in facilitating trade in goods, technology transfer, and the flow of capital and movement of people within the region. Decision 439 aims to establish a common market by the year 2005, by progressively eliminating measures restricting trade in services and harmonizing national policies to strengthen and enlarge the supply of services of members in the agreement.

The Andean Community's goal of policy coordination is in order to develop fiscal policies that avoid non-sustainable increases in public expenses during peak periods in international trade, adopt tax systems and employ effective customs officers to combat fiscal escape and smuggling, and coordinate efforts for regulatory norms. Professor Fairlie reported that progress has been made toward the establishment of a comprehensive approach to macroeconomic policy, including a push for a single-digit inflation rate for socio-political stability in member economies. The need for improved supervision of the financial system, modernization of customs administration, and simplification of the transactions needed to engage in external trade, have also been agreed upon. These agreements were accompanied by the establishment of regulations for the coordination of intellectual property rights, and foreign investment.

However, despite the advances in integration, intra-regional trade remains modest. Increased intra-regional trade is important to achieve the objectives of greater policy coordination and deeper integration at the Andean and South American levels.

In his discussion on the Andean Community's open regionalism, Professor Fairlie said that South American integration dynamics rotate around efforts to create a FTA between the Andean Community and MERCOSUR. An initial decisive step in this direction was the April 1998 general agreement for the creation of the FTA. This would gradually create a free trade zone by eliminating tariffs; establishing and promoting a framework for economic, energetic, scientific and technological cooperation; integration aimed at forming an enlarged economic area where goods and services could flow competitively, with a focus on promoting physical infrastructure; creating a normative framework to promote reciprocal investments; and coordinating positions in the process of hemispheric integration and multilateral fora. The Andean Community established

fixed preference margins with Brazil in 1999, and with Argentina in 2000. The remaining MERCOSUR members, Uruguay and Paraguay, plan to undertake negotiations also, and an agreement is expected in 2001.

Professor Fairlie went on to discuss relations with the Free Trade Area of the Americas. He noted that the Free Trade Area of the Americas (which includes MERCOSUR) has been the most dynamic, accounting for around 60 percent of the region's total exports to the world, followed by the European Union, with 20 percent.

The Andean Community's most important trading partner is the US. The Andean Rules of Tariff Preferences (approved by the US Congress in 1991 to support the program against drugs) allows the duty-free entry of most products into the US with certain exceptions such as oil, clothes, leather, etc. Similar programs are in place with respect to the EU. Professor Fairlie said that EU-Andean Community relations were sustained for reasons of political dialogue and preferential access to the European market, among others. The General Secretariat and the European Commission have been tasked to study the current state and prospects of economic and commercial relations toward the negotiation of an association agreement between both regions.

Professor Fairlie pointed out that most Andean countries have minimal trade relations with Asia. Exports to Asia from Venezuela, Bolivia and Colombia represent only one percent of their total exports while imports from Asia, mostly manufactured, account for 10-15 percent. For Peru, relations with the Asia-Pacific region and APEC are important, not only because these are instrumental to coordination in multilateral fora, but also for the impact on its flows of goods, services and investments.

Professor Fairlie said that the Andean Community must be considered a regional integration process compatible with the advances reached in APEC. He pointed out that both inter-relations are a special part of Peruvian commitments to open regionalism. This has brought about new dynamism in regional and subregional agreements as in the Latin American experiences since the crisis in the multilateral-level.

He then said that the Andean common market is expected to be established by 2005. The SAFTA is targeted for the middle of next year, or 2005 at the latest. FTAA negotiations will also finish in 2005. But a free trade area as in the Free Trade in the Americas Agreement (FTAA) will imply that the Andean community will also have to liberalize its market and denotes competition with the US, Canada, and other economies. Preparatory multilateral commitments are scheduled to finish by 2003, although the failure of the Seattle talks may slow them down.

Professor Fairlie concluded by saying that the great challenge for Latin American economies and APEC members is to achieve different levels from depth in the integration processes.

**Dr. Mohammed Ariff** began his discussion on the ASEAN Free Trade Area (AFTA) by giving a brief history of ASEAN. Formed in Bangkok in 1967, it was inactive until the Bali Summit of 1976, after which it launched preferential trading arrangements based on an item-by-item approach. This was followed by the implementation of the ASEAN Industrial Joint Venture Project and the ASEAN Industrial Complementation Program, both of which had a limited impact on Asian intra-regional trade. In 1992, ASEAN agreed to form a free trade area, and the AFTA was signed in June 1992, with a deadline set for 2008.

The AFTA has been criticized by the academia as well as other sectors as having too long a timetable, too many exclusions, and for its policy to reduce tariff to a range of 0-5 percent instead of a constant zero tariff. ASEAN has responded positively to these criticisms, reducing its deadline to 2003 in 1993, and then to 2002 in 1998. Its expansion to 10 member economies has not dampened the AFTA process. Dr. Ariff reported that the new members have been given ten years from joining ASEAN to complete the AFTA process. He said the 1997 financial crisis did

not derail the AFTA process. Indeed, it was during the height of the crisis in 1998 that the deadline was brought forward to 2002.

Dr. Ariff then spoke of the Common External Preferential Tariff scheme, which is the basis of the AFTA. The Temporary and General Exclusion Lists have been criticized as being too long. In response, the ASEAN has shortened the temporary exclusion list (TEL), phasing many items into the Inclusion List in five equal installments within 1996–2000, with the exception of the automotive industry, which was given two more years to enter the Inclusion List. As for the general exception list (GEL), which is composed of items not to be considered at all for inclusion due to strategic reasons – primarily many sensitive agricultural products – ASEAN has decided to phase sensitive products into the Inclusion List.

ASEAN has also considered the idea of imposing a flat-rate zero tariff rather than a 0–5 percent range. Dr. Ariff questioned the feasibility of the 0–5 percent scheme, saying that the cost of collection may exceed the proceeds thereof. He reported that in Singapore in 1996, ASEAN agreed to bring tariffs all the way down to 0 percent by 2015 for original members and 2018 for new ones.

#### **Open Forum 4:**

**Ambassador Edsel Custodio** thanked the presenters for showing the sharp dichotomy between the deeper integration approach presented by Dr. Pastor and Ambassador Groser, and the shallow, selective approaches to achieving global welfare and equality among and within regions and economies.

**Mr. Chinn** remarked that trading blocs are often perceived as induced by policy. He pointed out that much of this concentration of trade arises in part from the gravity models of trade. He then posed the question of how much trade is induced “naturally” and how much is policy-induced. He said that the extent of intra- versus extra-free trade area (FTA) trade is partly influenced by “who’s in and who’s out,” and in this regard asked about the optimal FTA. Mr. Chinn mentioned that East Asia is said to *not* be the optimal FTA, and that the biggest residual of extra trade is East Asia with North America. He said the perception is that the world is going to three trading blocs, but it is unclear if this is policy-induced.

He also commented on Dr. Pastor’s statement that the NAFTA has no institutions to deal with a crisis, asking if the Mexican peso crisis would have occurred even if NAFTA had not been in place. Mr. Chinn mentioned that Mexico had a history of bouncing payments preceding the NAFTA, and asked if it was right to draw impartiality between a trade and investment arrangement and macroeconomic phenomena. He also said that the EU has a well-developed system of inter-governmental support in cases of financial crisis, but some turmoil nevertheless occurred during the early 1990s.

**Dr. Pastor** concurred with Mr. Chinn’s observation on East Asia, saying that most of its increasing trade has been with the North American – including the US – market, but said that Mr. Chinn was not correct with regard to the NAFTA or the EU. He said that trade among the three North American economies, grew from less than 1/3 in 1980 to about 52 percent in 1998. While there was growth before the NAFTA, real acceleration occurred only after it was formed. Since then, Canada and Mexico have become the US’ largest trading partners. Furthermore, in the mid-1980s roughly 49 percent of the EU’s world trade was between EU member economies, and it is now about 63 percent. Dr. Pastor said that, while it has tapered off recently, this may be related to increasing trade with the 12 economies hoping to join the EU.

He then talked about the peso crisis, saying that the initial NAFTA negotiations included greater coordination between central banks. The Mexican government actually discussed this seriously

with President Clinton, but there was no mechanism for him to really enter into such a discussion. Dr. Pastor mentioned that this might be one of the dimensions that the NAFTA should have included, but it was rejected; and to this day there is still no mechanism in place. While a standby arrangement with the US Federal Reserve Board exists, and the International Monetary Fund (IMF) has gotten involved, there is really no degree of coordination between the two central banks. While such coordination is not an inevitable part of an FTA, it may contribute to deepening the NAFTA.

**Dr. Yamazawa** expressed appreciation for the new lessons on the current state of existing RTAs. He asked if more objective, quantitative assessments of RTAs – such as their implementation or impact on trade, investments, production and employment – could be provided for the benefit of interested non-members. He also asked the panelists to recommend any such studies conducted by RTA members or qualified research institutions.

**Ambassador Groser** said that he could not give hard, quantitative data due to time constraints, but assured Dr. Yamazawa that studies have been conducted on the issues he raised. These studies show that trade expansion from the FTA was faster for New Zealand, which was interesting given the political perception that small players do badly in negotiating with large players. He said that, before the CER, New Zealand was importing four times as much from Australia as it exported, but in 1990 this ratio was close to 1:1.

He also said that, while objective economic analysis may suggest that there is no significant difference between MFN and preferential rates, corporate behavior may still be influenced quite profoundly, as it was in the New Zealand experience, where firms began to start up, forging investment and commercial alliances with Australian firms.

**Ambassador Custodio** added that the WTO has yet to formulate bases for study, but there is empirical evidence to show the benefits and before-and-after effects of FTAs.

**Dr. Taniuchi** commended Ambassador Groser on his presentation of New Zealand's cautious position on RTAs, in view of its experiences in previous trade arrangements. However, his and Dr. Ariff's reports put across the message that past RTAs have been progressive rather than regressive. It seemed that New Zealand's position on RTAs sets standards that few bilateral arrangements can meet, denying new opportunities that in the long run may give rise to a more liberal market system.

**Ambassador Groser** said establishing principles that constrain the RTA process does not necessarily constrain it "contractually." The principles developed in APEC are not contractual because the APEC is a political, not a contractual, form-maker. He said that making the process more difficult is not a bad thing and clarified that his presentation used his economy's experience to illustrate the poor quality of some trade agreements. Ambassador Groser said that his fear of the dangers of those RTAs least constrained by APEC- and WTO-friendly principles is not a theoretical one, citing the Kennedy-Tokyo and Uruguay Rounds where the EU was a negative force due to its controversial discriminatory agricultural policy. He admitted that political realities impose themselves on any trade negotiation, saying that protectionism is a lethal combination between the fear of losing employment and capital, and rent-seeking behavior to preserve present economic gains. All trade agreements must be designed to deal with these fears, which is why Ambassador Groser continually emphasized the need for time and safeguards that still keep everybody in the same process.

**Dr. Ariff** added that, in the case of Asian economies, there was more liberalization in the second half of 1980s than in the AFTA framework. He noted that AFTA seems to stand for "Agree First Talk After" and ASEAN for "Ad hoc Strategy of Entity of Ambiguous Nature." Nevertheless, Dr. Ariff observed that Asia, in the face of all its problems, has been much bolder than Chile.

**Dr. Taniuchi** inquired whether RTAs would eventually promote global trade liberalization. He said that one presentation stated that deepening NAFTA and forming the FTAA would be important steps toward liberalization, perhaps to counteract the EU's agricultural protection. On the other hand, Ambassador Groser said that RTAs would promote liberalization through the commitments of member economies. He observed that different messages were being put forth and requested clarification.

**Dr. Taniuchi** also questioned Dr. Pastor about the relationship between trade and monetary arrangements. He asked if a monetary arrangement is consistent with extending the NAFTA to FTAA, saying that the US Treasury presently shows no indication of making any monetary commitment, even to economies in favor of "dollarization," and would not extend liquidity support in the event of a financial crisis after dollarization. He expressed doubt about the US' readiness to establish such a facility covering all South America.

Furthermore, on the necessity of loans from multilateral development institutions to assist the formation of the Latin American RTA, **Dr. Taniuchi** said that money did not seem to be important in this issue, and he agreed that ideas and discussions would be the best course of action to ensure global trade liberalization. He requested explanation of the East Asian philosophy dealing with collusive networks. He suggested that, in order to ensure that an RTA's trade creation and promotion effects would outweigh trade diversion effects, a WTO member economy may challenge an RTA's formation under the WTO panel as discriminatory. He asked Ambassador Groser whether New Zealand had raised the issue of the EU's agricultural policy in the GATT.

**Dr. Pastor** agreed with Ambassador Groser on the EU's agricultural policy, saying that it has contributed significantly to keeping the entity together, but has also played a negative international role for a very long time. He said the EU must address the issue soon, because they cannot continue their level of subsidies while expanding from 15 to 27 economies. This will also offer an opportunity for the rest of the international community to begin to negotiate more seriously on agriculture. He also said that the FTAA, like any successful open regional trading system, will put pressure on other economies to ensure that the WTO assimilates the progress made in the agricultural negotiations with the EU, because each of the major trading partners in each of the pan-regions has a very powerful global stake.

On the relationship between trade and monetary policy, **Dr. Pastor** mentioned that both the Fed and the US Treasury Department have made it clear that they are not interested in extending "dollarization" to Latin America. He deemed this position to be unnecessarily inflexible, and hoped it might change because many trading areas are now focusing on currency exchange and the need to move toward some unified currency system as means of deepening. He pointed out that in some ways the US position is strategically wise, for the US, instead of trying to push dollarization on Latin America and risking a negative reaction, may be encouraging them to consider it more positively by expressing disinterest. He reported that preliminary debates are ongoing in Mexico and Canada. Dr. Pastor recommended that North America channel resources into Mexico to facilitate integration and reduce disparities with its two North American neighbors. This may be done through the multilateral development banks, a move that may be applicable to Asia as well. On the subject of APEC's social philosophy, he said he would leave it for this forum to determine.

**Ambassador Groser** said that the underlying issue in the Tokyo and Uruguay Rounds was whether the EU's Common Agricultural Policy (CAP) was going to accommodate itself to the world or vice-versa. In the Uruguay Round, the European Community (now the EU) accommodated the specific CAP mechanism to an international framework, a massive political change. He believed the EU has fundamentally changed and can now easily accommodate their regional framework to the multilateral framework. It has become much more than the unfriendly system of agricultural subsidies of the past.

**Ambassador Groser** then addressed the question of whether New Zealand could have taken the EU to the GATT on a dispute. He said that GATT regulations do not forbid maintaining preferences in an RTA against the MFN. Perhaps New Zealand could have gone to the GATT on the legality of the variable levy, a tariff that moves in accordance with world price, but Ambassador Groser stated that they did not because legalism and the GATT/WTO are not magic solutions to such problems. The EU's attempt to carry on a colonial relationship with New Zealand is one example of the political realities that small economies must face in the world of *realpolitik*.

**Dr. Clarete** questioned Dr. Pastor on the impact of an RTA on its members. He expressed concern about the ASEAN Secretariat's study on the impact of the AFTA, which reported that the Philippines will have a welfare loss. He said that the question is for Dr. Pastor because of Dr. Pastor's findings that inequality within the EU was diminished through gains from trade specialization, or that compensating transfers were possible because of obvious positive gains of such an RTA.

**Dr. Pastor** said that there were various ways to solve intra-regional inequality. The EU, beyond its agricultural subsidies, employed a regional and cohesion policy involving seven different funds and roughly 40 percent of the EU budget. He recommended that multilateral development banks may also play a role in obtaining resources to help reduce inequality. However, Dr. Pastor said that the first thing to establish was whether the reduction of inequality was a "principle" or priority of the RTA. He said that most of the studies of the EU's success in reducing inequality between the rich and poor economies reported that a very important factor was national policy. If RTA member economies do decide to prioritize reducing inequalities, then a number of different mechanisms can be employed to pursue this objective.

**Ms. Mao** asked three questions: (1) the extent to which the trade expansion from RTAs arises from trade diversion and creation; (2) about the intra- and extra-regional trade patterns before and after the creation of RTAs; and (3) whether the panelists had any advice for smaller economies on how they could position themselves in the face of rising trade liberalization and regionalism.

**Ambassador Groser** said that, with respect to New Zealand's experience of the current FTA with Australia, if there was any expansion of bilateral trade due to trade diversion, the subsequent liberalization of the MFN tariff rate and the failure of trade to contract suggest either that it was very small or that those who gained the initial advantage from trade diversion got smart and were "intercaught" in the other market with MFN competition. He said that trade creation has been by far the most dominant force in New Zealand's FTA with Australia, certainly with respect to intra-industry trade. However, the factors behind this are still unclear, since there are obviously far more issues driving intra-industry trade than simply policy and change.

**Ambassador Groser** advised smaller economies to transcend the size of their markets by forging strategic alliances providing access to the best possible opportunities. While the perception is that small players cannot negotiate with big players, New Zealand's experiences validate this advice and so he encouraged small economies to be aggressive in their negotiations.

## **SECOND DAY (JULY 25, 2000)**

The following sessions were scheduled on the second day of the symposium:

**Session 5: Emerging Regional Trading Arrangements** with former Prime Minister Cesar E.A. Virata – Chairman, Task Force on AFTA-CER FTA; Dr. Ippei Yamazawa – President, Institute of Developing Economies, JETRO; Dr. Inkyo Cheong – Associate Research Fellow, Korea Institute for Economic Policy; and Ms. Karen Gilmour – First

Secretary, Australian Embassy, the Philippines as presenters. Dr. Florian A. Alburo of the University of the Philippines was the moderator.

**Session 6: WTO: Status and Issues** with the Hon. Jonathan T. Fried – Assistant Deputy Minister, Department of Foreign Affairs and Trade of Canada; Mr. Bonapas Onguglo of the United Nations Conference on Trade and Development (UNCTAD); and Ambassador Edsel T. Custodio, Philippine Alternate Representative to the UN and Other International Organizations, Geneva, Switzerland, as speakers. Mr. Antonio Basilio – President, Philippine Foundation for Global Concerns was the moderator.

**Session 7: APEC and Multilateralism: Initiatives and Achievements** with Mr. Mohd. Hamid Mohd. Jaafar, Brunei, Darussalam; Mr. Chan Boom Lee – Director, Ministry of Foreign Affairs and Trade, Korea; and Mr. Anthony Melville as speakers. Dr. Federico Macaranas – Associate Professor, Asian Institute of Management, the Philippines was the moderator.

## **SESSION 5: EMERGING REGIONAL TRADING ARRANGEMENTS**

*Proposed regional arrangements like the AFTA-CER FTA and bilateral initiatives such as the Japan-Korea and the Korea-Chile FTA will be analyzed. Some of the questions that may be addressed are: What is the nature of these new initiatives? Do these facilitate or impede WTO's goals? Is this emerging trend a response to the Seattle experience?*

**Mr. Cesar E.A. Virata** briefly presented the background of the study group formed in January 2000 to look into the proposed AFTA-CER FTA. The study group met three times, the first in Jakarta in February, the second in Queenstown, New Zealand, and then in Cambodia in the following week. He hopes to finish the report by the third week of September in time for the ASEAN Economic Ministers meeting in October 2000.

He reported on the outcome of the second meeting, which he considered as the architecture of the proposed AFTA-CER FTA. They have agreed as their basic principle that the AFTA and the CER will remain as separate arrangements. The AFTA-CER is another, separate, entity that will be comprehensive in scope and would like to achieve a faster pace than APEC in terms of liberalization. The agreement's scope is trade in goods and services with an investment provision. It will open to new issues and any other economy who would like to accede to the agreement. Flexibility will be given to new ASEAN members.

He noted that there will be market enlargement because of the combined AFTA and CER gross domestic product. Rules and regulations will be transparent to induce investment in the area. In addition, simplified and standardized rules of origin for both AFTA and CER will be needed.

With reference to tariffs, the reduction may proceed in varying phases and it will achieve free trading of goods by 2010 for the original six members and 2015 for the new members of ASEAN. ASEAN may extend tariff phase-outs to the CER by 2010 and 2015 while the CER may progressively reduce tariffs to ASEAN, with free trade by 2005. These are subject to negotiations. AFTA will implement the 0–5 percent tariff at the end of 2002.

On rules of origin, both AFTA and CER will follow the 40 percent rule. On non-tariff barriers, the agreement should cover anti-dumping, standards and conformance, price undertaking, import licensing, labeling, import quotas, and sanitary and phyto-sanitary provisions. The AFTA and the CER wanted simplicity and transparency for efficiency in administration.



He noted that the agreement should observe strict standstill and rollback principles. There will be a separate agreement on services, with a protocol and the suggestion is to adopt a negative list approach. A framework for investment will be established to increase capital flows and secure it within the region. On technical assistance, development and strengthening of the production basis of the different economies, especially the least developed AFTA economies, will be necessary. Specifically, there will be need for capacity building in ASEAN and technical assistance for compliance with Agreement on the Application of Sanitary and Phytosanitary (SPS) measures of CER economies.

He also tackled the consistency of the FTA and the WTO. He observed that majority of ASEAN members would like to use the Enabling Clause while Australia, Chile and Singapore would like the FTA to be under Article 24 of the GATT and GATS 5 for services. On intellectual property rights, the group will affirm the commitments to the WTO Agreement on Trade-related Aspect of Intellectual Property Rights (TRIPS). There is also a need for cooperation among the national intellectual property institutions and to strengthen them too. For competition policy, the proposed FTA framework is based on the principles endorsed by the APEC Leaders on 13 September 1999.

He added that the study group has to go into the principal steps to promote and protect processes of competition. He noted that trade facilitation was started earlier between the AFTA and the CER and they have been encouraged to continue work with an emphasis on deliverables especially on the resolution of the SPS issues.

**Dr. Ipppei Yamazawa's** report began with a history of Japan-Korea trade which expanded after bilateral diplomatic relations were normalized in 1965. However, as trade, investment and personnel exchanges increased, so did friction between the two economies. Korea set up the Program of Import Sources Diversification to curb imports of Japanese products and correct its persistent trade deficit. Then, in 1992, Japanese Prime Minister Kiichi Miyazawa and Korean President Roh Tae Woo agreed to institute cooperation programs to promote Korean exports to Japan and Japanese investments in Korea, as well as correct the trade imbalance. The private sector also implemented programs to foster industrial technology among small businesses, develop human resources and enhance productivity. These efforts have been effective in the long run as the Japan-Korea trade imbalance improved, but as the absolute value expanded, trade and investments shrank due to bilateral friction. The 1997 crisis seriously affected Korea, resulting in tight monetary policy and economic stagnation. Japan was still not over its 1992 recession, and in 1998, both economies had negative growth.

As Japan and Korea tried to restore their economies, there was a move to re-examine their bilateral relationship. In October 1998, Korean President Kim Dae Jung called for the building of a Japan-Korea partnership in 21<sup>st</sup> century. A series of meetings proposed that a Japan-Korea FTA be explored. In March 1999, Japanese Prime Minister Keizo Obuchi proposed the Japan-Korea Economic Agenda 21, setting out the path to stronger bilateral relations and aiming for an FTA.

The current trend in liberalization measures, as shown by the EU and the NAFTA, is toward adopting FTAs to promote economic integration with neighboring economies. Dr. Yamazawa stated that FTAs are a realistic approach to achieving global liberalization, and a Japan-Korea FTA not only removes tariff and non-tariff barriers but is also expected to promote investments, facilitate trade, and unify both economies' systems and rules. In the face of increasing globalization, companies are restructuring to boost a competitive edge via mergers and acquisitions with foreign companies. The Japan-Korea FTA aims to encourage companies in both economies to aggressively seek alliances. Dr. Yamazawa said that, to survive globalization, both economies must emphasize increasing profits by further combining their economic activities. His report aims to present a new vision of bilateral relations in the 21<sup>st</sup> century that encourages both economies to cooperate further.

He cited the GATT/WTO's encouragement of FTAs because these are expected to lead to global liberalization in the long run. The Japan-Korea FTA is a late reaction, but an FTA between such key players in world trade should naturally meet the following requirements set by the GATT/WTO that:

- (1) even if an FTA is formulated, trade barriers with other contracting parties should not be raised;
- (2) any intermediate treaty should include a timetable to establish an FTA within a reasonable period;
- (3) the participants in the FTA should immediately notify GATT/WTO;
- (4) under the FTA, customs tariffs and other restrictive trade rules should be essentially abolished for substantially all sectors; and
- (5) conditions must apply to FTAs with services trade as they do to commodities trade.

Dr. Yamazawa observed that Japan and Korea have yet to investigate the removal of barriers to substantially all sectors. He also said that, while the GATT/WTO provisions deal only with the removal of trade barriers, many FTAs do more: the Japan-Korea FTA, for example, combined with investment promotion and facilitation, will ultimately unify the two economies.

Dr. Yamazawa proceeded to investigate the current state of Japan-Korea bilateral commodity and service trade and investments, identify the barriers thereto and investigate how these restrictive measures affect the current state of trade and investments in order to predict the effects of an FTA.

Study of the state of the commodity trade revealed that both Japan and Korea export electrical, general, and transport machinery, as well as chemical products, metals, and other manufactured goods. Both import fossil fuels and raw materials, mostly from third economies. It has also shown that many products are being mutually exported and imported. In all of these product groups, Japan has a huge export surplus, implying the presence of intra-industry division of labor. Korea exports mainly metals, textiles and other manufactured goods, and imports general and electrical machinery in above-average quantities. Both economies export transport machinery but very little is traded between the two. Dr. Yamazawa said that these traits must be studied further to identify their causes. To what degree can these be explained by trade barriers?

Japan's existing trade barriers include import quantity restrictions on some fishery products and MFN tariffs only on manufactured goods, showing that there is no discrimination against Korean products. A generalized system of preferences (GSP) was applied to Korea from 1973 until 2000. Nevertheless, Korea demanded lower tariffs on certain sensitive items. In 1998, it listed the following as factors affecting its exports to Japan: quantity restrictions on imports of fishery and silk products; standards on processed-food additives; regulations on cosmetics components; an automotive certification/permit system; as well as remaining import restrictions and high tariffs on certain items of interest to Korea. However, no connection has been found between these and Japan's trade surplus in machinery, chemical products and metals, which results from Japan's competitive edge relative to other economies. Dr. Yamazawa also observed that completely identical products are never simultaneously exported and imported.

Korea has imposed higher tariffs than Japan, with an 8 percent rate on many Japanese imports. Besides the Import Sources Diversification Program, it also instituted country-of-origin certification and management regulation systems. Korea gradually abolished its restrictions after bilateral negotiations with Japan and criticism from third economies, completely eliminating them in June 1999. The resulting sharp rise in Japanese imports caused a public outcry, casting doubts on the political advisability of further liberalization and establishment of the FTA.

Dr. Yamazawa then went on to investigate the effects of the abolition of the Import Sources Diversification Program. According to the Korea International Trade Association, 32 items under dispute between Japan and Korea comprised 23.8 percent of all products imported from Japan in

1997, falling to 23.4 percent in 1998; and then rising sharply to 32.4 percent in January to July of 1999. This data has been used to show that the abolitions have increased Korean dependence on Japan. However, Dr. Yamazawa points out that imports of these 32 products during the pre-crisis January to July 1997 period, when imports were being regulated, were 16.6 percent higher than the 1999 imports. The background to this is that: (1) Korea has begun producing similar items domestically and become increasingly competitive; (2) it has less need for Japanese imports due to industrial restructuring; (3) Korea imports from other economies' products that are more competitive than those made in Japan; and (4) it imports products produced by Japanese companies in other economies and regions.

Dr. Yamazawa also points out that the lifting of the program overlaps with Korea's recovery from the financial crisis. Imports of specific items from Japan surged after the program was lifted because the market for highly competitive Japanese products was liberalized. However, he cautions that this is a unique case and cannot be compared with the effects of ordinary liberalization measures. The lifting of the program removes discrimination against Japan in compliance with the GATT/WTO's nondiscrimination principles. The resulting normalization of Japan-Korea trade relations is expected to bring about new business opportunities for both economies, as well as other benefits, such as Japanese-Korean corporate alliances.

Dr. Yamazawa then studied the current state of the services trade. This is seldom analyzed because the sector's business activities are not readily translated into comprehensive statistics, making it difficult to ascertain the enforcement of trade restrictions. However, the Japan-Korea services trade generates high revenue, and imposes trade restrictions more rigorous than those for trade in goods.

Japan has a large services trade deficit, while Korea had small trade deficits in both commodity and services trade until both went into surplus in 1999, albeit under unusual circumstances arising from the financial crisis. Services accounted for a 13–14 percent share of Japan's total exports, and 28–30 percent of its imports, implying that its services trade is not as competitive as its commodity trade. On the other hand, 15 percent of Korea's exports and 16–17 percent of its imports were of services. Japan exports 4–5 percent of its services to Korea, and imports about 3 percent from Korea. Korea's trade in services is about four times higher both ways, exporting 22 percent to Japan and importing 13–14 percent. Mutual exports and imports are stimulated by the geographical proximity of the two economies. The services trade is concentrated in the transport and travel subsectors, as well as in other profit-making businesses.

Both Japan and Korea impose rigorous restrictions on the free movement of labor in almost all sectors and business categories. This corresponds to entry and employment restrictions on overseas workers, but may not apply to the protection of domestic service industries. They also restrict the same types of services. The GATS requires the liberalization of all modes of services trade, but most treaties still restrict the free movement of labor. The WTO is prioritizing the liberalization of services in its new round of negotiations.

If liberalization is further stepped up, the mutual export/import of certain services is expected to expand sharply. Dr. Yamazawa said that the cross-border expansion of business perspectives and a rise in Korean income standards will also stimulate the mutual export/import of service trade.

He proceeded to discuss the current status of Japan-Korea investments, reporting that, until the end of 1998, Japan accounted for 23.4 percent of total investments in Korea, half of which was in the manufacturing and service industries. In 1996-97, Japanese investments in Korea remained unchanged, in contrast to increased investments from the US and Europe. Dr. Yamazawa explained this was due to Korea's deregulation policy toward joining the OECD, attracting the interest of US and European corporations. Additional financial deregulation arose from the depreciation of the won, attracting more outside investors. Furthermore, Japan, as a neighboring economy, viewed its Korean manufacturing bases as complementary to its own.

Korean investments in Japan from 1980 to September 1999 amounted to US\$540 million, with 50 percent in the trading sector and only 20 percent in manufacturing. The Kim Young Sam government gradually lifted foreign capital regulations, quickly easing obstacles to investments and restrictions on foreign land ownership. Dr. Yamazawa drew attention to Korea's restriction of Japanese culture, which hampers direct trade (in products such as CDs) and service trade (performers and musicians), and adversely affects Japan-Korea transactions as a whole. These restrictions have been gradually eased, but prompt removal is recommended to further promote Japanese investments in Korea.

Dr. Yamazawa then said that trade restrictions bring about differences in domestic and international prices. Comparing prices quantitatively determines the effects of trade restriction measures as a whole. A survey conducted in Seoul and Tokyo from August to October 1999 studied the retail prices of selected public utilities, services, and commercial products. Results show that many items differed by 1 percent or more, with most items costing more in Japan than Korea: utilities by 2 to 4 times as much, services 2 to 3 times, and daily needs up to 2 times as much. However, Dr. Yamazawa notes that Japanese workers are paid roughly 2.3 times more, implying that daily needs should cost about 130 percent more. Utility and service rates are strongly affected by differences in labor costs, and deliberately keeping them low is part of government policy. Items with two-to-fourfold price differentials appear to reflect differences in quality. Finally, Dr. Yamazawa said that, since exchange rates were accounted for, prices in Japan would be higher due to the 1998 won depreciation. The fluctuations in exchange rate have not yet completely fed through to commodity prices, and can by no means efface the two-to-fourfold price differentials found between Japan and Korea. He said that existing price differences can be explained by differences in income levels, customs and lifestyles, as well as low prices enforced by government policy.

He suggested that actual price difference far surpasses those directly arising from 8–20 percent tariff rates, which may reflect Japan's high-cost structure and both economies' long-standing business practices preventing full-scale competition with foreign corporations. Dr. Yamazawa also suggests that these two-to-fourfold price differentials promote market competition. The Japan-Korea FTA would allow lower-priced products to cross borders because there is always demand for them, even in higher-income Japan. He said that these price differentials would work to Korea's competitive advantage, and that the FTA would not eliminate price differences, but it would work to reduce them. It would certainly correct persistent high-cost structures, as well as competitive restrictions arising from business practices.

Dr. Yamazawa then discussed the predicted effects of a Japan-Korea FTA, beginning with a static analysis of its primary effect, the abolition of tariff and non-tariff barriers. This would result in reduced domestic prices of imported items in those sectors where Japan and Korea have a clear competitive edge, as well as the "trade creation effect" of increased import volumes. However, it might also divert trade, reducing imports from third economies because of the continued imposition of trade barriers thereto. Korean exports of textiles, sundry goods, and marine products; and Japanese machinery exports would be expected to increase.

The dynamic effects of the FTA, on the other hand, include the creation of a 5-trillion-dollar market with a combined population of 170 million people, roughly two-thirds the size of the US market. Korea stands to benefit from Japan's advanced technology, and Japan from Korea's continual growth, vitality and competitive stimulation.

Sales activities of Korean and Japanese corporations in their partner markets may pick up, increasing competitive pressure especially on Korean corporations. This has caused some concern that Japanese companies may dominate all sectors, but Dr. Yamazawa says this is an overly bearish viewpoint. Some Korean corporations may in fact disappear, but others will survive and become competitive globally, capitalizing on the two-to-fourfold price differential with Japan.

In sectors with technical division of labor between Japanese and Korean companies, a greater division of labor pertaining to research and development (R&D) activities in strategic areas, as well as sharing of technologies, is expected. Dr. Yamazawa suggests that another area for collaboration could be the reallocation of production activities to China and South East Asia.

The Japan-Korea integration might also get many US and European corporations interested in gaining entry into the Asian market. To reinvigorate the domestic economy, policy measures to attract foreign corporations, and even accept large-scale mergers and acquisitions, may be implemented. It is also suggested that Korea could capitalize on the integration with Japan to attract potential foreign customers within the larger market.

The integration will also step up personnel exchanges. With the expected strengthening of infrastructure, there is a strong possibility that Seoul will become a hub for North East Asia. Japan, to cope with its aging population, may allow the entry of more skilled Korean workers and R&D professionals. The increased personnel exchange may also halt decreasing consumption and, through cultural and information interchange, enhance similarities between the consumer markets of both economies.

Intensified competition, corporate alliances and the attracting of foreign corporations are expected in sectors where both Japan and Korea are internationally competitive and conduct active mutual trade. This implies further intra-industry specialization. Both economies' corporate, production and trade structures are also expected to change.

Dr. Yamazawa then attempted to forecast the industry-specific effects of a Japan-Korea FTA, focusing on the export and service categories most busily traded between Japan and Korea. The trade patterns by industry were investigated, reflecting the respective competitive strengths of Japan and Korea, and the static and dynamic effects of the FTA applied to each case.

The findings showed that the abolition of tariffs will result in increased textile exports to Japan and increased mutual imports/exports of chemical products and metals, as well as the possible entry of European and US corporations into the chemical products market. Strategic Japanese-Korean corporate alliances are expected in the metals, electrical and general machinery sectors, with technical transfer and division of labor/production possible in the latter. Mutual exports of transport machinery and technical exports may increase, and Japanese companies may advance into the parts sector to replace imports. Imports of other manufactured goods from Korea should increase, although there may be quality restrictions. Korea may also make inroads into the Japanese market due to cost competitiveness, while Japanese exports of famous-brand miscellaneous goods should also increase. Mutual imports/exports are also likely in the transportation and travel services sectors.

Dr. Yamazawa's report highlighted the need for closer industrial cooperation. In the area of technical cooperation, Japanese direct investments in Korea and in cooperative projects have resulted in technological transfer and will, in the long run, develop small- and medium-scale parts companies in Korea to lessen dependence on imported inputs from Japan. However, Japanese government-led cooperative activities will taper off in time, implying the need for a mechanism facilitating private-sector-led technological transfer.

Agreements on a range of issues are also called for. For instance, on the Japan-Korea Fisheries Agreement, there is no consensus as yet on the management and conservation of common resources. In the area of agricultural cooperation, sensitive items must be handled in manner consistent with GATT provisions and agreeable to relevant parties in both economies. There is also the need to adjust border protection policies to enable the agricultural and industrial sectors to co-exist and prosper.

A quantitative estimation of the effects of the FTA was then attempted using the CGE model and data from the GTAP4 database. The first simulation (S1) showed that Japanese exports to Korea will grow faster than Korea's exports to Japan. Both Japanese and Korean exports to the US will increase, and imports from the US decrease, the absolute values of which will be greater for Korea than Japan. Also, both Japanese and Korean imports from and exports to the rest of world will increase marginally, with Korea posting larger increases. Japan will have small increases in its output of general machinery, other manufactured goods, and metals; and small decreases in electrical machinery and services. Prices, excluding tariffs, would remain almost unchanged. On the other hand, Korea will enjoy increased output in all sectors and prices would drop across the board by about 1 percent.

Japan will have no change in wage rates, while Korea will experience excess demand for skilled labor and excess supply for unskilled labor. Real national income, as an indicator of the welfare effects of tariff abolition, would remain unchanged in Japan; and in Korea it would increase by 0.3 percent.

A second simulation (S2) was carried out using an alternative CGE model, and it showed that Japanese exports to Korea would increase, its imports decrease, and result in a trade surplus slightly higher than that predicted in S1. Korea would have a smaller increase in world exports, a larger increase in imports, and an expanded trade deficit. Real national income would also increase marginally in Japan.

Dr. Yamazawa says that the actual outcome will approach the effects of S1 with a more active capital transfer. He says that regardless of which simulation is more accurate, the abolition of tariffs will have some effect on Japan-Korea trade but only a minimal effect on either economies' overall production, trade and prices.

A third simulation (S3) attempted to forecast the dynamic effects of the FTA. It showed that, if productivity increases primarily in the machinery and metal sectors, output would increase at higher rate in Korea than in Japan, but prices would fall more in Japan. Japanese imports from, and exports to, Korea would increase, with the increase in exports from improved productivity being more or less the same as that arising from tariff removal. Korea's increase in exports to, and decrease in imports from, the US will be greater than those in Japan. The Japanese trade surplus is seen to expand, while the trade deficit in Korea would become a surplus. Japanese exports to the rest of the world would increase, and imports therefrom decrease, with its trade surplus expanding. Both Korea's world exports and imports would increase, and its trade deficit would again become a surplus. Impressive increases in real national income are seen in both Japan and Korea. Real wages for both skilled and unskilled labor are expected to increase as demand for both types of labor increases.

The dynamic effects of the FTA will also bring about changes in third-economy trade, but the CGE model assumes there are no changes in third economies. Dr. Yamazawa took this to mean that if two economies cooperate to revitalize their economies, the third economies that do not react will suffer trade-diversion-like effects.

He then discussed the process of formulating the Japan-Korea FTA, beginning with the framework set by the Japan-Korea Economic Agenda 21. This presents a wide-ranging inter-governmental cooperative framework, which includes, among other things, the conclusion of tax treaties and investment agreements; and cooperation in various areas such as developing domestic standards and protecting intellectual property rights. Dr. Yamazawa emphasized the need to conduct FTA negotiations concurrently with individual negotiations on economic cooperation, with the establishment of the FTA as the ultimate goal. He also said that, while the Japan-Korea Economic Agenda 21 defines the FTA only in terms of the abolition of tariff and non-tariff barriers, unifying the economies of Japan and Korea through a combination of liberalization, facilitation and economic cooperation is a new and more pragmatic approach to forming an FTA.

Furthermore, stable yen and won markets are integral to expanding trade and investments. As a result of the 1997 Asian crisis, Dr. Yamazawa reports that Japan and Korea are studying the pegging of their currencies to a basket of currencies including the euro and yen. This is expected to help the won market adjust better to changes in yen and dollar values, bringing about a more stable yen/won rate. The Korean concern about its continued trade deficit with Japan will be resolved as Korea optimizes Japan's advanced technology and capital exports, allowing its industries to catch up with Japan's. Dr. Yamazawa's report also suggests the use of capital outflow from Japan to make up for Korea's deficits, pointing to the need to integrate the two economies' financial and capital markets.

He concluded with a message to third economies, assuring them that the Japan-Korea FTA would reinforce Japan and Korea's liberalization efforts and boost their initiatives toward increased liberalization, both in APEC and globally. Dr. Yamazawa said that the FTA would be implemented in compliance with the GATT/WTO, and that the trade creation and diversion effects of tariff abolition would be minimal. Indeed, the dynamic effects of increased competition and corporate alliances will lead to trade creation surpassing that arising from tariff abolition, reinvigorating the FTAs economies by involving third economies.

The Japan-Korea FTA is expected to realize liberalization and facilitation earlier than planned in both economies, a will be a powerful driving force in helping APEC meet the goals set in its 1994 Bogor Declaration. In fact, the FTA will transcend the limits of APEC and contribute to liberalization on a global scale.

**Dr. Inkyo Cheong** began his discussion with an update on the Korea-Chile free trade agreement (FTA). The feasibility of an FTA between the two economies was reviewed in 1998, and leaders of both economies officially launched negotiations in September 1999. He reported that the third round of negotiations was recently completed.

Korea's choice of Chile as an FTA partner stems from their highly complementary trade structures, as well as Chile's wealth of experience in regional trading agreements (RTAs). Dr. Cheong explained that Chile chose Korea to capitalize on Korea's close linkages with neighboring Asian economies and gain entry into the Asian market, as well as on Korea's potential for growth through strong reforms in several sectors — including the financial. He stated that his presentation aims to discuss the Korea-Chile FTA, as well as the prospects of and policy implications for Korea's future FTAs.

Dr. Cheong observed that, while Korea achieved economic growth under the multilateral GATT/WTO system, there was domestic opposition to market opening under RTAs, therefore it did not participate in the spread and deepening of regional trading blocs. However, the post-financial crisis Korean government has re-evaluated the potential gains from removing trade barriers on a preferential basis, and eventually has decided to pursue the establishment of preferential trading blocs. He said that this new attitude is influenced significantly by the trade diversion arising from the growth of regional trading blocs, citing a 1995 WTO report on the causes of the rapid rise of regional trading blocs created in the early 1990s. This report concluded that the spread of regionalism was an insurance policy against the failure of the Uruguay Round, implying that regional integration initiatives would weaken as the multilateral trading system became firmly established. However, Dr. Cheong noted that, even after the inauguration of the WTO, regional trading blocs have continued to multiply and deepen; and today, regionalism is, in fact, one of the most dominant trends in the world economy.

He reported that only 26 new RTAs were reported to GATT prior to 1969 and, after slackened regional integration in the 1980s, 35 additional regional agreements were signed in 1995–1996 and 17 more in 1997–1998. This demonstrates the view that regionalism is a viable commercial

strategy complementary to multilateralism, rather than a mere insurance policy against the potential shortcomings of multilateral free trade formation.

In line with increasing regional integration, Dr. Cheong reported that Korea is now cautiously investigating the establishment of FTAs with major trading economies. He explained this shift as due to the fear of being left out of the regionalism trend, and the outbreak of the Asian financial crisis. Since the crisis, Korea has opened most of its financial sectors to foreign investors and implemented unilateral trade liberalization measures. Such measures under the IMF package included: (1) the early abolition of the import diversification program (IDP) and trade-related subsidies; (2) the simplification of restrictive import licensing procedures; (3) a reduction of the number of items subject to adjustment tariffs; and (4) the elimination of import certification procedures.

He said that the IDP was introduced in 1978 to restrict imports from Japan, with whom Korea was experiencing a serious trade deficit. Dr. Cheong said that its abolition in June 1999 can be regarded as one of the most dramatic liberalization measures.

He reported that most Koreans have viewed liberalization as beneficial, beginning to perceive the establishment of FTAs with major trading partners as bringing greater welfare gains. Moreover, Korea has recognized the importance of stable export markets, for the current account deficit preceding the financial crisis was thought to have reduced international confidence in the Korean economy.

Dr. Cheong said that another important factor behind the propensity for regionalism is the trade policy makers' recognition of the need to upgrade Korea's economic system to meet international standards. He noted that the broad structural reform programs implemented under the agreement with the IMF might not be enough to achieve fundamental reforms of the economic system. Therefore, Korea is pursuing regional trade liberalization toward reaching comprehensive FTAs that also cover investment and services, market access including tariff and non-tariff barriers (NTBs), customs clearance, and rules of origin.

Dr. Cheong reported that the Korean government is currently pursuing FTAs with small strategic economies with a view to establishing trade agreements with its larger trade partners in the future. Chile was chosen as the first candidate partly because it exported mostly primary goods, e.g., copper and wood products, highly complementary to Korea's manufactured exports of automobiles and electronic products. The political rationale in favor of Chile stems from its being a relatively small economy. Korean-Chilean trade amounts to only a small percentage of Korea's total trade, with Korean exports to Chile accounting for around 0.5 percent of total exports, and imports from Chile less than 1.0 percent of total imports. Thus any adjustment costs, such as labor displacement, will be relatively low. Further, the non-threatening size of the agreement will not elicit any major international response to Korea's new policy.

Dr. Cheong noted that some argue that the benefits from a Korea-Chile FTA may be minimal relative to those from an FTA with larger economies, such as the US or Japan. He explained that, while Koreans increasingly accept the need to open their economy, competitive disadvantages relative to the US or Japan would likely inflict excessive adjustment costs on Korea. An FTA with a relatively small economy incurs lower adjustment costs, yet still forces Korea to update many of its economic institutions and practices. Dr. Cheong said that this adjustment period will put Korea in a better position to enter an FTA with an advanced and/or large economy. He also pointed out that Chile is very active in terms of liberalizing trade, signing FTAs with Mexico, Canada, Peru, Venezuela, Ecuador and Columbia, and negotiating with Bolivia, Panama, Cuba, and the EU, among others. Dr. Cheong suggested that Chile's open and non-confrontational approach should allow Korea to sign a relatively comprehensive FTA agreement, unencumbered by numerous side agreements.



The agreement will set a favorable precedent for Korea to sign FTAs with other economies. Chile's experience with free trade and relatively liberalized markets will also aid Korea greatly as it further liberalizes its own economy and pursues FTAs with larger economies. The economic size, purchasing power and trade volume of Chile may not bring Korea substantial tangible benefits in the short-run, but a Korea-Chile FTA may bring sizable long-run gains in the form of lessons on establishing multiple regional trading agreements. Dr. Cheong also pointed out that Chile could serve as a gateway to the South American market.

He concluded by first summarizing his discussion so far, saying that Korea has joined the regional integration bandwagon and is now cautiously looking into forging FTAs with major trading economies. Since then, Korea has opened most of its financial sectors to foreign investors and implemented unilateral trade liberalization measures, having realized the danger of unstable access to foreign trade and financial markets. He said that the Korean government officially decided to negotiate an FTA with Chile in November 1998, planning to pursue FTAs with larger economies in the long run after thorough examination of the economic effects of FTAs with these economies.

Dr. Cheong reported that Korea has been negotiating the FTA with Chile since December 1999. Its successful conclusion will be significant for Korea, as it will serve as a model for future FTAs. Negotiations will likely last one to two years, but talks on sensitive trade areas might prolong the conclusion of the negotiations. He reported that Korea's manufacturing sector favors a Korea-Chile FTA, as Korea exports mainly manufactured goods to Chile. However, the agricultural sector, fearing increased Chilean exports, and the fisheries industry are deeply concerned.

He also mentioned that there are other issues of concern regarding Korea's FTA policy, including the harmonization of multilateralism and regionalism. Korea has actively supported the GATT/WTO system and, along with other developing economies such as Chinese Taipei, and Singapore, has benefited from the more liberalized global trading environment under the present multilateral system. Dr. Cheong said that economists have warned that increasing regional trading blocs may damage the multilateral system. He cited Thurow (1992), who stated that the current proliferation of regional agreements and the recurring fear of trade conflicts may discredit the global trading system by shifting to a tripolar "Asia, Europe, and North America" system. Bhagwati (1993) also viewed regional trading blocs unfavorably, arguing that expanded regionalism will undermine the multilateral system without making a positive contribution towards global trade liberalization. Dr. Cheong thus recommended that, while pursuing the establishment of beneficial FTAs, Korea must also continually try to contribute to free trade under the WTO. This will imply that the economy fully complies with the spirit of WTO regulations on the establishment of FTAs. Further, Korea must go beyond merely implementing WTO regulations in new areas such as investment, services, intellectual property rights (IPR), and environmental issues. He said that the Korea-Chile FTA must be directed toward comprehensive coverage, maximum liberalization, and transparency of implementation procedures in adopting international standards.

Dr. Cheong concluded by reporting that Korea has also found positive prospects in a possible FTA with Japan. It has also conducted joint studies with New Zealand and Thailand to look into the viability and feasibility of pursuing FTAs with both economies. He stated that these studies will provide the basis for an expansion of Korea's policy towards FTAs.

**Ms. Karen Gilmour** began with a short background talk on regional trading arrangements. RTAs have become an important feature of the international trading system: almost all WTO members belong to at least one RTA and about half of all global trade takes place through preferential regional arrangements. In an RTA, members agree to reduce or eliminate trade barriers to each other, but may maintain those relative to non-members.

RTAs began in the 1960s with the creation of the European Common Market, but elsewhere regionalism was weak because the US supported multilateralism. In the 1980s, slow multilateral GATT negotiations gave rise to the NAFTA. RTAs were once limited to trade in goods, but have since then extended coverage to include services, investments and competition.

Ms. Gilmour proceeded to discuss the relationship between RTAs and the multilateral system. Multilateralism requires that all reductions in trade barriers be applied on an MFN basis to all WTO members, and RTAs are an exception to this rule. The challenge is to ensure that they provide significant benefits to the region via liberalization, as well as contribute to overall global welfare.

The WTO rules regarding RTAs aim to ensure that they add to global economic welfare. An agreement that will liberalize trade in all goods and substantially all services will ensure that the agreement benefits all parties and contributes to trade liberalization. An agreement that does not increase barriers against non-parties after its conclusion ensures that trade diversion is minimized.

Ms. Gilmour said that the Australian government employs an integrated multilateral, regional, and bilateral approach to trade policy. Australia is open to concluding RTAs which deliver substantial gains to all sectors, namely faster and deeper liberalization than from the multilateral process, better market access for exporters, faster economic and stronger employment growth. The economy believes that such agreements must contribute to the multilateral system, hence the need to ensure WTO consistency; and that trade diversion could be reduced through open RTA membership.

Ms. Gilmour reported that APEC is proposing to survey the subregional agreements within the organization to investigate links between RTAs and the multilateral system.

She went on to discuss the Australia's existing regional agreements. One of these is the Closer Economic Relations (CER) Trade Agreement between Australia and New Zealand. It evolved from an existing New Zealand-Australia free trade agreement which failed due to tedious negotiations that neither produced agreements on meaningful product coverage nor tackled non-tariff barriers. In the early 1980s, a new FTA was proposed, and the CER took effect on 1983.

She said that the CER aims to expand free trade by eliminating barriers to trade and promoting fair competition, as well as contribute to trade liberalization. In 1990, the CER removed all tariffs and quantitative restrictions from trans-Tasman goods trade. It has resulted in the increase of total goods trade by more than 563 percent since 1983, with New Zealand's exports to Australia growing by more than 380 percent and Australia's exports to New Zealand by 300 percent. Two-way investment grew phenomenally from US\$1.5 billion in 1983 to US\$25 billion in 1999. Along with other Australia-New Zealand arrangements, considerable progress has been made in achieving freedom in the movement of goods, services, and labor.

Australia is also involved in the Papua New Guinea Australia Trade and Commercial Relations Agreement (PATCRA), which took effect in 1977 to ensure that Papua New Guinea could maintain its open access to the Australian market even after independence. The South Pacific Regional Trade and Economic Cooperation Agreement (SPARTECA) was created in 1981 in recognition of the special relationship and commitment of Australia and New Zealand to the South Pacific Forum island economies. It provides all products from Forum island economies with preferential, non-reciprocal access to Australian and New Zealand markets, subject to the products' meeting a rules of origin threshold of 50 percent. SPARTECA aims to encourage economic and industrial cooperation through expanding and diversifying trade, stimulating investments in exports, and promoting other forms of commercial cooperation. Finally, the Pacific Regional Trade Agreement (PARTA) was formed in 1999 when South Pacific Forum leaders agreed to examine the establishing of an FTA among Pacific island economies, with the "appropriate" inclusion of Australia and New Zealand.

Ms. Gilmour then discussed the proposed AFTA-CER FTA. It was proposed in 1999 when ASEAN, Australian and New Zealand ministers agreed to form a Task Force to examine the feasibility of establishing an AFTA-CER FTA by 2010. The Task Force was mandated to examine the range of relevant issues including WTO requirements and capacity building measures to allow economies to participate effectively in the negotiations and implement the results therefrom. The FTA would deepen the results of activities undertaken by the AFTA-CER linkage in order to facilitate AFTA-CER trade and investments. Ms. Gilmour reported that the Task Force, in its past two meetings, has discussed the costs, benefits and possible coverage of the proposed agreement, as well as the capacity building requirements of new ASEAN members.

Australia believes that the AFTA-CER agreement would bring significant trade and economic benefits to the region. The prospects for deeper cooperation and integration would provide further impetus to growing trade and investment links between AFTA and CER economies, while the resulting trade liberalization would boost regional productivity and competitiveness, and increase foreign investment.

Ms. Gilmour reported that the Center for International Economics sought to quantify these benefits via economic modeling. Its study showed that overall GDP gains in 2000-2020 were estimated at US\$48.1 billion, with even higher gains in real consumption, which the Center used as an indicator of welfare. Additional capital inflows to the region in 2000-2010 are expected to amount to US\$38.1 billion.

She said that Australia supports a comprehensive AFTA-CER agreement for consistency with the multilateral system and to advance the APEC's Bogor goals on trade and investment liberalization.

Ms. Gilmour concluded by saying that RTAs can be an effective means of dealing with certain challenges of globalization, offering a vehicle for achieving closer regional economic integration and greater trade liberalization, and bringing about increased welfare for the parties involved.

However, there is the need to employ an approach with a balanced prioritization of the benefits offered by a multilateral, non-discriminatory trading system for all economies and those from discriminatory arrangements securing preferential access to particular markets. Australia maintains that WTO rules on RTAs offer a means to reconcile these competing goals. Ms. Gilmour cites the CER as an example of an RTA consistent with the WTO requirements that has resulted in great benefits for the parties involved.

In the future, Australia will continue to aim to produce agreements offering substantial benefits for all parties, something that can best be achieved by maintaining consistency with the multilateral system.

#### **Open Forum 5:**

**Dr. Albuero** thanked Ms. Gilmour for her presentation and summarized the morning's presentations on emerging regional trading agreements, noting that those present had learned many new acronyms and proceeding to name some of them. He said that the slew of new agreements range from those not really regional but basically bilateral in nature to some that are between a region and two economies. He observed that those who espouse free trade may be concerned with the proliferation of RTAs, and explained that many of these RTAs are "trial balloons," a test situation with smaller economies in order to ascertain the strategies applicable to bigger economies. Dr. Albuero said that the present situation is one where free trade is always improving, but pointed out that not every move toward free trade is welfare-improving.

**Dr. Findlay** observed that APEC consistency is much a tougher test than WTO consistency. He asked Drs. Virata and Yamazawa if the APEC members they are dealing with have already made a 2010 commitment. Secondly, he asked if the Koreans would accept if they were asked to join one.

**Mr. Widjojo Santoso** (Indonesia) questioned Dr. Yamazawa on the possibility of a stable yen-won exchange rate as a result of close Japan-Korea economic relations. He asked how this exchange rate stabilization might be implemented in practice, suggesting that perhaps a joint intervention or an exchange rate monitoring system had been created.

**Dr. Virata** cited the study of the AFTA-CER FTA and said that members are cognizant of APEC and WTO guidelines, as well as the respective agreements themselves. He said that this has resulted in 1) the move to liberalize, and 2) open regionalism, where any other member is free to join if they agree with the proposed FTA's objectives and principles. He also said that benefits from the AFTA-CER FTA will come only if negotiations are concluded before the APEC deadlines and the advent of APEC-wide free trade. Dr. Virata mentioned that others are compliant with the WTO agreement, which is what his group is trying to achieve. He said they will pass this on to the governments for negotiation.

**Dr. Yamazawa** addressed Dr. Findlay's comment, which emphasized APEC consistency over WTO consistency, and said he saw no difference between the two although his presentation emphasized that promoting the Japan-Korea FTA is very much consistent with WTO's multilateralism and AFTA's liberalization efforts. He pointed out that his study had already considered this when it emphasized not only the removal of tariff and non-tariff barriers, but also facilitation and other investment promotion measures. Dr. Yamazawa asked Dr. Findlay to articulate the difference. On yen-won stabilization, he said that everybody agreed that yen-won stabilization is vital to the Korea-Japan bilateral relationship, but financial success is difficult. He wished to leave the question to the floor, and cited the ADB Institute report mentioning such a bilateral agreement.

**Dr. Cheong** mentioned Dr. Findlay's question on APEC consistency, saying that the ongoing Korea-Chile FTA negotiations have yet to consider open regionalism. He said that the plan to extend trade liberalization measures to other economies on an MFN basis will make it difficult for the negotiations to maintain momentum. He also addressed Dr. Findlay's question on North Korea and said that the meeting between President Kim Dae Jung and Chairman Kim Jong Yo in Peng Yong caused much concern. However, Dr. Cheong said that institutional issues, especially regarding APEC, have yet to be discussed. On the yen-won stabilization in the Korea-Japan FTA discussion, he said that the Korean side does not think that yen-won stabilization can be included in the FTA, but remains open to more talks about this issue.

**Ms. Qin Haijing** asked for comments on the management of the proliferation of FTAs within APEC, and asked if there were any suggestions for APEC members that do not belong to intra-APEC FTAs.

On the question of emerging bilateral FTA negotiations within the APEC region, **Dr. Kawai** mentioned that Japan may begin trade negotiations with Chile as Korea is negotiating with both Chile and Japan. He said that the three economies are going about it in a "triangular" way, rather than meeting all together and coming up with a sensible agreement. He then posed a question on the Japan-Korea FTA to Drs. Yamazawa and Cheong, requesting clarification on the treatment of agriculture, which was unclear in the IDE study provided. He observed that it seems to imply that both economies will mutually protect their problematic agricultural sectors and suggested that, for the Japan-Korea FTA to be meaningful, opening up agriculture between the two economies would send a strong message to the rest of the world.

**Dr. Kawai** also commented that the strategic alliances between Japanese and Korean firms seem to imply an international ‘cartelization’ of industry and said that the FTA would be a good idea if the agricultural issue was fully addressed and no impression was given to the rest of the world of an attempt to ‘cartelize’ a particular set of industries between the two economies. Finally, on the yen-won exchange rate stabilization, he said that a stable yen-won rate implies a volatile won-dollar exchange rate, which would be difficult in light of Korea’s connection with dollar area economies including North America. Dr. Kawai said that Korea would be better off with a stable effective exchange rate relative to a basket of currencies where the yen plays a more important role.

**Dr. Taniuchi** expressed appreciation for Dr. Virata’s presentation on the AFTA-CER discussion. He asked Dr. Virata for an approximate time of completion for the final agreement. He also asked if there were any sticking points in wrapping up the negotiations.

**Dr. Albuero** summed the questions as: (1) on current efforts to cope with the many FTAs in the context of APEC, where he commented that a lack of management will replicate the African case where every economy in Africa belongs to an intra-regional FTA and none benefit; (2) on the role of agriculture in the Japan-Korea FTA and the impression that strategic alliances imply international ‘cartelization’ of industry; and (3) the sticking points in the AFTA-CER. He also sought clarification on the term SRTA, asking if it stood for “subregional trading arrangement.” [The latter Q not responded to later but yes, it does.]

**Dr. Yamazawa** responded to Dr. Kawai’s comment by saying that the Korea-Chile negotiations are not a current concern of Japan. He also drew attention to the “hub countries” — e.g., Chile, Singapore, and perhaps New Zealand — who wish to make bilateral FTAs with many economies and said that the problem faced by the hub economy is making their FTAs with various partners consistent. Dr. Yamazawa said that Japan is not a hub economy, and that the consistency issue is still new and should be discussed by the economy taking initiative in the FTA negotiation.

On the issue of the Japan-Korea FTA policy on agriculture, he agreed that the sector should not be excluded completely, for GATT rules stipulate liberalization for substantially all sectors. However, he pointed out that agriculture and fishing have different problems. The conflict over fishing between Japan and Korea is unique, for they share common resources but not the methodology of catching fish. This has led Japanese fishermen to say that Koreans do not consider preservation of resources, make bigger catches and export these to Japan. Dr. Yamazawa said that, besides the abolition of non-tariff barriers, Japan and Korea must first agree on how to utilize and preserve their common resources. As for the issue of agricultural productivity, he mentioned that both economies protect their agriculture but that the trade between the two is very small. A pragmatic solution may be to specify a very limited area for liberalization.

On the won-yen rate, **Dr. Yamazawa** said that stabilizing the won-yen rate requires stabilizing the exchange rates among Asian economies and the yen-dollar rate. This implies that the question is very much related to the big issue of forming an international financial architecture. On APEC’s role in this issue, he admitted he did not have sufficient information on what APEC is now discussing, but he discussed the role of APEC’s Eminent Persons’ Group in Bogor in 1994. They indicated the leader relationship between APEC and its subregional trading arrangements like the AFTA, the NAFTA, and the CER. Their 1995 report proposed a four-part action plan for open subregionalism:

- (1) MFN liberalization to the maximum possible extent;
- (2) a clear intention to continue reducing barriers to APEC economies that are non-members of the subregional trading arrangement (SRTA) as well as within the SRTA itself;
- (3) an offer by each SRTA to extend the benefits of its SRTA liberalization to all other APEC members on a reciprocal basis; and

- (4) recognition that any individual SRTA member can unilaterally extend the SRTA liberalization on an unconditional basis to all other APEC economies and, under the rules of the WTO, to all its other members, or on a conditional basis to one or several other APEC economies.

Dr. Yamazawa said that at the time he did not completely agree with the plan, but since then he has become more supportive of it. However, he mentioned that APEC has not discussed this issue officially and hopes that this year the Economic Committee (EC) report will include it, paving the way for discussion by APEC ministers.

In his discussion on the good faith of these studies, **Dr. Virata** said that the reaction when his group last presented their progress report to the ASEAN ministers was that they would look into the study but reserve their decisions about negotiations, which depended on whether the economic ministers would approve of it in their next meeting. He mentioned that there were probably certain windows of opportunity that are open to enlarge the FTA — in other words, the ASEAN 6 could have an FTA by the end of 2002, and new ASEAN members could join the FTA based on their respective timelines. Dr. Virata said that, if there is not so much delay, 2003–2004 is a feasible date. He also said that, as time passes, the benefits will decline because everybody is moving towards an FTA, and therefore this decision is largely political and economic. Dr. Virata reported that a static analysis shows very few benefits from RTAs. He expressed his hope that this would be taken positively by the participating economies.

**Dr. Cheong** responded to Dr. Kawai's comment on the possibility of a Korea-Japan–Chile FTA rather than separate bilateral negotiations, saying that since 1998, before beginning negotiations, Korea and Chile have discussed and studied the FTA. On the other hand, Japan and Korea have only ended the first round of study and have not decided whether to begin FTA negotiations. Therefore at present it is not advisable for Japan to join the Korea-Chile FTA. However, Dr. Cheong agreed with Dr. Kawai's statements on the agricultural sector, security alliances and oriental stabilization. On oriental stabilization, he reiterated Korea's position that oriental stabilization should be a separate issue from the FTA between the two economies because Korea is affected by the dollar-won issue, in addition to oriental stabilization. Finally, he addressed Dr. Taniuchi's question on the most difficult matters in the Korea-Japan FTA discussions, saying that there are problems with economic, social and historical issues, the last two perhaps carrying the greater weight. Dr. Cheong reported that political leaders have been deeply involved, with President Kim Dae Jung and Prime Minister Obuchi giving a strong message in favor of economic integration, pointing to the recognition of social and historical issues between the two economies.

On the issue of monetary integration and its relationship to trade agreements, **Dr. Nellor** suggested that the body reflect on what these issues are. He said that, to the extent that trade arrangements promote trade between the parties, the pay-off from monetary integration is increased. However, there are other factors, which may make monetary cooperation less desirable. One is policy coordination, to the extent that there is harmonization of policy across economies. Another, and perhaps more important factor, is the nature of the economic shocks which economies face — if the shocks are the same, then monetary integration makes some sense. However, on the latter, Dr. Nellor discussed the scenario of an RTA between an oil producer and an oil consumer, who may have very close trade links; but in the event of an oil price shock, the oil-consuming economy would weaken and the oil producer would tend to increase to cope with the economic shock. This illustrates the importance of trade to the RTA pay-offs, but it is not a decisive factor when judging monetary integration. He then cited research investigating the shocks faced by Asian economies, to ascertain whether it is advisable for Asia, particularly the members of ASEAN, to look towards a common currency. A comparison of ASEAN with Europe thirty years ago showed that ASEAN has less internal trade within the group, but member economies face more similar shocks. Dr. Nellor concluded that there are pros and cons to moving

toward a common ASEAN currency. He also expressed agreement with Dr. Kawai's comments on the yen-won exchange rate.

**Dr. Albuero** thanked Dr. Nellor, then commented on the session as a whole, saying that it may provide the insight that all these emerging trading arrangements reflect the creeping void left by WTO and the failure to begin a new round.

## **SESSION 6: WTO: STATUS AND ISSUES**

*This session will serve as a forum for discussing the status of WTO negotiations. In addition, it will be an opportunity to discuss the views of the WTO and other multilateral institutions on regional trading arrangements. Although allowed, regional trading arrangements have remained a gray area in the WTO. The WTO's views and those of other institutions will help answer the following questions: Do regional trading arrangements (RTAs) complement the multilateral process? How can one ensure that such arrangements contribute positively to the multilateral process? Are these just an alternative approach to trade liberalization? Can regionalism solve problems that the WTO is having a hard time with?*

**The Honorable Jonathan Fried** began his discussion by giving the rationale for trade liberalization. He said that, on the home front, trade liberalization gives local firms, particularly those in the manufacturing and intermediate industries, more efficient access to less expensive and better-quality factors of production.

Abroad, a rules-based system of liberalization enhances and secures an economy's access to the international market, giving rise to opportunities for economies of scale and improved industrial efficiency. A rules-based system also protects smaller- and medium-sized economies from the exercise of pure economic leverage, leveling the playing field for all economies, regardless of their level of development. It also allows an economy to take best advantage of the world market in economic terms yet still preserves its freedom of action or sovereign choice.

Mr. Fried said that trade liberalization results in the enhanced contribution of the trade sector to the economy, higher paying jobs, higher standards of living, and, ultimately, benefits to the consumer.

He then discussed Canada's view on trade liberalization, saying that multilateral liberalization by the WTO will continue to be highly prioritized. In this context, regional initiatives will complement and support the WTO agenda as open models to anticipate the direction of multilateral rule-making.

Mr. Fried spoke of the events that transpired in Seattle. He said that there were certain divides at the table in Seattle: between the parties interested in a broad agenda and those proposing a narrower set of issues for discussion; between the East and the West on the level of ambition and willingness to tackle remaining distortions in agricultural trade; and between the north and south, where developing economies maintained that they were not given the market access needed for products of interest to them, that they found difficulty in implementing a complex set of rules, primarily because of a lack of administrative capacity, and that these rules were made with no genuine consideration for the issues of developing economies.

Mr. Fried also said that President Clinton's statements about labor sanctions gave rise to a particular push by the Americans to include the matter in the agenda. Further, the US refused to discuss the issue of anti-dumping.

He said that Seattle was a failure in part due to procedural shortcomings, where the change in leadership led to a lack of secretariat support during the preparations for the WTO meeting in Seattle. Further, he said that the United States failed to differentiate her role as the neutral chairman of the conference from her position as head of the US delegation.

There was also the absence of business support due to the lack of government responses to the concerns aired by protesters. Mr. Fried pointed out that said concerns were generally not about trade or even the WTO: many of the protesters were concerned about whether trade rules impinge too much on the government's ability to regulate. Others wanted to know more about the representatives to Geneva, or were pleading with the WTO to help ensure that the benefits of trade were distributed more broadly throughout society. Still others were simply just anxious about the phenomenon of globalization.

Mr. Fried then spoke of the WTO's plans for the short-term. He reported that Director-General Moore has outlined an agenda for confidence-building in favor of developing economies, comprised of (1) enhancing market access, which aims to convince larger economies to fast track the opening of their markets for products of interest to developing economies; (2) greater flexibility on implementation, particularly in the areas on customs valuation and trade-related investment measures; (3) capacity-building, or reinvigorating the so-called integrated framework designed to allow each recipient economy to identify for itself its highest capacity-building needs and present this agenda to donor parties; and (4) making decision-making processes more inclusive of the issues of developing economies. The WTO also hopes to conclude the accession negotiations, particularly with China and Chinese Taipei; and "the built-in negotiations," those on agriculture and services, in the short-term.

He then discussed the challenges facing the WTO in the long term. Mr. Fried said that the WTO needs rules that keep pace with the evolution of the global economy in order to protect an economy's freedom of action in this changing scenario. Individual governments need to achieve a coherence between their policies and institutions and those anchored in a multilateral framework. Further, to prevent a recurrence of the events in Seattle, governments must also win the support of their constituents by educating them on the benefits of liberal trading frameworks.

Mr. Fried discussed the pros and cons of regional trade agreements. He said that RTAs were beneficial because they create new trade opportunities through negotiations with a small number of like-minded economies; create new rules; advance necessary reforms; and enhance the connection between political and economic cooperation. On the other hand, the proliferation of agreements makes it almost impossible for business to take advantage of them. Furthermore, the complexity of rules may increase transaction costs rather than reducing them; and many studies have questioned whether or not rules of origin result in trade diversion.

He said that, at present, Canada has existing trade agreements with Chile and Israel in the visions of the NAFTA, as well as special partnerships and trade frameworks with Korea and Europe; and is pursuing a free trade agreement with the European Free Trade Area and Costa Rica. It has chaired negotiations in the Free Trade of the Americas Agreement, and is exploring free trade prospects with Singapore and Japan. Canada is also continuing its participation in the APEC, OECD and G-8 fora.

Mr. Fried then spoke of the lessons learned from recent experiences and studies. *First*, he said that, for trade liberalization to contribute fully to growth and development, it must be accompanied by an appropriate regulatory framework. *Second*, improving the supervision of a growing and transparent financial sector facilitates the development of the trade and economic activity by financing sectors that is essential to efficient and competitive businesses. *Third*, the full participation of developing economies in the global economy will bring about prosperity. *Fourth*, providing an environment conducive to the progress of developing economies will be through sustained business activity, contingent upon policy support that assures the businessman



of transparency and objectivity of regulation, and responds sufficiently to the needs of society. In this regard, Mr. Fried pointed out that existing trade negotiations in APEC and the WTO emphasize strengthening the market instead of merely opening it. *Fifth*, there is a need for an agenda for coherence, or an agenda for governance, or an international framework of rules for sustainable development. Establishing connections between various RTAs and the WTO, for example, is only the beginning. The world is faced with the challenge of linking various socio-economic agenda items to the political imperatives of democratic development and inclusiveness.

Mr. Fried concluded by saying that at the crux of the matter was a need to enhance liberalization along with building absorptive capacity, to ensure a sufficiently rapid pace of development and contribute to the well-being of individuals. He said that this was contingent on the generation of wealth through a policy environment that supports business activity but gives due consideration to global socio-political developments.

**Mr. Bonapas Onguglo's** presentation discussed certain rules affecting RTAs within the WTO context so that the participants could become familiar with the rules that would be invoked when WTO members — including most APEC members — were engaged in both the WTO and RTAs, or other forms of trading arrangements. He said that the main issue here is the complexity and variety of notification procedures for RTAs, both among developing and developed economies and among developed economies.

He cited Dr. Findlay's statement that in the WTO process very few reports have been issued addressing an RTA's consistency with the WTO rules. He also noted Ambassador Groser's statement that the WTO rules are ineffective in policing RTAs. In view of this, Mr. Onguglo mentioned that APEC is not a contractual RTA *per se*; and that within APEC, members are not obliged to report or notify APEC trade liberalization to the WTO. However, this may become necessary in the future, especially if APEC moves toward a contractual trade liberalization program.

He said his report would contain a broad survey of certain WTO provisions on RTAs, including notifications of RTAs covering trade in goods under the enabling clause, GATS Article 24, and the Uruguay Round (UR) understanding on that article; and of RTAs covering trade in services under GATS Article 5.

Mr. Onguglo stated that the notification of an RTA was obligatory for all WTO members, as contained in various WTO provisions. He explained that RTAs need to be examined to ensure their consistency with the relevant WTO provisions, which only aim to make sure that RTAs expand trade among the member economies and do not raise barriers against third economies. He said that normally an RTA is notified after its entry into force, although WTO rules state that notification must be made *prior* to entry into force, to allow WTO members to review the provisions and plans of the RTA.

He further mentioned that RTAs are notified under the following relevant WTO provisions: the Enabling Clause; GATT 1994 Article 24 and its Understanding; the waiver on GATT Article 25 and the WTO Agreement Article 9; GATS Article 5; and GATT Article 12.

Mr. Onguglo proceeded to discuss the notification and examination process, which begins when member-states submit a notification letter and legal text containing the agreement to the WTO Director-General, who circulates the notification to relevant WTO councils and committees. He said that notifications of RTAs under GATT Article 24 go to the Council for Trade in Goods; notifications under the Enabling Clause go to the Committee on Trade and Development; and trade in services RTAs notified under GATS Article 5 go to the Council for Trade in Services. They are reviewed by each committee, which then employs standard terms of reference for the examination of the RTA in terms of its consistency with the relevant WTO provision.

Under the past GATT, examination of the RTAs was conducted by working parties; today, they are carried out by the Committee on RTAs (CRTA). The CRTA reviews the notifications and submits a report to the referring policy body. Mr. Onguglo observed that the Committee on Trade and Development does not have a direct link to the CRTA, because most Enabling Clause agreements relate to RTAs among developing economies and WTO members disagree on whether agreements among developing economies should be referred to the CRTA. He mentioned that some have proposed that, even if they are not referred to the CRTA for examination, the Enabling Clause agreement should at least be referred to the CRTA for information purposes, a report made and submitted back to the Committee on Trade and Development. At present, the Committee on Trade and Development establishes a working party to consider the notification and prepare the report.

Mr. Onguglo said that Paragraph (Para.) 4 of the Enabling Clause, adopted in the 1979 Tokyo Round, states that any contracting party taking action to introduce an arrangement pursuant to Paras. 1, 2, and 3 of the Clause requires notification on GSP, differential treatment to LDCs, and RTAs among developing economies. This list is in Para. 3. The contracting parties, which are WTO members, are then notified, affording an opportunity for consultation.

He mentioned some developing economy RTAs notified under the Enabling Clause, including: ASEAN and its trading agreements; the Latin American Integration Association; the Global System of Trade Preferences Among Developing Economies; the Andean Community; the Common Market for Eastern and Southern Africa; the Bangkok Agreement, among certain East Asian economies; and the Protocol relating to Trade Negotiations among Developing Economies. Mr. Onguglo also pointed out the unique case of the MERCOSUR, notified under both the Enabling Clause and GATT Article 24.

He said that an Enabling Clause agreement must be designed to facilitate and promote trade, not to be an impediment to the reduction or elimination of tariffs and other trade restrictions on an MFN basis, and shall in the case of treatment accorded by developed member economies to the developing members be designed, and if necessary modified, to respond positively to the development, financial and trade needs of developing economies. The Enabling Clause provides more flexibility compared to GATT Article 24, as there are no obligations for ex-ante and ex-post assessments of levels of production and substantial trade requirements; and there is no defined 'reasonable timetable' as specified in GATT Article 24. Mr. Onguglo said that under Enabling Clause agreements RTAs are only obliged to notify the WTO.

He then discussed the provisions under GATT Article 24, relating primarily to RTAs formed among developed economies. Para. 7 of this Article stipulates that any contracting party deciding to enter into a customs union, free trade area, or interim arrangement leading to the formation of either, shall promptly notify the contracting parties and WTO members, making available to them information on the proposed agreement to enable them to make appropriate reports and recommendations to the contracting parties. Mr. Onguglo also mentioned that, should the contracting parties find that such an agreement will not likely result in a customs union or free trade area within the period contemplated, the parties cannot maintain their agreement or put it into force if they are not prepared to modify it in accordance with the recommendations made by other WTO members.

Under GATT Article 24, there are three types of RTAs: customs union, free trade area, and an interim arrangement leading to either one. Most RTAs fall into the third category to allow for the time period in which the FTA will be set or a customs union adopted. Mr. Onguglo mentioned that, while APEC is not a contractual RTA, it promotes a liberalization process progressively moving towards free trade between 2010 and 2020.

He also said that, even after the UR, Article 24 was adopted because during the UR it was recognized that the existing rules were weak, and lacking in clarity and precision, therefore they

needed to be reinforced. At the conclusion of the UR, there was only an understanding on GATT Article 24, which did not introduce any new rules but clarified some existing provisions. It basically requires an RTA to submit itself for an economic impact assessment in terms of the level of protection before and after it is formed; and imposes a 10-year-maximum transition period for interim arrangements, accepting only exceptional reasons for transitions of beyond 10 years. Mr. Onguglo reported that, unlike the previous GATT, there is now a provision linking RTAs under GATT Article 24 to a dispute settlement, wherein a member-state may challenge the agreement under a dispute settlement process if it feels that its benefits have been impaired by the formation or enlargement of an RTA.

He went on to discuss the annual report provided for the WTO reviewing the operations of FTAs or customs unions, mentioning an ongoing debate on how these bi-annual reports should be prepared. One side argues that they should be more than a report and assess the level of liberalization present in the RTAs, while others feel that they should only be a transparency exercise, a noting of progress rather than an examination process.

Mr. Onguglo proceeded to compare certain features of GATT Article 24 and the Enabling Clause. Both require RTAs to make all information available to other WTO members to enable them to conduct the examination process. Further, the Enabling Clause also states that prompt consultations shall be undertaken upon the request of any contracting parties regarding any difficulty or matter that might arise. On the other hand, GATT Article 24 requires prompt notification, but there is no clear definition on prompt consultations, only that recommendations will be made and followed through by RTA members. He also said that both provisions stipulate that duties and other regulations of commerce will not become more restrictive after the formation of the RTA, to prevent the creation of difficulties for third parties.

Mr. Onguglo proceeded to discuss certain difficulties with respect to the various provisions. Under GATT Article 24, the formation of an RTA must not exceed 10 years, with provision for acceptance of an exceptional reason for any excess. He recommended clarifying the term “exceptional reason.”

Furthermore, there must be a clear definition of the term “substantially all the trade” requirements under Article 24. He reported that there are continuing debates on the exact meaning, whether it covers *all* sectors, and/or whether agriculture and trade are wholly or partially included. Mr. Onguglo also said that the article makes it clear that “other regulation of commerce” refers to non-tariff barriers, but it has been very difficult to define, and thereby remove, these non-tariff barriers. Article 24 also stipulates that any member-economy has the right to resort to dispute settlement procedures if it feels that its rights have been impaired by the formation of an RTA, implying that the parties to an RTA must tread very carefully indeed to pass these conditions.

He concluded by reporting that these issues on Article 24 are being tackled by the CRTA. There is also at present a move to upgrade the examination of the provisions within Enabling Clause RTAs, whereas in the past these were merely noted and adopted without strict examination. Mr. Onguglo said that information and standard format requirements are being adopted toward bringing some kind of “Article 24 process” into Enabling Clause agreements.

**Ambassador Edsel T. Custodio** began his presentation by remarking on the irony of the greater proliferation of RTAs *vis-a-vis* successive rounds of multilateral negotiations that have deepened trade liberalization and driven multilateral trade disciplines well beyond the original GATT rules. He said that the basic question is whether RTAs have supplemented or contradicted the multilateral process, reporting that both positions are supported, however sparsely, by analytical studies and empirical evidence. He asked if there were sufficient pressures or guidelines to align present and future RTAs to multilateral rules and ensure that RTAs facilitate trade between its members and do not exclude third parties.

He then gave a profile of the present RTA situation. Citing information from the WTO Secretariat, he reported that as of June 2000, 124 RTAs have been reported to the GATT/WTO, with 78 percent notified in the past nine years, and around 80 RTAs remain un-notified. Ninety-nine reported RTAs are bilateral; 25 are plurilateral. Furthermore, the number of GATT/WTO members participating in RTAs rose from 55 in the 1980s to 100 (of 132 WTO members) in September 1998. Ambassador Custodio also observed that the frequency of RTAs (including services) to which an economy or another RTA has become a party have become more pronounced.

He stated that the EC is involved in 24 FTAs, 5 Customs Unions (Cus), and 8 Services Agreements; EFTA (Iceland, Norway, Switzerland, Liechtenstein) in 14 FTAs and 1 Services Agreement; Economies in Transition, EFTA and CEFTA members (Bulgaria, the Czech Republic and Slovakia, Hungary, Poland, Romania and Slovenia), 31; Turkey, 9; Israel, 10; Canada, 3 FTAs and 2 Services Agreements; and Bangladesh, 3. Mexico is reportedly in 13 FTAs, with 5 more in negotiation, but only the NAFTA was reported to the WTO.

Ambassador Custodio reported that 10 [11 mentioned above] Services Agreements were notified to the WTO, and RTAs have changed from inter- to cross-regional. An EC-EFTA European Economic Area (EEA) is in the works, bringing the provisions of EC 1492 to EFTA members. The EC is also involved in cross-regional RTAs with Mexico, Uzbekistan, and Kyrgyzstan, among others. The Free Trade of the Americas Agreement (FTAA) is due by 2005, and it has already brought about inter-regional groupings like SAFTA (Chile, MERCOSUR and the Andean Community) and the CARICOM-Dominican Republic. Cross-regional Canada-Israel, US-Israel, US-Palestine and Mexico-EC RTAs are in effect, with a Canada-EFTA RTA to follow.

Ambassador Custodio said that the WTO requires that all bilateral, regional and plurilateral preferential agreements be notified to the WTO. In 1996, the General Council established the Committee on Regional Trading Agreements (CRTA) to examine agreements in view of procedures and Terms of Reference adopted by the different WTO trade councils, and report to the relevant body for appropriate action.

Under the GATT, small, separate working parties were established for each agreement notified and a formal document was produced through a confidential process, from which parties would derive an agreed report for transmittal and adoption by the Council. Ambassador Custodio said that these gave rise to divergent views on RTAs' compliance with the rules and a mix of factual information and general judgements, and that the Council did not act further on the reports.

Under the WTO, the process dealing with RTAs changed. Today, relevant bodies adopt terms of reference (TORs) for examination and transfer the task of examination to the CRTA. Ambassador Custodio reported that under the old GATT, 98 RTAs were notified and examined by working parties. Consensus on conformity with GATT provisions was reached in only one case.

He said that the CRTA inherited the examination of a number of individual agreements. No agreed report has been produced thus far on any examination, leading to a backlog of 82 as of March 2000. He attributed the inability to reach a consensus to the interplay of several factors: (1) divergent interpretation of RTA-related rules, or lack of a common legal yardstick to reach consensus and a unanimous decision on an RTA's compliance with WTO requirements; (2) the nature of the agreements themselves, for not all RTAs are equal and, in theory, some are closer to any yardstick than others; and (3) linkages between reports, associating inclusion of a comment or an appraisal in the text of one to a similar inclusion in another.

Ambassador Custodio said that the CRTA has adopted a more structured examination procedure and a standardized format for information and examination reports. Under the standardized examination report, divergences, observations, and consistency pertaining to specific agreements

under Article 24 are noted. An illustrative list of systemic issues based on these observations is then drawn up and a responsive CRTA work program designed.

He then proceeded to discuss the legal bases for examination and consistency. The GATT 1947 made no provisions whatsoever for the examination of notified RTAs. Article 24:7(a), however, foresaw that members will need information to make appropriate reports and recommendations, implying the need for RTA parties to make such information available to them. Ambassador Custodio observed that this probably gave rise to the working parties that examined, in view of relevant GATT provisions, every notified RTA and make a report for review. He then said that Paragraph 7 of the Understanding on the Interpretation of Article 24 of the GATT 1994 clarified that all RTAs notified under that Article should be “examined...in light of the relevant provisions of GATT 1994 and Para. 1 of this Understanding,” and that a report on the findings be submitted to the Council for Trade in Goods. The standard TORs adopted by the CRTA for examining each RTA notified under the GATT contains similar language and Paragraph 1 of the Understanding says that RTAs must satisfy provisions in Paras. 5–8 to be consistent with Article 14. Ambassador Custodio also mentions that the 1995 Understanding, attached to the TORs for the examination of all RTAs currently under the CRTA, explicitly refers to “reporting on consistency with the provisions of Article 24.”

Article 5: 7(a) of the GATS mandates parties to RTAs (in the area of services) to supply all needed information, making it clear that an examination of an RTA to report on consistency with this article will be carried out if necessary. Ambassador Custodio pointed out that the corresponding mandate for examination also requires a report on the RTA’s consistency, showing that both GATT and GATS call for assessments of consistency.

He mentioned that RTAs notified under the GATS are not automatically submitted to an examination. Article 5: 7(a) suggests the following indications on how these two requirements may interact: 1) the required information exercise might be separate from the examination; and 2) the examination itself would have the sole objective of determining an RTA’s compatibility with the rules.

Ambassador Custodio then said that the CRTA is also mandated to consider systemic issues. It has thus far attempted to determine the subjects for the systemic “basket,” the structure of the debate, and the degree of emphasis on the different components. He proceeded to outline the CRTA’s three-pronged approach for dealing with systemic issues: (1) legal analyses of the relevant WTO provisions; (2) horizontal comparisons of RTAs; and (3) consideration of the economic aspects of RTAs. Through this approach, the Committee recognizes that “systemic implications” can cover legal shortcomings or problems of interpretation, as well as thematic, or horizontal, examination of certain themes or issues. One such issue is an analysis of the nature of CUs and FTAs, the reasons underpinning their formation, their contribution to the global liberalization of trade and their effect on the multilateral system.

Ambassador Custodio observed that each RTA deals differently with issues such as Rules of Origin (ROO), anti-dumping and countervailing measures, technical barriers to trade, safeguards, competition policy, and government procurement. He pointed out that different approaches to particular trade policy areas imply potential systemic implications, such as the extent to which these different approaches may hinder or facilitate promotion of multilateral disciplines in an area. In this regard, he suggested that the CRTA explore the following horizontal issues: (1) how different agreements deal with specific trade-related disciplines; (2) how RTAs’ treatment of specific disciplines relate to relevant WTO disciplines; and (3) how regional and WTO disciplines currently interact, and how this relationship may evolve to foster multilateral disciplines. He reported that CRTA has decided to commission the Secretariat to study the horizontal comparison of RTA provisions on internal trade liberalization by the end of summer 2000, so an appropriate event addressing these issues may be decided for 2001.

He then discussed the mandates on transparency in trade in goods, citing Article 24:7(a) of GATT 1994, requiring CPs deciding to enter into a CU or FTA, or an interim agreement leading to the formation of such a union or area, to notify the CPs and make information available, enabling them to make appropriate reports and recommendations. Furthermore, the Preamble on the Understanding of the Interpretation of Article XXIV of GATT 1994 states "...the need to reinforce the effectiveness of the role of the Council for Trade in Goods (CTG) in revising agreements...by clarifying the criteria and procedures for the assessment...and improving the transparency of all Article 24 agreements."

In the realm of trade in services, GATS Article 3 provides for a generic mandate on transparency. Article 5:7(a) also provides for parties to any agreement to "...promptly notify any such agreement and any enlargement thereof or any significant modification...to the CTG...make available to the Council such relevant information as to may be requested by it."

Ambassador Custodio began the discussion on the future handling of RTA issues by citing the WTO membership's articulation of the role of the CRTA: "The expansion and extent of RTAs make it important to analyze whether the system of WTO rights and obligations as it relates to RTA[s] needs to be further clarified." Tasked to examine RTAs' consistency with the provisions in relevant WTO agreements, he reported that the CRTA faces a dilemma arising from the interplay of factors discussed earlier, and from the fact that any categorical findings, recommendations, and/or interpretations emanating from it and adopted by the Council may have the force of a decision.

He proceeded to discuss the first-ever dispute settlement of RTA matters, the case of Turkey's Restrictions on Imports of Textile and Clothing Products, where the Appellate Body clarified a few points in Article 24. In 1999, the Appellate Body enjoined the Panel to determine if the EC-Turkey arrangement was a CU; declared that CUs — and RTAs — are not exempt from close examination by Panels, contrary to Turkey and India's argument that RTAs are political decisions not subject to Panel scrutiny; and declared that only measures preventing the realization of a CU could be validly claimed as derogation from MFN under Article 24, i.e., that QR regimes are not essential to the realization of a CU and therefore need not follow the regime of the EC.

Ambassador Custodio drew attention to the possibility of "nullification and impairment" cases arising from the implementation of more complex RTAs, saying that, without WTO guidance, parties in the new generation of RTAs may put themselves at risk. He recommended that the clarification of the system of WTO rights and obligations related to RTAs be altered immediately, and reported that members tabled several proposals for negotiations before Seattle. However, the chances of having another round and achieving any clarification appear slim. Furthermore, there is no "built-in" mandate for the review or assessment of Article 24 and its Understanding compared to other issues in the WTO's built-in agenda. Thus it falls to the CRTA to address this issue through its three-pronged approach.

Ambassador Custodio stated that the CRTA's work has had impact on the WTO's policy-making structure. Its Examination Reports and the biennial Reports on Operation of Agreements have been significant, even without consensus views, recommendations or conclusions, as effective channels for collecting information. They have also accurately reflected members' dissenting views on the different features of RTAs and their adherence to multilateral disciplines. He expressed optimism that the CRTA's work in addressing "systemic issues" will highlight the horizontal treatment among RTAs on the objectives, procedures and approaches they are taking on major trade and trade-related issues. Ambassador Custodio said that the analytical benefits of this work program could contribute to the change in WTO rights and obligations *vis-à-vis* RTAs needed to improve convergence, as well as reflect RTAs' focus on specific issues not presently covered by the WTO. He said that these on-the-ground experiences could help WTO members introduce these onto the future agenda.

By examining the RTAs' consistency with specific WTO agreements, the CRTA serves as an enforcement mechanism for certain obligations, reinforcing the WTO commitments for members participating in RTAs. However, Ambassador Custodio noted that there exists the risk of jeopardizing members participating in an RTA under question, causing the blocking of reports and the CRTA would thus be unable to perform its function.

He clarified that the CRTA is not a dispute settlement organ and cannot interpret with authority the relevant provisions on members' rights and obligations. The CRTA appears more closely related to the Trade Policy Review Mechanism (TPRM) that aims to enable regular evaluation of a full range of individual trade policies and their impact on the multilateral trading system. The TPRM also aims to improve all members' adherence to rules and commitments made under multilateral trade agreements. While its procedures and findings do not threaten members' rights and obligations, through transparency and peer pressure the TPRM is nevertheless effective in enforcing adherence.

Ambassador Custodio said that his paper limited its discussion to the interplay between different types of RTAs and the WTO system of rights and obligations. He concluded that, aside from dispute settlement rulings, the WTO appears in too weak a position to sufficiently align any RTAs with binding multilateral rules. However, through the CRTA, the WTO might be able to influence present and future RTA patterns. He pointed out that the collection of wider information is in itself an issue in the CRTA, and is critical for exerting influence. He suggested that stepping up awareness of this problem and a wider information campaign thereon could serve the WTO well.

At the same time, the role of the CRTA itself must be clarified if it is to perform its examination, transparency, systemic and information responsibilities without threatening members' rights and obligations. Ambassador Custodio said that this is contingent upon whether WTO commitments are reflected in members' RTA participation toward a sound multilateral trading system. He recommended that external pressure from other multilateral institutions, regional groupings, learning centers, and professionals may be of help. By recognizing the economic usefulness of RTAs, political and legal pressure to converge regional and multilateral initiatives must get the support of all shareholders.

#### **Open Forum 6:**

**Mr. Yokoyama** said that his understanding was that the biggest problem was that "substantially all trade" is not clearly defined and that the CRTA is still working to clarify it. In view of this, he asked how long it will take for the CRTA to reach a conclusion, and also what this conclusion will most likely be. He also asked if the WTO has ever done a major study on the proportion, in terms of number of items or monetary value, of the existing FTAs covered in the agreements.

**Dr. Pastor** questioned Ambassador Custodio on his emphasis on the process by which the WTO seeks to establish whether the RTAs are in compliance with its legal and theoretical standpoints. He asked about the findings from RTA biannual implementation reports on the extent to which the RTAs fulfill their objectives and initial deadlines. He questioned Mr. Fried on the disappointment felt by LDCs regarding the market access promised by the Uruguay Round, asking him to be more specific and inform the body if LDCs have taken the developed economies to the WTO or other dispute settlement mechanisms to ensure that those promises have been implemented. He also asked Mr. Fried about any institutional reform that may be put on the future long-term agenda.

**Ambassador Custodio** said that "substantially all trade" and "regulation of commerce" are two very specific phrases in Article 24 of the GATT, and to this day there is no single interpretation of these phrases within the CRTA and the WTO. This implies that an accepted report may result in a split decision. Despite the difficulty with consistency, descriptions are possible. Ambassador

Custodio's report attempted to describe the exchange of statements or views as far as the two important phrases are concerned. Furthermore, he does not see a definite resolution of the issues, barring re-negotiation or a dispute settlement. However, he reported that Turkey's case regarding QRs on textiles and garments may pose as an opening for some of the issues. Turkey has a customs union arrangement with the EC and this was questioned by several developing economies. A panel report was presented to the appellate body, who ruled that: (1) the panel should have verified whether the customs union is already in place; (2) certain elements of the QRs which Turkey defended as being part of the customs union process was not defensible, for the political and economic objectives expressed by a customs union can be subjected to examination, especially when the union is still in transition; and (3) the QRs adopted by Turkey are not essential to the customs union, therefore adoption was voluntary. Ambassador Custodio pointed out that in effect there was nullification and impairment from those adversely affected by the QRs, but he nevertheless maintained that a door has been opened to dispute settlement on RTA provisions. He said there was no timeframe for the conclusion of this, for the first set of biannual RTA implementation reports came only in mid-June and there is no framework, format, standards or basis for examining the reports.

**Mr. Onguglo** added a few comments on WTO studies, pointing out the difference between the WTO Secretariat *per se* and WTO member states. The WTO Secretariat undertakes studies at the request of the members and has conducted many but they were not specifically on the interpretation issues related to the CRTA and negotiations issues that would be affected. He said that the secretariat collects statistical information from RTAs on the coverage of trade, but, with the ambiguous definitions, the information from most submissions states that substantially all the trade is covered, leaving it up RTA members to decide whether or not it is actually covered.

**Mr. Onguglo** also said that the biannual implementation report once required was not strictly observed and collected. Today, the CRTA is looking into procedures for considering these biannual reports. He reported that the first set of reports have been submitted and are now under review, but said that what is important is whether or not the examination would verify the rate of progress in implementation towards achieving trade liberalization. There are many gray areas in this regard, e.g., whether the reporting should be a transparent exercise, wherein RTA members report the state of progress and others take note, or only an examination of the liberalization undertaken within the RTA concerned. Mr. Onguglo stated that the committee may find it difficult to start clarifying its procedures for reviewing the reports.

**Mr. Fried** observed that Canada, despite all its FTAs, does not think that the time is right to renegotiate Article 24. This is partly because the CRTA has not completed its horizontal examination to see if there is a pattern or practice establishing norms behind the rules.

He cited the study by Jackson and Hudeck examining FTAs and customs unions that had been negotiated at the time. They found that some agreements covered only 45–48 percent of trade, while others covered 100 percent. They qualitatively looked at questions raised by other members, and concluded that on average the most credible benchmarks for an Article 24-consistent FTA would be: about 80 percent of trade on a trade-weighted basis in volume terms and covering substantially all sectors, but not covering 100 percent. Mr. Fried pointed out its difference from GATS Article 5, which calls for a complete coverage of the services sector. He also said that cross-agreement work would provide an updated evaluation of consistency in practice and draw attention to inconsistencies.

He mentioned another dispute about FTAs, New Zealand's case with the US over the latter's Article 19-based action on lamb imports from New Zealand but not from Canada, which was exempted by virtue of the NAFTA agreement. Mr. Fried said that, in Canada's view, it was necessary to obtain that exclusion because safeguard actions, like anti-dumping, are restrictive commercial regulations that must be removed in compliance with Article 24. He mentioned that



the panel may have use on the relationship between exclusion on trade remedies on one hand, and Article 24 on the other.

On developing economies and market access, he said that two kinds of concerns have been expressed since the UR: on matters of expectation, and on matters of violation. **Mr. Fried** explained that developing economies expected an open market to lead to increased export earnings, because developed economies will buy and import more products at lower tariffs, contributing hard currency earnings to developing economies. What has actually transpired since 1995 was a “bottoming elbow” of commodity prices, particularly in agricultural exports.

He said that the developing economies’ disappointment was not as much in terms of violation as it was of expectation. On alleged violations, he observed that some developing economies have taken major trading partners to test, as evidenced by the case of Costa Rica versus the US on textile restraints. Costa Rica was victorious in disciplining the US, who abused textile restraints under the Multi-fiber Agreement. Mr. Fried said that many developing economies find dispute settlement to be very expensive and very adversarial and reported that one agreed result in Seattle was the creation of the WTO Advisory Center for Disputes, an independent non-government foundation associated with the WTO, the International Trade Center and UNCTAD, and jointly owned by the ITCS, UNCTAD and the WTO. This provides a group of affordable lawyers independent of the Secretariat to assist developing economies, especially least developed economies, make their case and assert their rights.

Finally, regarding long-term institutional reforms, **Mr. Fried** mentioned that at present there are all sorts of informal groupings because, outside the General Council, there is no smaller grouping to create an informal consensus. He said that one observer compared the WTO to a corporation, where shareholders are represented by the trade ministers of member economies; and the managing director is represented by the Director-General, tasked to carry on day-to-day activities as an employee. However, Mr. Fried pointed out that there are no equivalents to the board of directors, steering committee, or other executive body that provides guidance. He said that he does not recommend imitating the United Nations, vesting a smaller group with security council authority, but the WTO may benefit from having an advisory or steering committee that can openly and transparently represent the cross section of the membership. He cited the CGA Team of the UR, a consultative group of 18 that served as an indicator of the “temperature” of the more general membership, and suggested forming a similar, formally recognized, grouping in the WTO.

**Mr. Fried** then tackled the role of the WTO Director-General (DG), saying that, unlike other international organizations, the DG as chief executive is not truly free to act without specific authorization from the membership. He mentioned that this appears to parallel the early evolution of the role of the UN Secretary-General who, in the late 1940s and early 1950s, had to consult with the General Assembly and Security Council over such matters as communications and correspondence; but that the post gradually evolved into an independent executive authority in the UN. Mr. Fried pointed out that the WTO is undergoing the “initial teething pains” of the emergence of its own executive authority. He said that, as a member-driven organization, the WTO did not articulate the extent of independence it was prepared to grant the DG to sustain momentum in the UR, and cited Mr. Arthur Duncan’s initiative, midway through the round, of tabling a text representing his own views which served as a catalyst for bringing members together. Mr. Fried said that DG Moore did not do such a thing in the lead up to Seattle, and that he basically tabled the product that the members themselves have covered together. He concluded by saying that the WTO must find the “exact authority item.”

**Mr. Basilio** closed the forum by saying that any additional questions on this particular subject may be addressed to the organizers in the afternoon session. He mentioned that many interesting points had been raised on the risks of RTAs and the WTO, and said the panel agreed that ambiguities remain regarding the standards and processes for measuring consistency with WTO.

The panel diverges on the need for additional work before any definite decisions are made on the renegotiation of Article 24.

## **SESSION 7: APEC AND MULTILATERALISM: INITIATIVES AND ACHIEVEMENTS**

*The session will discuss APEC's role in advancing multilateralism. Early on, APEC played an important role in global negotiations, with its GATT-plus stance. APEC's liberalization projects have included the development of Individual and Collective Action Plans, the Information Technology Agreement and the Early Voluntary Sectoral Liberalization (EVSL) initiative. After the events in Seattle, what stance should APEC take?*

**Mr. Hamid Jaafar** began his presentation by briefly discussing the APEC leaders' meeting in Auckland. He reported that there, a number of issues relevant to the WTO – ranging from the support for launching a new round to the eventual evolution of agricultural subsidies and inclusion of industrial tariffs – were agreed upon. However, this meeting did not have a significant impact on succeeding events in Seattle. The failure of Seattle has raised the following questions: (1) What can APEC do to contribute to WTO efforts? and (2) How can APEC help restore the lost momentum of multilateral trade liberalization?

Mr. Jaafar gave an update on certain APEC initiatives. He said that, at the 1996 meeting in Subic, APEC agreed to a two-track approach to facilitate the trade and investment regime. The first track would be the various Individual Action Plans (IAPs), unilateral measures undertaken domestically and subject to improvement by the implementing member economy. Each IAP covers the 15 different sectors under the Osaka Action Agenda (OAA): tariff and non-tariff measures, services, investment, standards and conformance, intellectual property rights, customs and procedures, competition policy, deregulation, government procurement, dispute mediation, mobility of business people, implementation of the Uruguay Round and its outcomes.

Mr. Jaafar said that, by building on domestic liberalization and deregulation, as well as encouraging further action, APEC contributes to a more liberalized and open global trading environment. Worthy of special distinction is the development of an electronic IAP (EIP), geared to provide faster, easier online access, and a better understanding of the trade and investment regimes of each APEC member economy. This will be implemented in 2001, together with a comprehensive review of the Osaka Action guidelines, to make APEC more relevant to the current economic environment.

The second track is a Collective Action Plan (CAP) to be carried out by the Committee for Trade and Investment (CTI), wherein APEC members work together to reduce barriers to trade, facilitate the flow of goods relative to resources and technical know-how, and strengthen economic and technical cooperation. The CAP aims to improve the global economy via stronger ties between APEC members and other world economies while taking into account the interests of the private sector, especially those of the small and medium-sized enterprises (SMEs).

Mr. Jaafar said that APEC's efforts to strengthen the multilateral trading system have been concentrated on implementing the UR. Numerous activities to improve members' understanding and implementation of WTO commitments have been conducted, including comprehensive technical programs: to implement the Customs Valuation and TRIPS Agreements; to promote the active participation of APEC members in mutual recognition agreements; and on competition policy and deregulation. He also reported that, in Darwin in June, APEC reaffirmed its commitment to the early launch of a new round of multilateral trade negotiations. This would include capacity-building to implement the WTO agreement, through technical assistance specific to individual developing APEC member economies; preparatory work on tariffs and related areas;

an APEC-wide moratorium on the imposition of customs and duties on electronics transmission until the next WTO ministerial conference; and seminars on investment and competition policy.

Mr. Jaafar said that the APEC liberalization effort has been anchored to its commitment to strengthen the multilateral trading system by determining concrete ways to contribute to the WTO work program. In this vein, APEC has played a role in bringing the UR to a successful conclusion. He announced that APEC would work to build APEC's capacity to implement the WTO agreement, and integrate developing economies in the multilateral trading system. The Committee on Trade and Investment (CTI) will identify the needs of each APEC member and develop the appropriate strategy and implementing mechanism to address these. Mr. Jaafar said that an agreement was reached in Darwin that subregional trading arrangements should be consistent with the WTO and supportive of APEC goals and principles. Meanwhile, the EVSL initiative is focusing on the remaining areas of non-tariff measures and Economic and Technical Cooperation (ECOTECH). The CTI market access group has been tasked to organize the work based on the completion of list of generic non-tariff measures (NTMs).

APEC trade facilitation efforts cover a wide range of trade issues, among them customs standards, government procurement, intellectual property, business mobility, and access to information. Mr. Jaafar reported that work programs have been implemented to reduce these prohibitive transaction costs, particularly for SMEs. The CTI has set up an *ad hoc* trade facilitation task force led by Hong Kong, China, to pursue this and develop a set of non-binding principles on trade facilitation.

He also said that continuing globalization implies a need for global-wide practices and policies to improve the intra-regional flow of goods, services, investment and capital. APEC has agreed to promote a consistent legislative and regulatory environment strengthening e-commerce cooperation among members and enabling them to benefit from e-commerce. To this end, work and technical cooperation programs will be developed to address the specific needs of each member economy.

One of APEC's more significant contributions to the WTO's push for multilateralism has been the trade policy dialogues within the CTI, which has discussed multilateral trading systems and will move on to tackle the issue of the new economy.

In conclusion, Mr. Jaafar proposed that the diversity within APEC should be seen as a strength of the organization. Its activities should naturally reflect the balance of interest of developed and developing members and therefore be of practical value-added to WTO work. He said that a new round of negotiations may address more than border barriers to trade, and APEC's work in competition policy and investment facilitation should prove helpful in this respect. However, the continuing division among members that led to the failure of Seattle must be addressed and it may take some time before a new round of WTO negotiations can be expected. Mr. Jaafar recommended that APEC maximize the available time to work for a balanced next round that is, in itself, a good reflection of what is possible in the WTO. It should place emphasis on the growing acceptance of economic and technical cooperation as integral to liberalization and facilitation, as well as confidence- and capacity-building in order to address the concerns of developing member economies.

**Mr. Chan Buom Lee's** presentation was a retrospective on APEC's achievements toward strengthening the multilateral trading system. He said that the multilateral trading system has been top priority at every APEC ministerial and leaders' meeting since APEC's 1989 launch in Canberra. In fact, the Seoul Declaration states that developing and strengthening the open multilateral trading system is one of the APEC's core missions.

He then listed APEC's two-part contribution to the multilateral trading system: (1) political support to strengthen the multilateral trading system; and (2) efforts toward international creative liberalization.

Mr. Lee said that the Uruguay Round was adrift for several years after Brussels, as it looked for the right political moment and commitment, and the determination to get it through to the final phase. Fortunately, its text was basically agreed-upon at the time of the APEC 1993 meeting in Blake Island, and the APEC Economic Leaders were able to state their aim to conclude the UR by 15 December 1993. He also said that APEC's contribution to concluding the UR was a political matter. While it is difficult to gauge the contribution of APEC's upgrading to the Leaders' level to the UR's actual conclusion, APEC's decision, initiated by the US in early 1993, to hold a Leaders' Meeting may be considered as having some political influence on the UR.

APEC's contribution toward strengthening the multilateral trading system is embodied by the 1994 Bogor goals. Mr. Lee reported that the groundwork for these was carried out in the Seattle meeting, 1993, where leaders endorsed the Eminent Persons Group's proposal to make free trade in the Asia-Pacific region one of APEC's goals. He pointed out that the Bogor goals, being beyond the UR schedule, epitomize APEC's "WTO-plus" ambition, and the initiation of the EVSL initiatives, which APEC almost adopted but did not due to insufficient internal support. Mr. Lee said that the EVSL experience exposed the political difficulty of sectoral liberalization, and certain fundamental differences. He also said that APEC lost some of its momentum in effectively contributing to the multilateral trading system, reinforced by the lack of a united front in Seattle. He warned that the 2010 and 2020 deadlines are imminent and some fundamental homework on the Bogor goals remains undone.

Mr. Lee recommended that APEC conduct discussions on the definition of the Bogor goals in the interim, as these were not tackled in 1994, because otherwise there is the risk that members with sufficiently low tariff levels may arbitrarily say that they have already reached the Bogor goals. He said that this discussion on the definition would move between the extremes of "sudden death" and simple reduction of tariffs to an agreeable, mutually agreed-upon level.

APEC must also address the increasing proliferation of regional trading agreements and retrofit RTAs into its overall scheme in view of the APEC core value of open regionalism. In order to use these toward reaching the Bogor goals, APEC must underline the importance of making RTAs consistent with APEC and Article 24 of the GATT.

Mr. Lee suggests taking a look at APEC's accumulated ability to provide trade liberalization and capacity-building initiatives. It has also accumulated considerable know how in facilitating dialogue among a politically and economically diverse group on a broad range of issues. He said this should be cultivated as much as possible toward advancing the liberalization agenda, proposing the assessment of the market strength of the New Zealand/Brunei initiative to strengthen APEC's foundation, and the APEC initiative toward capacity-building of WTO agreements. Finally, he mentioned that APEC's most significant contribution to the multilateral trading system is its role in integrating China into the global trading system, and Korea's eventual participation in APEC activities.

**Mr. Tony Melville** began with a discussion of the history of APEC in conjunction with the multilateral system of the WTO. He said that APEC – comprised of 21 economies, or 2.4 billion people with a combined GDP of US\$17 trillion – has worked in parallel with the WTO since the first APEC Economic Leaders' Meeting (AELM) in 1993, which provided the impetus to bring the Uruguay Round to an early and successful conclusion. In 1996, APEC revitalized the Information Technology Agreement, which phased out tariffs on computers, computer equipment and related goods. In 1999, it made a unified call for the launch of a WTO round in Seattle. Mr. Melville said that APEC is the only forum linking the Americas, North and South East Asia, and Oceania and representing the interests of both its developed and developing members.

He also said that the intellectual "grounding" for APEC was established in 1980 through the Pacific Economic Cooperation Conference (PECC), which allowed the free discussion of issues

without the need to adhere to official economy positions, increasing mutual confidence and underlining the value of closer cooperation. In the late 1980s, economies sought regional agreements as an alternative to the slow multilateral GATT negotiations, which eventually gave rise to the NAFTA and the European Community's progression toward a single market. In 1989, ministers from 12 regional economies set the general principles of APEC, which aims to promote open trade and practical economic cooperation in the Asia Pacific region.

APEC, in its 1994 Bogor Declaration, targeted free and open trade and investments by 2010 (for industrialized economies) and 2020 (for developing economies). Each member then formulated an Individual Action Plan symbolizing its voluntary commitment to the Bogor goals. Through individual efforts in trade and investment liberalization, business facilitation, and economic and technical cooperation, APEC has been an effective partner to the multilateral trading system. It strengthens the multilateral trading system by keeping members focused on domestic liberalization policies, thereby allowing them to liberalize beyond their WTO commitments.

Mr. Melville said that, after helping conclude the Uruguay Round, APEC has assisted members in implementing Results and begun work in new areas, such as standards and conformance. It has also provided capacity building to help members implement their WTO commitments and supported non-members' accession to the WTO.

He then discussed the effects of the WTO Ministerial Conference in Seattle, reporting that Australia was disappointed with the failure to launch a new round, which would have benefited both developed and developing economies. Nevertheless, the commitment to the expedient launch of a new round remains.

Mr. Melville went on to discuss the recent Ministers Responsible for Trade (MRT) Meeting held in Darwin last June. He reported that it gave APEC the opportunity to reaffirm the consensus reached in Auckland and move beyond Seattle by rebuilding the political momentum for a new WTO round.

The meeting tackled the interrelations between the unilateral, subregional and multilateral frameworks for implementing the Bogor goals and called for the early launch of new WTO negotiations. Ministers also agreed on certain "Auckland-plus" elements, calling for preparatory work on industrial tariffs in the WTO, an APEC-wide moratorium on customs duties for electronic transmissions and a strategic capacity-building plan to help developing APEC economies implement their WTO commitments. APEC was commended for its efforts to help implement the Agreement on Trade-Related Aspects of Intellectual Property Rights and endorsed the Joint Statement on the WTO/TRIPS Agreement Implementation.

The meeting also recognized the need to inform the public on the economic and social progress arising from stronger integration into the world economy, and discussed the relationship between subregional trading agreements and WTO and APEC policy frameworks. It welcomed the proposal to study existing subregional trade agreements and bilateral investment treaties, agreeing that these should be consistent with WTO rules and APEC goals.

Mr. Melville said that APEC is challenged to ensure that all members remain firmly committed to implementing economic reforms supporting the Bogor goals, implementation which requires commitment at the highest political levels and domestic support. There is also the need to maintain political momentum for the new WTO round and, at the same time, address public concerns on globalization. APEC must continue to contribute to the multilateral trading system through policy dialogue and economic and technical cooperation, developing its members' capacity to implement trade and investment liberalization.

Mr. Melville concluded by saying that APEC, through its unilateral-regional-multilateral approach to achieving open trade and investment, has turned the Asia-Pacific region into a

dynamic area of rising prosperity and social improvement. The liberalization beyond WTO commitments has resulted in estimated gains of US\$30 billion per year. Finally, Mr. Melville said that there remains great scope for building on APEC's record of achievements, particularly its contribution to the multilateral trading system by drawing together the concerns of developed and developing members.

#### **Open Forum 7:**

**Dr. Federico Macaranas** thanked Mr. Melville for pointing out that APEC has added value, in gains from liberalization worth about US\$30 billion a year, to the multilateral trading system through policy dialogues and economic technical cooperation. He said the presentations have given a total picture of APEC and multi-lateralism and mentioned that, while governments say that APEC fora have helped promote multilateralism, there are nevertheless questions that could be raised to probe deeper into the nature of multilateralism *vis-a-vis* regional trade arrangements. He opened the floor to questions and comments.

**Mr. Jaafar** was asked to identify the two most important objectives for APEC emerging from the summit conference in Brunei. He responded by saying that at present people are preoccupied with: (1) recovery from the financial crisis; and (2) rapid development in information technology. Many have asked about APEC's role in addressing these issues. In this context, he said that the most important APEC objectives would be capacity-building, human resources, education, and training. He mentioned the GAD's addressing of the same issue, with focus on the digital divide, and asked how to put it into operation in the medium-term. Mr. Jaafar said this put the focus on the need for capacity-building to address the challenge of the so-called 'new economy.'

The panel was asked about the link between multilateralism and regionalism in the APEC experience. Clarification was also requested on the impression to outsiders that some of the liberalization undertaken in the APEC, especially in terms of the Early Voluntary Sectoral Liberalization (EVSL) Scheme, focuses on sectors of interest to developed member economies, implying that the only benefits derived by developing economies are in the form of capacity-building rather than market access. He also requested clarification on the EVSL, asking if there was any progress toward sectors of interest to the developing economies.

**Mr. Lee** said that, at present, the EVSL initiative is not very active. Certain elements were transferred to the WTO, but the EVSL process is floundering.

As to whether EVSL addresses sectors advantageous to developed economies, he said such a statement could not be made in a clear way. Mr. Lee reported that, as far as Korea is concerned, EVSL covers well over half its exports, and the economy stands to gain significantly from progress in market access, and the same goes for most of the other economies. However, he also said that the selection of the 15 sectors covered by EVSL was probably not very wise, recommending that it would have been better to limit the number of sectors. Nevertheless, he maintained that it would be difficult to say that benefits are skewed towards developed economies.

**Mr. Jaafar** added that, while liberalization is an important agendum, the EVSL experience has shown that perhaps APEC is not well-suited to address it. He mentioned that the sectoral approach was questioned seriously from the very beginning, and debate probably continues because APEC was meant to initiate and eventually push it to the WTO. On the 15 sectors, Mr. Jaafar said that the 15 sectors were heavily negotiated and the combination was considered to be a balanced reflection of the group's diverse interests. He suggested that APEC restore its focus on the issue of economic and technical cooperation. That would increase the comfort of member economies in the long-run and allow them to move with greater confidence toward liberalization.

**Dr. Macaranas** said that this last session may have addressed the very same issues discussed in the first six. He summarized the panel's accomplishments as presenting such various APEC initiatives as: the drive for multilateralism, expressed through the deadline for liberalization set in Bogor; the push for the early implementation of UR and adoption of the Information Technology Agreement and the policy dialogue on ECOTECH projects to promote multilateralism. The panel were also successful in reflecting on APEC members' seeming lack of a united front in Seattle; posing and answering questions on the fulfillment of the Bogor goals; exploring the contradiction between the proliferation of RTAs and open regionalism; and highlighting the importance of recovery from the financial crisis and recent IT developments as possible issues for consideration at the next summit. In this regard, Dr. Macaranas recommended reflecting on what APEC is really all about in this millennium. He said that it was important to address this issue, as the world is still trying to define the best architecture for governance.

He pointed out that ECOTECH's integral role in APEC today implies the developing member economies' view of APEC: that it primarily serves the interests of its membership. Dr. Macaranas suggested that APEC has a tall agenda for the future, saying that the inclusion by government of the private sector is being watched closely by those who say that APEC is trying to fit itself into the mold of the new millennium.

# ECONOMIC PROSPECTS

Yun Hwan Kim  
Asian Development Bank

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## I. ECONOMIC OUTLOOK FOR 2000 – 2001

### A. Recent Economic Performance

- (1) High growth in the first quarter of 2000 in most Asian Developing Economies:
  - China grew by 8 percent, Hong Kong, China 14 percent, Korea 13 percent, Malaysia 12 percent, Singapore 9 percent, and Chinese Taipei 8 percent
  - major factors are: strong domestic demand (both consumption and investment) and export (electronics and automobiles)
- (2) Indonesia: Ethnic and religious conflicts, and slow financial and corporate restructuring  
Philippines: Mindanao issues
- (3) Japan: In the first quarter of 2000, industrial production increased by 2.8 percent, maintaining the upward trend in output driven by strong exports, recovering consumer spending, and a large increase in housing starts.
- (4) The United States: GDP growth in the first quarter of 2000 was as high as 5 percent due to the strength of consumer demand and fixed investment.

### B. Forecasts for 2000 – 2001

- (1) A strong recovery is envisaged in 2000

#### *Major factors*

- the high growth performance in the first quarter of 2000;
- unlikely to be a hard landing of the US economy, despite the Federal Reserve's recent increases in interest rates and expectations for further increases;
  - GDP growth in 2000: over 4 percent, even close to 5 percent is possible.
- GDP forecasts for Japan have been revised upward, and OECD member countries are expected to perform generally well in 2000 and 2001.
  - Japan: the *Tankan* Survey in the first quarter of 2000 showed an increase in business sentiment for all sizes of business in both manufacturing and non-manufacturing. Consumer confidence is at the highest point since the third quarter of 1996 and consumer spending on some items, including computers and cars, is rising. Exports remain buoyant.



(2) 2001: Slower than 2000

- The US Federal Reserve is likely to raise interest rates in the second half of 2000 and 2001 given (i) the significant inflation in the early months of 2000; (ii) the record high current account deficits in 2000; and (iii) the widely-held view of economic overheating.
  - the impact of higher interest rates on production sectors, housing markets, consumption (durable items), and reversal of the wealth effects that have boosted consumer spending over the past few years.
  - contribute to a slowdown of Asian economies
- Foreseeable increase in oil price
  - International oil stocks are at low levels.
- Lower rate of expansion of consumption and investment in major East Asian economies, such as Korea.

## II. FINANCIAL RESTRUCTURING IN CRISIS ECONOMIES AND PENDING ISSUES

### A. Assessment of the restructuring

*Except for Indonesia, much progress has been achieved (Korea/ Malaysia/ Thailand).*

- Insolvent financial institutions have been restructured through closures, mergers, and recapitalization.
- Corporate governance is being improved: disclosure and transparency, international standards of accounting methods, capital adequacy, and shareholders' rights.
- The strengthened supervisory framework for financial institutions and corporations
  - Contribute to the recent economic recovery and an improvement in international credit ratings.

### B. Pending Issues

- (1) Large non-performing loans (NPLs) held by asset management companies (AMCs)
  - All crisis economies, except for Thailand, are running centralized government-sponsored AMCs and 50 to 70 percent of NPLs have been transferred to AMCs. The issue is how to dispose of those NPLs to reduce fiscal costs. Less than 5 percent of transferred NPLS have been disposed of as of January 2000.
- (2) Strengthening of ongoing reforms
  - Restructuring needs to be strengthened given that (i) signs of reform fatigue are emerging (Indonesia: slowest pace and at an early stage); and (ii) new NPLs are increasing.
  - Much needs to be done to improve corporate governance (internationalization and meeting international standards) in particular.
- (3) Reducing fiscal deficits
  - Fiscal deficits and public debt have significantly increased since 1998 because crisis-hit governments used public funds for financial restructuring and stimulating economic recovery.

**Fiscal Balances before and after the Asian Crisis  
(Percentage of GDP)**

<b>Economy</b>	<b>1996</b>	<b>1997</b>	<b>1998</b>	<b>1999</b>	<b>2000(e)</b>
Indonesia	0.2	0.0	-3.7	-2.3	-5.0
Korea	0.3	-1.5	-4.2	-2.9	-2.8
Malaysia	0.7	2.6	-1.5	-3.8	-2.0
Thailand	2.4	-0.9	-3.4	-3.0	-3.0

*Note: (e) = estimated figure*

**III. MID-TERM POLICY AGENDA – BEYOND RECOVERY**

**A. Financial stability and diversification**

1. Financial sector stability should be ensured through (i) a successful undertaking of the financial restructuring in the crisis-hit economies; (ii) improved credit risk management; and (iii) a significant increase in operational efficiency.
2. Financing options of the Asian industrial sector need to be diversified from the bank-centered method.

*Particular attention should be paid to capital markets, especially bond markets which have long been neglected. (“Spare tires” termed by Mr. Greenspan)*

**B. Developing the ‘Information Economy’**

1. An information age has been emerging while the industrial stage seems to be being phased out. Knowledge is the key to development.
  - services play a more significant role;
  - the role of information becomes increasingly important;
  - high-speed production, trading and distribution; and
  - economic and political border is virtually meaningless.
2. The economy/company with information advantages produces at a lower cost, enjoying competitive advantages.
3. The gap between the advanced economies and those lagging behind in terms of knowledge may increase progressively.
4. The new economy involves both constructive results and disruptive outcomes so an economy needs to carefully prepare to cope with the adverse impacts (e.g., temporary unemployment, new business culture and old generations, and new social systems)

**C. Globalization**

1. The new information economy accelerates the interdependence between economies, requiring an economy to be integrated into the global economy.
2. Globalization involves the opening-up of finance, trade, industry, and services. Any careless response to this agenda may bring tremendous adversities to the economy (e.g., the Asian crisis).

**D. Poverty reduction**

1. Many Asian members of APEC have a large number of poor households (China, Indonesia, the Philippines, Thailand, Viet Nam). The Asian crisis has aggravated the poverty in Asia.

2. Poverty leads to a reduced opportunity for education and worsened health conditions. This prevents the poor from participating in the socio-economic development process, causes lower economic productivity, and may even perpetuate poverty as well as prevent equitable development.
3. An economic spur as well as socio-economic policies targeted at the poor are essential to eliminate the poverty in Asia.

# JAPANESE ECONOMY IN RECOVERY: ITS ASSESSMENT AND PROSPECTS<sup>1</sup>

Jun Saito  
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*The recession in Japan that started in March 1997 proved to be a painful process for the economy. Out of seven quarters between 1997 Q2 to 1998 Q4, six quarters recorded negative growth. As a result, economic activity contracted for two consecutive years in Fiscal year (FY)1997 and FY1998. During the period, unemployment soared to a record high, and consumer prices fell for the first time since the introduction of the current index in 1971. It was feared that the economy was about to go into a 'deflationary spiral'.<sup>2</sup>*

*The long awaited recovery seems to be on its way, however. Economic indicators have been showing improvement since early 1999. It is now hoped that the recovery will lead to a firm self-sustaining growth, with private demand as the main driving force. This paper aims to assess the current recovery and discuss its prospects. It will also analyze the implication of the Japanese recovery for the developments in and the relationship with other Asian economies.*

## I. ASSESSMENT OF THE CURRENT RECOVERY

### 1. Aspects of the Recovery

Recovery of the Japanese economy can be confirmed by the recent developments in many of the main economic indicators. Almost all relate to the improvement in the corporate sector.

*Industrial production* started to pick up in 1999 (Fig.1). Production declined in 1997 and remained stagnant in 1998 due to the pressures from the high level of inventories. Adjustment in inventories seems to have been completed in the first half of 1999, and this paved a way for a gradual recovery in shipment that fed into a pick up in production. *Corporate profits* have also been improving since early 1999 (Fig.2). Current profits had fallen in 1998, more or less in all sizes of firms and in all industries. Improvement in profits owed much to the reduction in variable costs, but in the case of manufacturing sector, the cut in labor costs also made a significant contribution.

*Medium-term economic growth* expected by firms has risen during the course of 1999 (Fig.3). The trend of diminishing expectations has been reversed in 2000: The expected average growth rate for the coming three fiscal years rose to 1.3 percent from 0.8 percent in the previous year. *Business investment* also recovered in late 1999 (Fig.4). Improvement in cash flows and better prospects for growth in demand has prompted firms to resume investment. The recovery is led by the non-manufacturing sector, mainly the service and trade industries. In the manufacturing sector, investment increased in the electric machinery industry.

As the recovery in these indicators became increasingly apparent, the Diffusion Index of Business Condition (DI) also started to indicate that the economy might have entered a recovery phase. It

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<sup>1</sup> This paper is prepared for the 2000 APEC Economic Outlook Symposium held in 24-25 July 2000, in Manila, Philippines. The views expressed are the author's and do not necessarily reflect those of the Economic Planning Agency.

<sup>2</sup> A vicious circle where decline in aggregate demand and fall in prices reinforce each other.

was officially announced, in June 2000, that the trough of the last recession took place in April 1999.

In terms of *real GDP*, recovery has been witnessed since 1999 Q1, though fluctuation was inevitable. Real growth in FY1999 turned out to be 0.5 percent, the first positive growth in three years. The forecast for growth in FY2000 is for a somewhat stronger growth. The expected growth rate has gradually been revised upward by private forecasters to an average of 1.7 percent (Fig. 6). The government forecast of around 1.0 percent is now almost at the lower end of the forecasts<sup>3</sup>.

## 2. Driving Forces behind the Cyclical Recovery

The driving forces behind the recovery were to a large extent exogenous factors. *Fiscal policy*, which had been the favorite instrument for stimulating the economy in the previous recession (between 1991 Q1 and 1993 Q4), had once again been called into action. After suspending the Fiscal Reconstruction Law, on which the conservative FY1997 budget was based, an increase in public works as well as tax cuts were introduced in a series of economic policy packages and budgets. As a result, public investment, which fell considerably in FY1997, remained almost flat in FY1998 and FY1999.

*Monetary policy* was also at the forefront in the effort to support the economy. Monetary conditions had already been relaxed to a great extent in September 1995 when the official discount rate had been lowered to a then-unprecedented 0.5 percent. Further easing took place, however, in February 1999 when a ‘zero interest rate policy<sup>4</sup>’ was announced by the Bank of Japan. It was intended to be an emergency measure designed to prevent the economy from falling into a deflationary spiral.

In addition to the positive stimulus from these policy initiatives, improved confidence in *financial stability* also made an important contribution. The financial system became significantly fragile in 1997 when a few financial institutions failed. Confidence in the financial system was disturbed and increased uncertainty led to cautious behavior by households and firms; increasing precautionary savings and postponing investment. In response to the situation, a new arrangement was introduced in 1998 that allowed an injection of public funds into the system to take place in March 1999. These efforts helped in restoring the stability of the system and alleviating its negative influence on the economy.

## 3. Pace of Recovery

While the recovery is underway, the pace of it remains modest. The main reason for the modest recovery is in the sluggishness of private consumption (Fig.7). After a decline in FY1997, private consumption grew only nominally in the following two fiscal years. It is even more sluggish than in the previous recession in 1991–1993.

One of the main reasons for the sluggishness was the loss of consumer confidence that led to a fall in the propensity to consume. It owed much to the increase in uncertainty that was triggered by the financial instability and the subsequent loss of confidence in the economy. The growing

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<sup>3</sup> The forecasts by international organizations are also for a stronger growth: Forecast by the International Monetary Fund (2000) is 0.9 percent for calendar year (CY)2000 and 1.8 percent for CY2001. The forecast by the Organization for Economic Cooperation and Development (2000) is 1.7 percent in CY2000 and 2.2 percent for CY2001. Note that the forecast by OECD that was published later than the IMF one was able to incorporate recent data that turned out to be more favorable.

<sup>4</sup> A commitment to provide enough liquidity so that the inter-bank overnight call rate would be lowered to effectively zero.

concern over the future of the social security system is also considered to have had a considerable influence.

However, the fall in propensity to consume ceased in FY1999. To explain the sluggishness of private consumption, the decline in labor income became increasingly important. For instance, compensation of employees in nominal terms has been falling for eight consecutive quarters since 1998 Q2. The increase in labor income can be explained by the increases in employment and wages.

Employment has been contracting since 1998. It has been so even at a time when overtime working hours have started to increase, a circumstance that had historically led to an increase in employment. The contraction of employment is mainly taking place in manufacturing and construction sectors; smaller firms are also shedding more employment than their larger counterparts. In contrast to full-time workers, however, part-time workers are facing favorable employment opportunities. While downsizing of the work force is taking place, a shift from full-time to part-timers seems to be on the way (Fig.8). Partly as a result of the fall in labor demand, and partly because of a mismatch between labor demand and supply in terms of qualification and other conditions, the unemployment rate has risen to an unprecedented level (4.9 percent in March 2000).

Wages have also fallen since 1998 (Fig. 9). Overtime payments had declined in FY1998 as industrial production fell, but recovered in FY1999. Bonus payments, on the other hand, are falling significantly, and are doing so even at a time when profits are recovering. Scheduled payments have also shown almost no growth; this is due partly to the larger proportion of cheaper part-time workers.

These developments in employment and wages at a time of recovery reflect the ongoing restructuring in the corporate sector. One of the important elements of the restructuring process has been reduction of labor costs. Firms have sought a way to ease the burden of high labor costs. The improvement in indicators related to the corporate sector shows that restructuring is gradually bearing fruit. The progress of restructuring, however, is exerting a negative influence on the household sector<sup>5</sup>. It is, therefore, also responsible for making the recovery process a slow one. The contrast in corporate and household sectors is one of the distinctive features of the current recovery.

## II. PROSPECTS FOR THE RECOVERY

### 1. Impact of the “Three Excesses”

The pace of recovery in the future depends on the magnitude of the negative impact of the heavy burden that has been inherited from the ‘bubble’ period of the 1980s. The burden is often termed the ‘three excesses;’ excesses in debt, capacity, and employment (Fig. 10). All three excesses have, in FY1999, either exceeded or almost exceeded the previous peak reached in the recession of 1991-1993. There has since been some improvement, but the levels are still significantly high.

*Excess debt* rose in FY1998, and remained almost flat in FY1999<sup>6</sup>. The situation is most serious in the non-manufacturing sector, and particularly in small and medium-sized firms. In terms of long-term debt to cash-flow ratio, their level is around 10 percent and 20, respectively, compared

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<sup>5</sup> If the stock market is forward-looking, and incorporates the improvement in future profitability that should follow a successful restructuring, subsequent rise in stock prices can provide a wealth effect to the household sector. While such a mechanism seemed to have worked in the US at a time of the ‘Jobless Recovery’ in the early 1990s, it has not yet been observed in Japan.

<sup>6</sup> Based on estimates focusing on the divergence of long-term debt to cash-flow ratio from its long-run average.

to the overall average of around 8. Unless debts are reduced to more appropriate levels, firms would have to surrender much of their profits to service them and would not be in a position to make forward-looking investments. Also, it would mean a risk for financial institutions, which may face an increase in non-performing loans in the future.

*Excess capacity* has been reduced somewhat during the course of 1999, but is still high at around 52 trillion yen in 1999 Q4, roughly three-fourths of the annual business investment<sup>7</sup>. It is high in manufacturing, especially in basic material industries such as steel. In the processing industries, transportation machinery such as automobiles is notable. A considerable number of firms expect that more than two years may be required to bring excess capacity down to an appropriate level. This burden should prevent firms from undertaking investments to enhance capacity<sup>8</sup>.

*Excess employment* has also shown some improvement, falling to 1.4 million in March 2000 from 2.4 million in June 1999<sup>9</sup>. It is still high, however, in the non-manufacturing sector, and in small and medium-sized firms. Clerks and unskilled workers, and workers in their 50s are being made redundant. Reductions in the work force and adjustments in its composition should keep labor market loose for some time.

Unless these excesses are reduced significantly, it will be difficult for the pace of recovery to pick up. The economy may require some time before achieving a firm self-sustaining growth<sup>10</sup>.

## **2. Macroeconomic Policy Stance**

Since the economy is in a recovery process, the need for expansionary macroeconomic policies is less than before. In fact, significant deterioration of the fiscal position and extremely easy monetary conditions suggest that it might be more difficult to use fiscal and monetary policies more actively.

In particular, active use of fiscal policy as a stimulus measure has widened the budget deficit significantly since the beginning of the 1990s<sup>11</sup> (Fig.11). The budget deficit has reached 38.4 percent of total expenditure in the FY2000 budget. The outstanding stock of government bonds as a ratio to GDP now stands at more than 70 percent. At the local government level the situation has equally deteriorated, since local authorities have also been asked to take a similar expansionary stance. The total outstanding stock of central and local government debt is expected to reach 645 trillion yen, or 129.3 percent of nominal GDP in FY2000. Growing concern over the means to rectify the fiscal situation is another factor that may put a brake on the strong recovery of expenditures in the medium-term<sup>12</sup>.

A zero interest rate policy has brought down the long-term interest rate as well as the short-term rate. The response of real sector has been disappointing; Marshallian  $k$  (ratio of  $M2+CD$  to nominal GDP) has risen to an unprecedented level and the money multiplier (ratio of  $M2+CD$  to

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<sup>7</sup> Based on estimates making use of 'excess capacity D.I. direct investment' in the Bank of Japan's *Tankan* Survey. See EPA (2000b).

<sup>8</sup> Recent recovery in business investment owes much to investments for new products and R&D. Less emphasis is given to capacity enhancement.

<sup>9</sup> Based on estimates making use of 'excess employment D.I.' in the Bank of Japan's *Tankan* Survey. See EPA (2000b).

<sup>10</sup> The economic growth in the medium-term, which is expected by the government to take place once the recovery phase is over, is around 2 percent. See Economic Council (1999).

<sup>11</sup> Estimates of 'structural deficit' confirm that such deficit explains much of the actual deficit. See IMF(2000), OECD(2000), and EPA(2000).

<sup>12</sup> The IMF's estimate of the ratio of general government deficit to GDP is 8.4 percent in CY2000 (9.6 percent if social security fund is excluded). The estimate of the ratio of gross debt of general government to GDP is 136.1 percent in CY2000 (46.1 percent in net terms).

monetary base) has declined significantly. Meanwhile, excess liquidity has shown up as voluntary reserves in the system.

The recovery process is not yet firmly-based, and is still highly susceptible to exogenous shocks. In this sense, any reversal of the use of macroeconomic policies in a drastic and hasty manner involves great risk. Macroeconomic policies should at least avoid exerting a negative impact on the economy<sup>13</sup>. Meanwhile, more emphasis should be given to structural policies<sup>14</sup>.

### III. IMPLICATIONS FOR THE REGIONAL ECONOMY

#### 1. Trade

The increase in Japanese exports resumed in 1999 (Fig. 12). It owed much to the strong growth of exports to other Asian economies, which had dropped significantly in the aftermath of the Asian crisis. The main exports are VTR, semi-conductors and other electrical machinery and electronic devices. Needless to say, it reflects the rapid recovery of the Asian economies from the crisis. As a result, the share of exports to Asian economies in total Japanese exports has risen to 37.2 percent in 1999.

Imports to Japan have also increased since late 1998, hand-in-hand with the recovery of the Japanese economy. Here too, the increase in imports from Asia was noteworthy. The main imports are computers, semi-conductors and other information-related items. Of the total imports from Asia, around 30 percent are imports from Japanese subsidiaries exporting their products back to Japan. The Asian share of imports reached 39.6 percent in 1999. Taking exports and imports together, the recoveries in the Japanese and Asian economies seemed to have reinforced each other through trade.

Deeper interdependence between Japan and Asia can be verified by comparing the income elasticities of exports and imports<sup>15</sup>. The comparison shows that the income elasticity of exports to Asian economies is higher than that of exports to the world as a whole. Similarly, the income elasticity of imports from Asia is higher than that of imports from the world as a whole. Taking into account the fact that main commodities of both exports and imports are capital and intermediate goods, it is suggested that the Japanese and Asian economies have created a close interdependence between each other based on a horizontal division of labor in the manufacturing sector.

A comparison of price elasticities, on the other hand, show that the elasticity of exports to Asia is lower than that of imports from Asia. It implies that the effect of exchange rate fluctuation on trade with Asia would be felt mainly on the import side.

<sup>13</sup> The Bank of Japan has postponed the withdrawal of the zero interest policy in view of the nervousness of the financial system following the failure of a major department store. The government, on the other hand, has emphasized that fiscal consolidation should yield priority to efforts to strengthen economic recovery.

<sup>14</sup> Included in the long list of structural policies are (a) measures to promote small and medium-sized firms and starting-up of businesses, (b) measures to promote information technologies, and (c) measures to promote technology development projects.

<sup>15</sup> Based on estimates in EPA (2000b).

	Export Elasticity		Import Elasticity	
	Income	Price	Income	Price
World	0.821	-0.506	2.819	-0.314
Asia	0.991	-0.197	3.28	-0.427

Note: Estimation period (92Q1-99Q2)



## 2. Capital Flows

Capital inflow to Asian economies, which had contracted in the aftermath of the Asian crisis, has gradually recovered<sup>16</sup>. Foreign direct investment and bank loans, in particular, have both shown recovery in the recent periods.

From the side of Japan, however, capital flows to Asia haven't quite recovered the level recorded in the pre-crisis period: Foreign direct investment (FDI) to Asia hasn't recovered as much as it has to the rest of the world. Total FDI from Japan to the World increased by 42.6 percent in FY1999, while FDI to Asia declined by 6.8 percent<sup>17</sup>. Bank loans to Asia have remained low despite an increase in trade flows to Asia from other economies<sup>18</sup>.

The reasons Japan lags behind others in investing to Asia may partly reflect the cautious attitude of the investors in making a commitment to economies where major reforms are taking place. The main reasons, however, seem to lie on the investors' side: (a) a cheaper yen made overseas operations less attractive: (b) the capacity to invest abroad fell because of a decline in profits and difficulty in raising funds: (c) the overseas operation strategy was reviewed in favor of more focused-approach.

The deepening of interdependence between Japan and Asia may have slowed down in the area of capital flows.

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<sup>16</sup> See EPA (2000a). It should be noted that the current account balances of the Asian economies have improved considerably. There is, therefore, less need to reach out for foreign funds.

<sup>17</sup> Japanese Ministry of Finance, "Statistics on Foreign Direct Investment."

<sup>18</sup> Bank of International Settlements, "Consolidated International Banking Statistics."

# EAST ASIAN ECONOMIC RECOVERY AND STRUCTURAL REFORM

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## I. INTRODUCTION

After three decades of remarkable economic growth and poverty reduction, five economies in East Asia, namely, Indonesia, Korea, Malaysia, the Philippines, and Thailand fell into a severe recession in 1998. The economic crisis in these affected economies has caused a serious setback in development performance, but at the same time has provided a window of opportunity to strengthen domestic economic institutions and policy frameworks through wide-ranging structural reforms. The transition economies of China and Viet Nam, which were less affected by the regional crisis, maintain their momentum of economic reform for further marketization. The trade-driven, smaller, and poorer economies of the Pacific, Indochina, and Mongolia also continue their efforts to reduce poverty and to build institutions and capacity.

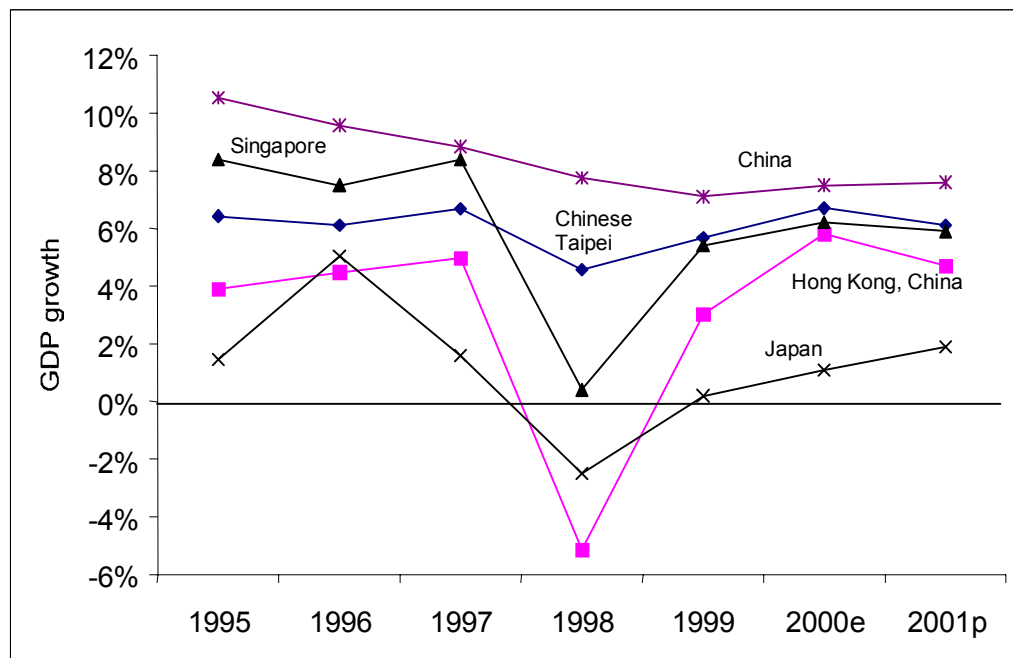
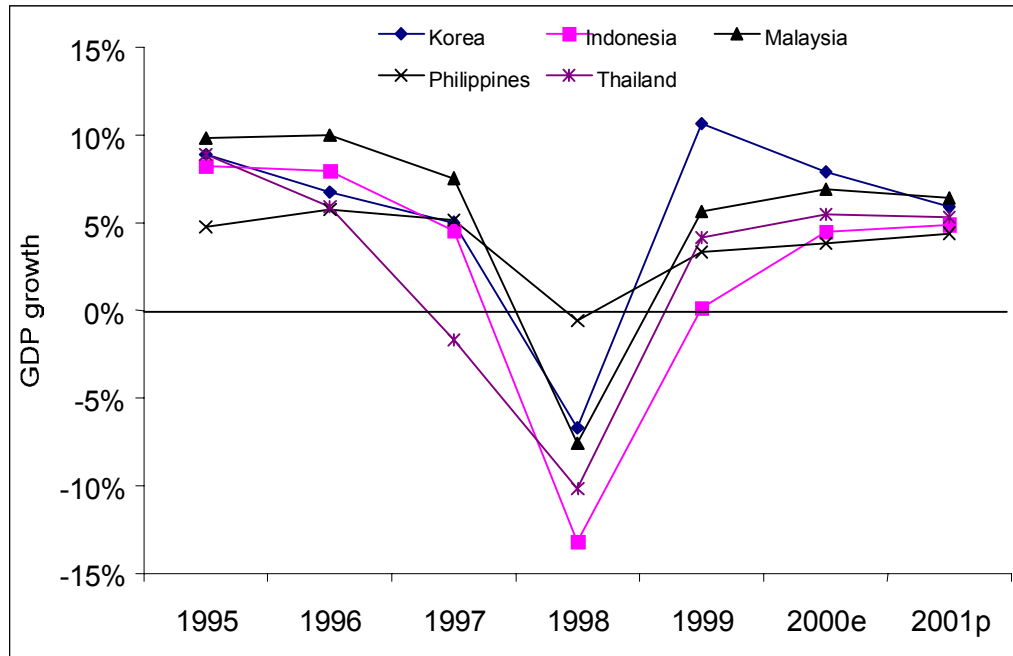
The affected East Asian economies have clearly emerged out of the worst of the crisis and recovered strongly in 1999 (Figure 1). Korea, Malaysia, and Thailand registered growth rates of 4-10 percent in 1999 and continue to recover strongly. The only exception is Indonesia, but even its economy is rebounding at a projected 4–5 percent growth rate in 2000.

Beyond the current recovery process, post-crisis East Asia faces two broad challenges. The first is how to cope with the forces of globalization. Facing global competition, governments throughout East Asia must ensure that public policies that regulate key economic activities—such as in the financial sector, corporate governance, infrastructure, or environmental protection—are effective at creating world-class frameworks. At the same time the government must manage the impact of globalization on the domestic economy. The second is how to respond to socio-economic changes, including demographic shifts, urbanization, and higher levels of education and income, and how to embrace political and societal transformation. Older, more urban, more educated, middle class populations have voiced louder demands for greater transparency and accountability of the government and for a range of public services, such as new forms of social safety net. The trend toward political and social pluralism, set in motion well before the recent economic crisis, has been reinforced by global connections—enhanced information access and increased demand for diverse lifestyles and values.

This paper addresses the questions: Is the current economic recovery process sustainable or is this just a temporary, cyclical rebound? What are the domestic and external risks to sustained

recovery, and how can the affected economies minimize such risks? Have policies addressing the East Asian financial crisis produced lasting reforms that can lead to sustained, long-term economic growth? What are the medium-term policy challenges the East Asian economies face?

Figure 1. GDP Growth Rates of the East Asian Economies



Note: e = estimate; p = projected

Source: International Monetary Fund; Consensus Forecast, June 2000.

## II. EAST ASIAN ECONOMIC RECOVERY

### 1. Sharp Economic Recovery

The worst period of output contraction ended during the first or second quarter of 1999 among the economies hit by the crisis. Economic recovery is strong and its pace is faster than expected. After a sharp recession, with growth down 7.8 percent in 1998, growth in the five affected economies surpassed 5 percent in 1999. The pace of recovery, however, is uneven. The economic consolidation and recovery phase has firmly begun in Korea, showing the most dramatic improvements in levels of output, exports and employment and recording growth of close to 11 percent in 1999 and a projected 8 percent in 2000. Even Indonesia, despite its political turmoil in the last two years, is showing signs of an incipient economic rebound. As a result of recovery, real GDP has exceeded the pre-crisis levels in Korea, Malaysia, and Thailand, while it may take a few years for Indonesia to attain its pre-crisis level.<sup>1</sup> China and Viet Nam continue to perform well, and the smaller economies also fared better in 1999 (see Appendix Table).

Foreign capital in the form of direct investments and portfolio equity investments has picked up (Table 1). After recording a net inflow of US\$70 billion in 1996, the private capital account of the East Asia-5 registered a net outflow of US\$60 billion in 1998, causing a capital flow reversal of US\$130 billion over the course of two years. With economic recovery, however, net private outflows of East Asia declined to US\$23 billion in 1999. Though East Asia is expected to continue to experience net outflows of private capital due to large net outflows of bank loans, net inflows of foreign direct investments and portfolio equity investments have expanded in 1999 and are expected to continue to expand in 2000.<sup>2</sup>

**Table 1. Capital Accounts in the Five Crisis-affected Economies  
1996–2000**

*(Billions of US dollars)*

<i>Crisis-affected Economies<sup>(a)</sup></i>	<i>1996</i>	<i>1997</i>	<i>1998</i>	<i>1999(e)</i>	<i>2000(p)</i>
Current account balance	-53.9	-25.2	69.6	60.5	47.7
Capital account	68.8	-31.1	-50.1	-15.0	-21.5
Private	70.2	-42.7	-60.0	-22.6	-27.8
Net direct investment	11.1	12.4	13.6	15.4	17.8
Gross portfolio investment	28.8	16.4	-4.1	8.5	15.6
Net long-term debt	36.0	27.7	-3.9	-5.5	4.3
Other <sup>(b)</sup>	-5.7	-99.2	-65.6	-41.0	-65.5
Official	-1.3	11.6	9.9	7.6	6.3
Multilateral (net)	-1.5	5.5	7.1	5.0	--
Bilateral	0.2	6.1	2.7	2.1	--
Overall	14.9	-56.3	19.5	45.5	26.2
Reserves <sup>(c)</sup>	-14.9	56.3	-19.5	-45.5	-26.2
IMF credit	-0.3	17.1	12.2	-11.2	--

*Notes:*

(a) Data is for Indonesia, Korea, Malaysia, the Philippines, and Thailand. Data for 1999 and 2000 is estimated and projected, respectively.

(b) Residual, including short-term private debt outflows.

(c) A negative number indicates increase.

*Source:* World Bank, *Recovery and Beyond*, 2000, p. 35.

<sup>1</sup> Due to real exchange rate depreciation, however, per capita GDP measured in US dollars is still lower than the pre-crisis levels in the affected economies. Full recovery in East Asia will mean that per capita GDP measured in US dollars (adjusted for US inflation rates) must recover to the pre-crisis level.

<sup>2</sup> Though brighter, most of these private flows have concentrated on one or two economies (Korea and China), leaving the rest of East Asia behind.

The five affected economies began to turn around essentially for three reasons. Financial stabilization (in the foreign exchange and financial markets) and counter-cyclical macroeconomic policy allowed domestic aggregate demand, and eventually personal consumption in particular, to recover. Assertive structural adjustment efforts helped boost consumer and investor confidence. Strong growth in the United States and Europe bolstered external demand in the East Asian economies, thus supporting a mutually reinforcing recovery process in the region.

These factors led to buoyant exports, fiscal stimulus, rising personal consumption, and inventory re-stocking. However, fixed investment has not recovered fully, except in Korea, due to the continued presence of excess capacity in the manufacturing sectors. Falling interest rates, the easing credit conditions and the restoration of export finance facilities should help the utilization of the prevailing capacity for domestic consumption and export production. As excess capacity is reduced, fixed investment in new equipment is expected to rise, thus making the current recovery process more solid and firm.

## 2. Progress on Financial and Corporate Sector Restructuring

There is no question that the current recovery process has been supported by progress achieved in the areas of financial and corporate restructuring. Governments indeed have created frameworks to resolve systemic crisis in financial and corporate sectors (Table 2) and have generally achieved progress, albeit at a substantial fiscal cost, in initiating and sustaining the process of financial and corporate sector restructuring.

**Table 2. Institutional Arrangements for Corporate and Financial Restructuring**

	<b>Agency for Voluntary Corporate Workout</b>	<b>Asset Management/Resolution Company</b>	<b>Agency for Bank Recapitalization</b>
<b>INDONESIA</b>	Jakarta Initiative Task Force (JITF)	Indonesian Bank Restructuring Authority (IBRA)	Indonesian Bank Restructuring Authority (IBRA)
<b>KOREA</b>	Corporate Restructuring Coordination Committee (CRCC)	Korea Asset Management Corporation (KAMCO)	Korea Deposit Insurance Corporation (KDIC)
<b>MALAYSIA</b>	Corporate Debt Restructuring Committee (CDRC)	Danaharta	Danamodal
<b>THAILAND</b>	Corporate Debt Restructuring Advisory Committee (CDRAC)	Financial Sector Restructuring Authority (FRA) and Asset Management Corporation (AMC) for non-bank finance companies	Financial Restructuring Advisory Committee (funded by the Financial Institutions Development Fund)

*Source:* World Bank, *Global Economic Prospects and the Developing Countries*, 2000, p. 85.

Significant progress has been made in establishing frameworks to address systemic crisis in the financial sector. These include frameworks to resolve insolvent financial institutions (closure, merger, and temporary nationalization), to carve out NPLs from financial institutions to asset management corporations, and to recapitalize weak, but viable financial institutions.

Many non-viable and insolvent financial institutions have indeed been closed or temporarily nationalized, bad loans of closed or weak (but viable) financial institutions have been transferred

to official (and, more recently, private) asset management corporations (AMCs), the capital bases of several weak (but viable) institutions have been strengthened by public resources, and the process of rehabilitating weak institutions is now underway (Table 3). In Korea and Thailand, temporarily nationalized banks began to be re-privatized. In addition, the banking sectors in these economies have been opened to foreigners to attract foreign strategic investors and technical expertise and to promote competition in domestic banking businesses.

Another round of financial sector restructuring and consolidation is expected. In Korea, the government has announced that additional resources (an estimated won 30 trillion) would be needed to complete the second round of financial sector restructuring. Further consolidation of financial institutions, including merger of nationalized banks, is expected. In Malaysia, 58 financial institutions are expected to be merged into 10 groups by end-2000. In Indonesia, where the banking system is still non-functioning, continued restructuring and consolidation of commercial banks is needed.

Corporate sector restructuring has been the other side of the process of financial sector resolution. The substantial overhang of bank non-performing loans (NPLs) was largely a consequence of the weak performance of corporations. Several frameworks have been introduced to resolve corporate debt overhang. First, court-based insolvency procedures have been strengthened, including the bankruptcy, reorganization and foreclosure laws and functioning judiciary systems have been established. This has particularly been the case in Indonesia and Thailand that previously lacked effective legislative procedures. Second, formal frameworks for voluntary, out-of-court debt negotiations have been developed under the “London Approach” arrangement.<sup>3</sup> Once financial obligations and property rights have been clarified and agreed upon by both creditors and debtors, market-driven mechanisms should facilitate the required debt restructuring and reallocation of productive assets.<sup>4</sup> Third, enabling environments to facilitate corporate sector restructuring have been created through tax and regulatory changes. These include favorable tax treatments to induce corporate restructuring, elimination of constraints to debt-to-equity swaps and mergers and acquisitions, and opening various sectors to foreign investors. Finally, official asset management companies have been empowered to restructure distressed debts and corporations, in addition to disposing of acquired assets

Some progress has been made in corporate debt and operational restructuring through various channels, i.e., court-based bankruptcy/reorganization procedures, voluntary negotiations of corporate restructuring between debtors and creditors, and AMC-led restructuring (Table 4). The number of court-based bankruptcy/reorganization cases is still limited, but the decision of sending TPI to a bankruptcy procedure in Thailand is an important positive step forward. Market driven restructuring of Daewoo in Korea is another example, putting further pressure on Hyundai and many other *chaebol* corporations to restructure. The replacement of PT ASTRA management by IBRA also signifies the importance of AMC-led restructuring. However, the overall pace of corporate restructuring is still slow. Given the prevalence of strategic defaulters in Thailand and Indonesia, creation of an effective legal enforcement mechanism is essential to induce non-cooperative debtors to come to the negotiation table with their creditors.

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<sup>3</sup> This includes the Corporate Debt Restructuring Committee in Malaysia, the Corporate Debt Restructuring Advisory Committee in Thailand, and the Jakarta Initiative Task Force in Indonesia.

<sup>4</sup> Governments have also changed regulatory and tax incentives in promoting greater asset mobility, especially by encouraging corporate mergers and acquisitions, FDI, and debt-equity conversions and swaps.

**Table 3. Financial Restructuring in East Asia**

<i>Action</i>	<i>Indonesia</i>	<i>Korea</i>	<i>Malaysia</i>	<i>Thailand</i>	<i>China</i>
<b>Initial Government Response</b>					
Liquidity support	\$21.7 billion (18 percent of GDP)	\$23.3 billion (5 percent of GDP)	\$9.2 billion (13 percent of GDP)	\$24.1 billion (20 percent of GDP)	None; banks liquid
<b>Non-performing Loans (NPLs)</b>					
NPL/total loans <sup>(a)</sup> (percent)	32.9 (12/99)	17.9 (9/99)	23.9 (12/99)	41.1 (12/99)	25.0 <sup>(b)</sup>
NPL/total loans after transfers to AMCs (%)	12.4	10.1	17.5	38.5	12.9 <sup>(b)</sup>
<b>Financial Distress Resolutions</b>					
Bank closures	66 of 237	None	None	1 of 15	1
Closures of other financial institutions	None	More than 200	None	57 of 91	40 urban credit cooperatives and 5 trust and investment companies
Mergers	9 nationalized or state banks are being merged	8 of 26 absorbed by other banks	58 to be merged into 10 groups by December 2000	3 banks and 12 finance companies	Multiple urban credit cooperatives and 2 banks
Banks temporarily nationalized	12	4	1	4	--
<b>Bank Recapitalization Strategies</b>					
Public funds for recapitalization	Bonds equivalent to \$40 billion issued in 1999; \$20 billion to be issued in 2000	Government injected \$50 billion into 9 commercial banks; 5 out of 6 major banks now 90 percent controlled by state	Danamodal injected \$1.7 billion into 10 institutions	Government injected about \$9 billion into private banks and about \$11 billion into public banks	Government injected 270 billion yuan (\$32.6 billion) in mid-1998) into the 4 state banks. Banks now being recap. as loans transferred to AMCs
Majority foreign ownership of banks	1 pending	1 announced, 1 pending	Not allowed. But foreign bank share is significant	4 completed, 2 pending	Allowed, but not for domestic currency operations
Weak financial institutions still in system	Many weak commercial banks	Many weak non-bank financial institutions	Difficult to assess	Some weak public and private commercial banks	Many weak banks and non- bank financial institutions

Notes: (a) Includes non-banks and loans transferred to asset management corporations.

(b) People's Bank of China estimate as of mid-1999; private estimates range higher.

Source: World Bank, *East Asia Recovery and Beyond*, 2000, p. 72.

**Table 4. Asset Resolution Strategies in East Asia**

<i>Strategy</i>	<i>Indonesia</i>	<i>Korea</i>	<i>Malaysia</i>	<i>Thailand</i>	<i>China</i>
<b>Establishment of Centralized Asset Management Corporation</b>					
Set up centralized asset management corporation to which the banking system's non-performing loans are transferred.	Yes. IBRA has accumulated over \$60 billion in assets (NPLs, investment in recapitalized banks, pledged assets from shareholder settlements)	Yes. KAMCO has accumulated assets: \$49 billion (face value); \$20 billion (purchase price)	Yes. Danaharta has accumulated \$10.3 billion in assets	No. NPL workout is decentralized. Three banks have established private AMC's and more are being considered. Hybrid approach to re-privatization of intervened banks is emerging	Set up four AMC's, one for each large state bank
<b>Nature of Asset Management Corporation</b>					
Purchase of assets at subsidized prices	Yes	Assets were initially purchased above market-clearing prices with recourse. Since February 1998 purchases have been attempted at market prices	Purchased assets are valued by independent outside auditors	Not applicable	Yes. Loans were transferred at book value.
Restructuring or disposition	IBRA created to resolve problem banks, manage and dispose of frozen bank assets	Not clearly defined. Mostly engaged in disposing of assets.	Restructuring	Not applicable	Too early to tell, but the agencies are planning for broad powers from asset disposal to debt equity swaps.
<b>Asset Transfer and Disposal</b>					
Type of assets transferred	Assets of frozen banks and worst assets	No particular strategy	Loans larger than RM 5 million and mostly loans secured by property or shares	Not applicable	Loans granted before end-1995, now rated doubtful or loss but not subject to write-off within the quotas allocated to each of the four banks.
Assets transferred	IBRA's total assets amount to 44 percent of GDP; transferred NPLs amount to 23 percent of GDP	49 percent of NPLs, equal to 11 percent of GDP	50 percent of NPLs, equal to 14 percent of GDP	Only assets from failed finance companies sold by the FRA (Bhat685billion of core assets; 15 percent of GDP)	It appears that the AMC's will take about 20 percent of total loans from the four state banks, (15 percent of end 1998 GDP, 12 percent of the total loans in the system).
Assets disposed of as a share of total assets transferred	0.1 percent	4.7 percent	0.1 percent	83 percent of closed finance company assets	Too early

Source: World Bank, *East Asia: Recovery and Beyond*, 2000, p. 79.



One of the consequences of financial sector restructuring is that governments have acquired not only banks but also, through asset management companies, the assets of failed institutions and the bad assets of weak but viable institutions. The state has thus become an important holder of corporate assets. In Indonesia, the government is the biggest holder of bank assets, acquiring 78 percent of banking assets, while the governments of Korea, Thailand, and Malaysia respectively own 58 percent, 32 percent, and 18 percent of respective banking assets (Table 5). The processes of disposing of the acquired assets or of restructuring the debts and debtor corporations have yet to take place on a large scale.

**Table 5. Government Ownership of Financial System Assets in East Asia, mid-1999  
(Percent)**

<i>Indicator</i>	<i>Indonesia</i>	<i>Korea</i>	<i>Malaysia</i>	<i>Thailand</i>
Share of assets carved out	23	3	4	10 <sup>(a)</sup>
Share of assets held by state-owned and nationalized financial institutions	55	55	14	22
Total share of banking assets held by state	78	58	18	32
Assets held by the state as a share of GDP	79	124	62	48
Share of assets held by foreign banks	17 <sup>(b)</sup>	8	23	13

Notes:

(a) Finance companies' assets transferred to the Financial Sector Restructuring Agency.

(b) Includes Joint Banks.

Source: World Bank: *East Asia Recovery and Beyond*, 2000, p. 86.

Another consequence is that the crisis has left heavy public debt with the government. Government debt has already risen to 30-50 percent of GDP in Korea, Malaysia, and Thailand, and to 90-100 percent of GDP in Indonesia and the Philippines (Table 6). The growth of government debt is attributable to the initial sharp depreciation of the exchange rate (which raised the domestic currency value of government external debt) and the resolution of troubled financial institutions: an initial injection of liquidity support to ailing financial institutions, purchases of NPLs, recapitalization of weak but viable banks, and temporary nationalization of non-viable banks—and fiscal stimulus. These public sector debt figures may not reflect the governments' underlying debt obligations because they do not include contingent liabilities, such as the future needs of financial sector resolution (recapitalization), and debts of public infrastructure corporations and other state-owned enterprises. Large government debts and debt servicing obligations may pre-empt development and social expenditures.

**Table 6. Public Sector Debt 1996-99**

<i>Year (a)</i> <i>Economy</i>	<i>(Percentage of GDP)</i>						<i>Recapitalization Cost</i>	
	<i>1996</i>	<i>1997</i>	<i>1998</i>	<i>1999</i> <i>Est.</i>	<i>1996-1999</i> <i>Changes</i>	<i>To date</i>	<i>Expected</i> <i>additional cost</i>	
<b>Indonesia</b>	22.9	61.9	67.3	91.5	68.6	37.3	12.7	
Domestic Debt	0.0	0.0	16.3	52.5	52.5			
Foreign Debt	22.9	61.9	51.0	39.0	16.1			
Interest/GDP <sup>(b)</sup>	0.0	1.6	3.2	3.9	3.9			
<b>Korea</b>	8.8	14.2	23.8	29.5	20.7	15.8	10.7	
Domestic Debt	7.6	9.5	12.4	22.2	14.6			
Foreign Debt	1.2	4.7	11.4	7.3	6.1			
Interest/GDP	0.4	0.5	1.0	2.6	2.2			
<b>Malaysia</b>	36.0	32.7	37.0	52.0	16.0	10.9	5.5	
Domestic Debt	31.8	28.0	31.6	44.0	12.2			
Foreign Debt	4.2	4.7	5.4	8.0	3.8			
Interest/GDP	2.7	2.3	3.6	3.2	0.5			
<b>Philippines</b>	105.1	114.5	108.9	105.0	-0.1	0.0	n.a.	
Domestic Debt	72.5	70.7	62.7	59.6	-12.9			
Foreign Debt	32.6	43.9	46.2	45.4	12.8			
Interest/GDP	4.7	5.5	6.2	6.8	2.1			
<b>Thailand</b>	15.7	29.2	38.2	50.3	34.6	17.4	15.4	
Domestic Debt	7.0	6.8	23.1	31.3	24.3			
Foreign Debt	8.7	22.5	15.1	19.0	10.3			
Interest/GDP	0.9	2.7	1.9	2.3	1.4			
<b>China<sup>(c)</sup></b>	19.0	20.0	26.0	29.0	10.0	3.0	n.a.	
Domestic Debt	6.0	5.4	10.8	14.0	8.0			
Foreign Debt	13.0	14.6	15.2	15.0	2.0			
Interest/GDP	0.7	0.8	0.9	2.0	1.3			

Notes:

(a) The years indicated are fiscal years for Indonesia (Apr. 1/Mar 31) and Thailand (October 1/September 30) and calendar years for China, Malaysia, Korea, and the Philippines.

(b) The figure for 1999 does not include a 2.1 percent GDP interest payment associated with the bank recapitalization bond.

(c) National government debt only.

Source: World Bank, *East Asia: Recovery and Beyond*, 2000, p. 98

### 3. Risks to Sustainable Economic Recovery

Despite the strong V-shaped recovery, East Asia continues to see uneven recovery and faces several risks that could reverse the current recovery process. They include weak economic policies on the domestic front, external negative shocks, and potential political and social instability.

First, weak economic policies include unsound macroeconomic policy, delayed restructuring in the financial and corporate sectors, and unsustainable public sector debt. The risk in the form of unsound macroeconomic policy does not appear to be serious at this point unless public debt becomes out of control or the economies are subject to significantly large external shocks.

The greatest risk is complacency in financial and corporate sector restructuring. The financial sectors of the affected economies remain plagued by the overhang of bank NPLs and corporate debt (Table 7). Progress in NPL resolution and corporate debt restructuring is uneven—again Korea leads and Indonesia lags—but no economy is near completion of these projects, which may well take close to a decade to fully resolve. Temptation to slow the restructuring process exists due to the presence of vested interests and a nationalistic backlash against ‘fire-sales’ of assets to foreigners. Vested interest groups are trying to slow the restructuring process in order to maintain their equity stake in, and control over, indebted corporations, which could otherwise be lost in the process of debt and operational restructuring. Domestic bank creditors may be unwilling to pursue aggressive NPL resolution because doing so would force them to realize losses, reduce capital, and thereby dilute bank ownership and control. Slow restructuring would mean that bank NPLs and corporate debt would continue to be a large overhang, thereby choking off credit flows to the corporate sector.

**Table 7. NPLs of Crisis-affected Economies**

*(Percentage of total loans)*

	1997	1998				1999				2000
	Dec.	Mar.	Jun.	Sept.	Dec.	Mar.	Jun.	Sept.	Dec.	Mar.
Indonesia <sup>(a)</sup>	7.2	11.3	--	--	49.2	50.9	39.7	38.8	32.9	32.1
Korea <sup>(b)</sup>	--	--	14.1	--	16.8	17.0	18.0	17.9	17.7	--
Malaysia <sup>(c)</sup>	6.0	9.1	12.6	21.3	22.6	22.7	23.4	23.6	23.9	24.3
Philippines <sup>(d)</sup>	4.7	7.4	8.9	11.0	10.4	13.2	13.1	13.4	12.5	14.0
Thailand <sup>(e)</sup>	22.6	--	32.7	39.7	45.0	47.0	47.4	44.4	41.1	39.8

*Note:* (a) For Indonesia, data is from Bank Indonesia and excludes NPLs transferred to IBRA. If these are included, the NPL ratio for March 2000 is estimated to be 65 percent. (b) Figures include commercial banks, specialized and development banks, merchant banks, insurance companies, mutual saving banks, credit unions, leasing companies, securities companies, and KAMCO. (c) Figures include commercial banks, finance companies, merchant banks, and Danaharta. (d) Figures are for commercial banks. (e) Figures include commercial banks, finance companies, and the estimated amount of NPLs transferred to wholly-owned private AMCs. If the last item were to be excluded, the NPL ratios for December 1999 and March 2000 would be 38.5 percent and 37.2 percent, respectively.

What is clearly needed for corporate debt restructuring is to firmly establish a credible threat from the judicial/legal system. For a voluntary process of corporate restructuring to work, the alternatives to an out-of-court agreement must be made clear and credible. The case of TPI in Thailand illustrates how crucial it is to establish an effective insolvency procedure and a well-functioning judiciary system. Improvements of the functioning of courts, not just bankruptcy but the procedures of foreclosing on collateral and registering of security interest, helps protect creditor rights and provides the debtor with a credible threat to negotiate in good faith. This would contribute to resolving bank NPLs.

Rising public debt is another important policy risk that needs to be managed. Large public debt has raised debt-servicing obligations and thus put pressure on development and social expenditures. In Indonesia, for example, close to half of government revenues will have to be spent on interest payments in the next several years. There is a serious risk that the public sector may not be able to meet the rising demand for development and social needs in such areas as infrastructure, health, education, and other public services. If the fiscal problem cannot be controlled, particularly in Indonesia and the Philippines, macroeconomic policy management will be difficult. With some of the social problems still ahead, governments face the complex task of managing their fiscal costs.

Second, external negative shocks can be another downside risk to the sustainability of recovery. The US economy, which has been the locomotive of East Asian recovery in the last two years, remains vulnerable to a potential abrupt decline, especially because of exuberant stock market activity, a record level of private sector financial deficits and the rising current account deficit. There are also concerns about the strength and durability of recovery in Japan. A slowdown of the US economy and a reversal of the Japanese economic recovery could hamper the current East Asian recovery process. Another external risk arises from the recent hike in oil prices and upward pressure on the interest rate. So far, the high oil prices and rising global interest rates have not constrained the recovery process in the region but, if the high oil prices and high interest rates continue for a substantial time period, an adverse impact on growth can be non-negligible. Domestic restructuring of financial institutions and corporations would be necessary to make them more resilient to such external shocks.

Third, political instability or uncertainty poses a risk to the sustainability of the current recovery process. This is particularly the case for Indonesia that is facing signs of rising domestic political polarization and regional conflicts. The Philippines is also facing a resurgence of violence at the provincial level. The lack of evolution of political institutions in China is a potential risk to the region's economic health. Even in economies like Korea and Thailand, political and social dissatisfaction is emerging, as an increasing number of people feel deprived of the benefits of economic recovery. The social impact of the economic crisis has been both severe and wide-ranging, and the costs of socio-economic dislocations are still to emerge fully. Though governments have been implementing various programs to mitigate the adverse social impact of the crisis, social distress could derail the current restructuring efforts.

An average 6 percent growth rate over the course of the next few years is possible for East Asia if there is further progress on economic policy (macro, structural, and public debt), external economic environments continue to be favorable, and political and social stability is maintained.

### **III. THE EAST ASIAN MIRACLE REVISITED: LESSONS FROM THE CRISIS**

#### **1. The East Asian Miracle**

East Asia's achievement of spectacular economic and social gains during the 'miracle years' (1965-96) is beyond dispute. The 'miracle economies' of East Asia recorded an average growth

rate of 7.5 percent per annum over the thirty-year period.<sup>5</sup> Poverty declined, not only in breadth (the number of poor) but also in depth (severity of poverty). The number of poor living below the international poverty line of US\$1 a day declined from 720 million (58 percent of total population) to 350 million (21 percent of total) during the period 1975-1995. Life expectancy at birth, infant mortality rates, and literacy indicators have all improved in tandem, generating real improvements in people's standards of living. East Asia succeeded in converting persistently high growth rates into improved social conditions because growth created jobs for the poor and opportunities to expand productivity. The miracle was real and tangible.

Propelling these achievements was a high and equitable performance of economic growth. Several factors lay behind this remarkable growth performance. These included:

- Stable macroeconomic environments (low inflation, disciplined fiscal policy, and stable, competitive exchange rates);
- High savings (through positive real interest rates and effective deposit protection) and high investment in fixed assets;
- High investment in human capital through public expenditures on education;
- Limited price distortions;
- Outward-oriented trade policy and absorption of foreign technology; and
- Relatively limited biases against agriculture.

Essentially, most of East Asia's extraordinary growth was attributed to the application of a set of common, market-friendly economic policies leading to both higher accumulation and better allocation of physical and human capital. These economies not only achieved stable macroeconomic environments and superior accumulation of physical and human resources, but also were better able than many counterparts in other regions to allocate these resources to highly productive investments and to acquire and master technology. In this sense, there was nothing "miraculous" about the East Asian economies' success; each has performed these essential functions of growth better than most other developing economies.

## **2. Reflection on the Crisis**

Following the Thai baht devaluation in July 1997 and the currency contagion throughout the region, all affected economies in East Asia plunged into a sudden, downward spiral of economic activity. The currency and financial crisis was quickly transformed into an economic and social crisis. Interactions between the force of globalization and domestic structural weaknesses were the major factors behind such a rapid, startling crisis.

In retrospect, rapid growth in the pre-crisis years had spawned structural weaknesses in three dimensions:

- Large current account deficits, financed by short-term capital inflows, exposed East Asian economies to sudden reversals of capital;
- Domestic financial markets' growth and integration with global markets outpaced domestic regulation, and exposed banks to asset-liability mismatches. Inadequate regulation allowed banks to assume unhedged external debt positions and maturity mismatches that left them vulnerable to sudden currency depreciations; and
- Corporations, without alternative sources of financing, borrowed heavily from banks (domestic or foreign) to finance their rapid expansion, and in the process became highly leveraged, which exposed them to interest rate hikes and/or currency fluctuations.

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<sup>5</sup> The original 'miracle economies' in the World Bank's (1993) study included Japan, four Asian newly industrialized economies (NIEs) (Hong Kong, China; Korea; Singapore and Chinese Taipei), and three ASEAN members (Indonesia, Malaysia, and Thailand). In this paper, the Miracle economies of East Asia refer to the four Asian NIEs, the three ASEAN members, China, the Philippines and Viet Nam.

It is important to note that domestic structural weaknesses explain only part of the emergence of these economies' vulnerabilities and subsequent crises. Failures in international financial markets in the boom period of the cycle, as well as during the crash, were no less pivotal; herd behavior, during both the boom and bust periods, and contagion in financial markets were another important factor behind the crisis. The East Asian crisis revealed that the risks of financial instability in a globalizing market environment—especially for developing economies—were greater than had previously been thought.

### **3. Lessons from the Miracle and the Crisis**

The East Asian crisis has exposed some of the structural weaknesses of the East Asian economies. These structural weaknesses were deeper than those observed in external accounts, the financial sector, and the corporate sector. They had been hidden or contained under the impressive growth performance of these economies. They were:

- The lack of capacity to manage the forces of rising globalization;
- The absence of good regulatory and supervisory frameworks to improve the functioning of the financial sector and market efficiency in general; and
- The lack of commitment to maintain transparency and accountability of the government.

First, economic policy did not recognize fully the forces of globalization and the need to manage them. Reaping the benefits of greater integration with the world economy will require careful attention to managing the risks associated with financial and trade integration. Though the international community's efforts to reduce, and respond to, global vulnerabilities are vital, each economy must manage globalization by strengthening the domestic economic system in a way resilient to shocks emanating from abroad. In an increasingly globalizing world economy, macroeconomic policy must be sound and consistent with the chosen exchange rate regime; the risk management of financial institutions and corporations must be prudent; and adequate social safety nets must be provided to protect those who are adversely and severely affected by globalization and external shocks. Policymakers should pay due attention to the right sequencing of financial sector liberalization and capital account liberalization.

Second, during the 'miracle years' many East Asian governments played a significant role in allocating real and financial resources to priority sectors and industries. Such a direct role of the government was already diminishing in the pre-crisis period, but the new role of government as a regulator and supervisor was not fully appreciated. Retreating from a direct, interventionist role does not imply that government should always take hands-off stance. On the contrary, the government should focus on establishing good regulatory and supervisory frameworks and institutions to govern private sector economic activity and to improve market efficiency.

Third, the importance of good governance of the public sector was not fully recognized. The public sector must improve its accountability, transparency, and efficiency, particularly in the areas of public service delivery and protection of the socially vulnerable.

## **IV. EAST ASIA'S MEDIUM-TERM CHALLENGES**

What is needed to transform the current recovery process into a sustained and broadly shared economic expansion? The East Asian economies must concentrate on revitalizing the private sector, streamlining the public sector, and forging a new social contract while recognizing the need to manage the forces of globalization.

## **1. Revitalizing the Private Sector**

The East Asian economies must make persistent progress on financial and corporate sector restructuring in order to set the stage for the next sustained growth era. Together with financial sector restructuring, these economies must strengthen the financial system by requiring commercial banks to conduct prudent asset-liability management (through, for example, sufficient capital adequacy ratios and loan loss provisioning), by improving the regulatory and supervisory frameworks, and by developing capital markets, particularly those for long-term bonds. Competition from the capital markets is expected to put greater pressure on commercial banks to increase efficiency and productivity within prudent regulatory supervisory frameworks.

Together with corporate restructuring, these economies must strengthen corporate governance through improved disclosure, accounting, and auditing requirements, redefining the role of the board of directors, and protection of minority shareholders. Since corporations are the mirror image of the underlying business societies and culture, improvement in corporate governance requires changes in the underlying business organization.<sup>6</sup> The technological developments and increased exposure to competition are expected to induce such fundamental changes. Rapid developments in information technology are expected to widen the level-playing field, thus increasing pressure to streamline business activities. Competition in the product, factor and capital markets is expected to impose greater discipline on the way corporations are run in these economies.

In order to enhance competitiveness, governments must create environments for the private sector to shift resources towards knowledge-based and information-intensive economic activities. In order to compete in a globalizing world economy, private firms must be able to create, acquire, use, and disseminate knowledge at low cost. Investment in human resources for a knowledge-based economy is vital to improving competitiveness in the global market.

## **2. Streamlining the Public Sector**

Economies throughout East Asia are experiencing profound changes in governance. Even before the crisis, East Asians were becoming inclined to accept greater participation in government, greater accountability from officials, and more comprehensive social safety nets in exchange for fast-rising incomes. The cessation of growth unleashed forces of political change, leading to new governments in Indonesia, Korea, and Thailand, and creating greater demands for good governance.

Fiscal pressures—emanating from debt burdens and socio-economic changes—and globalization are making economies rethink the role of the state. Under pressure to do more with less, governments will have to focus on regulations that support market development, contain its negative spin-offs, and help incorporate those left behind; they may have to enlist private investment in activities that are now the sole domain of the state. Governments are also rethinking the organization of the state and according more responsibility and power to sub-national governments. Finally, governments are being compelled to improve institutions of public management—revenue and spending agencies and ministries—as well as the civil service.

Though East Asian public institutions performed critical functions relatively well in the miracle period, the crisis has revealed some serious shortcomings in public sector performance. To increase the productivity of the public sector, governments must improve the institutions of

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<sup>6</sup> One of the features of the East Asian economies has been the prevalence of relationship-based businesses based on “trust.” Such business organizations have played the role of lowering transactions and agency costs due to asymmetric information. In an increasingly globalizing open market environment, however, trust is not enough to sustain complex operations, and arms-length relationships need to be developed.

expenditure and human resource management, civil service administration, and the service-delivery capacity.

Moving toward a higher degree of transparency and accountability may take some years, and involves many inter-related aspects of the governance regime. Attempts to improve accountability must be built into public sector management systems. For example, public expenditure monitoring and audit, along with a transparent budget process with timely reporting, are key mechanisms of oversight in the public expenditure system; and performance evaluation, merit-based promotion practice, and citizens' grievance processes are critical to ensuring the accountability of the civil service.

### **3. Forging a New Social Contract**

In East Asia, social protection has not traditionally been provided by the government's social programmes or income transfers, but by a combination of economic growth, labor market flexibility, informal social safety nets (such as support by extended families and communities), enterprise policies (such as the provision of social services and long-term employment), and a controlled and gradual type of external liberalization. The economic crisis has shown that the economies in the region are indeed flexible in absorbing the consequences of the crises: households have protected their consumption of some critical items by drawing on savings; informal social safety nets, provided by extended families and communities, have been quite resilient and effective in many economies; the labor market has proved flexible in securing employment, though real wages had to go down; and governments have beefed up safety net programs. What this means is that high savings, labor market flexibility, and informal safety nets must continue to be an integral part of the social safety net system.

Facing pressures from globalization, urbanization, and population aging, East Asian governments are now required to respond to heightened economic insecurity of households by ensuring that the poor and the socially vulnerable are insulated from downturns during bad times and benefit from growth during good times. With the simultaneous pace of globalization, growth in urban labor markets and the gradual aging of societies, there will likely be new demands on economic security. With growth increasingly dependent on skills and knowledge rather than on unskilled labor augmented by capital, the risk should not be dismissed that wage gaps could widen and the poor could be left out of the growth process. This risk underscores the important role of government, and the effects its revenue and spending policies have on incorporating low-income groups into the growth process or leaving them by the wayside.

These pressures would force East Asian economies to move towards a more formalized social safety net society, particularly in high-income economies such as Korea. Formal social safety nets are also important in China to make progress on SOE reform, which would require the state to play an important role in providing safety nets which have been traditionally provided by the SOEs in the form of housing, schooling, health care, old-age pensions, etc. It is also important to note that the provision of social safety nets is an important component of market reforms—it cushions the damage done on the most severely affected, it helps maintain the momentum of these reforms, and it avoids a backlash against the distributional and social consequences of globalization. However, it is quite unrealistic to implant top-notch OECD-type social protection systems into the East Asian economies, except for Korea that is already an OECD economy. Governments should carefully examine internationally recognized best practices of social sector protection, and establish a formal safety net system in a way consistent with the evolving reality of their economy, taking into account informal social safety nets based on families and communities.

Governments have to foster institutions able to respond to an aging, increasingly urban population that is likely to feel more vulnerable in a globalizing world economy. Government information systems must respond faster in times of crisis. And social safety nets have to be stronger,



complementing traditional family and community support systems, and be able to expand (or contract) in line with economic conditions.

## **V. CONCLUDING REMARKS**

Whether the East Asian economies can transform the current recovery process into a long-term growth path depends on whether they can reap the maximum benefit of globalization at the smallest cost and can provide a stable political and social environment conducive to a broadly shared economic expansion. In the short-term, they must diligently pursue the restructuring and reform efforts in the financial and corporate sectors and manage the public debt and fiscal deficits.

In the medium-term, these economies must focus on: revitalizing the private sector through reforming the financial sector, strengthening corporate governance, and enhancing the economic competitiveness and human resources; streamlining the public sector through improving public expenditure systems, reforming the civil service system, and making government more transparent and accountable; and forging a new social contract through achieving rapid poverty reduction and providing adequate social safety net systems.

Sustained economic growth requires total factor productivity to rise, in addition to a more educated labor force, efficient capital and technology. The reward for overcoming these medium-term challenges will be shown as higher total factor productivity and another era of stable, sustained economic growth.

**Appendix Table.**  
**East Asia's Macroeconomic Performance: Real GDP Growth and CPI Inflation Rates**

	<i>Real GDP Growth Rate</i>							<i>CPI Inflation Rate</i>						
	<i>Actual</i>					<i>Estimate</i>	<i>Projection</i>	<i>Actual</i>					<i>Projection</i>	
	<i>1995</i>	<i>1996</i>	<i>1997</i>	<i>1998</i>	<i>1999</i>	<i>2000</i>	<i>2001</i>	<i>1995</i>	<i>1996</i>	<i>1997</i>	<i>1998</i>	<i>1999</i>	<i>2000</i>	<i>2001</i>
East Asia 5														
Indonesia	8.2	8.0	4.5	-13.2	0.1	3.8	4.4	9.4	8.0	6.7	57.6	20.5	4.4	5.9
Korea	8.9	6.8	5.0	-6.7	10.7	8.3	5.9	4.5	4.9	4.5	7.5	0.8	2.5	3.1
Malaysia	9.8	10.0	7.5	-7.6	5.6	7.4	6.3	5.3	3.5	2.7	5.3	2.8	2.7	3.4
Philippines	4.8	5.8	5.1	-0.4	3.2	3.4	3.6	8.0	9.0	6.0	9.7	6.7	5.2	6.6
Thailand	8.9	5.9	-1.7	-10.2	4.2	5.3	5.1	5.8	5.9	5.5	8.0	0.3	2.3	3.1
Transition Economies														
China	10.5	9.6	8.8	7.8	7.1	7.5	7.5	16.9	8.3	2.8	-0.8	-1.4	0.8	2.0
Viet Nam	9.5	9.3	8.2	4.4	4.4	5.3	4.7	16.8	5.6	3.1	8.8	4.3	7.0	9.0
Small Economies														
Cambodia	7.6	7.0	1.0		4.0	5.5	6.0	1.1	10.1	3.2	14.8	4.0	3.5	4.5
Lao PDR	7.3	6.8	6.9	1.0	4.0	4.5	5.0	19.6	13.0	27.5	91.0	128.4	16.0	11.0
Fiji	1.4	3.4	-1.8	4.0	7.8	3.5	3.0	2.2	3.1	3.4	5.7	2.0	2.0	5.0
Papua New Guinea	-3.6	3.5	-4.6	-1.3	3.9	4.7	4.5	17.3	11.6	3.9	13.6	14.9	14.6	5.0
Solomon Islands	7.0	0.6	-0.5	2.5	1.0	2.0	3.0	9.6	11.8	8.1	12.3	8.3	8.0	7.0
Mongolia	6.3	2.4	4.0	-7.0	3.3	4.3	4.5	56.8	49.3	36.6	9.4	7.6	9.4	6.0
				3.5										
East Asia NIEs (excl. Korea)														
Hong Kong, China	4.9	4.5	5.0	-5.1	3.0	6.7	4.4	9.1	6.3	5.8	2.8	-4.0	-1.6	1.7
Singapore	8.4	7.5	8.4	0.4	5.4	6.5	5.9	1.7	1.3	2.0	-0.3	0.1	1.6	1.9
Chinese Taipei	6.4	6.1	6.7	4.6	5.7	6.7	6.0	3.7	3.1	0.9	1.7	0.2	1.6	2.3
Japan	1.5	5.0	1.6	-2.5	0.2	1.3	1.5	-0.1	0.1	1.7	0.6	-0.3	-0.4	0.0
U.S.A.	2.9	3.6	4.2	4.3	4.1	4.9	3.2	2.8	2.9	2.3	1.5	2.2	3.1	2.6

*Source:* World Bank; IMF; Consensus Forecast, June 2000, for Hong Kong, China; Singapore; Chinese Taipei, Japan, and the USA.

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# OLD ISSUES IN NEW REGIONALISM

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## INTRODUCTION

*Regional (preferential) trading arrangements are like street gangs: “you may not like them, but if they are in your neighbourhood, it is safer to be in one”<sup>1</sup>*

In the 1960s, about two to three regional trade agreements (as the World Trade Organisation [WTO] calls them, whereas preferential trade agreements [PTAs] is a better term) were being notified to the WTO every year.<sup>2</sup> The notifications were even fewer in the 1980s and in the early 1990s. Then came the boom. In the last part of the 1990s there were usually 11 notifications a year (see Figure 1). As at August 1998:

- 162 regional trading arrangements (RTAs) had been notified, and more than half the notifications had occurred in the previous eight years
- there were also 58 RTAs which existed, or had existed, but which had not been notified to the WTO (see Figure 2)
- the number of notified RTAs in force was far less than the number notified, and was estimated to be 87 in August 1998, but that is still more than double the number in 1991<sup>3</sup>
- more than 100 out of the WTO membership were members of RTAs in 1998, and it is estimated that 104 WTO members participate in non-notified RTAs
- an estimated 97 percent of WTO members participate in RTAs

Crawford and Laird (2000) report that the European Union (EU) members and Mexico belong to more than 10 RTAs. Brazil, Colombia, Venezuela and Chile amongst others belong to between 5 and 10. Most other WTO members belong to one RTA. The WTO Secretariat (1998) reviewed 69 regional trading agreements in force. Of these only 10 were customs unions.

Most APEC member economies are also members of RTAs. Long-standing arrangements in the western Pacific include the ASEAN Free Trade Area and the Australia-New Zealand Closer Economic Relations Agreement.<sup>4</sup> There are a large number of agreements already in place on the other side of the Pacific, including a string of bilateral agreements.<sup>5</sup> Recently there has been another round of activity, especially since the APEC Leaders Meeting in Auckland last September, and involving APEC members not usually noted for their participation in preferential approaches. Table 1 provides examples involving East Asian economies.

It is important to stress that the recent activity of this type involving East Asian economies has mainly taken the form of proposals or negotiation of agreements. Some drafts of agreements may never come to be signed, since, as the notes in Table 1 indicate, there are some serious constraints and sticking points. Some may end up being implementation agreements associated with processes established in APEC (on standards, for example) or in the WTO (on services, for

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<sup>1</sup> Attributed by Crawford and Laird to a remark by Alan Winters at seminar in mid 1999.

<sup>2</sup> Data on notifications is taken from WTO (1999).

<sup>3</sup> Crawford and Laird report a higher number of 102 notified agreements still in force at “the end of 1998”. They break this down to 78 goods agreements notified under Article 24 of the GATT, 13 goods agreements notified under the enabling clause and 11 agreements covering trade in services notified under the GATS.

<sup>4</sup> There are in addition a number of subregional cooperative arrangements in the region. See Pomfret (1996).

<sup>5</sup> Details are available at <http://www.sice.oas.org>.

example) and “free trade agreement” will turn out to be an incorrect label. Even so, there has clearly been a shift of opinion in East Asia about the use of preferential liberalisation.

A number of features of these discussions are striking:

- They involve economies not previously have engaged actively in the preferential route to reform, e.g. Japan
- While some agreements are between close neighbours, others involve some long distance relationships, for example, across the Pacific, Mexico with Singapore, or Korea and Chile. Geographic proximity is not necessarily a feature.
- At least one agreement involves a combination of two existing regional trading arrangements.
- There have also been extensions of existing regional trade arrangements (such as the extension of AFTA or the prospect of Chile joining NAFTA).
- Even more interesting is the example of an individual member of existing agreement signing with one member of another agreement, such as Singapore and Mexico, or New Zealand and Singapore.
- The coverage of these agreements extends beyond the traditional areas of trade policy, and includes investment, services and standards.
- The discussions make reference to WTO consistency, but also refer to other rules such as open access.
- The arrangements mooted or under discussion are all free trade areas, and not customs unions.

The purpose of this paper is to comment on these developments. Are they good news or bad?

### **GOOD NEWS OR BAD?**

The answer to this question is that “it depends”. Firstly, it depends on whose perspective is being taken – members or non-members. Secondly, even if a choice of perspective of members versus non-members is made, the answer is still that “it depends”. Unfortunately it depends on a lot of things. Krueger (1999), Laird (2000) and Crawford and Laird (2000) provide some of the more recent reviews of the range of issues that emerge and the literature to date.

The static effects of preferential arrangements on member economies include the familiar trade creation and diversion effects. Trade creation occurs when domestic production in a member economy is replaced by items purchased from another member of the preferential arrangement. Trade is created because it is cheaper to import the product from the other member than to produce it at home. Trade diversion occurs because members replace their imports from the rest of the world with higher cost imports from other members. The lowest cost worldwide source of the item is replaced by a higher cost source from among other members. Trade creation increases welfare. Trade diversion generally decreases it.<sup>6</sup> The impacts can vary a lot between members.

There are terms of trade effects to be taken into account. Some explanations of the interest in cooperation among economies for the purpose of trade liberalisation stress their value for offsetting adverse the terms of trade effects that might otherwise be associated with unilateral liberalisation. The presumption is that in a preferential arrangement, the members’ terms of trade will improve compared to the rest of the world.<sup>7</sup> The welfare of non-members is also affected via this route.

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<sup>6</sup> Vousden (1990, section 10.2) reviews literature on the case of three goods which highlights the welfare significance of the height of the pre-union tariffs and of the degree of substitutability or complementarity between goods produced inside a customs union and that produced outside. The traditional notion of trade diversion assumes substitutability.

<sup>7</sup> Vousden (1990) reviews the case of a small economy, which is a member of a customs union, that can achieve a terms of trade gain by diverting its trade away from a large, non-member, economy which determines world prices and which imposes a tariff on its imports (or when exporting, that large economy incurs transport costs).

Other issues to take into account are the relocation of rents (including away from non-members). For example, a preferential arrangement may lead to entry by firms from other members into the imperfectly competitive market of a member, which would see some of the profits captured by foreign firms. On the other hand, the change in the degree of competition has other benefits. There can also be opportunities to exploit economies of scale, and there may be positive effects of agreements on the variety of goods available. There can also be impacts on the flows of foreign capital, e.g., diversion of flows to member economies from non-members.

Krueger stresses that when combining all these effects, it is difficult to come up with firm general rules about when a preferential agreement is good for members. There are a couple of critical parameters. One is the extent to which the economies already trade extensively with each other. Existing high levels of trade suggest that the extent of costly trade diversion will be less. Another important parameter is the scale of the partners' external tariffs at the time of establishment: lower external tariffs mean less chance of significant losses from trade diversion.

With respect to effects on the world trading system, there are a number of arguments for and against preferential arrangements: Krueger provides a thorough and accessible review of these arguments. Her conclusion is that there can be no strong presumption in favour of the view that preferential agreements are building blocks of the multilateral system, and indeed there are "clearly grounds for concern" that they will weaken it.

One of the arguments in favour of a positive effect is that preferential arrangements build the momentum for further multilateral liberalisation. For example, Scollay (1996) argues that this catalytic effect was important in the Australia/New Zealand Closer Economic Relations Agreement (CER), especially in New Zealand, through the promise the arrangement offered of specific market access opportunities.

Another view is that preferential agreements help "lock in" policy change. Policy change which is announced but which is not credible will not have any impact. The commitments made in a preferential agreement provide one way of adding to the credibility of policy change, since backsliding will be punished by loss of the advantages provided by the agreement.

Preferential agreements may lead producers in economies with high external tariffs to argue for lowering those tariffs, especially the ones applying to intermediate goods. Krueger refers to this impact in New Zealand and in Canada.

Preferential agreements can be used as a threat to promote the multilateral process, it has been argued. They can help participants go further than they could in the multilateral system. They can establish ways to deal with new policy issues and with emerging impediments to trade and investment. A preferential approach is said to help the process of education about free trade and its benefits.

There are substantial contrary views. A general point is that many of the benefits claimed for preferential agreements will also follow from a general liberalisation of trade, and will also be larger in that case.

One more specific objection is that members of preferential agreements are more likely to raise barriers to non-members, even when external tariffs are low. This risk is a theme in this paper and more details on the mechanisms by which this could occur are offered below.

The second contrary view could be called "snouts in the trough". There are export interests who would normally be in favour of, or are at least able to be mobilised to be in favour of, multilateral change. But once they get their snouts in the trough of rents created in a preferential structure,

they either do not want to give them up, or cannot be compensated by the move to even freer trade.

Winters (1996), summarises a paper by Krishna which presents this outcome in a more formal way. In the Krishna model, there are imperfectly competitive markets that are segmented from each other. Policy is determined in this model solely by its effects on profits. A trade diverting free trade agreement (FTA) will attract political support. Compared to the starting situation profits would also have been increased by a move to free trade. However once the FTA is constructed, there is insufficient extra profit in the move to free trade to encourage producers to continue lobbying. Their profits may even fall in the move to free trade. There may also be no countervailing deal that producers in non-member economies can offer to encourage producers within the FTA to move to free trade. As a consequence liberalisation gets 'suspended'.

A third contrary view is that the negotiation of preferential agreements uses up scarce policy making and negotiating capacity, and diverts attention in the policy making system. For example, in the lead up to the Seattle meeting, some economies normally expected to be stalwarts of the multilateral process were marketing their regional initiatives, at the cost of effort that might otherwise have gone into building the multilateral agenda.

Fourth, other multilateral mechanisms do an even better job of providing some of the specific benefits claimed for a preferential agreement. The WTO for example provides more efficient mechanisms for binding policy. It also provides a process of liberalisation that avoids the disadvantages of trade diversion. The issue is whether the WTO is able to perform these roles over the range of policy areas that appear to be motivating the interest in preferential agreements.

### ***But why now?***

These arguments explain some of the impacts of preferential agreements. But there has clearly been a surge of interest in preferential agreements in the 1990s, and as pointed out above, an apparent shift in opinion within some East Asian economies. Apparently, some people think that impediments can be removed on a preferential basis, whereas their assessment is that it would be more difficult to do so without any discrimination. What factors contributed to this change?

One factor could be the domino regionalism effect proposed by Baldwin. This explanation focuses on the pressure to join an existing bloc. Preferential agreements result in trade (and investment) diversion. Excluded economies then seek to be included to avoid this effect. This pressure can be modeled explicitly through the impact on profits of exporters in non-member economies. They lose as a result of both trade diversion and the change in the level of costs of their competitors. The pressure is exaggerated if special interest groups fight harder to avoid losses rather than to secure gains. As Baldwin suggests, exporters may work harder to avoid losses due to discrimination than they would to make sure a multilateral round succeeds. As more members are included, the pressure on those outside increases.

This process suggests that the membership of preferential agreements will increase. The process might be set up by one or some key initial agreements, such as those within Europe or North America. If the initial arrangements do not accept new members on similar terms, then those denied access consider setting up their own arrangements.

Another motivation is the range of policy issues. This factor is related to the coverage argument offered in favour of preferential agreements. It is reflected, for example, in a recent survey of business in Australia by the Australian Department of Foreign Affairs and Trade in which respondents rated a series of business facilitation matters, particularly standards, relatively highly, (see below). Business applies pressure for market access to deal not only with tariffs but also with these other issues for which the multilateral disciplines are not seen as sufficient. There may be an

advantage in trying to deal with them in a small number setting. Furthermore, as discussed again below, there is seen to be extra advantage in dealing with these issues on a preferential basis.

The interest in preferential agreements is also supported in East Asia by the growth in intra-regional trade, leading to a re-evaluation of the costs and benefits of discrimination. The growth in intra-regional trade has not been driven by preferential agreements, but on the contrary occurs as a consequence of trade and growth associated with MFN liberalisation. Drysdale (2000) observes that this change has encouraged some in Japan and in other economies in the region to think more about preferential arrangements.

The interest in regionalism within East Asia can also be traced to developments in the international economic institutions. The failure of the WTO ministerial meeting in Seattle to launch a new round of negotiations has prompted a reconsideration of regional approaches. Related considerations, following the experience of the financial crisis, are the proposals for new currency arrangements in the region, as well as those for an Asian Monetary Fund.<sup>8</sup>

Expectations may yet be disappointed. The negotiation of the arrangements may seem 'easy' from the point of view of the bureaucracies involved. The preferential route might therefore be seen as a quicker way of getting some results. However this route is not easy for two reasons. While the number of parties involved is small, the issues they are discussing are complicated. Further illustration of this point is offered below in relation to standards and services. A lot of time could be spent thrashing out a solution that suits these two parties only to have the next set of negotiations lead to a different outcome, and for both outcomes to contradict principles established at the multilateral level.

The second difficulty is that negotiations can be easily derailed. The scope of the bilateral approach in terms of sectoral coverage is less. Violent objection by one sensitive sector, e.g., wine makers in Korea anticipating a flood of Chilean wine, or Japanese goldfish breeders concerned about infiltration of their market by Singaporean goldfish, can stop the negotiations since there are not enough countervailing forces which can be mobilised. This problem is becoming more evident as the various talks proceed.

## **EMPIRICAL EVALUATIONS**

What does the empirical work say about the impact of preferential agreements on trade and welfare? This section provides some notes on selected studies.

Anderson and Norheim (1993) apply and extend a set of indicators which can be used to comment on the extent to which preferential agreements have affected the growth in the propensity of members of preferential agreements to trade outside the group. Their conclusion is that global integration has deepened despite the greater number and coverage of preferential agreements. This result does not imply that the agreements are benign. Anderson and Norheim also stress that the world might still have been a better place without the agreements.

More recently, Laird (1999) looked at the shares in total exports of within-group and out-of-group trade for a series of preferential arrangements from 1990 to 1997. He also compared the growth of the two types of trade. The picture is mixed. Trade grew faster among members than with non-members in many agreements but at about the same rate for both groups in the case of the European Union (EU). Also trade with non-members in many cases actually grew faster than world trade on average.

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<sup>8</sup> Noland (2000) provides more discussion of Japan's interest in these strategies.



Table 2 provides an update (to 1998) to Laird's table for preferential arrangements. It shows: the values of imports by all members of each group listed (including those from other members<sup>9</sup>); each group member's share of total group imports in 1990 and 1998; and the growth rate of the imports into the group from other members and from the rest of the world. Some of the key results are the following:

- Trade growth in the EU and in the CER over the period was relatively slow compared to the growth in world trade, but imports into those groups from outside grew faster than imports to members from within
- Apart from the EU, the share of imports from outside the group was higher in each case than the share coming from inside (60 percent from within in the case of the EU)<sup>10</sup>.
- Of the arrangements apart from the EU, the highest within-group share was 40 percent for the NAFTA in 1998, followed by 21 percent for MERCOSUR, 19 percent for AFTA, 12 percent for the Andean group and 7 percent for the CER.
- In all cases other than the EU and the CER, trade grew faster within than it did from outside the group (by at least 45 percent) and so the within group shares of imports increased
- In all cases other than the EU and the CER, imports from outside the group grew faster than world trade.

For those groups in which trade grew faster within the group than from without, the margin was relatively large. Could this be due to the effects of the preferential arrangements or due to other factors? One way to get a first impression of the factors at work is to calculate the indices of the intensity of trade for imports and exports both within the group and with the rest of the world. These indices scale the shares of trade by the shares of the trading partner in world trade. A rising index value between 1990 and 1998 suggests trade within that group is growing much faster than might be expected by reference to the partner's share in world trade. The results are shown in Table 2. The key results include:

- Intensity values are greater than one for all forms of within group trade
- There is a remarkable degree of stability of index values for the EU, the NAFTA and the AFTA as well as the CER (except for the within group export intensity for CER members, that is, members are now exporting much more to each other compared to their share in world trade)
- Very high and rising values in both import and export indices are observed for within group trade for MERCOSUR and the Andean members.

These results suggest that the growth of trade within the EU, the NAFTA, the AFTA and the CER has in general been not much greater than would be expected according to the changes in the shares in world trade of their members. This is not to say that the preferential arrangements had no impact. They could have contributed to a greater degree of overall openness in the first four groupings in the table which, in turn, could have led to their rising shares of world trade.

At the same time, there does seem to be a different pattern for MERCOSUR and the Andean members. Their trade with each other grew much faster than might have been expected. However, more powerful tests are required to establish if these different results between the first four and the last two groups in Table 3 reflect the different impacts of preferential arrangements.

There is some other, more detailed, work on MERCOSUR. Yeats (1998) found negative results about the impact of preferential arrangements on trade creation versus diversion. He found that the growth in trade within MERCOSUR was greatest where the members were not internationally competitive (p. 20). His comparison was based on the period of 1988 to 1994: he points to the

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<sup>9</sup> It was not possible to isolate entrepôt trade in these data. In other words, one source of growth of within group imports could be the provision of trading services by members of a group to other members (e.g., Singapore in the AFTA).

<sup>10</sup> Redefining the EU to include the EFTA members puts this share up to 65%.

relatively high margins of preference within the agreement (p. 23). He concluded that if 'the MERCOSUR countries had achieved an equivalent degree of liberalisation on a nondiscriminatory basis, they would have maintained a more efficient import structure...and they would have purchased more from their trading partners outside the block' (p. 24).

A difficulty in studies based on trends over time (including studies of the events before and after the creation of an RTA) is the definition of the counterfactual. Yeats also discusses this issue. An alternative track to liberalisation could have led to greater increases in trade and welfare. A further issue is the amount of time that should be allowed in making the evaluation of the preferential arrangement.

A number of factors can affect the propensity of economies to trade with others in their region, including those in formal preferential agreements. One approach to sorting out these effects is to use a regression model of the determinants of bilateral trade flows (the gravity model). This helps separate the contribution of natural factors such as complementarity and distance, as well as size, from membership of the preferential agreement (see e.g., Greenaway, 2000). An extension of this approach is to test for changes in the effect of membership of preferential agreements over time, and to include dummy variables to test for special effects between members and non-members. In the latter case a fall in the value of the dummy variables would be consistent with trade diversion. In studies completed so far, the effects have been difficult to isolate and the overall impact of preferential agreements remains hard to assess.

Computable general equilibrium models have the advantage of providing more options for good choices of base scenarios and for capturing more of the detail of the preferential policies. The models are becoming increasingly sophisticated and are able to incorporate scale effects and imperfect competition, and also capital accumulation. The conclusion of the review of work in this field by Srinivasan, Whalley and Wooton (1993) is that the welfare effects of preferential agreements have probably been positive but are not necessarily very large. They suggest that vigorous proponents of arguments either in favour or in opposition to preferential agreements are probably overstating the quantitative assessments in support of their case (p. 74).

Krueger (1999) reports larger numbers from more recent studies that are based on models whose specifications permit the identification of more of the dynamic gains. An example of this approach is the work by Davis, McKibbin and Stoeckel (2000) who simulate the effects of a free trade area involving the AFTA and the CER, using the APG-cubed model (18 economies and 6 sectors). They allow for allocative efficiency effects, terms of trade changes and capital accumulation for goods and for services as well as endogenous productivity effects. They find positive effects of a joint AFTA-CER FTA (of an extra US\$25.6b GDP in net present value terms in the AFTA and US\$22.5b for the CER<sup>11</sup>). These gains are nearly three times as great as results of an earlier study which excluded services liberalisation and which excluded the productivity effect.

An important result stressed by Davis, McKibbin and Stoeckel is that if APEC proceeds on schedule then the additional gains from negotiation of the AFTA-CER arrangement is relatively small. The gain to AFTA members of an FTA with the CER falls to just over US\$10b and those to CER members fall to just under US\$2b. The reasons, as they point out, are that the AFTA-CER trade is relatively small compared to their members' trade with APEC as a whole, and because APEC is not preferential.

The authors identify a number of implications of these results. One they stress is that some of the APEC gains could in fact be attributable to the AFTA-CER connection, to the extent that it encouraged further liberalisation in the larger group (p. 40). However, as the literature suggests,

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<sup>11</sup> The real consumption gain allowing for the ability to shift spending through time is 1 percent by 2005 for the AFTA as a whole and 0.6 percent for the CER.

preferential arrangements could have the opposite effect. A set of preferential commitments, if they could be reached, could slow down a non-discriminatory program.

## ISSUES

These sorts of evaluations of regional trading arrangements are usually based on the analysis which focuses on the effects of tariff reduction (the new AFTA-CER study is an important breakthrough in its treatment of the service sector). Implementation of the agreements is usually assumed to be relatively 'clean'. The studies tend to concentrate on the impacts of the formation of large blocs.

The proposals under consideration in East Asia comprise instead a series of overlapping and bilateral FTAs. As recent events indicate, economies appear to be considering signing more than one agreement and when they do sign, or plan to sign, the coverage is not just restricted to tariffs.

What extra issues do these two features add to the consideration of the costs and benefits of regional trading arrangements?

### *Hubs and spokes*

The consistent role of some key economies in the discussions in progress, and the use of bilateral structures, highlight the relevance of earlier work on hub and spoke arrangements (e.g. Snape (1996a), Wonnacott (1996), Snape, Adams and Morgan (1993) and Snape and Anderson (1994)). Suppose there are three economies, A, B and C. Economy A concludes separate agreements with B and C but B and C do not have an agreement with each other. Economy A is the hub and B and C are the spokes. Lloyd (1996), using this example, points out that the hub economy A itself could be a regional trading agreement. He also notes that the hub and spoke approach is 'more common than is generally realised' and at that time he pointed to examples associated with the EU and the EFTA.

Hub and spoke agreements do not provide equal access to all participants. Even if tariffs are removed along each spoke, the spoke economies would still not have free access to each other's markets. They only have access to the hub. In fact, as explained below, the extent of access is also likely to vary along each spoke. The differential treatment of spoke members can also be a source of friction among the participants.

Snape (1996a) explains how there is an incentive to create tailor-made agreements to deal with products that are regarded as 'difficult' from the point of the hub economy. He also notes how small economies have incentives to join, especially as more and more economies sign up with the hub economy. The hub and spoke system can "spread like a rash" (p. 61), a process like that stressed by Baldwin for membership of preferential agreements. The spoke economies may or may not have deals with each other.<sup>12</sup>

Wonnacott (1996) stresses the benefits to the hub economy. It gains benefit from the preference it gets in access to each spoke economy, compared to all the other spokes. Also only firms based at the hub can get duty free inputs from each spoke.

Other ways in which the hub economy could gain is that it could divert investment from each of the spokes. This is because of the favoured position of the hub economy, which makes it sensible to build a plant there to get access to not just the hub but also all the spoke economies. Furthermore, a firm based in the hub is likely to be able to get more inputs at low or zero tariffs

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<sup>12</sup> A simple, one sector, illustration of this process at work is air transport. This case, of international air transport where the hub and spoke approach has been pursued by the United States, highlights the manner in which spoke economies can end up at a disadvantage compared to the hub economy. See Findlay (1997).

than if based in one of the spokes – it can source from the hub and any of the spokes. Wonnacott (1996) explains how the result might be an inefficient pattern of investment that remains due to inertia even if the hub and spoke system were to evolve into an FTA.

Spokes lose since they do not gain from free trade with other spokes, they could be damaged by discrimination in other spoke markets, and they might have a reduced ability to compete in all markets against firms based in the hub (Wonnacott, 1996). A spoke economy could respond to some of these problems in the following ways. It could, in principle, organise equivalent agreements with the other spoke economies. The cost of doing so may be high, and the risk is that a series of such agreements negotiated one after the other could simply add to the layers of discrimination, as each pair dealt with their own sets of difficult issues.

Perhaps all the spokes would consider joining a regional bloc. However, it is not clear that a larger group, the membership of which was defined originally by the pressures from interest groups in the hub, could agree subsequently and simultaneously on how to deal with a now larger set of ‘difficult’ issues.

Another response is that a spoke economy could unilaterally cut tariffs to the rest of the world. Depending on the extent to which this occurs, such an initiative could offset the investment diversion effects. The spoke agreement would then be part of a transition to free trade, but an expensive one. More preferable, in hindsight, than a couple of small steps would have been a ‘one giant leap’ to free trade.

Snape (1996a) discusses how the growth of hub and spoke mechanisms could lead to greater resistance to multilateral liberalisation. He argues that each spoke economy has paid a price for its preferential access to the hub economy. The spokes will resist further reductions of tariffs on an MFN basis which erode the value of their special deal on the sensitive products.

For the same reason, the current spokes would also resist, if they could, admission of new members to the arrangement. The value of their preferential access is diminished. While an FTA involving a group of economies might involve all members in the negotiation of the terms of accession of new members, in the hub and spoke arrangement the spokes may have little say in the process of admission. At the very least, the trade policy of the hub becomes a point of potential conflict among current and prospective members of the arrangement.

If spokes did have some influence, they may seek to have new members come in with fewer and fewer benefits. This resistance may come not only from domestic interests in the spoke economies, but also from foreign investors who might have invested in a spoke economy for the purpose of access to the hub. Those investors might even be investors originally from the hub economy, and they will not be without influence in their old home.

In summary, the hub and spoke structure contains many dangers. There are strong incentives for economies that are large enough to try to capture the role of hub economy, for example, in an attempt to dominate a group of complementary economies in their region. But doing so leads to a structure of layers of discrimination and potential conflict. As Wonnacott also points out, there can also be offsetting foreign policy impacts for the hub. A hub economy that was already dominant in economic terms would be seen as trying to add to its position by biasing the rules of the new trading system in its favour.

### ***Rules of origin***

Rules of origin in a regime dominated by the free trade areas become a key focus in international trade. There is scope for ‘trade deflection’ in the hub and spoke system. Depending on transport

costs, goods could be procured in the hub via the spoke with the lowest tariff. The establishment of rules of origin avoids such tariff-hopping in preferential agreements.<sup>13</sup>

The free trade area model will not help deal with border issues. That is, unlike a customs union, it will not be possible to discard border-crossing procedures (Krueger, 1995, p. 13). While these procedures weigh heavily in business assessments of the priorities in trade policy reform, the FTA route will not help them.

On rules of origin, Krueger (1995) stresses the scope to manipulate the rules to achieve degrees of trade diversion. There is great scope to vary the rules. Krueger illustrates the level of detail that is required by reference to the NAFTA experience.

This literature on FTAs also stresses the scope for rules of origin to distort input choices. As Krueger explains, there may be an incentive to procure inputs from a high cost trading partner, or do more of the value adding in that economy, in order to meet the rules of origin of that partner and gain market access for a finished product.

Stephenson (1997) and Scollay (1997) have reviewed the rules of origin in place in the Asia Pacific region. Stephenson argues that rules now in place in the region have significant restrictive effects and she draws on a Pacific Economic Cooperation Council (PECC) survey to report the extent of the burdens imposed on business in the region. Scollay examines the welfare significance of different degrees of restrictiveness of rules of origin. He argues that relaxing the rules will be welfare enhancing provided the relaxation is taken far enough.<sup>14</sup>

As noted above, the scope of the new interest in preferential agreements also includes services. A question is how rules might be applied to the origin of services within these agreements.

This issue has not yet been studied widely. There are some options.<sup>15</sup> The relevant GATS Article, Article 5, stresses that a 'juridical person' of a party to the agreement can access the benefits of a preferential agreement so long as 'it engages in substantial business operations in the territory of the parties to such agreement'. The definition of juridical person (i.e., any legal entity, like a company) suggests its identity would be based on residency in a partner economy and with either majority ownership of the firm providing the service or 'effective control' by persons of that economy. Negotiators involved in setting up the Free Trade Area of the Americas (FTAA) are considering concepts such as ownership, control, residency, and 'substantial business activities' to define origin for services. Clearly, as in the case of goods, there is considerable scope for variation and inconsistency in treatment, and therefore discrimination, in the application of rules of origin for services.

The FTA approach might be driven by different groups of business interests seeking market access, and wanting to avoid problems of trade facilitation or create a higher degree of certainty in the trade. The consequence however can be more complexity and in the end higher costs for business. Conflicting rules of origin in both goods and services are a good example.

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<sup>13</sup> The WTO (1998) reviews the various types of rules of origin used in preferential agreements. The options are a change in tariff heading, a value added rule, or a technical test (e.g., about production processes).

<sup>14</sup> As Scollay explains, it is possible that very tight rules will drive trade to zero so that no diversion occurs. From this point, relaxing the rules a little bit could induce trade diversion to occur, which might actually reduce welfare. Further relaxation makes it more likely the costs of diversion will be reduced. The exception is when the exporting industry is far from being internationally competitive.

<sup>15</sup> More detail on the rules on denial of benefits in services agreements in the western hemisphere economies is available from the trade unit of the Organization of American States at [http://www.sice.oas.org/cp\\_serv/english/sve1\\_21.asp](http://www.sice.oas.org/cp_serv/english/sve1_21.asp)

## *Standards*

There is plenty of evidence of the priority for coordinated policy action to deal with the impediments to international business associated with standards and conformance issues. One example is the report, issued by the Australian Department of Foreign Affairs and Trade, of a Survey of Business Needs for Trade Facilitation (August 1999). The summary of the report noted that concerns about standards issues attracted the highest number of individual comments, particularly the need for mutual recognition of approval processes for new products. Sixty-seven percent of companies (that is, of all respondents) were concerned about harmonising or more closely aligning standards in export markets, with 56 percent (of those commenting on standards issues) indicating this as a top priority for further standards work. Fifty-three percent (of all respondents) had problems with transparency and consistency of requirements, which was a top standards priority for 25 percent (of those commenting on standards issues). Business was also concerned about the cost of testing procedures, delays in testing/authorisation and the need for multiple testing.

Systems of standards can make markets work better. When operated efficiently, they lower the costs of doing business, compared to an environment in which they did not exist. The issue is to find the most efficient systems. There is a further risk, which is that new suppliers can abuse systems for the design and testing of standards in order to limit access.

There are a large number of parameters to be agreed upon in any cooperative approach to setting standards. These include:

- the choice of harmonisation, mutual recognition or other options for the standards themselves;
- the manner in which standards are specified (e.g., product characteristics compared to performance);
- the role of international standards in setting a benchmark and its relevance to all members of a regional arrangement;
- the manner in which conformance to standards is established; and
- which level of government is setting the standards and assessing conformance.

Options for adopting a common standard include harmonisation and mutual recognition. Harmonisation of standards in a region where economies are at different stages of development is difficult because the cost of achieving the standard varies and their communities' demands for products or services or particular qualities vary. There is benefit in maintaining flexibility for this reason.

At the same time, mutual recognition may not be acceptable to all economies in the region. Another may reject a standard accepted by one community of consumers. Mutual recognition is therefore more likely among a group of economies with similar preferences.

An intermediate position is to accept that a range of standards is inevitable among economies, but that if a product or service meets a commonly accepted set of standards, the supplier cannot be denied access to any market in the cooperating economies. This approach avoids an outcome in which individual economies can vary standards to reduce the extent of access to its markets by foreign suppliers.

There are also different approaches to the design of standards. One approach is to specify the characteristics of a product or service in order to achieve a particular level of performance. The other approach is to specify standards in terms of performance itself, not in terms of the characteristics that are expected to deliver a particular level of performance. The latter has advantages: for example, not locking in a particular type of design for a product or service. It promotes the competitive process in terms of innovation.

What standards are the relevant reference points? A common response is that existing 'international' standards should be adopted for this purpose. Such standards are developed by organisations such as the International Organisation for Standardisation (ISO). The issue then is whether economies that have an interest in the standards being adopted have taken the opportunity to be involved in their establishment. The standards setting process so far tends to be dominated by developed economies, in particular the EU members in many cases. Clearly there are strategic advantages in being the architect of the international standards and even if international standards are not immediately adopted by all economies, it is important that all economies have the opportunity to be involved in the process of designing them.

In the context of international transactions, the process of establishing conformance and of resolving disputes can also be a problem. Even if two economies adopted the same standards, the failure by one to accept the conformance processes in the other could become a barrier to trade. Different approaches can also be adopted with respect to assessment. One example is that a government standards body approves all products, and this body thereby accepts the risks associated with errors. For example, upon the discovery of a fault in a product that it has approved, it may be liable for any costs incurred by the damaged parties. The government becomes an insurer of the product or service in that case. At the other extreme, the government plays no role, the parties to the contract agree to adopt a set of standards and any dispute about the failure of the good or service supplied to meet the standard is resolved in the legal system. There are a variety of intermediate positions.

Clearly, the application of a preferential agreement to resolve all these, and other, issues will be a challenge. The outcome will be even more of a challenge to reconcile if one economy is a member of overlapping agreements, which because of the character of their membership, have taken different paths to resolving these issues. An agreement made up of just developed economies might have different preferences to one that involved a more diverse membership.

The key point is that some agreement is required to deal with standards issues. Standards applied to imports of goods or services would be difficult to reform unilaterally. Some agreement is useful on conformity assessment, for example, since otherwise the product or the capacity to provide a service has to be reassessed every time it crosses a border.

The scope for layers of discrimination therefore arises in the manner in which these issues are resolved. The resolution of an apparently simple issue such as conformity assessment could become a new means of discriminating between sources of supply. This already occurs at a sectoral level through bilateral mutual recognition agreements (MRAs) (PECC, 1999)

### *Services*

Dealing with impediments to services business may be another motivation for the use of a regional track. There is a built-in agenda on services in the WTO but progress appears relatively slow.

Sherry Stephenson (2000) has reviewed the treatment of services in a variety of regional arrangements. She examined:

- the ASEAN Framework Agreement on Services (1995);
- the Closer Economic Relations (CER) Agreement between Australia and New Zealand (1989);
- the Free Trade Agreement between Chile and Canada (1997);
- the Free Trade Agreement between Chile and Mexico (1997); and
- the North American Free Trade Agreement (NAFTA) between Canada, Mexico, and the United States (1994).

A review of these agreements highlights some of the issues that will be confronted in the bilateral arrangements now under discussion, and in the proposal to join AFTA and CER.

Stephenson found two broad approaches to services liberalisation in these five sub-preferential agreements that were entered into during the 1990s. One is based on the GATS (that of ASEAN) and the other is based on the approach first adopted in the CER and subsequently the NAFTA (and the Chilean bilateral treaties). The key to this distinction is based on whether the approach to sectoral coverage is a negative- (in the latter case) or positive-list approach.

She notes that neither approach guarantees the full liberalisation of trade in services since exemptions can be taken out in the NAFTA-type arrangement or some sectors just not listed in the GATS-type agreements. While each approach may specify a commitment to liberalisation, that commitment does not mean much without a time frame.

Stephenson also reviews the information and reporting requirements of each approach. She notes that the negative-list approach NAFTA-type agreements provide a great deal of information on barriers to trade, whereas the GATS-type agreements provide less information of this type. More information might be helpful for business planning, and might provide a source of pressure for further policy change. She also stresses that such comprehensiveness comes at a cost. A full negative list requires a lot of specification when significant impediments to services business exist in a number of sectors. It is easier for an economy with a service sector already relatively open to adopt a negative list approach. A negative list approach also means that new activities are automatically covered.

A more immediate issue is how these different approaches might be bolted together or how differences of approach could be resolved in a preferential agreement. One strategy would be to follow the GATS approach to listing, that is, for the negotiators to agree on sectors to be covered and then, in those sectors, all economies prepare their own negative lists which apply within the agreement. The risk is a proliferation of lists of such arrangements that essentially divert access in all modes of supply and therefore allocate rents created by restrictions on other suppliers.

## **NEXT STEPS**

One hope used to be that the sorts of risks outlined so far would be minimised by progress in the multilateral system as it drove down tariffs. The extent of discrimination and its costs would then be reduced. The problem is that there are many mechanisms other than tariffs that can deliver discrimination. Some were mentioned in the previous section and there are others, anti-dumping processes for example.<sup>16</sup>

Are there guidelines for the development of regional arrangements which are targeted on this new range of interests and which will constrain their application and reduce the chance of their capture by particular interests within members of a preferential arrangement? Are there some principles that will direct these preferential agreements towards liberalisation?

It is argued here that immunisation against the tendencies for regionalism to lead to fragmentation in the trading system might be achieved by applying new pressure from above. However given the origins of the pressures for preferential arrangements, including interaction through the sorts of domino effects discussed above, high level rules and unilateral action may not be enough. Some further regional cooperation will help contain the spread of the 'virus'.

With respect to trade in goods, the GATT contains an article that specifies the principles to be met. There are processes in the WTO which review the agreements which are notified to it. The

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<sup>16</sup> Richard Snape (1996b) has argued that far from being yesterday's problem, the question of discrimination in the trading system has considerable relevance.



numbers of notified agreements and their growth were discussed above. So far, the WTO processes have been able to reach consensus on only one of the close to 200 notified agreements, that is the Czech-Slovak customs union. What is the problem?

The article referred to (XXIV) says that members of a customs union or free trade area (or any interim arrangement leading to such arrangements) should not make 'higher or more restrictive' duties and 'the other regulations of commerce' in respect of trade with non-members. Furthermore, in the case of a free trade area, the article requires that 'duties and other restrictive regulations of commerce ...are eliminated on substantially all trade'. A definite timetable for implementation is supposed to be provided.<sup>17</sup>

Crawford and Laird provide a detailed discussion of the problems, include a review of background papers on the issues prepared by the WTO Secretariat (1998). Examples of the problems, to name just a few, are:

- the interpretation of the term 'substantially all trade' (for example, does this mean the share of trade, or coverage of sectors?),
- the definition of the term 'other regulations of commerce' (how extensive is the coverage?),
- the treatment of developing economies, and
- the treatment of transition periods and different time frames for implementation.

The relevant article in the GATS (V) says that groups of members can enter into an agreement liberalizing trade in services between or among themselves as long as it:

- has substantial sectoral coverage,
- provides for the absence or elimination of substantially all discrimination between or among the parties in the sectors covered.

There is also a requirement that the agreement should not raise the 'overall' level of barriers to trade in services with non-members compared to that before the agreement. Developing economies are provided flexibility for meeting the sectoral coverage condition when they are members of an agreement.

Again, there are questions about what is meant by substantial coverage. A footnote to the Article says that this requirement should be interpreted in terms of number of sectors, volume of trade affected and modes of supply and stresses that agreements should not provide for the a priori exclusion of any mode of supply. Even if the parameters could be agreed, that lack of data on trade and investment in services makes it difficult to implement any agreement.

Snape (1996a) notes further that even if the GATT conditions were met it could still be possible for there to emerge a network of preferential agreements which 'would harm the development of a truly multilateral and open trading system' (p. 60). These agreements could set out to be discriminatory, he suggests. They could contain administrative arrangements, of the type discussed above, which increased distortions, even though more formal barriers to trade were reduced.

There are problems are two levels: first, in the interpretation of the rules on preferential agreements in the GATT and the GATS and, second, their relevance to resolving the problems of overlapping, or hub and spoke structures, of the new, or potential, preferential agreements.

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<sup>17</sup> There is also scope to apply tariff preferences on a limited range of products under the so-called Enabling Clause. These agreements also do not require duty elimination, have no fixed timetables, and are not subject to periodic reporting. See Laird (1999)

There have been other suggestions for dealing with these issues. For example, Snape, Adams and Morgan (1993), reproduced in Snape (1996a), proposed that a regional agreement which involved trade preferences would be more likely to promote multilateral liberalisation if it involved:

- Full liberalisation of trade at least in all products if not also in productive factors
- No raising of external barriers to trade and investment on formation or subsequently, and a willingness and capacity to negotiate external barrier reduction after formation
- Homogeneous rules of origin and dispute settlement procedures
- Openness to new members on conditions similar to those faced by existing members.

The first of these conditions, rewritten today, would probably refer to services as well as goods. The conditions have some important features. The willingness and capacity to negotiate external barrier reduction after formation is important to reduce the trade diverting effects, and to reduce, even at formation, the investment diversion effects.

The reference to rules of origin is important in the light of the comments above. The nature of 'homogeneous' in the text above remains to be defined. Crawford and Laird stress that, at present, there are no WTO disciplines on rules of origin. There could be a single set of such rules which members agree to. At least, a set of reference rules could be developed which non-members could use as the basis of a complaint. A review of the existing set of rules and their scope for abuse could be the first step.

The accession clause is also a critical test of openness, a constraint on the extent of discrimination and a powerful signal to non-members about the purposes of the arrangements. Air transport was used earlier as a simple illustration of the consequences of the hub and spoke approach to reform. One solution proposed in that sector has been called an 'open club' model, a feature of which is this accession arrangement. Elek and others (1999) present the details of that proposal. The same sorts of accession rules are being considered within APEC as a device for managing what might otherwise be the discriminatory effects of agreements on trade facilitation issues (e.g., customs clearance arrangements or business mobility).

Could accession reasonably be expected to apply to more wide-ranging regional trade agreements which include a lot of sectors? The difficulty is that creating an agreement with the prospect of guaranteed accession to all on the same terms could undermine the incentives driving the interest in the agreement in the first place. At least there will be a limit to which accession is granted if higher prices cannot be extracted from later entrants.

On the other hand, proxies for the process of accession might be developed. For example, standard clauses for agreements where the scope for discrimination is great could be developed. This standard could include evidence of a long-term commitment to extend preferences to all trading partners, i.e., to liberalise on an MFN basis. Agreements could be assessed by non-members according to whether they used the standard approaches, on matters such as standards, rules of origin, etc.

With respect to services, the commitment in an Annex to the GATS for the Council for Trade in Services to review MFN exemptions could be taken up with some energy. The Annex calls for a review of all exemptions every five years. It also says that any exemption should not in principle last longer than 10 years.

### ***APEC contribution***

There is in addition scope to build mechanisms for review by peers (i.e., non-members) of preferential trade agreements. Within the Asia Pacific, the APEC process is the obvious location for such a peer review process, and that work has begun. The APEC Ministers in their meeting in Darwin said, "We believe that subregional trading arrangements should be consistent with WTO

rules. We believe they should be in line with APEC architecture and supportive of APEC goals and principles". They noted the proposal to survey existing agreements.

The APEC architecture to which the Ministers referred does have something to say about what are called subregional agreements. The Osaka Action Agenda provides for an accession arrangement. With respect to tariffs and non-tariff barriers it proposes a form of accession by suggesting that all members 'consider extending, on a voluntary basis, to all APEC economies the benefits of reductions and eliminations of (these) measures derived from subregional arrangements'. Furthermore, the long-term goal of APEC is free and open trade and investment no later than the year 2010 in the case of industrialized economies and the year 2020 in the case of developing economies. The long-term commitment on external impediments, across the wide scope of the APEC agenda, would undo the discrimination within a subregional agreement. This effect is stressed in the new AFTA-CER study outlined above.

A more immediate opportunity is the scope for APEC to play a role in a breaking the domino process of regionalism. The consultations it promotes can help reduce the concern about exclusion from preferential agreements. It is a forum for comment on the trade and investment diverting effects of such agreements. It could also provide a mechanism for the review of preferential agreements among its members. That evaluation could be based on an agreed set of principles that would ameliorate such disputes.

APEC, through its programs of liberalisation and facilitation, alongside capacity building, can contribute the confidence about market access among the membership that the subregional preferential agreements might otherwise be trying to engineer.

## CONCLUSION

Suppose an economy's trading partners propose a new free trade area, or an extension of an existing area? What is the appropriate response? The net welfare effects to the economy that is invited to join are uncertain, because of the presence of offsetting costs and benefits in this route to reform. The mechanics of the domino effect, however, provides a pressure to join in, especially in the current context of progress at the multilateral level.

A positive response to an invitation might also create other opportunities. Participation provides intelligence on the proposals and it provides a forum to present views, for example, on the trade diverting effects of existing or potential arrangements. In other words, rather than just lining up to 'join the neighbourhood street gang', it might be possible to influence it in a responsible way. Overall, for tactical reasons, it makes sense not to reject such an overture.

The problem is that this sort of tactical participation requires careful risk management and the clear specification of purpose. The risk is that participation for tactical purposes might be misinterpreted, or even captured, in the domestic policy making process. The scope for that to happen has been highlighted in earlier sections of this paper, in terms of the range of instruments available for discrimination. These were not just tariffs, but also rules of origin, procedures applying to standards and so on. The incentives for interest groups to get involved in the negotiating process, in order to capture the rents that become available, was also noted.

The final outcome, and the likelihood of a long-run liberalising result, therefore depends on the expectations which domestic policy makers establish for interest groups that might otherwise see scope for rent seeking via this new route. This signal sent to those groups will depend on the:

- a) clear and coherent presentation and explanation of long term goals of policy making.
- b) adoption of a credible set of criteria for evaluation of proposals (from within and outside the economy) for preferential arrangements: the most credible criteria are those consistent with an economy's interest defined in terms of efficiency objectives.

- c) development of mechanisms that provide transparent reviews and reporting of any initiatives related to these issues, so as to check outcomes against criteria.
- d) extent of cooperative international behaviour, of the types outlined above at global and at regional levels, to reduce the risk of domino regionalism of the narrow preferential type.

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**Table 1: Recent Discussion of Discriminatory Regional Arrangements involving East Asian Economies**

**Singapore/NZ:** Type FTA (agreed in September 1999). It is designed on the blueprint of the NZ/Australia CER, but the agreement is viewed as an open document in which other economies can participate. Negotiations are in progress. One issue appears to be the definition of rules of origin for Singapore products, given the role of Singapore as an entrepôt economy.

**AFTA/CER:** A task force made up of representatives of Australia, New Zealand, and the ASEAN economies is examining the feasibility of an AFTA-CER Free Trade Area. The reports are that the Task Force will recommend that a Free Trade Area combining the AFTA and the CER is feasible and that it would be beneficial to both groups. Its coverage would be comprehensive but the AFTA and the CER would also maintain their own identities. The new arrangement may cover issues not covered by either AFTA or CER, such as e-commerce. It would also be open to accession by other economies or by other regional groupings.<sup>18</sup>

**Korea/Japan:** A joint research effort was established after a visit March 1999 by Prime Minister Obuchi to Korea when he proposed establishing the 'Japan-Korea Economic Agenda 21', the coverage of which appeared to be a new investment treaty, a new tax treaty, cooperation in standards and conformance, an agreement to work on intellectual property issues and further talks leading up to the WTO Ministerial. The broad goal of this program was to 'solidify (the) bilateral economic partnership'. This agenda was interpreted and extended, apparently on their own initiative, by research groups in Korea and Japan to include an examination of the feasibility of a bilateral FTA. The model these groups have studied is comprehensive, including not just tariffs but also rules and standards, investment, and other trade facilitation matters.<sup>19</sup>

**Singapore/Japan:** A proposal was made in December 1999 by Prime Minister Goh and accepted by Japan to study and negotiate an agreement encompassing facilitation issues and some service sector issues. Recent reports refer to the goal of signing an agreement in 2001.

**Japan/Canada:** Japan's Ministry of Trade and Industry has commissioned a study of a proposal for a free trade agreement with Japan. Canadian business groups (see [www.bcni.com/presentations/may15-00.pdf](http://www.bcni.com/presentations/may15-00.pdf)) have argued in its favour. The context is the future of the relationship with the United States, including the evaluation of options such as common external tariffs or common currency. There is also an expectation that a free trade agreement with Japan might maintain market access in East Asia if that region pursues its own 'bloc'. Sensitive sectors identified include the auto and machinery industries in Canada and fishing interests in Japan (see a column by John Wiebe in *The Globe and Mail*, April 19, 2000).

**Korea/Chile:** Negotiations between Korea and Chile on a free trade agreement are in progress. Sensitive issues include Chilean exports of agricultural products.

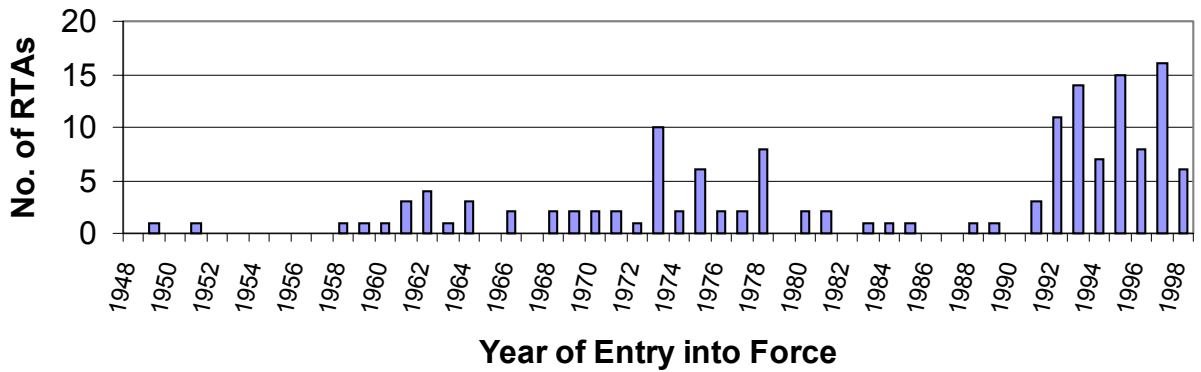
**Singapore/Mexico:** The Singaporean government has announced its intention to sign a Free Trade Area Agreement with Mexico at the time of the APEC Leaders Meeting in Brunei, November 2000. The Singapore Minister for Trade and Industry said that such an agreement would be easy to negotiate since there were 'no agriculture or other sensitive sectors to divide us'. He also expressed the hope that once this agreement is established, others in Asia and Latin America will want to follow.

**Korea/Australia:** A proposal to study an arrangement for a free trade "association" with Korea was made during Prime Minister Howard's visit to Korea in May.

<sup>18</sup> For details, see [www.dfat.gov.au/cer\\_afta/index.html](http://www.dfat.gov.au/cer_afta/index.html)

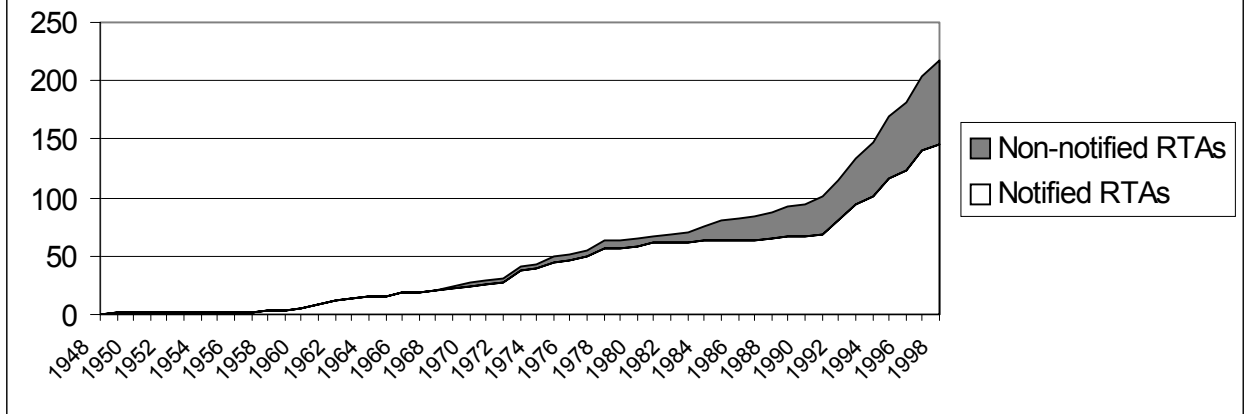
<sup>19</sup> A summary of the research completed so far is reported in a collection of papers prepared by the Korean Institute for Economic Policy and Institute of Developing Economies and the Japan External Trade Organisation for a symposium "Toward a Korea-Japan FTA: Assessments and Prospects", Shilla Hotel, Seoul, May 24, 2000 [also see [www.kiep.go.kr](http://www.kiep.go.kr)].

**Figure 1**  
**RTAs Notified to the GATT/WTO under Article XXIV**  
**and the Enabling Clause (1948-1998)**



Source: WTO (1999)

**Figure 2**  
**The Evolution of Notified and**  
**Non-notified RTAs (1948-1998)**



Source: WTO (1999)



**Table 2: Merchandise imports of members of selected preferential trading arrangements, 1990 to 1998**

Agreement	Trade flow	Value in 1998 (\$USb)	Share in total imports		Growth rate 1990-1998
			1990	1998	
<b>EU</b>	Intra-	1233	63.2	60.0	2.9
	Extra-	822	36.8	40.0	4.7
<b>NAFTA</b>	Intra-	509	33.3	40.2	11.0
	Extra-	757	66.7	59.8	7.0
<b>AFTA</b>	Intra-	50	14.3	19.4	10.7
	Extra-	209	85.7	80.6	5.7
<b>CER</b>	Intra-	5	7.4	6.7	3.3
	Extra-	65	92.7	93.3	4.6
<b>Mercosur</b>	Intra-	21	14.5	21.2	22.0
	Extra-	78	85.5	78.8	15.2
<b>Andean</b>	Intra-	5	6.8	11.7	20.6
	Extra-	40	93.2	88.3	11.9
<b>World Trade</b>		5600			6.2

Source: International Economic Data Bank, Australian National University

**Table 3: Import and export intensities of selected preferential trading arrangements, 1990 and 1998**

Agreement	Trade flow	Import intensity		Export intensity	
		1990	1998	1990	1998
<b>EU</b>	Within group	1.38	1.49	1.45	1.67
	With row	0.68	0.67	0.63	0.61
<b>NAFTA</b>	Within group	2.09	2.23	2.19	2.29
	With row	0.79	0.73	0.72	0.62
<b>AFTA</b>	Within group	3.38	3.30	3.99	4.18
	With row	0.89	0.86	0.86	0.85
<b>CER</b>	Within group	5.35	5.95	5.20	6.74
	With row	0.94	0.94	0.94	0.93
<b>Mercosur</b>	Within group	10.23	14.10	10.49	14.26
	With row	0.87	0.80	0.92	0.76
<b>Andean</b>	Within group	7.01	16.44	8.32	17.91
	With row	0.94	0.89	0.96	0.86

Source: International Economic Data Bank, Australian National University

row = rest of the world

# DEVELOPMENT ISSUES ARISING FROM LARGE ECONOMIC SPACES: OPTIONS FOR DEVELOPING COUNTRIES

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## ABSTRACT

*In the late 1980s and early 1990s, in parallel to the GATT negotiations under the Uruguay Round, many economies entered into trade negotiations aimed at the formation, revitalisation or extension of regional trade agreements (RTAs). Some developed economies have consolidated their existing regional integration mechanisms going well beyond 'shallow integration' (such as 1992 EU Common Market) while other economy groups have created new or are currently involved in RTA formation. Recently, new RTAs are initiated by economies that had traditionally been the main proponents of the multilateral approach under GATT (Japan, Korea, Singapore and other economies in East Asia). This paper reviews the main issues concerning the impact these new developments on developing economies with regard to market access and deep integration measures. The paper tries to identify several analytical issues and policy guidelines that are necessary to ensure that developing economies will benefit from trade liberalisation at regional level.*

## 1. RTAs ARE HERE TO STAY AS A PERMANENT FEATURE OF THE INTERNATIONAL TRADING SYSTEM

The integration process has progressed rapidly in many regions, especially in Europe and the Western Hemisphere. Regionalism, defined as both an increase in intra-regional trade flows (Table 1) and the number of regional trade agreements (RTAs) has intensified over the last decade. Currently the number of RTAs exceeds the number of World Trade Organisation (WTO) members and the trend towards increased regionalism appears to be continuing. This process became manifest with the effective entry into force of the North American Free Trade Agreement (NAFTA). The "deepening" of European Union (EU) integration through the Single Market program, European Monetary Union (EMU) and the "widening" of integration towards the East took place in a very short period. The economies in transition in Central and Eastern Europe have also adopted an active approach to regional integration, not only *vis-à-vis* the EU but also among themselves. The EU also has plans and in some cases has concluded free trade agreements with certain Commonwealth of Independent States (CIS) economies, with Mediterranean economies, MERCOSUR, South Africa and Mexico. Outside the EU framework, the other prominent cases are RTAs involving at least one Latin American economy. Twenty-two new agreements are expected in that region. The most active economy is Chile, which intends to conclude ten more agreements, followed by Mexico with six, and MERCOSUR with four (table 2).

Furthermore, the integration process has moved beyond the regional level to become inter-regional. New inter-continental integration projects with potentially significant impact on global trade and investment have been proliferating. APEC economies have agreed to achieve free and open trade and investment by 2010 (2020 in the case of developing economies) (United Nations Educational, Scientific and Cultural Aid Program [UNESCAP] 1998). In the Western Hemisphere, a Free Trade Area of the Americas (FTAA), comprising 34 economies from Canada

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to Argentina, is in the making, with negotiations to be completed no later than 2005 (Aninat 1996; Devlin, Estevadeordal and Garay 1999). The EU's widening of integration, as stated above, has extended to economies and regions outside of Europe. Also, discussions have been revived regarding freer transatlantic trade between the EU and the USA (European Commission 1999). All these regional integration arrangements account for a large share of total world trade (Chart 1). APEC accounted for almost 44.26 percent of total world trade in 1998 while the EU and NAFTA shares were 38.8 percent and 20.54 percent respectively. Based on the same 1998 trade figures, prospective FTAA members accounted for 24.07 percent of total world trade. This trend towards the formation of large economic spaces thus becomes an important development for non-member developing economies. One obvious reason for this is that these large regional economies represent major export markets for developing economies (table 3). For more than 30 developing economies large economic spaces such as the EU and the NAFTA absorb more than 70 percent of their exports.

In parallel, regional integration agreements among developing economies have expanded, increased and in general gained new momentum. Impetus was to some extent provided by the dramatic liberalisation of import regimes in developing economies consequent to structural adjustment programs. In Latin America, MERCOSUR and the Andean Community have moved rapidly ahead with the implementation of their programs to liberalise mutual trade and establish customs unions. Furthermore, a whole network of bilateral agreements is under formation among economies and groupings within and across regions. In Asia, ASEAN has accelerated the implementation of its free trade area in goods and started work on liberalising trade in services. In the Pacific, several economies have formed a free trade area within the Melanesian Spearhead Group and the Pacific Forum has agreed to form a free trade agreement. In Africa several groupings have been engaged in major revisions and restructuring of integration such as UDEAC into CEMAC, and others are intensifying sub-regional integration such as SADC's adoption of its trade protocol in February 2000 (calling for the formation of an FTA within eight years), and the expected entry into force of the COMESA FTA in October 2000.

The new dynamism in RTAs points to certain emerging results in the system of international trade relations. Some of these are the following:

- The creation and rapid expansion of large economic spaces seems set to remain a lasting feature of international economic relations;
- Mixed RTAs (North-South RTAs) with reciprocal commitments between developed and developing economies are becoming more frequent in all regions;
- RTAs are increasingly expanding to other regions and becoming more complex interregional integration systems with various grades and types of association such as APEC, EU-MERCOSUR etc.; and
- Some of the new or revived projects would combine substantial economic power and would exert a major impact on third economies and on the functioning of the multilateral trading system.

## **2. REASONS FOR RTA PROLIFERATION**

The failure to launch a new Round in Seattle has led many observers to the conclusion that regionalism will replace the incentives to seek a fresh start for a WTO Round (Palmer, 1999; Bergsten, 2000). While this may be true to some extent, it should also be mentioned the importance of pre-existing factors this shift toward a "multitrack" commercial policy (multilateralism, regionalism and unilateralism) during the 1990s. The introduction of the famous "Super 301" clause in a 1988 trade bill, which gave the US president the authority to retaliate

against what Washington deemed to be unfair trading behaviour, combined with the championing of the NAFTA and other regional trade measures, signalled that America was abandoning its unreserved commitment to multilateral cooperation (Gilpin 2000).

Although the Uruguay Round (UR) gave a new impetus to the multilateral trading system, these changes in strategy showed that RTAs are still a means to overcome barriers to trade beyond what could be achieved within the WTO. This is evident in those RTAs that aim at liberalisation beyond the multilateral level in sectors such as telecommunications, air transport, government procurement, and harmonisation or mutual recognition of standards and, to a lesser extent, in agriculture, textiles and clothing, important export sectors for developing economies.

Another explanation for the multiplication of RTAs lies in the changing nature of economic integration. Regionalism has moved far beyond pure trade/tariff or market integration in the form of free trade areas or customs unions. Integration has now become much deeper, much more multifaceted and multi-sectoral, encompassing a wide range of economic and other political objectives (Bora and Findlay, 1996; Whalley, 1996). New RTAs placing emphasis on liberalisation of services, investments and labour markets, government procurement, strengthening of technological and scientific co-operation, environment, common competition policies or monetary and financial integration. These are decisive components of the NAFTA, the FTAA, APEC, the EU and its partnership agreements, and agreements among developing economies.

Yet another rationale, among developing economies in particular, for entering into mixed agreements with their main developed trading partners is to open up these markets for sensitive products by removing tariff peaks or non-tariff barriers. The value of this improved market access is nevertheless reduced by other measures that remain in place among RTA members, especially anti-dumping and safeguard measures. So far only one mixed regional agreement has abolished antidumping actions among members: the 1997 Canada-Chile FTA (Niels and Kate 1997). Furthermore, in those cases where anti-dumping actions between RTA members are left in place (Table 4), there is little evidence that the RTA as such contributes towards the elimination of anti-dumping cases among RTA members (Hoekman 1998).

RTA formation also enhances expectations for attractiveness of foreign investment and increased technology transfers. As part of the price to pay for such benefits, developing economies are frequently assuming commitments as stringent as their developed partners (apart from some longer transition periods). Developed economies, on the other hand, appreciate 'mixed arrangements' (RTAs among developed and developing economies) through which they can obtain reciprocal advantages for their trade and investment, which are not available through traditional unilateral preferential trading arrangements with developing economies.

Finally, customs union theory states that economies, especially small and medium-sized economies, can reap significant economic advantages from RTAs that create economies of scale and other efficiency gains (Balassa, 1989; El-Agraa, 1996). These include benefits in terms of increased competitiveness, more efficient allocation of regional resources, or significant stimulation of investment, production and diversification, and trade growth owing to the creation of the wider regional market. The regional market may also provide a training ground and learning process for the businesses and governments of the member economies before engaging in highly competitive and complex international markets. This conclusion is not fully compatible with the static comparative advantage theory suggestion that neighbouring economies are unlikely to be internationally competitive in a large number of products covered by an RTA, a conclusion that would limit the number of cases where small developing economies RTAs are predominantly trade creating.<sup>1</sup> However, in recent years, CGE models employed in studies of regional

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<sup>1</sup> This conclusion is further strengthened by the argument that in the case of small economies the assumption of unlimited capability and constant costs is unrealistic.

arrangements brought empirical evidence showing that classical economic theories do not provide infallible predictions on regionalism. Scollay (2000a and 2000b), for instance, looking at the prospective regional agreement among the Pacific islands (PARTA) has shown that, under certain conditions, even an RTA among small, neighbouring developing economies may become welfare improving.

While CGE modelling needs further improvement, these studies show that regional integration can provide a stepping stone for the integration of its members into the global economy. Customs unions and deeper regional integration schemes can also assist members in co-ordinating their negotiation positions in international or multilateral trade negotiations and, provided that internal co-ordination is fast and efficient. This promise of the possibility of unlocking significant economic benefits for member economies and strengthened preparation for participation in global trade and commercial diplomacy is a traditional motivation underpinning RTAs that remains valid.

### **3. IMPACT OF RTAs ON DEVELOPING ECONOMIES**

Both the impact of these RTAs on third economies' access to the corresponding regional markets and their implication for the international trading system were among the main issues that have been examined at length.

In terms of the international trading system (the systemic implications), the concern is that the proliferation of RTAs may lead to an erosion and possible fragmentation of the multilateral trading system into some kind of federal system composed of semi-autonomous 'stumbling' trading blocs. This concern has led to debate over regionalism versus multilateralism, and whether the former is a "building block" or a "stumbling stone" towards the latter<sup>2</sup>. The effect of such fragmentation would be bigger on small exporting economies, especially developing economies. So they have a clear stake in the strengthening of the multilateral trading system. The trend towards the promotion of regional economic spaces, in particular among or involving the large industrialised trading economies, has raised concerns among non-members and developing economies in particular. The concerns about market access stem from the fear that negative trade and investment diversion effects of these RTAs would predominate over the positive trade and investment creation effects on third economy.

#### **3.1. TARIFFS AND MARKET ACCESS ISSUES**

Market access for developing economies will become more difficult as large integration systems enlarge to include new members or when free trade benefits are extended to newly associated economies with important supply capacities in products competing with those of developing economies. Trade diversion risks depend less on whether an agreement between developing or developed economies and more on relative prices of exportables between RTA members and third-economies (De Rosa 1998:12). The risk of trade diversion may be aggravated as new members take over common external tariffs, common quotas or common sectoral policies. Benefits accruing from the reduction of protective levels by new members are, in turn, likely to accrue mainly to regional suppliers, as they enjoy the far bigger advantages of full liberalisation.

Several studies have examined the ways regionalism affects incentives (both at international and domestic level) to engage in multilateral negotiations (World Bank, 1999). The relationship between regionalism and the incentives for multilateral liberalisation is also particularly important since the two are interrelated. There is strong empirical and theoretical evidence that the net

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<sup>2</sup> For a good survey of the literature on this debate see Bhagwati and Panagariya (1996) and Winters (1996). Other authors examining the issue of whether the formation of a regional arrangement leads to a higher or lower protection with respect to the outside countries are Panagariya and Findlay (1996), Bagwell and Staiger (1997), Krishna (1998), and Levy (1997).

balance between trade creation and trade diversion effects depend on the level of barriers towards external trade. Liberalisation commitments in regional schemes may affect the capacity to progress faster with MFN liberalisation, particularly if the regional market is to absorb the entire export supplies of an agricultural commodity of a member economy or if rapidly increasing export capacities in textiles and clothing products benefit from an accelerated liberal schedule.

Pre-Uruguay Round estimates by UNCTAD of the *ex ante* effects of large integration systems, such as the Single European Market or the NAFTA, suggest that the net effects would be small for developing economies as a group. While trade diversion could be significant, trade creation effects deriving from accelerated growth in the integrated economies would by and large compensate for it. However the net effects depend on the assumptions made in models regarding price and income elasticities. Also, these effects could be quite different for different types of developing economies, depending on their commodity patterns of exports and their capacity to benefit from the spill-over effects of accelerated growth in the integrating economies<sup>3</sup>.

While the tariff reductions of the Uruguay Round will be more significant for trade of developed economies, i.e., about half of the pre-Round MFN rates, they will nonetheless reduce significantly developed economies' MFN rates for imports from developing economies (and economies in transition). The average MFN rates for industrial products should fall to between 3.7 percent (USA) and 7.1 percent (Canada). Also the total removal of tariffs (zero-for-zero) for steel, pharmaceutical, beer, furniture, pulp and paper, construction and agricultural machinery, toys and various other products will essentially remove the risks of trade and investment diversion for those exporters which can effectively compete in EU and NAFTA markets (UNCTAD 1997:3-7).

As most developing economies (and economies in transition) enjoy duty-free entry under the general system of preferences (GSP) for a large number of their industrial products, the effective reduction of risks of trade diversion will relate more to products not covered by that scheme or which only benefit from small GSP margins. Average post-Round tariffs for such products will remain on average at about 12 percent *ad valorem* (some 10 percent of the tariff universe of Quad), with tariff peaks attaining 20 to 30 percent (and more) for individual products of the food, footwear or clothing industries (14-20 percent of the tariff universe of Quad). The risks of trade diversion will be smaller if these highly protected sensitive sectors are also liberalised.

In specific sectors of particular export interest to developing economies, which correspond to a large extent to "sensitive" products, the risks of trade diversion will remain significant over the short- and medium-term. They account for an important share of many developing economies exports to the NAFTA and the EU. The reduction of the level of protection through tariff cuts or quota elimination is small in the short- and medium-term for temperate zone and Mediterranean agricultural products, fishery products, clothing, textiles, shoes, leather and leather goods, and some industrial products (including many low-tech manufactures) (Finger and Schuknecht, 1999).

Clothing and textiles producers are still protected by high tariffs and stringent quantitative restrictions in imports from developing economies. The preferential rates for clothing under the EU's GSP scheme is less than 11.9 percent. The US excludes most textiles and clothing from its GSP scheme and its MFN rates range from 14 to 32 percent for most synthetic, wool and cotton clothing. Canada applies MFN rates of 18 percent. Japan's GSP rates range from 6 to 11 percent.

Developing economies' footwear, leather and leather goods face high tariffs in the developed economy markets. The US has no GSP preferences for these products. Its MFN rates range from 38 to 58 percent for certain sports shoes (made from rubber, plastic or textiles). Canada also has no GSP preferences for these products. Its MFN rates range from 16 to 20 percent for all footwear. In the EU, the GSP rate for these products is 11.9 percent and the MFN rate is 13

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<sup>3</sup> This section is based on an UNCTAD/WTO Joint Study 'The Post-Uruguay Round Tariff Environment for Developing Country Exports'.

percent. The Japanese MFN rates reach 30 percent for all leather, 140 percent for a pair of leather shoes priced at US\$25 and GSP imports are subjected to a ceiling.

Peak tariffs are frequent for agricultural products, particularly dairy products, sugar and cocoa, canned fruits and vegetables. Agricultural tariff peaks are quite high, exceeding 60 percent, for those products that are subject to tariffs. These include:

- in the EU: chilled bovine meat (86 percent), frozen (boneless) bovine meat (215 percent), grape juice (215 percent), fresh bananas (180 percent), milk with less than 3 percent fat (113 percent), milk powder without sugar (66 percent) and milk powder with sugar (54 percent), maize (84 percent), wheat (84 percent), dried manioc (75 percent), raw cane sugar (73 percent), white sugar (71 percent) and smoking tobacco (75 percent);
- in the US: stemmed and stripped tobacco (350 percent), smoking tobacco (310 percent), shelled or roasted ground-nuts (132 percent), peanut butter (132 percent); milk with less than 3 percent fat (66 percent), milk powder without sugar (55 percent) and milk powder with sugar (179 percent);
- in Canada: whole, frozen chicken meat (238 percent); milk with less than 3 percent fat (241 percent), milk powder without sugar (243 percent) and milk powder with sugar (243 percent); raw cane sugar (70 percent), white sugar (70 percent); and
- in Japan: frozen pork (66 percent), prepared pork hams (110 percent), milk with less than 3 percent fat (280 percent), milk powder without sugar (80 percent) and milk powder with sugar (85 percent); dried peas (640 percent), dried beans (460 percent), maize (60 percent), milled rice (550 percent), shelled ground-nuts (550 percent), raw cane sugar (73 percent), cane molasses (95 percent), prepared or preserved pineapples (110 percent), coffee preparations and extracts (130 percent), and tea preparations, essences and extracts (180 percent).

Also, tariff escalation will maintain a significant level of effective protection for certain food-processing industries and leather and shoe industries (UNCTAD 1997: 9-11). For consumer electronics, steel and metal products, the risk of anti-dumping duties being imposed will remain, in which case the significance of tariff reductions will be reduced. The decline in GSP margins of preferences, the removal of GSP benefits for certain products of specified economies, complicated and disparate rules of origin requirements and the progressive graduation of developing economies out of GSP may even result in an increase in effectively applied tariffs on imports from developing economies into the EU, the NAFTA and the Australia New Zealand Closer Economic Relations Agreement (ANZCERTA) markets.

For example, the NAFTA and the EU absorb more than 70 percent of the total exports of such developing economy outsiders and Bangladesh, El Salvador, Dominican Republic, Tunisia and Uganda (see Table 3). Many of these developing economies remain highly dependent on sensitive products. Their exports are heavily concentrated in a few products that remain subject to relatively high duty rates, quotas and anti-dumping and countervailing actions. Furthermore, certain products are frequently excluded from GSP benefits (such as textiles in the US scheme). The share of exports of sensitive products to the NAFTA and the EU exceeds one-third of total exports (excluding fuels) for economies like Bangladesh, Costa Rica, Pakistan, Honduras and Sri Lanka.

Once the Uruguay Round results have been fully implemented (in 2005 for most WTO members), the risks of trade diversion for developing economies should generally be reduced. However, until then the above arguments suggest that the aggregate effect of incomplete multilateral

liberalisation and spreading regionalism is likely to diminish the options for diversification of markets and products of developing non-RTA economies.

### **3.2. DEEPER INTEGRATION: RTAs AND THEIR EFFECTS ON 'BEYOND THE BORDER MEASURES'**

In recent years, both multilateralism and regionalism evolved to steps towards integration that go beyond tariffs or non-tariff border measures. Deep integration defined as 'beyond the border measures' (Lawrence, 1996; Mikesell, 1963) are becoming an essential feature of both globalization and regionalization and therefore it affects our understanding of regionalism. The implication of large RTAs for areas other than tariffs includes some of the more important and also complex issues related to regional technical product standards, sanitary and phytosanitary standards and environmental standards, which may imply substantial adjustment costs for developing economy producers. This will be felt particularly if the standards become more restrictive than those applied previously by the individual member economies of the large RTAs. Any tightening of standards may increase difficulties for developing economies to stay in the market or to enter it. On the other hand, such tightening of standards may increase costs for regional producers (to meet the standards) and bind significant investment and financial resources. Preferential opening of government procurement in favour of member economies also gives rise to regional import substitution to the detriment of non-members. Furthermore, regional cooperation for technological development and research or training may, if limited to members, reinforce existing gaps between the levels of human and technological development reached within the RTA and that of other developing economies. Common research policies are unlikely to take into account concerns of the developing economies, for example, projects for development of new substitute material for raw materials produced by developing economies (Balasubramanian, 1991).

The effects of large economic areas may also be felt in the services sector. The long distance flights of regional airlines will be more competitive than those of a developing economy's airline if they can collect passengers from various member economies. The "One World" network of airlines centred on British Airways is one example. In those RTAs where labour movements are strong, market access for developing economies' workers will become more difficult to the extent that developed economies maintain overall ceilings on access of foreign labour and immigration which will be reserved primarily for citizens from member economies of the RTA. Common rules and procedures for immigration within a large RTA may further tend to reduce access developing economies' labour, if visa and immigration controls are extended to a larger number of third economies and are also applied by hitherto more liberal member economies. On the other hand, tightening the application of labour standards within large RTAs may reduce the international competitiveness of a member economy.

Integration within large RTAs in new areas may, however, also bring about positive development effects. The creation of a monetary union, in principle, imparts stability in the regional economy and contributes to reduce exchange rate fluctuations. A common currency will furthermore reduce transaction costs for trade and payments within the RTA. This will primarily benefit regional enterprises, although third economy firms trading grouping-wide will also benefit. Furthermore common development policy within an RTA, like that of the EU under the Treaty of Maastricht, should lead to a strengthening of the RTA's overall development instruments for greater effectiveness. The enlargement of the EU to include Greece, Portugal and Spain has simulated closer co-operation between the EU and Latin American economies while the three new member economies widen the market and financial basis for co-operation between the Union and developing economies.

In the short term, the Uruguay Round may have little effect on investment, though over time incentives to invest in a member economy of a large grouping in order to jump tariffs and other barriers may be somewhat reduced. However, the Uruguay Round results have significantly



changed the environment in which developing economies design their industrial policies (Bora, Lloyd and Pangestu 2000). Other incentives for investment, such as rationalising multinational enterprise production or market proximity will remain strong attractions. Barrier-induced investments will, however, tend to diminish over the longer term, once quantitative restrictions on trade in textiles are phased out, and the programmed further negotiations on agriculture and services have brought about significant additional MFN liberalisation.

The implications of the expansion of large integration systems are likely to evolve substantially over the longer term. After 2010 when most of these large RTAs will have completed the implementation of their integration programmes, the structural effects of integration are expected to become manifest. They could include scale and efficiency effects; strengthened alliances and restructuring of enterprises; and the redesign of corporate strategies on a region-wide scale. They are expected to alter investment and production patterns within the integration systems, and hence the sectoral composition of future production, trade and international competitiveness. This type of effect may ultimately be the main change which third developing economies would face in their relations with the large RTAs.

In the longer term both the large economic spaces and the multilateral framework will probably change considerably. A rapid further expansion of large integration systems is already programmed. They will expand substantially in trade, investment, financial and monetary coverage. This raises the question of whether all of these new initiatives do not ultimately reflect a need to accelerate the process of multilateral negotiations in the fields in which these integration projects fall. These fields, such as agriculture, textiles, services, government procurement, environmental and technical standards, and investment liberalisation and cooperation, are ones where the Uruguay Round had brought modest immediate results. Such areas would appear to remain difficult to negotiate between partners which faced these same difficulties during the Uruguay Round, even if such negotiations were to be put into a “bilateral” context within an RTA. In turn, the multilateral trading system has also proved its capacity for further development and gradual, step-by-step improvements. Further elaboration of the multilateral trading system could provide developing economies with important advantages for defending their interests *vis-à-vis* partners with stronger bargaining power.

#### **4. DEVELOPING ECONOMIES’ OPTIONS FOR DIVERSIFICATION OF PRODUCTS AND MARKETS**

The importance of economic integration among developing economies as a policy option for fostering development and overcoming the constraints of small domestic markets has been recognised already (Bhagwati and Panagarya, 1996; Schiff, 1996). Strengthening sub-regional and regional integration among developing economies through deeper integration remains an option for smaller and medium-sized developing economies, since there are potential advantages which developing economies might expect to derive from scale and competition effects. Similarly, for developing economies, integration into the regional economy may be a ‘stepping stone’ to future integration into the world economy. Achieving the objectives of fully WTO-compatible regional integration may also become an intermediate step for developing economies towards the implementation of WTO commitments.

On the other hand, it has to be said that only relatively few integration groupings among developing economies have effectively achieved their integration objectives. Most RTAs among developing economies are still in the realm of shallow integration (understood as the removal or reduction of border measures), with little progress towards deeper integration. Even when the latter becomes a priority, often incomplete shallow integration limits the prospect of deeper integration. Consequently, significant economic advantages from integration have rarely been reaped in terms of export diversification, increased international competitiveness, more efficient allocation of resources, or significant stimulation of production and investment in the region (Yeats, 1998; Foroutan, 1993; Nogues and Quintanilla, 1993).

These potential benefits justify the renewed interest of developing economies for strengthening sub-regional and regional integration among developing economies. Some developing economies have become members of two or more RTAs. Some developing economies have already become aware of these tensions. Tanzania, for example, is a member of the EAC, the COMESA and the SADC. Simultaneous membership of several integration systems broadens the development option and minimises the implications of multilateral liberalisation and disciplines. But multiple membership may raise problematic issues of compatibility between different systems, increase administrative burden of following the obligations in different RTAs, increase financial burden of membership fees and others, and give rise to conflicts and constrain the economy to avoid discrimination between partners of different groupings. Reasoning along this line led Tanzania to announce in 1999 its withdrawal from COMESA as of October 2000.

In some cases, another option for outsiders would be to join a larger grouping as is happening in the NAFTA and APEC giving rise to the phenomenon of “mixed RTAs” i.e., regional economic systems with membership including both developed and developing economies, each assuming basically similar obligations. In mixed RTAs issues of implementation capacity, asymmetry, reciprocity and traditional concerns about particularly sensitive product sectors render negotiations of the mixed agreements difficult. They become even more difficult when potential new partner economies have a large production capacity for sensitive products such as staple foods, fruit and vegetable products, clothing or textiles. Overall, when contemplating the formation of mixed RTAs developing economies should balance the effects of ‘deep integration’ commitments (labour, technical and environmental standards) with those of liberalising trade in sensitive products and removal of non-trade barriers. In principle, mixed groupings with major trading partners should open wider prospects for trade and investment for developing economies than those available to them from sub-regional groupings with neighbouring developing economies, and, hence, better prospects for growth and development (Whalley, 1996). Such groupings can also be expected to provide improved stability of access to product and factor markets. Furthermore, a strongly integrated regional grouping may be a prerequisite for effective negotiations and advancement of the trade interests of developing economies with a developed partner (World Bank 1999: 14-17).

A more specific response to large integration systems is to encourage domestic enterprises to invest or establish affiliates within such groupings from which they can serve the whole region. In that way they can avoid barriers such as common external tariffs, and at the same time benefit from the advantages of a large market with common standards, rules and regulations. Of course this option is dependent on the existence of large and competitive enterprises in developing economies with investment funds.

Certain developing economies and economies in transition have been able to take advantage of mixed integration arrangements with major developed economies. Mexico has also been able to expand both its trade and investment to the US and Canada in the first year of its membership in the NAFTA. Turkey, Cyprus and Malta for example, have expanded their exports to the EU at faster than average speed in the first years of their RTAs. This example of EU hub-and-spoke regionalism (Cernat, 2000; Wonnacott, 1990) illustrates another aspect of overlapping membership. Smaller economies that are linked to larger economic spaces (like Turkey, Malta or Cyprus) have seen their market access eroded in the 1990s as economies in transition from Central Europe have taken advantage of their RTAs with the EU (Table 5). Although there is no evidence of causal links between the two trade patterns, the data suggests that erosion of trade preferences acquired through an RTA can be very substantial, once regional integration brings in new members.

Apart from uncertainties about the effective advantages and risks involved, the choice of joining a larger economic system may, however, not always exist. Developed economies have also been more inclined to enter into mixed groupings because of their advantages over traditional non-

reciprocal preferential trading arrangements with developing economies (reciprocity of advantages regarding market access, liberalisation and guarantees for investment, protection of intellectual property rights, or adherence to environmental and labour standards). However, the capacity and readiness of a deeply integrated RTA to absorb new members may be limited for economic, financial or institutional reasons. Furthermore, it sometimes proves as difficult to negotiate full liberalisation of sensitive products in an RTA or an association agreement (for example, the exclusion of agricultural products from EU association agreements with Eastern European economies and from the FTA with South Africa) as in multilateral trade negotiations.

For developing economies, conditions of fairly strict reciprocity presuppose that the applicant economy has already attained a high level of international competitiveness and maturity of its productive structures in order to be able to face intra-grouping competition and to forego a number of development policy instruments. Owing to this reciprocity aspect, mixed groupings may not be a feasible option for several developing economies, apart from the relatively advanced open economies. Even if a certain postponement of their liberalisation commitment is granted, it will be difficult for many developing economies to reach full competitiveness with major trading economies within the customary 10 years (as defined by the WTO (GATT Article 24 and the Understanding). In this context, it is essential that developed member economies provide, as part of such mixed RTAs, financial assistance and support to investment and technological cooperation and enterprise development in order to facilitate the necessary adjustment and raise the industries of developing economy members to comparable levels of competitiveness. Otherwise, economic integration among unequal partners could accentuate imbalances and polarisation.

Lastly, developing economies might consider exploring the possibilities of further progress along the multilateral route. Developing economies should actively prepare for the scheduled multilateral negotiations on the further liberalisation of agriculture and services. They may also seek to defend their rights in the WTO when access barriers increase when individual economies accede to RTAs. For that purpose they ought to be able to draw on technical advice. This will become more and more important as the memberships of the large integration systems expand.

## **5. FURTHER ANALYTICAL ISSUES**

Despite sustained research efforts, both the political and economic rationales behind the formation of RTAs continue to be debated (DeRosa 1998). Given the complexity of the issues surrounding the effects of and motivations for RTA formation, there is no one single conclusion regarding regional integration arrangements. It is difficult to say in precise terms and figures what these large RTAs among major trading economies portend for developing economies as a whole, for different groups of developing economies, or for individual developing economies. Most RTAs are still in the process of being established, implementing aspects of trade liberalisation provisions that will lead to free trade within a certain period of time ( mostly around 2005 to 2010) and precise data on trade within RTAs affected by liberalisation provisions of RTAs is not readily available. Therefore, the impacts of regionalism depend critically on the specific conditions surrounding each agreement. Notwithstanding these difficulties, RTAs can complement the multilateral trading system, provided they do not become vehicles for import-substitution industrialisation. They can do so if the new generation agreements are outward oriented, and if the WTO rules on RTAs formed by the industrialised economies are made clearer to minimise the inward-looking bloc orientation of RTAs. The former depends on the members of the RTAs, the latter depends on the members of the WTO.

Consequently, some of the development issues of large economic spaces are as follows:

- To what extent are concerns about possible trade or investment diversion still valid after the implementation of the Uruguay Round results, and how can these concerns be adequately addressed?

- How can developing economies benefit from advantages offered by large economic spaces?
- What are the likely effects of closer economic integration in areas/sectors outside the scope of the WTO?
- How do the combined effects of the rapid spread of large integration systems affect the development prospects of developing economies?
- How is the situation likely to evolve from 2005 to 2010 when the Uruguay Round results will be fully implemented for most WTO members and when many large integration systems will have achieved most of their stated objectives of integration?

One final point that should be made is that any attempt to tackle the impact of regional economic integration should be able to distinguish between trade creation, trade diversion and external trade creation. It should also be 'analytic' in the sense that any interpretation of post-integration outcomes should be based on sound economic explanations. While carrying the analysis at the appropriate level of aggregation, further research of RTA formation should take into account the effects of economic integration in an interdependent world.

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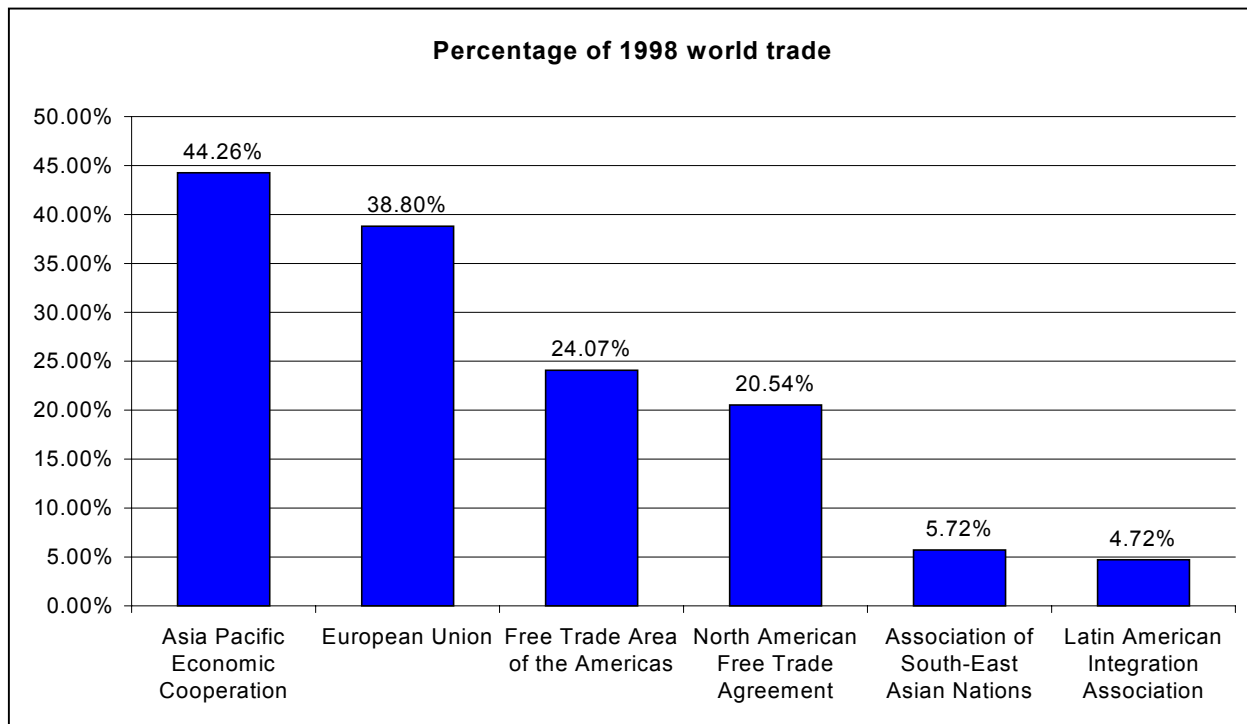
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## ANNEXES

### CHART 1. LARGE ECONOMIC SPACES AND THEIR SHARE OF WORLD TRADE



Source: UNCTAD Handbook of Statistics 2000





**TABLE 1. INTRA-REGIONAL EXPORTS (IN PERCENTAGES OF WORLD EXPORTS)**

<b>REGION</b>	<b>1970</b>	<b>1975</b>	<b>1980</b>	<b>1985</b>	<b>1990</b>	<b>1991</b>	<b>1992</b>	<b>1993</b>	<b>1994</b>	<b>1995</b>	<b>1996</b>	<b>1997</b>	<b>1998</b>
<b>Asia Pacific Economic Cooperation</b>	55.70%	53.38%	54.53%	65.87%	65.55%	65.49%	66.02%	67.89%	70.07%	69.21%	66.17%	66.03%	63.78%
<b>European Free Trade Association</b>	1.47%	1.41%	1.07%	1.02%	0.79%	0.74%	0.88%	0.85%	0.81%	0.74%	0.80%	0.79%	0.90%
<b>European Union 15 Economies</b>	59.47%	57.73%	60.82%	59.18%	65.93%	66.76%	66.72%	61.59%	61.88%	62.41%	61.38%	55.73%	57.20%
<b>North American Free Trade Agreement</b>	36.01%	34.56%	33.62%	43.92%	41.39%	42.24%	43.65%	45.83%	47.97%	46.24%	47.63%	49.10%	51.69%
<b>Andean Group</b>	1.78%	3.68%	3.79%	3.16%	4.14%	5.82%	7.77%	9.83%	10.54%	12.06%	10.67%	10.30%	11.85%
<b>Central American Common Market</b>	25.97%	23.44%	24.39%	14.43%	15.35%	17.62%	20.45%	18.96%	17.49%	16.98%	18.89%	15.51%	14.52%
<b>Caribbean Community</b>	4.22%	4.78%	5.34%	6.34%	8.13%	8.20%	7.77%	8.05%	4.22%	4.64%	13.28%	13.50%	15.73%
<b>Latin American Integration Association</b>	9.88%	13.48%	13.66%	8.35%	10.87%	11.67%	14.20%	16.33%	16.54%	16.79%	16.63%	17.16%	16.78%
<b>Southern Common Market</b>	9.39%	8.49%	11.60%	5.54%	8.86%	11.10%	13.98%	18.52%	19.16%	20.27%	22.70%	24.84%	25.08%
<b>Common Market for Eastern and Southern Africa</b>	12.50%	9.89%	8.42%	5.14%	7.90%	5.25%	5.59%	7.70%	8.48%	9.02%	10.20%	9.99%	10.80%
<b>Economic Community of West African States</b>	2.93%	4.19%	10.08%	5.23%	7.80%	9.21%	9.96%	9.32%	8.42%	9.31%	8.75%	9.03%	10.77%

**TABLE 3. TRADE FLOWS BETWEEN DEVELOPING COUNTRIES AND LARGE ECONOMIC SPACES**

<b>Economies for which the EU, the US, and Canada represent more than 70% of their exports markets</b>			
<b>YEAR: 1998</b>		<b>UNIT::percentage</b>	
		<b>FLOW: Exports</b>	
<b>Exporter</b>	<b>European Union</b>	<b>United States and Canada</b>	<b>TOTAL</b>
1. Haiti	10.5	88.2	98.7
2. Falkland Islands (Malvinas)	94.2	-	94.2
3. Albania	88.8	4.7	93.5
4. Mexico	3.1	89.2	92.3
5. Saint Kitts and Nevis	22.1	67.7	89.8
6. Mauritius	71.8	17.4	89.2
7. Iraq	55.3	32.6	87.9
8. Sao Tome and Principe	82.2	5.7	87.9
9. Gambia	86.2	1.5	87.7
10. Seychelles	85.4	2.2	87.6
11. Saint Lucia	63.8	23.8	87.6
12. Central African Republic	83.4	1.2	84.6
13. Dominican Republic	27.2	57.1	84.3
14. Bangladesh	45.7	37.9	83.6
15. Yugoslavia, Fed. Rep. of	81	1	82
16. Libyan Arab Jamahiriya	81.8	-	81.8
17. Comoros	78.5	3.1	81.6
18. Algeria	62.7	18.3	81
19. Tunisia	79.8	0.6	80.4
20. Dem. Rep. of the Congo	66.3	13.8	80.1
21. Macau	30.3	49.4	79.7
22. Gabon	22.8	56.5	79.3
23. Jamaica	27.8	51.3	79.1
24. Angola	16.4	62.1	78.5
25. Cameroon	73.8	3.2	77
26. Cape Verde	76.1	-	76.1
27. Burundi	72.4	3	75.4
28. Guinea	56.2	18	74.2
29. El Salvador	15	58.5	73.5
30. Chad	66.8	5.8	72.6
31. Guyana	24.9	47.4	72.3
32. Uganda	67.4	4.6	72
33. Sierra Leone	62.9	8.7	71.6

Source: UNCTAD Handbook of Statistics 2000

**TABLE 4. ANTI-DUMPING ACTIONS AMONG CERTAIN RTA MEMBERS**

Regional Agreement	Economies		Number of anti-dumping actions	
	Initiating	Against	07.98- 07.99 RTA member/Total	07.97-07.98 RTA member/Total
EU Agreements	EU	EU Associate economies	9/41	10/44
	The Czech Republic	EU economies	2/2	-
	Poland	Germany	1/2	-
MERCOSUR	Argentina	Brazil	5/15	3/8
NAFTA	US	Mexico	2/43	
	Mexico	US	6/12	1/8
	US	Canada	-	2/28
	Canada	US	-	1/10

Source: WTO

**TABLE 5. TRADE PATTERNS BETWEEN THE EU AND DIFFERENT ASSOCIATE COUNTRIES**

Percentage of Merchandise Exports to the EU		
Central Europe	1988	1998
Bulgaria	19.2	47.9
Czechoslovakia (former)	29.8	64.2
Hungary	30.3	72.9
Poland	36.9	68.3
Mediterranean economies		
Cyprus	46.2	35.6
Malta	70.4	41.5
Turkey	45.6	47.6

Source: UNCTAD Handbook of Statistics 2000

# THE NEW REGIONALISM: THE NEW ZEALAND EXPERIENCE

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For many years, the professional literature on regional trade agreements – by which I mean customs unions and free trade areas – has tended to be dominated by two opposing perspectives. These different perspectives are not explained by a difference of view about ultimate objectives; these are debates amongst analysts who, without doing any major violence to reality, can be described as free traders.

With greater or lesser attachment to what is called ‘New Trade Theory’, they might express the necessary qualifications to the theory in somewhat different ways. However, the overwhelming majority of both camps would agree on the essentials: protectionism damages any economy’s own economic performance; protectionism limits development options of other economies that would wish to have a more fully developed trading relationship.

There is also probably a political/strategic overlay that both sides would subscribe to: namely, the freest possible multilateral trading system binds nations together through their shared economic self-interest. The most important practical expression of this shared perspective is their common commitment to pushing ahead with the multilateral trading system – yesterday the General Agreement on Tariffs and Trade (GATT), today the World Trade Organisation (WTO). From a political perspective, this does not mean an absence of disputes over trade issues: the more fully developed the bilateral trading relationship is, the more disputes arise. Rather, it means a commitment to resolving those disputes within a structured dispute settlement process, which heavily constrains retaliation.

The important point of difference between these analysts relates to the interplay between regional trade agreements and the multilateral trading system. Both agree that the multilateral trading system – the WTO – remains the first best option. However, one side believes it is positively dangerous to the first-best multilateral option to engage in regional trade agreements, which may lead to the world being split into regional trading blocs; the other side will, by and large, promote any regional trade opportunity, seeing no intellectual or policy contradiction. Such people are not too concerned about the quality of such agreements.

New Zealand sits in neither camp. If, in the time-honored tradition, a pollster asked us to tick one of three boxes on regional trade agreements – agree, disagree, don’t know – we would all be amongst the don’t knows. If given the chance to explain in a few words, we would all answer: it depends on the design of the regional trade agreement.

I will now try to make our sitting on the fence on this matter a little more intellectually robust, or certainly more comfortable.

## THE MUSHROOMING OF FTAS: IMPLICATIONS

The first thing I wish to say is obvious: this is not a small matter. The number of regional trade agreements (RTAs) is mushrooming around the world: one estimate by the WTO has the number at some 220. In the APEC region this is taking the form of free trade areas (FTAs), not customs unions. Yet more are in the pipeline. Until recently, I led the New Zealand side on one of them: an FTA between New Zealand and Singapore, which has little to do with commercial considerations and everything to do with strategy.

East Asia – for so long standing aside from participation in FTAs – is also shifting its policy stance. This started before Seattle, but Seattle has given added momentum. Korea is engaged in an FTA negotiation with Chile. Korea is studying an FTA with New Zealand. I also believe that, if one reads between the policy lines, Japan has shifted its policy. It is ‘studying’ a FTA with Singapore and a number of other APEC economies. More ambitious ideas are also in play – we shall hear tomorrow from H.E. Mr. Cesar Virata who is chairing the Task Force looking into the possibility of merging two geographically contiguous FTAs – Closer Economic Relations (CER) and ASEAN Free Trade Area (AFTA).

My view is that we should neither applaud nor condemn these examples of accelerated regionalism. Whether they are ‘good’ or ‘bad’ for an inclusive world (WTO) and APEC open trading system depends entirely on the thinking driving their formation and the technical instrumentation that flows from that thinking.

This perspective arises in part through New Zealand analysts’ understanding of the literature on regional trade agreements, but more particularly from our direct, and sometimes painful, national experience with regional trade agreements.

### **THE MOTHER OF ALL REGIONAL TRADE AGREEMENTS: THE EC (EU) AND NEW ZEALAND’S EXPERIENCE:**

Like all countries, the consensus in New Zealand has been powerfully shaped by our historical experience. In this field, one issue stands out: the impact of by far the most important regional trade agreement, the European Community (EC) now the European Union (EU), on our country.

In making these observations, I am referring to the pre-Maastricht, pre-Euro, essentially pre-Uruguay Round EC. Up to the late 1980s, the EC was little more than a shonky system of agriculture subsidies. Some 70 percent of EC budgetary expenditure was spent on agricultural subsidies. Every Summit Meeting of European Heads of Government was dominated by the issue – who was going to pay and who was going to get the benefits. I can find no definition of this – even in Dictionaries of New Zealand slang.

The EC of the 1970s and 1980s was the best example of what economists and game theorists call the ‘restaurant table effect’. Broadly speaking, this is about perverse incentives. If you are a member of a lunch club which splits the bill and you know the fellow members of your lunch club really well from past experience, then you might as well order scallops with black truffles, followed by pheasant for main course, some elaborate dessert and God knows what else. There is no point in exercising restraint since you know from past experience none of the other eight will. You are still going to have foot one ninth of the bill. If you exercise restraint, you will benefit only to the tune of one-ninth of the difference between sensible eating and gluttony. Go for gluttony: it is rational.

I chose nine for my lunch club metaphor, since that corresponded to the number of European agriculture Ministers around the subsidy lunch table in the 1970s and 1980s.

Of course, as Milton Friedman would pipe up: someone had to pay for this. Someone did. It was in the first instance the taxpayers of Europe; in the second instance it was the food consumers of Europe who paid more for their food to limit the taxpayers’ bill; in the third instance it was food exporters to Europe who were progressively shut out of the regional trade agreement’s domestic market – namely, Australia, Brazil, Chile, Thailand, New Zealand and all the other members of the Cairns Group.

The instrument of choice to shut non-members out of their regional market was called the ‘variable levy’: a moving tariff that would always equalise the margin between the world price

and the European domestic price. This ensured permanent discrimination in line with what was called 'The Community Preference'. 'Fortress Europe' is the more popular term.

The next step in this malignant form of trade regionalism was undisciplined export subsidies. Recall the central point here: the disputes between the EC and its trading partners were overwhelmingly about agriculture. Apologists for the then EC were essentially correct when they said that the Common Agriculture Policy was the 'glue that kept the Community together'.

These variable export subsidies were known by the wonderful euphemism of 'export restitutions'. I will not go into the technical detail here. Suffice it to say that having pushed Brazil, Australia and others out of the European domestic market, they then compounded the malignant effect by driving them out of alternative export markets into which these non-EC economies sought to diversify.

The relative impact on New Zealand was far worse than on any other country. Every single economic study done in the 1970s and 1980s bore out that fact. In fact in one study, it was estimated that the impact of the Common Agriculture Policy (CAP) involved larger welfare losses for New Zealand in **absolute** terms than for the US. You will understand that these analyses are printed indelibly on my mind: I was for seven years New Zealand's Chief Agriculture Negotiator during the Uruguay Round.

The extraordinary impact on New Zealand arose from the intersection of three factors: the relative dependence of New Zealand on European agriculture markets, the differential distribution of EC agriculture subsidies on certain types of temperate agriculture goods, and the structure of the New Zealand economy.

For example, New Zealand in the mid 1980s supplied 70 percent of all of the EC's sheepmeat imports; more incredibly, we supplied a little less than 20 percent of total EC consumption of sheepmeat. I could quote you less dramatic, but still similar, figures for dairy. In the early 1970s, when the UK joined the EC, some 40 percent of total New Zealand exports went to the EC.

EC export subsidies (export restitutions) were also heavily focussed on dairy and New Zealand had 18 percent of world dairy trade in 1986. (We now, post the Uruguay Round export subsidy disciplines have 33 percent of world dairy trade.)

So severe was the impact of the CAP on New Zealand's economy that the UK negotiated a special protocol to diminish the full impact on our economy. I will not trace the long and at many times bitter history of this. Suffice it to say it averted an immediate economic execution. The alternative – death by a 1000 cuts – was stopped by the Uruguay Round disciplines.

I must add here that today I see the EC- the EU - in a totally different light. It is not just that the CAP's principal discriminatory mechanisms – the variable levy and export restitutions – have been constrained for the first time by operationally effective international disciplines. That is certainly part of it. But the EU has gone on impressively to construct the original Schuman-Monnet concept of European integration well past the point where it is any longer credible to describe European regionalism as 'little more than a system of agriculture subsidies'.

To elaborate would take me way beyond my topic. What I am trying to demonstrate is that this bitter New Zealand experience with the most important example yet of a regional trade agreement – the European version up to, say, 1990 – illustrates the great dangers of subscribing to any general notion that would embrace regional trade agreements without concern for their underlying philosophy and technical instrumentation. In the case of the EC – and this is the dominant model – we can see that this regional trade agreement was inward looking, permanently discriminatory, and hugely damaging to the economies of countries outside the European regional trade agreement.

It also complicated immensely the process of putting together a free and open multilateral trading system. Anyone familiar with the history of the Kennedy, Tokyo or Uruguay Rounds knows that. While attempts were made to diminish the significance of agriculture in the political differences that slowed those processes down, that was a smokescreen: the most bitter and protracted arguments were always about agriculture.

This is not to say that Europe does not face formidable political problems in taking the next step forward at the multilateral level on agriculture. But my view is that the corner was turned in the Uruguay Round.

In summary then, the nuanced New Zealand view on regional trade agreements owes a lot to this historical experience with the most important of all regional trade agreements.

### **NAFTA Mark I:**

However, I have been asked to address the issue of regionalism in a different context: the context of the ANZCERTA Agreement – which is a long name for an FTA – between Australia and New Zealand (the Australia-New Zealand Closer Economic Relations Trade Agreement).

First, a little history about Australia/New Zealand economic relations – but I promise only a little. In the collective memory, NAFTA means the North American Free Trade Area. Actually, the North Americans stole the name from us. The first NAFTA was the New Zealand/Australia Free Trade Area, which existed from 1965 to 1982 when it was superseded by the ANZCERTA – known today throughout Australia and New Zealand as the CER Agreement. The name stolen by the North Americans and the Mexicans – the NAFTA – is however one piece of intellectual property over which Australians and New Zealanders would be ashamed to claim paternity. The original NAFTA – call it NAFTA Mark I – was a deeply flawed trade policy instrument. The CER has, in my view, had an enormously beneficial impact, particularly for the smaller participant, New Zealand.

Indeed, both philosophically and technically the NAFTA Mark I and the CER are polar opposites of models of regional trade agreements. Again, no wonder New Zealanders have great difficulty subscribing to any general view of the value of regional trade agreements.

Go back to the 1960s when NAFTA Mark I was negotiated. At that stage, New Zealand and Australia had an economic relationship that could only be described as ‘thin’. New Zealand exports to Australia comprised a mere 4 percent of total New Zealand exports. Today, incidentally, the figure is 22 percent of our exports. New Zealand and Australia did not interact much with each other directly across the Tasman Sea, but only indirectly as if via a giant mirror placed in Britain. Our Prime Ministers were far more likely to meet in London than Wellington or Canberra.

We also had two deeply bifurcated economies: one side of our economies (the primary sector) was highly efficient and lightly protected; the other sides of our economies – call it manufacturing – was deeply inefficient in parts and survived behind very high frontier protection.

Australia started to reform its frontier protection in 1960 by abolishing import licensing, though it did retain very high tariffs designed to stimulate a broad industrial base. New Zealand did virtually nothing to correct its inefficiencies – until the CER 20 years later.

When it came to designing a bilateral trade agreement in the mid 1960s – the NAFTA Mark I – it was against this confused earlier set of policies. The NAFTA Mark I was a regional trade agreement designed in hell – the type of free trade agreement you negotiate when you are deeply opposed to free trade.



Its chief technical features were:

- Obsession with tariffs, when it was clear that non-tariff measures, particularly New Zealand's comprehensive import licensing system, were the primary problem;
- Non-comprehensive coverage of goods, to ensure sensitive goods did not have to confront bilateral liberalisation.
- Any tentative expansion of the scope for freer trade in the NAFTA Mark I was via a 'positive list' approach, not a 'negative list' approach. That is, a positive list requires you to agree later on to include other goods; a negative list holds that everything is included in the liberalisation framework unless specifically agreed otherwise. This, I assure you, is not diplomatic 'smoke and mirrors'. It is all about political momentum. When an agreement is being negotiated, there is some chance of economy-wide considerations counter-balancing sectoral protectionist pressures. After the ink is dry, the balance shifts swiftly back to the sectoral pressures. If you adopt a 'positive list' approach, you find that it is very difficult to get any political system to take the game forward. A 'negative list approach' has stood the test of time. Of course, you do not solve deep-seated political problems in trade policy through technical tricks. I will come later to potential political solutions when I examine the sharply different history of the CER agreement.
- The NAFTA Mark I was also enormously time-consuming. To give the appearance of momentum, high-level meetings were held frequently. Inside those rooms – I was inside many of them – we would hear inane discussions between Ministers or senior officials trying to manage a trading relationship as if it were a matter of moving stock from the back-room of the corner grocery store to the shop front. Quite literally, we would agree to import 2,000 more tonnes of Queensland tomatoes if, in return, the Australian automotive industry would agree to import some more New Zealand sheepskin car covers. It was like an Antipodean *Gosplan* on a bad day.

I could go on, but these lessons from a flawed regional trade agreement were deeply absorbed by a younger set of Australian and New Zealand economic officials. They are central to our overarching policy position of refusing to go along with any general proposition that regional trade agreements can either be supported or opposed: it all depends on the philosophy underlying these agreements and technical instrumentation flowing from the philosophy.

In most respects, the negotiation of the CER Agreement involved little more than looking closely at the model provided by NAFTA Mark I and doing the opposite.

This was, of course, hugely complicated by the political realities surrounding highly protected industries – particularly on the New Zealand side. In the early 1980s, when the negotiations began in earnest, the effective rates of protection (ERP) in New Zealand were the highest in the Organisation for Economic and Cultural Development (OECD). Indeed our average ERP was literally twice as high as the next most highly protected OECD member. I could give you a clue as to which OECD economy had the next highest levels of protection, but I don't really feel like launching into a rendition of *'Waltzing Matilda'*.

To deal with the real fears on the part of New Zealand manufacturers who thought they would be unable to compete on a level-playing field with their larger and more efficient Australian counterparts, we designed a CER agreement that, while comprehensive in coverage, and automatic in its mechanisms, gave an enormous amount of time to, and abundant safeguards, the New Zealanders to bring them into conformity with the full provisions of the FTA. The final end point, however, was clear.

In particular, in the phasing provisions for dealing with the most intractable problem – New Zealand’s import licensing system – we had an asymmetrical adjustment process. Australia agreed to give the New Zealanders far more time than Australian manufacturers had. When the agreement came into effect in early 1983, we had until 1995 to get rid of import licensing – and then only for goods of Australian origin, as defined in the CER rules of origin.

However, there was a price that had to be paid to achieve negotiating balance: a firm commitment to progressive liberalisation.

Thus, in broad terms, even the most sensitive industries had to make a start down the liberalisation path. Each year, a formula – deliberately designed to protect our own political system from rent-seeking behaviour – required another small step down this path. From a political economy perspective, this had the crucial effect of changing the behaviour of highly protected industries from lobbying against change to adjusting to change.

One further design characteristic was required: contractual certainty. Without that, the Australians could not have sold such an imbalanced adjustment process to their own political constituencies and New Zealand manufacturers would have spent their time trying to overturn, rather than adjust to, the new reality. I guess I would sum up the essence of the deal as ‘time does not matter, if the end result is certain’.

The final feature of the CER that I would like to highlight was that it was perhaps the first practical expression of ‘open regionalism’. Our first experience with a regional trade agreement – the NAFTA Mark I – had deliberately instituted a contractual commitment to preserve a margin of preference for each other’s goods over third country imports.

In short, the NAFTA Mark I sought to preserve permanent discrimination against Australia’s and New Zealand’s other trading partners. The CER did the opposite.

I will not spend much time describing the impact of the CER. Numerous studies have shown it has been, on balance, an overwhelmingly positive impact, particularly for New Zealand, the smaller economy. So much for the political theory that smaller economies suffer if they entertain regional trade arrangements with much larger entities. New Zealand manufacturers – understandably so fearful of their ability to compete with the Australians – quickly adjusted to the new reality once they realised it was a waste of time arguing with Ministers to preserve their protected position.

They had, of course, a huge amount of time to undertake the adjustment. They did not need it. Whereas the original CER called for the abolition of New Zealand’s import licensing in 1995 (and that was only for Australian imports), the adjustment to reality went so fast that opposition to removal of import licensing quickly fell away. By 1988 – eight years ahead of schedule – our government abolished all import licences (all quota restrictions) not only for goods of Australian origin but for all our trading partners.

In one important sense, a Free Trade Area between Australia and New Zealand barely exists any longer. I mean that in the sense that there are hardly any areas in either the New Zealand Tariff or the Australian Tariff in which either country’s imports enjoy any advantage over goods from Singapore, Thailand, Norway – whatever. In technical terms, the previous huge price wedge between the FTA preferential tariff rate and the Most Favoured Nation (MFN) rate has been reduced to zero for all but a tiny handful of tariff items. That should, in my view, be the long-term perspective of every regional trade agreement: it should aim for long-term obsolescence. It also, of course, eliminates one of the disadvantages long identified in the literature with regional trade agreements: namely, such an approach eliminates welfare losses through trade diversion. Trade diversion then becomes a purely temporary cost.

The NAFTA Mark I locked our economies into a deeply flawed, inward-looking regional agreement. The CER, in contrast, was an outward-looking regional agreement that helped New Zealand in particular open up to all its trading partners.

The central theme of this paper – and it reflects the central tenet of New Zealand policy – is that we should all be ready to explore regional trade agreements but only on the basis of some underlying principles and commitment to certain political economy procedures that reflect those principles. They are, in summary form:

- Comprehensive coverage of goods without question, and desirably services too.
- Generous – very generous – time provisions to deal with the most difficult political problems and acceptance that some parties to such agreements need more time than others to complete that adjustment. Protectionism is not a sin, the solution to which is moral lectures; protectionism represents a lethal combination between a genuine fear of being displaced and the economic self-interest of those who are gaining the economic rents from it. The solution to that is basically lots of time and many safeguards with final sunset provisions.
- In exchange, there have to be two other features locked into the agreement: phased liberalisation and certainty.
- By phased liberalisation, I mean everyone must make a modest start in adjusting to freer trade. Where the political problems are severe, it can be very modest: but get the adjustment (which is often more about psychology than commercial adjustment) going for everyone.
- By contractual certainty, I mean certainty about the very long-term result. Every negotiator has to be able to defend herself or himself against the charge that they have agreed to a ‘lop-sided’ deal. Our experience suggests that a deeply asymmetrical adjustment process can be **just** politically manageable, provided it is balanced by contractual certainty as to the long-term result.
- The principle of ‘open regionalism’ must be more than rhetoric inserted into the often meaningless preamble of trade agreements: it must be a living thing. Even small economies like mine have global interests and a network of political relationships with a large number of economies we want to nurture, not harm. We can live with some temporary discrimination; we must ensure it is temporary.

As we look into the future we see two broad features of the trade policy architecture that intersect with this analysis: a huge surge of interest in regional trade agreements and considerable uncertainty about the WTO process.

Our view is that this conjunction may turn out to be a temporary, and relatively benign, conjunction of events. The new regional trade agreements may help to maintain the momentum of trade liberalisation (recall the 'bicycle theory' of international trade) while we work out a new political formula to allow the tectonic plates of multilateral trade policy to realign themselves. Well-designed regional agreements may, in such a benign scenario, be building blocks both for APEC and the WTO.

But New Zealand’s experience with regional trade agreements tells us there is an alternative – a much less palatable alternative. Such a malign future would be based on regional trade agreements that are not comprehensive in coverage and thus take their participants backwards from the great achievement of the Uruguay Round: a WTO-minus regional trade agreement. Such agreements could, unless lessons have been learned, create in the Asia-Pacific region political

understandings that lock in partial and non-comprehensive liberalisation, preserve discrimination and run the risk of atomizing APEC.

So when we are asked whether we are in favour of or against Free Trade Areas, I am afraid we have to continue to put the New Zealand tick in the 'don't know' column. It depends.

#### **POSTSCRIPT: RE-ENERGIZING THE BOGOR GOALS:**

As a postscript, I should perhaps add that the New Zealand approach to FTAs, while short of uncritical enthusiasm for them, does take an activist approach. That is, New Zealand has been very active in trying to find new FTA partners that share our strategic perspective on FTAs. We have had mixed experiences. The Singapore/New Zealand negotiation is however going well and appears to have already achieved its real objective: acting as a catalyst for the broader, and far more important, concept of merging CER with AFTA.

While I do not wish to analyse that issue – there is a separate session devoted to Emerging RTAs, in which this matter will be examined – I do wish to close my remarks on what I see as the broader strategic opportunities for well-designed, WTO-plus regional trade arrangements. My remarks have everything to do with APEC and the Bogor Goals in particular. In doing so, I should perhaps make the point that this is a personal view: I might not have been so frank had I still been working for the Government. My justification for doing so is that this is an APEC symposium and I therefore feel that one should examine the issue of regional trade agreements first and foremost through the lens of APEC.

APEC is broader than a mechanism for trade liberalisation. Its very informality has encouraged political exchange at the highest level of international politics – sometimes very productively. Its work on trade facilitation and other forms of economic cooperation has produced tangible results. Yet, for all that, I believe there are storm clouds on APEC's horizon.

The centrepiece of APEC is the vision of an Asia Pacific Economic Community in which trade and investment flows freely: the Bogor Goals of 2010/2020. If the Bogor Goals are seen to be impossible, and some already argue in private they already are, I believe APEC will be in trouble.

It will be in trouble, **not** because APEC would cease to exist: few international organisations close down shop even when it is abundantly clear that the passage of history has passed them by. Rather – to put it bluntly – I cannot see, say, five to seven years hence, the presidents of the United States and Indonesia; the Chinese Premier; the prime ministers of Japan and Australia; and some dozen other heads of government getting together to discuss economic and technical cooperation (ECOTECH). APEC, in other words, would simply become another slot in the annual 'talkfest' calendar in which the level of representation and real interest slides.

For APEC to continue as a vibrant organisation, it must generate excitement and stick to the bold vision enunciated at APEC's inception.

I do not share the view that the Bogor Goals are already unattainable, but I do believe concrete initiatives are needed if they are to avoid that fate. The first verifiable test is obviously the first deadline – 2010, for developed economies. While I am aware of the nuances of the debate as to what precisely 'free trade and investment flows' means, let me put those aside. These nuances are basically about agriculture and if I were representing certain APEC economies rather than approaching it from a New Zealand perspective, I would probably wish to preserve my negotiating position by deliberately introducing similar ambiguities.

Will we have to wait until 2010 to find out whether Bogor is unattainable? In a purely technical sense, yes; in every other sense, no.

Political markets function like financial markets. Financial markets incorporate into current prices expectations about the future. It is not the announcements of corporate quarterly profits/losses that move share prices, as the naïve investor finds out to her or his peril. It is quarterly profits/losses that deviate from what the market has already built into the share price through the market's expectation that changes the share price. By analogy, we will not have to wait another 10 years before we know whether Bogor is in deep trouble. Political markets are well aware how long it takes to establish a consensus, through negotiation, to lower barriers to trade and investment flows. It takes years. We will know well before 2010 whether the Bogor Goals remain an attainable vision.

From that perspective, there are already grounds for concern. We all know that when political leaders met in Bogor in 1994, they could agree on the objective, not the means to attain the objective. That was as much as the political traffic would bear at the time.

Progress towards the Bogor Goals has been reasonably good in the six years since the meeting in Bogor. Precisely because the Bogor Goals were not prescriptive as to the means by which they would be achieved, progress has been made through the conjunction of three paths, loosely unified by the phrase 'concerted unilateralism'. Those three paths can perhaps be considered the principal 'drivers' of the liberalisation process:

- *Multilateral liberalisation*: the Uruguay Round commitments have made an important contribution;
- *Unilateral Liberalisation*: a number of economies have, for largely domestic economic policy reasons, initiated a number of unilateral steps to reform their frontier protection policies;
- *Regional Trade Liberalisation initiatives*: this takes us back to our topic: existing sub-APEC FTAs such as the ASEAN Free Trade Area (AFTA) and the NAFTA have led to the reduction, at least with respect to their members, of other trade barriers.

Of these three 'drivers' of past APEC liberalisation, two are problematic. Most of the liberalisation arising from the Uruguay Round has been phased in over the six-year transition phase from the end of the Uruguay Round. This is particularly the case for agriculture for developed economies. Note here that my initial concern is whether **developed** economies are going to reach the 2010 deadline. If the developed economies flunk their deadline, forget about 2020 for the developing economies. It is agriculture which remains the most intractable problem with respect to the developed economy 2010 deadline.

The gameplan at Auckland had of course been to help build the political consensus necessary for the launch of a new Round at Seattle. It went very well. We handed the baton to the US and, for a variety of controversial reasons, it appears to have been dropped somewhere between Seattle and Foggy Bottom.

I have no doubt that a new political formula will eventually be found at the multilateral level to re-engage, but when is another matter. Whenever that negotiation arrives, we know it will be years before new concrete negotiating commitments emerge and are implemented at the multilateral level. In short, therefore, one of the prime drivers of the Bogor Goals in the past six years – WTO commitments – looks doubtful over the medium term. Meantime, the Bogor Clock ticks on down to 2010.

Unilateral liberalisation, the second driver of past APEC liberalisation, is suffering from what I call 'political fatigue'. The first thing to note is that unilateral liberalisation has always been a political economy device for the smaller and medium-sized APEC economies. Japan and the US comprise collectively some 80 percent of APEC. As large economies with plenty of negotiating

leverage, unilateral liberalisation was never going to be seriously entertained by them. One can certainly argue, from a normative perspective, that they **should** have entertained it. I am sticking to the observed facts.

The smaller and medium-sized APEC economies have carried the torch for unilateral liberalisation. It is not quite extinguished, but it is flickering. My country, for example – a prime exponent of unilateral liberalisation – has rejected any further unilateral liberalisation. This is associated with a change of government. This policy shift has sometimes been confused with a shift into a protectionist direction. That is quite inaccurate. The current New Zealand Government is not only ready to engage in further liberalisation, but, with respect to the Singapore/New Zealand arrangements, is poised to put that into practice. But this is **reciprocal** liberalisation. And there is no effective political constituency left in New Zealand for unilateral liberalisation.

There may be some scope for further unilateral liberalisation in other economies. The torch, as I said, is flickering, not extinguished. The most important by far will be with respect to China. But that will proceed within the framework of China's accession to the WTO and then only by stretching the meaning of 'unilateral' can that be described in those terms. Nevertheless, whatever it is called, it is clear that the reforms we expect China to institute will make a significant contribution to the underlying objectives of the Bogor Goals. In this analysis, I am merely pointing to grounds for concern; the bigger game encapsulated by the Bogor Goals is by no means lost. That is why I profoundly disagree with those who say that Bogor is already unattainable.

Yet, China aside, I would expect to see only modest contributions to come from unilateral liberalisation in the medium term. I have, out of respect for my old profession as a diplomat, used only my own country as an example of 'political fatigue' with unilateral liberalisation. If I were less constrained by my past culture, I could certainly give examples of other APEC economies - some not too far from New Zealand's shores – which have lost interest in further systematic unilateral liberalisation.

Let us turn now to the third 'driver' of past progress towards the Bogor Goals: regional trade arrangements. This 'driver' is far from dead and is the one on which the political weight of progress towards the Bogor Goals will rest in the medium-term.

I earlier sketched two scenarios about the emerging FTA architecture in the APEC region: one benign, the other decidedly less benign – the latter being a vision of FTAs that would be based on design principles antithetical to the Bogor Goals of comprehensive liberalisation and open regionalism. It is, I believe, against this broader strategic framework that debate about sub-APEC regionalism must now proceed. We cannot rely on the mantra – 'they must be WTO-consistent' – a mantra that means almost nothing for reasons I have written about in the past. A new set of principles, designed from an APEC-friendly perspective, is clearly required to fashion these new emerging forms of regional trade arrangements. This is far from a new proposal: the original Bergsten Eminent Persons' Group made very similar observations as they laid down the conceptual framework for the Bogor Goals. It is time to act, even if belatedly, and to avoid the illusion that 'WTO-consistency' is a sufficient test.

I end my remarks on my central thesis: regionalism is neither to be condemned nor applauded. Quality is everything. There are lessons from past regionalism which are ignored at our peril.

# THE OPEN REGIONALISM OF THE ANDEAN COMMUNITY

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## I. Introduction

The eighties were a period of deep economic crisis: hyperinflation, high interest rates, devaluation, crisis of the balance of payments, credit rationing, a fall of investment, unemployment and an increase of poverty. In this context, the integration processes also suffered a deep crisis as a consequence of the policies and actions of unilateral adjustment with which each one of our economies faced the crisis.

During the nineties, the region faced a different scenario; most economies implemented economic reforms together with an opening of markets, liberalization and deregulation. The capital flows that arrived to the region, coupled with this new environment, contributed a great deal to the reduction of inflation, the recovery of the activity level, investment, and loans, and accumulation of international reserves.

The international crisis of the end of the nineties once again affected Latin America and its processes of integration; intra-regional commerce dropped to less than two digits. Fortunately, these flows have steadily picked up in the last year.

The Andean Group is one of the most advanced projects of integration of the developing economies, one which encourages a balanced and harmonic development of its members and facilitates the process of regional integration.

The Andean Group was born in 26 May 1969 with the subscription to the Andean Agreement of Sub-Regional Integration (which is known as “Acuerdo de Cartagena”) by the plenipotentiaries of Bolivia, Colombia, Chile, Ecuador and Peru. It became valid on the 16 October of the same year. In 1973 Venezuela joined the “Acuerdo de Cartagena” and in 1976 Chile withdrew. The five Andean Group economies occupy an area of 4,710,000km<sup>2</sup>. Their population surpasses 111 million habitants, and its annual gross product reached 272 thousand million US dollars in 1999.

This Agreement was carried out to facilitate the Latin American integration that had begun in 1960 with the Treaty of Montevideo (ALALC) which sought to create a free trade area in the whole continent. That project couldn't be executed due to the existing disparity amongst the Latin American economies. The doctrine that was followed from its creation is sustained by the need for integration to achieve the development. The agreements achieved by the member economies have been made in the more important areas of the international economic process.

The original purpose of the Andean Group was to improve the position of its members in the international economic context and to reduce the differences in development levels among the members. From a system based on the classic pattern of industrialization through import substitution, imposition of high tariffs, and restrictions to foreign investments, we moved towards an open model of integration, with community rules set to match international standards.

This adaptation process to the changes registered in the surrounding international reality – Latin American and Andean – was done based on several consecutive agreements of the members of the Andean Group, which were signed in a series of meetings of the representatives of the five member economies.

During the VIII Presidential Council in Trujillo, which was held in May, 1996, Peru subscribed to the Acta of Trujillo and the Protocolo Modificadorio del Acuerdo de Integración Subregional Andino (Agreement of Cartagena), where a series of institutional changes were introduced.

## **II. Objectives**

The objectives of the Andean Community are to promote the balanced development of the member economies, to speed up their growth through integration and economic cooperation, to encourage the permanent improvement of the levels of their habitants' life, and to impel regional integration.

After the meeting of the presidents, held in May 1999, the Andean Community agreed on the establishment of a common market, no later than 2005. A schedule of action in 2000–2001 towards its establishment was agreed at the most recent leaders' meeting, which took place in Lima in 2000.

To be able to attain a common market, it is not enough to conclude the liberalization process. It is also necessary to polish the common external tariff, to fulfill the goals of liberalization of services, to impel border integration and to eliminate the obstacles for free movement of goods and people, as well as to orchestrate a common foreign policy. There must also be the commitment to deepen the Andean integration agreement and to reach achievements in political, economic, social and cultural aspects.

Encouraging this process often means substantial progress is made in the coordination of policies, which implies the organic incorporation of the economy ministries and the Andean central banks in the implementation of the agreements. To tackle extra-Andean regional competition successfully safeguard clauses could and should be adopted.

In the regulation of the trade of goods and services, agreements have been made regarding the standards for the classification of the origin of the goods. The existing rules include technical regulation, sanitary laws, harmonization of customs instruments, regulations to prevent and counteract the distortions generated by the antidumping practices, subsidies, restrictions to exports and restrictive practices.

### **1. Free Trade Area**

The Andean economies began the formation of the free trade area (FTA) in 1969 and the process was completed in 1993. The main instrument they used was the Liberation Program, which contemplated actions directed to eliminate all the obstacles, i.e., the taxes and the restrictions, that interfered with the formation of the FTA.

The Andean Free Trade Area has a distinctive characteristic that no other scheme of integration on the continent currently possesses: all the products of its tariff universe are liberated. The List of Exceptions, common to other integration schemes, does not exist. Another characteristic of the Andean FTA is that it was conceived not as an objective in itself, but as a means toward a deeper integration.

The Peruvian tariff policy (virtual flat tariff) of the nineties initially prevented the adoption of the agreed schedule. This resulted in a crisis in 1997, when the economy was virtually retired because of disagreements regarding to the Common External Tariff.

Peru is being gradually incorporated to the FTA, after it suspended (in 1992) the totality of the commitments it had towards the Liberation Program, based on Decision 321 of the Commission of the Cartagena Agreement.



On 30 July 1997, Peru and the other partners of the Andean Community arrived at an agreement for its full incorporation to the Andean Free Trade Area. Through Decision 414, the Commission approved a schedule of tariff eliminations, whose application began on 1 August 1997, and which will be fully enforced by 2005.

Once the full liberalization of the goods trade inside the Andean Community is achieved and the advances in the liberalization of goods are considered, the next step towards reach the common market is to strengthen capital and labor liberalization. A project, which should be approved by members, is already in progress to modify the Cartagena agreement and to establish the common market.

## **2. Common External Tariff**

The approval of the Andean common external tariff (CET) was foreseen from the beginning of the process and was adopted on 26 November, 1994 by Bolivia, Colombia, Ecuador and Venezuela through Decision 370 of the Commission of Cartagena Agreement, which became valid on 1 February, 1995. Until the Commission decides the terms and modalities needed for it to join this mechanism, Peru is not forced to apply the CET.

Decision 370 establishes a four-tier structure (5, 10, 15 and 20 percent) that is applied for Colombia, Ecuador and Venezuela (Annex 1). Bolivia is authorized to apply its own tariffs of 5 and 10 percent and Ecuador is under a régime that allows it to maintain a difference of five points with regard to the levels described in Annex 1 for 930 tariff items.

Economies can apply transitory suspensions under two modalities: transitory insufficiency of supply and domestic emergency. In the first case the suspension is allowed to prevail up to six months and in the second up to three months.

There is a List of Exceptions, given as Annex 4. Initially, Ecuador included 400 items in that list, Colombia and Venezuela included up to 230 each. Subsequently the exceptions were reduced by 50 items per year and it was hoped that by 1 February 1999, no items would remain on the list. However this deadline was pushed forward to June 2000.

## **3. Services**

In June 1998, the Commission of the Andean Community approved Decision 439, which sets out the general framework of principles and norms for the liberalization of the services trade.

Services constitute an important element in the trade in goods, technological transfer, flow of capitals and movement of people within the sub-region. Therefore, the general framework of Decision 439 seeks to accomplish a common market by the year 2005 with a progressive elimination of measures that restrict the trade of services, strengthen and enlarge the supply of the services of the members in the agreement and harmonize each economies' policies.

The basic principles that a member economy will adopt are: National Treatment (Art. 8) and Most Favored Nation (Art.7), Transparency (Art. 9), and Market Access (Art. 6). Decision 439 incorporates the four modalities of supply in a similar way as GATS does.

Transport services in their different modalities have already been liberalized and community standards designed to eliminate technical and sanitary obstacles have been successfully applied, harmonizing the general sanitary legislation that includes medicines, packed food and cosmetic products in particular.

#### **4. Coordination of Policies**

The harmonization of macroeconomic policies is not a new topic for the Andean Community. It has been approached at different stages during the process and it became specially relevant when it was included as a high-priority matter among the agreements reached in the XI Presidential Summit, which took place in Sucre in April, 1997. A series of favorable circumstances, such as the progressive convergence of objectives in the economic policies of the five economies and the structural reforms, the programs of economic/governmental modernization of and the privatization process undertaken in the sub-region, all contributed to give a new impulse to this topic.

Policy coordination is done in order to develop fiscal policies that avoid non-sustainable increases in public expenses during favorable international trade periods. This could be accomplished, for example, by adopting efficient taxes and customs systems to reduce fiscal evasion and smuggling. Coordinated efforts will provide regulations and effective supervision of the Andean financial system, which will strengthen its patrimonial base and competitiveness among other goods.

Progress has been made with the establishment of regulations for the recognition of intellectual property rights (regarding industrial property and royalties), norms for the regulation of foreign investments and associations of subregional capital, agreements to avoid double taxation, and so on.

Regarding the coordination of macroeconomic policies, progress has been made towards the establishment of convergence approaches. One of these has been stressing on the need for single-digit inflation, since it is considered it will guarantee political and social stability in our economies. The improvement of the supervision and control instruments of the financial system has been agreed upon, as this will progressively allow appropriate community supervision. The same has happened with the modernization of the customs administrations and the simplification of the transactions needed to be able to engage in external trade. The Sub-Regional System of Statistic Information regarding macroeconomic indicators must be reinforced, as the establishment of a high level group that will study taxes and investments issues is needed.

Coordination of policies is fundamental for negotiations with other integration agreements. It is a step forward that in the groups of FTAA the work is done jointly, in the same way as it is done in the European Union (EU) and the World Trade Organization (WTO). These multilateral decisions in the WTO will be key for the destiny of our economies and we should look for common points, even though there are topics like agriculture where different positions exist.

#### **5. Competition**

The Andean Community establishes a set of canons which prevent and counteract any distortion that the existence of dumping and subsidies practices originated by non-members of the Andean Community (Decision 283) can cause to competition. They also regulate restrictions to exports (Decision 284) and restrictive practices that affect free competition (Decision 285).

Decision 283 establishes that member economies or companies having a legitimate interest, will be able to request from the General Secretary the authorization for the application of measures to prevent or to amend distortions in competition derived from dumping practices or subsidies:

- when the practices, originated in an economy outside the sub-region, threaten to cause or actually cause serious damage to production destined for export to another member; and
- when these are products affected by the common external tariff and the corrective measures would have to be applied in more than one member economy.

In regards to free competition, the community precept can be applied when the restrictive practices are originated in the sub-region or in a company stationed in a member economy.

All subsidies to intra-subregional exports were eliminated to avoid distortions inside the enlarged economic area. There are canons written to correct ex-post the distortions caused to competition derived from dumping and subsidy practices, restrictions of exports and of free trade. The rules of origin that are currently enforced in the Andean Group are being revised.

Since January 1994 the Andean Group has had a common régime for industrial property that regulates the granting of brand names and patents which protects, for the first time, industrial secrets and the denominations of origin, among others.

## **6. Common External Policies**

The General Secretary of the Andean Community has made substantial progress towards the elaboration common linings of foreign policy that we should jointly impel. The objective should be to strengthen the combined action with other blocks such as the European Union and Asia in the perspective of the creation of a multi-polar world. This is inscribed in the conception of open regionalism consolidating the Latin American and hemispheric integration. Progress in democracy, human rights and participation in a civil society has also been achieved. It should be highlighted that the limits of what would be the common foreign policy have already been approved. This includes joint integration in negotiation forums such as the FTAA and the WTO.

## **7. Social Agenda**

During the Cartagena Summit in 1999, the Andean presidents agreed “to develop a multidimensional social agenda that approaches the community of the new millennium to the expectations of the Andean citizens which will have at the core the generation of employment, education, health and housing.”

It should outline “the bases of a migratory common policy, a policy that protects the fundamental rights of the migrant workers, an educational, cultural and science and technology policy oriented towards the preservation and promotion of our own identity and an Andean strategy of sustainable development.”

The topics included are education, culture, labour and social, sustainable development, science and technology and civic participation.

## **III. Organisations and Institutions**

During the VIII Presidential Council in Trujillo, which was held in May 1996, Peru subscribed the Acta of Trujillo and the Protocolo Modificadorio del Acuerdo de Integración Subregional Andino (Acuerdo de Cartagena), were a series of institutional changes were introduced.

After the Protocol of Trujillo, the structure of the Andean Community was as follows:

- a) The Andean Presidential Council. It is the highest organisation of the Andean Integration System, made up of the presidents of the member economies.
- b) The Andean Council of Foreign Ministers, is the organisation that formulated, executed and evaluated the general policies of the Andean Subregional Integration Agreement.
- c) The Commission of the Andean Community, is composed of plenipotentiary representatives of each economy. It is in charge of the formulation, execution and evaluation of the policies of the process of the Andean Subregional Integration Agreement in trade and investment matters.
- d) The General Secretariat Office. It is the executive organisation of the Andean Community. It expresses itself through resolutions.

- e) The Andean Parliament. Constituted in 25 October 1979, this is the deliberating organisation of the community. It is made up of representatives of the member economies' National Congresses. Its headquarters are located in the city of Santa Fé de Bogotá, Colombia.
- f) The Business Consultative Council and the Labour Consultative Council. These are the consultative institutions of the System, constituted by the representatives of the business and labour sectors of each one of the member economy.

The Andean Community also has diverse institutions:

### **1) Financial Institutions**

Andean businessmen can benefit from the financial institutions created by the same Andean Group to support trade development and finance investment projects in the subregion:

- a) The Andean Corporation of Promotion (CAF) was legally constituted in February 1968. It operates as a development, investment and external trade bank and it works like an economic-financial promotion agency. It can obtain resources from third economies and has been successful recently
- b) In 1976 the Andean Reserve Fund was created, with the participation of the five member economies. Because of its success it has become the Latin-American Reserve Fund (FLAR), effective March 1991.

This financial institution supports the balance of payments of the Andean Group economies through credits or loans warrants. It promotes financial development through the granting of credit lines to first class banks that will finance external trade within the region.

### **2) Other Institutions**

- a) The Andrés Bello Agreement. Established in 1970, it is the organisation that preserves the Andean cultural identity, within a Latin-American cultural heritage context.
- b) The Hipólito Unánue Agreement. Created in 1971, it is the organisation in charge of improving the health in the Andean area.
- c) The Simón Rodríguez Agreement. Created in 1976 and whose objective is the design of strategies to improve living and working conditions in the member economies.
- d) Simón Bolívar Andean University, which is dedicated to research, post-graduate education and the strengthening of cooperation and coordination within the universities of the member economies.

## **IV. The Andean Community and the Open Regionalism**

### **1. Southern Common Market (MERCOSUR)**

The integration dynamic in South America revolves around the efforts made to create a free trade area between the Andean Community and MERCOSUR. The first decisive step was taken on 16 April, 1998, with the signing of the general agreement (Acuerdo Marco) for the Creation of the Free Trade Area that includes the gradual construction of a free trade area starting in 2000.

It includes:

- the creation of a free trade zone, which will be achieved by the elimination of tariffs and other trade barriers;
- the establishment of a framework for economic and physical cooperation and integration that will contribute to the creation of an enlarged economic space, where the goods and services will flow on the basis of equity and competitiveness;
- the promotion of the development of the physical infrastructure, with a special emphasis in the establishment of the denominated "integration corridors";
- the creation of a normative framework for the promotion of reciprocal investments;
- the promotion of an economic, energetic, scientific and technological cooperation; and

- the coordination of objectives in the process of hemispheric integration and multilateral forums.

After the eighth negotiation meeting – which took place in mid-March 1999 – and in the face of the nearly permanent interruption of negotiations, Brazil announced its decision of negotiating unilaterally with the Andean Community “the Agreement of Tariff Preferences.” On 12 August, 1999, Brazil and the Andean Community celebrated an agreement of partial economic complementation (Acuerdo de Alcance Parcial de Complementación Económica) that became effective four days later for a two-year period. Through it, both parts established fixed preference margins as a first step for the creation of a Free Trade Area between the Andean Community and MERCOSUR. This agreement will be evaluated and deepened, besides being regulated, in Lima in July of the current year.

For similar purposes, Argentina and the Andean Community (Colombia, Ecuador, Peru and Venezuela) negotiated an Agreement of Tariff Preferences, having agreed on 2608 items – that represents around 92 percent of the total exports by the Andean economies to Argentina – which was subscribed in July 2000. Uruguay and Paraguay, the other two member economies of the MERCOSUR, will undertake a negotiation process with the Andean economies that should also culminate in the subscription of an agreement of similar characteristics. A final agreement is expected to be reached by mid-2001.

In spite of the advances made in the integration process, the interregional trade flows are still modest and constitute one of the main challenges that should be approached. Only greater volumes of intra-regional trade will make the objectives of wider policies’ coordination and a more profound integration at the Andean and South American level coherent.

## **2. Free Trade Area of the Americas**

The economies of the Andean Community participated actively in the whole previous stage to the launching of the negotiations that will pursue the establishment of a Free Trade Area of the Americas (FTAA). They are still doing it now, after the second summit meeting, which took place in April 1998, in Santiago, Chile.

The Andean presidents pointed out the importance of the coordination of positions inside the sub-region for the creation of the FTAA, so that the goals achieved reflect the community position appropriately. The Andean delegations carried out multiple coordination meetings before group encounters and ministerial and vice-ministerial meetings, presenting themselves in these with a coordinated position and a unique voice.

During the year 2000 the meetings of the Groups and Committees of the FTAA were renewed. These are dedicated to make progress with the tasks set by the Ministerial Declaration of Toronto, which establishes that during the present year, the Negotiation Groups will prepare a draft of their respective Chapters of the Agreement. On the other hand, the Groups that are competent on access issues on markets of goods and services must discuss the modalities and procedures of the negotiations.

Inside the total trade of the Andean Community the most dynamic market is the FTAA, (which includes the MERCOSUR), and it represents around 60 percent of the total exports to the world. The European Union is next, with 20 percent, maintaining that level during the whole decade.

United States of America was, in commercial terms, the most important partner for Peru in the nineties, even though it has decreased its participation in the last decades. The special commercial preferences the USA gave Peru were given by the Andean Rules of Tariffs Preferences (LPCA). These agreements allow the entrance of duty free products for most goods (with the exception of

oil, clothes, leather, etc.) Imports from the USA in this group represent a total amount of 3 percent of the world, and 18 percent of the SELA member economies' imports.

As we know the US Congress approved the LPCA in 1991, aiming to support the anti - drugs programs. This rule gives tariff preferences to most of the imports that originated in the Andean economies with the exception of Venezuela. This agreement will be functioning until December, 2001. The Andean economies are expecting to extend the duration of this rule and include of Venezuela.

### **3. European Union**

The European Community (now the European Union, [EU]) granted the Andean Community a generalized system of preferences (for four years) which supported the Special Program of Cooperation (SPG Drugs) presented by Colombia for anti-drugs policy. In this way, most of the industrial products, textiles, main agricultural exports (such as coffee, flowers, cocoa and fish, but excluding bananas), and some fishing products entered the European Community market without being subjected to tariffs or quotas.

The Andean Community has recently revised the regime of tariff preferences with the European Union up to the year 2004. As an achievement of the Rio Summit, both groups have committed themselves to negotiate an association agreement, which will take into account the economic development of the participants.

The European Union is the second commercial partner of and foreign investor in the Andean Community, with an exchange that covers 17 percent of the total Andean trade and an investment that has been multiplied by 30 over the last four years. The relationships between the Andean Community and the EU are sustained on four pillars: political dialogue, preferential access to the EU market (SPG Drugs), the Acuerdo Marco de Cooperación and the specialized dialogue regarding the drug program.

In the Meeting of Chancellors of the Andean Community and the European Union, held on February 24 2000, it was agreed that the General Secretary of the Andean Community and the European Commission will carry out the study or diagnosis about the current state and the perspectives of the economic and commercial relationships between the CAN and the European Union. This was done with regards to the eventual negotiation of an Agreement of Association between both regions. Additionally, the General Secretary has already raised for the European Commission's consideration the proposal by the Andean Community of a developed scheme for this study and it is hoping to establish a meeting to agree on the definitive scheme.

### **4. APEC**

Peru is the only economy of the Andean Community that is a member of APEC. The other two Latin American economies that are full members of the agreement are Mexico and Chile. The first is associated with the North American Free Trade Agreement (NAFTA) and the second is associated with the MERCOSUR.

It is necessary to point out that most of the Andean economies have a small commercial relationship with Asia. In general it represents nearly 1 percent of the total exports, (which is the case of Bolivia, Venezuela, Colombia). Imports are generally manufactures and they represent a bigger percentage (10 to 15 percent). From the Asian perspective, the region of Latin America is not high-priority. Their interests are: their own region, United States, the European Union and then, possibly, Latin America. We also have other priorities in our agenda, like the Andean Community-MERCOSUR and the FTAA.

The first encounter between ASEAN and the Andean Community took place on the 8 and 9 May. The intentions to deepen the dialogue between them were manifested there and this could be useful for developing the integration between our two regions.

Peru is the economy that has made most progress in its institutional relationship with Asia Pacific, followed by Ecuador and Colombia. It would be good to point out that the Andean Community does not have a decree that an economy that participates could inform and coordinate with APEC, which is outlined for the future. It will be important to create a periodic system of information about the activities and evolution of APEC, and try to participate in working groups.

For an economy like Peru, relationships with the Asia-Pacific and APEC economies are not only important for political, geo-strategic or for coordination factors in multilateral forums; they are significant destinations for its flows of goods, services and investments. Therefore, it is clearly a necessity to improve our relations and integration with them, regardless of the method used to achieve it.

In this sense, we consider that the Andean Community has a regional process of integration, compatible with the progress achieved in APEC. This would allow Peru, given the current conditions, to act as a bridge between the two regions. Both integration processes carried out by Peru are an essential part of its commitment to its strategy of open regionalism.

It all depends on the relations that exist with the economies involved and the regional agreements in APEC. The heterogeneity and the deadlines allow Peru to consolidate the subregional agreements to which it belongs in order to achieve liberalization in better conditions, particularly regarding the economies of the Asia-Pacific region.

The priorities are certainly different, but they are very important for the three Latin American members of APEC: Mexico, Chile and Peru. The latter two would be in the free trade area of South America and would allow the construction of bi-oceanic corridors and projection to Asia-Pacific with Brazil and the neighboring economies.

## **5. World Organization of the Trade (OMC) World Trade Organisation (WTO)**

The coordinated and joint participation of the Andean economies in the multilateral commercial negotiations given in the framework of the World Trade Organisation (WTO) is viable because: there is political will and, since 1996 when Ecuador joined it, all the members of the Andean Community have been members of this multilateral organisation. .

The Andean economies are aware that the environment of competition in the WTO includes crucial matters for their development strategies and that the topics treated are closely linked with those of Andean integration. Therefore, in the Tenth Andean Presidential Council that took place in the city of Guayaquil in March 1998, the presidents agreed to strengthen Andean coordination in the World Trade Organisation.

A series of recommendations were given, related to the importance of the strengthening of Andean coordination in the WTO, the topics that should be contemplated for that coordination, and the importance of the Secretariat's technical support role in the coordination of the Andean economies within the framework of this forum.

The General Secretary has been following up the developments of the World Trade Organisation since the suspension of the Third Ministerial Conference. It would be good to highlight that in February 2000 the members of the WTO agreed to start negotiations in agriculture and services, according to the "incorporated agenda".

The Third Meeting of Government Experts regarding commercial negotiations in the framework of the WTO was carried out on 5 May 2000. In this meeting the tables that compared the positions of the members in regard to the topics debated in the WTO, successfully keeping them updated, were reviewed. Ideas were exchanged concerning the improvement of efficiency and the strengthening of the Andean coordination.

In the framework of the multilateral negotiation coordination, problems among the Andean economies arose, mainly due to the presence of a conflict of interest in many issues. For example the Andean economies did not present a joint position in the case of agriculture. Colombia was looking for trade liberalization, according to its participation in the Cairns group; on the other hand Peru was identified as a net food importing economy. Nevertheless, it should be noted that an Andean agricultural policy that it will need some adjustment in the future. Then aiming for a coordinated participation in WTO could make Andean economies sort out their own differences through their regional agreement.

## **V. Balance**

Open Regionalism is one of the pillars that is taken into account for other Latin American experiences and these regional or subregionals agreements have shown a new dynamism since the crisis in the multilateral level.

Peru has a unilateral policy that has tried to reconcile and to consolidate that opening at WTO level. The Peruvian second trade policy review and details of all the subregional agreements in which Peru participates have recently been presented to the WTO.

The establishment of a common market in the Andean Community is goal expected to be achieved by the year 2005. The Free Trade Area of South America is expected for the middle of 2001. Even supposing that this is not accomplished by 2001 it will surely be a reality before 2005.

The negotiations regarding the FTAA will finish in the year 2005, when the opening of markets begins; we have a series of products with free access. But a free trade area in FTAA will imply that we also liberalize the market. That means competition with United States, Canada and other economies. It is quite a complex challenge that will begin by 2005 and the multilateral commitments that will condition us are programmed to end by the 2003 (although they will take longer after the failure of Seattle). But the WTO is moving forward in the sectoral negotiations regarding services and agriculture, among others. They are influencing our policies, which must be compatible with the WTO approaches.

Then, I believe that the great challenge is how to make APEC become a WTO plus, the FTAA become an APEC plus, the Free Trade Area of South America become an FTAA plus and the Andean Community become a Free Trade Area of South America plus. Because if we do not achieve different depth levels in the integration processes, then there is no sense in maintaining formally the subregional agreements. We can only speak of complementarity among the integration processes if we are talking about different levels of integration. These objectives are outlined in theory, but it is necessary to observe their implementation.



**PREFERENTIAL SCHEMES OF MARKET ACCESS OF USA AND EUROPEAN UNION**

	<b>ATPA (USA)</b>	<b>Special treatment European Union</b>
	<b>1991-2001</b>	<b>Until 2004</b>
<b>Rules of origin</b>	Direct Expedition	Direct Expedition
	Format "A" is not required	Format "A" is required
	Products must have as a minimum of 35% of domestic components	Substantial transformation of the export products in origin
	Cumuli from the donated economy:	Tariff proof of tariff jump
	The inputs, parts and pieces from the USA are considered as inputs for the exporter economy up to a total amount of 15%	Cumuli from the donated economy:
	Regional accumulation origin: Andean economies, Puerto Rico, Caribbean Rim, Virgin islands.	There is regional accumulation: Andean economies, Members of ASEAN, economies of the Caribbean and Central America.
<b>Benefits</b>	6,300 tariff items of the supply entered into coordination of tariff franchise	Flat tariff 0 for industrial products and textiles composed in chapters 25-97 of tariffs.
	1,100 tariff items are excluded from the preferences	Agricultural products do not have preferences, except a positive list.
<b>Agropecuary</b>	Tariff franchise	It does not have preferences
<b>Agroindustrial</b>	Except: rum, tafia and sugar	Except a positive list, the products of this list are in this in franchise
<b>Fishing</b>	Tariff franchise	Tariff franchise
	Except 3 items of canned tuna fish	Exception: shrimps that enter with tariff of 3.5%
<b>Textiles and Confections</b>	217 items with preferences come in with franchise	Tariff franchise
	968 tariff items are excluded, come by normal rights	With no quotas Exceptions: cotton products, these enter in franchise with quotas.
<b>Industrials and Others</b>	Tariff franchise	General tariff franchise
	Exceptions contained in the list I	
<b>Handicrafts</b>	Tariff franchise	General tariff franchise

Source: *Andean Community (1999)*.

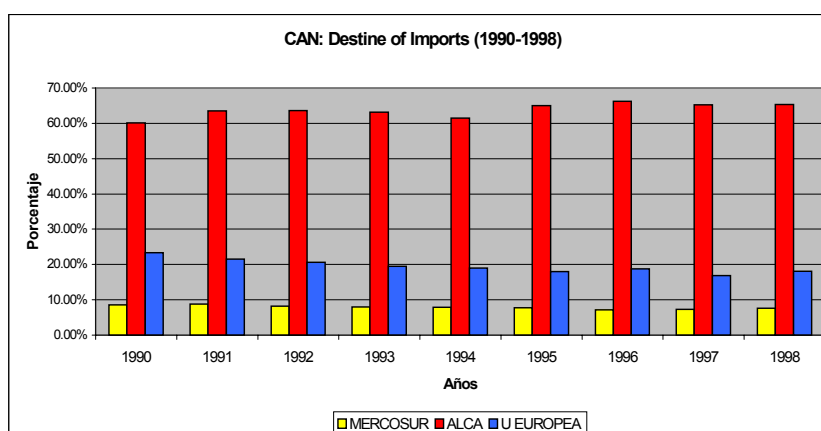
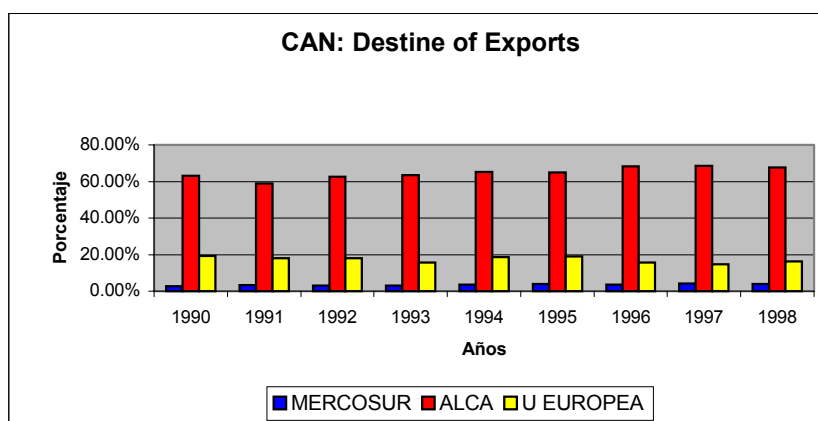
**EXPORTS OF THE ANDEAN COMMUNITY TO ASIA-PACIFIC: 1996**  
(In percentages)

	<b>East and Southeast Asia (8 economies)</b>	<b>Japan</b>	<b>Total</b>
Bolivia	0.3	0.3	0.6
Colombia	0.7	3.3	4
Ecuador	7	2.8	9.8
Perú	9.2	6.6	15.8
Venezuela	0.3	0.6	0.9

Source: CEPAL: *En impactos de la crisis asiática en América Latina. Cap. 2*

<b>Agreement</b>	<b>Maximum Deadline</b>	
	2005	2010-2020
Andean Community	Common Market	
CAN - MERCOSUR 2000	Free Trade Area	
FTAA	End of negotiations	Free Trade Area
European Community	SGP1	
APEC		Trade Liberalization
WTO	Ending of Millennium Round Program - 2003	

**ANNEXES**



Source: CAN General Secretariat

**PERU: EXPORTS TO THE WORLD**  
(US\$ m.)

	1997	%	1998	%	19991/	%
<b><u>NAFTA</u></b>	<b>1717.32</b>	<b>25.4%</b>	<b>1932.72</b>	<b>34.3%</b>	<b>818.26</b>	<b>29.6%</b>
CANADA	119.71	1.8%	124.96	2.2%	58.74	2.1%
USA	1597.61	23.6%	1807.76	32.1%	759.52	27.5%
<b><u>ALADI</u></b>	<b>1,073.05</b>	<b>15.9%</b>	<b>958.91</b>	<b>17.0%</b>	<b>399.51</b>	<b>14.5%</b>
<b><u>CANADA</u></b>	<b>515.70</b>	<b>7.6%</b>	<b>468.19</b>	<b>8.3%</b>	<b>161.67</b>	<b>5.9%</b>
BOLIVIA	111.31	1.6%	110.55	2.0%	49.82	1.8%
COLOMBIA	154.59	2.3%	143.38	2.5%	45.20	1.6%
ECUADOR	111.24	1.6%	106.24	1.9%	23.71	0.9%
VENEZUELA	138.56	2.0%	108.02	1.9%	42.94	1.6%
<b><u>MERCOSUR</u></b>	<b>310.92</b>	<b>4.6%</b>	<b>215.03</b>	<b>3.8%</b>	<b>96.65</b>	<b>3.5%</b>
ARGENTINA	48.33	0.7%	28.65	0.5%	11.84	0.4%
BRAZIL	256.09	3.8%	180.2	3.2%	81.96	3.0%
PARAGUAY	1.59	0.0%	1.48	0.0%	0.84	0.0%
URUGUAY	4.91	0.1%	4.70	0.1%	2.01	0.1%
<b><u>OTHERS</u></b>	<b>246.43</b>	<b>3.6%</b>	<b>275.69</b>	<b>4.9%</b>	<b>141.19</b>	<b>5.1%</b>
CHILE	132.27	2.0%	138.44	2.5%	84.34	3.1%
MEXICO	114.16	1.7%	137.25	2.4%	56.85	2.1%
<b><u>MERCADO COMUN CENTROAM<sup>2</sup></u></b>	<b>41.71</b>	<b>0.6%</b>	<b>36.31</b>	<b>0.6%</b>	<b>14.95</b>	<b>0.5%</b>
<b><u>COMUNIDAD DEL CARIBE<sup>3</sup></u></b>	<b>4.96</b>	<b>0.1%</b>	<b>2.76</b>	<b>0.0%</b>	<b>3.35</b>	<b>0.1%</b>
<b><u>RESTO DE AMERICA<sup>4</sup></u></b>	<b>68.83</b>	<b>1.0%</b>	<b>47.58</b>	<b>0.8%</b>	<b>24.04</b>	<b>0.9%</b>
<b><u>EUROPE</u></b>	<b>2,160.06</b>	<b>32.0%</b>	<b>1,396.80</b>	<b>24.8%</b>	<b>1,044.99</b>	<b>37.8%</b>
<b><u>ASIA</u></b>	<b>1,562.68</b>	<b>23.1%</b>	<b>1,183.22</b>	<b>21.0%</b>	<b>420.98</b>	<b>15.2%</b>
<b><u>AFRICA</u></b>	<b>74.91</b>	<b>1.1%</b>	<b>39.62</b>	<b>0.7%</b>	<b>18.72</b>	<b>0.7%</b>
<b><u>OCEANIA</u></b>	<b>22.98</b>	<b>0.3%</b>	<b>13.48</b>	<b>0.2%</b>	<b>7.73</b>	<b>0.3%</b>
<b><u>Others</u></b>	<b>32.90</b>	<b>0.5%</b>	<b>28.16</b>	<b>0.5%</b>	<b>10.62</b>	<b>0.4%</b>
<b><u>TOTAL</u></b>	<b>6,759.40</b>	<b>100.0%</b>	<b>5,639.56</b>	<b>100.0%</b>	<b>2,763.15</b>	<b>100.0%</b>

1/ Statistics: June 1999.

2/ Include a\*\* Costa Rica, Guatemala, El Salvador, Honduras and Nicaragua.

3/ Include a Antigua and Barbuda, Bahamas, Barbados, Belize, Dominica, Granada, French Guayana, Jamaica, Montserrat, St Vincent and the Granadas/Grenadines??, Saint Lucia and Trinidad and Tobago.

4/ Include a Aruba, Dutch Antilles, Bermudas, Cuba, Guadalupe, Guyana, Haití, Martinique, Panamá, Puerto Rico, Dominican Republic and Surinam.

Source: Estadísticas de ALADI y ADUANAS.

**PERU: IMPORTS FROM THE WORLD**  
(US\$ m.)

	1997	%	1998	%	19991/	%
<b><u>NAFTA</u></b>	<b>2561.16</b>	<b>29.9%</b>	<b>2372.4</b>	<b>29.4%</b>	<b>946.23</b>	<b>29.9%</b>
CANADA	289.91	3.4%	209.14	2.6%	58.82	1.9%
USA	2271.25	26.5%	2163.26	26.8%	887.41	28.0%
<b><u>ALADI</u></b>	<b>3,033.16</b>	<b>35.4%</b>	<b>2,573.67</b>	<b>31.9%</b>	<b>971.85</b>	<b>30.7%</b>
<b><u>CAN</u></b>	<b>1,571.66</b>	<b>18.4%</b>	<b>1,176.34</b>	<b>14.6%</b>	<b>448.12</b>	<b>14.2%</b>
BOLIVIA	151.27	1.8%	128.92	1.6%	26.69	0.8%
COLOMBIA	613.29	7.2%	437.25	5.4%	181.70	5.7%
ECUADOR	240.26	2.8%	205.03	2.5%	62.80	2.0%
VENEZUELA	566.84	6.6%	405.14	5.0%	176.93	5.6%
<b><u>MERCOSUR</u></b>	<b>800.13</b>	<b>9.3%</b>	<b>814.44</b>	<b>10.1%</b>	<b>275.57</b>	<b>8.7%</b>
ARGENTINA	360.66	4.2%	372.04	4.6%	123.56	3.9%
BRASIL	375.31	4.4%	380.96	4.7%	132.93	4.2%
PARAGUAY	24.99	0.3%	21.15	0.3%	9.90	0.3%
URUGUAY	39.17	<b>0.5%</b>	40.29	<b>0.5%</b>	9.18	<b>0.3%</b>
<b><u>OTHERS</u></b>	<b>661.37</b>	<b>7.7%</b>	<b>582.89</b>	<b>7.2%</b>	<b>248.16</b>	<b>7.8%</b>
CHILE	311.27	3.6%	285.47	3.5%	132.76	4.2%
MEXICO	350.10	4.1%	297.42	3.7%	115.4	3.6%
<b><u>MERCADO COMUN CENTROAM<sup>2/</sup></u></b>	<b>39.56</b>	<b>0.5%</b>	<b>82.74</b>	<b>1.0%</b>	<b>14.02</b>	<b>0.4%</b>
<b><u>COMUNIDAD DEL CARIBE<sup>3/</sup></u></b>	<b>5.64</b>	<b>0.1%</b>	<b>5.02</b>	<b>0.1%</b>	<b>0.87</b>	<b>0.0%</b>
<b><u>RESTO DE AMERICA<sup>4/</sup></u></b>	<b>18.56</b>	<b>0.2%</b>	<b>16.27</b>	<b>0.2%</b>	<b>5.02</b>	<b>0.2%</b>
<b><u>EUROPA</u></b>	<b>1,516.94</b>	<b>17.7%</b>	<b>1,444.52</b>	<b>17.9%</b>	<b>596.31</b>	<b>18.8%</b>
<b><u>ASIA</u></b>	<b>1,264.21</b>	<b>14.8%</b>	<b>1,478.64</b>	<b>18.3%</b>	<b>525.26</b>	<b>16.6%</b>
<b><u>AFRICA</u></b>	<b>19.22</b>	<b>0.2%</b>	<b>27.74</b>	<b>0.3%</b>	<b>62.66</b>	<b>2.0%</b>
<b><u>OCEANIA</u></b>	<b>98.96</b>	<b>1.2%</b>	<b>75.89</b>	<b>0.9%</b>	<b>41.74</b>	<b>1.3%</b>
<b><u>OTROS</u></b>	<b>0.93</b>	<b>0.0%</b>	<b>2.85</b>	<b>0.0%</b>	<b>1.18</b>	<b>0.0%</b>
<b><u>TOTAL</u></b>	<b>8,558.34</b>	<b>100.0%</b>	<b>8,079.73</b>	<b>100.0%</b>	<b>3,165.14</b>	<b>100.0%</b>

1/ Statistics: June 1999

2/ Include a\*\* Costa Rica, Guatemala, El Salvador, Honduras y Nicaragua.

3/ Include a Antigua y Barbuda, Bahamas, Barbados, Belice, Dominica, Granada, Guayana Francesa, Jamaica, Montserrat, San Vicente y Granadinas, Santa Lucía y Trinidad y Tobago.

4/ Include a Aruba, Antillas holandesa, Bermudas, Cuba, Guadalupe, Guyana, Haití, Martinica, Panamá, Puerto Rico, Rep. Dominicana y Surinam.

Source: Estadísticas de ALADI y ADUANAS.

# **SOUTH AMERICA FREE TRADE AREA (SAFTA) AND APEC: TOWARD RELATIONSHIPS FOR DEVELOPMENT**

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## **INTRODUCTION**

This paper examines the relationships among the Andean economies and the members of APEC. Particularly, it will examine the case of Peru, the only Andean member of APEC until the year 2008.

In the first part of the paper the Andean integration process will be discussed: the commercial and investment relationships with economies from Asia-Pacific region, as well as some effects of the recent crisis.

The second part, introduces the advances made in the construction of a South American free trade area, based on negotiations between the Andean Community and MERCOSUR economies. Also, some reflections about the relationship with the Asia-Pacific region will be expressed.

It is assumed that the different processes and negotiation or integration forums are complementary, and that strengthening the relationships with economies on the other side of the Pacific Rim is fundamental to the perspective of a multi-polar world construction.

## **ANDEAN COMMUNITY – APEC**

The Andean presidents have reaffirmed the transcendence of building the Andean Community under a scenario of open regionalism and globalization, searching for a growing participation by citizenship in this process and the reinforcement of the community institutions.

The agreed guidelines refer to the construction of a common market, the depth of the physical integration and border development, the design and development of a common foreign policy, the invigoration of the Andean System of Integration, the construction of a social calendar and civic participation, and the development of security and trust measures. This integral treatment constitutes a great advance, and Peru is committed to these objectives.

### **1. The Commercial Exchange**

Trade among Latin American economies and the Asia-Pacific region has been substantially increased in the first half of the nineties. Latin American imports from Asia were increased by a greater amount than the increase in the Asian purchases from Latin America. The Asia-Pacific region is one of the most important commercial partners for Latin America, but it has a small importance for the first ones.

Two interrelated problems can explain the moderate level of growth of trade flows between the two regions: the composition of the economies and the composition of products: trade flows between the Asia-Pacific and Latin America are concentrated in a few economies: Japan, China, Chinese Taipei and Korea in Asia; Brazil, Chile and Mexico in Latin America. About the composition of products: imports by Latin America from Asia are composed of manufactured goods and Latin America exports primary products.

With regard to the volume of trade, the biggest economies of the region have the largest volume, but the Asian market is also a very important part of the global trade of the smaller economies like Chile and Peru.

APEC is very important as a market of origin for Andean imports (around 55 percent) and as a destination for Andean products (52.7 percent of the total exports). The exports from the Andean economies to the APEC economies has risen from US\$14,000 million in 1991, to almost US\$25,000 million in 1996, although the most important export markets are the United States and Japan.

If we consider only the Asian economies, the commercial relationship with most of the Andean economies, is small. They represent in general almost 1 percent of the total exports (Bolivia, Venezuela, Colombia). Imports are generally manufactures and they represent a bigger percentage (between 10 to 15 percent),

**Exports from the Andean Community to the Asia-Pacific: 1996**  
(Percentage)

	<b>East and Southeast Asia (8 economies)</b>	<b>Japan</b>	<b>Total</b>
Bolivia	0.3	0.3	0.6
Colombia	0.7	3.3	4
Ecuador	7	2.8	9.8
Peru	9.2	6.6	15.9
Venezuela	0.3	0.6	0.9

*Source: ECLAC*

It is necessary to take into account that in markets of the OECD most Asian exports don't compete with the Latin American ones and particularly not with those from the Andean Community. The Asian exports are mainly manufactured consumption and capital goods (electronic, electric products, computers, machinery, which are different from the Latin American exports of raw materials and semi-manufactured goods to Europe and Japan mainly). But, the situation is different in the markets of the United States and the Region. These blocs absorb most of the manufactures of the Andean sub-region and it is where Andean goods compete with Asian products (chemicals, textiles, steel, and footwear products).

The entry of economies like China and Indonesia to the market for some manufactured products can change the prices of those products and limit the possibility of access for our economies.

## **2. Investment Flow Tendencies**

The characteristics of Asian investments in Latin America are: concentration in textile and footwear sectors, concentration in few economies of the region, trade in natural resources (Peru and Brazil).

The Asian investments in the region are small (1 to 2 percent in average), they are located mainly in the mining sector (petroleum, mining centers) and they are used to satisfy their own markets.

Factors that impel the investments are: cost of the labour; the proximity to the North American market; the presence of raw materials with advantages in price and quality; incentives to investment; stability of the region in macroeconomic terms and the growth of domestic market; as well as the localization advantages for the subregional initiatives of integration (the case of the FTAA) which can stimulate the flows of investment from the Asia-Pacific.

### 3. The Crisis

The financial crisis negatively influenced investment flows to Latin America in the short- and medium-term.

In the case of the Andean Community, the situation could get complicated, because of the dependence of these economies on foreign investment. This situation can produce a greater pressure on the Balance of Payments and on the economic growth, as well as a lack of liquidity.

After the Asian crisis, the commercial outlook for Latin America and, particularly for the Andean Community is not very encouraging. The immediate effects of the crisis on our economies, was a reduction in raw materials prices, (particularly for copper and petroleum), as well as the exit of short-term capital flows that were invested in the stock market.

#### Prices of the Basic Products (Variations in percentages)

	General Index	Copper	Petroleum	Coffee	Grains
Jun-97	-2.40	6.40	-4.30	60.00	-27.00
Jul-97	-4.00	15.10	-6.10	44.60	-31.10
Aug-97	-3.00	9.10	-9.10	41.20	-21.50
Sep-97	-1.70	4.60	-21.70	50.60	-15.70
Oct-97	-0.40	3.40	-18.70	32.40	-3.50
Nov-97	-0.90	-7.40	-17.90	22.60	3.00
Dec-97	-3.50	-20.60	-32.20	30.10	1.90
Jan-98	-6.20	-28.80	-42.10	15.70	-1.50

Source: Datastream

Bolivia was affected because of the restriction of investment flows. Looking at the social environment, the economy faced mobilizations from diverse sectors that demanded salary increases.

In the case of Colombia, monetary measures were applied (devaluation of 20 percent), because of the volatility of short-term capital flows which was experienced in the exchange and financial markets: the offer of foreign currencies was increased using reserves, this fact decreased the fitting tax to external credits, and the bank rate increased from 24 to 40 percent.

In Venezuela, because of the decreasing prices, the government had to reduce public expenditure. As it is known, the Petroleos de Venezuela exports (PDVSA) represent more than 50 percent of the government's revenues.

Ecuador had a similar problem, since 35 percent of its exports are composed of sales of hydrocarbons that generate 30 percent of the fiscal income. The measures taken in Ecuador were a 5 percent reduction in the expenditure and an increase in tariffs.

Because of the Peruvian commercial relationship with the Asian region and because of the characteristics of their exports structure, the Asian crisis had a negative impact on Peru. The exports volume fell, as a result of the reduction in demand and the fall in the world prices.

### 4. Peruvian Participation in APEC

Peru, after systematic negotiations during the nineties, increased its links with the Asian economies that culminated with the official Peruvian incorporation to APEC in November 1998

becoming the only Andean member of APEC. There are other two Latin American members that were already full members of the agreement: Mexico and Chile. The first one associated to the North American Free Trade Agreement and the second associated to MERCOSUR. One effect of this has been an increase of the trade (not investments) with Asia.

We can appreciate from the following table that trade with Asia is most significant for Peru, comprising almost 16 percent of the total amount of its exports. Looking at all South American economies Chile is Asia's biggest South American trading partner although trade has begun to diminish as Chile exports more to the European Union. Peru is Asia's second biggest South American trading partner.

**Exports from the Andean Community to Asian Economies  
(Percentage of the total)**

<b>Andean Economies</b>	<b>To Asia</b>	<b>To Japan</b>	<b>% of total</b>
BOLIVIA	0.3%	0.3%	0.6%
COLOMBIA	0.7%	3.3%	4.0%
ECUADOR	7.0%	2.8%	9.8%
<b>PERU</b>	<b>9.2%</b>	<b>6.6%</b>	<b>15.8%</b>
VENEZUELA	0.3%	6.6%	0.9%

*Source: APEC, Statistics, 1997*

Peruvian exports to Asia experienced an important growth until 1997. However, in 1998, as a result of the crisis, exports fell by about 48 percent, and making a recovery in 1999 (although the amounts didn't reach those obtained in 1997). Exports to Asia were US\$899 million in 1999, compared with the US\$1,563 million exported in 1997. Also, in 1999 the Asian share of exports puts them in third place (15 percent) after the United States (29 percent) and Europe (36 percent).

In the case of the imports, it must be pointed out that these kept constant between 1997 and 1998, having had a 12 percent fall in 1999. In 1998, the amount of imports was US\$1,339 million, and US\$1,166 million in 1999, becoming the third supplier for the Peruvian market.

**Peru: Evolution of the Trade with Asia  
(Rate of growth)**

	<b>1995</b>	<b>1996</b>	<b>1997</b>	<b>1998</b>	<b>1999</b>
EXPORTS	27.2%	3.6%	8.0%	-48.3%	11.3%
IMPORTS	28.5%	-6.3%	5.9%	5.9%	-12.9%

*Source: Statistics from ALADI and ADUANAS*

**ANDEAN COMMUNITY – MERCOSUR: RELATIONSHIPS WITH ASIA**

The South American integrationist dynamic turns around the efforts to create a free trade area between the Andean Community and MERCOSUR. The first decisive step towards this was taken one 16 April 1998, when the five Andean economies and the four MERCOSUR economies subscribed to the Framework Agreement to create the Free Trade Area (FTA) between the two blocks. It includes the gradual construction of a free trade area by the year 2000. This Agreement will benefit a population of 300 million people whose Gross Domestic Product amounts to US\$1.2 trillion.

This agreement includes the following objectives:



- Creation of a free trade area, by eliminating tariffs and other barriers to trade.
- Establishment of a framework for economic cooperation and physical integration that contributes to create an enlarged economic space, where the goods and services can flow competitively and equally.
- Promotion of the development of a physical infrastructure, especially in the establishment of what is defined as a “integration corridors.”
- Creation of a normative framework for the promotion of reciprocal investments.
- Promotion of economic, energy, scientific and technological cooperation.
- Coordination of positions in the process of hemispheric integration and multilateral forums.

In the following table the negotiation outlines that have been used from 1995 in the relationships between the two subregional blocks are described.

#### **Phases of the Andean Community – MERCOSUR Negotiations**

<b>Period</b>	<b>Topic of Discussion</b>	<b>Result</b>
<b>February, 1995 First Meeting</b>	<ul style="list-style-type: none"> <li>▪ Agreements for a creation of a free trade area, which included topics from the Uruguay Round, besides topics of services, origin norms, and others.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Stagnation because of the ambitiousness of the project.</li> <li>▪ Topics that were not still seen were included into the groups.</li> </ul>
<b>1995-1996</b>	<ul style="list-style-type: none"> <li>▪ Adoption of the negotiation scheme of the historical patrimony (ALADI framework).</li> <li>▪ Separated Agreements. MERCOSUR acted as a bloc and the Andean economies as individuals.</li> </ul>	<ul style="list-style-type: none"> <li>▪ The negotiation topics included issues approached in the framework.</li> <li>▪ Advances were not achieved.</li> </ul>
<b>1997</b>	<ul style="list-style-type: none"> <li>▪ Outline change: negotiation of a free trade area.</li> <li>▪ Only the tariff topic was included.</li> <li>▪ Negotiation among blocs.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Sluggishness of the negotiations because of the sensitive sectors in each bloc and regarding the topic of norms of origin, and safeguards clauses. Different proposals.</li> </ul>
<b>1998</b>	<ul style="list-style-type: none"> <li>▪ Change of schemes: negotiation of the historical patrimony.</li> <li>▪ It also included cooperation aspects, negotiations of goods and services and reciprocal investment.</li> <li>▪ Creation of a free trade area (2000) before a tariff reduction.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Stagnation in the first phase. Problems related to tariff preferences appeared. Andean Community looked for a reduction of 100% of tariffs while MERCOSUR was only willing to offer 30 to 50%.</li> <li>▪ An agreement was not reached on the list of products of the historical patrimony</li> </ul>
<b>1999-2000</b>	<ul style="list-style-type: none"> <li>▪ Brazilian proposal to the Andean economies to negotiate separately from the MERCOSUR with the purpose of creating a free trade area.</li> <li>▪ Andean Community and Argentina intend to restart negotiations in the style of that advanced with MERCOSUR- like bloc.</li> <li>▪ Uruguay and Paraguay get ready to develop a similar process with the Andean economies</li> </ul>	<ul style="list-style-type: none"> <li>▪ In August 1999, Brazil and the Andean Community subscribed to an Agreement of Economic Complementation as a first step toward the creation of a free trade area.</li> <li>▪ Andean Community and Argentina negotiated between 29 October 1999 and 31 March 2000. The Agreement will be valid in June</li> </ul>

Peru and Chile constitute concrete alternatives to export products from the MERCOSUR to the Pacific, and for the interaction and projection of these regions with the Asia-Pacific region. There are diverse projects of bi-oceanic corridors that would be functional to these objectives and the integration among our economies.

Chile has been presented as the natural exit from the MERCOSUR to the Pacific, and it has carried out big efforts to foment its economic and political links with the Asian region: infrastructure works (particularly ports), and investments in Bolivian railroads are examples of a great investment activity and projects for the future. Mexico has also strengthened its bonds and investments with the Asia-Pacific, but this market is not relatively important for Mexico the way it is for Chile. More than two-thirds of Mexican trade is with the United States and Canada, which are also full members of APEC.

Peru also can and should play an important role in creating bi-oceanic corridors and its projection to the Asia-Pacific region. This can be an advantage if the agreement between the Andean Community and MERCOSUR becomes a reality at the beginning of the 2000. There are diverse projects, some underway, for example the case of the construction of the Ilo–Desaguadero highway and the Bolivian articulation in this corridor. There are also experts that have proposed the importance of the Ilo and Matarani ports, against others which emphasize the Paita port (located to the north) or the Callao port, being transformed into a megaport.

Both Peru and Chile can have an important role during the next few years in the relationships among the Andean Community, as can the MERCOSUR with the Asia-Pacific region. In the north, Mexico, the United States and Canada are other economies of the FTAA which are also members of APEC and they have diverse interests in that region.

From the Asian perspective, the Latin American region is not high-priority. Their interests are: their own region, the United States, the European Union and, possibly later, Latin America. For Peru's case, we have other priorities in our calendar: for example, the Andean Community–MERCOSUR, and the FTAA.

Peru is the most advanced economy regarding an institutional relationship with the Asia-Pacific region. Ecuador and Colombia are in second place. It is important to point out that inside the Andean Community there is no institution to coordinate with APEC, but one is planned for the future. Besides, finishing a project related to a periodic system of information about the APEC activities and evolution is looked forward to, as is trying to participate in work groups.

## **PERSPECTIVE**

Our economies are participating simultaneously in several integration processes, adopting diverse modalities of open regionalism.

After the failure of Seattle, subregional and regional agreements have recaptured the attention: in South America, there are advances but also there are difficulties such as commercial differences in MERCOSUR and political turbulence inside the Andean Community.

Both integration agreements share, however, the objective of looking for a confluence and, when negotiations finish in the year 2005, to arrive cohesively at hemispheric integration. Consolidation of a multi-polar world is also looked forward to, and that is why relationships with Europe and Asia are fundamental for Latin America.

Certainly, the priorities in the relationships are different, but they are still very important for the three Latin American members of APEC: Mexico, Chile and Peru. The last two would be in the

South American free trade area, and would allow the construction of bi-oceanic corridors and their projection to the Asia-Pacific region with Brazil and neighboring economies.

But, there is no doubt that problems exist. Among those already mentioned, it should be added that Venezuela suggested a direct integration with MERCOSUR, Colombia is again insisting on its incorporation to the NAFTA, either through the invigoration of the G-3 or not.

Also, in Asia there are diverse positions. For instance, strengthening links among ASEAN economies with Japan, China and Korea. The Philippines is looking forward to an economic community in East Asia and a common currency, to which some economies have manifested their opposition or skepticism.

May 8 and 9, 2000 have been celebrated as the first ASEAN–Andean Community meeting, one that manifested greater will for deepening the dialogue than in the recent past. It would be good to develop the integration between our two regions.

For an economy such as Peru the relationship with the Asia-Pacific region and APEC, is not only important because of political or geo-strategic factors, or the coordination of positions in multilateral forums. It is an important region because of the flows of Peruvian and Asian goods, services and investments. Aside from being the best mechanism to make it, it is clear there is a need to focus upon our relationships and integration.

## TOWARDS CLOSER JAPAN–KOREA ECONOMIC RELATIONS: A SUPPLEMENTARY NOTE

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In a word, the Japan-Korea free trade agreement (FTA) aims to broaden and strengthen a pipe linking the two economies. Both Japan and Korea are transforming their economic structure dynamically in response to the challenge of globalization. With the existing pipe often affected by recurrent conflicts over trade imbalances, the two economies may come apart. The FTA is needed to combine their efforts so that both will survive the globalization challenge. In both North America and Europe neighbor economies collaborate closely for the same purpose. Why not the two closest economies in Northeast Asia?

### **Korean Concern about FTA**

Institute of Developing Economies (IDE) and Korea Institute for International Economic Policy (KIEP) organized jointly an open symposium in Seoul on 24 May 2000. Both Dr. Kyung Tae Lee and I presented a single joint message: we need an FTA to strengthen the tie between the two economies. However, Korean panelists expressed their concerns that:

1. The Korean trade balance with Japan will deteriorate further as a result of the FTA. They have become more sensitive to the balance of payment deficit since the East Asian crisis.
2. Korean firms will be overwhelmed by Japanese firms in open competition under the FTA so that Korea will specialize in low productivity sectors such as primary industries and textile, while Japan will specialize in high productivity sectors such as machinery, metal and chemicals.
3. Korea wishes to promote a trilateral cooperation with Japan and China rather than a bilateral one only with Japan.

The Japanese panelists responded to each of them as follows:

1. The Korean persistent trade deficit with Japan reflects principally its stage of industrialization and will resolve overtime as Korea catches up with Japan in the long-term, given Korea's growth rate (twice as high as Japan's) and Japan's rapidly aging population. Korea's trade deficits will continue to be financed by capital flow and cause no harmful impact on Korean growth.
2. Given the difference in size between Japan and Korea, more Japanese firms will survive through competition but it is too pessimistic to predict that Korean firms will survive only in primary and labor intensive industries and be defeated by Japanese firms in machinery, metal, and chemical industries. The prediction does not fit the current reality in which intra-industry specialization between Korea and Japan is in progress in those latter industries as well as service industries. It is more likely that both Korean and Japanese firms will survive the intensified competition and become globally competitive in those industries as a result of intra-industry specialization.
3. We welcome strengthening the trilateral cooperation with China through various channels including APEC. However, China is not ready for such high level cooperation as an FTA with Korea and Japan at a time when its all efforts are directed to joining the World Trade Organization (WTO). Will Korea just wait until China gets ready?

Korean panelists did not respond directly but stressed its cautious attitude. They pointed out that, while the negative effect of tariff elimination will emerge shortly, the positive effect of dynamic

impacts will emerge only later and they would like to see such preparatory measures taken in advance as: establishment of a Korea-Japan Investment Bank and an Industrial and Technical Cooperation Committee in order to guide industries towards a Korea-Japan pattern of intra-industry specialization, as was indicated in our Joint Communiqué. As regards the time dimensions of the effects of the FTA, a Japanese panelist commented that, contrary to the Korean suggestion, the positive effects will come sooner than the negative effects of tariff elimination (which will only be effected at the end of ten years). Businessmen will not wait until the FTA is completed but react quickly to the announcement of an FTA.

### **Domestic Resistance by Vested Interest Groups**

The Korean concerns reflect the remaining mistrust of the Japanese by the Korean public as well as the strong resistance to market opening of the Korean businessmen. Of course, Japan is never free from similar resistance by vested interest groups, especially in fisheries, farming, and apparel businesses. I have realized that one strong impediment to forming an FTA does not come from abroad but from vested interest groups at home. We had observers from 14 APEC member economies at the symposium who observed our discussion with concern of a different type. But I bet they would have been relieved to find that it would take time for Japan and Korea to agree on an FTA. However, this suggests a strong case for the FTA. The resistance by vested interest groups at home tends to impede the move for liberalization at the WTO and APEC. If we persuade them to accept an FTA, it will pave a road to a successful liberalization at APEC and the WTO. The FTA serves as a laboratory for liberalization as we stressed in our joint communiqué.

Incidentally, both Korea and Japan are now talking about FTAs with different partners: Korea with Chile, Israel, and New Zealand; and Japan with Singapore, Mexico, Chile, and Canada. It is likely that other FTAs combinations, especially the Korea-Chile and Japan-Singapore FTAs will be agreed before the Japan-Korea FTA. The same rationale for the FTA is shared by each of these FTA talks but the cost of domestic adjustment will be much less in these combinations than those in the Japan-Korea FTA.

Although bilateral FTAs have proliferated since the late 1980s, both Japan and Korea are late-comers on this bandwagon and neither has experienced an FTA yet. The last two FTAs will serve as experimental attempts in bilateral FTA for Japan and Korea. An FTA requires adjustment of domestic production and a wide set of individual arrangements at home. The Japan-Singapore FTA will be a "new age FTA," including not only the elimination of tariffs and non-tariff measures formulated by the traditional GATT Article 24, but also investment promotion and mutual recognition agreement of rules and standards. It should also be equipped with effective rules of origin and safeguard measures. Since Singapore is not a big exporter of fishery and farm products, Japan will be required to make much less adjustment in these sectors for an FTA with Singapore. It seems to be the most qualified partner with whom Japan can experiment with a new age FTA. In contrast, the Japan-Korea FTA will be burdened with far heavier adjustment costs at home.

In less than a week after our joint symposium, Japanese Prime Minister Mori visited Seoul and had his first summit meeting with Korean President Kim Dae Jung. Their joint press communiqué referred to our FTA reports and stated that the two governments would utilize our reports for strengthening the ties between Korea and Japan. It may take time for Japan and Korea to agree on the negotiation of the FTA. It is all right. Korea is an important neighbor. We cannot fail in this attempt. We will take time in talking about the Korean and Japanese concerns mentioned above and will push the FTA slowly but steadily.

# KOREA'S NEW DIRECTIONS TOWARDS REGIONALISM

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## I. INTRODUCTION

There has been great progress for the Korea-Chile free trade agreement (FTA), since leaders of Korea and Chile discussed a review of the feasibility of an FTA between two economies by working groups of both economies during the APEC Leaders' meeting in Kuala Lumpur, November 1998. Leaders of both economies declared the official launch of the negotiations for the FTA at the Auckland APEC Leaders' meeting in September 1999. Currently, the two economies have finished the third round of negotiations.

Korea chose Chile as its first FTA partner because of high complementarity in trade structure and learning effects from Chile's plentiful experience in regional trading agreements. Chile chose Korea not only because Chile highly valued Korea's close linkages with neighboring Asian economies (Chile can take advantage of Korea's trade linkages to widen Chile's market access to other Asian economies), but also because of Korea's growth potential through performing strong reforms in several sectors including financial sector.

This paper is aimed at providing a discussion of the Korea-Chile FTA: its future prospects as well as the policy implications of Korea's FTA.

## II. KOREA'S NEW DIRECTIONS TOWARDS REGIONALISM

Though Korea achieved economic growth under the multilateral system of the GATT/WTO, its reaction to a widening spread and deepening of regional trading blocs has been lukewarm, due to domestic opposition to market opening under regional trading agreements (RTAs). However, since the financial crisis began, the Korean government has been re-evaluating the potential gains to be made by removing trade barriers on a preferential basis, and has decided to pursue the establishment of preferential trading blocs.

One major motivation behind Korea's new thinking on regionalism is the trade diversion caused by the growth of regional trading blocs. A WTO (1995) report discusses the causes of the rapidly rising number of regional trading blocs<sup>1</sup> that were created in the early 1990s. That report concluded the growing trends of regionalism as an insurance policy in the event of failure of the Uruguay Round negotiations. An implication of that conclusion is that regional integration initiatives would be weakened as the multilateral trading system became firmly established. Yet following the inauguration of the WTO, the trend towards increasing numbers and deepening scope of regional trading blocs has continued.

Regionalism is one of the most dominant trends in the world economy today. There were only 26 new regional trade agreements (RTAs) reported to GATT prior to 1969. Following a weakening in the pace of regional integration in the 1980s, the number of RTAs exploded in the 1990s. 35 additional regional agreements were signed in 1995, and 1996 and 17 such agreements were reached in 1997, and 1998. This demonstrates that rather than simply being a type of insurance

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<sup>1</sup> Preferential trading blocs that must report their arrangements to GATT/WTO under GATT XXIV, GATS V, and the Enabling Clause.

policy against the potential shortcomings of multilateral free trade formation, regionalism is seen as a viable commercial strategy that complements multilateral trade agreements.

In line with this increasing trend towards regional integration, Korea has altered its past position opposing regional trade blocs and is now cautiously investigating the establishment of FTAs with major trading economies. Not only was a fear of being left out of the recent trend of growing regionalism a motivating factor for Korea's change, the outbreak of the Asian financial crisis also played a large role in Korea's decision to pursue the establishment of FTAs. Korea has opened most of its financial sectors to foreign investors and has implemented unilateral trade liberalization measures.

Trade liberalization measures under the International Monetary Fund (IMF) Package included the early abolishment of the import diversification program (IDP) and trade related subsidies, the simplification of the restrictive import licensing procedures, the reduction of the number of items subject to adjustment tariffs, and the elimination of import certification procedures.<sup>2</sup> The IDP, which was introduced in the early 1978, was a system of restricting imports from a specific economy (targeting Japan) with which Korea was experiencing a serious trade deficit list of items. The abolishment of the IDP in the end of June 1999, can be regarded as one of most dramatic liberalization measures.

This liberalization has been viewed as beneficial by most Koreans, and there is a growing perception that the establishment of FTAs with major trading partners will bring greater welfare gains. Moreover, Korea has recognized the importance of stable export markets; it is thought that the current account deficit that preceded the financial crisis resulted in worsening international confidence in the Korean economy. Another important background factor in the current trend towards regionalism can be found in trade policy makers' recognition of the necessity of upgrading Korea's economic system to meet international standards. Though broad structural reform programs have been implemented under the agreement with the IMF, these may not be enough to achieve fundamental reforms of the economic system.

Therefore, Korea is pursuing regional trade liberalization, and the economy ultimately wants comprehensive FTAs covering investment and services, as well as market access including tariffs, non-tariff barriers (NTBs), customs clearance, and rules of origin, rather than merely trade liberalization.

### **III. CHILE AS KOREA'S FIRST FTA PARTNER**

The Korean government is currently pursuing the establishment of FTAs with small strategic economies as a precursor to establishing trade agreements with its larger trade partners.

Chile was chosen as Korea's first candidate for an FTA partly because Chile's exports are weighted toward primary goods such as copper and wood (wood products), which are highly complementary to Korea's manufactured goods exports of automobiles and electronic products.

Aside from the economic aspects, political realities are also behind the choice of Chile as Korea's first potential free trade partner. While current opinions are certainly more favorable than in the past, Korea abandoning its insistence that free trade be pursued in an open and multilateral approach is a major policy reversal. However, the economic size of Chile is relatively small and the trade volume between the two economies amounts to only a small percentage of Korea's total trade. Korea's exports to Chile account for around 0.5 percent of Korea's total exports, while imports from Chile are less than 1.0 percent of Korea's total imports. Therefore any adjustment

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<sup>2</sup> See pages 72 and 73 of Wang and Zang (1998) for detailed discussion on trade liberalization under the IMF Agreement.

costs, such as labor displacement, will be relatively low. Furthermore, the international response to Korea's new policy will be muted due to the non-threatening size of the agreement.

Some may say that the benefits to be gained from an FTA with a small economy such as Chile would be very small as opposed to an FTA with a larger economy, such as the US or Japan. But while Koreans are increasingly accepting the need for opening their economy, their competitive disadvantages relative to the US or Japan would likely inflict excessive adjustment costs on Korea. Meanwhile, as already stated, an FTA with the relatively small economy of Chile would impose lower adjustment costs on the Korean economy, and yet force Korea to update many of its outdated economic institutions and practices. Following this adjustment period, Korea would be much better positioned to enter an FTA with Japan, the US or another major advanced and/or large economy. For all of these reasons, it is in Korea's interests to, at least initially, pursue an FTA with a smaller economy.

Moreover, Chile is one of the most active economies in terms of liberalizing trade and establishing FTAs. Chile has already signed FTAs with Mexico, Canada, Peru, Venezuela, Ecuador and Columbia, and is currently discussing the establishment of FTAs with Bolivia, Panama, Cuba, and the European Union (EU), among others. Chile's rather open and largely non-confrontational approach should allow Korea to sign a relatively comprehensive FTA agreement that is unencumbered by numerous side agreements.

Thus, the agreement would set a favorable precedent for Korea signing FTAs with other economies. Chile's experience with free trade and of operating a relatively liberalized economic market will likely provide invaluable experience for Korea, not only in its attempts to further liberalize its own economy, but also in pursuing FTAs with larger economies. Considering the economic size, purchasing power and trade volume of Chile, it is predicted that Korea will not realize substantial tangible benefits from a Korea-Chile FTA in the short-run. However, such an FTA may bring sizable gains to Korea in the long-run as Korea could learn from Chile's experience in having established multiple regional trading agreements. Furthermore, Chile can serve as a gateway to the South American market.

## **V. SUMMARY AND POLICY IMPLICATIONS**

In line with an increasing trend of regional integration, Korea has altered its past view of opposing regional trade blocs and now is cautiously investigating the establishment of FTAs with major trading economies. Not only was a fear of being left out of the recent trend of growing regionalism a motivating factor for Korea's change, but the outbreak of the Asian financial crisis also played a large role in Korea's decision to pursue the establishment of FTAs. Korea opened most of its financial sectors to foreign investors and implemented unilateral trade liberalization measures. The current account deficit that preceded the financial crisis has made painfully clear the danger in failing to secure stable access to foreign trade and financial markets.

The government officially decided to negotiate an FTA with Chile in November 1998 and to pursue FTAs with larger economies, such as Japan or the US, in the long run after thorough examination of the economic effects of FTAs with these economies. The successful conclusion of this first FTA will be of special importance for Korea because other potential FTAs will depend heavily on the first model.

Korea and Chile started negotiations for the FTA in December 1999. Most likely, negotiations will last one to two years. However, talks regarding sensitive areas of trade could prolong the conclusion of the negotiations. Korea's manufacturing sector favors a Korea-Chile FTA, as most of Korea's exports to Chile consist of such manufactured goods as automobiles and electronic goods. However, the agricultural sector, fearing an increase of such Chilean exports as grapes and kiwi fruit, and the fisheries industry are deeply concerned about a Korea-Chile FTA.



Beyond the sensitive nature of various trade items, there are a number of other issues of concern surrounding Korea's FTA policy. One such question is the harmonization of multilateralism and regionalism. As discussed earlier, Korea has been one of the most active supporters of the GATT/WTO system. Developing economies such as Korea, Chinese Taipei, and Singapore, have benefited from the more liberalized global trading environment under the present multilateral system.

However, economists have warned that the increasing influence of regional trading blocs may damage the multilateral system. Lester Thurow (1992) argues that the current proliferation of regional agreements and the recurring fear of trade conflicts will endanger the credibility of the global trading system by shifting the world to a tripolar system of Asia, Europe, and North America. Jagdish Bhagwati (1993) views regional trading blocs as stumbling rather than building blocks of trade, arguing that the expansion of regionalism will undermine the multilateral system without making a positive contribution towards global trade liberalization.

Therefore, while pursuing the establishment of beneficial FTAs, Korea must also continually search for ways to contribute to free trade under the WTO. Such an approach would mean that Korea is not only technically complying but fully complying with the spirit of WTO regulations regarding the establishment of FTAs. Further, Korea must not only implement but seek to go beyond all WTO regulations in such new areas as investment, services, intellectual property rights (IPR), environmental issues, etc. Thus, the basic direction of a Korea-Chile FTA should be based on the following principles: comprehensive coverage, maximum liberalization, and transparency of implementation procedures in adopting international standards.

In addition to the Korea-Chile FTA, Korea looked into the economic feasibility of an FTA with Japan in 1999, and came up with a positive prognosis. This year Korea has been undertaking joint studies with New Zealand and Thailand to look into the viability and feasibility of pursuing individual FTAs with each of these economies. These studies will provide the basis for an expansion of Korea's policy towards FTAs.

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# AUSTRALIA'S APPROACH TO REGIONAL TRADE AGREEMENTS

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## I INTRODUCTION

Globalisation and regionalism are the twin forces shaping the evolution of the world economy, and regional trade agreements (RTAs) have become a steadily more important feature of the international trading system. As examples of this phenomenon, all but three of the World Trade Organisation's (WTO's) members belong to at least one regional agreement, and around half of all global trade takes place through preferential regional arrangements.<sup>1</sup> Many APEC economies are members of regional trade agreements, including arrangements such as the ASEAN Free Trade Area (AFTA), the North American Free Trade Agreement (NAFTA) and Mercado Común del Cono Sur (MERCOSUR), and other APEC economies have recently been investigating their options.

In forming a regional trade agreement, member economies agree to reduce or eliminate trade barriers amongst each other, but they are not obliged to extend these benefits to non-members. The first significant wave of regionalism commenced in the 1960s, most obviously with the creation of the European Common Market. Beyond Europe though regionalism faltered because the US was a 'staunch supporter of multilateralism.'<sup>2</sup> A new wave of regionalism commenced in the 1980s, triggered by slow progress in the multilateral GATT negotiations. Most notably, the US concluded agreements with Israel, Canada, and, significantly, Canada and Mexico to form the NAFTA. Regional agreements traditionally covered trade in goods, but later agreements have often been more comprehensive, covering services, investment and competition as well as goods.

In this talk, I will firstly discuss the relationship between regional trade agreements and the multilateral system. I will then talk about Australia's approach to regional trade agreements and the agreements Australia has joined. Australia is a member of only one reciprocal arrangement, the Closer Economic Relations Agreement (CER) with New Zealand, but it is also a member of two non-reciprocal arrangements, with Papua New Guinea and other South Pacific economies. I will then discuss the proposed AFTA-CER free trade area.

## II REGIONAL TRADE AGREEMENTS AND THE MULTILATERAL SYSTEM

Regional trade agreements are an exception permitted to the multilateral system's first rule, namely that reductions in trade barriers should be applied, on a most-favoured nation (MFN) basis, to all WTO members. The challenge with regional agreements is to ensure that they provide significant benefits to the region through liberalisation, as well as contributing to overall global welfare.

The WTO rules on regional trade agreements are drafted in a way that seeks to ensure regional trade agreements add to global economic welfare. Thus, an agreement that complies with GATT Article XXIV and GATS Article V is, *prima facie*, likely to provide benefits for the parties and the wider trading system. For example, an agreement will involve meaningful liberalisation if it meets the criteria for covering 'substantially all the trade' for goods and providing 'substantial

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<sup>1</sup> 'A question of preference', *The Economist*, 22 August 1998, at page 62.

<sup>2</sup> DE MELO, Jaime and PANAGARIYA, Arvind (1993) *New Dimensions in Regional Integration*, University Press, Cambridge, at page 3.

sectoral coverage' for services within the ten year timeframe stipulated. This will lead to increased welfare by ensuring all parties to the agreement benefit, and by ensuring the agreement will be a spur to greater trade liberalisation efforts.

The WTO requirement that barriers should not be increased to non-parties following the conclusion of the agreement helps to ensure that the 'trade diversion' effects of the arrangement are minimised. The requirement that all regional agreements must be notified to the WTO helps to maintain the transparency of such agreements, and allows WTO members to examine the agreements in the Committee on Regional Trade Agreements (CRTA). As Shiells argues, "whether a regional trade agreement facilitates or impedes eventual global free trade depends on how it is designed"; an important part of this is "whether it satisfies World Trade Organisation rules."<sup>3</sup>

### III THE AUSTRALIAN POSITION ON REGIONAL TRADE AGREEMENTS

The Australian government pursues an integrated multilateral, regional and bilateral approach to trade policy. As part of this policy, Australia is open to concluding regional agreements which deliver substantial gains to Australia across all sectors, which cannot be achieved in a similar timeframe elsewhere. In August 1999, Prime Minister Howard, along with the then New Zealand Prime Minister Jenny Shipley, outlined our policy on regional agreements in a Joint Prime Ministerial Statement:

*New Zealand and Australia are willing to consider free trade agreements with other significant individual economies or regional groupings, where they would deliver faster and deeper liberalisation than the multilateral process, with the objective of gaining better market access for our exporters, faster economic growth and stronger employment growth. Such arrangements would need to reflect the principles underpinning CER, including WTO consistency.*

Given the renewed interest in regional agreements in our region, Australia believes it is important that such agreements contribute to the multilateral system. As aforementioned, one of the best ways of ensuring this occurs is for agreements to meet the criteria in the WTO agreements. Australia also believes that the trade diversion effects of regional agreements will be reduced if they have open membership – that is, agreements are open to new members, which join on the same terms as the initial parties. APEC is currently developing a proposal for a survey of subregional agreements within APEC which is designed to investigate further the links between regional agreements and the multilateral system.

As a more general policy point, the Australian government would like to see progress in regional trade liberalisation 'multilateral-ised' through WTO negotiations. This is one issue Australia will take up in the mandated negotiations in the WTO on agriculture and services, and in a new round, once launched.

The North American Free Trade Agreement was not the first NAFTA – that honour goes to the New Zealand Australia Free Trade Agreement. However, the first free trade area between Australia and New Zealand failed, due to torturous negotiations and the failure to produce an agreement which included meaningful product coverage and tackled non-tariff barriers. Thus, in the early 1980s, there were suggestions that a new free trade agreement was needed to govern trade relations between Australia and New Zealand. It was argued that 'an appropriately structured closer economic relationship would benefit the international competitiveness of both economies and improve living standards.'<sup>4</sup>

<sup>3</sup> SHIELLS, C (1995), 'Regional Trade Blocs: Trade Creating or Diverting?' *Finance and Development* 30.

<sup>4</sup> DFAT, *Closer Economic Relations: Background Guide to the Australia New Zealand Economic Relationship*, (1997) 7.

The Closer Economic Relations Agreement (CER) between Australia and New Zealand entered into force in 1983. In a WTO review, the CER was ‘recognised as the world’s most comprehensive, effective and multilaterally compatible free-trade agreement.’<sup>5</sup> The CER is interesting because, combined with the Trans-Tasman travel arrangements, it represents something more than a free trade agreement, but something less than an economic union.

The objective of the CER is to expand free trade by eliminating barriers to trade and promoting fair competition. The agreement assisted in building up momentum for trade liberalisation. By 1990, five years ahead of schedule, all tariffs and quantitative restrictions had been removed from trans-Tasman goods trade. The results have been impressive – total trade in goods has increased by more than 563 percent since 1983, to AUS\$11.3 billion in 1999. Interestingly, it is the smaller economy, New Zealand, which has benefited most from the arrangement, with New Zealand’s exports to Australia growing by 380 percent since 1983, compared with Australia’s exports to New Zealand growing by 300 percent since 1983. Two-way investment between Australia and New Zealand has also increased from AUS\$1.5 billion in 1983 to AUS\$25 billion in 1998 – a rate of increase almost twice that for investment with the rest of the world. It has been argued that the CER will serve as the basis for eventual monetary union between Australia and New Zealand. There is no formal proposal from either government for this step, but a New Zealand parliamentary committee is examining this issue as part of a broad inquiry into the CER. Thus, the CER and other arrangements between Australia and New Zealand have made considerable progress in achieving three of the EU’s four freedoms: in goods, services and labour. The CER does not, however, include any provision on investment.

## **V PATCRA, SPARTECA AND PARTA**

The CER is not the only regional agreement to which Australia is a party; Australia is involved in two non-reciprocal regional trade agreements. The Papua New Guinea Australia Trade and Commercial Relations Agreement, or PATCRA, entered into force in February 1977. The intention was to ensure that an independent Papua New Guinea would be able to maintain the open access to the Australian market which had existed prior to independence. PATCRA is a reciprocal agreement, but in practice it has been Australia that has provided non-reciprocal access to its markets.

PATCRA was the genesis for the South Pacific Regional Trade and Economic Cooperation Agreement, or SPARTECA. The South Pacific Island economies lobbied for the same preferential access to the Australian market as Papua New Guinea. Thus, SPARTECA was created in recognition of ‘the special relationship and commitment of Australia and New Zealand to South Pacific Forum Island economies.’ SPARTECA entered into force in January 1981. SPARTECA provides products from Forum Island economies with preferential, non-reciprocal access to Australia and New Zealand for all products, subject to products meeting a rules of origin threshold of 50 percent. The agreement also aimed to encourage economic and industrial cooperation. Like PATCRA, the objective of SPARTECA was to expand and diversify trade, stimulate investment in exports, provide cooperation in marketing, and promote other forms of commercial cooperation.

In October 1999, South Pacific Forum Leaders agreed to examine the establishment of a free trade agreement among South Pacific Island economies, with Australia and New Zealand to be included “in appropriate ways.” This will be the Pacific Regional Trade Agreement (PARTA).

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<sup>5</sup> See also WTO Trade Policy Review Body: Australia. Available at <http://www.wto.org/wto/reviews/tprb76.html> .

## **VI AFTA-CER**

In October 1999, ASEAN, Australian and New Zealand Ministers agreed to establish a Task Force to examine the feasibility of establishing an AFTA-CER free trade area by 2010. It was agreed that the Task Force would hold three meetings and report to ASEAN and CER Ministers in October 2000. The terms of reference for the Task Force call on it to examine a range of issues, including: options for architecture; requirements for WTO-consistency; and the capacity building measures that might be required to allow economies to participate effectively in the negotiations and to implement the results of the negotiations.

Efforts towards achieving greater economic integration between the AFTA and the CER are not new. Since 1995, a range of activities aimed at facilitating trade and investment between the two groupings have taken place under the AFTA-CER linkage. A regional trade agreement would help bring about a much higher level of integration between the two groupings.

The Task Force, which has met twice, has made good progress. Discussions have so far covered: the costs and benefits of an agreement; the capacity building assistance which might be required by the four newer members of ASEAN; and the possible scope and coverage of an agreement. The final meeting of the Task Force will be held in early August in Cambodia.

Australia believes an AFTA-CER agreement would bring significant trade and economic benefits to the region. Negotiations on such an agreement would offer the prospect of achieving faster and deeper cooperation and integration between the two regions than might otherwise be possible. This would provide further impetus to the growing trade and investment links between the AFTA and CER economies. Trade liberalisation through an agreement would in turn provide a boost to productivity and competitiveness in the region, and increase the attractiveness of the AFTA-CER economies to foreign investors.

A study undertaken by the Centre for International Economics for the Task Force has sought to quantify these benefits through economic modelling. This study estimates that an AFTA-CER agreement would lead to overall GDP gains of US\$48.1 billion in net present value terms over the period 2000 to 2020. Gains in welfare, measured in terms of increases in real consumption, would be even higher. The study also estimates that additional capital inflows to the region resulting from an agreement would amount to US\$38.1 billion over the decade to 2010.

Australia would support making an AFTA-CER agreement comprehensive in scope and coverage, with no sector being excluded outright. In this way, an AFTA-CER agreement would be consistent with the multilateral system, as well as advancing APEC's Bogor goals on trade and investment liberalisation.

Together, the AFTA-CER groupings account for almost half of APEC's membership. An agreement to begin negotiations on a regional trade agreement would underline the commitment of the AFTA-CER economies to APEC's goals on free trade and investment. This would send an important signal to other economies in the Asia-Pacific region and beyond about the need to sustain the momentum for further trade reform.

## **VII CONCLUSION**

In conclusion, interest in regional trade agreements has certainly grown in recent years. Such agreements can be an effective means for dealing with some of the challenges of globalisation, as they offer a vehicle for achieving closer regional economic integration and greater trade liberalisation, which can then result in increased welfare for the parties. However, there are two competing strategic goals that need to be acknowledged when contemplating regional agreements:

- the benefits offered by a multilateral, rules-based non-discriminatory trading system for all economies, particularly economies with a wide range of exports to diverse markets;
- the benefits offered by discriminatory arrangements which secure preferential access to particular markets, to promote regional integration and ensure the same access as competitors.

These strategic goals are not necessarily mutually exclusive, but there is a need for a well-thought out approach to balancing them. Australia believes that the WTO rules on regional agreements offer a means for reconciling these goals. This is why Australia has adhered to the WTO rules in its Closer Economic Relations Agreement with New Zealand – an agreement which has resulted in great benefits for both parties, but even more benefits for the smaller economy, New Zealand. Whatever agreements Australia is involved in negotiating in the future, we will again be aiming to produce agreements which will offer substantial benefits for *all* parties. We believe this can best be achieved through agreements which are compatible with the multilateral system.

# ISSUES CONCERNING THE NOTIFICATION OF REGIONAL TRADE AGREEMENTS TO THE WORLD TRADE ORGANIZATION

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*APEC economies, as members of the World Trade Organization (WTO), are under obligation to notify any free trade agreement or customs union they are parties of to the WTO for an examination and a decision on its consistency with relevant WTO provisions. The purpose of the examination is to ensure compliance of the regional trade agreement with the relevant WTO provisions in order to promote the objective of enhancing global trade and minimize the construction of barriers to trade. It is the membership of the WTO that agrees on the conformity or non-conformity of a notified regional trade agreement. This paper provides an overview of the relevant WTO provisions affecting regional trade agreements and issues arising from the examination of such agreements conducted by WTO members within the parameters of the WTO provisions. It highlights the practical experiences garnered by regional trade agreements in the notification and examination process.*

## A. WTO PROVISIONS ON REGIONAL TRADE AGREEMENTS

APEC economies have agreed to liberalize trade in goods and services and investment among them by the year 2020. In addition, they have agreed a list of products on which they would seek early liberalization among them and also within the World Trade Organization (WTO). Furthermore, individual APEC members are parties to regional integration agreements such as the Association of South East Asian Nations (ASEAN), the North American Free Trade Agreement (NAFTA), the Australia - New Zealand Closer Economic Relations Trade Agreement (ANZCERTA), and the Melanesia Spearhead Group (MSG). APEC economies thus are committed to the liberalization of trade and investment within a regional context with a view to building critical mass and support for further liberalization at the multilateral level.

APEC economies as members of the World Trade Organization (WTO) are under obligation to notify any free trade area or customs union agreement to the WTO. The notified agreement is examined by WTO members to gain more information about the agreement (transparency issue) and to adopt a report or recommendations or a decision on the agreement's consistency with relevant WTO provisions that are aimed at promoting the objective of enhancing global trade and minimizing the construction of barriers to trade. It is the WTO membership that has to agree on the conformity or non-conformity of the trade agreement under examination. Accordingly, if WTO members want to form a regional trade agreement (RTA) involving a free trade area or customs union, increase membership in an RTA (i.e., accession of a new member), or change its preferential trade agreements (goods and services), the new RTA or alterations to an existing RTA must be deemed by the WTO to be consistent with the relevant WTO provisions and have not impaired or nullified the benefits accruing to the WTO members. *De facto*, WTO members have only exceptionally agreed on the conformity of an RTA. In almost all cases, including the

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\* The opinions expressed in this paper are those of the author and do not necessarily reflect the views of UNCTAD Secretariat. The paper has been edited since first publication. Any remaining errors are the author's.



European Union (EU), the examinations remained inconclusive, but without any effects on the implementation of the RTA by the concerned member economies.

In respect of the timing of the notification, the practice in most cases in the WTO is for a notification to be made subsequent to (and not before) the entry into effect of the trade agreement. In other words, the notification is made after the implementation of the RTA has started. In the case of the Southern African Development Community (SADC), for example, the SADC free trade agreement (FTA) which is being finalized by member economies would be notified after the ratification of the SADC Trade Protocol by the required two-thirds of signatory member economies and its entry into operation. At times, economies have communicated to the WTO Council for Trade in Goods, for example, their intention to form a regional trade agreement, provided some broad details about the agreement, and then notified it upon its enactment. The SADC member economies, it could be argued, have followed this path. They announced the adoption of the SADC Trade Protocol and its free trade area objective to the First WTO Ministerial Conference in Singapore in December 1996.

The notification of an RTA covering trade in goods to the WTO has to invoke either the provisions of the **Enabling Clause of the 1979 Tokyo Round**, officially referred to as the Decision of 28 November 1979 on Differential and More Favourable Treatment, Reciprocity and Fuller Participation of Developing Economies. The notification can alternatively invoke the provisions of the **General Agreement on Tariffs and Trade (GATT) 1994 Article XXIV and as further clarified by the Understanding** on the Interpretation of that Article resulting from the Uruguay Round of Multilateral Trade Negotiations (UR).

The notification of an RTA for trade in services to the WTO has to invoke the provisions of the **General Agreement on Trade in Services (GATS) Article V**.

The notification is addressed to the WTO Secretariat (Director General) and it can be made by one party to the RTA (which is also a WTO member) on behalf of the group, or by a group of members (all of whom are WTO members). The notification must be accompanied by a copy of the legal treaty constituting the RTA, with all relevant documents such as the product liberalization list and the liberalization plan. The legal texts tend to be bulky and are kept in the Secretariat and made available to interested WTO members upon request. The notification is circulated by the WTO Secretariat to the relevant WTO Council/Committee. The relevant WTO body which receives the notification is the **Committee on Trade and Development (CTD)** for agreements notified under the Enabling Clause, the **Council for Trade in Goods (CTG)** for agreements notified under GATT Article XXIV, and the **Council for Trade in Services (CTS)** for agreements notified under GATS Article V.

With the exception of Enabling Clause agreements which are notified to the Committee on Trade and Development, **the examination of all other regional trade agreements is now centralized under the WTO Committee on Regional Trade Agreements (CRTA)** in contrast to the past GATT practice of constituting working parties. What happens in practice is that the WTO body to which an agreement is notified adopts a standard terms of reference for the examination of the agreement and refers the agreement, together with the terms of reference, directly to the CRTA for the actual examination.

Created on 6 February 1996 the CRTA has been one of the most active WTO committees, with a heavy work load encompassing: the examination of notified RTAs; a review of biennial reports on RTAs; the examination of systemic issues; and work on improving its method of operation. Owing to this heavy workload and the complexity of the issues, the CRTA has encountered difficulties and delays in concluding most of its examinations. As of July 2000, over 70 RTAs had been referred to it by the Council for Trade in Goods and the Council for Trade in Services and they are under various stages of examination. While the examinations have been extensive, the

CRTA has not yet released a concluding report on any of its examinations to the Council for Trade in Goods or Council for Trade in Services. It should be noted that the CRTA's report, and particularly its conclusions, are normally discussed in informal (and confidential) settings. The Committee on Trade and Development has not referred any RTA notified under the Enabling Clause to the CRTA. One exception is the Southern Cone Common Market (MERCOSUR) agreement that is being examined under both the Enabling Clause and GATT Article XXIV.

Beyond the two alternatives of the Enabling Clause and GATT Article XXIV, there is the **waiver procedure under GATT Article XXV** and, following the conclusion of the Uruguay Round, by the **Understanding in Respect of Waivers of Obligations under the GATT 1994 and the Marrakesh Agreement Establishing the WTO, Article IX**. GATT Article XXV can, and has been, invoked by parties to an RTA that does not fully respond to the requirements of the Enabling Clause or GATT Article XXIV. The requests for waivers are examined by the WTO Ministerial Conference and by the WTO General Council.

Mention could also be made of **GATT Article I:2 (grandfathering)** although its applicability has been eroded and it has become obsolete. Basically during the course of work on tariff-cuts and trade rules from 1946-1947 in the framework of the drafting of a charter of the International Trade Organisation, it was recognised that a number of the founding GATT members operated preferential trading systems. These schemes would be in clear violation of the most favoured nation (MFN) principle of non-discrimination (GATT Article I) that was being promulgated. It thus became apparent that some provision was required to cater for this anomaly. This situation established the basis for the GATT Article I:2, and also for GATT Article XXIV.

GATT Article I:2 explicitly exempts in perpetuity (grandfathers) from the MFN requirement certain preferential arrangements existing at the time the GATT came into force. These included British Imperial Preferences, preferences granted by the Benelux customs union and the United States, the preferences in force in the French Union, those exchanged between Chile and its neighbours, and the preferences granted by the Lebano-Syrian Customs Union to Palestine and Transjordan. These grandfathered preferences were limited by a requirement that they could not be raised above existing levels (those in force in 1947). Also, their value has been steadily eroded over the past decades by the successive rounds of GATT tariff negotiations and reductions. The introduction of the MFN principle, with existing trade preferences allowed but capped, laid the foundations for the future development of multilateral trade on the basis on non-discrimination.

## **B. NOTIFICATION OF AN RTA ENCOMPASSING TRADE IN GOODS UNDER THE ENABLING CLAUSE**

**Developing** WTO member economies are permitted to deviate from their MFN obligation and form among them RTAs under the provisions of the **1979 GATT Decision of 28 November on Differential and More Favourable Treatment, Reciprocity and Fuller Participation of Developing Countries (Enabling Clause), paragraph 3**. The permission is conditional upon the parties to the RTA to ensure that the RTA meets (complies with) the following criteria:

- (i) it is designed to facilitate and promote trade of member countries and does not raise barriers or create undue difficulties for the trade of third countries;
- (ii) does not constitute an impediment to the reduction or elimination of tariffs and other restrictions to trade on a MFN basis; and
- (iii) shall in the case of such treatment accorded by a developed member to developing member be designed and, if necessary, modified to respond positively to the development, financial and trade needs of developing countries.

Furthermore, the **Enabling Clause (paragraph 4)** stipulates that the RTA is notified to the WTO Committee on Trade and Development (CTD) upon its creation, modification or withdrawal. The provision states as follows:

“Any contracting party taking action to introduce an arrangement pursuant to paragraphs 1, 2 and 3 above or subsequently taking action to introduce modification or withdrawal of the differential and more favourable treatment so provided shall:

- (a) notify the CONTRACTING PARTIES and furnish them with all the information they may deem appropriate relating to such action;
- (b) afford adequate opportunity for prompt consultations at the request of any interested contracting party with respect to any difficulty or matter that may arise. The CONTRACTING PARTIES shall, if requested to do so by such contracting party, consult with all contracting parties concerned with respect to the matter with a view to reaching solutions satisfactory to all such contracting parties.”

Prior to the Enabling Clause, developing economies have justified the formation of RTAs among them on the basis of Part IV of GATT on Trade and Development which was added to the GATT 1947 in 1965; or have had to invoke GATT Article XXIV. Some examples include the Central American Common Market and the Caribbean Community and Common Market.

Most developing economy RTAs since 1979 have been notified under the Enabling Cause. These RTAs include the following:

- the Tripartite Agreement, the Protocol relating to Trade Negotiations among Developing Countries;
- the Bangkok Agreement;
- the ASEAN (Association of South East Asian Nations) Preferential Trading Arrangement and the Agreement on the Common Effective Preferential Tariff Scheme for the ASEAN Free Trade Area;
- the Latin American Integration Association;
- the Gulf Cooperation Council;
- the Global System of Trade Preferences among Developing Countries;
- the Protocol on Preferential Trade among members of the Economic Cooperation Organization;
- the Andean Community;
- the South Asian Preferential Trading Arrangement; and
- the Common Market for Eastern and Southern Africa.

The MERCOSUR agreement, as mentioned previously, was notified under the Enabling Clause and GATT Article XXIV, however many developing economies have insisted that this should not constitute a precedent for others.

The CTD may establish a working party upon the request of any interested member to examine the RTA for its conformity with the above-mentioned provisions of the Enabling Clause. The

practice under the former GATT has been for the CTD or its working party to take note of the notification with little or no discussion. This is not likely to be the case anymore for RTAs notified to the WTO owing to the growing concern of many WTO members over regionalism. In other words, developing economies will have to be prepared for a more substantive and lengthy examination of their RTAs, even under the Enabling Clause provision.

Developing economies have to be prepared to provide substantial documentation for the examination process and to ensure a physical presence in Geneva whenever the examinations occur. In addition, developing economies would be requested by WTO members, even in respect of Enabling Clause RTAs, to complete and submit the Standard Format for Information on Regional Trade Agreements which is now used by the CRTA as the basic document on which to start an examination. Though the use of the standard format is voluntary, the practice so far in the CRTA has been to oblige members of RTAs to use it (by refusing to examine any RTA for which the standard format is not available).

Furthermore, the GATT practice of questions and answers in oral sessions during the examinations and in writing if issues remain uncertified or pending is maintained. There is greater likelihood of a lengthy question and answer procedure for any RTA. It can be expected that some developed WTO members may request information/studies/analyses from RTAs among developing economies on the likely trade creation and or trade diversion effects, even though there is no operative obligation regarding such trade effects under the Enabling Clause (nor under GATT Article XXIV and the Understanding). Also, parties to the RTA can be asked to demonstrate that the level of tariff protection against third economies before and after the formation of the RTA has not changed upwards, although there is no legal obligation to this effect. There also will be heavy statistical requirements, which could be difficult for some members to meet if their foreign trade statistics are in a poor state. In the final analysis, it is not altogether sure that the CTD or its working party will easily agree on the conformity of an RTA with Enabling Clause.

Notwithstanding the above *caveat*, the provisions of the Enabling Clause offer more flexibility and are less demanding than the provisions of GATT Article XXIV and its Understanding. The differential treatment provided by the Enabling Clause include the following:

- there is no obligation to conduct an assessment of the *ex-ante* and *ex-post* level of protection of RTA members against third economies, and to verify whether the RTA conforms to the test of not raising barriers against trade of non-participants;
- there is no obligation in respect of “substantially all the trade” criteria;
- there is no time limitation specified for completion of the trade liberalization process although many recent RTAs among developing economies tend to respect the 10-year limit; and
- biennial reports on the RTA would not be required; reports are required only when the RTA is modified or withdrawn by its members. However, given the rising importance of regionalism, it could be expected that the examination of the RTAs under the Enabling Clause could lead to some sort of compromise requirements, including biennial reporting

The only obligation under the Enabling Clause is that the parties to the RTA must notify the WTO Committee on Trade and Development when the RTA is created (signed, ratified and in operation), modified or withdrawn.

The absence of a specified time period for trade liberalization is a major advantage for developing economies, in particular LDEs (Least-Developed Economies) which may face considerable difficulties in liberalizing trade and adjusting to the new situation of heightened regional

competition. A longer transitional period is required for them, accompanied by investment-production measures to improve competitiveness and production capacity. At the same time it is necessary to review periodically the rate of level of implementation of, and the effects of, special provisions in favour of LDEs and the observance of their own obligations by them. Parties to an RTA need to consider carefully the needs on the one hand, and the obligations on the other hand, of economically weaker parties. The special treatment should relate both to trade commitments, trade facilitation measures, and effective implementation of joint measures to strengthen industrialization and competitiveness.

In sum the Enabling Clause offers an easier option to developing economies to meet the WTO consistency test for RTAs. However, it is not evident that notification under the Enabling Clause would lead to an easy examination under the WTO. Thus, it would be appropriate for developing economies to be prepared for difficult examinations over the notification of their RTAs.

### C. NOTIFICATION OF AN RTA ENCOMPASSING TRADE IN GOODS UNDER GATT ARTICLE XXIV AND THE UNDERSTANDING

Developed economies and developing economies parties to RTAs involving developed economies such as the Canada-Chile FTA, EU-Tunisia FTA or the cooperation agreements between the EU on the one hand and individually Algeria, Egypt, Jordan, Lebanon, Morocco and Syria are permitted to do so and deviate from their MFN obligation **under GATT 1994 Article XXIV and the Understanding on the Article that resulted from the Uruguay Round**. This permission also defines three types of RTAs, *viz.*:

- a free trade area;
- a customs union; and
- an interim agreement leading either to a free trade area or a customs union.

Most RTAs are interim agreements leading to the establishment of an FTA or a customs union within an agreed time frame. For example, the Canada-Chile FTA entered into force in July 1997 and it is scheduled to be completed by the end of 2013 (by Chile); the NAFTA transition period is from January 1994 to the end of 2009; and the EU-Tunisia FTA transition period runs from March 1998 to the end of 2010 (for Tunisia). The APEC liberalization programme is an interim arrangement as it provides for the progressive establishment of a free trade in goods and services within a period of 10 years for developed economies and 20 years for developing economies.

The primary obligation of an interim agreement is stipulated by GATT Article XXIV: 5(c). The agreement shall include a plan and schedule for the formation of the free trade area within a reasonable length of time. This is an obligation to curtail the potential for participants in an interim agreement to use it as an excuse for introducing discriminatory trade preferences over an indefinite period. Some clarity has been introduced by the Understanding on GATT 1994 Article XXIV over the ambiguity on what constitutes a “reasonable length of time” for the duration of an interim arrangement. The reasonable length of time should exceed 10 years only in exceptional cases and in such cases a full explanation for a longer period should be provided to the WTO Council for Trade in Goods. The capping of the transition period following the entry into force of the Uruguay Round results has introduced clarity and a critical test for interim agreements. It is conceivable that in a number of interim RTAs, some members, especially the economically weaker economies, may not be capable of fulfilling the requirements of fully fledged trade liberalization within 10 years. A longer period may be necessary for them.

An FTA would also be tested as to whether it satisfies the definition of a free trade area. A *bona fide* free trade area is defined in GATT Article XXIV: 8(b) as a group of two or more customs

territories within which the duties and other restrictive regulations of trade are eliminated on substantially all trade between the participants in products originating in their territories.

There is no clear definition of the term “substantially all trade” and the CRTA is working on providing such clarity. Meanwhile, in most examinations so far, WTO members have tended to ask for qualitative and quantitative proof in terms of no exclusion of any sector of trade (especially agriculture), large coverage (in the range of 90 percent) of all tariff lines traded and the percentage of intra-trade affected. So parties to RTAs need to verify that their FTA meets at least one of these conditions so as to be in a position to defend the agreement on this crucial test.

There also is no clear definition of what constitutes “other restrictive regulations of trade”, namely non-tariff barriers, and the CRTA is working on providing more clarity here too. Thus no strict test can be applied as to the compliance of an RTA with the requirement to remove other restrictive regulations of commerce. However, the point is to remove non-tariff barriers that impede trade even as tariff barriers are being eliminated. While this is a legal obligation, it is nonetheless in the trade interest of RTA members to remove non-tariff barriers to facilitate trade growth.

In addition, parties to the FTA would have to show evidence their FTA promotes the trade of participants and does not on the whole raise barriers against trade with non-participants. This condition is stipulated in Article XXIV: 5(b) as follows: the duties and other trade regulations in each of the FTA participants applied to trade with third economies at the formation of the free trade area or adoption of the interim agreement shall not be higher or more restrictive than the corresponding duties and other trade regulations existing in the same FTA participants prior to the formation of the free trade area or the interim agreement. This “conformity test” should not be confused with the “economic test” of trade creation/diversion that is often requested by many WTO members. The “economic test” is not a legal obligation although studies on trade creation and trade diversion effects can be provided by any WTO members as an additional piece of information.

GATT Article XXIV: 5(b) shall essentially prevent an economy raising its MFN level of protection just before the entry into force of a regional trade agreement in order to start liberalizing from a higher level and/or to compensate customs revenue losses (this is also contrary to the interests of the member economies of the regional trade agreement itself, as the first stages of mutual preferences are in fact nullified). Likewise, import quotas should not be made more stringent for third economies in order to compensate for higher import competitions from within the regional trade agreement area. If this happened, it would seriously prejudice WTO acceptance of the FTA.

A *bona fide* customs unions is defined in GATT Article XXIV: 8(a) as a single customs territory substituting for two or more customs territories and having the following two essential characteristics, namely, free trade and a common external tariff.

**GATT Article XXIV (paragraph 7) also obliges parties to RTAs to notify the agreements to the WTO.** The relevant provision is as follows:

“(a) Any contracting party deciding to enter into a customs union or free trade area, or an interim agreement leading to the formation of such a union or area, shall promptly notify the CONTRACTING PARTIES and shall make available to them such information regarding the proposed union or area as will enable them to make such reports and recommendations to contracting parties as they may deem appropriate.

(b) If, after having studied the plan and schedule included in an interim agreement referred to in paragraph 5 in consultation with the parties to that agreement and taking

due account of the information made available in accordance with the provisions of subparagraph (a), the CONTRACTING PARTIES find that such agreement is not likely to result in the formation of a customs union or of a free-trade area within the period contemplated by the parties to the agreement or that such period is not a reasonable one, the CONTRACTING PARTIES shall make recommendations to the parties to the agreement. The parties shall not maintain or put into force, as the case may be, such agreement if they are not prepared to modify it in accordance with these recommendations.

(c) Any substantial change in the plan or schedule referred to in paragraph 5(c) shall be communicated to the CONTRACTING PARTIES, which may request the contracting parties concerned to consult with them if the change seems likely to jeopardize or delay unduly the formation of the customs union or of the free-trade area”.

The GATT Article XXIV agreements are more or less automatically referred by the WTO Council for Trade in Goods (which receives the notification) to the CRTA for an examination. The examination may be carried out over several CRTA sessions and possibly over several years, should there be major divergences of views. This is the case of the NAFTA, for example, which was notified in 1993 and has undergone several examinations that have yet to result in the adoption a report although the drafting of the report continues. Such a prolonged examination of an RTA increases considerably the work load of the parties to the RTA and of its secretariat (if any) in terms of the preparations for, and participation in, the examination including the provision of written answers to numerous questions for each meeting. This also entails a high cost to economies. The defense of the RTA cannot be made solely by the Geneva-based delegates of parties to the RTA. Often the questions asked are quite technical and require an in-depth and up to date knowledge of the agreement. Invariably therefore, trade officials from members' capitals and from the RTA secretariat will have to participate in the examinations until it has been completed. The delay in finalizing examinations of RTAs also increases the burden of work for the CRTA and has introduced a substantial back load of agreements to be examined, even as new ones are being formed and will be notified to the WTO in coming years.

In addition, the Understanding on GATT Article XXIV introduces an examination of the economic impact of regional agreements by way of seeking an assessment of whether the overall level of protection within the RTA has changed upwards or downwards following the formation of the RTA. It provides that the evaluation under Article XXIV: 5(a) of the general incidence of duties and regulations of commerce applicable before and after a formation of customs union shall be based upon an overall assessment of weighted average tariff rates and of customs duties collected. This assessment shall be based on import statistics for a previous representative period (to be supplied by economies involved), on a tariff line basis and in values and quantities, broken down by GATT economy of origin. The WTO Secretariat shall compute the weighted average tariff rates and customs duties collected in accordance with the methodology used in the assessment of tariff offers in the Uruguay Round. The assessment will be based mainly on tariff data owing to the difficulty of defining non-tariff measures. The result of the evaluation will constitute a major piece of evidence on which the CRTA will base its conclusions. Obviously, for any parties to an agreement being examined, a result that shows no change in the general level of protection is preferred. This provision, however, does not apply to an FTA but to a customs union with a common external tariff.

With regard to the procedure to be followed when a WTO member forming a free trade area or customs union proposes to increase a bound rate of duty, the Understanding reaffirms that the procedure set forth in GATT Article XXVIII must be commenced before tariff concessions under the free trade area or customs union enter into force. In negotiations for achieving mutually satisfactory compensatory adjustment as required under Article XXIV: 6, it is agreed that due account shall be taken of reduction of duties on the same tariff line made by other constituents of

the customs unions upon its formation. Compensation in the form of reduction of duties should be offered by the customs union if such reductions are not sufficient to provide the necessary compensatory adjustment. However, when no agreement can be reached within a reasonable period from the initiation of negotiations, the trade agreement shall be free to modify or withdraw the concessions; affected members shall then be free to withdraw substantially equivalent concessions in accordance with Article XXVIII. The Understanding imposes no obligations to provide compensatory adjustments to members of a customs union. This provision, as with the provision mentioned in the paragraph above, does not appear relevant to an FTA; its application is to a customs union.

The Understanding furthermore allows that the consistency of a regional trade agreement with Article XXIV may be submitted to a dispute settlement panel. The latter, i.e., the submission of Article XXIV issues to dispute settlement, is particularly significant in view of the creation of a more automatic and binding dispute settlement system under the new WTO Dispute Settlement Understanding. It is recalled that if a WTO dispute settlement panel considers the consistency of a regional trade agreement with Article XXIV (as authorized by the Understanding), its results will be adopted automatically unless there is a consensus against the report or it is appealed. If appealed, the Appellate Body report would be automatically adopted, absent consensus against its report. Thus, it is clear that dispute panels may consider Article XXIV issues, if these are placed before it, and that the conclusions of the panels will be adopted. However, no such cases have been tested so far.

Following the conclusion of the examination of the RTA, the CRTA would submit a report and recommendations to the Council for Trade in Goods. The report and recommendations is finalized during informal (and confidential) consultations among interested members of the CRTA. The Council may address recommendations to the RTA (i.e., the parties to the RTA) to adjust the provisions of their trade liberalization programme. The Council may also tie its acceptance of the RTA with certain conditions. There is also the consultation process to be observed in case of difficulties of individual WTO members with the RTA. Afterwards, the question of a dispute settlement panel might arise “on all matters”.

Following the initial notification and examination process and hopefully positive concluding report, parties to the RTA would have to fulfil biennial reporting requirements. The procedures for such report are being finalized by the CRTA. The important point is that parties to the RTA should be prepared every two years to provide a report to the WTO on the operation of the RTA and to engage in debate over any of its features in Geneva. This requirement adds to the cost element of bringing trade officials to Geneva to participate in the reporting exercise, and reporting on the updated changes. At the 26<sup>th</sup> session of the CRTA, biennial reports were provided by among others, EFTA, the Caribbean Community and Common Market, the General Treaty on Central American Economic Integration, and the EC cooperation agreements with, respectively, Tunisia, Egypt, Israel, Jordan, Lebanon, Morocco, Syria and Algeria.

The objective of the treatment of biennial reports has been controversial. Some WTO members view these reports as a way to ensure that RTAs continue to observe the process of internal trade liberalization (i.e., to carry out another examination), while other WTO members consider the reports merely to be a transparency exercise. The latter members have also expressed that the reporting must not overlap with reporting under the WTO’s Trade Policy Review mechanism. They have been concerned that the clear demarcation between the reporting and examination obligations may become blurred, and that the reporting obligation may become unnecessarily burdensome.

From the above, it is clear that the legal requirements for the RTAs’ notification and examinations under GATT Article XXIV are much more stringent and involve a high risk that there will be no



*ex ante* agreement on the conformity of the RTA with WTO provisions. GATT Article XXIV examination risks giving rise to heavy scrutiny on many provisions of an RTA.

To conclude, the standards of GATT Article XXIV and the Understanding are clearly more stringent than those of the Enabling Clause. These stringent rules however need to be contrasted with the basic theme driving GATT Article XXIV, namely, a rapid liberalization of a large proportion of the regional market within established time frames to generate the expected trade creation benefits. In the final analysis, whatever the choice of legal instrument to notify an RTA, it must be not be under-estimated that the examination of the RTA and adoption of a report or recommendations on consistency with WTO provisions will be matter of negotiation between concerned WTO members.

#### **D. NOTIFICATION OF AN RTA ENCOMPASSING TRADE IN SERVICES UNDER GATS ARTICLE V**

An integration agreement liberalizing trade in services trade in services is permitted by the **GATS (General Agreement on Trade in Services) Article V (paragraph 1)**, provided the agreement:

- has substantial sector coverage (in terms of number of sectors, volume of trade affected and modes of supply with no *a priori* exclusion of any modes); and
- provides for the absence or elimination of substantially all discrimination through elimination of existing discriminating measures and/or prohibition of new or more discriminatory measures. Agreements liberalizing trade in services involving developing countries will be accorded flexibility regarding the above conditions. Such flexibility has not been further clarified however it would appear to imply a lower standard than what is expect from developed countries.

The integration agreement must be designed to facilitate trade of members and shall not raise the overall level of barriers to trade in services within the respective sectors or sub-sectors compared to the level applicable prior to the agreement.

On its creation, and following any modifications, the integration agreement must be promptly notified to the Council for Trade in Services. This **notification requirement is stated by GATS Article V (paragraph 7)** as follows:

“(a) Members which are parties to any agreement referred to in paragraph 1 shall promptly notify such agreement and any enlargement or any significant modification of that agreement to the Council for Trade in Services. They shall also make available to the Council such relevant information as may be requested by it. The Council may establish a working party to examine such as agreement or enlargement or modification of that agreement and to report to the Council on its consistency with this Article.”

Agreements notified under GATS Article V include the EU, the NAFTA, the Canada-Chile Agreement, and the ANZCERTA. Following several examinations carried out by the CRTA on these integration agreements based on the same procedure as for RTAs on goods (i.e., notification, adoption of terms of reference, provision of information on standard format, questions and answers), CRTA members are consulting on the preparation of the reports of examinations for the EU services agreement, the NAFTA and the ANZCERTA.

Integration agreements liberalizing trade in services are permitted under GATS Article V BIS to provide for full labour market integration on condition that (a) citizens of parties to the agreement are exempted from requirements for residency and work permits; and (b) the agreement is notified.

#### E. WAIVER CLAUSE

Beyond the above three alternatives, there is also the **waiver procedure under GATT Article XXV, the Understanding in Respect of Waivers of Obligations under the GATT 1994 and the Marrakesh Agreement Establishing the WTO, Article IX (paras. 3 and 4)**. GATT Article XXV: 5 provides that under “exceptional circumstances,” members acting jointly can waive an obligation imposed upon another member by the GATT. It can therefore (and has been) invoked by members who, in breach of GATT Article I (MFN principle), want to enter into preferential trading arrangements. A waiver is typically requested if the parties to the preferential trading arrangement cannot comply with the terms of GATT Article XXIV (or the Enabling Clause).

In the first two decades of GATT, a number of developed economies invoked Article XXV: 5 to form preferential trading arrangements. In 1948 France requested and obtained a waiver for a proposed customs union with Italy, which was not at that time a member of the GATT. The founding members of the European Coal and Steel Community (Belgium, Netherlands, Luxembourg, France, and Italy) obtained a waiver in 1952 for their free trade agreement on coal and steel. The limited product coverage of the agreement meant that the parties could not invoke GATT Article XXIV that required substantial trade coverage. Likewise the USA had to obtain a waiver in 1965 for its agreement with Canada on free trade in automobiles. Thus GATT Article XXV has on occasions provided the basis for authorizing of a number of RTAs, especially sectoral trade agreements, in contravention of GATT Article I.

However, out of a total of some 28 waivers that have been granted since the formation of the GATT, the majority have involved preferences granted by developed economies to developing economies on a non-reciprocal basis in support of the latter's economic development. Most of these agreements drew inspiration from Part IV of the GATT which is intended to assist the development of developing economies. Examples include Australia's preferences to products from Papua New Guinea (1953), Canada's preferences to imports from the Caribbean Basin (1968), the USA's preferences granted to Caribbean economies under the Caribbean Basin Economic Recovery Act (1985), and the preferences granted by the USA under the Andean Trade Preference Act in 1992.

One of the more recent and controversial waivers granted by the GATT pertained to the Fourth Lomé Convention between the EU and the African, Caribbean and Pacific States (ACP). The Lomé Convention *inter alia* provides preferential, non-reciprocal access to the EU market for ACP exports. The EU did not seek a waiver for the first three conventions. It contended that the preferential non-reciprocal market access conditions granted to ACP economies was consistent with the GATT Part IV, read in conjunction with Article XXIV. It invoked these provisions as the legal basis for the Fourth Lomé Convention. This contention was challenged, however, by other GATT (at the time) members and the Convention risked being found to be inconsistent with GATT Article I. Thus the parties decided to obtain a waiver for the Lomé Convention, which was granted.

The decision to waive an obligation of a member under GATT 1947 Article XXV required its approval by a two-third majority of the votes cast and that such a majority shall comprise more than half of the WTO members.

Recourse to the use of waivers has been limited by the Understanding in Respect of Waivers of Obligations under the GATT 1994 (Uruguay Round result). Apart from the obligation to justify

the need for a waiver (Understanding paragraph 1), the Understanding provides (in paragraph 2) that all waivers existing as at the time the WTO Agreement entered into force (1 January 1995) shall lapse on the date of its (waiver's) expiry or not later than two years after the creation of the WTO (i.e., 1 January 1998), whichever is earlier, unless extended in accordance with Article IX of the WTO Agreement. The Understanding also provides (paragraph 3) a WTO member which considers that its benefits from GATT may be nullified or impacted owing to the waiver or non-respect of the conditions of the waiver by the member to whom the waiver was granted, may invoke dispute settlement procedures under GATT Article XXIII as further elaborated by the Dispute Settlement Understanding.

Under the terms of the WTO Agreement Article IX (paragraphs 3 and 4), WTO members seeking waivers have to go through a complicated process before being authorized to deviate from their obligations under the GATT. The waiver could be granted by the WTO Ministerial Conference in "exceptional circumstances," provided that the decision is taken by 75 percent of the WTO members (about 102 of the 137 WTO members at present count), which is more than the two-third majority votes required under GATT 1947 Article XXV.

Although the scope for the use of waivers is being limited, some flexibility nonetheless is provided in terms of decision-making:

- Article IX:3(a) provides for the possibility that upon request, the Ministerial Conference's decision on the waiver could be taken by consensus. In this case the Ministerial Conference shall establish a time period not exceeding 90 days to consider the request. Failing the reaching of consensus during that period, the decision would be taken by 75% of the WTO members; and
- Article IX:3(b) provides for a waiver request concerning the trade agreements relating to trade in goods, trade in services and trade-related aspects of intellectual property rights, to be submitted initially to its relevant supervisory body, namely the Council for Trade in Goods, Council for Trade in Services or the Council for TRIPS, for consideration during a time period not exceeding 90 days. At the end of that period the relevant Council shall submit a report to the Ministerial Conference.

A member (or group of them) that succeeds in obtaining a waiver, would have to abide by the stringent conditions that would be set by the Ministerial Conference. Article IX: 4 provides that the granting of the waiver shall clearly explain the exceptional circumstances justifying the decision, the terms and conditions governing the application of the waiver and its date of its expiry. The waiver, should it extend over several years, would be reviewed annually until its expiry. In each annual review the Ministerial Conference shall examine whether the exceptional circumstances continue to prevail and the relevant terms and conditions have been met, and on that basis extend, modify or terminate the waiver. This introduces some uncertainty over the sustainability of the waiver with adverse implications for economic operators wishing to take advantage of it.

The provisions of the Understanding on the waiver and the WTO Agreement Article IX indicate that unless a WTO member (or a group of them) requesting a waiver could mobilize widespread support from other WTO members in support of their request, they will not be able to easily obtain the waiver. Accordingly, further use of the waiver option as a basis for limited RTAs or for preferential trading arrangements that are not consistent with the provisions of GATT Article XXIV or the Enabling Clause is likely to diminish.

## **F. FURTHER DEVELOPMENTS**

The **examinations** of RTAs in the WTO carried out so far by the CRTA in particular indicate a major change from past practice. The examinations are substantive and parties under examination are expected to show concrete and substantial proof of the conformity of their trading arrangements with relevant WTO provisions. The examination normally has two phases. The first phase involves is an in-depth factual examination of the RTA in question with the relevant information provided by parties to the RTA. The first phase of examination is considered complete when general agreement is reached within the CRTA that all relevant factual information has been supplied and reviewed. The second phase comprises the drafting of a conclusion on the WTO conformity of the RTA mostly in an informal (and confidential) setting by the CRTA. The factual examination and negotiated conclusions are amalgamated into a single report that is presented to the relevant supervisory body. As of June 2000, the CRTA has not released such a report on an RTA to the relevant WTO body.

There appears to have been some disagreement among CRTA members as to the purpose of the **reporting of operations** of RTAs to the WTO. On the one hand, some members suggest that the biennial reporting obligation of RTAs should provide an opportunity for an examination of the liberalization programme of the RTA. On the other hand there are members of the view that reporting should not constitute a new/repeated examination of an RTA (as carried out when the RTA was first notified). It should be an updated report on developments in an RTA. It must not overlap with reporting under the WTO's Trade Policy Review mechanism. Members with such a concern have argued that the clear demarcation between the reporting and examination obligations may become blurred. They also argue that the reporting obligation may become unnecessarily burdensome, in particular for those member economies which are engaged in a multiplicity of RTAs (such as the EU which is the major customer of the CRTA). In addition, there has been some discussion of linking the reporting requirement under the GATT Article XXIV to those under the GATS and the Enabling Clause. There are suggestions that any reports submitted by parties to RTAs to the Council for Trade in Goods, the Council for Trade in Services or the Committee on Trade and Development should be jointly submitted to the CRTA.

CRTA members have also identified a checklist of over 20 **systemic issues** that need to be taken up for further consideration and clarification. The checklist is evolutionary and could be added to or reduced as appropriate by the CRTA. The CRTA agreed on a procedure to take up the systemic issues. It was generally expressed that for the purpose of better examination, the legal issues (GATT Article XXIV issues) could be distinguished from the economic/technical issues (e.g., multilateralism versus regionalism) and considered separately. But more importantly, prior analysis of each systemic issue must be undertaken and fuller intergovernmental debate carried out. This cautious approach was inevitable given the controversy and divergent views among WTO members on many of the proposed issues. It has also been suggested that identical technical issues arising from GATS Article V should also be considered.

Finally it is worth noting that during the preparatory process leading to the Third WTO Ministerial Conference in Seattle, USA, proposals on RTAs were submitted by Australia; Hong Kong, China; Hungary; Korea; Turkey, and Romania, among others. Several of these proposals (e.g., by Korea and Hong Kong, China) call for more work on bringing greater clarity, precision and reinforcement to some of the provisions (such as "substantially all the trade") and thus clarify the rights and obligations of WTO members in establishing RTAs. Others (e.g., by Australia) also relate to procedural issues, namely, to improve the efficiency and effectiveness of the WTO's examination of RTAs. Some proposals (e.g., Hungary, Romania, and Turkey) stated that currently notified RTAs should be assessed against existing WTO provisions and thus not against new standards that maybe evolved.

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# CONVERGENCE BETWEEN REGIONALISM AND MULTILATERALISM AND THE ROLE OF THE WTO

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## I. INTRODUCTION

It is rather ironic to see the greater proliferation of regional trade agreements (RTAs) at a time when successive rounds of multilateral negotiations have advanced trade liberalization to greater depths and stretched multilateral trade disciplines well beyond the original General Agreement on Tariffs and Trade (GATT) rules. The basic question is whether RTAs have supplemented or contradicted the parallel development of MTS. That is whether RTAs have functioned as “building blocs” or “stumbling blocs” in the multilateral process.

There are few analytical studies and scarce empirical evidence, which could validly confirm with precision, whether either position is true. Perhaps the more valid question would be: Are there sufficient pressures, guidelines or models within the World Trade Organization (WTO) or elsewhere to align present and future RTAs to multilateral rules and ensure that RTAs “facilitate trade between parties and not raise barriers to third parties” as reflected in the legal texts governing regional trading agreements<sup>1</sup>.

## II. MAPPING AN OUTLINE OF RTAs

The WTO Secretariat maintains a list of RTAs notified to the GATT/WTO and in force.<sup>2</sup> As of June 2000 the following situations exist on these RTAs:

1. Of the 124 RTAs reported to GATT/WTO, it is estimated that around 97 RTAs or 78 percent were notified in the past nine years. Around 80 RTAs remain un-notified.
2. 99 RTAs are bilateral; 25 are plurilateral.
3. The number of GATT/WTO members participating in RTAs rose from 55 in the 1980s to 100 (out of 132 WTO members) as of September 1998.
4. The number of RTAs (including services) to which an economy or another RTA has become a party has increased.

The EC is involved in 24 FTAs, 5 customs unions (CUs), and 8 Services Agreements; the (EFTA) (Iceland, Norway, Switzerland, Liechtenstein) in 14 FTAs and 1 Services Agreement; the Economies in Transition, EFTA and Central European Free Trade Area members (CEFTA: Bulgaria, the Czech Republic Czechoslovakia and Slovakia, Hungary, Poland, Romania and Slovenia) in 31, Turkey, 9, Israel, 10; Canada, 3 FTAs and 2 Services Agreements; and,

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<sup>1</sup> This principle is found in GATT Article XXIV: 4: the Preamble to the understanding on the Interpretation of Article XXIV of the GATT 1994; paragraph 3(a) of the 1979 Decision on Differential and More Favourable Treatment, Reciprocity and Fuller Participation of Developing Countries (Enabling Clause) and General Agreement on Trade in Services (GATS) V: 4.

<sup>2</sup> Annex 1 is an informal paper of the WTO Secretariat listing RTAs notified to GATT/WTO and in Force as of June 2000.

Bangladesh, 3. Mexico has reportedly 13 FTAs and 5 more in negotiations but only one, the North American Free Trade Agreement (NAFTA), has been reported to the WTO.

5. There are 10 Services Agreements notified to the WTO.
6. RTAs have moved from inter-regional to cross-regional. The EU and the EFTA aim to form a European Economic Area (EEA) which will bring the provisions of EC 1492 to the four member economies of the EFTA. The EC is also involved in five cross-regional RTAs with Mexico, Uzbekistan, Kyrgyzstan, the Gulf Corporation Council and P-TOMII (EC and Certain Non-European Economies and Territories).

The FTAA (Free Trade of the Americas) which is due to be off the ground by the year 2005 has acted as stimulus to the creation of inter-regional groupings like the South American Free Trade Agreement (SAFTA: Chile, MERCOSUR and the Andean Community) and the Caribbean Community (CARICOM)-Dominican Republic. There are now four cross-regional RTAs from the Americas in force (Canada-Israel, U.S.-Israel, US-Palestinian, Mexico-EC) and soon there will be a fifth – Canada-EFTA.

### III. EXAMINATION OF RTAS

The WTO requires that all bilateral, regional and plurilateral agreements of a preferential nature be notified to the WTO. Through a decision of 6 February 1996 the WTO General Council established the Committee on Regional Trading Agreements (CRTA) to “carry out the examination of agreements in accordance with the procedures and Terms of Reference adapted by the Council of Trade in Goods, the Council for Trade in Services, the Committee on Trade and Development, as the case may be, and thereafter present its report to the relevant body for appropriate action.”

**GATT 1947 Experience with RTAs** – Under the GATT, the Council established small separate working parties for each Agreement notified. Based on a question and answer format, usually in written form, a formal document was produced upon which working parties drew an agreed report for transmittal and adoption by the Council. The process was confidential and internal to the Working Party, except for the formal documents and agreed report. It produced, at best, divergent views on the relevant RTA’s compatibility with the rules and, at most, a mix of factual information and judgements of a general nature. No further actions were by the Council on the Reports.

**WTO Experience with RTAs** – Under the WTO, the process through which RTAs are dealt with, after notification and distribution of the text, has changed. The relevant bodies adopt the terms of reference (TORs) for examination and transfer the task of examination to the CRTA.<sup>3</sup>

Until the demise of the old GATT in 1994, a total of 98 RTAs were notified under Article XXIV and examined by working parties. Consensus on the conformity of RTAs with the GATT provisions was reached only in one case: the Czech-Slovak Customs Union.

At the date of its creation in 1996, the CRTA inherited the examination of a number of individual agreements previously mandated to working parties.<sup>4</sup> Since then, no agreed report has been produced on any of the inherited examinations or on any of the examinations referred to it. The current impasse on the examination front has delayed all other activities on examinations, leading to a backlog numbering 82 as of March 2000.

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<sup>3</sup> In the case of Services Agreements and those notified under the Enabling Clause, an examination is not automatic but should be decided by members. To date, such decisions were taken for 7 out of 12 Services Agreements and a simple Agreement under the Enabling Clause.

<sup>4</sup> Some of these agreements were carry-overs from the GATT.

The interplay of several factors may explain the members' inability to reach a consensus on the draft examination reports:

- Diverging views on the interpretation of RTA-related rules - The lack of a common legal yardstick makes it difficult to reach consensus on whether a given agreement is in line with a given requirement and it becomes virtually impossible to unanimously declare an agreement either fully consistent or fully inconsistent.
- The nature of the agreements themselves - An obvious difficulty, since not all RTAs are equal and, in theory, some should be closer to any one yardstick than others.
- Linkages between reports - This consists of associating the inclusion of a comment or an appraisal in the text of one report to a similar inclusion in the text of another.

The CRTA has adopted a more structured procedure for the examination and a standardized format for information and examination reports. Under the standardized examination report format divergences, observations, and consistency are noted in the relevant portion (Part C) of the report. This part pertains to the specific agreements under Article XXIV, i.e. paragraphs 5, 6, 7 and 8 and other relevant matters. They are then captured in the illustrative list of systemic issues for which a responsive CRTA work programme will be accordingly designed.

**Legal Texts Governing Examination and Consistency** – Before the Uruguay Round, no GATT 1947 provisions specifically referred to any kind of examination of notified RTAs. In Article XXIV: 7(a), it is however foreseen that Members will need information “to make such reports and recommendations...as they may deem appropriate”, and it is required that RTA parties make such information available to them. This was probably at the source of the practice that developed of mandating a working party “to examine in the light of the relevant provisions of the GATT” every notified RTA and to “report thereon”.

Paragraph 7 of the Understanding on the Interpretation of Article XXIV of the GATT 1994 clarified that all RTAs notified under that Article should be examined...in light of the relevant provisions of GATT 1994 and paragraph 1 of this Understanding” and that a report should be submitted to the Council for Trade in Goods with findings in this regard”. The standard terms of reference for the examination of each individual RTA notified under the GATT which the CRTA has adopted contains similar language: although the mandate does not mention paragraph 1 of the Article XXIV Understanding.

Paragraph 1 of the Understanding says that RTAs “to be consistent with Article XIV, must satisfy, *inter-alia*, the provision of paragraphs 5, 6, 7 and 8. Furthermore, the Understanding read out by the Chairman of the Council for Trade in Goods - 20 February 1995, which is attached to the terms of reference for the examination of all RTAs currently under the purview of the CRTA, explicitly refers to “reporting on consistency with the provisions of Article XXIV.”

Article V: 7(a) of the General Agreement on Trade in Services (GATS) also contains the requirement that parties to RTAs (in the area of services) supply all needed information, and its wording makes clear that, whenever an examination is deemed necessary for an individual RTA, the aim of such exercise will be "to report...on its consistency" with GATS Article V. The corresponding mandate for the examination uses the same words, i.e., it asks for a report on the consistency of the RTA.

Therefore, under both the GATT and the GATS there exists a call for an assessment of consistency. Because RTAs notified under the GATS are not automatically submitted to an examination, some indications as to how these two requirements may interact can be found in the language of the GATS article V: 7(a), which would suggest that:



- a. the required information exercise might be separate from the examination; and
- b. the examination itself would have, as its sole objective, the determination of an RTAs compatibility with the rules.

The consideration of systemic issues is part of the mandate of the Committee on Regional Trade Agreements.<sup>5</sup> The CRTA has tackled that mandate by attempting to identify what subjects should be put in the systemic “basket”, how to structure the debate, and what emphasis should be given to the different components.

The CRTA deals with systemic issues under a three-pronged approach:

- (i) legal analyses of relevant WTO provisions;
- (ii) horizontal comparisons of RTAs; and
- (iii) consideration of the economic aspects of RTAs.

In agreeing on a three-pronged approach to its systemic analysis, the CRTA recognized that “systemic implications” did not necessarily only mean legal shortcomings or problems of interpretation, but could also refer to the thematic, or horizontal, examination of certain themes or issues.

One such issue could entail an analysis about the nature of customs unions and free-trade areas, the reasons underpinning their formation, their contribution to the global liberalization of trade, and their effect on the multilateral system.

It has also been observed that RTAs have taken different roads in their dealing with issues related, for example, to Rules of Origin (ROO), anti-dumping and countervailing measures, technical barriers to trade, safeguards, competition policy, or government procurement. These different approaches to particular trade policy areas, or to particular trade disciplines, might point to potential systemic implications, in particular the extent to which the use of different approaches might hinder and/or facilitate the promotion of multilateral disciplines in an area.

Some of the horizontal issues which could be explored by the CRTA in this context are:

- How do different agreements deal with specific trade-related disciplines?
- How does the treatment of specific disciplines inside RTAs relate to the relevant disciplines in the WTO?
- How do regional and WTO disciplines interact currently, and how might their relationship evolve in the future to foster multilateral disciplines?

Annex I is an illustrative List of Themes Suggested for CRTA Consideration. The CRTA has decided to commission the WTO Secretariat to publish a study on the horizontal comparison of RTA provisions on Item I – Internal Trade Liberalization by the end of summer 2000 so that an appropriate event to address these issues can be decided for next year.

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<sup>5</sup> Item 1(d) of its terms of reference reads: “to consider the systemic implications of such agreements and regional initiatives for the multilateral trading system and the relationship between them, and make appropriate recommendations to the General Council”. Furthermore, the reporting required on the operations of the Agreements are intended to serve as “inputs to the systemic issues” in the CRTA work programme.

#### IV. ISSUES ON TRANSPARENCY

**Mandates on Transparency – Trade in Goods – Article XXIV:** 7(a) of the GATT 1994 mandates “Any CP deciding to enter into a customs union or free trade area, or an interim agreement leading to the formation of such a union or area, shall promptly notify the CPs and shall make available to them such information...as will enable them to make such reports and recommendations...as they may deem appropriate.

Furthermore, the Preamble on the Understanding of the Interpretation of Article XXIV of GATT 1994 states “...the need to reinforce the effectiveness of the role of the Council for Trade in Goods (CTG) in revising agreements...by clarifying the criteria and procedures for the assessment...and improving the transparency of all Article XXIV agreements.”

**Trade in Services –** The GATS Article 3 provides for a generic mandate on transparency.

Furthermore, the GATS Article V: 7(a) provides for parties to any agreement to “...promptly notify any such agreement and any enlargement thereof or any significant modification...to the CTG...make available to the Council such relevant information as to may be requested by it.”

#### V. FUTURE HANDLING OF RTA ISSUES IN WTO

In 1996 the WTO membership expressed its mandate on the role of the CRTA in paragraph 7 of the Singapore Ministerial Declaration, stating, *inter-alia*: “The expansion and extent of RTAs make it important to analyze whether the system of WTO rights and obligations as it relates to RTAs needs to be further clarified.” As an instrument of the WTO mandated to examine consistency in RTAs to Article XXIV of GATT 1994 and its Understanding; GATS Article V and the Enabling Clause, the CRTA is in a dilemma – not only because of the interplay of factors discussed earlier in this paper – but more so because any categorical findings, recommendations, and/or interpretations emanating from it and adopted by the Council may have the force of a decision.<sup>6</sup>

The first ever dispute settlement case involving RTA matters was the Turkey Restrictions on Imports of Textile and Clothing Products, and the Appellate Body clarified a few points in Article XXIV. While jointly adopting the Panel Report on the case in 19 November 1999, the Appellate Body in effect:

1. Enjoined the Panel to have passed judgement on whether the EC-Turkey arrangement was a Customs Union;
2. Declared that Customs Union (and RTAs for that matter) are not outside the purview of close examination by Panels (contrary to the defense presented by Turkey, supported by India, that RTAs are political decisions of governments which are not subject to Panel scrutiny); and
3. Further declared that only measures which would prevent the realization of a Customs Union could be validly claimed as derogation from MFN under Article XXIV (QR regimes are not essential elements towards the realization of a Customs Union and therefore need not follow the regime of EC).

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<sup>6</sup> Under Article IX: 2, Decision Making of the Marrakesh Agreement establishing the WTO “...Ministerial Conference and the General Council shall have the exclusive authority to adopt interpretations of this Agreement...”

There is a risk that a number of “nullification and impairment” cases arising from implementation of numerous and more complex RTAs may have been raised and, without guidance from the WTO, participants to a new generation of RTAs might lay themselves open to these risks.

Indeed the clarification of the system of WTO rights and obligations as it relates to RTAs requires immediate alteration. In the lead-up to the Seattle Ministerial Conference in November 1999, a number of proposals for negotiations were tabled by several WTO members. Without the prospect of another round there appears to be little likelihood of any clarification.

Moreover, there is no “built-in” mandate for the review or assessment of Article XXIV and the Understanding on Article XXIV compared to other issues in the built-in agenda of the WTO.

It is then left to the CRTA, through its three-pronged agenda, to address this issue. The role of the CRTA itself in the structure of WTO policy making has some bearing.

**The CRTA Reports** on Examination and the biennial Reports on Operation of Agreements are very important. Even without consensus views, recommendations, or conclusions, they are effective channels for collecting information (what and how much information is an issue still debated in the CRTA) and for factually and accurately reflecting members dissenting views on the different features of RTAs and their consistency with or adherence to multilateral rules and disciplines.

Hopefully, the CRTA work in addressing the “systemic issues” will highlight the horizontal treatment among RTAs on the objectives, procedures and approaches, RTAs have with regard to major trade and trade-related issues. The analytical benefits arising from this work program can contribute to the needed changes in the WTO rights and obligations *vis-à-vis* RTAs and contribute to improved convergence.

This work programme can also reflect the importance RTAs place on specific issues not presently covered by the WTO. The experience they gather from these on-the-ground practices can help WTO members when introducing these to the WTO agenda in the future.

The role of CRTA also has some bearing on this. The CRTA’s mandate on examining the consistency of relevant provisions in RTAs to specific agreements in the WTO is clear. In this sense it serves as a mechanism for the enforcement of certain specific obligations or to reinforce commitments under the WTO for members participating in RTAs. Any categorical finding or recommendation of this nature could, however, jeopardize the position of the WTO members participating in the RTA in question. So reports are blocked and the CRTA cannot perform its function.

The CRTA is not a dispute-settlement organ so it cannot interpret the relevant provisions governing members’ rights and obligations in a binding manner.

In some sense, perhaps the CRTA is closer to the Trade Policy Review Mechanism (TPRM) which “enables the regular collective appreciation and evaluation of the full range of individual trade policies and practices and their impact on the functioning of the multilateral trading system.” The TPRM is further intended to contribute to improved adherence by all members to rules, disciplines, and commitments made under the multilateral trade agreements...” The procedures and outcome of its work do not threaten members’ rights and obligations. But, through the process of transparency and peer pressure, the TPRM is nevertheless effective *vis-à-vis* the objective it is intended to serve.

## VII. CONCLUSION

In this paper, I have confined myself only to the interplay between RTAs in different forms and the system of WTO rights and obligations. Short of rulings arising from the Dispute Settlement process, the WTO appears in a weak position to align present or future RTAs to a desirable level of consistency with binding multilateral rules.

Through the work of the CRTA, the WTO might, however, provide peer pressure to influence changes in the present RTAs and guide the patterns of future ones. The collection of wider information is an issue in itself in the CRTA, is critical in this respect. A keener awareness of this problem and a wider information campaign thereon could serve the WTO well. But the role of the CRTA itself needs to be clarified to allow it to perform its examination, transparency, systemic, and information responsibilities without threatening members' rights and obligations.

Much of the responsibility reverts to the WTO membership themselves: whether they will reflect, in their intermingling RTA participation, their commitments to WTO rules and disciplines in the interest of a sound and stable multilateral trading system.

The external pressure from other multilateral institutions, regional groupings, learning centers, and professionals can help in this process. If one concedes the economic usefulness of RTAs, the political and legal pressures to find convergence between regional and multilateral invitations must get the support of all shareholders.

# **APEC AND THE MULTILATERAL TRADING SYSTEM**

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## **I INTRODUCTION**

In this session, I would like to discuss how APEC, as a regional forum, fits into the multilateral trading system. In particular, I would like to trace the history of how APEC, which represents 21 economies comprising some 2.4 billion people and combined gross domestic product (GDP) of US\$17 trillion, has contributed to the World Trade Organisation (WTO) process and the overall strengthening of the multilateral trading system.

Since the first APEC Economic Leaders' Meeting (AELM) in 1993 at Blake Island near Seattle, APEC has worked in parallel with the WTO. At Blake Island, APEC Leaders concluded their first meeting by giving the push needed to bring the Uruguay Round (UR) to an early and successful conclusion.

Other significant APEC contributions to the multilateral trading system include the revitalisation of the Information Technology Agreement at Subic Bay, the Philippines in 1996, which is phasing out tariffs on US\$1.5 trillion of trade in computers, computer equipment, semiconductors and related goods. In 1999 at Auckland there was consensus by APEC members in the call for the launch of a new WTO round at Seattle. Most recently, APEC Ministers Responsible for Trade (MRT) in Darwin, Australia, 6–7 June 2000, reiterated the call for the early launch of a new round and agreed on a number of 'Auckland-plus' elements, which I will discuss in greater detail later.

By looking at its evolution, from its philosophical roots to the comprehensive three pillar work program that brings together Leaders and Ministers together on an annual basis, we can better understand how APEC works in parallel to the WTO and how it strengthens the multilateral trading system. As a regional organisation, it is the only forum linking the Americas, North Asia, South East Asia and Oceania and representing the interests of both developing and developed member economies. Following this, I would then like to suggest some future challenges for APEC.

## **II THE EVOLUTION OF APEC AS A REGIONAL FORUM AND ITS CONTRIBUTION TO THE MULTILATERAL TRADING SYSTEM**

The philosophical framework for Pacific economic cooperation was extensively discussed for more than two decades before APEC's creation in 1989. However, although there was support for cooperation at the business and academic level, there was initially little support at the political level for formalising regional economic cooperation.

The intellectual "grounding" for APEC was established in 1980 through the Pacific Economic Cooperation Council (PECC), a joint initiative of Australia and Japan, which embodied a tripartite structure involving business, academics and government officials. PECC provided the format to discuss issues freely and without the need to adhere to official economy positions, thereby increasing mutual confidence and underlining the potential – and indeed value – of closer cooperation.

By the late 1980s, during the lengthy Uruguay Round negotiations, economies increasingly began to start looking at regional agreements as an alternative to the multilateral GATT process. Most

significant were the successful negotiation of the Canada-US Free Trade Agreement [the predecessor to the North American Free Trade Agreement (NAFTA)] and further progress by the European Community towards a single market. These both signified an important shift away from multilateralism to regionalism.

During this time, there were also a number of proposals from Japan, the US and Australia for closer regional economic cooperation. However, it was an initiative by former Australian Prime Minister Bob Hawke, during a visit to Korea in February 1989, to bring together a meeting of Ministers from the region that gave form and a sense of direction to these proposals.

Accordingly, in Canberra in November 1989, Ministers from twelve regional economies met and together set the general principles and objectives of APEC, that is, to promote open trade and practical economic cooperation in the Asia Pacific.<sup>1</sup> Then, in 1994, APEC Economic Leaders agreed to the Bogor Goals of free and open trade and investment by 2010 for developed economies and 2020 for developing economies.

The adoption of the Bogor goals and the subsequent decision by APEC member economies to develop Individual Action Plans (IAPs), which record member economies' voluntary commitment and progress toward the achievement of the Bogor Goals, demonstrated APEC's capacity to promote both multilateral and regional trade liberalisation.

Since APEC is not a formal negotiating forum, undertakings such as the Bogor Goals set aspirations which are higher than economies have been prepared to negotiate in legally binding form. APEC also provides a reference point for liberalisation efforts, reported in IAPs, regardless of where the commitments are made.

Through the work already being done by member economies within APEC's three pillars – trade and investment liberalisation, business facilitation, and economic and technical cooperation (ECOTECH) – APEC has been an effective partnership within the multilateral trading system. APEC strengthens the multilateral trading system by keeping member economies focussed on their own domestic liberalisation policies. As a result, APEC economies, as a whole, have now liberalised beyond their WTO commitments.

As I noted in my introduction, APEC Leaders at their first meeting at Blake Island played a key role in bringing the Uruguay Round to an early and successful conclusion. Subsequent APEC work programs have assisted members in implementing their negotiated Uruguay Round negotiations.

APEC has also undertaken important groundwork in new areas of interest to the WTO such as standards and conformance (to eliminate the duplication of product testing) and on other trade facilitation issues. At the same time, it has provided capacity-building to enable APEC economies to implement their WTO commitments and support the accession to the WTO of non-WTO member economies.

APEC has also contributed to strengthening the multilateral trading system by demonstrating its capacity to respond to the recent Asian financial crisis. For example, at their meeting in Kuala Lumpur in 1998, Leaders called for increased attention to the far-reaching social impacts of the 1997/98 crisis, particularly the need to strengthen social safety nets.

Two Australian initiatives formed an important part of that response: firstly, an Australian survey on the social impacts of the crisis on children in Thailand, Indonesia and the Philippines,

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<sup>1</sup> At the 1989 meeting, Ministers represented: Australia, Brunei Darussalam, Canada, Indonesia, Japan, Republic of Korea, Malaysia, New Zealand, the Philippines, Singapore, Thailand and the US.

particularly the impact on children's health and education and the implications for program design and delivery.

Secondly, the creation of the Asia Recovery Information Centre (ARIC), an Internet facility based at the Asian Development Bank in Manila designed to improve crisis related information flows and the sharing of experiences.

### **III SEATTLE WTO MINISTERIAL CONFERENCE**

Following the outcomes of the WTO Ministerial Conference, Seattle, 30 November–3 December 1999, Australia, like most economies, was disappointed with the failure of Ministers to launch a new round of global multilateral trade negotiations. This disappointment was even greater given the obvious benefits to both the developed and the developing world that a new round would have provided. For example, modelling included in a study entitled "Global Trade Reform – Maintaining Momentum", presented by Australia at last year's Organisation for Economic and Cultural Development (OECD) Ministerial meeting, estimated that the elimination of trade barriers would generate global gains in excess of US\$750 billion annually. A halving of protection levels would yield some US\$400 billion in global welfare.

Despite the setback at Seattle, Australia, and most WTO members, remain committed to the launch of a new round at the earliest opportunity.

### **IV MEETING OF APEC MINISTERS RESPONSIBLE FOR TRADE (MRT), DARWIN, AUSTRALIA, 6-7 JUNE 2000**

The Meeting of APEC Ministers Responsible for Trade (MRT) in Darwin, Australia, 6-7 June, was an opportunity to reaffirm the consensus reached at Auckland and to move beyond Seattle by rebuilding political momentum for a new WTO round. The presence of WTO Director General Mike Moore during the Ministerial Retreat discussions of WTO issues clearly demonstrated the commitment of APEC to the growth and strengthening of the multilateral trading system.

At the MRT meeting, as part of their discussions of key multilateral and regional trade policy issues, Ministers discussed the interrelationships between the unilateral, sub-regional and multilateral frameworks through which member economies are implementing the Bogor Goals.

Ministers called for the early launch of a new round of WTO negotiations and agreed on a number of 'Auckland-plus' elements, including the call for preparatory work on industrial tariffs in the WTO; an APEC-wide moratorium on customs duties for electronic transmissions; and a strategic plan to develop the capacity of developing APEC economies to implement WTO agreements – an idea proposed by Japan and co-sponsored by Australia.

Ministers endorsed the valuable capacity-building work being done in APEC to aid implementation of the Agreement on Trade Related Aspects of Intellectual Property Rights (TRIPS). The Ministers also endorsed the Joint Statement on the WTO/TRIPS Agreement Implementation.

In addition, Ministers recognised the need to explain to the public how stronger integration into the world economy would deliver economic and social progress. They welcomed the APEC report, *APEC – a Decade of Progress*, an Australian report prepared for the Darwin meeting of the APEC Ministers Responsible for Trade, which highlighted APEC's achievements. Ministers also discussed sub-regional trading agreements "and their relationship with WTO and APEC policy frameworks and welcomed a proposal for a survey of existing sub-regional trade

agreements and bilateral investment treaties.”<sup>2</sup> They also agreed they should be consistent with WTO rules, “in line with APEC architecture, and supportive of APEC goals and principles.”<sup>3</sup>

## V FUTURE CHALLENGES

A key challenge ahead is to ensure that all members remain firmly committed to the Bogor Goals. This can only be achieved if member economies remain committed to implementing economic reforms that support the principles of free and open regional trade and this is dependent on commitment at the highest political levels as well as domestic support.

At the same time, as the outcomes of the Seattle WTO Ministerial Conference demonstrated, APEC members will face a major challenge in maintaining political momentum for a new WTO round while at the same time continuing to address public concerns about globalisation.

Meanwhile, APEC will continue to add value to the multilateral trading system through its work on policy dialogue and economic and technical cooperation to develop the capacity of its member economies needed to implement trade and investment liberalisation.<sup>4</sup>

## VI CONCLUSION

In their pursuit of open trade and investment in the Asia Pacific region, APEC members continue to use all forms of liberalisation – unilateral, regional and multilateral to achieve their goals. As noted in *APEC – a Decade in Progress*, “it is no coincidence that APEC economies have constituted one of the most dynamic areas of rising prosperity and social improvement in the world.”<sup>5</sup>

Since 1989, APEC economies as a whole have liberalised beyond the WTO commitments they made during the Uruguay Round. In fact, modest estimates by the APEC Economic Committee place these additional gains at around US\$30 billion per year.

In moving outcomes forward, there will remain great scope for building on APEC’s record of achievements, in particular it’s value-added role in the multilateral trading system in drawing together developed and developing members’ perspectives.

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<sup>2</sup> Statement of the Chair, Meeting of APEC Ministers Responsible for Trade, Darwin, 6-7 June 2000

<sup>3</sup> *ibid*

<sup>4</sup> *APEC – a Decade of Progress*. A report prepared for APEC Ministers Responsible for Trade, 2000

<sup>5</sup> *ibid*



## GLOSSARY

ADB	Asian Development Bank
AELM	APEC Economic Leaders' Meeting
AFTA	ASEAN Free Trade Area
AMCs	Asset Management Companies
ARIC	Asia Recovery Information Centre
ASEAN	Association of South East Asian Nations
CAP	Collective Action Plan
CER	Closer Economic Relations
CIS	Commonwealth of Independent States
CTI	Committee for Trade and Investment
EC	European Community
EC	Economic Committee
ECOTECH	Economic and Technical Cooperation
EEA	European Economic Area
EFTA	European Free Trade Agreement
EMU	European Monetary Union
EU	European Union
EVSL	Early Voluntary Sectoral Liberalization
FDI	Foreign Direct Investments
FTA	Free Trade Area
FTAA	Free Trade Area of the Americas
FY	Fiscal Year
G8	Group of Eight
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
GSP	Generalized System of Preferences
IAPs	Individual Action Plans
IBRA	Indonesian Bank Restructuring Authority
IDE	Institute of Developing Economies
IMF	International Monetary Fund
IPR	Intellectual Property Rights
KIEP	Korea Institute for International Economic Policy
MERCOSUR	Mercado Comun del Cono Sur (Southern Cone Common Market)
MFN	Most Favored Nation
MRA	Mutual Recognition Agreement
MRT	Ministers Responsible for Trade
MSG	Melanesia Spearhead Group
NAFTA	North American Free Trade Agreement
NATO	North Atlantic Treaty Organization
NEDA	National Economic and Development Authority
NIEs	Newly Industrialized Economies
NPL	Non-Performing Loan
NTBs	Non-Tariff Barriers
NTMs	Non-Tariff Measures

OAA	Osaka Action Agenda
OECD	Organisation for Economic Cooperation and Development
PARTA	Pacific Regional Trade Agreement
PATCRA	Papua New Guinea Australia Trade and Commercial Relations Agreement
PECC	Pacific Economic Cooperation Council
PIDS	Philippine Institute for Developing Studies
PTA	Preferential Trade Agreement
RTAs	Regional Trading Arrangements
SAFTA	South American Free Trade Agreement
SPARTECA	South Pacific Regional Trade and Economic Cooperation Agreement
SRTA	Sub-Regional Trading Arrangement
TOR	Terms of Reference
TPRM	Trade Policy Review Mechanism
TRIPS	Agreement on Trade-related Aspect of Intellectual Property Rights
UNCTAD	United Nations Conference on Trade and Development
UNESCAP	United Nations Educational, Scientific and Cultural Aid Program
UR	Uruguay Round
WB	World Bank
WTO	World Trade Organization