Part I

Context
1 Europe and East Asia: a shared global agenda?

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The emergence of East Asia and the Asia Pacific economy, alongside the integration of Europe, have been among the most important developments in the world economy in the second half of the twentieth century. These developments have taken place in an increasingly integrated international economy with the institutional support of the General Agreement on Tariffs and Trade (GATT), now the World Trade Organization (WTO). They have also been associated with the growth of regionalism in international economic affairs, although the regionalism which is emerging in East Asia and the Pacific appears very different from the regionalism that earlier took root in Europe.

This volume sets out to explore how Europe and other parts of the world might respond to developments in the Asia Pacific economy and how, in particular, Europe might relate to East Asia and the process of Asia Pacific Economic Cooperation (APEC).

The essays collected here are the product of a European, East Asian, and Australasian collaborative research program that spanned the three continents. The objective here is to define the elements in a shared global agenda for Europe and East Asia. In this and the two following chapters — by Anderson and Francois, and Pomfret — we set the context, with a detailed examination of intra- and extra-regional trade and foreign investment flows in each region, as well as an analysis of the role of the European Union (EU) and East Asia in a tri-polar world in which the United States is the single most important national economy.

Regional origins and identities

Any discussion of trade relations between Europe and Asia, directed towards the issue of a shared global agenda, must begin with an understanding of the political and economic starting points of these two different regions of the
world. We begin with some of the contrasts between the notion of open regionalism, which is developing within the APEC framework, and regionalism as it has emerged in Europe. The reasons for the differences between developments in Europe and Asia are explored in the context of existing international institutions and their relevance to the global policy agenda.

Regionalism in East Asia and the Asia Pacific

East Asia has been the most rapidly growing region in the world: it has had two decades of double-digit economic growth rates. Growth may drop sharply over the next few years in consequence of the currency and financial crises that originated in East Asia in 1997, but the medium- to long-term growth potential of developing East Asia remains strong. Growth has been based fundamentally on industrialisation for the world market: the proportion of trade which goes to and comes from trading partners outside the region is much higher than that for either Europe or North America. Most of the countries of East Asia are linked economically and politically with other nations rimming the Pacific. The APEC region is incredibly diverse, both culturally and geographically: it includes not only the ASEAN6 (Brunei, Indonesia, Malaysia, the Philippines, Singapore, and Thailand); Japan and Korea in Northeast Asia; China, Hong Kong and Taiwan; and Australasia; but also Canada, the United States, Mexico and Chile. Vietnam, Russia and Peru are also scheduled to join APEC over the next two years.

In this vast and diverse region, there is a regional project committed to the promotion of strength and peace for the Asia Pacific region as a whole. In the 1980s and the 1990s, the Asia Pacific became a region of strong states pursuing economic prosperity by means of market-friendly policies. The pursuit of economic prosperity is the means by which stability and peace are to be achieved, and this prosperity is to be realised through rapid economic growth. In turn, it is intended that economic growth will be promoted by means of sound macroeconomic policies, economic reform and trade liberalisation.

This volume focuses, more or less exclusively, upon trade policies and the chapters in it were written before the financial crises of the second half of 1997. Nevertheless, a word about the macroeconomic background to East Asia’s trade relationships is necessary.

Macroeconomic policies, East Asian style, have essentially consisted of a high rate of national saving, a high investment rate and a competitive exchange rate. These form a coherent package which supports outward-oriented industrialisation. High savings support the investment that trade liberalisation and openness encourages. A high rate of savings also ensures that competitive exchange rates are not periodically jeopardised by periods
of monetary restraint, high interest rates, and forces which encourage currency appreciation.\(^3\) Until 1996, competitive exchange rates helped to underpin the profitability of investment for the world market and helped to preserve economic and political support for the policies of liberalisation.

In 1997, all this changed dramatically when a number of influences conspired to generate the East Asian financial crises. First, some analysts argue that the devaluation of the Chinese yuan in 1994 led to significant price under-cutting in many export markets. Second, and more importantly, the strength of the dollar against the yen and other major currencies led to a substantial nominal effective appreciation of currencies pegged to baskets with a high US dollar weighting. Third, domestic demand was allowed to rise too strongly in some Southeast Asian economies, driven by speculative capital in-flows, as well as unregulated and imprudent banking practices; this generated levels of inflation higher than international averages, which further appreciated real exchange rates. Finally, there was a slump in the world market for electronic products which sharply cut both the terms of trade and export sales of Thailand and other East Asian economies. As a result, export growth fell markedly.

This drop in export revenue fed anxiety about exchange rates which precipitated capital withdrawal and this change in sentiment fed upon itself, ultimately forcing retreat from pegged exchange rates to floating rates, accompanied by large depreciations. The necessary retreat from fixed exchange rates exposed a deeper problem in financial markets where large foreign borrowings were uncovered against the risk of devaluation.

The impressive Southeast Asian programs of macroeconomic reform, trade liberalisation and trade expansion in the 1980s and 1990s are challenged by the sharp adjustments and slower growth which will result from the financial crises of 1997. Protectionism is a common response for economies in times of slow growth. Significantly, this has not been the main initial response by ASEAN members, or in East Asia more generally, to the financial crisis. Early indications are that the APEC liberalisation agenda remains on track.\(^3\) If protectionism is not the initial response, it is unlikely to be the response at any stage. The currency depreciations will again spur strong export expansion out of East Asia and, in combination with domestic expenditure restraint and lower investment levels, declines in the region’s current account deficits. It appears at the time of writing that if the financial problems associated with debt overhang are decisively dealt with, then the macroeconomic conditions for the rapid expansion of exports which have characterised the East Asian growth experience may soon be re-established.\(^4\) Indeed, it may not be long before the problems of a ‘strong dollar’ and ‘strong euro’ — the decline of the United States and European competitiveness relative to East Asia — are the issue, rather than those of a weak baht, ringgit, rupiah peso or won.
Europe, East Asia and APEC

We now return to our main theme of trade liberalisation in East Asia. It has been pursued through a strategy of regional integration called ‘open regionalism’, an approach which has been officially promoted since 1989, when the APEC process was initiated at a meeting of foreign and trade Ministers in Canberra. Its intellectual origins stretch back much further, but the idea was entrenched through the Pacific Economic Cooperation Council (PECC) after 1980 (see Chapter 5). The meeting of APEC Heads of Government at Bogor, Indonesia, in November 1994 gave regional approval to a program of trade liberalisation which is designed to lead to free trade in the Asia Pacific region by the year 2010 for developed countries and 2020 for developing countries (see APEG 1994).

‘Open regionalism’ is a term whose very meaning is contentious. In this introduction, we adopt a precise and specific use of this term which denotes ‘concerted unilateral MFN (most favoured nation) liberalisation of trade’ by a number of states (see Chapter 5; Drysdale and Garnaut 1994; Garnaut 1997a). Despite adopting this usage, we note ambiguities in meaning as we proceed. ‘Open regionalism’, in the sense of concerted unilateral MFN liberalisation, implies the creation of something very different from a preferential trading area like the customs union of the European Union, or the North American Free Trade Area (NAFTA). Such open regionalism is of particular interest because it is a new form of regionalism. The development of a kind of ‘free trade club’ along open regionalist lines will have significant implications, not only for the countries participating, but also for the global trading system. This approach has been adopted by the East Asian and Asia Pacific communities for a variety of reasons which are detailed below.

We explore the significance of each of the components of open regionalism: that it is carried out on an MFN basis, that it is concerted and that it is unilateral.

Liberalisation on an MFN basis means that increased access to domestic markets is afforded to all trading partners, regardless of their location or their individual trade policies. APEC’s members are pursuing MFN-style liberalisation for three major reasons. First, MFN liberalisation does not cause trade diversion; after liberalisation, the member countries continue to trade both with the rest of the world and within the region on a level playing field. At least part of the impetus for the creation of APEC was a realisation in East Asia that it would be significantly hurt by trade diversion losses if it opted to develop a customs union. This is particularly true because, as already noted, a large proportion of East Asian trade occurs with countries outside the region (see Garnaut 1997a). Second, liberalisation of a preferential kind in the Asia Pacific region would put enormous pressure on the system of trade reform managed by the WTO. This is because Article XXIV of the WTO Charter allows the creation of preferential trading blocs only if they are
all-or-nothing affairs. According to the Charter, participants must completely liberalise, across ‘substantially all trade’, according to an agreed timetable, and they must do this by negotiating a formal trading bloc, for which they obtain explicit sanction from the WTO. Since it would be extremely difficult to agree on the terms of such a bloc in a region as diverse as the Asia Pacific, the most likely outcome would be a ‘dirty bloc’, in which there would be backsliding into partial preferential liberalisation, with a picking and choosing of the sectors to be liberalised, at different times, by different players, in bilateral deals. Such behaviour would fundamentally compromise the region’s respect for WTO principles, which participants are determined to uphold. Third, because this liberalisation is not preferential, other countries which are not members of the formal process, are free to join implicitly in the process by liberalising in the same way. This is particularly important in a region where a succession of economies is committing to programs of internationally-oriented industrialisation, as well as the trade and economic reforms that success in this ambition requires. By contrast, if liberalisation were to be preferential, then membership of the trading bloc is an all-or-nothing affair. Could one imagine China or Russia as members of a formal bloc which includes the United States? Furthermore, a preferential bloc would be the subject of continuing accession pressure from countries outside the arrangement hoping to obtain access to the markets within it. This would exacerbate all of the difficulties described above (see Baldwin 1993).

Ruggiero (1996) notes that:

The choice between the alternatives is a critical one; they point to very different outcomes. In the...case [of preferential discriminatory arrangements], the point at which we would arrive in no more than 20 or 25 years would be a division of the trading world into two or three intercontinental preferential areas, each with its own rules and with free trade inside the area, but with external barriers still existing within the blocs. The [open regionalism] alternative, on the other hand, points towards the gradual convergence on the basis of shared rules and principles of all the major groups...[to an outcome in which] both regional and multilateral approaches will have contributed to full liberalisation in a free global market.

The proposed approach to trade liberalisation is concerted because participants do believe that collective action in trade liberalisation may assist in overcoming domestic obstacles to reform. Foreign liberalisation may support domestic policy reformers; in particular, more liberalisation may be chosen if it is known that other countries are liberalising simultaneously. With such ‘concertedness’ each national government knows that, as it opens its own markets, there will be increased market access available in partner countries. We are all familiar with such concertedness in conventional customs unions
and free trade areas. In the creation of a conventional customs union, howev-
er, such concertedness must express itself as an all-or-nothing affair, for the
reasons already explained. By contrast, trade liberalisation based on open
regionalism is always intended to be MFN-consistent. Open regionalism
allows participants to pick and choose the sectors to liberalise, and to do this
at different times, in partnership with different players. Provided that all such
actions really are carried out on an MFN basis, absolutely no pressure on
WTO principles is implied by the gradual exploitation of this reciprocity. Of
course, to the extent that sectoral progress focuses on those goods and serv-
ices for which the origin and destination of trade is concentrated within the
region, trade liberalisation will be concentrated in sectors of importance to
players within the region and omit other areas of greater importance for those
exporting into the region from beyond its boundaries. This is thus to concede
that regionalism which is ‘open’ may nevertheless distort the liberalisation
agenda towards those sectors of most importance to the liberalising region.

That the liberalisation should be unilaterally means that it provides freedom
of action for participants to proceed in their own way, at their own pace,
without reference to formal international treaties. This may appear to reduce
the pressure on policy makers to liberalise, but the reverse may be true since
policy reform does not have to be held back by detailed multilateral negotia-
tions. Under the APEC process, there is freedom for individual countries to
liberalise ahead of international deadlines. Participants want this for three
reasons. First, this form of liberalisation has been claimed to command greater
political support in many East Asian countries than one which is driven by
trade specialists negotiating international treaties. Second, it is favoured by
East Asian participants on behavioural and cultural grounds. It has been
described as the ‘Asian Way of diffuse reciprocity through understandings
rather than through formally binding treaties’ (see Yamazawa 1992). For
this reason the APEC process may be more grassroots-driven and responsive than
are WTO rounds. Such global rounds can be thought — and are thought by
some Asia Pacific players — to involve a loss of sovereignty. There may be a
negative perception of the WTO in some East Asian countries because of a
sense that it has placed an excessive emphasis on harmonisation. In contrast,
the cooperative efforts associated with participation in a project of open
regionalism can give East Asian countries the confidence to prepare for WTO
negotiations, disciplines and bindings. Third, and perhaps most fundamen-
tally, open regionalism allows participants a great deal of scope for domestic
reform. This brings us back to one of the central questions in the political
economy of trade reform. Trade liberalisation is not in the nature of a prison-
ner’s dilemma, beneficial only if other parties undertake it. Unilateral trade
liberalisation, when it is well managed macroeconomically, and with attention
given to adjustment costs, is beneficial to the country undertaking it,
irrespective of whether it is being undertaken elsewhere. It is thus vital that
countries not enter into forms of international negotiation which induce par-
ticipants to hold back on liberalisations which they would be independently
willing to undertake, so as to use these as ‘concessions’ in treaty negotia-
tions. Such negotiations could actually lead to pressures which maximise the
‘cost’ of reform, thereby reinforcing domestic protectionist pressures and slow-
ing the process of liberalisation rather than accelerating it. Open regionalism
passes this core test in a way that no other form of international regional
trade association does. Because it does not require the negotiation of legally
binding treaties, participants are free to pursue the twin-track strategy of
international reciprocal negotiations about market opening on the one hand
and unilateral internal domestic reform on the other.

Indeed, in a strategy of open regionalism, international concertedness and
domestic unilateralism can complement each other. Because liberalisation is
not tightly locked together with international negotiations, participants are
free to pursue both strategies (international and domestic) hand-in-hand. Join-
ing in the process of a regional liberalisation ‘club’ may be a means by which
policy makers, who are in favour of free trade but subject to a protectionist
polity, can actually gain access to a form of ‘commitment mechanism’ which
enables them to counteract the influence of domestic protectionism. Thus,
peer pressures actually are exerted within APEC to ensure countries keep
liberalising domestically. Action Plans are publicly presented at heads of
government summits for approval. This brings international pressure to bear
on individual governments to produce Action Plans that are meaningful. The
intense publicity which these plans are afforded then acts as a particular form
of commitment mechanism: there is a lurking threat of shame awaiting any
leader who would subsequently depart from announced plans. This may lead
to more liberalisation than might otherwise be expected. The example of the
radical Philippines liberalisation, announced in preparation for the Manila
APEC Summit in November 1996, is a case in point: all tariffs are to be
reduced to 5 per cent by 2004. Until very recently, such a prospect would
have seemed highly unlikely. In Australia, where there has recently been
protectionist back-sliding, the existence of the APEC commitments has meant
that protectionist decisions have nevertheless left in place both the tariff cuts
promised to APEC by Australia in the run-up to 2000, and the target of free
trade in 2010.

APEC participants therefore claim that open regionalism creates the right
structure for incremental, cumulative, self-sustaining liberalisation. Chapter
5 lays out a number of core principles which underpin this process, in partic-
ular comparability, continuous process, and flexibility.

Whether the APEC process really represents such a coherent and durable
economic formation will, of course, become clearer over time. APEC style
Europe, East Asia and APEC

Unilateralism may be simply the best system that can be achieved given the diversity of the APEC region. The crunch on hard trade issues, including agriculture, trade facilitation, and standard-setting is yet to come. Many of these issues will need to be negotiated in the WTO, and there APEC may play a valuable catalytic role.

The recent spate of currency turmoil and macroeconomic instability may yet threaten the virtuous circle of policy reform, peace and prosperity that open regionalism promises. But so far there is no sign of retreat on the core trade reform agenda. Instead, there has simply been a broadening of the agenda to encompass regional financial cooperation and financial market reform.

Regionalism in Europe

The contrast between the Asia Pacific region and Europe could not be stronger. The European Union is a much more inward-looking group of relatively homogeneous countries bound together by strong constitutional structures. This view is presented in Chapter 4 by Portes and Vines. The next few pages draw in detail on that chapter.

The Single European Market, and the European customs union within which it was established, should be understood as the core of the European project, and its rationale should be seen as political. Europe has lived through two horrific world wars this century; the overriding end of the architects of the European Common Market/European Community/European Union was to put an end forever to these bloody conflicts. For France, which has been invaded three times by Germany in a 70-year period, and for Germany, whose political process led to the grotesque aggression of the Second World War, these experiences produced a search for forms of integration which reassured the former and tied the hands of the latter. Thus, Monnet, Schumann and the other founders of modern Europe created the European Coal and Steel Community in the 1950s, whose explicit purpose was to internationalise — and so immobilise — the means of waging war. This project then progressed to the creation of a customs union, the common market, and alongside this a heavily protected agricultural sector; it has now moved further still.

Thus, the way in which the European region has attempted to craft peace and stability as foundations for prosperity could not be more different from the approach of the Asia Pacific region. East Asia has pursued peace through prosperity and prosperity through trade liberalisation between independent sovereign states. Europe has pursued peace and stability through a process of supra-national political integration. This means that trade liberalisation initiatives for Europe will inevitably have to be achieved through a process of
supra-national negotiation and compromise, rather than being the outcome of the agendas and initiatives of individual states acting independently, as is the case in the Asia Pacific region.

From this realisation flows three key implications.

First, the supra-national institutions in Europe should be seen as an inevitable outgrowth of a natural evolutionary process in which the customs union led on to the structures of the Single European Market. By the early 1980s, unreformed domestic measures and regulations threatened to thwart the effects of the liberalisation of border barriers and this led to pressures for a more truly integrated market area. Thus was born the Single European Market. The creation of the Single European Market has led not only to the elimination of a large number of formal national trade barriers, the elimination of customs formalities at national borders, the replacement of these national trade controls by Community-level instruments and the passing of trade policy competence almost entirely to the European level (although not in services). It has also led to a Europe-wide process of harmonisation and standardisation: specifically, the construction of a Europe-wide apparatus of notification, mutual recognition directives, harmonisation and certification. The Single Market has also established freedom of trade in services as well as goods. Since such service provision is highly regulated throughout Europe, this has required the establishment of Europe-wide regulatory structures (in areas such as finance and transport services). In addition, the Single Market is in the process of removing internal barriers to public procurement, the completion of which requires regulatory discipline. There has been a Europe-wide competition policy since 1958, but in 1990 this policy was extended to cover mergers. Finally, the opening of the internal market in regulated industries (in particular, telecommunications and energy) is leading to the establishment of Europe-wide regulatory structures in these industries. The conclusion is that the creation of a genuine single market has required the establishment of supra-national structures both in standard-setting and regulation. These structures have been embedded in a supra-national system of law-making and the administration of justice. It can be argued that the creation of the Single European Market has led to a form of openness in Europe which is different from the MFN removal of external trade barriers characteristic of the open regionalism process. Mutual recognition has made European markets available to all producers, not just European companies. It has meant that foreign exporters into the Union, as well as foreign investors coming to produce in the Union, have only had to satisfy standards in one member country, rather than in all of them. Other aspects of the Single Market have benefited exporters to Europe and foreign investors in Europe in similar ways. Consequently, the European Union may be a great deal more ‘open’ than a casual assessment would suggest.