



Cordell Hull Institute

Trade Policy Analyses

Vol. 5, No. 10

September 2003



Reproduced opposite is the text of remarks presented by **Kihwan Kim** (above).

About the Author

Dr Kihwan Kim is Senior Adviser, Goldman Sachs (Asia), Seoul.

He was previously Korea's Ambassador-at Large for Economic Affairs, and Vice Minister, Ministry of Trade and Industry, Government of Korea.

Prior to these positions, Dr Kim was President, Korea Development Institute.

Pause for Reflection...

Tackling the Proliferation of Preferential Trade

Kihwan Kim

ECONOMIC engagement in the Asia-Pacific region is extremely important for relatively small countries in the region – and for that matter in the world economy – like Chile, the Philippines, New Zealand and Korea.¹ The ways in which other countries in the region have pursued their economic engagement in recent years leaves much to be desired. Small open economies would like from every country engaged in the process of Asian-Pacific Economic Cooperation (APEC) an unqualified commitment to a multilateral trade and investment regime with no discrimination.²

Reduced Commitment to Multilateralism

Until about 1998, countries in the Asia-Pacific region pursued, for the most part, policies in favor of such a regime. This was best illustrated in the concept of “open regionalism” embodied in the Bogor Declaration of 1994. Unfortunately, within a few years, a significant change began to appear. Most of countries in the region still prefer a multilateral approach to the liberalization of trade and investment, but virtually all of them have begun to resort as well to regional, sub-regional and bilateral trade agreements.

A case in point was the negotiation of the North American Free Trade Agreement (NAFTA), at first involving the United States and Canada, then Mexico. Even at the time when NAFTA was concluded, some in the region hoped that its discriminatory impact could be minimized by extending it westwards to cover virtually all economies in the Asia-Pacific region, including those in East Asia. This has not happened. What's more, there is very little likelihood of it happening because, for one thing, the United States is more interested in extending NAFTA southwards to form a Free Trade Area of the Americas (FTAA).

Moreover, there is little question the preferential regional trade agreements that are already on the books, are being negotiated or

are being contemplated by countries in the Asia-Pacific region and elsewhere are motivated to a large extent by the desire of many countries to look for alternatives to the liberalization of trade and investment on a multilateral, or global, basis in the framework of the World Trade Organization (WTO), which came into being in 1995, founded on the General Agreement on Tariffs and Trade (GATT). Many countries, large and small, have experienced considerable frustration in trying to pursue the liberalization of trade and investment through the WTO process because of the amount of time it takes, largely due to some fundamental flaws in its structure – addressed later in this presentation.

There is another important explanation for the shift to regional, sub-regional or bilateral trade agreements. In early 1990s, Mahathir bin Mohamad, then Prime Minister of Malaysia, was keen to promote what he called the East Asian Economic Caucus (EAEC), which amounted to advocating a free trade agreement encompassing the East Asian economies. As long as these economies did well, especially in terms of overall growth and investment, Dr Mahathir's idea had only a limited appeal. But the situation changed dramatically in the course of the East Asian financial crisis of 1997-98. When the financial crisis began in Thailand in the summer of 1997, the United States did not show much interest in helping the country directly. What the United States did was allow the International Monetary Fund (IMF) to do whatever it could or wanted to do to help Thailand. The U.S. policy response was similar when the financial crisis spread to Indonesia and Malaysia.

Furthermore, when it became obvious that many East Asian countries were about to succumb to the contagion, and that the usual IMF policy prescription was not appropriate for Asian countries, the Government of Japan proposed the establishment of an Asian Monetary Fund. But the idea was rejected by the United States. Only when the financial crisis spread to Korea did the United States show a willingness to get directly involved. Such an inconsistent policy response went far in raising the question whether the United States really cared about the problems of East Asia. This weakened the willingness of governments in the Asia-Pacific region to work towards an open, global and multilateral trading system through the APEC process.

Intentionally or not, some other significant developments in recent years have further weakened the sense of cohesiveness in the Asia-Pacific community.

(a) At the first "ASEAN plus Three" summit, the meeting of the Association of South East Asian Nations plus China, Japan and Korea in 1997, an agreement was reached on launching an East Asian "vision group" with responsibility for mapping out the future course of development for the grouping. The vision group soon issued a report

recommending the formation of a Free Trade Area of East Asia.³

(b) Another case in point was the offer by China to enter into a free trade agreement with ASEAN as a whole.⁴

(c) Yet another case in point is the eagerness on the part of Japan to form a bilateral free trade agreement with South Korea and what Japan calls a comprehensive economic partnership with ASEAN countries.⁵

All in all, there are well over thirty different initiatives by countries in the Asia-Pacific region to pursue regional, sub-regional and bilateral trade arrangements. They include free trade areas between Japan and Singapore, Australia and Singapore, the United States and Singapore, the United States and Thailand and Korea and Chile. In short, over the past few years, the region has been rushing to form both bilateral and plurilateral preferential trade agreements, contrary to its earlier orientation towards open regionalism and the strengthening the multilateral trading system.

The reasons for this rush are not confined to the region. As already noted, many economies in the region have been frustrated with the slow progress in liberalizing trade through the multilateral process, especially after "the Seattle fiasco" – the failure of the third WTO Ministerial Conference, hosted by the United States in December 1999. Preferential trading agreements have proliferated globally at an amazing speed and, as they have done so, many economies in the Asia-Pacific region have felt that unless they join the trend they will be left behind.

Why the Current Trend is Deplorable

Whatever the reasons, the change of attitude in favor of preferential trade agreements is having far-reaching consequences that are truly deplorable.

First, there have been debates among economists on whether preferential trade agreements represent "building blocks" or "stumbling blocks" towards the liberalization of world trade. I for one am not persuaded that under certain conditions they can be building blocks. The catch is what is meant by "certain conditions". These refer to nothing less than consistency with WTO principles and rules, the broad coverage of products traded and the degree and duration of barriers against non-members. But most of the agreements that have been concluded or are under discussion have failed to meet one or more of the conditions laid down in GATT Article XXIV for departures from the principle of non-discrimination, the keystone of the multilateral trading system, to form a free trade area or a customs union. With few exceptions, preferential trade agreements represent stumbling blocks, not building blocks. The development of overlapping and

inconsistent rules and disciplines is unavoidable with the proliferation of preferential agreements. This in turn is creating what Jagdish Bhagwati has called the "spaghetti bowl" effect – thereby hampering trade globally.

Second, the above problems are compounded if the limited resources of individual governments to negotiate and administer trade agreements are diverted from multilateral negotiations.

Third, preferential trade arrangements are likely to be stumbling blocks, especially if they result in interest groups that have a vested interest in them, for those interests then oppose the liberalization of trade through the multilateral process. There has been ample evidence of this in the behavior of the small Asia, Caribbean and Pacific (ACP) countries that have been a part of the European Union's preferential trade arrangements since the late 1950s under, successively, the Yaoundé, Arusha, Lomé and Cotonou conventions.

Fourth, if the East Asian countries continue on their current path towards more and more preferential trade agreements and North America continues to make efforts to expand NAFTA into the FTAA, there is a strong possibility of two "mega-blocs" emerging on both sides of the Pacific – *i.e.*, a large free trade area on the western rim, in the form of the so-called ASEAN plus Three, and a large free trade area on the eastern rim in the form of the FTAA. This development would give rise to a tri-polar world in which the European Union, the FTAA and East Asia groupings were key blocs.

Fifth, would a world split three ways, as compared with (say) the world split two ways, be desirable? The answer is no. Game theory tells us that any situation involving three major players is inherently unstable, because each of the players fears that the other two will gang up on it. This fear will generate insecurity and induce all three players to make pre-emptive strikes in order to obtain a tactical advantage.

This inference is not merely theoretical. The inherent instability of a tri-polar world has been demonstrated throughout human history. For example, before World War II, the world was split into three major blocs: the American bloc led by the United States, the European bloc led by Germany and the East Asian bloc led by Japan. As each bloc made the first move to obtain a tactical advantage, the relationships among the three blocs quickly deteriorated and the result was World War II. Allow me to observe, in this connection, it is no accident that marriage in more advanced societies is a bi-polar rather than a tri-polar arrangement.

Sixth, recent developments suggest another aspect, which may be fortunate or unfortunate, in diminishing the prospect in the foreseeable future of a single East Asian trade bloc forming. As China bids for a China-ASEAN free trade arrangement, so does

Japan for a similar arrangement with ASEAN in the name, as noted earlier, of "a comprehensive economic partnership". What these two developments seem to augur is a possibility whereby China and Japan might play the role of a "hub", while other smaller countries or economies serve as "spokes". Hub-and-spoke arrangements, however, has their drawbacks. While the hub country enjoys a superior bargaining position *vis-à-vis* spoke countries, as well as opportunities to trade on favorable terms with all spoke countries, a spoke country has to bear with a disadvantaged bargaining position and forgo the opportunity to trade with other spoke countries unless the spoke country negotiates with every other spoke country separately.⁶

Apart from the problems associated with the proliferation of regional, sub-regional and bilateral agreements, there are serious problems with financial flows within the Asia-Pacific region. Since the financial crisis of 1997-1998 the economies in East Asia in particular have come together to strengthen cooperation in this area. The Chiang Mai Initiative (CMI) is an arrangement whereby central banks in the region try to help each other through currency swaps in the event a member or members face a liquidity shortage. But the practical significance of the arrangement should not be overestimated. The total amount of the currency swaps agreed under the CMI is still very limited. Furthermore, the structure of the arrangement remains bilateral, rather than multilateral. What's more, Japan's efforts to provide leadership in the financial area, in the form of the Miyazawa Plan, have not gone beyond the discussion stage.

Many observers would argue there is little chance of East Asia running into another currency crisis similar to the 1997-98 crisis. I would not be quite so sanguine. For one thing, the pattern of financial flows in the Asia-Pacific region is not healthy. Currently, East Asia as a whole is a net-saving surplus region, whereas North America is a net-saving deficit region. In other words, in net terms financial resources flow from East Asia to North America, primarily to finance the budgetary deficits of the United States. This is an anomaly to say the least. East Asia as a whole is still a developing region with a higher marginal productivity of capital, but its savings are not used there to accelerate development in the region; instead they are used in North America to help finance, of all things, U.S. budgetary deficits [indiscipline]!

This is not the full story. Due primarily to the reliance of global trade on the U.S. dollar as the medium of settlement, and to the inability of the financial system in East Asia to intermediate effectively between savers and investors, the economies in the region are compelled to import safe but low-yield dollar-denominated assets such as U.S. treasury bills and inter-bank deposits, on the one hand, and to export risky but high-yielding assets such as equities and bonds, on the other. One of the problems with this pattern of asset holdings is that most of the

dollar assets are no longer as safe as they were once believed to be. This is especially true now that, with increasing U.S. budgetary as well as current-account deficits, the value of the dollar cannot help but decline. This is especially the case as the United States chooses to press Asian countries to appreciate their currencies *vis-à-vis* the dollar.

Where could this lead? I am afraid that, among other things, the prospect of the declining dollar will induce Asian holders of U.S. dollar-denominated assets to move out of those assets. This has the potential not only to wreak havoc in the international financial markets but also to cause financial difficulties for domestic manufacturing firms and financial institutions in East Asian countries, such as China in particular.

Indeed, if current U.S. efforts to appreciate East Asian currencies succeed, the economies in the region will be subjected to a high degree of deflationary pressure. With deflationary pressure, the economic recovery currently under way in East Asia may well be short-lived. As a matter of fact, there is a real possibility of East Asian economies suffering a prolonged period of stagnation, just as the Japanese economy did in the late 1980s after Japan had agreed to the Plaza Accord in 1985.

Let me also note in passing that, as far as dealing with trade and current-account deficits is concerned, U.S. policy-makers do not seem to have drawn any lessons from their experience in the 1980s. The basic cause for U.S. current-account deficits in the 1980s was the shortage of domestic savings relative to investment. Nonetheless, U.S. policy-makers chose to blame the absence of "a level playing field" in international trade for the growing U.S. deficits. Let us just hope and pray that the current efforts on the part of the United States to appreciate Asian currencies will not have the same kind of results for East Asia that similar efforts had for Japan in the earlier period.

What's to be Done?

What should be done about the many problems resulting from current approaches to trade and finance in the Asia-Pacific region?

First, and foremost, something must be done about the proliferation of regional, sub-regional and bilateral trade agreements. This is particularly important for small countries in the world economy. I am reminded of a comparison a leading international trade economist made between preferential trade arrangements and street gangs.⁷ The effects of street gangs are pernicious. But if they are operating in your neighborhood, the safest course of action may be to join one or more of them. Well, as far as I can tell, some small countries like Australia and New Zealand are not well positioned to take that course of action. Most of the preferential trade agreements that have been negotiated or are under

discussion in the Asia-Pacific region do not envisage Australia or New Zealand joining them. What's more, given their economic size and the composition of their exports dominated by agricultural products, not many find them attractive partners. So how should the multilateral trading system be made more effective?

First, and most obviously, the basic causes of the breakdown of the fifth WTO Ministerial Conference, held in Cancun in September 2003, have to be addressed. The breakdown emphasized, if emphasis was needed, that the most serious obstacle to progress in the Doha Round negotiations lies in the protectionist attitude of most industrialized countries, from the European Union and Japan to Korea, Switzerland and Norway, towards the long overdue liberalization of agricultural trade.

- Governments in industrialized countries have to be urged to shift away from the policy of agricultural subsidies to production to subsidies designed to support directly the incomes of [low-income] farmers.⁸
- In the short term, something has to be done about setting unrealistic deadlines, assuming away the difficulties in the way of achieving them, and that goes most of all for the deadline for concluding the Doha Round negotiations.
- In the long run, a new set of rules for making decisions in the WTO system need to be introduced, for countries with a minimal interest at stake in world trade cannot be allowed to dictate the course of future negotiations.
- What's more, governments must clarify and further develop WTO rules on regional trade arrangements, for the current rules in GATT Article XIV are for the most part ambiguous and unenforceable.

Second, governments in the Asia-Pacific region need to reaffirm the principles and goals of APEC process, which was initiated to pursue the reduction of barriers to trade and investment on a non-discriminatory basis. The Bogor Goal of achieving free trade for developed countries by 2010 and for developing countries by 2020 is as valid today as when it was first agreed. Similarly, the APEC aim to lower trade and investment barriers continuously is the best defense against the pernicious impact of the proliferation of regional and bilateral trade arrangements. The countries in the Asia-Pacific region should try to exercise the kind of leadership in the Doha Round negotiations they were able, as a result of the APEC initiative in 1989, to exert at a critical juncture in the Uruguay Round negotiations when the European Union is understood to have got the message that they were a serious factor.⁹

Third, since the East Asian crisis of 1997-98 the APEC countries have begun to pay attention to the need for greater cooperation in



The **mockingbird** is the state bird of Tennessee. Cordell Hull represented a district of Tennessee in the Congress of the United States, and was elected a senator from there, before becoming U.S. Secretary of State (1933-44).

"The mockingbird is known for fighting for the protection of his home – falling, if need be, in its defense. Mockingbirds are not intimidated by animals larger than themselves and have been known to attack eagles"

– Diana Wells, 100 Birds and How They Got Their Names (Chapel Hill, NC: Algonquin, 2002)

Trade Policy Analyses

Papers in the online series, *Trade Policy Analyses*, are published by the Cordell Hull Institute, which is a non-profit organization incorporated in the District of Columbia and is tax exempt under Section 501(c)(3) of the Internal Revenue Code.

The Institute's purpose is to promote independent analysis and public discussion of issues in international economic relations.

The interpretations and conclusions in its publications are those of their respective authors and do not purport to represent those of the Institute which, having general terms of reference, does not represent a consensus of opinion on any particular issue.

Copyright © 2003 by the Cordell Hull Institute and Kihwan Kim

Permission is granted to quote from the paper, but it would be appreciated if the source could be acknowledged in the usual way.

the financial area, but progress remains limited. APEC finance ministers have yet to come up with a meaningful program of cooperation. This deplorable state of affairs has to do with the lack of actionable ideas as much as anything else. What this suggests is that the Pacific Economic Cooperation Council, with tripartite structure (government, business and academia), should accelerate its work on monetary and financial cooperation. Priority should be given to issues like how to develop regional bond markets and to improve the risk-management capacities of financial institutions in the region.

Critical Role of the United States

In conclusion, two more points need to be stressed, one on the role of non-governmental organizations (NGOs), the other on the role of the United States.

On the first point, for APEC to become more effective in addressing regional trade and financial problems, NGOs like the PECC have to focus on how to become more effective. There are altogether too many NGOs trying to achieve the same purpose, promoting greater economic cooperation, on the basis of market principles, among a diverse group of Asia-Pacific economies. They would do well to coordinate their activities – or, better still, merge them if not their organizations.

On the second point, it is useful to remember that the fundamental cause of regional trade and financial problems, and the proliferation of preferential trade agreements, is the loss of momentum in liberalizing trade and investment at a multilateral level through the WTO system. This has much to do with the failure on the part of the United States to provide strong leadership in further strengthening the WTO system. Washington was not in a position to provide leadership of any kind because the Administration failed to secure from Congress the renewal of "fast track" trade-negotiating authority. It was U.S. leadership, more than anything else, which brought about the development of the multilateral trading system to what it is today.¹⁰

Since the end of the Cold War, however, the incentive on the part of the United States to provide leadership has greatly diminished. Relatively speaking, the ability of the United States to call the shots in world affairs, including trade, has weakened. If this judgment is correct, what is needed today is for several countries to help and support the United States in continuing to provide strong leadership. One way to do so is to work with the United States on issues such as the need to fight more effectively against terrorism.

¹⁰With Korea, for instance, nearly 70 percent of its exports go to the region and about 68 percent of direct foreign investment in the country comes from the region. In recent years the

importance of New Zealand's engagement with the Asian part of the region has grown. Asia accounts for 36 percent of its exports and 32 percent of imports. Asia also accounts for a quarter of all tourist arrivals and 80 percent of the country's income from international education.

² In this paper I have drawn heavily on my address on "Economic Engagements in the Asia-Pacific Region" to the annual meeting of the New Zealand Committee of the Pacific Economic Cooperation Council, Wellington, 2 October 2003.

³ Cite the formal title of the report and if possible a good account of its contents.

⁴ Ditto

⁵ Ditto

⁶ More than a decade ago, the pros and cons of a hub-and-spokes arrangement in the Asia-Pacific region were spelt out in a careful analysis by the Australian economist, Richard H. Snape, in a report for the Department of Foreign Affairs and Trade in Canberra. See Snape, with Jan Adams and David Morgan, *Regional Trade Arrangements: Implications and Options for Australia* (Canberra: Australian Government Publishing Service, 1993).

⁷ Cite the paper by Robert Scully mentioned in the original text.

⁸ Leave aside for the time being the question of why farmers should be the only beneficiaries in society of public assistance through subsidies and protection.

⁹ On the part played by APEC in the launch of the Uruguay Round negotiations, see Hugh Corbet, "How and Why the APEC Process is Working", *Journal of Northeast Asian Studies*, New Brunswick, NJ, Winter 1995, pp. 4-18.

¹⁰ But the story of the GATT system has not been a record of steady progress. As a result of American policies, agriculture was treated almost from the outset as "a special case", special arrangements were made for trade in textiles and clothing, quantitative import restrictions were maintained on imports of labor-intensive manufactures and the European Union was allowed to get away with negotiating new preferential trade agreements, in spite of the prohibition in GATT Article I, in the name of European unity.