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## **Conclusions: Choices, Risks, and Consequences**

The preceding chapters have identified a number of alternative pathways along which Asia-Pacific regional trade arrangements could develop, depending on choices made by the economies of the region, especially the region's major economic powers. Issues raised by the various alternatives have been explored, and an analysis has been provided of the welfare implications indicated by CGE analysis of a large number of possible trade arrangements in the region. The main conclusions to be drawn from the analysis will now be briefly summarized.

### **New Bilateral and Plurilateral SRTA Proposals**

The most conspicuous new trend at present is the proliferation of proposals for bilateral and plurilateral SRTAs. These include both transpacific and intra-Western Pacific initiatives, suggesting concerns both to maintain a transpacific dimension to the evolution of liberalized Asia-Pacific regional trade arrangements and at the same time to explore new approaches to the liberalization of trade within the Western Pacific. However, the trade flows covered by the new SRTA initiatives are for the most part small, and their effects on economic welfare not surprisingly tend to be negligible.

Various rationales have been proposed for the new initiatives, including to maintain momentum for trade liberalization in the region, and in some cases to serve as "best practice" models that it is hoped will influence the design of any future SRTAs in the region. Some initiatives are likely

to be motivated at least as strongly by the aim of encouraging investment and services trade between the partners as by the traditional aim of stimulating goods trade. Our simulations cannot address the full implications for services trade, nor do they capture foreign direct investment effects or the possible dynamic effects of the preferential liberalization of trade in goods. Their results may therefore understate the potential effects of the new initiatives.

Nevertheless, on any reasonable assessment, the effects of many proposed new SRTAs seem likely to be small. Moreover, against any potential positive effects must be set a number of potential negatives. There is a risk that proliferating SRTAs may lower the efficiency of regional trade through the creation of spaghetti bowl effects. To advance the new initiatives, governments in the region are using scarce negotiating resources and political capital that might otherwise be applied to avenues with greater potential to provide them with economic benefits by promoting more open regional and global trade. Furthermore, in the cases of SRTAs where the simulations do indicate potentially significant economic gains by some members, these are often accompanied by widespread negative effects on nonmembers, suggesting that these SRTAs may over time prove a source of increased trade conflict or tension in the region.

The SRTAs with more significant economic welfare effects are generally those involving Japan or the United States, giving support to the view that the strategies followed by these two major economic powers are likely to have a decisive influence in shaping the future course of regional trade arrangements. In addition to being leading economic powers in the region, Japan and the United States are major trading partners of almost every economy in the region, and between them also account for a dominant share of transpacific trade flows. China, the region's third economic giant, may also potentially have a major influence on regional trade arrangements. Its size, rate of economic growth, and the fact that it is one of the economies of the region with the furthest distance to travel in its trade liberalization efforts, are factors combining to suggest the potential for a much greater impact on regional trade.

The strategy of these economic giants toward developing trade arrangements in the region has yet to clearly emerge. China is as yet barely involved at all in the new-trend SRTAs, and the involvement of Japan and the United States is still at a very preliminary stage. However, given the clear indication that SRTAs with Japan or the United States are likely to provide the greatest potential for economic benefits to other economies of the region, active pursuit of bilateral SRTAs by Japan and the United States could well lead to competition among other economies of the region to secure one or the other of these two major economic powers as preferential trading partners. This could become a divisive factor in the region's trading relationships, particularly if the proliferating SRTAs in the region

become an arena for the pursuit of economic rivalry between Japan and the United States, or if the two countries use their attractiveness as preferential partners to promote arrangements that incorporate stringent, enforceable labor and environmental standards in the one case and exclude agriculture in the other. These developments would add a further dimension to the negative implications of the hub and spokes pattern of preferential arrangements likely to result from the pursuit of SRTAs by the region's major economic powers.

On balance, it is difficult to avoid a negative assessment of the current trend toward proliferating bilateral and plurilateral SRTAs.

## **Advantages of Larger Groupings**

In contrast, the analysis of welfare effects has demonstrated the much more powerful economic logic favoring two alternative approaches based on larger regional groupings. The first alternative is the continued pursuit of arrangements based on the existing APEC grouping. The second alternative is the emergence of a single East Asian or Western Pacific trading bloc. These groupings also offer the added potential advantage of avoiding the negative implications, both of the spaghetti bowl and of hub and spokes patterns of SRTA development in the region.

## **The Enduring Economic Logic of APEC**

The simulation results reported in this book underline the soundness of the economic logic behind the earlier selection of APEC as the vehicle for Asia-Pacific trade integration. APEC liberalization offers superior welfare gains for the region as a whole and for most of its individual economies in comparison with any other possible regional arrangements among APEC members. It preserves the transpacific dimension, which remains an important element of the trade relations of most economies of the region. APEC also offers the advantage of having already settled some thorny political issues that might have to be revisited in the context of the construction of an East Asian or Western Pacific bloc, most notably the simultaneous inclusion of China, Taiwan, and Hong Kong. The position of Australia and New Zealand is another example of an issue that may be problematic in the latter context but does not arise in the APEC context.

APEC, however, faces a serious challenge in maintaining—or perhaps restoring—the confidence of its members in its effectiveness as a vehicle of regional trade liberalization, and it remains to be seen whether it will be able to meet this challenge in its present form. Its chosen modality of concerted unilateralism is still attractive, both conceptually and for the economic benefits potentially attainable from its implementation—as

underlined by the simulation results reported above. Widespread doubts clearly exist, however, as to whether a process based on voluntary, non-binding commitments is capable of successfully realizing APEC's objectives. These doubts are compounded by perceptions of a lack of engagement with the APEC liberalization process by Japan and the United States. The recent proliferation of SRTAs appears to be widely interpreted as an implicit judgment by the region's economies that progress toward APEC's objectives under the existing process is likely to be unsatisfactory.

If confidence in APEC's effectiveness in its present form cannot be sustained, the simulation results analyzed in this book strongly suggest that there may be merit in considering adoption of an alternative modality by APEC rather than diverting efforts into other, less rewarding regional trade strategies. The results show that conversion of APEC into a preferential trade arrangement may offer economic benefits to the region as a whole comparable to the benefits from an APEC liberalization based on open regionalism. Adoption of a preferential approach would represent a dramatic change in APEC's underlying philosophy, and may well encounter objections from some APEC members precisely because of the considerations that led APEC to adopt its voluntary, nonbinding approach in the first place. Even if these objections could be overcome, negotiation of an APEC preferential trade arrangement would be a formidable task.

The various sensitivities of APEC members, particularly of the United States over environment and labor, and of Japan and some other East Asian economies over agriculture, would create as much difficulty in this context as in any other. Against this, an APEC preferential arrangement does appear to offer an alternative way to capture within APEC the benefits of APEC-wide liberalization—benefits that appear to be significantly greater than those attainable from preferential liberalization within smaller groupings. It would preserve the benefits of retaining the trans-Pacific dimension in regional liberalization, and the gains APEC has made in overcoming political obstacles to Asia-Pacific economic integration.

Support of the region's major economic powers is clearly vital to the success of any APEC approach to liberalization, and the advantages of an APEC preferential approach would be further enhanced if it proved successful in encouraging a greater engagement with APEC liberalization on the part of Japan and the United States. This—together with the provision of a framework requiring binding, enforceable commitments—would do much to address doubts that have been expressed about the effectiveness of APEC in its concerted unilateral mode. An APEC preferential trade bloc would—not surprisingly—have widespread negative effects outside the APEC region, but this may have a positive aspect if it prompts other WTO members, particularly the European Union, to place a higher priority on a successful outcome to multilateral negotiations.

The challenge involved in revitalizing APEC as a vehicle for regional liberalization should not, however, be underestimated. In the end, the

difficulties could prove too great, particularly if the changing priorities of the region's major economic players result in a diminished will to overcome them. There may be a corresponding tendency for APEC members to instead focus more and more attention on regional liberalization initiatives among large groupings (confined, in each case, to their own side of the Pacific). The FTAA clearly provides this focus of attention in the western hemisphere, and a number of possibilities on the western side of the Pacific have been explored above.

## **The Alternative Logic of an East Asian (or Western Pacific) Trade Bloc**

The results of the simulations discussed above show that the welfare gains from an East Asia-wide or Western Pacific-wide RTA are sufficiently favorable for these to be potentially attractive options for the East Asian economies. The results also show that if an East Asian bloc or Western Pacific trade bloc is to emerge, it will need to be as inclusive as possible to realize the full potential welfare gains from such an arrangement for the region as a whole, and to avoid damaging consequences for those economies excluded from the arrangement, with all the associated potential for increased trade conflict in the region.

The simulations show that preferential arrangements among subgroups of Western Pacific economies often deliver substantial economic welfare gains to their members, but at the cost of imposing substantial welfare losses on the Western Pacific economies excluded from the arrangements. The configuration yielding the greatest overall welfare gains for the East Asian region is a Western Pacific bloc joining together Northeast Asia, Southeast Asia, and Australasia. Most, though not all, economies in the region experience higher welfare gains under this configuration than under more limited configurations. However, the welfare gains from a Western Pacific bloc are lower than the gains attainable from APEC liberalization for most economies of the region, including China and Japan (and also South Korea, in the case of APEC preferential liberalization).

It follows also that if the trend to preferential liberalization initially takes the form of SRTAs among subgroupings of economies in the region, as seems likely, a strong economic logic will operate in favor of the progressive, expeditious expansion or amalgamation of these more limited arrangements. The results show that expansions of existing arrangements generally benefit both the formerly excluded members and the members of the existing arrangement, and that amalgamations generally benefit the members of both the agreements being merged. If economic logic prevails, a domino effect could thus operate through a series of expansions and amalgamations until ultimately a single regional trade bloc is created.

Northeast Asia is clearly the key to forming any East Asian trade bloc. The potential filling of the “empty box” in Northeast Asia in the map of Western Pacific SRTAs is thus of enormous significance, both as a signal of the changed attitude of the Northeast Asian economies toward participation in preferential trade arrangements and also potentially as the key building block in the possible stepwise development of an East Asian trade bloc.

The establishment of a new SRTA joining together the smaller AFTA and CER economies could also be a significant step in this development, but the involvement of Northeast Asia will be decisive. The apparent willingness of Japan and South Korea to consider a bilateral FTA may be a crucial initial step. A second vital step would be to establish a basis for the participation of China in any future regional trade arrangements. One possibility would be to expand the proposal for a Japan-Korea FTA to include China. The simulation results for this book show that this would be in the economic interests of all three countries. The political obstacles to such an arrangement are, however, formidable. An alternative possibility would be the formation of an FTA based on the ASEAN-plus-three grouping, although this would not necessarily diminish the political difficulties.

## **Economic Versus Political Logic: The Risks**

A major risk associated with the development of preferential trade arrangements in East Asia or the Western Pacific is that economic logic and political realities may point in opposite directions. Economic logic favors preferential arrangements among larger, more inclusive groupings. But these may also be the configurations that face the greatest political obstacles. If political considerations dictate that preferential arrangements in East Asia be restricted to more limited subgroups of the region’s economies, East Asia may in effect develop its own spaghetti bowl. The results reported in this book suggest a particularly strong potential for trade conflict in this case, because of the sharply negative effects that each possible arrangement is likely to have on the welfare of many of its neighbors. The potential for conflict may be particularly acute if each of the Northeast Asian economies sets out to develop its own network of SRTAs.

## **Global Liberalization Remains First Best**

An important question in considering the implications of possible regional trade developments in the Asia-Pacific region is their impact on the global trade architecture and the prospects for global trade liberalization. The results of this study strongly reaffirm that global liberalization remains

the first-best option—regardless of whether an APEC-based liberalization or the formation of an East Asian or Western Pacific trade bloc is postulated as an intermediate step. As indicated above, the aggregate gains from global liberalization—both for the world as a whole and for the combined APEC membership—are about 50 percent higher than under the next most favorable option simulated.

APEC members make particularly strong welfare gains under global liberalization, and thus should be strong supporters of further progress in multilateral negotiations. One possible change indicated is that the attractiveness of achievement of APEC's Bogor goals as an intermediate step on the way to global liberalization may diminish somewhat if a Western Pacific bloc is established. This is because a number of mainly smaller APEC economies enjoy greater welfare gains from the Western Pacific bloc than from APEC liberalization.

At the individual economy level, the gains from global liberalization are in most cases significant or highly significant, and for almost all APEC members the gains from global liberalization exceed those from any of the other options considered. A major difficulty, however, is that the United States is the one exception to the rule that gains from global liberalization are invariably positive. Terms of trade effects are clearly an important factor here. Given the degree of uncertainty that inherently attaches to the numerical results from CGE simulations, the appropriate interpretation of this result for the United States is that the impact of global liberalization on its economic welfare is zero—still a problematic result, which warrants further investigation and testing against results from simulations based on alternative model specifications. It is possible that our simulations significantly understate the positive welfare effects on the United States of global liberalization, due in particular to the inability to satisfactorily model services trade liberalization.

## **Some Potential Implications of a Tripolar World Trading System**

The parallel emergence of an East Asian or Western Pacific trade bloc and the FTAA on opposite sides of the Pacific would not only polarize the Asia-Pacific region in a way that APEC was explicitly designed to avoid, but would also herald the emergence of a tripolar international trading system, in which the three poles would be the European Union, the FTAA, and the East Asian bloc. Although this has been viewed by some analysts as the worst possible outcome for the world as a whole, the results here give some grounds for optimism that the effects may be rather more benign. Emergence of a tripolar world does not lead to a significant increase in the welfare gains attainable from preferential relative to nondiscriminatory liberalization. It might be inferred from this

that there may not be substantial incentives for the three trade blocs to aggressively raise barriers against each other or for two blocs to form a coalition against a third. But our simulations did not explicitly explore this possibility, and it cannot be definitively ruled out.

An important related question clearly is the extent to which the WTO will have the capacity to restrain—and if necessary discipline—any such behavior by the blocs. The extent to which the welfare benefits from global liberalization dominate those from other scenarios suggests that the three blocs will have a strong incentive to cooperate to ensure the continuing effectiveness of the WTO. The simulation results also suggest that the emergence of trade blocs in East Asia and the western hemisphere may place additional pressure on the European Union to seek a successful outcome from multilateral negotiations. There would also be potential for the outcome of multilateral negotiations to be structured to produce positive welfare benefits for the United States, thereby modifying the less favorable welfare outcome for that country predicted by our simulations.

It is also possible that a tripolar trading system may have favorable implications for the problematic relationship between regionalism and the multilateral trading system. A situation in which three large trade blocs—each with an interest in maintaining the effectiveness of the WTO—dominate both regional and multilateral trade may be less subversive of the multilateral trading system than the present worldwide proliferation of SRTAs, over which the WTO appears relatively powerless to exert effective discipline in a number of important respects.

Emergence of the FTAA does not make the establishment of an East Asian or Western Pacific trade bloc inevitable. In principle, APEC—either in its present form or reinvented as a preferential trade arrangement—still would be a potentially viable option. This would be true even though the overlap in membership between APEC and the FTAA would result in some challenging issues to address, particularly if it was decided that APEC should be reconstituted as a preferential arrangement.

## Issues for the United States

It is clear from the simulations that the United States has a significant interest in whether APEC remains a viable option relative to the development of an East Asian or Western Pacific trade bloc. A Western Pacific trade bloc has the largest negative impact on US economic welfare of all the scenarios simulated, whereas these negative effects do not arise under the APEC liberalization scenarios. The favorable welfare effects indicated for the United States from the FTAA—the most favorable outcome for the United States of all the simulations—are almost wholly negated if a Western Pacific trade bloc develops at the same time, but APEC liberalization leaves US gains from the FTAA largely intact.

The United States may therefore feel an incentive to promote—and to provide convincing demonstration of its commitment to—a more effective APEC liberalization process as an alternative to the establishment of a trade bloc on the other side of the Pacific. In doing so, it would of course also be promoting a more favorable outcome for the Asia-Pacific region as a whole, because APEC has more favorable regionwide welfare effects than an East Asian or Western Pacific bloc, whether or not the FTAA proceeds.

## **The Need for Leadership and the Role of APEC**

Successful pursuit of strategies based on APEC or an East Asian or Western Pacific trade bloc will require the exercise of political leadership of the highest order. In the absence of this, the risks are high that choices will be made leading to increased trade conflict and lower economic welfare in the region. An alternative possibility is that the proliferation of SRTAs, with its attendant risks and relatively low potential economic payoff, may emerge as the outcome, as the line of least political resistance. From the results presented here, it is clear that this would also be a suboptimal outcome for the region.

APEC is likely to remain an important regional institution, regardless of whether it remains a principal vehicle for trade liberalization. This is because the rationale for APEC's existence derives fundamentally from the highly integrated nature of Asia-Pacific trade and investment relationships, and because the rationale for its transpacific character derives from the importance of transpacific trade flows within those relationships.

The importance of these flows and the interdependence of the Asia-Pacific economies will remain, whatever the future development of arrangements governing regional trade. Continued proliferation of SRTAs or a split of the region between trade blocs is likely to place a premium on consultation among participants in the different groupings, to ensure that the benefits of transpacific interdependence and the progressive establishment of a more open trading environment in the Asia-Pacific region are not unnecessarily compromised. APEC is ideally suited to be the forum in which these consultations take place. APEC thus has a useful and potentially vital role to play in any future development of Asia-Pacific trade arrangements. The exact nature of that role, however, is likely to depend on which of the possible pathways for future development are eventually chosen by the economies of the region.